AUSTRALIA'S FUTURE TAX SYSTEM

SUBMISSION IN RELATION TO THE TAX TREATMENT OF PENSIONS PAID BY THE ASIAN DEVELOPMENT BANK IN AUSTRALIA

This submission supports our earlier submission, and is made on behalf of: (a) certain persons currently receiving pensions in Australia under the Staff Retirement Pan ("SRP") of the Asian Development Bank ("ADB"); and (b) certain Australian staff at ADB who may receive future pensions under the SRP.

Australia is a shareholder in ADB, which is an international organisation covered by Australia's *International Organisations (Privileges and Immunities) Act 1963* (Cth) ("Act") and associated regulations ("the IO Legislation"). The individuals covered by this submission who have pursued, or are pursuing careers at ADB, are Australian citizens and/or Australian residents and may be regarded as current or former international civil servants.

Briefly, this submission:

(a) proposes that the IO Legislation be amended to ensure that ADB pensions paid to Australian citizens and/or residents are treated in substantially the same manner as pensions paid to Australian residents under Australian superannuation schemes. Specifically, it is proposed that such ADB pensions should be exempt from tax when paid to persons aged 60 or over, and that such ADB pensions need not be declared in the tax return of an ADB pensioner; and

(b) offers sound public policy reasons to support such a proposal.

The recent report on retirement income[1] indicated that the issue of the taxation of benefits received by members of untaxed funds will be taken into account in the final report due in December 2009.

As at April 2009, there were a total of 71 Australian nationals or residents receiving ADB pensions.[2] The average annual pension, again as at April 2009, was AUD56,184.[3]

SUPERANNUATION IN AUSTRALIA TODAY

Current and future retirees in Australia are facing increasing challenges to make adequate provision for retirement income. The Government has already indicated that any retirement income system should be ***adequate*** (provides the means by which individuals save for their retirement), ***acceptable*** (equitable and does not bias saving decisions), ***robust*** (deals with investment, inflation and longevity risks), ***simple and approachable*** (allows individuals to make

[1] *Australia's Future Tax System – The Retirement Income System: Report on Strategic Issues* (Media Release – 12 May 2009) Available at http://taxreview.treasury.gov.au/content/downloads/retirement_income_report_stategic_issues/retirement_income_report_20090515.pdf

[2] This figure includes seven surviving beneficiaries receiving ADB pensions.

[3] The average annual pension paid to surviving beneficiaries ranged from AUD26,285 to AUD34,957.

decisions which are in their best interests) and ***sustainable*** (financially sound and detracts as little as possible from economic growth).[4]

Moreover, it is expected that any retirement income system will involve shared responsibilities between government and individuals. The system should be equitable, though recognising that individuals will approach retirement in different ways and, therefore, "retirement outcomes will differ for different people, depending on the extent to which they can and do make self-provision". The twin features of compulsory superannuation and voluntary superannuation (involving "a tax-assisted means for all to make self-provision for retirement in accordance with their circumstances and preferences") remain key components of Australia's current retirement system. Australia also wants to ensure that retirement income will be available throughout retirement, thus minimising the demand on the Age Pension.

Substantial tax benefits are now available to encourage Australians to save for their retirement. Those still working are able to make contributions to their superannuation schemes at a concessional tax rate of 15%, with no tax payable on the withdrawals. In contrast, ADB pensioners cannot avail themselves of the concessional tax treatment and, instead, they face tax payments on their superannuation up to the top marginal rate. This is contrary to the intent of the current retirement income system, is inequitable and is a disincentive for certain pensioners to self-provision for retirement.

In these circumstances, and where it is essential to ensure responsible retirement planning for all Australians, it is appropriate that the privileges and immunities available under the IO Legislation, including the exemption from tax for a pension received as an "emolument" from ADB, should be extended to Australian retirees who receive ADB pensions. We believe that the tax treatment of ADB pensions paid to Australian retirees should mirror the tax treatment extended to other Australian retirees.

THE CURRENT TREATMENT OF ADB PENSIONS IN AUSTRLIA
A Response to: The International Organisations (Privileges and Immunities) Act 1963[5]

The IO Legislation manifests Australia's policy in relation to organisations such as ADB. Under the IO Legislation, an Australian ADB officer is exempt from "taxation on salaries and emoluments received from … (ADB)"[6].

Having regard to the definition of "emoluments" contained in the Corporations Act, a reasonable interpretation of this exemption suggests that the amount or value of any consideration or benefit given, directly or indirectly, to an individual "in connection with" the performance of that person's services at ADB would be exempt from taxation. It is significant that this definition is not time-bound. The definition focuses on the link between effort and payment. Our view is that this definition conforms to the common usage of the term "emolument".

