SUBMISSION IN REGARD TO: THE RETIREMENT INCOME SYSTEM (AUSTRALIA'S FUTURE TAX SYSTEM REVIEW)

PART 1
RESPONSES TO QUESTIONS IN THE RETIREMENT INCOME CONSULTATION PAPER OF DECEMBER 2008

SUBMISSION BY: LLOYD FAIRHALL

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Summary

The key objective of policy should be that every person who is of sound mind and body should be able to retire with sufficient financial resources to not require any payments from the state for the remainder of their lives. Considerations of inter-generational equity may require a phase-in period of 10 to 20 years for achieving sufficient saving for this objective and it should be adopted without continuing the current massive level of financial incentives to people during their working lives.

This could be achieved with a “Future Fund Mark 2” backing a government defined benefit fund to provide a taxable, universal retirement income scheme that provided a little more than the current aged pension in real terms. This would be a more transparent approach to providing aged pensions.

The current tax regime for superannuation may become politically unsustainable as knowledge of its tax advantages for the wealthy becomes more widespread in the population, resulting in demands by younger voters that governments change the regressive nature of a system that puts additional taxation pressure on them. The ageing of the population will contribute to this taxation pressure.

Achieving the revenue for a funded universal pension scheme could be contributed by removal of the Senior Australians Tax Offset and modification of the superannuation taxation regime as detailed in the attached document.

Perhaps “myopia” in relation to saving for retirement should be further investigated to determine the nature of the problem including details such as its variation between age cohorts. Overall, perhaps governments should have more faith in the ability of their citizens to plan for retirement, particularly when they get into their 40s and 50s. If the commitment of governments to fund retirement does not extend much beyond the age pension then there appears to be no reason for concern by governments about the needs of their citizens beyond that. Each citizen should be equipped with sufficient education and information but the vast majority are in a better position than governments to determine their particular circumstances, such as the probability of significant inheritance, which was not mentioned in the Consultation Paper.

Responses to Consultation Questions

The following are responses to the questions posed in the "Retirement Income Consultation Paper", December 2008. The numbering in the sub-headings corresponds to that document.

Q1.1: Objectives

The key objective of policy should be that over a phase in period of 10 to 20 years, every person who is of sound mind and body should be able to retire with sufficient financial resources to not require any payments from the state for the remainder of their lives, and without directing massive financial incentives to people during their working lives to achieve this objective.

This objective obviously raises issues of intergenerational equity and hence a phase-in of increased saving is necessary and may need to be 10 – 20 years. However, an early start needs to be made on this objective because there is no reason that I can see why most people cannot save for their own retirement. The current age pension system was introduced early last century when average living standards were much lower and seems an unnecessary impost on younger taxpayers today. If need be, the personal taxation system should be made more progressive to achieve the objective.

Only 2 pillars are therefore necessary. The compulsory pillar should be increased substantially via the tax system ie increasing taxes and lowering expenditure to direct more into the superannuation system, or a replacement for it, with targeting towards those most at risk of falling below the level of savings required to fund their retirement. One source of revenue to achieve this is by eliminating the huge tax expenditures aimed at encouraging mostly wealthy citizens to contribute to superannuation and other retirement incentives for people already wealthy. Voluntary saving on top of the equivalent of the aged pension should attract minimal financial incentives and only to a certain level of saving.

This objective will require a highly financially literate population, so the education system should be modified to ensure this from a very early age for each child. For those who regard their knowledge or abilities as inadequate for the task of managing their life savings, or perhaps the population in general, the Australian Government should establish a default scheme managed by the Government, similar to the Future Fund. This should be a defined benefit scheme that aims to provide an equivalent of the old age pension at retirement for each person plus say 10 or 20%. Administration of this scheme, determination of contribution rates and investment management would be outsourced to the private sector, with the Government determining objectives, as per the Future Fund. Contributions would be paid directly from the Australian Tax Office to this Future Fund Mark 2. This could in fact be extended to the whole population and would result in a much more transparent system for funding the old age pension than at present. (The reason for a government-owned rather than privately-owned defined benefit scheme is to minimise mortality risk by pooling across the whole population and because the government is well placed compared to the private sector to provide such universal benefits.)

There will be some people, as identified in the Consultation Paper, who will be unable to achieve sufficient contributions to achieve an equivalent of the aged pension, and government support will be necessary for these people. Perhaps there should be a continuation of welfare schemes for those genuinely unable to obtain employment (such as people mentally and physically disabled) throughout their life that is distinct from the aged pension. The aged pension for those who fail to save or dissipate their savings rapidly after retirement should be set at a lower level than the lifetime disability pensions.

The aged pension should continue to be taxable (added to any other taxable income) but without the current seniors tax offsets ie they should be abolished. These offsets add complexity to the tax system and create very high effective marginal tax rates for some seniors. They also make it more difficult to achieve the key objective stated above by causing personal tax rates on younger people to be higher. In effect, these offsets work to make more people more dependent on the government in retirement.

