Information Note: Simpler Super - Notional Taxed Contributions

March 2008

Purpose

The purpose of this Information Note is to advise members of the outcome of Institute consultations with the Treasury and the Tax Office in regard to the determination of notional taxed contributions under the Simpler Super legislation regime applicable from 1 July 2007.

Background

The Income Tax Assessment Act 1997 and the associated Regulations require trustees of superannuation funds to obtain the advice of an actuary to determine:

- a new entrant rate or rates (to be used by the trustee to calculate the notional taxed contributions for members); and
- certain adjustments to the notional taxed contributions when certain events occur.

Actuaries may also be involved in providing advice to trustees in relation to the following:

- whether or not a member who was a member of the fund on 5 September 2006 continues to meet the requirements for the special grandfathering provisions which cap the member's notional taxed contributions; and
- determining whether an allocation from reserves should be classified as a concessional contribution and whether (and how) it should be grossed up to allow for contribution tax.

Consultation

For some time, the Institute has been concerned with the application of these requirements and wrote to the Department of the Treasury in May 2007 outlining many areas where we considered that urgent clarification was required or where the requirements appeared to result in inappropriate outcomes.

In August 2007, the Institute received a response (from the Australian Taxation Office) to some of the issues raised. The Institute's letter and the ATO response are available on the Institute website.

Although the ATO response helped in some areas, many issues remained unclear.

The Institute subsequently engaged in further discussions with the ATO, the Australian Government Actuary and the Treasury in attempting to progress these issues.

As a result, important changes were made to the Regulations on 26 September 2007.
These changes addressed areas of uncertainty in regard to the determination of the new entrant age and benefit categories, allowances for discretionary benefits and the circumstances in which a defined benefit member would remain eligible for the

'grandfathering' arrangements under which notional taxed contributions are capped at the concessional contribution limit.

However there still remain a number of issues where, in the Institute's view, further clarity or change is required. The Institute has continued correspondence with the authorities in attempting to progress these issues. While some progress has been made, from the viewpoint of the Institute further changes to the current Regulations will be required in order to achieve a satisfactory outcome on some matters.

It is clear that the delay in clarification of acceptable practices in regard to these outstanding matters has created difficulties for affected funds (which have to report concessional contributions to roll-over funds) and for members of those funds (who need to plan their contributions to avoid incurring any excess contributions tax).

The Institute had therefore hoped that it could agree with the ATO and the Treasury on various practices that the ATO would accept for the year ended 30 June 2008, despite these not necessarily being strictly in accordance with the current regulations, with a view to these "acceptable practices" being incorporated into the Regulations later in 2008. However the ATO has indicated that it cannot support any interpretations that go beyond the 'clear words of the regulations' as they currently stand.

Currently Acceptable Practices and Remaining Concerns

While it is unfortunate that certain matters remain as yet unresolved, the Institute intends to proceed now to make a formal submission requesting the further legislative changes we regard as necessary.

In the meantime, the attached note entitled "Notional Taxed Contribution Rates - Clarification of Various Issues" provides practitioners with information on acceptable practices in regard to the various issues on which the Institute has sought and received clarification, as well as details of those yet be resolved (due to requiring changes in legislation). We have also noted certain issues on which the ATO has indicated it will be providing further clarification.

Member Meeting

Insights meetings will be scheduled to discuss the issues set out in this Notice and to receive comments from members on the areas in which the Institute should seek legislative changes or further clarification.

Feedback

Any comment or feedback on this Information Note should be sent to Paul Shallue via email to paul.shallue@mercer.com

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Notional Taxed Contribution Rates
Clarification of Various Issues

This note sets out approaches which the Institute understands are acceptable to the ATO as well as details of circumstances where the ATO considers that the Institute's desired approach will require changes in legislation. We have also noted certain issues on which the ATO has indicated it will be providing further clarification.

The fact that a particular approach is not listed below as acceptable does not necessarily mean that the approach will not be accepted by the ATO. Such situations will need to be considered on their merits and actuaries will need to make their own assessment (having regard to legal advice, if appropriate) of whether the approach adopted is in accordance with the law.

