Australia’s Future Tax System

Retirement Income Consultation Paper

KPMG Submission

KPMG Superannuation Services Pty Limited
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This report contains 18 pages
Appendices comprise 2 pages
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1 Executive Summary

The review of the retirement income system should give consideration to our following recommendations:

- The requirement that a portion of all benefits beyond an agreed minimum is taken in the form of a pension.
- The extension of the SG system to all income earners, including the self-employed.
- The abolition of the '10%' rule for determining eligibility for the making of tax deductible contributions by the self-employed.
- The introduction of an income fluctuation policy to better accommodate the payment of contributions by the self-employed.
- A more considerate approach to the treatment of superannuation savings which are repatriated to Australia by migrants or Australians returning to local domicile.
- From a tax deductibility and concessional cap perspective, the elimination of the distinction between superannuation contributions made by employers, employees and the self-employed.
- Requiring employers to provide all employees with access to additional contributions by means of salary-sacrifice.
- Addressing the investment component of longevity risk by facilitating the creation of suitable fixed interest securities to back suitable financial products.
- Making the costs associated with financial planning advice tax deductible.

2 The retirement income system

2.1 Response to consultation question 1.1 – Retirement income system objectives

In considering the future of Australia's retirement income system, which objectives are relevant in setting retirement income policy? Does the current system of the Age Pension and compulsory and voluntary savings meet these objectives? If not, how should the system be changed to meet these objectives?

Discussion

The objectives as outlined in the consultation paper and the current three pillar retirement system are all relevant and notionally adequate for Australians. However, changes to the integration of the three pillars will see the objectives better met now and in the future.

Each of the three pillars has certain characteristics which contribute to a functional system:

- The provision of an Age Pension as a safety net addresses the issues of poverty alleviation;

- The SG system forces workers to forgo some of their immediate consumption to take some responsibility to save for their own retirement and alleviates the pressure on the Government to fund the Age Pension, particularly as the proportion of retirees to workers increases over time; and

- Finally, the provision of a tax effective vehicle for supplemental savings encourages people to save for a better standard of living in retirement and less likelihood of reliance on the Age Pension.

Conceptually, these three pillars give Australians a workable retirement income system, however, there remains scope for improving the interaction between each of these pillars.

Recommendation

Benefits to be taken as a pension

The system as it stands does little to encourage retirees to retain their savings for dissipation over their retirement years. Relative to lump sums, the only additional incentive provided relates to the exemption from tax of investment income generated by assets supporting a pension in the course of payment. Otherwise, broadly speaking, the same tax concessions apply regardless of the manner of benefit withdrawal. This provides recipients with the opportunity to receive the superannuation benefit as a lump sum, spend it and then access the Age Pension (commonly referred to as 'double dipping').

We do not believe that there is a need to further enhance the taxation attractiveness of pensions or conversely to detract from that of lump sums. Their relative tax treatments remain appropriate.

However, to ensure people take greater responsibility for their own long term support in retirement, the Government should mandate for a minimum level of benefits to be taken in the form of a pension. In circumstances where a full or partial Age Pension would otherwise be payable, our proposed approach would partially compensate the Government for the tax concessions provided at both the contribution and benefit levels. We recognise that the conversion of small lump sums to pensions would be meaningless and impractical. Accordingly, we suggest that a mandatory pension should be invoked once a single person's aggregated superannuation benefits reach $120,000. A pension should then remain a requirement for aggregated accrued benefits of up to $200,000. A tax free lump sum benefit should continue to be available outside this range.

Our proposed approach would:

- Reduce Social Security dependency in retirement; and
- Provide an incentive for making voluntary contributions if lump sum withdrawals are considered desirable in retirement.

Other issues for the improvement of the retirement income system are covered in the following sections.

