SUBMISSION TO AUSTRALIA'S FUTURE TAX SYSTEM REVIEW
16 October 2008

Australia's Future Tax System Review

The August 2008 Document on Architecture

The following are observations on some notable aspects of Treasury's "Architecture of Australia's tax and transfer system " of August 2008:

1. 125 sounds like too many taxes with most generating little revenue. The Australian Government levies most of them.
2. Of the top 10 taxes, only 2 are levied directly on the value of capital and land (local government rates and State land taxes) and they are very minor contributors to the total raised. Company and superannuation taxes are primarily on returns generated by assets, not specifically on the value of the underlying assets.
3. In the OECD comparison it should be remembered that Australia's "relatively greater contribution of corporate income taxes to total tax revenue" is in the context of the "flow through" system of franking of dividends for Australian residents for tax purposes. This is effectively a shifting of personal income tax into company tax.

Attractive Features of Australia's Tax System

1. Franking credits on dividends where company tax has been paid. This is an excellent system that avoids double taxation, encourages equity investment relative to owner-occupied property which is subject to little tax and discourages (particularly stock exchange listed) companies from avoiding tax. It also simplifies tax administration and reduces complexity for individuals by being effectively a tax pooling and pre-payment system. For example, retirees receiving only franked dividends do not have to pay quarterly instalments or even lodge returns in some cases. Listed investment companies protect their shareholders from the complicated tax administration of overseas interest, dividends and capital gains compared to the flow through nature of investment trusts.
2. The progressive nature of income tax scales is fairer than a flat tax system.
3. HECS is broadly a good system although it has some problems.

Questions Posed for Submissions

The following addresses the 4 questions posed in the call for submissions.

Major Challenges

"What major challenges facing Australia need to be addressed through the tax-transfer system?"

1. Concentration of wealth: The concept of a real return and the lack of effective taxes on the value of capital and on estates after death means that the only way very high wealth will not be entrenched in families through generations is by gross

incompetence. If a family's real after tax return on its wealth exceeds its living expenses then it has no financial incentive to work. It appears likely that despite limited re-distributive effects in the tax-transfer system, wealth will become more concentrated in Australia and this may reduce productivity and endanger social stability. Some aspects of the taxation system exacerbate this problem.

2. Unemployment and under-employment: While headline unemployment figures have been low, this may not always be the case and there appear to be high levels of underemployment and welfare payments for disability (disguised unemployment?) compared to previous decades. More should be done to increase employment.
3. Achieving a tax system that most people understand and that minimising administrative costs.
4. Aging of the Australian population and associated shrinking of the workforce.
5. Demand for medical services and infrastructure. Both of these impact on productivity and quality of life.
6. Environmental issues such as global warming, if this will impact as negatively as claimed by some, and incorporation of other "externalities" into costs where possible.
7. Minimising less productive investment.
8. Problems between the service delivery by States and revenue raising by the Federal Government.
9. Maximising skill levels amongst the population.
10. Security, both in terms of minimising chances of attack and maximising access to resources.
11. Changing the mindset of Australians away from an obsession with investment in property to equity investment and renting. High levels of owner occupied dwellings are not necessarily a positive as has been demonstrated in the USA and UK recently. This also reduces workforce mobility.

Features

"What features should the system have in order to respond to these challenges?"

1. Imposition of sufficient tax on the very wealthy in particular such that wealth in Australia does not become substantially more concentrated.
2. Transparency with less "tax expenditures" and transfers that provide subsidies or tax reductions to higher income earners without the average voter being aware of them.
3. Simplicity and low administration costs. Minimum disincentives to starting businesses.
4. Consistency.
5. Minimum disincentives for individuals to exit welfare for employment, for firms to employ more staff and for individuals to work until late in life if they wish.
6. More emphasis on direct taxation of capital rather than labour and the returns to capital.
7. Taxes that attempt to incorporate "externalities" into pricing.
8. Subsidisation of training that is beneficial to the country but may be underfunded due to market failure.
9. Tax policies that take into account security issues, such as the threats created by importation of large quantities of oil from countries that are unstable and run be regimes that are threats to world peace.
10. Less preferential treatment for owner-occupied dwellings in the tax system.

Current Problems

"What are the problems with the current system?"

1. Lack of transparency with "tax expenditures" and transfers that provide subsidies or tax reductions to higher income earners and thus concentrate wealth. Examples are the current taxation associated with superannuation, the capital gains tax discount (encouraging those who can to convert income into capital gains), small business tax concessions and subsidies to first home buyers.
2. Excessive complexity imposing costs on individuals and businesses: Much of the tax system seems to be beyond the comprehension of the majority of Australians and it costs too much to comply. This impacts on international competitiveness, demand for labour, public confidence in the system, revenue raising from unintentional tax evasion and the ease with which a business can be started.
3. There are policy inconsistencies, such as the intention to reduce carbon consumption while maintaining an FBT system for cars that includes substantial incentives to drive more and that is biased against more fuel efficient cars and public transport.
4. There are inhibitions on individuals starting small businesses, such as the rules forcing small company owners into complex administration if they earn more than 80% of their income from one customer.
5. The low income tax offset & Medicare levy increase the effective marginal tax rates faced by individuals wanting to increase modest incomes and in moving from welfare to work.
6. Owner occupied dwellings are highly tax-preferenced, which encourages over-investment in homes and results in higher income taxes.
7. Less productive investment includes elite sport (Institute of Sport), probably a lot of drought relief funding (what other businesses obtain subsidies because of bad luck?) and competition between States to fund high publicity events such as car races.
8. The franking credit system does not allow for overseas tax credits and therefore inhibits offshore investment.

Reforms Needed

"What reforms do we need to address these problems?"

1. More use of complusion and direct government payments for saving rather than tax subsidies biased to the wealthy with a complete reform of the superannuation system. (See attached proposals regarding reform of the retirement savings system.)
2. It is claimed by some that wealthy people avoid substantial amounts of taxation. To maintain public confidence, the ATO should investigate this and publically announce how this is achieved, if indeed the claims are correct.
3. Change the preferential taxation of capital gains compared to income. Various alternatives are possible, such as the return of indexation to CPI and "averaging" as applied before, which is only marginally more complicated than the current system. (The current system requires records of acquisition cost and acquisition date for each asset. The indexation system that applied originally required this plus calculation of an indexed cost for each holding.) A better alternative might be to reduce the discount on the amount of capital gain added to income from 50% to say 30% and allow an indexed dollar amount of capital gains to be tax free each year. The latter feature disadvantages large indivisible assets such as real estate so

an alternative to this is the carry forward of unused tax free amounts for CGT each year or an indexed life allowance per citizen for tax free capital gains.

4. Cap the exemption for CGT on owner-occupied residences for sale prices greater than $2 million.
5. Abolish the LITO. It increases marginal tax rates higher up the scale and impacts on effective MTRs in moving from welfare to work. Increase the tax free income threshold to around $20,000pa for every resident, replace of the higher tax free income threshold for seniors with this (SATO) and increase the top marginal tax rate. Obviously the former would be expensive but modifications to the tax system (such as noted here) could address this.
6. Removal the small business retirement and capital gains tax concessions. Few people understand the latter concessions, they involve compliance with highly restrictive rules, restrict liquidity in the market for small businesses and are highly regressive. Small business assistance should be targetting further down the income scale and more broadly.
7. Abolish the Medicare levy and incorporate it into the existing tax scales, thus removing more legislation and avoiding distortions in marginal tax rates, particularly at low income levels. In 2007/08, the Medicare levy added 10 percentage points to the EMTR for incomes over $17,309pa (ignoring welfare interactions).
8. Restore indexation of fuel excise and investigate congestion charging in cities. (This would have to be accompanied by substantial investment in public transport.)
9. Abolish all home buyer grants. This is a regressive measure. Any person able to buy or almost buy a house should not receive government assistance. This policy could lead to US-style problems in housing and reduces workforce mobility.
10. Loosen the rules so that small companies are less likely to fail the personal services income test, such as by applying the 80% rule over a longer period than 1 year.
11. Extend the GST to the likes of investment management firms to simplify its application.
12. Introduce a Federal owner-occupied land tax for residential land valued at over $2 million.
13. Subsidise courses that are for the common good, such as in various social sciences.
14. Reduce expenditures on elite sport.
15. Investigate ways to address the inhibition of overseas investment because of the nature of the franking credit system. One way is to provide 100% or less franking credits for overseas tax credits.
16. Allow all listed investment companies to be able to pass capital gains tax discounts through to shareholders, as was intended by the original legislative change in this area.

A PROPOSAL TO REFORM THE AUSTRALIAN RETIREMENT SAVINGS SYSTEM

16 October 2008, V005

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Summary

Not another change to superannuation! Many people probably feel this way after the seemingly endless changes over the past 20 years. However, the provision of substantial tax subsidies to those who do not or should not need them is probably unsustainable and relatively ineffective in reducing reliance on the age pension. Australia's superannuation system results in a shrinking population of primarily younger working families on lower incomes paying higher taxes to subsidise the retirement lifestyles of the wealthy elderly. Are these not sufficient reasons to act now to change a system that will inevitably have to be fixed in the future as the population ages?

A key problem is that alongside the income tax system, superannuation incorporates a 15% flat tax system. This parallel tax system offers legal avoidance of potentially tens of thousands of dollars in tax for those wealthy enough to put away up to $250,000 each year while providing relatively little incentive for low income earners who most need to save for retirement. Those aged over 50 who are wealthy enough to “salary sacrifice” $100,000 each year can save over $30,000 in tax while a single income family earning $75,000pa and paying a mortgage who can afford only compulsory contributions saved less than $1800 in tax in 2007/08. For a person on $30,000pa, the tax saving was less than $450. This is just one example of the bias of incentives. The superannuation changes of 2007 also provided one-off tax savings for more wealthy citizens of hundreds of thousands or even millions of dollars. Tax free superannuation for the over 60s means that, to a point, the more you have the more you get. This is relevant for every Australian because one person's tax subsidy is usually another person's tax liability.

In addition, the current system is still complicated, requires employer agreement to maximise savings and places restrictions on the amount that can be contributed or withdrawn each year. With the bias of incentives toward the wealthy it is perhaps not surprising that many Australians are making little progress toward adequate retirement saving. An ASFA report[2] based on 2003-04 ABS statistics projected to 2006-07 includes the following:

- “10% of Australians hold 60% of super assets.”
- “70% of men and 90% of women have less than $100,000 in super.”
- “More than 24% of people surveyed .... reported they had no super at all”.

