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Superannuation: Taxation Issues and Discussion of Proposals for Reform

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Glossary—Superannuation Terminology

Accumulation fund	A superannuation fund where the benefit comprises contributions to the fund plus earnings less expenses and taxes.
Age pension	A regular periodic payment paid to an individual who qualified under certain conditions, including reaching age pension age. Eligibility is subject to income and assets tests.
Annuity/pension	A series or stream of payments made at regular intervals, usually purchased with a lump sum from a life insurance company/superannuation fund to provide retirement income.
Assets test	The sliding-scale means test applied to the assets of a retiree to determine eligibility for social security or veteran's pensions.
Contribution	The money placed by an employer or individual into a superannuation fund.
Defined benefit fund	A superannuation fund where the benefit is the multiple of years of service with the employer and a percentage of salary.
Dividend imputation	Australian tax arrangements that eliminate the double taxation of company profits.
Grandfathering	The practice of introducing legislative changes without those changes affecting rights or benefits that have already been built up. Introducing changes that do not apply retrospectively.
Lump sum	A superannuation benefit taken as a single benefit rather than as a pension or annuity.
Income test	An income-based means test that determines the amount of social security and Veteran's benefits (including the age pension) to which a person is entitled.
Retirement incomes policy	The collection of policies of a government, party or other organisation which deal with the provision of retirement income.
Superannuation	A long term savings arrangement that operates primarily to provide income for retirement.

Major Issues

This paper canvasses the issues that would need be considered in any review of the taxation of superannuation. Its purpose is to show the inadequacies in the taxation of superannuation, and how it can be reformed.

The taxation treatment given to superannuation should, in theory, have the following features:

- it must be simple and transparent
- tax incentives must be equitable, and efficiently targeted over all groups in society, and
- retirees should also be encouraged to make full use of their retirement savings during their retirement years.

Unfortunately, the Australian superannuation system is not known for having these features. Rather, it is characterised by:

- lack of equity—most of the tax advantages go to high income earners
- lack of simplicity—the system is riddled with complexities, and
- complex treatment of contributions, pensions and annuities.

This paper argues that the taxation of superannuation does not achieve the goals of equity, and simplicity, and that the reforms proposed by the Association of Superannuation Funds of Australia, the Institute of Actuaries of Australia and the Australian Council of Social Service have a number of shortcomings.

In this light, this paper outlines a series of possible reforms that would address the shortcomings in the system:

Lack of Equity

The problem of the lack of equity in the superannuation system would be addressed by taxing compulsory employer superannuation contributions at the member's marginal income tax rate.

All superannuation contributions could be paid to the relevant superannuation fund on at least a quarterly basis. The employer would then report the payment of superannuation contributions to the Australian Taxation Office as part of the Pay-As-You-Go reporting system.

The concessional tax treatment of superannuation could be retained by introducing a rebate of, say, 30 per cent on the tax paid by the employee on their superannuation contributions. In order to simplify the assessment of the new superannuation contributions rebate, only Superannuation Guarantee contributions made to an accumulation superannuation fund would qualify for the rebate.

Too Many Levels of Taxation

With all employer superannuation contributions taxed at the member's marginal income tax rate, there would no longer be any rationale for taxing superannuation contributions. Therefore, the following taxes could be abolished:

- the 15 per cent contributions tax, and
- the superannuation surcharge tax.

Lack of Simplicity

Abolishing the contributions tax and the superannuation surcharge tax would greatly simplify the operation of superannuation funds and the Australian Taxation Office.

The level of compulsory superannuation contributions is currently capped by the maximum contribution base under the *Superannuation Guarantee (Administration) Act 1992*. By taxing superannuation contributions at marginal income tax rates, employer superannuation contributions are no longer concessionally taxed. Consequently, there would no longer be a rationale for retaining the aged based limits (another limit on the amount of tax deductible employer contributions available to an individual). Aged based limits could therefore be abolished, while retaining the maximum contribution base under the *Superannuation Guarantee (Administration) Act 1992*.

Taxing superannuation contributions at marginal income tax rates also removes the rationale for having Reasonable Benefit Limits (RBLs) (i.e., the amount of concessionally taxed superannuation benefits a person is allowed to receive over his or her lifetime). RBLs would also be abolished.

Transparency and the Treatment of Pensions/Annuities

All superannuation benefits could be taxed once at the point of retirement. Pensions/annuities purchased with this money would then be exempt from income tax. Transparency would also be improved by clearly demonstrating the benefits of purchasing a pension/annuity—tax free income. This would also encourage retirees to use their superannuation benefit to purchase a pension/annuity.

Other issues

The present system of unlimited un-deducted contributions into superannuation would continue.

Superannuation fund earnings would continue to be taxed at 15 per cent, as well as having continued access to the dividend imputation system. Nonetheless, in light of the effective rate of taxation being 6.5 per cent, and the immediate revenue shortfall faced by Government, there may be a need to consider raising the rate, in the short term, above 15 per cent.

Introduction

The (partially) open secret among people in the superannuation and financial services industry is that the Government is going to review Australia's superannuation system. It is an open secret in that everyone (including the Government) knows that it has to happen. It is only a partially open secret in that we don't know when it will happen.

