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Pages of particular interest

Pages 7 and 8: there is a strong indication that the Executive Officer is aware of the possibility that the rule for reducing pensions is passing a financial advantage to employers but that he considers this does not matter as long as the pension's net value is not reduced.

Page 11: a calculation is set out showing that the reduction of a pension would be 18.78% of its original gross amount. This would be the case even if the pension recipient had a large fraction of his/her eligible service completed before 1 July 1983 and had funded part of the pension with personal contributions made from after-tax income. The Executive Officer made no comment on this in his paper and it would appear that the Board did not see anything odd about such a large reduction being made to pensions when Board members must have known that lump sums were rarely, if ever, reduced by as much as 15% and by much less than 15% in most cases.

Paper Not Release

Attachment 31
27 Page 30 AR

Board Discussion Paper

Meeting Date: 29 June 2005

Topic: Contribution Tax Offset on Pensions (aka Benefit Reduction)

Issue

Pension Scheme members have voiced concerns over the equity of the contribution tax offset applied to pension benefits from the Scheme. These concerns were expressed directly and via the previous UTLC representative on the Board.

This paper looks at why the offset is applied and why it is structured in the way it is. The members' concerns are considered in detail, and recommendations for how to address these are made. Some of the concerns are due purely to a lack of understanding, but others may need more than education to solve them.

Health warning: this is a complex issue. Please feel free to discuss any confusion or concerns with the EO.

Background and History

Change in tax status

Prior to privatisation, the Scheme was "constitutionally protected" (also known as "untaxed"). This means that neither contributions nor investment income were taxed in the Scheme. However, members paid a higher rate of tax on benefits than they would in a taxed scheme.

From 1 July 2000, the Scheme lost its status as an untaxed scheme. This meant that it was required to pay tax on contributions and investment income.

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For retirement benefits, the tax rates changed as follows:

	Tax on employer contributions and investment income	Tax on benefits & Accounted for Pre & post 1983 Service	
Lump sums		*Applies to benefits accrued after 1983*	
Untaxed Scheme	0%	<$124,000	16.5%
		>$124,000	31.5%
Taxed Scheme	15%	<$124,000	0%
		>$124,000	16.5%
Pensions		*Tax applies to the whole pension*	
Untaxed Scheme	0%	Taxed as income	
Taxed Scheme	15%	Taxed as income, less a tax rebate of 15%	

Effectively, moving from being an untaxed scheme to a taxed scheme transfers 15% tax from benefits, and puts it onto employer/salary sacrifice contributions and investment income.

Had no change been made to benefits at this time, the impact would have been:

Employer contributions after tax – reduced by 15%
Member's benefits after tax – increased by up to 15%

That is, the members would have made a windfall gain at the expense of the employers.

The offset is there to ensure that the employers' costs did not rise significantly when the Scheme became taxed. The legislation also required that members' benefits not be reduced by the change in the taxation status of the Scheme.

Legislative basis for rule changes

Clause 11 of Part 2 of Schedule 3 of the Electricity Corporations (Restructuring and Disposal) Act 1999 made the contribution tax offset possible, and is shown in full as Appendix 1.

In summary, this states that the Treasurer may make a change to the rules following the Scheme's change in tax status so that any consequent increase in employer costs is avoided or reduced. However, members' benefits after tax cannot be lower than they would have been had the Scheme's tax status not changed.

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Rule changes

In June 2002, the Treasurer approved amendments that inserted rules 29, 30 and 31 into Division 1. These rules allowed gross benefits from Divisions 2, 3 and 4 to be reduced in line with Clause 11 of Schedule 1 of the EC Act.

The aim of these rule changes is to try to equate (as much as possible):

- **the benefit** that the member would receive **after tax** from the Scheme *had it not been taxed;*

to

- **the benefit** that the member would receive **after tax** from the Scheme *given that it has been taxed.*

For lump sums, Rule 29(3) reduces the gross benefit so that:

- the after tax lump sum paid from the taxed Scheme

is equal to THIS IS NOT MATHEMATICALLY THE SAME AS 'NOT LESS THAN'

- the after tax lump sum paid from an untaxed Scheme

With respect to pensions, Rule 29(4) specifies that the pension shall be reduced so that:

- the pension net of income tax from the taxed Scheme (ie allowing for a 15% rebate) MEMBER RECEIVES NO $ VALUE FROM THIS REBATE

is equal to

- the pension net of income tax from an untaxed Scheme.

