

Legislative References and Assumptions for

RIMHYPO

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LEGISLATIVE REFERENCES AND ASSUMPTIONS FOR RIMHYPO

INTRODUCTION

RIMHYPO is a model developed by the Retirement Income Modelling Task Force, a joint project of the Treasury, Department of Finance and the Department of Social Security. RIMHYPO is an individual hypothetical model of the interaction of superannuation accumulations with the tax and social security systems over the lifetimes of hypothetical individuals and couples. That is, it models the accumulation of superannuation benefits, the drawdown of the associated retirement benefits and income streams and all the associated tax and social security interactions for *individuals and couples* over their lifetimes. It takes account of characteristics such as salary level, work force participation, gender, marital status, home ownership and choices as to benefit type and drawdown patterns.

This paper outlines those provisions of the taxation, social security and superannuation law relevant to our modelling and how RIMHYPO has accommodated those provisions. Although every care has been taken in the compilation of this document, it should not be used as a legal interpretation of the relevant legislation. Wherever possible, we have included reference to the relevant provisions of the law so readers may look up those provisions if necessary.

SUPERANNUATION

Contributions

SGC Schedule

The SGC first applied in 1992-93. The rates are set out in Sections 20 & 21 of the *Superannuation Guarantee (Administration) Act 1992 (SGAA)*. The amount for years prior to 1996-97 is less for employees with a payroll of less than \$1m in 1991-92, or, if not an employer for the whole of that year, then the first year in which the person was an employer for the whole of the year.

The Government has foreshadowed the introduction of a compulsory member co-contribution under the SGC. This has not been legislated but the code allows for its introduction.

Scope of the SGC

Contributions are not required for persons who have turned 65, who are paid less than \$450 per month, or who are part-time workers aged less than 18. (Ref. Sections 27 & 28 *SGAA*)

'Part-time work' is defined as not more than 30 hours per week. (Ref. Section 6(1) *SGAA*)

Salary Base for SGC Contributions

Sections 13 and 14 of the *SGAA* provide that, generally speaking, the salary specified by a superannuation fund or scheme as the base for calculating contributions is acceptable for use in offsetting the SGC charge. For purposes of this model, the details can be ignored, except for the provision that if the salary specified under the rules of the fund or scheme is greater than the 'maximum contribution base', then the maximum contribution base applies.

In calculating the employer's existing or 'voluntary' contribution rate and the superannuation guarantee shortfall, if actual earnings or the salary for superannuation purposes is greater than the 'maximum contribution base' as calculated under Section 15(1) of the *SGAA*, then the 'maximum contribution base' is used. (ref. Sections 6(1), 13((3), 14(4), 18(3) & 19(3) *SGAA*).

The maximum contributions base is \$40,000 for each 6 month period in 1992-93. For each three month period in 93-94 it is \$20,000 times the indexation factor. For later years it is the maximum contribution base for a period in the immediately preceding year times the indexation factor. All amounts are rounded to the nearest \$10. (Section 15 *SGAA*).

For purposes of the model the maximum contribution base will be annualised.

The indexation factor is the greater of 1 or:

$$\frac{\text{AWOTE for March quarter of the previous year}}{\text{AWOTE for the March quarter of the year immediately preceding that year}}$$

AWOTE is full time adult average weekly ordinary time earnings. The factor is rounded to the nearest third decimal place, rounding up if the value of the fourth decimal place is greater than 4. (Section 9 *SGAA*)

“Year” means a financial year. (Section 6(1) *SGAA*)

RIMHYPO uses *annual* changes in AWOTE based on year average AWOTE estimates to index SGC variables rather than the movements over the year to the March quarter as set out in the legislation.

Adjusting the SGC rate

The SGC is a charge that is levied on an employer. The charge is reduced by amounts paid by the employer in respect of the employee to a superannuation fund as defined by the *Occupational Superannuation Standards Act 1987*. (ref. Sections 13,14 & 23 *SGAA*). The reduction is based on the amount of the contribution expressed as a percentage of salary for SGC purposes. Thus even if the percentage contributed is less than the SGC percentage, there may be no charge if the salary is higher than the maximum contribution base.

For purposes of this model, it is assumed that where the employer did not pay contributions prior to the SGC legislation, or paid contributions at a rate less than the

SGC rate, new or additional contributions are 'SGC contributions'. It is assumed that employers pay superannuation up to at least the SGC rate rather than pay the charge.

We have assumed that adjustment arrangements for any new compulsory member contribution would be the same as those for employer contributions.

Restrictions on Contributions to Superannuation Funds

With a few exceptions, contributions cannot be accepted in respect of a member who has retired, has ceased for a continuous period of 2 years to be employed part time or full time, or has turned 65. (ref. Sections 5AA(3) & 18B(3) *Occupational Superannuation Standards Regulations* and Part 7 *Superannuation Industry (Supervision) Regulations*)

Contributions during periods of non-participation

Such contributions are only disallowed after 2 continuous years without full time or part time employment. (ref. Sections 5AA(3) *SGAA*) For purposes of this model we assume that employers do not continue contributions but that members may do so.

Preservation

Modelling of preservation is based on provisions of the **Superannuation Industry (Supervision) Regulations 1994 (SIS)**, applying after the changeover date of 1 July 1996. Events effecting preservation before the start date of the model (1 July 1992) are not specifically modelled, though users may impute initial balances reflecting the effect of such events. Events occurring between the start date of the model and 1 July 1996 are treated as if the regulations applying after 1 July 1996 had been in force. Transitional arrangements for the period 1 July 1994 to 1 July 1996 are ignored.

Although different regulations apply for superannuation funds and approved deposit funds they are essentially compatible and for our purposes we use those applying to superannuation funds. All funds are assumed to be complying funds.

Definitions

- **'indexed'** in relation to a benefit means indexation in the same manner as prescribed by section 159SG of the Income Tax Assessment Act. That is, the amount is multiplied by the greater of:

one, or

AWOTE for the March quarter of the previous financial year
AWOTE for the March quarter of the financial year immediately preceding that year

RIMHYPO uses *annual* changes in AWOTE based on year average AWOTE estimates to index SGC variables rather than the movements over the year to the March quarter as set out in the legislation.

- AWOTE is full time adult average weekly ordinary time earnings for the middle month of the quarter. The factor is rounded to the nearest third decimal place, rounding up if the value of the fourth decimal place is greater than 4. (ref. sub regulation 6.01(2) *SIS*)
- '**part-time**' is defined as being gainfully employed for at least 10 hours but less than 30 hours each week. (ref. sub regulation 1.03(1) *SIS*)
- '**gainfully employed**' is defined as 'employed or self employed for gain or reward in any business, trade, profession, vocation, calling, occupation or employment'. (ref. sub regulation 1.03(1) *SIS*)
- '**retirement**' is defined as:
 - (a) for a person aged at least 55, ceasing gainful employment and having the intention of never again being gainfully employed full or part time
 - (b) for a person aged at least 60, a particular employment arrangement ends at or after attaining age 60.
 (ref. sub regulation 6.01(7) *SIS*)

Part 6 of the SIS regulations defines three categories of benefit - preserved, restricted non-preserved, and unrestricted non-preserved.

- **Preserved benefits** are defined as the total benefit less the sum of restricted non-preserved and unrestricted non-preserved benefits (see below). (ref. regulation 6.03 *SIS*)
- **Restricted non-preserved benefits** are defined as the greatest of:
 1. the indexed amount of restricted non-preserved benefit that would have been payable to the member on resignation at 1 July 1996, or
 2. the indexed amount of restricted non-preserved benefit that would have been payable to the member on retrenchment at 1 July 1996, or
 3. the person's restricted non-preserved contributions (defined in SIS regulation 2 as undeducted contributions other than those required to be preserved in satisfaction of the ITAA, OSS Laws or Superannuation Industry (Supervision)(Transitional Provisions) Regulations - this excludes the deducted contributions of the self-employed).

