APPENDIX B: CONCESSIONAL TAXATION OF FUNDED SUPERANNUATION

B.1 Scope

This Appendix sets out the estimated tax expenditures related to the superannuation system for 1999-2000 to 2002-03 and forward projections for the following four years. It also briefly examines some conceptual issues relating to the interpretation of these estimates.

The key features of the taxation of superannuation relate to the treatment of contributions, earnings and benefits. As outlined in the retirement benefits benchmark, funded superannuation in Australia is taxed at three stages:

- when contributions are made to a superannuation fund;
- when investments in superannuation funds earn income; and
- when superannuation benefits are paid out.

The benchmark treatment of superannuation is that *contributions* are taxed like any other income in the hands of the employee, *earnings* are taxed like any other investments in the hands of the investor and *benefits* from superannuation are untaxed. Any costs associated with superannuation investments are deductible under the benchmark.

Australia's taxation treatment of funded superannuation varies from the benchmark. Contributions and earnings are taxed concessionally relative to the benchmark but partially offsetting these concessions is the taxation of superannuation benefits. Consequently, the tax concessions identified individually in Table B1 should be understood as part of an integrated system. This system is significantly concessional taken as a whole. This concessional treatment reflects the requirement to preserve superannuation until retirement and encourages individuals to undertake private savings in order to secure a higher standard of living in retirement than would be possible from the age pension alone.

The calculation of the estimates requires projections of contributions, earnings and eligible termination payments (ETPs). The estimates use Australian Taxation Office and RIMGROUP[1] projections of contributions, earnings and payouts. They also assume that tax is collected from superannuation funds in the year in which the contributions and earnings occur.

B.2 Interpretation

The estimate of the tax expenditure in the forward projections is not necessarily indicative of the cost of the superannuation concessions over the long term:

- the taxes on superannuation pensions and lump sums could be expected to provide a greater offset to the cost of the under-taxation of contributions in future years, when there are larger numbers of taxpayers drawing down their superannuation savings relative to the numbers in the accumulation phase; and
- the current superannuation tax concessions will have an (intended) impact on certain direct budgetary expenses in future years, particularly age pension payments.

Further, the estimates in Table B1 cannot be interpreted as a time series of the ongoing revenue savings that could be obtained if the superannuation concessions were eliminated. This is because the increase in tax revenue arising from the elimination of the tax expenditures with respect to a particular year would cause the superannuation tax base to be smaller for the next year. For example, if contributions and fund earnings in 2002-03 had been taxed according to the retirement benefits benchmark, superannuation fund assets, and hence fund earnings, would be lower in 2003-04 than if the concessional tax treatment had applied in the previous year. The increase in tax due to taxation under the benchmark in 2003-04 would, in these circumstances, be lower than if the superannuation concessions had applied in 2002-03.

In addition, the estimated cost of the superannuation tax expenditure assumes no behavioural change involving either the portfolio composition or the saving rate. To the extent that this is an unrealistic assumption, the budgetary cost of these concessions will be overestimated.

B.3 Estimates

The separate components of the overall superannuation tax expenditure which are listed in Table B1 are explained further below.

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1 RIMGROUP is the model used by Treasury's Retirement and Income Modelling Unit to project superannuation fund contributions, earnings and payouts as well as related retirement income, social security and taxation aggregates.

1. UNDER TAXATION OF EMPLOYER CONTRIBUTIONS

The benchmark treatment for contributions by employers to superannuation funds is that they are taxed like any other income in the hands of the employee (that is, contributions are taxed at the employee's marginal tax rate) and are deductible to the employer. However, employer contributions after certain costs of the superannuation fund are deducted, are taxed at a concessional rate of 15 per cent. The superannuation surcharge for higher income earners also applies to some contributions.

The application of the benchmark treatment rather than the concessional tax rates to these contributions would increase tax revenue by the amounts indicated.

