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MERCER SUBMISSION TO THE TAX DISCUSSION PAPER

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MARSH & McLENNAN COMPANIES

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Executive Summary

Mercer is delighted to be making a formal submission to the Tax discussion paper released on 30 March 2015.

This submission has restricted itself to the following question in the paper:

> *22. How appropriate are the tax arrangements for superannuation in terms of their fairness and complexity? How could they be improved?*

Superannuation is normally taxed at one or more of the following three points:

1. When contributions are made by employers, employees or the self-employed into the superannuation fund
2. When the superannuation fund earns investment income in a variety of forms including interest payments, dividends, property rentals and realized capital gains or losses
3. When benefits are paid to fund members or their dependants in the form of a lump sum or regular pension payments.

As outlined in the Retirement Income Consultation Paper[1] produced by the Henry Tax Review there are several approaches to benchmarking the concessions provided to superannuation. Hence, before reviewing the tax concessions provided under the current arrangements, it is important to determine the most appropriate benchmark for taxing superannuation. In this submission, we discuss the following three benchmarks:

- the comprehensive income tax benchmark,
- the post-paid expenditure benchmark, and
- the pre-paid expenditure benchmark.

Pension systems around the world receive taxation support (or concessions) in a variety of forms. Several reasons can be suggested for the continuation of taxation concessions in Australia, including:

[1] Australia's future tax system (2008), Retirement income consultation paper, December, p25.

- *Preservation:* Superannuation is compulsorily preserved and is therefore generally not accessible or received by the individual until retirement.
- *Long term saving for a better retirement:* Superannuation is, by its very nature, long term saving. As the final Henry Report noted there is a bias in the current taxation arrangements against long term saving.
- *Income smoothing:* Superannuation takes income from the pre-retirement years and defers its receipt until later in life. In effect, it smooths income and consumption over the lifetime.
- *The presence of pooling (or risk sharing):* Superannuation contributions or earnings are not always received by individuals due to the pooling of longevity risk through defined benefit pensions, lifetime annuities or group self-annuities.
- *Legislative restrictions:* Legislative impediments, designed to increase the safety of superannuation savings are also in place.
- *Future age pension payments:* The presence of mandatory superannuation means that for many Australians there will be a reduction in the level of future age pension payments.
- *The tax treatment of other investment opportunities:* Superannuation is a long term investment and should be no less attractive to Australians who have the capacity to save when compared to other investments.

Before considering the existing arrangements and some options for reform, it is essential that some high level principles be established so options can be discussed with some objectivity. The following principles are suggested:

- A coordinated and holistic perspective towards retirement income is necessary taking into account the age pension arrangements.
- The taxation of superannuation should be as efficient as possible for employers, individuals, superannuation funds and the ATO.
- Community confidence in the overall taxation system is critical and fairness represents an important component of this acceptance.
- The current level of compulsory SG contributions is insufficient for many Australians to receive an adequate income in retirement. It is therefore important that Australian workers are encouraged to make additional contributions.
- In the absence of any particular legislative requirements, the taxation and social security arrangements should encourage retirees to take income streams and not lump sum benefits.

Many commentators have suggested that an approach similar to Recommendation 18 from the Henry Review (namely the use of marginal tax rates with a rebate) should be implemented to replace the current system whereby the “concession” received by the taxpayer is represented by the difference between the person’s marginal tax rate and 15% (the tax rate paid by the fund). This submission considers four options to implement such an approach but concludes that notwithstanding the current bias towards higher income earners, this general approach does not represent the best way to improve fairness in the system. It is our recommendation that we should consider lifetime contributions and a progressive element of taxation at the benefits stage which is both fairer and much easier to administer.

In August 2014 Mercer released the following four point plan to improve the fairness of the current taxation arrangements for superannuation:

1. Extend Division 293 tax to all those on the top marginal tax rate
2. Improve the Government Low Income Earners Superannuation Contribution
3. Introduce lifetime contribution caps but with a maximum contribution in any year
4. Limit the amount of assets that can exist in the tax exempt pension phase.

In the spirit of an open discussion about the taxation of superannuation with no restrictions on ideas or concepts, this submission also presents an alternative approach which comprises:

- A flat tax on concessional contributions, together with a credit for low income earners
- Investment earnings, in both the pre and post-retirement phase which are exempt from tax
- A progressive tax rate (t_2) on benefits.