I agree that myopia may be a problem, but the Consultation Paper does not present evidence for it. How widespread is it in the population and does it largely disappears as people get to ages of 40s and 50s? The current superannuation system works against people overcoming myopia with age by stipulating fixed dollar upper limits on what can be contributed. More importantly, should it be a role for government to ensure a certain level of income maintenance in retirement which is related to pre-retirement income and in excess of the aged pension? Personally I think not, but if a majority of the Australian people think it should be, then compared to the problems of the current superannuation system it would be better if the government created a greatly expanded Future Fund Mark 2 and used it to save on behalf of the whole population. Is not each individual the best judge of the amount of savings her/she requires for retirement, providing the government does its best to present the information that helps each individual to make a decision?

Q2.1: Individuals excluded from the SG system

Apart from those with disabilities, this is a matter for them – see above for accommodation of individuals partly or wholly excluded from the SG system. There is no prohibition on saving in Australia.

Q2.2: Adequacy of the retirement income system

The government should aim for a retirement income for every individual that is 10 – 20% above the current level of the aged pension in real terms – see above. The existing superannuation system is inadequate and inappropriate in that its incentives are not primarily aimed at helping those most likely to be wholly or partly dependent on the age pension.

Q2.3: Role of government

See above. The role of government should be to ensure that people receive an income in retirement that is around the current level of the aged pension in real terms. Political considerations mean that governments cannot avoid providing such an income but this should be the extent of their involvement. This level of support should be funded by compulsion, not tax incentives to individuals. Beyond this, there should be no financial support from governments. They should instead concentrate on lower taxes and/or better services and provision of infrastructure. The government's role should not change as an individual's income increases over his or her working life.

Q3.1: Are the settings of the system adequate?

As stated above, the compulsory level of contributions should be set so as to achieve a retirement income for each individual that is just above the current aged pension in real terms. Any increases in contributions required to achieve this objective should come from the personal taxation system or government contributions, not via additional imposts on employers.

Q3.2: The current superannuation concessions

I do not have the facilities to model the current superannuation tax system, but I doubt that the current tax regime for superannuation is sustainable. The answer to the sustainability question may not, however, lie in macro-economic modelling but in whether, as knowledge of the problems of the system become more widespread in the population, there are demands by younger voters that governments address the regressive nature of a system that puts additional taxation pressure on them. The ageing of the population will contribute to this taxation pressure. See the attached document.

Q4.1: Ages of eligibility

Eligibility for the age pension should be raised to 67 years, although this should only occur over a transition period. Choice of the age is a difficult decision, but if the above suggestions were adopted in relation to the Federal Government creating a universal defined benefit scheme to replace the pension, then the contributions required for that scheme would be determined in relation to the age of eligibility. There would then be certainty for each individual. The age of eligibility could be modified over time for various age cohorts. It has been suggested that life expectancies could fall for some cohorts in the future (due to obesity for example).

Q4.2: Investment and longevity risk

The government already provides a basic offset to investment and longevity risk in the form of the age pension and this could be extended as described above – slightly higher level and universal. Individuals should take responsibility for managing these aspects of their retirement savings. Again, the education system should be urgently reviewed to ensure that it addresses these matters at an early age by equipping young people with the skills to be able to take responsibility for their assets as they grow older. Governments should not impinge excessively on the flexibility of individuals in managing their life savings.

Financial markets generally provide the means to deal with these risks, although in most cases at an excessive price. There have been plenty of structured products and products with asymmetric risk profiles offered in Australia, including products listed on the ASX. I see no role for governments to address shortcomings. For example, despite the massive falls in stock markets over recent periods, workers who have been steadily saving for retirement over the last 15 to 20 years should have been able to achieve very good gains on their assets. (If further massive falls occur then this may not continue to be the case, such as the circumstances of 1930s Depression style falls in equities of 90%. In such circumstances, it would be likely that there would be a question mark over the competence of governments in managing economies around the world. Even so, if the government is providing the age pension as a fall back position then it has no further role to play, other than trying its best to re-start the economy. This is likely to include special payments to retirees to stimulate demand.)

Q5.1: Undue complexity and cost

This could easily be answered by a poll asking a sample basic questions about the superannuation system, which I expect would demonstrate very little understanding of it. For example, what proportion of the working population know that contributions can be concessional or non-concessional and that a 15% tax is applied in the fund on the former?

It is imperative that tax and other aspects of the superannuation system be fixed soon, and it is particularly important that it be done by starting from “a clean sheet of paper”, ie what system would be designed if the current system did not exist? Yet another patch-up of the current system as opposed to fundamental reform would add to complexity and further undermine public confidence in it.

See attached document on how to fix this complexity.

Q6.1: Role for the age pension

See above. If the above proposal for a government defined benefit scheme to fund the age pension was adopted then a taxable universal age pension without means test could be provided.

Q6.2: Workforce participation

Stipulating minimum pensions from superannuation funds is not conducive to continuing saving (and reducing longevity risk) or workforce participation. Tax-free superannuation pensions for those over 60 years of age implies that this should be the retirement age for most people and will be an incentive for most people to retire then. (See attached document for a solution to these problems.)

