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Superannuation Vesting Scales: The Revival of an Old Issue

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Superannuation Vesting Scales: The Revival of an Old Issue

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Introduction

After receiving scant public recognition in recent years, public attention has again returned to a range of issues concerning superannuation vesting, in particular through media commentary. For example, in February 2002, a press article reported how certain employers use superannuation funds with vesting rules to erode fund members' benefits, particularly where employees have fringe benefits and other salary packaging options.[1] In March 2002, a presenter at a major conference stated that vesting rules are a major issue for superannuation funds.[2] In addition, the Senate Select Committee on Superannuation is also interested in the issue. These events have again raised the prominence of vesting scales as a policy issue.

To assist Parliamentarians understand and respond to the current discussions, this paper explains what vesting is, how it works, the recent interaction between vesting and the superannuation surcharge, and previous reform options for minimum vesting standards.

Superannuation is said to vest in a member when the member becomes legally entitled to it. Prior to this recent renewal of interest¸ public debate on superannuation vesting rules had waned for ten years or more, chiefly because vesting rules do not apply to superannuation contributions made in compliance with industrial awards and the Superannuation Guarantee (SG) i.e., award and SG contributions are 100 per cent vested in the employee.

However since the introduction of the superannuation surcharge in 1996, vesting rules have sometimes been raised as an issue of importance for employees subject to the surcharge. For these people, vesting scales can lead to the taxation of superannuation contributions of which the employee has no legal entitlement (until they satisfy the requirements of the vesting scale).

What is Vesting?

The Dictionary of Superannuation[3] defines vest/vesting in the following manner:

> **Vest**. As noted above, superannuation is said to vest in a member when the member becomes legally entitled to it. Many employer–sponsored superannuation funds have progressive vesting scales. In such a fund a member is entitled only to a proportion of the employer's contribution in the early years of employment, and entitled to all employer contributions only after a set period (eg. five or ten years).

Accumulation funds or defined benefit funds can use progressive vesting scales. There are no statistics on the extent of use of progressive vesting scales, the number of employees covered by them, or whether they are more commonly used by accumulation or defined benefit funds.

The practice of using progressive vesting scales evolved over a period of time prior to the introduction of compulsory superannuation and the introduction of the SG in 1992. At this time, superannuation was more of a human resources issue than a retirement income issue. Superannuation was, in many cases, a benefit provided to a minority of workers. In such cases, the superannuation benefits were quite generous and were used as a method of attracting high value employees. Progressive vesting scales were used to reward employees with long service with a company. In essence, they encouraged people to remain with a company by increasing the employee's ownership of the employer–provided superannuation benefit with years of service. This practice has been likened to being a 'golden handcuff.'

Reforms to retirement income policy in the 1980s (i.e. introduction of award superannuation) and the 1990s (SG) introduced minimum vesting standards. Under these reforms, all future superannuation contributions made in compliance with an industrial award or the SG are 100 per cent vested in the employee.

Consequently, the pre-award/SG vesting rules explained and discussed in this paper have no retirement income policy objective, rather they are a method devised to ensure employee loyalty, that pre-date award superannuation and the SG, yet remain within the superannuation system.

Operation of Vesting Rules

This section explains, through the use of a hypothetical example, how employers can use superannuation funds with progressive vesting scales to reward longer serving employees over short-term employees. It also shows how progressive vesting scales can cause employees to lose superannuation entitlements when they change jobs if their benefit is not fully vested, and how employers can access fund surpluses that have accumulated, in part, through progressive vesting scales.

Practical Hypothetical Example

The hypothetical employee is a member of a long established superannuation fund. The employee's income is $100 000 per year. The employer makes a superannuation contribution of 20 per cent of income, subject to the fund's vesting scale. For simplicity, investment earnings have been ignored.

The column labelled 'benefit vested with employee (under fund rules)' contains the amount of the cumulative employer contribution to which the employee has legal entitlement. It is calculated by multiplying the particular year's cumulative employer contribution by the vesting rate for that year.

The column labelled 'benefit vested with employee (under awards/SG)' contains the cumulative employer contribution the employee has legal entitlement to under awards/SG. It is calculated by multiplying the SG rate (currently 8 per cent) by the employer's salary (i.e., $100 000).