We look forward to continuing to contribute to the discussion to develop a better tax system for a better Australia.

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Introduction

Mercer is delighted to be making a formal submission to the Tax discussion paper released on 30 March 2015.

This submission has restricted itself to the following question in the paper:

> 22. How appropriate are the tax arrangements for superannuation in terms of their fairness and complexity? How could they be improved?

We believe that the discussions and resulting recommendations relating to this question could have a significant effect on outcomes for our clients, their employees and members of superannuation funds.

Mercer is a global consulting leader in talent, health, retirement and investments. Mercer helps clients around the world advance the health, wealth and performance of their most vital asset – their people.

Mercer also provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have $55 billion in funds under administration locally and provide services to over 1.3 million super members and 15,000 private clients. Our own master trust, the Mercer Super Trust, has over 240 participating employers, 226,000 members and more than $20 billion in assets under management.

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Question 22 - Superannuation

Question 22. How appropriate are the tax arrangements for superannuation in terms of their fairness and complexity? How could they be improved?

The taxation framework for superannuation

Background

Superannuation is normally taxed at one or more of the following three points:

1. When contributions are made by employers, employees or the self-employed into the superannuation fund
2. When the superannuation fund earns investment income in a variety of forms including interest payments, dividends, property rentals and realized capital gains or losses
3. When benefits are paid to fund members or their dependants in the form of a lump sum or regular pension payments.

It has become common practice to use a summary to describe the taxation of superannuation (or pensions) at one or more of these points where

T represents full tax at the relevant personal income tax rates;
t represents tax at concessional rates (i.e. less than personal income tax rates); and
E represents exemption from taxation.

Current Australian practice

The taxation of superannuation[2] in Australia is unique, when compared to pension systems around the world, and can be described as a ttE approach as described below:

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[2] This brief description represents the position for most superannuation fund members. There are some public sector schemes which pay untaxed benefits where there is no tax on contributions but the benefits are taxed in the hands of the recipient. For the purposes of this brief description, these arrangements are ignored. However they remain important in the development of reform options as it would be unreasonable to affect members in most superannuation arrangements without also affecting members in these public sector schemes.

1. Employer contributions (including salary sacrifice contributions) and personal contributions for which a tax deduction (e.g. from the self-employed) is claimed are *taxed* at the concessional rate of 15% which is less than personal income tax rates which commence at 19% (excluding Medicare) for those who earning more than $18,200 in 2014-15. Through the provision of the Low Income Superannuation Contribution, most of this tax is, in effect, repaid for those earning below $37,000 until 30 June 2017.
2. Investment income is also *taxed* at the concessional rate of 15% with an effective tax rate of 10% generally applicable on realized capital gains held for more than 12 months, except for investment income arising from assets backing current pensions, which is exempt from tax.
3. Benefits paid to those aged 60 and over are *Exempt* from tax, except where any benefit remaining on death (for example, the balance of an account-based pension) is not paid to a spouse or financial dependant. Such payments are normally subject to a 15% tax.

Benchmarks for superannuation tax

As outlined in the Retirement Income Consultation Paper[3] produced by the Henry Tax Review there are several approaches to benchmarking the concessions provided to superannuation. Hence, before reviewing the tax concessions provided under the current arrangements, it is important to determine the most appropriate benchmark for taxing superannuation. The following three benchmarks are feasible.

The comprehensive income tax benchmark

Under this approach, the benchmark is the taxation used for normal savings such as the taxation of interest earned in a bank account. That is a TTE approach, as described below:

1. Contributions would be *Taxed* in full at the individual's personal income tax rate when received by the superannuation fund.
2. Investment income would be *Taxed* in full at the individual's personal income tax rate when received by the superannuation fund.
3. Benefits are *Exempt* from tax when received by the retiree as all contributions and investment income have been previously fully taxed.

This benchmark has been used by Treasury for many years to estimate the value of the taxation concessions to superannuation in its annual *Taxation Expenditures Statement.*

[3] Australia's future tax system (2008), Retirement income consultation paper, December, p25.