2. DEDUCTION FOR CONTRIBUTIONS BY THE SELF-EMPLOYED

Contributions to complying superannuation funds are fully tax deductible to employers up to the employee's age-based deduction limit. Self-employed persons receive a full tax deduction for the first $5,000 of contributions plus 75 per cent of any remaining contributions up to their age-based deduction limit. Under the benchmark, contributions by the self-employed to superannuation funds are not deductible on the basis that the contributions are not outgoings.

If the level of contributions made by the self-employed were maintained but the contributions were not deductible, revenue would be higher by the amounts indicated.

3. UNDER TAXATION OF FUND EARNINGS

The benchmark treatment for the earnings of superannuation funds is that they are taxed like any other income in the hands of an investor (that is, earnings are taxed at the investor's marginal tax rate). However, the earnings of complying superannuation funds, after certain costs of the funds are deducted, are taxed at a concessional rate. The tax rate is 15 per cent, however earnings on investments that are supporting pensions or annuities are not taxed. Complying superannuation funds are also entitled to refunds of excess imputation credits attached to dividends payable to the fund.

Item three reflects the extra tax that would be collected if superannuation earnings were held constant, but were taxed at members' personal tax rates rather than fund rates.

4. MEASURES FOR LOW-INCOME EARNERS

Low-income earners receiving superannuation support were eligible for a tax rebate on personal superannuation contributions made to a superannuation fund before

1 July 2003. The low-income earners rebate was based on the annual contribution made by the low-income earner. Specifically, the rebate was 10 per cent of the lesser of:

- the annual contribution made; and
- $1,000 (where the taxpayer's income is $27,000 or less, phasing out at $31,000).

This rebate has been repealed and replaced with a much more extensive Government superannuation co-contribution applying to eligible personal superannuation contributions made on or after 1 July 2003.

The maximum co-contribution of $1,000 is payable for qualifying low-income earners on incomes[2] of $27,500 or less making eligible personal superannuation contributions of $1,000. The maximum co-contribution reduces by 8 cents for each dollar of income over $27,500, phasing out completely at an income of $40,000.

The co-contribution measure is aimed at encouraging low-income earners to make greater personal contributions into superannuation, thus achieving greater self-reliance in retirement.

The amounts indicated represent the impact of the Government co-contribution not being taxed at the contribution tax rate of 15 per cent, and the value of the rebate in the past.

5. SPOUSE CONTRIBUTIONS AND REBATES

An 18 per cent rebate is available for post-tax contributions to the superannuation account of a spouse (where the total of assessable income and reportable fringe benefits for the spouse is less than $13,800). The rebate applies up to a maximum annual contribution of $3,000 where the spouse income is $10,800 or less, reducing dollar for dollar above that amount. The amounts reported are the value of the rebate.

The spouse contribution measure is intended to assist families to maximise the benefits available in superannuation and provide an avenue for spouses to share their superannuation benefits.

6. CAPITAL GAINS TAX DISCOUNTS FOR FUNDS

Capital gains on superannuation investments are taxed. However, only two thirds of any nominal capital gain is included in the assessable income of a fund when it disposes of an asset that it has held for at least one year. This measure was introduced

2 Income is defined as assessable income plus reportable fringe benefits.

in 1999 together with the freezing of indexation in capital gains tax calculations. The effect of this item is in addition to the effect of lower tax rates for superannuation investments reported in item three. The amounts reported reflect the additional tax that would be raised at fund rates on the same investments if total nominal capital gains were taxed instead of discounted gains or gains with frozen indexation.

7. TAX ON FUNDED PENSIONS

Pension and annuity payments received by a taxpayer are included in their assessable income and are subject to tax at marginal rates. However, annuities or pensions paid from a taxed fund to a taxpayer aged 55 or over generally attract a tax rebate of 15 per cent. The tax raised on pensions and annuities reduces the total superannuation tax expenditure, because under the benchmark withdrawals from superannuation are tax-free.

