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Tax White Paper Task Force
The Treasury
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Re: Challenger Limited Submission to the Tax White Paper

Challenger Limited is Australia's largest provider of annuities and the seventh largest fund manager with a corporate vision to provide Australians with financial security in retirement.

This submission is focussed on the tax treatment of superannuation and retirement incomes. It discusses the tax treatment of the superannuation system arranged according to the following eight policy objectives:

1. Objectives of superannuation;
2. Addressing adequacy
3. Improving equity
4. Targeting tax concessions;
5. Appropriate asset allocation;
6. Providing pension rules to achieve the objective for superannuation recommended by the FSI;
7. Reducing the need for complex pension rules to protect the revenue;
8. Improving the short term budget position; and
9. Improving the long term budget position;

Pursuing these policy objectives requires trade-offs and some are mutually exclusive.

This submission discusses the use of eight sets of tax policy levers as the means to pursue these objectives:

1. Contribution caps;
2. Contributions Tax and rebates;
3. Earnings Tax and exemptions;
4. Benefits Tax and exemptions;
5. Imputation system;
6. Capital Gains Tax and Discounts;
7. Relative tax treatment outside superannuation; and
8. Pension rules.

This submission draws on material from a previous submission by Challenger to the Review of Australia's Future Tax System (AFTS), the AFTS Final Report and some subsequent modelling published by Treasury's Retirement and Intergenerational Modelling Unit.

1. Objectives of superannuation

In addition to raising sufficient revenue, the general objectives for the tax system include, equity, integrity, efficiency and maintaining Australia's international competitiveness. The tax treatment of superannuation should also be consistent with these objectives as well as assisting the delivery of financial security in retirement for all Australians. The Financial System Inquiry (FSI) set out a well-reasoned set of objectives for the superannuation system, worthy of adoption:

To provide income in retirement to substitute or supplement the Age Pension.

The FSI also proposed a number of subsidiary objectives for the superannuation system:

- *Facilitate consumption smoothing over the course of an individual's life.*
- *Help people manage financial risk in retirement.*
- *Be fully funded from savings.*
- *Be invested in the best interests of superannuation fund members.*
- *Alleviate fiscal pressures on government from the retirement income system.*
- *Be simple and efficient, and provide safeguards.*

The primary objective of the superannuation system, providing retirement income, is central to the rationale for providing concessional tax treatment for contributions, earnings and benefits as well as the current co-payment for low income earners. Use of the taxing power to raise Superannuation Guarantee (SG) contributions and the tax concessions afforded superannuation contributions, earnings and benefits are the principal drivers of Australia's superannuation system. The FSI's recommended objective clarifies where future policy changes should be targeted.

The Government recently announced a policy decision to increase the thresholds and the taper rate for the Age Pension. Notwithstanding the FSI's objective and any closer targeting of Age Pension benefits, substantial tax concessions will continue to flow to individuals with significant assets and higher incomes. For reasons of fiscal sustainability further consideration should be given to the current superannuation tax concessions flowing to higher income earners. Control of these concessions is currently achieved using caps on concessional and non-concessional contributions.

One of the limitations on policy is that it is not fiscally sustainable to provide tax concessions to support accumulation of balances that are very large by community standards. High balance superannuation accounts were accumulated when there were no limitations on contributions. At the time holders of those accounts would have expected high tax rates to be applied on benefits above the Reasonable Benefits Limits (RBLs). The government conferred a retrospective benefit on these high account holders when it abolished the RBLs in 2007.

If the superannuation system does not have a primary policy purpose of delivering retirement incomes it will increasingly become a subsidised investment vehicle which will distort allocative efficiency and result in lower economic performance due to the need to raise additional revenue elsewhere.

The subsidiary objectives set out by the FSI relate to fiscal sustainability, the sustainability of individuals' retirement incomes and the need for simplicity and safety of the system. The subsidiary objectives which relate to consumption smoothing and the sustainability of individuals' retirement incomes are dealt with in the pension rules which provide access to continuing superannuation tax concessions. Revision of these rules is currently at an advanced stage of consideration by Treasury's Review of retirement income stream regulation. Given the number of baby boomers retiring without access to a full range of longevity products, resolution of these issues is urgent and should not be delayed. Those issues should be dealt with expeditiously outside the Tax White Paper process in conjunction with the Government's response to the FSI.

