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Submission to the *Australia's Future Tax System* review.

Summary

Title: A Valid Comparison of Net Values for Taxed and Untaxed Source Defined Benefit Pensions

From: *SA Government Superannuated Employees Association* trading as *SA Superannuants*
March 31, 2009

Contact Person: Dr R.J.S. Hickman, Membership Officer
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- The submission disputes an assumption that members of taxed-source defined benefit pension funds have pre-paid tax on their pensions at a rate of 15%.

- Arguments are presented to support the view that this assumption is inaccurate and potentially misleading.

- The submission requests that the Review Panel obtain expert advice on the validity of the 15% assumption.

- The submission concludes that there is a very strong case for a recommendation being made to the Federal Government that the non-superannuation income of members of untaxed-source defined benefit pension funds be taxed separately from their superannuation income after age 60.

- A protocol is outlined for the separate taxation of untaxed source pension income and non-superannuation income.

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Introduction

In an earlier submission to the *Australia's Future Tax System Review* S.A. Superannuants (the Association) described some unequal Tax and Centrelink outcomes for members of untaxed defined benefit pension funds compared to taxed defined benefit pension fund members. We claimed that, compared to taxed fund members, untaxed fund members are experiencing less favourable tax and Centrelink outcomes arising from taxation of non-superannuation income and the Centrelink income test respectively.

In its consultation paper on retirement income the Panel has expressed a view that people receiving pensions from taxed funds have pre-paid tax on their pensions at the maximum superannuation tax rate of 15%. The Association believes that this assumption is inaccurate and potentially misleading. In particular, it might lead the Panel to conclude that it is reasonable for untaxed pension recipients to be forced to pay more tax on their non-superannuation income as a 'catch-up' for tax they have escaped paying and which taxed pension recipients have paid.

We present below detailed numerical arguments to demolish the 15% pre-paid tax assumption but first there are some common sense considerations that are sufficient to cast doubt on it. If it was true there would have been no incentive for the New South Wales, Tasmanian and Victorian Governments to operate their defined benefit pension funds as taxed funds. And there would have been uproar from members of the pension schemes in these states as they were told that their pensions were about to decline by 15% as a result of new taxation on superannuation fund income. There was no uproar in 1988 when taxes on superannuation fund income were introduced, and there has been no complaint from members of taxed funds since, because no member of any state defined benefit pension scheme has experienced a pension reduction of anything like 15% as a consequence of that scheme becoming a taxed scheme. There are good reasons for this.

In this submission

a) The Association has set out the detailed reasons why we believe that the Panel's estimate of taxed source defined benefit pension recipients having pre-paid tax on their pensions at the rate of 15% is inaccurate and misleading.
b) Two equity principles set out in the Panel's summary of the consultation paper on the tax system are used to support the case for non-superannuation income to be taxed separately from superannuation income for all Australians aged over 60.
c) The Association requests the Panel to commission a study of the actual impact that the taxes on superannuation fund income introduced on 1 July 1988 have had on the gross values of defined benefit pensions commencing before or since that date. We are very confident that such a study will reveal that the impact has been nothing like 15%.

Discussion

1. Tax differences between taxed and untaxed fund pension recipients

a)The Panel's estimate of tax pre-paid by taxed fund pension recipients

On page 26 of the *Retirement Income Consultation Paper,* referring to a taxed source pension of $40,000 p.a., the claim is 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.*

With this statement the Panel is claiming that a taxed source pension has had its gross value reduced by 15% from what it would have been if it had been paid as an untaxed source pension. This claim can be expressed as follows:

Taxed fund pension = Untaxed fund pension x 0.85 OR

Untaxed fund pension = Taxed fund pension/0.85

Applying this relationship to a $40,000 p.a. taxed source pension the Panel has concluded that the value of the equivalent untaxed source pension is:

$40,000/0.85 = $47,058

This leads to the conclusion that the taxed pension recipient has pre-paid tax of $7,058. **However, this conclusion is seriously wrong for the large majority of recipients of taxed source, defined benefit pensions currently being paid.** The reasons for this are set out in the next sub-section.

b)Actual effect on pensions of the 1 July 1988 taxes on fund income

The reduction in a defined benefit pension caused by the introduction of taxes on superannuation fund income on 1 July 1988 is mainly influenced by two factors

a) the proportion of the pension that has been funded by the employee's contributions paid from after-tax income.
b) The proportion of service completed before 1 July 1988.

