



## Superannuation, social security and retirement income

The Australian retirement income system is made up of three parts, a means tested age pension, mandated superannuation savings and additional voluntary savings either through superannuation or outside it. The overall aim of the system is to reduce poverty in retirement and produce a higher income in retirement than can be achieved by reliance on the age pension alone. Recently, a third goal has begun to emerge, that of prolonging a person's workforce attachment. The success of the retirement income system depends on the interaction of the social security and superannuation parts with the taxation regime. This paper seeks to describe that interaction, examine some identified problems with this interaction, describe some recent changes, and consider whether, under a common set of retirement circumstances, the current system provides incentives for those past retirement age to maintain some attachment to the work force.

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## Glossary

### **Age pension age**

Age pension age is currently 65 years for men and 62.5 years for women. The qualifying age for women is being progressively raised to 65 by 2014.

### **Allocated Pension**

A superannuation account from which a series of regular payments can be drawn upon in retirement. The payments must lie between limits specified monetary limits set by factors in the Superannuation Industry (Supervision) Regulations 1994. An allocated pension can be turned into a lump sum (i.e. cashed out or commuted) at any time and is assessed against the lump sum Reasonable Benefit Limit only.

### **Annual Rate of Income (for social security purposes)**

The annual rate of income is the assessed rate at which income is expected to be received by a person or a couple, from all sources, over the following 12 month period for social security purposes.

### **Annuity**

A contract between a provider (usually a large life insurance company or superannuation fund) and a person to receive a regular series of specified payments, at specified times, over a specified period.

### **Complying Income Stream**

A complying income stream is one that meets all the requirements for assessment against the pension RBL. A complying income stream is usually an asset test exempt income stream.

### **Conditions of Release**

The requirements that a person has to meet in order to withdraw their superannuation benefits. These conditions are contained in the schedules to the Superannuation Industry (Supervision) Regulations 1994.

### **Deeming (for social security purposes)**

The deeming rules are a central part of the social security income test. They are used to assess income from financial investments for social security and Veterans' Affairs pension/allowance purposes. Deeming assumes that financial investments are earning a certain rate of income, regardless of the amount of income they are actually earning. If pensioners earn more than these rates, the extra income is not assessed.

### **Deeming Rates**

The deeming rates are the rates of return used by Centrelink to determine how much income, for social security purposes, is generated by financial assets (i.e. shares, fixed interest, bank accounts).

Generally, the rate of return calculated using the deeming rates is lower than the actual overall returns (made up of both capital growth and dividends paid) by most financial assets.

### **Effective Marginal Tax Rate**

An effective marginal tax rate (EMTR) shows the percentage of additional income lost, as private income increases, due to the withdrawal of means-tested social security benefits and the additional income tax payable.

### **Growth Pension**

See 'Term Allocated Pension'.

### **Indexation**

The amount by which payments from an income stream increases annually. Generally the indexation rate is expressed as a percentage of the annual payment.

### **Income Stream**

A series of regular payments (i.e. a stream of income). The term is a generic one covering such financial products as:

- annuities
- allocated pensions
- growth pensions, and
- superannuation pensions.

The term 'income stream' is mainly used in the context of the social security treatment of these products. An income stream can either be fully asset tested or asset test exempt. Attachment 1 gives further details on the criteria for the assessment of an income stream as either asset test exempt or asset tested for social security purposes.

### **Life Expectancy Income Stream**

An income stream that is paid for a term equal to the person's average life expectancy (as calculated by the Australian Government Actuary) on the date of purchase, or that person's average life expectancy for their age five years earlier.

### **Lifetime Income Stream**

An income stream that is paid for the whole of the person's remaining life.

### **Low Income Tax Offset (or Rebate)**

A low income rebate applies to resident individuals. The maximum rebate of \$235 p.a. is allowed for taxable incomes of \$21 600 p.a. or less. It is reduced by four cents for every dollar by which the taxpayer's taxable income exceeds \$21 600 p.a. with the result that the rebate phases out entirely at a taxable income of \$27 475 p.a.<sup>1</sup> For most tax payers it ensures that no tax is paid until a person's taxable income exceeds \$7568 per year.

### **Market Linked Pension**

See 'Term Allocated Pension'.

### **Means Test**

Means test in relation to Australia means the income and assets tests that are applied to a persons assets and non-social security income to determine the rate at which pensions, benefits and allowances are paid.

### **Preservation Age**

The age at which superannuation fund members can generally withdraw their superannuation benefits, providing that all other 'conditions of release', for superannuation have also been satisfied. For those born before 1 January 1960 their preservation age is 55. For those born on or after 1 January 1965 their preservation age is between 56 and 60, depending on the year of birth.

### **Primary Beneficiary**

The person who first receives payments from an income stream after it is purchased.

### **Reasonable Benefit Limit**

The amount of concessional taxed superannuation benefits a person is allowed to receive over his or her lifetime is limited by reasonable benefit limits. The table below shows the lump sum and pension reasonable benefit limits. The pension reasonable benefit limit is available provided that at least 50 per cent of the total benefit received by a person is taken in the form of a pension or annuity that satisfies the pension and annuity standards.

Reasonable Benefit Limits	2005-06
Lump sum	\$648 946
Pension	\$1 297 886

Source: Australian Taxation Office: TD 2005/21

### **Reversionary Beneficiary**

The person to whom an income stream is paid upon the death of the person who was first receiving the payments (known as the primary beneficiary).

### **Reversionary Pension**

A reversionary pension is the income stream that a reversionary beneficiary is paid.

### **Superannuation Pension Tax Offset (or Rebate)**

Where a person receives an eligible termination payment and uses it to purchase an annuity or pension from a taxed superannuation fund and the person is 55 or more years of age, the person is entitled to a tax offset, at 15 per cent, on the assessable part of the annuity or pension payment that is not in excess of the person's reasonable benefit limit.

### **Self Managed Superannuation Fund**

A self managed superannuation fund is a fund:

- that has a trust deed that meets the requirements of the *Superannuation Industry (Supervision) Act 1993* (SIS Act), and
- that has no more than four members, and
- that has all the members as trustees of that fund, and
- where no member of the fund is an employee of another member of the fund, unless they are related, and
- where no trustee of the fund receives any remuneration for their services as trustee.

The overwhelming majority of self managed superannuation funds have one or two members. Because all the members of a self managed superannuation fund are trustees, the fund is not subject to the full range of prudential regulation and supervision requirements.

### **Senior Australians Tax Offset (SATO)**

Certain low income aged persons, both pensioners and self-funded retirees, are entitled to a special additional tax offset. This offset, described in the legislation as the low income aged persons rebate, is generally referred to as the Senior Australians Tax Offset (SATO).

