Chapter 10

Whole of Life Taxation Arrangements

Introduction

10.1 The previous two chapters dealt with annual fund level taxes and the surcharge. In those chapters, the Committee recommended significant changes in those 'front-end' taxation arrangements. This chapter considers the impact of those recommendations, in the context of the evidence received during the inquiry, for the whole of life equity arrangements. The following issues are considered:

- reasonable benefit limits (RBLs); and
- taxation of end benefits.

10.2 The issue of income streams and taxation of lump sum benefits is discussed in more detail in Part IV- Integration.

Reasonable benefit limits

10.3 The RBLs are a whole of life equity arrangement. They are intended to limit the individual access to superannuation tax concessions.

10.4 The RBLs have been in place in one form or another for many years as a means of limiting the access to the taxation concessions available to superannuation. The RBLs are measured on a whole of life and whole of superannuation holdings basis rather than an annual basis like the annual deductible contribution limits and surcharge.

10.5 There are two RBL tests. One applies where the majority of the superannuation benefit is accessed as a lump sum (or allocated pension) and the other apples where the majority of the superannuation is accessed as an income stream. The RBLs for 2002-03 are $1,124,384 where at least 50 per cent of the benefit is taken as an income stream and $562,195 where the main benefit is a lump sum. The income stream RBL is higher than the lump sum RBL to encourage people to take their benefit as income. Any benefits that exceed the relevant RBL are taxed at the top personal marginal rate.

10.6 Treasury indicated in its written submission that very few people exceed the RBL over a lifetime.[1] The Treasury also informed the Committee that the average superannuation holding per person is about $62,000 and that average superannuation payouts are currently around $72,000 per person.[2]

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1 *Submission* 78, Treasury, p. 29.

2 *Submission* 78, Treasury, p. 16.

10.7 ASFA indicated that the real life impact of the RBLs is limited. ASFA stated that:

> Around about 650 people a year pay tax on excess benefits, but others are likely to have put in place strategies to deal with their potential excess benefits. This compares to the one million or so taxpayers in the age group where superannuation benefits are customarily or required to be taken.[3]

10.8 As indicated above, the RBLs are flat dollar based limits, irrespective of the income of the individual. In the past the RBLs have been based, at least in part, on income. There are layers of transitional arrangements currently in place that apply to people who have superannuation that was accrued under different RBL provisions. As will be seen later in this report the transitional, or grandfathering arrangements, add considerable complexity to the superannuation system.

Committee view – reasonable benefit limits

10.9 The Committee notes that the average superannuation holdings and benefit payments are a very small proportion of the lump sum RBL. The Committee considers that this large gap, which, taken together with the high lump sum tax free threshold, provides little encouragement for people to take income streams.

10.10 The Committee feels that, although the RBLs are having a minor role to play in the management of equity within the superannuation system, they are important as are the other measures such as annual contribution limits and the annual surcharge. The Committee also notes that RBLs would have less relevance if all superannuation benefits were taxed progressively.

10.11 The Committee considers that the RBLs become redundant in an environment where progressive taxation applies to all superannuation end benefits. Nonetheless if the Committee's recommendations relating to the taxation of end benefits are not adopted, the Committee considers that there would be merit in the Government examining measures that would make the RBL more effective. For example through freezing or reducing the annual indexation of both RBL thresholds, or just the lump sum threshold. Another option would be the introduction of single and couple RBLs that would more closely align with the age pension arrangements (which apply differently to singles and couples).

Recommendation

10.12 **The Committee recommends that the current Reasonable Benefit Limits (RBLs) be retained, but that the annual indexation applicable to RBL thresholds be limited.**

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3 *Submission* 73, ASFA, p. 29.

Taxation of end benefits

10.13 The taxation of end benefits also form part of the whole of life superannuation arrangements. Lump sums are taxed only once while income streams are taxed at regular intervals over the payment period. Accordingly the lump sum/income stream dichotomy has important implications in the level of access to the age pension.

10.14 The taxation of superannuation lump sum and income stream benefits have become very complex over the last 20 years. Largely this complexity is a product of the 1983 eligible termination payment (ETP) arrangements and the introduction of fund contributions and earnings taxes in 1988.

10.15 Prior to 1983 only 5 per cent of the lump sum benefit was taxable at the individual's marginal rate of tax. Any income stream was fully taxed as normal income.

10.16 The Committee requested the Australian Taxation Office (ATO) to provide some representative examples of the operation of superannuation taxes on end benefits. The examples provided by the ATO are at **Appendix 10.** The examples demonstrate the complexity of the arrangements.

