Association of Independent Retirees (A.I.R.) Ltd

Proposal to Restructure the Retirement Income Drawdown system for Retirees

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There is an urgent need to review and change the system for the regulation and taxation of individuals' assets and incomes after retirement.

The existing system is inequitable, hamstrung with regulations, very expensive for retirees, and inefficient.

This is particularly disappointing because Australia has one of the best superannuation systems in the world for the accumulation of retirement savings combining a carrot in the form of tax reductions for contributions and a stick in that the savings are compulsory for employees and inaccessible until retirement. However, one criticism that can be leveled is that it has proved to be costly as the management of the accumulating funds has been put in the hands of independently run superannuation funds, which must cover costs, will inevitably attract rent seekers, and involves some investment risks.

Unfortunately when this system was devised much less thought went into how retirees would be able efficiently to use these accumulated savings when they become available upon retirement. Each individual retiree has different and unique needs to manage as they age. They need simple and flexible financial systems and employment opportunities. They do not need welfare type regulation and control.

The result is a highly complex regulatory system for people to manage their superannuation in the retirement phase. They do have the option to take funds as a lump sum, tax exempt in the year in which it is withdrawn. However, the deterrent is that all earnings in future years are taxed at full marginal tax rates. Superannuation trusts effectively have control of retirees' superannuation assets and are able to charge fees for the privilege of managing them.

The level of complexity is continuing to increase. As the proportion of fund members who retire increases, the system will become increasingly unworkable.

A new structure for management of retirement assets during retirement is proposed:

a) upon retirement accumulated superannuation funds become the responsibility of the retiree, who may choose how to best manage these including maintaining them in retirement products provided by their superannuation trust,

b) an appropriate personal tax-free threshold is set by the Government to recognise the tax exempt component, and

c) personal tax is paid at full marginal tax rates on taxable income above the tax-free threshold value.

A tax-free threshold applying to all individuals over a prescribed retirement age would:

- Provide equity for all retirees over the tax-free threshold regardless of the way in which their retirement funds were accumulated;
- Dramatically simplify an individual retiree's retirement fund management, and remove all regulatory control;
- Provide equal taxation benefit for all retirees with incomes greater than the tax-free threshold regardless of their income and assets and whether they have accumulated some funds in superannuation or not;
- Provide a more balanced investment savings model for the Australian economy, maintaining and increasing investment in innovation and small business, by reducing the incentive to place all savings in superannuation with its overemphasis on investment in public corporations and high-value property.
- Act as an incentive for retirees under the tax-free threshold to undertake paid work as income would be tax free up to the tax-free threshold;
- In terms of the benefits gained, cost to Government is realistic and declining over time (in contrast to the existing system) at a reasonable value of the tax-free threshold consistent with the tax exemption available to the majority of people who accumulated their assets in superannuation under the existing structure;
- Allow Government to manage the extent of its retirement income support as the amount of retirement funds increases with time;
- Bring a deceased person's estate taxation into line with the personal tax system;
- Remove the need for a superannuation structure of public superannuation funds and SMSFs in the retirement phase and its costly and complex regulatory and administrative systems;
- Remove the existing cost of administration of superannuation funds in the retirement phase, adding this saving to each individual's retirement assets thus reducing future age pension liabilities;
- Create incentive for financial institutions including public superannuation funds to develop competitive and innovative retirement income products.

1. Introduction

Superannuation has become one of the important ways for people to accrue assets during working life to sustain them during retirement. Compulsory superannuation through the Superannuation Scheme (SG) extended superannuation to employees in the private sector. Another very important way is through personal savings initiative outside superannuation.

The SG scheme is widely held to be one of the best systems globally for accumulating individuals' retirement savings. Government has stated that superannuation is its preferred form of saving for retirement.

Employees are able to contribute earnings above the compulsory amount (presently 9% but rising to 12% of salary). Contributions from after-tax earnings may also be made, including on behalf of a spouse. These are subject to regulated caps that include age restrictions, adding complexity to regulations. Caps and regulatory restrictions are a crude method for achieving Government objectives for managing superannuation contributions and Government concessions.

Over one million of the 11.4 million workforce are excluded from the compulsory component of the SG system in industry sectors outside the traditional employer/employee relationship, such as SME owners, farmers, sole traders, and consultants[i]. Whilst the SG system allows non-employees to accumulate assets in superannuation, this is inappropriate for many in these sectors because they initially have low free cash flow relying heavily on early building of assets needed for the business, the asset becoming available to support retirement income later in life. Contributions to a superannuation fund from this group are also subject to the same caps as for employees.

A large group of retirees were excluded from superannuation during their working life. One important example is the large number of women in the public services, education, and health, and in private service sectors such as banking, who were forced to retire on marriage. Superannuation was not available to many men and women employees; the reason for introduction of the SG. Retired women, totally dependent on the superannuation income from their spouse during retirement, suffer serious discrimination on the death of their spouse because of the work rules in superannuation. Many in this group cannot make contributions because of work and age restrictions and because of the taxation consequences of selling and transferring assets into a superannuation fund.

Government superannuation policy is to tax accumulation of funds, but not to tax earnings from accumulated funds used to provide retirement income — a commendable and equitable structure. *Tax exemption on drawdown of retirement pensions is not a concession but an integral part of the policy of taxation of savings for retirement generally.* Pensions from untaxed funds accumulated in superannuation are taxed, directly reflecting this policy. The policy creates a fundamental difference between the accumulation phase and the drawdown phase of superannuation.

People who do not have access to superannuation, or have already retired without superannuation, are seriously discriminated against because the policy of non-taxing income from funds accumulated for retirement presently applies only to those with superannuation. It should not be restricted to superannuation but available equally to those who have voluntarily built their retirement savings while paying full marginal tax rates. All people should have equal right to application of the policy.

Retention of accumulated superannuation funds into a drawdown phase of superannuation permits the Government to regulate the conditions and amounts that can attract the tax exemption. It provides a mechanism for controlling tax revenue and tax revenue foregone as a consequence of superannuation policy. However, complex regulations have had to be developed, including the definition of a pension as the tax-exempt vehicle and the conditions applying to it. The use of superannuation as a vehicle for control has been demonstrated to be crude and unable to meet defined objectives. Complexity and difficulty of the regulations is demonstrated by the fact that the definition of when a pension is deemed to commence and when it ceases is still not resolved after four years of Simpler Super operation.

Growth of regulation as the SG system matures is expressed as a concern in the Retirement Income Report of the Henry Tax Review, where the need for a simple and approachable system is stressed[ii].

