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Taxed-source vs Untaxed-source Superannuation

Background

Prior to July 1988 superannuation funds did not pay tax on the contributions they received or on the earnings of the assets they held. But since then funds have paid a contributions tax of 15% on employer and salary sacrifice contributions and a tax on earnings of up to 15% (for a typical portfolio of assets the actual tax on earnings is usually less than 15%).

Soon after these new taxes were introduced South Australia made a High Court Challenge to the Commonwealth's power to apply these taxes to its superannuation funds. The decision of the Court was that there were constitutional limitations on the Commonwealth's power to collect tax from superannuation funds established under state legislation. However, there was no doubt about the power of the Commonwealth to levy tax on money paid by such superannuation funds to individual tax-payers. Nor was there any doubt about the Commonwealth's power to deny a superannuation fund, which was not subject to **all the taxes paid by private sector funds,** access to tax concessions.

The High Court decision prevented the Commonwealth from dealing with superannuation funds established under state legislation on the same basis as it dealt with private sector funds. However, it also made clear that any state that was not agreeable to having its funds taxed in accord with the Commonwealth's preference would need to have the agreement of the Commonwealth for it to operate its funds differently. Without that agreement it would not be possible for a state to pay comparable benefits to the members of its schemes at a comparable cost to the schemes that did cooperate fully with the Commonwealth. In other words there was no outright victory for either side in the High Court decision.

This legal stalemate was dealt with through the Commonwealth and every state signing a 'Heads of Government Agreement on Superannuation' (HOGAS). Under HOGAS state governments were permitted to elect to run funds that did not pay the taxes introduced on 1 July 1988. The states were also permitted to elect to run their funds without being subject to direct supervision by the *Australian Prudential Regulation Authority* (APRA). The dispensation to stay outside the July 1988 taxation regime is referred to as 'Constitutional Protection'. The dispensation to operate without direct APRA supervision is referred to by the term 'Exempt Public Sector Scheme' or EPSS. Most public sector schemes are EPSSs but relatively few are constitutionally protected schemes.

The ability of state governments to run funds that did not pay tax brought into existence two categories of tax status for superannuation funds.

The two categories of superannuation fund

Taxed-source superannuation funds: these funds, have since 1988, been paying all the taxes applied by the Commonwealth and the members of the funds are entitled to pay reduced taxes on receipt of their benefits compared to members of the funds that did not pay the Commonwealth taxes. All private sector funds and some public sector funds are in this category.

Untaxed-source superannuation funds: these funds do not pay tax on contributions and earnings. Only funds established under state legislation can be untaxed-source funds. These funds are also referred to as 'constitutionally protected funds'. People receiving benefits from untaxed-source funds usually pay more tax on their benefits than do people receiving benefits of the same amount from taxed-source funds.

For a given level of contributions made to a taxed-source pension fund the assets accumulated to pay pensions at retirement will be less than would have been the case if the fund had not paid the taxes introduced on 1 July 1988, and so the gross pension paid must be reduced if employer costs are to stay the same. To compensate for this members of taxed-source funds pay less tax on their pensions. In the case of the untaxed-source fund the assets available to pay pensions at retirement are greater allowing a larger pension to be paid but the pension will be depleted more by the larger personal income tax that is payable on it.

This raises the question – **which is better for the member, a smaller, taxed-source pension or a larger, untaxed-source pension?**

At July 1988 the unambiguous answer to the question posed immediately above was 'the taxed-source pension'. Where a fund became a taxed source anyone who had already retired at 1 July 1988 did not have his/her pension reduced but still became eligible to claim the 15% tax offset on the entire taxable amount of the pension. This did not alter the cost to the fund, or its associated employers, of paying the pension because, even after 1 July 1988, there was no tax payable by a superannuation fund on the earnings of assets held to fund pensions that had already commenced.

For pensions commencing after 1 July 1988 there was a tax cost to the fund and this increased with time elapsed after that date. Reductions in these pensions were justified and the reductions increased as the time elapsed between 1 July 1988 and the date of retirement increased. However, for any pension recipient with a significant part of his/her eligible service occurring before 1 July 1988, and who has funded part of the pension by personal contributions made from after-tax income, the pension reduction required to meet the employer tax costs of paying the pension from the taxed superannuation environment will be considerably less than 15%.

Most EISS pension members did have a large fraction of their service completed before 1 July 1988 and they had paid personal after-tax contributions of 6% of salary. And yet such people usually experienced pension reductions of more than 15%. People with the same service and personal contribution history who received lump sum benefits, rather than pension benefits, had their benefits reduced by much less than 15%. Even where a person eligible to receive a pension opted to take part, or all of it, as a lump sum the reductions due to tax were less for the lump sum than for the pension.

This is sufficient basis for being sure that EISS taxed-source pensions are determined by a method that has been designed to reduce the employer cost of the pensions. The basis for then saying that this makes the method illegal is sub-clause 11(2) of Schedule 1 of the Electricity Corporations Act 1994. This reads:

> (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 paragraphs (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.

