



1st June, 2015

Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600

Email to: bettertax@treasury.gov.au

Dear Sir,

**The 'Re:Think' Tax Discussion Paper
Submission by the Australian Investors Association Ltd**

We write to make a submission on behalf of the members of the Australian Investors Association Ltd (AIA).

The AIA is a non-profit organisation which exists to help our members become more successful long-term investors. We are Australia's leading national, not-for-profit, independent association of investors and we are dedicated to helping all self-directed investors achieve their goals through education, networking and advocacy.

In an association such as the AIA, one would expect a range of opinions. However, we have sought the views of our members, and we have assembled a response which we believe represents the views of the majority of members. We have deliberately omitted from our response any views which were submitted to us, which we considered as not representative of the majority of members.

Obviously, taxation is an important issue for our members. Thank you for accepting our submission

Yours faithfully

For and on behalf of the Australian Investors Association Ltd

A handwritten signature in blue ink, appearing to read 'G. Bottrill', with a stylized flourish at the end.

Graeme Bottrill

Vice President

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Q18. What tax arrangements should apply to bank accounts and debt instruments held by individuals?

Bank accounts and debt instruments are fully taxed at an individual's marginal rate (no CGT or superannuation-like concessions). As such, their current taxation treatment discourages Australians from investing in these low-risk instruments. The relatively low returns from these investments also discourages investors striving to build their capital over time and maintain a hedge against inflation.

Members have said that saving should be strongly encouraged by providing incentives, and reducing the disincentives such as taxing bank interest at full marginal tax rates. Individuals attempting to fund their living expenses find the low returns become even lower after payment of tax.

Thus, many individuals are encouraged to take on more risk than is prudent. They may feel compelled, especially in a low interest rate environment, to raise their allocation to riskier assets such as equities and property. In addition, if deposits are insufficient to fund Banks' lending activities, banks must seek funding from other sources, such as wholesale debt markets and offshore investors. These funding sources are more likely to "take flight" in a crisis and thus make Australian banks potentially vulnerable to external shocks e.g. a GFC-like loss of liquidity.

Despite these factors, the AIA believes that if the current taxation arrangements for cash and debt securities were changed (such as taxation discounts being applied), anomalies would be difficult to avoid. Some investors, who should pay the normal rate of tax on their interest income, may not do so and others could be unfairly impacted.

Therefore, the AIA is not an advocate of change in this area. A better solution would be to increase the attractiveness of bank accounts and debt instruments to low-wealth individuals by increasing the lower tax thresholds.

Deposit taxes and transaction levies should be avoided, as these have negative consequences for Australia's competitiveness and would further discourage such investments. It is difficult to see how existing arrangements could be changed without introducing further distortions.

AIA recommendation: No change to current system (incentives to encourage saving in bank deposits will likely have unintended consequences).

Q20. To what extent does the dividend imputation system impact savings decisions?

Australia's dividend imputation system was put into place to eliminate double taxation of company profits, and as such is a progressive policy. The downside of dividend imputation is that it encourages investors to adopt higher allocations to Australian equities (which are more likely to pay franked dividends) than may be appropriate for a balanced portfolio. The imputation system may add a significant 1-2% to annual total shareholder returns and reduces (or eliminates) the investor's overall tax liability.

The phenomenon of investors "chasing" yield discourages Australian firms from investing in their own growth, both domestically and by expanding overseas. This has both positive and negative aspects. Some argue that company boards are less likely to speculate on risky acquisitions, which results in improved shareholder returns as well as more company tax paid to the ATO.

The AIA has found that a "typical" SMSF has less than 1% of total assets allocated to international equities, compared with 25-30% held in institutional superannuation funds. This "home bias" leads to sub-optimal diversification and concentration risks. This is currently being exacerbated by the low yields available in many asset classes. A lack of imputation may be interpreted as a disincentive to invest more broadly into international equities, although poor investor education and, until recently, a lack of readily accessible retail products such as international ETFs and LICs has made it difficult for individuals to invest overseas.

