

# MERCER

Human Resource Consulting

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7 August 2006

General Manager  
Superannuation, Retirement and Savings Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Subject:

## **Mercer Submission No. 5 – Untaxed Schemes**

Dear Sir

This is the 5th submission made by Mercer Human Resource Consulting in response to the Government's Plan to Simplify and Streamline Superannuation.

### **Key Government proposals covered in this submission**

- Schemes providing untaxed benefits will be treated in a different manner to other schemes;
- Benefits paid on an untaxed basis will be taxed differently to benefits paid on a taxed basis;
- The imposition of a \$700,000 limit on untaxed benefits that are taxed on a concessional basis;
- A 10% tax offset to apply to all pension payments made on an untaxed basis.

### **Executive Summary**

We are very concerned, on both grounds of equity and complexity, with the proposed arrangements for funds which pay “untaxed” benefits.

On the one hand, members entitled to untaxed benefits may consider that they are unfairly treated with an effective cap on concessional taxed lump sum benefits of \$700,000. One example is where a member in a scheme paying taxed benefits could build-up such a benefit after only about 12 - 15 years of contributing at the proposed \$50,000 pa concessional taxed limit for “taxed” schemes. Contributing for a longer period would generate a benefit of significantly more than the \$700,000 limit proposed for untaxed benefits.

On the other hand, those who cannot participate in such “untaxed” schemes will consider that the proposed rules unduly favour such arrangements. Two, of several, examples are:

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Some members of “untaxed” schemes will be entitled to very significant pensions that involve a contribution cost of significantly more than the \$50,000 pa limit for “taxed” schemes yet will not incur the proposed higher 45% tax applicable to excess contributions made to a “taxed” fund; in addition to their concessional lump sum of \$700,000, members of “untaxed” schemes will also be able to make significant contributions to a “taxed” scheme, thereby taking double advantage of the concessional provisions.

Complexity is also a serious concern. Whilst it is clear that some differences between the treatment of “taxed” and “untaxed” schemes will be required, the significant differences in the proposed arrangements will create additional confusion and communication problems.

Whilst for some “untaxed” schemes, the process will be relatively clear cut, for other funds, particularly those which currently pay both untaxed and taxed benefits, or which change from paying benefits on an untaxed basis to a taxed basis (or vice versa), the proposed operation of the new system is totally unclear. It is difficult to envisage how the proposals can work at all, let alone on an equitable basis.

We strongly urge the Government to reconsider its proposals for “untaxed” schemes and instead to adopt a system that mirrors that proposed for taxed schemes.

We believe that such an approach will be more equitable, more acceptable to members of “untaxed” schemes and will appear more reasonable to the general public. You will recall that in our submissions 1 and 2, we argued for a system in which:

- funds report contributions (or notional contributions);
- the ATO determines whether any limits have been exceeded and deals with the member if this has occurred;
- the ATO issues an assessment to the member for any excess tax with the member able to pass the assessment to a superannuation fund for payment.

It is our view that this system could work equally well for “untaxed” arrangements. Where a constitutionally protected or unfunded scheme is asked to pay the tax, the tax liability could then be deferred until a benefit becomes payable in a similar manner to the deferral provisions used for the superannuation surcharge.

The attached report sets out more background and reasoning behind the recommendations outlined above.

Our full recommendations are set out in Appendix 1 to this letter.

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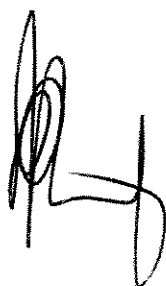
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In Appendix 2, we have listed the previous submissions made by Mercer on the Government's discussion paper. We intend making several more submissions over the next two days.

Please contact either John Ward (03 9623 5552) or David Knox (03 9623 5464) if you wish to discuss any of these issues. They will be happy to elaborate further on our ideas.

Yours Sincerely

A handwritten signature in black ink, appearing to be 'Peter Promnitz', written in a cursive style.