The current superannuation system and the range of financial advantages for older people (from near-zero public transport fares to pharmaceutical subsidies to the Seniors Australians Tax Offset) must result in higher personal taxes for young people. Higher taxes on income may be a disincentive to work and save for some, particularly if they are aware of the regressive superannuation taxation system.

Q6.3: Effect of financial mediation on retirement incomes

If the government does not have a role in trying to ensure income maintenance relative to pre-retirement income beyond the age pension then this should not be an issue. This is provided that lenders are adequately supervised to ensure that some citizens do not take on excessive debts that they are never likely to be able to repay, such as has happened recently in the USA.

SUBMISSION IN REGARD TO: THE RETIREMENT INCOME SYSTEM (AUSTRALIA'S FUTURE TAX SYSTEM REVIEW)

PART 2
A RESPONSE TO QUESTION 3.2 AND OTHERS IN THE RETIREMENT INCOME CONSULTATION PAPER OF DECEMBER 2008 – HOW SHOULD THE TAXATION OF SUPERANNUATION BE REFORMED?

SUBMISSION BY: LLOYD FAIRHALL

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Summary

The provision of substantial tax subsidies to those who do not or should not need them is probably unsustainable and relatively ineffective in reducing reliance on the age pension. Australia's superannuation system results in a shrinking population of primarily younger working families on lower incomes paying higher taxes to subsidise the retirement lifestyles of the wealthy elderly. Alongside the income tax system, superannuation incorporates a 15% flat tax system. This parallel tax system offers legal avoidance of potentially tens of thousands of dollars in tax for those wealthy enough to put away up to $250,000 each year while providing relatively little or no incentive for low income earners who most need to save for retirement.

The current system is still complicated, requires employer agreement to maximise savings and restricts the amount that can be contributed or withdrawn each year. The bias of incentives toward the wealthy results in many Australians making little progress toward adequate retirement saving. This document presents a proposal to replace superannuation with a Life Savings System (LSS) that will remove the regressive nature of the current system, reduce complexity and increase flexibility.

For the Majority

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

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

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

More Wealthy Account Holders

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

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

The proposed system is biased toward low to middle income earners. This compares to the current superannuation system with its substantial loss of tax revenue from contributions, investment earnings in both accumulation and pension phase and payments to those aged over 60. The current system offers unlimited tax concessions on investment returns in superannuation.

For the Federal Government

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

This document argues for removal of the current tax subsidies for saving via superannuation and advocates greater reliance on compulsory saving in a less regressive and administratively complex framework. Governments then have the option of either utilising those tax subsidies to transparently contribute to savings, lower income taxes or both.

Objectives

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

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

Finally, because the Australian Government is the last resort provider of retirement income to those citizens who fail to save adequately or lose their savings then it seems appropriate to reduce the risk to taxpayers of providing this insurance. If tax incentives for saving are continued then it could be argued that objectives of the retirement savings system should be to encourage pensions rather than lump sums and to limit tax incentives to encouraging that level of savings equivalent to or a little above the present value of the age pension at retirement.

A Summary of the Problems

A major problem with the current superannuation system is the application of taxes within funds, which by administrative necessity, must be flat taxes. Australia has a progressive income tax on the employment and investment earnings of individuals. There are potentially three taxing points associated with superannuation apart from the income tax system. All of these create costs in funds. Tax on payouts was eliminated for those over 60, but prior to that most Australians did not pay tax on most of their superannuation.

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

Inconsistency of Policy

The current regime for taxation of superannuation turns the progressive personal tax system upside down, providing substantial tax savings for higher income earners and little or even additional tax for lower income earners. In effect, it provides partial access to a flat tax of 15% to high income earners that is only partly available and of little or no benefit to low income earners who are the ones most in need of assistance to save to avoid the age pension. The following are the major inconsistencies within superannuation and with the progressive income tax system that can be exploited by more wealthy citizens with advice usually not available to those on low incomes:

1. Taxation of the assets backing superannuation accounts changes from a nominal 15% to zero as the beneficiary goes from accumulation to pension phase. This creates another tax opportunity for more wealthy citizens who have their own self managed superannuation funds (SMSFs) and can avoid capital gains tax on growth in assets in the fund by holding them until they take a superannuation pension.

2. Taxpayers provide substantial tax incentives for superannuation savings but fund members are not required to commit to applying those savings to fund their own retirements and any member can still be totally reliant on the aged pension, even if they accumulate hundreds of thousands of dollars in superannuation. For example, a fund member on the top marginal tax rate can salary sacrifice throughout their working life (costing up to tens of thousands of dollars per annum in lost tax revenue), withdraw all their superannuation after age 60 with no tax clawed back by the government and immediately gamble away the full amount. Other taxpayers have paid more tax to make up for the gambler's tax deductible superannuation savings and are then required to finance a pension for the rest of this person's life. This is called “double dipping” and has been exacerbated by former Treasurer Peter Costello’s changes because at least under the previous system there was some tax on most larger withdrawals from superannuation.

