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TAXATION INSTITUTE of AUSTRALIA
IT'S ESSENTIAL

9th August 2006

General Manager
Superannuation, Retirement and Savings Division
The Treasury,
Langton Crescent
PARKES ACT 2600

Email: simplersuper@treasury.gov.au

Dear Sir

**A Plan to Simplify and Streamline Superannuation**

The Taxation Institute of Australia (Taxation Institute) is pleased to provide the attached comments and feedback on the Treasury's *A Plan to Simplify and Streamline Superannuation* (the Plan) released in May this year. The Plan provides details of the Government's announcement in the 2006-2007 Federal Budget to simplify and streamline Australia's superannuation regime.

The Taxation Institute strongly supports the objectives of the Plan to simplify superannuation arrangements for retirees, improve incentives to work and save and introduce greater flexibility in how superannuation savings can be drawn down in retirement.

However, as a result of our consultations with Treasury in Melbourne on 27th June 2006, it was also apparent that there are a significant number of important issues that need to be clarified before the Plan is committed to legislation, which we understand will be before the end of this year.

In this regard, the Taxation Institute is particularly concerned that any reduction in the complexity and increase in the tax effectiveness of superannuation's end benefits under the Plan are not at the cost of increased complexity and cost in the other areas, such as contributions. Although we suggest some transitional rules, we acknowledge that for reasons of simplicity it may not be possible to take up all of these.

Therefore, the focus of our submission is on identifying a range of key issues that need to be resolved before the Plan is committed to legislation and in providing constructive comment, that will assist Government in meeting the Plan's stated objectives.

Our submission follows the structure of the Plan, noting that there are no specific comments on Chapter 1, which essentially summarises the remainder of the Plan or Chapter 9 because we endorse the portability and lost member register proposals contained therein.

If you have any queries regarding the content of our submission, please contact Dr Michael Dirkis, the Taxation Institute's Senior Tax Counsel, on 02 8223 0011.

Yours faithfully

Andrew Mills
President

**Taxation Institute of Australia**

**Submission in respect of**
**A Plan to Simplify and Streamline Superannuation**

Set out below are the comments and recommendations of the Taxation Institute of Australia (Taxation Institute) in respect of the following chapters of *A Plan to Simplify and Streamline Superannuation*:

## CHAPTER 2 – TAXATION OF BENEFIT PAYMENTS

In relation to the proposed taxation of benefits there are three key areas that require comment and further guidance:

- whether the proposed changes do in fact provide incentives for workers to remain in the workforce and to also retain funds within the superannuation environment;
- the way in which the new rules operate in the event of the death of a member; and
- other general issues.

### 2.1 Incentives

The abolition of employer ETPs from 1 July 2007 is likely to encourage many senior employees to retire from the workforce before 1 July 2007, rollover their employer ETPs into superannuation and then draw the benefits from the fund once they reach the age of 60.

While the retention of tax on benefits paid before 60 provides an incentive for individuals to remain in the workforce, the removal of such tax on benefits for those over the age of 60 lessens the incentive for workers to remain in the workforce and retain funds within superannuation.

The suitableness of any form of work test should be explained in the context of the overall framework. The relevant ages (ie 65 for the work test and 75 being the date beyond which no contributions can be made) are ages that are becoming less reflective of society and tend to make the rules unnecessarily complex, particularly in an environment where encouraging people to remain in the workforce and retain funds in superannuation are the key objectives.

In this context, the following issues need to be clarified in the proposed legislation:

- the status of disability pensions if they are received by someone under 60 years of age – (e.g., will they remain tax free?);

- indexation of the new contribution limits and employer ETP limits; and

- whether there is any change foreshadowed in the eligible person test under s.82AAS; and

- what will be the level of superannuation savings protected from a bankruptcy perspective and if the RBL figure is to be used will this be indexed? For those with transitional RBLs, will this figure be retained as the amount protected for bankruptcy purposes.

Rather than the existing, relatively complex, transitional rules concerning undeducted contributions, it is recommended that a simple lifetime limit be considered. This is particularly important for small business owners looking to exit their arrangements and make contributions (in addition to anything contributed via the small business capital gains tax concessions) to superannuation for their retirement.

The artificial and relatively small limitations on undeducted contributions penalise unnecessarily people who have not historically made contributions to superannuation. We would recommend that, subject to transitional relief on those who had commitments pre-12/5/2006 and overseas transfers and other exceptional cases, the proposed limits stay in place as indexed.

### 2.2 Payment of death benefits

There is an unnecessary inequality in relation to funds withdrawn prior to death and distributed to a non-dependant under a will (which would be tax free), as compared to the same person dying with their funds in superannuation, which would be taxed when paid to a non-dependant.

If the goal is to ensure people retain funds within superannuation for as long as possible there should be no distinction between payments on death from the fund to dependants or non-dependants from a tax perspective.

In this context, it should be clarified in the proposed legislation if the rules are to be retained concerning the payment of benefits to non-dependants and, in relation to the prohibition on the payment of a pension to a non-dependant, the treatment of existing pensions that revert to a non-dependant.

### 2.3 Low rate threshold

With reference to the low rate threshold with payments in excess of this amount taxed at 15%, it is recommended that the low rate threshold be indexed.

