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As with the 1998 Mercer Report this 2004 Report, in contrast to the Mercer Explanatory Memorandum of 27 June 2002, is credible in its prediction of the effect on employer costs for pensions of the method that EISS is using. It 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.

On page 7, under the heading 'Question 4: etc.' the report clearly states that when member net benefits are held constant employer costs are reduced.

On page 10 there is a reference to EISS experience which shows that the author of the report was well aware that EISS was reducing pensions by a method that held net member benefits constant.

Treasury has claimed, and the State Ombudsman accepted, that this 2004 report was not relevant to EISS because of differences between EISS and the State pension scheme. To believe this one has to believe that the author of the 2004 Report referred to EISS experience that was different to what he was predicting for the State pension scheme without seeing a need to explain the difference.

Attachment 18

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authorised representative
Mercer Investment Nominees Limited
ABN 79 004 717 533 AFS Licence #235906

75 Castlereagh Street Sydney NSW 2000
GPO Box 3479 Sydney NSW 2001
02 8272 6818 Fax 02 8272 6239
martin.stevenson@mercer.com

www.mercerHR.com.au

23 December 2004

Mr Deane Prior
Director, Superannuation
Department of Treasury and Finance
200 Victoria Square East
ADELAIDE SA 5000

Subject:
Review of Taxation Status of the SA Government Superannuation Funds

Dear Deane

I refer to the "Contract for Services – Review of Taxation Status of the SA Government Superannuation Funds" and to our conversation earlier this year.

The purpose of this letter is to provide an update of the Review of the Taxation Status of the SA Government Superannuation Funds, performed in January 1998, (the previous report), and to estimate the likely financial consequences of moving the State's superannuation arrangements from an untaxed status to taxed.

We are not tax professionals and before any action is taken as a result of this letter, advice should be sought from an appropriately qualified tax expert. However, through our experience of the financial outworkings of public sector superannuation funds in general, and the SA Government Funds in particular, we are qualified to comment on the effect of the main components of the taxation arrangements of the Fund.

For the purposes of this report we have considered three Schemes:

The Pension Scheme -	A final salary contribution point pension scheme closed to new members in 1986;
The Lump Sum Scheme -	A lump sum scheme with two components. The member financed component is the accumulation of member contributions plus interest. The employer financed component is a final salary contribution point lump sum. The scheme was closed to new members in 1994.
Triple S -	An accumulation scheme open to all current and future members.

Background to the taxation options

A regulation made under section 267 of the Income Tax Assessment Act in June 1997 declares that the SA Government Superannuation Funds are "constitutionally protected" and section 271A of the Income Tax Assessment Act specifies that no taxation applies to such superannuation funds.

The different tax treatments of constitutionally protected funds and taxed funds are set out in the following table:

Item	Constitutionally protected fund	Taxed Fund
Employee Post-tax contributions	Not taxed	Not taxed
Employer contributions	Not taxed	Taxed at 15% with deductions available for: • Cost of death and disability insurance; • Anti-detriment amounts; • Expenses of administration; • Pre 1 July 1988 Funding Credits (PJFCs).
Investment Income	Not taxed	Taxed at 15%. However the actual tax rate is usually significantly lower than 15% because of the effects of: • Dividend imputation; • Capital gains tax at 10% rather than 15%; • Foreign tax credits • Current pension liability exemption (CPLE).

Item	Constitutionally protected fund	Taxed Fund
Lump sum benefit – Post 30 June 1983 component below RBL		
Up to 55	30% + Medicare*	20% + Medicare
55 or over		
Amount up to $123,808	15% + Medicare	Nil
Excess over $123,808	30% + Medicare	15% + Medicare
Other components of lump sum benefits	Taxed at the same rate in constitutionally protected fund and taxed fund	
Pension – deductible amount (calculated by dividing the undeducted purchase price by the expectation of life)	Nil	Nil
Pension – balance of amount excluding excessive amount	Pensioner's marginal rate	Pensioner's marginal rate with a 15% tax rebate if the pensioner is over 55 or where the pension is payable due to the death or disability of the member
Pension – excessive amount	Pensioner's marginal rate	Pensioner's marginal rate

* Medicare normally includes the 1.5% Medicare levy but will also include the 1% Medicare levy surcharge applicable to those who do not have appropriate private hospital insurance and whose income (or family income) exceeds specified levels. For the purposes of this letter we have only taken into account the 1.5% Medicare levy.

Overview

The move from being "constitutionally protected" (or untaxed) to taxed has the following ramifications:

(1) The tax on benefits is reduced;

(2) Tax on employer contributions is increased and

(3) Tax on investment income in the funds is increased.

Essentially this letter is about whether the advantage of the tax reduction on benefits outweighs the disadvantage of increased tax on employer contributions and investment return.

Management of PJFCs and CPLEs

For the purposes of this letter it is assumed that if the Funds become taxed then the PJFCs and CPLEs are efficiently managed. The following two sections elaborate on this point.

