A CRITICAL ANALYSIS OF THE PROPOSED CHANGES TO SUPERANNUATION TAXATION

Introduction

Consultation has now concluded between government and interested parties concerning the proposed changes to be made to the way that superannuation is to be taxed from 1 July 2007.1

This paper critically analyses the proposed changes as they stand following completion of that consultation process.2

First, the changes are viewed in terms of their divergence from the basic design principle underlying the taxation of superannuation. That principle is that tax concessions are given for saving for retirement on the basis that the funds will be only available at retirement and will be used to replace employment or business income during retirement.

To the extent that these changes will remove the compulsory payment rules and the tax preferences given to pension benefits over lump sums, together with some other recent changes, they will have the effect of diluting even further the connection between tax concessions for saving and use of superannuation fund accumulations for income during retirement.

Secondly, the changes are viewed in terms of the effect of the replacement of the benefit limits with new limitations on contributions.3

It is arguable that these limitations will provide the same taxpayer equity function of the RBL rules. However, they will place tension around the meaning of

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2 A Plan to Simplify and Streamline Superannuation Detailed Outline May 2006. Referred to hereinafter as the ‘Detailed Outline’. As these changes have not been legislated at the date of writing it is possible that further changes will emerge. However, given the extensive consultation process undertaken to date it is expected that any further changes should not change the terms substantively.

3 A Plan to Simplify and Streamline Superannuation, Outcomes of Consultation 5 September 2006 referred to hereinafter as the “Outcomes of Consultation”.

3 This is a reference to abolition of the penal rate of tax that applied on over funding for retirement in the form of the Reasonable Benefit Limits (RBL) and their replacement with limits on contributions. Div 14 Part III ITAA1936 In one sense, this aspect of the changes is a reversion of the design of superannuation taxation to that which it was prior to introduction of RBLs when excess accumulations in low taxed superannuation funds were controlled through limitations on contributions rather than tax penalties for over funding.
contribution and invite scope for co-investing and value shifting between taxpayers and superannuation funds as taxpayers seek ways around them now that superannuation funds are such attractive investment vehicles.⁴

Thirdly, questions are raised about claims that the changes will simplify the rules with respect to taxation of superannuation. It is seen that simplification of the rules will be age dependant in that the rules have only been simplified for taxpayers over age 60, but largely remain the same for taxpayers below that age.

Finally, the increased tax burden and non-integration of employer sourced retirement payments is discussed. These aspects of the changes seem overly harsh and alternatives to the proposals are offered.

1. THE PLANNED CHANGES

The Government’s process

The announcement made by Government on Budget night (9 May 2006) was in the form of a proposed plan for changing the way that superannuation was to be taxed, rather than a fait accompli.⁵ The Government then invited consultation from interested parties and, indeed, received a surprisingly large number of responses.⁶

Government announcement

An outline of the changes to be made is in the Appendix. Following is a more detailed analysis of the changes together with the modifications to the original proposal after consultation.

Payment from age 60

Overall, the most significant of the changes that are to be made to how superannuation will be taxed after 1 July 2007 will be the abolition of tax on benefit payments to members over age 60, where the benefit is paid from a taxed superannuation fund.⁷

For over age 60 members receiving lump sums this change reduces the nominal rate of tax on contributions and on earnings of superannuation funds to 15%, from the previous nominal rates of 15% on amounts up to the low rate threshold

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⁴ Co-investing is where the fund invests in assets together with the members, where permitted. Value transfer means transferring value from that part of the investment owned by the member to that part owned by the superannuation fund.
⁵ P vii Detailed Outline
⁶ 1500 written submissions and over 3000 telephone calls were made; Treasurer’s Press Release No 093 2006
⁷ P12 Outcomes of Consultation
and 30% above that but below the RBL. 

In respect of pension taxation for this cohort, the nominal tax rate will be 15% on contributions and earnings in the fund during the accumulation phase and zero during the payment phase and on receipt, rather than at the marginal tax rate of the taxpayer on receipt.

**Payment before age 60**

However, for post-June 1983 lump sum payments made to a taxpayer below age 60 but above the preservation age, the current tax position with only minor modifications continues. That is, the reduced nominal aggregate rate (15%) up to the low rate threshold and the nominal aggregate tax rate (30%) for amounts in excess of that remain.

For recipients below age 55 this component is to be taxed at 20%, as is the case at the moment.

The taxation of pension payments made to both these taxpayer cohorts will also remain unchanged.

The taxation of lump sum benefits received below age 60 is said to have been simplified in that the eight classes of income that previously could have applied are reduced to two (exempt and taxable) and the previous tax on several of those classes (where 5% was included in assessable income) is to be reduced to zero.

