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Superannuation Taxation: less equitable, less
functional

Gordon MacKenzie*

*University of New South Wales

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Abstract

Taxation of superannuation is one of the most complex areas of taxation law largely because the Australian system has had three points at which tax was payable. These were when contributions were made to a superannuation fund, on the income of the fund itself and, finally, when a benefit was paid. The changes made to taxation of superannuation, which commenced on 1 July 2007, are a boon to those over 60 years old, but unless your marginal tax rate is greater than 15 per cent they do not make superannuation any more attractive as a savings vehicle. In addition, the changes have less obvious effects, including that employer sourced termination payments are now taxed separately from taxation of superannuation payments; and the rules that prevented individuals from overusing the favourable taxation of superannuation have been removed and replaced by limits on amounts that can be contributed to a superannuation fund. This paper will consider these, and other, changes to the system.

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Introduction

The changes made to taxation of superannuation, which commenced on 1 July 2007, are a boon to those over 60 years old, but unless your marginal tax rate is greater than 15 per cent they do not make superannuation any more attractive as a savings vehicle.

In addition, the changes have less obvious effects:

- First, the changes diverge from the basic design principle underlying taxation of superannuation, which is that tax concessions are given for saving for retirement on the basis that the funds are only available at retirement and are used to replace work income during retirement. The changes break the connection between tax concessions for saving and use of those savings for income during retirement.
- Second, the rules that prevented individuals from overusing the favourable taxation of superannuation have been removed and replaced by limits on amounts that can be contributed to a superannuation fund. It is arguable that the contribution limits will provide the same equity function of the rules that they are replacing. Also, removal of those rules will leave individuals potentially exposed to two financial risks, that is, investment and longevity.
- Finally, employer sourced termination payments are now taxed separately from taxation of superannuation payments. While it is reasonable that they should be taxed separately, the tax is harsh and alternatives have been suggested.

The changes, in brief¹

Taxation of superannuation is one of the most complex areas of taxation law largely because the Australian system has had three points at which tax was payable. These were when contributions were made to a superannuation fund, on the income of the fund itself and, finally, when a benefit was paid.²

Contributions were taxed at 15 per cent, the fund income at 15 per cent and lump sum benefit payments at either 0 per cent up to \$140,000 or 15 per cent up to \$600,000 and at the highest marginal tax rate for amounts above that. As a benefit from a superannuation fund is the total of the contributions made to the fund plus earnings on the fund on those contributions and each of these is already taxed at 15 per cent, the additional tax on benefits of 0 per cent and 15 per cent meant that the *aggregate* tax on a lump sum was 15 per cent or 30 per cent, depending on the amount. A benefit paid as a pension was taxed at the individual's marginal tax rate but with a rebate of tax at 15 per cent to compensate for the 15 per cent paid on the contributions and income of the fund. In other words, the net tax on a pension was the individual's marginal tax rate.

Within that context, the most significant change made to superannuation taxation is the abolition of tax on benefit payments for individuals from age 60.³ For that cohort, this reduces the aggregate rate of tax on their lump sum benefit to a flat 15 per cent, from the previous nominal rates of 15 per cent and 30 per cent, depending on the amount.⁴ For pension recipients from age 60, the aggregate tax rate is now 15 per cent, which is the tax paid on contributions and earnings in the fund, as there is no further tax paid on a pension benefit.⁵ The taxation of benefits, both lump sum and pensions, for individuals below age 60 has been simplified but largely remains unchanged.^{6 7}

In terms of contributions, the maximum deductible contribution that can be made to a superannuation fund is now limited to \$50,000 per annum (indexed in \$5000 increments) regardless of the age of the individual or their work status (employee or self-employed); amounts in excess of that are taxed at the highest marginal tax rate. Post tax contributions (that is, non-deducted) made to a superannuation fund are now limited to \$150,000 per annum or three times that amount over any three year period if under age 65.⁸

The rules that limited the amount that could be taken from a superannuation fund before penalty tax applied (called the Reasonable Benefit Limits [RBL] rules) have been removed.⁹ These rules performed several functions in superannuation taxation and one of those was to prevent excess

funding in the low tax environment of superannuation funds. Broadly, these rules have been replaced by the limits on contributions previously mentioned above.

The requirement that superannuation funds pay benefits at a certain age and based on work status have been removed such that accumulations can now be retained in a superannuation fund until death.

