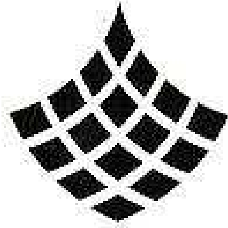

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Towards more equitable taxation and means testing treatment of untaxed-source defined benefit pensions

Tax Forum, Canberra, October 4 and 5, 2011
Forum sessions on:

- **Personal tax**
- **Transfer payments**

A submission from the South Australian Government Superannuated Employees Association (***trading as SA Superannuants***).

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Summary

- Untaxed-source defined benefit pensions have gross values larger than would be the case if the pensions had been paid from a taxed source, the difference being in the range 0-8% and greater for pensions that have commenced recently. However, until 1 July 2007, the 15% tax offset available on the smaller taxed-source pensions gave them larger after-tax values.
- The *Simpler Super* reforms of 2007, which saw taxed-source pensions become tax-free after age 60, and untaxed source pensions eligible for a 10% tax offset, made the after-tax values of untaxed-source and the equivalent taxed-source pensions more equal but introduced a difference between tax payable on non-superannuation income for the two types of pension.
- *Simpler Super* also introduced a difference between the severity of means testing for untaxed-source versus taxed-source defined benefit pensions. The latter were assigned a pre-1 July 1983 component which was both tax-free and exempt income under the age pension income test. This change has seen taxed-source defined benefit pension recipients receiving significantly more in age pension payments than people with equivalent untaxed-source pensions. *Commonwealth Seniors Health Card* applicants have none of a taxed-source pension counted in determining their eligibility while all, or nearly all, of an untaxed-source pension is counted.
- Over the period 1995/96 – 2010/11, and for pensions having values representative of most recipients, the combined effect of tax and means-testing differences has been to depress net incomes for untaxed-source pension recipients compared to what net incomes would be if the pensions had been paid from a taxed source.
- Over a 20 year period allocated-pension recipients drawing the same superannuation income as an untaxed-source pension recipients receive significantly more in age pension payments.
- The tax and means testing disadvantages being experienced by recipients of untaxed-source defined benefit pensions compared to other retirees of equivalent private means are significant holes in the integrity of the tax and transfer systems. But they are holes which could be closed by policy changes that would be simple to implement. In particular, if non-superannuation income was taxed separately after age 60, and the proportion of an untaxed-source pension counted in the income test set at 75% of the pension's gross value, the disadvantages currently being experienced by recipients of those pensions would be largely eliminated.
- Each of the *Australia's Future Tax System* **Recommendation 2** for changes to personal income tax rules and **Recommendation 88** for a comprehensive means test has the potential to increase the inequity of tax and means testing arrangements for recipients of untaxed-source pensions.

Introduction

The *South Australian Government Superannuated Employees Association* (trading as SA Superannuants) represents the interests of members of the South Australian Government's Pension Scheme. This scheme, which was closed to new members in 1986, pays lifetime defined benefit pensions to former employees of the South Australian public sector. The pensions are paid entirely from an untaxed source and there are about 15,000 pensions currently being paid.

Other untaxed-source defined benefit pensions are paid by the Commonwealth Government to its former military and civilian employees and by West Australia and Tasmania. Victoria and New South Wales pay taxed-source defined benefit pensions. Across Australia hundreds of thousands of people rely on untaxed-source pensions as their main source of retirement income.

The fact that New South Wales and Victoria elected to have their pension funds subject to taxation after 1988, when taxes were imposed on fund income, while the Commonwealth, South Australia West Australia and Tasmania elected to keep at least the employer-funded components of their pension schemes outside the new taxation regime, raises the obvious question- which arrangement is in the best interests of members?

Where Governments decided to operate their pension funds after 1988 as untaxed sources most members have been less well off than they would have been if the funds had operated as taxed sources. From 1988 until 2007, when the 'Simpler Super' reforms took effect, this was a consequence of the different taxation status of the two types of pension.

The 10% tax offset for untaxed-source pensions provided as part of the 'Simpler Super' reforms saw taxation treatment of the two types of pension income made more equal. But these reforms also saw non-superannuation income of untaxed-source pension recipients being taxed at higher rates than that of taxed-source pension recipients. Furthermore, means testing of taxed-source pensions was relaxed. This has maintained the systematic disadvantage associated with pensions paid from untaxed-sources.

PART A: Untaxed-source superannuation pensions

What makes a superannuation pension an untaxed-source pension?

During the accumulation phase for most superannuation pensions, tax is paid on the contributions and earnings that create the assets from which the pensions will be funded. This tax reduces the gross value of the pension compared to what it would be if accumulation phase taxes had not been paid. Such pensions are the norm and are called **taxed-source pensions.**

Government pension funds may accumulate assets that will eventually support pensions without paying the contributions tax or the tax on earnings. Government funds may also simply pay pensions from Government revenue as the pension payments fall due. Such pensions are not depleted in their gross values by accumulation phase taxes and are consequently called **untaxed-source pensions.** They have larger gross pension values than would be the case if the same amount of money needed to pay them had been subject to taxation during the accumulation phase. But, after age sixty, the untaxed-source pension remains taxable income, with the result that any other income a person has, including age pension, is taxed at a marginal rate for the combined income. Where a superannuation pension is from a taxed source, after age 60, other income is taxed as if it is the only income. Furthermore, at age 65 the untaxed-source pension has all, or nearly all, of its gross value counted for means testing purposes whereas a substantial part of a taxed-source pension is usually not counted.

The combined effect of tax and means testing differences between untaxed-source and taxed-source pensions has not previously been the subject of a detailed analysis to see if one or the other type of pension provides its recipient with a systematic advantage as far as net retirement income is concerned. Or, if there has been such an analysis carried out, the results are not readily accessible.

Australia's Future Tax System (AFTS) review and untaxed-source pensions

SA Superannuants, and others, made submissions to the AFTS review drawing attention to the unfairness of the taxation treatment of non-superannuation income for recipients of untaxed-source

pensions. Unfortunately the AFTS consideration of this matter was quite superficial. On page 26 of the *Retirement Income Consultation Paper,* published by the AFTS review in December 2008, and referring to a taxed-source pension of $40,000 p.a., the statement was made that:

The individual taking a pension from the taxed fund has already pre-paid tax on this pension amount. If it is assumed that this is at the rate of 15 per cent the member of the taxed fund has already paid tax on their pension of $7,058.

Following publication of this statement SA Superannuants made a supplementary submission to the AFTS entitled *A Valid Comparison of Net Values for Taxed and Untaxed Source Defined Benefit Pensions.* The submission advised the AFTS, giving detailed reasons, that its assumption of 15% tax prepaid by members of taxed funds was incorrect with the actual amount of pre-paid tax being nowhere near this much. The effect of pre-paid tax (tax on contributions and earnings paid during the accumulation phase of the pension) on the gross value of a taxed-source pension depends on the proportion of the pension that has been funded by member contributions made from after-tax salary and on the proportion of the person's membership of the pension scheme completed before 1 July 1988 when the taxes on contributions and earnings first became payable.

For Super SA pensions commencing in different years the value the pensions would have if they had been paid from a taxed-source (i.e. the value of the equivalent taxed-source pension) are expressed as a percentage of the actual Super SA pension value (100%) in Table 1. The assumptions made in the compilation of Table 1 and the method of determining the relativities between the Super SA and equivalent taxed-source pension values are set out in Appendix 1.

