# Better targeted superannuation concessions: consultation paper

Comments by Terrence O'Brien, 17 April 2023

## Summary: a framework for thinking about the Consultation Paper's questions

- The measures are poorly justified by reference to a small number of large super balances, cited without information about how long ago those balances were initiated with large deposits, how much of those balances today are the returns to compound growth over decades, and whether any such large balances could be created today. [1]
  - We suspect the proposals wrongly use examples from yesterday that could not occur today to make policy for tomorrow. Its proponents then argue that hardly anyone will be affected, until compound growth in the returns on saving propels many more savers over an unindexed threshold.
  - If we are wrong in that suspicion, the Government should show how projected large super balances tomorrow are being created by unreasonably large deposits today. That test has not been met.
- The higher proposed tax is effectively retrospective, denying the targeted savers the legislated taxation treatment that drew their lawful savings into superannuation in the first place.[2] We illustrate with a particularly glaring and relatively recent example: transitional incentives to facilitate simplification permitted time-limited large super deposits briefly until 1 July 2007. Those same savings would now be targeted for penalty under the new measures (Box 1). Such policy reversals destroy confidence in superannuation saving, and should be avoided by grandfathering (see Box 2 for the principles suggested by a previous taxation inquiry).
- Being un-indexed, the $3 million trigger damages confidence even among savers not presently near or over the trigger. If the measures proceed, the trigger should be indexed, at the least like the Transfer Balance Cap is indexed. There is now a shambles of different indexation rates for some key savings and retirement income parameters, coupled with failures to index others. [3]
  - It is misleading to claim that "By 2025-26, the changes are expected to apply to less than *[sic]* 80,000 people, meaning that more than 99.5 per cent of individuals with a superannuation account <u>will be unaffected.</u>" (Discussion Paper p 4, emphasis added.) Ministers have already acknowledged that significantly higher percentages will be targeted over decades to come as a result of the compound growth of savings balances.[4] It is laughable to claim that not indexing key parameters "provides certainty for people when arranging their tax and financial affairs" (Discussion Paper p 6).

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[1] The Government is explicit in enumerating the small number of savers with high superannuation balances (Press Conference Transcript, Prime Minister, Canberra 28 February 2023), but silent on the years at which those balances were created and the period over which initial contributions have compounded. Good policy formation demands that second set of information, as well as the first.

[2] For the idea of 'effective retrospectivity', see Address to the SMSF 2016 National Conference, Adelaide, Scott Morrison, 18 February 2016.

[3] Retiree time-bombs, Jim Bonham and Sean Corbett, Save Our Super, 30 October 2019

[4] Senate and House of Representatives Hansards, Questions without notice, 6 March 2023.

- For those who have reached a condition for release of super funds, the measures as outlined in the Consultation Paper would likely trigger an exodus of savings near or over the $3 million cap before 1 July 2025, and thus raise little revenue. This is because accruals taxing of capital gains within super without discount yields effective tax rates above what many would face if capital gains were made outside of super and taxed with 50% 'discount' only on realisation, under general tax principles.
- Savers also have the option of moving income caught under the proposed measures into their tax-free principal residence, which is unlikely to yield national economic benefit compared to allocation of super savings through competitive capital markets to finance productive investments.
- Imposing accruals taxation without discount for capital gains in superannuation – the longest-term, most patient saving in the Australian economy – seems driven wholly by the administrative convenience of superannuation funds rather than any consideration of sound tax principles.
- The measures introduce a distorting over-taxation of capital gains which creates an adverse precedent for the rest of the economy. They will embolden advocates of the reduction or elimination of the 50% 'discount' in general CGT practice and the taxation of capital gains from the principal residence. (The annual revenue estimated for the proposed measures equals only one day's Commonwealth expenditure.)[5]
- Having proposed a retrospective, distorting tax policy on high superannuation balances in retail, industry and self-managed super funds, the Discussion Paper then seeks to project 'commensurate unfairness' on to defined benefit schemes that are in no way comparable. That idea should be dropped.
- The Government's objective (which we take to be raising more taxation revenue from savers with high superannuation balances) could be better met with less revenue evasion, less damage to tax policy principles and less damage to confidence in superannuation if the measures were withdrawn for extensive redesign along the principles suggested in responses to the Consultation Paper Questions.
- The measures are presented as if purely redistributive, taxing rich savers with high super balances more heavily. But in terms of real resource flows, they crimp the compound growth over decades of high super balances that would have been invested through relatively efficient capital markets in the broader economy, and instead channel those resources to relatively inefficient current Government spending.[6]
- The measures apparently value the line of least resistance from retail and industry superannuation funds over alternative approaches that would preserve sound tax policy.