The post-paid expenditure tax benchmark

It is common practice in many developed economies to adopt an EET approach to the taxation of pensions or superannuation so that benefits are only taxed when received. This can be explained as follows:

1. Contributions are *Exempt* from tax when received by the pension fund.
2. Investment income is *Exempt* from tax when received by the pension fund.
3. Benefits are *Taxed* in full when received by the retiree. For pensions, this means taxation at personal income tax rates.

This approach is known as the post-paid expenditure tax benchmark. However as marginal tax rates are generally lower in retirement than during working years, this difference in income tax rates can be considered to be a significant concession arising from the use of this benchmark.

On the other hand it must be recognized that an EET system is much simpler to operate and has greater ability to properly target concessions and to provide greater equity across income levels as the benefits are only taxed when received in the retirement years.

The pre-paid expenditure tax benchmark

A concern with lower tax rates in retirement leads to the development of the pre-paid expenditure tax benchmark, which can be described as the TEE approach, as follows:

1. Contributions would be *Taxed* in full at the individual's personal income tax rate when received by the superannuation fund.
2. Investment income is *Exempt* from tax when received by the superannuation fund.
3. Benefits are *Exempt* from tax when received by the retiree.

The pre-paid expenditure tax benchmark is identical to the post-tax expenditure benchmark if there is no reduction in personal income tax rates following retirement. This result can be shown through the following simple example.

Example
Let us assume a contribution of $100 earns 7% pa for 20 years which results in a final benefit of $386.97. If the benefit is then taxed at 20%, the net benefit is $309.57. That is, the tax of $77.40 represents a 20% tax on both the contribution and investment income.

On the other hand, if the contribution is taxed at 20% at the outset and there is no tax on the final benefit, the final benefit is identical. Does this suggest that the investment income escaped tax? No, as there was 20% less investment income due to the reduced contribution. In addition, it should be noted that the tax of $20 at the outset was paid 20 years earlier than the tax on the final benefit. Or, to put it another way, the present value of a future tax payment of $77.40 discounted at 7% pa is exactly $20.

Summary

The following table summarises the above benchmarks.

Name	Taxation approach (in summary)			Comments
	Employer contributions	**Investment income**	**Benefits**	
Current in Australia	Taxed at 15%	Taxed at 15% during accumulation; 0% for pensions	Exempt	
Comprehensive income	Taxed in full	Taxed in full	Exempt	Used by Treasury in the TES
Post-paid Expenditure	Exempt	Exempt	Taxed in full	Common overseas
Pre-paid Expenditure	Taxed in full	Exempt	Exempt	

TES: Tax Expenditures Statement

Why superannuation should receive taxation support

Pension systems around the world receive taxation support (or concessions) in a variety of forms. Several reasons can be suggested for the continuation of taxation concessions in Australia, including:

- *Preservation:* Superannuation is compulsorily preserved and is therefore generally not accessible or received by the individual until retirement. As the Henry Review noted[4], the tax concessions may be seen as compensation for the inability by the individual to access these savings for other purposes. Preservation and tax concessions go hand in hand. If preservation did not exist, it would be much less likely that superannuation benefits would be used for retirement saving and it would therefore be difficult to justify tax concessions.
- *Long term saving for a better retirement:* Superannuation is, by its very nature, long term saving. However as the final Henry Report noted there is a bias in the current taxation arrangements against long term saving. Furthermore, by taxing superannuation earnings, the effective rate of tax on the real value of the investment increases the longer the asset is held. This result would become even more pronounced if the existing earnings tax is extended into the pension phase.
- *Income smoothing:* Superannuation takes income from the pre-retirement years and defers its receipt until later in life. In effect, it smooths income and consumption over the lifetime. Therefore consideration of this deferred income as annual income during the working years is not consistent with this fundamental characteristic of pension arrangements.
- *The presence of pooling (or risk sharing):* Superannuation contributions or earnings are not always received by individuals due to the pooling of longevity risk through defined benefit pensions, lifetime annuities or group self-annuities. This represents an argument not to tax superannuation until the benefits are received.
- *Legislative restrictions:* Legislative impediments, designed to increase the safety of superannuation savings are also in place. Restrictions on borrowing and negative gearing significantly reduce the attractiveness of superannuation compared with some alternatives for long term investments.
- *Future age pension payments:* The presence of mandatory superannuation means that for many Australians there will be a reduction in the level of future age pension payments. That is, taxation support for superannuation can be accepted today if this will