Peter Promnitz  
Chief Executive

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## APPENDIX 1: Mercer Recommendations In Relation To Untaxed Schemes

<b>Recommendations</b>	<b>Government Discussion Paper Reference</b>
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### **Inequities and Practical Problems – Refer to Section 1 of attached report**

1.1	The proposed treatment of “untaxed” schemes will create too many inequities and, in any event, cannot operate effectively due to the possibility of schemes moving from paying untaxed to taxed benefits or vice versa. A system that more closely mirrors that proposed for schemes paying taxed benefits should be adopted for Constitutionally Protected Schemes and other public sector schemes which pay untaxed benefits.	8
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### **Preferred Alternative Approach - Constitutionally Protected Schemes – Refer to Section 2 of attached report**

2.1	Contribution limits equal to those applicable to funds paying taxed benefits should also apply to Constitutionally Protected schemes. An assessment for any tax of 30% of any excess contributions would be issued to the member who could either pay the tax or request that their superannuation fund pay the tax on their behalf. If the member requests that the tax be paid by their Constitutionally Protected scheme, the tax payment could be deferred until a benefit becomes payable (similar to the arrangements put in place for surcharge).	
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**Preferred Alternative Approach - Other Schemes Paying Untaxed Benefits – Refer to Section 3 of attached report**

3.1	Contribution limits equal to those applicable to funds paying “taxed” benefits should also apply to superannuation schemes paying “untaxed” benefits. An assessment for tax of 30% of any excess contributions would be issued to the member who could either pay the tax or request that their superannuation fund pay the tax on their behalf. If the member requests that the tax be paid by a superannuation fund which is unfunded, the tax payment could be deferred until a benefit becomes payable (similar to the arrangements put in place for surcharge). (This recommendation is effectively the same as Recommendation 2.1 which covered Constitutionally Protected schemes.)	
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**Tax on Benefits – Refer to Section 4 of attached report**

4.1	Untaxed lump sum benefits received from age 60 should be included in tax returns but excluded from the definition of taxable income. The member would still be liable for the proposed 15% tax on the post-June 83 component of the superannuation benefit. (As with the current system, this 15% tax should be a maximum rate of tax. If including the lump sum in taxable income would have resulted in a lower amount of tax, the lower tax should apply.)	8.2.1 and 8.2.3
4.2	The Government should give further consideration to the tax treatment of untaxed pensions from age 60 in order to minimise the inequities between the treatment of taxed and untaxed pensions. We have outlined some possible methods for consideration in the attached report.	8.2.2 and 8.2.3

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## **APPENDIX 2: Previous Submissions made by Mercer Human Resource Consulting**

<b>Submission</b>	<b>Date</b>
Submission Overview	13 July 2006
Submission No. 1 - Undeducted Contributions	13 July 2006
Submission No. 2 - Deductible Contributions	13 July 2006
Submission No. 3 - Portability	31 July 2006
Submission No. 4 - Benefit Taxes	1 August 2006

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# **A Plan to Simplify and Streamline Superannuation**

## **Submission No 5: Untaxed Schemes**

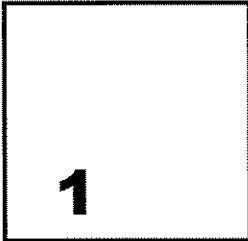
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**MERCER**  
Human Resource Consulting

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## **Section 1: Inequities and Practical Problems**

Wherever differences in treatment exist, there will be concerns that one group is being treated more or less harshly than the other. Differences are also likely to lead to strategies being developed to take advantage of the different treatments.

### *Inequities*

There will be a number of inequities between the Government's proposed treatment of members in "untaxed" schemes and those in "taxed" schemes. These inequities will become apparent over time. In some cases the inequities may be more perceived than real but nevertheless we consider that it is critical that inequities be avoided as far as possible.

Members entitled to untaxed benefits may consider that they are unfairly treated:

- The proposed \$700,000 cap on concessional taxed lump sum benefits is low. For example, a member of a scheme paying "taxed" benefits could achieve such a benefit by contributing at the maximum concessional taxed contribution limit of \$50,000 for 12 - 15 years;
- The proposed cap on untaxed benefits is also retrospective as it applies to benefits which accrued in the past and which will accrue in the future, whereas the limit on deductible contributions only applies to future contributions;
- All untaxed benefits will be included in members' tax returns and treated as taxable income. This will increase the tax payable on other income in retirement. On the other hand, taxed benefits received after age 60 will not be taxable at all and will not impact on the tax payable on other taxable income;
- The proposed \$700,000 cap may be lower than the current transitional reasonable benefit limit for some members;
- Members receiving large untaxed pensions will be disadvantaged as they may be paying marginal tax of 30% or 35% on a significant part of their pension (after allowing for the proposed 10% tax offset), whereas members receiving taxed pensions will have paid 15% contribution tax but will pay no tax on the eventual pension (after 60).

