

CHAPTER 8 : TAXATION OF BENEFITS

8.1 This phase of the superannuation cycle is probably the most complex and confusing. A large number of witnesses put it to the Committee in the plainest of terms that the complexity of the regime was undermining the Government's retirement incomes policy. In particular, the push for greater use of income-stream products rather than lump sums was being stymied.

8.2 The Committee received evidence that one of the greatest causes of complexity here is the array of grandfathering provisions that abound in the ITAA. The use of grandfathering provisions is essentially designed to overcome the otherwise retroactive effect of changes to tax law. This is one example of the conflict between equity and simplicity.

8.3 The changes introduced since 1983 have brought with them a raft of convoluted phraseology. Particular care has been taken to explain this area in a clear and simple manner – but reference to the glossary which is appended to the report should still be made.

8.4 This chapter begins by looking at the current arrangements applying to superannuation benefits. This includes the notions of 'Eligible Termination Payments' and 'Reasonable Benefit Limits'. The tax consequences of superannuation pensions, annuities and allocated pensions are then examined as are the tax consequences of rolling-over a benefit.

8.5 The Committee's detailed and instructive evidence is then outlined. Despite the confusion in this area, the Committee received some novel and thoughtful suggestions for future arrangements.

8.6 The quality evidence that has been received by the Committee during its on-going inquiry, and the public debate this has generated have in part prompted Government action with respect to simplification. Taxation Laws Amendment (Superannuation) Bill 1992 seeks to remedy many of the concerns raised by a number of witnesses. The key objectives of the Bill include:

- ♦ simplification of some of the more complex areas (for example RBL);
- ♦ removal of some of the unintended distortions caused by the tax law (for example pension v annuities);
- ♦ strengthening the integrity of the system by closing off some areas of abuse (for example redundancy payments, roll-over arrangements).

However, the Committee considers that notwithstanding the significant reforms contained in the Bill, more could have been achieved. In particular, the pre-July 1983 and post-June 1983 issue could have been tackled.

8.7 Also, this chapter reviews the submissions and evidence given during the public hearing on the taxation Bill held on Thursday, 26 November 1992. The evidence received was both informative and generally supportive of the proposed changes.

8.8 Finally, some conclusions are made about the Bills and about reform of this aspect of superannuation.

Current Arrangements

8.9 This section starts with an outline of the elements of an 'Eligible Termination Payment'(ETP) – essentially a payment on departure from an employer. Upon receipt of an ETP, a member may either take the lump sum, park it in a roll-over vehicle (and defer the payment of tax on it), or purchase an immediate annuity. In addition, members can often change from one option to another. All options have various taxation consequences.

Eligible Termination Payments and their Taxation

8.10 The 1983 changes to superannuation introduced the concept of an 'Eligible Termination Payment' (ETP). An ETP may include:

- ♦ a lump sum payment from a superannuation plan including commutation of a pension and refund of member contributions;
- ♦ a payment for redundancy or unused sick leave made on retirement or retrenchment;
- ♦ an ex-gratia payment or golden handshake; or
- ♦ a payment from an Approved Deposit Fund or Deferred Annuity.

8.11 These are the only sums that can be rolled over. Sums which are not ETPs (and hence cannot be rolled over) include payments for annual leave or long service leave and payments made to the dependants of deceased former employees/members (that is, death benefits).

8.12 For taxation purposes, an ETP may be broken down into the following components:

- **Undeducted contributions** are those contributions that were made by a member from 1 July 1983 but for which no tax deduction was allowed. Contributions for which a member received a rebate are also included in undeducted contributions. No tax is payable on this component. Where this component is rolled over it still retains its tax-free status.
- The **non-qualifying component** may arise where an immediate annuity is commuted into a lump sum. Where the annuity was purchased partly with an ETP and partly with other savings, the income portion of the commutation relating to the non-ETP proceeds is referred to as the 'non-qualifying component'. The non-qualifying component is fully assessable as income in the year of receipt. Taxpayers simply include this component in their income tax return and pay tax on it at their marginal rate. The non-qualifying component cannot be rolled over.
- The **concessional component** enjoys favourable tax treatment. It includes bona fide redundancy payments, payments from 'approved early retirement schemes' and invalidity payments. Taxpayers must include five per cent of the concessional component in their assessable income in the year in which it is received and pay tax on it at their marginal rate.
- The **excessive component** is essentially the amount of the ETP which is in excess of the member's Reasonable Benefit Limit (RBL).¹ The full excessive component is included in the taxpayer's assessable income in the year in which the ETP is received.
- The **pre-1 July 1983 component** of a benefit is that part of the benefit related proportionately to any part of the 'eligible service period' which predates 1 July 1983. Any concessional, non-qualifying and excessive components are excluded for the purposes of calculating the pre-July 1983 component. Hence the pre-July 1983 component is normally calculated using the following formula:

$$(\text{ETP} - \text{CC} - \text{NQC} - \text{EC})$$

multiplied by

$$\frac{\text{Pre-1 July 1983 Period}}{\text{Total Eligible Service Period}}$$

Taxpayers include five per cent of the pre-July 1983 component in their assessable income in the year in which the ETP is received.

¹ RBLs are covered at paragraph 8.13

Example 8.1

Richard Hunter started with XYZ Pty Ltd on 1 January 1979 and became a non-contributory member of the employer's superannuation scheme. He resigned on 30 June 1988 and received \$8 000 from the superannuation scheme. What is the pre-July 1983 component?

