A Submission to the Treasurer on the Funding Status of The Defence Forces Retirement Benefits and Defence Forces Retirement and Death Benefits Funds

AIM

To Achieve the Reclassification of the DFRB/DFRDB Funds as Funded, or Partly Funded

INTRODUCTION

General.

1. As part of the 2006 Federal Budget, the Treasurer introduced a "Plan to Simplify and Streamline Superannuation. The Treasurers response to inquiries on this matter, for DFRB /DFRDB /Contributors/ Superannuants was given in a letter dated 14th of July 2006:

"In some superannuation funds no employer contributions are made until the person is ready to retire and no contributions or earnings tax has been paid on this element of their superannuation benefits. Funds with members' interests

containing untaxed elements mainly effect military personnel and public servants."

"Under the Government's plan, an individual's own personal (after tax) contributions to superannuation would continue to be received tax free in retirement." In addition, from 1 July 2007, any investment earnings and employer contributions that have been taxed in the fund would also be paid tax free to a person aged 60 or over."

"Benefits paid from an untaxed source would still be taxed under the government's plan. To remove the tax on these benefits would mean that members of these funds would pay no tax on this part of their superannuation. This would be an unfair advantage to members of these funds as they have not paid the contributions and earnings tax that 90 per cent of Australians have paid on their benefits."

"However, in recognition that the tax on superannuation has been reduced for people receiving benefits from taxed sources, taxes will also be reduced on benefits paid from untaxed sources for people aged 60 and above.

"The 30 per cent rate of tax on lump sums will be reduced to 15 per cent up to a total of $700,000, with any excess taxed at the top marginal rate."

"A 10 per cent offset will apply to pensions paid from an untaxed source."

"There are substantial benefits for retirees receiving benefits from untaxed sources. Under the plan it is proposed, for people aged 60 and over, pensions,(including existing pensions) received from an untaxed source would be taxed at marginal rates, but would receive a tax offset of 10 per cent of the total taxable part of the pension. Currently such pensions are taxed at the individual's marginal rate with no offset."

"For example, a person who receives a pension of $56,000.00 with a deductible amount of $6000 (for contributions made from their after-tax income) would have a taxable pension of $50,000. The deductible amount of $6000 would be paid tax-free. The tax offset would be 10 per cent of $50,000 (that is $5, 0000). The actual reduction in tax payable would depend on the person's circumstances including the impact of other tax offsets."

"I note finally that it does not matter when the military pension was commenced for individuals to benefit from these changes. From 1 July 2007, as long as the individual is aged 60 or over they will receive the benefit of the changes outlined above."

"I trust this information will be of assistance to" (name suppressed).

(Signed) Peter Costello " [1]

[1] Treasurer's letter to The Hon Philip Ruddock dated 14th of July 2006

A Differing Opinion

2. Another opinion has been given to me by Robert Hodge B.Tax FASFA, the Senior Advisor (Tax), Association of Superannuation Funds of Australia, as follows:

"Our understanding is that prior to 1988 superannuation funds were not taxed on either the contributions to the fund or the investment earnings on those contributions. The Australian taxation office may be able to confirm the taxation arrangements at the relevant point in time."

"Generally, benefits paid out of superannuation schemes run by the Commonwealth Government for their own employees, judges and parliamentarians have two components. One component represents a member financed benefit (paid for out of the member's own 'after tax' contributions and earnings on those contributions); the other part represents the employer financed benefit (which is paid out of consolidated revenue). Where a benefit is paid out of consolidated revenue this is referred to as an 'untaxed element' - the money has never been subject to income tax. The term 'unfunded' also relates to these benefits because the money has never been separately put aside by the employer for the specific purpose of funding these liabilities as they arise."

"My understanding is that the DFRDB scheme is a part contributory, part unfunded defined benefit scheme. That is, the

benefits paid are in part financed by member contributions and in part by the employer, the Government, out of consolidated revenue. As such, benefits paid from the scheme would thus have a 'taxed' and an 'untaxed element'. "

"Our understanding is that under current taxation arrangements, the member financed component of a pension benefit is fully assessable but is subject to a 15% pension rebate and a further separate deduction (referred to as the undeducted purchase price or UPP) related to the employee's own contributions and calculated using the pensioner's life expectancy. The employer financed component is fully assessable at marginal tax rates. The differential taxation treatment arises from the fact that the member financed component is paid out of money that has previously been subject to taxation (either in the hands of the employee or in the fund) while the employer financed component has never been subject to taxation."