The classes of person eligible to claim the offset are as follows:

- a taxpayer who, at some point during the income year: (a) is eligible for a pension, allowance or benefit under the *Veterans' Entitlements Act 1986*; (b) has reached veteran pension age under that Act (for 2004/05, 57.5 years for women and 60 years for men); and (c) is not in gaol, or
- a taxpayer who, at some point during the income year: (a) is qualified for an age pension under the *Social Security Act 1991*; and (b) is not in gaol.<sup>2</sup>

In the 2005–06 year the maximum rebate is \$2230 for those with tax assessable income below \$21 968 p.a. The rebate reduces by \$0.125 for every dollar a person's assessable income exceeds this

threshold. SATO is not available to those with tax assessable incomes exceeding \$39 808 in this financial year.

### **Structural Ageing of the Workforce**

Australia's population is rapidly ageing. The share of the population aged over 65 years is projected to rise from 13.0 to 24.5 per cent from 2003–04 to 2044–45. An even bigger relative change is anticipated for the oldest old — those over 85 years. Their share increases from 1.5 to 5.0 per cent over this period.

Currently, there are 5.2 people in the potential workforce for every person aged 65 years or more (an aged dependency ratio of 19 per cent). By 2044-45, this will have fallen by more than half, to less than 2.4 (a ratio of 41 per cent).<sup>3</sup> This trend is the structural ageing of the workforce.

### **Superannuation**

Tax advantaged savings regime that cannot generally be accessed until the member of the superannuation fund has reached their preservation age (55 to 60, depending on date of birth).

### **Term Allocated Pension**

Term allocated pensions will have a similar account arrangement to an allocated pension, but investors will receive payments for a fixed period based on their life expectancy. Other points include:

- the pension's annual income payments will be worked out on the basis of the account balance at the start of the year (like an allocated pension) by a set formula (unlike allocated pensions where you can choose from a range of payment levels for a given account balance)
- there is no residual capital value at the end of the pension's term (except in limited circumstances)
- the pension cannot be commuted to a lump sum (except in limited circumstances) which means investors cannot access any of their capital
- the pension is partially (50 per cent) exempt from the social security assets test
- the pension is assessed under the more generous pension Reasonable Benefit Limit.<sup>4</sup>

## Executive summary

Australia's retirement income system is made up of the Government funded, means tested age pension; mandated superannuation savings via the Superannuation Guarantee regime and additional savings, either through additional superannuation savings, or through other vehicles, such as shares, managed funds, fixed interest or property investment.

The superannuation industry has called for better integration of the social security, superannuation and taxation systems. Specifically it has identified several problems:

- confusion and uncertainty in the operation of the social security means test for age pensions
- the persistence of high effective marginal tax rates applying to age pensioners, and
- the tendency of retirees to invest inefficiently so that they can receive some, or more, age pension payments.

There have been significant changes in the superannuation, taxation and social security arrangements that affect these issues. The most significant changes are:

- the introduction of a number of income tax rebates that are available specifically to older workers and retirees
- specific changes in the way that various superannuation based income streams are assessed for social security purposes
- the restriction on the type of income streams that are paid by self managed superannuation funds, and
- the introduction of a new income stream product, the 'Market Linked', or 'Term Allocated' pension.

Many, but not all, of the Superannuation Industry's concerns have been met by these changes.

In recent years taxation and superannuation policy has encouraged those approaching retirement, and those in retirement, to maintain their attachment to the workforce. However:

- age pensioners are still subject to significant effective marginal tax rates if they increase their non-social security income
- difficulties persist with the social security assessment of earned income of aged pensioners, and

- when a person retires, receives age pension payments and purchases a modest superannuation based income stream they appear to have very little financial incentive to maintain any significant attachment to the work force.

These problems potentially reduces an age pensioner's incentive to maintain an attachment to the workforce.

Of itself, this apparent lack of financial incentive does not necessarily prevent those over age pension age from engaging in paid employment, as mature workers may undertake work at different times for reasons other than an increase in their overall income.<sup>5</sup> Rather, it points to the potential lack of financial incentives for mature workers, in some circumstances, to engage in paid employment past age pension age.

## Introduction

There have been several calls for better integration of superannuation and private income with the social security system.<sup>6</sup> The aim of this paper is to outline how superannuation, and particularly superannuation-based income streams, are assessed for social security purposes. Some of the problems identified by the superannuation industry in the way this system works are then noted and discussed. In particular the superannuation industry's concerns about the perceived high effective marginal tax rates are considered. Part of this consideration is the calculation of effective marginal tax rates for a single age pensioner taking into account recent relevant changes to the tax, social security and superannuation regimes.

One of the recent developments of the retirement income system is that it appears to be acquiring a new objective. In response to the apparent structural ageing of the workforce<sup>7</sup> Government policy has shifted towards encouraging participation in the workforce by mature age workers.<sup>8</sup> This paper considers whether the current retirement income system encourages this participation for those over age pension age. It does this by noting some features of the current means test that may discourage those in receipt of age pension payments from participating in the workforce in certain circumstances.

## Background

Australia's retirement income system has three major components:

- a means-tested age pension
- arrangements whereby most employees can accumulate a superannuation benefit via the compulsory Superannuation Guarantee regime, and
- additional private savings within and outside the superannuation environment.<sup>9</sup>

The interaction between the first component (the age pension) and the other two is crucial to the overall success of this system in providing an adequate retirement income. Taxation

arrangements affecting this income also have a large impact on the effectiveness of this system in providing a retirement income.

## The age pension

The age pension is a safety net for those who need income support in retirement. Reaching age pension age (currently 65 for males, 62½ for females), and meeting the required residency requirements does not mean automatic access to the full rate of age pension. About 36 per of those receiving the age pension do not receive the full rate of payments.<sup>10</sup> Rather, their payments are reduced under the provisions of the age pension means test.