Pre-1 July 1983 component =

(ETP – CC – NQC – EC)	multiplied by	<u>Pre-July 1983 Period</u> Total period
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= (\$8 000 – 0 – 0 – 0)	multiplied by	<u>1 642</u> 3 469
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= \$8 000 multiplied by 0.4733

= \$3 786.40

where:

ETP	= Eligible Termination Payment
CC	= Concessional Component
NQC	= Non-Qualifying Component
EC	= Excessive Component

- The **post-30 June 1983** component is the residual of the ETP after the other components have been subtracted from it. The post-June 1983 component is further divided into taxed and untaxed elements which are subject to different rates of tax.
- **Post-30 June 1983 (Taxed element).** Where the ETP is paid from a taxed source, the post-June 1983 component is a taxed element. A 'taxed source' is one which consists of a funded benefit which has been subject to the 15 per cent tax on its earnings and contributions. The maximum rate of tax payable on the taxed element depends on the age of the recipient, the year in which the payment is received and the period of fund membership. These tax rates are set out in Table 8.1.
- **Post-30 June 1983 (Untaxed element).** Where the ETP is not paid from a taxed source, the post-June 1983 component will be an untaxed element. 'Untaxed' sources refer to items such as 'golden handshakes' and also payments from most government superannuation funds. For taxpayers under the age of 55, this amount is included in their assessable income and taxed at a maximum rate of 30 per cent. Where recipients are 55 years of age and over, the full amount is included in assessable income, with the amount up to the low-rate threshold (\$76 949 for 1992/93) taxed at a maximum rate of 15 per cent and the amount over that taxed at a maximum rate of 30 per cent.

Table 8.1. Taxation of 'Taxed Element' of Post-30 June 1983 Component

Age	Year				
	1988/89 %	1989/90 %	1990/91 %	1991/92 %	1992/93+ %
1. Fund membership commencing before 1 July 1985					
Pre-55	28	26	24	22	20
55 plus:					
◆ 0 to threshold*	12	9	6	3	0
◆ over threshold*	27	24	21	18	15
2. Fund membership commencing in period 1 July 1985 to 30 June 1986					
Pre-55	27	24	20	20	20
55 plus:					
◆ 0 to threshold*	10	5	0	0	0
◆ over threshold*	25	20	15	15	15
3. Fund membership commencing in period 1 July 1986 to 30 June 1987					
Pre-55	25	20	20	20	20
55 plus:					
◆ 0 to threshold*	7	0	0	0	0
◆ over threshold*	22	15	15	15	15
4. Fund membership commencing on or after 1 July 1987					
Pre-55	20	20	20	20	20
55 plus:					
◆ 0 to threshold*	0	0	0	0	0
◆ over threshold*	15	15	15	15	15

* For 1988/89 the threshold was \$60 000. For later years it is indexed to Average Weekly Ordinary Time Earnings. The indexed threshold is \$64 500 for 1989/90, \$68 628 for 1990/91 and \$73 776 for 1991/92. If the payment is made to the estate of a deceased taxpayer, the relevant age is the age of the deceased at the time of death.

8.13 The threshold applies once for each taxpayer. If a taxpayer is aged 55 or over he receives a payment with a post-June 1983 component of less than the threshold, then the balance may be applied to the post-June 1983 component of any subsequent payment. In any event, where the threshold is increased by indexation after one payment has been made, the amount of the increase is available for a later payment either in addition to any unused balance or, if there is no unused balance, on its own.²

² CCH, *Master Tax Guide* February, 1992

Reasonable Benefit Limits

8.14 An RBL is a limit on the amount of concessional tax superannuation a member may receive. Prior to the May 1988 tax reforms, the limit restricted the lump sum benefits that a fund could pay a member to seven times average salary in the final three years of employment and annual pension benefits to 75 per cent of average salary for the same period. Where funds paid a benefit in excess of these amounts, they jeopardised their complying status.

8.15 The May 1988 reforms revamped the RBL. A progressive RBL scale, effective from 1 July 1988 (see Table 8.2) was introduced and a person's undeducted post-30 June 1983 contributions were excluded from the RBL base. Transitional arrangements were introduced to ensure that any accrued entitlements were protected.

8.16 From 1 July 1990 a lower threshold of \$175 000 was established for the lump sum RBL and \$282 500 for the pension RBL; so that where a member's RBL is calculated as a lower figure the threshold applies. The RBLs were indexed to AWOTE and are now \$196 360 and \$315 560 respectively.

Table 8.2 Reasonable Benefit Limit Scales³

Salary Thresholds (a)	Lump Sum RBL Scale (b)	Pension RBL Scale (b)
First \$44 850	7	0.75
\$44 850 to \$83 280	5	0.55
Over \$83 280	3	0.35

(a) Indexed annually to movements in AWOTE.

(b) Marginal RBL scales. For example, the lump sum RBL for a person with salary of \$100 000 is:
 $(\$44\,850 \times 7) + (\$38\,430 \times 5) + (\$16\,720 \times 3) = \$556\,260$
 or 5.56 times salary.

8.17 Currently, responsibility for administering RBLs lies with the ISC. In fact, the rules pertaining to the RBL regime are found in Part 1A of the OSS Regulations. Briefly, a retiring fund member requires an RBL determination before lodging a tax return. These determinations (both interim and final) are made by the ISC and the member sends them to the Australian Tax Office with their return.

³ Source: Australian Taxation Office

Pensions and Annuities

8.18 An annuity is an income stream which has been purchased with a lump sum amount (for instance by rolling over an ETP). A pension is generally purchased from a superannuation fund by contributions over a period of time.

8.19 The amount of a pension or annuity is included in a taxpayer's assessable income, excluding an annual 'deductible amount' which represents the purchase price of the pension or annuity for which no previous tax concession has been granted (the undeducted purchase price), allocated over the remaining expected life of the recipient. Accordingly, rebatable amounts are taken into account for the purposes of calculating the undeducted purchase price.

8.20 For purchased roll-over annuities, in addition to undeducted contributions and any concessional component, any pre-July 1983 component of an ETP counts towards the undeducted purchase price (UPP).