**Payments from untaxed funds**

Payments of lump sums benefits from untaxed funds are to be taxed at 15% for benefits up to $1M and at the top marginal tax rate for amounts in excess of that. That $1M amount is to be a lifetime limit for these types of payments.

Pension payments from untaxed funds are to be eligible for a 10% tax offset.

**Employer sourced payments**

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8 Ibid
9 Ibid
10 P13 Outcomes of Consultation
11 Ibid
12 Ibid
13 P 14 Outcomes of Consultation
14 P 45 Outcomes of Consultation
15 Ibid
Retirement payments from employer sources, such as retirement gratuities, are to be more severely taxed, subject to transition rules. In addition, they cease to be integrated with other forms of retirement payments.\textsuperscript{16}

In respect of employer sourced payments, there is to be an exemption from tax for any post-June 1994 invalidity amount and the pre-1 July 1983 amount but the taxed component (post-30 June 1983 amount) will be taxed at 15\% up to $140,000 if received at or over age 55 and 30\% if received below that age. Amounts in excess of that are to be taxed at the top marginal tax rate per termination. Employer ETPs will no longer be permitted to be rolled over into a superannuation fund.\textsuperscript{17}

**Contribution limits**

Subject to certain transitional rules, the amount of deduction for contributions is to be $50,000 per annum regardless of the age of the taxpayer in respect of whom the contribution is being made or work status (employee or self-employed) and calculated on a per taxpayer basis, rather than a contributor basis. Deductible contributions will be allowed up to age 75 subject to satisfying certain work tests after age 65.\textsuperscript{18}

Limits are also to be placed on post tax contributions, which limits are calculated as three times the amount of contribution that is to be deductible, subject to transition exceptions.\textsuperscript{19}

**RBLs Removed**

In addition, the RBL rules are to be removed.\textsuperscript{20} These rules imposed a penal tax rate (the highest marginal tax rate), introduced equity between taxpayers and were intended to prevent excess funding in the low tax environment of superannuation funds. Broadly, these rules are to be replaced by limits on contributions, with excess contributions above the limits being subject to a penal rate of tax.

**Pre 1 July 1983 amounts**

Any pre-1 July 1983 component that a taxpayer may have is to be a fixed dollar amount rather than calculated by formula at the time of payment, as is presently the case.\textsuperscript{21} That amount is to be calculated at 30 June 2007 and, consequently,
will remain that amount in the future.

Also, payment from superannuation fund accumulation that has both taxed and exempt components will have to be made in the same proportion as the taxed to exempt ratio of those components in the fund.\textsuperscript{22}

\textbf{Payment and pension rules}

In respect of changes not directly related to taxation, compulsory payment of accumulations to taxpayers over age 65 who do not meet the work test is to be removed.\textsuperscript{23} Equally, the requirement that benefits must be paid regardless of the person’s work status on attaining age 75 is also to be removed. This means that accumulations can be retained indefinitely in a fund until the death of the member.

The pension requirements, which, broadly, prescribed five types of pensions, are to be removed and replaced with a minimum payment rule based on the age of the taxpayer and a percentage payment of the accumulation in the superannuation fund at the start of the year. On death, no residual amounts of a member’s pension will be permitted and pensions will only be permitted to be payable on death if that person is a dependant.\textsuperscript{24}

Finally, under the “Transition to Retirement” changes, taxpayer could receive a particular type of pension once they had reached the preservation age regardless of work status; this is to be limited to a pension equal to 10\% of accumulations.

\textbf{Consultation outcomes}

The changes that are to be made to the original announcement coming out of that consultation process can be grouped into two broad areas.

First, changes to the original proposals that will ease the administrative burden on the superannuation industry. For example, changes are to be made to the way that excess contributions are to be dealt with. The original proposal required a fund to return excess contributions but now, following consultation, the individual in respect of whom the excess contribution has been made is to be taxed at the highest marginal tax rate on the excess. The individual will have access to the superannuation fund accumulation to meet that liability.\textsuperscript{25}

Secondly in respect of concessions to be made on transition to the new rules. Those particular changes include increasing the amount of post tax contributions that can be made before commencement of the changes, increasing the amount

\textsuperscript{22}P3 Outcomes of Consultation
\textsuperscript{23}P19 Detailed Outline and p 5 Outcomes of Consultation
\textsuperscript{24}P20 detailed outline and p5 Outcomes of Consultation
\textsuperscript{25}P 27 Outcomes of Consultation
of employer sourced payments that receive concessionary treatment, increasing deductible contributions for taxpayers over age 50 at a particular date and increasing the allowable contributions coming from the proceeds of sale of a small business.\textsuperscript{26,27}

2. ERODING THE LINK BETWEEN TAX CONCESSIONS AND RETIREMENT INCOME

Tax concessions are granted to taxpayers to encourage saving for retirement so that the accumulations will be used to replace work income during retirement, thereby relieving government from some of the social security costs associated with an ageing population.