I understand that the rule changes and their application were discussed with the Board in May/June 2002, and were reviewed by Peter Seibels from KPMG.

How does this work in practice – lump sums?

For lump sums, formulae were developed to calculate the reduction in various situations, depending on the type of benefit, the date the member joined the Scheme and the age of the member.

The reduction to lump sums has a maximum of 15% applied to it. This is because one option that a member has on retirement from an untaxed scheme is to roll their benefit into a taxed scheme. They would pay contribution tax of 15%, and on taking a benefit will pay the taxed scheme rates of benefit tax.

No concerns have been expressed about the reductions applied to lump sums. From here on, we will only look at pension benefits.

How does this work in practice pensions?

For pensions, firstly the after tax pension is calculated ignoring the 15% tax rebate. Then the gross income that provides the same net income, but allowing for the tax rebate, is calculated.

The calculation is based on the income tax rates that apply when the pension is first payable.

Two examples are shown in Appendix 2.

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Members' concerns in detail

The following concerns regarding the offset on pension benefits have been expressed by members:

1. **the offset can be greater than 15% of the original benefit, and in the case of larger pensions, up to 21% of the original benefit.**

   Basis for concern:
   The offset is there to compensate the Scheme for contribution and investment tax paid to fund the benefit. The tax is at most 15%, so why is the offset greater than 15% in some cases?

   Looking at it slightly differently, the reduction in the gross pension is needed because:

   1) the aim is to equate after-tax pensions from taxed and untaxed Schemes;
   2) the difference is that pensions from a taxed Scheme is eligible for a 15% tax rebate;
   3) therefore a lower gross pension from a taxed Scheme will produce the same net pension due to the rebate.

   This is not legitimate given the rules

   However, the value of the rebate increases as the average tax rate on the pension increases. This relationship is complex, as it involves varying marginal tax rates and tax free amounts but that summarises it. What is being said?

   In percentage terms, if the average tax rate on the pension is at least 15%, then the value of the rebate (and hence the tax offset) will be 15%/(1-15%), or 17%.

   Response:
   The member is no worse off in net terms, so it shouldn't matter what is the percentage reduction. Wrong, Wrong it does matter - equality for one & it Reduces Employer's Costs

2. **But if the offset is greater than 15%, does this mean that the Scheme/employers are gaining the difference at the expense of members?**

   Response:
   At the time that the offset rules were introduced, the actuary did some calculations that showed that the estimated savings from the offset covered the additional tax payable by the Scheme following the change in its tax status. Where are the Calcs.

   The current actuary has also considered this issue, and his conclusions are discussed in an attached letter. This letter is discussed below.

Request this letter

— 'CRAP'

3. Inflation increases in future are based on the reduced pension

Basis for concern:
Are members being disadvantaged as future increases are calculated on a lower gross pension? Would members be better off if the inflation increase was calculated on the original gross pension, with the tax offset being recalculated on this new gross pension?

Response:
No. They are in fact better off if the inflation increase is based on the reduced gross pension. ?

This is counter-intuitive but is because the offset (as a percentage of the gross pension) increases as the pension increases, and hence the whole pension is subject to a greater offset (as a percentage).

This was tested on a range of pensions, and examples are shown in Appendix 3.

4. The legislation states that net benefits from the taxed Scheme *must not be less than* net benefits from the untaxed Scheme, whereas the rules require that the net benefits are *equal*.

Response:
The method that is being used complies with the legislation, as 'equal' is clearly within the definition of 'not less than'. For lump sum benefits, there are times when the net benefits can be slightly higher now than pre-privatisation, due to the 15% limit on the offset.

5. The reduction depends on income tax rates at the time of retirement — Y68!

Basis for concern:
A member may receive a different post-offset gross (and net) pension depending on whether they leave on 30 June or 1 July, say, and tax rates change over that time.

Response:
This is an issue for which the answer is less clear than most of the previous issues, for two reasons.

Firstly, there is an issue of equity if the gross benefit that a member receives can vary from one day to another due to changes outside of the member's or the Scheme's control.

