MINORITY REPORT – SENATOR KERNOT

Taxation Laws Amendment (Superannuation) Bill 1992

1. Whilst the package of measures in the Taxation Laws Amendment (Superannuation) Bill 1992 is generally supported by the Australian Democrats, there are two areas which should be modified.

Elimination of tax deductions for personal superannuation contributions

2. The Committee has received many submissions on the Government's proposal to eliminate, from 1 July 1992, the tax deduction for employee contributions. Universally the evidence has been that the proposal will detrimentally affect many existing members of superannuation schemes, in excess of one million people, and that this is unfair in most circumstances.

3. There is no dispute that the Government must take budgetary considerations into account in determining superannuation policy, and that the Government has a right to make prospective decisions concerning access to tax concessions. However, the proposal in the legislation to terminate all concessions for those earning in excess of $31 000 per year (that is average weekly earnings), with no prior warning, is unfair and discriminates against those already locked into binding contractual obligations. It is almost unbelievable that a Government could publicly advocate, and increase the tax concessions for, employees 'topping up' their employer's contributions with personal contributions and then capriciously terminate these tax concessions. This decision contradicts a statement by the then Treasurer, The Hon P J Keating, MP, in the May 1988 Statement at page 12:

> As a further encouragement to people to provide for their retirement, the limit on tax deductions for contributions to small business and related superannuation funds will be doubled to $3 000 a year.

4. The inability of current compulsory arrangements to provide adequate retirement incomes is the reason why 'topping up', especially for those over 50, is important.

5. The Government has claimed that it has targeted the employee contribution concessions very equitably by limiting the maximum concession – $100 per annum – to those earning less than $27 000.

6. Whilst this is superficially accurate, the reality is that those in a position to do so will simply cease making employee contributions and will enter into a salary sacrifice arrangement to ensure that the contributions formerly made by the employee will be made by the employer, and hence continue to qualify as a tax deduction. That is, many – generally those in higher income and managerial positions – will simply be able to avoid the change in tax concessions by rearranging remuneration packages.

7. As a consequence, the Government's assertion of greater targeting of the concession is clearly ludicrous and the new proposals may indeed operate in a regressive manner for some income groups.

8. The second issue raised by the Government is that the introduction of the SGC means that it is now unnecessary to encourage people to 'top-up' their employer contributions. For people now entering the workforce, the SGC will provide a reasonable retirement income – however people in the latter half of their working lives, who only receive the minimum SGC amount, will not accumulate anything approaching an adequate amount to sustain retirement.

9. Indeed the Government actually recognises this issue in the Bill, by moving to a system of age-based employer contribution limits. This allows very large employer contributions for those employees aged over 50, up to $62 000 per year, to qualify as a tax deduction.

10. The fact remains that there are many hundreds of thousands of people who have entered into long term personal superannuation contracts mainly on the basis of being eligible for taxation relief for their contributions. They did so on the basis of the urging of Treasurer Keating and they are now looking at having to continue their contributions without taxation relief or ceasing to contribute and incurring substantial penalties. There should be a phase out of the deduction for those people who have entered into a contract before 1 July 1992 as the SGC contribution rate increases.

11. The behaviour of the Opposition in this matter has been extremely disappointing and irresponsible. The initial response of the Coalition was to oppose the cessation of the deduction outright. However, because of the recent announcement of the Prime Minister concerning the GST, the Opposition has decided to acquiesce and support the elimination of the concession so as to present a stark policy contrast to the electors in the forthcoming election.

12. To treat over one million Australians as political pawns is an act worthy of condemnation, and it makes a mockery of the role of the Senate as a house of review. I urge the Coalition to reconsider their decision, so as to protect the superannuation fund members who will now unnecessarily incur costs and charges if they discontinue their personal superannuation policies.

Recommendation 1 – Senator Kernot:

It is therefore recommended that the provisions removing deductibility be amended to allow a phase out of the concessions to complement the increase of SGC minimum contribution for those people who have entered into a binding superannuation contract prior to 1 July 1992.

The revised Reasonable Benefit Limits arrangements

13. The legislation proposes to introduce, from 1 July 1994, a flat rate RBL which will apply to all superannuation fund members irrespective of their level of remuneration. The Australian Democrats support the move to a common RBL as it provides an absolute, and equal, limit on the amount of tax concession which each person can obtain through superannuation.