It is assumed that Pension Scheme and the Lump Sum Scheme are treated as one taxable entity; and that the Triple S Scheme is a separate taxable entity.

PJFCs

When superannuation funds became taxable as at 1 July 1988, the Commonwealth government realised that inequities could occur for funds that were wholly or partially unfunded as at that date. The potential inequity was that superannuation funds would be taxed on contributions made after 1 July 1988 that related to benefits accrued before 1 July 1988 when there was no tax payable on such contributions.

To avoid this inequity, superannuation funds are permitted to apply for a pre 1 July 1988 funding credit or PJFC. The PJFC balance is initially set at the unfunded liability as at 1 July 1988, and thereafter it increases with increases in AWOTE, and decreases as tax deductions are claimed.

The amount of the PJFC which can be offset against otherwise taxable contributions in any year is equal to the total taxable contributions:

- *less* the post July 1983 component of lump sum benefits paid in the year,
- *less* the capital value of pensions commencing in the year,
- *less* any untaxed benefits.

The first two items are known as the Section 275B amount.

If employer contribution in a particular year are relatively low, then the Section 275B amount will be equal to, or a high proportion of, the employer contributions. This will result in low annual PJFC utilisation and may result in the full PJFC never being fully utilised.

The optimum strategy for PJFC utilisation is for the employer to make large contributions in one year, so that the Section 275B hurdle is comfortably exceeded. Other State governments have achieved this in conjunction with a borrowings program, and/or an external (to the Fund) investment program.

Current Pension Liability Exemption (CPLE)

A proportion of investment monies is exempt from tax in a superannuation fund under Section 283 of the Income Tax Assessment Act. This proportion is equal to the average value of the current pension liabilities in a year divided by the average assets of the fund during that year.

By careful management it is possible to keep the combined Lump Sum Scheme and Pension Scheme assets below the Pension Scheme's current pension liability. This results in a zero or non significant level of tax on investment income in the Lump Sum Scheme and Pension Scheme.

Management of accumulation lump sum benefit payments

In a taxed fund, employer contributions will be taxed initially at 15%, leaving 85% of the contributions in the Fund, and this amount (together with earnings) for members over the age of 55 and above the threshold will ultimately be taxed at 16.5%, giving 71% of the original contributions (plus earnings).

In an untaxed fund, there is no contribution tax, but the benefit tax is 31.5%, leaving 68.5% of the original contributions (plus earnings).

The result is that a taxed fund appears to offer a tax saving of 3.6% because, although the total tax rate is the same (31.5%), the benefit tax is charged on the amount remaining after contribution tax, and not on the original contribution.

In practice, members have been able to obtain this tax benefit by rolling their benefit to a taxed fund, which incurs a 15% tax charge. When they cash in, they are then charged the remaining 16.5% on the balance, just as if they had been in a taxed fund. This advantage can therefore be achieved without the need to become a taxable fund, and we have assumed that the members in the current untaxed fund manage their benefit payments to achieve the lower tax rate.

Where the member is over the age of 55 but the benefit is below the tax threshold, the same principle applies to achieve benefit neutrality.

Question 1: Would the position of pensioners, contributors, and the employer to each of the superannuation schemes be improved or disadvantaged if the Schemes become fully taxable?

Pensioners

Net pensions after tax arising from the Pension Scheme would not decrease. (Refer Appendix A).

Contributors

Net benefits in the Lump Sum Scheme would not decrease (refer Appendix B). In respect of member financed benefits there would be an increase in the taxed environment (refer Appendix C).

With the Triple S Scheme, benefits arising from personal contributions would be slightly improved. However benefits arising from employer contributions would be detrimentally affected if employer funding is brought within a taxed arrangement (refer Appendix D).

Employer

Employer costs should not increase for the Triple S Scheme (refer Appendix D) and the Lump Sum Scheme (refer Appendix B).

We have modelled the financial effects of converting the Lump Sum Scheme and the Pension Scheme, and then efficiently utilising PJFCs and CPLEs (refer Appendix E). We estimate that savings are available of the order of a present value of $450 million. There are however significant risks associated with this strategy.

Also, any savings will be partially offset by the system changes that will be required and the communication exercise that will be necessary to explain the changes. Our experience indicates that pensioners in particular find change extremely distressing, and an enormous deal of effort may need to go into communication and counselling.

Question 2: Are the above conclusions dependent on the effective tax rate of earnings?

As stated previously, it is assumed that the funding of the Lump Sum Scheme and Pension Scheme is managed so that there is nil or non material tax on investment earnings. This will ensure that the member financed benefit in the Lump Sum Scheme is higher in a taxed environment (due to the reduction in benefit tax).

For Triple S a change to taxed status will generally result in lower benefits for members. Whilst in theory this effect could be offset by increasing the growth exposure in the asset allocation, such a change would expose the members to unacceptable volatility of return.

Question 3: What are the transition tax arrangements?

