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Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600

RE: TAX WHITE PAPER (RETIREMENT INCOME) SUBMISSION

About Lime Actuarial

Lime Actuarial is an actuarial consulting business specialising in superannuation. As the actuary and founder of our business, I have had over 20 years' experience in the superannuation and wealth management industries. I am concerned about the sustainability of the retirement tax and social security systems for 2 reasons:

1. The tax base is not sufficient, leaving the government with a shortfall in its revenue
2. Until the tax base is increased, the community won't have confidence in the system. People are reluctant to contribute to super because they don't know what the system will look like in the future. This can only be resolved by a "big bang" change followed by a period of stability.

Introduction

In particular I see the following issues with the Australian Retirement System:

1. The objectives of the superannuation system are not clearly defined
2. The superannuation, tax, and social security systems are not well integrated
3. Concessional contributions are incentivised by way of tax deductions, yet most concessional contributions are compulsory and therefore should not require an incentive
4. Wealthy individuals can accumulate large balances in super, so tax incentives are funding their extravagant lifestyles
5. Families are using super as a tax advantaged estate planning system rather than for retirement saving
6. Retirees can double dip by withdrawing their super, spending it, then living off the age pension
7. People over the age of 65 are entitled to receive the age pension before depleting their own assets.
8. People over the age of 65 are discouraged from working due to the income test

Below I have recommended solutions to these problems.

Objectives

Before any system can be redesigned, it is important to understand the objectives, as noted by the Financial Services Inquiry chaired by David Murray. I propose that the objective of the system should be to enable individuals to self-fund their retirement in a tax effective manner, to achieve a comfortable standard of living.

Importantly, this objective does not include:

- The purchase of a first home
- Achieving an extravagant lifestyle in retirement
- Passing on money to children tax effectively

It is also important to recognise that tax incentives are currently wasted on 2 groups:

- Those wealthy enough to save for retirement without incentives
- Those with little income and wealth that will still rely on the age pension, even with some superannuation savings.

Therefore <u>tax incentives should be targeted at the group in the middle</u>.

In addition, tax concessions should not fund inflated inheritances.

Compulsory (Superannuation Guarantee) Contributions

At present concessional contributions result in a tax deduction for the party making the contribution, whether that be an individual or employer. The majority of concessional contributions are compulsory, in which case a tax incentive is wasted. Furthermore, a disproportionate share of incentives are currently provided to high income earners.

I propose that <u>Superannuation Guarantee contributions should be made from after tax income</u> and that contributions tax should be eliminated.

This has a number of tax implications:

- Less money will go into super each year because the effective tax rate on contributions becomes people's marginal tax rate rather than 15%.
- The government will raise significantly more revenue.

The solution to these issues is:

1. Reduce personal and company tax rates, and
2. Increase contribution rates

This solution should be satisfactory for both businesses and individuals.

Another implication is that salary sacrifice contributions would serve no purpose, and therefore should be eliminated. As a result there is no requirement for an employer contribution limit.

Employer contributions should be added to the Tax Free component of member balances. At present they are added to the taxable component.

Voluntary Contributions

Individuals should be entitled to make voluntary contributions to super.

Individuals should be entitled to claim a tax rebate of 15% of voluntary contributions each year, up to a maximum of $7,500 (corresponding to a $50,000 contribution).

The 10% self-employment rule can be eliminated.

Voluntary contributions should only be allowed if the member's total super balance is less than $2,000,000 in either of the previous 2 years. I have selected 2 years to take into account the delay between the end of one year, and the production of member statements for that year. This process can take up to 11 months for a Self Managed Superannuation Fund.

There should be no limit on voluntary contributions for 2 reasons:

- As described below, I have separately proposed that the maximum member balance should be $2,000,000.
- Most people would be better off to stagger their contributions over a number of years (to claim the tax rebate) rather than contribute large amounts into super in one year. So even if someone has a large amount to contribute to super, they are still unlikely to do so in one year.

Removing contribution limits will simplify the system.

Voluntary contributions should be added to the Tax Free component of member balances.

Age Pension - The Income Test

There are numerous reasons why older members of our community should be encouraged to work:

1. To fund their retirement
2. To provide meaning in their lives
3. To increase the supply of labour

However the income test discourages people over the age of 65 from working. When tapering is combined with the marginal tax rate, there is very little financial benefit derived from additional work.

