A first step to stopping super being a taxpayer-funded inheritance scheme

Submission to the Senate Economics Legislation Committee inquiry into the Treasury Law Amendment (Better Targeted Superannuation Concessions) Bill 2023

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We welcome the opportunity to make a submission to the Senate Economics Legislation Committee inquiry into the Treasury Law Amendment (Better Targeted Superannuation Concessions) Bill 2023.

We support the Bill, which would limit tax breaks on earnings on superannuation balances larger than $3 million. But the government should go further – the threshold should be lowered to $2 million. If the $3 million cap stands, it should not be indexed until around 2040.

Superannuation has become a taxpayer-funded inheritance scheme

Tax breaks on superannuation mean less tax is paid on super savings than other forms of income. These tax breaks are excessively generous – extending well beyond any plausible purpose for Australia's superannuation system to provide for income in retirement – and their costs are unsustainable.

Super tax breaks cost $45 billion a year – 2 per cent of GDP – and will soon exceed the cost of the Age Pension. Two-thirds of the value of super tax breaks benefit the top 20 per cent of income earners, who are already saving enough for retirement and whose savings choices aren't much affected by tax rates.

Superannuation should not be a taxpayer-funded inheritance scheme. Yet that is exactly what it has become. Much of the boost to super balances from tax breaks is never spent. By 2060, one-third of all withdrawals from super will be via bequests – up from one-fifth today.

Nor do super tax breaks materially reduce Age Pension spending. That's because the cost of super tax breaks far outweighs the Age Pension savings they produce, with the bulk of the benefits going to higher-income earners who would never receive the Age Pension.

With the federal budget facing a deep structural deficit and big spending pressures looming, curbing super tax breaks should be an urgent priority. Without reform, super tax breaks will increasingly just end up boosting the inheritances received by children of well-off parents.

The $3 million cap on super earnings tax breaks is a sensible step in the right direction, but the government should go further

The Bill proposes that from 2025-26, the earnings on super balances bigger than $3 million will be taxed at 30 per cent (instead of 15 per cent currently). This is projected to affect about 80,000 people and trim earnings tax breaks for those with very-high balances by about $2 billion a year once the policy is fully operational.

People who will be affected by the $3 million cap will be quick to argue that these changes retrospectively affect superannuation investments. But lots of changes affect investments made in the past, and no-one suggests they are retrospective. If someone bought shares in a company yesterday, they expect that the future earnings on these assets will be subject to their marginal income tax rate, which may change in future.

The government should go further – the threshold should be lowered to $2 million.

Australians with more than $2 million in super should not benefit from generous tax breaks on the earnings. Only a tiny minority of Australians – about one in every 200 super fund members in 2019-20 – has accumulated more than $2 million in super. Yet these accounts contain almost one in eight dollars in the super system, or almost as much as the accounts of the two-thirds of Australians who have less than $100,000 in super.

There is no rationale for generous earnings tax breaks on balances between $2 million and $3 million, certainly not one that is consistent with the proposed objective for superannuation to 'deliver income for a

dignified retirement, alongside government support, in an equitable and sustainable way'.

People with that much in super will have a very comfortable retirement without taxpayer support. Dropping the cap to $2 million would save the budget a further $1 billion a year.

The earnings tax breaks on balances larger than $2 million can easily end up being more than poorer retirees get from the Age Pension. It's unlikely much, if any, of this boost will get spent in retirement, which means earnings tax breaks just end up subsidising bequests to the children of well-off parents.

Lowering the threshold to $2 million would also present an opportunity to simplify the superannuation system. Super tax is notoriously complicated, and no aspect is more complicated than the Transfer Balance Cap, which governs the maximum amount new retirees can bring into the tax-free retirement phase. A $2 million threshold would allow that cap to be abolished.

A $2 million, inflation-indexed threshold would align with where the Transfer Balance Cap should be by 2025 (it is currently set at $1.9 million).

Retirees could have all their savings in a single account and simply pay a higher (than 15 per cent) rate on earnings above the $2 million threshold to reflect the fact that their initial tax rate is 0 per cent (probably about 23.5 per cent after accounting for franking credits and capital gains discounts).