2. Adequacy

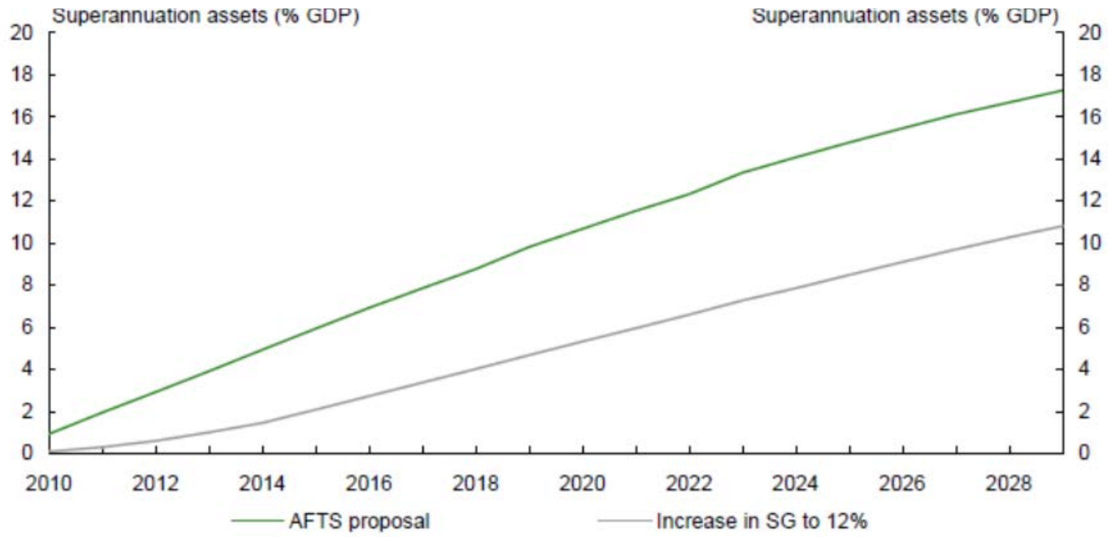
There is a direct relationship between the aggregate cost to government of additional tax concessions and the effect on aggregate retirement incomes. On average, if superannuation taxes are reduced then superannuation assets grow and ultimately retirement incomes will rise. On average, if superannuation taxes are increased then superannuation assets are reduced and ultimately retirement incomes will fall. In the absence of behavioural change, on average and with a lag, this is a zero sum game between retirees and government revenues.

However, the distribution of income and retirement savings is not equal so each tax option will have a different redistributive effect. A relatively small number of high income earners make large contributions and have significant superannuation assets while a relatively large number of low income earners make comparatively small contributions and have limited superannuation assets. As a consequence most of the benefits of superannuation tax concessions go to high income earners and, in terms of supplementing or replacing the Age Pension in retirement, these concessions are not targeted at meeting the objective for superannuation set out by the FSI. (The distribution of government fiscal support for retirement incomes is discussed in more detail below in section 3: Equity.)

AFTS proposed changing the mix of superannuation tax concessions by taxing contributions at the individual's top marginal rate with a 20% refundable rebate, and imposing a level Earnings Tax at 7.5% for both accumulation and pension phase. The expected outcome, in terms of the effect on total superannuation savings, were described at page 114 of AFTS Final Report:

"The recommended changes to the taxation of superannuation would increase private savings more than would an increase in the superannuation guarantee rate to 12 per cent under the current tax arrangements. These benefits would result mainly from halving the earnings tax to 7.5 per cent, which would significantly increase superannuation assets and increase private savings. Superannuation assets are estimated to increase by approximately $590 billion (nominal dollars) by 2029 under the taxation proposals, compared to approximately $370 billion (nominal dollars) if the superannuation guarantee were to be increased to 12 per cent" (see Chart 1).

Chart 1: Projected increase in superannuation assets



Source: Treasury projections.

Stamp duty

Duties on life insurance have a significant impact and are a contributing factor to underinsurance. Underinsurance in the context of life insurance impacts adequacy.

The issue of some types of annuity with particular features may result in part of the product becoming subject to State stamp duties which can be as high as ten per cent. This is because State Revenue Offices often have a broad view of what amounts to general insurance and will construe peripheral aspects of the product to be dutiable riders. In some instances, States and Territories have sought to explicitly enshrine this in legislation. For a recent example see the Revenue and Other Legislation Amendment Bill 2015 (NT) introduced into NT Parliament on 29 April 2015, which seeks to abolish duty on "life insurance" and yet continues to impose duty on "life insurance riders". Deferred lifetime annuities (DLAs) are superannuation annuities and should not attract stamp duty in whole or in part.