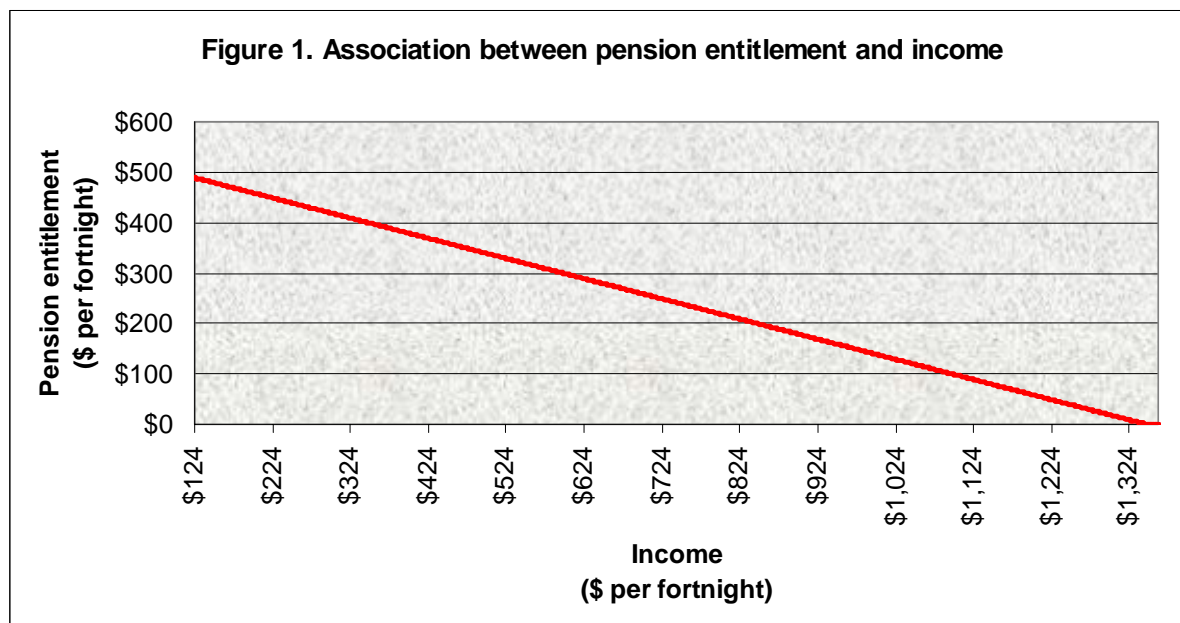
### Age pension means testing

Access to the age pension at age pension age is determined by application of the income test and the assets test. Briefly, pension entitlement depends on private income and private assets. A person is paid at the lower of the two rates determined by either the income or the assets tests.

#### Income test

The income test has two stages: a 'free' stage where income below a threshold can be earned and the full age pension entitlement still be received, and a 'tapered' stage where a person's age pension entitlements reduce in a graduated fashion. Currently, a couple can receive the full age pension with a combined income at the annual rate of up to \$5720 (\$220 per fortnight) and a single person can have an annual rate of income of up to \$3224 (\$124 per fortnight) before their age pension payments start to reduce. Every additional \$1 in the annual rate of income reduces both the combined, and single, pension paid by 40c. Entitlement to the age pension ceases once a couple's combined annual rate of income reaches \$57 798 (\$2223 per fortnight) and a single person's entitlement to an age pension ceases once their annual rate of income is \$35 379 (\$1360.75 per fortnight).<sup>11</sup>

From 20 September 2005 the maximum rate of age pension for a single person is \$12 711 per annum (\$488.90 per fortnight), for a married couple the maximum rate is \$21 226 per annum (\$408.20 per fortnight each). The following graph illustrates how the age pension income test reduces a single pensioner's age pension payments.



For social security purposes income is mostly derived from three sources:

- earned income, such as that arising from full or part time employment,
- income arising from income streams, such as pensions or annuities, and
- deemed income, arising from financial investments.

### Deeming

The deeming rates are the rates of return used by Centrelink to determine how much income is generated by financial assets (i.e. shares, fixed interest, bank accounts). They are set at a modest level so that most investment alternatives will produce returns above the deeming rates. The deeming rate is also designed in part to remove the opportunity for pensioners to reduce their private income and increase their pension or obtain the health card and other benefits.

Currently, a deeming rate of 3 per cent applies to:

- the first \$37 200 of a single pensioner's total financial investments, and
- the first \$62 000 of a pensioner couple's total financial investments.

Currently, a deeming rate of 5 per cent applies to financial investments above these amounts (they include superannuation fund balances and retirement income streams with less than five years duration-discussed below).

The thresholds at which the higher deeming rate begins to apply are indexed in line with the Consumer Price Index in July each year.<sup>12</sup> The deeming rates are adjusted from time to time in line with changes in general market rates of return from all asset classes, at the discretion of the Minister for Family and Community Services.

### **Superannuation and the income test**

If the superannuation benefit is left in a fund

For the age pension income test, superannuation assets left in a fund are deemed to generate an income. The relevant social security deeming rates are applied to determine the amount of income to be assessed.

If the superannuation benefit is converted into an income stream

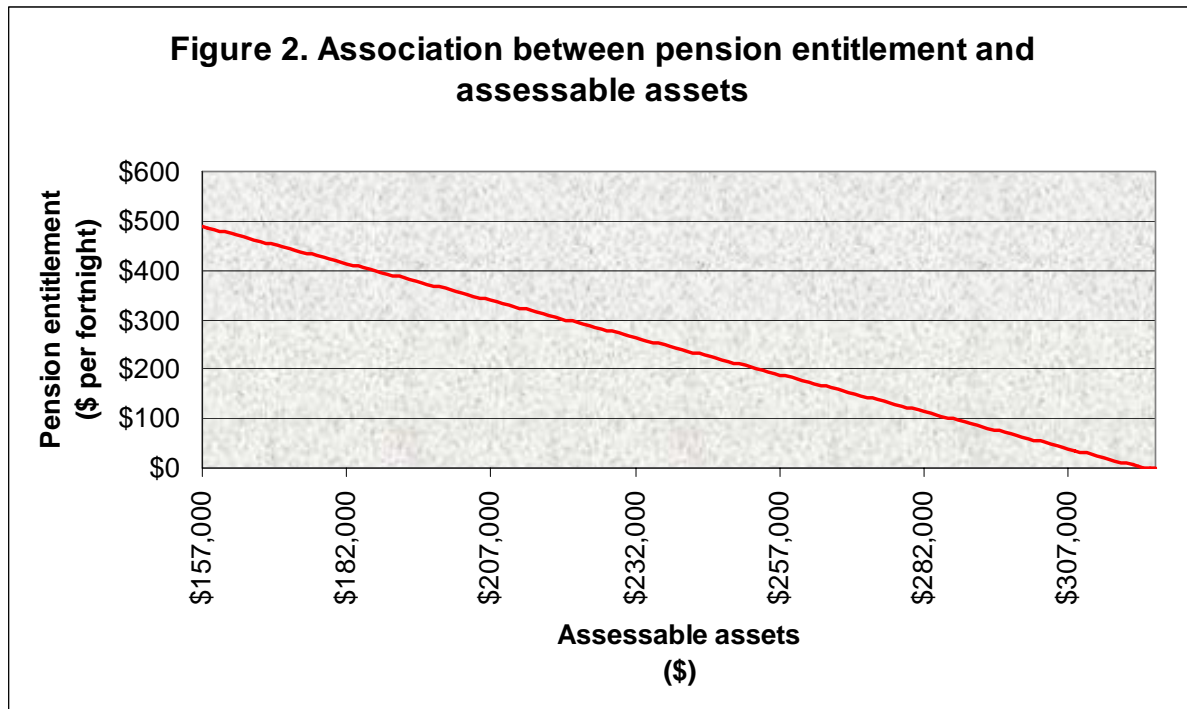
If the income stream has a duration of less than five years, income is assessed by applying the social security deeming rates.