In addition, a poorly developed retail bond market adds significantly to the "underweight" position of retail investors to these assets.

Rising US Bond yields have already impacted Australian bond rates, leading to sharp recent falls in bank shares. Worryingly, the AIA has heard that some investors have as much as 50-80% of their portfolios in bank shares, as they are attracted by the high yield, perceived earnings stability and fully-franked dividends. Banks are particularly vulnerable to speculation in the property market and their popularity to investors poses concentration risk, especially when US interest rates and bond yields may have bottomed and the cost of long-term capital is increasing.

However, modifying the dividend imputation system is likely to cause undesirable consequences for the stability of capital markets and the income that investors, especially retirees, increasingly depend upon. The AIA's view is that, despite some existing anomalies, changes to the dividend imputation system would likely introduce new and undesirable consequences.

AIA recommendation: No change to current system.

Q21. Do the CGT and negative gearing influence savings and investment decisions, and if so, how?

Yes, both CGT and negative gearing have an impact on savings and investment decisions. The CGT discount discourages short-term speculation in assets and rewards a greater than 1 year holding period, which is a desirable goal to reduce volatility and distortions in asset prices.

That said, CGT discounts also discourage lower risk investments like cash and bonds (where no such benefits apply and there is little or no capital growth), which generate a fully taxed income stream. Fixed-rate bond capital values rise in periods of falling interest rates, which may provide an incentive to invest in such instruments.

Also, negative gearing (and low interest rates) have encouraged many retail investors to borrow heavily to buy residential property, leading to concerns about affordability for younger home buyers. Many investment experts argue that both CGT discounts and negative gearing distorts investment decisions and asset allocations.

Some AIA members have argued that negative gearing should only be claimable for those conducting a genuine business enterprise, not those individual investors (and SMSFs) who merely choose to buy assets with insufficient cash flow to fund interest payments on the loans used to purchase the assets. The way our negative gearing system allows investors to knowingly acquire a negative-cash flow asset so as to reduce tax from other sources is of some bemusement to foreigners!

The AIA believes there are reasonable grounds for tightening both the current regimes for CGT discounts and negative gearing, but any such changes must have their impact carefully assessed, as many people have made asset purchase decisions on the basis of what they believed was a stable regulatory regime.

Australia has some of the highest and most unaffordable property prices in the world. This reduces the availability of funds to invest in new businesses and high-tech enterprises needed to build the future economy of our nation.

A high proportion of Australians have 'investment property', driven by CGT concessions and negative gearing. Property is seen by many as the best path to wealth and financial security (rather than superannuation). Negative gearing in property is seen as the easiest way to reduce the amount of tax paid. As such, negative gearing in property distorts investment decisions and is counter-productive to growing real wealth in the economy.

The AIA supports gradually reducing the tax-advantaged nature of speculative property "investment" over time to prevent shocks to the market and negatively impacting the supply of rental accommodation. Ultimately, though, tax losses from property should only be offset against income from property or other legitimate business, rather than total personal income. This would result in (i) increased tax income for the government, (2) improved affordability of housing for younger Australians, (3) less speculation, and (4) a redirection of capital investment towards activities more likely to grow the economy over time.

AIA recommendations:

1. Move to gradually restrict the availability of negative gearing to legitimate businesses and only offset against income from property.
2. Phase out favourable CGT of investment property.

Q22. How appropriate are the tax arrangements for superannuation in terms of their fairness and complexity? How could they be improved?

Introduction

There has been much media attention recently regarding the taxation treatment of superannuation. Some suggest that superannuants should be prepared to pay tax on their pensions, and in so doing, make their contribution to the services and facilities that we all enjoy. Others argue that any changes would be unfair to those who contributed to superannuation in good faith given the tax rules of the day and, while some changes may be warranted, should not be made retrospective.

One of the most substantial imposts on government expenses is welfare, including aged pensions. As we are all well aware and as highlighted in the Intergenerational Report, the ageing population is progressively exacerbating this problem, to the point where unless some significant action is taken, the cost will soon be unaffordable, if it has not become so already.