The industry's experience with some SROs is that an explicit clear announcement needs to be made at inception otherwise contrary interpretations can emerge from those offices at later points in time. However, notwithstanding the desirability of resolving this issue with the States, its resolution should not be permitted to delay removal of the impediments to DLAs.

The stamp duty rules as they apply to these types of annuity products are uncertain, ambiguous and inconsistent across jurisdictions. In our view, the complex, uncertain and inconsistent possible application of "nuisance" taxes such as insurance duty to DLAs clearly highlights the broader inefficiencies and difficulties in administering certain state taxes. More importantly, the current system of state taxation can impose real and significant obstacles to the promotion of products such as DLAs which should otherwise be facilitated as a matter of good policy.

The Australian government should consult with the State Governments to eliminate this potential unnecessary additional cost, both in the context of inefficient state taxes such as insurance duty on DLAs specifically and at a broader level the removal of inefficient state taxes such as insurance duty and other stamp duties in their entirety.

3. Equity

In 2009 the AFTS consultation paper noted that 5% of individuals accounted for over 37% of concessionally taxed superannuation contributions, including SG contributions, salary sacrificed contributions and deductible contributions made by the self-employed.

In 2012 Phil Gallagher PSM, then the Manager of Treasury's Retirement and Intergenerational Modelling Unit, made a presentation to the UNSW Colloquium of Superannuation Researchers titled; The Distribution of Government Support for Retirement Income – Point-in-Time and Lifecycle Estimates. (See Appendix A). The presentation showed that the top two deciles combined receive more than 57.2% of superannuation tax concessions while the bottom four deciles combined receive 6.8%.

This Treasury presentation also examined the distribution of total government support for retirement incomes, which combines both Age Pension and tax concessions for each decile, For males this showed that total income support in different combinations of Age Pension and tax concessions was distributed equitably for the bottom eight deciles but increased dramatically in the form of tax concessions over the 9th decile. Females, who generally have lower retirement savings receive higher Age Pension support and lower tax concessions, so total government income support is higher than for males initially but declines from the 5th to the 9th decile as a result of women receiving smaller amounts of tax concessions due to their lower retirement savings. Tax concessions and total government income support rises rapidly over the top decile but by a lesser amount than for males.

These two sets of distributions show that there is scope to reduce total government income support to the highest decile and target the same total level of income support to lower deciles, or make savings, or some combination of the two.

Those on high incomes receive more SG contributions and have the capacity to make more voluntary contributions. This is the group least likely to ever access the Age Pension and related benefits, and the most likely to provide for their own retirement, even without superannuation concessions.

Conversely, those on low incomes, below the tax free threshold or with a marginal rate of tax of 15%, get the least SG contributions, which without Low Income Superannuation Contributions (LISC), are taxed heavily relative to the rest of their income. They have little capacity and negative or zero incentives to make additional superannuation savings from before tax income.

It is this group that is most likely to access the Age Pension and related benefits, and the least likely to provide for its own retirement, even with superannuation concessions. This group, and those in the 30% tax bracket, could benefit from more significant superannuation saving tax concessions, and potentially reduce their reliance on the Age Pension.

The AFTS Review addressed these issues with proposals that were an alternative to an increase in the SG to 12% by recommending:

- Providing a more equitable distribution of tax concessions by taxing contributions at the individual's top marginal rate and providing a 20% refundable rebate; and
- Increasing the pool of superannuation savings by reducing Earnings Tax in accumulation to 7.5%; they also proposed to
- Simplify the pension rules by providing for the Earnings Tax to be at a level rate in both accumulation and pension phase.

The expected outcomes from these recommendations were summarised in Volume 1 of the Final Report of AFTS. Page 109 referred to the benefits for lower income earners:

"The effect of the superannuation tax recommendations, in addition to the increase in the Age Pension, would be equivalent to a 15 per cent superannuation guarantee rate over a full working life for a person earning 0.75 x AWOTE (approximately median earnings) and AWOTE before the 2009–10 Budget. However, an increase in the superannuation guarantee rate to 15 per cent under the existing tax rules would retain the existing inequitable distribution of concessions."

4. Targeting tax concessions

Challenger's submission to AFTS examined a spectrum of possible options for changing the taxation of superannuation in the contribution and accumulation phases. It did not examine the tax free status of benefits as that had been excluded by the then government from the review. It is worth noting that the tax free status of superannuation after retirement and age 60 had provided a powerful incentive and opportunity for many people, particularly late in their lives, to top up their superannuation using transition to retirement arrangements and/or to transfer other assets, savings and investments into superannuation.