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Secondly, the legislation specifies that the comparison between net benefits from an untaxed Scheme and net benefits from a taxed Scheme should be based on the tax rates applicable on the date that the Scheme lost its constitutional protection (see clause 11(8) in Appendix 1).

However, the Scheme Rules specify that the tax rates to be used are those that apply at the commencement of the pension. This rule was inserted by the Treasurer on advice from Mercer. !! But the EISS BOARD also Rec. & APPROVED these Rules

6. **If you are on a retirement pension, and tax rates fall, you would not get any more cash in hand.**

Response: This appears to be a lack of understanding. If you are receiving income and tax rates fall, your net income goes up. There is nothing about the scheme that changes that fundamental rule. — But A Member with Same service & Gross UN TAXED PENSION receives a higher GROSS TAXED/S PENSION.

7. **Members don't get any benefit from the 15% tax rebate.**

Response: This is true, but should they receive a benefit? They are still receiving the same after-tax income. THEN EMPLOYERS ARE Receiving this Benefit & they should not!!

Summary

The issues are:

1) Does the current offset calculation disadvantage members to the benefit of employers? THIS QUESTION is NOT ANSWERED !!
2) Does the offset reduce the value of inflation indexing? Relevance?
3) Do the Scheme rules with regard to the tax offset comply with the legislation?

Options

1) **Leave things as they are.**

We would need legal advice that the rules comply with the legislation, as discussed in point 5 above. If they do not, then this option is not applicable.

If they do comply, we need to put the message out that members are no worse off, and that the Scheme complies with the privatisation legislation. We also need to explain how the reduction works, with lots of examples.

If members continue to be unhappy with the offset calculation method, then they have the alternative of taking their pension as if the Scheme was still a government scheme. That is, there is no offset, and no 15% tax rebate. This removes any confusion associated with the offset, and avoids claims of the member being worse off at the expense of the Scheme. But its a TAXED SCHEME & all members of such schemes benefit from the 15% rebate, why should EISS be diff.

The financial impact of members choosing this option is addressed in the actuary's recent letter, and is fairly slight. This option is already available under the current scheme rules.

request this letter

2) **Amend the offset calculation in line with the legislation**
This would depend on the legal advice received as suggested under option 1.

3) **Place a limit on the current offset calculation of 15% or 17%**
4) **Amend the offset calculation in line with the actuary's suggestion**

The final two options reduce the impact of the offset calculation, and impose a cost on the employers compared to what is done now. But NOT when compared to employer costs in 2000!

The cost compared to pre-privatisation may in fact be lower, but the cost compared to now will be higher.

Recommendation

Can be reduced to:

- Keep things as they are now (depending on legal advice)
- Write as simple an explanation of the offset for distribution to members ⇒ A [illegible] Exp.
- Get it configured on Superb now. Is this the MERCER CALC process? How does it differ from the 1998 STRATEGY & METHOD

The current system means that members are no worse off, just confused. So let's try to reduce their confusion by improving their knowledge. Significant inequality & benefit to employer

Mercer are working towards having the offset configured on Superb in time for the benefit statements, so we will be able to show members their benefits pre-offset (as per the Scheme rules) and net of the offset. This appears to be the best method of showing the effect of the offset, as then it is out in the open. Very late considering the scheme started in July 2002 back dated to July 2000

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Appendix 1

Clause 11 of Part 2 of Schedule 3 of Electricity Corporations (Restructuring and Disposal) Act 1999)

Treasurer may vary Rules in relation to taxation

11. (1) The Treasurer may, after consultation with the trustee of the Scheme, insert into the Rules a rule or rules relating to changes in benefits for members and employer costs in relation to those benefits, following the Scheme's loss of constitutional protection.

(2) A rule inserted by the Treasurer may—

*(a)*prescribe a decrease in the level of gross benefits; or

*(b)*require benefits to be paid on an untaxed basis or partly on an untaxed basis; or

*(c)*make provisions of the kind referred to in both subparagraphs *(a)* and *(b)*,

in order to avoid or reduce an increase in employer costs caused by changes in the incidence of taxation as a result of the Scheme's loss of constitutional protection.