If a trustee wishes to clarify whether an alternate method is acceptable or seek an interpretation of the regulations as they apply to their scheme, the trustee can write to the ATO for general advice.

SECTION 1.1 DEFINED BENEFIT ARRANGEMENTS

Special rules apply to defined benefit arrangements (Section 292-D of ITAA 1997). These rules are, in general, set out in Section 292-D of ITAR 1997.

SECTION 1.2 SUB-FUNDS

Regulation 292-170.01 implies that, for these purposes, funds should be considered at a sub-fund level rather than at an overall level.

The definition of sub-fund, for this purpose, is set out in Regulation 292-170.01. As currently defined, this may result in inappropriate outcomes in certain circumstances.

Issue 1: related employers

One of the requirements is that all defined benefit members of the sub-fund must have the same employer sponsor. This may create difficulties where a number of *related* employers participate in an arrangement that would otherwise meet the definition of sub-fund.

Institute's desired approach – not accepted by ATO - regulation change required

Subject to meeting parts (a), (b) and (c) of the definition of sub-fund, an arrangement will be considered to be a sub-fund if any of the following apply:

- all of the defined benefit members (excluding current pensioners and deferred beneficiaries) have the same employer-sponsor; or,
- if there is more than one employer sponsor, those employer sponsors are or were related to each other.

The Institute will formally request that the above change be made to the regulations.

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Issue 2: non-related employers

In some schemes, multiple employers who are not directly related to each other participate in the same fund although in different sub-funds.

<u>Institute's desired approach – not accepted by ATO - regulation change required</u>

In cases where the benefits provided in each sub-fund are identical or predominantly identical and it is considered appropriate and reasonable by the actuary, a group of sub-funds can be treated as one sub-fund.

This is designed to cover a situation such as that in place for some Local Government arrangements whereby each local council may participate in its own sub-fund but the defined benefits provided are the same as those provided by all other councils in other sub-funds.

However it is not designed to cover other situations where, for example, a number of schools participate in sub-funds of a master trust arrangement but where each school has the flexibility to determine the level of benefit provided to their employees – even if the benefits provided by some schools are identical. In this situation treatment of the group of school sub-funds as a single sub-fund would not be considered appropriate and reasonable.

The Institute will formally request that the above change be made to the regulations.

SECTION 1.3: THE FIVE MEMBER RULE

Different rules apply to funds (sub-funds) with less than 5 defined benefit members. Funds need to determine notional taxed contributions in accordance with:

- Schedule 1A of the Regulations (if the fund has 5 or more defined benefit members);
- Regulation 292-170.03 (less than 5 defined benefit members).

Subject to rules set out in sub-regulations 292-170.02 (3), (4), (5) and (6), funds with less than 5 defined benefit members may be considered to meet the 5 or more member test and can then use the Schedule 1A approach.

Issue 1: Who is a defined benefit member?

There has been some confusion as to which members are to be included as a defined benefit member for this purpose (Regulation 292-170.02).

The ATO will accept that the following members can be included for this purpose (as well as currently accruing defined benefit members):

- persons receiving a defined benefit pension;
- persons entitled to a deferred benefit which is in a defined benefit form;
- members who are entitled to a defined benefit from the fund but are currently not accruing further defined benefits.

The ATO plans to publish further interpretive advice before the end of March 2008.

Issue 2: Funds with less than 5 defined benefit members may meet the 5 or more member test

Sub-regulation 292-170.02(4) effectively deems that, subject to certain requirements set out in that sub-regulation, funds will meet the 5 or more defined benefit member test even though there are currently less than 5 defined benefit members.

One of the requirements is that the fund (sub-fund) had been in existence for 5 or more years as at 1 July 2007. A strict reading of this requirement would exclude funds that had been established to replace a previous long standing fund (for example, where a stand alone fund was wound up in 2003 and members were transferred by a successor fund transfer to a newly established sub-fund of a master trust).