While the objective of the SG is to require people to accumulate funds for their retirement, nevertheless the regulations allow people who have retired to make further contributions. Regulations match those applying to the accumulation phase but contain additional age and work barriers. Compulsion to add contributions to superannuation as an employee is removed except where it is required under an industrial award. Concessions that have been applied to the accumulation phase because of the compulsory nature of that phase continue in the drawdown phase. Complexity of regulations is increased and consistency of policy is not apparent.

Extending, but modifying, the accumulation regulations into the drawdown phase of superannuation has created unacceptable complexity, confusion and cost of administration. Inclusion of the tax exemption component on drawdown of pensions has created an environment of increasing complexity, confusion, non-compliance, and high cost of administration. Without major change, the system will fail under its own weight.

The existing regulatory structure for the retirement phase of superannuation includes all the complex regulations that exist in the accumulation plus many additional complex regulations. Retirement phase regulation can be summed up as:

a) Retention of all compliance regulations applying to the accumulation phase;

b) Removal of the need for compulsory SG contributions other than under awards – the latter often an impediment to undertaking additional work;

c) Extension of the ‘concessional’ 15% tax treatment of contributions – the 15% tax ‘concession’ is often not a concession but an imposition for retirees who do not earn sufficient to pay tax;

d) Further restrictions on the ability to make additional contributions to those applying in the accumulation phase – age and work related barriers are inequitable and confusing;

e) Tax exemption of earnings from assets in a superannuation fund used to provide a pension – requiring complex restrictions and definitions of a pension and its application;

f) Compulsory drawdown of minimum age-related pension amounts aimed at reducing Government liability for tax exemption during drawdown — unable to be applied consistently and unable to meet its objective because retirees can retain assets in the fund indefinitely.

g) Exclusion of retirees without superannuation from the tax exemption.

The SG system, commenced in 1992, does not reach maturity until 2037 based on a 35 year working life[iii]. However, after twenty years of operation the number of people retiring with superannuation is now increasing rapidly and will continue to do so until that date.

Development of the superannuation system since 1992, and experience gained, has identified the issues raised above. The sheer size of accumulated assets, the growth of the superannuation industry, continued need for new and revised regulations, and increase in the number of superannuants retiring, highlights the need for a review of the appropriate regulatory structure for use of funds in retirement.

The personal taxation structure applying to working people cannot apply to retirees. Most retirees have little choice but to gain most of their retirement income from investment of their accumulated assets and run-down of those assets. They have to balance depletion of the assets against their retirement income needs. The majority of retirees do not have sufficient assets to last across their expected life span and in due course become dependent on the age pension.

Inadequate retirement assets, and need for a fulfilling retirement, are encouraging retirees to consider full or part time work. They are encouraged to do so by Government as a means of reducing skill shortages and reducing the need for age-pension support. The nature of work and the needs of individuals in retirement is changing and blurring the once sharp separation between working life and retirement. Government is increasingly looking at policies to encourage retirees to work and to remove impediments to mature age working. These changes are often in direct conflict with the regulations, which limit and try to control flexibility.

Because of the sheer size of assets accumulated through compulsory superannuation, management of which has been delegated to the private sector superannuation industry, Government has taken an active role in regulating the accumulation component of the industry. The same degree of interest has not been shown, either by Government or by the superannuation industry, in the utilisation of accumulated assets after retirement. It has been assumed that the drawdown phase is a simple extension of the accumulation phase. Nothing is further from the truth.

Superannuation as a vehicle for control of tax revenue from building and using retirement assets neglects other significant costs. Government preference for using superannuation as the preferred vehicle for retirement savings ignores the reality of the Australian economy. This paper demonstrates that the cost of extending the present tax exemption limits on drawdown of funds for retirement use to all retirees is matched by revenue from a more equitable and simpler structure based on the existing personal tax system. Costs arising from an unnecessary and duplicative retirement superannuation system reduce funds available for retirees who ultimately need to be supported by Government in welfare payments. The overall financial balances of the present system need to be examined in the suggested review.

Experience being gained with the existing structure of superannuation during retirement is raising serious questions about the relevance of existing regulations in matching and supporting the needs of individuals in utilising and husbanding their resources during their retirement. The significant proportion of retirees without superannuation is being heavily penalised. There are clearly better ways of providing incentive for retirees to use their savings wisely.

The whole structure of the use of savings in retirement needs to be reviewed.

2. Proposal

2.1 Proposed Structure

A new structure for management of retirement assets during retirement is proposed:

a) upon retirement accumulated superannuation funds become the responsibility of the respective retiree, who may choose how to best manage these including maintaining them in retirement products provided by their superannuation trust,

b) an appropriate personal tax-free threshold is set by the Government for all retirees to provide for the tax exempt component, and

c) personal tax is paid at full marginal tax rates by all retirees on taxable income above the tax-free threshold value.

The proposal retains the public superannuation sector and the SMSF Sector for the accumulation phase of superannuation. Taxation concessions on earnings and contributions are significant in this phase in recognition of restrictions on access and in providing incentive for contributing.

Responsibility for managing funds is transferred to individual members when they retire — defined in the proposal as reaching the prescribed age-pension age (presently 65). Accumulated funds in superannuation become the property of the retiree tax free at that time.

There is no need for any formal legal and/or regulatory structure for managing the assets of any retired person. All regulations, including those relating to minimum drawdown requirements, age and work barriers and contribution caps, pension restrictions, and superannuation estate tax, become redundant.

There is nothing to stop a retired person/s from setting up any Trust or similar formal structure if they so choose for management of their retirement funds.

There is nothing to stop retired individuals retaining some or all of their accumulated superannuation savings with their superannuation fund by transferring them into retirement investment products provided by the fund, such as the equivalent of the existing account-based pension; they may also choose to add private funds if they see advantage. Equally, there is nothing to stop them investing some or all of their accumulated superannuation funds with other financial organisations providing a more appropriate or more competitive retirement investment product or products.

Retirement investment products in the competitive financial management climate that will arise from the proposal will lead to many different forms of retirement investment products to meet the needs of retirees. These are likely to include pensions, annuities, and products that allow accumulation of earnings and/or additional contributions. Retirement investment products will be subject to meeting legislative and prudential requirements to protect retirees' assets.

The proposed retirement income structure removes the complexity associated with superannuation pensions and the various tax rebates currently available to retirees. Most retirees would not need to lodge tax returns, because they would not have earnings above the tax-free threshold, consequently removing administrative costs both to government and also to retirees. Those retirees with very large retirement incomes would pay their fair share of tax. Discrimination would be removed from those who have been excluded from superannuation.

