

# 4: Savings

## Overview

This chapter outlines the tax treatment of domestic savings, and highlights a number of efficiency and equity issues in the current arrangements.

### Key points

- Australia's current tax system taxes savings differently depending on the form of the saving. The result is that more savings are held in superannuation and housing than would otherwise be the case.
- The effect of the tax system on the aggregate level of domestic savings is uncertain. The effect of tax on domestic savings is unlikely to significantly affect the aggregate level of investment in Australia (which is determined largely by the decisions of foreign investors). This suggests that taxing income from savings (at least to a point) is a relatively efficient way of raising revenue. However, some level of concessional tax treatment for savings may be warranted to reduce any disincentives to save.
- Taxing savings income also has distributional effects, in part because higher income individuals have a greater capability to save in lower taxed savings vehicles. However, distributional judgments must take into account the full amount of any income support received, such as the Age Pension.

## 4.1: What is the general tax treatment of income from savings?

How income from domestic savings is taxed depends on various factors, including the form in which the savings are held.<sup>50</sup> In general, income from work (that is, labour income) is subject to full income tax. If an individual places their after-tax income in a bank account, purchases shares or uses it to make a deposit on a house, the tax treatment of the income earned from these savings varies significantly. Interest, rent and dividend income is subject to tax at full marginal rates, while income from capital gains on shares is subject to a discount (50 per cent for individuals) and capital gains on a family home are fully exempt from tax. Superannuation is subject to yet another tax treatment.

<sup>50</sup> The term 'savings' refers to stock of assets while 'saving' refers to an increase in the stock of savings.

Australian households save primarily through home ownership (43 per cent of total household assets), superannuation (15 per cent of total household assets), and other property, including investment property (15 per cent of total household assets).<sup>51</sup> Other popular vehicles for savings include shares, bank accounts and debt instruments, as well as trusts and company structures.

Taxation of income from domestic savings is a small but important revenue base for the Commonwealth. In 2013-14, receipts from superannuation alone raised \$6.1 billion and made up 1.8 per cent of Commonwealth receipts.<sup>52</sup> In 2011-2012, capital gains tax (CGT) from individuals raised around \$3 billion, while taxes paid on interest and dividend income for individuals yielded around \$7 billion.<sup>53</sup>

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## 4.2: What principles should underpin the tax treatment of income from savings?

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The appropriate tax treatment of savings is contentious. The first point of contention is whether income from savings should be taxed more concessionally than other forms of income, such as labour income.<sup>54</sup>

The main argument against taxing income from savings is that this can effectively amount to a double taxation of saving (once when it is earned, then again when it earns a return). This can create a bias against saving for future consumption. There is also an argument that some of the return from savings simply reflects inflation, which is not 'income' in a real sense as it offsets the loss of value to maintain purchasing power. Arguments of this nature are often used to suggest there should be little or no tax on income from savings.

Another argument, used in relation to taxing retirement incomes more lightly, is to address 'life-cycle myopia'. This is where individuals may not save enough for retirement because it is too far in the future for them to see clearly, and therefore they need encouragement to save to achieve a higher standard of living in retirement.

There are, however, several arguments for imposing at least some tax on income from savings.

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51 Australian Bureau of Statistics (ABS) 2013, *Household Wealth and Wealth Distribution, Australia, 2011–12*, cat. no. 6554.0, ABS, Canberra.

52 Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra.

53 Australian Taxation Office (ATO) 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

54 See for example: Banks, J, and Diamond, P 2010, 'The Base for Direct Taxation', in Mirrlees J, Adam, S, Besley, T, Blundell, R, Bond, S, Chote, R, Gammie, M, Johnson, P, Myles, G, and Poterba, J 2010, *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press for Institute for Fiscal Studies, Oxford; and Sørensen, P B 1994, 'From the Global Income Tax to the Dual Income Tax: Recent Reformers in the Nordic Countries', *International Tax and Public Finance*, vol. 1, no. 1, pages 57-79.

First, every tax discourages some economic activity. Taxing income from savings concessionally means other taxes (for example, on labour income) need to be higher to maintain the same level of revenue overall. This requires an assessment of the relative economic costs of alternative taxes.

Empirical evidence suggests the behavioural response to taxing savings is uncertain<sup>55</sup> and may not be significant.<sup>56</sup> This implies that the economic cost of taxing income from savings (at least to a point) is not large. Therefore, applying some tax on income from savings is likely to improve the efficiency of the overall tax system.