3 A broad and adequate retirement income system

3.1 Response to consultation question 2.1 – Adequacy of the SG system

As the SG system matures, it will become a greater part of an employee's retirement income. What are the implications for individuals partially or fully excluded from the mature SG system (the self-employed, individuals with broken work patterns such as carers, women and migrants), and how can the retirement income system best accommodate these groups?

Discussion

Under the three pillar system, those who are excluded from the SG system are catered for by means of the Age Pension. This is consistent with the objective of the Age Pension; to protect those who have not saved or were unable to save an adequate amount for retirement.

However, more can be done to include some of these groups in the SG system either to reduce their potential reliance on the Age Pension or to improve their quality of life in retirement.

Recommendations

This second pillar of the retirement income system must be widened to include a greater range of Australian workers and income earners. SG contributions for non-employee income earners could be linked to income earned during a particular period (as reported in Business Activity Statements), by reference to prior period income or some other base.

All income earners, regardless of their source of income, need to be covered by the SG system.

Self-employed

It is generally accepted that a three pillar system is adequate for Australia yet this second pillar essentially excludes those who are not considered an "employee". The need for retirement savings does not diminish because a person is self-employed nor does the notion that they "invest back into their business" as an adequate form of retirement savings necessarily hold true, particularly in the current economic conditions.

Recommendation

To ensure that people who are employed as well as self-employed are not inadvertently adversely affected, it would be necessary to eliminate the '10% rule', whereby a person ceases to be eligible to make concessional contributions as a self-employed person if more than 10% of their income is attributable to employment.

The self-employed often have fluctuating levels of income. This may be seasonal or related to periods of high outgoings and/or low incomes (perhaps during the setup of the business). The retirement income system needs to accommodate this.

Recommendation

Possible solutions include bringing forward several years of contributions (similar to non-concessional contributions) or the ability to carry forward tax deductibility of contributions to future years (where insufficient taxable income is available in the current year).

Partial or Full Exclusion from SG System

We acknowledge that adequacy of retirement savings is a major issue in circumstances where workers are late entrants to the SG system or have had broken work patterns. Similarly, the unemployed are not catered for. By its nature the SG system only provides for contributions to be made at the time of employment. The contributions are a function of employment income and are an employer obligation. Consequently to the extent that the SG System does not provide or only partially provides a benefit for such people, they remain dependent on the Age Pension and/or voluntary superannuation savings either directly or by means of contribution splitting.

Ultimately, this is a social policy consideration for the Government.

Migrants

Current legislation discourages Australian retirees from transferring assets held in overseas superannuation funds into the Australian superannuation system by assessing the transferred amount against non-concessional contribution caps in the year of transfer.

This current methodology is not consistent with the intention of the contribution caps to encourage saving for retirement progressively over one's working life and does little to assist migrants and Australians who have worked overseas to build their Australian superannuation savings.

Whilst in principal, we support legislation that prevents non-bona fide transfers (ie anti-avoidance mechanisms), we do not believe that the ATO's current interpretation for the treatment of bona fide transfers of overseas superannuation benefits is consistent with the recommendations made by the Standing Committee on Economics Tax Laws Amendment (Simplified Superannuation) Bill 2006. The ATO's Policy Statement Law Administration (PS LA 2008/1) does not recognise bona fide transfers as special circumstances and therefore it would appear that the ATO will not exercise their discretion to reallocate contributions to other years. This interpretation was formulated in spite of the following recommendation of the Standing Committee:

> '3.25 *The committee recommends that the government consult with the superannuation industry regarding the development of anti-avoidance mechanisms that will allow bona fide overseas transfers of superannuation benefits in excess of the non-concessional contribution cap at an appropriate time after the bill is enacted.'*

Attached as Appendix 1 are our recommended changes to the legislation to accommodate the fair and equitable treatment of overseas transfers.

The introduction of this legislation to provide for the transfer of bona fide overseas superannuation benefits would provide a balance between the desire to encourage Australian retirees to transfer overseas pension assets to Australian complying superannuation funds, the intention of the contribution caps and effective anti-avoidance provisions.