Years of service	Cumulative employer contribution	Vesting rate	Benefit vested with employee (under fund rules)	Benefit vested with employee (under awards/SG[4])
1	$20 000	10%	$2 000	$8 000
2	$40 000	20%	$8 000	$16 000
3	$60 000	30%	$18 000	$24 000
4	$80 000	40%	$32 000	$32 000
5	$100 000	50%	$50 000	$40 000
6	$120 000	60%	$72 000	$48 000
7	$140 000	70%	$98 000	$56 000
8	$160 000	80%	$128 000	$64 000
9	$180 000	90%	$162 000	$72 000
10	$200 000	100%	$200 000	$80 000

The example shows how with each year of employment, the employee's ownership of the superannuation contributions increases, in accordance with the vesting scale, by 10 per cent each year. It is not until the 10th year of employment that the employee is entitled to 100 per cent of the superannuation contributions made on his or her behalf. Although the employer will contribute 20 per cent of salary each year, the employee has no legal right to all of that 20 per cent of salary per year until 10 years of employment have been completed.

For the first 4 years of employment, the employee's vested benefit under SG is greater than or equal to their vested benefit under the fund rules. In the 5th year of employment the employee's vested benefit under the progressive vesting scale exceeds the SG vested benefit.

Interaction of Progressive Vesting Scales and Staff Turn-over

Regular staff turnover in companies that have superannuation funds with progressive vesting scales may cause employees to lose superannuation entitlements when they change

jobs. Employer-sponsors of long-standing defined benefit funds with progressive vesting scales can receive financial benefits from having such a scale.

In the hypothetical example, where an employee changes job prior to 10 years of service, the employee does not own 100 per cent of their superannuation. After 5 years of employment, $100 000 has been contributed on behalf of the employee, but under the fund's vesting rules the employee is only entitled to 50 per cent of those contributions, or $50 000. Under the SG, the employee is entitled to $40 000 of those contributions.

On termination of employment, the non-vested superannuation contributions (in the hypothetical example, $50 000 after 5 years) are retained by the superannuation fund. Over time, progressive vesting scales may combine with regular staff turnover to leave many non–vested benefits in the superannuation fund. In some cases, this may result in many non–vested benefits being retained in the fund and accumulating interest so that the employer–sponsored defined benefit scheme reports a surplus of assets over liabilities. The superannuation prudential legislation enables an employer–sponsor of a defined benefit superannuation fund that has a surplus of assets over liabilities to take a 'contributions holidays,' i.e., the surplus of assets over liabilities. Under the SG legislation, this surplus can be used to meet on-going fund members' superannuation entitlements under the SG, provided certain conditions are met.[5] This relieves the employer-sponsor of the obligation of making additional contributions to the fund.

A defined benefit fund can be restructured into what is known as a hybrid fund. Such a fund has both defined benefit members and accumulation members. In some cases, following the introduction of the SG, some employers that had defined benefit funds with progressive vesting scales closed the fund to new members. At the same time, the fund was restructured to contain a new accumulation division for new employees who would receive only SG minimum contributions. In this case, if there was a surplus in the defined benefit division (with the progressive vesting scale), that surplus could be legally repatriated by the employer and used to fund mandatory SG employer contributions for members of the accumulation division of the fund.[6]

Interaction of Progressive Vesting Scales and Salary Packaging

In recent times, press articles have reported how certain employers use superannuation funds with vesting rules to erode fund member's benefits, particularly where employees receive fringe benefits and other salary packaging options.

Employees should receive superannuation contributions calculated as a percentage of their salary, however, the SG legislation bases the employee's contribution as a percentage of the salary *actually paid* to the employee. Salary packaging in all of its forms (e.g., superannuation, novated car leases) reduces the employee's salary, and consequently the employee's minimum employer sponsored superannuation contribution. According to one commentator, employees opting for salary sacrifice run the risk of losing on their

employer superannuation contributions after the impact of progressive scales is considered.