The vast majority of Australians probably do not know the extent of the problems and how much more simple and attractive a better retirement savings system could be. This document presents a description of these problems and a proposal to replace superannuation with a Life Savings System (LSS) that will remove the regressive nature of the current system, reduce complexity, increase flexibility and offer the possibility of extending the tax-preferred savings system beyond just providing for retirement. The system proposed allows individuals to contribute their after tax earnings to accumulate in a tax free environment until they die. It is presented below in summary with detail provided later in this document.

For the Majority

For most Australians, the Life Saving System (LSS) will be as follows:

1. All current superannuation holdings declared tax free and all funds converted into Life Savings Funds (LSFs) with each member holding a Life Savings Account (LSA).
2. No taxes in funds: superannuation contributions tax and taxes on earnings abolished. This removes the flat tax system.
3. No tax deductions for contributions and no restrictions on contributions.
4. Continuing compulsory savings starting at 7% of after tax pay along with a 9% pay increase which results in no additional cost to employers. Employer involvement is not required for additional contributions. No restrictions on beneficiaries of contributions.
5. Retention of at least the current system of co-contributions. The extra tax revenue arising from the Life Savings System (at least initially) gives the government the option of increasing its direct contributions. (Subject to fiscal policy this may not be means tested.)
6. Contributions from members become the 'tax free component' (indexed to inflation) of each account. The remainder (earnings, government contributions & insurance payouts) is the 'taxable component' (see next point).
7. No restrictions on withdrawals past age 60 with the taxable component to be taken first and added to taxable income. This should mean that some will not pay tax and most people will only pay tax for a few years into their retirement and then enjoy tax free income and a tax free lump sum that they can pass on to whoever they wish.

This system encourages pensions over lump sums and the transition from the current system would be simple. There is some complexity in the Life Saving System, but it is primarily confined to a small and wealthy minority.

More Wealthy Account Holders

- An excess contributions tax of 20% per annum will apply to the amount by which the total of the tax free components of all holdings exceeds $3 million (indexed).
- An excess assets tax on the total amount (tax free and taxable) accumulated beyond $4 million (indexed) of 5% per annum and on the amount beyond $5 million (indexed) of 50% per annum.
- These excess taxes apply together and both would be payable by the member, not the fund. Withdrawal is allowed at any time of the total of a person's accounts exceeding $2 million with the same rule of taxable component first.
- Removal of most of the restrictions on investments and gearing.

These changes should be accompanied by an increase in the income tax-free threshold, modification of the current capital gains tax regime, removal of the low income tax offset (which increases marginal tax rates higher up the scale), removal of the higher tax free income threshold for seniors, removal of the small business retirement and capital gains tax concessions and incorporation of the Medicare levy into the normal tax scales.

The proposed system involves a tax subsidy, but it is restricted to deferral of the income and capital gains tax that otherwise would apply to investment earnings from the amounts contributed. The subsidy is biased toward lower to middle income earners. This compares to the current superannuation system with its substantial loss of tax revenue from contributions, investment earnings in both accumulation and pension phase and payments to those aged over 60. The current system offers unlimited tax concessions on investment returns in superannuation. Some optional modifications and additions to the proposed system and some alternatives are also presented later in this document.

For the Federal Government

An aging population receiving tax free superannuation pensions will increase the taxation burden on the shrinking proportion of workers. These proposals address that problem while reducing complexity and administrative workload, increasing flexibility, facilitating more orientation toward compulsory saving, reducing "double dipping" and achieving a fairer society. It is beyond the scope of this document to model the taxation revenue outcomes, but the proposed system should result in additional tax revenue because of the removal of all tax deductions for contributions (offset to some extent by the removal of the two 15% taxes in funds and the possibility of an expanded co-contribution scheme). In the short term there will be little tax revenue from payments to retirees because of "grandfathering" but this will grow over time. The extent of the revenue gain may justify additional government contributions with or without corresponding member contributions to assist lower income earners save and reduce future demands for age pensions.

Conclusion

This document argues for removal of the current tax subsidies for saving via superannuation and advocates greater reliance on compulsory saving in a less regressive and administratively complex framework. Governments then have the option of either utilising those tax subsidies to transparently contribute to savings, lower income taxes or both. In essence this document is a proposal for a start on a more rational tax system that will be fairer, easier to understand and that addresses rather than exacerbates the problems associated with an aging population.

Introduction

The changes to superannuation that commenced on 1 July 2007 have provided very substantial incentives: one off reductions in tax liability of millions of dollars to a few wealthy Australians and access to very substantial future tax benefits to those who earn well above average earnings while Australians on low incomes who need the cash incentives most have gained little.

In general, Australia has a progressive income tax system for individuals. One very significant deviation from this is the current superannuation system introduced by former Federal Treasurer Peter Costello and effective from 1 July 2007. Under the current system, it is possible for anyone who meets the requirements and can afford to save $100,000 to reduce their tax rate on that amount by up to 31.5 percentage points, which is $31,500 in tax each year until 30 June 2012. Some can also continue to save tax on investment returns on amounts contributed for decades into the future and withdraw all those amounts completely free of tax after the age of 60.

The current system does offer government co-contributions to extend a tax incentive on contributions to lower income earners, provided they can save. The offer is a maximum of only $1,500pa in government co-contribution for those earning less than $28,980pa (2007/08) who can find $1000 after tax to put into superannuation (and who are less likely to be able to afford after tax contributions). Compare this with the biggest winners from the current superannuation system. They are aged over 50, already have millions in superannuation and can afford to put away $250,000 each year. Most will pay less than 15% tax on investment earnings on the millions invested and gain a tax benefit on contributions of $31,500 each year until 2012. After that they will only get a tax deduction of $50,000 per annum on contributions and only save just over $15,000pa in tax (assuming the tax rates do not change). They will continue to save tax on investment earnings and when they commence a pension there will be no tax on those superannuation investment earnings or pension payments if taken after age 60.

The changes at 1 July 2007 have effectively resulted in a flat tax of 15% on all or a substantial part of the salaries of high income earners who meet certain liberal criteria. (This is the 15% tax on contributions for which a full income tax deduction has been claimed with nil tax on withdrawal for those over 60 years of age.) One estimate of the cost to tax revenue of deductions on contributions in addition to the compulsory 9% for 2007/08 is $6.4 billion[3]. The lack of public comment on this deviation from the progressive nature of income tax (apart from a few finance journalists and specialists) may be due to the general lack of understanding of the continuing complexity of the superannuation system. Presumably the reasons for these deviations from progressive taxation are the desire of governments to provide dollar incentives to save for retirement and to simplify the Australian retirement system from the absurd complexity that existed before Peter Costello's changes. The proposals in this document present a rational alternative that is less complex and regressive than the current system for the majority of Australians.

The expectation of inadequate retirement savings for many has been frequently expressed by the superannuation industry and other commentators. Australia has both substantial incentives to save (via tax deductions) and a compulsory savings system. If governments decide to continue with incentives to save then it seems more appropriate to target them at low income earners to at least the same dollar extent as higher income earners, as it is the lower income earners who are likely to face the greater problems in achieving sufficient savings for retirement.

In addition to the ongoing reversal of progressive taxation, the “simplification” of superannuation announced by Peter Costello gave some wealthy people an instant reduction in tax liability of millions of dollars. The lucky beneficiaries were those whose superannuation accounts included large amounts of what were termed “excess benefits” under the former system. These amounts would have been subject to tax of close to 50 cents in the dollar when paid out of superannuation funds but Costello's changes mean that most payments from superannuation to those over 60 years of age are now completely free of tax.

Some may champion the concept of a flat tax. If so, it seems more logical for it to apply generally to the income of those working and not be solely for the benefit of retirees.

Tax is a zero sum game around whatever level of revenue a government wants, unless a tax change can lead to some efficiency gain in the economy. A dollar in tax subsidy to one person can mean an extra dollar must be paid by another person. It is suggested below that the Costello changes could actually reduce efficiency.

The big one-off tax concessions under the last major changes are a “sunk cost” as far as Federal Government revenue is concerned and will presumably never be addressed. However, the ongoing problems with Peter Costello's system can be addressed, and in a way that reduces complexity. The issues and a proposal for a new system to last for at least this century are presented below.

Objectives

Proposals for tax reform often have stated objectives of efficiency, equity and simplicity. A fourth objective could be added: to achieve a tax system that anticipates future problems and achieves the above three objectives for the very long term, because the need for “grandfathering” in relation to changes has created immense complexity in the past. The current Australian savings system is unimpressive in terms of all four of these, but particularly in the areas of equity and suitability for the long term, both from the perspectives of wealth and age.

The objectives of this document are to propose a solution to the problems of the current superannuation system, particularly its inconsistency with the progressive income tax scale and the fact that higher income earners can access much greater incentives than low income earners, to further reduce complexity and to provide a system that has a good chance of surviving for all of the 21st century (at least). This proposal is also based on removing many of the current superannuation rules that are not related to tax, unless there is a strong case for retention, and trying to minimise the number of people that have to lodge tax returns and/or need complicated financial advice to save and retire.

Finally, because the Australian Government is the last resort provider of retirement income to those citizens who fail to save adequately or lose their savings then it seems appropriate to reduce the risk to taxpayers of providing this insurance. If tax incentives for saving are continued then it could be argued that objectives of the retirement savings system should be to encourage pensions rather than lump sums and to limit tax incentives to encouraging that level of savings equivalent to the present value of the age pension at retirement. The age pension is not an attractive level of retirement funding but evidence suggests that for many people, compulsion is necessary to achieve savings beyond its present value at retirement.

Issues with the Current Superannuation System

A major problem with the current superannuation system is the application of taxes within funds, which by administrative necessity, must be flat taxes. Australia has a progressive income tax on the employment and investment earnings of individuals. The current superannuation system allows income tax to be reduced by tax deductible ("concessional") contributions to superannuation, which are then taxed within superannuation funds at a flat 15%. Another nominal 15% tax is applied in the funds to the interest and dividends arising from the investment of those contributions. (This tax is also applied on realised capital gains and effectively falls to 10% for gains where an asset is held for more than 1 year and in some circumstances can be completely avoided.) Finally, there is tax on specified parts of withdrawals from superannuation if the recipient is less than 60 years of age, which may involve an interaction with the income tax system. Thus there are potentially three taxing points associated with superannuation apart from the income tax system. All of these create costs in funds.

