Submission to 2015 Tax Inquiry by Mr Peter Knight
April 2015.

To whom it may concern.

I would first like to deal with Superannuation and then address the general tax system.
As a general overriding comment, I believe that ANY changes that are going to be made should not apply retrospectively to existing arrangements. Pick a date in the future which allows affected people plenty of time to prepare for the changes before implementing those changes.

Superannuation Taxes

Over the course of my working life my superannuation taxes have taken on the following complexion.
My first job was in the RAAF where I was a member of the DFRDB scheme for seven years. In that time I compulsorily contributed a percentage of my salary every year to the scheme. At the end of my Return of Service obligation I left the RAAF and gained employment in an airline. The RAAF refunded all of my contributions without any earnings (interest) when I left the service. I got back what I had paid in and nothing more! I hope you would agree that this arrangement is totally unacceptable.
When I joined the airline, I automatically qualified for that company's super scheme. During the 23 years of employment with that airline, at various times I (depending on the legislation at the time) paid tax on contributions and earnings of between 15% and 30%, as well as the Superannuation Surcharge Tax. Whilst in the super scheme, my fund suffered from the effects of the 1987 stock market crash, the 1990's Asian Crisis, the Dotcom bubble of 2000 and the GFC of 2007, just to name the most catastrophic events. When I left the airline scheme due to TPD ill health, I was unable to access the company's TPD super payout because of a separate industrial award agreement that my Union had with the company. This separate payout award was supposed to be tax free, but because of unintended consequences flowing from Costello's better Super legislation that had just come into effect, the ATO proceeded to levy tax on this payout. The amount of tax that I had to pay the ATO was $69,500. To add insult to injury, I then had to pay the

outstanding superannuation Surcharge Tax bill to the ATO. This liability amounted to the sum of $50,600.
So at the age of 50 years having just lost my job due to ill health I was then obliged to pay the ATO over $120,000. My Superannuation balance amounted to a figure of about $1,700,000 at the time. Then of course the GFC occurred and all of a sudden, the total balance reduced significantly. I was able to access my super early because I had met a condition of release (TPD). I also had a Loss of Income (LOI) insurance policy with a private insurer, which was the main reason I was saved from financial disaster. My wife also had to leave her job in order to care for me. **The point being**, that my Superannuation balance wasn't enough to sustain my family and I for another 30 years or so. The devastating effects of sequencing risk were wholly applicable to me at that time. Just medically retired and the superfund loosing 50% in value and my wife had to quit her job. The LOI policy which I still pay tax on today, allowed me time to organise a strategy to survive. I pay tax on my super pension as well because I am less than 60 years of age. Medically retired and still paying income tax and superannuation tax, unbelievable isn't it? I can't complete this prese without saying that it is very difficult to manage one's financial affairs when one is physically and or mentally unwell. I am pleased that I had the foresight in the 1990's to undertake external education in finance and after five years part time study, acquired a, *Diploma in Financial Markets,* through the now defunct Securities Institute of Australia (SIA). I have no doubt that due to this course of study that I undertook, I was able to navigate the GFC and beyond, without losing a large part of my investments outside superannuation. I had developed by then a substantial property portfolio outside of superannuation. I invested outside of super because in my early years of asset accumulation, I could see that the constant meddling in the super rules by Governments of all persuasions and the ridiculous RBL legislation in place at the time, would ensure that I wouldn't be able to accumulate enough assets inside super to cater for my retirement needs. Furthermore, one was unable due to existing legislation at that time, to buy property through one's super fund. The fact that this investment class in superannuation is *again* under threat, just goes to show how uncertain investing in a superannuation trust can be and makes a mockery of the Government's ability to manage these decisions competently. It is with this historicall background information that I present the following.