A comparison of the existing structure and the proposed structure is summarised in Table 1

Table 1 Comparison of existing structure with Proposed Structure for Taxed Funds

1. **Accumulation Phase – <u>Unaffected by Proposed Structure for the Drawdown Phase</u>**

Issue	Taxed Fund
Employee/Employer compulsory contributions	Taxed at 15%
Salary sacrifice contributions	Taxed at 15%
After-tax contributions	Permitted – not taxed
Earnings in the Fund	Taxed at 15%

2. **Drawdown Phase - Comparison of existing structure of Taxed Funds with Proposed Structure for Taxed Funds**

Issue	Existing Structure Taxed Funds	Proposed Structure Taxed Funds
Structure	Pensions and earnings supporting pensions tax free. High degree of regulation.	Funds accumulated in superannuation passed to owner at prescribed age-pension age. No regulation.
Pensions	Tax free - Exempt from inclusion in personal taxable income.	Retirement investment product pensions and annuities included in personal taxable income. Tax payable reduced by a prescribed tax-free threshold.
Earnings on assets supporting retirement investment product pensions	Tax free except on death. Estate passed to beneficiaries can be subject to tax.	Included in taxable income and subject to personal tax provisions for annuities and death.
Lump sum withdrawals	Tax free.	All accumulated super funds passed to owner tax free at prescribed age-pension age.
Compulsory & salary sacrifice contributions after retirement	Amount Capped – taxed at 15%.	Unnecessary - prohibited in industrial awards.
After-tax contributions	Capped.	Unnecessary – may be added to some retirement investment products.
Regulation	Highly regulated with onerous, complex regulations and high penalties covering pension restrictions, minimum withdrawal amounts, contribution caps, and special estate taxation requirements.	Prudential regulation of retirement investment product providers.
Administrative Costs	High	Minimal

2.2 Transition Arrangements

Significant changes have occurred in superannuation affecting decision-making by retirees in best managing their financial affairs. With the introduction of Simpler Super in 2007, people were permitted to transfer up to $1million into super as a one-off provision. There were significant capital gains tax effects for many people who adopted this provision. Since then there have been changes in the level of caps affecting decisions as to the extent of voluntary contributions. Transfer of assets to the personal tax system on retirement as proposed in this submission will also have significant effects on decision-making with respect to capital-gains tax.

Transition arrangements will need to be considered if this proposal, or a variation of it, is adopted. A five-year transitional period is proposed.

3. Financial Impact

3.1 – Tax free Threshold Value

Government policy is for superannuation pensions built on taxed accumulation funds to be tax free. Clearly, this policy cannot be open-ended. A deficiency of the existing superannuation structure is that the tax-free component is controlled by regulating member input; the accumulation fund cap is crudely set through a range of caps on annual contributions favouring high-wealth individuals, and this is continued into the retirement phase. A simpler and more equitable system would transfer control of the tax-free component to the existing personal tax system using a common tax-free threshold for all retirees.

The proposed structure allows the Government to set a reasonable tax-free threshold in the personal tax structure. Possible tax-free thresholds could be a) the long-term average earnings on the average member fund accumulated at age 65, b) the long-term average earnings on the funds accumulated by a person paid at average weekly earnings over a given working life span of say 35 years, or c) a tax-free threshold seen to be reasonable by the retirement community and consistent with Government expenditure policies. Escalation of the tax-free threshold should be based on escalation of the Age Pension. The Government should be able to justify the choice of the tax-free threshold and the method of determining its escalation over time, as is the current practice for the age pension.

For the purposes of estimating savings and cost to the stakeholders in this proposal the tax-free threshold has been based on the earnings of the average SMSF balance for people over the age of 65 in the Financial Year 2008/2009[iv]. The average SMSF balance for people over 65 was $708,374. Noting that retirees with assets above the average value are presently entitled to tax-free earnings in the fund when the assets are taken as a pension, a fair value of $1million has been used with earnings based on the long term earning rate of 6%. A figure of $60,000 is taken as the tax-free threshold value for the purposes of the calculations below. Comparison with other threshold values is also provided. SMSF data is used because it is not available for public superannuation funds which are account-based and not member-based.

Retirees with taxable incomes below the tax-free threshold would not need to complete personal tax returns. Eligibility for the part- or full- Age Pension would not be affected. Eligibility for the Commonwealth Seniors Health Card would not be affected.

It has been noted that some costs for a couple can be shared making the cost of living for a single person greater than half that of a couple. For example, savings can be effected in shared housing, rates, utilities and maintenance. The tax-free threshold for a single person should be raised to recognise this situation. The Centrelink ratio, which recognises this issue, for a single person is 1.33 times that of a person living as a couple. Using this ratio, at a tax-free threshold of $60,000 for a person living as a couple, the tax-free threshold for a single person should be $80,000.

3.2 Existing Superannuation Structure

The superannuation structure provides concessional tax treatment for accumulating assets in recognition of the compulsory nature of the structure. Tax exemption on drawdown of retirement pensions is not a concession but an integral part of the policy of taxation of savings for retirement generally. It is inequitable and unjustifiable to limit the tax exemption to superannuation alone.

The superannuation structure was not designed to be open-ended. It was designed to assist employees to build funds for retirement at a minimum prescribed level of work income (presently 9%). Recognition that accumulation at this level would not generate sufficient assets for the target group of employees to gain a reasonable life style over the time spent in retirement has led to (a) ability of superannuants to add to superannuation over and above the minimum prescribed level, and (b) an objective of lifting the minimum prescribed level over time to 12%.

A consequence of the regulations is that people with sufficient means are able to take advantage of the 15% tax concessional rate to build substantial assets in superannuation. The extent of this is unknown for people accumulating assets in public funds because these are account-based and it is not possible to determine the extent of member contributions. However, Self-Managed Superannuation Funds (SMSFs) provide more reliable data because they are closer to being member-based and the majority of more wealthy people with superannuation use SMSFs as their vehicle. The data below is based on SMSF data for this reason.