(ref. regulation 6.08 *SIS*)

The restricted non-preserved benefits referred to in (1) and (2) are defined by SIS regulation 6.07 as total benefit less preserved and unrestricted non-preserved benefits. In most cases there will be no unrestricted non-preserved benefits (see definition below). The preserved benefits are as defined in SIS regulation 6.02 with reference to the OSS laws as modified by Schedule 2 of the SIS regulations and as if sections of

the Occupational Superannuation Standards Act 1987 had not been repealed by the Occupational Superannuation Standards Amendment Act 1993.

Preserved benefits under the OSS laws are defined by regulations 9-12 of the OSS Regulations and with reference to the vesting standards defined in OSS regulation 8. The following are preserved:

- benefits from employer contributions not in excess of the SGC requirement and made on or after 1 July 1994,
- benefits from member contributions which were made during a period before 1 July 1994 when the member did not have employer support (ignoring any different provisions prior to July 1992),
- benefits from member contributions that are not undeducted contributions and were made on or after 1 July 1994,
- benefits from employer contributions made under an industrial award, and
- any new or improved benefits arising from an arrangement or agreement made after 22 December 1986 for a private sector fund, or 1 July 1990 for a public sector fund.

However, where the total preserved benefit would be less than \$500, the benefit is not preserved. (ref. regulation 12 *OSS* and Schedule 1 *SIS*)

It is not practical to model the detail of these provisions. Accordingly RIMHYPO will assume that all employer financed benefits are preserved benefits at 1 July 1996, except where the total preserved amount would be less than \$500. Member financed benefits from contributions that are not undeducted will also be treated as preserved at 1 July 1996.

The effect of this is that the restricted non-preserved benefit payable on resignation or retrenchment at 1 July 1996 is limited to (in RIMHYPO equal to) undeducted contributions plus earnings, *less* any amount that has become an unrestricted non-preserved benefit (see below). At the point where this amount, indexed, is less than the member's total undeducted contributions without earnings, the latter becomes the person's restricted non-preserved benefit.

Unrestricted non-preserved benefits are defined as benefits that were preserved or restricted non-preserved benefits but ceased to be such because the member satisfied a condition of release for which there was no cashing restriction (see below). For our purposes, this will only involve amounts under \$500 and restricted non-preserved benefits that become unrestricted when the person resigns or is retrenched. Earnings on these amounts are also unrestricted. (ref. regulations 6.10, 6.11 and 6.12 *SIS*)

Payment Of Benefits

Unrestricted non-preserved benefits can be taken at any time. (ref. regulation 6.20 *SIS*)

The circumstances under which preserved and restricted non-preserved benefits can be paid are defined in Schedule 1 of the SIS regulations. There are no cashing restrictions on these benefits when the person:

- retires (see definition of retirement above),
- attains the age of 65,
- dies,
- becomes permanently incapacitated,
- leaves Australia permanently, or
- has preserved benefits less than \$500 and employment with relevant employer is terminated.

When relevant employment ceases, and the preserved amount is \$500 or more, there is no restriction on the cashing of restricted non-preserved benefits. However the preserved amount can only be taken as a non-commutable life pension or annuity.

In cases of financial hardship a single lump sum, the amount determined by the Commissioner, may be paid.

Payment of preserved and restricted non-preserved benefits, in the form of an income stream, may also be made in respect of temporary incapacity. RIMHYPO does not model this. The model will permit preserved benefits to be taken before retirement either at or after age 55 only in cases of death or permanent disability. In other circumstances benefits that may be cashed out will be deducted from the relevant category and either be added to unrestricted non-preserved benefits or subtracted from the fund.

The compulsory cashing age for benefits held in an ADF is age 65. (ref. regulation 6.25 *SIS*.) The compulsory cashing age for benefits held in superannuation funds is set at 70 for those not employed full time (more than 30 hours per week) and 65 for those not employed full time or part time (at least 10 hours per week). (ref. regulation 6.21 *SIS*.) For simplicity, RIMHYPO pays final benefits no later than age 65.

The Government has announced its intention of progressively raising the preservation age to 60. The proposed change would not effect persons born prior to July 1960 and would be fully phased in for persons born after June 1964. Persons with a preservation age higher than 55 but less than 60 will still be permitted to retire and access a lump sum benefit subject to certain limits, provided the remainder of their benefit is taken as a non-commutable lifetime pension or annuity.

As no time has been determined for the presenting to Parliament legislation to enact this policy, the policy is not modelled in RIMHYPO.

Taxation of Contributions and Fund Earnings

Note: All funds are assumed to be complying funds

The income of complying superannuation funds is subject to taxation under Section 278 of the Income Tax Assessment Act (ITAA). The income of complying Approved Deposit Funds is subject to taxation under section 289 of the ITAA.

The nominal tax rate for superannuation funds and approved deposit funds is 15% in respect of 'standard' income. The 47% rate for 'special' income is ignored in RIMHYPO. (ref. sections 26(1) and 27(1) Income Tax Rates Act 1986.)

Contributions in respect of which the member or the employer is entitled to a deduction, and contributions by a tax exempt entity are included in the taxable income of the fund. (ref. sections 82AAC, 274(1), 281 ITAA).

Note: although taxable contributions are taxed in the same way as other fund income, RIMHYPO uses different variables with the same value for tax on contributions and tax on earnings.

Premiums paid by a fund to cover death and disability insurance are deductible. Where the fund self insures for these risks, a deduction can be claimed for an amount equal to a reasonable premium. (ref. section 279 ITAA). RIMHYPO deducts tax from contributions at the fund's nominal rate after contributions have been reduced by deductible amounts (death and disability insurance and fees, which are assumed equal to deductible expenses).

The effective tax rate on earnings of the fund is assumed to be reduced by the use of imputation credits, capital gains etc. The user specifies this effective tax rate.

Persons who are self-employed or substantially self-employed (ie income from employment other than self-employment does not exceed 10% of the person's assessable income) can claim a deduction from their taxable income for their own superannuation contributions. The limit of the deduction is the lesser of:

- (1) \$3000 plus 75% of contributions over that amount, or
- (2) the person's maximum deductible contributions calculated in accordance with regulation 18B(9) of OSS.

Calculation in accordance with the OSS regulation involves modelling characteristics of the fund, which is outside the scope of RIMHYPO. Accordingly the limit used will be (1). This amount is not indexed.

(ref sections 82AAS & 82AAT ITAA)

Persons who are not self-employed or substantially self-employed (ref section 82AAS of the Income Tax Assessment Act (ITAA)) can claim a rebate of tax for their own superannuation contributions. Assessable income must be less than \$31,000 for the income year. The amount of the rebate is the lesser of 10 % of:

- (1) their eligible contributions or
- (2) \$1000 reduced by 25 cents for each \$1 of assessable income in excess of \$27,000.

These amounts are not indexed.

(ref. section 159SZ ITAA).

The amount of contributions for which a person did not claim a deduction are counted as undeducted contributions. (ref. section 27A(1) ITAA)

Employers are entitled to a deduction for contributions made in respect of employees. (ref section 82AAC ITAA). Limits on deductible contributions are set in regulation 18B(9) of the OSS regulation and, from 1 July 1994, section 82AAC(2), (2A)-(2G) of the ITAA. However as the limits are very high, can be averaged over the employer's workforce and would effect very few persons, they are not modelled in RIMHYPO.

SOCIAL SECURITY PAYMENTS

Income Definitions

Income for Social Security purposes is defined in section 8(1) of the Social Security Act 1991 and broadly speaking conforms to the ordinary meaning of the word. Excluded amounts are defined in subsections 8(4), 8(5) (home equity conversion amounts) and 8(8). Excluded amounts under 8(8) include any return on an investment in a superannuation fund, approved deposit fund or deferred annuity until the person reaches age pension age or commences to receive a pension or annuity from the fund.