<u>Institute's desired approach – not accepted by ATO - regulation change required</u>

The conditions of requirement (c) of this sub-regulation to be widened to:

- the fund had been in existence for 5 or more years at 1 July 2007; or
- if the fund had not been in existence for 5 or more years at 1 July 2007, it met the following conditions:
    - o it included defined benefit members at 1 July 2007 who had transferred from another superannuation arrangement as a result of a restructuring or winding up of either:
        - that other arrangement; or
        - the members' employer;

    AND

    - o that other superannuation arrangement had been in existence on 1 July 2002.

(For this purpose, it is irrelevant whether there was one transfer from a previous fund to the current fund or whether there was a series of transfers from say Fund A to Fund B to Fund C.)

The Institute will formally request that the above change be made to the regulations.

SECTION 1.4: FUNDS WHERE THE 5 OR MORE MEMBER RULE DOES NOT APPLY

Where the 5 or more defined benefit member rule does not apply, the method set out in Regulation 292-170.03 must be used.

SECTION 1.5: NOTIONAL TAXED CONTRIBUTIONS – NIL AMOUNT

Regulation 292-170.04 sets out circumstances where the notional taxed contributions in respect of the member's defined benefit interest will be considered to be nil.

Issue 1: Pensioners – indexation rules

A strict interpretation of sub-regulation 292-170.04(4)(b) would imply that an existing defined benefit pensioner would not be a non-accruing member if the pension

indexation rules had changed at any time since the pension commenced. This could include changes that were made 30 or more years ago.

Institute's desired approach – not accepted by ATO - regulation change required

Sub-regulation 292-170.04(4)(b)(iii) should be amended to:

(iii) the pension payments increase at rates that are consistent with the rates prescribed under the rules of the fund when the pension commenced or, if the pension commenced before 1 July 2007, (or for a deferred pension, where the deferment period commenced before 1 July 2007) the pension payments increase at rates that are consistent with the rates prescribed under the rules of the fund as at 30 June 2007.

The Institute will formally request that the above change be made to the regulations.

Issue 2: Pensioners – changes to indexation rule - yet to be resolved

Changes to the indexation rules in a future year would also indicate that the pensioner would not be treated as a non-accruing member in subsequent years. It is unclear whether such a change would result in:

- a concessional contribution in the year of the change (based on the full value of all future increases); or
- additional concessional contributions in that year and each subsequent year (based on the higher pension paid in that year alone).

The Institute will continue to liaise with relevant parties in regard to this matter.

Issue 3: Final average salary

Sub-regulation 292-170.04(5) sets out provisions which need to apply for a member to be classified as a non-accruing member. For example, a member would be classified as a non-accruing member if the member's benefit only increases "at the rate (if any) at which the salary on which the member's benefit is based increases".

It is noted that there is no similar provision for benefits which only increase in line with a member's Final Average Salary. As set out in its August 2007 letter to the Institute (available from the Institute's website), the ATO will accept that sub-regulation 292-170.04(5)(b)(iv) can be interpreted to also encompass situations where the benefit is based on Final Average Salary rather than salary.

The ATO plans to publish further interpretive advice before the end of March 2008.

Issue 4: Minimum Requisite Benefit (MRB) underpin

Most defined benefit members are entitled to a defined benefit which is underpinned by an MRB. The MRB may be either in defined benefit or accumulation form (or a combination). Where a member has accrued the maximum benefit allowed under the rules of the fund, the MRB may continue to accrue. The Institute has received queries from actuaries as to whether the continuing growth of an MRB will mean that the member cannot be treated as a non-accruing member.

Clearly it would be reasonable to treat such a member as non-accruing during any period in which the member's MRB was less than the member's undiscounted accrued retirement benefit.

If the MRB is greater than the member's undiscounted accrued retirement benefit, then the member will not be a non-accruing member unless the MRB also meets the requirements of sub-regulation 292-170.04(5). The actuary will need to consider which benefit category the member belongs to for the purpose of determining the notional contributions. This decision will need to be made in the light of all of the circumstances but could be:

- a special "category" covering only members who have reached their maximum accrual; or
- the member's original category before reaching the maximum accrual; or
- another relevant category.