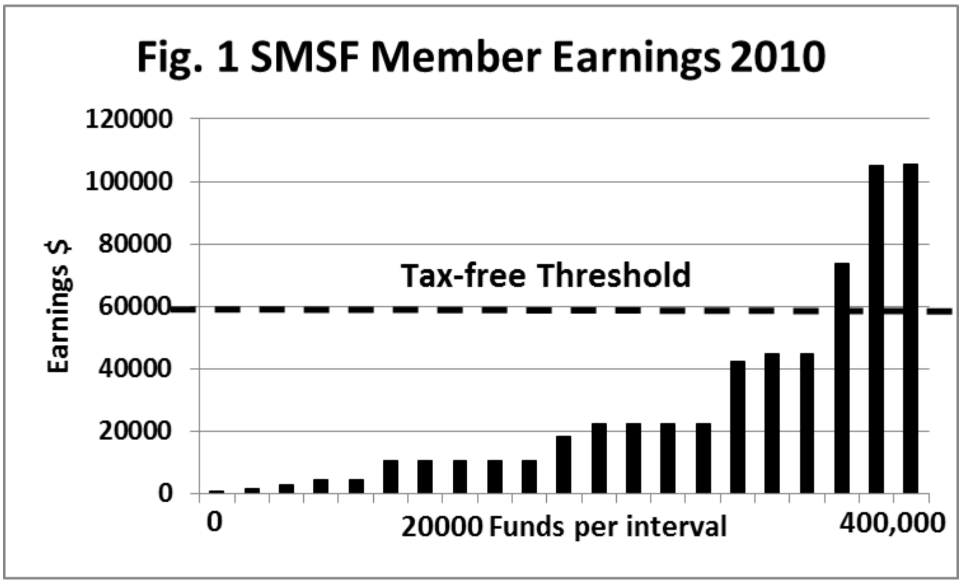
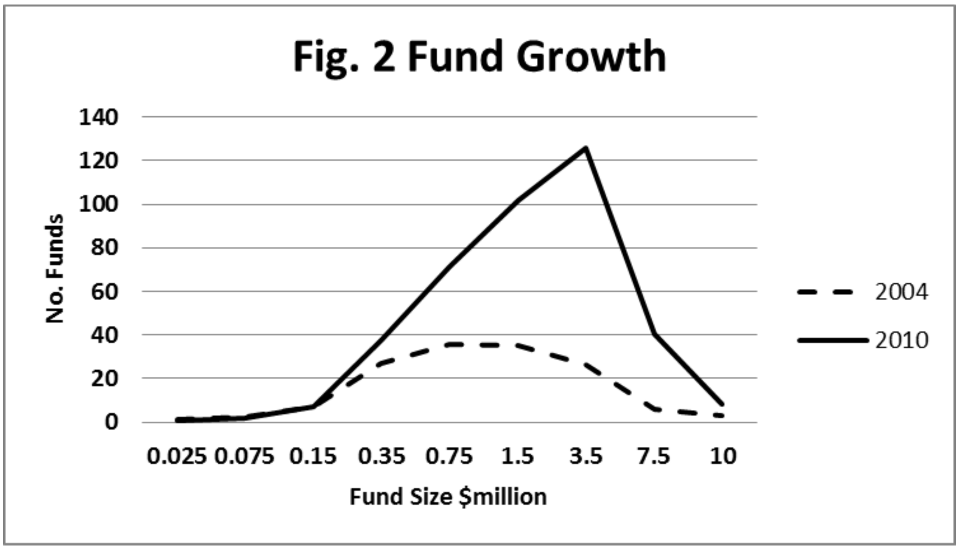


Figure 1 shows an estimate of the size distribution of SMSF earnings (based on the long-term return on superannuation assets of 6%) and funds for the Financial Year 2008/2009. The figure shows that about 45,000 funds, with accumulated assets in excess of $5 million, had individual member earnings in excess of $60,000. Reducing the tax-free threshold to $45,000 would not change the number of funds with member earnings above the tax-free threshold value. Increasing the tax-free threshold to $80,000 would reduce the number of funds to about 25,000 with member earnings above the tax-free threshold value.



Superannuation assets in SMSFs have grown from $143 billion in 2003/2004 to $395 billion in 2009/2010 as shown in Figure 2. Not only has the overall amount grown but Figure 2 shows that the growth is skewed to high-value funds. If this trend continues, high-value members will increasingly obtain a greater benefit from the tax-free amount.

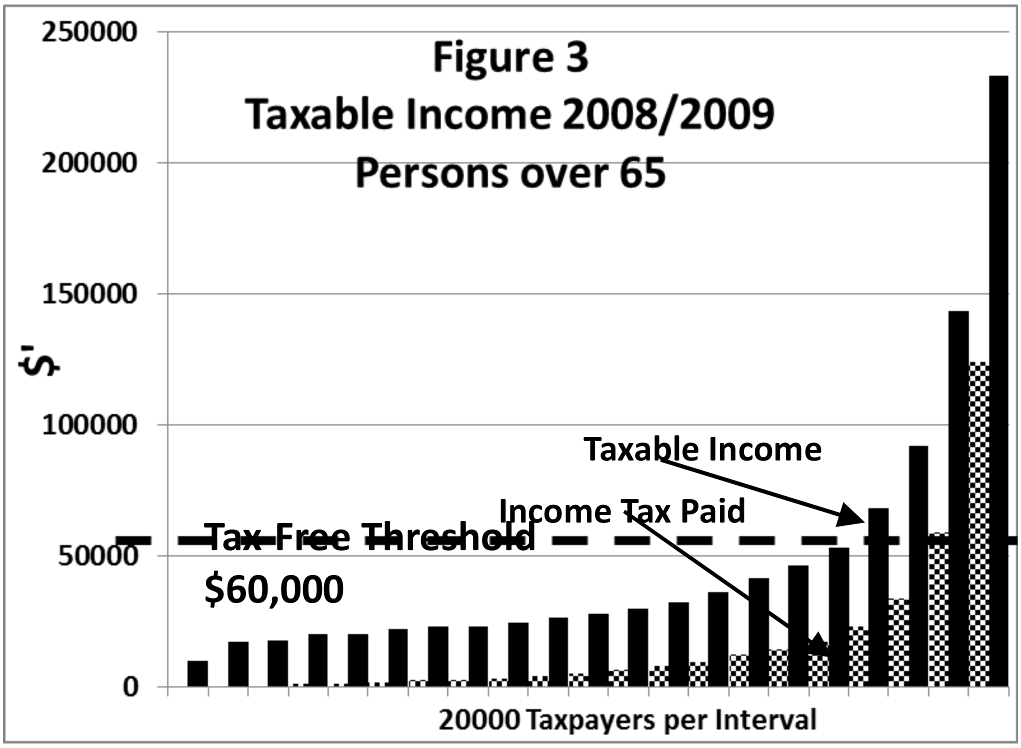
All funds accumulated in super, of the order of $1.3 trillion, are tax free when taken as a pension, a contingent liability for Government. Fund size is growing steadily, not only because of accumulation of individual assets with increasing working age, but also because of increase in wages with inflation and standard of living. Growth in the amount of superannuation represents a significantly growing loss to Government revenue over the medium term. It is highly unlikely that future Governments will be able to sustain this loss of revenue. It is for this reason that the Government has moved recently to reduce the concessional rate by a further 15% for people with taxable incomes over $300,000 per annum.