1) How much should an individual be allowed to hold in Super? I would prefer that no cap exists at all, but if that is not politically acceptable, then the following should be considered as an absolute minimum. An equivalent amount that would generate 67% of that individual's pre-retirement income. As an example; a person retires at age 55 and let's say was earning $300K at retirement, therefore, 67% of $300K would be $201,000 annual pension. Based on this pension amount and the minimum legislated drawdown of 4% of the fund's total balance, this would calculate a maximum pension account balance figure of $5,025,000. Any amount in excess of this calculated 67% (calculated at the time the fund enters pension phase) amount, could stay in the funds separate accumulation account which would continue to be taxed at 15%, whilst leaving the pension account paying a *tax free* pension to the recipient. This figure should be indexed yearly to cater for the effects of inflation and to maintain the real purchasing power of the pension. Rules would have to be in place to decide when and if the accumulation account could eventually be allowed to be converted to a pension account at some time in the future. As an example the accumulation account could be used to guard against longevity risk or legislated to remain in cash to mitigate market risk or sequencing risk. The other point to consider is; how can the account based pension payments keep up with inflation? If inflation is only 4% per annum, then the purchasing power of the dollar reduces by 50% after <u>only</u> 18 years (rule of 72). That's why I don't believe maximum caps are a good idea because in a relatively short period of time, a large balance can reduce significantly due to adverse events. This is of course, precisely what happened to me! The focus really should be on the income stream that the fund is producing, NOT the balance of the fund. That's why defined benefit (DB) funds are so much more valuable than defined contribution (DC) funds; more on DB later. In DC funds the recipient bears all the risk, whilst in DB funds, the employer bears all the risk!

2) Any taxation of existing super pensions should <u>not</u> be retrospective. If the Government does foolishly decide to retrospectively tax existing pensions for people over 60, then at least realise the following. Only the taxable element (concessional contributions) of the fund's holdings should be taxed and the non-taxable element (non-concessional contributions) should not be taxed, as is the <u>existing</u> case for pensions being paid to individuals less

than 60 years of age. It should be noted and continually reinforced, that there must be adequate compensation (tax concessions) for people who choose to defer consumption in their younger years in order to live unencumbered to government in later years. A person MUST be compensated for foregoing consumption now in order to lock up their money in super for decades to come. This compensation largely, but not totally, comes from Concessional Contributions. There is absolutely no incentive in saving extra for retirement if the Government sets the example of changing the goal posts at the same time that financially prudent people have decided to retire.

3) There is an argument doing the rounds at the present time which simplistically states that the higher income earners receive the biggest tax concessions in super. That is true and is only true because the high income earners are paying a lot more tax in the first place! The reason the lower income people don't get a tax concession is because they are not paying much if <u>any</u> tax at all. It's pretty hard to get a tax concession if you're not paying any tax!
4) I have already stated what I believe the tax should be on pensions but what about lump sums. At present all of one's super can be taken as a pension because there is no maximum drawdown limit. I believe this is not a good idea for many reasons; but the chief one being that some people withdraw their whole balance and then go on to apply for the old age pension. The best way to stop this is to perhaps introduce a maximum drawdown limit of 10% of the funds balance per year, which incidentally is the same as the transition to retirement pension arrangements which exist at present. In any event, anyone who has a super balance that delivers more than the age pension amount, should not be able to withdraw their funds below a minimum calculated balance. The super system is designed by government legislation at present, for people to exhaust all of their funds before they die. This in my view is pretty stupid because no one knows exactly when they are going to die and the Government wants people to plan for the possible effect of longevity risk! It would make more sense if the Government made sure that people <u>didn't</u> exhaust all of their funds before they died in order to safe guard the old age pension Government liability which should only be accessed by people who don't have enough super to begin with. This brings me neatly to my next point.

5) How much super should be allowed to be passed on to a person's beneficiaries? If the beneficiary is a retired spouse then the answer should be; *the whole lot, tax free as a super pension*. I think the anti-detriment payment should be abolished because it makes a mockery of super tax in the first place and most people either don't know about it and it can't always be universally accessed anyway. If the beneficiary is a person who is either a child or is still working, then the bequeathed funds should only be allowed to be placed in the beneficiary's <u>super fund</u> and taxed at 15% on entry to the fund. This then helps that person to achieve an adequate retirement savings balance and maintains the core integrity of superannuation, which is; <u>to provide for peoples' retirement</u>. It also acts as a disincentive for extremely wealthy people to use super as a tax minimisation vehicle. This is because there would be no point in accumulating large balances simply just to be able to gift to a beneficiaries' super fund which has or will have, a high preservation age of 65 years or so. This arrangement would then deliver the Government a 15% contribution tax and maintain the 15% tax all the way through the system! I would rather be taxed on my Super *after* I die rather than when I need the funds whilst alive! Therefore, keep the zero tax in pension phase (60 years and older) but only whilst the individual or retired spouse, is still alive!
6) It should be noted that superannuation is just another type of Trust. There are many types of trusts of which superannuation is just one with its own unique set of tax and access rules. The question goes begging, therefore; why is superannuation getting all of the attention but no one is talking about all of the other types of trusts?
7) Furthermore, if some politicians, some union leaders, some businessmen and ASFA, believe it to be unfair that people with $2.5 million in their respective super accounts are somehow *gaming* the system and should not be allowed to achieve such balances, then another question goes begging. Why are politicians on the old parliamentary retirement benefits system allowed to remain on Defined Benefit super accounts? These pension entitlements would require balances of up to and exceeding, an initial balance of $5 million in DC funds in order to fund the projected income streams of these recipients. These DB pensions are payable to politicians when they leave parliament, regardless of their age (no preservation age), are indexed for life and are payable even if that person pursues further employment outside parliament! Why are Judges and Commonwealth

