

SUBMISSION TO THE REVIEW OF AUSTRALIA'S TAX SYSTEM

There are two areas where Australia's tax system is inequitable in relation to retired Commonwealth employees.

The first issue relates to the taxing of pre 1 July 1988 accrued superannuation benefits where superannuation recipients from other superannuation funds (funded and unfunded) did not and have not paid tax on superannuation benefits that accrued before 1 July 1988.

The second issue relates to the rate of marginal tax that applies to those receiving superannuation pensions from an untaxed source.

Inequitable tax treatment of CSS pensioners

Before 1 July 1988 superannuation funds did not pay tax on their earnings or on employer contributions. Accordingly, there was no difference between a taxed and an untaxed superannuation scheme as all pension benefits paid from superannuation schemes and funds before 1 July 1988 were taxed at marginal tax rates.

Under "Better Super", benefit recipients aged 60 and over do not pay tax on their superannuation benefits that are paid from a taxed source. This means that from 1 July 2007 no tax was ever paid (by the superannuation fund or benefit recipients) on superannuation benefit that accrued before 1 July 1988.

However, there is one group that still pay tax on pre 1 July 1988 benefit accruals and they are Commonwealth superannuation scheme (CSS) pensioners. Recipients of other unfunded Commonwealth superannuation schemes also suffer this inequity. As I am receiving a CSS pension I will only refer to the CSS in my submission.

Tax applied to unfunded CSS pensions that have an accrual period before 1 July 1988 is inequitable when compared to the tax being applied to pension recipients from other non Commonwealth unfunded superannuation schemes. The inequity arises out of the inability to apply Pre 1 July 1988 Funding Credits to CSS superannuation retirement benefits.

The *Income Tax Assessment Act 1997* contains a provision to allow unfunded superannuation schemes to utilise Pre 1 July 1988 Funding Credits. This mechanism is designed to ensure that superannuation benefits that accrued before 1 July 1988 in an unfunded superannuation scheme are regarded as if they were funded from a taxed source and accordingly taxed as an element taxed. This avoids benefits that accrued before 1 July 1988 from being taxed as untaxed benefits. This is necessary as tax was not applied to superannuation funds (earnings or contributions) before 1 July 1988 and accordingly no taxes were applied to such accruals in funded or unfunded superannuation schemes.

A good description and purpose for Pre 1 July 1988 Funding Credits was provided at paragraph 9.2, Chapter 9 of the Explanatory Memorandum to the *Tax Laws Amendment (2006 Measures No. 3) Act 2006*. The paragraph states:

“9.2. Since 1 July 1988 most contributions (eg, employer and other deductible contributions) to superannuation schemes have been subject to a 15 per cent tax. Funding credits were granted to unfunded superannuation schemes so that contributions made after 1 July 1988 to fund benefits that accrued prior to 1 July 1988 are not taxed. This ensures equity with funded superannuation schemes which only pay tax on contributions from 1 July 1988.”

However, with regards to CSS superannuation benefits there is no mechanism to ensure equity with funded superannuation schemes for benefit accruals before 1 July 1988. Pre 1 July 1988 Funding Credits cannot be used by the CSS Trustee and as a result when benefits are paid out of the CSS the component of the payment that accrued before 1 July 1988 is taxed as if it was paid from an untaxed superannuation scheme. Unfunded State Superannuation Schemes were able to utilise Pre 1 July 1988 Funding Credits to ensure that tax is applied equitably against the payment of their superannuation benefits, that is, no tax paid on benefit accruals before 1 July 1988.

The reason why Pre 1 July 1988 Funding Credits cannot be applied in the CSS appears to be due to the way the Commonwealth chooses to pay CSS retirement benefits. The Trustees of unfunded State Superannuation Schemes chose to pay their superannuation benefits out of their respective superannuation funds after receiving unfunded contributions from the employer at the time of retirement or benefit payment. When the unfunded employer contribution was paid into the superannuation fund at the time of benefit payment, no contributions tax is paid on that part of the employer contribution that is funding accruals before 1 July 1988 as the tax that would have been paid on those employer contributions is offset by Pre 1 July 1988 Funding Credits. Therefore, even though benefits that accrued before 1 July 1988 were not funded until the time of retirement or benefit payment and with no contributions tax effectively being paid on those employer contributions (similar arrangement to the CSS) the benefit payment is regarded as being paid from a taxed source and taxed accordingly.

The difference between the CSS and other unfunded superannuation schemes that are entitled to utilise Pre 1 July 1988 Funding Credits is that the Commonwealth chooses to pay CSS retirement benefits out of Commonwealth revenue rather than out of the CSS superannuation fund. That is, when a benefit becomes payable the member's accumulated member and productivity contributions in the CSS superannuation fund is transferred from the CSS superannuation fund into Commonwealth revenue. The Commonwealth then adds employer contributions to the benefit payment and pays the CSS superannuation benefit to the benefit recipient from Commonwealth revenue. This process is prescribed in section 112 of the *Superannuation Act 1976*.