The proportion of a defined benefit pension funded by employee contributions made from after-tax income is unaffected by the taxes introduced on 1 July 1988 as the following facts demonstrate.

a) the member-funded component of NSW pensions was not reduced after 1-7-1988 and
b) the member-funded component of Tasmanian pensions is now being paid as a taxed source pension without any reduction in the total pension being paid.

The reasons why it is possible to protect the member-funded component of a defined benefit pension from taxation include

a) the member contributions themselves are not subject to the contributions tax because they are paid from after-tax income and
b) the earnings of assets backing pensions that have commenced are tax exempt.

The employer-funded component of a pension will be reduced by taxation but, to a good approximation, only that part accruing after 1 July 1988.

If we assume that a person retired from an untaxed fund in July 2008 after 35 years service and that 20% of the pension has been funded by member contributions made from after-tax income then the amount of untaxed source pension that is equivalent to a $40,000 pension from a taxed source can be estimated as follows:

i. Eligible service period is 35 years and commenced in 1973
ii. Service completed before 1 July 1988 is 15 years
iii. Fraction of pre-1 July 1988 service is 15/35 = 0.43 (43%). Only the fraction accruing after 1-July 1988 (57%) is subject to reduction
iv. Employer funded proportion of the pension is 80% and so the proportion subject to reduction is 57% of 80% = 46%
v. Pension reduction is 15% of 46% = 6.8%
vi. The amount of untaxed source pension equivalent to $40,000 p.a. taxed source pension is $40,000/0.932 = $42,918 p.a.

So, the Association's estimate for an untaxed source pension equivalent to a taxed source pension of $40,000 p.a. in the case of a person retiring in 2008, after 35 years service, is $42,918 p.a. As we compare people retiring earlier the untaxed source pension will decrease in value eventually becoming $40,000 p.a. for retirements before 1 July 1988.

For those retiring after 2008 the value of the untaxed source pension will rise **but it will never reach $47,058 p.a.** For a pension that is 20% funded by member contributions paid from after-tax income the maximum pension reduction caused by the 1 July 1988 taxes is 12% (15% of 80%). Such reductions will not be seen until 2023. This is the earliest that a person having 35 years service, and no 1 July 1988 service, can retire. The S.A. pension fund closed to new members in 1986 and so there are no members of the fund having 0 years pre-1 July 1988 service.

c) Tax-free component of defined benefit pensions after 1 July 2007

Taxed source pensions have, since 1 July 2007, a pre-1 July 1983 component which contributes to the pension's tax-free amount. This reduces tax payable for a pension recipient aged 55-59 years.

There is no pre-1 July 1983 component for an untaxed source pension even though members of untaxed pension funds are just as likely to have pre-1 July 1983 service as taxed fund members. For people retiring after 35 years fund membership there will be some pre-1 July 1983 service for anyone retiring before 2018.

2. Centrelink differences between taxed and untaxed fund pensions

The pre-1 July 1983 component of a taxed source pension not only contributes to the tax-free amount of the pension, it is not counted in the Centrelink income test. The effect is that a taxed fund pension recipient has a greater potential age pension entitlement than an untaxed pension recipient with the same service and salary history.

A person retiring in July 2008 after 35 years service has about 10 years pre-1 July 1983 service. This person's taxed source pension will have a pre-1 July 1983 component equal to about 29% of the gross pension value (10/35=0.29, 29%). This will lead to additional age pension entitlement of 40% of 29% = 12% of the superannuation pension's gross value.

3. $40,000 p.a. taxed, or $42,918 p.a untaxed: which is better?

Tables 1 and 2 compare net incomes delivered by a $40,000 p.a. taxed source pension and a $42,918 p.a. untaxed source pension. In Table 1 the pension recipients are single and in Table 2 each is married to a person with no income (other than age pension). For both the single and the married circumstance net incomes have been calculated for three different age blocks. The calculations take account of all applicable tax offsets.