Second, exempting or providing concessional taxation treatment of income from savings creates incentives to minimise tax by artificially ‘converting’ labour income into income from savings.

Third, income from savings contributes to a person’s ability to pay tax. Further, individuals with higher incomes tend to have higher levels of income from savings.

Taxing the income from savings more lightly than labour income is a way of striking a balance between these competing considerations. For example, it can help address the effects of inflation (by reducing tax on the part of the return that simply reflects the saved money maintaining its real value), while ensuring that some tax revenue is raised so that other tax rates can be lower.

The second point of contention is the extent to which different forms of income from savings should be taxed differently. Different tax treatment can have an effect on the form in which savings are held.<sup>57</sup> More favourable tax treatments for some assets may lead households to engage with a different risk-return profile than they otherwise would. An OECD literature review concluded that low-income individuals may respond to tax incentives with new saving. High-income individuals are more likely to divert savings to more tax-preferred savings,<sup>58</sup> likely resulting in some change in the risk-return profile of their savings portfolios. The Financial System Inquiry found that, to the extent that tax distortions direct savings to less productive investment opportunities, a more neutral tax treatment would likely increase productivity.<sup>59</sup>

A third point of contention is whether the tax treatment of income from savings has a distortionary effect on the real allocation of investment in the Australian economy.

It is probable that there is some effect on investment, particularly in Australia’s real estate market, where investment is primarily domestic. If this is the case, any additional savings in housing would amount to additional investment in housing and, given housing supply constraints, lead to increased house prices.

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55 Johansson, A, Heady, C, Arnold, J, Brys, B and Vartia, L 2008, *Tax and economic growth*, working paper no. 620, OECD, Paris.

56 New Zealand Treasury Savings Working Group 2010, *The Effect of Tax Incentives on Retirement Savings*, working paper, New Zealand Treasury, Wellington.

57 Poterba J M 2002, ‘Taxation, risk-taking, and household portfolio behaviour’, in Auerbach, A, and Feldstein, M 2002, *Handbook of Public Economics Volume. 3*, North-Holland, Amsterdam, pages 1109–1171.

58 OECD 2007, *Encouraging savings through tax preferred accounts*, tax policy studies no. 15, OECD, Paris.

59 Australian Government 2014, *Financial System Inquiry: Final Report (Murray Inquiry)*, Australian Government, Canberra.

It is important to note that, although taxes may affect the allocation of savings, they are unlikely to affect significantly the overall level of investment in the economy. If taxes on income from domestic savings are raised, but not taxes on income from foreign investment in Australia, it is likely that total investment in Australia would be largely unaffected, as foreign savings would be expected to replace the fall in domestic savings. As such, there would be little effect on the level of overall investment in Australia.

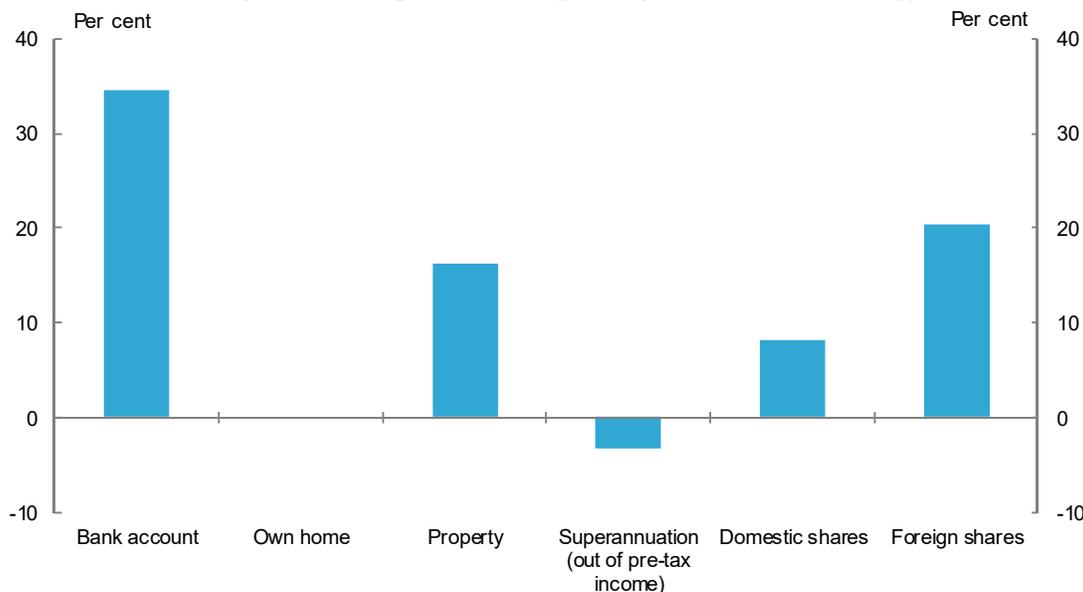
Furthermore, if individuals are saving through financial intermediaries (for example, banks or superannuation funds), then to the extent that those intermediaries' investment profiles are similar, there will be a muted effect on the pattern of investment.

