

**A Plan to Simplify and Streamline Superannuation –
Submission from G A Dunsford FIAA and D B Wickham FIAA**

4 August 2006

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

Dear Mr Lonsdale,

AN EQUITABLE SUPERANNUATION TAX SYSTEM

It has been widely agreed that ideal tax systems meet the objectives of simplicity for understanding, efficiency of collection and equity between taxpayers.

The elimination of tax on benefits taken after age 60 under the Treasurer's Plan clearly meets the objective of simplicity. In also eliminating the complexities of its determination and collection, it also represents a clear improvement in efficiency. However, we are concerned that it fails to meet the general objective of equity between taxpayers. Moreover, it is significantly regressive.

We note that only a minority of those currently retiring actually pay tax on their benefits. Consequently, the elimination of such tax provides no advantage to the majority of retirees

The superannuation tax system has always favoured the higher income earners throughout its many changes over the years. The elimination of tax on benefits therefore increases the degree of inequity in the system.

We also note that there are many other areas where further simplification is desirable.

This submission suggests possible **additional** measures to those in the Plan that may be made to achieve an equitable and even simpler system – and they could be introduced without any transitional arrangements.

A further advantage of the suggested measures is that benefits accumulated from the 9% SG contributions would be increased for all members – thereby assisting the general aim of improving the adequacy of retirement benefits.

We would be happy to expand on our submission at your convenience.

Yours sincerely,



Geoff Dunsford
3 Lindel Place
Lindfield NSW 2070
Telephone 02 9416 6944 / 0411 297 627



Darren Wickham
22 Parkview Rd
Fairlight NSW 2094
02 9977 1717 / 0408 900 095

AN EQUITABLE SUPERANNUATION TAX SYSTEM

This submission focuses on additional measures to those in the Treasurer’s Plan, that may be introduced easily to eliminate the inequity between members on different incomes under the superannuation tax system. The measures would also result in further simplification of the system.

Summary

Main Features:

A comparison of the main features of the suggested system with the current system and the Treasurer’s Plan is as follows:

- Current System*
- tax relief for deductible contributions paid by self employed; employer contributions (including salary sacrifice) not taxed in the hands of the employee – so that the employee effectively receives tax relief on them
 - 15% tax on contributions and investment income received in superannuation fund (10% on capital gains); and
 - tax at various concessional rates on benefits paid in excess of a tax free threshold, currently \$135,590;
 - Government co-contributions for lower earners.
- Treasurer’s Plan*
- As above, but with no tax on any benefits paid after age 60.
- Equitable System*
- **No** personal tax relief for contributions; employer contributions treated as taxable income; (effectively all contributions become “undeducted”);
 - **No** tax on contributions and investment income received in the superannuation fund;
 - **No** tax on benefits paid;
 - Government co-contributions for lower earners.

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Equitable System

The system presented above recognises that super contributions paid by an employer, whether or not on a salary sacrifice basis, could reasonably be considered as part of the employee's remuneration. Hence, without the current tax rules, the contributions would be part of taxable income.

Contributions invested on this basis would then carry no tax advantage. Investment of those contributions in a tax free fund would provide an equitable tax incentive – ie, the investment returns would be proportionate to the contributions invested.

With benefits tax free, again equitable outcomes are achieved.

Increased Benefits for Most Members

On reasonable assumptions, over a working lifetime of 40 years, financial outcomes under the Equitable System for workers on incomes up to \$75,000 pa. are higher than those under the Treasurer's Plan.

Thus the around 90% of all workers with such incomes would have increased benefits on this basis.

Adequacy Improved

By eliminating the tax on contributions, the Equitable System enables the 9% Superannuation Guarantee contributions to generate higher benefits for all members than under the either the current system or the Treasurer's Plan.

This assists the general aim of improving the adequacy of retirement benefits.

Impact on Members' Personal Tax

While the removal of fund taxes will ultimately provide satisfactory financial outcomes, the immediate impact of introducing the Equitable System will be the withdrawal of tax concessions on (deductible) contributions – leading to an increase in personal tax payable.