[4] Ibid., p 23

lead to a reduction in future social security payments. In effect, it represents an investment by the government over the long term.[5]

- *The tax treatment of other investment opportunities:* Superannuation is a long term investment and should be no less attractive to Australians who have the capacity to save when compared to other investments such as negative gearing, those which generate capital gains, or investment through a lower income partner or in the family home. That is, voluntary contributions to superannuation are likely to be diverted to other investments (and/or to consumption) if superannuation concessions are removed or significantly reduced.

Some high level principles

Before considering the existing arrangements and some options for reform, it is essential that some high level principles be established so options can be discussed with some objectivity.

A coordinated perspective

It must be recognized that superannuation provides retirement income to many Australians, which is often supplemented by a part or full age pension. Inevitably, higher taxation of superannuation would reduce the level of retirement income provided which must increase future age pension costs and lower living standards for retirees. It is therefore critical that the taxation of superannuation is viewed from a holistic perspective rather than just considering superannuation in isolation from the effects of future age pension costs. That is, there needs to be an integrated approach to the combined effects on retirement incomes of taxation, superannuation (including contribution levels and benefit design) and social security.

Efficiency

The taxation of superannuation should be as efficient as possible for employers, individuals, superannuation funds and the ATO. There have been many examples of complex changes in the superannuation area[6] that have added considerable costs to the operation of superannuation arrangements which, in turn, have affected the benefits provided to members. The superannuation surcharge, introduced in 1996, is perhaps the best example of a very

[5] It is sometimes suggested that the availability of lump sum benefits in Australia means that this reduction in future age pension benefits will not occur. However this is a fallacy. The recent Colonial First State Income Streams Index shows that 83.3% of benefits (in terms of assets) are taken to provide an income stream.

[6] Many of the existing complex rules are discussed in the next section.

complicated taxation change that cost the industry millions of dollars to implement and administer. However there are many others. Simplification would also lead to improved experiences by employers, employees and retirees which would improve confidence in the superannuation system and encourage voluntary superannuation savings.

Fairness

Community confidence in the overall taxation system is critical and fairness represents an important component of this acceptance. Superannuation is no different. Hence it is important that the taxes and related concessions relating to superannuation are seen to be fair and there are limited opportunities for abuse. For example, low income earners should not be paying more tax in respect of their superannuation contributions than in respect of their normal income. Similarly higher income earners, many of whom have the capacity to save, should have some limits placed on their ability to access these concessions. However, it should also be recognized that superannuation taxation represents part of the overall taxation system and that it is therefore inevitable that those who pay more income tax are likely to receive more concessions than others.

Incentives to save

Although Australia has the well-known three pillar system for retirement income, the third (or voluntary) pillar is often ignored in many discussions. The current level of compulsory SG contributions is insufficient for many Australians to receive an adequate income in retirement. It is therefore important that Australian workers are encouraged to make additional contributions from pre-tax income (salary sacrifice) or post-tax income. It is also important that every additional dollar of contribution should lead to an increased income in retirement after allowing for the effects of taxation and the Social Security means tests, that is sufficient to motivate additional savings and defer some immediate consumption.

Income streams

In the absence of any particular legislative requirements, the taxation and social security arrangements should encourage retirees to take income streams and not lump sum benefits. However it is also recognized that flexibility is needed in the provision of retirement benefits as capital needs (both the expected and unforeseen) can arise during the retirement years.

The existing complexity

There is no doubt that the existing taxation arrangements are complex, poorly understood by many members and add considerable costs to the administration of superannuation in Australia. As noted earlier, tax can be paid in respect of contributions, investment earnings and/or benefits. The following three tables outline the existing 'standard' treatment in each case and then a non-exhaustive list of the exceptions or variations.