In RIMHYPO, non concessional scenarios assume that there is no concessional treatment of superannuation. Therefore the earnings are fully assessable at all times.

Superannuation pensions and rollover annuities

Once the person has reached age pension age or commences to receive a pension or annuity, the payments become assessable as income under sections 1098 (annuities) and 1099 (superannuation pensions). The amount assessed is the amount payable less the 'deductible amount'. The 'deductible amount' is defined in section 9(1) as:

- The amount that would be the 'deductible amount' under section 27H(2) of the Income Tax Assessment Act (ITAA) if the definition of “non assessable purchase price” in the Social Security Act had the same meaning as “undeducted purchase price” in the ITAA.
- The Section 9(1) defines the “non-assessable purchase price” for *superannuation pensions and non-rollover annuities* as being equal to the definition of “undeducted purchase price” (UPP) in Section 27A(1) of the ITAA as it was *prior to* 1 July 1994. That defined UPP as:

- that part of the *purchase price* of the pension or annuity paid before July 1983 that did not comprise deductible or rebatable contributions; *plus*
 - that part of the *purchase price* paid after June 1983 that was not a deductible contribution, reduced by any taxed or untaxed elements of the post June 1983 component of any ETP rolled over to purchase the pension or annuity; *less*
 - any residual capital value of the annuity (if any).
 - For the purposes of the definition of UPP in the ITAA, *purchase price* of a pension or annuity means the sum of any contributions made or amounts paid to acquire the pension or annuity and excludes fund earnings. (*ITAA section 27A(1)*).
- Section 9(1) defines the “non-assessable purchase price” for a *rollover immediate annuity* as being the UPP as defined above plus an amount equal to the tax threshold amount for the post June 1983 component of an eligible termination payment (ie the “upper limit” under section 159SG of the ITAA) or the actual purchase price, whichever is the lesser.
 - Section 9(1) defines the “non-assessable purchase price” for an annuity purchased with ordinary monies (ie not by rollover of an ETP) as the purchase price of the annuity *less* any residual capital value.
 - The ‘deductible amount’ for a superannuation pension or annuity is equal to the UPP divided by the number of years the pension or annuity is expected to be payable. The expected payment period will generally equal the term of the pension or annuity, where that term is a fixed number of years, or a period equal to the life expectancy of the longest lived potential recipient.

This definition of UPP is more restrictive for superannuation pensions and deferred annuities than for rollover annuities. This reflects two factors:

First, the effect of the *former* ITAA definition was to exclude from UPP virtually any part of the pre-83 component of the accrued fund, except for that which may have initially been included as part of a lump sum rolled over into the fund. Where a person rolls over a lump sum into a pension or deferred annuity, the value of the pre-July 83 component is frozen as at the rollover date. Because most superannuation contributions prior to July 1983 were entitled to some tax concessions, very few pre 83 contributions to a superannuation pension are likely to be included in UPP. This does not affect rollover immediate annuities because they are purchased and commence to be payable from the purchase date. This means that their UPP included *all* of the pre-July 1983 component of the rolled over lump sum as at the purchase date.

From 1 July 1994, the ITAA definition of UPP for superannuation pensions and *rollover* annuities is limited to the post June 1983 undeducted contributions. However, the Minister for Social Security has announced that the Social Security Act will retain the pre-July 1994 definition of UPP for calculating the deductible amount

for social security purposes. This means that the Social Security Act will continue to treat superannuation pensions and rollover immediate annuities differently.

Second, the “non-assessable purchase price” of a rollover immediate annuity also includes, on a once off basis for each person, an extra amount equal to the ETP low rate threshold (\$77,796 for 1993-94). This is the case irrespective of whether the person has already used that threshold up for taxation purposes.

Allocated pensions

Allocated pensions and annuities are defined by sub-section 9(8) of the Social Security Act (as amended by the Social Security Legislation Amendment Bill (No2) 1994) to include only those purchased on or after 1 July 1992. These are treated the same as other pensions and annuities under the income test. Previous amendments which would have assessed allocated pensions and annuities as managed investments have not been implemented. RIMHYPO does not model allocated pensions purchased before July 1992.

Interest income

RIMHYPO assesses as income the interest earned on savings accounts and fixed interest investments. For share investments both the dividends and capital growth are assessed as income. RIMHYPO does not model the details of DSS provisions applying to managed investments, shares, deprivation of income, deemed income etc. It is assumed that subjects behave with a reasonable degree of knowledge and self interest in choosing investments and achieve overall a reasonable rate of return at or above the 'deeming rate'. Setting the rate of return lower than this may result in inaccuracy.

Capital gains

Sub-section 9(1) of the Social Security Act defines an “accruing return investment” as an arrangement with a fixed or quantifiable rate of return or a rate or return that may reasonably be approximated, the value of which from time to time is unlikely to decrease as a result of market changes. The return on such investments is included in the income test definition of income under Sections 1074A to 1074G of the Social Security Act.

RIMHYPO includes the return on investments in the income test definition of income, including the value of capital gains on assets in each period.

Assets definitions

'Assets' for Social Security purposes is defined in section 11(1) of the Social Security Act 1991 as 'property (including property outside Australia)'. Exempt assets are described in paragraphs 1118(1)(a) to (s). These include:

- the person's home,
- the value of any superannuation pension, and

- the value of any investment in a superannuation fund, approved deposit fund or deferred annuity until the person reaches age pension age or commences to receive a pension or annuity from the fund.

In RIMHYPO, non concessional scenarios assume that there is no concessional treatment of superannuation. Therefore the fund balance is assessable at all times.

For all non superannuation investments, RIMHYPO uses the balance at the end of the previous year for assets test purposes. Deprivation is not modelled.

Pensions and annuities

The Social Security Act does not include the value of a superannuation pension as an asset counted towards the assets test (SSA Section 1118(1)(d)).

Section 1119 provides for some annuities to be disregarded under the assets test, but not an annuity purchased or becoming presently payable after 15 August 1989. The value of an assessable annuity is worked out by multiplying the purchase price (*less* any residual capital value¹) by the 'adjustment factor'. The adjustment factor is the number of years payable minus the number of years elapsed plus one, divided by the number of years payable. That is, the value assessed is the expected balance at the end of the year of assessment. The 'plus one' adjustment assumes the recipient has received one years' payment immediately at the time the annuity commences to be payable, whether that is the case or not.

Allocated pensions and allocated annuities

The Social Security Act treats allocated pensions and allocated annuities purchased prior to 1 July 1992 in the same manner as superannuation pensions (assets test exempt) and annuities (assets tested on a depletion basis) generally. Social Security Legislation Amendment Bill (No2) 1994, passed by Parliament in July 1994, however, amended the SSA to include a separate assets test treatment for allocated pensions and allocated annuities. For allocated pensions and allocated annuities purchased on or after 1 July 1992, the Social Security Act counts the current account balance as an asset for the assets test.

Because RIMHYPO starts from 1 July 1992, it only models the new assets treatment of allocated pensions and allocated annuities.

Payments

Rent Assistance

Rent assistance is payable to pensioners and allowees who do not own a home and who pay private rent. Conditions of eligibility and rates are contained in sections 1064-D and 1068-F of the Social Security Act. RIMHYPO ignores the effect of the 'rent threshold' whereby the amount of rent assistance paid depends on the amount of

¹RIMHYPO does not model residual capital value.

rent paid, and the different payment arrangements for families with children. It is assumed that all couples are living together and that anyone who does not own a home pays private rent.