Yet the linkage between tax concessions for saving and the use of the accumulated funds during retirement has been gradually eroded over recent years and, indeed, these changes take that erosion a significant step further.\textsuperscript{28}

RBLs: pension bias and taxpayer equity

Historically, Australia had been unique in continuing to allow taxpayers to take all their retirement funds in the form of a lump sum rather than taking at least part as a pension. Lump sum payments can be exhausted shortly after retirement and, also, pensions offer better integration of the tax concessions given for saving with social security system expenditure.

Certain initiatives had been made to have taxpayers take their accumulation as a pension.

The most significant attempt to reduce taxpayer’s taking lump sums benefits in retirement was on introduction of the set dollar amounts for Reasonable Benefit Limitations (RBLs):

\begin{itemize}
  \item Individuals can contribute up to $1m of post tax amounts between 10 May 2006 and 30 June 2007: page 12 Outcomes of Consultation. For employees with employer ETPs specified in existing employment contracts at 9 May 2006, provided payment is made prior to 1 July 2012, amounts up to $140,000 will be taxed at 15% and excess up to $1m taxed at 30%. These amounts can be rolled over to a superannuation fund until 1 July 2012: page 17 Outcomes of Consultation. A five year transitional period will apply for people aged 50 and above where deductible contributions of up to $100,000 per annum are allowed: page 8 Outcomes of Consultation. Proceeds from disposal of assets that qualify for the small business Capital Gains Tax exemption, up to a lifetime limit of $1M and proceeds from a settlement from an injury resulting in permanent disablement are excluded from these limits: page 12 Outcomes of Consultation.
  \item Page vii, A Plan to Simplify and Streamlined Superannuation, Detailed Outline, May 2006.
  \item For example, introduction of the rules in respect of transition to retirement, which facilitated access to retirement funding once the preservation age had been attained. In addition, the changes made to regulations in respect of pensions and annuities that facilitated better risk management.
\end{itemize}
Limits introduced in 1994 (The RBL rules).\textsuperscript{29}

These RBL rules had two effects. First, they capped the maximum amount that could be paid as tax preferred retirement funding as a fixed dollar, rather than applying a formula related to a taxpayer’s average salary.

In that regard they had an equity effect in that the maximum amount that could be paid as tax preferred retirement funding was determined regardless of what the taxpayer was earning immediately prior to retirement. This redressed concern about wealthy taxpayers receiving significantly greater benefit under the previous system than did less wealthy taxpayers.

Secondly, they inserted a bias in favor of pension benefits over lump sum benefits.

In that later regard they marked a determined attempt at directing taxpayers to take superannuation fund accumulations as a pension rather than as a lump sum.

Rather than prohibiting payment of lump sums to taxpayers, they favored accumulations that were paid as pensions. Accumulations used to fund a pension were allowed up to around twice the amount that could be accumulated with tax concessions than the maximum available to fund wholly lump sum payments.

Even though not going so far as to prohibit the payment of retirement accumulations in the form of a lump sum, the effect was to put pressure on taking accumulations as a lump sum by making them less attractive in terms of the amount of tax preferred accumulations, when compared with funding for a pension.

However, in order to be able to access that more favorable RBL amount the pension that was being funded had to be of a certain type.

\textbf{Pension conditions}

That type of pension, in effect, required that the taxpayer commit the amount accumulated at retirement to a pension that had a term related to the life expectancy of the taxpayer (and dependant, if applicable) and in respect of which there was no residual value on termination. This meant that the accumulation at retirement was converted into an income stream contractually payable over the remaining life of the taxpayer (and any dependant) and which left little if any by

\textsuperscript{29} Inserted by Act 208 of 1992. Previously, maximum superannuation benefits had been formula based, related to the Highest Average Salary of the taxpayer.
way of residual amount on termination.\textsuperscript{30}

The expectation in these rules was that the accumulation at retirement would be exhausted over a period related to the taxpayer’s (and dependant) life during retirement thus linking the tax concessions for saving with use of the funds in retirement.

**Linkage being reduced**

However, prior to the most recent changes that are discussed here, there had been other changes the effect of which was to reduce this linkage between tax concessions and use of amounts accumulated at retirement.

First, there were changes made to the pension conditions that needed to be satisfied in order to access the more favourable pension RBL. These changes extended the period over which the pension could be paid to the pensioner’s 100th birthday thereby potentially allowing significant residual capital value on the death of the taxpayer. \textsuperscript{31}

Secondly, changes were made under the banner of Transition to Retirement, whereby a taxpayer could access their retirement accumulation without retiring from work. These also reduced the connection between tax concessions for saving and retirement income by allowing accumulations to be accessed before retirement. \textsuperscript{32}

However, the connection between tax concessions for saving and use of the accumulation during retirement is further significantly diluted under the changes discussed here.