8. TAX ON FUNDED LUMP SUMS BEFORE 1 JULY 1983

The part of a lump sum benefit relating to service prior to July 1983 is taxed at a lower rate. Only 5 per cent of these amounts is included in a taxpayer's assessable income and subject to tax at marginal rates. This more concessional treatment reflects the fact that the current regime for taxing eligible termination payments did not exist before this time and applying the current tax rates to these benefits would impose a tax retrospectively. The amounts reported are the tax raised on these lump sums.

9. TAX ON FUNDED LUMP SUMS FROM 1 JULY 1983

Funded lump sums are generally taxed at 20 per cent (plus Medicare levy) where the taxpayer is aged under 55 years. For taxpayers aged 55 or over, the elements of any lump sum benefit taxed during the accumulation stage are typically taxed at zero per cent up to the lump sum threshold and 15 per cent (plus Medicare levy) thereafter. Some superannuation benefits are not taxed during the accumulation phase, for example because the fund is protected from any taxation by the constitution. For elements untaxed during accumulation, the corresponding taxation rates are typically 15 per cent (plus Medicare levy) and 30 per cent (plus Medicare levy) respectively for taxpayers aged 55 or over, and 30 per cent (plus Medicare levy) where the taxpayer is under age 55. The amounts reported are the tax raised on these lump sums.

COMPARABILITY OF ESTIMATES WITH THOSE PUBLISHED PREVIOUSLY

These estimates are comparable with those published in the 2002 Tax Expenditures Statement, with the significant exception that unfunded superannuation is now a separate tax expenditure (C2). To obtain a comprehensive number for superannuation that is comparable to the 2002 estimates, C1 and C2 should be added.

New policy measures, such as changes in the surcharge rate, have been incorporated into the estimates. Each year there are also variations arising from the revision of earnings estimates. The taxable earnings of superannuation funds are not readily predictable. A major reason is that it lies within the discretion of a fund manager to decide when any accrued capital gains of a fund are realised. In addition, the earnings series is intrinsically volatile, reflecting fluctuations in interest rates and dividends. Fund earnings have been 'smoothed out' for the forward projections.

Table B1: Concessional taxation of funded superannuation,[a] 1999-2000 to 2006-07

	1999-00 ($m)	2000-01 ($m)	2001-02 ($m)	2002-03 ($m)	2003-04 ($m)	2004-05 ($m)	2005-06 ($m)	2006-07 ($m)
Costs								
1 Under taxation of employer contributions (b)	5010	4400	4810	5410	5850	6230	6630	6960
2 Deduction for contributions by the self-employed	220	190	220	230	260	270	280	300
3 Under taxation of fund earnings	5380	4630	3820	4050	4420	4780	5200	5660
4 Measures for low-income earners (c)	10	10	10	10	10	65	65	60
5 Spouse contributions and rebates	10	15	15	15	20	20	20	20
6 Capital gains tax discounts for funds	-	300	210	250	310	340	380	410
Sub-total (d)	10,630	9,545	9,085	9,965	10,870	11,705	12,575	13,410
Less offsets								
7 Tax on funded pensions	(e)	(e)	(e)	(e)	(e)	(e)	(e)	(e)
8 Tax on funded lump sums before 1 July 1983	-25	-20	-20	-20	-20	-20	-20	-20
9 Tax on funded lump sums from 1July 1983	-400	-310	-320	-340	-360	-380	-400	-410
Sub-total (d)	-425	-330	-340	-360	-380	-400	-420	-430
Total tax expenditures	**10,205**	**9,215**	**8,745**	**9,605**	**10,490**	**11,305**	**12,155**	**12,980**

(a) The concessional treatment of unfunded superannuation (C2) and the concessional treatment of non-superannuation benefits (C3) are reported as separate tax expenditures and are not included in this table.
(b) Includes the revenue impact of the surcharge on superannuation contributions for high income earners.
(c) For years up to 2002-03 this line shows the level of the tax offset available to low income earners who made personal contributions. From 2003-04 the line shows the impact of the government co-contribution being untaxed.
(d) Totals may not sum due to rounding.
(e) Indeterminate, but likely to be insignificant.