Rent assistance rates are expressed as annual amounts for pensioners and fortnightly rates for allowees. However the amounts are identical. Under section 1191(1) rates are indexed each 20 March by the CPI for the preceding December quarter divided by the CPI for the highest preceding June quarter, and each 20 September by the CPI for the most recent June divided by the CPI for the highest preceding December quarter. The amount is rounded to the nearest \$5.20 per annum.

Where both partners of a couple are in receipt of a pension or both are in receipt of an allowance, each receives a separate entitlement of rent assistance (1064-D5, 1068 F15). Where only one partner receives a pension or allowance the combined amount is payable to that partner (1064-D5, 1068-F15). Where one partner is a pensioner and the other an allowee the combined amount is payable to the pensioner and no rent assistance is payable to the allowee (1064-D5, 1068-F1(e)).

Rates per fortnight as at September 1994 are \$69.20 for singles and either \$32.60 for each partner of a couple or \$65.20 combined.

Pharmaceutical allowance

Pharmaceutical Allowance is payable to sickness allowees, long term allowees aged 60 or over and certain other allowees who are incapacitated for work, and to pensioners. In RIMHYPO it is only paid to pensioners and allowees aged 60 or over. Conditions of eligibility and rates are contained in sections 1064-C and 1068-D of the Social Security Act.

Under sections 1191(1) and 1206A fortnightly rates are indexed each 1 January by the CPI for the preceding September quarter divided by the CPI for the highest preceding September quarter. The amount is rounded down to the nearest 10 cents per fortnight.

Generally each member of a couple receives a separate entitlement of rent assistance at half the single rate (1064-C8, 1068 D10). Currently, partnered allowees whose allowance is increased by an amount for the spouse receive the full amount. We have assumed that the new arrangements for individual entitlement for couples will result in benefit pharmaceutical allowance being paid to each partner at the same rate as for partnered pensioners.

Rates per fortnight as at September 1994 are \$5.20 for singles and either \$2.60 for each partner of a couple.

Labour Market Allowances

RIMHYPO assumes that where the person is not employed full time they will have a *prima facie* eligibility for some type of allowance; eg Jobsearch, Newstart, Sickness , Partner or Parenting Allowance. AUSTUDY, which is not a DSS payment, is not modelled. Imputation of DSS benefit in lieu gives a rough approximation. As

children have no explicit existence in the model, sole parent pension and payments in respect of dependent children are not modelled.

Income testing for benefits is based on measures announced in the White Paper *Working Nation* in May 1994. These measures are planned to come into effect from 1 July 1995. For the sake of simplicity, benefits paid prior to that date are income tested in the same manner.

The income test thresholds for DSS allowances are not indexed and historically are increased infrequently. RIMHYPO allows the user to select an indexation rate, including zero, for these thresholds.

Under the new arrangements the first \$30 per week of income will not reduce benefit. Income between \$30 and \$70 per week will reduce benefit by 50%, with a 70% withdrawal rate thereafter. These thresholds and withdrawal rates apply to single persons and to each member of a couple. (*Working Nation* p154)

Each member of a couple will have a separate entitlement. The income of a spouse will only affect a person's allowance after the spouse's entitlement has been exhausted. In this case the entitlement of the lower earner is first reduced by 70 cents for each dollar of the spouse's income over the basic allowance cutout before any personal income test is applied. Where one partner receives a pension and the other an allowance each will be assessed according to their own income test based on an even split of combined income. (*Working Nation* p150)

The assets test for allowances is 'sudden death'; that is, assets in excess of the limits preclude any payment. For couples, combined assets are assessed regardless of whether both partners are in receipt of an allowance. The limits as at September 1994 were:

single homeowner	115,000
single non homeowner	197,000
partnered homeowner	163,500 (combined)
partnered non homeowner	245,500 (combined)
(ref Social Security Act sections 529, 611, 680)	

Under section 1191 these limits are indexed on 1 July each year. The indexation factor is the CPI for the year to the preceding December quarter. The amount is rounded to the nearest \$250.

Basic rates of allowance for various ages and circumstances are set out in section 1068 - B1 of the Social Security Act and are expressed as fortnightly amounts. These rates are indexed under section 1191.

- The under 21 rate is indexed each January by the CPI for the most recent June quarter divided by that for the highest preceding June quarter. The amount is rounded to the nearest 10 cents.

- Other allowance rates are indexed each 20 March by the CPI for the preceding December quarter divided by the CPI for the highest preceding June quarter, and each 20 September by the CPI for the most recent June divided by the CPI for the highest preceding December quarter. The amount is rounded to the nearest 10 cents.

In practice, rates for couples and those over 60 are equal to pension rates, which are also indexed by the CPI according to the legislation. However Government policy links the pension rates to AWE. Ad hoc adjustments result in *de facto* AWE indexation. RIMHYPO allows the user to choose the indexation factor. For consistency with current policy the factor should be the same as that for pensions.

Basic rates per fortnight as at September 1994 are:

single aged 18-20	241.50
single aged 21-59	297.30
single aged 60 or over*	321.60
partnered**	268.20

*Although the higher rate is payable to those 60 or over who have been in receipt of a payment for at least 12 months, RIMHYPO ignores this second condition. This group is also entitled to pharmaceutical allowance. The mature age allowance, payable under pension conditions is not modelled as it is a temporary measure with no new claims to be lodged after 30 June 1996.

**RIMHYPO ignores lower payments for partners aged less than 21 and without children.

Pensions

RIMHYPO models age and disability support pensions.

- Persons retiring on disability grounds are assumed to be eligible for disability support pension.
- The age pension age is defined in section 43(1)(a). Legislation before Parliament (Social Security Legislation Amendment Bill (No 2) 1994) as at May 1994 will phase in an increase in the female age pension age to age 65. Income and asset testing for pensions is based on section 1064 of the Social Security Act. The income test and the assets test are separately applied to the person's maximum payment rate. The amount paid is the lesser of the income test rate and the assets test rate.
- The Government has announced that there will be no new grants of wife pension from 1 July 1995 (*Working Nation* p 148). Accordingly we have not included it in RIMHYPO. Wives of pensioners who do not themselves qualify for a pension will be tested for social security allowances.

Under section 1064-A2 the income and assets of a couple are treated as shared on a 50/50 basis.

The amount of reduction under the income test is calculated under section 1064-E. The reduction is half the person's income in excess of the threshold. In calculating the reduction for a couple, the combined threshold is halved and the income of each partner is assumed to be half the combined income.

The income test thresholds as at September 1994 are \$90 per fortnight for singles and \$156 combined per fortnight for couples. The thresholds are indexed each 1 July by the CPI for the preceding March quarter divided by the CPI for the next most recent preceding March quarter. The annual threshold amounts are rounded to the nearest \$52 per annum.

The amount of reduction under the assets test is calculated under section 1064-G. The assets test *thresholds* are the same as the assets *limits* for allowances. As at September 1994 these are:

single homeowner	115,000
single non homeowner	197,000
partnered homeowner	163,500 (combined)
partnered non homeowner	245,500 (combined)

(ref Social Security Act section 1064-G3)

Under section 1191 these thresholds are indexed on 1 July each year. The indexation factor is the CPI for the year to the preceding December quarter. The amount is rounded to the nearest \$250.

In calculating the reduction for a couple, the combined threshold is halved and the assets of each partner is assumed to be half the combined assets. The amount of reduction under the assets test is \$78 per annum (\$3 per fortnight) for each \$1000 of assets over the threshold. Any part of the assets excess that is not a multiple of \$250 is disregarded.

Basic rates of pension are set out in section 1064 - B1 of the Social Security Act. Under section 1191 the annual rates are indexed each 20 March by the CPI for the preceding December quarter divided by the CPI for the highest preceding June quarter, and each 20 September by the CPI for the most recent June divided by the CPI for the highest preceding December quarter. The amount is rounded to the nearest \$2.60.

