AUSTRALIAN **B**ANKERS' **A**SSOCIATION **I**NC.

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Mr John Lonsdale
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Dear Mr Lonsdale,

'A Plan to Simplify and Streamline Superannuation'

Please find attached the Australian Bankers' Association (ABA) submission on the Federal Government's *A Plan to Simplify and Streamline Superannuation*.

The ABA welcomes the proposals as a package of reforms designed to reduce complexity and increase flexibility of the superannuation system as well as encourage greater superannuation and private savings for Australians.

We support the policy principles guiding the proposals. It will be important to ensure that the required technical changes to superannuation, taxation and social security legislation effectively deliver the objectives of the proposals and maximise the opportunity to reduce administration burdens and compliance costs.

It will also be important that the changes made are certain and provide stability so that, particularly younger Australians, trust that the savings incentives offered by these reforms are robust and enduring. A stable system will make it easier for consumers to understand superannuation and make informed savings and investment decisions.

The ABA would be happy to discuss any of the issues raised in our submission with you further. Please contact me or Diane Tate, Director, Corporate & Consumer Policy on (02) 8298 0410: dtate@bankers.asn.au.

Yours sincerely

David Bell

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David Bell

Submission on 'A Plan to Simplify and Streamline Superannuation'

9 August 2006

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‘A Plan to Simplify and Streamline Superannuation’

1. Executive summary

The Australian Bankers’ Association (ABA) welcomes the opportunity to provide comments on the Government’s *A Plan to Simplify and Streamline Superannuation* as announced by The Hon Peter Costello MP, Treasurer, on 9 May 2006.

As part of the 2006 Federal Budget, the Government announced a number of proposals that represent the most significant changes to superannuation and retirement incomes policy since the introduction of compulsory superannuation.

The ABA commends the Government on its vision and welcomes the proposals as a package of reforms designed to reduce complexity and increase flexibility of the superannuation system as well as encourage greater superannuation and private savings for Australians.

The ABA strongly supports the policy principles guiding the proposals. It will be important to ensure that the required technical changes to superannuation, taxation and social security legislation effectively deliver the objectives of the proposals and maximise the opportunity to reduce administration burdens and compliance costs.

The ABA has assessed the changes to the superannuation and retirement incomes system from four policy principles:

- Do the changes *simplify* the superannuation and retirement incomes system, reduce complexity for consumers and lower administrative burden and cost for providers?
- Do the changes increase *flexibility*, so that retirees can select and use products and strategies to meet their changing needs across retirement?
- Do the changes improve the *adequacy* of retirement incomes, by encouraging greater superannuation and private savings, so that Australians are more likely to achieve the living standards they expect in retirement?
- Do the proposals help to improve financial *literacy* and consumer understanding, so that retirees are more able to take control of their superannuation and retirement income decisions?

In addition to these four policy principles, it is important that the changes foster competition and avoid economic distortions for savings and investment products.

The ABA acknowledges the proposals as building on other recent amendments to superannuation and retirement incomes policy, including ‘Super Choice’ and transition to retirement. These ‘retirement incomes choice’ proposals will further enhance Australians’ ability save for the future and determine what savings and investment choices best suit their needs pre and post retirement.

Private saving in Australia (as in other Anglo-American countries) has been in decline for over a generation. Some commentators have pointed out that, were it not for our superannuation system, the decline would be rather worse. It is critical that changes to the superannuation system encourage private saving. The ABA believes that this package will lift confidence in the superannuation system, which will directly encourage additional savings.

Finally, it will be important that the changes made are certain and provide stability so that, particularly younger Australians, trust that the savings incentives offered by these reforms are robust and enduring. A stable system will make it easier for consumers to understand superannuation and make informed savings and investment decisions.

2. Background

'Three pillars policy'

The three basic pillars of Australia's retirement income system are:

- Age pension funded by Government revenue;
- Compulsory superannuation contributions (9% of earnings); and
- Incentives to encourage private saving for retirement.

It is important for Australians to have confidence in the superannuation system, including the continuance of the age pension as part of the overall retirement income system. The World Bank continues to affirm multi pillar retirement incomes systems as sound policy.

The ABA supports Australia's sustainable three pillars retirement income system.

Incentives to save and plan

Importantly, the ABA believes that Australians should have incentives to save and plan for their future. Reducing complexity and increasing flexibility will go a long way to removing barriers to early saving and retirement planning.

As we said in our submission to the House of Representatives Standing Committee on Economics, Finance and Public Administration on its inquiry into improving the superannuation savings for people under age 40:

> "Understanding the factors that influence younger peoples' decisions about superannuation, savings and investment will be important for determining how best to target savings messages, encourage greater superannuation contributions and promote greater voluntary and private savings. Ultimately, improving superannuation savings by encouraging voluntary superannuation and other private savings will assist in closing the retirement savings gap…"

Reducing complexity and increasing flexibility will lead to greater confidence in the superannuation system, which in turn will lead to greater interest and commitment in saving and planning early for retirement and benefits for private and national savings.

The ABA believes that the proposals will enhance Australia's retirement income system, by encouraging greater compulsory superannuation and voluntary superannuation and private savings.

Encouraging private saving

Superannuation is a vital part of retirement incomes; however, other private savings are also important. Self-provision in retirement should be the aim of strategies for enhancing financial independence and retirement income adequacy. The ABA considers that as part of improving retirement income adequacy, incentives for superannuation and private savings should promote long-term savings and address current inequities between particular financial products and investments.

The proposals will go some way to encouraging diversified pre-retirement savings and post-retirement incomes and will supplement superannuation savings by enabling greater choice, financial independence and a higher standard of living in retirement. Improving the private savings environment will also reduce future fiscal pressure of Australia's ageing population.

Australia has a low level of deposits compared to other countries. Some evidence as to why deposits might be low in Australia was given when the report on *International Comparison of Australia's Taxes* ("Hendy/Warburton report") was released in April 2006. It showed that Australia has the highest top marginal tax rate on interest income amongst OECD countries[1].

One of the simplest means to protect against unforeseen circumstances (such as the loss of a job or the loss of a family member providing supporting income) is to encourage people to have a savings buffer and/or protect themselves against such unforeseen circumstances. For example, the Government could consider addressing current anomalies in tax treatment and introducing rebates for people that invest in life insurance or other risk products. It is important that disincentives are replaced with incentives for savings and investments.

The ABA suggests that Government could consider strategies for improving incentives for private savings and supporting development of risk products for increasing national savings, sustaining retirement incomes and managing age-related expenditure.

