This is my second submission is on the tax and transfer system and related benefits. It builds on my first submission and is in four parts:

(1) a brief follow up on my first submission

(2) some contextual remarks

(3) some personal income tax issues (all age groups) around tax rates, taxfree thresholds, unit of taxation and superannuation contributions, and

(4) some retirement income issues around personal and superannuation tax and the age pension.

Abbreviations used in this submission are:

ATO	Australian Taxation Office
CSHC	Commonwealth Seniors Health Card
DSTO	Dependent Spouse Tax Offset
EMTR	Effective Marginal Tax Rate
FTB	Family Tax Benefit
LITO	Low Income Tax Offset
METO	Medical Expense Tax offset
PTO	Pensioner Tax Offset
RESC	Reportable Superannuation Contributions
SATO	Senior Australian Tax Offset
SG	Superannuation Guarantee
SMSF	Self Managed Super Fund
SNI	Separate Net Income

A brief follow up on my first submission

My first submission referred to the ATO taxation Statistics 2005/06. I note that the ATO Taxation Statistics for 2006/07 have been released since then.

My first submission suggested replacement of SNI with taxable income. The issue should have been addressed a decade ago with FTB and DSTO changes at that time. Tax Laws Amendment (Measures No. 1) Bill 2009 repealed the term SNI and replaced it with adjusted taxable income. I assume this change applies everywhere, including the Medicare Levy and the METO. The same bill also introduced the terms “rebate income” “reportable superannuation contributions” and “total net investment losses”. We now have SATO, a tax offset, means tested by “rebate income”. There is a need for real reform rather than complex administrative changes. Will LITO be subjected to means testing in the future in the same way as SATO?

Social Security and Veterans’ Entitlements Amendment (Commonwealth Seniors Health Card) Bill 2009 is still before Parliament. It appears to me that it will include return of after tax personal contributions in adjusted taxable income. This does not apply when you deposit after tax money into a bank account held in your own name and then withdraw it. This concept represents substantial legislative risk.

The following paragraph from my first submission is repeated with figures for 2006/07.

Personal Tax Table 11 in ATO Taxation Statistics 2005/06 shows that:
551,825 individuals aged 65 and over paid $7,106,865,107. Of these, 124,755 had taxable income over $60,000 and paid $5,223,017,868. The remaining 427,070 had taxable income of $60,000 or less and paid $1,883, 847,949. Total tax paid for all age groups was $108,704,189,065.

Personal Tax Table 11 in ATO Taxation Statistics 2006/07 shows that:
544,745 individuals aged 65 and over paid $8,174,439,325. Of these, 146,045 had taxable income over $60,000 and paid $6,446,245,081. The remaining 398,700 had taxable income of $60,000 or less and paid $1,728,194,244. Total tax paid for all age groups was $113,932,213,880.

The following additional calculations were not in the first submission.

Taxable income in 2005/06 for individuals aged 65 and over was $30,652,773,599. Taxable income for those aged 65 and over with taxable income over $60,000 was $16,390,043,866.

Taxable income in 2006/07 for individuals aged 65 and over was $34,688,810,132. Taxable income for those aged 65 and over with taxable income over $60,000 was $20,542,616,686.

Contextual remarks

The White Paper on Climate Change includes some benchmarks for low, middle and high incomes for different family types. The middle income benchmarks in 2010/11 dollars for singles without children and couples without children are $30,000-$80,000 and $45,000-$120,000 respectively. These benchmarks are based on projected estimates of CPI to 2010/11. It also estimates Australia will have around 3.2 million low-income households, 3.9 million middle-income households and 1.5 million high-income households in 2010/11. It also proposes tax changes for compensation that include an increase of $390 in the LITO.

My first submission provides most of the context. I gained useful but nowhere no complete information from the SMSF statistics on the ATO website, the ATO Taxation Statistics and the Treasury Paper (file CP08) “Projecting the distributions of superannuation flows and assets” from the Retirement & Intergenerational Modelling & Analysis Unit. I have also used several other sources of information. The Treasury Paper CP08 has a section on Data Sources (Strengths and Weaknesses). It would seem useful for Superannuation Member Contribution Statements to be provided for all members whether they make contributions or not and the account balance question to be always answered. This is subject to the cost and ability of funds to provide the information. It should then be possible for the ATO Taxation Statistics to include a table showing account size versus taxable income for relevant age groups. This would facilitate policy development and provide some transparency. The member’s share of fund income is of less value because of the volatility of capital values, and I don’t know if it is easy for funds to provide the information. It appears that data on people drawing a large account based pension from a taxed source may not be provided to the ATO or Centrelink by either the individual or their fund. If they are paying no tax on an account based pension and are not in receipt of Centrelink benefits, they may also have considerable assets outside super held in their own name and pay no tax on those because of the SATO, although they may apply to the ATO for refund of imputation credits. The various papers provided by the Henry and Harmer Reviews are very long. However, I do not recall seeing a global approach that compared the number of people over 65 from the Bureau of Statistics with the number of Centrelink and ATO clients, and then discussed those who are not clients.