Basic rates per fortnight as at September 1994 are:

single	321.60
partnered (each)	268.20

Indexation

The indexation provisions for Social Security payments vary by indexation factor and periodicity. Some, such as the benefits threshold are not indexed. RIMHYPO

generally allows the user to specify the indexation factor (including zero) but will not permit indexation more frequent than annual.

Order of Withdrawal of Payments

Section 1207(1) of the Social Security Act describes the order in which reductions under the income and assets tests are applied to components of pension and benefit payments for income tax purposes. The reduction is applied first to the basic rate, then to the rent assistance and lastly to the pharmaceutical allowance.

note: disability support pension, rent assistance and pharmaceutical allowance are not assessable income for taxation purposes

INCOME TAX

Superannuation contributions and earnings

Refer to the Superannuation, Taxation of Contributions and Fund Earnings section above.

Individuals, Assessable Income and Taxable Income

Section 6(1) of the Income Tax Assessment Act 1936 (*ITAA*) defines taxable income as assessable income less allowable deductions. The same section defines assessable income as 'all the amounts which under the provisions of this Act are included in the assessable income'. Lacking a more useful legislative definition, we have assumed all income to be assessable except for specifically exempted Social Security and superannuation amounts.

Disability support pension is exempt under section 24ABD when paid to a person under age pension age. RIMHYPO imputes this payment only to persons under age pension age. Section 24ABA lists an amount paid as pension or benefit because the person pays rent as a 'supplementary amount'. Supplementary amounts are exempt under section 24ABC for age pensioners, and under sections 24ABL, 24ABM and 24ABO for allowees. Pharmaceutical allowance is exempt under section 24ABDA.

Under the non concessional scenarios the grossed up earnings of funds are included in the person's assessable income as if they were ordinary investments. The fund fees are deductible under section 51(1) as outgoings incurred in gaining assessable income.

Tax Scales

Income tax scales are set out in Schedule 7 of the Income Tax Rates Act 1986. The scales have been amended several times since 1992. RIMHYPO uses the actual tax scales applying for 1992-93, 93-94 and 94-95. For years thereafter the scales are indexed, with the rate and periodicity of indexation being chosen by the user.

Medicare Levy

Medicare levy is payable under section 251S of the *ITAA*. Under section 251R(7) levy payable is not included in the meaning of 'tax' for purposes of rebates applying under Division 17 of Part 3 of that act. That is, rebates of tax cannot be applied to reduce a Medicare liability.

The levy is imposed under section 5 of the Medicare Levy Act 1986 (*MLA*). The rate is specified in section 6(1) of that act as 1.4% of taxable income, a rate of 1.25 % having applied immediately prior to 1 July 1993.

MLA section 7(1) exempts from the levy persons with taxable income less than \$12,688. Section 7(2) prescribes a shade in of 20% for incomes between \$12,688 and \$13,643. (note: this is the point at which 20% of the excess over \$12,688 is equal to 1.4% of taxable income.)

Reductions and exemptions for couples and families are prescribed by section 8. The family income threshold is defined in section 8(4) at \$21,366 plus \$2,100 for each dependent child or student. If the taxable income of a couple or sole parent is below this threshold no levy is payable. RIMHYPO does not model sole parents.

Where the couple's income is above the levy threshold a 'reduction amount' is calculated under section 8(2). This is equal to 1.4% of the family income threshold less 18.6% of the excess above the threshold. Where only one spouse would have a levy liability, this amount is subtracted from that liability under section 8(2). Where both have a normal liability, the reduction amount is shared between them in the same proportions as their respective shares of the couple's taxable income (ref 8(3)).

Prior to 1994-95 the Medicare levy thresholds were set each year to correspond to the maximum taxable income of a pensioner eligible for pensioner health benefits under the now abolished income test. In the 1993-4 Budget, the Government restated its policy of exempting persons who would have been entitled to free medical care prior to the introduction of Medicare. As there were 27 rather than 26 pension paydays in 1993-94 there was no need to increase the thresholds in 1994-95 to meet this commitment.

Pensioner and Beneficiary Rebates

Under section 160AAA of the *ITAA* recipients of certain Social Security pensions and allowances are entitled to a rebate of tax. The rebatable benefits and pensions include age pension and Jobsearch, Newstart and Sickness Allowances.

The amount of the rebate is calculated in accordance with Part 8 of the Income Tax Regulations. Regulation 151 prescribes the method of calculating the pensioner rebate. The maximum rebate is the amount of tax that would be payable at the lowest marginal rate on the excess over the first tax threshold of the relevant annual taxable pension amount plus the pensioner income test free area. This is rounded up to the nearest whole dollar (151(3)). The rebate is reduced by 12.5 cents for each \$1 of taxable income in excess of the pensioner's rebate threshold (151(1)). The rebate

threshold is the rebate amount divided by the lowest marginal tax rate, plus the first tax threshold. This amount is rounded up to the nearest whole dollar (151(2)).

Under regulation 151(6), where one partner of a pensioner couple is entitled to a rebate greater than their ordinary tax liability, the excess rebate is added to that of the other partner. This increased rebate is used to calculate the rebate threshold of the higher income partner under 151(2).

Under section 152 the beneficiary rebates and thresholds are calculated in manner similar to those for pensioners. However, where a person receives a partnered rate benefit (ie, including an amount for a dependent spouse) the dependent spouse rebate for a person without children is subtracted from the rebate that would otherwise be available (152(3-5)). This is of no concern in RIMHYPO as separate payments are calculated for partners in all cases. Unlike the rebate for pensioners, the rebate calculation for beneficiaries does not cover any income test free area.

Dependent Spouse Rebate

Section 159J of the *ITAA* provides for a rebate of tax in respect of a dependent spouse. Section 159J(1B) provides for a higher rebate where there are dependent children. However, from 29 September 1994 a spouse caring for children can claim a direct payment (Home Child Care Allowance or HCCA) from the Department of Social Security. The payment is income tested on the income of the caring spouse and any amount paid is deducted from any amount of DSR that would otherwise have been available. The 'with child rate' of DSR will be phased out by freezing the amount until it is less than the 'without child' rate. As the presence of children is not modelled in RIMHYPO, the DSR without child rate will be imputed to the higher earner in all couples. The maximum rebate amount will be income tested against the income of the lower earner.

The maximum no child DSR for 1992-93 was \$1,177. Under section 159HA this amount is indexed each year by the CPI (calculated to 3 decimal places) for the year ending on the 31 March immediately preceding the year of income.

Under section 159J(4) the DSR is reduced by \$1 for every \$4 by which the dependant's separate net income for the year exceeds \$282. This threshold is not indexed.

The Income Tax Assessment Act is not particularly helpful in defining 'separate net income', merely stating that it includes 'assessable income' and some payments in respect of children and students (159J(6)), but not social security family payments. Generally the term is taken to mean amounts which are income in the generally accepted sense, less expenses incurred in gaining that income. Thus certain amounts, such as equity imputation credits, which are taxable income are not separate net income. Disability support pension is not taxable, but it is separate net income. Amounts which are allowable deductions for taxable income purposes, such as superannuation contributions, are not deductible from separate net income.

RIMHYPO calculates separate net income as salary, investment income and all DSS pension and allowance payments both taxable and non taxable. Investment fees and

fund fees (as in the non concessional scenario) are deductible, but contributions and insurance premiums are not.

Low Income Rebate

From 1993-94 person's with taxable income less than \$24,450 are entitled to a rebate of \$150, reduced by 4 cents for every \$1 of taxable income in excess of \$20,700 (Section 159N, *ITAA*). These amounts are not indexed. RIMHYPO permits indexation as specified by the user.