3. Benefits of the new superannuation system

The ABA welcomes the superannuation proposals as moving the high-level policy principles of *simplicity*, *flexibility*, *adequacy* and *literacy* into practice. We have long been an advocate of these policy principles. The ABA also believes the proposals will deliver other social and economic policy benefits, such as introducing consumer sovereignty and fostering competition.

3.1 Simplifying retirement incomes

Simplicity of superannuation: Do the changes simplify the superannuation and retirement incomes system, reduce complexity for consumers and lower administrative burden and cost for providers?

While supporting the basic design and vision of the Australian retirement income system, the ABA has in the past criticised Australia's three-stage taxation treatment of retirement savings. For the first time since 1988 - when superannuation taxes were imposed at all three stages of retirement saving - tax has been lifted completely from one stage.

Currently, retiree investment and income decisions are strongly directed by tax and social security incentives. The strength of incentives and penalties could amount to over-regulation, and indeed in some respects distortion of the retirement income system.

The ABA suggests that goals for the retirement income phase should be simple and clear, such as:

- Strategies, tools and products should help retirees spread their available income across retirement – subject to their needs and preferences.
- Strategies, tools and products should be able to be tailored to individual circumstances.

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[1] http://comparativetaxation.treasury.gov.au/content/report/downloads/CTR_full.pdf (p xxv)

- Strategies, tools and products should be flexible to adapt to the inevitable changes retirees will face.

The ABA considers the superannuation proposals will largely address these goals. The abolition of reasonable benefit limits (RBLs) and the changes to the assets test mean that retirees no longer face complex and cumbersome commutation rules. In particular, the RBL system added complexity and reduced understanding for consumers, as well as put heavy administrative burdens and compliance costs on providers, and thereby costs on every consumer. Reducing complexity and minimising administrative burdens and compliance costs should be a continuing goal for these and any future changes.

On the age pension side, the proposed changes will remove significant complexity from income stream assessment. Five different categories of income streams under social security legislation will be replaced with a single approach for all income streams.

The ABA applauds gains in simplicity, and encourages the legislative drafters to ensure that high-level simplification gains are translated into technical amendments. We would suggest a number of areas for attention, including:

- The social security means test rules do not need to list several income stream categories (as they do now). A single, basic list of criteria to qualify for the income test deduction would be sufficient - and would create a single category of income stream to replace multiple current categories.

- Similarly, *Superannuation Industry Supervision Act 1993* (SIS Act) and *Retirement Savings Accounts Act 1997* (RSA Act) regulations for income streams should be simple and streamlined. It would be useful if "complying" (or any such word) has a single meaning across SIS, RSA, income tax and social security legislation.

- Removal of grandfathering provisions to schedules attached to legislation and regulations, so that the current provisions are actually simple to read and understand.

- Cross-checking of regulations as they are drafted to ensure terms are equivalent in meaning.

The tax exemption on fund earnings for income streams remains as an appropriate incentive. In addition, the removal of many complex rules will simplify the system, which will result in greater consumer understanding and confidence in superannuation.

The ABA considers that:

- Removing tax from superannuation benefits represents a significant step forward for the Australian retirement income system. The legislative rules developed to implement this package of reforms should be consistent with simplifying and clarifying the system for consumers and providers.

- Abolition of RBLs will reduce complexity for consumers. A simplified system should reduce the administration and compliance burden on providers; however, some other potential administrative and transitional complexities may impact providers.

- Retirement income rules should be simple and consistent. Rules should promote a range of products, strategies and tools that will help retirees manage capital and income across retirement in ways that suits their needs, circumstances and preferences.

3.2 Increasing flexibility

Flexibility of retirement incomes: Do the proposals increase flexibility, so that retirees can select and use products and strategies to meet their changing needs across retirement?

Retirement can extend over 30 years and retirees' circumstances are certain to change over that time. The current rules tend to constrain both income and capital flexibility, especially in complying income streams. The new contribution rules, removal of tax from superannuation benefits, and income stream changes will improve flexibility.

In the contribution phase, the replacement of lower maximum deductible contribution limits (age-based limits) for people aged under 50 with a single limit of $50,000 will remove a barrier to higher early contributions. This will give people the flexibility to make higher contributions according to their earning and saving capacity. In addition to increasing flexibility, the ability to make higher contributions early in working life will significantly boost retirement savings through compounding investment returns. It will now be possible for young adults to make a head start on superannuation, and also perhaps allow them to ease contributions when individual or family disposable income is low, such as when paying off a HECS or HELP debt, saving for a mortgage or when children are young.

In preparing for retirement, people will have fewer constraints imposed on their options by complex rules. The nature of tax and age pension incentives tended to throw up a limited range of retirement income options, often a single strategy, regardless of the individual/couple's circumstances and desires.

In retirement, the tax and superannuation rules also put barriers in people's way. A prime example is onerous RBL assessment, which has acted as deadweight on options to switch providers - even though few retirees actually have any tax consequences of that reporting. Removal of the maximum annual drawdown and a simplified lower limit for all income streams will further boost retiree flexibility.

The flexibility offered by the new regime will allow retirees far wider scope to tailor retirement income choices to their needs, and to adjust their arrangements to suit changing circumstances.

The ABA considers that these proposals will increase flexibility, especially in retirement. It is important that retirees be able to tailor their retirement incomes and financial investments to their needs, circumstances and preferences.

3.3 Improving adequacy

Adequacy of retirement incomes: Do the proposals encourage greater superannuation and private savings as well as improve the adequacy of retirement incomes, so that Australians are more likely to achieve the living standards they expect in retirement?

Generally, Australians are still not planning early enough, or saving enough, for their retirement. It is vital that sustainable public policies provide incentives as well as address disincentives for superannuation and other private savings, to ensure optimum living standards in retirement.

Under the new superannuation system, Treasury forecasts an improvement in retirement income adequacy of $37,000 for an average income earner, which equates to $136 per week. This would be a noticeable improvement in retirement living standards and assist in addressing the 'retirement savings gap' in Australia. The ABA has not commissioned modelling to test these examples.

We note that a number of organisations have modelled the relative benefits of removing tax from contributions, earnings and benefits. This modelling suggests that removing contributions tax would achieve the largest improvement in retirement incomes adequacy.

Notwithstanding, removal of tax on superannuation benefits, coupled with the removal of the age-based limits and RBLs and replacement of these limits with the annual contribution limit, in effect establishes a lifetime cumulative limit that balances concessionality and accessibility.