Finally, it is also worth noting that differential tax treatments may also have distributional effects. Higher-income earners tend to be more capable of taking advantage of more favourable tax treatments (like superannuation), while those with the lowest ability to pay tend to save more in the more heavily taxed vehicles (such as bank accounts).

## Current tax treatment of key savings types

In Australia, the varying tax treatments of different vehicles, physical assets and types of savings income have led to wide disparities in their effective marginal tax rates, which show the actual tax paid as a proportion of the nominal pre-tax return. The outcomes of these different treatments are illustrated in Chart 4.1.

**Chart 4.1 Nominal effective marginal tax rates by savings vehicles for an individual on 32.5 per cent marginal tax rate (plus 2 per cent Medicare levy)<sup>60</sup>**



Assumptions: 6 per cent nominal return (except shares, which assumes 6 per cent after company tax); assets are all held for 25 years, and for rental property, 50 per cent of the return is attributable to capital gain and 50 per cent to rental income and superannuation contributions do not exceed the prescribed contribution caps. No assets have been negatively geared. The own home has a nominal effective marginal tax rate of zero, as it is purchased out of after-tax income, but subsequent returns on it are not taxed. Bank accounts, property and shares also use after-tax income but their returns are taxed depending on the vehicle. The nominal effective

60 While the chart looks at nominal effective marginal tax rates the same relativities would apply for real effective marginal tax rates, albeit with higher rates. Real effective tax rates incorporate the effects of inflation.

marginal tax rate for superannuation is negative because contributions to superannuation are made pre-tax and are only taxed at 15 per cent. For example, \$100 of pre-tax labour income would result in a super contribution of \$85 (after 15 per cent tax) but an individual would only receive \$65.50 if they put it into other saving vehicles because of the application of their marginal tax rate (34.5 per cent in this case).

## Bank accounts and debt instruments

Bank accounts and debt instruments are subject to tax at full marginal rates, with no allowance for inflation. This treatment is consistent with most other countries, although some provide exemptions for particular types of interest income. For example, the US provides an exemption for interest earned on bonds issued by US states and municipalities for particular purposes. The UK and Japan have developed methods to exempt the interest earned on certain types of bank accounts from taxation.<sup>61</sup>

While introducing a general discount on income from bank deposits may be desirable to address the impact of inflation, doing so would introduce an asymmetry between the tax imposed on interest income earned from bank deposits and the deduction allowed for interest repayments on borrowings used to purchase an asset that generates income, leaving the system open to arbitrage. Given this asymmetry, introducing such a discount would require careful consideration.

### Discussion questions:

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

## Shares, private companies and trusts

Investment in equities (or company shares) generally produces two types of income: dividend income from business profits; and capital gains from changes in the value of the share. Both of these are subject to individuals income tax to some extent.

The tax system may encourage Australian households to invest more of their savings in companies, particularly Australian companies, than they would otherwise.

There are three key reasons for this. First, CGT is generally paid on 50 per cent of the gain (Box 4.1). This discourages saving in instruments such as bank deposits, and supports saving in capital assets such as equities or property. Second, because the imputation system only benefits Australian shareholders, it has the effect of increasing the return for Australian shareholders in Australian equities (for a more detailed explanation see Chapter 5 — Business). Finally, because Australian households do not receive imputation credits for foreign company tax paid, they may face an extra layer of tax on savings in foreign equities

61 Warburton AO, R E, Hendy, P 2006, *International Comparison of Australia's Taxes*, Australian Government, Canberra.

(subject to tax treaties) compared to Australian equities. These factors may also have effects on the broader financial system as noted recently by the Financial System Inquiry.<sup>62</sup>

Many companies use retained earnings as an easily accessible source of funds for new investments. However, retention of earnings within private companies also allows for the payment of any additional tax on dividends to be delayed. This can be a preferred means of saving for individuals facing marginal tax rates higher than the corporate tax rate.