On the other hand, members who are not entitled to untaxed benefits may consider that members entitled to untaxed benefits are significantly advantaged:

No additional tax applies to contributions (or notional contributions) in excess of the proposed \$50,000 pa limit as would have applied in a scheme paying taxed benefits; Members entitled to untaxed benefits can effectively receive unlimited pension benefits (in addition to the \$700,000 concessionally taxed lump sum); Members entitled to untaxed benefits can also arrange for contributions to be made to schemes paying taxed benefits and hence double dip by maximising their superannuation under two different sets of rules; Many members of schemes paying untaxed benefits will be able to avoid tax on **both** contributions and benefits. With no contribution tax generally being taken into account during the employment phase, the gross benefit could then be paid in the form of an untaxed pension. For single pensioners over 65, the pensioner could receive an untaxed pension up to \$31,700 pa without incurring any tax on the pension (assuming no other income).

### *Practical problems*

From a practical point of view, we do not consider that the Government's proposals for untaxed benefits can operate effectively. The decision as to whether a benefit is paid on a taxed basis or an untaxed basis is made when the benefit is paid - not when the contribution (or notional contribution) is made.

Funds can and, have in the past, changed from paying untaxed benefits to paying taxed benefits. There is generally no reason why funds could not make further changes in future and recommence paying benefits in untaxed form.

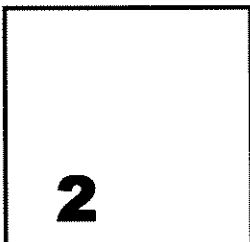
In at least one very large scheme, members are actually given a choice, at retirement, of taking a taxed benefit or a higher untaxed benefit. These arrangements have been provided to ensure that members were not disadvantaged by changes in the scheme's rules.

For a scheme operating on an untaxed basis, members would not be impacted by the higher contribution tax imposed on schemes paying taxed benefits where contributions exceed \$50,000 pa. Yet by the time they retire, the scheme may actually be paying taxed benefits and so the \$700,000 limit applicable to concessionally taxed lump sum untaxed benefits would not apply to them either. In other words, these members would avoid all of the proposed limits.

On the other hand, if the \$50,000 pa contribution limit is imposed during the member's membership period, and the eventual benefit is paid in untaxed form, the member may have been penalised by both the \$50,000 pa contribution limit and the \$700,000 benefit limit.

It is therefore difficult to understand how the Government's proposals can work effectively in this environment.

**Recommendation 1.1: The proposed treatment of “untaxed” schemes will create too many inequities and, in any event, cannot operate effectively due to the possibility of schemes moving from paying untaxed to taxed benefits or vice versa. A system that more closely mirrors that proposed for schemes paying taxed benefits should be adopted for Constitutionally Protected schemes and other public sector schemes which pay untaxed benefits.**



## **Section 2: Preferred Alternative Approach – Constitutionally Protected Schemes**

### *General*

Constitutionally Protected schemes have generally been set up by State Governments in a manner which protects them from various Federal taxes. There are only a small number of such funds in existence. Most funds operated for employees of State Governments are not constitutionally protected.

The Commonwealth Government is unable to assess Constitutionally Protected schemes for tax on contributions or investment income. The Commonwealth is however, able to tax members of these funds in respect of benefits payable and also contributions (as was done in relation to the superannuation surcharge, albeit successfully challenged in the High Court in *Austin v The Commonwealth of Australia*).

These schemes may be fully or partly funded, or may not be funded at all.

We accept that it would not be legally possible to impose an extra tax on these schemes based on excess contributions (or notional contributions).

However, we see no reason why the Federal Government could not impose a tax **on members** in respect of (notional) contributions in excess of the same \$50,000 pa limit as has been proposed for “taxed” schemes. This proposal to tax members (rather than the fund) is consistent with the proposals we have made in our Submission No. 2 on deductible contributions in relation to “taxed” schemes. As with “taxed” schemes, the additional tax would be 30% of the excess contribution.

Having received the assessment, the member could request that the superannuation scheme pay the tax on the member’s behalf.

Alternatively, for unfunded Constitutionally Protected schemes, the Government could consider allowing the payment of the tax debt to be deferred (and grow with interest) until

a benefit becomes payable. This is similar to the treatment under the superannuation surcharge legislation.

However, particularly where the scheme is unfunded, the above approaches could create similar difficulties to those exposed in the High Court case referred to above.

In particular, the Court considered that the surcharge legislation placed a particular disability or burden upon the operations or activities of a State so as to be beyond the legislative power of the Commonwealth. We understand that this “burden” involved the particular State in amending State legislation to enable a retired judge to commute part of his/her previously non-commutable pension to pay the accumulated surcharge debt.

However we think that it may be possible to avoid this particular problem. For example, the Government could allow any accumulated tax debt under the new system to be paid off over time by the pensioner, similar to the repayment of a HECS debt. This would avoid any need for States to amend their own legislation to allow non-commutable pensions to be commuted for the purposes of paying the accumulated tax debt.

