The Taxation of Superannuation Savings

- **Superannuation Savings should be viewed differently to Labour Income**

  Much of the contemporary debate surrounding the taxation of superannuation savings is coloured and distorted. This is largely attributable to a simplistic and misguided approach of viewing such savings as if they were ordinary labour income. Thus, for the purposes of the debate, the taxes applicable (or the absence of tax) at various levels of the superannuation system are contrasted with the taxes that are paid on labour income. Because the rate of tax applicable to amounts that comprise permitted contributions to superannuation, earnings generated by superannuation savings or withdrawals from superannuation in drawdown phase is generally lower than the tax that would be payable on such amounts if they were ordinary labour income, the differential is described as a "concession", and the amount of the "concession" is treated as a "cost" to the revenue or as a "taxation expenditure". The use of such language unfortunately serves to characterise superannuation savings as just another pool of potential government revenue available, as required, to meet revenue shortfalls. Those who contribute to and participate in the superannuation system in a legitimate way are impliedly supposed to be grateful that the government has done them a favour by allowing them to keep more of their own money than would otherwise be the case if the "concession" was not available. Where a superannuant's savings exceed some entirely subjective and arbitrarily determined "fairness" threshold, this is to be viewed as inequitable. At the extreme, those superannuants who have legitimately accumulated a level of superannuation savings that is viewed as too large by the proponents of higher taxes for superannuation are to be regarded, falsely and unfairly, as "rorters" and "tax avoiders".

  This perspective on superannuation has become more strident and pronounced in recent years particularly as government revenues have come under pressure – not surprising when superannuation savings are seen as a potential revenue source. However it is a misguided perspective and one that has prompted the constant government tinkering and interference with superannuation that has been witnessed over the years. Nothing could be more calculated to undermine confidence in and the stability of the superannuation system over time. Nothing could be more inimical to the incentive to save that the superannuation system is supposed to foster nor more damaging to the ultimate sustainability of that system.

  Employing language such as "concession", "tax expenditure" or "revenue foregone" as part of the discussion surrounding superannuation also serves another purpose. When proposals are put forward such as that recently announced by the Australian Labor Party to impose a 15% taxation rate on superannuation earnings in pension mode in excess of $75,000 per annum and to lower from $300,000 to $250,000 the income threshold at which the highest tax rate of 30% on superannuation contributions will apply – such language can be employed to present the proposal in a more politically palatable way. The need to use plain (but uncomfortable) language to describe the proposal as what it really is – a significant tax increase for a large number of Australians – can thus be averted. Further the proposal can be presented in a way that implies an onus on those affected to justify why the so called "concessions" they enjoy should not be reduced rather than placing an onus on the proponents of the proposal to justify why the government should be entitled to appropriate from superannuants their own money.

The taxation of superannuation savings should be seen as a separate taxation system to that applicable to the taxation of labour income. The taxation of superannuation together with the rules governing superannuation should be viewed within the context of superannuation's purpose and policy goals. The superannuation system was never intended to facilitate the creation of a large pool of potential revenue to be available as needed to meet the expenditure needs of the government. The purpose of the superannuation system should be to not only compel Australians to save but also to facilitate their ability to provide for a comfortable retirement and to eliminate or, as far as possible reduce their need to rely on government in retirement through access to the pension. The fulfilment of this purpose is rightly seen as beneficial to the community and good for the nation's economy. It facilitates the creation of a large national pool of private savings that serves as a bulwark in times of financial crisis as it did during the global financial crisis.

The taxation of superannuation should therefore be designed so that the level of taxation applied to it is low in order to compensate a person for the disadvantage of being denied immediate access to that portion of his or her income that is mandatorily directed into superannuation. Further, the level of taxation applied to superannuation should be sufficiently low to provide an incentive for Australians to voluntarily contribute to superannuation from both pre tax and after tax income, amounts (within prescribed contribution limits) over and above their compulsory contributions. Despite the impact of constant government tinkering over the years the design of the current taxation regime for superannuation still generally meets those objectives.