Because of the concessional 15% taxes (compared to most marginal tax rates), the superannuation system that existed before the changes that commenced on 1 July 2007 included tax disincentives for accumulation of assets beyond what were referred to as Reasonable Benefit Limits (RBLs). It also included a system for applying the progressive income tax scale (with a 15% rebate) to superannuation pensions paid to retirees. Peter Costello's most important change was the elimination of tax on superannuation withdrawals over 60 years of age and the abolition of RBLs. This immediately created substantial reductions in tax liabilities for select individuals, few of whom are likely to need the age pension. Anecdotal evidence is that some Self Managed Superannuation Funds contained over $10 million and even up to $30 million in total assets. Depending on how these funds were structured, the changes may have given the members of these funds tax gifts of $5 to $10 million or more.

Much was made of the elimination of tax for those over 60, but prior to that most Australians did not pay tax on most of their superannuation. It has been suggested that "Simple Super" may be "the biggest reform ever" for "less than 20% of super members"[2]. Ross Clare of The Association of Superannuation Funds of Australia Limited (ASFA) has been quoted as stating that the abolition of tax after age 60 "is not currently relevant to the majority of Australians with super". An ASFA report based on 2003-04 ABS statistics projected to 2006-07 "shows that":

- "10% of Australians hold 60% of super assets".
- "70% of men and 90% of women have less than $100,000 in super".
- "More than 24% of people surveyed .... reported they had no super at all".

In addition, the "2004 figures for average balances ($56,440 for men and $23,900 for women) are just over half the projected balances for men and less than half those for women made by Treasury when compulsory super was introduced in 1992". Average payouts in 2003-04 and estimated average payouts for 2006-07 were well below the $135,590 tax free threshold applying for the latter year. Given the skewed distribution of superannuation assets, this data suggests that Peter Costello's changes will only benefit a small minority of the Australian population, and the more they have in superannuation, the more the benefit. A self funded retiree over 60 years of age can be on a pension of hundreds of thousands of dollars per annum (or withdraw millions in a lump sum) and pay no tax on money for which they received a substantial tax deduction. There is no upper limit on the tax concessions for the over 60s. Bear in mind that all assets in superannuation will have been subject to 15% tax or less in the fund. A system has been created for an uncontrollable bleed from Federal Government revenue in the context of an aging population and a shrinking workforce expected to make up the difference.

Saul Eslake[4], Chief Economist, ANZ Bank, has described "a growing tendency for the income tax system to be used to favour particular types of income over others, particular groups of taxpayers over others, particular areas of expenditure over others, and particular forms or economic organisation over others". He adds: "The revenue forgone from these and other forms of special treatment in the tax system has risen from just under $20 billion a decade ago to more than $50 billion this financial year, and it is expected to top $60 billion by 2010-11. That is equivalent to almost one quarter of all Commonwealth Government spending. Yet, unlike the spending side of the budget, these "tax expenditures" are not reported in detail in the annual budget papers, they are not subject to scrutiny by the auditor-general, and (once entrenched in legislation) they are not regularly reviewed in Parliament." The current superannuation system is a major contributor to this figure.

A "leading expert on superannuation"[5], Jeff Bresnahan, Managing Director of SuperRatings, estimated that a person with $2 million in superannuation would receive tax benefits with a present value of $1.1 million, a 55% benefit. The Australian Financial Review quoted his comments: "At the lower end of account balances, a person would need to have $280,000 before receiving any benefit from the cuts (ie Peter Costello's) in benefits tax. Savers with a $300,000 balance would receive a benefit of about $13,000, or 4.4% of the retirement pot." Jeff Bresnahan was quoted as describing the benefits given to "rich people" in the superannuation system as "ludicrous".

Some Details of the Current System

To understand superannuation and its taxation, it helps to understand the concept of the marginal tax rate, which for you is the amount of tax that you would pay if you were to earn an extra dollar in the financial year in question, usually expressed as a percentage. The maximum marginal direct tax rate for the 2007-08 financial year was 45% plus Medicare levy and this will also apply in 2008-09. Since changes in the 1980s, superannuation contributions and investment returns have been subject to a flat tax system with a maximum rate of 15% (apart from the period of the "superannuation surcharge"). Peter Costello's abolition of tax on superannuation withdrawals over the age of 60 means that some can pay tax on their savings at a maximum rate of 15%, ie just the contributions and earnings taxes and nothing else. The best opportunity for selective reduction of marginal tax goes to those over the age of 50, who can achieve a tax rate of 15% on pre-tax contributions of up to $100,000 per annum until 30 June 2012.

Marginal tax rates are important in determining not only whether the long standing system of progressive taxation applies on income but also the incentive to work harder to "get ahead" and thereby contribute to growth in the economy.

The Current Problems – A Summary

The major problems with Peter Costello's “Better Super” system can be summarised as follows:

1. Mr Costello's changes have done little or nothing to assist those who are most in need in terms of saving for retirement, but has substantially assisted those who should need less help because of higher incomes. The current superannuation system offers higher income earners partial access to the tax rates of low income earners via a selective flat tax. It allows some of the Australian community to earn amounts well in excess of average earnings but only be exposed to effective marginal tax rates of less than half those of workers on much lower incomes. Whilst it may be argued that this provides an incentive to save, it is lower income earners that are in greater need of help to save, rather than those who currently receive the biggest dollar incentives. Australia has a progressive taxation system and it is strange that the tax subsidy available for superannuation contributions is greater for more wealthy members of the community, particularly in a country trying to improve productivity by lifting workforce participation rates. For example, a retiree receiving a superannuation pension of $150,000pa pays no tax while someone receiving an equivalent salary from work pays more than $47,000pa in tax[3] (plus Medicare levy).
2. Still complicated: Whilst Peter Costello made a good start in reducing complexity, many may not regard the current superannuation system as simple. For example, tax may still apply at 3 points as withdrawals are still subject to tax for those under 60 years of age and some recipients of death benefits. Thus fund administrators must maintain the capacity to deduct tax from benefit payments. High rates of tax apply to anyone who errs in making excessive contributions. Tax can still apply at 3 points: entry (contributions), on investment returns in the fund and on withdrawals. Whilst tax does not apply on payments from superannuation to those over 60, data on taxable components must be maintained in case the member dies and payments are made to non-dependants (who are likely to be subject to tax on the payments). There are also complicated rules relating to contributions, death benefits, gearing and what investments are allowed. All this causes administration costs for superannuation funds and issues in valuing members' holdings.
3. Flexibility in terms of contributions is limited by annual caps. This also results in a relative benefit to the wealthy, particularly those who can afford “concessional” (tax deductible) contributions of $50,000 and “non-concessional” contributions of $150,000 each year throughout their life to obtain the greatest tax benefit. Most people put their savings toward home ownership earlier in their working lives and have little to contribute to superannuation. If they pay off their mortgage and want to contribute larger amounts in later years then they are restricted by the rules, which presumably apply to prevent excessive loss of government revenue to the large upfront tax concessions available. Caps on contributions are a legislated constraint on saving every year, they do not suit the changes in capacity to contribute as people age, they do not allow for changing preferences through life and they are administratively difficult to administer (potentially for every single person, particularly with multiple funds). These administrative costs fall on the funds and thus every member.
4. Still employer/work related: Obtaining tax deductions for superannuation contributions beyond the compulsory 9% pa is dependent on the agreement of employers because deductible contributions by individuals are primarily restricted

to the self-employed, again presumably so that the benefits of the tax deductions do not place an excess burden on government revenue. This makes extra tax deductible contributions difficult or impossible for some and interferes with calculations of remuneration related to overtime. Individuals should be able to save whatever they want in a tax-preferred fund without needing the agreement of their employer.

5. Taxation of the assets backing superannuation accounts changes from a nominal 15% to zero as the beneficiary goes from accumulation to pension phase. This creates another tax opportunity for more wealthy citizens who have their own self managed superannuation funds (SMSFs) and can avoid capital gains tax on growth in assets in the fund by holding them until they take a superannuation pension.
6. With an aging population and the probability of economic downturns in the future, it is questionable whether the current system is sustainable from a government revenue perspective.
7. The abolition of tax on all superannuation benefits paid after 60 years of age may encourage earlier retirement by many individuals than might otherwise be the case. This would be an undesirable outcome with an aging population and skills shortages.
8. The taxpayer provides substantial tax incentives for superannuation savings but fund members are not required to commit to applying those savings to fund their own retirements and any member can still be totally reliant on the aged pension, even if they have hundreds of thousands of dollars in superannuation. For example, a fund member on the top marginal tax rate can salary sacrifice throughout their working life (costing tens of thousands of dollars per annum in lost tax revenue), withdraw all their superannuation after age 60 with no tax clawed back by the government and immediately gamble away the full amount. Other taxpayers have paid more tax to make up for the gambler's tax deductible superannuation savings and are then required to finance a pension for the rest of this person's life. This is called “double dipping” and has been exacerbated by the Costello changes because at least under the previous system there was some tax on most larger withdrawals from superannuation.
9. Transition to retirement pensions amplify the benefits available to those on higher incomes.
10. There is an anomaly in Peter Costello's system in relation to death. Benefits paid to a member over the age of 60 are tax free but if paid to a non-dependant of the member after death (such as adult offspring), then the whole taxable component of the payment is subject to tax, irrespective of the age of the recipient. Whilst this gives an advantage to those notified of their imminent death (when it becomes prudent for those over 60 years to cash out all remaining superannuation tax free to avoid beneficiaries paying tax), it is of little help to the majority who die unexpectedly.

Many complicated rules related to contributions have been abolished in recent years and for people under age 65 the system is simple but there are some restrictions beyond this age.

The bias in incentives toward the more wealthy and their substantial dollar value has been a bonanza for fund managers and financial planners. It has naturally led to lobbyists for these industries to call for expansion of the co-contribution system and adding other incentives for low income earners to save, but not reducing incentives for wealthy citizens. Their proposals would further increase the drain on tax revenue and/or lead to higher taxes on income not going into superannuation than would otherwise be the case. That is, the greater the tax subsidy to superannuation, the higher income or other taxes must be.

In summary, the current superannuation system offers substantial tax subsidies to save for retirement to those who do not or should not need them, while lower income earners who are most likely to have inadequate retirement savings and be dependent on the aged pension receive much less. It is primarily younger working families on lower incomes that pay more tax to subsidise the retirement lifestyles of the wealthy elderly. In addition, there is no obligation on those retirees who have benefited from substantial tax subisidies all their working life to apply those savings to avoiding dependence on the age pension in retirement.

John Head, Professor of Taxation Law and Policy Research at Monash University summed the situation up as follows[1]: "In all my years of observing Federal tax policy, I have never seen anything so inequitable or inefficient as the superannuation tax concessions of 2006".