For each different age block the advantage, or disadvantage, of the taxed source pension over the untaxed source pension is shown. Finally a figure for advantage or disadvantage over a common retirement period comprising age 60-78 years has been calculated. In Table 1 the common retirement period advantage of the taxed pension has been calculated as follows:

(5 x -$374 + 13 x $4,293)/18 =(-$1,870 + $55,809)/18 =$53,939/18 =$2,997 p.a

Table 1: Net income for equivalent pensions. Single person

Age	$40,000 p.a. taxed source pension	$42,918 p.a. untaxed source pension	Advantage of the taxed source pension p.a. (disadvantage)
55-59 years	$39,574	$36,082	$3,492
60-64 years	$40,000	$40,374	($374)
65+ years (Age pension)	$44,765 ($4,765)	$40,472 ($0)	$4,293
Common retirement period advantage for the taxed source pension p.a. (disadvantage)			**$2,997**

Table 2: Net income for equivalent pensions. Married person with a dependant spouse

Age	$40,000 p.a. taxed source pension	$42,918 p.a. untaxed source pension	Advantage of the taxed source pension (disadvantage)
55-59 years	$40,000	$38,182	$1,818
60-64 years	$40,000	$42,274	($2,274)
65+ years (Age pension)	$55,700 ($15,700)	$51,086 ($9,890)	$4,614
Common retirement period advantage for the taxed source pension p.a. (disadvantage)			**$2,700**

Note: the dependant spouse has no income other than age pension and the age pension amounts shown are for the couple i.e. each member of the couple receives half the amount shown.

The values in Tables 1 and 2 are quite sufficient to answer the question posed in the heading to this section:

> **for the case of people retiring about now, after 35 years service, a taxed source pension of $40,000 p.a. is considerably better to start with than the equivalent untaxed source pension of $42,918 p.a. As people have additional income the taxed source pension recipient moves even further ahead.**

4. The effects of other factors

The comparison made in Section 3 will alter as the following factors alter

i. **The amount of private, non-superannuation income.** As this increases the advantage of the taxed source pension becomes larger in all cases.

ii. **The date of retirement.** For people who retired before 2008 the advantage of the taxed source pension will be greater the earlier the retirement. For people retiring after 2008 the advantage of the taxed source pension will be less, the later the retirement. However, the large majority of people receiving defined benefit pensions have retired before 2008 and there will be relatively few examples of people retiring in future, with taxed source pensions, who are worse off than they would be with untaxed source pensions of equivalent value.

iii. **The gross superannuation pension value.** As the gross superannuation pension values increase the advantage of the taxed source pension will become greater. As gross pension value decreases the advantage of the taxed source pension will become less. However, gross pension values less than those used in Section 3 will tend to be those being paid to people who have been retired for some time. Therefore as pension value decreases this factor will be offset by the factor described in ii.

Summary of the effects of these other factors: they ensure that the conclusion reached in Section 3 about the superiority of a $40,000 p.a. taxed source pension over a $42,918 p.a. untaxed source pension holds for the large majority of the members of taxed and untaxed pension funds.

5. A protocol for achieving separate taxation of other income

A way of achieving the separate taxation of other income for people in receipt of untaxed source superannuation pensions, with relatively little alteration to existing arrangements, is set out in the seven step protocol below.

1. the income tax return includes all assessable income and deductions allowing a value for taxable income to be determined (as it is determined now).
2. the income tax return identifies the tax payer’s age and the amount of any taxable superannuation income stream that has been received from an untaxed source (as is the case now)
3. taxable income determined at 1 can be used to calculate LITO and SATO/Pensioner tax offset (as happens now)
4. the 10% tax offset and dependent spouse tax offsets are determined as they are determined now.
5. by simple departure from the current arrangements, the tax and medicare levy payable on the untaxed source superannuation income is determined. This tax payable (not the

medicare levy) is reduced by application of tax offsets and any resulting amount above zero is the taxpayer's liability for tax attributable to his/her untaxed source superannuation income.

6. Next the tax and medicare levy payable on the tax-payer's other income is determined as if it was the tax-payer's only income. The tax payable on this income is reduced by any tax offsets that remained unused after the tax liability attributable to untaxed source income stream income was determined. Any tax liability above zero is the tax-payer's liability for tax attributable to his/her non-superannuation income.
7. The total liability for the tax payer is the sum of the two medicare levy amounts and the two tax amounts determined at 5. and 6.