It is sometimes argued that no taxation incentive is required for the compulsory contribution element of superannuation because it is compulsory. This argument is reported in the White Paper. The argument is, with respect, naïve. As many people object (not without justification) to the government forcing them to defer their access to their own money, the likelihood that the introduction of a system of mandatory superannuation contributions would ever have been attempted by government or would have survived politically without appropriate compensation or incentive being offered is extremely remote.

Once the superannuation system is benignly viewed in the way policy makers originally intended as good for the nation and the economy and once the taxation regime applied to superannuation is correctly seen as necessarily differing from the taxation regime for labour income but nevertheless consistent with superannuation's purpose, an accurate and I would submit, correct perspective of superannuation emerges. Superannuation is then not viewed through a prism coloured by the perception that everything should be taxable and to the extent that something is not taxed or is taxed relatively lightly it must be seen as tax avoidance. The relatively lower tax rates applicable at various levels of the superannuation system can then be correctly seen as incentives to save consistent with achieving worthwhile national policy goals rather than as "taxation concessions" or "taxation expenditures" with all the negative connotations that such language promotes. Discussion about the taxation of superannuation can then proceed in an objective, balanced and neutral way rather than within a highly emotive and prejudiced context.

- **Discussion should start with facts not myths**

As noted above, the debate about the taxation of superannuation has for several years proceeded with an exaggerated focus on the cost to the revenue of superannuation"taxation concessions" without recognizing the policy goals that those "taxation concessions" or, more correctly, incentives, were intended to promote. However it has done this on the basis of grossly inflated and highly misleading claims as to the magnitude of the cost to the revenue of those concessions. This has occurred because many of the more vocal proponents for increased taxes on superannuation (including the Federal Opposition) make the common mistake of adding together Treasury sourced estimates that measure two entirely different things – an estimate of the annual revenue cost of the current "tax concessions" for superannuation contributions, and an estimate of the annual cost of the current "tax concession" for superannuation earnings. This is repeatedly and publically done despite cautions from Treasury that the two estimates should not be added.

The error can be demonstrated simply. If those contributions to superannuation currently taxed at the "concessional" tax rate of 15% were instead taxed at the contributor's marginal tax rate (i.e the contributions “concession” was removed) the post tax amount of those contributions would be reduced by the additional tax paid. This would leave a much smaller pool of superannuation savings from which “concessionally taxed” earnings would be derived and hence the estimate of the cost of the earnings “concession” would be much less.

Unfortunately this “double counting” error is not the only flaw in the false and misleading claims about the revenue cost of superannuation “concessions”. The assumed earnings rate on superannuation savings used by Treasury in estimating the “cost” of the “tax concession” on superannuation earnings in 2013 was 7%. Whilst the earnings rate on superannuation earnings could be expected to fluctuate over time as market and interest rate conditions alter, the rate used by Treasury is rightly seen as grossly inflated – particularly in the current environment where Bank Term Deposit rates are at levels which at best barely cover inflation. The inflated earnings rate assumed by Treasury results in exaggerated earnings against which the “tax foregone” calculation is artificially inflated.

Yet a further flaw in the use of these Treasury estimates is that they make no allowance for the changed behaviour of superannuation investors that could be expected to occur if the superannuation “tax concessions” were reduced or removed. In such an eventuality it could be expected that money that might otherwise be invested in superannuation would be redirected into other tax sheltered forms of investment rendering the assumed “taxation revenue” gain from reducing or removing the concession illusory. Admittedly it would be very difficult to make a reliable estimate of the “changed behaviour” impact but that does not negate the fact that such an impact would be real.

Finally, these Treasury estimates make no allowance for the offsetting additional “revenue cost” that could be expected to result from increased numbers of people accessing the pension should the incentives to invest in superannuation be removed or curtailed.