The Proposed Solution – The LSS

A summary of the main points of a reformed savings system (the Life Savings System or LSS) consisting of Life Savings Funds (LSFs) holding Life Savings Accounts (LSAs) to replace the current superannuation system is as follows:

A) All tax deductions to be abolished for contributions, contributions to be only allowed from natural persons (individuals, although companies could pass the contributions on) and superannuation contributions tax (the tax within funds) to be abolished. Rationale: These flat taxes are the root of many of the problems and are unnecessary and inappropriate in parallel to a progressive income tax system.

B) All tax on investment earnings within funds to be abolished so all capital gains and income would be tax free with franking credits on dividends from Australian company shareholdings to be fully refundable to the Life Savings Fund. Thus there is no distinction between a fund in accumulation and a fund in pension phase. The rationale for the removal of all tax from within funds is to shift all the tax process back to the income tax system, a fundamental generator of government revenue, rather than continuing with a partially duplicated tax system in the funds with its associated administrative cost and lack of progressive rates. (Note that remittance of PAYG for some withdrawals will continue – see below.) The abolition of contributions and earnings taxes will reduce ongoing administration costs and increase flexibility for the system.

C) Compulsory contributions to be a much more important contributor to private savings, particularly for the lower paid, with an initial level of 7% of after tax pay (hence the lower rate). The objective is to ensure an increase in compulsory contributions over time (with an early start) so that most citizens will not need the old age pension. This would be by directing future tax cuts into compulsory contributions. The current system of co-contributions could be retained (unless it is decided to replace it with an expanded system of government contributions – see below). The before tax pay of all affected employees would have to be increased by about 9% to compensate for the loss of the current 9% "superannuation guarantee". (The objective is to ensure no change in costs to employers.) The resulting percentage increase in after tax salary depends on the average and marginal tax rates of the employee (which are interrelated depending on the original dollar remuneration). Note that for those on higher incomes and thus higher tax rates, the initial compulsory contribution will be a lower percentage of gross cash salary, but they are less likely to need compulsory contributions. Rationale: Compulsory contributions are well accepted and justified given the government's liability for old age pensions. They are a better way of achieving higher savings than regressive tax subsidies that have not been comprehensively successful. (See below re possible government contributions.)

D) Life savings accounts (LSAs) to consist of 2 components: tax free and taxable. The tax free component is the amounts contributed, indexed to inflation. At any time during a financial year, the tax free component will be the value of the tax free component at the most recent 30 June plus any subsequent contributions to that point in time. The value at any 30 June will be the value for one year earlier, increased by the change in the Consumer Price Index (CPI) for the last calendar year, plus any contributions up to the 30 June in question. The taxable component is defined as the remainder (which is earnings plus insurance payouts less expenses). Thus the tax free component will usually change after contributions and every year on 30 June, even after the member has retired. If accounts are shifted between funds then the dollar amount of the tax free component transferred does not change. It is added to the tax free component for that account in the receiving fund. Note that these amounts are determined throughout the life of an account by multiplying one by an indexation factor and subtracting to determine the other, not by the complicated method of calculating a ratio. (See below re defined benefit funds.) It may be appropriate for administrators to keep a record of the history of changes to the tax free component for each member in accumulation funds. Rationale: Contributions, which are after tax, should be able to be withdrawn tax free and indexed to ensure that their value is not eroded by inflation.

E) No limits on contributions for persons over age 18 (although see below re tax on 'excess contributions'): Because this system does not offer the substantial upfront tax deductions available to some taxpayers, there is not the need for tight limits on contributions (or as much government interference in the running of funds – see below). Compulsory contributions could be split with anyone else such as a dependant wife. Anyone (bankrupts excepted) could make a contribution on behalf of themselves or anyone else of any age over 18 and irrespective of whether they are doing paid work or not, so the disabled, people overseas or on welfare and the elderly could be beneficiaries of, and make contributions on behalf of, themselves or anyone else. Rationale: Simplification and to give more flexibility, suiting a wide range of preferences, life styles and life outcomes. Existing accounts for children under age 18 could be maintained without contributions until they become adults.

F) Withdrawals of taxable components will be added to the account holder's taxable income and therefore effectively taxed at their marginal rate. (An option is to exempt the first $5,000pa (indexed) - the "life saving tax exemption" (LSTE) - for those eligible (see below)). All withdrawals must be from the most recent 30 June taxable component first (rather than a figure calculated at the time of withdrawal as this component could vary continuously). There would be no rules regarding maximum and minimum withdrawals. Certain withdrawals at any age to be allowed, including the same rules as apply at present (such as for terminal illness) and for holdings over $2 million, with any taxable components to be withdrawn first and added to the recipient's taxable income. Apart from stipulated exemptions, the current preservation rules would apply to the age at which withdrawals would be allowed (55 years phasing to age 60 with access for retirees from age 55). Rationale: Since there is no tax in LSFs, there must be tax on withdrawals of investment earnings to avoid tax distortions. Requiring withdrawal of taxable components first avoids loss of revenue for too long, avoids application of complicated ratio analysis and means that most people's tax liability on pensions will occur early in their retirement, leaving them tax free for the rest of their lives. (See below re annuities.) Note that the LSTE is not an essential part of the system if the government regards it as too generous and/or complex, but if initially included then it must always be retained.

G) An excess contributions tax of 20% per annum will apply to the amount by which the total of each person's tax free components in all their LSAs exceeds $3 million (indexed). (See next paragraph re individual responsibility for paying this tax.) Rationale: Although this system does not need the same tight controls on contributions as the current system to prevent massive loss of government revenue, it does need some limits (because of deferral of tax) which will obviously only apply to a small percentage of the population, if any.

H) An excess assets tax of 5% per annum would apply to the total amount (tax free and taxable) accumulated across all accounts by an individual which exceeded $4 million (indexed) and to the amount beyond $5 million (indexed) of 50% per annum. Funds would have to report every member's account balance at 30 June every year and it would be each affected member's responsibility to calculate, declare and pay these taxes, avoiding any additional administration for the funds. (The total holdings would be calculated as averages of the start and end values for the financial year, with appropriate anti-avoidance measures applying. The thresholds would be indexed to CPI.) Those members with a liability under this provision would have to pay the tax from their own financial resources. Total amounts in LSAs exceeding $2 million could be withdrawn at any time. Note that these two tax measures affect only a small minority of the population and those with sufficient financial resources to deal with any administrative costs generated, rather than the majority being burdened with the costs via additional fees in their funds.

I) Most restrictions on investments by funds to be removed including the prohibitions on gearing, acquisition of unlisted assets from members and buying residential real estate except that all transactions with funds to be on a demonstrable “arm's length” basis with the onus of proof on members. Borrowing to be non-recourse only. Restrictions on inhouse assets would remain so Life Savings Funds (LSFs) could not hold shares in the private company of any account holder beyond the current 5% limit. This is because the refund of franking credits would allow tax free accumulation of income, contrary to the principle of no tax deductions for contributions. The current effective prohibition on funds operating businesses would continue. Lending to members and associates to be permitted but only if sufficient security external to the fund was provided. That is, a member could not borrow from a Life Savings Fund just on the recognition that he/she had contributed assets to that fund. Also, members of Private Life Savings Funds (see below) could not borrow more than their account value. Rationale: Individuals can borrow as much as their offering of security will allow and invest in geared unit trusts, so why restrict savings vehicles?

J) Welfare: The total of a member's accounts (both taxable and tax free components) would be included for assessment under the assets test, except for the existing exemptions for those under pension age. All withdrawals of taxable components would be included in the income test.

K) LSFs to be either accumulation or defined benefit and if the former, reserving is not allowed. (Reserves to be allocated as of the starting date and included in the tax free component.) Any taxed defined benefit fund could transition to be a Life Savings Fund but subsequent contributions to it could only be from individuals from their after tax dollars. The calculation of the tax components of defined benefit LSFs would be the same as for accumulation LSFs (see below). New defined benefit funds could still be started but only by insurance companies supervised by APRA with tax free pools and with contributions only from individuals. Transition issues are addressed below.

L) Self-managed superannuation funds (SMSFs) to be replaced by Private Life Savings Funds (PLSFs) which could have a maximum of 10 members (versus 4 for SMSFs) with tight controls to ensure that small business owners do not coerce employees into funds that they create, etc. Maintaining the existing rules for who can be a member may be the best policy.

M) Transfers: Subject to the rules of the LSFs involved, account holders could transfer all or part of their accounts to any other LSF provided the owner of the account does not change. The tax free and taxable components of the amount transferred would be as calculated above at the date of transfer and there would be full flexibility in partial transfers as regards the ratio of the 2 components in the amount shifted. Any taxable components withdrawn must be added to the account holder's taxable income.

N) Insurance: There is no tax in LSFs and therefore no deductions but life and disability insurance could be offered with no tax payable in the fund for insurance payouts to the fund. Premiums would come from the taxable component and insurance payouts would form part of the taxable component.

Note that the above proposals still involve a deferral of tax and this effectively provides a subsidy. The electorate is accustomed to a subsidised system for saving and some incentive may still be required to encourage saving. However, the approach under the Life Savings System to achieve the objective of replacing the age pension is primarily via compulsion rather than tax subsidies with the option of government contributions that can be varied from year to year, giving maximum flexibility to the government.

Associated Changes

Possible LSTE and/or Government Contributions

This section presents some options if governments decide that the Life Saving System does not include sufficient incentives.

A guarantee could be provided that any member meeting the stipulated conditions for release (as apply at present) will be allowed a tax free withdrawal of say $5,000 per annum (indexed to CPI) for life from the taxable component of their Life Saving Account – the “life saving tax exemption” (LSTE). (This is in addition to any other tax free threshold that might exist in the financial year of the withdrawal.) The Government may wish to stipulate a different figure to $5,000, but if the LTSE was adopted then the figure chosen would have to be indexed and committed to as a minimum in relation to all existing accounts and future contributions.

Upfront incentives to save are probably more effective psychologically than incentives that could be decades away. It is arguable that the LSTE can be regressive because more wealthy people have more savings to take advantage of it and are likely to live longer. The LSTE also creates complexity so there are good arguments against it. (One source of complexity is where a person is taking pensions from multiple funds.)

Alternatives to the LSTE include co-contributions or an expanded government contributions scheme. For example, the current co-contribution scheme could be retained with the Life Savings System, although it is not ideal. Some low income earners may miss out on its boost to their retirement savings because they are unable to find $1000 to contribute to superannuation. Another problem is that it can go to wealthy people who are able to reduce their income below the stipulated threshold.

