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On page 1 in its introduction this document states that 'employer costs are not expected to change as a result of the tax changes'. Further down on page 1 it is stated that Clause 11 allowed the Treasurer to insert rules that 'avoid or reduce an increase' in employer costs arising from loss of constitutional protection but only to the extent permitted by the constraint that no net benefit is to be less than the net benefit that would have been obtained if constitutional protection had not been lost. On page 4 in point (a) near the top it is stated that 'benefit reductions must not lead to a reduction in employer costs.'

The validity of the rule for reducing pensions depends on the assertion that employer costs are not expected to change being true for pensions and not just for lump sums. **SA Superannuants, Richard Vear and Barry Foster believe it is not true for pensions.**

In the section 'Actuarial Analysis' on pages 2-3 a set of figures is presented to support the claim that employer costs would not change as a result of the tax changes. But there is no detail given of the calculation of the figures. Without this detail for all the figures presented the assertion that employer costs have not changed has no credibility as far as pension costs are concerned.

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EXPLANATORY MEMORANDUM

AMENDMENTS TO THE RULES OF THE ELECTRICITY INDUSTRY SUPERANNUATION SCHEME

REDUCTION OF BENEFITS ON ACCOUNT OF TAXATION

Introduction

The purpose of these amendments is to specify the way in which benefits from the Electricity Industry Superannuation Scheme should be reduced to allow for the Scheme being taxed with effect from 1 July 2000.

In summary, the reductions to gross benefits payable from the Scheme are such that:

- benefits after tax received by existing members will not be lower than would have applied had the Scheme remained untaxed;
- employer costs are not expected to change as a result of the tax changes.

Background

By regulation made by the Commonwealth on 29 May 2002, the Electricity Industry Superannuation Scheme lost its constitutional protection with effect from 1 July 2000. The Scheme therefore became a taxed complying superannuation fund as from that date.

Clause 11 of Schedule 1 of the Electricity Corporations Act 1994 allows the Treasurer to vary the rules of the Scheme following the Scheme's loss of constitutional protection in order to avoid or reduce an increase in employer costs caused by the taxation changes arising from the Scheme's loss of constitutional protection. As part of the privatisation process, the Treasurer indicated to the tenderers that he would vary the rules so as to avoid an increase in employer costs, to the extent permitted by a constraint contained in Clause 11.

This constraint is that a rule variation which reduces benefits may **not** result in the level of the net benefits received by members being less than the level of their net benefits had the Scheme not lost constitutional protection – refer Clause 11(3). This constraint is further defined in Clause 11(8) by specifying that the comparison between net benefits before and after taxation is carried out on certain assumptions regarding taxation on benefit payments.

Clause 12 provides a mechanism whereby a Scheme member can appeal against the application of the rule variation on the ground that it reduced his/her net benefits.

Current Benefit Reduction Formulae

As from 1 July 2000 benefit payments from the Scheme have been reduced on account of taxation on an interim basis and paid out as "taxed benefits", *ie* as benefits paid from a "taxed" source. This action was taken with the knowledge of the Commonwealth and State Treasuries on account of the delay by the Commonwealth in ceasing the constitutional protection while it waited to pass legislation to impose tax at the time of loss of constitutional protection.

The formulae used since 1 July 2000 for the benefit reductions are designed to ensure that each exiting member receives after tax at least the same amount as would have been received after tax had the unreduced benefit been paid out as an "untaxed benefit", *ie* a benefit from an "untaxed" source. Assumptions are made for the purpose of the reduction formulae, as follows:

1. As much of a lump sum benefit as possible is taken in cash by the Member, rather being rolled over;

2. A member is assumed to receive other Eligible Termination Payments (ETPs) of such size that all of the lump benefit from the Scheme is above the tax-free threshold.

3. A pensioner receives no other income.

The assumptions lead to the lowest practical level for the benefit reductions. In practice, many benefits which are cashable are rolled-over, most members retire with other ETP payments which are less than the tax-free threshold and some pensioners have other income. To the extent to which these situations exist, members end up with higher net benefits than before.

Payment of Tax on Loss of Constitutional Protection

In late 2001, the Commonwealth Government passed legislation to impose a tax at the time of loss of constitutional protection. This legislation requires the Scheme to pay $6 million as a "rollover tax" as part of its 2001 tax year assessment.

Pre July 1988 Funding Credits

At the end of May 2002, the Scheme received from APRA confirmation of a Pre-July 1988 Funding Credit, which allows tax credits on account of the unfunded nature of the Scheme when superannuation funds in general become taxed in July 1988. The extent to which these tax credits can be utilised each year depends upon whether employer contributions paid to the Scheme in that year exceed the sum of the post 1983 part of the taxed benefits paid by the Scheme over the year.

The actuary has estimated that these credits are worth around $25 million (in present value terms) to the Scheme.