### 2.4 General issues

In addition to the above matters relating to incentives, the payment of death benefits and the low rate threshold, the following issues require clarification:

- it is unclear on the current material whether people under the age of 60 will still be required to report details of ETPs and pensions;

- the interrelationship between the new superannuation rules and the bankruptcy legislation. A comprehensive approach is required in relation to this issue;

- similarly from a family law perspective, the interrelationship between the new rules and the Family Law rules needs to be explained with reference to provisions such as the splitting arrangements;

- further clarification is also required in relation to the framework of contributions from a taxation perspective and what the ramifications will be for contributions made in excess of the thresholds nominated. Similarly, the penalties that will arise if the thresholds are breached need to be clear. A specific example in relation to a breaching of thresholds relates to undeducted contributions and in particular how the earnings on the excess contributions will be determined if there are savings via multiple funds for a member or segregated assets within the same fund;

- the treatment of resident and non-resident funds should be clarified in the context of the new rules and the desire to provide incentives for workers to continue in the workforce and retain funds within the superannuation environment;

- It appears that the rate of tax payable on excessive contributions paid from a taxed source (38% - Schedule 7 Part I 1(a)) not been adjusted to reflect the changes in the tax rates. Will this rate be adjusted?

## CHAPTER 3 – PAYMENT RULES SIMPLIFIED

### 3.1 Withdrawal arrangements

The Taxation Institute supports both the retention of existing rules on voluntary withdrawal, and the abolition of compulsory withdrawal requirements.

### 3.2 Proposed pension rules

In general we support the simplification of pension rules and the move to one type of pension, which is commutable at will (except during the transition to retirement period). We also support the proposed arrangements for transition to retirement pensions.

The proposal noted that the new pension rules would provide for only one reversionary pensioner on death. The Taxation Institute is concerned that this may pose some difficulties in the event that there are several dependants, particularly if there are minors or dependent children.

We recognise that if newly commencing pensions are commutable at any time, those receiving existing income streams may be at a comparative disadvantage. The Taxation Institute would support appropriate changes to permit commutation of existing pensions if the pension provider and the pensioner both agree to the terms.

## CHAPTER 4 – SIMPLIFIED CONTRIBUTION RULES

Noting that the Taxation Institute supports the overall objectives of the Plan, set out below are a number of areas within the Plan relating to the payment of contributions, which appear to contradict one or more of the Plan's objectives in the following areas:

- deductible contributions;
- undeducted contributions;
- the reporting associated with both measures; and
- miscellaneous issues relating to contributions.

### 4.1 Deductible contributions

In summary, the Plan proposes that:

- the existing age based deductible contribution limits (which operate on a per *employer* for employees) are to be removed and replaced with an *individual* limit of $50,000 per annum;
- deductible contributions in excess of $50,000 will be taxed at the top marginal tax rate of 45% (whereas contributions above the age based limits are currently subject to no additional tax within the superannuation fund but are not tax deductible to the contributor);
- the self employed (or more specifically, those claiming a personal tax deduction for their superannuation contributions under s82AAT of the Income Tax Assessment Act 1936 (ITAA 1936)) will be treated in the same way as above. In other words, they will receive a full deduction for contributions up to the relevant limit rather than a partial deduction which currently applies; and
- transitional arrangements will apply to those who reach 50 before 30 June 2012. Essentially, they will be entitled to a higher limit ($100,000 pa) until 30 June 2012 once they turn 50.

The Taxation Institute's concerns in relation to this measure relate primarily to the size of the new limit and its impact on certain individuals' ability to save effectively for their retirement.

Naturally the purpose of imposing any limits at all is to ensure that particularly wealthy individuals are not able to secure unlimited benefits from a highly concessional system. The Institute can appreciate that concern. However we believe that the proposed system contains potential flaws.

In comparison to the existing rules this change:

- represents an increase in the amount of tax concessional contributions that can be received by taxpayers who are less than 50 years old (for those aged between 35 and 50 in 2006/2007 it represents an increase of approximately 20%); but

- represents a decrease in the amount of tax concessional contributions that can be received by taxpayers who are over 50 years of age (in comparison to the existing age based limits for those aged over 50 in 2006/2007 it represents a massive decrease of over 50%).

The majority of individuals in Australia retire on a combination of the government funded age pension and the balance derived from compulsory minimum superannuation guarantee payments. Whilst other improvements in the superannuation system that result from the overall policy thrust of the Plan (eg, reduction in taxation and complexity) may result in some increases in voluntary superannuation contributions, the biggest constraint on the size of these additional contributions will be an individual's personal cash flow needs rather than any statutory restriction.

This means that for the vast majority of Australians the proposed changes to the treatment of tax deductible contributions will have no impact on the amount of tax concessional superannuation contributions made in their lifetime.

There is another (smaller) group of Australians who are largely self-funded in retirement. These individuals are also constrained by cash flow and for most people in most years, this will be a greater constraint than the statutory limit.

However, in our experience, many self funded retirees are able to add significantly to their savings via superannuation contributions at particular points in time. For many, it is in the years leading up to retirement – and this is specifically recognised in the current age based system which allows much higher contributions after age 50. Even the current system, however, fails to recognise that not all individuals are the same – some experience their key saving opportunities at younger ages and both the current and proposed systems significantly hamper the ability of this sector of the community to contribute to superannuation tax effectively.