In addition to benefits from this delay, in some cases dividends can be made in periods when an individual's income from other sources is lower to ensure that dividends are taxed at relatively low marginal tax rates. For example, an investor who is close to retirement but is on the top marginal tax rate, may structure their affairs so that dividends are paid after they retire with a lower marginal rate. Alternatively, if dividends are not paid and earnings are retained indefinitely in a company, individuals can access these funds by selling shares in the company and receiving a 50 per cent discount on capital gains (this is discussed further in Chapter 6 — Small business).

Australian households can also use discretionary trusts to save. Discretionary trusts offer tax advantages to groups of individuals who share the income from savings, and the trustee of a discretionary trust usually has complete discretion to choose which beneficiaries receive distributions from the trust in any particular year. This can provide tax benefits if beneficiaries have different levels of income from other sources.

A common example is a small family business, operated through a discretionary trust. The trustee of the trust can decide each year which family members should receive distributions of income or capital from the business. This typically results in all beneficiaries paying less tax than if all of the business income were taxable in the hands of a single taxpayer business owner or if a corporate structure was used (Box 3.3 on income splitting in Chapter 3).

### Discussion questions:

19. To what extent is the rationale for the CGT discount, and the size of the discount, still appropriate?
20. To what extent does the dividend imputation system impact savings decisions?

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62 Australian Government 2014, *Financial System Inquiry: Final Report (Murray Inquiry)*, Australian Government, Canberra.

### Box 4.1: Capital gains tax explained

Capital gains tax (CGT) is a form of income tax that is levied on an individual's 'net capital gains' at their relevant marginal tax rate.

CGT is payable on a realisation basis. An individual needs to trigger a capital gains event (such as by selling an asset) to realise a capital gain or loss. A capital gain or loss is the difference between what it cost an individual to acquire the asset and the proceeds from realising the asset (i.e. sale proceeds). If a net gain is realised, the net gain forms part of the individual's taxable income for that year, which is subject to income tax. If a net loss is realised, the individual can use it to reduce other realised capital gains in the current income year (if they have any), otherwise they can carry it forward to apply against future capital gains.

CGT is subject to a number of exemptions and concessions (see also Chapter 6 — Small Business). Most importantly, individuals can generally discount a realised capital gain by 50 per cent if they have held the asset for more than a year. The 50 per cent discount was introduced in 1999. This replaced the arrangement that had been in operation since 1985 whereby the capital gain to be included in taxable income could be adjusted for price inflation (CPI) since purchase to ensure only real gains were subject to tax.

### Investment properties

The tax treatment of investment properties is the same as it is for investment in any asset that produces a mix of current income and capital gain. That is, the rental income is taxed at the individual's marginal tax rate as it is earned, while generally only half of the capital gain is taxed, and only when the property is sold (or realised in some other way).

Investment properties are the third most popular saving vehicle after the family home and superannuation. Many of the reasons people invest in housing over other assets have little to do with the tax treatment. However, the role of the tax treatment in driving investment in real estate and the impact that this has on housing supply and affordability is a contentious issue. One issue that is contested is the role that 'negative gearing' (Box 4.2) plays in driving investment in rental properties.

## Box 4.2: Negative gearing

A property is said to be negatively geared when the mortgage interest repayments exceed the net income from the property (rental income minus other deductible expenses such as property agent fees, insurance, gardening, land tax and depreciation). In these circumstances the taxpayer can apply this 'loss' against their other income, such as salary and wages. This strategy is only financially effective where the taxpayer expects a future capital gain more than offsetting this 'loss'. Generally only 50 per cent of that capital gain is subject to tax upon realisation, which the Financial System Inquiry's final report noted could encourage 'leveraged and speculative investment' in housing.<sup>63</sup>

Negative gearing does not, in itself, cause a tax distortion, but it does allow more people to enter the market than those who might have had the equity alone to do so. Purchasers can make bigger investments in property by borrowing, in addition to using their own savings. This behaviour is encouraged by the CGT discount, as larger investments can result in greater capital gains and therefore benefit more from the CGT discount.