In calculating the amount of pensioner rebate used by a member of a pensioner couple, in order to determine if any excess rebate may be available to the other partner, the low income rebate is not to be taken into account in reducing the tax liability offset by the pensioner rebate (Income Tax Regulations 151(6)(d)).

Superannuation and retirement benefits

RIMHYPO allows users to select from the following benefit types in retirement:

- A superannuation pension *or* rollover annuity;
- Allocated pension;
- or an Eligible Termination Payment, which is taxed and may be disposed of in the following ways:
 - immediate consumption (ie dissipation);
 - investment in interest bearing securities;
 - investment in an ordinary savings account; or
 - investment in capital gaining assets (eg shares).

RIMHYPO allows the user to select any of the above benefit forms or any combination of those benefit forms as the retirement benefit.

Reasonable Benefit Limits

The amount of *concessionally taxed* superannuation benefits a person is allowed to receive over his or her lifetime is limited under the reasonable benefit limits (RBL). The RBL rules are set out in Division 14 of Part III of the *Income Tax Assessment Act*.

From 1 July 1994, the RBL are expressed as flat dollar limits. Where a person takes at least 50% of superannuation benefits as a *RBL complying* superannuation pension or rollover annuity, the flat dollar RBL is \$800,000, otherwise the RBL is \$400,000. These limits are indexed annually to movements in average weekly ordinary time earnings. Indexation occurs on 1 July each year and is based on the movement in AWOTE over the year to the immediately preceding March quarter and the resulting outcome is indexed and rounded up to the nearest \$10. (*ITAA* s140ZD(3) & S159SG)

Where a person receives benefits before age 55, the *lump sum* RBL is discounted by 2.5% for each whole year of age of the person under 55 (ITAA s140ZD(1)(a)).

RIMHYPO indexes the base level of the RBL limits to the annual level of AWOTE in the model. The model assesses individuals against the indexed RBL thresholds in the year benefits are received and discounts the lump sum RBL where benefits are received before the preservation age.

Subdivision F of Division 14 sets out the benefits counted against a person's RBL, while *Subdivision H* sets how much of each type of benefit counts towards the RBL. The RBL generally count the following types of benefit:

- eligible termination payments:
 - 100% of the pre-July 1983 component of the ETP;
 - 100% of the post-June 1983 *taxed* element of the ETP; and
 - 85% of the post-June 1983 *untaxed* element of the ETP.
- the capital value of a superannuation pension (which under *Subdivision J* excludes the amount of any undeducted contributions):
 - all of the capital value attributable to pre-July 1983 service;
 - where the pension *is* a rebatable superannuation pension, all of the reduced capital value attributable to post-July 1983 service; and
 - where the pension *is not* a rebatable superannuation pension, 80% of the reduced capital value attributable to post-July 1983 service.
- the amount of any ETP that is rolled over to purchase a rollover annuity:
 - 100% of the pre-July 1983 component of the rolled over ETP;
 - 100% of the post-June 1983 *taxed* element of the rolled over ETP; and
 - 85% of the post-June 1983 *untaxed* element of the rolled over ETP.

At this stage, RIMHYPO does not deal with “untaxed” superannuation benefits and so does not have to discount any components of such benefits.

The RBL *exclude* any concessional components of benefits, undeducted contributions and benefits rolled over into a roll over fund. Roll over benefits are assessed against the RBL when the roll over fund pays them out.

The RBL only count the value of such benefits received by a person since 16 February 1990 (ITAA s140ZC(1)(c)). When a person receives such a benefit, its value is recorded and the recorded value carried forward, indexed by AWOTE (ITAA s(140ZA(4)). In assessing a current year benefit against the RBL, the indexed value of previously received benefits is taken into account.

The RBL assessment in RIMHYPO does not count concessional components, undeducted contributions or benefits rolled over to another superannuation fund or rollover fund. Because RIMHYPO will generally only examine benefits received after July 1992, the January 1990 threshold date does not apply and the model will consider all superannuation benefits for RBL purposes.

To qualify for the higher pension RBL, a person must take at least 50% of their superannuation benefits (current and previous) as a pension or annuity that satisfies the "pension and annuity standards" set out in the regulations (ITAA s140L). A current benefit is assessed against the lump sum RBL if:

- the current benefit is an ETP or non-complying pension or annuity and:
 - the sum complying pension or annuity benefits the person has received is less than 50% of total indexed benefits (including the current benefit) the person has received; or
 - the sum of the ETP and any previous benefits that were not complying pension or annuity benefits exceeds 50% of the pension RBL; or
- the current benefit is a complying superannuation pension or annuity and:
 - the sum of the benefit and any previous complying pension or annuity benefits of the person is less than 50% of total indexed benefits the person has received; or
 - where total indexed benefits exceed the pension RBL, the sum of the benefit and any previous complying pension or annuity benefits of the person is less than 50% of the pension RBL.

A pension or annuity satisfies the 'pension and annuity standards' if it satisfies all the following conditions:

- The pension or annuity is payable at least annually throughout the life of the primary beneficiary and if there is a reversionary beneficiary, annually throughout the reversionary beneficiary's life. Further provisions deal with to allow them to receive a reversionary benefit until they reach age 16, the cessation of full time study or age 25, whichever is later.
- The size of payments of benefit in a year must be fixed, allowing only for variations as specified in the contract;
- the benefit must be indexed to the lesser of 5% annually or the year on year increase in the CPI each quarter;
- the purchase price of an annuity must be wholly converted into annuity income;
- the benefit must not have any residual capital value;

- the benefit must not be commutable more than 6 months after it commences to be payable, except where:
 - the commutation represents payment of a payment guarantee on the death , within a period not exceeding 10 years, of the principal and any reversionary beneficiaries; or
 - the commutation ETP is rolled over directly to another complying superannuation pension or complying annuity;
- the value of any reversionary benefit does not exceed 100% of the benefit payable to the primary recipient;
- the pension or annuity is not transferable to any other person other than a reversionary beneficiary on the death of the current recipient; and
- the capital value of the pension or annuity cannot be used as security for a borrowing.

(Income Tax Regulations Reg 53J and also Superannuation Industry (Supervision) Act, Reg 1.05(2); 1.06(2))

RIMHYPO only allows ETP benefits prior to reaching retirement age. The model carries the value of these prior benefits forward indexed to annual movements in AWOTE in the model.

Benefits paid to a person before retirement age are assessed against the discounted lump sum RBL. Benefits received after retirement are assessed to see which RBL applied by testing whether the sum of the indexed pre retirement benefits, current ETP benefits and allocated pension benefits exceeds 50% of total benefits or 50% of the pension RBL. RIMHYPO applies the tests for complying superannuation pension and rollover annuity benefits to pension and annuities as part of the RBL assessment.

Once the RBL assessment is done RIMHYPO determines the amount, if any, of the excessive benefit. RIMHYPO assumes the person takes pension or annuity benefits first, allocated pensions second and lump sum benefits last.

Benefits in excess of the RBL are treated as follows:

- excessive lump sum benefits are taxed at the highest marginal rate of personal income tax plus the Medicare Levy; and
- the excessive proportion of any superannuation pension benefit is not rebatable and is therefore taxed at the individual's marginal rate of tax (ITAA Section 140ZQ).

Superannuation pensions and rollover annuities

The assessable income of a taxpayer includes any amount derived from a superannuation pension or annuity, excluding the “deductible amount”. (Section 27H ITAA)

The deductible amount is equal to the “Undeducted Purchase Price” (UPP) of the pension or annuity, divided by the number of years the pension or annuity is expected to be payable (the “relevant number”). The relevant number will generally equal:

- where the term of the pension or annuity is a fixed number of years, that number of years;
- where the pension or annuity is only payable during the lifetime of a nominated person, whether the original recipient or not, a number equal to the life expectancy of that person. Where a pension or annuity includes a reversionary benefit, the relevant number will be the *greater* of the life expectancy of initial and reversionary beneficiary. Life expectancy is looked up from the Australian Life Tables applicable to the year in which the annuity is purchased (ITR Reg 9); or
- in more complex cases, a number calculated by the Commissioner for Taxation based on all relevant factors.