ADB's contributions to the ADB Staff Retirement Plan ("SRP"), which are applied towards the pension **for the benefit** of a current officer of the Bank, constitute emoluments for the purposes of the IO Legislation.

---

[4] The *Retirement income consultation paper* (AFTS 2008) available at http://taxreview.treasury.gov.au/content/ConsultationPaper.aspx?doc=html/publications/Papers/Retirement_Income_Consultation_Paper/index.htm
[5] Act No. 50 of 1963, as amended, and Regulations made under that Act.
[6] Act, s. 6(1)(d)(i) and Fourth Schedule, Part I, paragraph 2

The SRP is an asset of the ADB and, by virtue of the IO Legislation, earnings derived from contributions to the SRP are also exempt from taxation in Australia. While ADB's contributions to the SRP for officers are exempt from tax in Australia (as they clearly fall within the definition of emoluments), the tax status applying to an ADB pension payment in Australia is less clear.

The Australian Taxation Office ("the ATO") has declined to exempt ADB pensions from tax because the IO Legislation does not explicitly purport to extend tax exemption to ADB pension payments. ADB pension payments are currently treated as assessable income and taxed at the pensioner's marginal tax rate[7]. Specific references to "former officers" of the Bank in the IO Legislation (Fourth Schedule, Part II) refer only to immunity from suit and other legal process.[8] The ATO takes the position that as the IO Legislation does not expressly mention the exemption from taxation in respect of emoluments, including pension payments, in relation to "former officers", there is no exemption.

Recent Australian law however, supports the approach that amounts in connection with, or as an incident of employment, even upon cessation of that employment, may still be treated as an emolument.[9] The High Court applied the principles which underpin the concept of 'remuneration'. Moreover, it was noted that the legislation which introduced the Contributions Surcharge Tax in respect of Federal and State judges recognised that 'remuneration' includes pensions. This approach under Australian law supports the argument that an ADB pension payment, even though paid following retirement of an ADB officer, must also be regarded as an "emolument" for the purposes of the IO Legislation.

Clearly the tax exemption under the IO Legislation (Fourth Schedule, Part I) should apply to ADB pension payments as each payment is a component of the "salary and emoluments" provided by ADB.

THE CHARACTERISTICS OF ADB PENSIONS

In response to a submission on this issue by the Australian Association of Former international Civil Servants ("AAFICS"), the Minister for Superannuation and Corporations Law, Senator Nick Sherry, outlined the "restrictions and limits" applicable to Australian complying superannuation funds and that underpin the policy decision to extend tax concessions to such funds.[10] Among other things, Senator Sherry pointed to the "range of investment requirements and obligations designed to limit the risks associated with superannuation investments", the limits on contributions, "rules around the preservation of benefits until retirement" and the encouragement of superannuation "as a long-term retirement savings vehicle". Senator Sherry also refers to the fact that employer contributions and earnings have been taxed.

The IO Legislation reflects an Australian government policy decision that ADB's contributions to the SRP and earnings from the SRP are exempt from tax. However, in other respects the SRP is subject to a range of restrictions and rules that clearly match the "restrictions and limits"

---

[7] Most ADB pensioners may be able to receive a tax offset to take into account the undeducted purchase price of their pension. This offset reflects the fact that the ADB pensioner has not received an Australian tax deduction for the contributions made.

[8] Act, op cit, Fourth Schedule, Part II

[9] See the High Court decision in *Austin v Commonwealth of Australia* (2003) 215 CLR 185.

[10] Letter dated 10 March 2009 from the Hon. Nick Sherry to Ms Mary Johnson, President, AAFICS

contemplated in the letter from Senator Sherry. In short, the SRP is designed to encourage savings for retirement, and should do so in Australia, in exactly the same manner as outlined by Senator Sherry.

Staff contributions to the SRP are compulsory

The SRP rules and regulations stipulate that each ADB staff member must contribute to the SRP. ADB makes parallel contributions to the SRP. The SRP is a defined benefit scheme and, with appropriate tax treatment, can make adequate provision for retirement income.

For most concerned ADB staff the contribution rate remains at 9.33% of salary.[11] ADB's contributions to the SRP vary: as at 2008, the contribution rate was 16%, and in 2009, the contribution rate increased to 19%, reflecting the current high risk in the global financial markets and the likely value of the US dollar.

The SRP is professionally administered and managed

The funds contributed to the SRP are held in various asset classes in various currencies, and in most cases, such assets and the corresponding accounts are held outside Australia. In some instances, the SRP may hold assets that include Australian securities but, as mentioned, income from these securities is exempt from Australian tax by virtue of the IO Legislation. The SRP is administered by ADB, but it employs the services of professional investment managers.