The government should take its proposals back to the drawing board. With the measures yet to be put to Parliament and not scheduled to take effect until 1 July 2025, there is plenty of time to achieve better outcomes.

[5] Allegra Spender's talkfest misses the obvious on tax, Dimitri Burshtein, The Australian, 13 April 2023.
[6] See my comments on the discussion paper on legislating the objective of superannuation for examples of how superannuation savings could be diverted to unproductive government uses (p 8).

### BOX 1: Encouraged in 2007, penalised in 2025

As part of the Simplified Superannuation reforms of 2006 and 2007 and after extensive review and consultation, the Age Pension asset test taper rate was reduced to avoid penalising more superannuation saving with high effective tax rates from the rapid reduction of part Age Pensions. Superannuation taxation was also simplified and allocated pensions paid from life savings were made tax-free, subject to the requirement that the allocated pensions reduced the capital left in the super account by annual percentages rising with age. This ensured super savings were substantially run down by average life expectancy.

As part of the simplification, annual post-tax contribution limits for super were unified at $150,000 from 1 July 2007 (since further reduced to $110,000).

As a conscious transition policy for late-career savers who may have counted on previous rules for making higher contributions over their remaining career, people were allowed make up to $1 million of post-tax contributions between 10 May 2006 and 30 June 2007, but not after.

From 1 July 2007, people aged less than 65 were able to bring forward two years of post-tax contributions, enabling $450,000 to be contributed in one year, with no further contributions in the next two years.

In addition to the transitional annual caps, savers with small business assets could contribute a lifetime limit of $1 million from the sale those assets if they been held for 15 years or more.

Such targeted transitional arrangements for those adversely affected by change close to retirement conformed to the principles for grandfathering proposed by Justice Asprey's Taxation Review Committee in its January 1975 report to the Whitlam Government. (See Box 2.)

So for a fortunate few with qualifying small business assets, the law thus encouraged some $2 million dollars to be transferred into super over a short period.

If $2 million had been saved under 2007's legislated incentives into superannuation 'growth funds' (which have averaged around 5.5% growth per annum over 15 years), the $2 million would have grown to exceed the current Government's proposed $3 million trigger in just under a decade by 2016 (after paying 15% tax each year on earnings) and would stand at about $4.5 million by 2025. (Over that time, the savings would have paid some $450,000 in earnings tax.)

Were the 2007 transitional measures justified, or too generous? Assessments may differ. But in any event, they were legislated incentives in a well-modelled and costed package which savers were entitled to act on in good faith. Instead, under the current Government's proposals, such savings encouraged under the transitional, time-limited incentives of 2007 are to be penalised from 2025.

Successive governments are of course entitled to change policies. But 180 degree reversals within 20 years of the incentives for superannuation savings should be done only with prospective effect, not with effective retrospectivity.

### BOX 2: Asprey Taxation Review Committee on principles to avoid retrospectivity by grandfathering adverse changes to superannuation

"21.9. Finally, and most importantly, it must be borne in mind that the matters with which the Committee is here dealing involve long-term commitments entered into by taxpayers on the basis of the existing taxation structure. It would be unfair to such persons if a significantly different taxation structure were to be introduced without adequate and reasonable transitional arrangements. . . .

"21.61. . . . Many people, particularly those nearing retirement, have made their plans for the future on the assumption that the amounts they receive on retirement would continue to be taxed on the present basis. The legitimate expectations of such people deserve the utmost consideration. To change suddenly to a harsher basis of taxing such receipts would generate justifiable complaints that the legislation was retrospective in nature, since the amounts concerned would normally have accrued over a considerable period—possibly over the entire working life of the person concerned. . . .

"21.64. There is nonetheless a limit to the extent to which concern over such retrospectivity can be allowed to influence recommendations for a fundamental change in the tax structure. Pushed to its extreme such an argument leads to a legislative straitjacket where it is impossible to make changes to any revenue law for fear of disadvantaging those who have made their plans on the basis of the existing legislation. . . .