8.21 In contrast, for pensions the UPP will generally include only a person's contributions post-June 1983 to the extent that no deduction has applied (plus a person's contributions pre-July 1983 for which no deduction or rebate has applied).

8.22 A tax rebate is currently available for certain roll-over annuities and pensions (but not tax paid annuities). Generally, a recipient is entitled to a 15 per cent rebate (from the 1992/93 year) on the assessable component attributable to fund membership after 30 June 1983. The rebate was introduced in the 1988/89 year at three per cent to compensate recipients for the taxation of contributions from 1 July 1988 and was phased in at three per cent per year.

8.23 The rebate does not apply to a pension where the payments are funded by continuing employer contributions and the fund trustee elects to exclude those contributions as taxable contributions and gives written notice to the recipient that the pension is non-rebatable. For example, this may occur with unfunded government schemes.

Roll-overs

8.24 Upon receipt of an ETP, a departing member under the age of 65 has the following alternatives: first, take the lump sum and pay tax on it in the year of receipt; and second, roll-over all or part of the lump sum and defer the payment of tax.

8.25 There are basically four roll-over options available for a recipient of an ETP, namely:

- ♦ purchasing an immediate annuity;
- ♦ rolling over benefit into a new plan;
- ♦ rolling over benefit into an Approved Deposit Fund; and
- ♦ rolling over benefit into a Deferred Annuity.

8.26 An ETP will not be included in assessable income where it is rolled over. Roll-overs must be made within 90 days of payment of the ETP and can proceed by way of either direct payment from the payer or by deposit by the payee within the required time.

8.27 A rolled over payment will be subject to tax in the hands of the roll-over institution to the extent that the ETP came from an untaxed source (for example a golden handshake).

8.28 The concessional components and undeducted contributions of an ETP are preserved on roll-over with the same tax consequences arising on ultimate withdrawal. On withdrawal, the retiree can elect to receive the concessional and or undeducted contribution amounts separate from the pre-July and post-June 1983 components. On withdrawal of the pre and post components, the amounts are apportioned over the time of service including the time of deposit in the roll-over fund. Accordingly, the pre-July 1983 period will remain fixed while the post-June 1983 proportion will grow with the passing of time. However, it should be noted that any undeducted contributions will reduce the post-June 1983 component after the appropriate apportioning has been completed.

Committee's Evidence

8.29 The Committee noted considerable sentiment that the end benefit stage should be the sole or predominant stage of taxation of superannuation.⁴ The IFAA Ltd recommended that:

⁴ Westpac Banking Corporation, sub no 132, p 9; IFAA Ltd, sub no 154, p 7; Dr John Knight, sub no 171, p 1; Rothschild Australia Asset Management Ltd, sub no 141, p 2; Australian Friendly Societies Association, sub no 136; Mr Peter Griffin (Managing Director, Rothschild Australia Asset Management Ltd), sub no 133, p 3,4; County Natwest, sub no 98, p 26; ASFA, sub no 89, p 23; Government Employees Superannuation Board (WA), sub no 84, p 4

Taxing superannuation on exit can act as a self-balancing mechanism. Distinct age group bubbles (such as baby boomers) will all retire together. Tax on exit will help pay the social security expenses of those without sufficient means.⁵

8.30 Other advantages of taxing end benefits solely include the increased attractiveness of the initial investment,⁶ increased ability to accrue investment earnings⁷ and reducing the complexity of administration.⁸

Eligible Termination Payments

8.31 It was overwhelmingly acknowledged that the system of taxing end benefits is extremely complex⁹ and some witnesses even advanced this as a reason for abolishing the tax on end benefits altogether.¹⁰ It was also suggested that the concessional nature of income tax imposed at this juncture has gradually waned due to the reductions in personal and corporate income tax since 1983.¹¹

8.32 However, it was also indicated that many of these complications have arisen from the equitable policy of preserving rights accrued at the dates of various changes¹² and that to remove them would be a breach of faith.¹³

8.33 The Australian Taxation Office provided an excellent summary of why taxpayers experience difficulty in complying with the taxation of ETPs. They indicated that the following factors create problems:

- (a) the tax rates applicable to an ETP are dependent on a number of variables including:
 - the source of the payment;

⁵ Sub no 154, p 11

⁶ IFAA Ltd, sub no 154, p 12; Westpac Banking Corporation, sub no 132, p 9

⁷ IFAA Ltd, sub no 154, p 12; Westpac Banking Corporation, sub no 132, p 9

⁸ IFAA Ltd, sub no 154, p 12; Westpac Banking Corporation, sub no 132, p 9

⁹ ASCPA/ICAA, Sub no 119, p 8; Bankers Trust, sub no 105, p 5; LIFA, sub no 115, p 6-12; Metway Corporation, sub no 117, p 1; South Australian Employers Federation, sub no 185, p 14; CEDA, *op cit*, p 17; Mr Barry Thompson (Northern Territory Superannuation Commissioner), sub no 77, p 2; Taxation Institute of Australia, sub no 124, p 2

¹⁰ ASCPA/ICAA, Sub no 119, p 8; CEDA, *op cit*, p 17

¹¹ ASCPA/ICAA, Sub no 119, p 8

¹² GESB, sub no 84, p 4

¹³ Australian International Pilots Association, sub no 134, p 4-7

- the components (up to seven different components) of which it is comprised;
 - the year in which it is received;
 - the receipt of an ISC determination;
 - the year in which employment or fund membership commenced;
 - the age of the recipient; and
 - the recipient's income level.
- (b) the receipt of ETPs having a partly taxed and partly untaxed source (such as payments from government superannuation funds);
- (c) the determination of an eligible service period which is used as the basis for dividing the ETP into its pre-July 1983 and post-June 1983 components;
- (d) difficulties in identifying payments which qualify for concessional treatment as bona fide redundancy payments or approved early retirement scheme payments;
- (e) the number of forms that have to be completed by payers and recipients for the ATO and the ISC, some of which involve a duplication of information.¹⁴