3.3 Financial Impact of Proposed Retirement Funding Structure

1. *Cost to Government of Extending Tax Exemption to people over 65 with a taxable income* – these people may or may not also have superannuation. Tax Revenue data is based on the Financial Year 2008/2009[v].

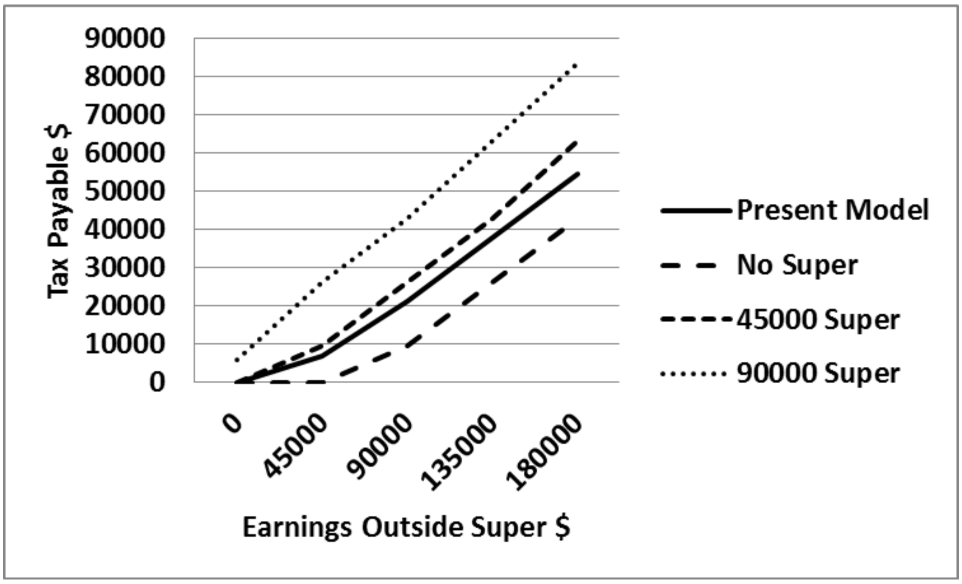
   Up to a taxable income level of $60,000, 280,820 people over 65 paid tax of $1.08 billion. As an offset to the carbon tax, the personal income tax threshold has been increased to $18,200 from 1 July 2012. Applying this personal income tax threshold to the 2008/2009 financial year figures, 8,975 people paid tax totalling $7.77million. Therefore, the net cost to Government of setting a tax-free threshold of $60,000 for people over 65 is $1.07billion after the carbon tax. However, all people above the $60,000 tax-free threshold will pay less tax. The proposed structure requires people with incomes above the tax-free threshold to pay tax on the excess at full marginal tax rates. Hence, the reduction in tax paid will always be the tax payable on the tax-free threshold value (presently $11,550). Loss of revenue from those above the tax-free threshold (404,710-280,820 in the financial year 2008/2009) will be $1.43billion.

   Taxable income and Tax payable by the 404,710 people over 65 paying tax is shown in Figure 3. The number of people over 65 paying personal income tax over the tax-free threshold value is small, approximately 45,000 people.



2. *Effect of people over 65 with both private taxable income and a superannuation fund.* The effect of the tax-free threshold structure on people with both private taxable income and a superannuation fund is shown in Figure 4. People with superannuation funds above the tax-free threshold and with private taxable income would pay more tax than under the present system where earnings on superannuation pensions are tax exempt (some superannuation funds in the retirement phase retain some accumulated funds which are taxed concessionally at 15% but this data is unavailable). Consequently, the additional tax paid, as shown in Figure 4, will be lower. Nevertheless, the tax paid will be greater than under the existing structure. The cost to Government of implementing the tax-free threshold would be correspondingly reduced. However, the saving would be expected to be considerable as high value people are most likely to have both private taxable income and a superannuation fund with assets greater than the tax-free threshold value.

Fig. 4 Effect of Super on Tax Payable – Proposed Model, Tax-free Threshold $60,000



3. *Tax revenue gained from people over 65 with a superannuation fund who pay tax on earnings above the tax-free threshold of $60,000*. The distribution for tax purposes can be approximated from Figure 1. There are approximately 46,000 members with earnings above the tax-free threshold of $60,000. The estimate of tax revenue gained is $0.5billion. Note that this is a contingent liability based on the assumption that all assets will be taken in the form of a pension over the life of the member.

4. *Reduction in administrative cost from removing the need for superannuation funds in the retirement phase.* The tax-free threshold structure removes the need for a superannuation fund in the retirement phase. For the financial year 2008/2009[vi]:

   4.1. SMSFs: average fund administration fee was $5,300 and the total number of funds was 425,300, of which 30% were in pension phase. Therefore, the administrative saving would be $700million.

4.2. The cumulative effect of a saving of an administration fee of $5,000 over twenty years is a conservative $184,000, highly significant in its impact on Government pension savings (See Appendix 1)

4.3. Public Funds: operating and investment expenses were $5.8billion and benefit payments were $42.2billion[vii]. Average assets were $766.3billion. Hence the administrative saving would be up to $320million.

5. *Untaxed Funds.* Retirees, typically from the public services, have had the employee contribution taxed and the employer contribution untaxed. Retirees are required to include the untaxed portion of a pension in their taxable income. In return a 10% tax rebate is available on the tax payable.

   This situation would remain unchanged in the proposed structure. For example, a retiree would pay income tax at marginal rates on any taxable income amount above the tax-free threshold less the 10% rebate.

6. *Summary*

   A summary of the financial savings and costs are set out in Table 2 together with a comparison between three different tax-free thresholds of $45,000, $60,000 and $80,000. The net cost to Government of a tax-free threshold to Government would be less than $2billion per year, reduced significantly by (a) the effect of retirees with both an SMSF and also private taxable income, and (b) savings in regulatory and compliance costs to Government. The savings to retirees in simplified administrative costs would be up to $0.7billion per year.