The last two lines of (c) preclude the Treasurer from inserting rules that would reduce employer costs. The state Ombudsman disputed this and the reader can check his basis for doing so by going to the primary document and its Links 15-21.

Pre-July 1988 service versus pre-July 1983 service: some readers of this online resource will be aware that 1 July 1983, rather than 1 July 1988, is a date influencing the amount of tax payable on superannuation. When tax is paid by individuals on lump sums there is a fraction of the lump sum on which no tax is payable and it corresponds to the fraction of the person's service that was completed before 1 July 1983 rather than 1 July 1988. When EISS lost constitutional protection from 1 July 2000 the part of the assets held at that time corresponding to the fraction of member service completed before 1 July 1983 was exempt from tax. As a result the amount of tax paid by EISS was only 5% of the assets held.

The date 1 July 1988 enters a tax calculation only if the fund involved is at least partially unfunded with some of the unfunded benefit having accrued before that date. As employer contributions are made to bring the fund up to full funding the fraction of the contribution corresponding to the benefit accumulated before 1 July 1998 is exempt from the 15% contributions tax. This is described by saying that the fund is able to use pre-1 July 1988 funding credits (PJFCs) to reduce its taxable income and the amount of tax payable. When EISS lost constitutional protection, 1 July 1983 was used to calculate the tax-free part of the assets held at the time. Then as contributions were made to bring EISS up to full funding over the next five years PJFCs were used to create a tax-free component of the contributions. As a result EISS paid only 3.7% of these contributions in tax.

In summary EISS paid much less than 15% tax on the assets it held at the time it lost constitutional protection and much less than 15% tax on contributions made to achieve full funding but reduced pension benefits by more than 15%.

Had EISS been given a rule that reduced its lump sum benefits by more than 15% after loss of constitutional protection this would have been noticed by financial advisers who would have alerted people to the fact that their benefits were being reduced by much more than was needed to meet a tax cost.

It was the greater complexity of the relationship between the value of an untaxed-source pension and that of a taxed-source pension having the same total cost (cost of the pension plus cost of tax paid by the fund before the pension commenced) that introduced the risk of members having their pensions reduced by more than the tax cost of paying the pension from the taxed superannuation environment. Instead of the members getting the advantage of the move to the taxed environment the advantage could be diverted to employers without members being aware of this. SA Superannuants and at least two members of the *Electricity Industry Superannuation Scheme* (EISS) (Mr Richard Vear and Mr Barry Foster) believe that this is what happened when EISS pensions became payable as taxed-source pensions.

For private sector superannuation funds Commonwealth legislation, regulation by APRA and access for members to an independent and low-cost appeals tribunal (the Superannuation Complaints Tribunal) provided robust protection for superannuation fund members against unauthorised reductions in benefits. None of these protections were available to EISS members when EISS changed its taxation status in 2002 (effective from 2000).

The *Electricity Corporations Act 1994*, under which EISS is established, contains the following provision in its Schedule 1 (highlights added).

> **12—Appeal to trustee against rule under clause 11**
>
> (1) A member of the Scheme, or if the member has died, a person who is entitled to receive a benefit in respect of the member, may appeal to the trustee of the Scheme on the ground that a rule made under clause 11 has the effect in relation to the member of reducing the level of net benefits to which the member or other person is entitled below the level permitted by clause 11.
>
> (2) An appeal—
>
> (a) must be made in the manner and form determined by the trustee;
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> (b) may be made at any time before the expiration of six months after benefits have become payable to the member or other person and the member or other person has received a written statement from the trustee as to the amount of the benefits.
>
> (3) If the trustee (after giving the appellant and the employer of the member, or former member, a reasonable opportunity to appear and be heard, either personally or by representative) is satisfied that the appeal should be allowed, it must—
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> (a) vary the effect of the rule as it applies to, or in respect of, the member; and
>
> (b) determine the amount of the benefits to which the member or other person is entitled following the variation under paragraph (a); and
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> (c) make any ancillary determination or order that in its opinion is necessary or desirable.
>
> (4) No proceedings for judicial review or for a declaration, injunction, writ, order or other remedy (other than an appeal under this clause) may be brought before a court, tribunal, or other person or body to challenge or question the validity or operation of a rule made under clause 11.
>
> (5) In this clause—
>
> ***level of net benefits*** has the same meaning as in clause 11.

If sub-clause 12 (4) was not obstacle enough for any member contemplating an appeal against the extent of reduction of his/her pension the complexity of the relationship between the employer cost of untaxed-source and taxed-source pensions made it very unlikely that the member would be able to sort out this complexity within six months of commencing the pension.

In 2008 access to the Superannuation Complaints Tribunal (SCT) was made available to EISS members but this entity cannot review matters occurring before a fund entered its jurisdiction. From 2000 to 2008 EISS members did not have access to the SCT or any other external review body and it was during this period that the changes we believe were illegal were made to the EISS rules. To the best of our knowledge there is no other group of Australian superannuation fund members that has been rendered as vulnerable to unlawful reductions in their benefits as EISS pension division members.

Had they been designed for the purpose of disempowering EISS pension division members this set of circumstances surrounding the move of EISS into the taxed superannuation environment could not have been more effective.