Table 1: Super SA pensions and their taxed-source equivalents

Commencement year	Super SA pension	Equivalent taxed-source pension
2010/11	100%	92% (8% reduction)
2005/6	100%	94% (6% reduction)
2000/1	100%	96% (4% reduction)
1995/6	100%	98% (2% reduction)
1986/87	100%	100% (0% reduction)

PART B: Net Incomes from Super SA and equivalent taxed-source pensions

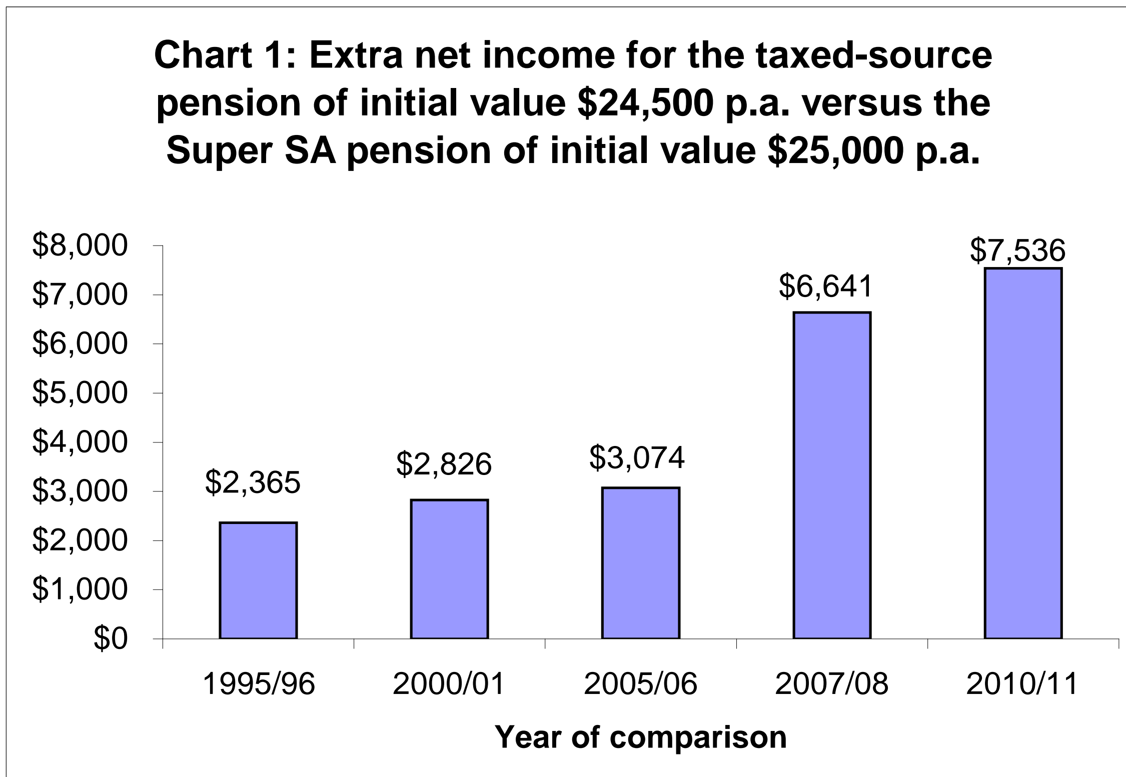
In this part the net incomes provided by Super SA pensions are compared with those provided by the equivalent taxed-source pensions. In the first comparison a Super SA pension of $25,000 p.a. commencing in July 1995 is compared with the equivalent taxed-source pension of $24,500 p. a. (2% less than the Super SA pension, see Table 1). The pensions are compared in each of five different years from 1995/6 until 2010/11. In a second comparison a $50,000 p.a. Super SA pension is compared, for the single year of 2010/11, with the equivalent taxed-source pension of $46,000 p.a. (8% less than the Super SA pension, see table 1). Both comparisons are made for couples where the defined benefit pension income is in the hands of one partner. Application of the analysis to single people provides results that are qualitatively similar.

The pension values used in these comparisons are 'round figures' likely to be less than the average Super SA pension commencing in that year. The basis for saying this is as follows:

- The 2010 triennial actuarial review of the South Australian pension scheme reported that, at 30 June 2010, there were 2,734 contributors with total salaries of $235.0 million. This gives an average salary of $85,954 p.a. Assuming a pension value of two thirds of salary gives an estimate of $57,245 p.a. for the average pension commencing in the year beginning 1 July 2010.
- In the period August 1995 to August 2010 male total ordinary time weekly earnings for South Australia increased from $640 to $1200 i.e. roughly doubled. On this basis a Super SA pension value of $25,000 p.a. is likely to be less than the average value of pensions commencing in 1995/6.

Net Incomes from pensions commencing on 1-7-1995

Chart 1 displays the extra net income provided by a $24,500 p.a. taxed-source pension compared to a Super SA pension of $25,000 p.a. at intervals over the period 1995/96 – 2010/11



Note: A full account of the assumptions made in calculating these extra net income values, and the breakdown of income and tax amounts for the two pensions, is provided in Appendix 2.

Discussion of Chart 1

- For the years 1995/6, 2000/1 and 2005/6 the extra net income for the taxed-source pension is due to the 15% tax offset that recipients were able to claim. This offset, combined with the

others available to both couples, reduced tax payable on the $24,500 p.a. pension to zero leaving only the medicare levy to be paid. The couple with the Super SA pension of $25,000 p.a., after applying the tax offsets available to them, still has a substantial tax bill to pay on top of the medicare levy (see Appendix 2).

- For the years 2007/8 and 2010/11 the extra net income for the taxed-source pension becomes more than double the value for 2005/6. The reason for this is that the *Simpler Super* reforms of 2007 saw taxed-source pensions assigned a new component that was both tax-free and not counted in the age pension income test. The new component is called the *pre-1 July 1983 component* and it is, more or less, the same proportion of the pension as the member's service completed before 1-July 1983 is a proportion of his/her eligible service period. The pre-1 July 1983 component is discussed in detail in Appendix 2. Having a pre-1 July 1983 component to their pension saw the couple with the taxed-source pension having only 46% of the pension counted in the income test from 1 July 2007. This provided about $7,000 p.a. more in age pension than the Super SA couple from 1 July 2007 even though the difference in superannuation income for the two couples is less than $1,000 p.a. (see Appendix 2).

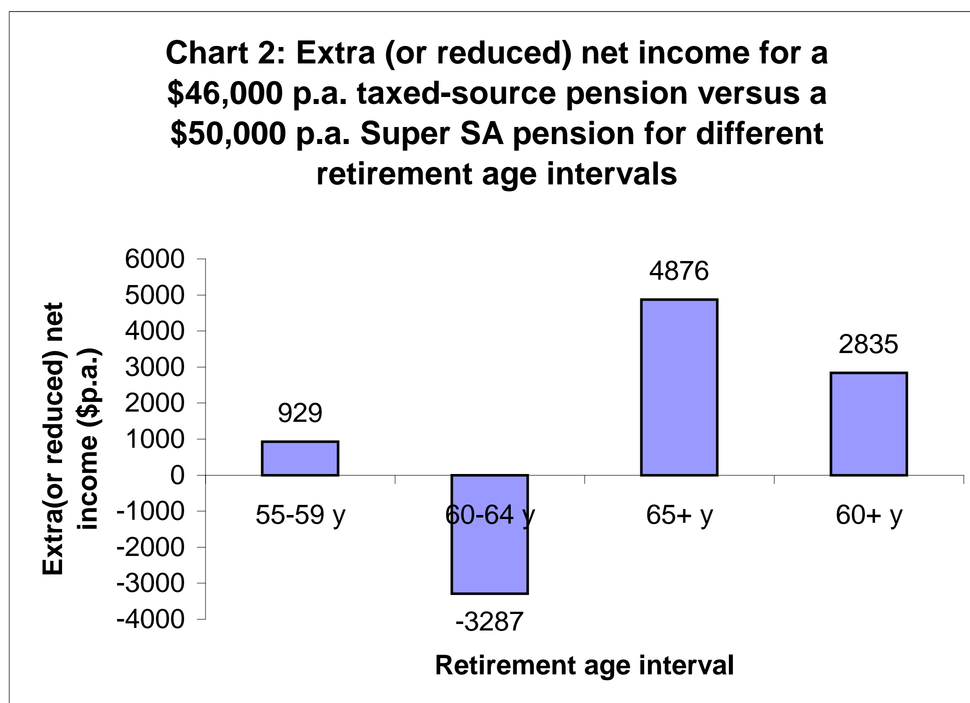
- In 2007/8 and 2010/11 there was little difference between the after-tax values of the two pensions. The reason is that, from 1 July 2007, a 10% tax offset became available on the Super SA pension and this reduced the tax payable on the pension to zero. After 1 July 2007, taxed-source pensions became tax-free but, as explained above, the tax payable on the taxed-source pension was already zero because of the availability of the 15% tax offset on the taxable amount of taxed-source pensions. The only improvement in the net income from this taxed-source pension, as a result of it becoming tax-free, was that the medicare levy was no longer payable.