Public Servants allowed to access similar arrangements? If any retrospective changes are made to the rest of us, then all of these DB recipients should be retrospectively affected as well.

8) The other most salient point is the following. Anyone on a defined benefit pension doesn't have to spend time managing his or hers investment portfolio because they can sit back and simply do nothing whilst their guaranteed monthly cheque arrives in the mail until the day they die and after that, the spouse collects the defined benefit pension until they too die! The rest of us receiving account based pensions have to spend a great deal of our time worrying about investment considerations such as but not limited too; sequencing risk, legislative risk, credit risk, asset allocation risk, market risk, specific risk, capital loss risk, administration fees, high adviser fees coupled with poor investment returns, minimum drawdown requirements, yield risk, constantly changing legislative requirements, possible poor health and longevity risk. If a major stock market correction occurs at any time, then all of a sudden a healthy $3 million dollar super fund balance can look a bit sick at $1.5 million with another say, 25 years of life expectancy to look forward too; or should I say, continue to worry about! Just remember this; if a portfolio loses 50% in value, that portfolio will need to increase in value by 100% just to get back to the original NOMINAL value of that portfolio! None of these concerns are applicable to recipients of defined benefit pensions. The conclusion to all of this should, therefore, be blindingly obvious? Recipients of account based pensions from DC funds should be entitled, without penalty, to achieve <u>larger</u> balances than people in defined benefit funds. This is because the risk of capital loss is <u>not</u> applicable to defined benefit funds. Whereas the risk of capital loss is far and above the greatest risk applicable to DC funds. So instead of legislating a maximum cap applicable to all and sundry, look at the 67% pre-retirement income formula that I mentioned in point one above, with excess funds placed in a separate accumulation account for a specified time limit-say ten years-or at a point in time when extra cash is needed to be placed in too the pension fund due to poor investment returns, ill health etc.

9) Contribution Limits: when people are young and paying off mortgages and raising a family the last thing they are going to be able to do is contribute extra to super. It is only later on at about the age of 50 or so that people have the means to contribute more. It is for this reason that I think the

present limits of $35K/annum concessional contribution (age 50 and over) and $180K non concessional contribution or $540K three year bring forward rule, is far to arbitrary. If someone wishes to forego consumption at an earlier age in order to contribute proceeds of an inheritance of say; $735K to super at the age of 44 or 52 or 49 or 32, then why shouldn't they be able to do so? They could after all spend this money on gambling, drinking and smoking themselves to death! The idea should be to encourage people to contribute as much to super (within reason) whenever they are able to do so. Surely this in the end would benefit the government? This is because there would be less chance that the person will go on the age pension later on. It's pretty hard to get most people to save anyway, so why make it harder? That's why concessional contributions are so important psychologically. People get a tax break now in order to not be a burden on future governments! I think concessional contributions should become larger the older people become. This would achieve a number of things. It would keep people working longer because of the incentive of saving a lot more money through concessional contributions as they would be paying less tax as they become older. Greater balances at retirement would be achieved. Psychologically positive attitudes would be fostered towards superannuation savings. Confidence in the system would be enhanced. I would suggest a target of $50K concessional contribution before and up to age 50 and then increasing this by $5,000 for every year after that. This would result in reaching a target of $100K concessional contribution by age 60. Just to emphasise once again. DON'T change existing arrangements by making any future changes retrospective.

I would like to now make some general comments about the tax system.

The tax system should reward those who take risks. It is my belief that this is not the case in Australia.

1. Why is the top marginal tax rate not the same as the corporate tax rate? By being significantly different the Government is encouraging entities that really shouldn't incorporate, to actually do so. All this does is increase the administrative burdens on entities, increase administrative costs and gives accountants more unproductive work.

