ISSUES ON OWNERSHIP AND USE OF SUPERANNUATION SURPLUS IN AUSTRALIA

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INTRODUCTION

The purpose of this paper is to give you a feel for current issues relating to surplus in Australian defined benefit superannuation funds.

For those of you who are interested in researching the legal aspects of this subject in more depth, I commend "Superannuation Fund Surpluses", a very readable paper by Libby Slater a partner of one of the large legal firms in Australia. It is part of a Butterworths publication "Superannuation & Retirement Benefits in Australia" which is regularly updated.

Before getting to those issues though I need to give you some background:

- on the way superannuation is legislated and regulated, and
- events of the last few years

which have impacted on how surplus has emerged and how it has been handled.

LEGISLATIVE FRAMEWORK

Superannuation in Australia is largely governed by Federal rather than State legislation. Superannuation funds are established as trusts and are subject to (State) trust law. However the levels of benefits which funds can provide and the taxation conditions which apply are governed by Federal legislation.

Until 1987 Federal control of superannuation was entirely through the Australian Taxation Office (ATO) and income tax legislation. In 1987 the Insurance and Superannuation Commission (ISC) was established. Its focus is to regulate the superannuation industry and to ensure funds comply with Government policy. The role of the ATO now relates primarily to:

- collecting tax on the investment and contribution income of funds and on the benefits they pay, and
- ensuring claims for tax deductions on employer contributions are reasonable.

Superannuation has been subject to substantial regulatory and legislative change over the past 10 years. Ten years ago fund contributions and investment income were tax free and benefits were largely tax free. Now employer contributions are taxed at 15%; investment income is taxed at 15% (but with offsets); benefits in excess of a modest tax free threshold are also taxed at 15% with an effective rate of about 2% on pre July 1983 accruals.

Previously tax approved superannuation funds could pay lump sum benefits up to 7 times final average salary (FAS). Now we have a three tiered system involving 7, 5 and 3 times FAS for post July 1988 service. The 5 times multiple comes into play for the excess of salary over about 150% of average weekly earnings.

The rate of change appears unlikely to abate with:

(1) the Government due to impose a minimum level of employer support of 5% of salary p.a. for all employees from 1 July 1992,

(2) the Government having "promised" it will simplify what has become an inordinately complex regulatory system, and

(3) the Opposition having outlined in November 1991 a radical new approach to superannuation as part of its reform of the taxation system.

APPROVAL OF SUPERANNUATION FUND DEEDS

Prior to 1987 a fund had to secure ATO approval for the wording of its trust deed if it wished to secure the tax advantages available to superannuation. The ATO did not apply completely consistent rules in approving deeds over time or on a state by state basis. As a result different concepts can arise in existing trust deeds relative to using surplus.

The ATO tended not to allow the establishment of funds which specified that the employer had a right to part or all of the surplus on wind up or during the working life of the fund. However it would approve deeds which were silent on these points i.e. it did not require that the deeds prohibit payment of surplus to employers.

The ATO changed its attitude in the early 1980s and it then commenced to approve deeds which permitted surplus to be paid to the employer. The ISC has taken over the ATO's approval responsibility and surplus repayment continues to be permitted. As a consequence we have today:

(1) some funds where the trust deed specifically permits surplus to be repaid to the employer,

(2) many funds which are silent on whether or not surplus can be repaid, and

(3) some funds which prohibit repayment of surplus both on wind up and during the life time of the fund.

Some of the funds which have the right to repay surplus may have been amended in recent years and the amendment may not necessarily withstand scrutiny. An example of this from a different country is the UEB case in New Zealand.

MEMBER TRUSTEES

Since 1987 all new large superannuation funds (defined as those with more than 200 members) must have equal member and employer representation on the trustee board. In 1995 it is proposed to make this requirement compulsory for existing large funds as well. In recent years many large funds have voluntarily included significant and sometimes equal member representation on their trustee boards.

These changes and pending changes together with greater disclosure requirements on reporting to members and the generation of significant surpluses in funds mean that trustees are much more conscious of their responsibilities and much more open to scrutiny than was previously the case.

GENERATION OF SURPLUS

In the 1980s many defined benefit funds generated substantial surpluses. Most of the assets were invested in equity type investments and high real rates of return were

achieved. Surpluses still continue to be significant in some funds despite the 1987 share market crash and action taken to reduce surpluses.

Many of these funds are providing a contribution holiday to the employer, others have returned surplus to the employers, a few have been merged with funds in deficit and others still have improved benefits. Many variants of these four broad approaches have occurred. Most funds which have returned surplus have also improved benefits.