The effect of other income: if the couples receiving the pensions compared in Chart 1 have additional income the extra net income for the taxed-source pension couple will be even greater. Up until 2007/8 the reason for this is that the taxed-source pension couple has tax offsets that they are not using whereas the Super SA couple has used all the tax offsets available to them. In 2007/8 taxed-source pension income became tax-free after age 60. This saw the taxed-source pension couple get the benefit of a tax-free threshold for their other income and the amount of tax offsets available to them to reduce the tax payable on any other income increased. As a result, people with taxed-source pensions having other taxable income do not pay tax on that other income until it is very substantial and no matter how large the taxed-source pension is. Once a Super SA pension is large enough to make its recipient a tax-payer any other income will be taxed at a marginal rate of at least 31.5%.

Super SA and taxed-source pensions commencing on 1 July 2010

The 'Simpler Super' reforms of 2007 made the tax and/or means testing treatment of defined benefit pensions significantly different for the age intervals 55-59 y, 60-64 y and 65+ y. Furthermore the *Australia's Future Tax System* (AFTS) review included in its final report a **Recommendation 2** for the *Low Income* and *Senior Australians Tax Offsets* to be abolished and replaced by a higher tax-free threshold and flat tax rate for most taxable incomes above the threshold. **Recommendation 2** has the potential to further reduce the net incomes of untaxed-source pension recipients compared to those with the equivalent taxed-source pensions.

For this comparison, values of $50,000 p.a. for a Super SA pension and $46,000 p.a. for the equivalent taxed-source pension (8% less than the Super SA pension, see Table 1 above) are used. Net income values for the two pensions were calculated for the three different retirement age intervals assuming that couples had no other private taxable income and that neither the Newstart allowance nor the Disability Support pension was being claimed before age 65. The result was that the taxed-source pension provided more net income for the 55-59 y and 65+ y retirement age intervals while the Super SA pension provided more for the 60-64 y interval. This is displayed in Chart 2.



Note: the assumptions made in calculating these net income values, and the breakdown of income and tax amounts for the two pensions is provided in Appendix 3.

Discussion of Chart 2

- For the retirement age interval 55-59 y the extra net income ($929) for the taxed-source pension is due to the availability of the 15% tax offset, and the tax-free 1-July 1983 component of the pension. The effect of these is more than sufficient to make up for the smaller gross value of the taxed-source pension.
- From age 60-64 y it is the Super SA pension that delivers extra net income ($3,287 p.a.) and this is due to the availability of the 10% tax offset after age 60. This offset reduces tax payable on the Super SA pension to zero and its larger gross value moves it in front of the taxed-source pension. However, the taxed-source pension couple will be better off than the Super SA couple if, for both couples, there is other private, taxable income of more than about $12,000 p.a. and/or the Newstart allowance or Disability Support Pension is being claimed.
- For the 65+ retirement age interval the extra net income ($4,876 p.a.) for the taxed-source pension is due to both extra age pension for the taxed-source pension and tax/medicare payable on the Super SA pension.
- For the 60+ y retirement interval the extra net income ($2,835 p.a.) for the taxed source pension has been calculated by combining the values for the 60-64 y and 65+ y intervals. The 65+ y interval was taken to be 65-80 y (15 y) i.e. three times as long as the 60-64 y interval and $2,835 is an average for the two periods weighted for their different lengths.

If the *Australia's Future Tax System* Recommendation 2 is adopted net incomes for the $50,000 p.a. Super SA pension will move further behind those for the $46,000 p.a. taxed-source pension. This illustrates the fact that tax rules are now irrelevant for the large majority of retirees who receive their private income from taxed-source superannuation funds. It is possible for such retirees to have very large superannuation incomes **and** substantial additional income while paying no tax. In contrast to this untaxed-source pension recipients remain exposed to the risk of having their net incomes reduced through changes to tax rules. This is a good reason why the properties of untaxed-source pensions need to be taken into account as personal income tax policy is developed.

Summarising the results displayed in Chart 2 one may say that a $46,000 p.a. taxed-source pension commencing in 2010/11 will provide couples with a higher standard of living in retirement than a $50,000 p.a. Super SA pension except where the Super SA couple begin their retirement close to age 60 and are dead soon after age 65.

PART C: Comparison of Super SA pensions and allocated pensions

Taxation of contributions and earnings in the accumulation phase

The recipient of a Super SA pension is, during the accumulation phase for the pension, required to make a personal contribution from after-tax salary, with the standard rate of contribution being 6% of gross salary. Assuming a marginal tax rate of 31.5% this requires a contribution having a before-tax value of 6 x 100/68.5 = 8.76% of gross salary. So during the accumulation phase of his/her pension the Super SA pension recipient has, each year, paid tax equal to 2.76% of salary as well as paying 6% of salary as a contribution to the South Australian Superannuation fund. This 2.76% of gross salary may be thought of as a contributions tax.

Assuming that the account balance for an allocated pension has resulted from employer contributions of 9% (the Superannuation Guarantee) and personal salary sacrifice contributions of 8.76% (the same level of contribution that a Super SA pension recipient makes) the contribution tax payable by the super fund on the contributions of 17.76% of salary will be 17.76 x 0.15 = 2.66% of gross salary. Now it must be remembered that the Super SA pension recipient has paid his/her 'contribution tax' every year since joining the South Australian pension scheme and, in most cases, for years before 1988. An allocated pension recipient contributing over the same period did not begin to pay contributions tax until 1988. On the other hand, for the allocated pension it is not just the 15% contribution tax that has been paid since 1988, there has also been a tax on earnings that has been paid. Tax has not been paid on the earnings of the contributions that the Super SA pension recipient has made.

It seems reasonable to conclude from the above that, for people who are now aged over 55, there is not much difference between tax paid in the accumulation phase by those with allocated pensions and those with Super SA pensions. Furthermore, after age 60, it can only be the Super SA pension recipient who pays any tax and medicare on the superannuation income Where there is a significant amount of non-superannuation income the allocated pension recipient will have that taxed as if it is the only income and, consequently, pay less tax on that other income than the Super SA pension recipient will pay on the same amount of additional income.

Means testing

Before age pension age: for defined benefit pensions there is no difference in means testing before and after age pension age. But a person who has an unpreserved, account-based superannuation interest has the option of delaying the commencement of his/her allocated pension and taking income from the account in the form of withdrawals. The withdrawals are not assessed as income for either the Newstart Allowance or Disability Support Pension and the account balance is not assessed as an asset. This allows a couple to collect a full Newstart Allowance (currently $22,292 p.a.) or Disability Support Pension (currently $28,584 p.a.) for up to 10 years before age pension age and regardless of the amount of a superannuation account balance they hold, or the amount of withdrawals they make from it.