It is estimated that the suggested additional measures will increase the Budget surplus by around \$7.5bn pa, and growing. This could be used to adjust the personal income tax scale to offset or ameliorate the personal tax increases - at least for the 65% of workers on less than average earnings.

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Advantages of Equitable System

- Provides a “level playing field” for members with different taxable incomes – the tax benefits are proportionate to the contributions invested;
- Investment in a tax free fund provides significant tax incentive to encourage voluntary contributions
- Provides simplicity for superannuation funds - no taxes on contributions, investment income, capital gains; no provisions for unrealised gains and no complex unit price adjustments;
- Provides further simplicity for members – no two tiered system of contributions; more comprehensible system generally – which should generate increased enthusiasm and support for the superannuation system;
- No need for transitional measures: the removal of personal tax relief and contributions tax can take place simultaneously from the beginning of a particular tax year, putting all members in the same position;
- No need for special provisions for spouse contributions or income splitting;
- No concern with potential re-contribution strategies abusing the system (which will exist for those still working after age 60 when benefits become payable on a tax free basis under the Treasurer’s Plan and partial draw down is permitted);
- Reduces need for further changes to the superannuation tax system;
- Improves adequacy under the Superannuation Guarantee arrangements without increasing the 9% contribution rate.

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Current System

The inequity in the current system arises mainly as a result of the different rates of personal tax relief effectively available on (deductible) contributions.

Subject to quite high limits, contributions paid by employers are not taxable in the hands of employees; this facilitates employees sacrificing part of their salary in order to increase their contributions through their employers. Effectively, employer contributions are paid out of pre tax income and are equivalent to obtaining personal tax relief on those contributions. Self employed members are able to obtain tax deductions for contributions paid directly (subject to some restrictions).

After allowing for the 15% contributions tax, the net tax concession for those on different levels of taxable income are as follows:

Taxable Income (\$)	9% Contribution (\$)	Personal Tax Relief (%)	Contributions Tax (%)	Current Net Tax Concession	
				(%)	(\$)
20,000	1,800	16.5	15	1.5	27
50,000	4,500	31.5	15	16.5	743
80,000	7,200	41.5	15	26.5	1,908
150,000	13,500	46.5	15	31.5	4,253

This position could be justified if benefits payable from superannuation funds were taxed at the same marginal rates, ie they were treated as deferred income.

In practice, there are a myriad of tax concessions, and most retirees pay little or no tax on their benefits.

This structure is highly regressive, and arguably, significantly inequitable.

All members enjoy the additional benefits of the application of the concessional tax rate of 15% tax on investment earnings (10% on capital gains) during the accumulation period, and zero tax when the fund is supporting pension payments. This exacerbates the inequity in the financial outcomes.

Those members with retirement proceeds less than the tax free threshold of \$135,590 pay no tax on their benefits. Above this level, tax is paid on a concessional basis, albeit varying in highly complex ways according to a range of grandfathered conditions following previous changes to the system, and whether a lump sum or pension is taken.

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Treasurer's Plan

Under the Plan, benefits paid for all members would become tax free.

This measure is significantly beneficial to those with higher benefits; however there would be **no** improvement for those with benefits below the current tax free threshold of \$135,590 – ie, the majority of those currently retiring.

According, while generally welcome, the Treasurer's Plan **increases** the regressive nature of the system and the degree of inequity.

Equitable System

It is suggested that the superannuation tax system is further simplified as follows:

(1) Remove the personal tax relief applying to contributions by self employed members, and that effectively applying to employees in respect of employer contributions; employer contributions would be included in taxable income.

(2) Remove the contributions and investment income tax on superannuation funds.

These additional measures would have the effect of producing a superannuation tax system where there would be:

No personal tax relief for contributions; employer contributions would be treated as taxable income; (effectively all contributions become “undeducted”);

No tax on contributions and investment income received in the superannuation fund;

No tax on benefits paid.