If superannuation benefits are taken as an income stream, the payments are assessed under the income test for social security purposes. If the income stream has a duration exceeding five years, the amount of income assessed is that income less an amount that reflects the return of the capital value of the income stream averaged over the person's life expectancy, or the actual duration of the entitlement, at the date of purchase.<sup>13</sup>

### **Assets test**

The assets test also has a 'free' stage and a 'tapered' stage. A home-owning couple (as at 20 September 2005) may have assets valued up to \$223 000 (not including their own home) before the rate of pension is affected. Every \$1000 in assets over \$223 000 reduces the rate of age pension \$3 per fortnight, until no pension is payable when the value of their assets reaches \$497 500. Non-home-owning couples have asset test limits set \$113 500 higher than home owners.

A single pensioner homeowner may have up to \$157 000 in assessable assets (again, not including their own home) before their pension entitlement is potentially affected by the assets test. Once their assessable assets reach \$322 000 they lose entitlement to the age pension altogether.<sup>14</sup> The following graph illustrates the manner in which a single age pensioner's entitlements reduce under the assets test.



### Superannuation and the assets test

Superannuation may be included in a person's asset test assessment. If the superannuation benefits are taken as an income stream, the particular asset generating the income stream may be subject to the assets test, depending on the type of income stream and the date on which it was purchased. Attachment 1 gives a summary of the asset-test treatment of income streams purchased with superannuation benefits, non-superannuation monies or arising from superannuation entitlements in public sector superannuation schemes.

Superannuation entitlements may be taken as a lump sum and used to purchase a host of other assets. Generally they will also be subject to the assets test, but those arrangements are outside the scope of this paper.

### The superannuation industry's concerns with the retirement income system

The superannuation industry has identified some concerns with the social security means test, as applied to age pension recipients. These are:

- confusion and uncertainty about the way the social security income and assets tests work
- high effective marginal tax rates over the income ranges covered by the income and assets test, and

- investment inefficiency (that is, lower yields than could be achieved) created by structuring a person's income or assets to meet the requirements of these tests.<sup>15</sup>

## Income test confusion

The common description of the income test is that a person can receive up to a certain amount of income per fortnight before their age pension payments are affected. But the income test for the age pension operates on the principle of assessing the *annual* rate of income.<sup>16</sup>

The annual rate of income is the assessed rate at which income is expected to be received, from all sources, over the coming year for social security purposes. It is used to determine a person's current need for the age pension. It is based on the income produced by financial assets calculated by the application of the deeming rates, plus income expected to be produced by predictable sources of income such as income streams or employment. The assessed annual rate of income is not the same as the actual income received by the pensioner. Nor is it the same as income assessed for taxation purposes.

The annual rate of income method, used to assess a person's entitlements to the age pension under the income test was adopted because the actual amount of income received during the year is not accurately known until after it has been received. Often there are lengthy intervals between the receipt of a pensioner's private income, such as the period between dividend payments from shares or the payment of private pension income once a year. Accurate social security pension payments need to be made before this occurs, and the annual rate of income allows Centrelink to estimate the pensioner's current need for income support so that appropriate social security payments can be made.

Basing a pensioner's payments on the actual income received would involve complex and intrusive assessments and re-assessments of a retiree's income several times during the year, or the very politically unpopular recovering of payments already made, should the actual income received exceed the amount on which the pension payments were based.

The adverse impact of assessing earned income for age pension using the 'annual rate of income method, in assessing income for social security purposes can be seen in the so called 'Santa Claus' decision by the Administrative Appeals Tribunal (AAT) in 1998.<sup>17</sup> Briefly, some age pensioners worked as casual Santa Clauses during the December period. They declared their earnings to Centrelink. This caused their assessed rate of annual income to increase to the point where they then experienced a significant drop in pension entitlements for the period they were working. However, the amount they actually earned over their period of employment, together with their other income, remained below the annual rate of income at which no effect on age pension entitlements occurs. The AAT decided in favour of the pensioners.

The superannuation industry is concerned that this sort of problem points to the poor integration of the means test rules with the likely sources of private income in retirement.

Further, it is apparent that rules that appear to work well enough for the assessment of unearned income do not appear to work well for the assessment of earned income.<sup>18</sup>

## **Assets test confusion**

The relationship between the income and assets test is also an issue. There is a view in the community that the rate at which pension entitlements are withdrawn under the assets test is too severe and that there should be greater correspondence between the respective withdrawal rates under the income test and the assets test. In particular, it is felt that the rate at which pension entitlements are reduced under the assets test should, at various rates of investment earnings, be the same as the reduction in entitlements under the income test.<sup>19</sup>

## **Effective marginal tax rates**

An effective marginal tax rate (EMTR) shows the percentage of additional income lost, as private income increases, due to the withdrawal of means-tested benefits and additional income tax payable. A 70 per cent EMTR means that a person is only 30c better off after receiving an extra dollar of private income.<sup>20</sup>

In July 2003 the Association of Superannuation Funds of Australia (ASFA) calculated that a single age pensioner faced 70 per cent EMTRs, mainly where the pensioner started to pay income tax.<sup>21</sup>

ASFA is concerned that a high EMTR discourages savings for retirement, as it considers that those able to save for retirement will not do so if they perceive that their entitlement to an age pension is reduced or eliminated by this additional saving.

## **Investment inefficiency created by the income and assets tests**

Access to the age pension is highly valued by retirees. Consequently, they may make investments with the aim of getting the age pension. This entails purchasing less efficient investments. In this context less efficient investments are those that produce a comparatively low rate of return.

One method of accessing the age pension, in situations where the assets test may restrict this access, is to purchase income streams that qualify for an exemption under the assets test. Until 20 September 2004 one of the qualifications for the exemption was that the income stream payments be backed by a guarantee.

Generally, individuals who wish to purchase these 'guaranteed' income streams had to approach large life insurance companies. The income streams are usually backed by fixed-interest securities that reflect prevailing interest rates at the time of purchase. Generally, fixed-interest investments do not produce as high a rate of return over a long period of time and can be seen as an 'inefficient investment' according to the above definition.

Because there are significant penalties for exiting these products, the purchaser is more or less locked in to that level of income for the term of the product (either their life expectancy or their actual lifetime).<sup>22</sup> The consequence may be that, while they may get the age pension, or an increased level of age pension, the overall investment income they receive may be lower than if they were to put their capital into assets that provide a higher overall rate of return.

## **Self-managed superannuation funds**

A related problem is that some retirees source these ‘guaranteed’ income streams from self-managed superannuation funds. These funds have more difficulty than the larger retail funds in effectively spreading the risk associated with the ‘guarantees’. To offset this problem, for a given level of risk, those that purchase an income stream from such funds have to commit more capital to obtain a particular level of income, than would be the case for a larger retail provider. In these circumstances, social security payments are being used to support a very inefficient use of the retiree’s capital.