The solution is to abolish the income test. That is, people over the age of 65 (or to be more precise the eligibility age of the age pension) should be able to receive the age pension regardless of income (but subject to a more stringent assets test as described below).

Age Pension – The Assets Test

I find it difficult to fathom why the age pension should be provided to anyone with personal assets. Surely retirees should be required to deplete their own assets before asking for a government handout. Or, to put it differently, why should the government provide social security to people that have their own assets? The age pension should be a safety net.

The problem here is a political and cultural problem. We have a culture of entitlement which cannot continue if we are to prosper as a nation and compete with developing countries. In essence the social security system is currently funding inheritances. This isn't acceptable.

The threshold for the assets test should be reduced significantly to around $160,000 for singles (or say 7 x the annual age pension payment) and $240,000 for couples combined (or say 7 x the annual age pension payment). Note that these thresholds have been selected arbitrarily.

There should be no tapering. Tapering is problematic because it creates perverse incentives.

In addition, the family home should be included in the assets test. If this is not acceptable politically then there should be maximum value of a family home excluded from assets, for example the median apartment price in Australia (around $500,000). I have suggested the median apartment price as opposed to home price because age pensioners usually don't have children and should not require a home.

Some commentators will claim that this encourages people to spend their money and then receive the age pension. I don't agree for 4 reasons:

1. Restrictions on withdrawals from super should also be implemented (as explained below)
2. For those families with assets outside super – Let's say they have $300,000 net assets outside super and $200,000 inside super. Let's also suppose they are currently spending $60,000 each year. With investment earnings their assets will probably last about 15 years. That is, they can afford to spend $60,000 per year for the next 15 years. Will they really waste $260,000 now just so they can receive a government pension, and then have to:
    a. Live more frugally for the rest of their lives, and
    b. Have a smaller inheritance for their children

   I don't think so. Furthermore, people in this situation are already receiving the full age pension. So even if a small percentage of people decide to double dip, the system is no worse off for those people.
3. Some commentators would rightly claim that a family with say $260,000 outside super (and no assets in super) could spend $20,000 just to get under the threshold. For the sake of simplicity of the system – let them do so. There won't be a lot of people in this category anyway. We shouldn't have rules to catch the 1% minority. And let's face it – the threshold is arbitrary. If we are concerned about this then we should reduce the threshold slightly. In any case, that family would have fallen below the threshold in the next 1-2 years.
4. The Productivity Commission has recently shown that this is not the case.

In order for this to work it will be important to ensure that we have a competitive and robust reverse mortgage industry.

The benefits of this system are:

- Simplicity – no assets test, no tapering, the same amount of pension for all recipients. You either get it or you don't.

- A significant reduction in cost of the system

- Encourage more people to save for retirement because they won't be as reliant on the age pension
- Fairness – why should the government provide financial support to families with significant assets?

Large super balances

It has been reported that there are member balances of over $10 million. In fact I am aware of members with balances exceeding $200 million. While contribution caps will ensure that balances will not reach this size in the future, it will still be possible to accumulate significant super balances.

<u>A limit should be set on a reasonable super balance.</u> In my opinion this should be around $2 million per member. Anything above this is deemed excessive. There are 3 ways to solve this issue:

1. A lifetime contribution limit of say $1.5m (noting that investment earnings will take the balance up to $2m)
2. Tax on pension balances where the member has over $2m in super
3. A requirement that a member withdraws assets over $2m from the super system each year. That is, it becomes a condition of release.

Of these, my preference is option (3) because it is the easiest to administer. Furthermore, it could be applied to existing funds that have already build up large balances.

Any such withdrawals should be taken from the tax free component of super (if applicable).

Withdrawing money from super

At present it is too easy to take large amounts of money out of super. For example, a retired 56 year old can withdraw their entire balance from super.

The Productivity Commission has recently found that people are not drawing down on their super irresponsibly. This situation could change when the age pension assets test threshold is reduced as proposed.