The modelling showed that the tax options such as abolishing the contributions and earnings taxes, would increase the level of superannuation assets by as much as 25% of GDP and increase retirement incomes by about 1% of GDP by 2040-41. However the cost to the Commonwealth budget would have been about 1.5% of GDP a year and the redistributive effects substantial and severely regressive. An overwhelming proportion of the benefits would go to the affluent and the costs would have to be borne elsewhere.

At the other end of the spectrum the regressive nature of the current incentive arrangements could be corrected by tax measures such as taxing contributions at the individual's top marginal rate. However, this would have only a small positive impact on the circumstances of those on incomes below the tax free threshold, no impact on those on a 15% tax rate, a negative impact of 15% on those on the 30% rate, and it would result in a very substantial reduction in the tax incentives received by those on the 40% and 45% marginal tax rates. While its redistributive effect would objectively measure as progressive it would do so as a result of increasing tax not by increasing superannuation savings.

The benefit of the tax changes of about 1% of GDP would go to government revenue. As a result, by 2040-41 superannuation assets would have fallen by about 15% of GDP and retirement incomes would be about 0.5% of GDP lower. In reality the loss of tax incentives by the affluent would mean that the assumption of no behavioural change would not hold and there would be a significant reduction in voluntary retirement savings, resulting in a much larger reduction in superannuation assets and retirement incomes.

There are of course many possible options between these extremes which could be used to alter the levels of tax, superannuation assets and retirement income at the margin to achieve various combinations of beneficial effect. These are arrayed on a continuum between the progressive and the regressive tax measures described above, in Charts 1 and 2 to show the costs, benefits and redistributive effects. The options and the methodology are fully described in separate reports by Geoff Carmody and Associates (See Appendix B) and Access Economics (See Appendix C). Of the possible tax options discussed a number have features which are worth further examination:

- Taxing contributions at the individual's top marginal rate and providing a level refundable rebate to their superannuation fund, so that all retirees receive the same rate of concession.
- Taxing contributions at the individual's top marginal rate but then applying different rebates to adjust the impact of the contributions tax on each tax bracket. This approach has advantages in terms of targeting. Standard reductions in income tax rates flow to all higher income groups and do so without reducing their marginal tax rates, unless they are targeted and withdrawn, in which case the withdrawal produces even higher effective marginal tax rates (EMTRs). In contrast, these rebates can be quarantined to lower income groups without giving rise to any EMTR problems, because they apply only to each individual's marginal taxable income.