The Taxation Institute believes that the proposed changes may actually result in those who would be self funded retirees contributing *less* to superannuation than the current system.

By ignoring this uneven pattern of earnings, the proposed system favours the wealthy. Not only will this group be able to make use of the $50,000 deduction limit every year, they are also unlikely to be deterred by the penal tax rate of 45%[1] being applied to contributions over the limit. If they are already top marginal tax rate payers, contributing in excess of $50,000 will still:

- enable them to avoid medicare on the contributed amount; and

- ensure that a higher amount is ultimately saved within the concessional superannuation environment.

For example, a very high income earner could contribute $150,000 pa undeducted contributions, plus unlimited tax deductible contributions (albeit only the first $50,000 would be taxed at 15% and the remainder would be taxed at 45%). The fact that the excess deductible contributions are not subject to any limit makes them extremely attractive for those who would be paying top marginal tax rates anyway.

We believe that the following alternative measures should be considered:

- limited number of opportunities to exceed the $50,000 limit. Identify an appropriate higher limit (say $100,000 pa) and allow this limit a set number of times over an individual's lifetime (eg 5). The appropriate regulator (presumably the ATO) would not need to record the specific deductions claimed indefinitely into the future, it would simply be important to

[1] Note that we have assumed this tax rate would apply to contributions *instead of* (rather than *in addition to*) the normal 15% contributions tax. In other words, an additional 30% tax would be levied at some point.

track the number of times an individual had legitimately exceeded the normal $50,000 limit; or

- lifetime limit on "excess" deductible contributions. A slight variation would be to permit all individuals a set amount (say $250,000) to be contributed on a tax deductible basis over and above the normal $50,000 limit for their lifetimes. While this undoubtedly represents a more complex solution than the current proposal, it is no more complex from a record keeping perspective than the records currently required to track an individual's use of his "low rate threshold" on ETPs. The ATO currently maintains a lifetime record of this threshold; or

- extend the transitional arrangements for those over 50 in the five years ending 30 June 2012 (ie, where the proposed concessionally taxed deductible contribution limit is $100,000) indefinitely. Additionally, consideration could be given to taxing any contributions in excess of the $100,000 concessional cap at a lower rate.

Note that the first two suggestions remove the need for concessional arrangements for taxpayers over 50 before 30 June 2012.

## 4.2 Undeducted contributions

In summary, the Plan proposes:

- a cap of $150,000 pa is to be applied to post-tax superannuation contributions;

- a three year "bring forward" process is to apply to enable large one off payments totalling $450,000 over any (cumulative) three year period – ie, effectively taxpayers are able to bring forward up to two years' contribution limits; and

- any contributions found to exceed the limit will be returned with interest. The interest will be taxed at the highest marginal rate (45%)

The Taxation Institute has a number of concerns about this proposal, which are outlined below.

### *4.2.1 The limit should not have been imposed immediately*

As outlined above, many individuals are only in a position to begin seriously accumulating for their retirement in the years leading up to that retirement.

Even though a "bring forward" process has been proposed, the experience of our members suggests that a great many individuals have been caught mid-stream by the Budget announcements and have had to seriously amend their retirement plans as a result.

The Taxation Institute is concerned that the immediate imposition of this measure on 10 May 2006 has potential inequitable results. Accordingly, we recommend the following alternatives:

- no cap to be applied until 1 July 2007 and for this to be announced immediately; and/or

- defer the introduction of this cap for an even longer period for those over age 50.

### *4.2.2 The bring forward / averaging concession adds significantly to the complexity of the package*

The Taxation Institute is concerned about the potential complexities flowing from this proposal, both for individuals to understand and for the relevant regulator (presumably the ATO) to police.

While it is technically a “prospective” provision – ie, one brings forward future entitlements rather than “catching up” years in which the entitlement was not used – it will naturally need to be measured in retrospect.

Doing the calculation correctly will require the ATO to look back significantly more than three years, as the following example illustrates:

**Example of “bring forward” provisions**

| | |
|---|---|
| 2005/06 | $200,000 |
| 2006/07 | $200,000 |
| 2007/08 | $200,000 |
| | This exceeds $450,000 so a refund of $150,000 will be required. Presumably will be made in 2008/09 (although this will depend on timing) |
| 2008/09 | $200,000 contributed and $150,000 refunded – net $50,000 |
| 2009/10 | $250,000 |
| | At this point, contributions over last three years is ($200,000 + $50,000 + $250,000) = $500,000 suggesting a refund of $50,000 is required. In fact, however, the refund in 2008/09 presumably should have “wiped the slate clean” – so all that is relevant is whether the 2008/09 and 2009/10 contributions ($200,000 + $250,000 = $450,000) are over the $450,000 limit – which they are not. |

#### *4.2.3 The work test requirement for the “bring forward” provisions is unnecessarily draconian*

The “Post-tax contributions” Fact Sheet issued by Treasury on 13 June 2006 provides several examples of how the proposed averaging / bring forward provisions will work.

Importantly, that Fact Sheet indicates that any contributor bringing forward an undeducted contribution limit from one or more future years must be able to meet the relevant tests to make a contribution in each of those future years. This is presumably designed to ensure that a contributor aged (say) 64 and retired could not contribute $450,000 immediately before turning 65.