AWARD SUPERANNUATION

Until the early 1980s superannuation was not considered a negotiable item between employers and unions. There were a few exceptions which typically involved the consent of the employer to having superannuation included as an industrial matter.

The picture changed in the 1980's. The peak union body and the Federal Labor Government were looking for ways of providing a share in perceived productivity increases without a cash in hand wage increase. Superannuation was the answer and the national wage fixing body facilitated an employer sponsored 3% contribution for all award covered employees in 1986. However the spread across all awards was slow and the non compliance rate - particularly among small employers - was high.

From 1 July 1992 the Federal Government proposes to overcome this defect by the introduction of a "superannuation guarantee levy" (SGL). Under this an employer which does not contribute 5% of salary for each employee will be required to pay a tax levy at that level and not secure a tax deduction on the levy. The SGL tax collected will be contributed to funds for the benefit of the employees concerned.

With one stroke the Federal Government proposes to:

(1) ensure all award employees receive superannuation,

(2) achieve a significant increase in the level of contribution from 3% to 5%. (The Government envisages the 5% progressively increasing to 9% over the next decade with possibly a further 3% of salary coming from employees themselves or from cuts in income tax), and

(3) extend the minimum requirement to non award employees.

At the present time award superannuation is being provided for more than half the employees under awards. The way it is being provided varies substantially. Large employers were the earliest to comply and many agreed with their unions that the additional 3% of salary would be used to provide benefits through their own funds. This occurred at a time when few industry funds had been established to accommodate 3% award contributions. Smaller employers were slower implementing the 3% award and in many cases the contributions were directed to industry funds which by then had been established for just this purpose. These industry funds are controlled by a board of trustees half of whom are nominated by the relevant unions and half by the employer association.

In the larger defined benefit funds where there was early agreement, the 3% was typically used to provide defined benefits (e.g. by improving vesting and retirement accruals); however sometimes accumulation style benefits were provided or a mixture. It was a matter for the employer and its unions to decide whether or not to have their agreement ratified by the Industrial Relations Commission (IRC). When they did seek ratification, the IRC award would invariably require the employer to contribute 3% of salary.

Where employers and unions decided not to have their agreements ratified by the IRC (and many would have good reason for not including the IRC in the process) there would usually have been no 3% contribution requirement. As a consequence there are a significant number of defined benefit funds which are providing the first 3% round of award superannuation and financing that from surplus.

This approach has already led to one court case in relation to the validity of this use of surplus. More may be on the way. Later I will discuss this specific case.

THE UNION PERSPECTIVE

There is no Federal or other legislation stating to whom the surplus in superannuation funds belongs. That is a matter of trust law and an interpretation of each fund's trust deed. In many funds the surplus is being run down either by specific actions taken by the employer and/or trustees in relation to contribution holidays or benefit improvements.

The public position of the unions is clear. They believe the surplus belongs to members and say it loud and long.

In terms of risk sharing this is regarded as unreasonable by employers because the cost to members is restricted e.g. 5% of salary whereas their costs fluctuate. Against that:

- most employers are not locked into funding the liabilities emerging if experience is poor, and
- most trust deeds have as their prime purpose the use of their assets to provide benefits for members.

In summary I have some sympathy for the union view. However their public stance is primarily a negotiating one - which of course is neither unreasonable nor unexpected.

In private, unions are negotiating with individual employers about the use of surplus. Usually these negotiations have been designed to secure some benefit improvement for members at a time when surplus was being used up through an employer contribution holiday or when surplus repatriation was likely.

Unions have challenged (or supported actions taken against) decisions by trustees of funds or the employers sponsoring them in relation to surplus. Later I discuss two specific cases.

The threat of industrial action by unions has proved sufficient on a number of occasions to dissuade employers from taking direct steps to repatriate surplus. Several years ago the same threat helped persuade some employers not to take a contribution holiday. That has changed and contribution holidays are usual when there is a substantial surplus. Employers are looking more closely at utilising surplus now than they did five years ago.

THE EMPLOYER PERSPECTIVE

Employers consider they should have first call on surpluses in defined benefit schemes. However typically they are sympathetic to using surplus to improve benefits, particularly where benefits are behind the market.