Chart 1: The 24 Tax Reform Options: Summary Trends

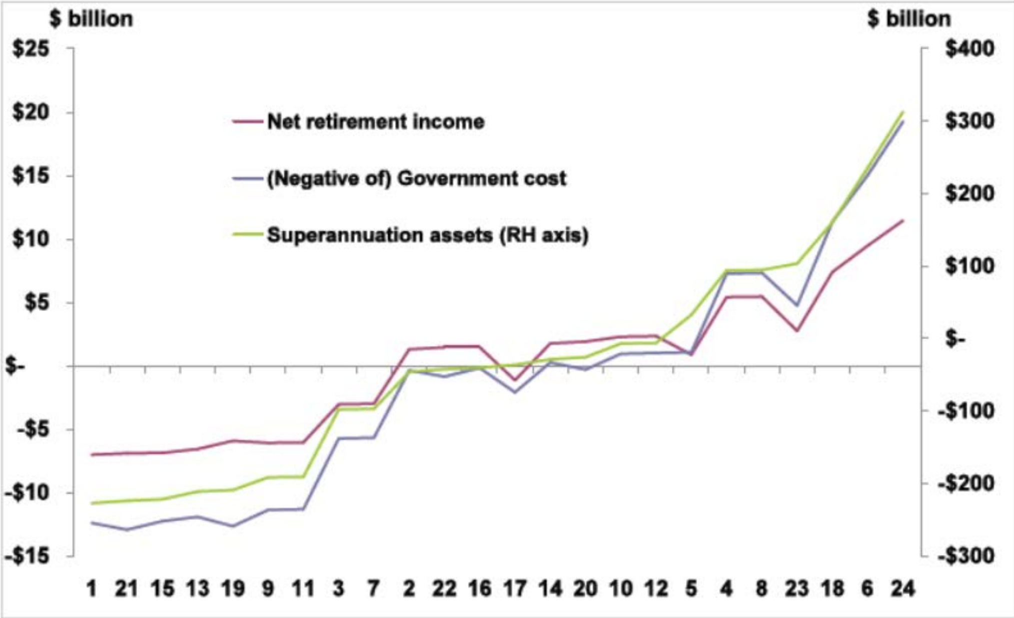
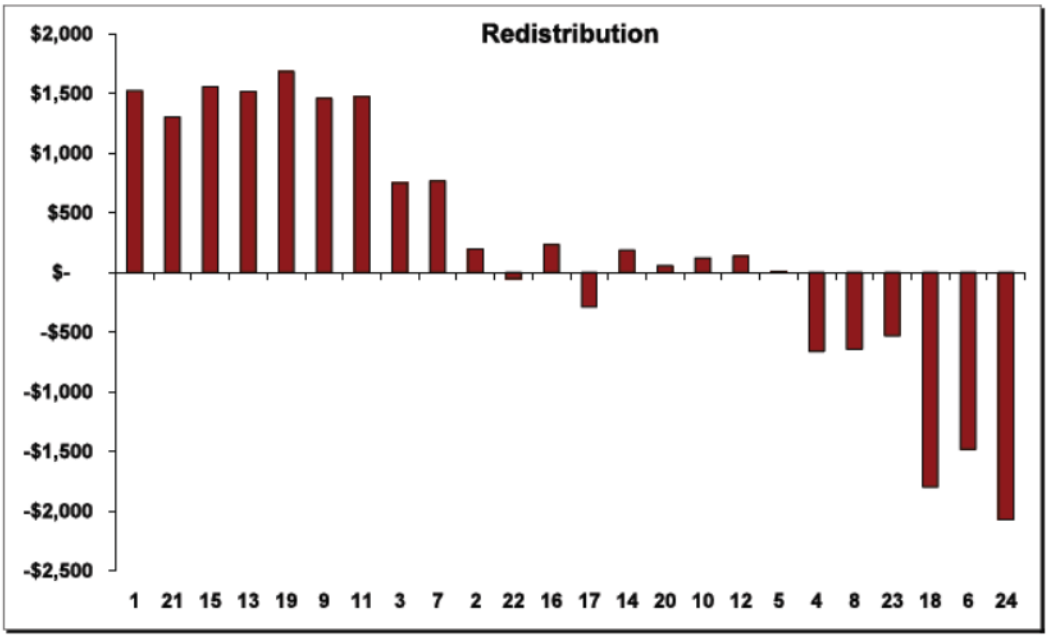


Chart 2: The 24 Tax Reform Options: Summary redistributive Effects Versus the Modest but Adequate' Standard



Taxing contributions at the individual's top marginal rate and providing a refundable rebate makes practical some structural reforms to superannuation taxation:

1. By notionally providing full income tax treatment of superannuation contributions it allows contributions tax to be paid from before tax income by the employer rather than by the superannuation fund, removing administrative complexity for superannuation funds.
2. Any rebate would be paid by the Tax Office to the individual's nominated superannuation fund, again removing administrative complexity for the superannuation fund.
3. It would address concerns about the adequacy of the 9.5% SG without having to increase it.
4. It is less regressive than the current arrangements.

5. Appropriate asset allocation

Imputation System

Australia's imputation system was introduced in 1987, primarily to remove the double taxation of dividends. It was also intended to reduce the tax bias toward debt. Defined Contribution (DC) superannuation was in its infancy and some policy makers believed that superannuation asset allocations would benefit from a shift away from investment in fixed interest. The investor response has greatly exceeded those early expectations with a strong bias now to investment by superannuation funds in equities. The provision of franking credits as refundable offsets in excess of tax liabilities has reinforced that bias.

The period in which Australia has had an imputation regime also coincided with the era of major privatisations which broadened the shareholder base to a large number of mum and dad investors. These small investors put a high value on franking credits and, whether the shares are held in an SMSF or outside superannuation, have factored them into their financial plans and income expectations. After almost 30 years franking credits are part of the landscape.

However, there is good reason to question Australian superannuation investors' high allocation to equities, particularly as fund members approach retirement and begin drawing a pension. Sequencing risk is a major issue for this group and larger allocations to defensive assets are appropriate to help manage this risk. More focus needs to be placed on assets capable of delivering income in retirement requiring some rebalancing away from seeking equity risk premiums. With the Baby Boomers entering retirement there should be a considerable increase in demand for lifetime annuity products and the fixed interest securities needed to back them.