Taxation on contributions

Standard case	Concessional contributions – taxed at 15% Non-concessional contributions - untaxed
Contribution caps	Concessional - $30,000 (indexed) but $35,000 (non-indexed) for over 50s Non-concessional - $180,000 but can be increased to $540,000 through "bring forward" provisions Capital Gains Tax - $1,395,000 subject to certain integrity measures
Exceeding the caps	Concessional contributions – overall at the member's marginal rate plus interest Non-concessional contributions – refunded or an extra tax is payable
High income earners	An extra 15% tax (division 293) on concessional contributions up to the cap, where the definition of income is different from taxable income
No TFN for the member	An extra 34% tax
Deemed earnings on refunded non-concessional contributions	Taxed at the member's marginal tax rate

The standard 15% tax on concessional contributions and the no-TFN tax is paid by the superannuation fund. In the other cases, the additional tax is paid by the members although in some of these cases it may be passed onto the fund.

In addition, there are special conditions relating to child contributions, contribution splitting with a spouse and a tax offset for eligible spouse contributions.

Taxation on investment earnings

Standard case	Taxed at 15% except for assets backing pensions in payment where it is exempt
Realised capital gains*	Taxed at 15% except for assets backing pensions in payment where it is exempt

*Realised capital gains on assets held for at least 12 months are discounted by one third leading to an effective tax rate of 10%.

Taxation on benefits

Note that components of any of the following benefits equal to the member's after tax contributions and/or relating to any pre 1983 service are not assessable.

Standard case	After age 60 – tax exempt for lump sums and pensions After preservation age but before age 60 – lump sums: 0% up to a limit (currently $185,000) and then taxed at 15% + Medicare for benefits above $185,000; pensions taxed at marginal tax rates with a 15% offset Before preservation age – lump sums taxed at 20% + Medicare; pensions taxed at marginal tax rates
Permanent incapacity	Before age 60 – part of the lump sum benefit is tax exempt; for pensions a tax offset of 15% applies
Terminal medical condition	Lump sums are tax exempt
Death (lump sums)	Lump sums are tax exempt if paid to a spouse, child or financial dependant; Otherwise subject to a tax of up to 30% depending on level of insurance; An increased (anti-detriment) benefit may be available to a spouse or child
Death (pensions)	The tax is dependent on the age of the member at death, the age of the beneficiary, the relationship with the beneficiary, and whether insurance applied
Lump sums paid to a former temporary resident	Taxed at 38% other than a 405 or 410 visa or if the benefit is a result of death, permanent incapacity or a terminal medical condition
No TFN for the member	Withholding tax at 49%

The above examples ignore the different arrangements that apply to members of constitutionally protected schemes or those members who receive a mixture of taxed and untaxed benefits arising from the pay-as-you-go funding arrangements used by many public sector schemes.

Comments on a recommendation from the Henry Report

Recommendation 18 of the Henry Report was:

> The tax on superannuation contributions in the fund should be abolished. Employer superannuation contributions should be treated as income in the hands of the individual, taxed at marginal personal income tax rates and receive a flat-rate refundable tax offset.
> An offset should be provided for all superannuation contributions up to an annual cap of $25,000 (indexed). The offset should be set so the majority of taxpayers do not pay more than 15 per cent tax on their contributions. The cap should be doubled for people aged 50 or older

Many commentators have suggested this approach (or a variation of it) should be implemented to replace the current system whereby the "concession" received by the taxpayer and represented by the difference between the person's marginal tax rate and 15% (the tax rate paid by the fund) varies from minus 15% for low income earners (assuming LISC ceases from 1 July 2017) to plus 30% to those earning above $180,000 but not subject to Division 293.

There are four broad approaches that could be used to introduce this type of change. They are:

1. Use superannuation funds as the main collection vehicle
2. Use employers as the main collection vehicle
3. Use superannuation funds to collect the standard 15% tax and for employers to collect the balance
4. Modify the existing Division 293 process

Option 1: Using superannuation funds

Under this option, the contribution tax payable by the superannuation fund on each contribution would be adjusted to reflect the individual member's marginal tax less the offset (say 15%). Division 293 would be repealed. After the fund had reported contributions to the ATO and the member had lodged his/her individual tax return there would be an adjustment to the individual's tax assessment. Questions arise as to whether any additional tax could be paid by the member's superannuation fund and whether any excess tax (i.e. a refund) should be paid to the individual or the superannuation fund.