Here, efficient use of capital means the commitment of the minimum necessary to achieve the required outcome. The amount of capital needed to pay a guaranteed income stream from a self-managed superannuation fund is significantly above that required to pay the same income from a life insurance company statutory fund. Thus social security payments were encouraging the inefficient use of a retiree’s resources.

The stability of guaranteed income streams paid from self managed superannuation funds is not of the same quality as guaranteed income streams paid from much larger life-office statutory funds. Asset-test exemption is given to these income streams in recognition that the capital invested has a very high probability of lasting through the expected term of the income stream. This cannot be assumed in respect of every asset–test–exempt income stream paid by a self-managed superannuation fund.

Self-managed superannuation funds paying an asset-test-exempt income stream may also provide estate planning opportunities. This occurs because, on the death of the pensioner, the capital backing the pension stays in the superannuation fund, and becomes available to other fund members for their own retirement. These other fund members will usually be members of the pensioner’s own family. The capital that passes to their accounts in these circumstances has been exempt from the assets test. Thus social security benefits, that might not otherwise have been paid, have underwritten the passing of this capital to other family members.

## **Recent changes**

### **Mature Age Worker Tax Offset**

As part of the 2004 election campaign, the government announced that it would introduce the Mature Age Worker Tax Offset. In the 2005–06 year, a tax rebate of up to \$500 will be paid

to those 55 years and older with earned income (before tax) of between \$10 000 and \$53 000 per annum.<sup>23</sup> Unearned income, such as income received from social security or superannuation-based income streams, is not taken into account in assessing eligibility for this particular tax offset. But provided a person qualifies for this particular tax offset, it can be used to reduce their overall tax payable, irrespective of sources of their income.

#### Reduction in income tax rates

On 10 May 2005 the Government announced additional changes to the income tax rates for low income earners, and increases in the tax-free thresholds for other taxpayers. Of greatest relevance is the reduction in the lowest marginal tax rate from 17 to 15 per cent for those whose assessable income is between \$6000 and \$21 600 p.a.

#### Changes to Medicare threshold

As part of the 2005–06 Budget, the Medicare threshold was increased for those eligible to receive the Senior Australians Tax Offset, to \$21 968.<sup>24</sup> Normally, in 2005–06, the Medicare levy starts to apply once a taxpayer's income exceeds \$15 902 p.a.<sup>25</sup>

#### Existing tax offsets

In addition to these recent measures people of age pension age may also benefit from the Senior Australian's Tax Offset, the Low Income Rebate, and if they receive a superannuation based income streams containing post 1983 monies, the superannuation pension tax rebate. While not new measures these tax rebates are included in the paper's calculations for a single age pensioner.

#### Measures affecting investment inefficiency

Recent changes in the treatment of income streams under the social security assets test have reduced some of the incentives to purchase low-yield investments.

From 20 September 2004:

- only 50 per cent of the purchase price of a complying 'guaranteed' lifetime or life expectancy income stream purchased from that date is exempt from the assets test, and
- 50 per cent of the account balance of market-linked income streams, where the income paid has a direct link to the performance of various investment markets, is exempt from the assets test.

Prior to 20 September 2004 100 per cent of the purchase price of an eligible income stream was exempt from the assets test and 'Market Linked' or 'Term Allocated' pensions were not exempt from the assets test.

From 12 May 2004, self-managed superannuation funds, with limited exceptions, can no longer provide a ‘guaranteed’ lifetime or life expectancy pension. However, these funds can offer market-linked income streams. A Commonwealth Treasury review of these rules has recently confirmed these new rules.<sup>26</sup>

These changes reduce the attractiveness of guaranteed income streams for gaining access to the age pension under the assets test. Therefore, there is less incentive for retirees to invest in products that produce a low rate of return, simply to gain access to the age pension.

## **Are the industry’s concerns still valid?**

In the light of these changes, are the superannuation industry’s concerns still valid?

### **High Effective Marginal Tax Rates (EMTRs)**

To date, there is no empirical evidence that those who might make additional contributions to superannuation are discouraged from doing so by the means test. Theoretically, so long as the EMTRs lower the rate of return on investment, there is a prima facie case that suggests the current incentive structure discourages savings. However, it is unlikely that those making additional contributions to superannuation are even aware of this argument, as awareness of retirement income issues is not at all widespread.<sup>27</sup>

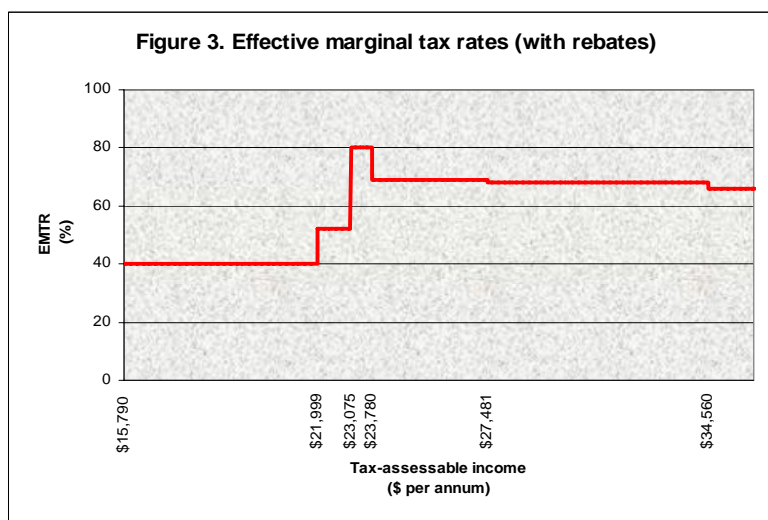
A possible major impact of a high EMTR is that it may discourage those seeking to work to earn that extra dollar. This has a significant potential impact on incentives for the participation of older people in the workforce. It can be argued that high EMTRs will discourage older workers from remaining in, or re-entering, the work force, even on a part-time basis.

With the application of the Mature Workers Tax Offset, Senior Australians Tax Offset (SATO) and the newly introduced tax rebates, what are the possible effective marginal tax rates faced by a single age pensioner?