10.17 Much of the evidence quoted in the chapters on the annual taxation measures, indicated that Australia should move taxation away from front-end measures that apply during the accumulation phase to the end benefits. In the chapters dealing with annual taxation measures and the surcharge, the Committee made a number of recommendations to gradually phase out the front-end taxes in the long term.

10.18 As discussed, in its written submission to the inquiry, Treasury indicated that most superannuation benefits are taken in lump sum form, with the average superannuation payment around $72,000 per person, which is well below the lump sum tax free threshold of $112,405.[4]

10.19 The Committee is aware that in the year ending 30 June 2001 some $30.2 billion was paid as superannuation benefits. Of this, about 79 per cent, or $23.8 billion, was taken in lump sum form.[5]

10.20 The Committee is also aware that ASFA has calculated that the post 30 June 1983 lump sum tax for the year ending 30 June 2001 was $510 million.[6] This implies an average lump sum tax of just over two per cent on the $23.8 billion in lump sum payments. With such a small amount of lump sum tax, there does not appear to be any incentive to take an income stream and no real progressive base for an equity measure.

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4 *Submission* 78, Treasury, p. 16.

5 APRA, *Superannuation Trends*, June quarter 2001.

6 ASFA, 'Revenue implications of removing the contributions tax and recent developments in the tax attractiveness of superannuation', September 2000.

Committee view – taxation of end benefits

10.21 The Committee is concerned that the RBL and end benefit arrangements are implicated in the current situation whereby most superannuation benefits are paid as tax free lump sums. The Committee considers that there would be merit in the Government looking at ways of reversing this situation so that lump sums are not limited or banned but are discouraged by the application of a progressive tax.

10.22 The Committee is aware that a person can access a lump sum of $112,405 from age 55 and pay no additional tax. The lump sum tax threshold is indexed to AWOTE annually. The Committee considers that the threshold encourages people to access superannuation in lump sum form rather than as an income stream. Often no additional end benefit tax is paid on the lump sum. By contrast any income stream purchased with the same lump sum would attract income tax at the members' marginal rate less any rebate.

10.23 The Committee considers that all possible measures to encourage income streams relative to lump sums need to be implemented. There are several reasons for this view. Income streams provide people with regular and certain income. The income is more likely to be captured by the age pension asset test than a lump sum. In addition the progressive nature of the income tax provisions provides a high degree of equity at the benefit payment end of the system than the high lump sum tax free threshold.

Recommendation

10.24 **The Committee recommends that:**

- **the lump sum tax free threshold be gradually reduced to the annual equivalent of average weekly ordinary time earnings (AWOTE) and maintained at that level; and**
- **lump sum taxes on amounts in excess of the thresholds be gradually adjusted in line with the tax rate applicable to income streams.**

Overall conclusions - equity

10.25 The Committee found that the current taxation arrangements applying to superannuation are not delivering equity to all Australians because of flat rate contributions and earnings taxes and end benefit taxes that encourage lump sums.

10.26 The Committee considers that equity in the superannuation system is best achieved through a whole of life approach to taxation concessions. The Committee suggests that, together with industry, the Government undertake a review of the appropriate benchmark for determining and measuring the impact of superannuation taxation concessions.

10.27 The Committee prefers to gradually move the taxation of superannuation away from the accumulation phase, that is at the front-end, in favour of end benefit taxation.

However, not all members of the Committee are attracted to the suggestion of providing front-end rebates on individual contributions. Instead, the majority of the Committee prefers phasing out the contributions tax in the long term.

10.28 The Committee considers that by implementing the measures outlined in this report, there is scope to improve the ability of individuals, such as women and others with broken working patterns and baby boomers, to increase their retirement incomes.

10.29 The Committee considers that the surcharge is an inefficient tax which is costly to administer. It causes serious inequities for members of defined benefit funds. It also imposes costs on all members, irrespective of whether they are liable to pay the surcharge or not. For this reason, the Committee would prefer to transfer the administration of the surcharge to the ATO and to introduce a maximum 15 per cent cap on employer financed benefits in all defined benefit fund schemes.

10.30 In the context of the Committee's preference to remove or reduce superannuation taxes during the accumulation phase, the Committee considers that lump sum benefit taxes should be adjusted in order to provide for equity through the progressive tax system and to replace revenue lost through any reduction in front-end taxes.

10.31 In addition, the Committee considers that, while the current RBLs should be retained, the annual indexation applicable to the RBL thresholds should be limited.