Institute's desired approach – not accepted by ATO

To ease administration of these cases, the Institute requested that the ATO accept that such a member be treated as non-accruing in a particular year if the provisions of sub-regulation 292-170.04(5) would be met if the growth in the MRB was ignored PROVIDED THAT at the start of the financial year, the member's MRB was less than the member's undiscounted accrued retirement benefit.

The ATO did not agree to this approach. The Institute does not propose to seek any change to the regulations to allow this approach.

SECTION 1.6: LOSS OF GRANDFATHERED CONCESSIONAL CONTRIBUTIONS CAPPING FOR 5 SEPTEMBER 2006 MEMBERS

Those members who were in the fund as at 5 September 2006 may be eligible for a special grandfathered provision that limits the concessional contributions in relation to their defined benefits to their concessional contributions limit for the year. This protection can only be retained subject to the provisions of Regulations 292-170.05 and 292-170.06.

Issue 1: Loss of grandfathering protection prior to determination of new entrant rate by actuary

The regulations set out the circumstances in which a member can lose this protection. These circumstances are different to those announced by the Government on 5 September 2006. This means that some members may have already inadvertently lost this protection.

The Institute has made representations to the Treasury on this issue and notes that a small improvement was made in the amending Regulations dated 26 September 2007.

The Institute does not propose to seek any further change to the regulations in relation to this matter.

Issue 2: Moving to a new benefit category

One of the events which results in a loss of a member's grandfathered protection is if the member moves to a new benefit category with improved benefits before the actuary

has determined the new entrant rate applicable to the member. The Institute has received queries from members relating to what is meant by this as the reference to benefit category in the Regulations appears to be based on the category for notional taxed contributions purposes. This relates to an argument that such categories cannot exist until the actuary has determined what they are.

At this point, no resolution has been reached and trustees may need to obtain legal advice in order to interpret the Regulations.

The Institute does not propose to seek any further change to the regulations in relation to this matter.

Issue 3: Measurement of high salary increases

It is also unclear how the yearly and three yearly salary tests should be applied in practice, ie is this a once a year test or is it 365 tests each year?

The ATO have accepted that the tests can relate as follows:

Yearly test:
The following periods should be tested:

- 5 September 2006 to 30 June 2007
- 30 June 2007 to 30 June 2008
- 30 June 2008 to 30 June 2009 and so on

Three yearly test:
The following periods should be tested:

- 5 September 2006 to 30 June 2009
- 30 June 2007 to 30 June 2010
- 30 June 2008 to 30 June 2011 and so on

The ATO plans to publish further interpretive advice before the end of March 2008.

SECTION 1.7: MEANING OF BENEFIT CATEGORY

Under the amending Regulations dated 26 September 2007, an actuary can certify a benefit category under Part 1.3 of Schedule 1A if either the requirements in (a) **OR** (b) of this Part are satisfied.

SECTION 1.8: CALCULATION OF NEW ENTRANT AGE

The method of calculating the new entrant age is set out in Part 3.6 of Schedule 1A to the Regulations. In broad terms this is the average age of entry to the fund of the persons who were defined benefit members of the fund at 1 July 2007 with the age being rounded down as set out in the Table in this part of the Schedule.

Where the actuary believes that there is insufficient information to calculate the average age of entry, the actuary is to assume that the age of a new entrant is 40.

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The intention is that one average age be calculated which will apply to all members of the fund (sub-fund). It is not intended that different new entrant ages apply to different benefit categories.

Issue 1: Do all defined benefit members need to be included?

Under the amending Regulations dated 26 September 2007, the average new entrant age calculation is to be based on the average age of all defined benefit members excluding current pensioners and members with only deferred defined benefit entitlements.

Issue 2: Transfers on or before 1 July 2007

Under the amending Regulations dated 26 September 2007, the average age at entry can be based on the age at entry to a predecessor fund, where the actuary considers it reasonable to do so.

As many funds have merged in recent years, this may result in a significantly lower average age than that which would have applied if the predecessor fund entry age could not be used.

The ATO have confirmed that they will accept that predecessor fund can be interpreted as a relevant previous fund (if any) which provided defined benefits for the relevant member PROVIDED THAT all members within a related group were involved in the transfer). (It is not intended that predecessor fund extend to the prior fund of an individual member who rolled their benefit from one fund to another after resigning from an employer.) Where there have been a number of such transfers, the ATO will accept that the age a current defined benefit member joined the earliest such fund can be used in determining the average.

