Institute of Actuaries of Australia

26 August 2009

AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

Email: AFTSretirement@treasury.gov.au

Dear Sir/Madam

Australia's Future Tax System (AFTS)
Retirement Income Consultation Paper
Further submission from the Institute of Actuaries of Australia

In March 2009 the Institute of Actuaries of Australia (IAA) provided a submission in response to questions raised in the Retirement Income Consultation Paper (RICP).

The Institute is the sole professional body for actuaries in Australia, representing the interests of over 1,500 Fellows and 2,000 other members. Many of our members work in the superannuation field and, in particular, with defined benefit funds.

Our previous submission covered a wide range of issues relevant to the retirement income system, including tax. In that submission, we did suggest that the government could consider a review of the tax exemption for the investment income on assets supporting pension liabilities. The purpose of this letter is to highlight how the removal of this tax exemption could negatively impact on defined benefit funds, their employer sponsors and members (including pensioners), and to present some solutions which would overcome these problems. We also take the opportunity to highlight some practical implementation issues for defined benefit funds in relation to any proposed changes to contributions tax.

Removal of the tax exemption on investment income from assets backing pensions

On 12 May 2009, the report "The retirement income system: Report on Strategic Issues" was released by the AFTS Review Panel. The key recommendations of this report did not mention the existing tax exemption for investment income earned from assets backing pensions. However, because removing or reducing this exemption would have special and very significant implications for defined benefit pension funds, we felt it was important for us to bring these implications to the attention of the Review Panel.

Defined benefit pensions are payable for life, and often indexed. Importantly, the amount of pension would not automatically adjust if investment taxes changed. The removal of the tax exemption on investment income from assets backing pensions would, therefore, immediately increase the existing accrued liabilities* for employer sponsors of defined benefit pensions, and increase the future cost of providing future pension accruals:

**The liability is the actuary's assessment of the amount of current assets that, together with future investment income on those assets, is expected to be sufficient to provide for the defined future pension payments. If tax were to be imposed (and no other factors changed), the liability would increase by the present value of the expected future tax on the investment income.*

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- Any such change will increase current pension liabilities immediately. Assets that have previously been accumulated on the basis of a nil taxation environment for lifetime pensions will suddenly become inadequate to meet their pension obligations. This will place a considerable additional strain on employer sponsors of defined benefit plans that offer such pensions, unless such pensions can be reduced.

  For funds with large pension sections, this additional cost would be very significant. It may force some funds into an unsatisfactory financial position or even into technical insolvency. As an example, an employer sponsor of a fund with $100m of accrued pension liabilities might have its obligation increased by something in the order of $10m. The effect of contributions tax (at 15%) would increase the additional employer funding cost to around $12m.

  Further, employer contributions to finance the pension benefits of non-employee pensioners are not presently deductible to the employer, further adding to the employer cost of funding the increase in tax.

- Any change will also immediately increase the future cost of the providing new pension accruals, because some current employees have a guaranteed entitlement to a life time pension on retirement and allowance would need to be made for the future investment tax that would apply.

- To contain the employer's cost, the only alternative would be for pension payments to be reduced, although superannuation law and Trust Deeds will generally not allow this. This approach would also be necessary for funds with no employer sponsor available to act as guarantor. Therefore, superannuation laws would need to be changed to allow pension benefits to be reduced and to override any restrictions in Trust Deeds.

- The 'reduction of pensions' approach would also be problematic:

  - It would be necessary to use actuarial assumptions to determine the expected impact of the imposition of tax;
  - One of the assumptions required would be the future investment mix, as this would affect the expected tax payments;
  - Another important factor would be the expected duration of pension payments – the shorter the expected duration, the lower the impact of the imposition of tax; this suggests that older pensioners should be subject to lower reductions than younger pensioners, but clearly a system of age-based reductions would add greatly to complexity;
  - Hence there is good reason to suggest that pension reductions would vary between funds and may also vary between pensioners within a single fund, with substantial scope for argument about the level of reduction for any individual.
  - It is likely, therefore, that pensioners would be aggrieved not only about the fact that their pensions were being reduced, but also that their particular reduction is subjective and 'not fair' in their eyes.

- The main alternative to a 'reduction of pensions' approach would be to grant defined benefit pension funds a 'tax credit' equal to the expected future investment income tax on assets backing accrued pension liabilities, including pension liabilities in respect of employed members who have an accruing pension that has not yet commenced. Again the calculation of the 'tax credit' would be complex and require detailed assumptions.

In summary, removal of the tax exemption on pension assets without compensating tax credits would retrospectively increase costs (or reduce pensions). In the case of lifetime pensions provided by defined benefit plans, this cost would be significant, and would generally be borne by sponsoring employers.

Contribution taxation

In the discussion of the superannuation tax concessions available to individuals, a number of ideas have been put forward to improve the equity between low and high income earners. Broadly these would seek to achieve a decrease in the taxation on contributions for low income earners and, possibly, an increase in taxation on contributions for high income earners.

In our view, in assessing any such options it is important to consider the mechanism by which any changes would be delivered. Experience with the superannuation surcharge leads us to believe that a system which attempts to impose differential contribution tax rates on superannuation funds that depend on each individual's personal taxable income, would be administratively difficult and, therefore, inefficient and costly to both members and the Australian Tax Office. Furthermore, it may not achieve the intended outcome, particularly for a defined benefit fund:

- In a defined benefit fund, the benefits are fixed and the employer meets the cost of those benefits, often with a (part) contribution from the employee/member. A reduction in the contribution tax payable for a low income earner would not change the amount of the benefit received by the individual, unless the fund benefits were altered. It would simply reduce the amount of tax payable by the fund and, therefore, reduce the employer's cost. Conversely, an increase in contribution tax for a high income earner would result in an increased cost to the employer, but not an automatic reduction in the employee's benefit.

- In a defined benefit fund, an employer simply pays contributions into an unallocated asset pool. This means that the employer contributions attributable to each individual are not readily identifiable. Therefore, some type of notional measure of employer contributions would be required, as is currently done for testing contributions against the concessional contribution limits.

The current system of levying excess contributions tax on individuals (rather than funds) avoids the first issue above for defined benefit funds, as well as substantially reducing the costs of super funds in dealing with payment of assessments.

Please do not hesitate to contact the Institute (Philip French, Director Public Affairs, tel (02) 9239 6111) or Andrew Boal, Convenor of the Institute's Superannuation and Employee Benefits Practice Committee ((03) 9655 5103) if you require any further information.

Yours faithfully

Trevor Thompson
President