Therefore Australia must act to contain the escalating cost of the aged pension, which is unsustainable. We must consider ways of encouraging our fellow Australians to save for their own retirement when they are able, and reduce the burden of the aged pension on the public purse.

So how do we provide this encouragement? The only possible real mechanism is a financial one. That is, it has to be made attractive to save so as to provide for one's own retirement and not be a drain on the rest of society. So how is this saving to be made attractive? What can we offer as an incentive? It may be that the only viable incentive is a tax advantage, in whatever form we believe best serves the greater interest.

Australia's superannuation system was set up to encourage Australian's to save for their retirement and not be reliant on the aged pension. Contributions are compulsory for working Australians, and various tax incentives have been put in place for individuals to contribute additional amounts. We are still 10 to 15 years away from reaching a stable and steady state where most Australians have built up super over their working lives.

The AIA believes that constant changes to the rules for superannuation provide a worrying and negative incentive to the sustainability of the system. If tax rules are changed, then people will reduce their reliance on superannuation and increasingly fall back on the age pension in retirement.

So the debate needs to be – what is best for the country? Aged pensions for all, or an incentive for those who are able to save to take care of themselves?

Rather than tinkering with rules for superannuation, the AIA encourages the government to conduct a comprehensive review of retirement income, encompassing all aspects of superannuation, old age pensions, health cards and alternative income streams such as deferred annuities. A holistic approach is essential.

Superannuation Tax Concessions

The tax concessions lost to super funds containing very large non-concessional contributions in pension phase **are more significant** than the tax concessions lost to high income earners using the 15% tax on their concessional contributions, rather than their own marginal tax rate. This is because concessional contributions, and the associated tax concessions, are now strictly limited but it is still possible to accumulate large super balances with after-tax money which then enjoy tax-exempt earnings in a pension fund and can then be taken as a tax-free pension by the member after age 60.

Many members agree that having unlimited tax-free allocated pensions over 60 was an over-reach in 2006 by the Howard Government. Clearly, a situation in which pension funds can have \$20 million or more comprising mainly non-concessional contributions and borrowings, is inequitable if it means members can draw pensions of more than \$1 million per year and pay no tax. On the other hand, for a couple who have worked hard to accumulate a nest egg that ensures them a comfortable retirement income, the present tax arrangements around super can mean the difference between being self-funded retirees or dependent on the Age Pension for all or part of their retirement income.

If we are going to return to a concept of a reasonable benefit limit, beyond which a member should enjoy no further tax concessions, the obvious place to start would be to look at the total level of non-concessional contributions. Placing limits on the size of the pension fund would automatically limit the size of the tax concession associated with that fund. If we could agree on the size of a fund required to provide a comfortable retirement as well as a reasonable level of tax concessions, there could easily be a tax on funds over a certain size or there could be a lifetime cap on these non-concessional contributions. The issue revolves around what is regarded as a reasonable amount a person should be allowed to have in super with all its associated tax concessions.

Taxing super pension funds at the same rate as accumulation funds would reduce the pension fund's capacity to pay a retirement income and therefore place greater strain on the Age Pension system, because it would accelerate depletion of the super funds. It would also mean double-taxation of concessional contributions on which tax has already been paid.. it would defeat the purpose of a pension fund if the member was required to take a higher level of payments than they need, and in the process deplete the capital remaining in this low-tax environment.

Comparing Age Pension and super concessions

When discussing the “generous” tax concessions given to super, it is easy to overlook the “generous” government payments make to the Age Pension. The Age Pension can be seen as an annuity, funded by the taxpayer. It pays a guaranteed amount for life and it is indexed to inflation. Michael Rice of Rice Warner Actuaries has calculated the present day value of the Age Pension based on average life expectancy.

For a single male pensioner with a life expectancy of 20 years at age 67 the value of the pension payments is \$402,000. For a single woman with a longer life expectancy the figure is higher at \$461,000 while for a couple, Rice says the pension is worth \$685,000 over their lifetimes.