ADB stipulates a compulsory retirement age

The compulsory retirement age at the Asian Development Bank is 60. ADB staff are not permitted to make early withdrawal of pension entitlements while employed at ADB. Staff who meet strict criterion, may opt for early retirement, either with a deferred pension or an immediate pension calculated at a reduced amount, but this course is seldom used.

Upon retirement, ADB pensioners may receive benefits in the form of lump sum payments and/or pensions

ADB pensioners may elect to receive the full amount of their entitlement as a pension or commute a portion of their entitlements and receive that amount as a lump sum upon retirement. ADB's Australian pensioners may elect to receive their pension payments in Australian dollars, United States dollars or a combination of the two currencies.

ADB pensions offer retirement income and reversionary interests

For almost all long-term ADB staff, ADB pensions offer a secure source of retirement income. By retirement, ADB pensioners are likely to have adequate self-funded retirement income, and will therefore not have to rely on an Australian Age Pension to supplement their retirement income. Upon the death of an ADB pensioner, ADB pensions carry reversionary rights permitting the pension to be paid, usually at reduced amounts, to surviving beneficiaries.

---

[11] For staff that joined ADB after 1 October 2006 the contribution rate was reduced to nil, with no vesting rights until after 10 years' of service; however, this revision does not affect most of the individuals covered by this submission.

<u>THE PROPOSAL TO EXTEND EXPLICITLY THE EXEMPTION FROM TAXATION UNDER THE IO LEGISLATION TO ADB PENSIONS</u>

The Pension Review Report notes that the taxation of benefits received by members of untaxed funds is an issue that needs to be addressed. This is in the context of the "general case for providing concessions under income tax arrangements for all forms of savings ... (and) reasons for favouring additional tax assistance for superannuation ..." The same Report also recognises that " ... the distribution of concessions for superannuation guarantee contributions is highly dependent on individual circumstances ..."

Since the promulgation of the Act (1963), superannuation in Australia has undergone immense changes, including in the concessional tax treatment of superannuation savings, particularly the removal of taxes on most pensions paid to Australian pensioners over 60. This submission argues that there are sound public policy reasons why pensions paid to Australia's former international public servants, such as ADB pensions, should be treated in a manner commensurate with the concessional tax treatment of superannuation savings in Australian based superannuation schemes. This submission argues that Part II of the Fourth Schedule of the Act be amended to apply clearly to "*Privileges and Immunities of Former Officer (other than High Officer) of International Organisation*" and that it should expressly include a reference to the privilege of "exemption from taxation on emoluments, including pensions, received from the organisation".

The extension of tax exempt status to ADB pensions is supported by public policy factors which have been consistently recognised as being important to Australia's national and foreign policy interests. This distinguishes ADB pensions (and similar pensions paid by other international organisations) from ordinary foreign pensions paid in connection with private sector or commercial employment. For public policy reasons similar to those that underpin the Act, the privilege of tax exemption should be extended to ADB pensions. This is particularly so in the current climate of concessional treatment of superannuation savings in Australia.

The tax exemption will provide an incentive for experienced international civil servants to return or relocate to Australia. Increasingly, as ADB and similar pensions are taxed at the marginal rate, there is less incentive for Australians working in organisations such as ADB to return to Australia on retirement. Furthermore, the taxation of ADB pensions is a deterrent to non-Australians who may consider relocating to Australia. Consequently, Australia will lose the benefit of having many former ADB officers participating in the Australian workforce, and spending pensions and investing in Australia. Former officers of international organisations who subsequently work in Australia bring important benefits to Australia – such persons bring a wealth of international experience, world class skills and education, and a wide network of international relationships and contacts to the Australian workforce. In an increasingly globalised world, it is in Australia's interests to attract this diaspora of skilled and experienced Australians back to the workforce and to redress, to some extent, the increasing flow of intellectual capital out of Australia. Australia's economic future may also be strengthened by attracting non-Australian former ADB officers to relocate to Australia. They would bring substantial human and financial capital and extensive personal and commercial networks, notably in the Asia Pacific Region.

Without the extension of tax exemption to pensions, more Australian ADB officers will choose to stay in or move to countries where such pensions are taxed more favourably than in Australia. Non-Australians who would otherwise choose to relocate to Australia will move elsewhere. We understand that in the majority of ADB member countries, ADB pensions are tax free or receive highly concessional tax treatment.

Perhaps most importantly, where Australian international civil servants choose to continue to work overseas in their retirement and not return to Australia, Australia will lose the benefit of the skills and global experience of those involved and the tax revenue which it would otherwise have received had they returned to Australia and paid tax on their income received from the new employment or from investments held, whether in Australia or elsewhere. For example, substantial GST revenue that would have been paid on their expenditure is forgone. Moreover, as the ADB retirement age is 60 years, former ADB officers are capable of many years of productive work even after their reach the ADB retirement age.

