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

From: *SA Government Superannuated Employees Association* trading as *SA Superannuants*
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Title: Elimination of Unequal Tax & Centrelink Outcomes for Members of Untaxed Pension Funds Compared to Taxed Pension Fund Members

Relevant Terms of Reference
2. Raising revenue should be done so as to do least harm to economic efficiency, provide equity (horizontal, vertical and inter-generational), and minimise complexity for taxpayers and the community;
3.2 Improvements to the tax and transfer payment system for individuals and working families, including those for retirees;
7. The review should take into account the relationship of the tax system with the transfer payments system and other social support payments, rules and concessions, with a view to improving incentives to work, reducing complexity and maintaining cohesion;

Introduction
Taxed pension funds are intrinsically superior to untaxed pension funds when it comes to delivering after-tax income to members. This superiority is due to the facts that

a) The tax concessions on personal income available to recipients of taxed source pensions have a value greater than the tax that the funds have paid on the assets accumulating to fund the pensions; and
b) a higher proportion of pensions paid from untaxed funds is counted in the Centrelink income test than is the case for most pensions paid from taxed funds.

This submission argues that the 'Better Super' reforms which took effect from 1-7-2007 have added to tax and Centrelink disadvantages that members of untaxed defined benefit pension funds experience compared to members of taxed funds.

The submission includes proposals which, if adopted, would see members of untaxed funds have their self-funded superannuation income assessed more fairly for tax and Centrelink purposes. SA Superannuants urges the tax review panel to adopt the remedies proposed below so that the unequal outcomes for untaxed fund members, introduced by 'Better Super', are eliminated.

We make the point that each untaxed superannuation fund only exists because an Australian Government (State or Commonwealth) determined that it would, and made the decision to operate an untaxed fund, rather than a taxed fund, without making any attempt to obtain the informed agreement of the people who would be affected. In our view this places an obligation on the Commonwealth Government to ensure, as far as practicable, that members of untaxed funds enjoy equal retirement income outcomes as are enjoyed by members of comparable taxed funds.

The submission also requests the tax review panel to keep in mind the importance of tax offsets for members of untaxed pension funds. Simplification of the tax system through changes to tax offsets must not have the effect of putting members of untaxed funds even further behind members of taxed funds than they now are.

We want to emphasise that our submission is not about escaping the payment of tax and the Medicare levy, or about getting more age pension. It is about paying the same level of tax on the same forms of income, and having income assessed in the age pension income test on the same basis, as other Australians with comparable incomes. We know that receiving our superannuation income as tax-free income would not be fair to members of taxed funds and so we have no quarrel with the fact that our superannuation income is still taxable when that of taxed fund members is tax-free after age 60. **It is the extra tax we pay on non-superannuation income, and the more severe assessment of our pensions under the Centrelink income test, that are the matters of concern to us**.

Unequal Tax Outcomes

Unequal tax outcomes for untaxed fund members after 'Better Super' arise from two main sources

a) for people age 60+ belonging to taxed pension funds other income (non-superannuation income) is taxed as if it was the only income while the corresponding members of untaxed funds have other income added to superannuation income
b) members of taxed pension funds retiring after 1-7-1994 now have a pre-1 July 1983 component calculated for their pensions and this component is tax-free at any age. There is no corresponding component of an untaxed source pension even though untaxed fund members usually have pre-1 July 1983 service, and even though taxes on superannuation fund income were not introduced until 1 July 1988.

Unequal Centrelink Outcome

The unequal Centrelink outcome for untaxed fund members following 'Better Super' arises from the fact that 'Better Super' included an expansion of the tax-free amount of a taxed source, defined benefit pension to include a pre-1 July 1983 component when the same change was not made for untaxed source pensions. This difference sees members of taxed pension funds get larger age pension entitlements than members of untaxed pension funds with equivalent service and salary histories. This happens because the expanded tax-free amount of taxed source pensions not only reduces tax liability, it reduces the amount of pension income counted in the Centrelink income test and therefore increases the amount of age pension received.