The superannuation and financial services industry has been lobbying for a review of the superannuation system since the Government released its tax reform plan in August 1998.[1] This package of reforms did not consider reforming the taxation of superannuation contributions and benefits. In the meantime, the superannuation and financial services lobbyists were not content to let the issue be forgotten. They made numerous calls for the Government to reform the entire superannuation system, not just the taxation of superannuation. The Government eventually announced its informal views on the matter. In his National Press Club address after the May 2000 Budget, the Treasurer nominated superannuation reform as his next challenge.[2] Some people speculated that this reform would be problematic. One person noted that:

> If Prime Minister John Howard thought reforming the tax system was difficult, just wait until he tries to open the Pandora's Box of Superannuation.[3]

Details have yet to emerge about the Government's 'next challenge'. The delay in progressing this reform may be because the Government sees a lot of political problems in superannuation, in particular any reforms that involved the removal of 'grandfathering provisions' that could make some retirees worse off.

In the meantime, the Government has stated that its priority in superannuation policy is securing passage of its choice of superannuation fund legislation. In addition, any review of superannuation will not occur until tax reform has been fully bedded down and absorbed by the community.[4] In contrast, the Labor Party considers it more important to conduct a review of superannuation than to implement the Government's chosen model for implementing choice of superannuation fund.[5]

The need for reform of superannuation was restated in November 2000 by a coalition of 15 major financial, employer and employee groups that prepared for the Federal Government and other major political parties a so called 'declaration of principles' on Australia's superannuation and retirement income system. The declaration of principles added to earlier calls for reform by stating that taxes should be designed to provide a clear incentive to save, preferably at the point of contribution, and have a focus on taxes of benefit payment.[6]

In light of these recent developments, this paper outlines the goals of the taxation of superannuation, shows how the current complex tax rules conflict with those goals, considers some existing models for reform of these tax rules, and proposes a new alternative model for the reform of those rules. Other issues that may be considered by a review of superannuation—such as whether the current level of contributions are adequate and the interaction between superannuation system and the social security system—are not examined since they go beyond the principal subject of this paper, which is public policy debate over the taxation of superannuation. This paper does not address other related issues such as the macroeconomic debate on whether superannuation improves national savings; nor does it provide financial planning information that may assist individuals in their personal financial affairs.

The issues covered in this paper include:

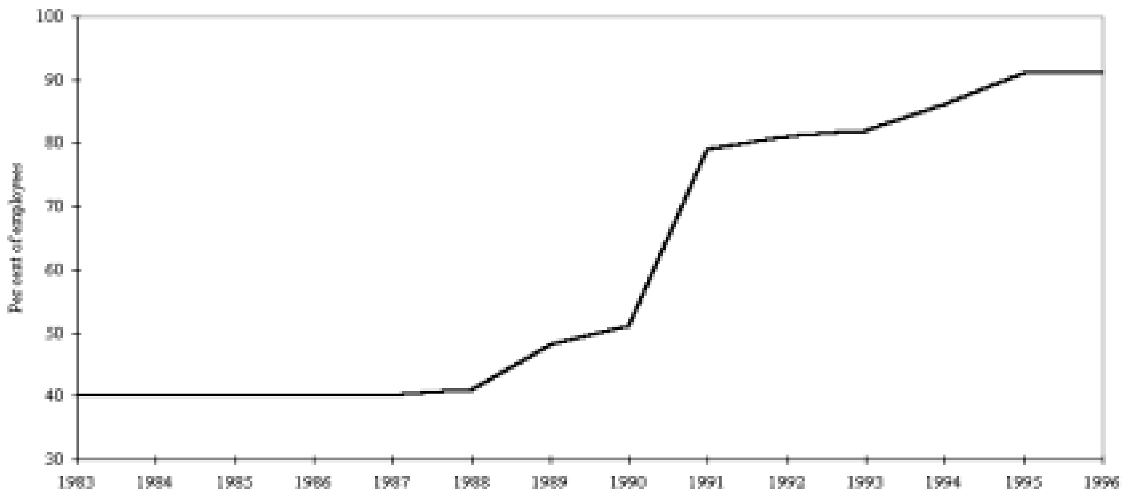
- an overview of the industry—just how much money is involved
- the public policy of the superannuation system
- how the superannuation system stands up against those goals
- why some reform proposals are unlikely to be adopted by Government
- why superannuation cannot be taxed only at the end benefit stage, and
- a suggested alternative reform proposal.

Industry Overview

It may benefit the reader to have a brief overview of the superannuation industry. The scale of this industry and its annual growth are impressive as the following illustrates.

- total superannuation assets reached $477.4 billion at 30 June 2000.[7] This is 11.5 per cent of GDP
- total superannuation assets are increasing at around 17 percent per year
- 91 per cent of employees have superannuation, while only 36 per cent of the self employed have superannuation.[8] The growth in this coverage is shown in Figure 1.

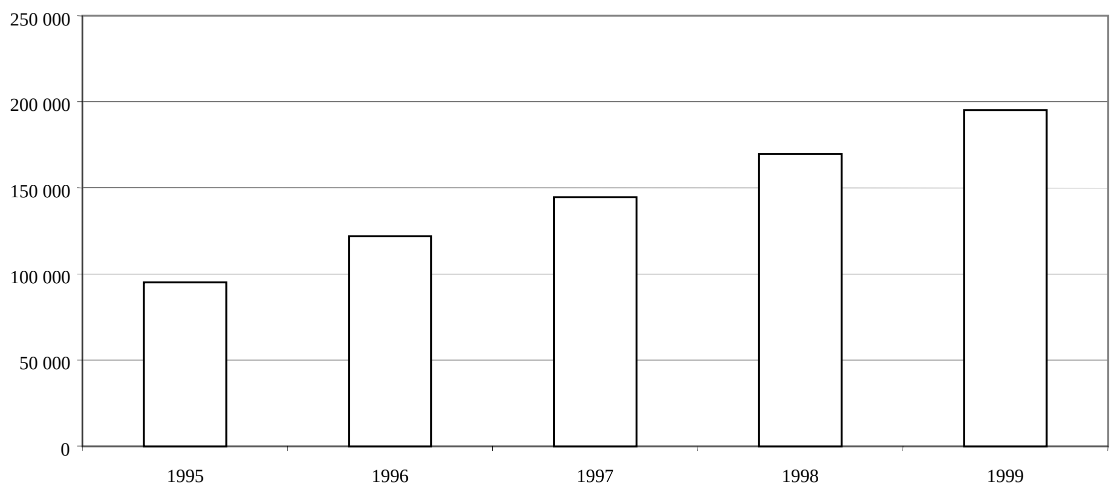
Figure 1: Growth in Superannuation Coverage



Source: Australian Prudential Regulation Authority, *Insurance and Superannuation Trends*, September 2000.