**Effect of removing RBLs**

This is particularly the case where the RBL rules have been abandoned entirely, including that part of those rules that conferred greater tax preferred accumulations if the taxpayer committed the accumulated funds to an income stream during their retirement, rather than a lump sum.

In other words, the previous attempt to direct taxpayers away from taking lump sums and into pensions has largely been abandoned.

The only incentive for taxpayers to take a pension during retirement, as opposed to a lump sum, is that the fund will be zero taxed.

Putting that another way, taxpayers will now have the freedom to take lump sum

\textsuperscript{30} Regs 1.05 and 1.06 SIS Regulations
\textsuperscript{31} 1.06(4)(e) SIS Regs, for example
\textsuperscript{32} Div 6.3 SIS Regs
benefits with the only cost being payment of a 15% nominal rate of tax on income in the fund, rather than zero tax had a pension been taken.

That will mean that the only incentive to use accumulations at retirement as replacement income during retirement will be to obtain a zero rate of tax on income of the superannuation fund. Otherwise the accumulations at retirement do not need to be withdrawn at all during retirement, potentially defeating the reason for the tax concessions given for saving in the first place.

**New pension conditions**

The pension conditions that need to be satisfied in order for the income of the fund to be exempt from tax are based on a theoretical term, rather than life expectancy in retirement.\(^{33}\)

That assumed minimum term is now to be the period to age 100. An example is given in the Treasurer’s “outcomes of Consultation” of the pattern of payments of such a pension, which show that, on certain earnings assumptions and using the required percentage payment of year commencing accumulations, the accumulation at retirement will be exhausted by age 100.\(^{34}\)

Yet again, this is a theoretical calculation not related to life expectancy over retirement so, to that extent, such pension conditions cannot be said to be a usage of the accumulation during the life of the taxpayer over retirement. A point acknowledged in the announcement.\(^{35}\)

Abandoning the tax preferences favoring pensions over lump sum payments and allowing complete freedom between the two forms of payments must be seen as a retrograde step in terms of attempting to move the Australian system to pension paying, rather than lump sum.

**Removing compulsory payment**

This disconnect between tax concessions for saving and usage of the accumulations during retirement will also come about from removal of the existing compulsory payment rules whereby superannuation funds were required to pay accumulations after a certain age depending on work status.

Removal of these requirements means that the accumulation can remain in the superannuation fund until death, effectively meaning that there is no pressure to

\(^{33}\) That, of course, is the case anyway before the most recent changes prior to those that are being discussed here.

\(^{34}\) Indicative minimum annual pension payments p6 Outcomes of Consultation

\(^{35}\) “Individuals would be able to choose the amount they take from the pension each year. A minimum amount would be required to ensure that capital is generally drawn down over time” p 21-Detailed Outline.
draw down the accumulation.\textsuperscript{36}

As is the case for the choice between taking a lump sum or pension benefit, the only incentive to use the accumulation during retirement at all once the compulsory payment rules are removed will be the exemption from tax on income of the fund if the minimum pension payments are made.\textsuperscript{37}

**What is “superannuation” now?**

This break in the linkage between tax concessions for retirement funding and actual usage of the funds accumulated in retirement will potentially create other less obvious difficulties.

Specifically, a number of the tax laws in superannuation are dependent on payments being made for the purpose of superannuation for the requisite effect to be achieved.

For example, tax deductions for contributions require that the contribution be made for “the purposes of making provision for superannuation”, amongst other things.\textsuperscript{38}

This requirement is, in effect, an anti-avoidance provision, which is invoked where the legal form for deductibility of the contribution is achieved but the economic effect is contrary to the intention of the Act. For example, re-contribution strategies to leverage the formula for calculating the pre-1983 component of a lump sum payment were threatened with attack on the basis that the recontributed amounts were not made for ‘the purposes of superannuation’ where they were made shortly before the lump sum benefit was taken.\textsuperscript{39}

Also, the ATO has invoked this requirement in cases where the superannuation fund was being used for tax avoidance purposes.\textsuperscript{40}

Nevertheless, the courts in the future could be expected to have difficulty in interpreting this requirement in light of the changes where usage of the

\textsuperscript{36} “These changes would mean that a person would be able to keep their benefits in their superannuation fund indefinitely…” p 20 Detailed Outline

\textsuperscript{37} In any case, the effective tax rate on income of the fund can be reduced to zero through appropriate asset selection in the fund from such things as imputation credits and more lightly taxed capital gains.

Also, if a taxpayer simply does not need a pension equal to the minimum pension payments then, at least for taxpayers up to age 75, they can re-contribute any excess pension payments to the fund where income will be exempt.