Apart from the clear further simplification, the tax concessions would become equitable as between members with different taxable incomes. The tax concessions would comprise simply the application of a zero tax rate on investment earnings (with imputation credits paid), so that the tax benefit would always be proportionate to the amounts invested.

The tax free investment environment, together with the Government's co-contribution scheme for lower earners, would provide appropriate incentive for all individuals to save for retirement.

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Impact on Members

Comparison Process

The projected benefits under the Equitable System would **automatically be larger** than under the Treasurer’s Plan for the same contributions. This is because no tax would be deducted from either the contributions or the investment returns.

This increase in projected benefits under the Equitable System is a result of the shift of the tax burden out of the superannuation system and on to the individual. It may be argued that this represents a forced increased in saving as disposable income is reduced by the increased PAYG incurred, but the resulting net amount going into superannuation will be larger.

Therefore, to ensure a fair comparison between the Treasurer’s Plan and the Equitable System, we have adjusted for this amount of “forced saving”. A reasonable way to do this is to adjust the contribution under the current system by “grossing up” by the member’s effective tax relief, ie at his or her marginal tax rate. This is equivalent to “salary sacrificing” the difference, and has the effect of putting the member in the same “net cost of contribution” position under both systems.

For example: assuming salary \$50,000, 9% contribution of \$4,500 “grossed up” at 31.5%
= $\$4,500 / (1 - .315) = \$6,569$

Item	Current System		Equitable System
	Basic 9% contribution	“Grossed Up” contribution	
Cash Salary	\$50,000	\$47,931	\$50,000
Superannuation Contribution	\$4,500	\$6,569	\$4,500
Total Remuneration	\$54,500	\$54,500	\$54,500
Personal PAYG Tax (before tax relief for employer contributions)	\$12,518	\$12,518	\$12,518
Tax relief for employer contributions	\$1,418	\$2,069	Nil
Net PAYG	\$11,100	\$10,449	\$12,518
Net Cost of Contribution = Superannuation Contribution Less Tax Relief	\$3,182	\$4,500	\$4,500

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Assumptions

The following comparisons assume superannuation contributions of 9% of taxable income and the proposed personal tax scale for 2006/07.

Superannuation fund investment earnings after expenses, are assumed at the rate of 8% pa including 1% from imputation credits. A 4% pa inflation rate has been assumed for earnings; this has also been used to convert final benefit numbers to 2006 dollars. All tax thresholds are assumed to be indexed at 4% pa.

Benefits Comparison after 40 years

Current Taxable Income	Marginal Tax Rate (+ medicare levy)	Treasurer's Plan	Equitable System
\$20,000	16.5%	\$138,000	\$171,000
\$50,000	31.5%	\$421,000	\$429,000
\$80,000	41.5%	\$788,000	\$686,000
\$160,000	46.5%	\$1,582,000	\$1,372,000

Overall, the numbers suggest that long term benefit outcomes under the two systems are likely to be broadly equivalent.

The Equitable System provides higher benefits than those under the Treasurer's Plan for the members with taxable incomes of \$20,000 and \$50,000. But it generates lower outcomes than the government's Plan for those whose incomes exceed around \$80,000 – ie when the marginal tax rate increases to 41.5%. This is due mainly to the withdrawal of the effective tax relief on contributions under the suggested system.

Benefits Comparison after shorter periods

For example: 20 years

Current Taxable Income	Marginal Tax Rate (+ medicare levy)	Treasurer's Plan	Equitable System
\$20,000	16.5%	\$48,000	\$53,000
\$50,000	31.5%	\$147,000	\$132,000
\$80,000	41.5%	\$275,000	\$211,000
\$160,000	46.5%	\$554,000	\$422,000

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While arguably it is the 40 year working lifetime that is most relevant period over which to compare the systems, it is noted that the Equitable System outcomes are lower over the 20 year period for those with marginal tax rates of 31.5% and higher.

Indeed in the first year, the loss of effective tax relief on contributions would be felt keenly by members, as employees would be required to pay tax on their employer’s contributions for the first time.