- total benefit payments to retirees totalled $26.8 billion in the year to 30 June 2000
- there are over 21.7 million superannuation accounts for 6 million workers
- total benefit payments are increasing at around 17 percent per year
- many people are managing their own retirement savings through self-managed superannuation funds. These funds have grown in number from 95 000 in 1995 to 195 000 in 1999.[9] This is shown in Figure 2.

Figure 2: Number of Self Managed Superannuation Funds



Source: Australian Prudential Regulation Authority, *Insurance and Superannuation Trends*, September 2000.

- the tax concessions given to superannuation are provided to employers, fund members and retirees at a cost to Government revenue. These concessions have been valued at $9 billion per year. In the precise technical terms, in 2000–01, removing these tax concessions for superannuation would raise an additional $9 billion dollars.[10] A debate on the merit of the Treasury's method of calculating tax expenditures has emerged. Although this is not the place to analyse the debate, it should be noted that the Treasury's figures are the official costings, and that these costings have been challenged.[11]

- the Government raises considerable taxation revenue from superannuation funds. The 2000–01 Budget contains estimates and projections of the income tax revenue expected to be raised from superannuation funds:[12]

2000–01	**2001–02**	**2002–03**	**2003–04**
$5.175 billion	$4.01 billion	$4.279 billion	$4.553 billion

- at least $3.5 billion of the revenue raised by superannuation taxes is attributable to the taxation of superannuation contributions and the superannuation surcharge tax.[13]

Australia's Superannuation System

The statistics provided above demonstrate that superannuation is a large and growing business. But what is its purpose? Australia's superannuation system forms part of Australia's retirement income policy, which has an established legislative framework to enable people to have a better income in retirement than they would have under the age pension alone. This objective is pursued through a three-pillared retirement income system comprising:

- compulsory superannuation savings, including through the Superannuation Guarantee (SG)
- voluntary superannuation and other private savings, and
- a means tested age pension and associated social security arrangements.

In 1994, the World Bank endorsed[14] such a three-pillar approach, although not necessarily Australia's particular implementation strategy.

The age pension provides a safety net for those who reach retirement age with low levels of self provision. The Superannuation Guarantee offers the opportunity for significantly improving the retirement incomes of a large sector of the population.

Goals of the Superannuation System

In order for the long-term retirement income policy objectives to be achieved the superannuation system must operate efficiently, effectively and be cost effective. In short, it must be sustainable. Such a benchmark superannuation system must encourage people who are able to save privately for their retirement to do so, and encourage those people to save who would, in the absence of them possessing any superannuation entitlements, be dependant on the age pension alone for their retirement.

Consistent with broader fiscal and national savings objectives, tax incentives (or concessions) to boost retirement income must be efficiently targeted and affordable over the long-term. They must encourage taxpayers to provide for their own retirement. In this regard, tax and social security system rules should encourage retirees to maximise returns from investing their retirement savings, taking account the level of risk considered acceptable. Retirees should also be encouraged to make use of their retirement savings during their retirement years, including through an orderly draw-down of investment earnings and capital over their retirement years, rather than using financial planning and estate planning strategies to maximise both their age pension entitlement and the amount of money that ultimately passes onto their estate.

The tax system should be equitable. Tax incentives (or concessions) for private retirement saving should be spread fairly over all groups in society and the system should also seek to achieve reasonable equity across different generations. Nonetheless, since people with higher disposable incomes are more likely to save, invest and provide for their own retirement, taxation concessions should particularly target those people on lower incomes who would ordinarily be expected to receive the age pension in order to encourage them to save for their retirement.

The system should be relatively simple so as to maximise public acceptance and compliance with the system and minimise compliance and administration costs for individuals, industry and government. The system must also be flexible. In particular, it must be able to cope with future changes in employment and retirement patterns—including changing employment patterns both before and after an individual's 'initial' retirement—and with the development of new retirement products.

Does the Superannuation System Achieve these Goals?

The superannuation system is not fully achieving these goals, which in turn restricts the effectiveness of Australia's retirement income policy. This is apparent due to structural and other problems in the system. This section canvasses these structural and other problems.

Structural Problems

Lack of Equity

The structure of the taxation concessions for superannuation mean that high-income earners have gained greater benefits from the concessions than lower-income earners.

In the 1996–97 Budget, the Government moved to improve the equity of the superannuation arrangements by introducing the superannuation surcharge for high-income earners. It is arguable that this has had limited success in reducing the proportion of tax concessions flowing to high-income earners. For example, analysis has shown that the greatest advantage of investing in superannuation is for people in the highest tax brackets, even after the introduction of the superannuation surcharge tax.[15] With any tax deduction, the greatest benefit in dollar terms accrues to those on higher incomes that are subject to higher marginal rates of taxation. High-income earners generally have the discretionary private resources to switch their investments from other less concessionally taxed savings vehicles and to maintain current consumption while saving for a particular target level of retirement income. Therefore, high-income earners are able to obtain the greatest benefit from the tax concessions available to superannuation.