These changes will enhance overall retirement incomes as well as give retirees more options to improve their retirement income from other sources, including employment. Many retirees indicate they would like to continue to work, at least a part-time basis. Removal of compulsory cashing will enable Australians to transition from work to retirement in a more flexible manner.

Many retirees have income from other sources as well as superannuation, including investments where capital gains tax must be managed. Removing the tax from superannuation benefits allows more flexibility to manage these issues without losing the Senior Australians Tax Offset (SATO).

The ABA acknowledges the Treasury forecast that these changes will improve the adequacy of retirement incomes. The ABA considers the changes will encourage people to continue to work, where this suits their circumstances.

3.4 Improving consumer understanding

Financial literacy so that Australians make informed savings decisions: Do the proposals help to improve consumer understanding, so that retirees are more able to take control of their superannuation and retirement income decisions?

Currently, it is difficult, if not impossible, for many Australians to understand the technical details and implications of the superannuation system. The ABA and its member banks have demonstrated a long-term commitment to promoting consumer understanding and financial literacy. However, even as recently as at the ABA's Financial Literacy Symposium "Broadening Financial Understanding" held in June 2006, commentators pointed out that superannuation had become so complex that basic messages are difficult to get across to consumers.

The proposals have considerable potential to enable consumers to better understand the system and thereby make better retirement savings and income decisions. However, if this potential is to be realised, materials and strategies must be developed to explain the new rules to consumers so that they gain the capabilities to better manage their savings.

In the past, rule and system changes of smaller scale than this package of reforms have largely been left to the financial services industry to explain to customers. The ABA believes the Government's efforts to simplify and streamline will be most effective when people get clear information at the time they are ready to receive it.

The ABA considers that information should be developed around 'information seeking opportunities'. Much of this material already exists and there is an opportunity to produce simpler information people can understand more easily, including:

- General superannuation and contributions queries – how much can I save; what is the co-contribution and how will it help me; how much do I need for retirement, etc. (Many of these questions are, or will, be addressed by the Financial Literacy Foundation, and the simplified rules provide a great opportunity to capitalise on individual interest when it arises.)

- Starting to think about retirement – what are my options; how do I work out what is enough; how long will my money last; how can I accelerate my savings; should I put my savings in one place, etc.
- Considering retirement – what do I have to do; what is an income stream (now a much simpler question); when and how do I want income in retirement; where do I find more detailed information, etc.
- In retirement – how do I match my income with my needs; how do I make my savings last; what do I need to do for tax/age pension, etc.

Reducing the complexity of the superannuation system will go quite some way to improving understanding, thereby assisting retirees in planning and taking control of their retirement income choices. While financial planning will be less orientated towards the taxation and regulation surrounding superannuation, it will remain a vital part of the financial services system, as consumers will need to receive information and advice about savings and investment opportunities that best suit their needs, circumstances and preferences.

Consumer behaviour will be a driver for further innovation in the wealth management industry. It will be important for the superannuation and retirement incomes framework to enable retirees to take advantage of greater superannuation flexibility to build responsible retirement income strategies that best suit their needs, circumstances and preferences.

The ABA and member banks will produce materials to assist consumers understand the new superannuation system. The ABA suggests that the Government undertake a national campaign (similar to 'Super Choice') to raise awareness of the changes and promote consumer understanding and financial literacy. We envisage that the Financial Literacy Foundation will be instrumental in delivering key messages and coordinating information dissemination.

3.5 Introducing consumer sovereignty

Compulsory and voluntary retirement saving in the Australian retirement income system is private saving. Consequently, Australians who hold superannuation and retirement savings accounts (RSAs) are consumers protected by prudential, conduct and disclosure regulation.

At policy level, the proposals represent a very significant step by Government towards consumer sovereignty. Many of the rules which directly restricted individual flexibility have been removed, and the system will now be simpler.

The Treasury has indicated that research demonstrates that retirees behave quite conservatively toward their capital. These changes acknowledge the low actual risk of dissipation of retirement savings, and have great potential to improve consumer sovereignty through simpler and more flexible rules.

Currently, retirement income decision-making can be characterised as tax-centric; however, under the proposals, it will move towards being consumer-centric. The superannuation and tax changes will remove significant limitations from people saving for retirement, allowing retirees to have far greater scope to tailor their retirement income to their needs, circumstance and preferences.

For example, retirement income planning tends to be dominated by tax incentives once retirees exceed the eligible termination payment (ETP) low rate threshold. While tax on lump sums and rebates for income streams tended to push retirees into income streams, there has been no convincing evidence that retirees were anything but careful and conservative in dealing with sizeable lump sums. Now that lump sum tax has been removed after age 60, retirees are able to consider a wider range of options to better manage their capital and income across retirement.

The ABA supports the removal of limitations on consumer sovereignty. We commend the Government for removing a significant disincentive for Australians to save and plan early for retirement. We believe a consumer-focused approach should be reflected in retirement incomes policy – regulations should impose only those limits on individual flexibility that are necessary to achieve policy objectives, and to limit behaviour that would otherwise compromise the policy objectives.

3.6 Fostering competition

One of the disadvantages for consumers of a highly specific regulatory regime is that rules can impede competition, and thereby consumer choice. The ABA considers that the best outcomes will be delivered for retirees where the market for retirement savings and income products is open and competitive.

The ABA believes that the proposals should seek neutrality of rules. Lack of neutrality can arise in retirement savings and incomes products in a number of ways.

- Concessions in tax or social security law can directly favour one business model, or effectively exclude or disadvantage others. The former requirement for exemption from the social security assets test is a good example – it provided that annual payments from exempt income streams could not vary except by inflation. This requirement imposed an effective guarantee on providers, which in practice could (and was) only met through a life insurance office.

- Rules can apply different treatment to similar products, inadvertently or by misconception about the nature of products and/or the market.

- Onerous regulatory and compliance requirements can act as barriers to entry and restrict competition in a market. There are very significant requirements in the superannuation market, though some (e.g. prudential requirements) are quite justifiable given the compulsory aspect of superannuation.

The package of reforms seeks to promote competition in the market and thereby promote consumer choice in significant ways. For example, it will also remove largely product-specific regulation from the income stream environment, freeing up that market significantly by both removing direct concessions and, if implemented carefully, ensuring consistent treatment across a variety of investment products used by retirees.

Importantly, the ABA highlights that competitive neutrality does not imply the same outcomes from different products. That is, a retiree with a strong preference for guaranteed investments would not expect to receive the same income overall as from a more volatile investment.

The ABA believes that the rules surrounding superannuation and retirement income products should promote competition.