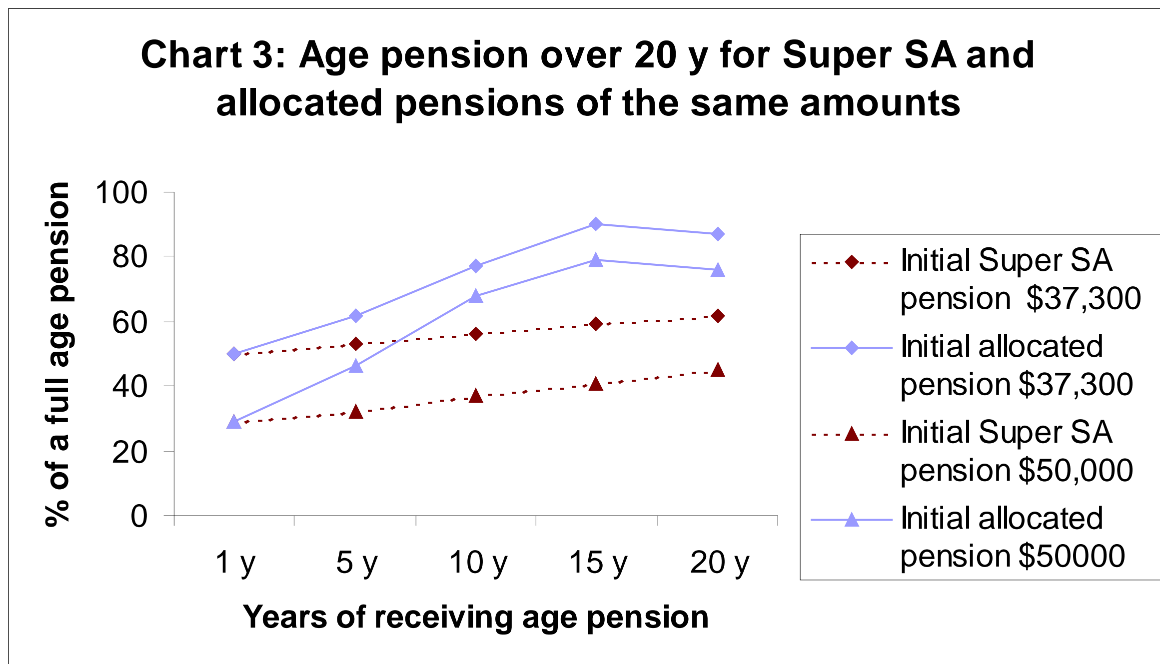
A couple in receipt of a Super SA pension of $36,800 p.a. would be eligible for 50% of a Disability Support Pension or 28 % of a full Newstart Allowance while a couple making withdrawals of $36,800 p.a. from a superannuation account with a balance of any amount will be eligible for 100% of whichever payment applies to them. When a Super SA pension has a value of $50,000 p.a. a couple receiving the pension will be eligible for 29% of a Disability Support Pension and no Newstart Allowance. A couple making withdrawals of $50,000 p.a. from a superannuation account will remain eligible for 100% of each payment.

After age pension age: Super SA pensions nearly always have their age pension payment determined under the income test, with 95% or more of the pension being counted. The pensions have an asset value of $0 for asset test purposes reflecting the fact that they cannot be cashed in except under very restricted and prescribed conditions. Means testing of allocated pensions sees them assessed under both the assets test and the income test reflecting the fact they can usually be cashed in. When age pension payments commence it is usually the asset test that determines the

payment for an allocated pension but as capital is drawn down and the allocated pension amount is increased there may be a switch to the income test as the determinant of the age pension payment.

Comparing age pension payments over 20 y for Super SA and allocated pensions
In Chart 3 Super SA pensions of $37,300 p.a. and $50,000 p.a. are compared with allocated pensions of the same value and having initial account balances that qualify couples for the same proportion of a full age pension as do the Super SA pensions. These account balances are $581,000 for the $37,300 p.a. allocated pension and $736,000 for the $50,000 p.a. pension. For the Super SA pensions 95% of the gross pension value is counted in the income test.

Chart 3 covers a 20 year period after the commencement of age pension payments with the amount of the age pension payment being expressed as a percentage of a full age pension. Throughout the 20 year period the allocated pension annual amount has been held equal to the defined benefit pension amount and at the end of the 20 year period there is still an account balance for each allocated pension (see Appendix 4).



Note: A full account of the assumptions made in calculating the values plotted in the chart, the breakdown of super income, age pension income for the two pensions and account balances for the allocated pensions is provided in Appendix 4.

Discussion of Chart 3

- While a Super SA pension and allocated pension of the same amount initially give the same part age pension entitlement, the entitlement of the allocated pension couple, over time, moves well ahead of that of the Super SA couple. The reason for this is that, for most of the 20 years, the part age pension payment to allocated pension couples is controlled by their account balances rather than the annual pension amounts or deemed incomes. As allocated pension account balances are diminishing in their dollar amounts the asset cutout point for age pension is increasing at a rate greater than the CPI. Thus there are two factors pushing up part age pension payments for allocated pension recipients. For Super SA pension recipients part age pensions also go up because they are determined under the income test and the pension values increase at a rate less than the rate of increase of the age pension cutout point. But this is the only factor pushing up part age pension entitlements for Super SA pension recipients and so they fall behind their allocated pension counterparts.
- For the initial super pension value of $37,300 p.a. after 15 years of receiving a part age pension the allocated pension couple has moved ahead of the Super SA couple by 31% of a full age pension. The allocated pension couple has their part age pension increase from 50% of a full age pension to 90% and the Super SA couple's part-age pension increases from 50% to 59% of a full age pension (see Appendix 4).

- For the initial super pension value of $50,000 p.a. after 15 years of receiving a part age pension, the allocated pension couple has moved ahead of the Super SA couple by 39% of a full age pension. The allocated pension couple has their part age pension increase from 29% of a full age pension to 80% and the Super SA couple's part-age pension increases from 29% to 41% of a full age pension (see Appendix 4).
- If the percentage of the Super SA pension counted in the income test is reduced to 75% from 95% the initial age pension payment for those pensions is greater than for allocated pensions but the twenty year average for the allocated pensions remains greater (see Appendix 4).

A Comprehensive Means Test

Recommendation 88 of the *Australia's Future Tax System* review is for adoption of a *Comprehensive Means Test* (CMT) in which assets will be deemed and the deemed income used to determine a person's entitlement under the income test.

A couple's entitlement to some age pension is currently lost under the asset test when the asset value exceeds $998,000. Under a CMT, and use of current deeming rates, this asset value would see the couple assigned a notional income of $43,830. Under current income testing arrangements this would give them an age pension entitlement of $10,101 p.a. At current deeming rates a comprehensive means test would see the asset value at which age pension entitlement for a couple is extinguished rise from $998,000 to $1,448,000. **Clearly there is the potential for the cost of a CMT to be huge and it is likely that this cost would have to be reduced by increasing the income test withdrawal rate.**

In Table 2 three Super SA pensions are compared with allocated pensions of the same amounts being drawn down from account balances that currently provide the same age pension payment under the asset test. Comparisons are made for three means testing circumstances:

- The current means testing rules
- A comprehensive means test with an income test withdrawal rate of 50 cents (CMT50)
- A comprehensive means test with an income test withdrawal rate of 60 cents (CMT60)

Table 2

Type of private means	Level of private means		Age pension entitlements (% of a full age pension)		
	Annual income	Account balance	Means testing arrangements		
			Current	CMT50	CMT60
Super SA pension 1	$13,200	Not applicable	90%	90%	88%
Allocated pension 1	$13,200	$288,000	90%	91%	90%
Super SA pension 2	$37,300	Not applicable	50%	50%	41%
Allocated pension 2	$37,300	$581,000	50%	68%	62%
Super SA pension 3	$61,300	Not applicable	10%	10%	0%
Allocated pension 3	$61,300	$875,000	10%	45%	34%

Table 2 shows that, for Super SA and allocated pensions of the same annual amount, abolition of the asset test and its replacement by a comprehensive means test will increase part age pension payments for allocated pension recipients with current age pension entitlements above 10% of a full age pension (account balances greater than $288,000). For the two higher super pension amounts the extra age pension payment for allocated pensions under the CMT is greater for both an income test withdrawal rate of 50 cents and 60 cents. However if the income test withdrawal rate was to increase to 60 cents the Super SA pension couples will receive less age pension than now. All this is displayed graphically in Chart 4.