Australia's current system also fails to achieve horizontal equity as there is varying access to tax concessions across similar income ranges for different groups of individuals. For example, the superannuation contributions of an employee who can enter into a salary sacrifice scheme are treated as employer contributions and are deductible against the employer's assessable income. For people on the highest marginal income tax rate, this amounts to foregoing income taxed at 48.5 per cent, in exchange for superannuation contributions taxed at 15 per cent—a differential of 32.5 per cent. Employees that are unable to enter into salary-sacrifice agreements with their employer are unable to benefit from this taxation differential. While these people are able to make personal superannuation contributions from their after-tax income (also known as un-deducted contributions) which are not subject to the contributions tax, this does not fully remove the horizontal inequity.

Regulating which people are able to receive tax concessions has also created inequities between those inside and those just outside the 'definitional boundaries', while policing such boundaries imposes significant administration and compliance costs. For example, if substantially self employed persons earn 10 per cent or more of their income in the form of salary and wages, they are denied access to the generous personal tax deductions as they are no longer included in the definition of self employed. This distinction has caused substantial difficulties for certain groups, including doctors and farmers. However, the boundary has to be drawn somewhere, unless employees are also to be permitted to deduct superannuation contributions.

The system also offers significant opportunities for tax deferral.

The Association of Superannuation Funds of Australia has a different view of the issue of equity. Its views are contained in its paper *Equity and Retirement Income Provision in Australia.* [the link is www.superannuation.asn.au/policy/equity.pdf]

Lack of Simplicity

The provisions governing the retirement phase of Australia's current retirement income system are highly prescriptive and suffer a number of inconsistencies and inefficiencies. The result is that the system is extremely complex to use and imposes significant compliance costs on redress, the superannuation industry and regulators. This, in turn, undermines community confidence in, and support for, superannuation.

An example of this complexity is the Reasonable Benefit Limit (RBL) system. The amount of concessionally taxed superannuation benefits a person is allowed to receive over his or her lifetime is limited by RBLs. The table below shows the lump sum and pension RBLs. The pension RBL is available provided that at least 50 per cent of the total benefit received by a person is taken in the form of a pension or annuity that satisfies the pension and annuity standards. RBL's are also indexed, and therefore increase on 1 July each year.

Reasonable Benefit Limits (for year 1/7/00 to 30/6/01)	$
Lump sum	**506 092**
Pension	**1 012 181**

In practice, every draw-down of a person's superannuation has to be reported by the superannuation fund to the Australian Taxation Office, which then records this draw-down against the person's RBL. This is an on-going reporting requirement, both for superannuation funds and the Australian Taxation Office, particularly for the latter who must maintain records of these draw-downs conceivably for the person's lifetime. Anecdotal evidence[16] suggests that not all superannuation funds provide complete and accurate reports to the Australian Taxation Office. This then undermines the credibility of a complex reporting system that must continue to operate for the lifetime of every superannuation fund member.

The taxation laws for superannuation are also complex and highly prescriptive. This is not the place to go into all of the details, however, interested readers are referred to another publication by the Department of the Parliamentary Library that provides an overview of these rules (*Superannuation Ready Reckoner: Taxation and Preservation Rules for 2000–2001*, Current Issues Brief No. 16, 1999–2000).

Lack of Transparency

The system is not transparent in that existing incentives for retirees to invest in income stream products are not clearly identifiable and/or quantifiable. In some cases, incentives in the tax treatment of retirement savings conflict with those in the social security means test arrangements. The result is that it is extremely difficult to identify and compare the underlying returns of different retirement products. Most individuals need to access professional advice to make informed decisions as to the best retirement strategy.

Tax Treatment of Superannuation Pensions and Annuities

Under the current system, the taxation of superannuation lump sums is completed at the point of retirement. That is, when superannuation savings are accessed and taxed in lump sum form on retirement, they cease to be superannuation and from that time on simply become an ordinary (taxed) source of capital available for investment or expenditure by the retiree. In general, such savings then become subject to the age pension assets test with those invested in financial assets subject to the extended deeming provisions.

By contrast, the taxation of superannuation pensions and annuities is not completed at the point of retirement, but continues over the life of the product. That is, if accessed as a pension/annuity, superannuation savings remain superannuation in retirement, and income from this source is taxed in a different manner from income derived from non-superannuation sources. This gives rise to a whole range of extra provisions specifically required for the taxation of superannuation pensions/annuities that retirees must be aware of. For a retiree with a superannuation pension/annuity, this complicates their annual tax return, and often requires a retiree with a part age pension to make quarterly reports to Centrelink on the capital and income of their superannuation pension/annuity for the purpose of complying with the income and assets test.

Complex Treatment of Superannuation Contributions

Perhaps the major complexity involved with determining the size of a superannuation benefit (i.e. determining just how much a person will have accumulated on retirement after considering the payment of taxes) arises because superannuation contributions are not taxed uniformly. The level of tax depends on a number of factors including who made the contribution, whether a tax deduction was claimed, the source of the contribution, and the timing of the contribution. This different treatment of contributions passes through to the end benefit, which when taken, comprises numerous components. As a result, retirement benefits may comprise as many as 13 different components (although most would comprise 2 or 3 different types) and are subject to up to 7 different tax rates including a zero rate on certain components. A person's tax liability on retirement will depend on the proportions of their retirement benefits that fall into each of the 13 components and decisions about how the benefits will be invested or spent on retirement. Those decisions will also influence the tax liability during retirement and will possibly also affect their age pension entitlement.