Since the previous report, a new amendment section 281A of the Income Tax Assessment Act has been enacted. Section 281A states:

"281A The assessable income of a complying superannuation fund of a year of income that ceased to be a constitutionally protected fund at a time during the year of income or at the end of the previous year of income includes the sum of the specified roll-over amounts that would be included in that assessable income if all accumulated member benefits:

(a) were paid out of the fund immediately before it ceased to be a constitutionally protected fund; and

(b) were rolled over back to the fund (within the meaning of Subdivision AA of Division 2 of Part III) immediately after it ceased to be a constitutionally protected fund."

For EISS this amount was calculated as the post 30 June 1983 component of the assets.

Question 4: Summarise the advantages and disadvantages of moving to a taxed status.

In the Lump Sum Scheme/Pension Scheme there is a net tax advantage in moving from an untaxed environment to a taxed environment. These advantages could be used to increase members' benefits and/or reduce employer costs. If members' benefits are maintained at current levels (after allowing for tax effects), then savings of the order of $450 million are estimated for the employer.

However, disadvantages of changing the tax status include:

(i) Costs of communicating the change. An enormous deal of effort will be required for communication and counselling, particularly for existing pensioners.

(ii) There are some tax risks associated with the change. Optimum results are only obtained by careful management of CPLEs and PJFCs; and it is always possible that the best results are not achieved. It would be necessary to ensure that the whole project is not perceived as a tax driven transaction. There is always a concern that at some stage the Commonwealth Government will declare a "sunset date" for PJFC utilisation. Before any action is taken it is essential to consult professional tax advisers.

(iii) Rigorous scenario testing has not been carried out.

(iv) The defined benefit funds have been closed for many years and are in "run off" mode. Does it make sense to go through a very complex exercise for these entities?

A change to Triple S has the disadvantage that members are worse off (or the employer costs increase).

On the other hand, the Australian superannuation environment is moving to a very 'member centric' rather than 'employer centric' approach. Governments in Australia are moving to distance themselves from the operational provision of superannuation. This process (which involves public sector funds operating on the same playing field as private sector funds) could not be achieved in South Australia whilst Triple S is untaxed.

To be consistent with these trends (and to prevent an increase in employer contributions) an appropriate course of action would be to commence a new taxed Triple S Scheme. This Scheme could embrace current superannuation themes such as member investment choice and enhanced member investor education. In respect of the current Schemes, the alternatives are:

(a) continue all three Schemes in an untaxed environment in run-off mode; or

(b) convert the Lump Scheme and Pension Scheme to a taxed environment, with the employers achieving some savings, and leave current Triple S members in an untaxed Scheme;

(c) convert all three Schemes to taxed, with the government guaranteeing that members of Triple S will not be worse off. The option will only work if the savings from the Lump Sum and Pension Schemes outweigh the costs of the guarantee. Further projections would be required to determine if this option is feasible, and such projections are outside the scope of this assignment.

Sincerely,

Martin Stevenson
Authorised Representative #264298 of Mercer Investment Nominees Limited
AFS Licencee #235906
Email: martin.stevenson@mercer.com

Appendix A

Position in respect of pensions

A1. Employer's perspective

From the employer's perspective, a move from untaxed to taxed means that benefits from the Fund would need to be reduced to take into account that:

- employer contributions from 1 July 1988 for existing members are now regarded as taxable; and
- going forward the taxation of members' benefits will be reduced.

To ensure that employer contributions remain the same (before and after the fund becomes taxable) other superannuation funds have adjusted benefits (other than death benefits and the insured component of disability benefits) to the following level:

Current (untaxed) benefit x (1 - .15 B/C x P)

Where	B =	the period in days of contributory service that began on 1 July 1988
	C =	the period in days of contributory service
	P =	the proportion of the benefit deemed to be employer financed

A2. Employee's perspective

From the employee's perspective, a move from untaxed to taxed means that, as pensioners, they would commence to receive a tax rebate each year equal to 15% of their pension.

However not all pensioners 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 or 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
$6,000	0.0%
$10,000	6.8%
$20,000	11.9%
$30,000	17.2%
$40,000	17.6%

The reductions in the above table are calculated assuming that the pensioner has no other income. This produces a lower reduction that that necessary to 'break even' where there is other income; and conversely produces a higher reduction where the pensioner have losses on other income. Generally, the reductions err on the side of generosity to pensioners.

A3. Balancing the employer and employee perspective

Since the employer contributions are taxable from 1 July 1988 in the taxed environment, and since the 15% rebate applies back to the commencement of the pension, there is an overall tax advantage to be gained by switching from untaxed to taxed. Refer Appendix E.

A4. EISS experience

As at the date that EISS switched from untaxed to taxed, pensioners were not considered since they were transferred to the State Scheme.

Now EISS has commenced to pay pensions. The method of determining the new pension is to calculate the net pension from an untaxed source assuming that it is the pensioner's only income, and then calculating the corresponding gross pension from a taxed source, again assuming that it is the pensioner's only income, and taking into account the effect of the rebate. That is, the pensioner's after tax income does not alter.