> For smaller and some unscrupulous larger employers, salary sacrifice packaging arrangements provide an opportunity to reduce their ongoing super payments. One large computer company, for example, aggressively markets novated leases and other salary sacrifice arrangements.
>
> The company operates a defined–benefit superannuation fund based on the model of its overseas parent, where employer–funded benefits are only fully vested in employees over a 10 year period. Given the large staff turnover in the industry, few employees serve the whole 10 years to obtain the total amount of the employer's contributions.
>
> Therefore, a significant number of employees end up with only part of the promised employer benefits, with the bulk of their payouts consisting of a return of their own personal contributions plus interest.[7]

Vesting and the Superannuation Surcharge

The operation of vesting rules was complicated by the imposition of the superannuation surcharge in 1996 under the *Superannuation Contributions Tax Imposition Act 1997* and related acts.

The superannuation surcharge did not affect the operation of vesting rules. On the contrary, the operation of vesting rules may affect certain peoples' superannuation surcharge liability. For example, it is possible for employees subject to the superannuation surcharge to pay the surcharge on non–vested contributions, or contributions they are not legally entitled to until they satisfy the requirements of the vesting scale. This can be demonstrated by referring to an example.

Consider again the earlier hypothetical example where an employee earns $100 000 per year with an employer superannuation contribution of 20 per cent of income, with those contributions subject to a progressive vesting scale.

For the 2001–02 financial year, the superannuation surcharge is imposed at the rate of 1 per cent for each $1219 of assessable income where the member's assessable income and superannuation contributions are in excess of $85 242. The maximum surcharge is 15 per cent when assessable income and superannuation contributions reach $103 507.[8]

The hypothetical employee will be subject to the superannuation surcharge since his or her income ($100 000) exceeds the lower surcharge threshold of $85 242.

The hypothetical employee is subject to the surcharge, not just on the vested contributions, but on all of the annual contribution made by the employer. This is because the calculation of a member's surchargable contribution depends on the contributions *made* by an

employer (in the case of accumulation fund members) or on the actuarial value of the benefits accrued to the member (in the case of defined benefits fund members).[9] Consequently, surcharge is payable on contributions the member has no legal entitlement to (until they satisfy the vesting scale) resulting in a higher surcharge liability than would have accrued if the member was liable for surcharge only on the vested contribution. The calculation of superannuation surcharge on vested and non-vested benefits is demonstrated below.

Hypothetical Example: Superannuation Surcharge on Vested and Non-Vested Benefits

Assume that we are calculating superannuation surcharge liability for the first year of fund membership. The required data is as follows:

Employee's income:	$100 000
Upper surcharge threshold:	$103 507
Lower surcharge threshold:	$85 242
Denominator for year:	$1219
Contributions for year:	$20 000

Actual Surcharge Payable

Rate of Surcharge Payable = 15 per cent (since income + contribution exceeds the upper surcharge threshold of $103 507).

Surcharge payable = Rate of Surcharge Payable x Contributions for year
= 15% x $20 000
= **$3000**

Surcharge payable if levied on vested benefits only

Employee's vested benefit (under vesting rules) = 10% x $20 000
= $2000

However, employee is entitled to 100 per cent of SG contributions.

Employee's vested benefit (under SG rules) = 100% x ($100 000 x 8%)
= $8000

Surcharge payable on vested benefit (under SG rules) = $8000 x 15%
= **$1200**

Cost to employee of being taxed on non-vested contributions = $3000–$1200
= **$1800**

The hypothetical example shows how an employee subject to progressive vesting rules is taxed more heavily (an extra $1800) than if they were taxed on only their vested SG benefit. In effect, they pay tax on money they have no legal entitlement to (until they satisfy the vesting scale).

There is no discretion given to the Australian Taxation Office (ATO) in the superannuation surcharge legislation in how they apply the surcharge to non-vested contributions. As noted above, the law requires that the superannuation surcharge be levied on superannuation contributions irrespective of whether they are or are not vested. There is no other way for the ATO to calculate the surcharge. In light of the ATO having no discretion to exempt non-vested benefits from the surcharge, the issue is one for employees and employers. If an employer agreed with the employee to take the necessary steps to remove a progressive vesting scale from a superannuation fund, the taxation of non-vested benefits would no longer be an issue.

An alternate approach would be for Government to legislate to abolish progressive vesting scales. Recent proposals along this line are provided in the next section.

Reform Options over the Past 13 Years

Over the past 13 years, successive governments have made announcements about vesting. These announcements are reproduced below.

Hawke Government Announcement (1989)

In August 1989, the then Minister for Social Security, the Hon. Brian Howe, MP released a social security and retirement income policy statement titled *Better Incomes: Retirement Income Policy Into the Next Century*. Part of that report, reproduced below, dealt with the issue of vesting.