A situation could easily arise where the intention of the individual at the time they make the contribution is that they will meet the work test during those years but they subsequently find (possibly through no fault of their own) that they have not met those conditions. In this scenario the “excess” contributions are to be returned and the interest generated upon them taxed at the top marginal rate. Consider the following examples:

- a member (of any age) dies shortly after making a large contribution;
- those who are over 65 during a year that they have “brought forward” their entitlement could easily have their plans derailed by serious illness, illness of a partner, illness of another family member, retrenchment).

In contrast to the stated objectives of the Plan this approach to the “work test” is potentially very complex and inequitable. The Taxation Institute recommends in the interests of simplicity and equity that the work test is only applied at the time the contribution is made.

### 4.2.4 *Disposal of a small business*

For many small business owners their business is their "superannuation". The cash flow needs of their business will often mean they are unable to make substantial contributions to superannuation until they dispose of their business at the end of their working lives. They are also significantly affected by the need to meet the "work test" for several years after 65 if the business is sold shortly before (or even after) their 65th birthday.

In order to mitigate the impact of the new measures on small business owners, the Plan states that rollovers of "CGT exempt components" from the sale of a small business will be exempt from the cap.

However, situations will arise where a substantial portion of the disposal proceeds from a small business cannot be contributed into superannuation because they were not subject to CGT in the first place. This could arise because:

- a business was sold for (say) $1.5m (but only $500,000 was subject to capital gains tax) when the business owner was 64 years of age and who subsequently permanently retired. Assuming the 15 year exemption and the goodwill exemption do not apply but assuming the individual tax payer was entitled to a 50% discount, only $250,000 of the proceeds will be subject to CGT. Based on our understanding of the current proposal this would mean that only $400,000 (ie, $250,000 CGT exempt rollover and $150,000 undeducted contribution) of the business proceeds could be rolled over/contributed into the superannuation system; or
- a pre CGT business was sold which means the disposal will not be subject to capital gains tax at all. All contributions subsequently made from proceeds of this disposal will therefore be subject to the cap.

These examples illustrate the potential inequitable impact of the proposals and we suggest that all proceeds received from the disposal of a small business (whether the proceeds have been subject to CGT or not) are exempt from any superannuation contribution cap or perhaps subject to an overall maximum amount.

### 4.2.5 *Treatment of overseas transfers*

Transfers from overseas superannuation funds enter Australian funds as undeducted contributions. The measure may potentially (depending on the form of implementation) place a cap on those rollovers despite the fact that:

- individuals have a very limited (6 month) window in which to transfer their foreign superannuation on a tax effective basis; and
- under the law applying in many foreign jurisdictions, individuals cannot bring their overseas superannuation to Australia unless the full amount is placed in an Australian fund and "preserved" – effectively forcing the individual to make the contribution.

The Taxation Institute recommends that those transferring funds from overseas superannuation funds are in a unique position and the amount of their foreign superannuation should be excluded from the undeducted contribution limit.

### 4.2.6 *Calculating the earnings on the excessive contributions*

One possible alternative to ameliorate the complexities of calculating the earnings on excessive contributions is to develop a statutory formula in order to determine the amount of earnings on the excessive contributions. A statutory formula is necessary to ensure that:

- a uniform approach is undertaken;
- all members across all funds are treated equitably;
- members will be able to verify the calculation; and
- administration of the system can be simple and straightforward for all industry participants without creating onerous administration complexities for all concerned (as was the case with the superannuation surcharge, discussed further below).

The Taxation Institute also suggests that Treasury considers:

- the imposition of a statutory interest rate. In practice, the mechanics of the earnings calculation performed across different funds (and often across individual members) varies substantially, for example, some funds allocate actual earnings, others adopt a weighted average, others hold reserves for "smoothing" purposes and apply a formula. A statutory interest rate will ensure that administration of the system can remain straightforward and is less open to manipulation. We recognise that in some instances, this may result in the interest being repaid exceeding the interest actually earned. Hence a maximum amount of the member's account balances across all superannuation funds should be refunded;
- stipulating that the calculation method includes pro-rating the interest calculation for the number of days in the year that the superannuation fund has held the contribution. We would expect that contributions held for a longer period in the superannuation fund would have earned more than contributions held for a shorter period. We would also support a "last in first out" approach in deciding which contributions are being refunded and therefore how much interest applies on the basis of simplicity and transparency; and
- an "amnesty period" during which over contributions can be voluntarily repaid with no interest (say 2 weeks after the year end). This would be designed to assist those who contribute an excessive amount in error.

Furthermore, it would not be appropriate to issue a blanket penalty (ie, effectively set the interest at a fixed % of the excess contributions for all taxpayers) as this ignores the possibility that taxpayers may exceed the limits entirely by accident.

### 4.2.7 *Taxing the interest on earnings on the excessive contributions*

When excessive undeducted contributions are returned "with interest" this interest will be taxed at 45% in the hands of the recipient (ie, the contributor – although see our comments on contribution splitting in "Miscellaneous issues" below).

Note, however, that if the interest relates directly to the actual earnings of the fund rather than a statutory rate, those earnings will already have been taxed at 15% within the fund itself. Hence, if a 45% tax rate is simply applied to the interest received by the contributor, the total tax extracted will be 53.25% (ie, 1 – (1-0.15)*(1-0.45)).