Five years ago employers would usually have been content to leave surpluses in funds. This attitude has changed, influenced by such things as the size of surpluses that have emerged, the publicity they have attracted, takeover activity, the state of corporate profits and the current recession. Typically surpluses are being run down by the use of a contribution holiday and generally employers are considering how any balance can be utilised in the short term. Many employers are concerned that lack of action now will mean they will lose control of surplus in a few years' time. Further, the tax deduction available to the fund for the amount of surplus returned to an employer sponsor will cease after 30 June 1995.

There have been a whole variety of actions taken by employers to run down the surplus of schemes in addition to contribution holidays. Examples are:

(1) (in funds that do not permit surplus to be paid out) establishing new funds which do permit repatriation of surplus. Members are invited to transfer to the new fund on attractive terms bringing with them a share of surplus to the new fund, and

(2) (in funds that are silent on repayment of surplus but do not preclude it) amending the deed to permit surplus repayment at the same time as some of the surplus is distributed as additional benefits, and

(3) merging funds so that a surplus in one either offsets a deficit in another or is substantially diluted.

Usually when a new fund has been set up under which surplus can be repaid, members are invited to transfer from the existing fund and are advised the implications of transfer. The quality and depth of information that members are given in such cases has improved markedly over the past few years.

WHO OWNS THE SURPLUS?

There is no simple answer to the question "who owns the surplus?" There appears unlikely to be any Government action or court decision (as have occurred in the UK and Canada) which will comprehensively clarify the situation. Accordingly ownership will depend on the individual circumstances of each fund.

As indicated earlier many funds do not have a specific clause which provides for repatriation of surplus either on wind up or during the working life of the fund. However this does not mean that the employer is precluded from access to any surplus. In many such funds it would be possible to amend the trust deed to permit surplus to be repaid with the consent of the trustees. A recent case discussed later in this paper illustrates this.

While many funds are silent on the use of surplus, most defined benefit trust deeds require the payment by the employer of contributions as determined by the trustees on actuarial advice. Sometimes the actuary alone decides; sometimes the sponsoring employer does. Typically the employer meets the balance of cost and it has been usual where funds have a substantial surplus for the actuary to certify that no employer contribution is required in the short term. In these cases the employer effectively has access to the surplus but no direct payment is involved. Sometimes it will take many years to use up the surplus.

While an employer's responsibility to meet the "balance of cost" is typical of defined benefit funds, there are substantial variations. While most funds require the employer to meet the balance of the cost, some place a maximum rate on the employer's contribution, others require some sharing of the cost between employer and members above a pre determined level.

Normally while the funds are structured on the basis of the employer meeting the balance of cost, the employer is not in fact legally compelled to contribute. There have been fund insolvencies because the employer refused to meet the cost involved. Most large ongoing employers would believe this is an extreme situation and only likely to occur if the company itself was going to be wound up.

In summary, for most defined benefit funds employers can claim ownership of the surplus via the contribution holiday route. The issue becomes more clouded where employers wish to have surplus repatriated. If the deed can be amended to permit this, it is probable that some sharing of surplus would occur.

ACCOUNTING STANDARDS

The Australian Securities Commission requires public companies to disclose the superannuation funds they operate, whether vested benefits are soundly funded and where there are deficiencies, the extent of them.

As yet there is no Accounting Standard on how superannuation surpluses should be recognised in corporate accounts. However in August 1991 the Australian Accounting Research Foundation (AARF) published an exposure draft of a new accounting standard (ED53) which proposes that surpluses in defined benefit schemes be recognised in a corporation's accounts. The proposed standard has some controversial elements and is currently under discussion. The major areas of contention are that it requires a company to report:

(1) as a liability, any deficit in a superannuation fund even though it may not be legally bound to make good the deficit,

(2) as an asset, any surplus in a superannuation fund even though the company may have no access or only limited access to that surplus,

(3) in its profit and loss statement each year, the full change in surplus or deficit arising from experience. For this purpose assets are valued at market value less realisation costs. In other words there is no concept of spreading experience gains or losses as occurs in SSAP24 and FAS87.

If ED53 is adopted then surpluses will be reported by companies as assets. Once this occurs there will be no point in companies repatriating surplus merely to bolster their profit and loss accounts in a particular year. However it may increase pressure to ensure that this reported asset is utilised for the benefit of the company. This suggests some speeding up of the repatriation process.

Undoubtedly the union movement will have something to say on ED53. It assumes the surplus belongs to the sponsoring company, not the members of the fund!

RELEVANT LEGAL CASES

There have been relatively few cases in Australia which deal with surpluses in superannuation funds. Australian law has much in common with the laws of other countries which form part of the former British Empire and precedents in other jurisdictions are considered when a case comes up. Since 1978 there have been four cases of interest, three involving surpluses and one a deficit.