Another significant change is that payments from an employer are taxed separately to payments made from a superannuation fund. Employer sourced termination payments are now taxed at 15 per cent up to \$140,000 if received from age 55 and 30 per cent if received below that age. Payments in excess of these amounts are taxed at the top marginal tax rate per employment termination. Exemptions apply for payments related to disablement or that can be traced to before 1 July 1983.

Making superannuation equitable

Within the context of those complex rules, the actual tax benefits of superannuation as a saving vehicle are opaque and difficult to appreciate for the casual observer.

However, under the system immediately before the changes and, indeed, for anyone taking a benefit below age 60 after the changes, one tax benefit is the reduced tax rates on lump sums (15 per cent and 30 per cent). For a pension, the tax benefit of a reduced rate is less certain as pensions are taxed at the individual's marginal tax rate with a rebate of the taxes paid on contributions and on the earnings of the fund. In this case the tax benefit is based on the expectation that the individual's marginal tax rate will be less when being paid as a pension, than it was when contributed.

A second tax benefit is deferral of some of the tax until the benefit is paid. Until the late 1980s taxes on superannuation were only paid on benefits. That is, there were no taxes when contributing, nor on the earnings of the fund, thus maximising the deferral benefit. That changed when some of the tax that otherwise was paid on a benefit was brought forward and paid on contributions and earnings. Of course, advancing part of the tax on benefits reduced the benefit of deferral, but there is still deferral of some of the taxes.

In any case the aggregate tax on both lump sum and pension benefits for those aged 60 and over is now 15 per cent.

Clearly, under this system if the individual's marginal tax rate is around 15 per cent then they get no advantage from the changes at all. This is even more so if one takes into account the cost of locking away the funds until at least age 55. On the other hand, individuals who pay tax at the highest marginal tax rate now get the benefit of saving at a net tax rate of 15 per cent.

There is an ongoing debate about whether, if at all, tax concessions increase savings or just cause money to be moved from other forms of saving to those that are taxed concessionally. As part of that debate, it is argued that giving tax concessions to encourage saving is inequitable, as only those individuals with disposable income to save will use the tax concessions. Therefore, the cost of those tax concessions is borne by everyone through reduced government revenue, whereas the benefits go only to the wealthy with funds to spare.

One solution to the inequity in the new system for those with marginal tax rates around 15 per cent is to exempt them from the 15 per cent tax on contributions. However, that would be difficult to administer simply because superannuation funds do not know the marginal tax rates of contributors. It is also doubtful that individuals on marginal tax rates around 15 per cent would have more disposable income with which to contribute to a superannuation fund.

A better suggestion could be for the government to increase the rate of co-contribution for low-income earners by the amount of revenue that it would otherwise have foregone had it removed the 15 per cent tax on contributions for those whose marginal tax rate is around 15 per cent. Briefly, the co-contribution is where the government contributes 150 per cent of contributions that individuals make to their superannuation. There are maximum income levels with tapering and, also, a maximum amount of contributions. This system, which has been in place for several years, has been very well received. It replaced a tax rebate for low income earners contributing to superannuation and has been better at increasing superannuation than that rebate system, where the savings from the rebate could be used for consumption and did not have to be contributed to

superannuation. Indeed, part of the original debate on introduction of the co-contribution system was that the individuals to whom it was targeted simply would not have had the disposable income with which to contribute in order to get the government's co-contribution. That appears not to have been proven correct, given the uptake of this system.

Savings used for retirement?

One reason for tax concessions for retirement saving is that they will be used to replace work income during retirement, thereby relieving government from some of the social security costs associated with an ageing population. Yet, one of the effects of these changes is that there is now no connection between the tax concessions for saving in a superannuation fund and the use of those savings during retirement. Australia had been unique among countries with similar retirement schemes in continuing to allow individuals to take all their superannuation fund accumulations in the form of a lump sum rather than as a pension. Lump sum payments can be exhausted shortly after retirement leaving individuals to revert to social security. Also, pensions offer better integration of the tax concessions for saving with the social security system and ensuring that accumulations are used to fund retirement.

There had been several initiatives to have individuals take their superannuation fund accumulation as a pension rather than as a lump sum benefit, the most important of which was the RBL rules.¹⁰ These rules had three effects.

Bias favouring pensions

First, the RBL rules inserted a bias in favour of pensions over lump sum in the form of tax incentives. They did not go so far as to prohibit payment of lump sums. Instead they offered greater tax benefits if the accumulation was paid as a pension, being the ability to accumulate twice the amount in a superannuation fund at preferential rates if at least half the amount was used to acquire a pension.

