

**Submissions in Respect of  
The Financial System Enquiry Final Report  
In respect to the  
Superannuation and Retirement Incomes Section**

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## Introduction:

Appendix A contains extracts from the Financial System Enquiry Final Report (The Report) to which this paper refers.

The Report recommends consideration of two additions to the superannuation system's objectives:

- *The removal of tax barriers to a seamless transition to retirement, and*
- *The targeting of superannuation tax concessions.*

Further it states that:

- *Adjustments to tax settings and efforts to improve equity have been major contributors to superannuation policy change in the past.*

Whilst this paper supports the two above recommendations and contends that further efforts to improve equity need to be made, it is significant that the recommendations in the Report do not satisfactorily address the problems. This paper is intended to do that.

Under *Options Considered*, The Report states:

*However, a positive tax rate in retirement could reduce equity for some lower-income individuals taking income streams.*

This is an accurate statement but no alternative that alleviates this quite serious problem is considered. This paper's main proposal does address this issue.

The Report identifies two areas to better target tax concessions and in both cases notes disadvantages of these two areas. It does not identify any solutions to the issues addressed in respect of the stated disadvantages:

***1. Reduce the non-concessional contribution cap and better target superannuation contribution tax concession.***

*However, it would reduce individuals' flexibility to save for their retirement at different times of their life and could adversely affect individuals with broken work patterns.*

***2. Levy additional earnings tax on superannuation account balances above a certain limit.***

*The Inquiry is aware that similar policy proposals in the past have not succeeded due to their complexity and the high costs of implementation*

and further that this would

*impose high compliance costs and complexity on funds*

This paper submits that the disadvantages noted in both cases are real and other ways of achieving the same outcomes are available.

**Overview:**

There is a reasonable perception that the superannuation tax concessions are being used by some to unreasonably avoid their fair share of tax. Very large superannuation balances take advantage of a concessional tax environment beyond that envisaged by the designers of this system. The tax free status of funds in pension phase provides this environment.

This paper addresses this issue and provides a possible solution as well as making recommendations in regards to five other perceived inequities and one proposed change within the superannuation tax systems. It is not a comprehensive review but the items identified are in common use and, if these recommendations are accepted, will simplify some aspects and improve equity within the superannuation system. These seven items are:

- Taxation of “excessive” pension fund income.
- Elimination of the “10% rule”.
- Carry forward of some unused concessional contribution caps.
- Restrictions on borrowing to ensure liquidity.
- Allow those over 65 years of age to access the “bring forward” provisions.
- Allow those over 75 who pass the work test to make contributions.
- Do not increase the preservation age beyond 60.

**Superannuation:**

Superannuation was set up to encourage self-funded retirement planning and to take the pressure off the social security system with an ageing population.

The Report’s proposed primary objective for superannuation is:

*To provide income in retirement to substitute or supplement the Age Pension.*

The incentive for this is the provision of generous tax concessions. These concessions were never intended to provide an avenue for excessive tax reduction beyond what is reasonably required for a comfortable retirement without accessing the social security system.

There is a growing element of excess use of this subsidy beyond what is considered reasonable and this paper addresses this issue. This has arisen as an unintended consequence of Peter Costello’s removal of the old RBL system which limited the amount that could be accumulated within superannuation but was very inefficient and complex. It is generally considered that he was right to remove it but there needs to be some form of control where there is excess use of this concession. The announcement of the previous government which was to cap the tax free pension payment at \$100,000, was an attempt to address this issue. This was an ad-hoc attempt to solve the problem but wasn’t thought through properly and would have created its own problems. The solution needs to be market based.

This paper provides a credible solution to the above and also addresses the six other issues of equity within superannuation.

## Executive Summary

### Recommendations

1. Introduce a system of franking credits for superannuation pension payments. Apply tax at 15% to income of pension accounts which would add to a franking account. Pensions paid, to the extent they are paid out of the income of the pension account would have the franking attached and would again be assessable income to the recipient. The tax paid in the fund would be refunded to the member as a franking credit but only to the extent of any pension taken.

This needs to be done in conjunction with a pension offset which would ensure effectively tax free status provided all income was taken as a pension as at present but only up to a pension of \$80,000 per member. Beyond that, there would be some minor but increasing tax applying as assessable income increases. The tax on income generated in the fund's pension account that was not paid as a pension would be added to a franking account for possible use in future years.