The need for more appropriate asset allocations in retirement are only a small part of any policy debate on the merits of retaining the current imputation arrangements. Since imputation credits are only available to Australian taxpayers they represent a subsidy to local owners of equities, resulting in the corporate tax rate being higher than it would otherwise need to be, affecting Australia's competitiveness in attracting international capital.

This lack of international tax neutrality has the converse effect of making international investments by Australian domiciled companies relatively less attractive than local Investments. However, it is unlikely that this is decisive in those investment decisions.

Capital Gains Tax Discount

The current CGT discount system was introduced following the recommendations contained in 'A Tax System Redesigned' ('the Ralph Report') which was released in 1999. This system effectively allows a 50% discount to the tax rate for individuals and trusts, and a one third discount to the tax rate for superannuation funds, on capital gains realised on the sale of assets which have been held for more than 12 months. The CGT discount system replaced the previous system where CGT relief was based on the movement in CPI over the period that the asset was held.

According to the Ralph Report, the CGT discount system was primarily introduced to 'enliven and invigorate the Australian equities market, to stimulate greater participation by individuals, and to achieve a better allocation of the nation's capital resources'. In making its recommendation, the Review concluded that a stepped rate system, linked to the holding period of an asset:

- Only rewarded 'patient capital' rather than freeing up capital markets, thereby exacerbating the 'lock in effect' of realisation; and
- Would not appropriately reward short term investment in venture capital markets.

In a low inflation environment, the current CGT discount rates which apply after a 12 month holding period can distort investor behaviour, asset allocation decisions and retirement planning.

The following table highlights the differences in the tax treatment of certain assets:

	Effective tax rate – Individual*	Effective tax rate – Super fund
Gains on non CGT assets; interest income; unfranked dividends; rental income	47%	15%
Net capital gains on CGT assets held for more than 12 months	23.5%	10%

* Including Medicare Levy of 2%, excluding Temporary Budget Repair Levy of 2%
** Refund position of excess 15% tax

A review of the appropriate level of discount to be applied to certain taxpayers warrants further consideration to ensure there is an equitable tax treatment of, and between, retirement savings products and investments.

Tax neutrality

The Carmody paper (see Appendix B) notes that that exempting superannuation from Earnings Tax would produce a set of arrangements for taxation of superannuation which mirror the tax treatment of the principal place of residence. That is, both would be purchased out of after-tax income, earnings on both types of investments would be tax free, and realization of both investments (when the family home is sold or superannuation savings drawn down) would be tax free.

While this would remove any tax preference for the principal place of residence over superannuation, it would have little effect on current preferences for investment in the family home because of the immediate consumption component associated with owning a better home and the non-neutrality of social security treatment given the exemption of the family home from the Assets Test.

6. Providing pension rules to achieve the objective for superannuation recommended by the FSI

In furtherance of the objectives of superannuation, the final FSI report recommended superannuation fund trustees be required to pre-select Comprehensive Income Products in Retirement (CIPRs) for members to receive their superannuation benefits. CIPRs should take into account the particular risks of retirement, including longevity, inflation and market risks, as well as behavioural factors which currently result in retirees not managing these risks.

The final FSI report also recommended that impediments to development of appropriate retirement income products should be removed, such as DLAs.

Deferred lifetime annuities

A DLA will provide an income stream for life commencing at a specified later date, conditional only on survival. DLAs will provide protection against longevity risk and investment risk later in retirement. A DLA can provide a guarantee against inflation risk. DLAs can remove the uncertainty about how long other components of a retirement portfolio must provide income. There may be a gap if a market linked component of the total retirement solution fails prior to the DLA's drawdown starting.

By pooling longevity risk DLAs ensure that retirees do not become totally dependent on the Age Pension. A relatively modest premium on retirement should produce sufficient income to cover the care component of aged care when they become frail. In terms of fiscal sustainability, DLAs provide private income in the latter stages of retirement which is available for both the Age Pension and aged care means tests thus reducing the longevity risk borne by taxpayers. DLAs are an intense promise regulated by APRA with strict prudential standards, supervision, powers of regulatory intervention, substantial capital requirements and guaranteed income.

There are a number of impediments, including tax treatment, which render DLAs unattractive to retirees uneconomic to provide and preclude their provision.

Revision of the rules to remove these impediments is currently at an advanced stage of consideration by Treasury's Review of retirement income stream regulation. Given the number of baby boomers retiring without access to a full range of longevity products, resolution of these issues is urgent and should not be delayed. Those issues should be dealt with expeditiously outside the Tax White Paper process in conjunction with the Government's response to the FSI.