Defined Benefit Pensions and the Centrelink Asset Test
Defined benefit pensions are exempt from the Centrelink assets test and this fact is sometimes claimed to be an advantage that recipients of such pensions have over other Australians in receipt of account-based pensions (allocated pensions). This claim does not stand up to close examination, as explained below, but we have a concern that it might be used as a justification for continuing with less favorable treatment of untaxed source defined benefit pensions under the Centrelink income test.

There are two good reasons why the asset test exemption of an untaxed source defined benefit pension should not be seen as providing a justification for assessing the pensions more severely in the income test.

The first reason is that both taxed source and untaxed source defined benefit pensions are exempt from the asset test. If asset test exemption was a real advantage then taxed-source defined benefit pensions would be assessed in the Centrelink income test on exactly the same basis as untaxed source pensions. Taxed source pensions would not have a pre-1 July 1983 component that was exempt income under the income test. But they do.

The second, and more fundamental, reason is that a defined benefit pension cannot be cashed in except in very restricted and prescribed circumstances. Account-based pensions can be cashed in at any time after preservation age. After preservation age an account-based pension is a genuine asset able to be deployed in any way the owner decides. A defined benefit pension only yields an income stream and has no asset value once the right to commute has lapsed.

Illustrative Examples of Disadvantage
Example 1: Thelma and Louise are both age 60 and have recently semi-retired. Thelma gets a $40,000 pension from a NSW pension fund which is taxed and Louise gets a $35,000 pension from an untaxed fund in SA. They are both doing some part-time work from which each earns $20,000. Thelma pays $900 tax on her $20,000 employment income because it is taxed as if she has no other income. Louise pays 30% of her employment income as tax ($6000) because it is taxed at her marginal tax rate for her super pension.

Example 2: Fred and Barney aged 67, with wives who have no income other than age pension, were both in state government employment before retiring in 2000 after 35 years service. Their salaries were identical throughout their employment. Fred was a NSW public sector employee belonging to one of that state's taxed pension funds and his pension is $37,000 p.a. Barney receives a pension of $40,000 p.a. from SA's untaxed state pension fund. The reason that Fred has a smaller pension than Barney is that his pension fund has been subject to taxation since 1 July 1988. Otherwise he would also be getting a $40,000 p.a. pension. In other words the two pensions are equivalent.

Note: It was not Barney's choice to get a $40,000 pension from an untaxed fund rather than a $37,000 pension from a taxed fund. He was compelled to take an untaxed source pension as a result of a government decision to run his fund as an untaxed fund and not a taxed fund. **Barney had no say in this.**

Any well-informed person, given a choice in 2000 between what has now become a $40,000 untaxed source pension and what has now become a $37,000 taxed source pension, would have opted then, and would opt now, for the lower, taxed-source pension. The Table on the next page shows why.

It can be seen from the Table that, before ‘Better Super’, Barney and his wife were $2,600 p.a. worse off than Fred and his wife. The effect of ‘Better Super’ has been to increase the advantage enjoyed by Fred and his wife from $2,600 p.a. to $6,538 p.a. This substantial improvement is due to the much greater age pension entitlement that Fred and his wife now have, and the fact that they pay no tax or Medicare on a substantially larger total income. The greater age pension entitlement has come from the inclusion of a pre-1 July 1983 component in Fred’s super pension which Centrelink does not count in its income test.

Note: the fact that taxed fund members aged over 60 can receive any amount of superannuation income without that income creating an obligation to pay the Medicare levy seems quite illogical to us. However, we make no argument for this particular inequality between untaxed fund members and taxed fund members to be eliminated by extending the exemption from the Medicare levy to income received from untaxed pension funds.

	Fred (taxed fund)	Barney (untaxed fund)
Super Pension	$37,000	$40,000
Age Pension	$19,118	$10,717
Total Income	$56,118	$50,717
Tax Paid	$0	$472*
Medicare Paid	$0	$665*
Net Income	$56,118	$49,580
Untaxed fund disadvantage with ‘Better Super’		$6,538
Untaxed fund disadvantage without ‘Better Super’		$2,600**

*Calculated on a taxable amount of $39,000 p.a. for Barney’s superannuation pension to allow for a tax-free amount arising from his undeducted contributions. Fred also made the same amount of undeducted contributions but his entire pension is tax-free after ‘Better Super’. Barney’s tax paid of $472 is the result of his ability to claim a 10% tax offset of $3,900 on the taxable amount of his super pension and additional tax offsets.