The benefit of this over the suggested system of taxing incomes over \$100,000 is that, in good years where not all income is taken as a pension, there would be net tax payable by the fund on retained income only. Income and attached franking credits would carry forward to benefit poorer years in the economic cycle. The effect will be that those on taxable incomes above \$80,000 will be assessed for some tax, albeit with a pension offset and franking credit applied.

The previous government's \$100,000 rule does not allow for economic cycles and would influence the way trustees invest. It is an ad-hoc figure with no logic attached to it. Time and inflation would reduce any perceived equity in this system.

The proposed system would retain the tax free status of super fund pensioners up to a reasonable level in line with the stated aims of the superannuation system but would catch those who are gaining an unfair advantage paid for by ordinary taxpayers. This would be significantly revenue positive.

2. Eliminate the "10% rule". This discriminates against some small business people and is an arbitrary figure with no logic attached to it. This might have a slight revenue negative effect in the short term but would be ultimately good for our economy and thus positive in the longer term. This is a carryover from when RBL's were in force and needs to be eliminated.
3. Maximum concessional contributions limit. The halving of this for the over 50 year olds has hurt many people who, quite reasonable, have left the accumulation of their superannuation fund until their children are off their hands and they can afford to contribute more. This includes a recommendation for some carry forward of unused concessional contribution limits. This would be revenue negative but would be partly restoring the concessions recently removed. It would help towards gaining higher superannuation balances.
4. Borrowing within a SMSF needs to be restricted. It's too late to stop it but the application of a liquidity test within a fund would ensure not all available funds are tied up in one illiquid asset. "How to pay a benefit on the death of a member?" should be a consideration with guidelines from the regulator. It is suggested that no more than 50% of available funds should be invested in one asset or group of like assets. Other restrictions such as not allowing guarantors and restricting borrowing to a lower LVR have been suggested and should be considered.

## Detailed Recommendations

### 1. Taxation of Superannuation so called "excess benefits".

The proposal by the previous Federal Government to tax superannuation fund incomes over \$100,000 does not take account of the cyclical nature of the various investment markets and their income generation. Like so many decisions of various Governments it hasn't been properly thought through. Also \$100,000 is a purely arbitrary figure with no relevance to any other threshold or logic in the tax system. In the event that it is deemed necessary or equitable to introduce a new tax, it should be designed to integrate with existing arrangements. The unnecessary complication of the tax system is partly caused by designers not keeping that very important principle in mind.

This proposal retains the effective tax free status of benefits for those up to the \$80,000 threshold where the personal tax rate increases beyond the so called standard rate of 34.5% (including the Medicare levy). Beyond \$80,000, the tax that would be levied on pension payments less the pension offset would mean that some net tax would be payable.

This proposal is to tax all superannuation income just as income from accounts in accumulation phase is now taxed. However, tax paid on income from *accounts in pension phase only* would add to a franking account within the fund at the superannuation tax rate of 15%, just as company tax adds to the companies franking account at the 30% rate. Franking would not apply to tax paid on income of or on contributions made to accounts in accumulation phase. It is noted that contributions cannot be made to accounts in pension phase in any case and tax on contributions is not intended to form a part of this franking system.

Pensions paid, including franking credits, would be assessable income to the pensioner and would then have the benefit of the franking credit so that tax paid in the fund on accounts in pension phase would be refunded to pensioners to the extent they took the after tax amount in the account in the pension fund (the **optimum pension amount**). Pensions that exceeded this amount would be deemed to be out of capital but there needs to be an incentive to retain capital within superannuation, otherwise the reason for giving the tax incentives is lost (refer items 12 to 14 below). Pensions below this optimum pension amount would allow excess franking credits to accumulate to be available for use in future years. This allows for the effects of the economic cycle.

An effect of this would be that personal income, other than from a superannuation pension, would likely be taxed in a higher tax bracket. This is probably more equitable than at present as it would affect those who have had larger benefits from the tax concessions during the accumulation phase and therefore would have larger pension incomes.

The attached Excel spreadsheet shows the effects of this using several scenarios. Of necessity, the formulae are fairly complex but the concept is not.

The following summarises what would be required to make this system work.