"21.81. . . . [I]t is necessary to distinguish legitimate expectations from mere hopes. A person who is one day from retirement obviously has a legitimate expectation that his retiring allowance or superannuation benefit which may have accrued over forty years or more will be accorded the present treatment. On the other hand, it is unrealistic and unnecessary to give much weight to the expectations of the twenty-year-old as to the tax treatment of his ultimate retirement benefits.

"21.82. In theory the approach might be that only amounts which can be regarded as accruing after the date of the legislation should be subject to the new treatment. This would prevent radically different treatment of the man who retires one day after that date and the man who retires one day before. It would also largely remove any complaints about retroactivity in the new legislation. . . ."

**Source:** *The Taxation Review Committee Full Report* (31 January 1975), Chapter 21: Income Taxation in Relation to Superannuation and Life Insurance. Cited in *Grandfathering super tax increases*, Terrence O'Brien, Centre for Independent Studies*, Policy* Vol 32 No 3, Spring 2016, pp7-8.

## Consultation Paper Questions 4, 5, 8, 10, 11 and 13

My responses below to six specific questions of implementation should be read in relation to my comments on the discussion paper on legislating the objective of  superannuation.[7]

### 4. Do you have an alternative to the proposed method of calculating earnings on balances above $3 million? What are the benefits and disadvantages of any alternatives proposed including a consideration of compliance costs, complexity and sector neutrality?

**Suggestion 1:** Measures should be prospective, rather than effectively retrospective.  An example of a superior, propsective approach was implemented in May 1983, when the Hawke government announced higher taxation of lump-sum superannuation payments. Previously, only 5% of such payments were added to the retiree's assessable income and taxed at the retiree's highest marginal income tax rate.  The government proposed imposing a tax rate of 30% on such lump sums in future, but the change was grandfathered to ensure there was 'no element of retrospectivity':  for lump sums received after 1 July 1983, only that portion saved after the implementation date attracted the new higher taxation rate.

Paul Keating has reflected on the reforms of that era:

> That change preserved the concessionality of the system to 1983 while changing the tax treatment of superannuation post-1983. This meant that those people who, for a large part of their working lives had enjoyed the concessionality of the superannuation provisions, would have those accumulations protected under a 'grandfathering' concession—that is, with no retrospectivity—while income after 1983 would be taxed on a less concessional but sustainable long-term basis.[8]

The application of this idea could be developed using the Asprey principles recommended to the Whitlam Government (Box 2).  Essentially, any fund interests over the threshold at 1 July 2025 would continue to be subject to the tax treatment under which savings took place. But any balances that go over the threshold from that date as a result of new contributions (not as a result of earnings) would pay the new higher tax on earnings over the trigger. Immediate and direct revenue from the measure would be less, but so would future deposits into super balances nearing or at $3 million. If one places any weight on Treasury's 'tax expenditure' estimates for superannuation, these 'tax expenditures' would be crimped as the Government desires.

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[7] Legislating the objective of superannuation: Consultation paper, 20 February 2023
Comments by Terrence O'Brien,  31 March 2023, to be available at
https://treasury.gov.au/consultation/c2023-361383

[8] *Grandfathering super tax increases,* Terrence O'Brien, Centre for Independent Studies, *Policy* Vol 32 No 3, Spring 2016, page 9, https://www.cis.org.au/wp-content/uploads/2016/08/32-3-obrien-terrence.pdf

**Suggestion 2:** Rather than introduce unprecedented accruals taxation of unrealised capital gains on long term saving without discount as if income, good tax policy requires the application of existing taxation of capital gains within superannuation: on realisation, with the current one-third discount applied to realised capital gains within the fund on assets held for 12 months or more. See comment below on question 5 on how this could be done.

**Suggestion 3:** The $3 million should be indexed. Indexation of the threshold could be achieved simply by expressing it as a multiple of the Transfer Balance Cap, which is indexed. Thus, a multiple of 2, for example, would result in a threshold of $3.4 million currently, but $3.8 million from 1 July 2023.

A more systematic approach would be to move to consistent indexation practice over all the key parameters of the retirement income system, so savers were not progressively disadvantaged over time as at present.[9]

## 5. What changes to reporting requirements by superannuation funds would be required to support the proposed calculation or any alternative calculation methods?

Retail and industry superannuation funds pool savers' assets, so suggestion 2 above could not be implemented under present arrangements. Moreover, some people have multiple funds and may have less than the threshold in each fund but more than the threshold in aggregate. The ATO knows about the aggregate but each individual fund doesn't.