At least some of the other concerns raised in this Court case would or could also be removed under our recommended approach. In particular, judges would be treated in the same way as all other Australians (except perhaps in the ability to pay off any tax debt over time).

Clearly specifying in the legislation how the tax is to be calculated (as opposed to the very vague methodology initially legislated for surcharge) may also diminish concerns that the notional contributions are “fictional” and are calculated by reference to actuarial assumptions that may have no relationship to the personal situation of a particular taxpayer. We envisage that the method for calculating notional contributions should not involve assumptions but be based on a fixed formula. We will be recommending such a formula in a subsequent submission.

#### *Change of tax status*

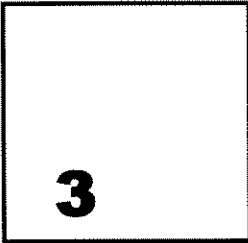
We note that Constitutionally Protected schemes cannot pay benefits in a “taxed” form. They can elect to lose their constitutionally protected status, however this would incur a tax of 15% of assets (less undeducted member contributions) at the time of the change. Once the scheme is no longer constitutionally protected, the scheme could elect to continue paying benefits in an untaxed form, convert to paying taxed benefits or pay a mixture of untaxed and taxed benefits.

Where the split between taxed and untaxed benefits is related to different benefit types (eg defined benefits are treated as untaxed and additional contributions funded by salary sacrifice are paid on a taxed basis), this may be relatively straightforward.

However, where the defined benefit is split between taxed and untaxed elements, we do not understand how the Government’s proposals would operate.

**Recommendation 2.1: Contribution limits equal to those applicable to schemes paying taxed benefits should also apply to Constitutionally Protected schemes. An assessment for tax of 30% of any excess contributions would be issued to the member who could either pay the tax or request that their superannuation fund pay the tax on their behalf. If the member requests that the tax be paid by their Constitutionally Protected scheme, the tax payment could be deferred until a benefit becomes payable (similar to the arrangements put in place for surcharge).**

This approach would naturally require Constitutionally Protected schemes to determine notional contributions for each member in a similar manner to taxed defined benefit funds. We are preparing a separate submission relating to the calculation of notional contributions. Our submission will recommend a methodology which will be considerably simpler and more equitable than the approach adopted for the superannuation surcharge.



### **Section 3: Preferred Alternative Approach – Other Schemes Paying Untaxed Benefits**

We assume that the proposals outlined in Section 8 of the Government’s discussion paper relate to benefits which are paid on an “untaxed” basis rather than benefits which are paid from schemes which may be unfunded or only partly funded.

#### *Unfunded Government Sector Schemes (not constitutionally protected)*

Generally only funds in the Government sector are able to operate on an unfunded basis. In some cases there may be some level of funding (perhaps only employee contributions or a partial level of funding by the employer).

These schemes are still liable for tax on employer contributions and investment income, however it is often possible to significantly reduce the tax payable by the use of exemptions from tax on investment income from assets backing pensions, Pre July 88 Funding Credits and the deductions available under Section 274(7) of the Income Tax Assessment Act 1936.

Benefits can be paid as either taxed benefits or as untaxed benefits. These schemes are able to change the basis of paying benefits at any time and could hence move from paying untaxed benefits to paying taxed benefits or vice versa. No additional tax liabilities arise at the point of such a change.

We do not understand how the Government’s proposals would operate in an environment where benefits are, at some point, changed from taxed to untaxed or vice versa.

Again, we see no reason why the Federal Government could not impose a tax on members in respect of (notional) contributions in excess of the same \$50,000 pa limit as proposed for “taxed” schemes. This is consistent with our recommendations set out in our Submission No. 2 in relation to deductible contributions for “taxed” schemes.

It would be possible for the member to take the assessment to the fund and request that the fund pay the tax on the member's behalf, or alternatively, as with the superannuation surcharge arrangements for these funds, the additional tax could accumulate with interest and be paid to the ATO when a benefit payment falls due.

*Funded Government Sector Schemes (not constitutionally protected)*

Some Government sector schemes, even though they might now be fully funded, are also able to pay benefits in either an untaxed or taxed form. Again, the scheme may be able to change its approach at any time and it is unclear how the proposed limits will be applied following any such change.

At least one such scheme enables members to choose, at the time of retirement, whether the benefit is paid as a taxed benefit or a higher untaxed benefit (which is subject to a higher rate of benefit tax).

Again, how will the Government's proposals operate? If it is considered that the scheme is paying taxed benefits, and the proposed \$50,000 pa cap applies, this would appear to be inequitable if the member eventually decides to take an "untaxed" benefit where the "untaxed benefit limit" would also apply.

