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Unlike the Mercer Explanatory Memorandum of 27 June 2002 this extract from the 1998 Mercer report is credible in its prediction of the effect on employer costs for pensions of the method that EISS is using. This document deals explicitly with pensions and sets out a detailed account of how the method recommended for their reduction on a move to the taxed superannuation environment will reduce employer costs. The most important part of this account is given in paragraphs 19.18 – 19.21.

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Attachment 13

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Page 13 AR

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Department of Treasury & Finan

STUDY OF THE TAXATION STATUS OF THE SA GOVERNMENT SUPERANNUATION FUNDS

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19. THE PENSION SCHEME

19.1 This section looks at the Pension Scheme which was closed in 1986 to new members.

19.2 As with the Lump Sum Scheme, the Pension Scheme is just part of the total arrangements under the Superannuation Act, but is considered separately in this section to help isolate some of the issues.

19.3 Practically all of the benefits under the Pension Scheme paid in future will be defined pensions or lump sum commutations of these pensions.

Lump Sum Commutations

19.4 If the Pension Scheme is moved to a taxed environment, tax on commutation payments would be affected similarly to the tax on the defined-benefit lump sums under the Lump Sum Scheme.

19.5 Thus, on moving to a taxed environment, a lower benefit tax would be applied to the post June 1983 component of commutations, payments (unless the benefit is declared to be untaxed).

19.6 A lower benefit tax rate would give a windfall gain to the members unless there is a reduction in the post June 1983 component of the benefit payable. Such a reduction would be reasonable, as otherwise there would be an extra employer cost as a result of the 15% tax on employer contributions.

19.7 The same results would apply as for the Lump Sum Scheme defined benefits, viz:

- with benefit reductions there could be a small increase to members' net benefits where these are over the threshold, and a small reduction in employer costs (provided that most of the employer funding is outside the Superannuation Act); and
- with the alternative of "untaxed benefits", the status quo would remain substantially intact (provided again that most of the employer funding is outside the Superannuation Act).

Pensions

19.8 As far as pensions are concerned, a move to a taxed environment would allow these pensions to become "rebateable". This would mean that all the pensioners would receive a tax rebate each year equal to 15% of their pensions. A key feature of this (as commented upon later) is that the rebate is 15% of the **total** pension, not just 15% of the post June 1983 component.

This contrasts with the case of lump sums where the lower tax rate just applies to the post June 1983 component.

19.9 As with lump sums, the reduction in tax on pensions would produce a windfall benefit to the beneficiaries and the movement to a taxed environment would bring extra costs to the employers from the 15% tax on employer contributions. Thus it would be reasonable for gross pensions to be reduced.

Pension Reductions

19.10 Not all pensioners however would benefit from a tax rebate on their pension from the State Scheme, principally because of low taxable income. Also the extent to which a pension could be reduced, to create a neutral situation after tax, with the pensioner neither winning nor losing, depends upon the pensioner's marginal tax rate. The following table sets out the pension reductions which could be applied to various levels of pension.

Current Annual Pension	Pension Reductions for Equal Net Value to Pensioner
$5,400	0%
$10,000	7.7%
$20,000	13.9%
$30,000	18.5%

19.11 The reductions in this table are calculated assuming that the pensioner has no other income. This produces a lower reduction than that necessary to "break even" where there is other income. Thus the reductions err on the side of generosity to such pensioners.

19.12 The converse however applies for those pensioners who have losses on other income. Because of this loss possibility, it would be impossible to have a formula whereby each and every pension would not be detrimentally affected, so there may be a need to allow for special "non detriment" exceptions. One way of achieving this would be to allow each pensioner the option of retaining an "untaxed" pension with no rebate.

Effect on Employer Costs

19.13 In a taxed environment, the employer contributions are taxed at 15%. Thus, ignoring any other tax issues for the moment, a pension would need to be reduced by 15% so that the employer cost would remain the same. On this basis, the above table suggests that the annual pension would need to be at least $23,000 pa or so for both the pensioner to be no worse off and for the employer to avoid an increase in costs. There are however other tax issues which come into play.