\textsuperscript{38} S82AAC (1)(a) and s82AAT (1)(b) ITAA1936

\textsuperscript{39} IT 2393

\textsuperscript{40} See Raymor Contractors v FC of T 91 ATC 4259
accumulation to replace work income in retirement has virtually disappeared and accumulations can either be dissipated immediately after retirement or accumulated until death.  

3. RBL ABOLITION; EQUITY EFFECT OF CONTRIBUTION LIMITS?

Prior to introduction of the RBL rules, excess accumulation in the tax preferred environment of a superannuation fund was prevented by limiting the amount of contributions that could be made to the fund and, indeed, the number of funds a person could have.

The superannuation system, through the RBL rules, in effect limited the amount of tax preferred payments that a taxpayer could receive over their lifetime from superannuation and other similar retirement type payments.

In that case there was not the same need to limit the amount that could be contributed to a superannuation fund as any accumulations in excess of an RBL were taxed at the highest marginal tax rate, which acted as a disincentive to overfund.

In addition, these rules created equity between wealthy and less wealthy taxpayers by linking maximum aggregate tax preferred amounts that could be taken as superannuation to a common index.

In the future the function of the RBL rules in preventing excess accumulations in tax preferred superannuation funds is to be replicated through limits to be placed on the amount of deductible and post tax contributions

Those limitations include flattening the amount of contributions that can be deductible to $50,000 pa (indexed) for each taxpayer regardless of age, a limit on post tax contributions and a limit on contributions for individual taxpayers from all contributors.

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41 See definition of “superannuation benefits” s 6(1) ITAA 1936, ‘individual personal benefits, pensions or retiring allowances”. Also, Meulman & Ors. V OTC Ltd (1990) 96 ALR 223 at 227: “...it is my view of the ordinary meaning of the word ‘superannuation’ and related words, that benefits are provided for the purpose of enabling or assisting an employee or office holder to give up work and retire from economic activity if he wishes to, on reaching an age where it is appropriate to do so or on reaching a state of health in which it is appropriate to do so.”

42 Reg 18B Occupation Superannuation Standards Regulations

43 Indeed, the effective rate on the excess was significantly higher in aggregate as the taxes on contributions and on exit added to greater that the highest marginal tax rate. This rate, in aggregate, was reduced to the then highest tax rate by section whatever in whatever. (Indeed, it was not until 1999 that the taxation of contributions and earnings on the fund were integrated with the highest marginal tax rate paid on excess accumulations).

44 The outline acknowledges itself that one of the effects of abolition of tax on benefit payments taxpayers over age 60 and of the RBL rules will be to make superannuation funds an attractive vehicle for accumulation of wealth.
A sub set of those limitations is the prohibition on employer sourced retirement payments being rolled into a superannuation fund, as that restriction will prevent breach of the contribution limits.\footnote{P17 Outcomes of Consultation}

**Contribution limits and taxpayer equity**

The replacement of the RBL rules with limitation on contributions raises a number of issues.

First, will the new contribution limits fulfill the same equity function that the RBL rules did?

In 1994 RBLs became fixed amounts (indexed) instead of amounts related to the taxpayers’ average final salary before retirement.

Those fixed limits in the RBL rules were related to income indices, such as AWOTE, whereby under certain assumptions these RBL amounts would provide replacement income over retirement related to that index. In that regard, they performed an equity function by limiting tax concessions for superannuation fund accumulations for all taxpayers measured against a standard index.

In that case, the actual income of the taxpayer was not relevant to how much could be accumulated in a favorable tax environment.

The new contribution limits which are to replace RBLs will not replicate the equity function previously provided by the fixed amount RBLs simply because they are a fixed amount regardless of age and not tied to any income index.

**Tax free investment fund**

Secondly, with the potential for a tax free investment fund and no restrictions on accumulating indefinitely, superannuation funds will be the investment vehicle of choice for wealthy taxpayers.\footnote{Tax free investment income is subject to making minimum pension payments and indefinite accumulation comes from abolition of compulsory payment rules}

So it is reasonable to expect that taxpayers will start to consider how all of their wealth, in addition to that which can be contributed under the contribution limits, can be put into this environment.

It is not an overstretch to predict that the contribution limits will be under tension through taxpayers seeking to re-locate all their wealth in a superannuation fund.

This is likely to generate a lot of interest from taxpayers in such things as co-
investing with superannuation funds and value shifting.  

4. SIMPLIFICATION? “I DON’T THINK SO”

The major change to be made in taxation of superannuation benefits is age related. That is, once a taxpayer reaches age 60 any benefit payment, either lump sum or pension, will be tax free. In addition, those payments are not to be included in the taxpayer’s tax return, which means that the payments from a superannuation fund will not included in the income calculation for other tax offsets.