Case 1 - Metro Goldwyn Mayer

The winding up provision of this small fund was to pay benefits in accordance with the rules. It also had a provision that excess assets could be used to pay benefits to former members or dependants as nominated by the company or to meet the company contributions.

Deed amendments needed to be executed both by the company and trustees and could be made "provided they did not prejudice <u>any</u> benefit secured by contributions made on behalf of any member prior to the date of such alteration".

Assets were about 4 times the size of benefits accrued. The major source of excess assets were "forfeited benefits" i.e. company contributions in respect of employees who left service before they were fully vested.

The company asked the trustees to agree to an amendment which permitted excess assets to be repaid to the company. The trustees sought a court determination as to its validity.

The company contended that "benefits secured" only related to normal benefits payable in terms of the rules, not to any windfall which might arise on winding up. The members argued that they had a right both to the benefits they would normally be entitled to and any windfall on winding up.

The judge upheld the view of the members. It appears that the words "any benefits" in the amendment clause were important. Had the words used been "the benefits" then the company's argument might have succeeded.

Case 2 - James Miller Holdings

In this case a deficit existed. The company was the trustee and the trust deed could not be amended without the consent of the National Mutual Life Association (NMLA) which administered it.

The deed provided the company could cease contributions on three months' notice after which period the fund would be closed. Assets would then be equitably apportioned amongst members and paid when they eventually retired. Amendments could be made to the fund provided they did not detrimentally affect benefits already secured for a member without his consent in writing.

The company went into receivership and the receivers realised fund assets would be insufficient to meet benefits accrued. Giving three months' notice of closing the Fund would exacerbate the problem since those leaving within the three months would receive full benefits and those remaining would have their benefits eroded.

The receivers sought to prevent inequity by:

(1) announcing that all employees were terminated on a particular date and that they were then immediately re-employed, and

(2) by agreeing with NMLA that the Fund would be treated as terminated on that particular date.

An amendment to the trust deed was executed about a month later which had the effect of waiving the three month notice period for terminating the fund and which was to take effect one day before the agreed termination date.

In this case the judge concluded that:

- the employment termination announcement did not terminate employment,
- the amendment was invalid because the deed did not permit retrospective amendments, and
- even if the deed had permitted retrospective amendments, the particular amendment would still have been invalid because it would prejudice benefits for those members who left within the three month period.

Thus the intention of the receivers was defeated.

Case 3 - Shell Australia

This was a large fund which did not permit surplus to be repatriated to the employer. It had a substantial surplus and the employer was on a contribution holiday. Shell had agreed with its unions in 1987 to provide improvements through the fund to reflect the 3% award. The cost of these improvements was being financed out of surplus.

Shell decided to establish a new fund which would permit a refund to it of the excess of net market value of assets over 125% of the face value of accrued lump sum benefits plus 125% of the actuarial value of pensions being paid. Members of the existing fund were invited to transfer on attractive terms and they brought with them a share of surplus in the existing fund. 98% of members elected to transfer. Some objected and appealed to the Industrial Relations Commission through their unions to overturn Shell's action.

The main thrust of their claims was:

(1) the 3% award agreement required Shell to contribute to the fund and it was not agreed that the cost could be financed from surplus. The unions claim that Shell should now contribute to the new and existing funds, the amounts due under the agreement from 1 July 1987,

(2) whether or not there is a surplus should be determined jointly by two actuaries, one representing the employers and the other the union, and

(3) if there is a surplus Shell should ensure 50% of it is distributed as a fully vested account to those members at 30 June 1990 who were also union members.

This is an interesting turn of affairs because the appeal is not being made through the Equity Court on the legal merits of Shell's action but through an industrial tribunal. The main advantages to the member are that the industrial remedy are much quicker and cheaper. Accordingly employees are increasing challenging superannuation issues in this way and a power only exists under S.88F of the NSW Industrial Arbitration Act.

Where the Commission has jurisdiction there is the prospect not only of the employer decision being reversed but the Commission going further and ordering a different distribution altogether.

The first step was for the Commission to decide whether or not it had jurisdiction in this particular case. It ruled that it did. Shell has appealed to the High Court against this ruling. The appeal is due to be heard in April 1992.

Case 4 - Westpac Banking Corporation

Westpac has a large fund for its employees with assets of over $A2 billion (about $US 1.5 billion). During the 1980's it generated a substantial surplus which was more than sufficient to finance future employer contributions for all members.