If this is not the government's intention, any interest returned to the contributor should perhaps be taxed at 35.3%. This is calculated as (1 – (1-.45)/(1-.15)).

### 4.3 Reporting and payment of assessment notices

There are three stages to the reporting process as set out below. However, the third is the most problematic and our submission focuses in particular on the third stage.

#### *4.3.1 Reporting stage 1 : Who reports the raw data (ie, how much was contributed) and to whom?*

In our view, this is logically done by the receiving superannuation funds as part of the existing "Superannuation member contributions statement". This statement would need to be modified to encompass the following:

- the reporting requirements of the Government co-contribution scheme;
- the proposed concessionally taxed deductible contribution regime; and
- the proposed cap on the level of undeducted contributions.

It is also suggested that the existing "Superannuation member contributions statement" should be modified to remove various redundant and/or unnecessary items.

We acknowledge that there are other approaches, for example:

- notices from employers (with annual Payment Summaries) as to the amount contributed on a pre-tax basis and the amount remitted after tax (although this would be difficult for employers contributing to defined benefit funds) could be issued to members for inclusion with their personal returns; and
- notices from funds (with annual member statements) could be issued to members also for inclusion with their personal returns.

On balance, however, the reporting is most appropriately *prepared by* the relevant fund and *issued to* the ATO.

#### *4.3.2 Reporting Stage 2 : who consolidates this information, ascertains whether or not there has been an over contribution and instigates the appropriate assessment?*

This task is most appropriately performed by the ATO and it is necessary for sufficient resources be allocated to the ATO to carry out this task to ensure that the errors and anomalies, which plagued the superannuation surcharge reporting, are not replicated in this new reporting.

An example of the type of statement (along the lines for deductible contributions) that could be issue by the ATO is set out below:

| **Fund Name** | **Fund ABN** | **Amount of deductible contributions received** |
|---|---|---|
| XYZ Superannuation Fund | 123 456 789 | $35,000 |
| ABC Superannuation Fund | 987 654 321 | $25,000 |
| Total deductible contributions | | $60,000 |
| Deductible contribution limit | | $50,000 |
| Deductible contributions in excess of limit | | $10,000 |
| Additional contribution tax required (@30%) | | $3,000 |

For undeducted contributions, the ATO would need to expand this statement to include multiple years to demonstrate how the excess over $450,000 was calculated. It is recommended that the ATO would advise the amount of the excess contributions but the calculation of the interest component would be carried out at the Fund level. This is discussed below.

### *4.3.3 Reporting Stage 3 : to whom is the assessment issued and who has responsibility for having it paid?*

Under the surcharge regime, assessments were issued to funds and the fund then either:

- paid it;
- advised the ATO that the member had transferred to another fund so that the ATO could issue a revised assessment to that Fund.

This system was cumbersome and imposed a significant burden on both the ATO and the various funds. We suggest that under the new regime:

- assessments prepared by the ATO are first issued to the member, noting that the assessment for deductible contributions would include a precise amount of tax to pay while assessments for undeducted contributions would simply indicate the amount of the excess);
- members would not be permitted to pay assessments personally (applicable to deductible contributions only) as this would permit enormous scope for leaving more funds in the superannuation environment than intended;
- members would be required to pass these assessments to their chosen fund within a specific timeframe. The ATO would need to provide a suitable form for this purpose that permitted multiple funds to each pay part of the assessment / refund part of the contributions; and
- the Funds would then be required to make payments to the ATO (or the member, in the case of excess undeducted contributions).

A weakness of this system is the potential administrative burden on funds (ie, they would be receiving multiple assessments at different times for payment to the ATO). It may therefore be appropriate for members to return the assessments to the ATO indicating which funds should make the payments and for the ATO to then pass a consolidated assessment to funds say once each quarter.

However, this issue is more appropriately addressed by trustees of large superannuation funds as they would experience the most significant increase in workload.

Most importantly, we believe the responsibility for having the assessment paid should rest with the member. If they nominate a fund which is no longer able to pay their assessment (because, say, benefits have been transferred out), some type of penalty / disincentive should apply.

## 4.4 Miscellaneous issues

The following additional issues are noted in relation to contributions:

- the contribution splitting legislation will require some amendment to allow for the new limits on both deductible and undeducted contributions. For example, it is currently possible to “split” up to 85% of deductible contributions in favour of the contributor’s spouse. If those contributions are to be subject to 45% tax instead, the original contributor may be able to engineer a situation where he or she does not have a sufficiently large balance to pay the tax. The same applies to refunding excess undeducted contributions. Perhaps contribution splitting should only be permitted with some agreement from the “receiving” spouse that his or her account will be adjusted for any excess tax (deductible contributions) or refunded contributions (undeducted contributions). It is noted that it is not practical to try and also report splitting information to the ATO so that the assessment can be directed immediately to the spouse because contribution splitting can occur as late as 30 June the following year;

- changes will be required to all pensions commencing after *budget night 2006* to permit commutations for the purposes of refunding excessive undeducted contributions (with interest). A similar change will be required for pensions starting after 1 July 2007 which are partially commuted to meet additional tax assessments in relation to deductible contributions. This will not be necessary for many pensioners as they will be receiving the new "unlimited" pensions proposed by the budget (which place no limits on commutations in any case) but will still apply to those who start "old style" pensions after 1 July 2007 (eg lifetime annuities etc) or who are under 60 and receiving pensions under the transition to retirement rules; and

- Given that the changes to deductible contributions, is there any benefit in continuing s82AAT or should all taxpayers simply be entitled to a personal tax deduction on their contributions, up to the new limit?