For taxpayers of that age this will indeed result in simplification and also obviate the need for professional assistance, such as financial planners, in managing funding and payments.

Eight classes become two

However, there have only been very limited changes for benefits paid before that age. In effect, for taxpayers below age 60 the existing eight classes of income that a lump sum payment could potentially be divided into are to be replaced by two classes of income, being taxed and exempt.

However, those eight classes of benefit will continue to exist in practice as there will still be a requirement to calculate them in order to determine what part of a payment is taxed and what part is exempt.

Of the eight payment amounts, the CGT exempt, concessional and undeducted contributions amounts are fixed amounts thereby not requiring calculation anyway, just record keeping.

So, again, the changes for these taxpayers will not generate any simplification.

Pre-1 July 1983 freezing

Of course, the pre 1983 amount, which is now taxed on 5% and is to be tax free, will be calculated as at 1 July 2007. That will obviate the need for funds to continue to record employment and fund membership details in order to calculate

47 Co investing means the superannuation fund investing in the same asset as the member such as in the form of tenants in common. These are an exception to in-house asset rules s 69-85 SISA. Value transfer envisages a member and superannuation fund co-investing in, say, an ungeared unit trust and value being transferred form the units owned by the member to the units owned by the superannuation fund.

48 Table 2.1 Comparison of current system to proposed system, p14 detailed Outcome

49 CGT exempt component defined in s 27A(1) ITAA 1936, concessional component defined in s 27A(1) as bona fide redundancy, approved early retirement and invalidity payments made before 1 July 1994 and undeducted contributions defined in s 27A(1) as qualified by s27A (7) and
the ratio for determining that part of a benefit that is the pre-1983 component at payment.\textsuperscript{50}

Of course, to be 60 of age a taxpayer necessarily must have been below age 60, during which time they will have been a member of a fund. Therefore, funds will still be required to keep the information and perform the calculations mentioned above up until the taxpayer reaches age 60.

**Reducing classes, not simplifying**

So, to say that the changes are a simplification is an overstatement in respect of these payments as the compliance for them, in terms of calculation, was insignificant anyway.

These changes will not result in simplification even in respect of amounts that do require calculation.

For example, the post 1994 invalidity payment is calculated using a formula of days from disablement to normal expected retirement date, over the total days of accumulation.\textsuperscript{51} Broadly, this formula calculates the amount of a lump sum payment that is related to the future service of the taxpayer had they not become disabled.

Under the new rules superannuation funds will still be required to calculate the amount of that payment, presumably using the same formula as that in the legislation at the moment.\textsuperscript{52}

Overall it is questionable whether these rules will result in simplification other than for taxpayers once they are age 60.

**5. EMPLOYER SOURCED PAYMENTS: INCREASED TAX AND NO INTEGRATION**

There will now be a complete non-integration between the taxation of employer sourced termination payments and payments from a superannuation fund. This is quite a break from tradition in that payments from both these sources have, until now, always been taxed equivalently. They were treated on an identical basis in such things as the way that they were included for RBL purposes and in terms of

\textsuperscript{50} That formula can be manipulated by increasing the undeducted contribution (now called post tax contribution) and it would be expected that some taxpayers would be seeking to achieve that prior to 1 July 2007. Of course, tax rules prevent any deduction for interest costs for borrowing to contribute to a superannuation fund but one could conceive of taxpayers who were close to age 60 borrowing nevertheless and being willing to forgo deductibility of the interest expense on the bases of enhanced pre 1983 portion.

\textsuperscript{51} S27A (1) ITAA 1936

\textsuperscript{52} P14 Detailed Outcome
the rates of tax that applied at least since the introduction of the 15/30% tax rates on lump sums in 1983.53

Employer sourced payments tax increase

Under the changes, employer sourced termination payments are to be taxed more severely than they are at present and, indeed, more severely than payments from a taxed superannuation fund. Also, integration of payments from both these sources is being abandoned.

“Employer lump sum payments are to be comprised of two components – exempt and taxed. The exempt component will be any post June 1994 invalidity amount and the pre-1 July 1983 amount. These will be exempt from tax. The taxable component will be taxed at 15% for amounts up to $140,000 (indexed) for recipients aged 55 and over and at 30% for recipients aged under 55. Amounts in excess of $140,000 will be taxed at the top marginal rate. These arrangements will apply per termination and any payment must be made within one year of termination.”54

Taxation of the exempt component of an employer sourced payment is comparable with similar type payments paid from superannuation funds. It is in respect of the taxed component of employer sourced payments where the increase in taxation in these types of payments is seen.