The prospect of pensions exempt from tax will provide an incentive for Australians to work in organisations such as ADB. Tax exemption provides a tremendous incentive for Australians to work in international organisations. Such involvement of Australians brings important benefits to Australia in that it allows for Australia's interests, policies, standards and principles to be effectively communicated and represented at a global level. In short, from Australia's perspective, these organisations, in which Australia has a stake, will benefit from the presence of Australian members of the international civil service.

There are virtually no comparable opportunities to work in similar organisations in Australia and, as such, it is necessary for Australians to relocate overseas to pursue a career as an international civil servant.[12] As mentioned, it is compulsory for employees of such an international organisation to contribute to the organisation's pension plans and, as such, these officers have no opportunity to elect to contribute to an Australian superannuation fund.

Tax exemption of ADB pensions will provide a disincentive against artificial structuring of taxpayer superannuation benefits to reduce Australian tax. Under current arrangements, there may be an incentive for ADB pensioners to commute a large proportion of their pension entitlement to a lump sum before returning to Australia, and this would almost certainly increase the risk that the pensioner is unable to fund his or her retirement adequately and then increase future demands on the Australian pension system. It can be expected that the lump sum will be considerably less valuable than the lifetime ADB pension. In addition, without the exemption there are strong incentives to engage in elaborate tax planning and to spend excessive amounts on obtaining financial advice, which in turn are a cost to government agencies that must review and assess the proposed schemes.

Tax exemption would have an insignificant impact on Australian tax revenue. Having regard to the number of Australian and Australian resident ADB pensioners, the average annual ADB pensions being paid to Australian residents and offsets representing the undeducted purchase price of contributions, this submission estimates that the amount of tax revenue foregone if those pensions are exempt from tax, would be about AUD900,000 annually, or less than 0.0008 percent of total individual income tax expected to be paid in 20009/10.

However, this amount would most likely be more than offset by tax receipts generated by the investment and other income produced by those former ADB officials in Australia, if the exemption was allowed. In contrast, if the exemption is not granted, this additional tax revenue would be diminished along with other economic benefits to the extent that ex-ADB Australian

[12] ADB does maintain a small Pacific Liaison and Coordination Office in Sydney; however, to date, no or few Australian professional staff have been assigned to that Office.

staff do not return (or relocate) to Australia because of the unfavourable tax treatment of their ADB pensions. In this respect, it is important to recognize that retirement at 60 still means there is considerable scope to work after that age and it is well recognized that many former ADB officers do so particularly in the fields of international economics and development. There are benefits to Australia in terms of national income and its development objectives from such activity which would not be realized where tax policy deters former ADB officers from living in Australia.

Therefore, this submission contends that potentially the revenue foregone under the current policy is in excess of the revenue that is actually raised under the current policy.

CONCLUSION

At a time when there is an emphasis on responsible retirement income planning and, to the extent possible, the self-funding of retirement needs, current and former international civil servants are making/have usually made effective provision for their retirement income and, upon returning to Australia, can benefit from retirement plans that will ensure that they would not place any burden on the Australian retirement system.

At the present time, with ADB pension payments being taxable at the top marginal rate and without the benefit of tax concessions, there is a strong disincentive for such Australians against taking up long-term international civil service and importantly for Australian ADB pensioners against returning home (bringing skills, experience and global networks). Non-Australians that would otherwise seek to relocate to Australia, bringing their skills, experience and global networks and financial wealth, are choosing not to do so.

The repatriation of such international skills is in Australia's long-term interest; and the proposed exemption would encourage Australians to work in international organisations. Again this is in Australia's long-term interest, as Australia voluntarily joined these organisations and to evidence its support, granted a number of privileges and immunities, including the privilege of exemption from taxation. The restricted application of taxation relief to exclude former employees is arguably inconsistent with a strong Australian commitment to such development institutions.

Given the relatively small numbers of Australian ADB pensioners, it is difficult to see that exemption of ADB pensions would lead to a significant loss of fiscal revenues in Australia. This is especially so when offsets provided by income generation, spending and other taxes is taken into account for those ADB pensioners who would surely take up the incentive to return to Australia with a pension exempt from tax. There is potentially a net gain in fiscal revenue from the GST and other taxes through encouraging ADB pensioners, both Australians and others, to relocate to Australia.

Therefore, this submission recommends that the IO Legislation be amended to extend the privilege of tax exemption explicitly to emoluments, including pensions, paid to former officials of ADB.