EMTR calculations suggest that single pensioners face high EMTRs at various points, even with the benefit of these tax offsets. The following table shows the EMTR faced by single pensioners who increase their income to these levels:

Table 1: Effective Marginal Tax Rates—single age pensioner

Annual tax-assessable income	EMTR with rebates
\$15 790	40%
\$21 999	52%
\$23 075	80%
\$23 780	69%
\$27 481	68%
\$34 560	66%



Source: author’s calculations<sup>28</sup>

If EMTRs are accepted as a valid measure of incentives—or the lack thereof—to participate in the workforce, then current tax arrangements, even after all of the recent changes have been applied, may be a significant financial disincentive to continued participation in the workforce by aged pensioners. This would be true where significant EMTRs apply over an extended income range, as they do in the above example.<sup>29</sup>

However high these EMTRs appear, some additional points should be kept in mind:

- the disposable income of a single pensioner increases as their private income increases over the income range in the above table, despite the EMTRs in table 3
- EMTRs are not a very practical guide to examining decisions to engage in paid work or to increase the amount of paid work since people do not typically increase their private incomes by a dollar at a time<sup>30</sup>
- as the above graph indicates what may be thought of as a very high EMTR (80 per cent) only applies over a very narrow income range. A person confronted with a steeper EMTR over a narrow income range may consider the overall effect on their income, if their income is higher than the range over which the very high EMTR applies<sup>31</sup>, and
- the average tax rates faced by mature workers remain below the rates faced by other workers, until the Mature Age Workers Tax Offset, SATO and the low income tax rebate cut out altogether. By this point the person is no longer an age pensioner.

The following table shows the average tax rates with the benefit of the Mature Age Workers Tax Offset, SATO and the Low Income Tax Rebate compared with the average tax rates that a normal taxpayer would face during the 2005–06 year:

**Table 2: Average Tax Rates—single age pensioner**

Annual tax-assessable income	Average tax rate with rebates	Average tax rate without rebates
\$15 790	0.00%	9.30%
\$21 999	0.03%	11.21%
\$23 075	1.02%	13.02%
\$23 780	2.94%	14.09%
\$27 481	9.01%	16.43%
\$34 560	16.17%	19.52%

Source: author's calculations

Although significant EMTRs apply at various points after all the available tax rebates are applied, that does not necessarily lead to the conclusion that they form serious financial disincentives to continued participation in the workforce by mature-aged workers. As the table above suggests, mature workers on low incomes face a far lower tax burden than other participants in the labour market.

## Efficient investing

The amount of a complying income stream's purchase price that is exempt from the assets test has decreased, but has not been eliminated. Those with sufficiently high superannuation balances upon retirement will still have an incentive to invest in partly social security asset test exempt products to gain access to the age pension. Consequently, there is still an incentive to invest in these low-yield products.

Over time this incentive may apply to an increasing number of the retired population. As superannuation balances continue to build, leading to increases in the end benefits, increasing numbers of retirees will have a sufficient incentive to invest in asset test exempt products. Generally, retirees are risk adverse in their investment preferences. Accordingly, the number of retirees preferring guaranteed asset test exempt income streams may also increase. This incentive may become compelling during periods of sustained poor investment returns. During such periods retirees may prefer a guaranteed level of payments from an income stream.

The availability of the new Market Linked (or Term Allocated) Pensions addresses some of the investment efficiency concerns, by allowing a proportion of assets that are more exposed to investment markets to be exempt from asset-test assessment. While the superannuation industry's concerns are met for the moment, the combination for increasing superannuation balances and a significant decline in overall investment returns may increase the proportion

of guaranteed asset test exempt income streams purchased solely to gain access to the age pension.

As noted above the ban on self-managed superannuation funds paying a complying guaranteed asset-test-exempt pension has been confirmed. This addresses concerns regarding estate planning funded by the age pension. It also addresses concerns about the over-investment of a retiree's resources in these products to receive a given level of income.

Self-managed superannuation funds will still be able to pay a Market Linked pension and thereby gain benefits under the assets test. With these products the person's financial resources may be more efficiently invested (that is, in assets that may well produce higher returns over a longer period), and are simpler and less costly to administer than traditional complying guaranteed asset-test-exempt income streams.

## **Assets test**

While there is no link between the way the income and the assets tests operate, this is not currently a large problem, as only between 5 and 6 per cent of age pensioners are assessed under the assets test.<sup>32</sup>

As superannuation balances increase, it may be the case that an increasing number of those receiving lump sum superannuation entitlements may be affected by the assets test. However, the tax and social security incentives to purchase a 50 per cent asset test exempt income stream remain strong, and are likely to reduce the rate at which the assets test will impact on entitlements. These incentives will most likely restrict the growth in the number of pensioners whose rate of payment is determined under the assets test.

## **Income test: annual income testing discourages work**

The method of assessing a person's pension entitlements under the income test, based on their annual rate of income, allows Centrelink to assess their current need for income support. But it was also introduced, when most age pensioners did not work, and when it was not the Government's intention to increase older workers' participation in the workforce.

An income test based on the concept of an annual rate of income does not encourage a pensioner's participation in the workforce, as earned income is difficult to assess under this type of income test. This is due to:

- earned income, fluctuating sometimes significantly, especially from part-time employment, leading to rapid changes in the amount of pension paid
- changes in payment levels occurring some time after the work has been undertaken and the resulting income been used. In these circumstances pensioners may be left without income or resources at a time when they least expect it, and

- earned income being assessed as representing a rate of annual income that is far higher than the actual income received, leading to a suspension of pension payment for the time this annual rate of income is being received
  - for example a single aged pensioner earns \$2720 over a four week period. This is their only private income for the following 12 months. For social security purposes this is equal to an annual rate of income of \$35 260 (or \$1360 per fortnight). Under the income test this particular age pensioner cannot receive payment in respect of those four weeks, even though his total income for the year is well below the lower income test threshold (\$124 per fortnight or \$3224 per year).

An alternative approach is to assess the pensioner's income for social security purposes in these circumstances as \$2720 for the whole year and reduce the pension payments accordingly for the next twelve months (in this case there would be no reduction unless the pensioner earned further income). Another example of how this can occur is at Attachment 2.

Following the Federal Court decision in [\*Secretary of the Department of Family and Community Services vs. Rolley\* \(2000\)](#), Centrelink is bound to adopt a method of assessing a pensioner's earned income that will produce the best result for the pensioner. However, implementation of this approach is also subject to the administrative practice of individual Centrelink officers, who may, or may not, be aware of this requirement. A safer course of action would be for further amendment of the *Social Security Act 1997* to ensure that a pensioner's earned income is assessed in a manner that gives them the highest amount of pension payments over the coming 12 months.

However, in the circumstances discussed above a single age pensioner may be reluctant to undertake further employment due to the possible affect on their pension entitlements. Though they may achieve an overall increase in income by doing so, it is possible that the operation of the income test at this point acts as a disincentive to further participation in the work force for the following 12 months.

## **Income streams, the age pension and continued workforce participation**

An unintended side effect of the interaction of superannuation and the age pension is that the purchase of even a modest income stream may actually reduce the incentive to participate in the workforce past retirement age.

This proposition rests on the assumption that mature age workers may not want to increase their income beyond a certain point. Rather, they may simply wish to achieve a certain secure level of income and not further participate in the workforce.