Discretionary lump sum withdrawals should not be allowed. That is, with the exception of certain circumstances (such as death, disability, financial hardship etc, and excessive super balances as proposed), the <u>only way to withdraw money from super should be via a pension.</u>

Furthermore, there should be a maximum placed on the amount of pension withdrawal each year. This maximum should be approximately double the existing minimum Transition to Retirement allowance. That is:

Age	Minimum (%)	Maximum (%)
55-64	4	8
65-74	5	10
75-79	6	12
80-84	7	14
85-89	9	18
90-94	11	22
95+	14	28

The maximum withdrawal should be subject to having enough cash to achieve a reasonable living standard. If a single or couple over the age of 65 is not receiving the age pension (because they have failed the assets test) then they should be allowed to withdraw up to 120% of the amount of the age pension for the year. For example – suppose a couple has assets of $250,000, all of which is in super. Withdrawing 10% from super would only provide them with $25,000 to spend, which is less than the annual age pension for couples ($33,717). They should be allowed to draw up to 33,717 x 120% = 40,460.

The upper limit will ensure that people don't spend their super too quickly.

Another outcome of this recommendation will be the elimination of the Recontribution Strategy adopted by many financial advisers, whereby taxable components of super are converted to tax free components. The result will be higher long term tax collected from the taxable component of super upon death. This tax is likely to increase significantly over time as people with larger super balances pass away.

It should be noted that many Self Managed Super Funds do not properly account for their components and therefore the amount of tax currently being collected is not as great as it could be. The ATO should monitor this more carefully.

Removal of contribution limits

With the changes proposed, and in particular:

- limiting super balances to $2m, and
- removing the distinction between concessional and non-concessional contributions,

<u>there is a strong argument to remove contribution limits altogether</u>. This would simplify the system significantly.

Very few people would have an incentive to contribute large amounts to super. Most people would be better off staggering their contributions and taking advantage of the 15% rebate on voluntary contributions up to $50,000 p.a.

Tax components

Earlier in this paper I proposed that all contributions should be allocated to the tax free component.

In this section of the paper I propose that <u>all investment income (both in accumulation and pension phase) should be allocated to the taxable component.</u>

The implication is that investment income earned during the pension phase will be taxed at 15% upon death (if it remains in the fund).

A death tax on super is equitable – it ensures that funds being inherited don't receive the same tax concessions as funds that are genuinely providing for retirement. This will become a significant source of additional tax revenue over time.

Tax rates on investment income

It has been proposed by some superannuation practitioners that the tax rate on income in the accumulation and pension phases should be equalised (eg 12% across the board). I don't agree for the following reasons:

- It would be inequitable across generations – there is a current cohort of super fund members around the age of 60 which has paid 15% tax throughout their accumulation years with the expectation that their pension investment income would be tax free. It would be unfair to double tax them.
- People with assets outside super would have less incentive to commence a pension and draw down their assets in super. The 0% tax rate on pension income serves as an incentive to draw down super balances.
- If pension income is taxed then people are less likely to make voluntary contributions to super, noting that the tax free threshold for senior Australians is around $30,000 each.

That is – <u>the current tax rates of 15% (accumulation) and 0% (pension) on investment income should be retained.</u>

Transitional arrangements

Some suggestions for transitional arrangements are outlined below

Recommendation	Timing	Comment
Compulsory contributions	July 2016	If company and personal tax rates are adjusted at the same time then nobody is worse off.
Voluntary contributions	July 2016	Nobody is worse off
Age Pension – Income Test	Progressively	If this was introduced immediately then the cost of the age pension system would increase. By introducing this in line with the assets test, the additional cost will be offset. Thresholds should be progressively increased over 5 years.
Age Pension – Assets Test	Progressively	This would represent a large adjustment with many people losing their entitlement to the age pension. The thresholds should be reduced progressively over 5 years
Large super balances	July 2017	Trustees of SMSFs may need time to sell illiquid assets, although a counter-argument is that assets could be transferred out of super in-specie. In addition, a once-off opportunity should be provided for spouses to transfer super balances to each other.
Maximum Pension Withdrawal	July 2017	Many people might have planned to withdraw money from super in the coming years. People who have met an existing condition of release should be given 12 months to exercise that option, with existing tax rules applying.
Remove contribution limits	July 2016	Nobody is worse off
Tax components	July 2016	Nobody is worse off as long as they are living members of a super fund

Most elements could be introduced immediately which will help us move to a better system sooner.

Conclusion

The tax, social security and superannuation systems are vital for ensuring comfortable retirement for all Australians and a sustainable government fiscal position. The proposals outlined will enable those outcomes to be achieved.

I would be pleased to discuss these proposals further.

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