Table 2 Summary & Comparison of Financial Balances for the Proposed Structure

Item	Tax-free Threshold		
	$45,000	**$60,000**	**$80,000**
Tax revenue gained from SMSFs	($0.7b)	($0.5b)	($0.2b)
Tax revenue foregone from retirees without superannuation	$1.9b	$2.5b	3.1b
Less Effect of people with combined private income and superannuation	Value NA	Value NA	Value NA
Less Tax savings from reduced tax return administration	Value NA	Value NA	Value NA
Net effect on Tax Revenue	**<$1.2b**	**<$2.0b**	**<$2.9b**
SMSF Fund fees saved	$0.7b	$0.7b	$0.7b
Public superannuation fund fees saved	<$0.3b	<$0.3b	<$0.3b
Net Effect on Retirees over 65 Without superannuation With superannuation only	 <$1.9b <$1.0b	 <$2.5b <$1.0b	 <3.1b <$1.0b

A summary of the net effect of the proposed structure is set out below:

- Tax on retirement income is transferred to the personal tax system with a tax-free threshold;
- A reasonable tax-free threshold can be set which is essentially cost-neutral to Government;

- All retirees are able to access the tax-free threshold and all are subject to marginal tax rates on income above the tax-free threshold;
- The savings to Government are greater than shown in the table as the effect of people over 65 having both private taxable income and also a superannuation fund has not been estimated.
- The cost of all retirees accessing the tax-free threshold is reducing due to the number of people over 65 paying tax decreasing as a result of the growth of superannuation.
- The need for a superannuation structure of public funds and SMSFs in the retirement phase and its complex regulatory and administrative systems is removed;
- The cost of administration of the existing funds in the retirement phase is removed. The cost is escalating rapidly — public funds benefits paid out increased by 7% between September 2009 and September 2010;
- There is incentive for financial institutions including public superannuation funds to develop competitive and innovative retirement income products.

4. Removing Inequity in Retirement Incomes

Lack of application of the principle of exempting earnings on assets used during retirement to those without superannuation is a cause of serious discrimination; taxation of retirement income for those without superannuation is at full marginal tax rates. There are many retirees without superannuation who have modest incomes consistent in value with those the Government is supporting through superannuation. Rundown of their retirement assets is hastened where the earnings of the assets are taxed.

Figure 3 shows the distribution of tax paid for persons over 65 (Persons between 60 and 65 have not been included although the benefits of superannuation are accessible to people over 60). The figure shows that tax paid was heavily skewed to the few people with high taxable incomes. Of the 405,000 people over 65 who paid tax in the 2008/2009 financial year, some 332,000 or 82% had a taxable income less than $90,000. They paid 27% ($1.83billion) of the total tax paid by persons over 65. The remaining 18% of taxpayers paid nearly three-quarters of the tax paid.

Tax paid by people over 65 has declined from $8.2billion in 2006/2007 before the introduction of Simpler Super on 1 July 2007 to $6.7 billion in 2008/2009, a decline of 18%. This trend is expected to continue and can be attributed to taxed-fund superannuation pensions being exempt from tax. Data is not available to estimate this effect, although it may be inferred that many SMSF members with high-value funds are also likely to be paying high levels of personal tax.

There is significant distortion in the fairness of the existing structure because:

- Accumulating assets in superannuation is skewed to high-wealth individuals;
- A very high proportion of people of modest means without superannuation are required to pay income tax at marginal tax rates on their earnings, including capital gains tax;

The need to change the existing structure will become urgent in the next few years because of the loss of revenue from the increasing number and value of tax-exempt superannuation pensions and the decline in revenue from personal tax paid by persons over 65.

A structure which relieves the 80% of people on modest incomes from paying tax, whether they accumulated their assets within or outside superannuation, is an appropriate structure to assist in managing their assets across their expected life span, to maintain their quality of life, and to avoid increasing reliance on the age pension.

A more equitable structure would be to set a tax-free threshold of equal benefit to all those who can reach the tax-free threshold income and which would remove the bias toward large funds. This structure would not disadvantage those whose superannuation assets generate earnings less than the tax-free threshold but would remove the inequity between those with superannuation and those without.

A more appropriate structure for administering the taxation of retirement savings would be to integrate it into the personal taxation system by introducing an income tax-free threshold that would account for the tax-free component element in retirement income. As a consequence, the drawdown phase of superannuation would be abolished. Above this tax-free threshold normal marginal tax rates would apply.

5. Administration Costs of the Existing Structure

Administration costs differ between large superannuation funds and SMSFs. SMSFs administer approximately one-third of superannuation assets. Over 85% of SMSF trustees use an Accountant for preparation of financial reports and the Annual Return. Trustees of SMSFs are required to have their fund audited annually as part of the Annual Return process.

In the retirement phase many funds are ‘simple’ funds; earnings are tax free, many have two members (a couple), the only regulatory requirement is to draw a minimum amount as a pension. Auditing of the fund is an unnecessary expense, which for a modest fund can represent a significant proportion of the earnings.

SMSFs incurred fees of $2.12billion in 2008/2009 at an average fee of $5,300. The average fee included an audit fee of $656 and a supervisory levy of $45 ($200 in 2011/2012). The fee represents a direct loss of income to a retiree, or a loss of accumulated funds.

In 2009/2010 approximately 30% of funds included some drawdown component. Hence, if a structure where a tax-free threshold replaced the retirement phase of superannuation, an annual saving of over $636million would be achieved. Note that this may be an overestimate because some retirees would continue to need financial advice.

The cumulative reduction in income available from superannuation because of administration fees is shown in Appendix 1.

Removal of the need to have an SMSF in retirement would:

a. ***Simplify the Trust Deed for SMSFs in the accumulation phase and reduce legal fees;***
b. ***Remove accounting and auditing fees making more funds available for retirement needs;***
c. ***Remove supervisory fees and cost of administration.***

6. Treatment of Superannuation Pensions

Superannuation pension requirements arise mainly as a consequence of the existing superannuation retirement phase regulations.

Under existing regulations there is no requirement for a retiree to withdraw any assets accumulated in superannuation. The level of assets held at 75 may be retained in the superannuation fund until the death of the retiree. The earnings of the assets are taxed at the concessional rate of 15%. Therefore, it is possible for a person with sufficient assets outside superannuation to take advantage of the concessional tax rate for those assets held in superannuation until death. This is inconsistent with the Government intention, expressed through minimum age-related pension drawdown rates, for retirees to steadily use up their superannuation assets to meet retirement living costs and to avoid concessions being able to be transferred as part of estate planning.