Removal of the substantial tax subsidies for superannuation should allow more generous government contributions instead of the current co-contribution scheme. For example, the Federal Government could provide dollar for dollar contributions of say $1,000 pa for all taxpayers within certain age ranges or even make payments into accounts without corresponding contributions by account holders (subject to financial constraints, as this could cost $10 billion plus, less the cost of the current co-contribution scheme). This is a much more transparent approach than the current superannuation taxation regime. The reduction in tax deductions inherent in the Life Savings System should give some scope for more government contributions, although such macro-economic modelling is not within the scope of this document. Governments could vary their contributions depending on fiscal conditions. The amounts to be contributed could be announced each year in the Federal Budget to avoid an impression that they are a normal part of the system.

Any government contributions would be included in the taxable components of LSAs so they potentially become subject to deferred tax (on withdrawal) for those with more assets/income but will be subject to lower or zero tax for low income earners. (Rationale: If the contribution is based on a measure that the recipient is in need of assistance at the time, the recipient's financial circumstances may improve substantially in later life.)

Another method of providing effective government contributions would be to channel tax reductions into Life Savings Accounts rather than providing cuts in income tax. Prior to the financial market problems of 2008 there were calls for tax cuts to be contributed to superannuation. The Life Savings System makes it easier to do this by decreasing taxes but concurrently raising the compulsory contribution rate by an equivalent amount.

In conclusion, an expanded government contributions scheme and directing tax cuts into LSAs via higher compulsory contributions appear to be a superior approach than the LSTE concept. However, it should be remembered that a major factor in retirement incomes is the nature of the means test for the age pension and the generosity of this can make a case for no government contributions. A consideration in this is inter-generational equity.

CGT Changes

Alongside the introduction of the Life Savings System, the current capital gains tax (CGT) regime that is more generous than the tax on income would have to be changed as it provides a similar avenue for reducing tax for those more financially able as the current superannuation system. In other words, the same arguments for altering the superannuation system of equity and achieving a rational tax system apply to CGT, which provides a similar lower tax alternative in parallel to the income tax system. Various CGT reform options are possible, such as the return of indexation to CPI and "averaging" as applied before, which is only marginally more complicated than the current system. (The current system requires records of acquisition cost and acquisition date for each asset. The indexation system that applied originally required this plus calculation of an indexed cost for each holding.) A better alternative might be to reduce the discount on the amount of capital gain added to income from 50% to say 30% and allow an indexed dollar amount of capital gains to be tax free each year. The latter feature disadvantages large indivisible assets such as real estate so an alternative to this is the carry forward of unused tax free amounts for CGT each year or an indexed life allowance per citizen for tax free capital gains.

Other Taxation System Changes

In addition to capital gains tax changes, the above should be accompanied by removal of the low income tax offset (which increases marginal tax rates higher up the scale), an increase in the tax free income threshold to around $20,000pa for every resident, removal of the higher tax free income threshold for seniors and removal of the small business retirement and capital gains tax concessions. Few people understand the latter concessions, they involve compliance with highly restrictive rules, restrict liquidity in the market for small businesses and like superannuation involve reversals of the progressive tax system. The Medicare levy should also be removed and incorporated into the existing tax scales, thus removing more legislation and avoiding distortions in marginal tax rates. Raising the tax free income threshold and applying it to everyone would obviously be very expensive but the other measures offset this change and the removal of tax deductions for superannuation contributions should result in substantial additional revenue. The rationale for these changes is that they would rationalise and simplify taxation and fit well with the Life Savings System. The LSS provides an attractive replacement for some of the existing measures.

Purposes of LSFs and Death of Account Holders

Concerns have been expressed by commentators about the need for savings for purposes other than retirement such as for medical expenses. The "sole purpose test" should be abolished as it effectively does not apply now. It should be replaced with a primary purpose of saving for retirement, but with recognition of ancillary purposes of supporting dependants and adding other functions regarded as socially desirable by governments.

Death benefits could be paid from the fund to the account holder's estate if stipulated or if no beneficiaries are stipulated, in which case the taxable component would all be added to the estate's income for its tax return. Any person could be nominated to receive remaining balances on the death of the member and there would be a requirement to pay out a deceased member's balance within a period of no more than 3 years from the date of death except for any recipient under the age of 18 (not necessarily a dependant) nominated by the deceased, in which case the payments could continue until the child reached the age of 18 years. Such payments would be treated the same as other withdrawals – taxable components required to be taken first and added to the beneficiary's taxable income (at adult rates for children), followed by tax free components. Recipients or guardians would have full flexibility in the frequency and size of withdrawals, just as for a retired member. Any amount remaining as the child approaches the age of 18 would have to be paid to that child prior to his or her 18th birthday. That is, amounts in accounts could be paid over 3 years or to the age of 18, whichever is later. The account would remain in the name of the deceased (as deceased) with administrators flagging that fact in their databases and recording the date of death and the recipients of the withdrawals.

The Life Savings System could also provide an administratively simple system for governments to offer other tax-advantaged savings schemes such as for first home owners' savings. This would be by allowing early release under specified circumstances with the same rules of taxable components first and added to the taxable income but with a direct dollar subsidy to offset all or part of the tax. The progressive tax system could then remove the need for means testing of the government subsidy. This approach could also be adopted for unusually high medical costs.

International Aspects and the CM&C Test

Australians should be free to live overseas and continue to contribute to savings pools in Australia and be trustees of Private Life Savings Funds. PLSFs and LSFs should therefore be available to contributions by any person irrespective of whether they reside overseas, with withdrawals subject to tax as for non-residents, whether below or above retiring age. Expatriate Australians should be encouraged to maintain their savings in Australia, not discouraged as at present (probably because of the revenue losses inherent in the current system). It may even be desirable to offer LSFs as savings vehicles to overseas residents because of their tax-free status, thus providing an effective service export. (Overseas residents for tax purposes may not find the tax aspects of withdrawal as attractive as the tax regime in their country of residence.)

The only part of the “central management and control” (CM&C) test that should be applied to determine if a trust is a Life Savings Fund is that the fund was established in Australia and at least one asset of the fund is situated in Australia at the relevant time.

Operational Details

Negative Taxable Components

Note that because the tax free component is determined at 30 June (and adjusted for each contribution), a Life Savings Account can have a negative taxable component. For example, say a member's total account value is $150,000 and the tax free component is calculated at 30 June 2020 as $100,000. The taxable component (the remainder) is therefor $50,000. Say the member withdraws $50,000 (which will be all of the taxable component) during the year and after the withdrawal there is a 20% decline in the value of the member's account. This decline therefor results in an account value of $80,000 at financial year end. Assuming no other changes in value, zero inflation and no contributions or insurance payouts during the financial year, at 30 June 2021 the tax free component is still $100,000. This means that the taxable component is negative $20,000 at this date. This could then be carried forward and offset against future investment gains that would otherwise create or increase the taxable component. It could also be shifted to another Life Savings Account of that person to offset taxable components in the other account. The fund would notify a negative taxable component to the member who could instruct the fund to notionally distribute it for that or any future financial year, but only based on the value of the taxable component at the end of the financial year. In the example above, the member would be notified of a negative tax component of $20,000 at 30 June 2021. That member could instruct the fund to “distribute” that negative tax component to the member (continuing the rule that taxable components must be withdrawn first) and he/she would include it as a tax deduction for the 2020/21 financial year or the 2021/22 financial year. If this action was taken then the member's account at 1 July 2021 would show $80,000 as the balance, all tax free, with a zero taxable component. Any negative tax free components could be carried forward indefinitely either by the member in their individual tax returns or by the fund in the member's account, until obliterated by either sufficient personal income in the former case or sufficient investment returns generating taxable components in the latter case.

It is also possible that all cash could be withdrawn from an account but a negative taxable component remains. As above, this would be notified to the member who could leave it in the fund (but only if the trustees of the fund agreed), instruct the fund to shift it to an account in another Life Savings Fund or “withdraw” it and obtain a tax deduction equal to the negative taxable component for that member for the year in which all the cash was withdrawn or the subsequent financial year.

The above situations should be uncommon for retirees. If they occur and create an administrative difficulty for financially unsophisticated account holders then there could be a default option for funds whereby the negative taxable component is notified by the fund to the Tax Office which automatically deducts it from the account holder's taxable income when he/she submits a tax return and/or carries it forward. Note that transfer of the negative taxable income to the member could only occur once the member had met the conditions for withdrawal from funds, which is another reason why most account holders would not need to know about this aspect of the system.

Issues Related to Withdrawals and Transfers

Holdings can only be transferred between funds in the name of the member, not to other members without first withdrawing the holding and paying any tax that may be due. (Note this difference with contributions, which can be made by anyone to anyone else, except children under the age of 18 years.)

The PAYG system for employees would apply to withdrawals so funds would have to maintain tax file numbers and collect a form (as per employment arrangements) regarding the tax status of the member. (Funds would have to report payments, both components and total holdings to the ATO for 30 June each year.) Over the next 10 or more years, many or most retirees should either start with or soon get to a situation where they will pay no tax on the withdrawals – see Transition below.

Educating Consumers

Given the proposals to reduce regulation included in this document, the losses of investors' funds in bad investments in recent years and the responsibility being given to citizens to manage their own retirement savings, governments should include basic training in investment matters early in the education system and put more resources into improving the investment knowledge of the general population. Being an Australian citizen now requires an understanding of the relationship between risk and return and that “guaranteed” investments do not continuously generate returns exceeding 20%pa in a low inflation environment, for example. The education should also cover the Life Savings System so there is eventually clarity in the minds of all voters as to how taxation works in relation to retirement savings.

Costs

The Life Savings System should not impose additional net administrative ongoing costs on funds. The requirement to withhold tax and provide payment summaries continues to exist in the current system for members under the age of 60 and for payments from untaxed funds. Under these proposals, any payments from tax free components and from taxable components up to the tax free threshold of the income tax system would not require tax to be withheld or payment summaries to be provided if the account holder declared no other significant income. Where tax is payable, PAYG arrangements should remove the need for tax returns to be lodged by recipients.

Defined Benefit Funds and Retirement Annuities

Defined benefit funds offer the attraction of pooling mortality risk, but may be risky if run by businesses other than insurance companies due to lack of specialist expertise, possible insolvency of those businesses and ownership issues. Therefore, only insurance companies regulated by the Australian Prudential Regulation Authority should be authorised to start new defined benefit funds.

All assets of taxed defined benefit funds would be declared as tax free on commencement of the Life Savings System and earnings would become tax free. Tax deductions would not be available for contributions and contributions would be sourced only from individuals. Trustees of defined benefit funds would be authorised by the regulatory system to demand contributions from members and transfer out amounts for members if they failed to contribute. Those amounts could be transferred into accumulation accounts created for this purpose or another LSF nominated by the member. (Rules such as those applying to life insurance policies could be applied to address the issue of members of defined benefit LSFs failing to contribute the stipulated amount.)