Robert Hodge B Tax FASFA
Senior Policy Adviser
Association of Superannuation Funds of Australia
Email dated 1 September 2006 10AM

BACKGROUND TO THE DFRB SCHEME

3. The Defence Forces Retirement Benefits Scheme legislation was introduced in 1948 in conjunction with a general review of policy to the Defence forces The possibility of a uniform scheme of retirement benefits for permanent members of the Defence Force was assisted by the introduction of a pay code for the Forces in July 1947, bringing members of the Navy, Army and Air Force on to a uniform base of pay and allowances. Associated with the revised pay code, was the introduction of lower retiring ages for Army Officers, more in line with those for officers of Navy and Air and the reduction of the compulsory retiring age for other ranks of the Army and Air Force from 60 to 55 years. The DFRB Scheme was introduced to meet the special needs of the Defence Force for retirement benefits under the new conditions of service..

4. The type of scheme that resulted was similar to other public sector schemes in existence, particularly the Commonwealth Superannuation Scheme (CSS). Broadly this involved the establishment of an actuarially based superannuation scheme, the membership of which was compulsory, financed partly by members' contributions and partly by government subsidy and administered by an independent statutory authority. The scheme was based on recommendations of a committee under the

chairmanship of the Minister for Defence and Post War Reconstruction, the Honourable J.J. Dedman, M.P. [2]

Costs.

5. It was accepted that the scheme would be ultimately funded on a full actuarial basis, but the novelty of some of the provisions led to an interim arrangement for financing the benefits.

6. The cost of providing the benefits was not apportioned between the contributors and the Commonwealth in strict shares, but the accumulated contributions of the member were paid into a pension account, the Commonwealth meeting the cost of the benefit once the contributions of the member were exhausted. Some adjustments were legislated to make the scheme more equitable for members. [3]

7. The method of financing the member's share of 22 ½ % of the cost by means of a percentage rate of contribution was consistent within numbers of private superannuation plans, in the 60's. Pre 1959 contributors had to pay additional contributions to obtain the same benefits as those who entered after that date.[4]

---

[2] From Joint Select Committee on Defence Forces Retirement Benefits Legislation, dated May 1972, Chapter 1, paragraph 23.

[3] From Joint Select Committee on Defence Forces Retirement Benefits Legislation, dated May 1972 Chapter 1, page 9, paragraph 25.

[4] From Joint Select Committee on Defence Forces Retirement Benefits Legislation, dated May 1972 Chapter 1, page 11, para 26.

Review of the DFRB Scheme.

8. The Report from the Joint Select Committee on Defence Forces Retirement Benefits Legislation of May 1972 (Jess Report) concluded the original scheme, although providing a short term answer of providing retirement benefits for Defence personnel had not provided a lasting solution. In fact, the remedies had tended to create their own problems. In particular, problems had arisen in regard to Officer Retirement and the provision of retirement benefit for invalidity Jess also stated "it is also clear that the arrangements that have been made for financing the cost of benefits have worked to the disadvantage of contributors. This is particularly the case with those members of the scheme who entered before 1959…..The relief afforded to members confronted with very high rates of contribution of allowing pre-1959 entrants to 'freeze' their contributions at selected levels thereby rejecting the Fund's share of further entitlement has created its own problems." [5]

9. The plight of certain pre 1959 contributors was of concern to private members and of Senators of all parties with the operation of the legislation. [6]

10. There is little doubt that Jess rectified many of the problems in the Act, particularly for pre-59 contributors. Most Military personnel, of that time, respected Jess.

[5] From Joint Select Committee on Defence Forces Retirement Benefits Legislation, dated May 1972 Introduction, page 7, paragraph 7.
[6] From Joint Select Committee on Defence Forces Retirement Benefits Legislation, dated May 1972 Introduction, page 7, paragraph 7.