## CHAPTER 5 - CONTRIBUTION INCENTIVES FOR THE SELF-EMPLOYED.

In light of our recommendations to the then Minister for Revenue and Assistant Treasurer, Mal Brough, in October 2005 for the need for reform to redress superannuation discrimination against the self-employed and his subsequent undertaking in a letter to the Taxation Institute (29 November 2005) that he would undertake to have our recommendations taken into account as part of the 2006-07 Budget considerations, the Taxation Institute is strongly supportive of the proposals in the Plan to improve contribution incentives for the self-employed.

Therefore, the purpose of our submission in respect of Chapter 5 of the Plan is to highlight further opportunities for reform to address the significant and varied ways in which the existing superannuation tax system continues to discriminate against the self-employed.

There are still a number of areas within our superannuation laws where self-employed taxpayers are treated relatively more harshly than employee taxpayers. There is no definition of a "self-employed" person within either of the Income Tax Assessment Acts but there is clear discrimination in a number of areas between "working" taxpayers who have employers and "working" taxpayers who do not. We are not aware of any policy reasons as to why this should be the case and in relation to some of the older provisions the situation would appear to have arisen by accident.

The Taxation Institute believes that the analysis below highlights the breadth of this problem and urge the Treasury to reform the discriminatory treatment of self-employed persons as soon as possible.

### 5.1 Taxation consequences of invalidity payments

#### *5.1.1 Personal tax issues*

Certain tax concessions are provided to certain individuals who receive a superannuation payment on becoming seriously disabled. In brief, a disabled person may become entitled to have part of their benefit classified as a post 1994 invalidity component which is tax free.

However, s 27G of the ITAA 1936 (which triggers the creation of a post 1994 invalidity component) requires the taxpayer to have received the payment "in consequence of the termination of any employment". The ATO interpret this as cessation of employment as an employee rather than cessation of gainful employment in the broader sense. The ability to receive a post 1994 invalidity component can provide employed taxpayers with a significant tax benefit relative to their self-employed colleague.

The following example illustrates the point.

Facts:

- The taxpayer meets the definition of "permanent incapacity" within the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS);
- The taxpayer has received written opinions from two legally qualified medical practitioners that he cannot ever be employed again in any capacity for which the taxpayer is reasonably qualified by reason of education, training or experience;
- The taxpayer receives a payment of $200,000 from his superannuation fund on 1 July 2005;
- The taxpayer's date of birth was 1 July 1960; and
- The taxpayer's eligible service start date was 1 July 1983.

| | **Employee Taxpayer** | **Self employed taxpayer** |
|---|---|---|
| Gross benefit | | |
| • Post 94 invalidity | $95,238 | $0 |
| • Normal taxable | $104,762 | $200,000 |
| Total | $200,000 | $200,000 |
| Tax | | |
| • Post 94 invalidity | $nil | $nil |
| • Normal taxable | $22,524 | $43,000 |
| Total | $22,524 | $43,000 |
| Net benefit | $177,476 | $157,000 |

The self-employed taxpayer is around $20,000 worse off and has paid around 100% more tax on his invalidity payment than his employed colleague.

### *5.1.2 Superannuation fund tax issues*

In addition to the difference in tax treatment between the two individual taxpayers there is also a significant potential difference in the tax position of the paying superannuation funds.

S279B of ITAA 1936 permits the trustee of a complying superannuation fund to claim a tax deduction for a portion of the death and /or disability ETP if all of the relevant conditions within the section have been met. The portion of the payment that may be claimed as a tax deduction by the superannuation fund is calculated in the same way as a post 1994 invalidity component so the tax deduction and the post 1994 invalidity component will be the same size.

However, one of the conditions that must be met in order for the superannuation fund to claim any deduction for a death or disability payment is that the ETP must be paid "in consequence of the termination of any employment of the member". The same issues arise here as in s.276.

Therefore, using the example above, the fund that made a disability payment to the employee taxpayer may be entitled (subject to meeting the relevant conditions in s 279B) to a tax deduction of $95,238 whereas the fund which made a disability payment to the self-employed taxpayer may not be entitled to any deduction. Whilst this deduction may not be of any immediate value to the superannuation fund it may (at the very least) result in a tax loss that can be carried forward and offset against the fund's future assessable income. In the SMSF environment where the disabled member's spouse may well continue working and making superannuation contributions this tax loss will be of significant value.

## 5.2 Eligible service periods

The pre 1 July 1983 component of an ETP received by a taxpayer generally receives significantly greater tax concessions than a post 1 July 1983 component of an ETP.

In order to have a pre 1 July 1983 component the taxpayer must be able to establish an eligible service start date that pre-dates 1 July 1983. There are several ways in which a taxpayer could achieve this but one of the most common is where a taxpayer has been working for the same employer for many years and the commencement date with that employer pre-dates 1 July 1983. However, if a taxpayer has been running the same business as a self-employed person for the same period they will not be entitled to any pre-1 July 1983 service because their activities as a self-employed taxpayer are not taken into account when determining their eligible service period.