Government Budget Impact

Approximate calculations estimate that the impact of the suggested measures in the current year would be:

- Removing personal tax relief on employer contributions – additional revenue \$15.0bn.
- Removing superannuation fund taxes – additional expenditure \$7.5bn.

Thus the suggested measures would increase the Budget surplus by around \$7.5bn in the first year.

The table below illustrates the projected fiscal impact of superannuation taxes (and the tax expenditure as a result of the elimination of personal tax relief on employer and self employed contributions):

Year Ended 30 June	Tax Revenue as a Proportion of GDP					
	Contributions Tax	Investment Tax	Benefits Tax	Total Super Tax ¹	Personal Tax Relief on Contributions ²	Net Budget Impact of Super ³
2007	0.50%	0.20%	0.05%	0.75%	-1.50%	-0.75%
2025	0.51%	0.45%	0.19%	1.15%	-1.43%	-0.28%
2040	0.49%	0.59%	0.33%	1.40%	-1.37%	0.03%

A conclusion that can be drawn from the table is that the most significant superannuation tax measure impacting on budget outcomes are not the superannuation taxes, but the tax expenditure as a result of personal tax relief on employer and self employed contributions. The main beneficiaries of this tax relief are high income earners.

¹ Total Super Tax (including Contributions Tax, Investment Tax and Benefits Tax) reproduced from the Institute of Actuaries of Australia paper “Tax-free superannuation benefits: a future revenue problem?”

² Estimates by Darren Wickham

³ Excludes tax expenditure on concessional investment tax

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“Spending” Additional Surplus

The additional Budget surplus could be utilised in making (further) adjustments to the personal tax scales to provide the majority of members with some compensation for paying tax on their contributions.

One option would be to adjust the tax thresholds to ensure that all those on less than average earnings are fully compensated for the tax on the contributions.

Based on the ATO’s taxable income bands, we have calculated that the average taxable income for workers is currently around \$43,000 pa. About 65% of workers have incomes less than this; (somewhat more than half due to the skewing of incomes towards the higher end).

Possible adjustments to the tax bands to provide for all those earning less than \$43,000 pa to pay no more personal tax under the Equitable system than currently, and for the estimated Budget cost to be no more than \$7.5bn, are as follows:

Rate of Tax	Current Taxable Income Band	Proposed Taxable Income Band
0	Up to \$6,000	<i>Up to \$8,600</i>
15%	From \$6,001 to \$25,000	<i>From \$8,601 to \$30,600</i>
30%	From \$25,001 to \$75,000	<i>From \$30,601 to \$62,000</i>
40%	From \$75,001 to \$150,000	<i>From \$62,001 to \$150,000</i>
45%	\$150,001 and over	<i>From \$150,001 and over</i>

In addition, it is assumed that the low income tax offset threshold would be increased from \$21,600 to \$23,600 to cover the taxing of 9% contributions.

For those whose taxable incomes are above \$43,000, gradually increasing additional tax as income increases would be payable. This is consistent with the planned intention to make the system fairer.

Even so, it is not until an income of around \$61,000 that the additional tax exceeds the 15% contributions tax currently payable (on 9% contributions). For those with higher incomes, it is worth relating the excess to the reduction in tax enjoyed as a result of the change in tax scales from 2005/06 to 2006/07.

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Examples of the effect of the above proposals are shown below: (\$)

Taxable Income (1)	Additional Personal Tax (tax saving) (2)	Tax on 9% contributions saved (3)	Net Excess Tax (tax saving) (4) = (2) - (3)	2005/06 to 2006/07 tax saved (5)
20,000	(103)	270	(373)	365
30,000	(379)	405	(784)	910
40,000	(96)	540	(636)	510
50,000	188	675	(487)	510
60,000	711	810	(99)	510
75,000	2,771	1,013	1,758	1,950
100,000	3,705	1,350	2,355	2,700

Thus those on higher incomes would still be paying less tax overall than in 2005/06 – and investing their contributions in a tax free fund. In the context of moving to a superannuation tax system which deliberately “levels the playing field”, this outcome for those on higher incomes could be considered quite reasonable.