> **Vesting and Preservation**
>
> The Federal Government supports changes to employer provided superannuation which would improve the benefits to employees at retirement through improvements to vesting and preservation standards.
>
> Many employees in traditional employer schemes currently lose the benefits of superannuation when they change jobs. This is usually because their schemes have long vesting periods, reflecting the traditional role that superannuation had in rewarding long service. Younger people, in particular, are likely to change jobs frequently and women tend to have broken working careers.

> Women and young people will benefit from award superannuation which is already fully vested. However, many other employees would also benefit from improvements to vesting in traditional superannuation schemes.
>
> Progress has already been made by many employers, but there is a need for a general minimum standard. To avoid onerous cost burdens on employers, it is proposed to phase in a minimum vesting standard over a 10 year period.
>
> Employer financed benefits accruing from 1 July 1995 (other than those already required to be vested under existing standards) will vest in the employee at a rate of not less than 10 per cent per annum so that by the end of the tenth year with an employer there will be a 100 per cent vesting of those benefits. This is a minimum standard. It does not prevent an employer, as many already do, from providing a faster vesting process.[10]

Keating Government Announcement (1992)

On 30 June 1992, the then Treasurer, the Hon. John Dawkins, MP announced the introduction of the Superannuation Guarantee Charge in his policy statement titled *Security in Retirement: Planning for Tomorrow Today*. Part of that report, reproduced below, dealt with the issue of vesting.

> **B: RULES FOR SUPERANNUATION CONCESSIONS**
>
> **1. VESTING AND PRESERVATION**
>
> **(i) Vesting**
>
> Only benefits that are fully vested will count as employer support for the purposes of the SGC.
>
> In light of the SGC and given the importance of vesting for labour mobility, the Government will review the previously announced 1995 vesting proposals.[11]

No announcement was made on the results of the review the 1995 vesting proposals.

Keating Government Announcement (1995)

On 9 May 1995, the then Treasurer, the Hon. Ralph J. Willis, MP announced changes to superannuation regulation in his policy statement titled *Saving for Our Future*. Part of that report, reproduced below, dealt with the issue of vesting:

> Also from 1 July 1994, the Government has required that all employer funded superannuation benefits provided pursuant to awards and the Superannuation Guarantee must be fully vested in employees (ie placed within their ownership and control) …

> These vesting … requirements have improved substantially the role and capacity of superannuation saving in meeting the Government's retirement income objectives.[12]

This policy statement was silent on the Government's 1989 intention of phasing in a minimum vesting standard over a 10 year period.

Future Prospects for a Minimum Vesting Standard

During the 2001 election campaign, the Government released a number of proposed reforms to superannuation.[13] The date of effect of the Government's proposals is only indicative since amending legislation has not been passed by the Parliament. The proposed reforms that affect the taxation of superannuation, preservation, and interaction with social security, and the Government's proposed date of effect are in the following table.

Proposed reform	**Proposed date of effect**
Allowing couples to split their superannuation contributions	1 July 2003
Allowing superannuation contributions up to $1000 per annum to be made on behalf of children who do not otherwise have superannuation	1 July 2002
Increase the current deduction limit for the self employed	1 July 2002
Reducing the superannuation and termination payments surcharge rates by ten per cent of their current level over each of the next three years (a maximum of 1.5 percentage points each year)	1 July 2002
A Government co–contribution of up two $1000 per annum (in place of the current $100 rebate) for superannuation contributions made by low income earners	1 July 2002
Reducing the tax rate on the excessive component of an eligible termination payment	Not announced
Allowing the First Child Tax Refund to be contributed by the parent to their superannuation fund	Not announced
Increase from 70 years to 75 years the age up to which working members of superannuation funds can make personal superannuation contributions	1 July 2002
Greater worker choice of superannuation fund and portability	On going[14]
Examine whether certain market linked income streams (also known as growth pensions or account-based income streams) should receive concessional tax and social security treatment	Not announced
Permitting non–residents to access their superannuation benefits after they have permanently departed from Australia, subject to withholding of tax concessions provided to the benefits	1 July 2002[15]

The majority of these proposals are to change the tax treatment of superannuation through changes to rebates and tax deductibility, which are generally applicable to all individual taxpayers. The Government's priorities for superannuation do not appear to include a minimum vesting standard.