By paying superannuation benefits in the reverse way to the manner in which unfunded State Superannuation funds pay their retirement benefits, has resulted in no employer contributions actually being paid by the Commonwealth into the CSS superannuation fund and therefore there is no contribution tax liability generated to enable Pre 1 July 1988 Funding Credits to offset any tax liability. The result is that unfunded pre 1988 accruals in the CSS and PSS are element untaxed and taxed accordingly when unfunded pre 1 July 1988 accruals in other unfunded

superannuation funds are regarded as element taxed and not subject to tax where the recipient is aged 60 and over.

The method of paying CSS superannuation benefits is grossly unfair, especially as the Commonwealth Government has set up a mechanism for benefit recipients of other unfunded superannuation schemes to receive equitable tax treatment with funded superannuation schemes. CSS superannuation scheme benefit recipients miss out on equitable tax treatment of their superannuation benefits only because the Commonwealth Government chooses to pay superannuation benefits through the Consolidated Revenue Fund rather than through the CSS superannuation fund. There is no difference in the end result irrespective of the payment mechanism other than the loss of the application of Pre 1 July 1988 Funding Credits and CSS benefit recipients paying tax on pre 1 July 1988 accruals, which is tax free for everyone else. Accordingly, I believe that there is no reason why CSS benefit recipients should not be taxed the same way as other recipients of unfunded superannuation schemes in respect of their unfunded superannuation benefits that accrued before 1 July 1988.

A possible solution to correct the inequitable tax treatment applied to CSS benefit recipients with accruals before 1 July 1988 would be for the Government to make regulations in accordance with division 307 of the *Income Tax Assessment Act 1997* to specify that CSS benefits that accrued before 1 July 1988 be treated as element taxed in the fund. This would have the same affect as applying Pre 1 July 1988 Funding Credits to the CSS in respect of benefits that accrued before 1 July 1988. This would then enable a fair and equitable tax treatment to apply to CSS benefits as intended for other unfunded superannuation schemes through the application of Pre 1 July 1988 Funding Credits.

Rate of tax on additional non superannuation income for those aged 60 and over

The tax treatment of additional non superannuation taxable income applied to a person receiving an element untaxed superannuation income stream is inequitable when compared to a person receiving an element taxed superannuation income stream.

For example, a recipient aged 60 and over receiving a superannuation pension from a taxed source will not pay any tax on their superannuation pension irrespective of the amount of the superannuation pension being received. In addition, the income from the superannuation pension will be exempt income and not be counted with any other non-superannuation income to determine the marginal tax rate to be levied against other non-superannuation income. On the other hand, where the superannuation pension is paid from an untaxed source the amount of the pension will continue to be assessable income and therefore will be used in determining the recipient's marginal tax rate. As a result, a higher marginal tax rate will generally be levied against any additional non-superannuation income. This is illustrated in the following table.

Type of income	Superannuation income stream element tax	Superannuation income stream element untaxed
Superannuation pension	\$40,000	\$40,000
Non-superannuation income	\$20,000	\$20,000
Total income	\$60,000	\$60,000
Tax	\$ 1,169	\$ 8,900
Net income	\$58,831	\$51,100
Tax on \$20,000 non superannuation income	\$ 1,169	\$ 7,100

The additional \$20,000 non superannuation income for the recipient receiving a superannuation income that is element untaxed is taxed at the rate of 35.5%. The tax is as follows:

30% marginal tax rate	$\$20,000 \times 30\% =$	\$6,000
4% tax rate for loss of low income tax offset	$\$20,000 \times 4\% =$	\$ 800
1.5% Medicare levy	$\$20,000 \times 1.5\% =$	<u>\$ 300</u>
Tax on additional \$20,000 non superannuation income		\$7,100

On the other hand, the additional \$20,000 non superannuation income received by the recipient receiving a superannuation income that is element taxed is taxed at the rate of 5.8%. The tax is as follows:

0% marginal tax rate for \$6,000	$\$6,000 \times 0\% =$	\$ 0
15% marginal tax rate for \$14,000	$\$14,000 \times 15\% =$	\$2,100
Less full low income tax offset		\$1,200
Reduced Medicare levy		<u>\$ 269</u>
Tax on additional \$20,000 non superannuation income		\$1,169

Non-superannuation income received by recipients with a superannuation pension from an untaxed source, as illustrated in the above table, is taxed at the marginal tax rate of 30%, plus an extra penalty of 4 cents in the dollar due to the reduction in the low income tax offset and the full Medicare levy.

This does not produce an equitable result between the recipients of the two superannuation pensions, especially in regard to the marginal tax rate applied to non-superannuation income and the reduction in the low income tax offset.

To make the tax applied to non superannuation income more equitable between those receiving income streams from tax and untaxed sources it is suggested that the income stream from an untaxed source be separated out as special income and taxed separately and other non superannuation income be assessed as normal assessable income.

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