In some cases, particularly where there has been more than one transfer, there may be insufficient data to determine the average age joined a previous fund. In such cases the ATO will accept the calculation if the age for any particular member is based on the age they joined the earliest fund for which sufficient information is available.

The ATO plans to publish further interpretive advice before the end of March 2008.

Issue 3: Transfers after 1 July 2007

Where a group of members transfer (after 30 June 2007) from one fund to another as part of a successor fund transfer, this could potentially result in an increase in the new entrant rate even if the defined benefits provided are unchanged. Without special consideration, this could seriously inhibit the use of successor fund transfers in future. Several different circumstances could apply:

<u>Institute's desired approach – not accepted by ATO - regulation change required</u>

Example 1: A fund winds-up in future with all members transferring (on a successor fund basis) to a new sub-fund in a master trust. The Regulations imply that the new entrant age to be used would be 40 as there were no defined benefit members in the new fund (sub-fund) at 1 July 2007.

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The Institute's view is that the new entrant age used in the previous fund should be allowed to continue to be used - effectively this would mean the new entrant rates determined for the predecessor fund could be carried over to the new fund..

Example 2: Following a company take-over, a fund (Fund A) winds-up in future with all members transferring (on a successor fund basis) to an existing defined benefit fund (Fund B). Where benefits continue to accrue in Fund B on a substantially similar basis as in Fund A, the Institute's view is that the new entrant age for the transferring members should be allowed to be either:

- the age previously used for Fund B.
- the age used for Fund A; or

The Institute will formally request the regulations be changed to facilitate the above approaches.

Issue 4: New Defined Benefit Fund (Non-Successor Fund) – yet to be resolved

There is some uncertainty in regard to the determination of the new entrant age for a new defined benefit fund commencing after 1 July 2007, other than via a successor fund transfer. It is noted that current expectations are that such cases are likely to be rare in practice.

As such a fund would need to have at least 50 new defined benefit entrants on its commencement date, the Institute considers that it would be appropriate to determine the average new entrant age based on the average age of the fund's defined benefit members on its commencement date.

However the Regulations imply that the new entrant age to be used would be 40 as there were no defined benefit members in the new fund at 1 July 2007.

The Institute will formally request the regulations be changed to facilitate the above approaches.

SECTION 1.9: BENEFIT OPTIONS

Where a member is entitled to a choice of benefits (eg a choice between a pension or a lump sum or a choice between an immediate benefit and a deferred benefit), we understand that the ATO expects that the actuary will incorporate an appropriate assumption about the take up rate of each option in calculating the new entrant rate. Where appropriate this could be a zero assumption.

Where this is done, the ATO have confirmed that no further notional taxed contribution will arise under item W when a member selects any of the available options.

In some cases, the fund rules may provide that a member has an entitlement to an optional benefit but only if the employer or trustee consents. The ATO have confirmed that these cases should be considered to be options rather than discretions.

The ATO plans to publish further interpretive advice before the end of March 2008.

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SECTION 1.10: DISCRETIONS

Where the employer and/or the trustee have the power to provide a discretionary benefit, Part 2.5 of Schedule 1A may require that the actuary take the discretionary benefit into account in determining the new entrant rate. The Institute interprets the requirements in the following manner:

2.5(2) – if a discretion exists for a higher benefit on voluntary exit *from age 55* the actuary must assume (for the purpose of calculating the new entrant rate) that this higher benefit will be paid in 100% of cases of voluntary exit from age 55. If the higher benefit may exceed the accrued retirement benefit, Part 2.5(2A) allows the actuary to assume the benefit is any amount between the accrued retirement benefit and the higher benefit.

2.5(3) – if a discretion exists for a higher benefit on voluntary exit at any age or ages and there is a reasonable expectation that this higher benefit will be paid in the majority of cases, the actuary should assume (for the purpose of calculating the new entrant rate) that this higher benefit will apply in 100% of cases.