We note also that the consequences of the ATO's interpretation are significant for migrants from the UK transferring their pension assets to the Australian superannuation system. Excess contributions tax in Australia that is paid from transferred UK benefits will constitute an unauthorised payment from those benefits under the UK Finance Act 2004 and may become liable for a tax payment to the UK government of up to 55% of the excess contributions tax amount. This presumably unintended consequence of the ATO's interpretation is counter-productive to encouraging Australian superannuation savings and an equitable system for Australian retirees.

Recommendation

To bolster the Australian superannuation savings of migrants and Australian residents who have worked overseas for a period of time, and to bring some equity to the system, the application of caps against overseas transfers should be assessed based on the number of years that the person has lived overseas less any Australian contributions during that time. That is, allow transfers by migrants and Australians who have worked overseas to be assessed against a non-concessional cap of $150,000 for each year that the person has lived or worked overseas less any contributions made during that period directly into the Australian superannuation system.

3.2 Response to consultation question 2.2 – Adequacy of the Age Pension

Noting that the adequacy of the Age Pension is being considered by the Pension Review, what is an appropriate concept of adequacy for the retirement income system? Should it be to ensure there is a minimum level of income in retirement, to replace a proportion of income earned prior to retirement, or some other alternative?

Discussion

Provided that the provision of the Age Pension ensures no retiree will be living in poverty, then the retirement income system can be seen as adequate in the sense that it provides for the most vulnerable members of society in their retirement.

However, "not living in poverty" will not be sufficient for the majority of workers for their retirement, nor will the income that is provided by means of SG contributions. Therefore, a truly adequate system will not only provide a safety net for retirees but also encourage those who are able, to save for a better standard of living.

Although replacement rates are typically used as a measure of adequacy, this can prove unreliable as each person's needs will differ on retirement. For example, many people will not have extinguished their mortgages prior to ceasing work and will therefore still require a high proportion of their pre-retirement income compared to those that have no mortgage. Non-home owners will require a high proportion of pre-retirement income also to cover rental expenses. Additionally, application of replacement rates are predicated on certain life expectancies, which many people will exceed.

An adequate system may be one in which not only are safety nets provided but scope exists for people to determine their own levels of income in retirement and how much they are willing to forgo in consumption now to ensure that happens. Caps on contributions will ensure that the tax concessions available in superannuation are not able to be abused.

3.3 Response to consultation question 2.3 – Government's role

What should the role of the Government be in assisting individuals to meet their retirement income expectations in relation to the support provided by the Age Pension, the level of compulsory savings and incentives to make additional savings? Should the role of Government change as an individual's income increases over their working life?

Discussion

Age Pension

The Age Pension should only operate as a safety net for those that have been unable to save adequately for their own retirement. It is appropriate to distinguish between the above situation and where people make certain lifestyle choices which result in their qualifying for the Age Pension

The SG System

The SG system goes some way towards ensuring that superannuation savings accumulate for workers however, the Government must also ensure that these savings are utilised to fund a retiree's own "age pension".

As recommended in response to Q1.1 above, the Government should mandate a level of compulsory pension using accrued benefits sourced from SG Contributions and/or other voluntary superannuation savings.

Voluntary contributions

Non-concessional contributions are already adequately catered for. All participants, both working and unemployed, can make non-concessional contributions until at least age 65. The non-concessional cap is also applied equitably between classes of contributors. However, this is not the case for concessional contributions.

Currently, the capacity to make concessional contributions is restricted to employers in respect of their employees and the substantially self-employed. We consider this practice to be discriminatory because employees (who do not have access to a salary sacrifice arrangement) and the self-employed (who do not satisfy the '10% rule') are not catered for.