Under the existing system employer sourced termination payments are equivalently taxed with payments from superannuation funds, so the effect of these changes is best viewed by comparing the proposed taxation of these types of payments with the proposed taxation of payments from a superannuation fund. 55

If an employer sourced payment is made after age 55 but below age 60 the rate of tax on the amount up to $140,000 will still be equivalent to that had it been paid from a superannuation fund under the changes.

However, the excess above that amount will, in future, be taxed at the highest marginal tax rate rather than 30% which would have been the case had these payments continued to be taxed comparably with payments from a superannuation fund.

Where the payment is made after age 60, the extent of the increase in tax on these types of payment is obvious, when compared with equivalent amounts paid from a taxed superannuation fund.

53 “RBL amount” s140ZF (1) (a) ITAA1936
54 P17 Outcomes of Consultation
55 Definition of Eligible Termination Payment s 27(1) ITAA 1936
In that case, the excess over $140,000 will be taxed at the highest marginal tax rate. Whereas, had it been paid from a taxed superannuation fund, the whole amount would have been tax free.

Also, these types of payments will not be able to be rolled over into a superannuation fund.\footnote{Page 17 Outcomes of Consultation The reason for that is said to be to prevent circumvention of the contribution limits}

**Payments not equivalent**

The reason given for the changes to be made to taxation of employer sourced payments is that “as RBL is to be removed from superannuation benefits, it is necessary to consider the taxation of employer ETPs, particularly the upper limit on the amount of employer ETPs that receive concessional taxation treatment.”

Indeed, there is some validity to this because RBLs prevent excess funding in superannuation and in the future that function will be fulfilled by the contribution limit, which will be an effective mechanism in a pre funded superannuation environment but not for employer sourced payments.\footnote{Perhaps also the increase of taxation on these amounts is being driven by the excessive payments made by large corporates or by the ability of controlling shareholders in closely held companies to pay disguised dividends as retirement payments (although this is already controlled (s 109 ITAA 1936)).}

The detailed explanation arguably gives a hint about the real reason for this dramatic change in that it identifies the types of payments under discussion as:

“Unused rostered days of,

Amounts in lieu of notice,

A gratuity or “golden handshake’,

An employee’s invalidity,

Bona fide redundancy or approved early retirement schemes in excess of the tax free amounts, and

Certain payments on death of an employee.”\footnote{P 41 and 42 Outcomes of Consultation}

Certainly there is no obligation that any of these payments be used to replace income during retirement and, indeed, they are in no way quarantined until a
certain age of the taxpayer, as is the case for contributions to superannuation funds under the preservation rules.

Therefore, these are not payments that are made to replace income in retirement so, arguably, should no longer be taxed the same as superannuation accumulations.

Also arguably, they are either deferred remuneration, a reward for long service or future salary lost through invalidity, death or, in the case of redundancy, loss of employment through corporate restructure. On that view, they should equally not be entitled to the same taxation treatment as payments from superannuation fund because they do not serve the same purpose as accumulations in a superannuation fund.

**Age 55 not relevant**

Nevertheless, it is not clear why different tax rates based on age fifty-five are to be applied in respect of employer sourced payments. That is, it is not obvious why there are still different tax rates for these payments dependant on whether they are received either before or after age 55.

Age 55 was relevant in 1983 in terms of differential tax rates. At that time there were no preservation rules so the differential rates based on age 55 acted as de facto preservation rules. That is, a lower rate of tax on termination payments if paid after age 55 acted as an incentive to keep moneys in a superannuation fund until that age.

However, now that there is to be no integration between payments made from a superannuation fund and those employer sourced, the relevance of this age based rate change to employer sourced payments is questionable. Even more so as these payments are not discretionary and cannot be kept in the superannuation environment by being rolled over anyway.

In any case the rates of tax that are to apply on these types of payments are, to say the least, regressive by reason of being fixed at the top marginal tax rate.

This point can be illustrated by way of example. Say a person is paid $165,000 as an employer sourced lump sum termination payment. In that case they would have to pay the highest marginal tax rate on the excess above $140,000 even if they have no other income in that year.

Of course, had they received the excess of $25,000 as normal income the tax applying would have been minimal and certainly not at the highest marginal tax

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59 1 July 1983 when lump sum benefits were taxed at 15% up to the low rate threshold and 30% thereafter.
rate.\textsuperscript{60}

**A fairer alternative**

It would be fairer if any excess above $140,000 was simply assessed as normal income. Indeed, that would be a more consistent treatment with the apparent view being taken in the Government announcements that the majority of these types of payments are just deferred remuneration.

**Alternative tax basis**

Could employer sourced payments have been taxed in a different way?

Assuming that the putative view that employer sourced payments are not being taxed more severely because they are just deferred remuneration does not stand, arguably parity in taxation between employer sourced termination payments and payments from a superannuation fund could be achieved even though RBLs are to be removed.