Note that the discretionary power may be a general discretionary power (eg. the power to augment any benefit) rather than a power related solely to the early retirement benefit.

The ATO has not confirmed the above interpretation. Their preference is to publish some examples via interpretive advice on this matter before the end of March 2008.

However the ATO has confirmed that when an exercised discretion is already incorporated in the current new entrant rate, no further notional taxed contribution arises under item W.

If the discretionary benefit actually paid exceeds the benefit allowed for in calculating the new entrant rate, then an additional notional contribution may arise under item W as set out in Part 4 of Schedule 1A.

SECTION 1.11: TREATMENT OF PART-TIMERS

The formula in section 1.7 of Schedule 1A of the Regulations does not appear to allow for any adjustment if a member's part-time status changes during a year.

However as set out in its August 2007 letter to the Institute, the ATO's view is that it is open to the actuary to specify how the superannuation salary (S) used should be determined for members in part-time employment during the financial year.

SECTION 1.12: TREATMENT OF SPECIAL DESIGNS

The Appendix sets out the agreed treatment of a number of benefit designs with particular features which have resulted in queries being raised. This does not preclude the adoption of alternative approaches where the actuary considers that it would be more appropriate or reasonable given the fund design.

Appendix - Treatment of Special Designs

Section A: Designs with Variable Rates of Accrual

Where the benefit design is such that the accrual rate varies with either age or service, it is not clear whether only one benefit category will apply (based on the average new entrant age) or, for example, a separate benefit category will be required for each accrual rate. Examples of such designs are:

(i) a retirement benefit rate of accrual of 15% to age 40 then 20% to age 65,

(ii) a retirement benefit rate of accrual of 15% for members joining up to age 40, 20% for members joining on or after age 45, and a multiple of 4.00 for members joining between 40 and 45 (ie. a rate of accrual of between 15% and 20%)

(iii) a retirement benefit rate of accrual of 10% for the first 10 years of membership and 20% thereafter, and

(iv) the Retirement Benefit Multiple (RBM) at age 65 is 20% x membership with a maximum RBM of 7.00 and a pro-rata approach to the determination of the accrued multiple prior to age 65. Hence members joining under age 30 have an accrual rate of less than 20%.

The ATO has confirmed that each of the above designs can be treated as a single benefit category with the design based on that applicable to the hypothetical new entrant at the fund-based new entrant age.

This is because, although the rates of accrual vary between members joining at different ages, each hypothetical new entrant to the benefit category *at the same entry age* would accrue retirement benefits on the same basis. Hence each design meets the definition of single benefit category under Part 1.3(a) of Schedule 1A of the Regulations.

While this approach may arguably 'overstate' or 'understate' the NER for some members and potentially lead to some anomalies, this is considered acceptable taking into account the simplifying assumptions already inherent in the methodology, the purpose for which the NERs are to be used and the small number of cases which are likely to approach the concessional limits.

However, noting that it would be theoretically possible to design variable accrual rate configurations which have substantial levels of 'understatement', the ATO is giving consideration to measures which would prevent the use of the above approach for new variable accrual rate designs, or modification or extensions to existing variable accrual rate designs, without ATO approval.

The ATO has also indicated that its agreement to the above approach does not preclude the adoption of alternative approaches where the actuary considers that it would be more appropriate or reasonable given the fund design.

Section B: Maximum Average Accrual Rate ("Catch-Up") Design – Benefit Categories

For the purpose of the issues addressed in this Section and Section C, we will use a hypothetical fund (the XYZ Super Plan) which has two design features which generate questions in regard to the determination of New Entrant Rates (NERS). These features, which affect a number of funds in practice, are:

- A varying rate of accrual depending on the member contribution rate in combination with a maximum accrued multiple (12% times years of membership), and
- The fact that, while the accrual of defined benefits requires members to make contributions, the member contributions do not go towards funding of the salary-related defined benefit but rather go towards an additional accumulation-style benefit (refer Section C issue).