To get that tax benefit the accumulation at retirement must have been converted into a specific type of income stream contractually payable over either expected life during retirement or until death.¹¹ The expectation in these rules was that the accumulation at retirement would be exhausted over a period from when the individual retired until they died, thus linking the tax concessions for saving with use of the funds during their retirement. By removing this bias favouring pension benefits, the previous attempt at directing individuals from taking lump sums and into pensions through tax incentives has been abandoned.¹²

Removal of the tax bias together with removal of the compulsory payment rules, whereby superannuation funds were required to pay benefits after a certain age depending on work status, also means that the accumulation can remain in the superannuation fund until death, potentially defeating the reason for the tax concessions given for saving in the first place.¹³

Abandoning the tax preferences favouring pensions over lump sum payments and allowing retention until death must be seen as retrograde steps in terms of moving the Australian system to the more functional payment of pensions, rather than lump sum.

Capping maximum tax concessions

Secondly, as mentioned, the RBL rules capped the maximum amount that could be paid to an individual from a tax preferred superannuation fund to an amount considered adequate to provide a reasonable income in retirement. Amounts in excess of that were taxed at the highest marginal tax rate. The maximum amount that could be paid under the RBL rules was tied to multiples of AWOTE,¹⁴ which meant that there was equity between the wealthy and less wealthy by linking the aggregate tax preferred amount that could be taken from a superannuation fund to a common index. In that regard, the rules performed an equity function by limiting the tax concessions from superannuation measured against a standard index.

That function of the RBL rules has now been replaced by limits on the amount of contributions that can be made to a superannuation fund. However, will those contribution limits fulfil the same equity function that the RBL rules did? Probably not, simply because they are not tied to any income index and, also, they are a fixed limit, regardless of the age of the individual.

Investment and longevity risks

Finally, the RBL rules favouring pension benefits payable until death had a secondary effect of protecting individuals against two financial risks: selecting inappropriate investments in the superannuation fund (the investment risk); and, the risk of outliving the accumulation in the fund (the longevity risk).

The investment risk is reasonably well understood. Yet, with increasing life expectancy, the historically accepted investment paradigm, of conservative investments just before and during retirement because of the inability to cover losses, is losing relevance. Life expectancy at age sixty-five is now between eighteen to twenty two years, and selecting investments based on that time horizon is completely different from selecting those appropriate to a life expectancy at retirement of less than ten years.

However, the longevity risk, which is the risk of outliving the funds, is yet to be fully appreciated by most retirees, even more so in the context of that increasing life expectancy. A better understanding of how retirement accumulations are used during retirement is now emerging, and shows that the largest expenditure during retirement is usually in the last stage of life, when medical and accommodation (nursing home) expenses are greatest. Putting the increasing life expectancy together with the better understanding of the pattern of use of the accumulations during retirement makes the choice of investments to manage that risk even more difficult for inexperienced investors.

The previous bias for pensions protected against these risks, as the tax benefit favoured the type of pension that was payable for a period related to the person's actual or expected lifetime. These types of pensions were usually sold by prudentially regulated financial institutions, such as life companies.¹⁵ Of course, the estate received nothing when the pensioner died. Indeed, that aspect made these pensions unattractive to those who wanted to leave something for the next generation. But they protected people against the investment and longevity risks because of the ability of the financial institution to pool those risks.¹⁶ Individuals approaching retirement will now need to quickly develop an appreciation of these risks, and the ability to manage them.

Employer termination payments taxed more severely

Employer sourced termination payments are now taxed differently from payments from a superannuation fund. This is quite a break from tradition in that payments from both these sources had, until now, always been taxed equivalently, including the rates and thresholds. Employer sourced termination payments, which are generally defined as lump sum payments paid directly by an employer on termination of employment, are taxed more severely than they were and, indeed, more severely than payments from a taxed superannuation fund. The taxable part of these payments, which is the balance of the payment after excluding certain exempt amounts, is taxed at 15 per cent for amounts up to \$140,000 (indexed) for recipients aged 55 and over and at 30 per cent for recipients aged under 55. Amounts in excess of \$140,000 are taxed at the top marginal rate.¹⁷

The severity of these changes is best understood by a comparison with past practice. If an employer sourced termination payment is made after age 55 but before age 60 the rate of tax on the amount up to \$140,000 would be equivalent to that had it been paid from a superannuation fund. However, the excess above that amount is taxed at the highest marginal tax rate rather than at 30 per cent, which would have been the rate had these payments continued to be taxed comparably with payments from a superannuation fund. Where the payment is made after age 60, the extent of the increase in tax is more obvious when compared with equivalent amounts paid from a taxed superannuation fund, as the excess over \$140,000 is taxed at the highest marginal tax rate. Had it been paid from a taxed superannuation fund the whole amount would have been tax free.