8.34 In addition, an earlier submission from the ATO suggested that:

- The concessional tax treatment extended to redundancy payments is open to abuse. Instances have occurred where termination payments of millions of dollars have received highly concessional tax treatment.
- There is scope under the current provisions of the income tax law to change the incidence of tax on an ETP by the use of tax effective investment decisions.
- Compliance costs are unduly high because of the difficulty in understanding the legislative requirements.¹⁵

8.35 National Mutual contended that the ETP system is too complex and offered the following as evidence:

- The source of payments affects the tax treatment (there are 16 types of ETPs);

¹⁴ Sub no 155, p 4

¹⁵ *ibid*, p 2

- ◆ An ETP may consist of up to six separate components, depending upon the type of payment, with different taxation treatment applying to each component;
- ◆ The post-June 1983 component may consist of a taxed and an untaxed element, which are taxed differently;
- ◆ The rebatable amount is determined by sixteen separate items;
- ◆ A single ETP can include more than one taxed element, depending on the source and start date of previous benefits rolled over into the fund;
- ◆ Calculations of a concessional component for an approved early retirement scheme and bona fide redundancy payments have become increasingly complex as a result of Income Tax Rulings, so much so that the topic is a minefield; and
- ◆ Problems are encountered in determining a member's 'eligible service period' for differentiating between pre-July 1983 and post-June 1983 purposes.¹⁶

8.36 Most of the above points were also suggested by LIFA.¹⁷

8.37 Mr Barry Thompson, the Northern Territory Superannuation Commissioner, suggested that the components of a lump sum should be reduced from the current number to three, namely; undeducted contributions, benefits from a taxed source and benefits from an untaxed source. Tax would only be levied on the final component (taxes having been paid on the other two). He further advised that this would involve eliminating the pre-July 1983 and post-June 1983 components.¹⁸ Mr Thompson also recommended that ETPs be restricted to superannuation benefits while other benefits (such as redundancy and unused sick leave) could be dealt with elsewhere in the ITAA.¹⁹ Similarly, he advocated amendments to the concessional component of the ETP. Noble Lowndes suggested that the concessional components also be removed as 'there is no logical reason why such members should be actively encouraged by the taxation system to take a lump sum benefit'.²⁰

¹⁶ Sub no 100, p 15

¹⁷ Sub no 114, pp 11 and 12

¹⁸ Sub no 77, p 2-7

¹⁹ Sub no 77, p 5

²⁰ Sub no 80, p 7

Eliminating the pre-July 1983 and post-June 1983 components of benefits.

8.38 A cause of great complexity with respect to ETPs is the partitioning of pre-July 83 and post-June 83 benefits. The division applies to many taxpayers and due to the stark advantage of having a benefit characterised as mainly pre-July 83, it invites taxpayer manipulation. However, due to the perceived retroactive impact of any attempts to assimilate the treatment of pre-July and post-June 83 benefits, simplification in this area has stalled.

8.39 The Committee received a number of novel suggestions for removing this distinction which attempted to retain the overall position of a taxpayer with pre-July 83 benefits. Mr Thompson advised that this could be done quite simply suggesting that if the Government wished to tax end benefits (from taxed sources) at fifteen per cent, then this could be phased in by starting at a rate of ten per cent and increasing it by 0.5 per cent every year. He said 'this would militate against the retrospective impact while at the same time allowing a uniform tax rate to be applied to all benefit payments in a particular year'.²¹ A similar approach was recommended by the AM Corporation who indicated that a flat rate of ten per cent could be applied to the entire lump sum benefit up to the maximum RBL, increasing by five per cent over the next five to ten years.²² Although existing members (with large pre-July 1983 components) would be taxed more heavily, a higher RBL (of \$750 000) should minimise any disadvantage 'and this, in turn, will provide further incentives to take a pension or annuity'.²³

8.40 Noble Lowndes suggested a unique method of overcoming any possible community resentment to abolishing the pre-July 1983 component over a longer time frame. They submitted that at a particular point in time, fund trustees should determine the pre-July 1983 component of a member's entitlement and this amount would be frozen. These pre-July 1983 credits could be paid to members free of tax. They acknowledged, however, that there may be a small cost to revenue.

8.41 A similar proposition was advanced by the Government Employees Superannuation Board (WA) who suggested that end benefits be subject to concessional but progressive tax rates, for example the first \$100 000 would be exempt, the next \$100 000 taxed at ten per cent, and the third \$100 000 at 20 per cent. They went on to suggest:

²¹ Sub no 77, p 3

²² Sub no 96, p 9

²³ Sub no 96, p 10

As a way of phasing out the pre-July 1983 component it may be possible to have a substantial part of a lump sum benefit tax exempt for a given period of time and then introduce a rate of taxation on the first component at some future date.²⁴

8.42 The application of progressive tax rates to end benefits was also recommended by the Hon Frank Blevins MLA, South Australian Minister for Finance.²⁵

8.43 The Metway Corporation also supported phasing out the distinction between pre-July 1983 and post-June 1983 components, possibly over five years.²⁶ Similarly, the Taxation Institute supported phasing out the division of such benefits.²⁷ Alternatively, Mr David Rolleston, suggested converting all accrued pre-July 1983 service benefits into undeducted contributions with an appropriate tax payment being made by the fund at the time of adjustment.²⁸

Reasonable Benefit Limits

8.44 The RBL system came under strong and widespread attack being described as 'cumbersome and confusing'²⁹ and 'complicated and confusing'.³⁰ The Treasury conceded that:

Notwithstanding the reforms over recent years, the current RBL arrangements have attracted some criticism. Linking RBLs to salary and measuring an individual's RBL over their full working life imposes a very substantial record-keeping and administrative task. In addition, the open-ended nature of the RBLs (ie the absence of a maximum dollar limit) has been questioned on equity grounds by some sections of the community.³¹

8.45 The Treasury also intimated that 'the determination of a person's entitlement to concessional taxed benefits under the RBLs is an area of considerable complexity'.³² The Insurance and Superannuation Commission

²⁴ Sub no 84, p 5

²⁵ Sub no 122, attachment

²⁶ Sub no 117, p 1

²⁷ Sub no 124, p 6

²⁸ Sub no 129, p 4

²⁹ AM Corporation, sub no 96, p 7

³⁰ LIFA, sub no 114, p 12

³¹ Sub no 195, p 10

³² Sub no 195, p 18

submitted that the complexity of the RBL rules is mainly due to 'reliance upon the historical practice of expressing benefits as multiples of salary'.³³

8.46 The salary-based nature of RBLs came under attack from ACOSS who suggested that a uniform RBL rather than a sliding scale should be adopted.³⁴ Alternatively, if that policy was unsuitable, they suggested that a mix of requirements curtailing the benefits for high income earners may be appropriate.³⁵ Similarly, the ACTU supported a review of the RBL system particular in relation to an upper ceiling of maximum tax-assisted benefits.³⁶

8.47 Jacques Martin advised that where tax concessions are limited at the contributions phase (through an age-based scale for tax-assisted contributions), the need for an RBL on end benefits would 'disappear'.³⁷ This approach was also preferred by the AM Corporation.³⁸ Similarly, Mr David Rolleston suggested, as part of a package of measures, the abolition of the RBL³⁹ as did the Government Employees Superannuation Board (WA).⁴⁰

8.48 There was strong support for the imposition of a flat-dollar RBL.⁴¹ The main advantages of such a limit were seen as the removal of the whole RBL determination system,⁴² the Highest Average Salary (HAS) figure from the calculation,⁴³ and its ease of understanding by the general public.⁴⁴ The AM Corporation suggested a limit of \$750 000 plus non-deductible contributions (without earnings).⁴⁵

8.49 However, there was concern expressed that the introduction of a flat-dollar RBL would:

³³ Sub no 151, p 23

³⁴ Sub no 35, p iv

³⁵ *ibid*

³⁶ Sub no 106, p 17-18

³⁷ Sub no 90, p 5

³⁸ Sub no 96, p 7

³⁹ Sub no 129, p 4

⁴⁰ Sub no 84, p 4

⁴¹ For example Metway Corporation, sub no 117, p 2; Mr Barry Thompson, sub no 77, p 4; University of NSW Superannuation Economics Research Group, sub no 150, p 13

⁴² AM Corporation, sub no 96, p 8

⁴³ AM Corporation sub no 96, p 8

⁴⁴ AM Corporation, sub no 96, p 8

⁴⁵ Sub no 96, p 7

achieve nothing other than an increase in tax revenue and would be inequitable to those whose retirement planning and contributions were based on the present, or earlier, provisions.⁴⁶

8.50 In light of this sentiment, the obvious challenge for the Government would be to select a flat-dollar limit which would take account of expectations based on past arrangements.

8.51 Suggestions for the dollar level of the RBL ranged widely. The AM Corporation suggested \$750 000,⁴⁷ the Taxation Institute \$750 000 to \$1 million,⁴⁸ and CEDA \$800 000.⁴⁹ As Mr Barry Thompson indicated, however, 'the level at which such a maximum benefit should be set (and indexed) is a matter of judgement'.⁵⁰ He went on to suggest a limit based on the lump sum value at age 60 of a CPI indexed and reversionary pension equal to 200 per cent of Average Weekly Earnings – approximately 30 times the annual value of the AWE.⁵¹

8.52 Peter J. Vere suggested that the current lump sum and pension RBLs be replaced with a flat dollar limit of \$750 000, with a maximum of \$187 500 being taken as a lump sum.⁵²

8.53 With respect to indexation, the AM Corporation submitted that the RBL should be adjusted with changes in AWOTE 'but only when the application of this rate exceeds a \$25 000 multiple [thus avoiding] the rather cumbersome approach of using the precise AWOTE figure which leads to unusual and unnecessary precision'.⁵³

RBLs – Administrative issues.

8.54 OSSA provides for ten different notices which may be required for administration of RBLs:

- ◆ Notice to ISC from payer re 15 February 1990 roll-over balances;
- ◆ Notice to ISC from payer re payments made;

⁴⁶ Australian International Pilots Association, sub no 134, p 5

⁴⁷ Sub no 96, p 8

⁴⁸ Sub no 124, p 6

⁴⁹ CEDA, op cit, p 21

⁵⁰ Sub no 77, p 5

⁵¹ *ibid*

⁵² Sub no 241, p 1

⁵³ Sub no 96, p 8

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- Notice to recipient from payer re payments made;
 - Notice to ISC from payer re payments made between 15 February 1990 and 30 June 1990;
 - Notice to ISC from recipient re roll-over;
 - Notice to ISC from payer re commutation of pension or annuity;
 - RBL interim determination to recipient from ISC;
 - RBL final determination to recipient from ISC;
 - Amended determination to recipient from ISC; and
 - Notice to life office or registered organisation from ISC re deemed commutation of pension or annuity.⁵⁴

8.55 The Australian Taxation Office submitted that compliance concerns in relation to RBLs are:

- (a) the calculation of the RBL is salary based and therefore very difficult to determine because no other party, other than the individual, has ready access to all the information;
- (b) the determination process to advise people about their RBL entitlement and the tax consequences of their ETP can be onerous; and
- (c) the RBL administrative arrangements require payers and recipients of ETPs to have dealings with both the ISC and the ATO.⁵⁵