Once again this can be significantly detrimental to the self-employed taxpayer and another simple example illustrates the point. We have listed out below certain facts that are attributable to two different taxpayers. The point we are trying to make is that their circumstances are identical apart from the fact that one individual has always been "employed" and the other individual has always been "self-employed.

The facts common to both individuals are as follows:

- gainfully employed continuously since 1 July 1965. The employee taxpayer has been working for the same employer since that date and the "self-employed" taxpayer has been working in his own business as a self-employed person since that date;
- they have never received any previous amounts that have been assessed against their RBLs;
- the first superannuation contributions made on their behalf were made on 1 July 1991;
- they have $50,000 in undeducted contributions in their balance;
- the rest of their superannuation balances are normal taxable superannuation;
- they were both top marginal rate taxpayers in 2005/2006; and
- they both retired on 1 July 2005 and received a superannuation ETP of $500,000.

The following table illustrates the difference in tax treatment on the ETP between the two taxpayers.

| | **Employee Taxpayer** | **Self employed taxpayer** |
|---|---|---|
| Gross Benefit: | | |
| Pre-July 1983 | $224,967 | $0 |
| Post June 1983 | $225,033 | $450,000 |
| Undeducted contributions | $50,000 | $50,000 |
| Total | $500,000 | $500,000 |
| Tax | $21,177 | $52,841 |
| Net Benefit | $478,823 | $447,159 |

Despite the fact that both taxpayers had been in the workforce for exactly the same amount of time and all other relevant facts about their circumstances were the same the self-employed taxpayer has $31,664 less capital available to him for the purposes of funding his retirement.

Once again the Taxation Institute is not aware of any policy reason behind this differing treatment of the two taxpayers.

## 5.3 Retirement

Current proposed arrangements do not change the rules as to when individuals can voluntarily choose to access their superannuation moneys, ie, individuals would still be able to access their superannuation once they reach preservation age and have retired, and from age 65 where they have not retired.

### *5.3.1 What is retirement?*

For SIS purposes, there are two definitions of retirement. The definition under SIS reg 6.01(7) as alluded to by the above paragraph, depends on the age of the member. To be retired:

- for members who are aged between 55 and 60 years, the arrangement under which the member is gainfully employed must have ceased and the trustee must be reasonably satisfied that the member intends never to again become gainfully employed for more than 10 hours a week; and
- for members who are aged 60 or over, an arrangement under which the member is gainfully employed must have ceased. However, the trustee is not required to have a bona fide belief that the member never intends to be gainfully employed for more than 10 hours in a week.

Therefore, to summarise the current position, where a member is between 55 and 60, it is necessary for that person to generally terminate all their gainful employment.

However, where the member is 60 years or over, to be considered retired for SIS purposes, the person just needs to change their employment arrangement, ie, one employment arrangement has ceased and another has begun with a different employer.

The problem is that the criteria hinged on ‘employment’ and this is discriminatory to those who are self-employed and passive investors (who have never been gainfully employed). These taxpayers have far greater difficulty retiring to unlock their preserved superannuation savings, eg, a primary producer who seeks to access their super other than by way of a transition to retirement pension must give up their entire primary production business.

# CHAPTER 6 - AGE PENSION ARRANGEMENTS

## 6.1 Status of other types of complying pensions

The Plan states at Section 6.2.2 that

> The current 50 per cent assets test exemption for 'complying' income streams would be removed from 20 September 2007..........This change would only apply to income stream products purchased on or after 20 September 2007......

The Plan also states at Section 3.2.2 that

> The new minimum standards for pensions commencing on or after 1 July 2007 would require.....” and “Pensions that meet existing rules and commenced before 1 July 2007 would be deemed to meet the new minimum standards” and “Guaranteed lifetime pensions provided on an arm's length basis that meet relevant existing requirements would continue to be acceptable.

In light of the above, further clarification is required as to whether other types of complying pensions that meet existing rules effected between 1 July 2007 and 19 September 2007, inclusive, will also be deemed to meet the new simplified minimum standards for pensions.

## CHAPTER 7 - OTHER MEASURES

### 7.1 Low rate threshold for employer ETPs

The Plan states at Section 7.1.2 that

> The taxable component......would be taxed at 15 per cent for amounts up to $140,000 for recipients aged 55 and over and at 30 per cent for those aged under 55. Amounts in excess of $140,000 would be taxed at the top marginal rate.

In respect of benefits from untaxed sources, the Plan states at Section 8.2.1 that

> …the post-June 1983 untaxed element of a benefit paid from an untaxed scheme would be taxed at 15 per cent up to $700,000 (approximately the lump sum RBL) and the top marginal tax rate above that amount.

The Taxation Institute believes that the proposed low rate threshold of $140,000 for employer ETPs is far too low and recommend that it be increased to $700,000 to match the low rate threshold for payments from an untaxed scheme. We further recommend that the proposed low rate threshold for employer ETPs be indexed in accordance with movements in AWOTE.