3. Transition to retirement (TTR) pensions amplify the benefits available to those on higher incomes, particularly by eliminating tax on superannuation holdings. For example, take a person between 50 and 60 years of age on the top marginal tax rate with $2 million in superannuation. On a TTR pension this person must take an annual payment of at least 4% of the balance which will be $80,000pa. Only part of this, say $50,000, will be taxable with a 15% tax offset. But if $50,000 is “salary sacrificed”, this eliminates any additional tax due to the superannuation pension but retains the 15% tax offset, which would be useful for a person on the top marginal tax rate. A 15% contributions tax applies on the salary sacrifice of $50,000, so this exercise is tax neutral. What is not tax neutral is the elimination of all tax on the $2 million in superannuation providing the pension. If the underlying assets generate a taxable return of 4%pa then the annual tax due on this in the accumulation phase is $12,000. Thus by taking a TRP this person saves $12,000pa in tax on their superannuation while not suffering any change in their personal tax position. This is not the full tax story, however, as the tax free part of the pension can finance higher levels of salary sacrifice to further reduce income tax.

4. There is an anomaly in Peter Costello's system in relation to death. Benefits paid to a member over the age of 60 are tax free but if paid to a non-dependant of the member after death (such as adult offspring), then the whole taxable component of the payment is subject to tax, irrespective of the age of the recipient. Whilst this gives an advantage to those notified of their imminent death (when it becomes prudent for those over 60 years to cash out all remaining superannuation tax free to avoid beneficiaries paying tax), it is of little help to the majority who die unexpectedly.

5. The substantial tax advantages of contributions to superannuation for those near 60 years of age can be “donated” to younger relatives to allow them to save with only a 15% tax rate by giving amounts to their parents to put into superannuation and take out tax free later. Potentially $150,000pa could be directed into this strategy.

Infexibility

For the Australian Government

Up to a point (and that may be up to $30 billion per annum), governments now and into the future have no control over the level of tax expenditure on superannuation tax concessions. This is illustrated by the inconsistency of the current situation where the Australian Government is spending large amounts of money to stimulate demand and hoping these amounts will not be saved while at the same time continuing to offer huge tax concessions to higher income earners to save via superannuation.

For Individuals

1. Caps on contributions and minimum and maximum levels for pensions restrict flexibility and enforce lower levels of saving than some people may desire. Caps on contributions are a legislated constraint on saving every year, they do not suit the changes in capacity to contribute as people age, they do not allow for changing preferences through life and they are difficult to administer (potentially for every single person, particularly with multiple funds). These administrative costs fall on the funds and thus every member.

2. A problem with minimum levels for pensions has emerged following the massive declines in stockmarkets over 2008. The levels of pensions are determined on asset values at a particular point in time and beneficiaries are complaining that they are being forced to take higher pensions than they would at current valuations and thereby realise losses on share investments.

3. Still employer/work related: Obtaining tax deductions for superannuation contributions beyond the compulsory 9% pa is dependent on the agreement of employers because deductible contributions by individuals are primarily restricted to the self-employed, again presumably so that the benefits of the tax deductions do not place an excess burden on government revenue. This makes extra tax deductible contributions difficult or impossible for some and interferes with calculations of remuneration related to overtime. Individuals should be able to save whatever they want in a tax-preferred fund without needing the agreement of their employer.

4. The abolition of tax on all superannuation benefits paid after 60 years of age may encourage earlier retirement by many individuals than might otherwise be the case.

Complexity

The Consultation Paper illustrates some of the continuing complexity with the current system. This level of complexity is unnecessary and is partly due to trying to contain the extent of the tax expenditure. For example, what other justification is there for allowing tax deductible contributions by employers and the self-employed but not for the vast majority of employees?

Whilst tax does not apply on payments from superannuation to those over 60, data on taxable components must be maintained in case the member dies and payments are made to non-dependants (who are likely to be subject to tax on the payments). There are also complicated rules relating to contributions, death benefits, gearing and what investments are allowed. All this causes administration costs for superannuation funds and issues in valuing members' holdings.

Sustainability?

With an aging population and the probability of economic downturns in the future, it is questionable whether the current system is sustainable from a government revenue perspective. It also may not be sustainable from a political perspective as younger voters become aware of the extent to which they are subsidising wealthy older voters with their taxes.

The Proposed Solution – The LSS

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

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

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

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

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

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

F) Withdrawals of taxable components will be added to the account holder's taxable income and therefore effectively taxed at their marginal rate. All withdrawals must be from the most recent 30 June taxable component first (rather than a figure calculated at the time of withdrawal as this component could vary continuously). There would be no rules regarding maximum and minimum withdrawals. Certain withdrawals at any age to be allowed, including the same rules as apply at present (such as for terminal illness) and for holdings over $2 million, with any taxable components to be withdrawn first and added to the recipient's taxable income. Apart from stipulated exemptions, the current preservation rules would apply to the age at which withdrawals would be allowed (55 years phasing to age 60 with access for retirees from age 55). Rationale: Since there is no tax in LSFs, there must be tax on withdrawals of investment earnings to avoid tax distortions. Requiring withdrawal of taxable components first avoids loss of revenue for too long, avoids application of complicated ratio analysis and means that most people's tax liability on pensions will occur early in their retirement, leaving them tax free for the rest of their lives. (See below re annuities.)

