The facts on the concessional tax treatment of superannuation

ASFA Research Centre

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Federal Secretariat

Level 19
Piccadilly Tower
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 1005
Tel: (02) 9264 9300
Fax: (02) 9264 8824

The Association of Superannuation Funds of Australia Limited ABN 29 002 786 290 ACN 002 786 290
ASFA Website: www.superannuation.asn.au

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The Commonwealth Treasury in the annual Tax Expenditures Statement (most recently released in January 2003) publishes estimates of what it claims to be the tax expenditures on superannuation tax concessions along with estimates for a large number of other tax concessions not related to superannuation.

The Treasury estimates suffer from a number of conceptual problems, as detailed in publications of Access Economics and ASFA amongst other research papers. In essence, Treasury argues that the benchmark for the taxation of superannuation should be a comprehensive income tax system in which savings are made from after-tax income and earnings from savings are taxed at full marginal tax rates based on the income of individuals in any one financial year. Any departure from this is seen as a tax concession for which an estimate of a tax expenditure can be calculated.

On the other hand, the preferred tax benchmark of Access Economics, and a number of major OECD countries such as Belgium, France, Germany, Netherlands, and Portugal, is an expenditure tax benchmark in which the appropriate point for taxation is when superannuation benefits are received and spent. The benchmark is based on the notion that a superannuation or pension benefit only crystallises in a taxation sense when it is being paid out. Using this benchmark, applying taxes to superannuation contributions or fund earnings before they are actually paid out to individuals involves a tax penalty rather than any concession.

As shown in Table 1, using the conceptual basis and methodology favoured by the OECD countries and Access Economics highlights the fact that superannuation contributions and fund earnings are overtaxed, nor undertaxed. The surcharge on certain contributions made on behalf of some individuals (with an adjusted taxable income above a set threshold) has also been an important contributor to this overtaxation. **The overtaxation of superannuation on an expenditure tax basis has grown from $2,390 million in 1994-95 to a forecast $4,410 million in 2002-03.**

However, not all elements of the superannuation system are overtaxed. While an expenditure tax approach would tax all benefits received at marginal tax rates, benefits in Australia generally are taxed at less than marginal rates in order to compensate for taxation at a prior stage and/or to deliver some degree of concessional tax treatment. The main category for which superannuation payments were undertaxed on an expenditure tax basis is the treatment of unfunded lump sums. Such lump sums typically are paid to retiring or retrenched members of public sector superannuation schemes. No contributions or earnings taxes are associated with such amounts, and they are taxed at marginal rates of 15% or 30% depending on the amount and whether they are paid before the recipient is aged 55. The cost of these arrangements peaked in the early to mid 1990s but has fallen away a little with the closure of a number of unfunded schemes to new members and the substantial completion of retrenchment programs.

Funded lump sums attributable to pre-1983 employment also receive very favourable taxation treatment on both an income and expenditure tax basis. Such amounts were not subject to contributions tax, and only 5% of the amount paid forms part of taxable income. However, the costs of this concession are decreasing as the proportion of the labour force with substantial pre-1983 service has decreased. Over the next 20 years or so the cost of this tax concession will fade away as individuals retire. It also can be considered to be a cost of the pre-1983 tax provisions for superannuation rather than an inherent part of the current provisions.

The final item in the table, under taxation of post-1983 lump sums, shows a fairly steady increase, apart from the drop in 2000-01 attributable to decrease in personal income tax rates associated with the New Tax System. This reflects growth in the payment of retirement benefits attributable to post-1983 employment service. This will generate a growing stream of taxation for government, a revenue stream that would be stronger if contributions and earnings were not taxed. Post-1983 lump sums are taxed (putting the Medicare levy to one side) at the marginal rate of 20% for those aged under 55, and at the rates of zero or 15% for those aged over 55 depending on the amount of the lump sum.

Table 5: ASFA update of cost of tax concessions – expenditure tax basis ($m)

	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Overtaxation of contributions & earnings (a)	-4,540	-4,053	-5,140	-4,440	-4,750	-5,000
Overtaxation of contributions by way of surcharge	-296	-577	-690	-824	-840	-890(d)
Undertaxation of unfunded lump sums (b)	520	520	450	450	450	450
Undertaxation of funded lump sums pre-83(c)	475	475	380	380	380	380
Undertaxation of funded lump sums post-83(c)	380	400	310	330	350	430
Total	**-3,460**	**-3,235**	**-4,690**	**-4,105**	**-4,410**	**-4,630**

(a): Estimates derived from superannuation funds contributions and earnings tax in November 2002 Mid-Year Economic and Fiscal Outlook adjusted for superannuation business conducted by life insurance companies.
(b): As estimated in 2002 Treasury Tax Expenditures Statement
(c): ASFA Research Centre estimate
(d) No allowance is made for the yet to be legislated reduction in the surcharge rate

In comparison, Treasury estimates using the flawed income tax benchmark claim that the cost of tax concessions on superannuation and other employment termination tax concessions was a very large $10.1 billion in 1998-99, rising to $10.6 billion in 2002-03.