Untaxed Benefits

19.14 Firstly, rather than applying pension reductions which are not sufficient to prevent an increase in the employer's cost, it would be feasible to treat those smaller pensions as "untaxed". This means that their tax status could remain as at present (with no rebate) and the employer contributions to pay the pensions would not be taxed.

19.15 A considerable advantage of this approach is that it would limit pension reductions to those cases where it is more likely that the pensioners would understand and receive a net benefit from the pension rebate/reduction.

Pre July 1988 Funding Credit

19.16 The second tax issue, which is more important from a financial point of view, is that the Pre July 1988 Funding Credit (PJFC) is available to reduce tax on employer contributions. As described previously, by now the PJFC has increased with Average Weekly Earnings to around $3.6 billion. By moving the Schemes to an investment environment, the PJFC will be able to be progressively applied.

19.17 In the earlier section dealing with the Lump Sum Scheme, mention was made of the application of this credit to negate the tax payable on employer contributions to cover the pre July 1983 component of the benefits. In the lump sum environment those components can not be reduced, because tax on them remains the same. Thus the application of the PJFC just neutralises extra costs which otherwise would arise.

19.18 The pension environment is different however. As mentioned above, the 15% tax rebate applies to the **total** pension, so that both pre `83 and post `83 components can be reduced to prevent employer costs increasing. The PJFC therefore can applied on a basis which **reduces** employer costs.

19.19 A simplified example may help (the main simplification being that the pension is all employer-financed):

- Suppose that an employee is about to retire with an untaxed pension of $30,000 pa, with one-third relating to post June 1983 service and two-thirds relating to pre July 1983 service.
- Suppose that the capital value of the pension is 14 times the annual pension and that the employer pays this to the fund when the pension commences.
- With a $30,000 pa pension, the cost to the employer is $420,000.
- If the pension is instead rebateable and the pensioner can use the full 15% rebate, then, according to the table shown earlier, the pension can be reduced by 18.5% without detrimentally affecting the pensioner.
- Thus the pension payable can be $24,450 pa.
- To support the one-third of this reduced pension which relates to post June 1983 service, the employer would now need to pay $134,000 so as to cover the 15% tax on employer contributions.

  (The $134,000 is calculated as $^1/_3$ rd of 14 times $24,450 divided by 0.85).
- The two-thirds which relates to pre July 1983 service should not incur any 15% tax on employer contributions because of the application of the Pre July 1988 Funding Credit. This it will cost the employer about $^2/_3$ rd of 14 times $24,450, viz $228,000.
- The total employer cost is therefore now $362,000 (ie $134,000 plus $228,000).
- The employer has therefore saved $58,000 (ie $420,000 less $362,000). This represents a 14% reduction in employer costs.

Extent of Cost Reduction

19.20 The extent of the cost reduction across the whole Pension Scheme could be very large. A measure of the savings could come from considering the size of the Pre July 1988 Funding Credit.

19.21 If the whole $3.6 billion PJFC could somehow be applied straightaway, the savings would amount to the 15% tax rate times this figure, ie $540 million. However it is of course not possible to apply the PJFC straightaway - there are constraints on the extent to which it can be applied each year, and there is a strong possibility that not all of it may ever be able to be used. Furthermore some of it would be needed to maintain present costs in respect of lump sum benefits. Also if benefits are reduced, the amount of the Funding Credit available is also reduced. Nevertheless its size is certainly such that multi-million dollar savings to the Government in present value terms may be feasible.

19.22 To achieve this though, benefits under the Superannuation Act would need to be reduced and we anticipate that this exercise would need careful handling and very good communications.

19.23 The Government may need to cope with demands from members of the Pension Scheme that they, as well as the Government, should share in the gains achieved. An important part of the response would be that these people are still members of schemes which have been closed because of their generosity, and yet their benefits have been continued. Thus they should have little to complain about if the advantage of applying the PJFC is not passed through to them, so long as they are not detrimentally affected. A critical point is that the benefit reductions should be such as to remove the windfall gains, but not to the extent of causing detriment to any members.

19.24 An area which needs to be managed is the effect in the first year. We understand that the Taxation Office's interpretation is to bring into account the value of all existing pensions in that year. The impact of this upon tax payable could be countered by limiting employer contributions in that year.