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

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

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

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

K) LSFs to be either accumulation or defined benefit and if the former, reserving is not allowed. (Reserves to be allocated as of the starting date and included in the tax free component.) Any taxed defined benefit fund could transition to be a Life Savings Fund but subsequent contributions to it could only be from individuals from their after tax dollars. The calculation of the tax components of defined benefit LSFs would be the same as for accumulation LSFs (see below). New defined benefit funds could still be started but only by insurance companies supervised by APRA with tax free pools and with contributions only from individuals. Transition issues are addressed below.
L) Self-managed superannuation funds (SMSFs) to be replaced by Private Life Savings Funds (PLSFs) which could have a maximum of 10 members (versus 4 for SMSFs) with tight controls to ensure that small business owners do not coerce employees into funds that they create, etc. Maintaining the existing rules for who can be a member may be the best policy.
M) Transfers: Account holders could transfer all or part of their accounts to any other LSF provided the owner of the account does not change. The tax free and taxable components of the amount transferred would be as calculated above at the date of transfer and there would be full flexibility in partial transfers as regards the ratio of the 2 components in the amount shifted. Any taxable components withdrawn must be added to the account holder's taxable income.
N) Insurance: There is no tax in LSFs and therefore no deductions but life and disability insurance could be offered with no tax payable in the fund for insurance payouts to the fund. Premiums would come from the taxable component and insurance payouts would form part of the taxable component.

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

Associated Changes

If Australian Governments were to adopt an objective of creating a government defined benefit scheme to replace the aged pension then additional government revenue will probably be required. The following addresses that issue, along with options for additional government contributions to saving by individuals.

Possible Government Contributions

This document questions the need to subsidise saving beyond that required to achieve the age pension or somewhat more. However, this section presents some options if governments decide that the Life Saving System does not include sufficient incentives.

To subsidise savings in conjunction with the Life Savings System, governments could provide co-contributions or an expanded government contributions scheme with the additional tax revenue resulting from the elimination of tax deductible contributions to superannuation. Governments could vary their contributions depending on fiscal conditions, which is an advantage over the relatively rigid current system. The amounts to be contributed could be announced each year in the Federal Budget to avoid an impression that they are a normal part of the system.

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

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

CGT Changes

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

Other Taxation System Changes

In addition to capital gains tax changes, the above should be accompanied by removal of the low income tax offset (which increases marginal tax rates higher up the scale), an increase in the tax free income threshold to around $15,000 to $20,000pa for every resident, removal of the higher tax free income threshold for seniors and removal of the small business retirement and capital gains tax concessions. Few people understand the latter concessions, they involve compliance with highly restrictive rules, restrict liquidity in the market for small businesses and like superannuation involve reversals of the progressive tax system. The Medicare levy should also be removed and incorporated into the existing tax scales, thus removing more legislation and avoiding distortions in marginal tax rates. Raising the tax free income threshold and applying it to everyone would obviously be very expensive but the other measures offset this change and the removal of tax deductions for superannuation contributions should result in substantial additional revenue. The rationale for these changes is that they would rationalise and simplify taxation, lower marginal tax rates for low to middle income earners and fit well with the Life Savings System. The LSS provides an attractive replacement for some of the existing measures.

Purposes of LSFs and Death of Account Holders

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

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

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

International Aspects and the CM&C Test

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

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

Operational Details

Negative Taxable Components

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

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

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

This approach provides a tax offset that advantages individuals in relation to their personal tax situation when substantial market declines decimate account balances as has happened recently with superannuation funds.

Issues Related to Withdrawals and Transfers

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

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

Educating Consumers

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

Costs

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

Defined Benefit Funds and Retirement Annuities

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

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

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

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

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

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

Retirement Annuities

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

How Should the Life Savings System be Used?

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

- Many may see it as attractive to hold all long term savings (up to the excess contribution and assets thresholds) for retirement in LSAs (and perhaps for other needs such as for housing and medical expenses, subject to government policy) because their earnings are tax free within the fund and tax free components are indexed. If amounts are needed for short term problems then they can be borrowed from the LSF, provided a market rate of interest is paid. (Many may not see an attraction in the LSS, as many have not taken full advantage of the current highly tax advantaged system. It may be appropriate therefore to allow borrowing of part of each account at a market interest rate.) When withdrawals are allowed for an account holder, it appears advisable for him/her to withdraw each year such that his/her taxable income is at least the dollar amount of the income tax free threshold if available. Above this, retirees may prefer to withdraw according to their needs as taxable components not withdrawn are not subject to tax in the Life Savings Fund (depending on their attitude to the tax liability they leave to their heirs). If the amounts withdrawn were not required for consumption then they could be contributed back to the fund (or perhaps to a spouse's account) to increase the tax free component. This may not be advisable if it resulted in exceeding the contributions and asset tax thresholds.
- Couples retiring at the same time may want a situation where each has equal taxable components to take full advantage of tax free thresholds. Flexibility of switching to others is not allowed without withdrawal (and possible tax liability from taxable components), but this could be achieved over time when withdrawals are allowed. Direction of compulsory or other contributions to any other account holder is allowed prior to meeting a condition of release.
- It is likely that the more people that receive the proceeds of a deceased's savings in the Life Savings System, the less the total amount of tax paid. An account holder may wish to nominate a number of beneficiaries for after his/her death if there is a substantial taxable component rather than the single taxing point of an estate.
- Residents such as retirees with taxable components whose income is so low that they do not pay tax on it may be better to withdraw from their Life Savings Account to the point where the return on their personal investments verge on creating a personal tax liability (if they qualify to withdraw). This is because they otherwise are likely add to their taxable components in the Life Savings System and possibly generate tax liabilities later. It appears advisable to re-contribute these amounts back into the Life Savings System. Taxable components not withdrawn are not subject to tax until withdrawn so the answer to this question