RIMHYPO assumes pensions or annuities are payable for the life of the recipients. In a single person case the pension or annuity is payable for the life of that person only, while for a married couple, the payment period depends upon whether the pension or annuity includes a reversionary benefit. Where a reversionary benefit is payable, RIMHYPO assumes the pension or annuity is payable for the life expectation of the longest lived recipient. RIMHYPO does not model the case of surviving dependent children or other more complex cases.

RIMHYPO calculates the relevant number from the 1985-87 Australian Life Tables for years before 1995 and uses life tables from the POPMOD demographic model for years from 1995 onwards. RIMHYPO uses a new POPMOD life tables for each 5 year period from 1995 on and automatically selects the appropriate life table to use based on the year a person retires.

The definition of UPP for a superannuation pension or annuity depends upon when the pension or annuity was purchased. For pensions or annuities purchased before 1 July 1994, the ITAA defined UPP as:

- that part of the *purchase price* of the pension or annuity paid before July 1983 that did not comprise deductible or rebatable contributions; *plus*
- that part of the *purchase price* paid after June 1983 that was not a deductible contribution, reduced by any taxed or untaxed elements of the post June 1983 component of any ETP rolled over to purchase the pension or annuity.
- For the purposes of the definition of UPP in the ITAA, *purchase price* of a pension or annuity means the sum of any contributions made or amounts paid to acquire the pension or annuity and excludes fund earnings. (*ITAA section 27A(1)*)

This definition of UPP was more restrictive for superannuation pensions and deferred annuities than for rollover annuities. For a full discussion of this see the section on the Age Pension income test for superannuation pensions and annuities.

For pensions and annuities purchased on or after 1 July 1994, the UPP is defined as being equal to the amount of any *undeducted contributions* included in the purchase price of the pension or annuity. Undeducted contributions are the person's own contributions made after 30 June 1983 to secure the superannuation benefit for which the person was not entitled to a tax deduction (ITAA Section 27A(1)).

Where a person receives a superannuation pension from a "taxed superannuation fund", the person is entitled to a tax rebate on the assessable pension or annuity payment. (ITAA, Part III, Subdivision AAB) The rebatable pension or annuity payment is equal to the payment less the deductible amount. From 1 July 1994 onwards, the rebate rate for all pensions or annuities qualifying for the rebate is 15%. (ITAA Section 159SM(1)). This rebate rate is reduced where part of the pension or annuity is in excess of the RBL (Div 14 ITAA). The reduction proportion is calculated as part of the person's RBL assessment.

Superannuation pensions paid from a fund that is not a "taxed superannuation fund" are not rebatable. (ITAA Section 159SM(2))

RIMHYPO currently assumes all superannuation pensions are paid from taxable superannuation funds and does not model the pre-July 1994 rebate arrangements. Accordingly, RIMHYPO calculates the rebate as equal to the rebate percentage (15%) times the assessable pension or annuity payment.

Complying superannuation funds are exempt from tax on that part of their income that is attributable to their current pension liabilities (ITAA, sections 282B, 283). Life insurance companies are exempt from tax on any income that would be exempt income of a superannuation fund policyholder (ITAA, section 110C) and in respect of that proportion of their assessable income attributable to exempt immediate annuity policies (ITAA, section 112A).

RIMHYPO calculates the cost of superannuation pensions and rollover annuities on the basis that the investment income underlying these income streams is exempt income of the issuer in both the concessionally taxed and non-concessional counterfactual cases. This is done in the counterfactual cases because it would be impractical to tax such income in the funds concerned at the individual's marginal rate and because the pension and annuity rules aim to ensure there is not excessive tax deferral.

Allocated pensions

An allocated annuity or pension is a benefit paid from an account with a life company or superannuation fund that allows a person to draw down from that account, subject to limits on the minimum and maximum drawdown amount, for as long as the account balance lasts. The annuity contract or rules of the fund must include certain minimum conditions:

- the annuity or pension cannot be transferred except to a reversionary beneficiary on the death of the primary beneficiary or of another reversionary beneficiary;
- the capital value of the annuity or pension and the income from it cannot be used as security for a borrowing;
- payments of the annuity or pension must be made at least once annually; and
- the payments in a year (other than by way of commutation) must be within the maximum and minimum limits calculated in accordance with Schedule 1A of the SIS Regulations.

(SIS Regulations 1.05(4),(5); 1.06(4),(5))

Allocated pension payments are taxed in the same manner as superannuation pension or rollover annuity payment, with a deduction for the undeducted purchase price and rebate calculated in the same manner as outlined above. However, they do not satisfy the conditions for complying superannuation pensions or annuities set out in Income Tax Regulations 53J and do not count for the pension RBL.

Schedule 1A of the SIS Regulations sets out the drawdown factors for allocated pensions. Those factors were calculated on the following basis:

- the minimum drawdown factor is based on the pension valuation factor for a CPI indexed lifetime annuity with an 85% reversionary factor for the person's age at 1 July each year; and
- the maximum drawdown factor is based on the pension valuation factor for a non-indexed single annuity payable to age 80 based on the person's age at 1 July each year.

Commutations of allocated pensions are treated as ETPs.

RIMHYPO calculates allocated pension payments based on the minimum and maximum drawdown limits set out in Schedule 1A of the OSS Regulations. The model calculates commutation payments as being equal to any amount in excess of the maximum payment limit. At this stage, RIMHYPO does not include any taxation treatment of commutations of allocated pensions.

Eligible termination payments

Eligible termination payments are defined in Section 27A(1) of the ITAA and include:

- retirement, termination and similar payments made in consequence of the termination of the taxpayer's employment. These payments include ex gratia termination payments from an employer and payments from a superannuation fund (except pension or annuity payments) or approved deposit fund; and
- payments from the commutation or residual capital value of a superannuation pension and certain annuities (including deferred annuities) are also treated as ETPs.

This definition includes all of the accumulated superannuation benefits in RIMHYPO.

Eligible termination payments consist of the following components:

- the *concessional component*, which is that part of the ETP attributable to a bona fide redundancy payment, approved early retirement scheme payment or invalidity payment. From July 1994 these components are exempt from tax.

- Invalidation payments are defined in Section 27G of the ITAA and equal:

$$\frac{AB}{C}$$

where:

A is the amount of the ETP;

B is the number of whole days from the time the employment was terminated until the “last retirement date” of the person. The last retirement date is the date by which the person’s employment would normally end (eg where there is a compulsory retirement date) but for invalidity or in the absence of such a date, age 65;

C is the sum of the person’s eligible service period for the benefit in days (see below for details of eligible service period) and B.

- An invalidity payment is only payable if the person is certified by 2 medical practitioners as no longer ever being able to perform any employment for which that person is reasonably qualified because of education, training or experience. This definition under Subsection 27G(b)(i)(A) is effective from 1 July 1994 and is much more restrictive than the previous definition which related invalidity to the person’s particular employment.
- *undeducted contributions*, which are that part of the superannuation benefit comprising contributions made after June 1983 for which no deduction was allowable to any person. These will generally only equal the members own non-deductible contributions. This component is not taxable.
- the *non-qualifying component*, which is an anti avoidance provision which can effectively be ignored. It deals with the commutation of annuities that do not wholly consist of rolled over ETPs. *RIMHYPO does not model this component*;
- the *excessive component*, this is the amount of an ETP that the ISC determines exceeds the person’s reasonable benefit limit entitlement. This component is taxable at the highest marginal tax rate plus Medicare levy (see the section on RBL above);

- the *pre-July 1983 component*, which arises where the ETP is attributable to days of service before 1 July 1983. This component is calculated according to the following formula:

$$(ETP - C - NQ - EC) \times \frac{\text{Pre-1 July 1983 eligible service days}}{\text{Total eligible service days}}$$

where:

ETP is the amount of the ETP;

C is the amount of the concessional component;

NQ is the amount of the non-qualifying component; and

EC is the amount of the excessive component.