Equivalence in taxation of these two types of payment could have been achieved in number of alternatives ways.

First, tax treatment of employer sourced payments could have mirrored that for payments made to a superannuation fund member between age 55 to age 59, which is effectively taxed at 15\% on the first $140,000 and 30\% thereafter.

Or it could have been achieved through equivalence with the taxation of payments made from a taxed superannuation fund to a taxpayer under age 55.

Nevertheless, there is a minor advantage to the taxpayer in the lack of integration between payments that are employer sourced and those made from a taxed superannuation fund in that the taxpayer will, in effect, be entitled to two low rate thresholds if receiving a lump sum amount under age 60 from both these sources.

But otherwise there is little to support this aspect of the changes.

**CONCLUSION**

The planned changes to the taxation of superannuation from 1 July 2007 will be of benefit mostly to taxpayers over age 60 with benefits in excess of the current tax free threshold, who will be able to take superannuation payments tax free.

\textsuperscript{60} Indeed, having no reportable income in a year means that this is a likely scenario as payments from a superannuation fund after age 60 are to be not reportable.
For taxpayers below age 60 the changes have less significant effect in that the number of components that can potentially make up a lump sum benefit is being reduced to two and the tax applying to some of those components (otherwise where 5% was included in assessable income) will, in the future, be zero.

Removal of RBLs and of compulsory benefit payment rules for superannuation funds will have a significant effect.

To a large extent the role fulfilled by RBLs in limiting the over funding of superannuation will be replicated by the limitations that are to be placed on contributions.

The linking of granting of tax concessions for saving with use of the accumulation during retirement will be lessened by abolition of RBLs.

This is because the RBL rules favored the payment of pension benefits over lump sums and pensions are a better form of payment for ensuring that the accumulation in a superannuation fund at retirement will be used to replace income during retirement.

Indeed, the linkage had already been diluted through changes that had already been made to the pension condition that needed to be satisfied to ensure that benefits did not exceed the RBL and, also through allowing taxpayers who had reached the preservation age to access their accumulations under transitioning to retirement rules.

To the extent that the RBL rules introduced equity between wealthy and less wealthy taxpayers by capping the maximum tax preferred payments by reference to an income index, this will not be replicated in the limitation of contribution rules, which are replacing the RBLs.

One of the major benefits on introducing the planned changes is simplification and that certainly will be the case for recipient taxpayers over age 60.

However, that will not be the case for taxpayers below that age, notwithstanding the changes to be made to the taxation of benefit.

Employer sourced termination payments are to be taxed more severely than at present and will not be integrated with taxation of payments from superannuation funds.

The increased taxation and non-integration of employer sourced termination benefits are explained to be as a result of abolition of RBLs and, indeed, that is a plausible explanation.

However, the way that the Detailed Outline describes these types of payments it
could not be said that they fulfill the same function as superannuation and so should not be taxed similarly.

Nevertheless, the taxation of these types of payments in the future does appear harsh in that it is to be at the top marginal tax rate. A fairer basis would be to include the excess over the low rate threshold as normal assessable income. That would be consistent with the way that these types of payments have been defined and also introduce progressivity into the rates.

Yet, separating the taxation of these two payments will give taxpayers two low rate thresholds.
APPENDIX

The changes are conveniently summarised in the document reporting the outcomes of consultation.

“OUTLINE OF PROPOSAL

Under the proposals described in the detailed outline, from 1 July 2007:

• Superannuation benefits paid from a taxed source either as a lump sum or as an income stream such as a pension, would be tax free for people aged 60 and over.

- Benefits paid from an untaxed source (mainly affecting public servants) would still be taxed, although at a lower rate than they are now for people aged 60 and over.

• RBLs would be abolished.

• Individuals would have greater flexibility as to how and when to draw down their superannuation in retirement. There would be no forced payment of superannuation benefits.

• The concessional tax treatment of superannuation contributions and earnings would remain. Age-based restrictions limiting tax deductible superannuation contributions would be replaced with a streamlined set of rules.

• The self-employed would be able to claim a full deduction for their superannuation contributions as well as being eligible for the Government co-contribution for their post-tax contributions.

• The ability to make deductible superannuation contributions would be extended up to age 75.

• It would be easier for people to find and transfer their superannuation between funds.

To increase further the incentives to save for retirement, from 20 September 2007 the pension assets test taper rate would be halved to $1.50 per fortnight for every $1,000 of assets above the assets test free area.

The superannuation preservation age would not change. The preservation
age is already legislated to increase from 55 to 60 between the years 2015 and 2025. People would still be able to access superannuation benefits before the age of 60, although they would continue to be taxed on their benefits under new simplified rules.\textsuperscript{61}

\textsuperscript{61} Page i, Outcomes of Consultation