Employees could nominate defined benefit Life Savings Funds for their compulsory contributions. If these exceeded the amounts necessary to maintain their defined benefit account then the excess could be directed into an accumulation Life Savings Fund.

Dollars of tax fee components will usually be worth more to withdrawing members than taxable components. The taxable components first rule may be regarded as inequitable between members as taxable components will start at zero and rise over time. However, applying this rule to defined benefit funds is similar to the approach for accumulation funds because the change from the current superannuation system will preserve generous benefits for members of those funds. Also, the nature of defined benefit funds is that they usually cannot give members the exact return of the underlying assets of the fund. Therefore, the rule of withdrawal of taxable components first should also apply to defined benefit funds. This introduces some complexity into assessment of such funds as prospective investments as over time they will differ in proportions of tax free components.

It is more difficult to apply the excess contributions and assets tests to members of defined benefit funds. It is beyond the scope of this document to nominate a methodology but a number of approaches are possible in avoiding excessive loss of tax revenue from investment earnings on assets backing very substantial future benefits. As future benefits are by definition known, actuarial calculations could calculate present values which could then be added to other holdings to determine tax liability using the same thresholds as for accumulation funds listed above. As there cannot be early withdrawals from defined benefit funds, there would be a case for funds to provide loans to affected members for payment of these taxes. Loans to members are allowed under the LSS, providing all transactions are on an arms length basis. Another alternative is to limit to a dollar figure the amount of pension or lump sum that can be promised from a defined benefit fund for all new accounts to prevent excessive loss of tax revenue. This would not limit individuals from saving whatever they like as they could open one or more LSAs with accumulation funds to add to their defined benefit.

Whatever system is chosen to calculated these taxes, it must not be more generous than the system of excess contributions and asset taxes for accumulation Life Savings Funds or it will provide another major loophole. Only a minority are members of defined benefit funds and an even much smaller minority would be likely to retire with benefits worth millions in current dollar terms, although this could change in the future.

Retirement Annuities

The above taxation treatment could also apply to lifetime annuities offered by LSFs operated by insurance companies (only). On retirement, a person could shift their LSA balance to purchase an annuity. The taxable and tax free components would then be added to the respective components in the fund that will provide the annuity and tax would apply as above on withdrawals. Various products could be offered such as lifetime and life expectancy annuities, with no government interference in this market other than the vital role of setting and enforcing prudential requirements. The capacity of annuities to reduce “double dipping” may warrant some subsidy for these products. An obvious and easy way to provide this would be to offer a higher tax free threshold for payments from these products. A less attractive alternative is to make annuties compulsory.

How Should the Life Savings System be Used

Individuals will find the ways that the proposed system best meets their needs, but some obvious general comments are:

- Many may see it as attractive to hold all long term savings (up to the excess contribution and assets thresholds) for retirement in LSAs (and perhaps for other needs such as for housing and medical expenses, subject to government policy) because their earnings are tax free within the fund and tax free components are indexed. If amounts are needed for short term problems then they can be borrowed from the LSF, provided a market rate of interest is paid. (Many may not see an attraction in the LSS, as many do not take advantage of the current highly tax advantaged system now. It may be appropriate therefore to allow borrowing of part of each account at a market interest rate.) When withdrawals are allowed for an account holder, it appears advisable for him/her to withdraw each year such that his/her taxable income is at least the dollar amount of the income tax free threshold if available. Above this, retirees may prefer to withdraw according to their needs as taxable components not withdrawn are not subject to tax in the Life Savings Fund (depending on their attitude to the tax liability they leave to their heirs). If the amounts withdrawn were not required for consumption then they could be contributed back to the fund (or perhaps to a spouse's account) to increase the tax free component. This may not be advisable if it resulted in exceeding the contributions and asset tax thresholds.

- Couples retiring at the same time may want a situation where each has equal taxable components to take full advantage of tax free thresholds. Flexibility of switching to others is not allowed without withdrawal (and possible tax liability from taxable components), but this could be achieved over time when withdrawals are allowed. Direction of compulsory or other contributions to any other account holder is allowed prior to meeting a condition of release.
- It is likely that the more people that receive the proceeds of a deceased's savings in the Life Savings System, the less the total amount of tax paid. An account holder may wish to nominate a number of beneficiaries for after his/her death if there is a substantial taxable component rather than the single taxing point of an estate.
- Residents such as retirees with taxable components whose income is so low that they do not pay tax on it may be better to withdraw from their Life Savings Account to the point where the return on their personal investments verge on creating a personal tax liability (if they qualify to withdraw). This is because they otherwise are likely add to their taxable components in the Life Savings System and possibly generate tax liabilities later. It appears advisable to re-contribute these amounts back into the Life Savings System. Taxable components not withdrawn are not subject to tax until withdrawn so the answer to this question depends on the account holder's attitude to the tax liability they leave to their heirs. An exception is where the account holder is or may be subject to the excess contributions or excess assets taxes.

Positives and Negatives

Why would any individual save for retirement via the proposed system (in addition to the compulsory requirement)? The LSS does not continue the substantial tax incentives to higher income earners but offers the following attractions:

1. No tax on investment earnings in the funds = tax deferral: The less the frequency of application of a tax of a given rate then the less its impact. Life Savings Accounts will allow young people starting out in a job to defer tax on the earnings on their retirement savings for decades. They will see growth unhindered by taxation. In summary, the zero tax rate and full refund of franking credits makes Life Savings Funds a very attractive way to save for retirement (up to the point of being affected by the excess contributions and asset taxes).
2. The LSS provides protection from tax on their after tax contributions by indexation to the CPI. This is not the case with the current superannuation system and the full investment gains are potentially subject to tax if withdrawn befor 60 years of age. Assets where the principal is not protected from tax by indexation are better held within a Life Savings Account than directly by an individual or company. For example, bank accounts and bonds.
3. Double utilisation of the income tax free threshold and/or lower income tax thresholds – each year during a person's working life and each year in retirement. Employees are currently subject to a progressive tax scale on their

income. Via the Life Savings System, most would get the opportunity to “split income” through time. That is, taking advantage of the progressive tax scale again on their investment returns in retirement. If a tax-advantaged savings alternative does not exist then earnings on investments held by individuals are added to other earnings for tax purposes. (This advantage of the LSS would not exist if a flat tax was introduced.)

4. The proposed system moves away from contributions mainly deriving from employers (to achieve maximum tax effectiveness) to giving individuals the capacity to access the best tax advantages directly, either on behalf of themselves or their spouses, children (over 18 years), etc. For example, husbands could (and under the Life Savings System should, to maximise tax benefits by splitting income in retirement) contribute on behalf of their wives while the latter are out of the workforce to give birth and raise children and still the maximum tax advantages available under the system will be accessed. Unlike the current system, the Life Savings System does not discriminate between workers and non-workers at any age.
5. The existing co-contribution system could be retained (or expanded because of the elimination of the tax expenditures inherent in the current system).
6. Greater flexibility with no limits on contributions or withdrawals (although tax can influence decisions with regard to the latter and at the extremities in regard to the former).

Why would an individual not save for retirement via the proposed system?:

1. The very substantial tax subsidies available via the current superannuation system would cease, and this may make saving via LSFs less attractive for higher income earners. However, up to very high LSA balances (where the excess assets test applies), there are still attractions in the proposed system for high income earners as described above. It should be remembered that the current system also allows after tax contributions although these go into an environment that is subject to a nominal 15% tax on superannuation investment earnings.
2. It is suggested by some that under the current superannuation system, lower income earners are not attracted to saving for retirement when it is far into the future. The proposed system can give them some immediate cash incentives to save via greater government contributions and there are longer term attractions as described above. However, the continuation of compulsory contributions solves this problem to a large extent and should be expanded because the government has to “pick up the tab” with age pensions for those who fail to save adequately.

Attractions for government and the economy of the above system are:

1. Abolition of substantial tax subsidies to more wealthy taxpayers: The biggest advantage of the Life Savings System is that it will result in a substantial saving in tax revenue that can be directed other than to primarily subsidising the retirement of people who are already comfortable and who should be self-reliant. The LSS provides a substantial shift of tax incentives to save away from what one commentator described as “upper class welfare”. With the tax subsidies eliminated, tax thresholds can be shifted up or marginal tax rates reduced. Alternatively, the savings could be directed into an expanded government contribution scheme to reduce reliance on the age pension by low income earners. The LSS will also avoid the risk that the current system will

become unsustainable as the population continues to age and pressures younger workers with higher taxes than would be the case without the tax distortions of the current system. (If governments want lower taxation for higher income earners then it seems more apppropriate to provide it in the income tax system where it may achieve higher participation rates and incentives for workers.)

2. Simplification: The LSS will be a less complicated system for retirement savings which should be easier to understand for people with low levels of financial knowledge and it should lower ongoing costs. Two taxes are removed from within the savings environment. The LSS aims to use the existing income tax system (which appears likely to remain for a very long time) and remove two other taxes – on contributions and superannuation fund earnings. The income tax system takes over from the contributions tax that currently applies to concessional contributions to superannuation. This should lower costs for the approximately 300,000 superannuation funds in Australia, all of which presumably lodge tax returns. In comparison, Peter Costello estimated that the removal of tax on superannuation payments to over 60 year olds would mean that 150,000 people would no longer need to lodge a personal tax return.
3. Those investing retirement money would not need to spend time trying to manage tax issues apart from the attraction of fully franked dividends from Australian companies.
4. Consistency of taxation of retirement savings with the progressive income tax system: There is an income tax system for individuals and it is better to let that apply first to amounts before they enter the tax-preferred savings environment, rather than having a partial flat tax system applying to the amount saved for retirement. If an incentive for retirement saving is required then it can be applied transparently via direct subsidy.
5. Bias against taking of lump sums: Because of progressive income tax and the absence of tax in funds, the proposed system encourages taking payments as pensions over a long period. That is, it generally discourages withdrawal of large lump sums which can be dissipated by individuals, resulting in the need for welfare in retirement. If this does happen in some cases, it will at least be preceded by some tax being taken out first. Taxpayers provide insurance for the risk of individual retirees making financially incompetent decisions and losing all or most of their retirement savings and the proposed system reduces the risks for taxpayers. (It could be argued that allowing gearing in Life Savings Funds still allows this to happen. However, if it does happen to an individual then it seems that it would be less likely in retirement and more importantly it would not result in the concurrent loss of the large initial tax subsidies inherent in the existing system.)
6. The Life Savings System should provide better inter-generational equity. It involves no loss of revenue from income tax related to work by individuals in contrast to the current system. It does involve a tax subsidy related to investment earnings and to income taken in retirement (and from possible government contributions), but the tax subsidies will be of most benefit to lower income earners who are more likely to need help to avoid reliance on the aged pension.
7. Flexibility for individuals and government: It is easy for governments to adjust the proposed system because the existing income tax system is applied first. (That is, it is effectively a 'take tax first and consider subsidies later' system. The current system is so generous that the only sensible way to reform it is to increase tax, which is very difficult for governments on a piecemeal basis and without hurting low income earners.) For example under the LSS, if a

government wanted to direct proposed tax cuts into savings then it could give the tax cut but concurrently raise the compulsory contribution level from 7%. It could also boost saving for retirement by expanding government contributions, for example in a year when tax revenues are very high but there is a risk of inflation.