The result is a system with different categories of contributions to superannuation funds treated differently under the tax and social security systems, depending on when they were contributed, who made the contributions, whether they were made from pre- or post-taxation income and so on.

The major source of this complexity is the so-called 'grandfathering provisions'. 'Grandfathering' refers to the practice of introducing legislative changes without those changes affecting rights or benefits that have already been built up; in other words, introducing changes that do not apply retrospectively. Much of the complexity of Australia's current superannuation reflects its evolution through a series of successive changes. In many cases, when changes were made, given concerns regarding the need for stability and predictability in the system, earlier arrangements were 'grandfathered' to minimise the impact on individuals who organised their affairs under earlier arrangements. For example, one 'grandfathered' provision is the distinction between different periods of employment. Superannuation benefits have a pre-1 July 1983 component and a post-30 June 1983 component that effectively apportions an employee's superannuation benefit between periods of employment that occurred on either side of this demarcation point. This is one of a number of provisions that complicate compliance and administration.

Other Criticisms

Lobby groups have been vocal advocates of reform of the taxation of superannuation based on some specific shortcomings of the current taxation of superannuation; however, they have rarely addressed all of the relevant issues. The following section examines some recent reform proposals and their shortcomings.

Superannuation is no Longer as Concessional as it once was

The Association of Superannuation Funds of Australia (ASFA), the peak industry body of the superannuation industry, has argued that the value of superannuation taxation concessions have dropped by 25 per cent due to the change to the taxation of superannuation funds flowing on from the implementation of the recommendation of the Review of Business Taxation.[17] As a consequence of these reforms, superannuation funds are required to pay tax sooner than they did previously due to the introduction of the PAYG (Pay-As-You-Go) tax system.[18] Superannuation funds are not alone in this regard, since the PAYG system applies to all employers and companies.

ASFA has also argued that superannuation is not as concessional as it once was due to the narrowing of the differential between the lowest marginal tax rate (reduced from 20 per cent to 17 per cent on 1 July 2000) and the tax rate on compulsory superannuation contributions (15 per cent). The reduced differential of 2 per cent makes superannuation unattractive for people on the lowest marginal tax rate.

A contrary view is that even after the 1 July 2000 personal income tax cuts, superannuation remains concessional. In fact, even where a person's superannuation entitlement is comprised of only Superannuation Guarantee contributions, for persons in all tax brackets investing through superannuation produces a greater return over a lifetime than investing in a share portfolio.[19] The greatest advantage of investing through superannuation (compared with investing in a share portfolio) is for people in the highest tax bracket who earn 71 per cent more through investing through superannuation than investing a comparable amount in a share portfolio due to the tax effectiveness of investing through superannuation. By comparison, people in the lowest tax bracket earn 10 per cent more through investing through superannuation than investing a comparable amount in a share portfolio due to the tax effectiveness of investing through superannuation.

The author of this research[20] also argues that analysts that claim that superannuation is no longer concessional make the following errors:

- they add together the rates of taxation (i.e. the 15 per cent contributions tax, the 15 percent superannuation surcharge tax, the 15 per cent fund earnings tax and the 16.5 per cent eligible termination payment earnings tax). This approach is not valid because the different rates apply to different components, and

- they ignore the Eligible Termination Payment (ETP) tax-free threshold for a superannuation benefit.

Research conducted by AMP also concluded that voluntary superannuation contributions remain concessional.[21] A study by BT Funds Management also demonstrated a 73 per cent advantage of investing in superannuation over other non-superannuation investments for persons in the highest income tax bracket.[22]

Too Many Levels of Taxation

A common claim is that there is hardly any tax advantage for a person with a marginal tax rate of 30 per cent to invest in superannuation. This is because the combination of the 15 per cent contributions tax and the 15 per cent (plus Medicare Levy) payable on lump sum payouts at the time of retirement. One expert noted:

> The main rewards for having money locked away in superannuation for their working lives are a concessional 15 per cent tax on annual earnings, an indexed tax-free component on lump-sum payouts ($100 696 for 2000–01) and/or a tax rebate on superannuation pensions. For these people, the tax benefits from superannuation are minimal, particularly if an employer does not allow pre-tax, salary-sacrifice

> contributions … [This] is particularly chilling when it is considered that 81 percent of taxpayers have marginal tax rates of 30 per cent or less.[23]

It is often overlooked that the 15 per cent tax on annual earnings is not the rate of tax actually paid. The effective tax rate on earnings for a typical superannuation fund is around 6.5 per cent, taking into account dividend imputation and other factors.[24]

As stated above, it is erroneous to add together the different rates of taxation (i.e. the 15 per cent contributions tax, the 15 percent superannuation surcharge tax, the 15 per cent fund earnings tax and the 16.5 per cent eligible termination payment earnings tax). This is because the different rates apply to different components.

Another contrary opinion is that 'despite constant changes in the laws and the resulting complexity, super used wisely and strategically still remains the best wealth accumulation and investment vehicle', and, 'even after all the taxation changes, super still remains a most effective tax shelter, allowing wealth to be built up subject to low rates of income tax'.[25]

Existing Mandatory Contribution Levels are Inadequate to Fund Retirement

Another common criticism is that the existing schedule of Superannuation Guarantee contributions, once fully implemented, will not be sufficient to provide an adequate income in retirement. ASFA has argued that after 30 years of work just receiving Superannuation Guarantee contributions (at 9 per cent), only a relatively high income earner or a home owner on average earnings would be in a position to maintain a 'modest but adequate' lifestyle in retirement, while most people would only be able to afford a low cost lifestyle. ASFA claims that a figure of 12 per cent Superannuation Guarantee contributions are more consistent with achieving the 'rule of thumb' 60 per cent of pre-retirement income compared to the current maximum 9 per cent Superannuation Guarantee.[26]

A contrary view is that the fully implemented Superannuation Guarantee system should, after a full working life, provide a retirement income of a least 60 per cent of pre-retirement net expenditure. This superannuation benefit in combination with the age pension could give a retiree on a very low income more than 100 per cent of their net annual expenditure.[27]

Since the focus of this paper is the taxation of superannuation, the issue of whether the existing level of mandatory superannuation contributions will be adequate to fund a person's retirement will not be addressed. Such a discussion should of course consider superannuation accumulations in conjunction with eligible social security benefits.