Indexation of Defence Force Pensions.

11. Defence Force Superannuants, who have made an important contribution to the quality of life enjoyed by this country, are falling behind in their retired incomes that are the basis of their standard of living and quality of life. If average weekly earnings are increasing at a faster rate than the CPI then those whose income is tied to the CPI will be left behind in the quality of life they can afford.

12. It is understood that Federal Parliamentarians and Reserve Bank officers have access to schemes that, which ensure that superannuants maintain relativity, as retirees, to the present day workforce but this is not deemed necessary, by the Government, for others.

13. A comparison of the reversionary benefits for a surviving spouse shows that the reversionary benefit of a surviving spouse of a parliamentarian is 83% , and of a military superannuant of 62.5%.

Reversion on Completion of Repayment of Commutation

14. There is no provision, for reversion to the full value of retired pay once the Commutation Lump Sum has been repaid. Once the Commutation Lump Sum has been repaid, in the interests of equity, the pension should revert to the full value. However the government seems to hold retired Defence personnel in contempt, and natural justice apparently counts for little.

The Principle of Funding.

15. At the time of presentation of the Jess Report, the DFRB scheme was pronounced to be "partly funded" by that Committee, along similar lines to those stated by Mr. Robert Hodge, earlier in this paper. [7] The DFRB was only partly funded because the Commonwealth did not fund its share This meant that the Commonwealth did not contribute to the DFRB Fund but met its liability on an 'pay as- you- go' basis'.

Investment of funds.

16. Members' contributions were invested mainly in Commonwealth Government bonds. Earnings were in the range of 6.0 to 6.1/2 percent. The earnings were not taxed<u>. No tax was payable on the earnings of Superannuation funds, Public or Private Sector, until 1988.</u>

17. The Commonwealth did not contribute toward the DFRB/DFRDB Fund, thus not contributing to the health of it.

[7] From Joint Select Committee on Defence Forces Retirement Benefits Legislation, dated May 1972 Chapter 1, page 13, paragraph 39.

Taxation of Superannuation Funds.

18. Taxation of funds, both Public Sector and Private sector, did not come into effect until 1988. Up until 1988, the taxation treatment of Private and Public Sector Superannuation schemes was the same ie,

- **There was no tax on earnings of either type of fund;**
- **There was no tax on the funds themselves; and**
- **All contributors were treated in the same manner in their annual Taxation Returns; and all were treated in the same manner, by the Taxation Department, 'on retirement'.**

Refund of Surplus Contributions.

19. Section 22 of the principal Act required the Commonwealth Actuary to undertake periodical reviews of the state and suffiency of the DFRB Fund as at 13 June 1964 and thereafter at intervals of not less than five years. A surplus of contributions to pre-1959 contributors was made to them in the early 70's. The surplus existing at the time of the transfer of members' contributions, in 1972, was appropriated by the government of the day. At that same time the PM stated that he would ensure that it would be made impossible for any future determination as to whether

contributions were in 'surplus'. The Fund was still in surplus at the time of transfer, but Jess could not report on that as the Report of 1965, by the Commonwealth Actuary, had still not been made available at the time of the Report. [8]

Disposal of DFRB Fund and Assets.

20. The total DFRB assets were transferred to consolidated revenue at the time of establishment of DFRDB, including surplus contributions that had been reported by the Commonwealth Actuary in 1965. There was a further surplus at the time of establishment of the DFRDB Scheme, also reported by the Commonwealth Actuary. All DFRB serving contributors were transferred to the DFRDB Scheme, without choice.

Comparative Benefits between Commonwealth Superannuation Schemes.

DFRB/DFRDB

The basic entitlements are:

- **Pension**.
  A pension determined by the person's rank and years of service;
- **Commutation**
  An ability to commute four years of pension and accept a reduced pension;

[8] From Joint Select Committee on Defence Forces Retirement Benefits Legislation, dated May 1972 Chapter 5, page 46, paragraph 180.