Withdrawal of funds by a retiree from a superannuation fund can be in the form of a lump sum or a pension. Both are tax free except for the special case of transition to retirement between the ages of 55 to 60. In this case a lump sum is included in the personal taxable income of the retiree withdrawing the lump sum. Regulation 1994 – Reg 1.06 defines a pension as a series of regular payments that must be made at least once in each financial year. For most retirees there is no difference between a lump sum and a pension except in the way the fund is structured to minimise the minimum drawdown requirement.

Where a retiree draws down at least the defined minimum amount per year as a pension,

- the pension is tax free and not included in taxable income;
- income from assets used to provide the pension is tax free;
- the minimum drawdown is calculated on the assets applicable to the pension as at the 1 July in the year of the pension where the pension applies to that full financial year;
- there is no maximum limit on the amount drawn down;
- the amount may be drawn down at any rate including one payment per year;
- a retiree may commence a pension during a financial year.

The minimum drawdown percentage increases with age. Therefore, as a healthy retiree ages and demands on income decrease, the amount withdrawn must be increased. The regulations can interfere with the appropriate husbanding of assets because of the difference between the minimum drawdown required and the needs of the retiree.

The minimum drawdown percentage has had to be changed each year since 2008 because of the global financial crisis and its effect in reducing retirees' assets. It is not possible to set a minimum drawdown percentage that can match investment risk to retiree need.

This regulation attempts to control the way in which a retiree uses superannuation assets and cannot match the investment climate to the income needs of a retiree, nor individual income needs to regulated drawdown. Needs of every retiree are different. For many reasons, including their own health and longevity, retirees should have the freedom and responsibility to manage their own affairs.

If the intention of the Government is to compel retirees to use their superannuation in retirement, a) as a means of reducing the amount which is tax free, b) as a means of reducing the tax concession available to high-wealth people, and c) as a means of reducing the amount available to the estate on death, then it has failed.

The definitions of commencement and end of a pension for taxation purposes are highly complex and have not yet been resolved and set in legislation. The definition of the end of a pension on the death of the pensioner has taxation implications, particularly for capital gains tax, because of the definition of transfer of funds to the estate. Calculation of capital gains tax may go back many years and detailed records (otherwise unnecessary) need to be kept in the event of a retiree with a pension dying during a financial year. Transfer of retiree's income to the personal tax system removes this issue.

Adoption of complex definitions of this type lead to high administrative cost and mistakes which, when compared with the additional taxation revenue obtained give a high negative value-added. Removal of the need for a superannuant to take a pension by removing superannuation in the retirement phase would remove these complexities.

Abolition of the drawdown phase of superannuation and incorporation of the taxation exemption into the personal taxation system by establishing a tax exempt threshold would:

1. ***allow retirees to make individual decisions as to how best to husband their retirement assets without regulatory distortions;***
2. ***remove the need for a definition of a lump sum and a pension;***
3. ***introduce a level playing field for all retirees based on a uniform tax free threshold and marginal tax rates;***
4. ***make estate management consistent with existing community rules.***

7. Treatment of Contributions after Retirement

A superannuation fund is identified as being (a) in the accumulation phase, where capital is being accumulated for the future payment of a retirement pension, or (b) in the pension or drawdown phase where the capital is being used for the purpose of paying a pension[1]. A retiree taking a pension may also make contributions to the superannuation assets, but not to the assets supporting a pension.

Regulation 1994 – Reg 1.06 defines a pension as a series of regular payments that must be made at least once in each financial year. It prohibits addition to the assets supporting a pension.

A person may have a number of pensions a) because of purchasing a number of discrete types of pension, for example an account-based pension and an annuity, or b) because of the restriction on adding to a pension, additional pensions must be nominated from contributions made during retirement. It is possible to commute a pension, add additional assets to the commuted capital assets and commence a new pension with the total of the assets. This is a complex, not understood, and unnecessary process usually incurring an additional fee.

[1] A pension is now defined as a number of income streams but the term "pension" is used throughout this paper.

For the earnings of the assets nominated to support the pension, or the total of multiple pensions, and the pension or pensions themselves, to be tax-free a defined minimum amount of pension must be taken each financial year. Thus, a person may nominate all their assets to support a pension or pensions, but the total amount withdrawn may be nominated to be substantially less than the earnings of the assets. The assets of the retiree may therefore be steadily increased. In this case all earnings of the assets are tax free. The regulations, which allow tax free earnings from assets that are not being used for the purpose of paying a pension, is inconsistent with the Government's objective.

Many retirees undertake additional paid part- or full-time work during the course of their retirement. They are encouraged to do so by Government. Many with modest assets arrange for their total assets to support the maximum possible pension and do not have any assets in the accumulation phase. Because of Regulation 1.06, a retiree with a pension who wishes to make further contributions, or is forced to by an Award, cannot add those contributions to the pension. From the point of view of the retiree, addition of contributions to increase the pension is the obvious and desirable outcome, particularly where the contributions from part-time or casual work are small. However, the retiree has only three options:

(1) Commence an additional pension/s immediately following the contribution/s.
(2) Commute (cancel) the original pension and commence a new pension with the total amount.
(3) Have the contribution/s used to establish, or add to, an accumulation section of the fund.

Irrespective of whether the nominated pension asset amount balances the pension taken or not, the earnings of the asset are tax free. However, if a contribution is made to the fund assets, whether from working — the contribution is taxed at 15% — or whether from the after-tax personal savings of the retiree, the earnings of the contribution are also taxed at 15% until such time as the contribution/s are nominated to be a pension. To overcome this problem the retiree is forced to pay an administrative fee to establish a new pension. In many cases the taxable income for the retiree is low and does not incur any tax. However, the superannuation contribution is taxed at 15% upfront. Even though a change to the regulations is imminent to allow a refund of this tax after the end of the financial year, this is nonsense to a retiree and clearly an impediment to undertaking work.

The definition of a pension, which prohibits addition of capital to an existing pension, makes the treatment of contributions extremely complex. Many retirees have no idea of the options open to them and see superannuation contributions withdrawn from part- or full-time work as an impediment to seeking such work. The superannuation industry has a vested interest in adding all such contributions into an accumulation component of a retiree's fund for simplicity of administration, at least for the financial year in which the contributions are made. Where a retiree presses for the right to take the contribution as an additional pension, the administrative charge to establish the pension will be such as to offset the benefit to the retiree of the contribution.

Removal of the need for a pension by removing superannuation in the retirement phase would remove these complexities.

8. Work and Age Barriers

Barriers to making contributions from work and because of age are contained in the regulations.