8. Franking credits will still be very attractive to a substantial part of the investors in the Australian stockmarket. This should continue to provide a disincentive for listed Australian companies to push tax avoidance to the limits.
9. A major reform like the LSS gives the opportunity to include changes that are not related to tax and structure. For example, the adoption of default additional contributions on top of the compulsory 7%, such as an extra 1 to 3% or default directions of after tax pay increases into LSFs.

Possible problems/issues/negatives with the above system are:

1. The absence of tax on investment returns will lead to faster growth of assets and over decades there will be a very substantial amount held in LSFs. These assets will not generate any tax revenue for the Australian Government compared to the nominal 15% tax that applies to superannuation now. However, offsetting this is the removal of tax deductions on contributions, which should result in a substantial net gain in tax revenue. It should also be remembered that under the current system when superannuation funds pass into pension phase they become tax free so this system already partially exists. Over time, the Life Savings System should result in increased retirement savings for lower income earners who, under the current superannuation system, are more likely to be dependent on aged pensions in retirement. (This will arise from higher net investment earnings in a tax free environment and rising compulsory contributions over time.) Reduced need for pensions will reduce demands on future Federal Budgets as the population ages. (It is beyond the scope of this document to model the relative revenue outcomes, which will change depending on the balance between workers and retirees, etc.)
2. This proposal will result in substantially less tax benefits for some higher income earners while increasing advantages for lower income earners. It is therefore likely to be subject to attacks by vested interests and politicians. This may impinge on the attraction of saving for retirement by the general public. This proposal also allows withdrawals of some existing superannuation holdings. It is possible that the combination of these factors may result in an initial contraction of total savings for retirement. However, such withdrawals are more likely from more wealthy members (which is unlikely to add much to the burden on taxpayers for age pensions). The removal of the need for employer agreement to obtain the best tax outcomes, tax free investment returns plus the expansion of compulsory contributions should be able to improve growth of retirement savings, particularly for those who most need it.
3. In the future some (more wealthy) Life Savings Fund account holders will be subject to tax on withdrawals after the age of 60 although they may not necessarily be disadvantaged relative to the current system of tax free withdrawals from superannuation after that age. Some may have to lodge tax returns although the tax free threshold plus the indexation of the tax free component in the new funds should avoid this for most people at some stage of their retirement. For an individual with little income and capital gains apart from withdrawals from Life Savings Accounts, it should be possible for the PAYG deductions to remove the need for lodgment of a tax return in most cases. When

all the taxable component is withdrawn, payments from the tax free component will not require lodgment of a tax return. (There will probably be a taxable component generated each year from investment returns but this should not create the need for lodgment of tax returns by most people as they age.)

4. With compulsory contributions being a fixed percentage of after-tax remuneration, the proportion that this represents of pre-tax remuneration declines with higher incomes because of the progressive tax system. That is, the current system results in higher compulsory contributions by higher income earners than the Life Savings System. Given that potential future problems for taxpayers in funding age pensions is more likely to arise in relation to lower income earners, this may not be much of a problem and can be addressed by raising the compulsory percentage over time. There is also the attraction that non-compulsory contributions of any amount can be made at any time.
5. There may be a complication for administrators of Life Savings Funds in relation to some members who withdraw taxable components and have accounts with multiple funds. For example, a member may have an account with Fund A that is 100% tax free and an account with Fund B that has a substantial taxable component. If the member applies to withdraw from Fund A then one way to enforce the rule of taxable components first is for its administrators to know of the Fund B holding. This may require members to comply with rules on withdrawals, declarations from members, communication of data between funds, encouraging consolidation of accounts and/or dealing with the tax issues retrospectively. Another method in theory would be for all funds to electronically report tax free and taxable components with tax file numbers to the ATO after each 30 June with the ATO acting as a reference point to check before withdrawals. This may present substantial operational challenges for the ATO. In practice it will be unusual for account holders to have only a tax free component with one fund and no taxable component with another. This is a similar problem to taxpayers who work for multiple employers and can be partly addressed as this situation is – by declarations by members as to whether their account in a Life Savings Fund is their sole account and therefore to be taxed as such, etc. (Note that there is a similar complication with the existing system in relation to tax on contributions that exceed the concessional cap, because this cap applies to accounts held in multiple funds. This requires calculation of total contributions across multiple funds.)
6. The fund management industry may be alarmed that the Life Savings System will result in reduced inflows. However, this may not be an issue in the long term as tax free growth will eventually result in higher amounts from compulsory contributions in most accounts. (See calculations below.) Like the current superannuation system, the LSS will be the most tax effective way to save so it should attract substantial funds. It seems unlikely that the changes will cause strong outflows, except from the small minority who will be exposed to the excess contributions and assets taxes. Also, the LSS discourages withdrawal of lump sums and this should maintain a high level of funds under management in the long term. Finally, the government should raise the compulsory percentage over time.
7. The proposed system will require valuations of all assets in funds at least at 30 June of each year for reporting to the ATO and members. Those with very substantial holdings will assess their possible liability to the excess assets test. This may increase the attractiveness of exotic investments that are difficult to value so the ATO will have to be vigilant in monitoring such investments and funds to ensure there is no evasion of this tax.

8. Accounts should grow faster over time in the Life Savings System than in the current superannuation system due to a zero tax environment, but Life Savings Accounts can be considered to have contingent tax liabilities for those over 60 years of age. A criticism may be that this will give retirees a false sense of the worth of their retirement savings under the LSS compared to the current superannuation system. There is some validity in this argument but for most people who do not have multi-million dollar holdings and take moderate withdrawals over the decades of their retirement, the tax liability should be low.

Achieving Adequate Retirement Savings

Much has been written around claims that many Australians will have insufficient savings for a reasonable retirement. Since those with such problems will be primarily low income earners, the Life Savings System addresses this issue by removing the bias of the current tax incentives to higher income earners to allow greater assistance to those who are likely to otherwise accumulate relatively low levels of savings. In effect, the LSS provides a framework for achieving better retirement savings for low and middle income earners. Based on this system, the best way to avoid inadequate savings problems is for governments to raise the level of compulsory contributions as they continue the trend of tax cuts, so low income earners' after tax situations are not significantly negatively impacted. As the LSS should result in substantial savings in tax revenue, particularly in the short term, achieving this should not be difficult.

Transition to the New System

Transitioning to new rules is an area that has substantially complicated previous changes to superannuation and so must be handled carefully and with the same commitment to attempting to avoid disadvantaging existing beneficiaries. Thus there appears to be no alternative in transitioning to the proposed system other than to deem all existing superannuation holdings to be tax free components. This could be done at the date of announcement of the change, although the change to the new system should be on a 1 July date following the announcement. This may require that current arrangements involving concessional and non-concessional contributions continue until the end of the financial year of the announcement.

In summary, the government should announce that the Life Savings System would commence on a 1 July date (provided that the current fund administrators etc are given at least 12 months to prepare – and possibly up to three years), declare that all holdings at that date will form part of the tax free component at that date and allow the existing rules of contribution to apply until either that 1 July or say 3 months into the future. Future earnings would be taxable, except for the indexation of the tax free components.

Assets Initially Exceeding Asset Thresholds

There would not need to be an exemption from the assets included in the calculation of the excess assets tax each year for the total of beneficiaries' holdings at 30 June prior to the financial year of implementation of the proposed system (ie “grandfathering”) because the LSS includes a provision for total holdings in superannuation that exceed $2 million to be withdrawn, including if the account holder is under preservation age. Normal tax applies on such withdrawals but at commencement, all amounts in existing superannuation accounts would be declared to be part of the tax free component. Thus a person with more than $3 million in superannuation at the date of commencement of the LSS could immediately withdraw the amount exceeding $2 million free of tax and thereby avoid the excess contributions and assets taxes, if they wished.

Recipients of Superannuation Pensions

For those people receiving a superannuation pension, all of their pension accounts would be declared to be tax free components at the 1 July date of commencement of the proposed system. Life Saving Funds are not subject to tax so the tax status of pension funds would not change. For most superannuation pensioners, there would probably be no change. Those with pension accounts of millions of dollars may be subject to excess assets tax and/or generate sufficient taxable components over time to be subject to tax on withdrawals. As described in the previous section, they could withdraw any amounts exceeding $2 million and avoid these taxes in the Life Savings Fund. (Note that if done early enough in the life of the holding under the LSS, such larger withdrawals would not be subject to tax on withdrawal because there would be insufficient time to generate a taxable component.)

Alternatives, Comments and Tax Minimisation

Alternatives

Allowing Full Deductibility of Contributions

An alternative reform is to allow full deductibility of contributions by individuals and companies, abolish all tax within funds and only have tax on withdrawals. The attraction of this approach is that account balances can grow very rapidly and if there are no after tax contributions then they consist of only 1 component – untaxed contributions and untaxed investment returns. (It is unlikely that post tax contributions would be prohibited, in which case there would be 2 components, just as in the LSS.)

The first problem with this system is that it requires continuation of restrictions on contributions and other complex rules or the loss of government revenue becomes too great. Many Australians may not be able to take full advantage of the tax deductions because of unavailability of sufficient earnings for each year or the need to save for a home purchase but are restricted later in life by the limits. Second, it bypasses the progressive tax system and provides greater benefits to those who can afford to contribute more, up to the limit on contributions.

These problems could be addressed to some extent by allowing unlimited contributions but imposing a low level excess assets tax and/or contributions tax, starting at say $2 million. This would require more people to declare and pay tax on their superannuation accounts and many people would probably have to file tax returns into their 80s and 90s. Overall, this is a much less attractive option.