1. All funds, including those in pension mode, to be taxed as at present for accumulation funds
2. Tax on funds in pension mode only to add to a franking account
3. Pensions paid to be assessable and grossed up for franking
4. Excess franking credits on pensions actually paid to be refundable
5. Tax on pensions would effectively be at the recipient's marginal tax rate less the pension offset
6. The pension offset to equal to the tax on the pension up to \$80,000.
7. The pension offset cannot create a refund unlike excess franking credits
8. The current super fund tax rate of 15% was, until 30 June, 2014, the difference between the lowest rate of 19% which starts at an income of \$18,200 (No Medicare levy applies at this stage) and the next rate with Medicare of 34% which starts at \$37,000. With the extra 0.5% for the NDIS added to the Medicare Levy, this difference is now 15.5%. If the super fund tax rate were to increase to 15.5%, the effect of franking on pension incomes up to \$80,000 would provide effectively tax free.
9. Pensions taken that are less than the net income, after tax, in the fund will allow untaken franking credits to build up and carry forward.
10. Pensions taken that are more than the after tax income in the fund, and to the extent they have used up carried forward franking credits, if any, will be taking part of their pension out of their capital. There needs to be a rule that pensions will use up any accumulated income with franking credits before accessing capital. Any capital amount paid, to the extent it comes from the non-concessional component, should remain tax free and not included in assessable income. Once that is used up, drawings from the concessional component (taxed element) of capital should be taxed at 15% with no offset after allowing for the present lifetime exempt amount of \$185,000.
11. Untaken franking credits will always attach to net income remaining that is unpaid as a pension in the same ratio, ie, 15:85. The taxable component of capital gains will form a part of the income: The discount amount will not. It should add to the non-concessional capital component. Any pension paid after using up unpaid income will be considered to be paid out of capital with tax consequences as in 10 above.
12. At present for those over 60 all capital can be withdrawn tax free regardless as to whether it is out of concessional or non-concessional components. The proposal in 10 above would therefore represent an element of retrospectivity which may be seen to be inequitable and possibly politically difficult to sell. A politically acceptable solution could be that, on the introduction of this, all concessional components as at that date would transfer to non-concessional for those over 60. Any new concessional balance would then build up from that date. For those under 60, their concessional balance as at the same date could also transfer to non-concessional on their reaching 60 years of age.

This proposal should provide a quite large increase in net revenue from funds and members where larger balances exist than are deemed necessary for a comfortable retirement.

## 2. The "10% Rule".

This rule prevents concessional contributions being made personally where more than 10% of a taxpayer's assessable income comes from salary or wages and superannuation is contributed by the taxpayer's employer.

This rule is an anachronistic carry over from when there were retirement benefit limits and should be rescinded. Why does it matter from whence a concessional contribution is made? There are many instances where taxpayers earn more than 10% of their assessable income from salary or wages but are predominantly in their own business. There are many instances where professional people would otherwise provide part time teaching or medical services but do not because of the impost of this very unfair rule.

10% is a purely arbitrary figure in any case. What logic is there to this?

**After an employer has made its concessional superannuation contribution for an employee, the employee should be able to top up to the concessional contribution limit and claim a personal tax deduction. Most employed people can do that through salary sacrifice. Small business self-employed people cannot.**

This inequitable rule discriminates against many small business people and should be rescinded urgently.

This proposal will be a relatively minor cost to the net revenue but will improve equity and encourage part time teaching and medical services. There will be a good benefit to the community in the longer term.

## 3. Concessional Contribution Limits.

The halving of these limits for people over 50 was counterproductive and inequitable. It is usually not until people are in later working life that they can afford larger contributions.

This is especially so for small business people who, traditionally, have used their business as a proxy for their superannuation. In earlier years they traditionally reinvest excess cash flow back into their business and need this catch up phase in later life. Business valuations have fallen considerably since the onset of the global financial crisis and this makes good superannuation planning all the more important.

The arbitrary doubling of concessional contribution limits at age 50 and beyond, as it had been, was one way to cater for this but it wasn't perfect either. There needs to be some ability for higher payments in good years to make up for lower ones when economic conditions don't allow for reasonable concessional contributions to be made. This is especially so for people in small business.

**This proposed solution would be to allow a carry forward of untaken concessional contribution limits for, say, five years. There does need to be some limit on taxpayer subsidy but that needs to be balanced with the incentive to provide for retirement benefits and the effects of the economic cycle.**

The effect of this would be an initial cost but be a long term benefit to the revenue and would restore, to an extent, a benefit unreasonable taken from those over 50 approaching retirement and needing to catch up their superannuation balances.