depends on the account holder's attitude to the tax liability they leave to their heirs. An exception is where the account holder is or may be subject to the excess contributions or excess assets taxes.

Positives and Negatives

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

1. No tax on investment earnings in the funds = tax deferral: The less the frequency of application of a tax of a given rate then the less its impact. Life Savings Accounts will allow young people starting out in a job to defer tax on the earnings on their retirement savings for decades. They will see growth unhindered by taxation. In summary, the zero tax rate and full refund of franking credits makes Life Savings Funds a very attractive way to save for retirement (up to the point of being affected by the excess contributions and asset taxes).
2. The LSS provides protection from tax on account holders' after tax contributions by indexation to the CPI. This is not the case with the current superannuation system and the full investment gains are potentially subject to tax if withdrawn before 60 years of age. Assets where the real value of principal is not protected from tax by indexation are better held within a Life Savings Account than directly by an individual or company. For example, bank accounts and bonds.
3. Double utilisation of the income tax free threshold and/or lower income tax thresholds – each year during a person's working life and each year in retirement. Employees are currently subject to a progressive tax scale on their income. Via the Life Savings System, most would get the opportunity to "split income" through time. That is, taking advantage of the progressive tax scale again on their investment returns in retirement. If a tax-advantaged savings alternative does not exist then earnings on investments held by individuals are added to other earnings for tax purposes. (This advantage of the LSS would not exist if a flat tax on all income was introduced.)
4. The proposed system moves away from contributions mainly deriving from employers (to achieve maximum tax effectiveness) to giving individuals the capacity to access the best tax advantages directly, either on behalf of themselves or their spouses, children (over 18 years), etc. For example, husbands could (and under the Life Savings System should, to maximise tax benefits by splitting income in retirement) contribute on behalf of their wives while the latter are out of the workforce to give birth and raise children and still the maximum tax advantages available under the system will be accessed. Unlike the current system, the Life Savings System does not discriminate between workers and non-workers at any age.
5. The existing co-contribution system could be retained (or expanded because of the elimination of the tax expenditures inherent in the current system).
6. Greater flexibility with no limits on contributions or withdrawals (although tax can influence decisions with regard to the latter and at the extremities in regard to the former).

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

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

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

1. Abolition of substantial tax subsidies to more wealthy taxpayers: The biggest advantage of the Life Savings System is that it will result in a substantial saving in tax revenue that can be directed other than to primarily subsidising the retirement of people who are already comfortable and who should be self-reliant. The LSS provides a substantial shift of tax incentives to save away from what one commentator described as "upper class welfare". With the tax subsidies eliminated, tax thresholds can be shifted up or marginal tax rates reduced. Alternatively, the savings could be directed into an expanded government contribution scheme to reduce reliance on the age pension by low income earners. The LSS will also avoid the risk that the current system will become unsustainable as the population continues to age and pressures younger workers with higher taxes than would be the case without the tax distortions of the current system. (If governments want lower taxation for higher income earners then it seems more apppropriate to provide it in the income tax system where it may achieve higher participation rates and incentives for workers.)
2. Simplification: The LSS will be a less complicated system for retirement savings which should be easier to understand for people with low levels of financial knowledge and it should lower ongoing costs. Two taxes are removed from within the savings environment. The LSS aims to use the existing income tax system (which appears likely to remain for a very long time) and remove two other taxes – on contributions and superannuation fund earnings. The income tax system takes over from the contributions tax that currently applies to concessional contributions to superannuation. This should lower costs for the approximately 300,000 superannuation funds in Australia, all of which presumably lodge tax returns. In comparison, Peter Costello estimated that the removal of tax on superannuation payments to over 60 year olds would mean that 150,000 people would no longer need to lodge a personal tax return.
3. Those investing retirement money would not need to spend time trying to manage tax issues apart from the attraction of fully franked dividends from Australian companies.
4. Consistency of taxation of retirement savings with the progressive income tax system: There is an income tax system for individuals and it is better to let that

apply first to amounts before they enter the tax-preferred savings environment, rather than having a partial flat tax system applying to the amount saved for retirement. If an incentive for retirement saving is required then it can be applied transparently via direct subsidy.