- **Surviving Spouse's Pension**

  On the death of the contributor, of 5/8ths of contributor's pension, before commutation;

- **Lump Sum.**

  There was no entitlement to a lump sum by a refund of member contributions on reaching pension-able age and having the required years of service, as there is for an MSBS member, or for the Public Service.

MSBS.

The basic entitlements are:

- **An Employer Benefit.**

  The employer benefit is that part of the benefit paid by the Department of Defence, including the productivity benefit If a member has reached age 55 and is genuinely retiring from the workforce,, he/she may take the employer benefit as a full lump sum or convert 50% or more of it to pension; [9]

---

[9] Retirement Benefits Office Leaflet M20

Member Benefit.

- **The member benefit is made up of the member contributions and interest accrued at the earning rate of the MSBS Fund.**

- **Member benefits can .be taken as an immediate lump sum.**

- **If the member transferred from the DFRDB Scheme the member benefit includes the member's DFRDB contributions.**

Public Service Scheme (PSS).

23. It is enough to say that eligible Public Servants also receive a total refund of their contributions, with interest, under similar conditions of contributors to MSBS, and have done so for very many years. *Thus, they have, ultimately, contributed nothing to their pensions. This scheme can fairly be classified as 'unfunded'*.

A Fair Go

24. The Prime Minister recently appeared on the media asking for 'a fair go' from the public regarding the recent Parliamentary Superannuation amendments. That scheme includes indexation to Parliamentary Superannuants based on current remuneration

rates of serving parliamentarians, and reversionary benefits for widows of MPs. Well, how about a fair go for the Government's very own employees?

CONCLUSION

25. <u>The DFRB/DFRDB Schemes are not unfunded Superannuation Schemes but, at least, part funded schemes.</u> The Government has never met its share of contribution of its employees' during their service, but on a 'pay-as you-go' basis after discharge. <u>Taxation on Funds, or earnings was not introduced until 1988, on Public or Private Sector Funds.</u> Members who retired prior to the date in 1988, when taxation on Funds and earnings were introduced should be treated in the same manner as their Private Sector counterparts, as DFRB /DFRDB contributors had no advantage over them (in relation to the Treasurers point). It is wrong of the Government to classify all Public Sector pension schemes as the same.

26. The DFRB and DFRDB were/are very different schemes to the PSS and MSBS, and in the interests of equity, DFRB/DFRDB contributors should benefit more than those members in other schemes, that is, better than the ten percent offset in the Government's proposed changes to taxation/ reform of superannuation. MSBS and PSS members have paid nothing, in the end, towards their pension; DFRB/ DFRDB contributors have.

Post 1988 DFRDB Contributors

27. Post 1988 contributors should be given due consideration, on the amount of offset/ tax exemption, for the time they had been in the scheme prior to 1988 when no superannuation levied on funds, or on earnings of funds.

Differing Benefits Between Public Sector 'Funds

29. Public Service retirees receive a full refund of their contributions, with interest, on retirement.

30. MSBS Defence retirees receive a full refund of their contributions, with interest, that have been paid to the MSBS Scheme. Their contributions to DFRB and DFRDB were ultimately absorbed into the MSBS for those who elected to join the new scheme ie, they receive a refund of their contributions from their first day of eligible service.

31. DFRB/DFRDB superannuants paid for their Superannuation schemes and, therefore, cannot fairly be classed as 'unfunded', whereas PSS and MSBS contributors will ultimately have paid nothing towards their pensions. Accordingly, it is felt those schemes can fairly be classified as unfunded.

32. Parliamentary Superannuation benefits include continued alignment with current Parliamentary remuneration, something

that has been deemed essential for them, but not for the Government's very own employees.

33. There has been a perception of incredible discrimination against Defence Personnel in many matters, over the years, and this incorrect classification of DFRB/DFRDB is a further example of this attitude by government that is not, in 2006, too late to rectify.

Recommendation

34. That a review of the Government's classification of the DFRB/DFRDB fund, currently incorrectly classified as unfunded, be conducted with a view to granting the members of these funds equity in the proposed superannuation changes proposed by the Government , for introduction on July 1st, 2007.

J.A Graham

Tel 02 47516653.

Email: firebug.63@pacific.net.au

19th November 2006