Recent Proposals for Reform and their Limitations

In addition to criticising current arrangements, superannuation lobby groups have contributed to the public policy debate by preparing proposals to reform the taxation of superannuation. Some of these are discussed below.

ASFA's 'down payment' proposal

ASFA's 'down payment' proposal[28] is to require employees to contribute an extra one per cent of their salary to superannuation if, in turn, the Government matched this contribution by abolishing the current 15 per cent tax on employer contributions. ASFA claimed that their proposal was supported by 87 per cent of people who responded to their survey.

On the face of it, this proposal appears to be a method for increasing the amount of money flowing into superannuation funds. Despite abolishing one level of taxation, this proposal does not deal with many of the other existing structural difficulties with the system, such as the lack of equity, transparency, simplicity and the complex taxation of annuities and superannuation pensions. There is also no consideration of how to handle the revenue shortfall from abolishing the contributions tax.

Institute of Actuaries of Australia (IAA)

The IAA is the professional body for actuaries in Australia. It proposes a model for the taxation of superannuation, as follows:

- the taxation of superannuation would be based on the taxation of superannuation benefits alone (i.e. on an expenditure tax model); however some level of tax on investment income will be retained to maintain government revenue in the shorter term. This means abolishing the tax on employer superannuation contributions, and the 15 per cent superannuation surcharge tax.

- all superannuation contributions up to an annual limit would be either deductible or receive a rebate. The limit would be higher than the current maximum deductible contribution limit.

- superannuation benefits accruing after a so-called 'tax changeover date' would be taxed at marginal income tax rates when the benefit is paid—although some level of tax-free threshold will be retained.

- transitional benefit tax provisions would be used to protect the tax position of benefits accrued prior to the tax changeover date. This would involve a one-off benefit tax calculation under the current rules as at the tax changeover date. The dollar value of the pre-changeover benefit (indexed) and an overall tax rate on this benefit would be retained and used to calculate the tax payable on this component of the final benefit at the date of payment.

- an upper limit on the maximum benefits available (at a level similar to the current pension RBL) may be required to limit the total deferral available (possibly be applying penalty tax rates on benefits above this level).[29]

This proposal has some merit. First, it would remove the complexities and anomalies of the current different tax treatment of different types of contributions for funded/unfunded arrangements, employees/employers/self-employed, pre-tax/post-tax contributions. These would be removed or reduced. Second, it would allow the current 13 current different benefit tax components to be reduced to two—pre and post-changeover—while protecting (to a large degree) accrued entitlements. Third, the application of marginal tax on all benefits (i.e. lump sum and income streams) should encourage more people to take their entitlements as income streams.

The proposal also has a number of disadvantages. First, the policy cannot be characterised as an 'expenditure tax' approach since it retains the taxation of earnings. This is likely to require a much higher tax rate on earnings (at least in the short term) than currently applies if it were to recoup the cost of abolishing the tax on contributions. This would have a substantial impact on benefits accruals because of compounding effects, particularly for people who are close to retirement and whose benefits are growing the fastest due to the effects of compounding earnings.

Second, it also ignores the strong preference of retirees to take some portion of their retirement benefit as a lump sum. Any proposal to restrict the taking of lump sums would have considerable political risk.

Third, the treatment of all superannuation contributions the same way is at a considerable cost to revenue (at least $3.5 billion per year), with no guidance on how such a Budget shortfall would be re-couped or alternatively, which spending programs should be cut to fund it. Any claw-back through taxation of end benefits at marginal rates would take some time to realise.

Fourth, it is not necessarily true that taxes on contributions are more of a burden than taxes on benefits. To the average person, a tax is a tax no matter how it is levied. The main difference between taxes at the two points is the formal incidence. It is arguable that a retiree is not in a better position to comply with tax laws than someone still in the workforce.

Finally, and perhaps most importantly, it is likely that there would be a strong negative reception from the public to tax a retiree's superannuation at their marginal tax rate. Under this proposal, the combination of relative high marginal rates coming into effect at relatively low levels of income, would result in many retirees paying 48.5 per cent tax on their superannuation benefit.

ASFA's 'Blue Skies' Proposal

This proposal provides the Government 'with a strategy for developing a coherent retirement income system and ensuring its viability into the future'.[30] It proposes what ASFA considers to be a comprehensive model for retirement income policy as it should be in the long term, including taxing superannuation in the following manner:

> A gradual transition to a system based solely on the taxation of benefits as income streams because it would be fairer and more equitable, more efficient, less costly to administer and more supportive of saving for retirement.[31]

It could be argued that this proposal merely attempts to return to the form of taxation of superannuation that applied before the 1988 reforms, that is, the taxation of benefits only. The ASFA paper fails to answer a question raised by their proposal: what should the Government do about the revenue shortfall caused by the abolition of the contributions tax and the superannuation surcharge tax? In the absence of any recommendation as to how to replace this revenue, political reality often elevates budgetary fiscal responsibility over the ideal design of the taxation system, making it unlikely that ASFA's 'blue sky' policy or the IAA suggestions would be adopted by Government.