To demonstrate this point, consider the position of a single age pensioner, who has purchased an income stream with a superannuation benefit of \$100 000.<sup>33</sup> The following table shows the required amount of before-tax earned income for two pensioners to achieve a level of after-tax income. One is an annuitant (that is, with an income stream), the other has no investments

at all (a ‘zero assets’ pensioner). Both pensioners take advantage of all available tax offsets and rebates, including, for the annuitant, the superannuation pension rebate and the pension deductible amount, and are subject to the normal tax rates and Medicare levy.

**Table 3. Earned income required to receive a set level of after tax income—single age pensioner**

Required after-tax income p.a.	Zero assets pensioner: required earned income p.a.	Annuitant pensioner: required earned income p.a.
\$20 000	\$10 293	\$0
\$25 000	\$22 743	\$2 796
\$30 000	\$36 400	\$11 130

Source: author’s calculations

Obviously, the annuitant pensioner’s incentive to participate in the workforce is a lot less than that of the ‘zero assets’ age pensioner.<sup>34</sup> By the time the ‘zero assets’ pensioner earns sufficient to achieve an after-tax income of \$30 000 per year, they are no longer in receipt of the age pension. In contrast the annuitant pensioner still receives some age pension as part of their \$30 000 after-tax income.

In the above example, the ‘zero assets’ age pensioner is an unrealistic figure, because there may be a declining number of age pension claimants with few assets. Due to the operation of the Superannuation Guarantee since 1992, the overwhelming majority of age pensioners will retire with some superannuation benefits. The size of these benefits is in dispute, but a recent estimate suggested that the average size of superannuation benefit for 20 per cent of those between 50 and 69 is above \$100 000.<sup>35</sup> While some of these amounts may well be used to eliminate debt (particularly housing debt) post-retirement, there will still be a significant number of retirees with both the resources and the incentive to purchase an income stream and commence to receive the age pension.

## Further challenges

The recent changes referred to above have increased the complexity of the superannuation and social security systems, even though specific changes have partly addressed particular problems. ASFA has suggested that the complexity of the superannuation and social security systems is a disincentive to save for retirement. ASFA is concerned that people will not save if they cannot understand how they will benefit in retirement.<sup>36</sup>

Despite this assessment there is little evidence that this complexity is acting as a disincentive to save amounts above the mandated Superannuation Guarantee contributions. The recently reported outcome of the Government Co-contributions Scheme suggests that low to middle income earners put additional funds into superannuation despite this complexity.<sup>37</sup> This may be because of widespread ignorance of retirement and social security matters on the part of the working population. However, the Government is attempting to increase financial literacy in the community.<sup>38</sup> A better informed community should lead to better decision making about retirement matters.

A particular challenge is to ensure the public has a correct understanding of the operation of the social security system, particularly that increased resources in retirement do produce a higher retirement income despite the gradual withdrawal of social security benefits.

## **Conclusion**

The calls for better integration of the social security, tax and superannuation systems continue. The changes introduced in the last few years have had the effect of meeting some of the superannuation industry's concerns and addressing some looming policy problems, especially in relation to income streams paid from self-managed superannuation funds. These changes have also led to a reduction in the use of 100 per cent asset-test-exempt income streams. However, the industry's concerns over the apparently high levels of EMTRs remain, despite the recent changes to the tax and superannuation systems.

The current system was formulated at a time when most retirees did not work. Further, the aim of Australia's three-pillar retirement income system (encompassing the accumulation of superannuation benefits) has been to give retirees a higher income than just the age pension alone. The increasing number of age pensioners receiving payments at less than the full rate suggests that this objective is well on the way to being met. But the game appears to have changed. The goal of retirement policy appears to be shifting towards keeping people in the workforce, as well as supplementing the age pension and thereby reducing reliance on the public purse.

The policy objective of increasing the workforce participation rate of older workers increases the need to re-examine the way the social security income test operates. If it is the Government's intention is to encourage those of retirement age to continue participating in the workforce, there appears to be very little incentive for a retiree with a modest income stream to continue participating in the workforce.

## Attachment 1—Requirements for income stream asset test exemption

Complying pensions/annuities come in two different varieties, those paid for a person's life, and those based on a person's, or partner's life expectancy at the date of purchase.

There is no requirement to use superannuation monies to purchase asset-test-exempt income streams. But the majority are purchased using superannuation balances.

### If purchased before 20 September 2004

For social security purposes an income stream purchased before 20 September 2004 is asset-test-exempt if the product meets the following conditions:

- it is payable for life or a term that is at least equal to a person's life expectancy at the date of purchase, and
- the payments are made at least annually, and
- the payments may vary upwards in response to indexation, but may only be varied downwards in response to allowable commutations, and
- the income stream's annual indexation is capped at the greater of 5 per cent per annum, or CPI plus 1 per cent, and
- there is no residual capital value, and
- the income stream's purchase price is returned to the pensioner over their life expectancy at the time of purchase, or the term of the product, and
- except in limited circumstances the income stream is non-commutable, and
- the income stream can ONLY be transferred to a reversionary beneficiary on the death of the primary beneficiary, or another reversionary beneficiary on the death of the first reversionary beneficiary (or if there is no other reversionary beneficiary, to their estates), and
- the amount payable to the reversionary beneficiary cannot exceed the amount paid to the primary beneficiary immediately before their death, and
- the income stream cannot be used as security for borrowing.<sup>39</sup>

For asset-test-exempt status, a life expectancy product must be purchased at or after retirement age.

## **If purchased after 20 September 2004**

If an income stream is purchased after 20 September 2004, the criteria by which lifetime complying pensions/annuities qualify for a 50 per cent exemption under the assets test are the same as for those purchased before 20 September, with the exception that the ‘guarantee period’ for pensions/annuities purchased after 20 September may be the lesser of the individual’s life expectancy, or 20 years.

Life expectancy and market-linked income stream products may have a term based on the purchaser’s life expectancy at time of purchase, or the person’s life expectancy at an age five years younger than their current age. For example, a person may purchase an income stream at age 65. They may choose to have a term of that product that is equal to their current average life expectancy (currently 17.4 years male or 21.15 years female<sup>40</sup>). Or such a person can choose to have a term for their product that is equal to their average life expectancy at age 60 (21.66 years male, 25.44 years female).

If the purchaser is a member of a couple, the term may be based on the longer of the couple’s life expectancies, or the longer life expectancy at five years younger. Again for example, say a member of a couple purchases an income stream when he is 70, but his partner is age 65; he can choose to have a term for the product equal to his current average life expectancy of 14.08 years, or his partner’s average life expectancy (21.15 years) or the life expectancy of his partner at age 60 (25.44 years). This approach guards against a person outliving their capital where an income stream, that is not guaranteed to be paid for the whole of a person’s remaining life, is purchased.