The Treasury estimates referred to above reflect what is known as “the revenue foregone” approach to measuring “tax expenditures”. An alternative approach presented by Treasury is the “revenue gain” method. In the case of superannuation the “revenue gain” approach produces significantly lower “taxation expenditure” impacts because it at least reflects assumptions about behavioural change.

Nevertheless, the proponents for increased taxation of superannuation savings commonly misuse Treasury’s “revenue foregone“ estimates in the way described above. This is done to misleadingly amplify the extent of the perceived “equity” problem that their” increased taxation” solutions purport to address. Not only is this approach misleading and wrong but it ignores the policy goals and objectives of the superannuation system and the entirely rational reasons for the existing taxation regime of relatively lower tax rates that applies to it.

The flawed figure often bandied about as the current annual cost to revenue of superannuation "taxation concessions" is claimed to be in the region of $32 billion and growing. Whilst it is obviously difficult to estimate the true annual cost with reliable precision without the data available to Treasury, when the flaws in methodology described above are accounted for the true current annual cost is considered by respectable commentators to be but a fraction of that amount and likely closer to $10 billion.

- **The Focus on Large Superannuation Fund Account Balances**

  In the "taxation concession" oriented contemporary debate about superannuation much attention has been paid to what are perceived to be large superannuation account balances. The perception of what is "large" is of course entirely subjective but depending on the agitator for taxation changes, generally seems to range between $1.5 million and $2.5 million. The general theses propounded about these "large" balances vary but all reflect an assumption that the availability of "concessional" taxation treatment to the holders of these superannuation accounts should be eliminated or reduced in respect of superannuation savings that exceed a subjective and arbitrarily specified threshold. This view is driven by notions such as "the rich can look after themselves and do not need taxpayer support", that "if nothing is done more and more "large" superannuation account balances will occur with ever increasing and unaffordable costs to the revenue", that "the superannuation system will become unsustainable", that "people are using the superannuation system as a tax haven" and so on.

  Such concerns are overblown. The existence of "large" superannuation account balances (however "large" is defined) is relatively rare and would comprise a minor percentage of superannuation account balances generally. Further, where such balances exist, they do so largely for legacy reasons associated with the absence of contribution limits in the past or the existence of higher contribution limits in the past which no longer apply. Another factor would be the result of abnormally successful investment strategies enjoyed by particular accounts but this could be expected to be rare. The larger part of these "large" superannuation account balances are likely to have been originally sourced from monies that were, when contributed, already fully taxed at the contributor's marginal tax rate. Current restrictions on superannuation contributions combined with the uncertainty and lack of stability from constant rule changes and tinkering that increasingly make superannuation less attractive as an investment proposition make it unlikely that many “large” superannuation balances will be able to accrue in the future.

That the cost to the revenue of the “taxation concessions” for these “large” superannuation account balances is relatively minor is demonstrated by the estimated savings in “taxation expenditure” associated with the Australian Labor Party’s recently announced “Fairer Super Plan” which I have described above. The $75,000 pension earnings tax threshold element of that proposal has been determined by applying an assumed earnings rate of 5% to a superannuation account balance of $1,500,000. An account balance of that amount is obviously regarded as “large” by the Labor Party and as a threshold where the existing “taxation concession” should be wound back. Further it apparently will , in the Labor Party’s mindset, remain “large” over time despite inflation, as the threshold is not indexed.

The estimated saving to the revenue of this proposal is only $14 billion spread over a ten year period. Most of that saving is loaded at the back end of that period as, with the effects of inflation, more superannuation account balances exceed the unindexed threshold. This estimated “saving” will have a very minor impact on projected revenue shortfalls. This indicates that the proposal is primarily symbolic and not one that has any serious or meaningful impact as a revenue savings measure. However, although largely symbolic it nonetheless telegraphs a dangerous message that once again increases the uncertainty surrounding the superannuation system, undermines its stability and subverts the system’s policy underpinnings. The message to existing and potential participants in the superannuation system is that existing superannuation settings can never be relied upon and will remain subject to change. An account balance that may fly under the “large” threshold today will not necessarily escape taxation leakage tomorrow when someone seeks to impose a new definition of “large”. The fact that the proponents of this proposal claim that there will be no further changes to the taxation of superannuation is irrelevant, as given the history and frequency of superannuation taxation changes and the history and frequency of similar pronouncements, such claims are simply not believed.