An Alternative Treatment of Death Benefits

An alternative to the death benefits rules proposed above is a requirement to pay out a deceased member's balance immediately for non-dependants and over a reasonable period for dependants. Prior to 30 June 2004, the law only defined dependants as a spouse, child and any other person financially dependent on the fund member. This was extended to those in an “interdependency relationship”. Defining this inevitably results in complication and imprecision. However, if it is desired to continue with this in the LSS then the definitions of dependants would continue to apply except that any person under the age of 18 (not necessarily a relative) who is nominated by the deceased would be included with the dependant provisions. A dependant would be paid the deceased's benefit over their lifetime except that a child under 18 would only be paid from the account until reaching 18 years of age. Such payments would be treated the same as other withdrawals – taxable components required to be taken first and added to the beneficiary's taxable income (at adult rates), followed by tax free components. Account holders (first preference) or beneficiaries could stipulate any rate of payment they wished and the latter could vary it over the period of payments. Any amount remaining at the age of 18 for a child would have to be paid to that child prior to his or her 18th birthday. Beneficiaries who are adult non-dependants at the time of the member's death would be required to be paid the full benefit within 12 months of the member's death and taxable components would be added to their taxable income.

In summary, the difference is that dependants are given much more time to receive the deceased member's holdings. This may mean that a non-dependant may have to pay more tax.

Abolishing Inhouse Asset Restrictions

An alternative to the inhouse asset restrictions is to reduce the level at which the excess assets tax applies and remove all restrictions on investment including exposure to inhouse assets. The latter would allow Private Life Savings Funds (PLSFs) to invest in private companies owned by members. (The lower excess asset tax threshold could be restricted to PLSFs.) An owner of a private company could sell it to their PLSF, limit their remuneration to a low level and effectively direct a large part of the company's after tax profits into the PLSF via fully franked dividends. The result is complete avoidance of tax on the amount going into the PLSF after refund of franking credits. Everything is eventually potentially taxable under the LSS, but it would provide a method for deferring tax for decades and create asset valuation problems for application of the excess assets test. An attraction is that it removes another layer of complexity and allows a small business owner to maintain his or her retirement savings in the tax effective environment but still invest in an associated business. It also provides an alternative to the current complex small business CGT concessions. Such a change would be likely to encourage higher levels of incorporation of small businesses and ownership of them by PLSFs. One way to address the tax deferral problem would be to lower the threshold for the excess assets tax in LSFs (to say $2 million). Removing inhouse asset restrictions would create a substantial tax deferral opportunity for those with private companies, up to the point where they were affected by the excess assets tax.

Appendix

Contribution and Accumulation Examples

The proposal is for a contribution of 7% of after tax remuneration to be compulsory, replacing the current 9% of pre-tax remuneration, with an increase in gross remuneration of 9%pa. The following are examples of the effects of this regime using 2007/08 tax scales and for simplicity ignoring Medicare levy and other effects such as welfare payments and payroll tax. It is also assumed that there is no government contribution on top of the compulsory contribution (as these may be a feature of both systems and thus not different between them). The calculations for the 2 examples are followed by a summary table.

Example 1 - $30Kpa Cash Salary Before Tax

In 2007/08, income tax on a cash salary of $30,000pa was $3,600pa less the low income tax offset of $750 (leaving $27,150 after tax) and the employer would contribute $2,700pa in superannuation guarantee payments (compulsory contributions). Under the proposed system, the employee's remuneration would increase to $32,700pa (& thus the employment cost is unchanged for the employer). The effective marginal tax rate at this level of earnings is 34% (including withdrawal of the low income tax offset) so actual tax resulting from this higher remuneration is $3,600 - 750 + (0.34 * $2,700) = $3,768, leaving $28,932 after tax. 7% of this is $2,025, leaving net remuneration after tax and after compulsory contribution of $26,907. There is a small decline of $243pa in cash remuneration, assuming the income tax system is unchanged. There is no contributions tax with the Life Savings System and the full contribution, although smaller, generates tax free earnings for as long as it is in the system. In comparing the 2 systems it should be remembered that a larger amount is contributed under the current system but it is subject to contributions tax, while the final superannuation amount will be tax free on withdrawal for a member over 60 years of age.

Example 2 - $75Kpa Cash Salary Before Tax

In 2007/08, income tax on $75,000pa was $17,100pa (leaving $57,900 after tax) and the employer would contribute $6,750pa in superannuation guarantee payments (compulsory contributions). Under the proposed system, the employee's remuneration would increase to $81,750pa (& thus the employment cost is unchanged for the employer). The marginal tax rate at this level of earnings is 40% so tax on this higher remuneration is $17,100 + (0.40 * $6,750) = $19,800, leaving $61,950. 7% of this is $4,337, leaving net remuneration after tax and after compulsory contribution of $57,614. This is a small decrease of $286pa (0.5%) in take home cash remuneration.

Summary Comparison of Examples 1 & 2

The following table shows the effects of the current and proposed systems for the 2 levels of gross remuneration with only compulsory contributions. The first line at each remuneration level is under the current superannuation regime and the second line is under the proposed Life Savings System. All figures are annual and in dollars ($). Note that zero government co-contribution is assumed, although continuation of the current scheme would boost the lower income earner's contribution by nearly $1500.

Table 1: Compulsory Contributions Under the Two Systems at $30K & $75K Annual Salaries

Sup'n G'tee Contribution (9%)	Gross Annual Salary	Tax on Gross Salary	After Tax Salary Before LSS	LSS Compulsory Saving (7%)	Net Take Home Pay	Amount Saved in Fund After Tax*
2,700	30,000	2,850	27,150	N App	27,150	2,295

N App	32,700	3,768	28,932	2,025	26,907	2,025
6,750	75,000	17,100	57,900	N App	57,900	5,738
N App	81,750	19,800	61,950	4,337	57,614	4,337

Note that the "Amount Saved in Fund After Tax*" for the current system is the superannuation guarantee contribution less the 15% superannuation contributions tax. The compulsory contribution for the proposed Life Saving System is not subject to tax in the fund and so all of it is invested. This column shows the amounts that actually start generating investment returns in the funds. Note also that the proposed system results in a drop in the initial compulsory savings amount after tax of about 12% at the lower income level and 24% at the higher income level. Also, whilst the ratio between the higher and lower salaries is 2.5 and the ratio between the higher and lower superannuation guarantee payments before and after contributions tax is 2.5, the ratio between the higher and lower compulsory savings under the Life Savings System is 2.1. Both employees end up with about the same take home pay after tax and compulsory contributions, but the lower income employee's compulsory savings gain in relative terms. In other words, this system achieves its goal of targeting compulsory savings more toward lower income earners, although both income levels start with less than they would under the current system, assuming no government co-contributions. (The reduction in tax expenditure under the Life Savings System gives scope for increased government contributions or lowering of income tax.)

The following table shows the value of the above single contributions of compulsory savings after various decades under the current and proposed systems at the 2 income levels. If the employee was 20 at the time of the contribution to the fund, the table shows the value up to the age of 70 years assuming no part of it was withdrawn and the investment return before tax was a constant 6%pa nominal. This is then the rate that applies to the Life Savings Account but the superannuation account under the current taxation regime is subject to a nominal 15% tax on earnings. If the full amount of this tax always applied then the net investment return would fall to 5.1%pa. Tax effects on income will not differ much from the nominal 15% between the systems as there is a full refund of franking credits for both. However, the effective tax on superannuation investment earnings under the current system is actually likely to be less than 15% because tax on capital gains can be 10%. For those with the financial resources to have their own SMSF, the impact of capital gains tax can be reduced or avoided, so the average tax rate may even be below 10%. The following calculations assume an after tax rate of return of 5.3%pa in superannuation which is based on an average tax rate of about 12%. All figures below are in dollars.

Table 2: Accumulation Comparisons Under the Two Systems Over Decades for $30K & $75K Annual Salaries

Savings System	Amount Saved in Fund After Tax*	Value After 10 Years	Value After 20 Years	Value After 30 Years	Value After 40 Years	Value After 50 Years
Current (low inc)	2,295	3,847	6,447	10,805	18,110	30,353
LSS (low inc)	2,025	3,627	6,495	11,632	20,831	37,305
Current (med inc)	5,738	9,616	16,117	27,013	45,275	75,882
LSS (med inc)	4,337	7,766	13,908	24,907	44,604	79,879

Note the following re the above table:

1. Both accumulated amounts under the Life Savings System exceed the amounts under the current system between just after 30 years for the lower income earner and just after 40 years for the higher income earner (although under the LSS, some of the savings may be subject to tax on withdrawal). It is beyond the scope of this paper to present every possible scenario but the table suggests that over long terms, most people will accumulate more in gross assets in the fund under the Life Savings System. Note also that this situation results from the fact that tax is brought forward. If governments want to bring forward the cross over points then they should have the revenue to add to members' contributions under the Life Savings System. The LSS is designed to encourage long term saving and retaining funds in the system after retirement and on commencement of the LSS all existing amounts in superannuation will be declared tax free. The objective of the LSS is not to maximise the savings of individuals via tax subsidies but to achieve sufficient savings for everyone to avoid reliance on the age pension.
2. The amounts in the "Current" system rows can be withdrawn without tax after age 60 whereas withdrawal of amounts in the "LSS" rows may be partially subject to tax, depending on the amount involved, inflation over the period, the account holder's personal income and the tax scales at the time of withdrawal. (The superannuation system prior to the 1 July 2007 changes was also dependent on the tax scales at the time of withdrawal and still is for withdrawals prior to the age of 60 years.) Here also the Life Savings System biases the incentives toward lower income earners because of the zero tax threshold for personal incomeand the progressive income tax scale. It also should be noted in assessing tax effects that the amount contributed (which can be withdrawn tax free) is indexed to inflation under the Life Savings System.
3. When the account holder commences a pension, the after tax returns will equilibrate between the two systems as in the current system, tax falls to zero for superannuation in pension phase. This has been omitted for simplicity from the above table but unless there is early retirement, the above conclusions should not be materially altered. (It is likely that the differences between the two

systems in the 50 year column would change if retirement has happened before then, which will probably be the case.)

An example of the tax effects on withdrawals from Life Savings Accounts follows using the 50 year column, assuming CPI inflation of 2.5%pa and for simplicity that the only contribution is the figure in the far left column. The $2,025 contributed by the lower income earner will result in a tax free component of $6,960 out of $37,305 and the higher income earner's contribution of $4,337 will grow to a tax free component of $14,907 out of $79,879. If the current tax free threshold was increased by CPI each year (ignoring the low income tax offset), then after 50 years the current $6,000 figure will have increased to $20,623. However, this calculation is of very limited value because of the large number of important other factors impacting on the extent of tax payable in retirement.

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