Flaws in the Treasury analysis

Apart from the inappropriate conceptual basis being applied by Treasury, their estimates of tax expenditures appear to be seriously flawed even using a comprehensive income tax benchmark. While the absence of publicly available detailed worksheets for their estimates makes replication of the Treasury estimates difficult, on the face of it the Treasury estimate of what is claimed to be the under taxation of fund earnings in 2001-02 is a gross exaggeration, and the similar projection for 2002-03 does not appear to be much better.

More specifically, the Treasury claim that in 2001-02 (a year in which official figures from the regulator APRA indicate that funds had negative returns in aggregate of around $8 billion) the tax expenditure associated with the under taxation of fund earnings and the concessional capital gains tax treatment available to funds was $4.8 billion. While some funds will have had positive returns, under taxation of the order claimed by Treasury seems implausible even or particularly if the Treasury conceptual benchmark is accepted.

The increase in the claimed under taxation of fund earnings is also inconsistent with the forecast fall in fund earnings and superannuation fund tax receipts in the November 2002 Mid-Year Economic and Fiscal Outlook relative to the 2002 Budget papers, with both of these prepared by the Treasury. Treasury increased their estimate of the claimed undertaxation of fund earnings for both 2001-02 and 2002-03 in the 2002 Tax Expenditure Statement compared to the 2001 Tax Expenditure Statement despite evidence of falling if not negative, investment returns. Perhaps when the adjustment was made the wrong sign was attached to the figure, and a digit was mistakenly left out of the adjustment number.

In the same vein, the Treasury assumption of a steadily increasing cost of the capital gains tax concession also appears totally unrealistic given the capital losses suffered by many funds in 2001-02 compared to significant capital gains the year before. The Treasury methodology seems more designed to deliver a figure of $5 billion or so a year for the under taxation of fund earnings than a figure which bears any relationship to what fund earnings actually were in any given year.

Taxes on superannuation in a wider context

Taxes on superannuation funds are a significant and increasing proportion of total Commonwealth tax revenues. Extracting another $10 billion or so from super, as suggested by the Treasury Tax Expenditure estimates, would be extracting the last drop of blood from the superannuation stone given the substantial blood donation already provided by superannuation funds to the Budget. However, even the Treasury Tax Expenditure Statements acknowledge that removing all tax "concessions" for superannuation (that is, by taxing all contributions and earnings at marginal individual rates of income tax) would not lead to increased tax revenue commensurate with the claimed tax expenditure, at least in any other year apart from the year in which such a change was made. This would especially apply in the medium to long term as the effect of such taxes eroded the aggregate assets invested and led to fewer discretionary contributions being made.

Over the period 1989-90 to 2002-03 the taxation revenue collected from superannuation funds from taxation of fund earnings and from the standard tax on contributions is likely to be of the order of $40.4 billion. When the tax collected in regard to the superannuation business of life companies is taken into account, this figure increases to some $50.5 billion.

If these taxes had been left to grow in member accounts the aggregate assets in superannuation funds alone would have been some $78 billion higher as at June 2003. If accounts held through life companies were taken into account the figure would be higher still. There has also been some $3.6 billion in surcharge collections between 1997-98 to 2002-03. The surcharge is becoming one of the more significant Commonwealth taxes, and in another year or two revenue from the surcharge is projected to exceed that from major taxes such as the resource rent tax. Surcharge tax collections continue to outgrow initial government projections, and are now approaching twice the original forecasts of annual surcharge collections.

An additional $80 billion in the system would have helped to provide adequate retirement incomes, would have reduced pressures on government expenditures on the Age Pension, and through the taxation of end benefits would have strengthened the revenue base of future governments. In effect, governments have spent this money in advance of when it is really needed to meet the multi-billion dollar "blackhole" of income support and health and aged care costs identified in the Intergenerational Report.

In conclusion, the tax take by governments since 1989-90 has been around 10 times the net investment losses incurred in the superannuation sector as a whole in 2001-02. If these negative returns are a concern to fund members, then the tax take from superannuation should be a concern at least 10 times greater, or even more given that positive earnings will return but the tax on contributions and earnings appears set to continue.