4. Changes to superannuation taxation

Summary of ABA position

- The ABA supports the removal of tax on superannuation benefits after age 60. The system can now be characterised as TTE (Taxed contributions, Taxed earnings, Exempt benefits), and the simple message that superannuation is tax-free in retirement should encourage retirement saving.
- The ABA agrees with the Government's view that the removal of tax on superannuation benefits will lift a significant disincentive for those older Australians who wish to work to do so.
- The ABA supports the abolition of RBLs. The RBL regime imposed a significant burden across the superannuation system, but affected very few retirees. Abolition of RBLs will reduce complexity.
- The ABA supports the simplification of tax components for payments under age 60.
- The ABA supports the simplification of the annual contribution limits. The new $50,000 annual limit on concessional deductible contributions (pre-tax contributions taxed on entry to a fund) will be both simpler and more flexible than the current age-based limits.
- The ABA supports the extension of the simple $50,000 annual limits on concessional deductible contributions to the self employed.
- The ABA continues to support the tax exemption on fund earnings for annuities, superannuation pensions and RSA income streams. The ABA is pleased to see the Government continues to regard the exemption as an important incentive toward income streams.
- The ABA generally supports the use of the Tax File Number (TFN) as an identifier, but is concerned that the new arrangements may cause transitional and ongoing administration and compliance issues for providers. The ABA is also concerned that the application of the highest marginal tax rate when a TFN is not quoted may disproportionately affect casual and part-time workers. Therefore, we suggest the Government consider amendments that overcome this problem.
- The ABA is concerned that the proposed tax provisions for death benefits could continue an administrative burden on providers, and therefore we suggest that these provisions be as simple as possible.

Introductory comments

The tax proposals are the most significant changes since the introduction of the Superannuation Guarantee in 1992. As noted in the report *International Comparison of Australia's Taxes*[2], Australia has been alone in taxing retirement savings at all three stages of contribution, earnings and benefits ("TTT"). All other OECD countries tax saving only on benefits (EET), with the exception of New Zealand where contributions are after tax, earnings are taxed and benefits are exempt (TTE).

Commentary on the Australian superannuation system has consistently made the point that the "TTT" approach has tended to discourage retirement saving, notwithstanding that, for many Australians, the actual rate of tax levied at each stage has been lower than their marginal rate of income tax.

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[2] http://comparativetaxation.treasury.gov.au/content/report/downloads/CTR_full.pdf (p xxvii)

The problem inherent with a system that is "TTT" has been twofold:

- Additional tax directly reduces the amount of superannuation available to support retirement living standards; and
- Tax impost and complexity tend to reduce incentives to make additional contributions to boost retirement savings.

By removing tax on retirement benefits after age 60, the proposals will create a retirement income system that is "TTE" (lower incomes) or "ttE" (middle to higher incomes):

- Incomes with marginal rates at 15% will pay tax at roughly marginal rate on contributions (T) and earnings (T), with retirement benefits exempt (E).
- Middle income earners with marginal rates at 30% will have significant concessions on contributions (hence "t" rather than "T") and earnings (t) while exempt on benefits (E).
- Higher income earners with marginal rates at 40% or 45% will have the highest concessions on contributions (t) and earnings (t) while exempt on benefits (E).

In some cases, TTE or TEE is offered precisely because post-tax contributions, with tax concessions during the earnings and/or benefits stage, can be more attractive to lower income earners than EET or ETT arrangements.

For example, so-called "Roth IRAs" (Individual Retirement Accounts) in the United States are TEE to complement the 'traditional' IRAs which are taxed on an EET basis. Contributions to Roth IRAs are made from after-tax income, but no further tax is payable. Like the proposed tax arrangements after age 60 in this package of reforms, drawings from Roth IRAs are tax free in retirement. They are marketed along lines such as: "You never pay taxes on this money again".

Other voluntary retirement schemes tend to offer up-front tax concessions, with concessional or deferred tax during the earnings phase, and final tax paid when the monies are drawn down in retirement. For example, Registered Retirement Savings Plans (RRSPs) in Canada are taxed on an EET basis, and annuities can receive further concessions if the funds are transferred to a registered retirement income fund (RRIF) on retirement.

Low and middle income earners in Australia also have access to the Government co-contribution as a further 'third pillar' instrument to target adequate retirement income. For incomes below about $50,000, the amount of co-contribution is a far more powerful incentive than concessional tax on contributions. The co-contribution is also preserved until retirement, directly adding to retirement saving. While the co-contribution has lost some relative advantage in retirement (because taxed and exempt amounts will be tax-free), its advantage at contribution stage is still very powerful for those on lower incomes.

Limits to concessionality for high income earners are found in the limits on pre-tax ($50,000) and post-tax contributions ($150,000). There is a further limit to concessionality in the death benefit rules (death benefits to non-dependants will generally be taxed at 15%).

4.1 Removal of tax after age 60

For retirees aged over 60, there will be no tax payable on superannuation withdrawals, whether taken as a lump sum or through an income stream. Superannuation funds and RSAs will not be required to report these payments to the ATO for RBL purposes and individuals will not be required to include these amounts in their tax returns. The current rules are much more complicated.

- Retirees pay 15% tax on the amount of lump sum(s) above the ETP Low Rate Threshold ($135,590) and below the RBL ($678,149).
- Income from superannuation annuities and pensions is included in taxable income, less a Deductible Amount (if any) and a 15% rebate.

Removal of tax from lump sums and income stream payments will make the Australian retirement income system genuinely TTE in design. The removal of tax will have a number of benefits above and beyond the lifting of the tax itself.

- Retirees' tax reporting will be simpler: no superannuation will be included in their tax return. It is hard to estimate the level of stress ordinary retirees face from uncertainties or lack of understanding about tax matters. (Reporting will be less simple if retirees have a pension from an untaxed fund - usually a government defined benefit pension.)
- Retirees will have more flexibility to invest superannuation without paying tax because their superannuation payments will not use up their SATO threshold.
- Retirees will not have a disincentive from taxable superannuation income to earn additional income from employment – where they can work and wish to do so.

This change will make the tax incentives within superannuation easier to explain than under the current rules: "You'll pay no further tax on this money" is a far simpler concept than: "After we adjust for your undeducted purchase price and allow a 15% rebate on the rebateable component, and apply the senior Australians' tax offset, you should pay no tax". For those who would have paid some tax under the current rules, this change will both increase incentive to save and improve the adequacy of their retirement income.

4.2 Abolition of RBLs

The abolition of the RBL regime will remove one of the most complex parts of the Australian retirement incomes system. The ATO received some 676,000 RBL reports in 2004-05, yet very few people actually have amounts above the RBL (so-called "excessive benefits"). The superannuation system will now rely on annual contribution limits to ensure integrity.