Taxing other income separately from untaxed source superannuation income by this method makes no difference to the single, untaxed source pension recipient of Table 1 because that person has no other income even after reaching age pension age. He/she is inevitably worse off than the corresponding taxed pension recipient because of the age pension entitlement of that person. But where people have additional non-superannuation income the method would reduce the disadvantage experienced by the untaxed source pension recipient.

For the couples compared in Table 2 this method of separately taxing the non-superannuation income of the untaxed source pension couple will reduce the disadvantage they currently experience. As the amount of non-superannuation income increases the reduction of the disadvantage will be greater but the couple in receipt of the taxed source superannuation pension will always be better off.

6. Equity issues

In the Consultation Paper Summary document in *Chapter 2 Principles and features of a new system,* under the heading *Equity,* there are a number of equity issues described as having been raised in the submissions. The relevant passage is reproduced below with two of the equity statements underlined

> <u>There is also a general view that individuals or families with the same capacity should face the same tax burden, although this is often not stated explicitly.</u>
> Other issues relating to the equity of the system include:
> • the impact of complexity, which tends to fall most heavily on those with the least capacity to deal with it;
> • the role of the beneficiary principle — that people should pay tax broadly in accordance with the benefits they receive from government spending, regardless of their income;
> <u>• the importance of inter-temporal equity — which considers how the system affects individuals over their entire lifecycle, not just in a particular year; and</u>
> • what account to take of intergenerational equity, which is concerned with how tax-transfer decisions taken now will affect the wellbeing of future generations.

The validity of the first statement we have underlined is self-evident and it is not surprising that the Panel has received many submissions consistent with the statement but in which it was not explicitly stated.

The second underlined statement about 'inter-temporal equity' is particularly relevant to the case we are trying to make. **The members of untaxed defined benefit pension funds and the members of taxed defined benefit funds may be fairly described as two groups of**

Australians that have lived parallel lives. Roughly equal proportions in each group began work at about the same time, worked for about the same length of time and then retired about the same time. The importance of inter-temporal equity creates the need to compare how the tax system has affected members of the two groups over an extended period.

We will make this comparison by considering two people who both retired in 1999 after 35 years service. We will assume that in 1999 one person was in receipt of a taxed source pension of $40,000 p.a. and the other an untaxed source pension of equivalent value, $41,580. This equivalent value for the untaxed source pension has been estimated using the method set out in Section 1(b) above.

Using the 1999/2000 financial year tax parameters the net values for the taxed and untaxed pensions in that year were:

$40,000 p.a. taxed source pension. Net value =$35,598 p.a.
$41,580 p.a. untaxed source pension. Net value =$30,475 p.a
Advantage of the taxed source pension is $5,123 p.a.

So we see that from 1999 until 2007 the taxed pension recipient enjoyed a very large advantage over the untaxed pension recipient with an equivalent pension.

Taking all of the above discussion into account the Association believes that the overwhelming majority of the members of untaxed defined benefit pension funds will, during their retirements, pay substantially more tax than the members of taxed defined benefit pension funds with the same salary and employment histories. This inequitable state of affairs will be remedied, at least to some extent, if non-superannuation income is taxed separately after age 60 for all Australians rather than just for those Australians belonging to taxed funds. **The Association believes that the case for separate taxation of non-superannuation income of untaxed defined benefit pension recipients, aged over 60, is unanswerable.**

7. Improving the evidence base

In Appendix D of the Consultation Paper the Association has noted the following statement:

> To help inform the Review Panel's deliberations, a wide range of opinions and expertise needs to be considered. The consultation process will help elicit some of this information. However, the Review Panel is conscious of the need to engage technical and academic expertise where required. As such the Review Panel has decided to commission research in a number of areas, some of which may be published by the review and/or presented to the tax conference planned for 2009.

We commend the Panel for making an effort to ensure that it has a high quality evidence base for its deliberations but we have been very disappointed to see it make the statement that taxed pension recipients have pre-paid tax on their pensions at the maximum superannuation tax rate of 15%.

For this reason we request the Panel to seek an independent and detailed analysis of the impact that the taxes on superannuation fund income introduced on 1 July 1988 have had on the gross value of defined benefit pensions paid from taxed funds and that have commenced between 1 July 1988 and the present time.

This analysis once obtained should be published

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