These payments don't fund retirement

The reason given for these particular changes is the removal of the RBL rules, as those rules also applied to employer sourced termination payments. Indeed, there is some validity to this, because RBLs prevented excess funding in superannuation and excess payments from employers; now that function is fulfilled by the contribution limit, which is an effective mechanism in a pre funded superannuation environment, but not for employer sourced termination payments.¹⁸

The practice of employers paying lump sums to long serving employees is disappearing in any

case, as the majority of working individuals are entitled to superannuation benefits. But is that the only reason for the tax changes being made? The detailed explanation of the changes gives a hint about what is possibly the real reason for this dramatic change, when it identifies the types of payments as, essentially, deferred remuneration.¹⁹

Certainly there is no requirement that any of these types of payments be used to replace income during retirement and, indeed, they are not quarantined until a certain age of the individual, as is the case for contributions to superannuation funds. So arguably, it is correct that these types of payment are best described as either deferred remuneration or a reward for long service. On that view, they should also not be entitled to the same taxation treatment as payments from superannuation fund because they simply do not serve the same purpose as accumulations in a superannuation fund, which is to provide income in retirement.

Age 55 not relevant to these payments

Nevertheless, it is not clear why these payments have a different tax rate, based on the age at receipt by the individual, whether before or from age fifty-five. That age is relevant to retirement income funding, as it is the age after which accumulations in a superannuation fund can be released. Now that there is no integration of the taxation of payments made from a superannuation fund and those from an employer on termination, the relevance of this age based rate change is questionable.

In any case, the rates of tax that are to apply to the excess over \$140,000 are regressive, because they are fixed at the top marginal tax rate. To use an example, say a person is paid \$165,000 as an employer sourced lump sum termination payment. In that case she/he would have to pay the highest marginal tax rate on the excess above \$140,000 even if they have no other income in that year. Had they received the excess of \$25,000 as employment income, the tax applying would likely have been minimal and unlikely to be at the highest marginal tax rate.²⁰

It would be fairer if any excess above \$140,000 was simply assessed as normal income. Indeed, that would be a more consistent treatment with the apparent view being taken in the government announcements, that the majority of these types of payments are just deferred remuneration.

Alternative tax basis

Assuming that employer sourced payments are not being taxed more severely just because they are deferred remuneration, arguably parity in taxation between employer sourced termination payments and payments from a superannuation fund could be achieved in number of alternative ways, even though RBLs are removed. For instance, taxation of employer sourced payments could have mirrored that for payments made to an individual between age 55 to age 59, which is taxed at 15 per cent on the first \$140,000 and 30 per cent thereafter. Or it could have been achieved through equivalence with the taxation of payments made from a taxed superannuation fund to a taxpayer under age 55, which is a flat 30 per cent.

Nevertheless, there is a minor advantage in the lack of integration between employer sourced and taxed superannuation fund payments, in that a taxpayer is entitled to two low rate thresholds if receiving a lump sum amount under age 60 from both these sources. Otherwise there is little to support this aspect of the changes.

Conclusion

In summary:

- The changes made to the taxation of superannuation from 1 July 2007 is of benefit mostly to individuals over age 60 who are able to take superannuation payments tax free. For individuals below age 60 the changes have less significant effect, but there is some simplification of the previous rules.
- Employer sourced termination payments are to be taxed more severely than at present and are not now integrated with taxation of payments from superannuation funds.
- Removal of RBLs and the compulsory payment rules will mean that funds can be retained until death.
- The complexity of the taxation rules makes it difficult to see the actual tax benefits of superannuation, but to the informed person they are a low rate of tax; and, deferral of some of

the tax until payment.