Whilst proposals to increase the taxation of superannuation savings such as this purport to be framed in the interests of equity and fairness, rarely is any heed paid to the obvious unfairness and betrayal involved in retrospectively and adversely changing the goal posts for superannuation investors. Such investors in good faith not only accrued and locked away savings that might have been deployed elsewhere in reliance upon the taxation rules that existed when superannuation monies were contributed, but they did so with the government's active encouragement. Nor is any heed paid to the fact that superannuants with more substantial account balances are likely to be or, during their working lives to have been, substantial contributors to Australia's highly progressive income tax system. More likely than not such superannuation investors are, or have been, part of that approximately 17% cohort of individual taxpayers that bear approximately 63% of the nation's total income tax burden.

Proper considerations of fairness and equity as well as the need for certainty and stability in superannuation should dictate that existing superannuants be shielded by appropriate grandfathering measures from proposals that increase the taxation of superannuation or otherwise alter existing arrangements in a way that adversely affects them. These are requirements that the Australian Labor Party's recently announced "Fairer Super Plan"plainly do not meet.

- **Sustainability**
  Most proposals to increase taxation on superannuation are submitted not only to address purported fairness and equity concerns but also concerns about the future sustainability of the existing superannuation system. There is an inherent illogicality in the proposition that the future sustainability of the superannuation system can be improved through an increased appropriation of money from it. The real threat to the sustainability of the superannuation system comes, not from the relatively lower taxation rates that apply to it for necessary and rational reasons aligned with its policy objectives, but rather from the erosion of certainty and stability that comes from constant government tinkering with the taxation framework for superannuation. When the advocates of increased taxation for superannuation talk about the sustainability of the superannuation system what they really mean is the inability of the system, other than through increased taxation, to ensure the sustainability of existing and future government expenditures. There is an inherent assumption that such expenditures will not reduce and will just keep growing. Any discussion about the sustainability of superannuation, or, for that matter any other element of the overall taxation system, is pointless unless government expenditure levels are addressed and made part of the equation. However that unfortunately is not a subject matter addressed in the White Paper and will not be addressed in this submission.

- **Piecemeal Approach to Taxation Reform**

  Whilst the focus of this submission is the taxation of superannuation savings, any serious and meaningful examination of the Australian Taxation System with a view to making taxes lower, simpler and fairer can only usefully proceed if an holistic approach is taken. This should not involve developing reform proposals for individual elements of the taxation system such as superannuation in isolation from the consideration of their interplay or potential interplay with all the other elements of the taxation system. Regrettably any possibility of the discussion about taxation proceeding in this way has already been largely subverted. It is now apparent that a critically important element within the taxation system, namely consumption tax, will not be altered by the current government nor alternate government if elected. Such a possibility was ruled out by the alternate government within hours of the release of the White Paper, whilst the current government has made it plain that no consumption tax reform can proceed in the absence of bipartisan consensus and a consensus among state governments. The government shows no enthusiasm to seek such consensus.

Further, the alternate government (if elected) has already pre-empted any meaningful collective discussion about the taxation of superannuation and eschewed any holistic approach to the taxation discussion by peremptorily releasing its policy on the taxation of superannuation which is discussed above.

These developments do not bode well for the collective discussion and community participation that the government's Taxation Reform process was intended to engender. Nor do they bode well for the quality or integrity of any outcomes that this process is likely to produce.

- **Complexity in Superannuation Taxation Arrangements**

One worthwhile stated aim of the government's taxation reform process is to make Australia's taxation system simpler.