The XYZ Super Plan defined benefit design allows Contributory Members a choice of contribution rates of 2% to 10%. The rate of accrual is equal to the member contribution rate plus 7% for each year of membership, subject to a maximum accrued multiple of 12% times years of membership (i.e the accrued multiple which would apply if the member contribution rate had been 5% throughout membership). Members may also choose to be Non-Contributory, in which case there is a zero accrual rate (and the employer makes SG contributions to an accumulation account for the member).

While the accrual of defined benefits requires members to make contributions, the accumulation of member contributions plus interest is paid <u>in addition to</u> the accrued multiple times final average salary.

Essentially this design is aimed at allowing members who have contributed less than 5% in the past to make 'catch-up' contributions of 6% to 10% in order to 'catch-up' to the maximum accrued multiple. However technically a member could 'catch-up' in advance, by contributing more than 5% for a period and then less than 5% for a period to achieve the same multiple as a member who had done the reverse or who had contributed at 5% throughout.

Once a member on a contribution rate of 6% to 10% has 'caught-up' to the maximum accrued multiple, application of the maximum multiple (which accrues at 12% each year regardless of the member contribution rate) means that their effective accrual rate will fall back to the 12% rate which applies to a 5% contributor.

The question therefore arises as to whether the New Entrant Rate for a 10% contributor (for example) should be based on the standard 17% accrual rate which would apply for a 10% contributor in 'catch-up' mode or the 12% accrual rate which would apply if they have already accrued the maximum multiple for their membership period.

A similar question may also apply to members contributing 2%, 3% or 4%. If they have contributed 5% or less on average in the past, they will effectively be accruing at the standard 9%, 10% or 11% rate respectively. However if they have contributed more than 5% on average in the past (and hence their accrued multiple is currently being restricted to the maximum), they will effectively be accruing at the 12% rate of accrual at which the maximum multiple accrues, until their average contribution rate falls below 5%.

The question therefore may also arise as to whether the New Entrant Rate for a 2% contributor (for example) based on the standard 9% accrual rate can also be applied for a 2% contributor if they effectively had a 12% accrual rate (for a limited period) due to contributing more than 5% on average in the past.

For the purpose of this question, let us say the New Entrant Rates are as set out in the following table, depending on the approach taken (as set out below the table):

Member Contribution Rate	Provisional New Entrant Rate			
	Approach 1	Approach 2	Approach 3	
			Standard	on-Standard
0%	0%	0%	0%	8%
2%	6%	6%	6%	8%
3%	7%	7%	7%	8%
4%	7%	7%	7%	8%
5%	8%	8%	8%	Not applicable
6%	8%	9%	9%	8%
7%	8%	10%	10%	8%
8%	8%	10%	10%	8%
9%	8%	10%	10%	8%
10%	8%	11%	11%	8%

Approach 1

Under Approach 1, the hypothetical new entrant to each category is assumed to join that category when first joining the plan and to remain in the category throughout service. Under this approach, due to the maximum accrued multiple rule, members contributing 6% to 10% would accrue the same defined benefit (12% of final average salary for each year of membership) as those contributing 5%. Hence their NER is the same as the 5% contribution category.

- This is a simple approach.
- It is arguably generous to members contributing 6% to 10% for any period when they are accruing at more then 12% as their NER is arguably understated, but the understatement is only up to 3% (i.e a NER of 8% for 10% Contributors as compared with an NER of 11% under Approach 2) and the period of 'understatement' will be limited to when they catch up to the maximum accrued multiple.
- It is also arguably generous to members contributing 0% to 4% for any period when they are accruing at 12% because they have contributed more than 5% on average in the past, but this period will be limited to when their average contribution rate falls to 5%.

Approach 2

Under Approach 2, the maximum accruing multiple is ignored for members contributing 6% to 10% (i.e effectively they are assumed to have enough <5% membership so the maximum multiple does not kick in), so the hypothetical new entrant in each category is

assumed to remain in the category throughout service and to accrue at their member contribution rate plus 7% throughout service.