2. Negative gearing is continually demonised in this country despite the following facts. (a) Negative gearing generally becomes positive gearing after about ten years or less (real estate) depending on the LVR to begin with. (b) Negative gearing doesn't only concern real estate investments. It concerns all investments where a cash-flow loss (not capital loss) is made. (c) Negative gearing exists to compensate the investor by reducing his/her tax burden for taking on the risk that the investments' value may not keep pace with inflation. (d) When negatively geared, losses are compounded if the investment doesn't increase in capital value in <u>real</u> terms. (e) Negative gearing is not a panacea for wealth creation. In fact, if an investor seeks to become rich by only focusing on tax minimisation, then he will surely fail in the endeavour of wealth creation. The focus should always be on wealth creation with tax considerations secondary. (f) If negative gearing were to be abolished, it would logically follow that capital gains tax (CGT) should also be abolished. If negative gearing were abolished and CGT kept, then most retail investors would not be adequately compensated for the investment risks being undertaken. This would mean that investor demand for rental properties would decline significantly, the supply of rental properties would then dramatically reduce, with the predictable result of increasing rents which would arguably adversely affect the low income groups the most. This is exactly what happened in 1985 when the Hawke Govt. abolished negative gearing.
3. Discount on Capital Gains Tax (CGT). Capital gain is taxed at a concessional rate if the investment is held for twelve months or more. The concession is 50% of the *<u>total</u>* gain. I believe this is more than enough of a tax impost because we are not considering the REAL gain after inflation, but rather we are talking about the nominal gain. Before the 50% discount was introduced the capital gain was indexed using the CPI quarterly figures to determine the real gain and then the <u>real</u> gain was taxed at the person's MTR! Complicated, time consuming and again, just gave accountants more unproductive work. Indexing the gain was replaced by the discounted 50% CG to make life simpler and yes; sometimes the ATO won and sometimes they lost; swings and roundabouts! Due to these historical reasons I believe the discount should remain as it is. All the commentary about what a rort this CGT discount is, totally ignores the reality that only the REAL gain should ever be taxed, otherwise most retail investments just wouldn't stack up after the risks were taken into account! None of us can have it all

his or her way. The tax system needs to be flexible, not punitive. Let's encourage Mum and Dad investors to take some risk. We can't all be financial experts and some people find the subject of money and tax dull and scary at the same time. The Government can't expect everyone to be able to manage adequately his or hers financial affairs. Most people simply don't have the time or expertise to do so. The Government really should focus more on reducing taxes and beefing up the financial adviser competency levels so people have confidence in their financial adviser. There simply has to be reasonableness and fairness in the system as a whole, otherwise one may as well go and live in a Communist country.

4. Franking Credits. This one is getting a hammering in the media lately as well and is another prime example of misguided commentary by people who should know better or merely by folk pushing their own vested interests. I say this, because anyone advocating the abolition of Franking Credits is really saying that they believe in double taxation! It should be remembered that companies can whenever they like, reduce or suspend dividends, either temporarily, or permanently, as they see fit, unlike most fixed interest securities; the majority of which have compulsory coupon payments. Companies can also reduce their payout ratios and thereby reduce the quantum of the dividend payment to their shareholders. All of these factors means that equity income streams are more volatile than fixed income payment streams. It also highlights the fact that shares are higher risk than just about any other investment. That is of course why the returns are greater over much longer time frames and can be extremely unpredictable and volatile over shorter periods of up to five years or so. Why would anyone with any financial acumen make the most risky investment asset class, even more risky by abolishing franking credits? Furthermore, just at the time when investors in retirement who are desperate for yield finally succumb to entering the stock market, they find the legislation changes and the expected yield from the shares that they have purchased, takes a 30% hit because franking credits have been abolished. Even with franking credits still in existence, the *equity risk premium* at time of writing is becoming quite stretched. Therefore, to do anything as stupid as to abolish franking credits would be tantamount to political suicide. As I said earlier, if you abolish franking credits you do so with the full knowledge that you are endorsing double taxation and

therefore, you might as well tax everything twice just to be consistent! Just don’t expect to be re-elected-ever!