This burden not only affected administration systems at the point of retirement and in carrying data until then – it required reports and compliance effort throughout the retirement phase. It could add doubt and uncertainty over the treatment of pensions to the surviving member of a couple at a time when she or he had most need of some certainty.

The abolition of RBLs also removes the need to use non-commutable income streams. This is consistent with the policy thrust of the budget changes, and reflects the general removal of limits on maximum payments from superannuation.

4.3 Simplified tax under age 60

The proposals will remove eight current superannuation components and replace them with just two – taxed and exempt. The various components are to be crystallised at a future date (which has not yet been specified).

The ABA welcomes this simplification, and urges that the amendments ensure these arrangements do no inadvertently become complex. For instance, it will be important to design crystallisation rules that operate on information superannuation and RSA providers already hold, and which do not require extensive and costly compliance checking.

Any resulting information must be easy for the current superannuation fund or RSA to hold and transfer to a future superannuation fund or RSA. It must also be simple to incorporate into administration systems and platforms.

4.4 Tax exemption on pensions

The proposals do not envisage removing the current earnings tax exemption on assets used to fund an annuity, superannuation pension or RSA income stream (ITAA 1936 section 282B for superannuation funds and RSAs).

The ABA supports this exemption in principle, as it retains an important incentive to use income streams. This incentive still has merit as an encouragement, particularly since the proposals remove the current requirements to draw down benefits. Retirees will face a simple and understandable choice between earnings tax at 15% (less offsets) if they choose to remain in the accumulation phase, or tax exemption if they move to an income stream.

The main qualifying criteria for this exemption are found in SIS Regulations 1.05 and 1.06 and RSA Regulation 1.07. (We have commented on the simplification of these regulations in section 7 below.)

4.5 Annual contribution limits

The ABA supports the simplification of annual contribution limits. Previously the ABA has called for the removal of maximum deductible contribution limits (age-based limits).

Currently, an employer is unable to claim a deduction for contributions made above the age-based limit; however undeducted contributions can be made by the employer, on behalf of the individual, above the age-based limit.

Removing the age-based limits and applying the $50,000 annual limit on deductible contributions will allow younger Australians to make larger contributions to their superannuation. Removing RBLs, coupled with the annual contribution limit will limit concessionality, and achieve a simpler lifetime accumulation. The new annual limit on deductible contributions will enable younger people to make better use of salary sacrifice and therefore encourage greater voluntary superannuation contributions.

However, contributions made above the annual contribution limit will be subject to the marginal tax rate – it is important that individuals are aware of this change, as it is proposed that tax will be deducted from their account.

The proposal will apply the simplified contribution limit at the level of the individual. This is a new arrangement, and one that has considerable potential to impose administrative burdens and compliance costs on providers. It is vital that the administration rules and arrangements are developed in close consultation with superannuation and RSA providers. For instance, a given fund or RSA cannot know the full circumstances of any account holder, and will not know whether any other contributions have been made elsewhere by that person or on her/his behalf. As the detailed plan acknowledges, only the ATO can know this, and then only once it has information from funds and RSAs.

Providers are currently required to report information to the ATO and it is envisaged that any additional information will be reported through the same processes. The ATO already has collection and payment processes with funds and RSAs.

Arrangements for applying the $150,000 annual limit on undeducted (post tax) contributions will be very new. There are very significant administrative hurdles in the requirement to hold a TFN to accept these contributions and in the proposal to return amounts over $150,000 (this will require ATO to instruct a fund/RSA).

The ABA supports comments provided by IFSA on the technical details of the new annual contribution limits. In addition, we consider that the following principles should be applied:

- Any instruction to return monies to an individual should take the form of an instruction from the ATO to the trustee or RSA provider to return a specified sum to the individual. The ABA understands IFSA has already provided examples where any other approach would be unworkable.

- Under no circumstances should a fund/RSA be required to trace and reverse contributions. Aside from cost, this would be a practical impossibility in many cases.
- It would be helpful if the ATO publicised the TFN requirements for personal undeducted contributions to help people understand that the return of contributions is a legal requirement.

Finally, the ABA encourages the Government to consider indexing the annual contribution limits. The previous limits were indexed to movements in average weekly ordinary time earnings (AWOTE). It makes sense, given the simplicity objectives of these proposals, to consider an indexation arrangement that results in easily understood and calculated contribution limits.

In addition, following transitional arrangements for people over 50, it may be reasonable to reassess the annual contribution limit for those over 50 to ensure adequate access to concessional tax treatment for contributions to encourage greater superannuation savings.

4.6 Extension to self employed

The ABA strongly supports the extension of the fully deductible $50,000 annual limit for contributions to the self employed. Previously, we have called for harmonisation of these rules between employed and self employed Australians. However, it is important to ensure that the problems previously encountered by self employed Australians in accessing superannuation concessions are avoided. The principal problem is the rule that a self employed deduction is only available where an individual has less than 10% of her/his income from employment. The difficulties many Australians had with this rule have been raised numerous times – at its simplest, many people will not know whether they qualify as a self employed person until after the financial year has ended. This situation should be avoided now that the tax treatment is to be identical.

4.7 Tax File Numbers

The consequences of failing to quote a TFN is a significant new rule. The administrative process should be as efficient as possible. While there was an antecedent in the requirement for surcharge reporting, here the penalty is double – an extra 31.5% instead of 15%. From experience with the superannuation surcharge, industry knows that it will be casual and temporary workers who suffer this impost most.

The ABA understands the importance of the policy objective – to ensure the integrity of the concessional system by enforcing the contribution limits. Therefore, the ABA encourages the Government to consider appropriate softening of the impact on lower income earners.

The ABA believes that as part of the national campaign about the new superannuation system, the Government should inform Australians of the need to quote TFNs (as outlined at section 4.5 above).

The ABA supports comments provided by IFSA and suggests that the ATO and industry work together to develop workable arrangements.

4.8 Death benefits

The proposals appear to mean that tax-free death benefits will be payable only to (tax) dependants. Estate payments are to be taxed on the same basis as lump sums taken before age 60. Whilst this proposal is welcomed, it seems to retain some complexity for providers. Since it is not possible to predict who will receive a death benefit, providers will have to retain, check and manage enough data to identify tax components and status for any death benefit scenario. While administration and compliance systems could well be simpler than for current rules, the burden will nonetheless be significant.