Contrary to popular perception, negative gearing is not a specific tax concession for taxpayers with investment properties — it is simply the operation of Australia's tax system allowing deductions for expenses incurred in producing assessable income (Chapter 3 — Individuals). Expenses incurred in producing income from other types of investments are also generally deductible. This includes interest costs incurred when borrowing to purchase assets like shares. In 2011-12, around 285,000 individuals deducted a total of nearly \$1.4 billion for expenses incurred in earning dividend income.<sup>64</sup> (See chapter 6 for a comparison with the tax treatment of non-commercial losses.)

However, investment properties constitute a substantial proportion of the total value of negatively geared assets. Chart 4.2 shows that deductions claimed for investment properties as a proportion of gross rental income have increased over the last 15 years and are now greater than gross rental income.

Chart 4.3 shows the proportion of tax filers with negatively geared investment property, and indicates that the majority of tax filers with negatively geared properties fall into the middle income bands. This largely reflects the distribution of taxpayers across taxable income bands — with the majority of taxpayers at the low to mid-point of the income distribution (for more information on the distribution of taxpayers across taxable income bands Chart 3.2, Chapter 3 — Individuals). Chart 4.3 also shows that the proportion of tax filers with negatively geared properties increases as taxable income increases.

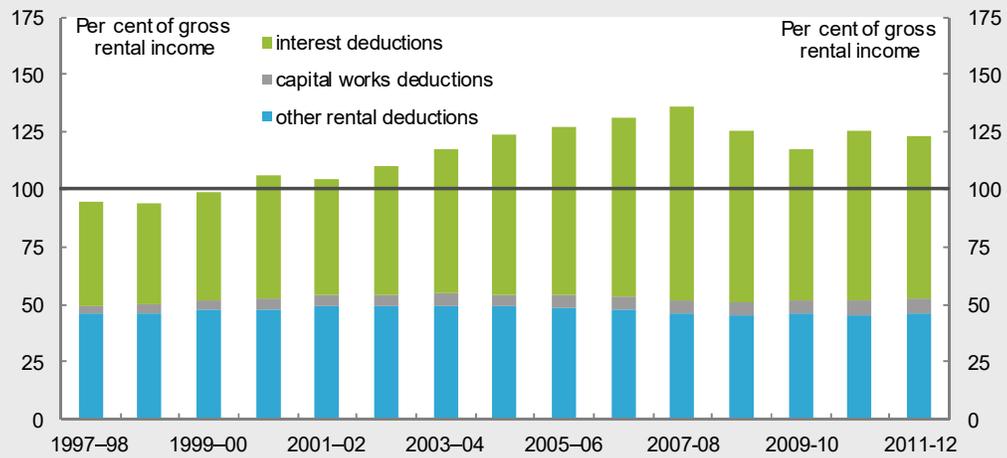
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63 Australian Government 2014, *Financial System Inquiry: Final Report (Murray Inquiry)*, Australian Government, Canberra.