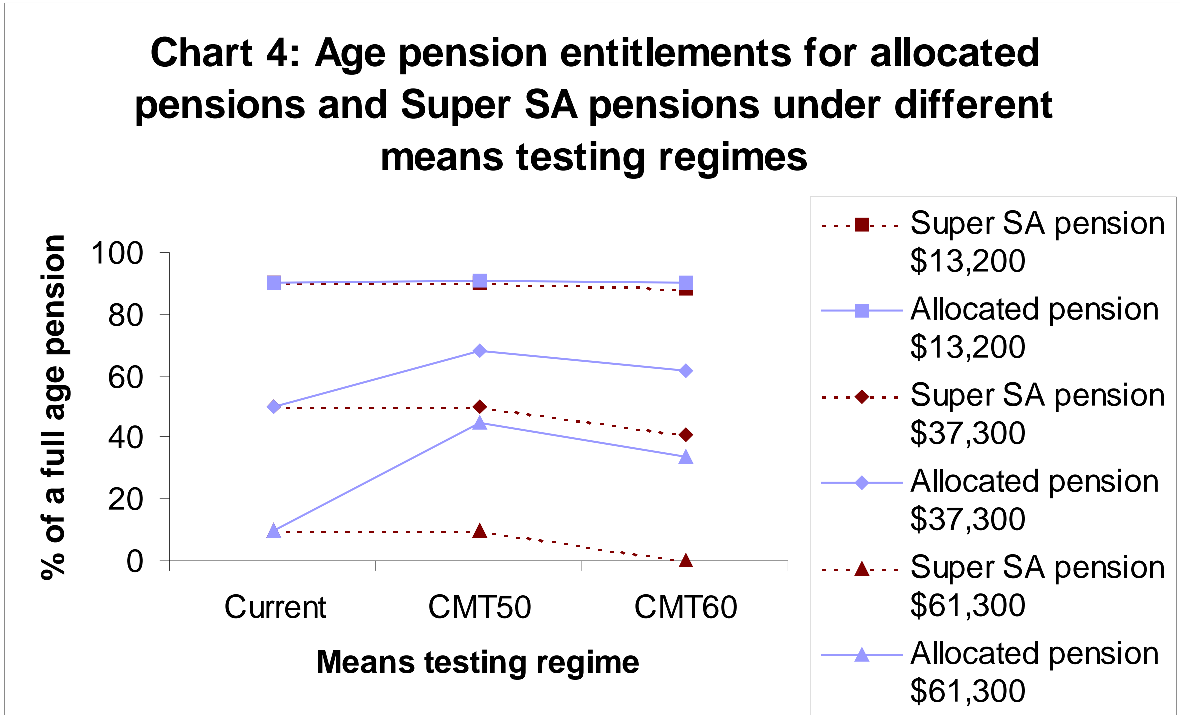


Chart 4 highlights the fact that the Comprehensive Means Test will be regressive as well as costly. The increase in age pension entitlement under both CMT50 and CMT60 is greatest for allocated pension recipients when private means is greatest. Under CMT60 the allocated pension couple with a $13,200 p.a. pension will receive no increase in age pension while a couple with an allocated pension of $61,300 will move from 10% of a full age pension to 34%.

For Super SA pension recipients, and other income-tested part age pensioners, the Comprehensive Means Test represents a significant risk of reduced incomes. For example, the Super SA pension recipient with a $61,300 p.a. pension (95% of which is counted in the income test) will move from receiving 10% of a full age pension now to being ineligible under CMT60.

PART D: Reducing inequities

Setting a fair proportion of an untaxed-source pension to be counted in the income test.
The analysis above supports a change to the age pension income test which would see less of an untaxed-source superannuation pension being counted. In its Recommendation 88 for introduction of a comprehensive means test the *Australia's Future Tax System* (AFTS) review says:

> …Superannuation income streams where deeming income would be difficult to apply would be tested on gross income but with an actuarially fair deduction for capital….

Presumably an untaxed-source defined benefit pension is an example of an income stream 'where deeming income would be difficult to apply'. Under the age pension asset test the asset value for a defined benefit pension is $0 because the pensions cannot be exchanged for cash except in prescribed circumstances. Obviously, it would not be appropriate to use an asset value of $0 for a defined benefit pension to calculate a deemed income of $0 p.a. for the pension. This would see everyone with a defined benefit pension getting a full age pension as well.

However, the fact is that defined benefit pensions do have actuarially determined values and these values are already being used in Family Law settlements. In its recent consultation paper on superannuation contribution caps, which has little to do with Family Law, the Government proposed to use the Family Law methodology to assign pension values. Consequently, there would seem to be no good reason why the proportion of an untaxed-source defined benefit pension to be used in the income test could not be determined through a **'deeming of actuarial value'** approach. Thus:

> The actuarial valuation factor for Super SA pension, being paid to a 65 year old male, is 13.05. This provides an actuarial value for a $50,000 p.a. pension of 13.05 x $50,000 = $652,500. Deeming of this sum provides a deemed income of $28,260 p.a. or 56% of the pension's gross amount.

An alternative, that would also be reasonable and more equitable than the current arrangement, would be to apply an **'income disregards'** approach to obtain the proportion of an untaxed-source superannuation pension counted in the income test. Thus:

> When financial assets are deemed for income test purposes the effect is that a substantial fraction of the income that the assets will provide is disregarded. For example, the current maximum deeming rate is 4.5% when bank term deposit rates of 6% are readily available. So the deeming rate disregards more than 25% of probable investment income. It also disregards running down of assets. On this basis it would seem reasonable for means testing to disregard at least 25% of the gross amount of an untaxed-source pension.

From these two examples one might say it would be equitable for the proportion of an untaxed-source pension counted in the income test to lie somewhere in the range 55-75%.

Achieving more equal net incomes for untaxed and taxed-source pensions.
Table 3 lists a set of remedies for inequities in the current arrangements for taxation and means testing of the incomes of untaxed-source pension recipients. Of these remedies the most effective will be separate taxation of non-superannuation income and counting 75% of the untaxed-source pension's gross amount in the income test and when determining *Commonwealth Seniors Health Card* eligibility. If both these remedies were applied the effect would be as displayed in Table 4 and Chart 5 below.