On the other hand, if no annual contribution cap is applied, then it would be unreasonable that the member could eventually take a "taxed" benefit where there is no limit on the benefit amount.

Our proposed solution would also work in these schemes, with the tax liability on excess contributions either paid by the member or passed to the fund for payment.

*Other Schemes*

Technically, there is no reason why schemes in the non-Government sector could not also start paying benefits in untaxed form. This would involve claiming the deductions allowable under Section 274(7) of the Income Tax Assessment Act 1936. We do not think that any schemes will move in this direction, but depending on how the new requirements are legislated, the significant differences in the proposed treatment of the different arrangements may provide selective opportunities for smart operators to manipulate the system.

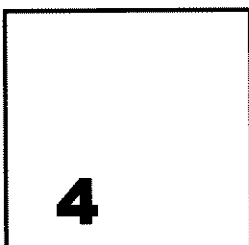
On the other hand, our proposed approach would remove the possibilities of such manipulation.

The following recommendation is effectively the same as recommendation 2.1 which related to Constitutionally Protected schemes.



**Recommendation 3.1: Contribution limits equal to those applicable to funds paying “taxed” benefits should also apply to superannuation schemes paying “untaxed” benefits. An assessment for tax of 30% of any excess contributions would be issued to the member who could either pay the tax or request that their superannuation fund pay the tax on their behalf. If the member requests that the tax be paid by a superannuation fund which is unfunded, the tax payment could be deferred until a benefit becomes payable (similar to the arrangements put in place for surcharge).**

This approach would naturally require funds providing untaxed benefits to determine notional contributions for each member in a similar manner to taxed defined benefit funds. As indicated in Section 2, we are preparing a separate submission relating to the calculation of notional contributions. Our submission will recommend a methodology which will be considerably simpler and more equitable than the approach adopted for the superannuation surcharge.



## **Section 4: Tax on Benefits**

Recommendations 2.1 and 3.1 would remove the major structural differences in the proposed system.

Nevertheless, because untaxed benefits have effectively avoided contribution tax, it will be necessary to tax untaxed benefits differently when they are received by the member.

### *Lump sum benefits*

By imposing limits on concessional tax contributions, there would be no need for the proposed \$700,000 cap on benefits.

This would have a further advantage for the ATO as it would not need to monitor benefits against this limit.

Ignoring the \$700,000 limit, the Government has proposed tax rates on lump sums payable from “untaxed” schemes from age 55 which are 15% higher than those applicable to taxed benefits. This appears broadly reasonable as an offset for the 15% contribution tax that has not been paid.

In practice, as it has in the past, this treatment marginally favours taxed benefits. Nevertheless the differences are minor and we see no need to change the proposed approach.

Prior to age 55, the proposed (and current) tax differential between taxed and untaxed benefits is only 10%. This clearly favours the provision of untaxed benefits. However, few benefits can actually be paid before age 55, so again we are comfortable with the Government’s proposals.

However, one aspect of the proposals remains a significant concern. From age 60, taxed benefits are not subject to tax. The Government has also proposed that retirees will not need to include them in tax returns. As such, taxed benefits have no impact on the

marginal rates of tax applicable to the retiree's other income. However untaxed benefits will still be treated as taxable income and will therefore continue to impact on the marginal tax rates applicable to other income.

This raises further equity issues. This could be solved by effectively ignoring superannuation benefits payable from age 60 for the purposes of determining taxable income whilst retaining the tax on the lump sum benefit. That is, the benefit would be included in tax returns and subject to the relevant tax but would **not** impact on the tax on other income. It would also be necessary to ensure that any tax on the lump sum does not exceed the tax that would have been payable if the benefit had been paid as normal income (as applies under the current system.)

**Recommendation 4.1: Untaxed lump sum benefits received from age 60 should be included in tax returns but excluded from the definition of taxable income. The member would still be liable for the proposed 15% tax on the post-June 83 component of the superannuation benefit. (As with the current system, this 15% tax should be a maximum rate of tax. If including the lump sum in taxable income would have resulted in a lower amount of tax, the lower tax should apply.)**

### *Pensions*

The treatment of pensions is less straightforward.

Prior to age 60, the Government proposals (except for some minor changes) replicate the current tax arrangements. Taxed pensions are generally entitled to a 15% tax offset, whereas untaxed pensions are not entitled to this tax offset.