64 ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

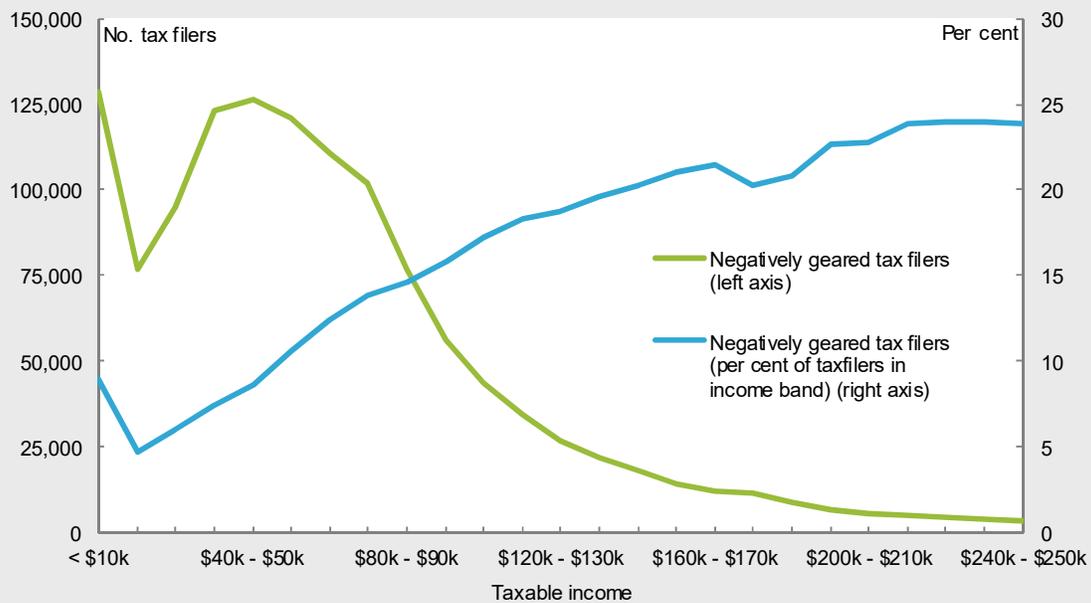
Box 4.2 Cont'd

Chart 4.2 Expenses claimed for investment properties over time, as a percentage of gross rental income



Source: ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra

Chart 4.3 Proportion of tax filers with negatively geared investment properties, split according to taxable income,<sup>65</sup> 2011-12



Source: Treasury calculations using administrative data from 2011-12 tax returns for individuals

65 It is important to note that taxable income is total income less any deductions (for example, interest deductions) and any exempt income (for example superannuation benefits). For tax filers claiming a rental loss, their taxable income would be less than their total income.

### Box 4.2 cont'd

Allowing investors to claim deductions for interest expenses ensures consistent tax treatment between debt and equity financing, as is illustrated in the stylised example below.

Let us say two individuals both earn a salary of \$90,000. One has equity of \$100,000 and decides to use this money to invest in a one-bedroom unit worth \$200,000. The other individual also invests in a one-bedroom unit worth \$200,000, but borrows the entire \$200,000.

Both individuals receive \$10,000 in annual rent from the property, which is subject to tax at their marginal rates (39 per cent, including the Medicare levy).

The individual who borrowed the full \$200,000 to purchase the property faces an interest rate of 6 per cent on the mortgage, or \$12,000 per year. As the interest payments can be deducted from assessable income, the tax liability can be reduced by \$4,680 (amount of the deduction multiplied by the marginal tax rate).

The individual who funded 50 per cent of the property with equity has a smaller borrowing of \$100,000, and therefore faces interest expenses of \$6,000 per annum. This reduces the tax liability by \$2,340. However, because they have used equity, they forgo the earnings that would have otherwise received and which would have been subject to tax. Given an earnings rate of 6 per cent<sup>66</sup> and the individual's marginal tax rate of 39 per cent, this equates to income of \$6,000 forgone and so \$2,340 less tax paid. This means, in total, this individual has reduced the tax liability by \$4,680.

This illustrates that any tax advantage for individuals investing in property does not come from borrowing.

The potential tax advantage comes on the income side from the taxation of the capital gain earned from the asset. If the individual realises a capital gain when selling the property, only 50 per cent of this income is included in their taxable return. In this situation, the effective tax rate on the investment is lower than their statutory rate (in this case, their statutory rate is 39 per cent). This is not a result of the gearing but of the taxation of the capital gain.

### Discussion questions:

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

## Owner-occupied housing

A dwelling is both a consumer durable — a house provides benefits over time like a washing machine or a television — and also a savings vehicle. Australian households hold 43 per cent of total household assets in the value of the family home.<sup>67</sup> Of the 7.8 million

66 This example assumes that the return on equity is the same as the cost of debt. The observation that any tax advantage from investing in property or other assets derives from the CGT treatment, and not from the deductibility of any interest on borrowings, is not materially affected if those rates differ.

67 ABS 2013, *Household Wealth and Wealth Distribution, Australia, 2011-12*, cat. no. 6554.0, ABS, Canberra.

households living in private dwellings in Australia in 2011, 5.2 million or 67 per cent owned their own home (with or without a mortgage) and a further 2.3 million were renting either privately (25 per cent) or in social housing (5 per cent).<sup>68</sup>

Like most other OECD countries, Australia taxes owner-occupied housing more favourably than other types of investment (including dwellings purchased purely for investment). Both the ‘imputed rent’ — in other words, the value of housing services a home owner receives from their own home — and capital gains on the property are exempt from income tax; Chart 4.1 accordingly shows the effective tax rate of zero. This makes it an attractive vehicle for saving. The primary home is also exempted from the means-test for transfer payments.