Australian Council of Social Service

The Australian Council of Social Service (ACOSS) is the national peak council of the community welfare sector in Australia, the principal voice of low-income and disadvantaged people in social and economic policy matters. ACOSS's model for the taxation of superannuation attempts to balance equity, cost and flexibility,[32] and is summarised below.

- employer contributions and fund earnings should be taxed at the marginal income tax rate for each fund member

- superannuation benefits (apart from excessive lump sums) would be largely tax free, and

- a tax rebate would replace the 15 per cent tax on employer contributions and fund earnings. The rebate would increase with the level of contributions made (whether by employers, employees or the self-employed) up to an annual ceiling, which could increase with the member's age. The rebate could then be deposited at the end of each financial year in the relevant superannuation fund so that it adds to savings rather than consumption.

This proposal has some merit. First, it improves the equity in the superannuation system by taxing all superannuation contributions at the member's marginal tax rate. Second, it simplifies the superannuation system by applying the same rate of taxation to superannuation contributions, irrespective of who made them and when they were made. Third, the proposal improves the level of transparency by delivering tax concessions in the form a capped rebate. This makes transparent the level of tax concessions available to each fund member.

The proposal also has some disadvantages. First, the proposal does not address all of the equity and complexity concerns in the superannuation system because of changes that have been implemented since the ACOSS model was released in 1995. For example, the paper was written prior to the introduction of the superannuation surcharge tax, which was introduced in 1996, and therefore does not address the issues surrounding it. Second, the proposal to tax superannuation fund earnings at the member's marginal rate may be difficult to implement, and may further complicate the taxation laws applying to superannuation. Third, the paper fails to articulate what constitutes an 'excessive' lump sum since 'excessive' is likely to mean different things to a high income earner and a low income earner. Therefore an objective standard is required.

Difficulties with only Taxing Superannuation at the End Benefit Stage

Both ASFA and the IAA support the principle of taxing superannuation only at the point of retirement (i.e. using an expenditure tax base). According to these organisations, an expenditure tax base is preferable to the existing taxation arrangements of taxing superannuation contributions, fund earnings and benefits (i.e. using an income tax base). The relative merit of one tax base over another was considered by the Government's Review of Business Taxation. Its views were as follows:

> Historically, the Australian business tax system has been based on income. The Government's tax reform strategies announced in *A New Tax System* are likewise predicated on an income tax base. Conversion to either of the alternative bases would entail resolution of a number of substantive design issues. As part of the overall design of a new tax base, the treatment of depreciable assets now in place, the taxation of financial arrangements, transitional provisions and international taxation implications would all need consideration. With these consideration and its reporting timeframe in mind, the Review has interpreted its terms of reference as confining its attention to an income tax base as the relevant operating principle.[33]

In theory, an expenditure tax base may be a highly desirable way to tax superannuation. In light of the reforms over the past 20 years of expanding the income tax base (e.g. through bringing superannuation into the tax base and taxing fringe benefits) and the views of the Review of Business Taxation on the appropriateness of the income tax base, it is highly unlikely that any reform of taxation would involve the adoption of an expenditure tax base. In light of the Government's acceptance of most of the recommendations of the Review of Business Taxation (including the retention of an income tax base), the question that remains is what reforms could be made to improve the taxation of superannuation within an income tax framework that also improves equity, simplicity, transparency, and internal consistency. An attempted solution to these particular problems is provided in the following section.

Reform Options

In light of the structural and other deficiencies in the taxation of superannuation (outlined above) and in proposals to date for its reform, a number of possible reforms could be proposed and these are discussed below.

Lack of Equity

The problem of the lack of equity in the superannuation system could be addressed by taxing compulsory employer superannuation contributions at the member's marginal income tax rate. In particular, all compulsory employer superannuation contributions made in accordance with the *Superannuation Guarantee (Administration) Act 1992* and industrial awards would be paid to a superannuation fund out of post-income tax money and not taxed again. This would require amending the *Income Tax Assessment Act 1936*. This would replace the current requirement that compulsory employer superannuation contributions not be subject to income tax in the hands of the employee.

All superannuation contributions would be paid to the relevant superannuation fund on at least a quarterly basis. This would require additional amendments to the *Superannuation Guarantee (Administration) Act 1992*. The employer would then report the payment of superannuation contributions to the Australian Taxation Office as part of the Pay-As-You-Go reporting system.

The concessional tax treatment of superannuation would be sustained by introducing a rebate of, say, 30 per cent on the tax paid by the employee on their superannuation contributions.

Taxing compulsory employer superannuation contributions at marginal income tax rates combined with the introduction of a rebate would improve the targeting of tax concessions. It is the tax deductibility of employer superannuation contributions that makes salary sacrifice so attractive to employers and employees. The evidence suggests that this deductibility has been abused, most notably by mass marketed employee benefits schemes such as 'controlling interest superannuation schemes' that, according to the Commissioner of Taxation, 'seek to secure even more concessional treatment than that supported by the Parliament'.[34] By taxing superannuation contributions at marginal rates (and thereby effectively abolishing salary-sacrifice into superannuation) the so-called 'abusive schemes', that together with other employee benefit arrangements that have allegedly cost the Government revenue of $1.5 billion,[35] could largely disappear.

In order to simplify the assessment of the new superannuation contributions rebate, only Superannuation Guarantee contributions made to an accumulation superannuation fund would qualify for the rebate. In practice this would mean that employers with defined benefit superannuation funds would have to meet their Superannuation Guarantee obligations by paying into a complying accumulation superannuation fund. Defined benefit funds will not be outlawed, but contributions to such funds would not meet the employer's obligations under the Superannuation Guarantee scheme. Defined benefit funds would be permitted to receive above-award and above-Superannuation Guarantee mandated contributions.