- This is a reasonably simple approach.
- The assumption that the maximum accrued multiple will not apply through to age 65 is unrealistic for most new entrant ages (i.e. 40 or below).
- It arguably overstates the NER for members contributing 6% to 10% for any period when they are only accruing at 12%. While they could elect to move to the 5% contributory category without reducing their current defined benefit accrual rate, they are likely to consider this approach unfairly penalises them.
- As for Approach 1, this approach is arguably generous to members contributing 0% to 4% for any period when they are accruing at 12% because they have contributed more than 5% on average in the past, but this period will be limited to when their average contribution rate falls to 5%.

Approach 3

Under Approach 3, the categories of members contributing other than 5% are each treated as forming two benefit categories, split according to whether the member's current accrual rate is the standard rate for that category or at the 12% rate which applies to the 5% category. The Standard accrual rate benefit category would use the Approach 2 NER and the Non-Standard benefit category would receive the 5% category NER

- This is arguably the most equitable approach insofar as the NER is consistent with the member's accrual rate at any point in time.
- However it is a more complicated approach which will require considerable additional administrative effort to split members of 9 categories (0% - 4% and 6% - 10%) into 18 categories and re-categorise them whenever required eg. when a 10% contributor reaches the point at which they have contributed more than 5% on average in the past, they will need to be moved from the Standard 10% (Catch-up) benefit category to the Non-Standard 10% (Non Catch-up) benefit category.
- It is also more complex to communicate to members.
- The Standard NER assumption that the maximum accrued multiple will not apply through to age 65 is unrealistic for most new entrant ages (i.e. 40 or below).

Institute's Recommended Approach

The Institute recommended that the ATO accept Approach 1 as it is the simplest approach and considered to be the most consistent with the new entrant rate methodology adopted for notional taxed contribution rates. While this approach could arguably be generous to members in certain circumstances, the level of 'understatement' is generally expected to be minor and to apply only for limited periods.

The ATO has confirmed that it will accept Approach 1 for the above and similar catch-up designs which are in place at 1 July 2007.

However, noting that it would be possible to design 'catch-up arrangements' which have far greater levels of 'understatement' than the above hypothetical fund, the ATO has advised that the application of Approach 1 to any new designs, or modification or

extensions to existing catch-up designs, be subject to the approval of the ATO in each instance. It is expected that few, if any, such cases will arise.

The ATO has also indicated that its agreement to the above approach does not preclude the adoption of alternative approaches where the actuary considers that it would be more appropriate or reasonable given the fund design.

Section C: Treatment of Member Contributions in Hybrid Design

As noted above, the design of the XYZ Plan defined benefits requires members to make a contribution (eg 5%, which may be via salary sacrifice of 5%/0.85 = 5.88%) in order to be eligible for a salary-related defined benefit which is fully employer-sponsored i.e. the benefit is a hybrid comprising the employer-sponsored multiple of salary benefit plus the member-sponsored (in many instances via salary sacrifice) accumulation of the compulsory member contributions with interest.

In this case, it is unclear from the Regulations whether the benefit used in determining the NER should be inclusive or exclusive of the accumulation of the compulsory member contributions with interest i.e should the NER be based on:

- just the cost of the salary-related defined benefit (sample rates as set out in the table above); or
- the cost of the salary-related defined benefit **plus** the member contribution rate?

It would be possible to take the view that the accumulation of the compulsory member contributions with interest is not a defined benefit and therefore should not be included in the NER.

However, if this approach is taken, the 'cap' which was designed to protect defined benefit members (subject to conditions) from excess contributions tax in respect of their existing defined benefits, would be ineffective for any member whose compulsory member contributions are paid by salary sacrifice. Such a member would not be able to maintain their defined benefit if they cease their compulsory member contributions but these would not be included in the notional taxed contributions subject to the cap.

Looking from this viewpoint leads to the view that the NER should be determined including allowance for the accumulation of the compulsory member contributions with interest. The NERs for the XYZ Plan would then be the sample rates as set out in the table above plus the member contribution rate of 0% to 10% (after allowance for contributions tax in the case of salary sacrifice contributions) as applicable to the category.

The ATO has NOT accepted this interpretation.

The Institute will not be further pursuing this issue. However, it remains open for trustees of funds with designs similar to that of the above scheme to write to the ATO to seek an interpretation of the regulations as they apply to their scheme.