Without criticising the simplification, the ABA wonders whether there is scope to consider further simplification that would obviate the need to carry and check these data. We realise this may come at some cost to future tax revenue, and so suggest that any such review be undertaken and results implemented when and if the Government's fiscal position allows it.

5. Changes to co-contribution scheme

Summary of ABA position

- The ABA welcomes the proposal to extend of the co-contribution scheme to self employed Australians from 1 July 2007.
- In addition, the ABA would support cost-effective expansion of the co-contribution scheme as fiscal conditions permit.

The co-contribution scheme for low to middle income earners has been a considerable success. It allows Australians important additional flexibility and incentive to build up retirement savings, and its matching rate of $1.50 for each $1.00 of personal contribution is both generous and effective.

The initial limitation of the co-contribution scheme to employees was understandable, but undesirable in the long-term. The self employed remain the largest group outside the 'second pillar' of compulsory savings, so it makes sense to include them properly in the 'third pillar' by matching the incentives available to employees.

In addition, the ABA would support cost-effective expansion of the co-contribution scheme. Analysis by Access Economics[3] shows that the scheme could take further advantage of higher response levels among middle income earners. This research shows that people with incomes around average weekly earnings and higher would respond well to matching contributions of $0.50 for each $1.00 of contributions, so increasing the co-contribution leverage (or 'bang for buck'). It also shows that a cost-effective extension of the co-contribution scheme would also improve the relative 'gap' in superannuation incentives for income between 0.8 and about 1.25 times average earnings.

In our submission to the House of Representatives Standing Committee on Economics, Finance and Public Administration on its inquiry into improving the superannuation savings for people under age 40, we made a number of suggestions to lift access to co-contributions, in addition to permitting access for the self employed, including:

- Extending access to co-contributions for low to middle income earners by pegging the maximum co-contributions threshold to the 30% personal tax rate ($63,000 for 2005-06; $75,000 for 2006-07) thereby providing greater incentive for superannuation savings.
- Extending access to co-contributions for low to middle income earners by rescaling phasing-out (currently 5 cents for every $1,000) so that more low to medium income earners can gain access to the full co-contribution thereby providing greater incentive for superannuation savings.

Finally, the ABA commends the Government for indexing the co-contribution threshold from 1 July 2007. Indexing the co-contribution threshold to AWOTE will maintain eligibility in line with community standards.

[3] http://www.ifsa.com.au/public/content/ViewCategory.aspx?id=367 (p10)

6. Changes to social security rules

Summary of ABA position

- The ABA considers the reduction in the impact of the assets test should increase incentives to save for retirement.
- The ABA considers that, to realise the flexibility gains of this package, competitive neutrality should be preserved between the income tests applied to income streams and other financial investments.
- The ABA considers the income test for income streams should contain a cut-off between assessable income and return of capital.

Introductory comments

The reduction in the impact of the assets test on retirees should increase incentives to save for retirement. A number of commentators have argued that the current assets test has had the effect of reducing incentive to save for retirement, with particular impact for retirement accumulations between about $200,000 and $400,000. While many of these analyses failed to account for basic planning strategies, such as complying income streams, nonetheless there has been a perception that the assets test withdrawal rate meant there was little net gain for increasing retirement saving. The proposals will address that perception.

The assets test has affected an increasing share of age pensioners, even though it was initially intended to affect only a small proportion of retirees. It was introduced on 21 March 1985 at the rate of $4.00 per fortnight per $1,000 in assets, yet less than 1 per cent of pensioners (actually 0.77%) were paid under the assets test in 1989[4]. Since that time, the assets test has become much more significant, so that by June 2004, 7.3 per cent of age pensioners were paid under the assets test[5]. 20.4 per cent of retirees paid a part-rate age pension were assessed under the current assets test in 2003-04.

There are secular reasons for this increase, and reasons related to the design of the means tests themselves.

- Recent retirees are wealthier overall at age pension age than were earlier retirees. This wealth is both in general assets and in superannuation.
- The maximum rate of age pension is benchmarked to Male Total Average Weekly Earnings (MTAWE) as well as being indexed to price movements, while the assets test thresholds are only indexed to price movements. This means the assets test threshold has fallen relative to the rate of age pension, affecting more retirees.
- The change in superannuation from defined benefit pensions to purchased income streams means more retirement income streams have an asset test value (most defined benefit pensions are exempt from the assets test). Since non defined benefit income streams qualify for the income test deduction (purchase price/term), while defined benefit income streams do not, the combined effect of assessable asset values and lower assessable income increases the number of retirees paid under the assets test.

It is interesting to note that the detailed plan refers to retirees needing to earn a rate of return of 3.9 per cent to match the asset test withdrawal rate. In the original design of the assets test, the withdrawal was based not on a rate of return, but on a relatively high

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[4] *Occasional Paper 1,* DFaCSIA.

[5] *Income support customers: a statistical overview 2004*: DFaCSIA.

starting threshold and a relatively low cut-out point. This was intended to achieve an assets test that affected few retirees and kept 'wealthy' retirees from qualifying for a part-rate age pension. The steep withdrawal rate was an artefact of these principles rather than an end in itself.

No proposals were published for changes to the *Social Security Act 1991* (SSA) income test rules. However, other changes proposed affect the way the income test works in practice. Changes to the requirements for income streams also affect how the income test operates and raise the issue of neutrality between the income test for income streams and for other financial investments.

6.1 Assets tests changes

The proposals will reduce the assets test withdrawal rate from $78 to $39 per annum per $1,000 in assessable assets. This will significantly increase the value of assets a retiree can hold and still qualify for a part rate age pension.

The package of reforms will also remove the partial assets test exemption from non-commutable income streams (with grandfathering of existing income streams).

The following chart shows how the new assets test will affect homeowner couples in the amount of age pension withdrawn according to the value of financial assets or the asset value of an income stream. To enable a simple comparison with the income test, this chart assumes all assets held are financial assets under the SSA (in reality, the couple would hold non-financial assets assessable under the assets test, but not assessable under the income test).