This has, in very broad terms, provided a reasonable balance between the two types of benefit with two significant exceptions:

The 15% tax offset for taxed pensions applies to the whole taxable part of the pension including the part which accrued before contribution tax was introduced in 1988 whereas this offset is not available for the pre-July 1988 portion of untaxed pensions. This difference results in a more favourable treatment of taxed pensions;

For lower income pensioners, the availability of the tax free threshold, as well as other offsets such as the Senior Australians Tax Offset (SATO), means that some pensioners receiving an untaxed pension may be paying no, or little tax on their pension after having had no contribution tax impact whilst their pension was accruing. This results in a more favourable treatment for untaxed pensions, as those receiving taxed pensions have had to meet the contribution tax liability.

However, from age 60, the Government is now proposing significant changes. Taxed pensions will not be subject to any tax whilst untaxed pensions will be subject to marginal tax rates but will qualify for a 10% tax offset.

For low income “untaxed” pensioners, no tax may be payable at all after taking into account the tax free threshold, the Senior Australians Tax Offset, the low income tax offset and the 10% offset. A single pensioner with an untaxed pension of \$31,700 pa would not be liable for any tax (assuming no other income).

A similar low income pensioner receiving a taxed pension will also pay no tax but has effectively paid 15% contribution tax on the portion of pension which accrued after June 1988.

The Government’s proposals therefore clearly favour untaxed pensions for low income earners.

Example 1:

Consider a single person over age 65 and compare the tax payable where an untaxed pension is payable or a similar taxed pension is payable. (We have assumed that there is no pre-July 1983 component or deductible component.)

	Untaxed pension		Taxed pension	
	Current basis	Government proposed basis	Current basis	Government proposed basis
Annual pension (assume no deductible portion)	\$25,000	\$25,000	\$25,000	\$25,000
Level of other income	\$5,000	\$5,000	\$5,000	\$5,000
Gross tax on income	\$4,350	\$4,350	\$4,350	\$0
Less low income offset	\$400	\$400	\$400	\$600
Less SATO	\$1,588	\$1,588	\$1,588	\$2,230
Less pension rebate	-	\$2,500	\$3,750	-
<b>Net tax payable</b>	<b>\$2,362</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>

In this example, the person receiving a taxed pension gains no benefit from the proposed changes, whereas the person receiving an untaxed pension benefits from a reduction in tax. Both pensioners will pay no tax, although the person receiving the taxed pension has effectively paid a 15% contribution tax throughout.

On the other hand, a high income pensioner with an untaxed pension may be paying net tax of 30% or 35% (plus Medicare) on their untaxed pension. A high income pensioner with a taxed pension may be paying no tax. Again there is a clear inequity with the tax payable on the untaxed pension clearly outweighing the contribution tax that has been paid in respect of the taxed pension.

Example 2:

Consider a single person over age 65. Again assume that there is no pre-July 1983 component or deductible component.

	Untaxed pension		Taxed pension	
	Current basis	Government proposed basis	Current basis	Government proposed basis
Annual pension (assume no deductible portion)	\$75,000	\$75,000	\$75,000	\$75,000
Level of other income	\$35,000	\$35,000	\$35,000	\$35,000
Gross tax on income	\$31,850	\$31,850	\$31,850	\$5,850
Less low income offset	-	-	-	\$200
Less SATO	-	-	-	\$963
Less pension rebate	-	\$7,500	\$11,250	-
<b>Net tax payable</b>	<b>\$31,850</b>	<b>\$24,350</b>	<b>\$20,600</b>	<b>\$4,687</b>

In this example, the Government's proposals will result in the person receiving the untaxed pension paying over \$19,000 more tax each year than the person receiving the taxed pension. This additional tax is likely to far outweigh the level of contribution tax incurred by the person receiving the taxed pension.

In summary, the Government's proposals seem to favour low income earners with "untaxed" pensions compared to similar low income earners with "taxed" pensions. On the other hand, the proposals treat higher income earners with "untaxed" pensions less favourably than similar earners with "taxed" pensions.

It may be that the proposed 10% tax offset is a reasonable "average" adjustment. However in practice there will be significant equity differences depending on the level of the pensioner's income and is likely to result in some "arbitraging" between the two proposed approaches.

*Most equitable approach*

Based on the Government's proposed approach for taxed pensions, the most equitable method of taxing untaxed pensions after age 60 would be as follows:

The portion of the pension which accrued before 1 July 1988 should be tax free as it will be for taxed pensions, and not included in tax returns. As contribution tax did not apply before July 1988, there is no reason why this part of untaxed and taxed pensions should be treated any differently;

The employer financed portion of the untaxed pension which accrued after 30 June 1988 should be subject to a flat rate of tax of 15%. This would be consistent with the treatment of taxed pensions where a 15% contribution tax has already been applied. The 15% tax should not be offset by other rebates, deductions or tax offsets. As with taxed pensions, the untaxed pension should otherwise be excluded for income tax purposes.