8.56 The Insurance and Superannuation Commission provided an explanation for the delays in processing RBL determinations received by people in the 1990/91 year stating that such delays were due to resource and software problems coupled with problems in data received from funds and employers.⁵⁶ The ISC also provided the following five options by which the RBL system could be simplified. In summary these were:

- revert to the pre-July 1990 arrangements under which funds were required to determine a member's RBL and were not allowed to pay out any amounts in excess of that;
- maintain current arrangements;

⁵⁴ National Mutual sub no 100, p 21

⁵⁵ Sub no 155, p 4

⁵⁶ Sub no 151, p 24

- ♦ maintain current arrangements but only send annual determinations to member's whose benefits exceed their RBL.
- ♦ replace the tapering scale based on HAS with a maximum money figure; and
- ♦ alter the composition of the ETP for RBL purposes.⁵⁷

8.57 National Mutual (NML) lucidly detailed the complexity of the RBL system. They indicated that:

RBLs are benefit specific. Therefore a person can have a different RBL for each benefit received. A consequence of this is that the order in which benefits are taken will affect the tax paid. This introduces unnecessary complications and further, members with the resources available to undertake effective financial planning can manipulate the system to their financial advantage – which of course disadvantages members who do not have those resources.⁵⁸

8.58 In addition, with respect to benefit determination, NML noted that OSSA prescribes:⁵⁹

- ♦ five situations in which the Commissioner must not make a determination;
- ♦ four situations in which a determination is to be revoked; and
- ♦ seven situations in which a determination is to be revised.

8.59 National Mutual further noted considerable delay in the issuing of interim and final determinations. They contended that 'this delay has created considerable confusion amongst taxpayers and unnecessarily delayed the lodgement of personal Income Tax Returns'.⁶⁰

8.60 The ASCPA/ICAA submitted that the ATO should administer the RBL system and the payments of superannuation benefits, as:

... it has the administrative framework and resources; the computer infrastructure; and people with appropriate skills and experience necessary to manage such a task.⁶¹

⁵⁷ Sub no 151, pp 9 & 10

⁵⁸ Sub no 100, p 20

⁵⁹ Sub no 100, p 21

⁶⁰ Sub no 100, p 21

⁶¹ Sub no 119, p 9

RBLs – Highest Average Salary

8.61 NML noted that there are five situations (and methods) in which the HAS is indexed and three exceptions to these rules. They also noted that there is a glaring need for clear guidelines to be issued by the ISC on what it includes in HAS.⁶² The AM Corporation described the HAS figure as 'hard to establish' and requiring 'maintenance of considerable records'.⁶³ The Taxation Institute submitted to the Committee a number of technical anomalies with the RBL rules. These generally involved the explanation of the term 'salary' in the OSS Regulations.⁶⁴

Death Benefits

8.62 NML noted that the assessment of death benefits against RBLs is confusing, saying that whether benefits are counted against an RBL depends on to whom the benefit is paid and the timing of the payment. Similarly, they contended that complex actuarial calculations are necessary where part of a death or disability payment is 'self-funded' by the trustees of a scheme.⁶⁵ ASFA advised that there appeared to be some confusion within the ATO about the assessability of lump sum death benefits paid to child beneficiaries on trust and recommended that such benefits be exempt from tax.⁶⁶ The Treasurer in his *Security in Retirement* Statement has foreshadowed changes in the tax treatment of death benefits.⁶⁷

Pensions and Annuities

8.63 The Australian Taxation Office provided an excellent exposition of some of the complexities in the area of pensions and roll-over annuities. These included:

- (a) the difference in the undeducted purchase price calculation for pensions from a superannuation fund to which the taxpayer has contributed over a number of years and pensions or annuities purchased with the roll-over of an ETP;

⁶² Sub no 100, p 20

⁶³ Sub no 96, p 7

⁶⁴ It should be noted that the current RBL rules are overhauled by the amendments contained in the Taxation Laws Amendment (Superannuation) Bill 1992. See paragraph 8.76.*

⁶⁵ Sub no 100, p 13

⁶⁶ Sub no 89, pp 19 & 24

⁶⁷ John Dawkins *Security in Retirement* AGPS Canberra June 1992 p 13

- (b) the different treatment of unused undeducted purchase price received on commutation of a pension entitlement and undeducted contributions received on the payment of a lump sum entitlement; and
- (c) the difficulty in determining the entitlement to a pension and annuity rebate and the level of that entitlement.⁶⁸

8.64 Noble Lowndes suggested that taxation of these two items has possibly become the most complicated area stating that anomalies in the treatment of the two have caused superannuants to prefer receiving a lump sum and then purchasing an annuity rather than taking a pension from their superannuation fund.⁶⁹ Support for more consistent treatment of pensions and annuity income also came from LIFA,⁷⁰ the AM Corporation,⁷¹ Metway Corporation,⁷² and CEDA.⁷³

8.65 This incentive to purchase an annuity reflects the point made by the ATO at point (a) in paragraph 8.71, namely that the UPP of the two instruments differ. ASFA provided data (see Table 8.3) which succinctly illustrates this difference.⁷⁴

Table 8.3 : Items included in Undeducted Purchase Price

Benefit Type	Part of Purchase price paid before 1 July 1983.	Part of Purchase price paid after 30 June 1983.
Pension from Superannuation Plan	Non-deductible/ non-rebatable member contributions	Non-deductible member contributions
Annuity from roll-over superannuation lump sum	All	Non-deductible member contributions*
Annuity from superannuation lump sum on which tax has been paid	All	All

* Also eligible for a rebate. The rebate is higher for an annuity than a pension if any purchase price is paid before 1 July 1983.