The Government has decided to provide more flexibility to the market linked income stream by extending the term of the pension so that payments can continue until the member reaches age 100 (or until a person’s spouse reaches age 100). Currently the term of the market linked income stream is based on the life expectancy of the member or their life expectancy as if the member was five years younger. (A longer term is possible if the pension is a ‘reversionary’ pension.) These changes will apply to new pensions commencing from 1 January 2006.<sup>41</sup>

There are no social security age-based restrictions on the purchase of life expectancy and market-linked pensions/annuities.

Asset values for complying lifetime and life expectancy pensions/annuities are initially 50 per cent of the purchase price. This amount is depleted to zero over life expectancy (for lifetime products), or over the term of the product (for life expectancy products). Asset values for market-linked pensions/annuities are based on 50 per cent of the account balance backing the product.

Market-linked pensions/annuities are subject to similar restrictions to life-expectancy products, but payments may vary up or down subject to calculation annually in accordance with a specified formula.<sup>42</sup>

Type of superannuation income stream	Social Security asset-test treatment
Public-sector defined-benefit pension	100% of purchase price asset-test exempt
Complying pension/annuity purchased before 20 September 2004, meeting all requirements in <i>Social Security Act 1991</i> , sections 9A or 9B	100% of purchase price asset-test-exempt
Complying pension/annuity purchased after 20 September 2004, with proceeds of a commuted pre-20 September 2004 asset-test-exempt pension or annuity, meeting all requirements in <i>Social Security Act 1991</i> , sections 9A or 9B	100% of purchase price asset-test-exempt in limited circumstances
Complying pension/annuity purchased on or after 20 September 2004 meeting all requirements in <i>Social Security Act 1991</i> , sections 9A or 9B	50% of purchase price asset-test-exempt (remaining purchase price is depleted for asset-test purposes over time)
Complying market-linked or term-allocated pension meeting the requirements of section 9BA	50% of account balance asset-test-exempt
Allocated pension or annuity (no matter when purchased)	Account balance fully asset tested
Complying pension/annuity that does not meet requirements for asset test exemption in <i>Social Security Act 1991</i>	Purchase price fully asset tested (amount depleted over time subject to asset test provisions.)

Source: FaCS – Guide to Social Security Law<sup>43</sup>

## Attachment 2—The social security income test—a case study

A married age pensioner undertakes a casual job over Christmas serving drinks at a local club. The job lasts four weeks and the pensioner receives \$5000. This is the pensioner's only private income for the entire year. The pensioner understands that he can earn \$5720 per 12-month period before Centrelink reduces his and his wife's age pension payments. However, his payments may be stopped for the time he is earning that amount of money. Or they may be reduced over the next twelve-month period.

Age pension entitlements under the income test are based on the annual rate of income at any one time. They are not based on the amount earned over a year.

Following the Federal Court case [\*Secretary of the Department of Family and Community Services vs. Rolley\* \(2000\)](#), Centrelink may assess a pensioner's earned income in two different ways.

### Alternative A

Over the time that the pensioner was working, the couple's annual rate of income was \$65 000 a year or \$2500 a fortnight (i.e. \$5000 divided by 4 = \$1250. Multiply this figure by 52 for the annual rate of income). As this annual rate is way above the current cut-out threshold for a couple (\$2275.50 per fortnight or \$59 163 a year), their pension is reduced to zero. After the period of employment ends, the couple's annual rate of income returns to its former level for social security purposes, i.e. zero. The pensioner couple's entitlement to the full rate of age pension is then restored.

### Alternative B

If circumstances warrant it, the amount earned may be treated as the pensioner's total annual rate of income for the year. Under this approach, there would be no reduction in the couple's age pension entitlement in this particular case. This is because their annual rate of income (under this approach \$5000 for the following 12 months) is below the level at which the pension begins to be affected (\$5720)

But if the pensioner's earnings were, say, \$7000 for the four weeks, then under this approach the couple's pension entitlements would be reduced for the next twelve months. This is because the amount earned is above the rate of annual income at which the couple's pension payments begins to be reduced.

### Comment

Centrelink is obligated to choose whichever assessment method gives the greatest benefit to the pensioner; that is, the one that, taking all the circumstances of the particular case into account, results in the highest rate of payments.<sup>44</sup>

The income test works well for those with stable sources of assessed income for social-security purposes. Such sources include income streams, where the changes in annual income are predictable, or various financial investments where the deeming rates used to calculate their income change relatively infrequently. However, it is more difficult to apply the pension income test to individuals whose income is subject to significant fluctuations during a 12-month period, e.g. income from casual employment.

There is sometimes confusion on how exactly to assess a pensioner's earnings from casual or part-time work, as Centrelink officers have the discretion to choose which of the above approaches applies in each particular case.

## Endnotes

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4. ISFA, *All about Term Allocated Pensions*, Education Fact Sheet, 2004 at <http://202.92.75.45/public/content/viewCategory.aspx?id=59#02> accessed 21 October 2005.
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7. Most recent report on this issue is the Productivity Commission, *The Economic Implications of an Ageing Australia*, March 2005.
8. Treasury, *Australia's Demographic Challenges*, February 2004 and Treasury, *A More Flexible and Adaptable Retirement Income System*, February 2004. More recently, The Hon. Peter Costello, MP, Media Interview 24 October 2005:

People are living longer, and we are having less children, so that means that the proportion of older people to the proportion of workforce age people is growing all the time. Now if we are going to make this economically sustainable, we have got to get control on costs, we have got to have a productive economy, and we need to encourage older people to maintain a connection with the workforce, if not full-time, maybe in a part-time capacity longer than they currently do. With people living longer and in better health they have a capacity to maintain a connection with the workforce longer.

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15. ASFA, *ibid.*, p. 18.
16. See Family and Community Services: *Guide to Social Security Law*, '4.2.1.10 Pensions Income Test & Limits'
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18. Private conversation with industry lobby group.
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20. Gillian Beer and Ann Harding, 'Effective Marginal Tax Rates—Options and Impacts', paper presented to Centre for Public Policy Conference on Tax Reform: Directions and Opportunities, 18 February 1999.
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26. The Hon. Mal Brough MP, Minister for Revenue and Assistant Treasurer, 'Outcome of the Review of Pensions in Small Superannuation Funds', *Media Release*, 27 September 2005.

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33. Life expectancy income stream purchased by a 65-year-old male, 2% indexation at rates current mid-June 2005, with a purchase price of \$100 000 in un-deducted contributions. The assumption is that the pensioner only has \$100 000 in total superannuation benefits. Since lump sum tax does not apply to withdrawn benefits below \$129 751 of post-1983 monies in the 05–06 tax year, the pensioner is assumed to have withdrawn the whole amount and immediately purchased an ordinary money income stream. Source of annuity rates: Plan for Life Limited, published in June 2005 edition of *Personal Investor*.
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