This is also broadly equivalent to a member of a scheme paying untaxed benefits transferring their benefit to another scheme (and incurring the 15% contribution tax on rollover) and then commencing a reduced pension (although we acknowledge that such transfers may not be readily available in many "untaxed" schemes).

*Practical difficulties*

We understand that it may not be possible to introduce the equitable approach at this stage as it would result in an increase in the tax payable by many lower income pensioners receiving untaxed pensions.

The fact that inequities exist between the two types of pension is also not new.

However, the proposed changes would seem to increase rather than decrease these inequities.

We consider that further consideration needs to be given to modifying the proposed treatment of untaxed pensions in order to reduce the levels of inequity.

**Recommendation 4.2: The Government should give further consideration to the tax treatment of untaxed pensions from age 60 in order to minimise the inequities between the treatment of taxed and untaxed pensions. We have outlined below some possible methods for consideration.**

*Pensions which commenced before 1 July 1988*

Many existing untaxed pensions commenced payment before 1 July 1988 when contribution tax was introduced. Under the Government's proposals, these pensions will be taxed more harshly than similar taxed pensions which commenced before that date.

In neither case has any contribution tax applied. Even if the pension were funded after 1 July 1988, perhaps on a pay-as-you-go basis, “untaxed” schemes would have been able to avoid contribution tax by utilising the elections under Section 274(7) of the Income Tax Assessment Act or Pre-July 1988 Funding Credits. (Constitutionally Protected schemes would not have paid any tax in any event.)

Consideration could therefore be given to treating the untaxed pensions which commenced before 1 July 1988 as tax free in the same manner as taxed pensions.

*Pensions commencing after 1 July 1988 – pre-July 1988 portion*

If this logic is followed through, consideration would need to be given to untaxed pensions which commenced after 1 July 1988. For these pensions a significant proportion of the pension also accrued prior to 1 July 1988 when no contribution tax applied. So a portion of these pensions should also be taxed in the same manner as a taxed pension.

In effect, only the post-June 1988 portion of an untaxed pension should be subject to tax after age 60. A simple methodology would be needed to determine this.

For taxed pensions commencing from 1 July 2007, the Government has proposed that the pre-July 83 component will form part of the deductible amount and hence will be tax free (Section 2.3.2 of the Discussion Paper). We assume that this revised methodology of calculating the deductible amount will also apply to new untaxed pensions although this is not definitively stated in Section 8.2.2 of the Discussion Paper. This strengthens the argument that a part of any existing untaxed pensions should also be tax free.

For untaxed pensions which have already commenced, or commence before 1 July 2007, the following practical approach could be considered:

$$\text{Tax free portion of pension} = \text{Current deductible amount} + \text{Current taxable portion of pension} \times A/B$$

Where:

A = days of eligible service of the pensioner (or the original pensioner if it is a reversionary pension) up to the earlier of 1 July 1988 and the commencement date of the pension; and

B = days of eligible service of the pensioner (or the original pensioner if it is a reversionary pension) up to the commencement date of the pension.

(Any member financed portion of the pension would have been taken into account in determining the deductible amount and hence would not be included in the current taxable portion of the pension.)

For pensions which commence on or after 1 July 2007, the Government has proposed that the deductible amount take into account the pre-July 1983 component. Assuming that

this change will also be applied to untaxed pensions, this will automatically result in a higher tax free amount.

A simpler approach for pensions commencing on or after 1 July 2007 may be to use a formula similar to that proposed above for pensions which have already commenced.

*Pensions commencing after 1 July 1988 – post-June 1988 portion*

To achieve a more equitable outcome, it would be necessary to tax the post-June 1988 portion of the pension at a flat 15% with no offsets or rebates (to replicate the 15% contribution tax applicable to taxed pensions).

However, even if the changes to tax on the pre-July 1988 portion of the pension proceed, this could still result in some lower income pensioners paying more tax than they currently do.

This impact could be minimised (or almost avoided) in two ways.

One approach would be to treat some of the post-June 1988 portion of the pension as non-taxable. For example, the 15% tax could be applied to the excess of the post-June 1988 pension over, say, \$6,000 or \$10,000 pa.

This tax could be deducted by the fund from any pension payments. It would then be unnecessary for any part of the pension to be included in the pensioner's tax return as there would be no adjustments available in respect of the tax.