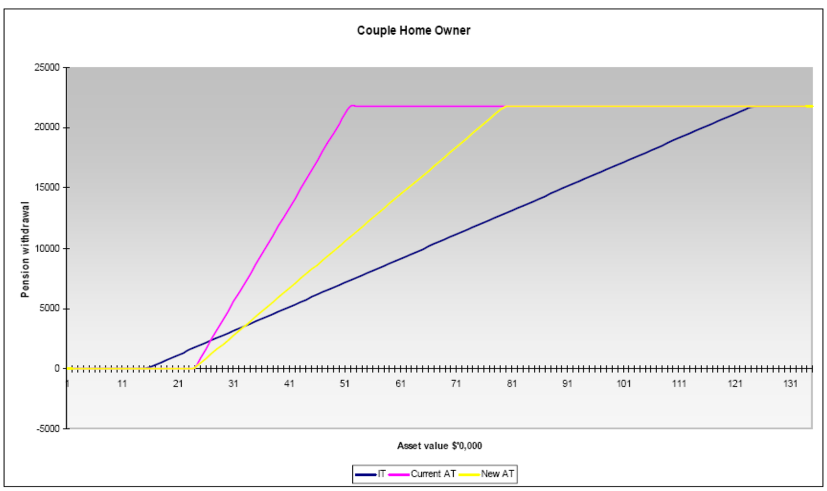

Figure 1: Age Pension Withdrawal – Homeowner Couple

6.2 Income test neutrality

The SSA applies different income tests for income streams than for other financial investments. The difference does not necessarily imply there is a neutrality of treatment, but it does raise the question of what relativity should apply between the two tests. The package of reforms proposes significant changes to the requirements for income streams generally, and these changes will affect the operation of the income test for income streams.

The proposals are silent on whether the income test deduction will continue to apply in its current form, and no position has been announced by the Government. Therefore the ABA assumes the income test for income streams will continue and supports this position. If there was to be a change, the ABA wishes to be consulted.

The SSA income tests are based on a tiered structure for financial investments set out in the definitions in section 9. These definitions specifically exclude income streams from the general definition of financial investments, through subsection 9(1C).

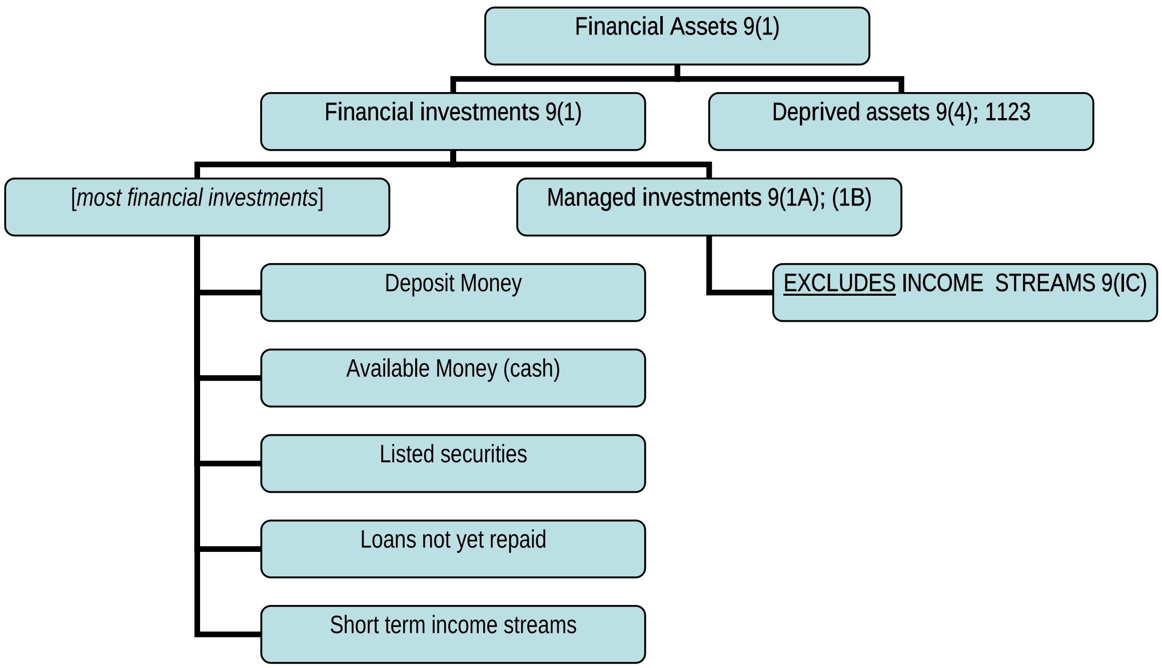

Figure 2: Financial investments (section 9 of the Social Security Act)

* Financial assets are subject to income assessed at the deeming rates, applied to the asset value.

** Income from income streams is assessed by subtracting an income test deduction from the annual income drawn. The deduction is based on the purchase price divided by the term of the income stream (or the life expectancy of the purchaser).

The ABA supports the principle of neutrality between the income tests. This does not imply the tests should be identical, but that they should be equivalent. For instance, the deeming rules for financial investments do not assess the return of capital as income; and the income test deduction for income streams similarly excludes return of capital from assessed income.

The proposals seek to enable more flexibility in retirement decision-making. To realise this objective there must be consistency in the principles behind the income tests. Consistent rules will allow retirees to make their own investment decisions on the basis of their preferences for guarantees, stable returns, high returns and so on.

Importantly, the ABA highlights that neutrality does not imply that outcomes will be the same; merely that regulatory treatment is consistent. The ABA is not proposing any change to the structure of the income test for financial investments. It is our understanding that the deeming regime is not under review. The ABA believes the current balance between income tests is acceptable and that major changes should not be made without direct consultation with industry on proposals and options.

6.3 Income test – capital / income distinction

The proposals omit one critical point of detail – it is unclear whether a line will be drawn between assessable income and the (non-assessed) withdrawal of capital, and if so, how. Currently this maximum amount is achieved via the payment valuation factors (PVFs) applying to account-based income streams. The SSA counts actual income drawn in a year toward the income test (less the income test deduction). Because SIS legislation currently recognises partial commutations, this implicit capital/income distinction has carried over into SSA assessment.

The ABA assumes that Treasury and DFaCSIA intend to create a rule to limit the amount drawn from an income stream that is to be counted towards income test assessment. If this is not done, some retirees could lose age pension in part or full for capital withdrawals.

For example, elderly retirees with no assets outside their home and superannuation may need to withdraw a larger than usual sum to make repairs or maintenance to their home. There are numerous possibilities, but let's say the retirees need to repair a roof. The sort of sum needed for these repairs could, if counted as income, reduce their age pension to zero. If so, they could need to use up more capital to replace the age pension for up to a year, further depleting their retirement savings.

The ABA strongly suggests that the means test rules include an appropriate limit on the amount of drawings that count towards income test assessment.

7. Changes to income stream regulations

Summary of ABA position

- The ABA welcomes the intention to reduce regulation to minimum annual drawing and simple core requirements for annuities, superannuation pensions and RSA income streams.
- The ABA suggests that the current regulations at SIS Regulations 1.05 and 1.06, and RSA Regulation 1.07, be entirely replaced by the new core requirements and minimum annual drawing. Grandfathered current provisions should be moved to schedules to the relevant Regulations.