⁶⁸ Sub no 155, p 6

⁶⁹ *ibid*

⁷⁰ Sub no 114, p 12

⁷¹ Sub no 96, p 10

⁷² Sub no 117, p 2

⁷³ CEDA, *op cit*, p 22

⁷⁴ Sub no 89, p 20

8.66 The import of Table 8.3 is that the UPP of an annuity is greater than for a superannuation pension. As the UPP is deducted from the annuity or pension before it is included in assessable income, the tax on the superannuation pension will generally be higher.

8.67 The point was also made by National Mutual who suggested that this 'long standing' anomaly 'continues to accentuate the uneven playing field that exists in the area of purchasing a retirement income stream'. Furthermore, they suggested that the pension and annuity rebate provisions are 'exceedingly complex' and involve complicated calculations.⁷⁵

*Lump sums v. Income streams*⁷⁶

8.68 The use of the taxation system to encourage the taking of benefits as income streams was widely supported.⁷⁷ Equally, there was support for a cap on lump sum benefits with the balance being taken in income form,⁷⁸ or even that lump sum payments be banned altogether⁷⁹ or annuity purchase be mandated.⁸⁰

8.69 Noble Lowndes proposed that all pension and annuity income be assessable, but that a 15 per cent rebate apply to the entire payment, regardless of its purchase source. They justified this extension of the rebate on the grounds that it would encourage the use of pensions and noted that there is currently no reason for a person to take a pre-July 1983 benefit in pension form.⁸¹

8.70 Noble Lowndes intimated that there are still substantial tax concessions for taking a benefit as a lump sum. The high tax-free threshold applying to the post-June 1983 component is the most visible attraction.⁸² In discouraging lump sums, Noble Lowndes suggested a revolutionary approach. They recommend that lump sums (including the pre-July 1983 amount but less

⁷⁵ *ibid*, p 16. It should be noted that the Taxation Laws Amendment (Superannuation) Bill 1992 remedies the divergent treatment of pensions and annuities.

⁷⁶ Chapter 4 of this report examines the basic policy considerations of this issue.

⁷⁷ Hon. Frank Blevins MP, South Australian Minister for Finance sub no 122, attachment; Institute of Actuaries, sub no 108, p 2-3; Department of Social Security, sub no 127, p 12-13

⁷⁸ AMP, sub no 120, p 66; Department of Social Security, sub no 127, p 12-13

⁷⁹ Mr Peter Griffin (Managing Director, Rothschild Australia Asset Management Ltd), sub no 133, p 4

⁸⁰ CEDA, *op cit*, p 17

⁸¹ Sub no 80, p 5

⁸² Sub no 80, p 5

undeducted contributions) received prior to age 60 be taxed at 25 per cent. Lump sums taken after that date could be taxed at 20 per cent above a threshold (they nominated \$73 776 indexed).⁸³ They further advised that this would also solve the vexed pre-July/post-June 1983 issue. As part of the overhaul of lump sums, Noble Lowndes suggested that the 'concessional component' also be dropped. Upon disability, recipients of an ETP should take their benefits in pension form and be allowed the 15 per cent rebate.⁸⁴ Due to the revolutionary nature of these proposals, they suggested a three to five year transitional period.

8.71 CEDA's approach is that rather than providing incentives for income stream rather than lump sum benefits, 'it is more straightforward to mandate annuity purchase'.⁸⁵ This would facilitate the removal of the tax on end benefits from funded schemes (up to an RBL), and hence substantially assist simplification.⁸⁶

8.72 Taking an alternative approach, the Westpac Banking Corporation suggested that non-compulsory means of encouraging income streams over lump sums should be used. This, they stated, could involve increasing the lump sum tax and reducing pension tax.⁸⁷ In addition, incentives including access to pensioner benefits could be spread to some superannuants.⁸⁸

TAXATION LAWS AMENDMENT (SUPERANNUATION) BILL 1992

8.73 Most of the tax reforms announced by the Treasurer in his *Security in Retirement* Statement of 30 June 1992 are contained in the Taxation Laws Amendment (Superannuation) Bill 1992. The Bill contains five Parts of which only Part Two relates to amendments to the *Income Tax Assessment Act 1936*. Part Two, in turn, contains twelve divisions of which only Divisions 4 to 11 are germane to this chapter.⁸⁹

⁸³ Sub no 80, p 6

⁸⁴ *ibid*, p 7

⁸⁵ CEDA, *op cit*, p 17

⁸⁶ *ibid*

⁸⁷ Sub no 132, p 7

⁸⁸ *ibid*

⁸⁹ Divisions 2 and 3 were dealt with in chapter 5 of this Report. Division 1 simply notes that the 'principal Act' amended is the *Income Tax Assessment Act 1936*. Division 12 deals with amendment of assessments and is not discussed in the Report

8.74 Division 4 makes various amendments with respect to rebates for certain superannuation pensions and qualifying annuities. Division 5 makes amendments relating to the undeducted purchase price of annuities and superannuation pensions. In particular, it replaces the current definition of 'undeducted purchase price' with a new definition of UPP so that, for rebatable superannuation pensions and rebatable ETP annuities, the UPP consists only of undeducted contributions. Division 6 includes 'unused undeducted purchase price' within the definition of 'undeducted contributions' (and as such, within the definition of ETP). Division 7 inserts the definitions of 'pension' and 'annuity' in various parts of the Act. It also contains amendments to extend the meaning of pensions and annuities and to provide for minimum standards for certain annuities.