Proper taxation of oncome and capital gains would require, instead, an important change: savers approaching the $3 million trigger would be required to convert all their super accounts into a single individual account with their chosen fund, or in a self-managed super fund. Each consolidated account could then be taxed within the fund, which would then have the same information as the ATO holds about the saver's total superannuation position.

The Government's proposed tax increase could then be applied (ideally prospectively under suggestion 1) to income and capital gains as presently defined in superannuation, in accord with sound taxation principles, including the broader CGT landscape.

There has long been a campaign to encourage the consolidation of multiple super accounts into one, with potential economies to the saver in administration fees and elimination of the problem of 'lost super' from small accounts created with previous employment. The Government's proposed measure could incidentally achieve that beneficial consolidation.

High-balance savers affected by the consolidation would of course have the option of literally switching from a consolidated retail or industry fund to an actual self-managed super fund. This switching option would create competitive pressure on administrative fees charged by the retail and industry funds. There are well-established support networks of administration, accounting and auditing for self-managed super funds. The overall numbers that would be affected by this measure are at present small, as the Government stresses.

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[9] Retiree time-bombs, Jim Bonham and Sean Corbett, Save Our Super, 30 October 2019

Retail and industry funds would vigorously oppose this proposal. But life has been sweet for the those funds under the superannuation guarantee levy, conscripting customers by law to save from 3% of their earnings in 1992 to 12% by the time the proposed tax measures are intended to take effect in 2025. Since July 2022, employers of anyone aged 18 or over has had an obligation to make a Superannuation Guarantee payment from the first dollar paid to that worker.[10]

The Government should encourage retail and industry super funds to make the administrative changes that would consolidate the balances of those in multiple funds and preserve a stable super taxation environment, with only prospective policy changes, consistent indexation practices and sound CGT tax principles for the benefit of all their clients.

### 8. Does the proposed methodology for determining the tax liability create any unintended consequences?

Yes. The Government's proposal for accruals taxation of capital gains as if income creates a strong incentive for savers who can meet a release condition for their super savings to reduce balances to under $3 million before 1 July 2025. Revenue from the measures is likely to be significantly overestimated, as the effective tax rates from the proposed doubling of the nominal tax rate on a wider tax base are high, and capture any withdrawal of funds from superannuation accounts in 2025-26 or subsequently (Discussion Paper p 9).

The levying of tax on accrual of capital gains that may be reversed or never be realised, and taxing such capital gains in full as if income creates a general disincentive to saving in super. An accrued capital gain one year attracts a tax liability that must be paid up front, even absent any income stream form the investment. If that gain is offset in part or whole by an accrued loss in the following year, that does not generate a refund of tax already paid, but only a tax loss that can be carried forward for offset against tax in a third or subsequent year (Discussion Paper, p 11). Enthusiasts for big government will demand the approach be extended to other 'patient saving' (such as in the family home), other superannuation balances and general investments, either by accruals taxation, reducing the CGT 'discount', or both.[11]

Both saving in the principal residence and normal capital gains tax treatment on realisation of benefits with a 50 % discount outside of super offer potentially better after-tax outcomes than leaving funds within super.

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[10] *Work out if you have to pay super*, Australian Taxation Office, 4 November 2022, https://www.ato.gov.au/business/super-for-employers/work-out-if-you-have-to-pay-super/ Initially, the Superannuation Guarantee was only due on payments over $450 gross a week. See *Grandfathering super tax increases,* Terrence O'Brien, Centre for Independent Studies*, Policy* Vol 32 No 3, Spring 2016, page 11 fn 7, https://www.cis.org.au/wp-content/uploads/2016/08/32-3-obrien-terrence.pdf

[11] Back in black? A menu of measures to repair the budget, Grattan Institute, April 2023.

- 'Super-charged' investment by the comparatively rich in ever more valuable houses is unlikely to be beneficial for the broader Australian population.
- The usual 50% 'discount' of capital gains subject to income tax outside of superannuation rightly addresses an important principle in a simplified way to reduce the compounding effect of the CGT tax wedge on long-held investments.[12]

High historical savings balances in superannuation under previous rules is a good thing for financing efficiently allocated investment, even when those historical savings were made by 'the rich'.

### 10. Do the existing valuation methods for defined benefit interests in the pre-pension phase (under the existing TSB definition) work appropriately for the purpose of calculating superannuation balances over $3 million?