It is likely that the proposal to offer a rebate only on contributions made to accumulation (defined contribution) funds would be criticised. Some may argue that such a proposal marks the end of defined benefit funds. This is not that intention since they will be able to receive superannuation contributions made in excess of award and superannuation guarantee obligations. The main rationale is simplicity. To pay a similar rebate on contributions made to defined benefit funds (which are made by the employer) would require a complex method of determining the amount of employer contribution attributable to the employee. Such a method would require an actuarial calculation that employed a method similar to that use to calculate superannuation surcharge liabilities. The proposals put forward in this paper abolish the superannuation surcharge tax (and all of the costs associated with it compliance) to help simplify the taxation of superannuation. It is arguable that also offering the rebate on contributions to defined benefit funds would reinstate the complexity, something everyone wants to avoid. In simple terms, reforms should not give with one hand and take away with the other.

Too Many Levels of Taxation

With all employer superannuation contributions taxed at the member's marginal income tax rate, there would no longer be any rationale for taxing superannuation contributions. Therefore, the following taxes could be abolished:

- the 15 per cent contributions tax, and
- the superannuation surcharge tax.

Abolishing the 15 per cent contributions tax would be achieved by amending the *Income Tax Assessment Act 193*6. Abolishing the superannuation surcharge tax would be achieved by repealing the following Acts:

- *Superannuation Contributions Tax Imposition Act 1997*
- *Superannuation Contributions Tax (Assessment and Collection) Act 1997*
- *Superannuation Contributions Tax (Application to Commonwealth) Act 1997*
- *Superannuation Contributions Tax (Application to Commonwealth–Reduction of Benefits) Act 1997*

- *Superannuation Contributions Tax (Members of Constitutionally Protected Superannuation Funds) Assessment and Collection Act 1997*
- *Termination Payment Tax Imposition Act 1997,* and
- *Termination Payment Tax (Assessment and Collection) Act 1997.*

Lack of Simplicity

Abolishing the contributions tax and the superannuation surcharge tax would greatly simplify the operation of superannuation funds and the Australian Taxation Office. Abolitions of the surcharge tax alone would greatly simplify things.[36]

The *Income Tax Assessment Act 1936* sets maximum limits on the amount of tax deductible employer superannuation contributions that can be made on behalf of an employee each financial year (also known as age-based limits). This paper's proposal to tax compulsory employer superannuation contributions at marginal income tax rates makes redundant these contribution limits. Under the arrangements proposed by this paper, the maximum level of compulsory superannuation contributions (taxed at marginal tax rates) an employer could make on behalf of an employee are limited by the existing maximum contribution base under the *Superannuation Guarantee (Administration) Act 1992.* It makes no sense then to also retain age-based limits (designed to limit the amount of employer superannuation contributions made that attract the concessional tax rate of 15 per cent) given that this paper proposes that:

- the level of superannuation contributions is capped by the maximum contribution base under the *Superannuation Guarantee (Administration) Act 1992*, and
- employer superannuation contributions no longer be taxed concessionally, and that superannuation contributions be taxed at marginal income tax rates.

Therefore, the aged based limits set under the *Income Tax Assessment Act 1936* would be abolished.

Taxing superannuation contributions at marginal income tax rates also removes the rationale for having RBLs (i.e. the amount of concessionally taxed superannuation benefits a person is allowed to receive over his or her lifetime). Abolishing RBLs would simplify superannuation fund reporting requirements and remove a complex administrative requirement from the Australian Taxation Office.

Transparency and the Treatment of Pensions/Annuities

All superannuation benefits should be taxed once at the point of retirement. Pensions/annuities purchased with this money would then be exempt from income tax.

This proposal, which would be implemented by making amendments to the *Income Tax Assessment Act 1936*, would remove (as far as is possible) people from the superannuation system at the date of their retirement. It also removes the current need for retirees to report pension/annuity income and capital values to the Australian Taxation Office and Centrelink. In many instances this reporting continues through retirement for the life the pensioner/annuitant.

Transparency would also be improved by clearly demonstrating the benefits of purchasing a pension/annuity—tax free income. This would also encourage retirees to use their superannuation benefit to purchase a pension/annuity.

Taxing all superannuation benefits at the point of retirement would significantly reduce the scope for tax deferral through the application of particular retirement investment strategies, and provide for the orderly draw down of capital and earnings, while retaining freedom of investment choice for retirees.

Other issues

The present system of unlimited un-deducted contributions into superannuation would continue.

Superannuation fund earnings would continue to be taxed at 15 per cent, as well as having continued access to the dividend imputation system. Nonetheless, in light of the effective rate of taxation being 6.5 per cent, and the immediate revenue shortfall faced by Government, there may be a need to consider raising the rate, in the short term, above 15 per cent.

Conclusion

There is almost universal agreement that the taxation of superannuation is complex and in need of agreement on. Despite this agreement, there is no perfect tax system for superannuation, let alone how tax should apply to superannuation. This paper has argued that the superannuation system should have certain goals and objectives that include simplicity, transparency, and equity. Unfortunately, the taxation of superannuation does not meet these goals. A number of lobby groups have proposed reforms to the taxation of superannuation, however, these proposals have a number of shortcomings that would make it unlikely for Government to adopt them. A number of reforms that could be made to improve simplicity, transparency, and equity have been identified in this paper. It should also be noted that doing nothing is also an option. However, given the aging of Australia's population and the impending retirement of the 'baby-boomer' generation, the longer that governments leave reform, the more pressing will be the political imperative to do something.

Endnotes

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