While the family home is exempt from paying land tax, it is subject to stamp duties and municipal rates levied by local and state governments (Chapter 8 — GST and state taxes).

Given the central importance of the home for Australian families, there is a strong consensus that it would not be appropriate to tax either the imputed rent on owner-occupied housing or capital gains derived from it.

## Superannuation

Pre-tax contributions to superannuation are more concessionally taxed than other forms of savings for many, but not all, taxpayers. This, in part, reflects that these savings have restricted access until retirement. Because superannuation contributions and earnings are generally taxed at flat rates, the level of concessionality differs depending on the individual’s marginal tax rate.<sup>69</sup> Those with high incomes receive the greatest tax discount relative to their marginal tax rates, and will generally save a higher proportion of their income. As such they will receive the largest aggregate level of tax expenditure, measured against a benchmark of full nominal income taxation. However, the policy merit of this level of tax concessionality has to be judged taking into account Australia’s full retirement income support arrangements, including the means-tested Age Pension.

There are two common public policy arguments for the concessional tax treatment of superannuation. First, for many people, saving through superannuation is compulsory (the current Superannuation Guarantee rate is 9.5 per cent of an employee’s ordinary time earnings). A lower rate of taxation can be justified as individuals cannot choose to save less. On the other hand, tax concessions are generally provided to encourage people to undertake more of an activity or behaviour, which is not the case with compulsory savings for retirement.

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68 Australian Institute of Health and Welfare (AIHW) 2013, *Australia’s welfare*, no. 11. cat. no. AUS 174, AIHW, Canberra. Note: the remaining 3 per cent either had an ‘other’ tenure type or the information was not specified.

69 This assumes an income tax treatment of savings consistent with the current Tax Expenditures Statement. That is, using a comprehensive income tax benchmark for measuring the extent of the tax concessions. Under this benchmark, all income is taxed at marginal rates. The alternative would be an expenditure tax benchmark, where income from capital is exempt from tax. Using either benchmark, superannuation is in aggregate taxed concessionally. For more information see the 2013 Tax Expenditures Statement. The choice of benchmark should not be interpreted as indicating a view on how an activity or class of taxpayer ought to be taxed.

The second argument for the lower taxation of superannuation contributions is that unlike other savings, superannuation cannot be accessed on demand, but is 'locked up' for retirement. The preservation age for superannuation is currently 55, gradually increasing to 60 with effect from 1 July 2024.

Superannuation is designed to improve individuals' retirement incomes. In doing so, it also reduces pressure on Age Pension expenditures.

At 31 December 2014, total Australian superannuation assets amounted to \$1.93 trillion. This constitutes around 121 per cent of GDP.<sup>70</sup> Superannuation assets are expected to continue to grow as the system matures and wages grow.

Compulsory superannuation savings appear to have made a significant contribution to national savings (around 1.5 per cent of GDP in 2011 and rising to close to 3 per cent over the next few decades). This is despite some reduction in other forms of savings.<sup>71</sup>

Voluntary savings can also be made to superannuation funds. Individuals, including the self-employed and those who do not work, can choose to save in a superannuation fund to have a higher income in retirement.

The majority of superannuation savings in Australia is in accumulation funds (where the final retirement benefit depends on contributions made, the earnings accrued and fees paid over the period invested). Pre-tax contributions, whether compulsory or voluntary, are generally taxed at the rate of 15 per cent. Income generated in the fund is generally taxed at 15 per cent during the accumulation phase, and tax exempt in the retirement phase where assets are supporting a retirement income stream. Benefits withdrawn in retirement are then generally exempt from tax (Box 4.3). Australia's system is unique in that other countries do not tax contributions and earnings, but rather tax retirement savings when benefits are paid.

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70 Australian Prudential Regulation Authority (APRA) 2015, *Quarterly Superannuation Performance (interim edition)*, December 2014, APRA, Sydney; and ABS 2015, *Australian National Accounts: National Income, Expenditure and Product*, cat. no. 5206.0, ABS, Canberra.

71 Gruen, D, Soding, L 2011, 'Compulsory Superannuation and National Saving', Address by Gruen, D, to the Melbourne Institute/the Australian 2011 Economic and Social Outlook Conference, 1 July 2011.