Impediments

DLAs face a number of impediments which render them unattractive to retirees, uneconomic to provide and preclude their provision. Specifically, DLAs:

- Are not eligible for either an Earnings Tax or Benefits Tax exemption in pension phase and after age 60.
- Are not treated as a risk product even in cases where they are non-commutable.
- May be subject to accruals tax if purchased by a superannuation trustee.
- Could be required to offer a minimum surrender value, which would undermine pricing by precluding the availability of mortality credits inherent in the pooling arrangement.
- Are incompatible with the minimum drawdown rules, as discussed by AFTS.
- Are not contemplated by the means test arrangements for the Age Pension and aged care during the deferral period.

With appropriate integrity measures there is no scope for DLAs to be used for tax deferral and estate planning mischief. Provision of DLAs requires the following policy changes:

- Define a DLA as a SIS pension from payment of the premium. This would exempt DLAs from both Earnings and Benefits Tax. This was provided for in the unimplemented DLA measure of 2013.
- Exempt non-commutable DLAs from the minimum drawdown rules during the deferral period, as discussed by AFTS and provided in the unimplemented DLA measure of 2013.
- It would be preferable to treat non-commutable DLAs as a risk product, whenever they are bought but if there are insurmountable fiscal constraints provide this treatment from age 60.

- Ensure no conflict of laws between this treatment under the SIS Act and general provisions pertaining to accruals tax. This should ensure that DLAs receive the same tax treatment whether they are bought directly by an individual or by a superannuation trustee.
- APRA needs to amend the prudential standard on paid up and minimum surrender values to explicitly exempt non-commutable DLAs from having a surrender value.
- Exempt non-commutable DLAs from the Age Pension and aged care means tests during the deferral period, consistent with the treatment of other risk products. If there are insurmountable fiscal constraints set the asset value at the purchase price.

Non-commutable DLAs as Risk products

A key change would be to treat non-commutable DLAs as risk products for tax and Age Pension purposes. As a non-commutable DLA does not have a surrender value and, consistent with the treatment of other risk products, it should be exempt during the deferral period from:

- Earnings Tax; and the
- Assets Test for Age Pension and age care purposes.

This treatment was supported by the Final Report of AFTS; “given the unique nature of deferred annuities, there is a case that they should only be means tested when they start to pay an income, unless a person can access the capital before this time.” (AFTS page 119).

The appropriateness of this treatment as a risk product for non-commutable DLAs with no death benefit has been confirmed in the advice by KPMG (see Appendix D).

It should be noted that while an exemption from Earnings and Benefit Tax for non-commutable DLAs will result in no tax being paid by the annuitant, the life company would pay tax at the company rate of 30% on any excess of assets over liabilities.

Death benefits important for DLAs

The provision of death benefits will also be important to the take up of certain DLAs. Challenger’s submission to the Review of retirement income stream regulation presented two types of DLA:

- Low premium pure longevity insurance with a long deferral period. The value proposition provided by these products would be destroyed by a significant death benefit so they are self-regulating.
- Large premium DLAs bought essentially as private DB pensions or to de-risk the timing of retirement. These larger DLAs with typically shorter deferral periods would be unlikely to find a significant market without a death benefit.

7. Reducing the need for complex pension rules to protect the revenue

Levelling Earnings Tax between accumulation and pension phase was proposed by AFTS with the objective of simplifying the rules which protect the Earnings Tax concession in pension phase.

Introducing a positive Earnings Tax in pension phase carries the risk that retirees who have superannuation assets below about $364,000 and therefore superannuation income which would be tax free if the assets were held outside superannuation would have an incentive to leave the superannuation system.

However, this could be overcome by levelling the tax treatment inside and outside superannuation to provide tax neutrality for this large group. One method of achieving that would be to provide superannuation fund members with a rebate of Earnings Tax paid in pension phase up to the level of tax free income available outside superannuation.

There are other important considerations:

- This is a large group of retirees and many do not have the financial literacy, skills and temperament to manage their retirement savings. In most cases their savings would be more vulnerable if moved outside superannuation.
- Individuals cannot efficiently manage their own longevity risk, this requires pooling.

8. Improving the short term budget position

Government confronts an underlying deficit of $35.7 billion in the coming financial year declining to $6.9 billion in 2018-19, and $82.3 billion over the Forward Estimates.