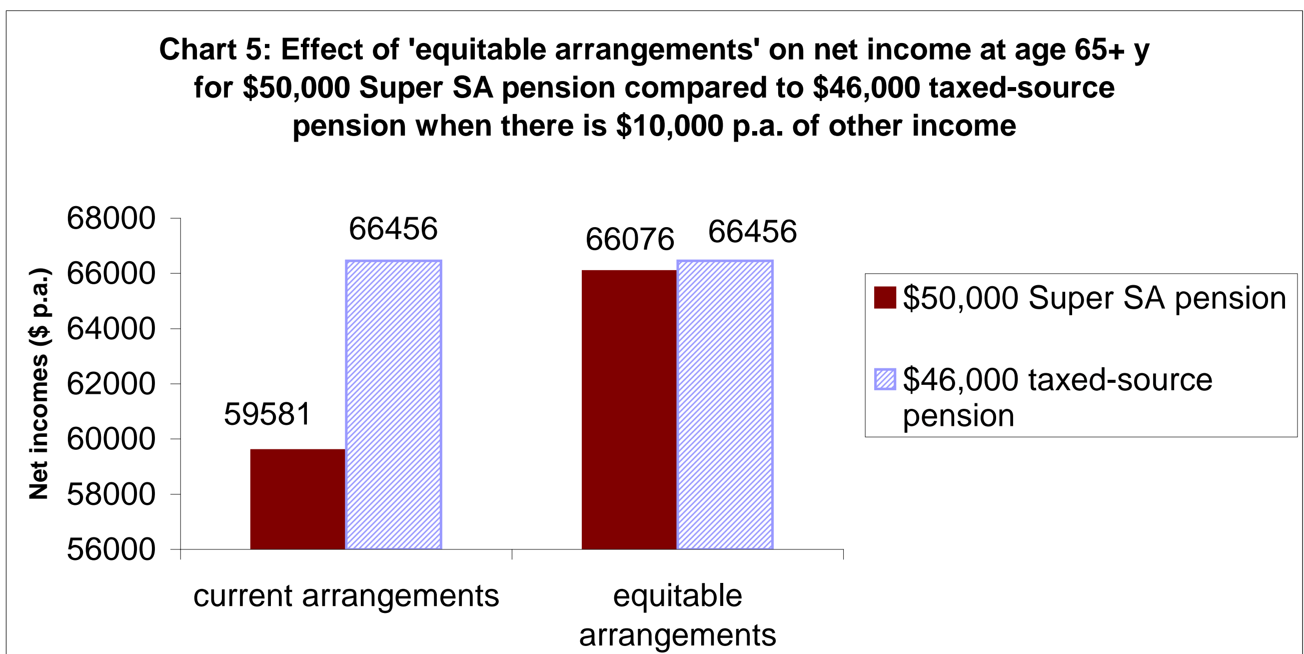
Table 3

Taxation remedies	Means-testing remedies
separate taxation of untaxed-source pension income and other taxable income after age 60	the proportion of an untaxed-source pension counted in the income test and for *Commonwealth Seniors Health Card* (CSHC) eligibility to be set at a fixed proportion around 75% of the pension's gross amount.
age pension income to be tax-free	the taxable income values at which eligibility for the CSHC is lost be increased to $70,000 (singles) and $100,000 (couples) and indexed to the CPI thereafter.
couples be permitted to split superannuation income for tax purposes after age 60	the income threshold beyond which age pension begins to reduce be raised to $9,000 p.a.
overseas pensions to be allowed a 10% tax offset	the income test withdrawal rate to be moved back towards 40 cents

In Table 4 and Chart 5 two sets of age pension and tax/medicare levy values are displayed for the case of a $50,000 p.a. Super SA pension being paid, since 1 July 2010, to one member of a couple both aged 65 and with $10,000 of other private (non-superannuation) income split evenly between them. One set of values is calculated under current arrangements. The other set of values corresponds to what, for the purposes of this discussion, have been called 'equitable arrangements'. Under 'equitable arrangements' other income is taxed separately and only 75% of the untaxed-source pension is counted in the age pension income test. In table 4 the values for 'equitable arrangements' are in brackets. Table 4 also contains the net income values for the equivalent taxed-source pension of $46,000 p.a.

Table 4

	Super SA Pension	Equivalent Taxed-source Pension
Super pension gross amount ($ p.a.)	50,000	46,000
Other private income ($ p.a.)	10,000	10,000
Age pension ($ p.a.)	3,266 (8,266)	10,456
Total Income ($ p.a.)	63,266 (68,266)	66,456
Tax and Medicare ($ p.a.)	3,685 (2,190)	0
Net Income ($ p.a.)	59,581 (66,076)	66,456
Extra net income for the taxed-source pension		6,875 (380)



The figures in Table 4 and Chart 5 show that under current arrangements a $50,000 p.a. Super SA

pension and $10,000 of additional income provides a couple with $6,875 p.a. less in net income than they would be getting if their super pension had been paid as $46,000 p.a. from a taxed-source.

Under 'equitable arrangements' the Super SA pension provides a net income effectively equal ($380 p.a. less) to that provided by the equivalent taxed-source pension of $46,000 p.a.

Among the other remedies of Table 9 the making of age pension income tax-free was part of **Recommendation 4** of the *Australia's Future Tax System* (AFTS) review. Recommendation 4 was for all income support and supplementary payments to be tax exempt. The case for age pension payments to be tax-exempt is particularly strong because they are already tax-free for the large fraction of people over 65 receiving age pension and having private income in the form of taxed-source superannuation income. Another remedy of Table 9 that was also part of an AFTS recommendation is the splitting of income for couples of age pension age (**Recommendation 3**).

Commonwealth Seniors Health Card (CSHC)

A couple with taxed-source superannuation income will have none of that income counted for CSHC eligibility and will remain eligible for the CSHC until their other taxable income exceeds $80,000 p.a. ($50,000 p.a. for a single person). A couple with an untaxed-source pension has any other income added to the taxable amount of the pension (usually at least 95 % of the gross amount) and if the combined income exceeds $80,000 they will be ineligible for the CSHC. The amount of taxable income beyond which people are not eligible for the CSHC has not been increased since its introduction 10 years ago.

This striking example of inequitable treatment for untaxed-source superannuation pensions demands, at the very least, the increase in thresholds suggested in Table 3 above.

Appendix 1: Relativies for untaxed-source and taxed-source pensions

In its final report of December 2009 the *Australia's Future Tax System* (AFTS) review referred to the matter of the taxation of non-superannuation income of people in receipt of untaxed-source superannuation pensions as follows:

> People in untaxed superannuation funds, such as some public sector funds, are currently taxed differently from people in the more common taxed superannuation funds. Untaxed funds do not pay tax on some, or all, of the contributions and earnings in the fund. Benefits from these funds remain taxed to achieve a broadly equivalent tax outcome between people in taxed and untaxed funds.
>
> Superannuation pensions paid from an untaxed superannuation fund are taxed at marginal tax rates less a 10 per cent offset. Lump sums from an untaxed fund are taxed at 15 per cent up to a threshold, currently $1.1 million (indexed), and at the top marginal tax rate beyond that.
>
> Several submissions raise concerns that members of untaxed funds pay more tax on their non-superannuation income than members of taxed funds. A pension from a taxed fund is not included in assessable income while a pension from an untaxed fund is. This means that non-superannuation income is added to a pension from an untaxed fund. As a result, the person can pay a higher marginal tax rate on that income than they would have if the pension was paid from a taxed fund.
>
> The considerable differences between taxed and untaxed funds make it very difficult to achieve complete parity between the benefits paid from them. On balance, it is considered that the current tax treatment of benefits paid from an untaxed fund remains appropriate given the recommended changes to the taxation of superannuation contributions and earnings in taxed funds. The treatment of contributions to untaxed funds would need to be carefully considered.
>
> *Australia's Future Tax System* Review Report to the Treasurer Final Report December 2009 Part 2, Vol 1 pp 116-117

This discussion is very superficial. To make a judgement about parity of benefits being paid from untaxed and taxed funds the AFTS review needed to separately compare taxed and untaxed accumulation funds then taxed and untaxed defined benefit pension funds.