The current approach has the following weaknesses:

- It fails to satisfy the Government's objective of maximising the opportunity for people to be Age Pension free;

- It is discriminatory between taxpayers ultimately all of whom will require an adequate level of retirement income; and

- It involves additional and unnecessary administrative complexity for employers (administering the salary sacrifice), individuals (complying with the '10%' rule) and the Australian Taxation Office (enforcing compliance with the '10% rule', enforcing compliance with section 290-170 of *the Income Tax Assessment Act,1997*)

Recommendation

We recommend that in conjunction with their employer (if any) all individuals (irrespective of their employment status) should be able to claim a tax deduction for contributions made up to the concessional caps.

Discussion

The role of Government

There should be no change to the Government's role as a worker's income increases – there are no guarantees that a high income at any time ensures financial security on retirement. Minimum levels of superannuation savings must be continued regardless of income levels.

4 An acceptable retirement income system

4.1 Response to consultation question 3.1 – Retirement income system settings

Do the settings of the retirement income system, such as the level of SG and access to concessions, adequately consider the needs and preferences of individuals both before and after retirement?

Discussion

It is widely held that a 9% SG contribution is not adequate to fund a person's retirement. Despite Treasury modelling suggesting that it is, there exist too many variables over an extended period of time that could result in insufficient incomes in retirement. For example, changes in life expectancies, interruptions to working lives, changes in economic conditions to limit earnings on savings, personal circumstances requiring varying levels of income in retirement, whether a retiree is a home owner, with or without mortgage or renter requiring income to pay rent.

Recommendation

An increase in the level of SG contribution would be appropriate to ensure better coverage for most variables.

An adequate system should provide scope for people to determine their own levels of income in retirement and how much they are willing to forgo now in consumption to ensure that happens. Caps on contributions ensure that superannuation tax concessions are not over utilised by high income earners.

Tax concessions must be applied equitably. As recommended in response to Q2.3 above, tax deductions for superannuation contributions up to the concessional caps should be available to everyone.

Recommendation

If the Government does not consider it appropriate to legislate for tax deductions for personal superannuation contributions, then it should at least mandate that employers allow all employees to make salary sacrifice contributions. This would align them with those who already have access to salary sacrifice and the substantially self-employed who are able to access the full benefit of the concessional contribution caps.

4.2 Response to consultation question 3.2 – Income tax concessions

Is the current level of superannuation income tax concessions appropriate and sustainable into the future? Are the current concessions properly targeted, and if not, how should they be reformed?

Discussion

Inequity exists between the self-employed and employees able to salary sacrifice into superannuation and those who are unable to salary sacrifice. Access to the concessional cap should be available to everyone regardless of their work status or ability to salary sacrifice. The Government should therefore mandate for employers to offer salary sacrifice or, in conjunction with any employer contributions, allow workers to claim a tax deduction for personal contributions into superannuation up to the concessional caps.

5 A robust retirement income system

5.1 Response to consultation question 4.1 – Age for access to benefits

At what age should an individual be able to access their superannuation and at what age should they become eligible for the Age Pension?

Discussion

We consider the current age restrictions to be relevant and appropriate, however they will need to be reviewed regularly in order to ensure they keep pace with changing life expectancies and other demographics.

5.2 Response to consultation question 4.2 – Investment and longevity risk

What is the role of individuals in dealing with investment and longevity risk in accumulating and drawing down their retirement income? Do financial markets provide the means to deal with these risks? If not, is there a role for Government to address these shortcomings?

Discussion

Individuals should have a significant role in the accumulation and management of their retirement savings including addressing investment and longevity risk.

Different people have different risk profiles, which are very subjective in nature and can change over time. An individual is ultimately the only one who can determine what is right for them and they must take responsibility for this. By being pro-active about their superannuation savings instead of accepting "defaults" and investing in line with their risk profile, they can take some control over future savings.

Although the Age Pension acts as a safety net against longevity risk, the Government should take further steps towards ensuring that a greater portion of superannuation fund members take their benefits in the form of a pension.