- Under the previous system tax was payable at three points: on contribution, on earnings of the fund and when the benefit was paid. Now benefit taxes have been abolished from age 60, the net tax for that cohort is 15 per cent, being only on contributions and on earnings of the fund.
- This means that superannuation is not an effective savings vehicle for anyone whose marginal tax rate is around 15 per cent. It could be made more equitable by increasing the amount of government co-contribution with an amount equivalent to the tax on contributions, instead of foregoing the tax of 15 per cent on contributions for individuals with that marginal tax rate.
- The role fulfilled by RBLs in limiting the over funding of superannuation is now replicated by the limitations placed on contributions. But to the extent that the RBL rules favoured pension benefits over lump sums, and that pensions are a better form of payment for ensuring that the accumulation in a superannuation fund at retirement is used to replace income during retirement, the connection between tax concessions for saving for use during retirement is reduced by abolition of RBLs.
- To the extent that the RBL rules introduced equity between wealthy and less wealthy individuals by capping the maximum tax preferred payments by reference to an income index, this will not be replicated in the limitation of contribution rules, which are replacing the RBLs.
- In that the RBL rules biased pensions over lump sums, those pensions protected individuals from investment and longevity risk, which were borne by the financial institutions that assumed those risks. Individuals will now need to understand and manage those risks themselves.
- The increased and separate taxation of employer sourced termination benefits are explained as a result of abolition of RBLs and, indeed, that is a plausible explanation. The Detailed Outline describes these types of payments in terms of deferred remuneration, which is probably correct. (Employers generally no longer reward long service; they use these payments as a form of deferred remuneration). From that perspective, they should not be taxed similarly to superannuation. However, the taxation of these types of payments in the future does appear harsh, in that it is fixed at the highest marginal tax rate. A fairer basis would be to include the excess over the low rate threshold as normal assessable income. That would be consistent with the way that these types of payments have been defined and also introduce progressivity into the rates.

Overall then, these changes make superannuation, as a means of saving for retirement, more attractive to high marginal tax rate payers over age 60 individuals whose marginal tax rate is around 15 per cent are indifferent. In that regard, they are simply less equitable.

In terms of the underlying reason for giving tax concessions for superannuation, which is that the accumulated funds will be used for retirement, these changes simply make superannuation less functional.

Gordon Mackenzie is a researcher and teacher in the Australian School of Taxation (ATAX), Faculty of Law, in the University of New South Wales, where he specialises in superannuation taxation, as well as funds management taxation in general. He is looking forward to celebrating his thirtieth year in superannuation, next year.

¹ Commonwealth of Australia (2006). Detailed Outline. May 2006 and Final Decisions (referred to as *Outcomes of Consultation*). <http://simplersuper.treasury.gov.au/documents/>.

² This discussion is restricted to taxed superannuation funds, which make up ninety per cent of superannuation funds in Australia. The remaining ten per cent are called 'untaxed' funds; largely government superannuation funds.

³ *Outcomes of Consultation op cit: 12.*
⁴ *Ibid.*
⁵ *Ibid.*
⁶ *Ibid: 13.*
⁷ *Ibid.*
⁸ Post tax contributions are contributions in respect of which no tax deduction has been claimed. See Detailed Outline in *Outcomes of Consultation op cit: 30*, Para 4.5. Indeed that terminology is a misnomer as, for example, the proceeds of the disposal of a residence that is tax free can be contributed.
⁹ *Outcomes of Consultation op cit: 12.*
¹⁰ Previously, maximum superannuation benefits had been formula based, related to the Highest Average Salary of the individual.
¹¹ Regs 1.05 and 1.06 SIS Regulations.
¹² The only incentive now for individuals to take a pension during retirement is that the superannuation fund is zero taxed if the minimum pension payments are made. However, the benefit payments that must be made from superannuation fund for it to be treated as paying a pension and, consequently, entitled to zero tax on its earnings, are minimal. For example, a superannuation fund need only pay four percent of the individual's accumulation between ages sixty five and seventy for it to get zero tax on its earnings and even then, there is no restriction on the fund paying a lump sum benefit at any time.
¹³ 'These changes would mean that a person would be able to keep their benefits in their superannuation fund indefinitely...' See Detailed Outline: 20.
¹⁴ Average Weekly Ordinary Time Earnings.
¹⁵ Of course, the superannuation fund could fund the pension itself without buying one from a life company, but that would only be the case if it were sufficiently large.
¹⁶ As a result of the removal of this bias in the tax rules, the market for these types of pensions has collapsed. There are only four providers remaining in Australia. On the positive side though, some financial institutions are starting to offer deferred type pensions that only commence payment much later in life, which can be used to mitigate these two risks.
¹⁷ *Outcomes of Consultation op cit: 17.* These arrangements will apply per termination and any payment must be made within one year of termination.
¹⁸ Perhaps too, the increase of taxation on these amounts is being driven by the excessive payments made by large corporates.
¹⁹ That defined these payments in terms of unused rostered days off, amounts in lieu of notice, a gratuity or 'golden handshake', an employee's invalidity, *bona fide* redundancy or approved early retirement schemes in excess of the tax free amounts and certain payments on death of an employee.
²⁰ Having no reportable income in a year means that this is a likely scenario as payments from a superannuation fund after age 60 are not reportable.