5. Bias against taking of lump sums: Because of progressive income tax and the absence of tax in funds, the proposed system encourages taking payments as pensions over a long period. That is, it generally discourages withdrawal of large lump sums which can be dissipated by individuals, resulting in the need for welfare in retirement. If this does happen in some cases, it will at least be preceded by some tax being taken out first. Taxpayers provide insurance for the risk of individual retirees making financially incompetent decisions and losing all or most of their retirement savings and the proposed system reduces the risks for taxpayers. (It could be argued that allowing gearing in Life Savings Funds still allows this to happen. However, if individuals suffer large losses due to gearing then it seems that it would be less likely in retirement and more importantly it would not result in the concurrent loss of the large initial tax subsidies inherent in the existing system.)
6. The Life Savings System should provide better inter-generational equity. It involves no loss of revenue from income tax related to work by individuals in contrast to the current system. It does involve a tax subsidy related to investment earnings and to income taken in retirement (and from possible government contributions), but the tax subsidies will be of most benefit to lower income earners who are more likely to need help to avoid reliance on the aged pension.
7. Flexibility for individuals and government: It is easy for governments to adjust the proposed Life Savings System because the existing income tax system is applied first. (That is, it is effectively a 'take tax first and consider subsidies later' system. The current system is so generous that the only sensible way to reform it is to increase tax, which is very difficult for governments on a piecemeal basis and without hurting low income earners.) For example under the LSS, if a government wanted to direct proposed tax cuts into savings then it could give the tax cut but concurrently raise the compulsory contribution level. It could also boost saving for retirement by expanding government contributions, for example in a year when tax revenues are very high but there is a risk of inflation.
8. Franking credits will still be very attractive to a substantial part of the investors in the Australian stockmarket. This should continue to provide a disincentive for listed Australian companies to push tax avoidance to the limits.
9. A major reform like the LSS gives the opportunity to include changes that are not related to tax and structure. For example, the adoption of default additional contributions on top of the compulsory 7%, such as an extra 1 to 3% or default directions of after tax pay increases into LSFs.

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

1. The absence of tax on investment returns will lead to faster growth of assets than with a nominal 15% tax on returns. Over decades there will be a very substantial amount held in LSFs. These assets will not generate any tax revenue for the Australian Government compared to the nominal 15% tax that applies to superannuation now. However, offsetting this is the removal of tax deductions on contributions, which should result in a substantial net gain in tax revenue and lower contributions. It should also be remembered that under the current system when superannuation funds pass into pension phase they become tax free so

this system already partially exists. Over time, the Life Savings System should result in increased retirement savings for lower income earners who, under the current superannuation system, are more likely to be dependent on aged pensions in retirement. (This will arise from higher net investment earnings in a tax free environment and rising compulsory contributions over time.) Reduced need for pensions will reduce demands on future Federal Budgets as the population ages. (It is beyond the scope of this document to model the relative revenue outcomes, which will change depending on the balance between workers and retirees, etc.)

2. The proposed Life Savings System will result in substantially less tax benefits for some higher income earners while increasing advantages for lower income earners. It is therefore likely to be subject to attacks by vested interests and politicians. This may impinge on the attraction of saving for retirement by the general public. This proposal also allows withdrawals of some existing superannuation holdings. It is possible that the combination of these factors may result in an initial contraction of total savings for retirement. However, such withdrawals are more likely from more wealthy members (which is unlikely to add much to the burden on taxpayers for age pensions). The removal of the need for employer agreement to obtain the best tax outcomes, tax free investment returns plus the expansion of compulsory contributions should be able to improve growth of retirement savings, particularly for those who most need it.
3. In the future some (more wealthy) Life Savings Account holders will be subject to tax on withdrawals after the age of 60 although they may not necessarily be disadvantaged relative to the current system of tax free withdrawals from superannuation after that age. Some may have to lodge tax returns although the tax free threshold plus the indexation of the tax free component in the new funds should avoid this for most people at some stage of their retirement. For an individual with little income and capital gains apart from withdrawals from Life Savings Accounts, it should be possible for the PAYG deductions to remove the need for lodgment of a tax return in most cases. When all the taxable component is withdrawn, payments from the tax free component will not require lodgment of a tax return or withholding of tax. (There will probably be a taxable component generated each year from investment returns but this should not create the need for lodgment of tax returns by most people as they age.)
4. With compulsory contributions being a fixed percentage of after-tax remuneration, the proportion that this represents of pre-tax remuneration declines with higher incomes because of the progressive tax system. That is, the current system results in higher compulsory contributions by higher income earners than the Life Savings System. Given that potential future problems for taxpayers in funding age pensions is more likely to arise in relation to lower income earners, this may not be much of a problem and can be addressed by raising the compulsory percentage over time. There is also the attraction that non-compulsory contributions of any amount can be made at any time.
5. There may be a complication for administrators of Life Savings Funds in relation to some members who withdraw taxable components and have accounts with multiple funds. For example, a member may have an account with Fund A that is 100% tax free and an account with Fund B that has a substantial taxable component. If the member applies to withdraw from Fund A then one way to enforce the rule of taxable components first is for its administrators to know of the Fund B holding. This may require members to comply with rules on withdrawals, declarations from members, communication of data between funds,