#### **4. Restrictions on borrowing within superannuation.**

Allowing 100% of funds within a superannuation fund to acquire one illiquid asset does not allow for the possibility of death benefits being paid, especially when the property market is in decline as happens in every economic cycle.

Allowing a fund to borrow to acquire one asset compounds this problem because the fund then has to ensure it has a regular supply of funds to meet repayments and interest. The risks are that properties can lose tenants from time to time and that business tenants can and often do encounter times of financial stress. At such times, there may not be cash flow to pay rent and/or contributions to cover loan obligations.

The inequity in this rule is that taxpayers are helping to fund an asset which may not provide the intended benefits of the superannuation system as outlined at the start of this paper.

**It is suggested that investing in one asset or class of assets be restricted to 50% of available funds with the other 50% being required to be invested in liquid assets (For example; listed securities, cash and term deposits)**

**It is further suggested that LVR's for real property be limited to the ability of the income generated by that property to meet repayments without relying on contributions or income from other sources (that is, positively geared). The benefit of this is that contributions and earnings from other assets would then go towards increasing the size of the fund and not just to prop up one asset which may or may not be performing.**

#### **5. Allow those over 65 to use the bring-forward provisions for non-concessional contributions.**

I question the justification, and indeed the logic, of stopping this ability for those over a certain age to access a contribution cap available to others. Whilst 65 has been the age when the age pension starts, this is now increasing in any case. But more importantly, if we as a society are trying to encourage people to provide for their retirement through superannuation then why restrict a certain group just because they have attained a certain age. Where's the logic. It's age discrimination.

#### **6. Allow those over 75 to make contributions provided they pass the work test.**

As in 5 above, this is a highly age discriminatory rule. If a person is still working beyond 75, then he/she is not a drain on society and should not be disadvantaged. The government is encouraging people to work beyond the "normal" retirement age and should have the ability to make contributions along with any other worker regardless of age.

#### **7. Do not increase the preservation age beyond 60.**

It is difficult enough now to encourage younger people to make extra contributions because age 60 is "so far off" and "we can't access our own money until then", "then" being beyond the younger person's comprehension. People need to be able to retire at a reasonable age and 60 is at the upper end of younger people's expectations. And yet, we need them to start contributing as early as possible to take the ultimate weight of age pensions off the budget.

Yes, there needs to be some encouragement to ensure the bulk of the capital remains in the superannuation environment and this can be done with a carrot and stick approach rather than by mandating it. Taxing capital drawdowns of concessional components beyond \$185,000 as at present is in place as is the tax concession of earnings in super being concessionaly taxed or not taxed at all. These present arrangements actually work in the vast majority of cases. Most people want to retain their superannuation balances and draw a pension. There is no need to change these arrangements and certainly not increase the preservation age. To do so would inhibit younger people contributing.



## **Conclusion**

The above items are presented as solutions to some, but not all, existing taxation and savings inequities that have become evident perhaps as unintended consequences of past decisions but which, nevertheless, need to be addressed. Australia's superannuation system, as introduced by the Hawke/Keating government and modified by the Howard/Costello government is a very good concept and, generally, works well. But, like any system, the superannuation system needs constant maintenance. This paper does not purport to identify all issues that need attention, just some of the more important ones that have come to the constant attention of the author who works in this industry.

An Excel spreadsheet comes with this paper to demonstrate how the suggested system of franking credits could work.

## **The Author:**

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- Member of CPA Australia since 1970 with current CPA Practicing Certificate
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- Public Accountancy Practice since 1977
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## Appendix A

### Extracts from the Financial System Enquiry Final Report

#### Chapter 2: Superannuation and retirement incomes

##### Objectives of the superannuation system

Government should seek broad agreement on the following primary objective for the superannuation system:

*To provide income in retirement to substitute or supplement the Age Pension.*

In achieving this primary objective, Government should also seek broad agreement on the subsidiary objectives of the superannuation system, as set out in Table 3.

##### Introductory section

Tax concessions in the superannuation system are not well targeted at improving retirement incomes, which has a number of consequences. It increases the cost of the superannuation system to taxpayers; it increases distortions due to higher levels of taxation elsewhere in the **economy and due to the differences in the way other savings vehicles are taxed; and it** contributes to the broader problem of policy instability, which imposes unnecessary costs on superannuation funds and their members and undermines long-term confidence in the system.