The available mechanisms for improving the short term budget position are:

1. Increases in Contributions Tax;
2. Increases in Earnings Tax;
3. Reimposition of a Benefits Tax; and
4. Reducing the caps on concessional contributions.

Such changes ultimately impact retirement incomes. It is therefore desirable that any changes that are made to the superannuation tax arrangements are made having given due consideration as to their appropriateness in the long term for both fiscal sustainability and sustainability of retirement incomes.

Achieving greater fiscal sustainability for the retirement income system also includes the means test arrangements. The Government is seeking to contain Age Pension outlays by adjusting the thresholds and taper for the Asset Test to reduce eligibility for retirees with sufficient other assets not to warrant direct government income support in retirement.

9. Improving the long term budget position

In the long term Australia faces a fiscal gap measured by the 2015 IGR as 0.7% of GDP for the Age Pension and 0.8% of GDP for aged care, which together require an addition to total government outlays of 4.8% by 2054-55.

There is a larger fiscal gap for health of 1.5% of GDP but only a tenth of that relates specifically to ageing factors and a proportion of a further tenth to a combination of ageing and non-age related factors.

Long term fiscal benefit of annuities

Challenger has previously commissioned independent modelling to estimate the potential fiscal benefits of wider take up of lifetime annuities. Challenger's first submission to the Review of a Australia's Future Tax System in 2009 included Access Economics modelling showing that if 30% of retirement starting balances were used to purchase a lifetime annuity deferred for ten years there would be fiscal savings of 0.2% of GDP per annum after 40 years as a result of retirees having significantly larger assets and private income late in life which would be available for means testing. (See Appendix E).

In 2011 Challenger commissioned modelling by Deloitte Access Economics for the Tax Summit which showed that an average $10,000 take-up of DLAs (deferred lifetime annuities) deferred until age 80 would result in savings after 40 years of 2.6% of total annual Age Pension and aged care outlays, as a result of the Age Pension and aged care means tests. (See Appendix F).

Longevity solutions for funding aged care and health insurance

The capacity for retirees to better manage funding of their aged care and health needs with greater self-reliance is dependent on the tax and social security treatment of various products which can be designed to assist them. As with more innovative superannuation longevity products, it is impossible for financial services providers to offer products for these purposes without the government determining the appropriate tax and social security treatment.

Some of these products would be bought with superannuation money and since they would be providing for expenditure for purposes that would otherwise come out of retirement income it would seem at face value reasonable that these products bought with superannuation money would receive no less favourable tax and social security treatment than superannuation. Some people would want to buy these products before retirement and with non-superannuation money. Government would need to consider whether to extend any concessional treatment to these products in those circumstances. If they were insurance, or risk products, no tax or social security considerations need apply, although it would be desirable to provide certainty about their treatment when benefits are actually being received. Availability of such products would improve self-reliance taking some pressure off both state and federal budgets in the long term for health and aged care costs. The Tax White Paper process could consider tax arrangements for retirees to better manage their aged care and health insurance costs. Longevity risk is a major consideration in providing private funding to manage these risks and facilitating private pooling arrangements would be efficient.

Long term fiscal cost of cutting and levelling the Earnings Tax

If the Earnings Tax is set at a level rate of zero between accumulation and pension phase there will be a significant budgetary cost, with the transfer of the foregone revenue to superannuation accounts. This is likely to require an adjustment in the tax treatment of superannuation elsewhere. The options are a Benefits Tax or an enhanced Contributions Tax, possibly taxing contributions at the individual's top marginal rate without a rebate.

Implementation of this option would result in Australia having adopted a TEE (fully taxed contributions, exempt earnings and exempt benefits). With the exception of Australia and New Zealand, most countries have variants of EET regimes (where contributions and earnings are exempt and only benefits are taxed).

Adopting a TEE system results in a considerable bring forward of tax which may worsen long term fiscal pressures. The IGR says; “The number of people aged 15 to 64 for every person aged 65 and over has fallen from 7.3 people in 1975 to an estimated 4.5 people today. By 2054-55, this is projected to nearly halve again to 2.7 people.” This will result in a disproportionate tax burden falling on working taxpayers as the population ages, if a TEE regime is adopted.

10. Conclusion

Challenger supports the adoption of a retirement incomes objective for Australia's superannuation system and has provided this summary of the mechanisms available to policy makers which it hopes will be useful to the Tax White Paper process in designing more efficient, equitable and sustainable taxation arrangements.

Yours sincerely

David Cox
Head of Government Relations