**Without ‘Better Super’ Fred’s $37,000 p.a. super pension (reduced in the Centrelink income test by $1000 for his undeducted contributions) would give him and his wife a net income of about $48,300 after allowing for age pension entitlement and the requirement to pay the Medicare levy. Without ‘Better Super’ Barney and his wife would have a net income of about $45,700.

Proposed Remedies

1. Superannuation income to be taxed separately from other income for everyone aged 60+.

Justification: people receiving the same category of income (bank interest, employment income, age pension….) should have that income subject to the same rates of taxation. It seems illogical for people who have tax-free super income without limit, from a taxed source, to have their additional income taxed as if it was their only income while people in untaxed funds who pay tax on their super income, once it exceeds a modest level, have any additional income taxed at a rate of 31.5%.

It seems particularly odd that people in receipt of age pension income pay tax on that income according to whether their superannuation income is sourced from a taxed fund rather than an untaxed fund.

2. Untaxed, defined benefit pension funds to be permitted to calculate a pre-1 July 1983 component for pensions in the same way that this is now being done for taxed, defined benefit pension funds. This component to be included in the tax-free component as for taxed pension funds and/or as a component used for Centrelink purposes. This to apply for all pensions (taxed and untaxed) regardless of when the pension commenced.

Justification: members of both untaxed and taxed pension funds are equally likely to have made undeducted contributions and are equally likely to have pre-1 July 1983 service. The tax-free component of both types of pension should therefore take account of both factors at least for Centrelink purposes if not for tax purposes. This would be a valuable improvement for untaxed fund members in receipt of small super pensions and having pre-1 July 1983 service. Many of these people gained little, if anything, from 'Better Super'.

The fact that a pension, whether taxed or untaxed, commenced before 1-7-1994 should not preclude the recipient from having a pre-1 July 1983 component calculated for the pension.

3. Age pension income to be tax-free for all recipients
Justification: most people receiving their self-funded retirement income from a taxed source are already paying no tax on any amount of age pension income they might also be receiving. This is because such income would be getting taxed separately from their income derived from a taxed source. Therefore it would be reasonable for age pension income to be treated as tax-free income for everyone.

4. A 10% Tax Offset to be allowed for overseas occupational pensions
Justification: overseas occupational pensions closely resemble Australian defined benefit pensions in that a person makes a contribution from personal income towards the cost of the pension. It seems reasonable to allow recipients of such pensions to claim a 10% tax offset on this form of income.

The Importance of Tax Offsets for Members of Untaxed Pension Funds
Being about the only substantial group of retirees who now pay any tax or Medicare levy on modest retirement incomes, members of untaxed funds cannot afford to have tax offsets removed. For example, most senior Australians no longer make use of the Senior Australians Tax Offset because they are no longer taxpayers. Removal of the Senior Australians Tax Offset would have no impact on net income of the majority of retirees, but it would have an impact on senior Australians who rely on pensions paid from untaxed sources.

In the example above, of Fred and Barney, removal of the Senior Australians Tax Offset will have no effect on Fred and his wife. They will still pay no tax and no Medicare levy on their total income of $56, 118 p.a. But without the Senior Australians Tax Offset, Barney and his wife will pay a substantial amount of additional tax and end up even further behind Fred and his wife than they are now.

The Importance of Providing the Reasons for Policy Decisions
When it first came to the notice of our Association that the non-superannuation income of untaxed pension recipients would be taxed at a person's full marginal rate while that of taxed pension recipients would be taxed as if was the only income we sought an explanation. All we got was an unsubstantiated claim that this difference was taken into account when the

10% tax offset was allowed for untaxed source pensions paid to people aged over 60. Requests made for documentation of how the difference had been taken into account have not been met.

Similarly, there is no reason available for the remarkable decision to allow a pre-1 July 1983 component for taxed pensions to be exempt from the Centrelink income test but not for untaxed source pensions.

The Association urges the review panel to ensure that its recommendations to Government on the future tax system are accompanied by clear accounts of the basis for the recommendations wherever they will affect one group of Australians differently than another group.

Dr R.J.S. Hickman, October 2008