5. Bracket Creep. Ever since I entered the workforce I can still remember the PM at the time, the late Malcolm Fraser, talking about bracket Creep and every PM after him subsequently talking about it! In order to fix this simple issue I see the possibility of two options; (a) introduce a flat rate tax which must be the same or less than the company tax rate, with whatever GST rate is required to offset the revenue loss. I can hear the cries now- what about the low income earners? Answer, they can be compensated by the tax/welfare/transfer system! Problem solved! Second option (b) index the tax scales to the CPI to avoid bracket creep. Again problem solved!
6. The GST must be included in any tax review otherwise the subsequent report and recommendations will be unsatisfactory and inadequate for our modern economy. The poor can always be compensated via welfare, so what’s the problem here with reviewing and if necessary increasing the GST?
7. Finally, no tax review would be complete without a review of Executive Salaries. Instead of hitting defenceless Pensioners and frightening the wits out of them, start getting tough on executive pay. Years ago the CEO’s of American companies payed themselves no more than 30 times the lowest paid employee of the group. This means that today if the lowest paid employee makes say-$40,000, then the CEO would make $1.2 million. Isn’t that enough for any CEO? If the focus is all about limits on super accounts, then how about limits on executive salaries? The tried and worn out response by CEO’s when questioned about their remuneration goes something like this; *the Board determines the CEO’s pay and the Shareholders endorse the decision of the Board at the AGM*. Unfortunately for the retail shareholders, the vote is always stacked against them by the Institutional Shareholders, who always vote in favour of excess remuneration because most of the Institutions have the same excess remuneration policies in place for themselves! The other pathetic response goes something along the lines of; *if you pay peanuts you get monkeys*. This is an insult to all of the other employees of the enterprise because presumably if they don’t earn large sums then they must be, by definition, monkeys? As I said, no tax review can be complete without reference to executive salaries. Having said that, I know it will never happen because of vested interests inside and outside of Government.

Finally, it is not lost on myself, or others that I know, that the fiscal mess this country finds itself in at the present time, is not due to the citizenry of this country and how much tax they do, or don't pay, but rather the whole responsibility lies with the administrators of the country. Specifically, the Rudd and Gillard governments, which allowed the country's pristine financial status to decline into the abyss of financial mismanagement. Why should I and thousands like me be called upon in our retirement years to try and help plug a financial hole left by these two incompetents? Throughout my working life I have paid a great deal of tax, but I have also accumulated a substantial asset base largely thanks to my own due diligence, taking calculated but significant risks whilst young, using negative gearing when appropriate, enhancing my financial knowledge along the way and foregoing consumption in my younger years. I have never asked the Government for assistance despite losing my job for medical reasons at the age of 50. My Parents didn't have much money and they never received any entitlements (even though they had three kids) until reaching pension age. I went to a Government school and later, started work in the service of my nation, with no money or financial education. Fortunately, I did know how to save because money was so scarce when I was growing up and my Parents imbued in me, a sense of self-preservation, rather than a feeling of envy for others, or a feeling of self-entitlement. I now spend many hours per week reading about financial matters in order to manage my retirement fund. I do this even though my health is not particularly robust. I don't use a financial adviser because most of them are not focused on wealth creation and preservation for their clients, but rather enhancing their own remuneration through targeted sales commissions etc. If they are competent and honest they generally charge too much for what they deliver and take zero responsibility for financial losses of ANY magnitude. Hence there is very little or no accountability with financial advisers. The same can be said for CEO's that are paid millions of dollars per annum regardless of their performance. Share price based remuneration was always a furphy and if you don't believe me, then go and ask Warren Buffet! There is no accountability with Politicians either. PM's Rudd and Gillard in my view and I think the publicly available evidence draws the same conclusion, were both totally devoid of any moral convictions and as a result, totally incompetent. They still managed, however, to walk away with all of their entitlements as if they had done nothing untoward. As I said in the beginning, there is not a national sentiment in this country that says; *we will reward those that take risks*. Instead, there is a national sentiment that says; *pull down the tall poppy and allow crooks to prosper and CEO's to be unethical in their behaviour and allow them to steal from Shareholders by the awarding of huge salary largesse.* Just see the latest press about financial advisers and excess fees at CBA, Westpac, ANZ, Macquarie and NAB. Furthermore, I can't believe that people who get paid millions in salary every year have the nerve to talk about reducing the minimum wage and/or reducing penalty rates! I too believe penalty rates are an anachronism, but so is executive salary largesse. You can't fix one without the other. Which incidentally, is exactly the same as the tax system. Only a fool would assume that by taxing superannuation pensions, abolishing negative gearing, abolishing franking credits and increasing CGT that it would help solve the Governments increased need for revenue. Rather, if these measures were put in place, such an intense and overwhelming climate of doom, pessimism, laziness and failure would pervade the country's psyche and everyone would just give up in despair. The only winners in this situation would be those who applaud and practice the politics of envy!

Good luck with your deliberations!