14. Hence a reasonable flat rate RBL will increase the equity of the distribution of the $4 billion tax expenditure – that is the foregoing of collection of revenue – which the Commonwealth provides to superannuation fund members every year.

15. Unfortunately, the legislation before the Committee does not propose to set an appropriate RBL. The RBL is proposed to be set at $400 000 (indexed) for lump sums and to be double that amount (that is initially $800 000) where at least 50 per cent of the benefit is taken as a pension.

16. Evidence given to the Committee by Treasury officials indicates that about 95 per cent of people retire on benefits below $400 000. That is, the proposed new lump sum RBL will encompass 95 per cent of all retirees in the future. This means that 95 per cent of persons will not be influenced **by the RBL** in their choice of either a lump sum or some form of income stream.

17. This can be contrasted with the current system of differing salary based RBLs of seven times highest average salary for lump sums and 11.25 where at least half is taken as a pension or annuity. Taking a person on $30 000 annual income (for example approximately average weekly earnings) as a typical example, the effect of this change will be to increase the lump sum threshold from $210 000 to $400 000.

18. Clearly this will eliminate any incentive provided by the RBLs for retirees on average weekly earnings to opt for an income stream. This situation can only lead to the increase in 'double dipping', that is the use of superannuation moneys for purposes other than providing retirement income. The obvious implication of such a scenario is a reduction in the level of future budgetary

savings (due to clawbacks from social security) which the Government estimated would flow from the introduction of the SGC. The cost of this is potentially enormous and must be considered in any rational analysis of this legislation.

19. That this provision regarding reasonable benefit limits is contained in the same Bill as the flawed proposal to remove tax deductibility for contributions from ordinary battlers, on the basis of budgetary constraints, would be hilarious if it were not so serious.

20. The worst aspect of the RBL proposal is that the Government has allowed political motives to interfere with the proper setting of policy in this area. The Opposition, in its *Fightback!* superannuation package proposes that -

- any amount up to twice average earnings (about $60 000) will be able to be taken in lump sum form; and

- where the entitlement exceeds twice average annual earnings, the lump sum will be limited to $60 000 plus one half of the remaining benefit **subject to a total maximum lump sum benefit of $300 000 indexed.**

21. Clearly the Government's choice of the $400 000 limit is to enable it to go to the election promising a higher RBL than the Coalition. That the Labor Party would choose to deliberately make the taxation system less equitable for political purposes is regrettable, but unfortunately more commonplace – with the regressive *One Nation* income tax cut proposals being the most recent example of this disturbing trend.

Recommendation 2 – Senator Kernot:

It is recommended that the Bill be amended to reduce the lump sum RBL from $400 000 to $300 000. The 'pension' RBL of $800 000 should also be amended down to $600 000.

Social Security Legislation Amendment Bill (No 3) 1992

22. There are two areas in the Bill which should be modified.

A. Unrealised capital gains on listed shares

23. The Government is proposing to change the way in which pensioner investments in shares will be treated. At present, only the dividends paid to

shareholders are taken into account for the purposes of the income test for social security payments, while the actual capital value of the shares is included in the assets test. Until now, the capital growth on listed shares has been disregarded. Amendments to the *Social Security Act 1990* contained in the Bill provide for net unrealised capital gains on listed securities (other than bonds and debentures) to be taken into account under the income test. Losses accrued on listed shares (or similar investments) can be offset against the capital gain over the same assessment period, but cannot be carried forward. The Government says this brings listed shares into line with managed investments where capital growth on the investment is treated as income.

24. Several aspects of this proposed change are highly unsatisfactory.

- It continues the questionable practice in the social security area (which is at odds with taxation practice) of treating an unrealised accretion to capital as income, rather than assessing it under the assets test.

- It discriminates against shares as an investment, as similar treatment is not meted out to other investments (such as antiques, art work, collectibles and other less liquid investments upon which there could also be an unrealised capital gain which is not to be treated as income).

- Shareholder pensioners in similar assets and income positions will be treated differently because of the type of share asset owned. In a submission made to all Senators, the Chairman of the Australian Stock Exchange, Mr Laurence Cox, has argued that, under this proposal, shareholders in a publicly non-listed company (such as Linfox) will not be affected by the change, but investors in a listed company (such as TNT) will be.