It is in this context that the government's plans, to increase the pension age to 70 and index pension increases to CPI rather than wages, should be seen. It also provides a valid comparison with the level of superannuation tax concessions a self-funded retired couple receive over their lifetime.

Mercer note in their report “Securing Retirement Incomes, Tax, Super and the Age Pension: Assessing the Value of Total Government Support” (February 2012) that:

- The level of total government support provided for retirement income is remarkably level across most individuals, irrespective of an individual's lifetime income
- This support comprises both superannuation tax concessions and the means-tested age pension, reflecting Australia's three pillar system of retirement income
- The value of the tax concessions increase with income but this is offset by a reduction in future Age Pension payments

The Age Pension is subject to both assets and income tests. After age 65 a person's super balance is assessed under the assets test and will be “deemed” to earn an income which will be assessed under the income test. This means that people with low super balances will receive more Age Pension and people with healthy super balances should not have high expectations about Age Pension eligibility.

Interestingly, the government's data on people of pensionable age shows that the number of people receiving at least part pension remains fairly constant around 30% of the eligible population while the

number of people receiving a full pension rises as they get older. This reflects their falling super balances as they age.

It should also be noted that the Age Pension was made considerably more generous in 2007 when the government changed the assets test. Before that time the assets test ensured that a person lost \$3 of age pension per fortnight for every \$1000 that you exceeded the threshold. In 2007 that was changed so that they only lost \$1.50 of age pension for every \$1000 over the threshold. This effectively doubled the assets they can hold and still receive a part age pension. It also greatly enlarged the number of people who are eligible for a part-pension.

The end result is that today, a couple can hold \$1 million in assets and still receive a part pension of over \$200 per fortnight.

Of course, for Centrelink purposes, the family home is never counted as an asset, regardless of its value, and it is never counted when it comes to capital gains tax. That arrangement has the capacity to greatly distort decision making around retirement planning and the allocation of resources needed to pay for the increasing costs associated with longevity. This anomaly should be reviewed.

Several members took issue with the ability to withdraw very large un-taxed pensions, depleting a superannuation account to fund holidays, cars, boats etc., and move to a government pension. There is no requirement to show how this money will be used to fund your retirement. Some people have a view that “when the money runs out, I’ll just go on the pension” and this again is against the design concept of funding one’s own retirement.

We are not in favour of raising taxes on contributions at lower levels. If taxes on contributions are raised, people are discouraged from funding their own retirement - the original goal and “sole purpose” of superannuation.

It is perhaps unreasonable to tax super pensions without some loosening/reductions in other areas? Otherwise, we’re taxing contributions, earnings AND pensions - most countries, like the US, only tax the pension (at full marginal rates).

Returning to a regime where pension were taxed in the hands of members after the age of 60, besides being politically fraught, would collect little tax as was the case before 2007.

Therefore, it seems that we should build in a progressive tax on the earnings of super balances above a certain limit – say 15% tax on earnings for member balances over say \$5m.

AIA recommendations:

- 1) Through tax concessions, continue to encourage the population to contribute to superannuation during their lifetime, to reduce their reliance on the Aged Pension when they retire.
- 2) Restrict the tax-deductibility of concessional contributions to 20% under the individual’s marginal tax bracket.
- 3) For superannuation balances in excess of \$5m, tax the earnings in pension phase at the rate of 15%
- 4) Develop a unified, holistic policy integrating the Australian retirement funding system, so that the aged pension is seen as a safety net for those who have been unable to save for themselves. Consider including the family home in the assets test, but balance with advanced equity withdrawal schemes to supplement the pension.

Q25. Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?

The imputation system is justified, as it avoids the double-taxation of dividends, as occurs in most other countries, but as pointed out in the response in Q.20, it may discourage investors from being diversified through offshore investment and non-equity investments.

A possible anomaly, however, is that tax-free superannuation funds get their franking credits refunded in full - this is very attractive to retirees, but costly to the Commonwealth budget and causes those who do not benefit to comment that it is "unfair".

However, the principle of 'single taxation' is fundamental and should be maintained.

AIA recommendation: No change to current system.