This approach has significant problems for superannuation funds including:

- There would be significant extra administration for superannuation funds with a range of tax rates applying to different contributions
- Many superannuation funds do not know the member's salary and therefore cannot estimate the marginal tax rate without the provision of additional information

- It does not work for employees with income subject to a zero marginal tax rate (i.e. estimated taxable income below $18,200 in 2014/15)
- It is likely to increase the cost of defined benefit arrangements significantly (as the average rate of contributions tax is likely to increase from 15%) although the level of the extra cost is difficult to predict as it will vary between funds (and between years for the same fund) depending on the levels of income received by individual members
- It is unclear how it would work for DB schemes where employers contribute an overall contribution for all members which are not allocated to individual members
- The timing of the reporting by funds to the ATO would need to be changed, particularly for DB funds
- Members could be subject to a significant tax liability at the end of the year and release authorities and deferred arrangements for DB schemes (as currently occurs under Division 293) would be needed
- Low income Australians may need to lodge a tax return to receive the Government rebate

In short, this approach is likely to increase administration costs for superannuation funds and the ATO and cause significant concerns and misunderstanding amongst individuals.

Option 2: Using employers

Under this approach, the need for superannuation funds to pay contribution tax would disappear and Div 293 would also be repealed. It is unclear how tax deductible contributions for the self-employed would be treated by the superannuation fund.

On the other hand, the employer would withhold tax at the individual's marginal tax rate less the offset (say 15%) and pay the net contribution to the superannuation fund. If there were to be a cap on the offset, this would add complexity. This option is likely to be simpler than Option 1 as most employers use payroll systems that adjust for tax. Nevertheless there remain significant issues or concerns, some of which are similar to Option 1:

- There would be significant extra administration for employers or payroll systems with a range of tax rates applying to different contributions, together with extra reporting by employers to the ATO
- It does not work for employees with low incomes and a zero marginal tax rate
- As noted for Option 1, it is likely to increase the cost of DB arrangements significantly although the level of the extra cost is difficult to predict

- It is unclear how it would work for DB schemes where employers contribute an overall contribution for all members
- Members could be subject to a significant tax liability at the end of the year and release authorities and deferred arrangements for DB schemes (as currently occurs under Div 293) would be needed
- Low income Australians may need to lodge a tax return to receive the Government rebate
- Superannuation funds may lose the right to claim certain tax deductions in respect of their expenses
- If this were to extend to insurance premiums, there would be a significant increase in the net cost of insurance, which would have flow-on implications for insurance provided by superannuation funds

Option 3: Use super funds to collect the 15% tax and employers collect the balance

Under this approach:

- superannuation funds would continue to be subject to tax at 15% on concessional contributions
- employers would withhold tax at the individual's marginal tax rate less 30% (where the 30% rate takes into account the 15% tax on contributions payable by the fund and the offset, assuming it is 15%) and pay the net contribution to the superannuation fund (strictly the withholding tax, if positive, would need to grossed up by dividing by 0.85, to allow for the fact that the super fund would not receive this amount as a contribution and would therefore not pay 15% tax on this component; a further adjustment may be required if there were to be a cap on the 15% net concession).
- where the employee is on marginal rate of less than 30%, a credit could be applied against other PAYG withholding tax for the employee (although employees with a zero marginal tax rate would still be problematic)

Compared with Options 1 or 2, this approach would have the advantages of:

- maintaining the current tax arrangements for superannuation funds
- avoiding imposing additional tax costs on employer sponsors of defined benefit funds
- for the majority of members in the middle income tax brackets, only involving a relatively small change in the tax arrangements on their employer super contributions i.e. they would be subject to an additional personal tax of 3% to 7% (plus Medicare levy) on those contributions (or the offset could be set at a higher level to avoid any additional tax for those on the lower middle bracket).

On the other hand, this structure would be more complex to administer and explain than Options 1 or 2.

Option 4: Extending Division 293

Division 293 currently applies to members who adjustable taxable income above $300,000. Therefore, in theory, it could be extended down the income scale to apply to more members.

The advantage of using Division 293 is that this process is already operating, albeit with some complexity, and therefore it could be introduced more quickly than the other options. That is, it builds on current arrangements.

However it is a complex arrangement, particularly for DB funds and their members, primarily due to the end benefit cap.

Our conclusion

We agree that the current taxation arrangements on concessional contributions appear unfair and are biased to higher income earners. However we do not believe that this general approach represents the best way to improve fairness in the system.