### 7.2 Transitional arrangements for employer ETPs

The Taxation Institute believes that there are many existing contractual arrangements, entered into prior to 9 May 2006, where termination of employment is contracted to occur on or after 1 July 2007. The terms of these contracts have been agreed based on the current treatment of employer ETPs.

Many individuals in such contracts will, therefore, be disadvantaged by the proposed treatment of employer ETPs. An increase in the proposed low rate threshold, as discussed above, would reduce the impact somewhat for such individuals.

Also, many individuals will terminate employment on or before 30 June 2007, but the employer ETP will not be paid until on or after 1 July 2007.

To address these concerns, the Taxation Institute recommends that:

- transitional arrangements for employer ETPs are be available where contractual arrangements were in place as at 9 May 2006 and termination is scheduled for on or after 1 July 2007; and
- transitional arrangements will apply in cases where termination of employment occurs on or before 30 June 2007, but the employer ETP is not paid until on or after 1 July 2007.

### 7.3 Rollover of employer ETPs to superannuation

Employer ETPs are currently able to be rolled over into superannuation. The Plan states at Section 7.1.2 that

> …it is proposed that employer ETPs would no longer be able to be rolled over into superannuation.

As mentioned above, there will be cases where termination of employment occurs on or before 30 June 2007, but payment of the employer ETP is not made until on or after 1 July 2007.

The Taxation Institute recommends that transitional arrangements be available to allow rollover of employer ETPs into superannuation on or after 1 July 2007, where the termination of employment occurred on or before 30 June 2007.

### 7.4 Tax File Numbers

The Plan states at Section 7.2.1 that

> ...in cases where a tax file number has not been quoted to a taxed fund, the top marginal rate of tax would apply where taxable contributions to that fund for a member exceed $1,000.

The Taxation Institute recommends that the contributions threshold of $1,000 is indexed to AWOTE.

There will be instances where a tax file number has not been quoted, tax has been deducted at the top marginal rate and the tax file number is then subsequently quoted to the fund, possibly in a later financial year. In this regard, further clarification is sought from Treasury as to whether or not retrospective adjustment of the contributions tax deducted will be permitted in such cases.

The Plan states at Section 7.2.3 that

> ....where a tax file number is not quoted only the post-June 1983 component (the taxable element) would be subject to withholding at the top marginal tax rate...

The Plan also states at Section 2.2.1 that

> All lump sum payments from a taxed source to an individual aged 60 or over would be tax free when paid.

In this regard, further clarification is sought from Treasury as to whether or not withholding at the top marginal rate will apply to benefits from a taxed source paid to individuals aged 60 or over where a tax file number has not been quoted.

## CHAPTER 8 – UNTAXED SCHEMES

### 8.1 Benefits received by members of untaxed schemes aged 60 or over

Pension benefits received from an untaxed scheme are currently not eligible for a 15% rebate, whereas pensions from a taxed source are eligible for a 15% rebate. It is proposed that as from 1 July 2007, pensions received from an untaxed scheme will be eligible for a 10% rebate, whereas pensions received from a taxed source will be tax free. Likewise, lump sums received from an untaxed source are taxed at a higher rate than those received from a taxed source.

The above arrangements highlight the fact that members of untaxed schemes have been, and will continue to be, disadvantaged compared to members of other schemes or funds.

A fundamental rule of taxation policy is that all taxpayers should be treated equitably. The taxation of superannuation benefits should be the same for all taxpayers regardless of how their benefit has been funded. That is, the taxation of benefits under the present and future arrangements should not be determined by such matters as whether the benefit is from a defined benefit fund or accumulation fund, whether the fund is a government sponsored fund or a private sector fund, and whether the fund has previously been subject to tax.

In the case of untaxed schemes, the issue as to whether the fund has been subject to tax is generally a matter between separate arms of the Commonwealth, or a matter of public policy and funding between the Commonwealth and the States. Accordingly, this should not be a factor for determining the basis of taxation of superannuation benefits received by retired public servants.

The terms of employment of those persons was such that they received salary and other benefits, together with superannuation benefits on retirement. Similarly, persons employed in the private sector received salary and other benefits, together with superannuation benefits on retirement. The free enterprise system encompassing mobility of employment and market forces ensures that the relevant packages and pre-tax retirement benefits have been equitably determined. Therefore the basis of taxation of superannuation benefits should be the same for all retired persons regardless of the source of those benefits.

The reform proposals when implemented will deliver significant taxation advantages to high net worth individuals with substantial accumulated superannuation benefits in taxed schemes, including excess benefits under the existing arrangements. The average pension benefit received from an untaxed scheme would be significantly less than that received by such persons.

It is noted that on page 45 of the Plan that only 10% of all superannuation fund members are members of such schemes and the majority of such schemes are now closed to new members. Accordingly, the cost of extending full tax free status to both pensions and lump sums received from untaxed schemes should not be significant in comparison to the total cost of the overall reform proposals.

It is recommended that benefits received by members of untaxed schemes aged 60 or over should also be tax free as from 1 July 2007.

A further issue for consideration is that other investment income received by members of taxed schemes is likely to attract little or no tax after 1 July 2007, whereas the same level of income received by a member of an untaxed scheme will be taxed at the member's effective marginal rate. This is due to the impact of the proposed tax free status of pension income for members of taxed schemes versus the rebate arrangements for members of untaxed schemes.