Actuarial Analysis

The Scheme actuary has estimated the financial effects of the tax changes to the Scheme. These estimates show a present value of the Scheme's relevant tax liabilities of $44 million in respect of the current membership, comprising:

- $30 million value for the tax on employer contributions after 1 July 2000, including contributions to fund the previously unfunded liability;
- $6 million rollover tax upon the loss of constitutional protection (as above);
- $8 million tax on investment earnings related to the accumulation benefits payable in future to current members.

The actuary estimates that this $44 million present value of tax costs for current members can be covered by –

- continuing the interim reductions to gross benefits (described above) at the level that maintains net benefits for all members (which saves $20 million in costs to the scheme), less a minor adjustment associated with post-tax member contributions (which reduces the $20 million to $19 million);
- using the Pre-July 1988 Funding Credits (which have a value of $25 million, as above).

This result indicates that an increase in employer costs will be avoided if the Treasurer reduces benefits to the maximum extent permitted under legislation (given the assumptions above). The outcome for members is that they will receive at least the same benefits after tax as they would have received had the Scheme remained untaxed. The proposed rule amendments provide this outcome.

Detail of the Proposed Rule Amendments

The purposes of the various elements of the proposed amendments are as follows:

Division 1

The proposed amendment to **Rule 1** clarifies that the expression "investment return" means the return after allowing for tax (though Rule 30 modifies this effect in particular circumstances).

The proposed new **Rule 29** provides the mechanism for reducing gross benefits to the extent that net benefits are unchanged under certain assumptions. The assumptions are conservative in that they provide that members will not receive any net benefit lower than before, though some may receive higher net benefits according to whether their benefit payments are taken in cash, or rolled over, and according to their other income and benefits.

This approach of reducing benefits at the time of payment is applied to all Divisions 2, 3, and 4 members and to the benefits payable from Division 5 in 2000/01 and 2001/02. Division 5 members in the Scheme on 1 July 2002 are treated differently by reducing their current balances as at 30 June 2002 and by deducting tax from ongoing employer contributions – refer below for further comment. Similar treatment is given to the Additional Voluntary Contribution Accounts which were introduced into the Scheme from 1 April 2002, in that tax is deducted from additional employer contributions as these are paid, rather than the benefit being reduced at the time of payment. This approach gives more visibility to members and is not inconsistent with the legislation since it only affects a benefit whose availability commenced after the effective date when Scheme's taxation commenced (*ie* 1 July 2000).

Proposed **Rule 29(7)** provides for a slightly smaller benefit reduction where the member contributions are paid post-tax. The purpose of the adjustment is two-fold, *viz*

(a) to reduce slightly the extent of the benefit reductions in order to meet the constraint that the benefit reductions must not lead to a decrease in employer costs; and

(b) to provide a small differential between benefits where there have been post-tax contributions and benefits where there have been pre-tax contributions, in order to make the Scheme cost-neutral for an employer whether member contributions are paid post-tax or pre-tax under a salary sacrifice arrangement.

Rule 30 provides that the crediting rate applied to member accounts will not be reduced on account of tax on investment returns in certain situations. These situations are:-

- all accumulations over the period 1 July 2000 to 30 June 2002, so as to reflect practice to date;
- accumulations for all future years in respect of members who joined the Scheme prior to 1 July 2002, apart from the accumulation of any Additional Voluntary Contributions.

This protection against tax on investment returns only applies up to the level of tax on the basis of taxation law as at 1 July 2000. Also the rules allow for this provision to be modified or ceased by the Superannuation Board, on the advice of the actuary, upon any substantial change to taxation law affecting investment returns.

Rule 31 allows certain benefits to be paid as "untaxed" benefits or as "non-rebateable" pensions. This approach would be used for benefits transferred to the State Scheme and may be appropriate in other circumstances where a member might otherwise be adversely affected by the changes (*eg* a member with significant negative gearing tax losses).

New **Schedule 1A** shows the tax rates to be assumed in the benefit reduction calculations. These rates codify the practice adopted since 1 July 2000 whereby members are assumed to be in a situation where the lowest level of benefit reductions can apply.

Division 5

The proposed amendments to **Division 5** reconstruct Division 5 benefits so that this Division will operate as from 1 July 2002 as a normal taxed accumulation scheme. This will provide members with a simpler presentation of ultimate benefits than that which must be used in the other Divisions. This approach is possible in Division 5 as there is limited pre 1983 service amongst the Division 5 members.

Rule 11 is amended to ensure that the death benefit for Division 5 is not affected by the reconstruction process. This action is necessary as zero tax is generally payable on a death benefit. Hence there is no tax reduction for death benefits on moving from an untaxed to a taxed arrangement and there is no potential for reducing gross benefits without reducing net benefits. Taxation law provides an "anti-detriment" provision to fund the continuation of the death benefit at its previous level.

Allan Archer

Allan Archer
Principal

27 June 2002