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A Credible Formula for Calculating EISS Taxed-source Pensions

The method that EISS is using to calculate its taxed-source pensions is not credible as a method that reduces the pensions without altering employer costs. This can be said confidently because the method takes no account of the tax cost to employers of paying the pensions as taxed-source pensions rather than as untaxed-source pensions.

The EISS method for calculating a taxed-source pension makes use only of personal income tax rates which are entirely unrelated to the rate of tax payable by a superannuation fund on its contributions and earnings. The EISS method also takes no account of a person's service history and this is an important determiner of how much tax a fund has paid on the assets backing a taxed-source pension. Nor does the EISS method give due weight to the fraction of the pension that has been funded by a member's personal contributions made from after-tax income. The assets originating from such contributions attract little or no tax.

A credible formula for reducing a pension so that there is no change in employer cost would be the following:

Taxed-source pension = Untaxed-source pension 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

This formula is described on page 9 of the 2004 Mercer Report (the relevant part of the 2004 Mercer Report is accessible from the HUB document) as a formula that keeps employer costs the same when an untaxed-source pension is converted to a taxed-source pension. It is a formula that has been actually used elsewhere in Australia.

What makes this formula credible, when the EISS method for reducing pensions is not credible, is that
1. it makes use of the tax rate (0.15, 15%) applying to superannuation funds.
2. it takes account of a person's service history by applying the tax rate to only that part of the pension corresponding to service completed after 1 July 1988 and financed by the employer
3. it does not reduce the part of the pension financed by the member's personal contributions made from after-tax income.

For a pension that is 20% funded by member contributions, and that is to be paid to a person who had completed half of his contributory service prior to 1 July 1988, the taxed-source pension is related to the untaxed-source pension as follows:

Taxed-source pension = Untaxed-source pension x (1 – 0.15x0.5x0.8)
= Untaxed-source pension x (1- 0.06)
= Untaxed-source pension x 0.94

The taxed-source pension is 94% of the untaxed-source pension. In other words the pension reduction that is sufficient to keep employer costs from increasing is 6%.

However, the EISS method reduces most pensions by more than 15%.

There is another credible method that an EISS pension division member can use to estimate the reduction in his/her pension that would be sufficient to meet the tax cost of paying it from the taxed superannuation environment. This involves calculating the percentage of the lump sum obtained by commuting the untaxed-source pension that is payable as tax when the lump sum is rolled over into the taxed superannuation environment. The reduction in the pension that meets the tax cost should be about the same as for the commuted lump sum.

Examples: Barry Foster's untaxed-source pension was reduced by 17.2%. Had Barry commuted this pension to a lump sum the percentage of the lump sum payable as tax would have been 5.7%.

Richard Vear's untaxed-source pension would have been reduced by 17.6% and the commuted lump sum by only 7.9%.

This is strong evidence that these two pensions have been reduced by about 10% more than was needed to meet the tax cost of paying them from the taxed superannuation environment.