In addition to the issues raised above, there exists a major problem with the philosophy behind this proposal in that it considers superannuation on an annual basis and adjusts the tax on contributions according to the individual's taxable income in each year. However superannuation should be considered over a lifetime as the taxable income in a particular year may have a limited relationship to the amount of superannuation provided over the lifetime.

It is therefore our recommendation that we should consider lifetime contributions (see next section) rather than annual contributions and that a progressive element of taxation in superannuation is much easier and fairer to introduce at the benefits stage (as discussed in the final section of this chapter).

Mercer's recommendations from 2014

In August 2014 Mercer released the following four point plan to improve the fairness of the taxation of superannuation and to address the current tax free post-retirement years:

1. **Extend Division 293 tax to all those on the top marginal tax rate**

   The current arrangements apply an additional 15% tax on concessional contributions for people who earn above $300,000. Extending it to everyone on the top marginal tax rate would reduce the concession to those currently earning above $180,000 (but less than $300,000) from 34% to 19%.

2. **Improve the Government Low Income Earners Superannuation Contribution**

   Ensure nobody pays more tax on their concessional contributions than they do on their income and those subject to the 19% marginal tax rate pay no tax on their concessional contributions.

3. **Introduce lifetime contribution caps but with a maximum contribution in any year**

   Maintain current concessional caps with the standard cap continuing to be indexed. Introduce a lifetime approach to concessional caps – for example, a person's annual cap could be increased by half the unused amount from the previous year but with a limit of say three times the annual cap in any single year. A similar approach could apply to non-concessional contributions thereby removing the existing complex three year rule. The maximum cap would limit the cost of the tax concession in any one year while allowing individuals who have started saving late or had interrupted careers to catch up.

4. **Limit the amount of assets that can exist in the tax exempt pension phase.**
   Limit assets in a tax free account-based pension to $2.5 million (indexed) per pensioner. Assets in excess of this amount could be commuted (i.e. paid out) or transferred back into the accumulation section of the superannuation fund and therefore be subject to the normal 15% tax on investment earnings. Special consideration would need to be given to defined benefit pensions and annuities. A five year transition period could also be provided for existing pensions. This is simpler than taxation on investment earnings above a certain level.

These suggestions remain relevant for the existing arrangements. However if a progressive taxation on benefits were to be introduced then items 1 and 4 may no longer be necessary to improve the fairness of the overall system. However improving the low income earners superannuation contribution may remain important.

As indicated earlier, one of the major problems with much of the current thinking about taxing superannuation is that many proposals consider superannuation contributions on an annual basis. This is inappropriate for the purposes of developing a sound and robust retirement system. It needs to have a lifetime perspective.

The proposal for a lifetime perspective on contributions can commence immediately. There is no need for any retrospective element. For example, if an individual is unable to use the full contribution cap in the first year, then half (or some other percentage) of the unused component can be added to the individual's cap in year 2. Such an approach would give individuals much more flexibility and enable those who have had periods out of the workforce to catch up, when they have the capacity to do so. A similar approach could apply to non-concessional contributions which could enable the existing cap to be reduced and the complex "roll forward" mechanism to be removed.

An alternative approach – simpler and fairer

In the spirit of an open discussion about the taxation of superannuation with no restrictions on ideas or concepts, we also present the following as an alternative and more radical approach that could be considered.

As noted above, the EET benchmark for taxing superannuation (or pensions) is commonly used around the world. It has many advantages including:

- It is fairer as it takes a lifetime approach (consistent with the concept of income smoothing) as the taxation is not determined by an individual's income in particular years but by the retirement income or benefits received accumulated from contributions and investment earnings over a working lifetime
- As a result of this lifetime approach it is fairer for individuals (including many women) who have interrupted working careers
- Superannuation (or pension) funds are not involved in the taxation system at all, as the tax is paid by individuals (similar to normal income tax), thereby reducing administration costs considerably
- The community understands the tax much better as it is paid when the benefits are received

- The real value of the taxation collected by the government over many years is likely to be higher as the investment earnings are exempt from tax so the effect of compounding is greater thereby increasing benefits and the real value of the tax collected
- The taxation is collected in future years when most countries will be suffering a revenue reduction due to the effects of the ageing of the population