No. First, a declaration of interest. I entered in 1972 a composite super scheme with both a defined benefit element financed from Consolidated Revenue and a smaller accumulation benefit element financed from my own contributions and earnings on them. I saved in that scheme until 2012, and am now retired and drawing an indexed pension from that scheme. I have thus been a superannuation saver for 40 years, and a retiree dependent on those savings for a decade to date. That half-century experience would not be unusual, and if income streams from it were now to be taxed more highly, it would be clearly a retrospective measure.

As the Discussion Paper notes (p 14), for a defined benefit scheme participant, "there are no contributions invested that are attributable to these [employee or employer contribution] components, no earnings upon which tax concessions are received, and no tax payable [by the defined benefit fund] until the benefit stage. Instead, pension payments attributable to these components are taxable in an individual's hands at their personal marginal tax rate, with a [capped] 10 per cent offset provided for some pensioners aged 60 or over."

To pursue the concept of 'broadly commensurate treatment' of diverse defined benefit stream to match the Government's proposed tax increase on earning on fund balances over $3 million seems to us a fool's errand. There are no fund balances to commensurately tax, but the income stream of the indexed pension is already taxed.

The major defined benefit systems (the major examples of which have been closed to new entrants for over a quarter century) are essentially bygones, like the very high balances some have built in other super funds. Receivers of such defined benefit pensions are dying out.

For Commonwealth defined benefit streams, a CPI-indexed pension is paid out of the Consolidated Revenue Fund. From the saver's perspective, it is as if on retirement they commence an annuity that had been promised by the Government as a condition of their employment, but there is no identifiable asset behind that promised annuity that the retiree

[12] Myth vs Reality: The case against increasing capital gains tax, Robert Carling, CIS Policy Paper No 18, March 2019.

owns. They have simply no equivalent to the $3 million super balances on whose earnings the Government is seeking to impose higher taxes.

On the other hand, they are already fully income-taxed on the pension they receive, with the capped 10% offset reflecting that their employee contributions did pay 15% tax on deposit during their working lives. Unlike those with over $3 million in the retirement phase of a super scheme, they can not receive an allocated pension, tax free on the condition that they deplete the capital in their fund by a percentage rising each year with age to approximately exhaust the savings by average life expectancy.

Consider a person with only a defined benefit pension and no other superannuation savings in other funds. Imagine the annual gross value of the indexed pension were to multiplied by 16 to very roughly estimate a hypothetical capital backing that would be required to finance the pension. If their existing annual income tax liability on their pension were to be increased by some analogy to the impost paid by those with $3 million in super assets in an account of their own, they have no superannuation assets they could sell down to pay their increased tax liability, as is an option for those with a contributions based super fund (see Discussion Paper, pp 13-14). They can only reduce their retirement living standards by paying more tax to the ATO. That hardly seems 'broadly commensurate treatment'.

### 11. Do the existing valuation methods for defined benefit interests in the pension phase provide the appropriate value for calculating earnings under the proposed reforms?

No. The 'times 16' rule used in 2017 to determine whether a defined benefit pension had a notional capital value of over $1.6 mn was a one-off means of preventing a high-income defined benefit pensioner building further super savings in a retail or industry super fund. It forced any such additional super savings outside of defined benefit schemes back into the accumulation phase where their earnings were taxed at 15%, rather than funding a conditionally tax-free allocated pension in addition to the taxed defined benefit pension.

To achieve what the Discussion Paper seems to be seeking in this area would require the 'times 16' calculation to be performed annually, to see if the CPI-indexed pension's hypothetical capital value had risen above the non-indexed $3 million trigger. Gradually, any beneficiary who lives long enough would become more highly taxed under the measures just because of the differences in indexation practice, even though their capacity to pay tax would not have increased. The tax increase would progressively erode their living standards.

The 'times 16' rule of thumb is actuarially very approximate. If it is accurate for a 60-year old retiree, it will be too high for an 80 year-old retiree whose remaining life expectancy is 20 years less. Thus if a rule were to be applied annually, the rule would have to be adjusted so a lower multiplier was applied for every extra year of age.

### 13. Are there any preferred options in providing commensurate treatment for defined benefit interests?

No. As noted above the search for a ‘broadly commensurate treatment’ of an entirely different product is a fool’s errand.  The idea should be dropped.

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