The existing taxation arrangements for superannuation are certainly highly detailed, complex and difficult to easily understand . The level of complexity of these arrangements has increased over time as ongoing government tinkering with the superannuation system has occurred. Currently there are a complex series of different tax rates, caps, limitations and requirements imposed at both the accumulation and drawdown phases of the superannuation system. This adds an administration overlay to the superannuation system together with its attendant cost. Most people require professional assistance to gain even a rudimentary understanding of the applicable taxation rules and this necessarily imposes further additional costs.

Proposals to alter the present taxation framework for superannuation that add to existing complexity or increase the existing administrative burden should be rejected unless there is an overwhelmingly sound reason for adopting them.

A recent example of a proposal that failed the complexity test prior to the last Federal election was the then government's measure to impose a 15% tax rate on the earnings of superannuation funds in pension mode where those earnings exceeded a $100,000 threshold. For reasons that included superannuants affected by the measure potentially having a number of superannuation accounts held on a pooled basis with different institutions any one of which would not necessarily be aware of the superannuant's aggregate superannuation position, this proposal fortunately proved so complex that it was virtually impossible to implement in practice and consequently did not proceed. It should be observed in passing that the Australian Labor Party's current policy proposal to tax superannuation earnings in pension mode appears to be merely a reworked version of this previous proposal, albeit with a lower earnings threshold of $75,000. So far no information has been forthcoming as to how the virtually insuperable implementation difficulties identified in relation to the previous proposal are to be overcome by the current proposal.

Another concerning aspect of the Australian Labor Party's current policy proposal to tax superannuation earnings in pension mode is the absence of any definition of "earnings" and suggestions (hopefully wrong) that "earnings" is intended to include unrealised profits from investments. If this is correct, then apart from the obvious objections that might be made on fairness and equity grounds to the taxation of unrealised income, any such proposal is also likely to be impossibly complex in practice.

- **Specific Reforms Proposals For The Taxation of Superannuation**

Under the current taxation arrangements for superannuation low income earners (i.e those whose income is less than $37,000) are nonetheless subject to mandatory superannuation contributions which are taxed at 15%. But for a tax refund scheme known as The Low Income Super Contribution a portion of the income of low income earners that is mandatorily directed to superannuation would be taxed at a higher rate than would be the case if such income was not contributed to superannuation. This situation has come about as a natural corollary to Australia's highly progressive income tax system which incorporates a relatively high income threshold before income is subject to tax. The Low Income Super Contribution which was introduced by the former Labor government provides for the additional tax paid to be refunded directly to the superannuation accounts of income earners affected, up to a maximum amount of $500.00 for each Tax Year. This refund arrangement which was to be funded from the proceeds of the now repealed Mineral Resource Rents Tax will not continue beyond the 2017 Tax Year. The current government has indicated that it does not propose to extend the life of this measure.

Clearly, in the absence of the presently operating refund measure income earners in this category would not be adequately compensated or incentivised to participate in the superannuation system and this is inconsistent with the purposes and policy goals of that system previously described. This is an anomaly that should be addressed by extending the life of the Low Income Super Contribution or by legislating some similar compensatory measure. However the revenue cost of so doing should not be met by increasing tax rates elsewhere within the superannuation taxation system, nor for that matter within the rest of the taxation system, if that can be avoided. Rather the funding solution should be found in measures to reduce government spending – an area not within the ambit of the White Paper nor traversed in this submission.

A further worthwhile reform proposal that should be entertained as consistent with the policy objectives and goals of the superannuation system is the restoration in whole or in part of the higher caps for concessional contributions to superannuation that prevailed in the past. This could only serve to increase the national pool of superannuation savings thus reducing the future revenue cost of the pension and, for reasons previously given, be beneficial the nation's interests. Again the cost of increasing concessional superannuation contribution caps should not be funded by increasing taxes elsewhere within the superannuation taxation regime or the broader taxation system. Rather attempts should be made to find the funding for such costs through reduced government expenditures.

T G Walsh.