Notwithstanding these significant advantages, it is recognized that it is impractical for Australia to move to a pure EET system given the revenue that is currently collected from concessional contributions and investment earnings received by superannuation funds. However it may be possible to move to a much simpler approach than the current arrangements which we will call a t_1Et_2 approach representing:

- A flat tax (t_1) on concessional contributions, together with a credit for low income earners
- Investment earnings which are exempt (E) from tax
- A progressive tax rate (t_2) on benefits

Initially let us consider the feasibility of exempting investment income from taxation which would represent the most immediate change. Obviously this would cause a significant reduction in current revenue from the pre-retirement years. However, it needs to be recognized that this revenue is likely to reduce in the coming years due to the low interest rate environment and the expectations of lower returns for some years. Hence this reduction in revenue may not be as significant as it may first appear. Secondly, the effects of exempting investment income from taxation could be ameliorated by not providing superannuation funds with franking credits as investment income would be tax exempt. This outcome is similar to the situation which currently applies to constitutionally protected superannuation schemes. Thirdly, this reduction in revenue could be offset by a small increase in the rate of tax paid on concessional contributions, say increasing it from 15% to 17%.

The exemption from taxation of all investment income received by superannuation funds has many advantages including:

- Equalisation of the tax rate in the pre- and post-retirement stages as advocated by the Henry Tax review and the recent Financial System Inquiry, thereby removing arbitrage and other issues related to the existing two tax rates
- A higher expected long-term investment return for all pre-retirement investors meaning increased retirement benefits which will have a positive effect on future age pension costs

- Continued exemption for investment earnings in the post-retirement phase will ensure that post-retirement benefits remain attractive to retirees whereas any taxation in this phase may encourage some retirees to withdraw from the superannuation system
- Increased efficiency for the superannuation industry due to considerable simplification leading to a reduction in costs and fees to members
- Removal of taxation differences between current and deferred pensions/annuities

Exempting investment income naturally leads to the question of the taxation of benefits. It is suggested that these benefits should be taxed using a progressive scale so that those with higher withdrawals will be subject to higher tax rates. The appropriate rates could be determined through modelling and scenario testing but these rates must be lower than the current marginal tax rates to recognize the concessional tax that has been paid on concessional contributions and the full tax that has been paid on non-concessional contributions. Whatever rates are deemed appropriate; this taxation source would represent increasing revenue for government in the years ahead.

The advantages of taxing benefits are many, but include:

- Tax is paid when benefits are received
- The system will be considered to be much fairer as the taxation of superannuation will no longer be perceived to be subject to "flat" tax rates
- Existing retirees with significant assets will pay some taxation on their benefits
- A lifetime approach will be endorsed as these benefits have been accumulated over many years and those who have accumulated more benefits will pay relatively more tax
- Lump sum benefits would continue to be available but be subject to higher taxes, thereby implicitly encouraging income streams
- Increased taxation revenue would be received in future years from the aging population thereby counteracting the expected reduction in revenue from earned income

It is recognized that such reform would represent significant change. However in considering the earlier high level principles, it is considered that these reforms would represent:

- A more coordinated approach to retirement income would be present as the actual taxation on superannuation benefits can consider the effects of the means tests on eligibility for the age pension
- It would be a more efficient system for superannuation funds as the tax on concessional contributions would be at one level thereby removing the Division 293 complexity as well as removing the taxation on investment income in the pre-retirement years.

- It would be considered a much fairer system as there would be a very clear progressive relationship between the tax paid and the benefits received.
- The exemption of investment income from the taxation system would provide a very clear incentive for additional contributions to be made for retirement purposes.
- Similarly, if income streams and lump sum benefits were subject to the same progressive tax rates, there would be a natural encouragement for income streams.

One final point. Depending on the actual tax rates used in respect of benefits, there may need to be a transitional period to recognize the fact that tax on investment earnings has been paid in the pre-retirement phase and that benefits (other than some death benefits) are currently tax free after age 60. The transitional arrangements could be a gradual increase in the tax rate paid on benefits or a personal tax credit to broadly represent the tax previously paid on investment earnings and non-concessional contributions. However any transition period should be kept relatively short.

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