encouraging consolidation of accounts and/or dealing with the tax issues retrospectively. Another method in theory would be for all funds to electronically report tax free and taxable components with tax file numbers to the ATO after each 30 June with the ATO acting as a reference point to check before withdrawals. This may present substantial operational challenges for the ATO. In practice it will be unusual for account holders to have only a tax free component with one fund and no taxable component with another. This is a similar problem to taxpayers who work for multiple employers and can be partly addressed as the employment situation is – by declarations by account holders as to whether their account in a Life Savings Fund is their sole account and therefore to be taxed as such, etc. (Note that there is a similar complication with the existing system in relation to tax on contributions that exceed the concessional cap, because this cap applies to accounts held in multiple funds. This requires calculation of total contributions across multiple funds.)

6. The fund management industry may be alarmed that the Life Savings System will result in reduced inflows. However, this may not be an issue in the long term as tax free growth will eventually result in higher amounts from compulsory contributions in most accounts. (Sample calculations suggest this.) Like the current superannuation system, the LSS will be the most tax effective way to save so it should attract substantial funds. It seems unlikely that the changes will cause strong outflows, except from the small minority who will be exposed to the excess contributions and assets taxes. Also, the LSS discourages withdrawal of lump sums and this should maintain a high level of funds under management in the long term. Finally, the government should raise the compulsory percentage over time.
7. The proposed system will require valuations of all assets in funds at least at 30 June of each year for reporting to the ATO and members. Those with very substantial holdings will assess their possible liability to the excess assets test. This may increase the attractiveness of exotic investments that are difficult to value so the ATO will have to be vigilant in monitoring such investments and funds to ensure there is no evasion of this tax.
8. Accounts should grow faster over time in the Life Savings System than in the current superannuation system due to a zero tax environment, but Life Savings Accounts can be considered to have contingent tax liabilities for those over 60 years of age. A criticism may be that this will give retirees a false sense of the worth of their retirement savings under the LSS compared to the current superannuation system. There is some validity in this argument but for most people who do not have multi-million dollar holdings and take moderate withdrawals over the decades of their retirement, the tax liability should be low.

Achieving Adequate Retirement Savings

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

Transition to the New System

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

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

Assets Initially Exceeding Asset Thresholds

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

Recipients of Superannuation Pensions

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

Alternatives, Comments and Tax Minimisation

Alternatives

Allowing Full Deductibility of Contributions

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

The first problem with this system is that it requires continuation of restrictions on contributions and other complex rules or the loss of government revenue becomes too great. (The contribution limits would probably have to be lower than the current limits to protect government revenue.) Many Australians may not be able to take full advantage of the tax deductions because of unavailability of sufficient earnings for each year or the need to save for a home purchase but are restricted later in life by the limits. Second, it bypasses the progressive tax system and provides greater benefits to those who can afford to contribute more, up to the limit on contributions. Unless personal deductible contributions were allowed (creating even more loss of tax revenue), this system would continue the need for employer co-operation.

This system would also require more people to declare and pay tax on their superannuation withdrawals and many people would probably have to file tax returns and pay tax into their 80s and 90s, although deduction at source may remove the need for tax returns.

Some of the problems could be addressed by allowing unlimited contributions but imposing a low level excess assets tax and/or contributions tax, starting at say $2 million.

Overall, this is a much less attractive option.

An Alternative Treatment of Death Benefits

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

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

Abolishing Inhouse Asset Restrictions

An alternative to the inhouse asset restrictions that would continue under the LSS is to reduce the level at which the excess assets tax applies and remove all restrictions on investment including exposure to inhouse assets. The latter would allow Private Life Savings Funds (PLSFs) to invest in private companies owned by members. (The lower excess asset tax threshold could be restricted to PLSFs.) A problem then arising is that an owner of a private company could sell it to their PLSF, limit their remuneration to a low level and effectively direct a large part of the company's after tax profits into the PLSF via fully franked dividends. The result is complete avoidance of tax on the amount going into the PLSF after refund of franking credits. Everything is eventually potentially taxable under the LSS, but it would provide a method for deferring tax for decades and create asset valuation problems for application of the excess assets test. An attraction is that it removes another layer of complexity and allows a small business owner to maintain his or her retirement savings in the tax effective environment but still invest in his/her business. It also provides an alternative to the current complex small business CGT concessions and is probably not as generous. Such a change would be likely to encourage higher levels of incorporation of small businesses and ownership of them by PLSFs. One way to address the tax deferral problem would be to lower the threshold for the excess assets tax in LSFs (to say $2 million). Removing inhouse asset restrictions would create a substantial tax deferral opportunity for those with private companies, up to the point where they were affected by the excess assets tax.

However, the advantages that this approach gives of removing the disincentive with superannuation of locking savings away for decades may make it worth consideration as a replacement for the current small business tax concessions. Removing all inhouse asset restrictions still means savings are locked into the LSS but they can be effectively utilised in any person’s business.

Conclusion

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