The current regulations governing income streams set out requirements in considerable detail. Life office annuities are covered by SIS Regulation 1.05, superannuation pensions by SIS Regulation 1.06 and RSA income streams by RSA Regulation 1.07, with each regulation containing a number of sub-regulations. In effect, the regulations have determined product design at quite detailed levels.

At a policy level, it is questionable whether such detail should be set in regulations. In the new regime, the minimum drawdown percentages and streamlined core requirements do not need detailed regulations. The proposals acknowledge this and propose a simplified approach; however, this is not set out in the detailed plan.

Removal of the detailed requirements will enable considerable flexibility in product design and income strategy, so that retirement income products can be tailored to individual needs, circumstances and preferences.

The ABA applauds the objective to simplify the rules and agrees that detailed regulation is no longer necessary. New and simplified regulations for annuities, superannuation pensions and RSA income streams will have many benefits.

- They would make the 'rules' easier to communicate and understand (with obvious benefits for retirees).
- They would foster product innovation and help providers and retirees take advantage of increased flexibility to tailor income streams to their needs, circumstances and preferences.
- They will ease the administration and compliance burden on providers, which is ultimately borne by customers.

The ABA suggests that a new, simple regulation should replace each existing separate regulation. It need contain only the core requirements and the drawdown scale. The current provisions, which are to be grandfathered for existing products, should be transferred from the current sub-regulations to a schedule by the transitional provisions, where they are easy to locate but do not confound understanding of the new, simple rules. The ABA notes that life office annuities, superannuation pensions and RSA income streams will remain subject to prudential, conduct and disclosure regulation.

The new regulations will flow through to the income tax exemption on assets used to fund a complying income stream – currently section 282B of the ITAA 1936 for superannuation pensions and RSA income streams. These links should be retained (and perhaps be made more plain), since this exemption is the key incentive remaining for income streams.

Finally, these changes will themselves create legacy products, and tend to exacerbate administrative and systems issues for existing legacy products. The ABA supports IFSA's efforts to minimise adverse impact on legacy products, as also outlined in their product rationalisation proposals.

8. Changes to contributions, cashing and account consolidation

Summary of ABA position

- The ABA supports the extension of concessional deductible contributions to age 75, and the three year averaging rule on undeducted contribution limits.
- The ABA believes that the removal of compulsory cashing is an integral part of the new flexibility measures.
- The ABA supports policies and programs to re-unite people with their superannuation, and considers that account consolidation should be with the individual's approval for account balances over a threshold of, say, $5,000.
- The ABA understands the motivation for the 30 day transfer limit where a member requests transfer to another fund. This period should not commence until a 'from' fund has sufficient information to execute the transfer properly.

8.1 Contribution rules

The proposal to extend the capacity to make concessional deductible contributions for employees and self employed people up to age 75, applying a three year averaging rule on undeducted contribution limits (i.e. post tax), will simplify the system. It will also enable more flexibility for older workers to top up superannuation and so improve their living standards in full retirement. The rules do not introduce a new eligibility test and so will not add to the administrative burden.

Contributions after age 65 will still be allowed only where the individual has worked 40 hours in 30 consecutive days in the current financial year (trustees can accept mandated contributions without this requirement). The specific eligibility test can have some wrinkles for contributions early in the financial year. The ABA supports IFSA comments on developing a simple solution for this problem.

8.2 Cashing rules

The proposal to remove compulsory cashing (the requirement to pay benefits, including by commencing an income stream) after age 65 will promote greater flexibility in the system. Removing the cashing requirement will generally simplify administration. Because superannuation held in the accumulation stage is subject to earnings tax and is subject to social security deeming rules, the net increase in tax revenue and decrease in age pension outlays should mean public spending is relatively indifferent to whether individuals draw down or not. Income streams will require a minimum drawing in return for their tax and social security treatment.

8.3 Account consolidation

The package proposes that the ATO identify and contact holders of lost superannuation accounts (where possible) and have authority to instruct superannuation funds and RSAs to transfer accounts to consolidate them if the member so requests. The ATO has already undertaken a number of exercises to help people find and consolidate 'lost' superannuation accounts. The ABA applauds these efforts, and the commitment to an ongoing program to trace and contact holders of 'lost' accounts.

Account consolidation is a good thing where the member requests transfers, and the ATO power to instruct funds on members' behalf will help this process; however, it will raise some significant legal issues. Funds will need some form of indemnity from the ATO/government for liabilities arising from following ATO instructions, even though the ATO is in a sense acting as the member's agent. There are also significant compliance and administration costs in transfers – which some individuals might prefer not to incur and which the ATO may not be in a position to advise on when it provides transfer options. The fund may also hold a previous instruction not to transfer, and may not have direct advice to disregard that instruction.

The proposals also shorten the current 90 day time limit on transfers to 30 days. While most transfers are completed promptly, a superannuation transfer requires compliance checks to ensure that the component moves smoothly and the destination fund is complying and not fraudulent. (The ASIC has successfully prosecuted a number of unlawful transfer schemes.) If the 90 day period is shortened, it should be clear (as now) that it does not commence until the trustee has all the information needed to effect the transfer.

These matters are very complex and will be difficult to resolve. The ABA supports comments provided by IFSA on the technical details on transfers and account consolidation.

9. Conclusion

The ABA believes financial independence, financial security and a better lifestyle in retirement should be attainable for Australians. It will take a multidimensional approach from the Government, financial services industry and the community to ensure that all Australians take responsibility for their savings early so they are well prepared for retirement.

Such a multi-dimensional approach should involve strategies to promote confidence in the superannuation and retirement incomes system by addressing the broad policy principles of *simplicity*, *flexibility*, *adequacy* and *literacy*, as well as deliver other social and economic benefits.

The ABA has assessed this package of reforms on the basis of its potential to increase the level of private savings overall. While we have not undertaken modelling of this aspect, the ABA does consider the changes introduced in this package will lift confidence in the superannuation system, which in turn will directly increase the levels of superannuation and private savings. The tax changes after age 60 will directly increase private saving by removing one leakage from those savings. On these points, the ABA considers the package will benefit private and national saving.

The ABA considers that the proposals will improve the Australian superannuation and retirement incomes system. The greatest benefit will come from the reduction in complexity resulting in a simpler and more flexible system for consumers. It will also be important to ensure that reduction in complexity does minimise the administration burdens and compliance costs for providers.