The deed was silent on surplus repatriation but did provide that on dissolution assets were to be distributed equitably by the trustees on actuarial advice taking into account the provisions of the deed and any other circumstances considered relevant. The deed also provided that it could be amended by Westpac, with the consent of trustees, provided that either the actuary certified the value of accrued rights of members, dependants and pensioners at the date of alteration were not reduced or 75% of members consented to the amendment.

Westpac resolved to amend the deed to enable surplus to be dealt with in a number of ways including benefit improvements, reduction of member contributions, establishment of a reserve account and repatriation of surplus to Westpac. It also proposed that trustees agree to repay $A300 million to Westpac and to use $A300 million to improve benefits to members. The trustees of the scheme (of whom four were elected by members and four nominated by Westpac) unanimously consented to the proposed amendment and action.

A member (with union support) challenged the validity of the amendment and trustees' actions claiming that:

- in the event of dissolution Westpac did not have any entitlement to surplus assets,

- Westpac owed a fiduciary duty to scheme beneficiaries and was not entitled to amend the scheme for its own benefit, and
- the trustees breached their fiduciary duty in amending the deed.

The judge found against the claimant and in favour of the action taken by the trustees and Westpac. He concluded that:

(1) on dissolution there would be a resulting trust in favour of Westpac if there was surplus assets after meeting members benefits as provided in the deed,

(2) Westpac was entitled to act in its own interests while recognising it had a duty to the beneficiaries of the scheme,

(3) the trustees were entitled to consider the interests of Westpac, and

(4) if the trustees concluded the overall package of changes to the scheme and the proposed disposition of surplus were reasonable from all points of view, they were entitled to consent to the amendment.

This last decision is regarded as a landmark case. However as with any other case it cannot necessarily be translated generally to other funds, each of which will have features peculiar to its own circumstances. In particular, initial reaction to (4) above has been that the judge might have considered the trustees to be in breach of their fiduciary duty if the changes had just allowed Westpac to access the surplus (i.e. no improved benefits for members).

SURPLUS IN TRANSFER SITUATIONS

This paper has focussed primarily on the disposition of surplus in an existing fund. However in practice, probably more issues arise where one company sells part of its business and assets need to be transferred from the superannuation fund of the vendor to that of the purchaser.

The deeds of the great majority of funds will have a clause which permits transfer, although often the definition of how the amount to be transferred is to be determined is far from clear. Further confusion can arise where there are several clauses with different provisions which could be applied eg. a clause relating to transfers out, another covering the withdrawal of an associated company, another covering termination of a group of members.

Often the relevant clause has been drafted with no concept that the fund may be in surplus or deficit e.g. an "equitable share" of the assets will be transferred. Sometimes the clause requires transfer of the actuarial value of accrued benefits which may preclude the transfer of a share of any surplus (and the reduction of transfer values by a share of any deficit!) In some deeds the trustees decide the amount of assets to be transferred whereas in others the sponsoring employer has control.

The terms of the purchase/sale agreement will set down conditions for the protection of superannuation rights. In the past actuarial advice was often sought after the agreement has been struck. That in itself has caused plenty of problems because often:

- the definition of the value of accrued benefits was sufficiently vague to permit wide interpretations,
- the trust deed of the fund and its financial status were not taken into account in drafting the agreement. (On occasion there has been a conflict between the agreement and the trust deed!)

Increasingly today actuarial advice is sought before sale agreements are finalised. In an ideal world consideration will have been given to the deed and funding status of the vendor's fund before the agreement is signed. Also ideally the sale price will reflect if surplus can be (and is to be) transferred.

Of course we live in a less than perfect world!

In recent years many funds have been amended to clarify the transfer clause and reflect the intention of the sponsoring employer or give it control over the determination of transfer values.

To date there have been no Australian legal cases involving transfers of assets between superannuation funds following mergers or acquisitions.

WHERE TO FROM HERE?

Surplus in defined benefit funds will continue to be an issue. While investment conditions are not as favourable as in the mid 1980's, funds generally remain in a healthy state and many have material surpluses. Inflation is currently running at the

lowest level seen for 30 years. As a consequence funds already in surplus might continue to maintain their surplus levels even though they are on contribution holidays.

The potential for unions to challenge fund amendments or to seek a share of surplus is likely to encourage employers to take early action to secure control of the surplus and use it at least partly for their own benefit.

The taxation system also encourages early action on surplus. This is because a fund which repatriates surplus receives a 15% tax deduction for any surplus repaid prior to 1 July 1995.

Interesting times lie ahead!