Possible ways of achieving this could include:

- Retain the tax free status of funds in pension phase;
- Mandated minimum pensions from complying superannuation funds;

- Allow retirees to purchase a Government guaranteed lifetime pension ;
- Limits on tax free lump sum withdrawals (per annum or in total); and
- Lump sum withdrawals to be reported in income tax returns. Whilst no tax would be payable on these amounts, they would be included in determining the marginal tax rate on other income (similar to foreign sourced income)

Currently, financial markets do not have adequate means for dealing with longevity risk.

Recommendation

The Government needs to consider facilitating the development of investment grade products to allow superannuation funds to affordably manage the longevity risk thereby avoiding the Age Pension safety net for those who outlive their life expectancy and run out of superannuation assets.

6 A sustainable retirement income system

6.1 Response to consultation question 6.3 – Financial intermediation

What impact could financial intermediation have on the effectiveness of retirement income policy?

Discussion

Whilst the existence of certain incentives, such as tax effectiveness, and benefits may exist in relation to retirement income policy, the only way retirement savings will prove to be attractive for most people is if they have access to and take advice from qualified advisers who can walk them through the superannuation maze. Advice needs to be available on an ongoing basis as many features of the superannuation system need to be adjusted at least annually. Individual circumstances change and people need to take advice on how this will impact on their developed strategies.

Recommendation

The Government should give consideration to making the cost of financial planning tax deductible to individuals. This would encourage greater utilisation of the services of financial planners.

Appendix 1

First proposed amendment

We propose an amendment to Subdivision 305-B of the ITAA to include the following new Section:

Section 305-85 Lump sums paid into complying superannuation plans from foreign superannuation funds – measurement against non-concessional contribution cap

305-85(1) This section applies if:

(a) any of Section 305-60, Section 305-65 or Section 305-70 applies to a superannuation lump sum that is paid from a foreign superannuation fund;

(b) you are taken to receive the lump sum under Section 307-15;

(c) all of the lump sum is paid into a complying Australian superannuation fund; and

(d) immediately after the lump sum is paid into the complying superannuation fund, your superannuation interest in the foreign superannuation fund ceases.

305-85(2) You may choose for a portion of the lump sum, calculated in accordance with the formula under Section 305-85(3), to be excluded from the definition of a non-concessional contribution under Section 292-90.

305-85(3) The formula for the portion of the lump sum that can be excluded from measurement against the non-concessional contribution cap is:

(a) $\dfrac{\text{Total days of non-residency}}{365.25} \;\text{X}\; \text{Non-concessional contributions cap}$

less

the sum of any non-concessional contributions made to an Australian superannuation fund during the period to which the lump sum relates

where:

total days of non-residency is the number of days during the period to which the lump sum relates, when you were not an Australian resident

non-concessional contributions cap is the amount determined under Section 292-85(2) of the ITAA that is applicable during the year of income during which the last date of non-residency falls.

305-85(4) Your choice:

(a) must be in writing; and

(b) must comply with the requirements (if any) specified in the regulations.

Second proposed amendment

We propose the inclusion of a new line under item (c) of Section 292-90(2) of the ITAA, as follows:

(c) it is *not* any of the following:

…

(vii) the portion of a lump sum transfer from a foreign superannuation fund allowed for under Section 305-85.

Example

To illustrate this approach and calculation, we provide the following example:

A member commenced employment in the United Kingdom on 01/07/2000 and moved to Australia on 01/07/2007. Prior to moving to Australia, the member opened a complying superannuation fund in Australia and made an initial contribution of $200,000.

On 31/12/2007, the member's UK Pension of $AU1,000,000 was transferred to their complying superannuation fund in Australia. The amount of this contribution that would not be measured against the member's non-concessional contribution cap would be calculated as follows:

$$\frac{(2739 - 183)}{365.25} \quad \text{X} \quad \$\,150{,}000 \quad - \quad \$\,200{,}000$$

= $ 849,692

This would result in $150,308 [$1,000,000 – $849,692] of the member's transfer being measured against the non-concessional contribution cap.