- It is possible that investors will be encouraged to invest overseas and not in Australia, as those investments are unaffected by the proposed change. For example, Mr Cox has suggested investors may elect to invest in IBM shares listed on the New York Stock Exchange purchased through an Australian broker, rather than invest in BHP. Accordingly, this move may well discourage small scale investment in Australian companies at a time when such investment is desperately needed.

25. The likely outcome of the Government's move is that many, if not all, of the 85 000 pensioners presently holding share portfolios will sell their shares. I note that Mr Michael Heffernan, the Stock Exchange's chief economist, believes a 'significant number' of pensioners will sell, adding that he doubts the Government's ability to reach its projected savings of more than $85 million a year 'because no-one will have the shares.' (*The Age*, 5 December 1992).

26. Once again, it makes little sense to be discouraging investment in Australian companies at the present time.

- The flawed nature of the formula to be used in assessing gains and losses (set out in Clause 116 of the Bill) combined with the volatility of the share market will result in inequities, as illustrated by the following examples.

  - A share portfolio increases in value from $10 000 to $12 000 over the 12 month period prior to the day of assessment and pays a dividend of $500. The return (for social security purposes) is $2 500: the increase in capital value ($2 000) plus the distribution ($500). The return expressed as a percentage of the value of the asset at the start of the review year is 25 per cent. Under the formula, the past rate of return is applied to the current asset's value. So the past percentage value is applied to the asset value on the day of assessment – that is, 25 per cent of $12 000, or $3 000. So we end up with the situation where the DSS calculated income figure of $3 000 is $500 more than the actual return.

  - Where share prices fall, the dollar amount of the loss relates to the value of the assets at the start of the review year and the resulting percentage is applied to the lower closing price. For example, in the situation in 5.1 (above), if – in the subsequent year – the asset value reverts to $10 000, the $2 000 capital loss is related to the $12 000 opening value and the result is a negative rate of return of 16.67 per cent. That percentage is applied to the closing value of $10 000 and a negative return is calculated ($1 667) which may be offset against gains on other securities, but not other source of income.

  - These examples demonstrate that the formula magnifies gains and minimises losses. In the example above, a $2 000 gain was assessed as $2 500; however, a $2 000 loss attracted a credit of only $1 667. This becomes a problem where a shareholder has two parcels of shares, one of which rises in value and the other falls in value. If the shareholder's two parcels are each valued at $10 000 and one goes up by $2 000 and the other falls by $2 000 (assuming no dividends are paid), the shareholder's DSS calculated income will be $800 ($2 400 income offset by a $1 600 loss), despite the fact there was no capital gain across the entire portfolio. The greater the variation in the price, the greater the calculated income (irrespective of whether or not any actual gain has accrued).

In other words, pension losses caused by share price increases cannot be fully offset by the same drop in share prices.

- This particular problem in the formula also demonstrates the inequity in the treatment between a person with an 'individual' share portfolio and a person who has invested in a managed investment with an identical shareholding. Each gain and loss on the individual's shareholdings are going to be separately assessed and (as pointed out in 5.3) will result in assessable income even if there is no overall net change in the asset value. But the managed investment will have no assessable income where there is no net capital gain.

27. It is also quite clear that, unless DSS reviews are all carried out on the same day (and there has been no suggestion this will occur), pensioners with identical share holdings and the same dividend income could have markedly different pension outcomes.

28. The ability to offset losses is not as positive as it initially appears. This is partly because of the magnification of profits and minimisation of losses already mentioned and partly because of the requirement that losses can only be offset within the same time period against income from other shares or managed funds (not against income from other sources).

29. This makes a mockery of statements by the Government that the move is 'fair' because reductions in share values will be able to be offset against gains.

30. The measure has the potential to result in significant administrative costs for the Department of Social Security as it will be extremely difficult to keep track of market fluctuations.

Recommendation 3 – Senator Kernot

It is recommended that the proposed amendments in the Bill relating to unrealised capital gains on shares, as set out in Division 18, be rejected and the Department of Social Security be advised to re-examine the proposed formula.

B. Allocated Pensions

31. The Bill also changes the manner in which allocated pensions and annuities are assessed for the purposes of the income and assets tests. Under

the proposed amendments, both unrealised capital gains and income applying to allocated pensions will be treated as earned income for the purposes of the age pension assets and income tests. At present, allocated pensions are assessed under the income test only (using a different assessment method to that proposed by the amendments).