##### Recommended actions

The Tax White Paper should consider the **removal of tax barriers to a seamless transition to retirement** and **target superannuation tax concessions** to the superannuation system's objectives. Adjustments to tax settings and **efforts to improve equity** have been major contributors to superannuation policy change in the past. The Inquiry believes community concerns about these issues need to be addressed to achieve greater policy stability and long-term confidence and trust in the system. (Emphasis added)

##### Taxation of superannuation

###### Objectives

1. Remove tax barriers to enable a more seamless transition to retirement.
2. Better target superannuation tax concessions to achieve the objectives of the superannuation system discussed earlier in this chapter and, in doing so, reduce the cost of the superannuation system to Government, reduce distortions to the allocation of funding in the economy, and improve long-term confidence and policy stability in the superannuation system.

Superannuation tax concessions are not well targeted at the objectives of the superannuation system discussed earlier in this chapter. As illustrated in Figure 4.3 of the Interim Report, a small minority of members hold a high proportion of superannuation assets.<sup>102</sup> **Individuals with very large superannuation balances are able to benefit from tax concessions on funds that are likely to be used for purposes other than providing retirement income**, such as tax-effective wealth management and estate planning.<sup>103</sup> The AIST supports "... a focus on promoting and delivering greater equity in the system to build retirement incomes over the course of every person's working life, as opposed to making superannuation a tax effective wealth creation vehicle and estate planning tool, for the few".<sup>104</sup>

As a result, the majority of tax concessions accrue to the top 20 per cent of income earners (Chart 6). These tax concessions are unlikely to reduce future Age Pension expenditure significantly. (Emphasis added)

## Options considered

Align the earnings tax rate between the accumulation and retirement phases

As noted in some submissions, aligning the earnings tax rate between the accumulation and retirement phases would result in significant simplification benefits. This was also recommended by Australia's Future Tax System Review (AFTS).<sup>109</sup>

Aligning the earnings tax rate could be revenue-neutral for Government, would reduce costs for funds, would help to foster innovation in whole-of-life superannuation products, would facilitate a seamless transition to retirement and would reduce opportunities for tax arbitrage. **However, a positive tax rate in retirement could reduce equity for some lower-income individuals taking income streams.** (Emphasis added)

## Better target tax concessions

The Inquiry considered two options to better target superannuation tax concessions at achieving the objectives of the system. Both options would limit tax concessions for individuals with large superannuation balances.

### 1. Reduce the non-concessional contribution cap and better target superannuation contribution tax concessions

Some submissions suggest applying a more neutral tax treatment of superannuation across taxpayers. This could be done by implementing the AFTS recommendation to tax superannuation contributions at marginal rates less a flat-rate rebate.

Tightening the non-concessional contribution cap — currently \$540,000 over three years — would help to target the tax concessions for superannuation contributions better by reducing the extent to which individuals could accrue very large balances in the system in the future. The administrative and compliance costs would be relatively low. **However, it would reduce individuals' flexibility to save for their retirement at different times of their life and could adversely affect individuals with broken work patterns.**

### 2. Levy additional earnings tax on superannuation account balances above a certain limit

This option imposes a higher rate of earnings tax on individuals with superannuation balances in excess of a certain limit. It would target superannuation tax concessions to achieve the objectives of the system and reduce costs to taxpayers. It would also facilitate the removal of the non-concessional contribution cap.

The Inquiry is aware **that similar policy proposals in the past have not succeeded due to their complexity and the high costs of implementation.**<sup>110</sup> Industry express a strong view that imposing a different rate of earnings tax inside a pooled superannuation trust based on members' individual incomes would impose **high compliance costs and complexity on funds.** Submissions also stress the need to avoid options that impose large compliance costs on funds.<sup>111</sup>

To avoid these large compliance costs, stakeholders raise alternative implementation options to which the Inquiry is attracted. One approach is to apply the higher rate of earnings tax to affected individuals outside the superannuation system, with the option of paying the tax liability out of superannuation benefits — similar to the mechanism for applying the tax on excess contributions. To reduce complexity further, the tax could be calculated on a simplified tax base.<sup>112</sup> This option would increase Government revenue. (Emphasis added)