- the eligible service period of an ETP for this calculation is the period starting at the start of the earliest employment or period of membership of any element of the benefit being paid;
 - 5% of the pre-July 1983 component of the ETP is included in the person's assessable income and taxed at marginal rates. (ITAA Section 27C)
- The *post June 1983 component* is equal to the amount of the ETP reduced by all of the other components. The taxation of this component is discussed below.

RIMHYPO divides superannuation payments into the undeducted contributions, the pre-July 1983 component and the post-June 1983 component. RIMHYPO deals with concessional components [arising as a result of invalidity] but ignores those arising from redundancy or bona fide early retirement and the non-qualifying component.

The post June 1983 component of an ETP may comprise further elements. These are:

- the *untaxed elements of the post-June 1983 component*. Essentially, these are those parts of the post June 1983 component of a benefit that are not paid from a taxed superannuation fund, approved deposit fund or as a consequence of the commutation of a rollover annuity or which are specifically nominated as "untaxed elements" by the fund under Section 27AB(4). These payments represent the part of the post-June 1983 component of a benefit that are either paid directly by an employer or in respect of which the 15% contributions tax was not paid. Generally such components will only arise in respect of ETPs paid by untaxed superannuation funds (mainly public sector funds) or directly by employers.
- the *taxed elements of the post-June 1983 component*. These are those parts of the post June 1983 components paid from taxed superannuation funds, ADFs or as commutations of annuities. They represent payments from sources liable to the 15% tax on contributions, hence the term "taxed".

These elements are fully included in the taxpayers assessable income (Section 27B, ITAA) and the tax assessed is then reduced by a rebate of tax under Subdivision AAA of Part III of the ITAA. The rebate reduces the tax paid on each dollar of ETP income to an amount equal to the lesser of the tax payable at the person's marginal rate of tax and the tax payable under the ETP tax scales. This is a very complex calculation involving a rebate rate equal to the difference between each income tax rate and each ETP tax rate. The ETP tax rates are applicable to the elements of the post-June 1983 components are:

	Taxed elements	Untaxed Elements
Below ETP threshold	0%	15%
Above ETP threshold	15%	30%
Before age 55	20%	30%

(ITAA, Section 159SA)

RIMHYPO models the tax on the *taxed elements of the post-June 1983 component* of ETPs by calculating the tax on the ETP as the lesser of tax at the ETP tax rate and tax at marginal rates for each dollar of ETP income. The code works by determining the point on the tax scale where ETP tax commences to be payable and then calculating the tax from that point. This entails a different equation for each marginal tax rate in the model, depending upon where the ETP commences to be taxable.

Because the RIMHYPO ETP tax code *does not* deal with *untaxed elements of the post-June 1983 component* at this stage, RIMHYPO does not yet model ETPs paid from untaxed superannuation funds.

Ordinary investment income - interest bearing accounts

RIMHYPO allows users to assume an after tax ETP and other savings of a person may be invested in a number of ways, including in a ordinary savings account or in interest bearing securities.

Where the person invests in such accounts the interest income is included in the person's assessable income under Section 25 of the ITAA as ordinary income in the year it is derived. The amount included in assessable income is the actual interest paid, and is unaffected by the deeming of interest on amounts held in low interest accounts for the Social Security Income test. Withdrawals from such an account are not assessable income of the person.

RIMHYPO allows for two interest bearing accounts for a person. The first is a savings account from which the person withdraws an amount equal to the interest earnings only. The second is an investment account from which a range of withdrawal options are allowed. In both account types, RIMHYPO includes the full amount of the account interest in the person's assessable income, upon which tax is then assessed at marginal rates of tax.

Ordinary investment income - capital gainings assets

RIMHYPO allows users to assume some or all of an after tax ETP and other savings of a person may be invested in capital gaining assets. Such assets generally yield their return in the following ways:

- regular income payments, such as rents or dividends; and
- the capital appreciation of the asset.

Rents on property assets or other income arising from asset ownership are included in the recipient's assessable income under Section 25 of the ITAA with deductions allowed under Section 51(1) of the ITAA for any expenses incurred in earning that income.

Similarly, any dividend income on assets such as shares is included in the recipient's assessable income and deductions are allowed for expenses in incurring the dividend. However, where the dividend is derived from a taxable Australian resident company that has paid Australian company tax, the dividend may be "franked" with dividend imputation credits. Where this occurs, the taxpayer's assessable income is "grossed up" by the amount of the imputation credit and the franking rebate amount deducted from the tax payable by the taxpayer on total assessable income (Division 6, Part IIIA, ITAA). The dividend imputation system ensures company income distributed as dividends to resident shareholders is only taxed once, at the shareholder's marginal rate of tax.

The imputation credit received by a shareholder on a dividend is equal to:

$$\text{DIV} \times \% \text{Franked} \times \frac{\text{CR}}{(1-\text{CR})}$$

Where:

DIV is the amount of the dividend payment;

%Franked is the percentage proportion of the payment notified to the shareholder in a statement from the company in respect of which the shareholder is entitled to an imputation rebate; and

CR is the applicable general company tax rate (currently 33%).

(Section 160AQT, ITAA)

RIMHYPO allows users to model rents and dividends by setting a rate of return for regular income payments from assets and by allowing users to specify the franked proportion of such payments. RIMHYPO then calculates the amount of imputation rebates using the formula above and includes the grossed up amount in the person's assessable income. The imputation rebate is then deducted from the tax assessed on the person's taxable income.

Capital gaining assets also provide a return to the individual in the form of the appreciation in the capital value of the assets. Capital gains on the disposal of assets which were acquired after 19 September 1985 and which are held for 12 months or more are taxed under Part IIIA of the ITAA. The Capital Gains Tax (CGT) provisions tax only the “real” component of realised capital gain.

Assets acquired before 20 September 1985 are exempt from the CGT, as is a person’s principal residence and up to 2 hectares of adjacent land. Gains on all assets disposed of within 12 months of purchase are fully assessable under Section 25.

The CGT works as follows:

- when an asset is acquired, the purchase price becomes its cost base. This cost base is then indexed by the quarterly CPI;
- when the person disposes of the asset:
 - if the sale price exceeds the nominal purchase price, a capital gain amount equal to the greater of the sale price less the indexed cost base or zero arises in the year in which the disposal occurred;
 - if the sale price is less than the nominal purchase price, an amount equal to the difference between the nominal purchase price and the sale price is allowed as a capital loss, the nominal value of which the taxpayer may offset against any capital gains in that or subsequent income years.
- Where a capital gain amount arises in an income year the tax payable is subject to notional averaging. The tax payable is calculated as being five times the tax payable on one fifth of the gain, if one fifth of the gain is added to the taxpayer’s assessable income in the year concerned. This calculation assumes the capital gain amount included in assessable income is the last element in the taxpayer’s assessable income. The effect of this calculation is to reduce the extent to which a “lumpy” capital gains are taxed at higher marginal tax rates.

RIMHYPO allows users to specify a rate of capital gain on capital gaining assets acquired at retirement, calculates an indexed cost base and calculates the tax on the disposal of such assets allowing for the effect of averaging. RIMHYPO does not model trading in assets. Rather it assumes people acquire their capital gaining assets as investments on retirement and dispose of those assets as necessary in order to achieve a target level of gross income.

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