32. There is no problem with the move to have the pensions assessed under both tests. The problem in the application of the new income test being proposed by DSS.

33. At present, allocated pensions and annuities are assessed in the same way for the purposes of the income test, that is, DSS assesses the actual amount of income paid on these investments (less the tax concessions). Under the proposed amendments, DSS will assess the *earnings* of the allocated pension's underlying capital rather than the actual income drawn down.

34. DSS estimates this change will save about $2 million a year.

35. This measure is also highly unsatisfactory for several reasons.

- The vast majority of allocated pension holders will be assessed by DSS to be earning more income than they actually receive. They will have their pensions reduced even though their allocated pension income has not changed.

- It is inconsistent with moves in the taxation area where allocated pensions, annuities and other superannuation products are treated in an equal manner. Because of the withdrawal rates applied by DSS, the loss of $1 in income through the application of the income test is equal to a $1 increase in taxation. This cannot be seen as enhancing the integration of the taxation and social security systems.

- The Explanatory Memorandum states that, as the drawings from an allocated pension are variable, it would operate 'in a similar way to a bank account ... at the recipient's discretion.' This would seem to represent a fundamental misunderstanding of the nature of allocated pensions. Allocated pensions can only be opened while applicants are in employment and then only with rollover funds or ETPs, deposits are not permitted, drawings are restricted to government prescribed maximum and minimum limits and can only be made monthly, and most (if not all) allocated pensions only allow the pensioner to vary the amount to be drawn on an annual basis. Therefore, the pensioner's discretion in relation to the allocated pension is severely curtailed.

36. In evidence to the Committee, DSS said they were attempting to 'provide neutral treatment vis-a-vis other similar sorts of investments.' But an examination of the structure and purpose of the product suggests it is stretching both logic and equity to propose they be treated as ordinary investments.

- In fact, it makes considerably more sense to treat allocated pensions in the same way as annuities. This is particularly so in light of the Government's clear statements to the personal investment industry that it prefers retirement benefits to be taken more in income stream form.

37. In evidence to the Committee, DSS advised it accepted a 'similarity' between term annuities and allocated pensions. DSS went on to say: 'For that reason, we will be doing a review of the treatment of term annuities ... [to be] submitted to the Government by the end of January.' It makes little sense to proceed with these changes to the treatment of allocated pensions when a review of annuities is underway in the Department.

- Because an allocated pension is structured in order to build up an investor's capital in the initial stages of the life of the product, the income received during this period is less than what the underlying capital is earning. The likely outcome of the new rules is that people will increase the size of their allocated pension drawings, defeating the purpose of the product and possibly making allocated pensioners onto the age pension at an earlier stage.

- DSS made it quite clear to the Committee that it had no consultation with the providers of these products prior to introducing the changes to allocated pensions. The Insurance and Superannuation Commission has had extensive consultation with the industry on allocated pensions. Mr Michael O'Neill, Assistant Commissioner of the ISC, told the Committee the ISC had received submissions on allocated pensions as long as 12 or 18 months ago. He said 'There were some components of those submissions concerning DSS matters, but that was not our concern.'

Recommendation 4 – Senator Kernot:

It is recommended that the proposed amendments in the Bill relating to allocated pensions, as set out in Division 19, be rejected and DSS be advised to include an exploration of more equitable treatment between allocated pensions and annuities within its current review of term annuities.

Preservation Age

38. As part of the package of changes negotiated prior to the introduction of the SGC, the Democrats insisted that the Government address the question of an increase in the preservation age. We proposed that an appropriate phase-in period for this necessary change was 10-15 years.

39. This was not accepted by the Government because of external pressures, although the Government did agree to a much slower implementation timetable. This at least shows that the Government does acknowledge that a potentially large problem exists in this area – especially as Australia now has a uniform national superannuation system.

40. The relevant industry and professional bodies, namely ASFA, LIFA and the Institute of Actuaries, all welcome the Government's decision in this area. However, they are unsure as to why such a simple and overdue change should take place over a timeframe of over 30 years. I share these sentiments.

41. It is an absurd situation where the Government refuses to address an acknowledged flaw in its policy, which has serious long-term consequences, because of external pressures. The irony is that there is no political resistance to speeding up the changes; the resistance is industrial in nature.