It may be possible to freeze the tax free limits (ie our suggested amounts of \$6,000 or \$10,000 pa) at those levels (rather than indexing them) as their purpose is merely to avoid/minimise an increase in tax on current pensions.

Another approach would be to allow any tax offsets such as the low income offset and the Senior Australians Tax Offset to offset the 15% tax on the post-June 1988 portion of the pension. This would be particularly effective for those over age 65. However it may result in a higher number of pensioners who would need to lodge tax returns.

Consideration should also be given to whether the 15% tax should apply to the post-June 1983 portion rather than the post-June 1988 portion. This may provide greater consistency with the treatment of taxed pensions where only the pre-July 1983 component will be able to be used to determine the deductible amount.

Consider again Examples 1 and 2 discussed above. Using the above approaches would result in the following comparison with existing tax levels.

The Mercer proposed basis 1 is based on a tax of 15% of the post-June 1988 pension in excess of \$10,000. This tax cannot be reduced by tax offsets.



The Mercer proposed basis 2 is based on a tax of 15% of the full post-June 1988 pension but this could be reduced by other tax offsets.

Example 1 revisited:

	Untaxed pension				Taxed pension	
	Current basis	Government proposed basis	Mercer proposed basis 1	Mercer proposed basis 2	Current basis	Government proposed basis
Annual pension (assume no deductible portion)	\$25,000	\$25,000	\$25,000	\$25,000	\$25,000	\$25,000
Level of other income	\$5,000	\$5,000	\$5,000	\$5,000	\$5,000	\$5,000
Gross tax on income	\$4,350	\$4,350	\$0	\$0	\$4,350	\$0
Additional 15% tax on untaxed pension	-	-	\$2,250#	\$3,750##	-	-
Less low income offset	\$400	\$400	\$600*	\$600	\$400	\$600
Less SATO	\$1,588	\$1,588	\$2,230*	\$2,230	\$1,588	\$2,230
Less pension rebate	-	\$2,500	-	-	\$3,750	-
<b>Net tax payable</b>	<b>\$2,362</b>	<b>\$0</b>	<b>\$2,250</b>	<b>\$920</b>	<b>\$0</b>	<b>\$0</b>

# 15% on excess over \$10,000

## 15% on \$25,000

\* cannot be claimed as no tax to offset

In this example, the tax payable by the “untaxed” pensioner reduces under our proposals, but not by as much as under the Government proposal.

These approaches provide greater equity as the pensioner is at least paying some tax to compensate for the fact that no contribution tax has been paid.

We note that in some cases, where part of the pension accrued before 1 July 1988, there would be larger reductions in tax under our proposals as the pre-July 1988 portion would not be subject to the additional 15% tax.

On the other hand, there would be some income levels where our proposals would result in an increase in tax from current levels.

Example 2 revisited:

	<b>Untaxed pension</b>				<b>Taxed pension</b>	
	Current basis	Government proposed basis	Mercer proposed basis 1	Mercer proposed basis 2	Current basis	Government proposed basis
Annual pension (assume no deductible portion)	\$75,000	\$75,000	\$75,000	\$75,000	\$75,000	\$75,000
Level of other income	\$35,000	\$35,000	\$35,000	\$35,000	\$35,000	\$35,000
Gross tax on income	\$31,850	\$31,850	\$5,850	\$5,850	\$31,850	\$5,850
Additional 15% tax on untaxed pension	-	-	\$9,750	\$11,250	-	-
Less low income offset	-	-	\$200	\$200	-	\$200
Less SATO	-	-	\$963	\$963	-	\$963
Less pension rebate	-	\$7,500	-	-	\$11,250	-
<b>Net tax payable</b>	<b>\$31,850</b>	<b>\$24,350</b>	<b>\$14,437</b>	<b>\$15,937</b>	<b>\$20,600</b>	<b>\$4,687</b>

# 15% on excess over \$10,000

## 15% on \$75,000

In this example, the Mercer proposals would result in less tax for the pensioner who is receiving an untaxed pension. The difference between the tax payable by the “untaxed” and “taxed” pensioners is more consistent with the contribution tax differential.

*Conclusion*

These approaches have some significant advantages over the Government's proposals, including:

- Greater consistency and equity between the treatment of taxed and untaxed pensions;
- Many pensioners receiving untaxed pensions would no longer need to lodge tax returns (at least in the case where the tax on the pension is fixed at 15% with no offsets available).

On the other hand, the level of tax may increase for some existing lower income pensioners unless further protection measures are included.

Nevertheless, there would appear to be some scope to adjust the proposed tax basis to create greater equity in line with Recommendation 4.2.

# MERCER

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