Conclusion

As has been demonstrated, the reduced importance of vesting rules over the past decade or so can be attributed to the mandated vesting of superannuation guarantee and award contributions. Since awards and SG contributions are 100 per cent vested in the employee, the reason for vesting applying at all seems to be out dated.

Most employers will only provide employees with the level of superannuation required under the SG. Today's high value/high income employees (that vesting scales were targeted at) also tend to be highly mobile. It is arguable that high value/high income employees (particularly those in the computer industry) would not accept a salary package where their superannuation was subjected to a vesting scale that required them to remain with the company for a period of time to get full benefit of those superannuation contributions.

It is also arguable that few people know employers can legally use the interaction of salary sacrifice, SG laws and vesting rules to erode fund member's benefits. In the absence of reform, the Government may be criticised if it does not prohibit the practice of employers using superannuation funds with vesting rules to erode fund member's benefits where salary packaging is used.

While the superannuation system requires future award and SG contributions to be 100 per cent vested in the employee, it also recognises previous employment contracts in the current system in that some employees may still be subject to vesting rules. Although the superannuation system does make this concession to past practices, there is no retirement income policy reason why a law could not be introduced to require 100 per cent vesting.

The introduction of the superannuation surcharge has affected some fund members. However, that number appears to be small since the grievances of those affected has not received any coverage in the public arena. Since vesting again became an issue for some people with the introduction of the superannuation surcharge, affected fund members may be better off campaigning against its imposition rather than proposing minimum vesting standards. The Government's election promise to reduce the surcharge rate indicates that campaigners against the superannuation surcharge may have found some sympathetic ears. The revived interest in vesting as a policy issue by a variety of groups may result in legislative action. In the long run, only time will tell.

Endnotes

1. Daryl Dixon, 'Super duper,' *The Bulletin*, 26 February 2002, p. 48.
2. Garry Weaven, 'Confidence in the Public Policy Environment,' 12th Annual Conference of Major Superannuation Funds, Royal Pines Hotel, Ashmore, Queensland, 13–15 March 2002.
3 Beth Quinlivan, *The Dictionary of Superannuation*, ASFA, 1994.
4 Assume SG rate is 8 per cent.
5. Contributions made under a contributions holiday qualify as SG payments. Although this is not implicitly stated it is implied through the use of the benefit certificate required under section 22 of the *Superannuation Guarantee (Administration) Act 1992*. Under this section, if the actuary asserts that the benefit to be provided to the employee satisfies SG then the employer has meet their obligations. If, at the same time, the actuary also says that to meet the defined benefits they can go on a holiday then the two interact to satisfy SG.
6. See *Superannuation Industry (Supervision) Act 1993*, section 117.
7. Daryl Dixon, 'Super duper,' *The Bulletin*, 26 February 2002, p. 48.
8. Commissioner of Taxation, *Superannuation Contributions Determination SCD 2001/2*, 13 June 2001.
9. CCH Australia, *Australian Master Superannuation Guide 2001/2001*, p. 329.
10. The Hon. Brian Howe, MP, Minister for Social Security, *Better Incomes: Retirement Income Policy Into the Next Century*, Canberra, AGPS, 1989, pp. 38–39.
11. The Hon. John Dawkins, MP, *Security in Retirement: Planning for Tomorrow Today*, Canberra, AGPS, 30 June 1992, p. 56.
12. The Hon. Ralph Willis, MP, *Saving for Our Future*, Canberra, AGPS, 1995, p. 20.
13. Liberal Party of Australia, *A Better Superannuation System*, November 2001.
14. A bill to allow greater employee choice of superannuation fund, the *Superannuation Legislation (Choice of Superannuation Funds) Bill 1998*, was defeated in the Senate on 8 August 2001. The Government remains committed to choice and portability in superannuation.
15. Originally announced to apply from 1 January 2002. This proposal only applies to individuals who hold or have held a temporary residence visa (not all non-residents), and does not apply to Australian citizens and permanent residents. Minister of for Revenue and the Assistant Treasurer, Senator the Hon. Helen Coonan, *Access to Superannuation for Departing Non-residents*, Press release C3/01, 27 December 2001.