8.75 Division 8 relates to the practice of rolling-over and abolishes a taxpayer's ability to choose which parts of an ETP (other than undeducted contributions and concessional components) are rolled-over. It deals with the distinction between the pre-July 83 and post-June 83 components with respect to rolled-over benefits. The clauses add integrity to the roll-over system by assimilating the identity of benefits before and after roll-over. These clauses have the effect of smothering the ability of taxpayers to substantially reduce the tax payable on their ETP. In addition, Division 9 makes a slight change to the roll-over rules. The effect of Division 9 is that from 1 July 1994 benefits must be rolled-over directly from the source to the destination fund. Amendments to the OSSA will allow benefits to be retained by superannuation funds for 90 days during which taxpayers must decide what to do with their ETP.

8.76 Division 10 makes amendments relating to the components of ETPs known as bona fide redundancy payments (BFRPs), approved early retirement scheme payments (AERSPs) and invalidity payments. Broadly, the Division provides a limit on the concessionally taxed amount of bona fide redundancy payments and approved early retirement scheme payments and exempts amounts within that limit from tax. The tax-free amount will be excluded from the ETP definition, will not be able to be rolled over and will not count against the recipient's RBL. The excess over the tax-free limit will be treated as an ordinary ETP.

8.77 Perhaps the most significant reforms in the Bill are those relating to RBLs. The amendments made to the RBL regime are contained in Division 10 and may be summarised as follows:

- ♦ transfer administration of the RBLs from the ISC to the ATO;
- ♦ make the RBL a set dollar amount rather than a multiple of a recipient's highest average salary; and

- make other minor changes to simplify the treatment of the excessive amount of pensions and annuities for RBL purposes.⁹⁰

Evidence on the Bill

8.78 The Committee heard evidence and received a number of written submissions on the Bill. Comment on the new benefit taxation arrangements was mostly favourable – particularly with respect to the RBL amendments.

8.79 In his introductory remarks to the Committee, Senator McMullan stated that:

The new flat RBLs are simpler than the current salary linked limits. In addition, the new arrangements are far more equitable. The RBLs will no longer be open ended and will afford equal access to the superannuation tax concessions for everyone.⁹¹

8.80 Mr Ian Robinson of the Treasury submitted that approximately 95 per cent of employees would fall below the \$400 000 lump sum RBL figure. In describing how the \$400 000 limit was arrived at, Mr Robinson commented that 'it was a matter of judgement' and that no precise formula was used.⁹²

8.81 Support for the new RBL arrangements came from Mr Scullin of ASFA,⁹³ Mr Ken Robinson of LIFA⁹⁴ and Mr Iain Ross of the ACTU.⁹⁵ Mr Scullin, noting that an RBL limit of \$400 000 equates to a salary of approximately \$60 000 per annum under the current arrangements, stated that

We strongly believe that we did need to move away from the salary related RBLs to a dollar RBL so that then it became a matter of choosing the level. Our view is that the \$400 000 limit is a reasonable trade-off in the situation.⁹⁶

⁹⁰ See Explanatory Memorandum, p 97

⁹¹ ST Bills Evidence, p 4

⁹² *ibid*, p 7

⁹³ *ibid*, p 20

⁹⁴ *ibid*, p 20

⁹⁵ Evidence, p 2141

⁹⁶ ST Bills evidence, p 20

8.82 ACOSS, however, argued that the \$400 000 lump sum limit was too generous and suggested \$200 000 being an amount 'sufficient to fund an annuity for life at about half average weekly earnings'.⁹⁷ In addition, they noted that 'an RBL of \$800 000 for annuities' allows a superannuant to purchase an annuity of \$60 000 per annum – approximately twice average weekly earnings.

8.83 The Taxation Institute of Australia made four points in relation to this part of the Bill, namely:

- the RBL should be indexed from 1 July 1992 rather than 1 July 1994.
- the RBL calculations required by Subdivision A of Division 14 are too complex;
- the amendments relating to taxpayer choice in rolling over an ETP should be take effect upon passing of the Bill rather than retrospective to 1 July 1992; and
- the upper dollar limit placed on bona fide redundancy payments and approved early retirement schemes should be linked to the earnings of the employee in receipt of the amount.⁹⁸

Conclusion

8.84 The amendments proposed by the Bill with respect to this phase seem to have struck an appropriate balance between equity, simplicity and efficiency.

8.85 The amendments relating to pensions and annuities remedy an unsatisfactory situation on which the Committee had earlier received evidence. It is hoped that the removal of the previous anomalous situation will facilitate Government encouragement for income-streams over lump sums by increasing the demand for superannuation pensions

8.86 The reforms proposed for the concessional component are also welcomed as they will hopefully diminish the incidence of abuse and hence strengthen the integrity of the system.

8.87 Similarly, it has been overwhelmingly acknowledged that the current salary linked RBL must be changed to a flat dollar limit. Possibly the single greatest achievement of this Bill is that it makes considerable inroads into improving the

⁹⁷ *ibid*, p 25

⁹⁸ Sub no ST 30, p 2

administration of RBLs. Importantly, the Government has retained a high figure for its pension RBL. As mentioned earlier, the challenge then becomes to select an appropriate level; satisfying everyone is impossible. The Committee received a number of submissions on this limit, ranging from \$200 000 to \$1 million. The \$400 000 limit provided for in the Bill equates to an RBL pertaining to a salary of \$60 000 under the current arrangements – or approximately twice average weekly earnings. However, it is to be remembered that the Bill must be looked at as a coherent package – not as a concoction of unintegrated proposals.

8.88 However, there are still some areas that the Bill leaves unaffected. In particular, amendments to the taxation of death benefits, announced in the Treasurer's *Security in Retirement* Statement, are noticeably absent. The Committee expects that these important reforms will follow shortly. Similarly, the Government has yet to tackle the pre-July 1983 and post-June 1983 problem. The Committee expects that progress will be made on this matter in 1993.