The suggested tax scale is, of course, only one of a range of options. Moreover, the Government reviews the personal income tax scale every year to determine their desired level of progression in the tax rate bands, as well as to assist meeting Budget requirements.

Contribution Limits

Under the Treasurer’s Plan, annual contribution limits are \$50,000 “deductible” plus \$150,000 “undeducted”.

Under the Equitable system, where all contributions are treated similarly, ie, as undeducted, it could be argued that the logical maximum annual contribution is made equal to the sum of the Treasurer’s Plan annual contribution amounts, ie \$200,000.

The focus of the analysis in this note has been on comparing financial outcomes from making “deductible” contributions. We have noted that broadly equivalent benefits are achieved over a working lifetime under both the Treasurer’s Plan and the suggested system.

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Undeducted contributions under the Treasurer's Plan are invested in a fund on the basis that the investment income is taxed at 15% (realised capital gains taxed at 10%) during the accumulation period.

Under the suggested system, this tax is reduced to zero. This would provide a significant extra benefit for undeducted contributions over time.

Consequently, if the suggested system is implemented, the government may wish to review contribution limits.

Maximum/Minimum Draw Down

Need for Maximum and/or Minimum Draw Down

Successive Governments have generally indicated that the purpose of allowing a generous tax treatment for the superannuation system is to encourage saving to meet expenditure during retirement.

The logic of this suggests that:

- A **maximum** benefit should apply each year to ensure that the benefits are not used up too quickly – ie they should ideally last until death, thereby minimising the need for government welfare support; and
- A **minimum** benefit should be drawn down each year so that benefits are spent during retirement as far as possible, rather than left for children and others – ie, it is reasonable to ask other taxpayers to support the population's retirement needs – but not personal estate planning.

Minimum Draw Down

It is suggested therefore that there should be a requirement for a minimum draw down of superannuation benefits from an age when virtually all people will have retired – say age 75.

Arguably, the minimum draw down at age 75 would logically be the initial annual pension payable for life assuming indexation at the expected rate of increase in average earnings, able to be purchased with the whole of the member's superannuation benefits at that date. For administrative purposes, a factor could be prescribed which approximated to such a pension, capable of being purchased in the market place over a recent period. For convenience, the same factor could apply for both males and females, being an average of the two calculated separately.

For those reaching age 76, the same approach could be adopted for the minimum benefit to be taken at that age, ie application of a suitable pension factor based on the lifetime indexed pension purchasable in the market at that age with the then remaining superannuation benefits.

And so on, as the person gets older.

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This approach could provide the following draw down scale at the present time. This scale is compared with the proposed minimum pension scale in the Treasurer’s Plan.

Age	Minimum Draw Down % Value of Benefits	
	Suggested	Treasurer’s Plan
75	7.4	6.0
80	9.8	6.0
85	13.5	10.0
90	18.9	10.0
95	26.5	14.0

It is noted that minimum draw down factors for allocated pensions to be introduced next year produce amounts that are close to the suggested scale. Accordingly, such factors could be adopted for the minimum draw down from age 75 under the suggested system, regardless of how the draw down is effected.

It is suggested that, in the absence of any instruction from the member, the superannuation provider pays out the minimum draw down benefit.

Maximum Draw Down

The Treasurer’s Plan does not impose any maximum benefit to be taken in any year. This will provide flexibility to meet the occasional large expenditure – like a car or retirement home bond or major home improvement.

However, there remains the possibility that some retirees will spend a major part of their superannuation benefits in the early years of retirement, knowing that the Government will provide an Age Pension and other “safety net” benefits. It is possible that a future Government may need to introduce some measures to restrict the dissipation of superannuation proceeds.

Transitional arrangements?

We suggest that the additional measures could be introduced without the need for any transitional arrangements (other than possibly in relation to any change to contribution limits and the personal income tax scale).