(3) Subject to subclause (4), the change in benefits effected by a rule made under this clause must not result in the level of net benefits to which a member, or a person in respect of a member, is entitled being less than the level of net benefits to which he or she would have been entitled if the Scheme had not lost constitutional protection.

(4) The level of net benefits to which a member, or a person in respect of a member, is entitled may be reduced below the level permitted by subclause (3) to avoid or reduce an increase in employer costs attributable to tax under the *Superannuation Contributions Tax (Assessment and Collection) Act 1997* of the Commonwealth in relation to the member.

(5) A rule made under this clause may operate differently in relation to—

(a) different classes of members;

(b) different classes of benefits;

(c) different classes of components of benefits.

(6) A rule made under this clause—

(a) must be made by notice in writing given to the trustee of the Scheme before the relevant day;

(b) may be varied or revoked by the Treasurer by notice in writing to the trustee before that day;

(c) is not subject to the *Subordinate Legislation Act 1978*.

(7) The trustee of the Scheme may vary or replace a rule inserted in the Rules under this clause in the same manner as it can vary or replace any of the other rules of the Scheme.

(8) In this clause—

"level of gross benefits" in relation to a member means the amount of the benefits to which the member, or another person in respect of the member, is entitled under the Scheme before tax attributable to those benefits has been paid or allowed for;

"level of net benefits" in relation to a member means the amount of the benefits to which the member, or another person in respect of the member, is entitled after tax attributable to those benefits has been paid or allowed for using the tax rates applicable on the day on which the Scheme loses constitutional protection and based on the assumption that the member has reached the age of 55 years;

"the relevant day" means the day on which the approval of the Treasurer ceases to be required for the variation or replacement of the Rules.

(9) For the purposes of this clause—

(a) benefits are paid on an untaxed basis where the trustee of the Scheme has made an election under the *Income Tax Assessment Act 1936* of the Commonwealth as a result of which the person receiving the benefits is liable for a higher rate of tax in relation to them;

(b) the Scheme loses constitutional protection when it ceases to be a constitutionally protected fund for the purposes of the *Income Tax Assessment Act 1936* of the Commonwealth.

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Appendix 2

Examples of Contribution Tax Offset Calculations for Pension Benefits

Example 1: Pension greater than $70,000

Step 1: Calculate deductible amount

Life expectancy	25.05
Undeducted contributions	64,020.29
Deductible amount	2,555.70 pa

Step 2: Calculate net value of untaxed pension

Gross untaxed pension [1]	72,782.32
Income tax [2]	-18,769.91
Net pension	54,012.41

Step 3: Calculate equivalent taxed pension

Gross taxed pension [3]	59,114.63
Income tax	-13,586.06
Rebate [4]	8,483.84
Net pension	54,012.41

Reduction

Gross untaxed pension	72,782.32
Gross taxed pension	-59,114.63
Reduction	13,667.69
as a % of the gross untaxed pension	18.78%

Why did this Not Raise Q's from Board Trustees?

1) *Gross untaxed pension* is calculated according to the Scheme rules
2) *Income tax* in this example is calculated using the post 30 June 2005 rates.
3) *Gross taxed pension* is calculated as the gross pension required to give the same net amount as step 2, but allowing for the rebate. That is, the calculation goes backwards from the *Net pension* of $54,012 to find the corresponding *Gross taxed pension*.
4) *Rebate* is 15% of the *Gross taxed pension* minus the *Deductible amount*.

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Example 2: Pension around $20,000

[illegible]

Life expectancy	24.57
Undeducted contributions	34,705.09
Deductible amount	1,412.50 pa

[illegible]

Gross untaxed pension [1]	20,089.16
Income tax [2]	-2,345.18
Net pension	17,743.98

[illegible]

Gross taxed pension [3]	17,743.98
Income tax	-1,862.98
Rebate [4]	1,862.98
Net pension	17,743.98

[illegible]

Gross untaxed pension	20,089.16	
Gross taxed pension	-17,743.98	
Reduction	2,345.18	
as a % of the gross untaxed pension	11.67%	THE FULL 15% R cannot be used Due to the 15% THRESHOLD

1) *Gross untaxed pension* is calculated according to the Scheme rules
2) Income tax in this example is calculated using the 2004/2005 rates.
3) *Gross taxed pension* is calculated as the gross pension required to give the same net amount as step 2, but allowing for the rebate. That is, the calculation goes backwards from the *Net pension* of $17,743.98 to find the corresponding *Gross taxed pension*.
4) *Rebate* is 15% of the *Gross taxed pension* minus the *Deductible amount*, subject to a maximum of the income tax payable. As 15% of the gross is greater than the tax payable, the net pension is equal to the gross.