A retiree cannot make a contribution from previously taxed personal assets after the age of 65 unless they work for forty hours in a thirty-day period at least once in a financial year. Problems arise:

- Where a person undertakes short term casual work such as in an election campaign or census of less than forty hours and which may not extend over thirty days (manning a polling booth is an example);
- Where a person has been the full-time family supporter, has little work experience, and the financial supporter of the family dies. They do not have the experience to be able to work to assist their retirement income;
- Where a person has access to family or friends running a small business for example, it is commonly possible to arrange short-term employment to meet the criteria for adding personal after-tax contributions. Retirees who do not have such access are discriminated against.

This regulation is inequitable and additional cost of administration and certification is required where such work can be established.

Until the age of 70, if a retiree meets the work test, then they can make the contribution to the assets of their spouse. After the age of 70 this is not possible, adding further complexity.

A retiree cannot make contributions to superannuation after the age of 75. However, where an award provides for this the award takes precedence. Because of this anomaly, the Government is now moving to allow contributions to be made after the age of 70

Removal of the need for contributions to be regulated by removing superannuation in the retirement phase would remove these complexities.

9. Administration associated with the existing structure

Shortcuts, deliberate lack of information to retirees, and errors of omission exist because of the complexity of the regulations. Examples include:

a) Retirees cannot be expected to understand all the subtleties of the complex regulations. If they wish to understand their options they must access the advice of Financial Advisers or Accountants, many of whom do not understand the full repercussions of the regulations or the options available and their costs. It is acknowledged that many people have little interest in the accumulation phase of their superannuation for a variety of reasons including compulsion, third-party distance, and the systems complexity, which has led to legislation requiring superannuation funds to establish default options. These problems are exacerbated for retirees.

b) Retirees are discouraged from making contributions by lack of information. They are not made aware of their rights in converting contributions to pensions. Fund administration is not set up to handle multiple contributions, particularly where a series of fortnightly SG contributions would force a new pension fortnightly. Without removing the rights of retirees, the charges of administering multiple pensions would be penal;

c) All funds, including SMSFs, are required to maintain records of contributions. In SMSFs, establishment of a new pension with a contribution can be achieved by minuting the intention. The process of administering and establishing the minutes leads to errors and omission. Auditors, including ATO Auditors, are often not aware of the requirements. As a result incorrect penalties are being applied and the cost of appealing is high.

d) Certification that work and age barriers have been met must be provided to funds, records kept with the associated costs of administration.

The complex regulations, which cause shortcuts, errors, and deliberate circumvention, exist because of the taxation requirements associated with superannuation in the drawdown phase. An alternative system, consistent with the personal tax system, would allow all regulations to be removed.

10. Incentive for Financial Institutions to meet the needs of Retirees

A well-developed financial industry has grown from the SG with the ability to administer and invest huge amounts of superannuation funds (some $1.3 trillion dollars). However, the Cooper Review into the Superannuation Industry was established because of concerns over lack of competition, excessively high fees, and poor governance and transparency.

Until recently, emphasis has been placed on accumulation and investment of funds because of rapid growth. It is only in recent times that interest is growing in management of funds during the retirement phase. Systems are lacking in ability to handle the complexity of the retirement regulations and the options available to retirees for drawing down funds and making contributions through work. There has been little incentive for funds to develop a competitive market to maintain and manage accumulated assets for retirees during retirement.

Continuation of the SG into the retirement phase has been a major reason for lack of interest by Funds in meeting the needs of their retiree members.

Transfer of the responsibility to individual retirees for managing their retirement assets by transferring accumulated assets to them on retirement would dramatically change the culture of the existing system and better meet Government objectives in the following ways:

- Individuals, who previously had little interest in their superannuation assets, would be more likely to take an interest.
- Individuals would have an incentive for education to understand their options and the issues in husbanding retirement assets. Competition would lead to providers developing such education programs;
- Superannuation funds would move into a competitive environment cutting costs and reinvigorating the incentive to provide products improving retirees' management of assets and consequent reduction in pressure on the part- and full-age pension. They would:

- Have incentive to design products which would attract retirees and encourage them to retain their assets with the fund. This incentive would also lead to provision of education programs;
- Have incentive to attract funds held outside superannuation including personal savings and SMSFs;
- Come under pressure from other financial institutions to attract retiree funds through more appropriate products.

Transfer of responsibility to the individual owner of superannuation assets would improve incentive to manage, awareness, and knowledge. The existing financial system would improve its competitiveness leading to better retirement products.

APPENDIX 1 Total Accumulated Cost of Fees and Charges to an SMSF over a Twenty-Year Period1 These calculations are based on a fund which has annual fees and charges that have been held at $5000 and no allowance has been made for inflation.

2 The fund is assumed to average **net** earnings of 6% per annum on assets and which may be more or less over the years depending on how well the fund's investments perform.

3 The figures for the fees and charges of $5,000 and earnings rate of 6% were based on ATO and treasury statistics and obviously vary from fund to fund but they illustrate the general principle which is the important point.

4 These calculations come solely from fees and charges and will arise quite independently of the total fund size.

Year	Annual Costs Calculation	Total Cumulative Cost
1	5,000	$5,000
2	5,000+300*=5,300	$10,300
3	5,000+618=5,618	$15,918
4	5,000+955=5,955	$21,873
5	5,000+1312=6,312	$28,185
6	5,000+1,729=6,729	$34,914
7	5,000+2,095=7,095	$42,009
8	5,000+2,520=7,520	$49,529
9	5,000+2,972=7,972	$57,501
10	5,000+3,450=8,450	$65,951
11	5,000+3,957=8,957	$74,908
12	5,000+4,494=9,494	$84,402
13	5,000+5,064=10,064	$94,466
14	5,000+5,668=10,668	$105,134
15	5,000+6,308=11,308	$116,442
16	5,000+6,986=11,986	$128,428
17	5,000+7,706=12,706	$141,134
18	5,000+8,468=13,468	$154,602
19	5,000+9,276=14,276	$168,878
20	5,000+10,133=15,133	$184,011

*This cost is the assumed 6% earnings on the money that an SMSF **would have accumulated** if it had not paid out those annual fees and charges in previous years. These are virtual costs in that they are foregone earnings which are quite often ignored because they are not actually paid out but they are in fact real losses and rapidly rise so that they will eventually well exceed the actual paid out annual fees and charges. Please note that 6% is a very conservative assumption and if the figure of 10% was assumed then the total would be $286,397.

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[iv] Australian Taxation Office, December 2011. Self-managed Superannuation Funds – A Statistical Overview 2008-09. NAT 74068-12,2011. Australian Government Canberra.

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