Untaxed accumulation funds versus taxed accumulation funds

For the same contribution payments made to an untaxed accumulation fund, earning at the same rate as a taxed accumulation fund, a member of the untaxed fund will pay less tax, (and have a larger final benefit) than the corresponding member of a taxed accumulation fund. The reason is the delay in the collection of tax which remains, and grows, in the untaxed accumulation fund over the member's working lifetime. This property of untaxed accumulation funds was made clear by the West Australian superannuation authorities in their recent approach to the Federal Government over a possible shift of the West Australian funds (currently untaxed) to the taxed superannuation environment. An account of the negotiations involved here includes the statements:

> "Members generally are tax advantaged from their SG contributions being paid to an untaxed accumulation scheme. Members do not pay tax on contributions and earnings in an untaxed scheme but instead pay a 15% tax on the untaxed component of their balance when exiting the fund. In general, this results in pre tax contributions providing a tax advantage through earnings accruing on a higher balance..."
> and
> "As most contributions are pre tax in nature, most members gain a tax advantage in an untaxed accumulation scheme relative to members of a taxed accumulation scheme."
> Source: *Putting Members First A Review Of Public Sector Superannuation Arrangements for the West Australian Government.* Rod Withear, February 2010 p160

Untaxed defined benefit funds versus taxed defined benefit funds
For the same contributions and earnings rates, taxed funds delivered larger after-tax benefits than untaxed funds to most members until July 2007. The reasons are:

1. the common marginal tax rate on personal income has always been greater than the rate of tax payable by taxed funds and
2. the 15% tax offset available to recipients of taxed-source pensions applies to the entire taxable amount of the pension even though tax was only payable by the fund on employer contributions made to fund benefits accruing after 1 July 1988.

The intrinsic superiority of taxed pension funds over untaxed pension funds before July 2007, as far as delivering after-tax benefits to members is concerned, has been confirmed by a 2004 review of the taxation status of the South Australian superannuation funds (all untaxed at that time). This review describes the effect of moving an untaxed defined benefit fund into the taxed environment as follows:

> …"there is a net tax advantage in moving from an untaxed environment to a taxed environment. These advantages could be used to increase members' benefits and/or reduce employer costs. If members' benefits are maintained at current levels (after allowing for tax effects) then savings of the order of $450 million are estimated for the employer"
> **Source:** *Review of Taxation Status of the SA Government Superannuation Funds* Martin Stevensen, Mercer Human Resource Consulting, December 2004, p7.

3. A formula connecting untaxed-source and taxed-source pension values
Stevensen explained why there was " a net tax advantage in moving from an untaxed environment to a taxed environment" by reference to a formula that connects the gross value of an untaxed-source pension to the value it would have if the assets needed to fund the pension were moved into the taxed environment. This formula is:

$T = U \times (1- 0.15A/B \times P)$
Where:
T = gross value of the taxed source pension; U = gross value of the untaxed-source pension
A = the member's post 30 June 1988 service; B = the member's total service
P = the proportion of the pension financed by the employer

For a South Australian untaxed-source pension the triennial actuarial reviews have estimated the employer-financed component at 80-86% of the gross pension value. The value of 86% is the most recent reflecting the impact of the Global Financial Crisis on fund assets. If we consider people retiring from the South Australian pension scheme between 1995 and 2010, after 35 years service and assuming a value of 86% for the employer-financed component, we can use the formula above to calculate the percentage of their current pension that they would be receiving if the South Australian pensions were paid from a taxed source **i.e. the equivalent taxed-source defined benefit pension.** These percentages are shown in the Table.

Super SA pensions and their taxed-source equivalents

Retirement year	Super SA pension	Equivalent taxed-source pension
2010/11	100	92 (8% reduction)
2005/6	100	94 (6% reduction)
2000/1	100	96 (4% reduction)
1995/6	100	98 (2% reduction)
1986/87	100	100 (0% reduction)

Pension reductions to the extents shown in Table 1 have the effect of meeting the employer tax cost associated with shifting a pension fund from the untaxed to the taxed superannuation environment. The same reductions, prior to July 2007, saw most members of taxed funds end up better off than would have been the case if their fund had remained in the untaxed superannuation environment. For example, even when the pension was reduced by 8% the member lost 8% of his/her gross

pension but only about 5.5% of the after-tax value of the pension because 31.5% of the pension lost was already being lost as tax and medicare levy. The after-tax value of the 15% tax offset that a person was able to claim on the taxed-source superannuation pension increased its after-tax value by 15% of 92% = 14% of the gross value of the original pension. The net result was that the member ended up with additional net income of 14% - 5.5% = 8.5% of the gross value of the original untaxed-source pension.

The statement by Stevensen quoted above includes the possibility of an employer making a saving from the move of a pension fund into the taxed environment. But for an employer to make such a saving it would have to persuade the fund Trustee to reduce pensions by more than the tax cost arising from the change. A Trustee doing this would be in breach of its obligation to prefer no other interest over that of fund members. Stevensen's suggestion of an employer getting an advantage, instead of members, probably reflects an awareness on his part of the fact that there are no Trustees for the South Australian superannuation funds.

The savings from the move of a pension fund into the taxed environment on, or after 1 July 1988, should flow to members as happened with the New South Wales *State Superannuation Scheme.* The Trustee for this scheme, the *SAS Trustee Corporation*, has outlined the consequences for members of a change from an untaxed to a taxed pension scheme as follows:

> *The State Superannuation Scheme changed from an untaxed to a taxed fund effective from 1 July 1988. From this date the post 30 June 1988 portion of employer financed benefits were reduced by 15%.*
>
> *Pensions that commenced prior to 1 July 1988 were not reduced as a result of the change in tax status of the fund. The benefit reduction provisions apply in respect of post 30 June 1988 service only.*
>
> *All SSS pensioners, regardless of when their pensions commenced, are eligible to claim up to the 15% rebate.*
>
> *The current application of the benefit reduction provisions provides that only the part of the employer financed benefit that is attributable to a member's service since 1 July can be reduced. This means that a member with a larger proportion of pre 1 July 1988 service receives a smaller benefit reduction than a member with a lesser amount of pre 1 July 1988 service.*
> **Source:** Letter to *SA Superannuants* from the *SAS Trustee Corporation,* 15 August, 2005

The second and third paragraphs above reveal that members of taxed funds who had retired prior to 1988 experienced no reduction in their pensions but were able to claim the 15% tax rebate (offset) on the pension's taxable amount. Compared to untaxed source pensions this was an increase in the after-tax value of the pension equal to 15% of the taxable amount. The fourth paragraph reveals that the maximum reduction in pensions is 15% of the employer-financed component and this reduction will only be reached in the case of people who have no pre-July 1988 service. All of this is consistent with the formula set out above.

Appendix 2: Net income calculations for pensions commencing 1995/6

The Tables contain the results of calculations leading to net incomes for a Super SA pension ($25,000 p.a. in 1995/6) over the period 1995/6-2010/11, compared with the equivalent taxed-source pension ($24,500 p.a. in 1995/6). The net incomes in the Tables are displayed in Chart 1.

Super SA pension

Comparison year	**1995/6**	**2000/1**	**2005/6**	**2007/8**	**2010/11**
Super SA pension	25,000	26,852	31,944	33,733	36,827
Age pension	0	0	0	13,197	16,087
Tax payable	4,097	4,695	5,276	6,194	6,459
Tax offsets	1,239	1,340	1,572	6,233	6,756
Net tax (Tax payable - Tax offsets)	2,858	3,355	3,704	0	0
Unused tax offsets	0	0	0	39	297
Medicare	356	383	455	580	645
Net Income	**21,786**	**23,114**	**27,785**	**46,351**	**52,269**

Equivalent taxed-source pension

Comparison year	**1995/6**	**2000/1**	**2005/6**	**2007/8**	**2010/11**
Taxed-source pension	24,500	26,315	31,306	33,059	36,090
Age pension	0	0	0	19,993	23,715
Tax payable	3,936	4,522	5,094	595	1,757
Tax offsets	4,749	5,090	6,033	2,702	4,704
Net tax (Tax payable - Tax offsets)	0	0	0	0	0
Unused tax offsets	813	568	939	2,107	2,947
Medicare	349	375	446	0	0
Net Income	**24,151**	**25,940**	**30,859**	**52,992**	**59,805**
Extra net income for the taxed-source pension	**2,365**	**2,826**	**3,074**	**6,641****	**7,536****

**See discussion below of pre-1 July 1983 component and age pension since 1 July 2007

At each comparison point in the tables the two pensions have been adjusted for the CPI movements since July 1995. Tax and age pension parameters used were those applying in each year. Age pension income was received in the 2007/8 and 2010/11 years but not the earlier years.