Adding power to your

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Appendix 3

Impact of Inflation indexing on pensions

What are we trying to show?

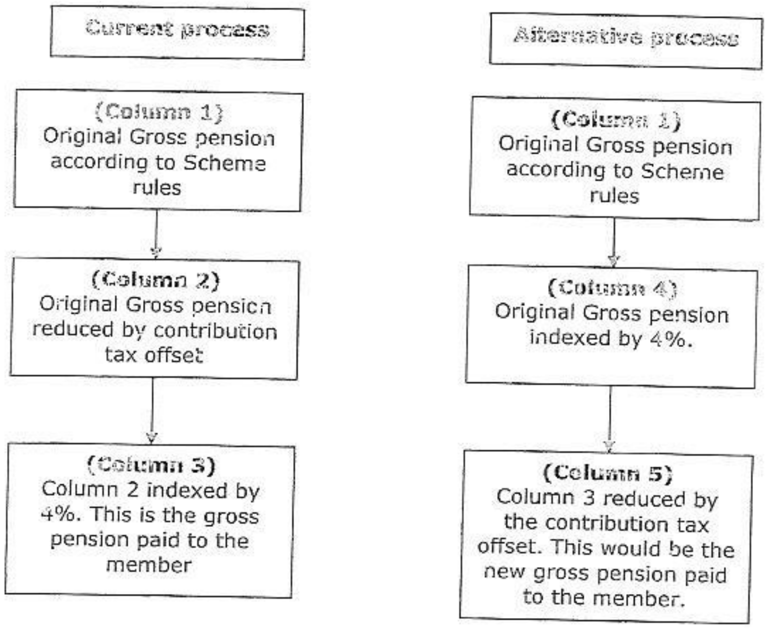
Members are concerned that they do not receive the same value for indexing if a pension has had the offset applied to it. What they are asking for is for indexing to be applied to the original pension, and then for the offset to be calculated on the new gross pension.

The examples below show that this reasoning is wrong. Members are better off by having the indexing applied to a reduced pension. That is because the offset increases (as a percentage) as the pension increases. For example, on a pension of $60,000, the offset is 17.33% of the pension. On a pension of $62,400 ($60,000 indexed by 4%) the offset is 17.88% of the pension. So the reduction in the whole pension goes up as the pension increases.

Original			Original unreduced indexed		Difference (3)-(5)
Unreduced (1)	Reduced (2)	Reduced Indexed (3)	Unreduced (4)	Reduced (5)	(6)
100,000	77,924	81,040	104,000	81,021	19
88,000	68,875	71,630	91,520	71,410	220
80,000	63,113	65,638	83,200	65,418	220
70,000	57,108	59,392	72,800	58,962	430
60,000	49,604	51,588	62,400	51,246	342
40,000	33,197	34,525	41,600	34,509	16
20,000	17,804	18,516	20,800	18,456	60

What a convoluted explanation * is Not Relevant had the gross Pension ~~be~~ from a Untaxed Source been reduced applying the pre-post 1983 as is done for TAXED Source benefit

So what do all these columns mean:



1) Is an example pension. $88,000 was chosen to illustrate the effect of indexing and the offset on a taxed pension that moves across tax thresholds. $70,000 was chosen to illustrate the same effect on an untaxed pension.

2) Is the post-offset equivalent to column 1.

3) Column 2 indexed by 4%. This is what happens in practice.

4) Column 1 indexed by 4% as an example.

5) Is the post-offset equivalent to column 3. So the result in column 4 is if we did as the members asked, ie took the original gross pension, indexed that, and then applied the offset to the new gross pension. The question is therefore is column 5 higher than column 3.

6) The difference between columns 5 and 3. This shows that members are better off by having a reduced pension indexed (column 3) than having an indexed pension reduced (column 5).

SMOKE MIRRORS!