Unlike the government's $3 million threshold, a $2 million threshold should be indexed in line with inflation right away, as per the current arrangements for the Transfer Balance Cap.

Should the government persist with applying the higher tax rate only to the earnings of super balances bigger than $3 million, the threshold should not be indexed until the real value of the threshold falls to $2 million due to inflation. That will occur by around 2040, or in about six federal elections' time.

Implementation challenges with the earnings cap are manageable

Levying a higher tax rate on the earnings of large super balances is complicated by the fact that existing super earnings taxes are levied at the fund level, not the individual member account.

The approach in the Bill to levy a 15 per cent surcharge on the implied earnings of the account over the year (the change in account balance, net of contributions and withdrawals) is the best available.

It strikes the right balance between the need to apply the tax in line with the income earned (which would normally account for capital gains) and the need to limit the regulatory burden on super funds in order to administer the tax.

This approach will impose tax on unrealised capital gains on superannuation, with super fund members offered the choice of paying any tax liable on unrealised gains from within the fund, or from outside super.

The 2010 Henry Tax Review highlighted a number of benefits of shifting to taxing capital gains on an accrual basis, compared to taxing realised gains, including removing incentives to 'lock in' investments to hold onto untaxed capital gains while moving quickly to realise losses. Some other taxes – such as state land taxes and council rates – are levied accounting for the unrealised portion of capital gains on property assets.

Taxing unrealised gains could create cash-flow problems for some self-managed super fund (SMSF) members who hold illiquid assets, such as property, and who will be required to pay tax before realising those gains.

But these problems shouldn't be overstated, for three reasons.

First, about 85 per cent of accounts larger than $2 million are held by people over the age of 60 who are likely to be in draw-down phase and must already have enough cash on hand to pay out pensions each year in line with the 'minimum draw-down' rules. Further, under superannuation law, SMSFs are required to have an investment strategy that accommodates liquidity and the ability of the fund to discharge its liabilities.

Second, the first tax bills from the policy won't be sent out until after 2026, which gives SMSF trustees plenty of time to update their investment strategies to be consistent with their new potential liquidity requirements.

And third, the tax does not have to be paid from super in any case. Australians with large super balances typically earn as much income from investments outside super.

Further reforms to super tax breaks are needed

The government will need to go further than the super tax provisions in this Bill.

Past changes to super tax breaks have not gone far enough, and nor will the provisions in this Bill. With the federal budget facing a long-term structural deficit of 2 per cent of GDP, and big spending pressures looming as our population ages, curbing excessive super tax breaks should be an urgent priority.

The government should therefore bring forward further legislation to:

- Raise Division 293 tax, which curbs tax breaks to high-income earners on their pre-tax super contributions. The tax should be increased from 30 per cent to 35 per cent, and the income threshold at which the tax applies should be lowered from $250,000 to $220,000 a year. This would save the budget about $1.1 billion a year and stop many high-income earners benefiting from larger tax breaks, per dollar contributed to their super, than low- and middle-income earners.
- Lower the cap on pre-tax super contributions, from $27,500 to $20,000 a year. This would save about $1.6 billion a year, mostly by reducing voluntary contributions made by older, wealthier Australians to minimise their income tax bills.
- Abolish carry-forward provisions and government co-contributions, which were intended to encourage catch-up contributions but in fact facilitate tax minimisation for high-income couples. This would save about $1.1 billion a year.
- Tax all superannuation earnings in retirement at 15 per cent – the same rate that applies to super earnings before retirement. Retirees would then pay some tax on their superannuation savings – the same as those working today – but still much less than younger workers pay on their wages. This reform would save more than $5.3 billion a year.

These changes, together with lowering the the cap on limiting super tax breaks to $2 million, could save the federal budget more than $10 billion a year.

Further detail on our proposals to reform to the tax treatment of superannuation can be found in Grattan Institute's 2023 report, *Super savings: Practical policies for fairer superannuation and a stronger budget.*

We would also welcome an opportunity to appear before the Committee. For further information please contact Brendan Coates, Economic Policy Program Director, Grattan Institute: [redacted].