The ATO SMSF statistics on the web show a lot of funds in excess of $1,000,000 with a handful exceeding $10,000,000. Most funds have two members, usually husband and wife. The ATO Taxation Statistics for 2006/07 show all funds had a deduction for exempt current pension income of $13,213 million for 2006/07 and that this figure had grown by 32.9% from 2005/06. I note that a 15% tax on this is about $2 billion. Brian Toohey reported in the Australian Financial Review on 26 February 2008 on modeling done by Rice Warner Actuaries for the newspaper on the cost of superannuation concessions. It is quite detailed and I note that Rice Warner Actuaries have made a submission to this review.

I also note that the Weekend Australian newspaper of 25-26 April 2009 made reference to Treasury estimates that almost 40 per cent of concessional superannuation contributions are made by just 5 per cent of taxpayers.

The following example illustrates the relative contribution of contributions, fund earnings in the accumulation phase and in the pension phase.

Let us assume a continuous salary for 40 years that increases at 5% pa, sole contributions pre-tax of 9% (ie SG) of salary less 15% contribution tax and a constant earning rate for the super fund of 7% pa after taxes and fees. At the end of the 40 years, the balance will be about 6 times final annual salary and that will include about 1.6 times final annual salary for the total after tax SG contributions. The remaining 4.4 times annual salary will be the fund earnings. Fund earnings (after taxes and fees) in the final year will be about 0.4 times final annual salary. An individual will have access to a part age pension and/or other savings in retirement and the value of the fund will decline slowly in the early years of retirement. The total fund earnings during retirement will be several times final annual salary.

Any additional contributions at the start have an enormous impact. A contribution of one years salary contributed at the start will compound to about 3.2 times final annual salary at the end. The current caps on annual contributions allow for more than three times an average annual salary every year and for accounts to grow to very large sums with fund earnings greater than average salaries.

Personal income tax issues

EMTRs

Why not have some benchmarks for EMTRs that will guide policy development over several government cycles? What are reasonable levels of EMTRs both for individuals and for families? This might vary for different groups. Some taxes and benefits are based on other peoples income or circumstance. This is commonly husband and wife, or a child and the parents. Middle incomes are subject to high EMTRS due to the withdrawal of FTB, SATO and the age pension in particular. Is 50% (or 40%) a reasonable upper limit for EMTRs over a significant income range? The groups above and below often have relatively low EMTRs. Is a nil EMTR acceptable for a retiree with an income above $120,000 (and maybe as high as $1,000,000) when many retirees face EMTRs of 40-80%? Is a 15% EMTR acceptable for a worker with a high income? Looking through the legal artifice of a super fund, is a 15% EMTR acceptable for a worker with fund earnings in excess of $120,000? If there is an economic or other justification it should be stated.

Flat rate personal income tax

Individuals under age pension age and in full time work face the equivalent of a flat rate personal income tax with a high effective tax free threshold. The progressive nature of the tax scale comes largely from the rates under the 30% threshold. Is there any argument for multiple tax rates?

Should people between 18 and 65 with an income less than some minimum benchmark pay tax? If they are on Centrelink support, it will generally be taxable. They will probably have some other support, eg a spouse, or a parent. Possible benchmarks in 2010/11 dollars are the low income benchmark from the Climate Change White Paper ($30,000), the minimum full time wage (about $29,000), or cut-out thresholds for Centrelink support (about $23,000 for a single person on New Start Allowance, about $43,000).

What is the argument for a 15% rate for a small range of income, as opposed to a higher taxfree threshold?

The $6,000 taxfree threshold has not changed for many years. It is being progressively replaced by the LITO in real terms. I don’t see any justification for both. What are the arguments for increasing LITO by $900 and applying the 15% rate from nil income, or alternatively dropping the LITO, and increasing the taxfree threshold to $15,000 for 2009/10? These figures would be adjusted if the effective threshold is increased or the 15% rate is merged with the 30% rate. If the LITO is dropped, is there an argument for an increased rate for middle incomes? The effective rate with the LITO is 34% plus Medicare levy. Supporters of the LITO say it stops high income earners getting the benefit of the high effective taxfree threshold. In truth, this benefit is progressively wound back for incomes above $30,000 and affects low to middle income earners.

There may be other implications from the replacement of the LITO with corresponding changes to the basic tax scale. My first submission pointed out that it effectively increases the EMTR for a low income person who transfers unused SATO to a spouse. Are there any other interactions in the tax and transfer system that would be affected by the removal of the LITO?

Part of the LITO is held back until the annual tax return is processed. I do not agree with the concept and the PAYG tables could be adjusted to do the same thing without the LITO.

My first submission referred to the complex policies for couples both with and without dependent children. It would be easier if the basic tax scale issues for couples were dealt with separately from the policies for dependant children. Should couples without children have two taxfree thresholds and if one person has a large income, should the spouse have an initial tax rate that is low or nil as an individual, or should it be high because the family already has a high income? The DSTO effectively applies a family rate of 25% on the initial income of the spouse, and FTB Part B has a similar effect higher up the income scale.