In calculating tax payable amounts up until 2005/6 95% of the gross value of each pension has been used as the taxable amount. For 2007/8 and 2010/11 95% of the Super SA pension was used to determine both tax payable and the age pension payment. The taxed-source pension was tax-free in both years and the proportion of the pension's gross amount counted in the determination of age pension payment under the income test declined from 95% to 46%. This is due to the taxed-source pension having a 1-July 1983 component of 49% of its gross value assigned to it from 1 July 2007 (see discussion and Table below).

Pre-1 July 1983 component of superannuation benefits
Before 1 July 1983 only 5% of a superannuation lump sum was taxable and the amount of tax was determined by adding 5% of the value of the lump sum to the person's other taxable income for that year and taxing it at the resulting marginal rate. On 1 July 1983 lump sum superannuation benefits became subject to increased tax rates on the part of the benefit accruing from that date. This created a benefit component known as the pre-1 July 1983 component i.e. a component of the lump sum that was attributed to service completed before 1 July 1983 and the old tax rates (close to zero) applied to this component. Defined benefit pensions did not have a pre-1 July component although, if the pension was commutable, the resulting lump sum did. This remained the case for both untaxed-source and taxed-source pensions until 1 July 2007 when the 'Simpler Super' reforms were

implemented and a pre-1 July component was assigned to taxed-source defined benefit pensions but not to untaxed-source pensions. This newly-created component of taxed-source defined benefit pensions is not only tax-free from age 60, it is also not counted in the Centrelink income test.

The pre-1 July 1983 component for a defined benefit pension that commenced in the 1995/96 financial year, and was still being paid on or after 1 July 2007, is calculated by expressing the number of days service completed before 1 July 1983 as a percentage of the total days between when the person commenced work for the employer funding the pension and 1 July 2007. Where a pension commenced after 1 July 2007 the retirement date is used in place of 1 July 2007. (see Australian Tax Office fact sheet *Calculating the tax-free component after a trigger event – non-account based superannuation income stream*) . For people retiring between 1995 and 2010 after 35 years service the pre-1 July 1983 component of their pension estimated this way is shown in the table as a percentage of the taxed-source pension's gross amount.

Retirement Date	Pre 1 July 1983 component of the taxed-source pension
1-7-2010	23%
1-7-2005	35%
1-7-2000	43%
1-7-1995	49%

Appendix 3: Net income calculations for pensions commencing 2010/11

The tables contain the results of calculations on net income values for the 2010/11 year for a Super SA pension of $50,000 p.a. and the equivalent taxed-source pension of $46,000 p.a. Calculations have been performed for three different retirement ages. For the Super SA pension net income has also been calculated under AFTS Recommendation 2 (tax-free threshold of $25,000 and marginal tax rate of 35% for income above this amount).

Super SA pension, $50,000 p.a. Current tax rules apply

	Retirement Age		
	55-59 years	**60-64 years**	**65+ years**
Super SA pension	50,000	50,000	50,000
Age pension	0	0	**8,266**
Tax payable on taxable income	7,800	7,800	9,040
Tax offsets	3,086	7836	8,129
Net tax (Tax payable - tax offsets)	4,714	0	911
Unused tax offsets	0	36	0
Medicare	713	713	774
Net Income	**44,574**	**49,287**	**56,580**

Super SA pension, $50,000 p.a. AFTS Recommendation 2 applies

	Retirement Age		
	55-59 years	**60-64 years**	**65+ years**
Super SA pension	50,000	50,000	50,000
Age pension	0	0	**8,266**
Tax payable on taxable income	7,875	7,875	9,322
Tax offsets	2,286	7,036	6,074
Net tax (Tax payable - tax offsets)	5,589	839	3,247
Unused tax offsets	0	0	0
Medicare	713	713	774
Net Income	**43,699**	**48,449**	**54,244**

Equivalent taxed-source pension, $46,000 p.a.

	Retirement Age		
	55-59 years	**60-64 years**	**65+ years**
Taxed-source pension	46,000	46,000	46,000
Age pension	0	0	**15,456**
Tax payable on taxable income	4068	0	518
Tax offsets	8,629	3,786	3,554
Net tax (Tax payable - tax offsets)	0	0	0
Unused tax offsets	4,561	3,786	3,036
Medicare	497	0	0
Net Income	**45,503**	**46000**	**61,456**
Extra (reduced) net income for the taxed-source pension under current tax rules	**929**	**(3,287)**	**4,876**
Extra (reduced) net income for the taxed-source pension under *AFTS* Recommendation 2	**1,804**	**(2,449)**	**7,212**

In the calculations for the taxed-source pension a pre-July 1983 component of 23% was assigned to the pension (see Table of pre-1 July 1983 proportions in Appendix 2) with the result being that 72% of the pension's gross amount was used in calculating tax payable during the retirement age interval 55-59 y. This percentage was also used to calculate age pension payment under the income test.

Appendix 4: Age pension payments to Super SA and allocated pension recipients
The tables show age pension amounts payable to Super SA and allocated pension recipients over 20 y and for initial superannuation pension values of $37,300 p.a. (initial age pension entitlement is 50 % of a full age pension) and $50,000 p.a. (initial age pension entitlement is 29% of a full age pension).

The consumer price index(CPI) is assumed to be 2.5% p.a. and both pensions are increased by this factor annually. The full basic age pension is assumed to increase by 4% p.a. and the supplementary payment by the CPI. The earning rate used for the allocated pension account balance was 6.5% p.a.

Personal use (non-income producing) assets of $50,000 have also been assumed for the allocated pension couples. The proportion of the defined benefit pension counted in the income test is assumed to be 95%. The age pension entitlement for the allocated pension couples is the smaller of that determined under the income and assets test. The asset test amount is the smaller for most of the 20 y interval with a switch to the income test occurring towards the end.

Initial pension value $36,800 p.a.

Years of receipt of age pension	Super SA pension	Age pension	Allocated (account-based) pension		Age pension
	Annual super income ($p.a.)	% of a full age pension	Annual super income ($p.a.)	Account balance ($)	% of a full age pension
1	37,300	50	37,300	581,000	50
5	41,172	53	41,172	566,042	62
10	46,583	56	46,583	513,884	77
15	52,704	59	52,704	408,042	90
20	59,630	61	59,630	224,129	87
Average % of a full age pension over 20 y with 95% of the Super SA pension counted in the income test.		56	Average % of a full age pension paid over 20 y		75
Average % of a full age pension over 20 y when 75% of the Super SA pension is counted in the income test.		67			

Initial pension values $50,000 p.a.

Years of receipt of age pension	Super SA pension	Age pension	Allocated (account-based) pension		Age pension
	Annual super income ($p.a)	% of a Full Age Pension	Annual super income ($p.a.)	Account balance ($)	% of a Full Age Pension
1	50,000	29	50,000	736,000	29
5	55,191	33	55,191	703,682	46
10	62,443	37	62,443	613,379	68
15	70,469	41	70,469	443,568	80
20	79,933	45	79,933	158,767	77
Average % of a full age pension over 20 y with 95% of the Super SA pension counted in the income test.		37	Average % of a full age pension paid over 20 y		63
Average % of a full age pension over 20 y with 75% of the Super SA pension counted in the income test.		53			