Centrelink combines income and assets of age pensioner couples for means testing. It also applies to some extent to other Centrelink benefits. What is the rationale for combined assessment by Centrelink and individual assessment for tax? FTB and SATO and transfer of unused benefits between members of a couple just go to confuse the policy intent.

Some of these issues apply to people over age pension age, but they are impacted by the provision of the age pension, the SATO and the access to superannuation. Most people are clients of Centrelink rather than the ATO, and unequal incomes are less of an issue.

Retirement income issues

Why have super over for people over 64?

People over 64 can hold investments directly in their own name, inside super in accumulation phase, or inside super in pension phase, or in various combinations. (Some people may also have income from wages or a business or a pension from an untaxed source. This income is taxable and assessed under the income means test. There is no corresponding asset.) Under current policy, the trend over time is also for most people to have a part age pension. The way investments are held affects the treatment by both the tax and age pension means tests. The tax is obvious, but there is a bias towards the account based pension because the deductible component for return of capital is a flat amount each year. This favours the early years unless there is a lengthy deflationary environment. People use income in early years and then withdraw capital in later years if necessary, which is the usual case.

Aside from the minimum withdrawal rules in pension mode, there are no restrictions on the rate at which superannuation is withdrawn. I question any attempt to control withdrawal rates. It is ludicrous to think that Government should control actual spending patterns during retirement.

Superannuation has significant overheads. Some people retire with assets inside and outside superannuation. Why impose the overheads? The superannuation industry has enormous financial assistance from the Government. Is this to save on age pension outlays, to ensure people save a modest safety net amount, to ensure the economy as a whole saves, or to ensure that high income individuals save as much as possible? Do these goals apply past age 64?

Deemed income versus actual income and assets means test

On balance, I favour the use of annual income rather than deemed income and assets testing. The latter are intended to give people an incentive to maximize income as a percentage of assets and to consume assets. Their use is inconsistent across the whole tax and transfer system. The consumption of assets may be relevant to age pensioners, but not to younger people. Deemed income is actually an assets test that produces a figure that is then added to other sources of income for an incomes test. The current assets test provides for a reduction in the age pension of 3.9% of assets over the relevant threshold. A 3% deeming rate over the relevant threshold provides for a reduction of 40% times 3% reduction, ie 1.2%, in the age pension. A deeming rate of 10% would provide for a reduction of 3.9%. The interaction between the assets test and means test is very dependent on the deeming rates which tend to move up and down with short term cash rates in the money market. The use of deeming rates and assets tests also applies to some other benefits including those for people below age pension age. However, there are exceptions. Notably, neither is used fro FTB which was once called Family Allowance and was paid by the Department of Social Security. The concepts do not apply to our progressive personal income tax. Deemed income also requires that assets are valued at some point in time. This may vary with the payment, but it is usually more than once a year. It also means advising Centrelink of changes in assets such as buying or selling shares, or changing bank accounts. Centrelink payments are fortnightly and the worst case legal requirement for notification to Centrelink is 26 times a year. While people with volatile wages may have to do this, I believe Centrelink automatically revalue assets such as shares twice a year.

If deeming is to continue, then why is it not applied to account based pensions?

It would remove the need for the calculation of a deductible component and remove the need to move to pension phase except for tax. Alternatively, deeming should be replaced by actual income. This would be straight forward for directly held investments. I would like to hear if it is practical for fund administrators.

Why not tax super funds in pension phase at the same rate as accumulation phase?

Assume for the moment that all funds in an account are eventually withdrawn by the member, ie there is no exit tax. Taxable contributions to super and fund earnings in the accumulation phase are each taxed at 15% (ignoring the capital gains discount). Earnings in the fund in pension phase are tax free. I believe capital gains on assets bought during the accumulation phase and sold during the pension phase by a SMSF are also taxfree. The original policy was that the pension would be fully assessable as personal income with a 15% tax offset. I believe this offset was in principle there because 15% tax had been paid during the accumulation phase. The marginal rate was anything up to 45-49% in previous years. We have now moved to a situation where a personal contribution can be made prior at 64 and then all earnings are taxfree in the fund and on withdrawal. Furthermore, most of this benefit is accruing to a small percentage of people who have high incomes or have received large inheritances. What economic justification exists for this policy? Equity demands that the tax in the pension phase be aligned with the accumulation phase. This change with the alignment of means testing for the age pension would remove the need for the pension phase. The accumulation phase can be structured to provide for periodic withdrawals in retirement.

Other issues and possible policy options

The fund tax could be to increased to a maximum of 30%

Why distinguish between SG and other contributions?

Treat all RESC or all taxable contributions as assessable individual for personal income tax

Move to a non-means tested age pension above age 79 or above age 64

Higher means tests thresholds for age pension

Age pension half means tested and half not

Reduce taper rates for age pension

Reduce caps on contributions

Unrealized capital gains are an issue