### Box 4.3: Tax treatment of superannuation savings: accumulation funds

| Contributions  | Earnings  | Benefits  |
|--|---|---|
| <p>Pre-tax contributions: taxed at 15%; for high-income earners 30% up to an annual cap (currently \$30,000 for people aged under 50 and \$35,000 for people aged 50 and over). The government effectively refunds the 15% tax for people with income under \$37,000 up to an amount of \$500 (until 2017).</p> <p>Post-tax contributions: no additional tax if below an annual cap (currently \$180,000).</p> | <p>Taxed at 15%.</p> <p>Earnings on assets supporting income streams (i.e. pensions) are tax-free.</p> <p>CGT: if asset is sold during accumulation phase, effectively taxed at 10%; if sold while supporting an income stream, tax-free.</p> | <p>60 and over: tax-free</p> <p>Between preservation age and age 60:</p> <ul style="list-style-type: none"> <li>Lump sums are tax-free up to \$185,000 and taxed at a maximum of 15% thereafter.</li> <li>Income streams are taxed at marginal rates less a 15% offset.</li> </ul> <p>Below preservation age:</p> <ul style="list-style-type: none"> <li>Lump sums are taxed at a maximum of 20%.</li> <li>Income streams are taxed at marginal rates.</li> </ul> |

Note: Pre-tax contributions include personal deductible contributions. Tax rates on benefits exclude the Medicare levy.

While there are policy grounds for superannuation being taxed at a lower rate than labour income, there are issues around the distribution of the impacts and their effectiveness in supporting higher retirement incomes, as well as their complexity. The Financial System Inquiry made observations relating to the differential earnings tax rate across the accumulation and retirement phases, as well as the targeting of superannuation tax concessions.<sup>72</sup> The Government has indicated these will be considered as part of the Tax White Paper process.

### Issues associated with differential treatment of superannuation earnings

The different rates of tax on earnings in the pre- and post-retirement phases add costs to the operation of the superannuation system. They also give rise to tax planning opportunities that are usually more accessible to high income earners. For example, it may be possible to delay realisation of a capital gain until the post-retirement phase so that no CGT is payable. Furthermore, it may also complicate the development of retirement income products.

With Australia's ageing population, more individuals will enter the retirement phase where no tax is paid on earnings in superannuation funds. This will put pressure on the long-term sustainability of the superannuation tax arrangements, particularly given other long-term budgetary pressures as the population ages, such as calls for higher spending on health and aged care, and relatively lower revenue from personal income taxes.

<sup>72</sup> Australian Government 2014, *Financial System Inquiry: Final Report (Murray Inquiry)*, Australian Government, Canberra.

## Issues with the distributional effects of superannuation

The flat rate of tax on superannuation contributions means that most high income people receive a larger tax concession, relative to their marginal tax rate, than low income people. The same is true during the accumulation phase and even more so during the retirement phase when there is no tax on earnings.

## Overall government assistance for retirement

Superannuation is only one pillar of Australia's retirement income system. The Government also provides assistance for retirement through the means tested Age Pension which ensures that all Australians receive a minimum level of income through their retirement.

As at 30 June 2013, there were 1.39 million people receiving the full-rate Age Pension 960,000 receiving a part-rate Age Pension (partly self-funded), and almost 250,000 individuals aged 65 years and over on some other pension payment, such as the Service Pension, Disability Support Pension or Carer Payment. Around another 760,000 individuals aged 65 years and over were self-funded and/or still employed, of which almost 290,000 were in receipt of the Commonwealth Seniors Health Card.<sup>73</sup>

Age Pensioners receive income support through the base rate of the Age Pension and through supplements and other non-cash concessions. For example, a single full rate Age Pensioner may currently receive a total payment of \$860.20 per fortnight, which comprises a base rate pension of \$782.20 per fortnight, as well as a Pension Supplement of \$63.90 per fortnight and an Energy Supplement of \$14.10 per fortnight. In addition to these cash payments, Age Pensioners may also be eligible for in-kind benefits, including the Pensioner Concession Card which entitles the holder to a range of concessions including cheaper medicines and discounts on utilities, council rates and public transport. The Government also provides generous subsidies for residential aged care, targeted at low-income earners.

Most middle-income individuals will also receive a tax discount relative to their marginal tax rate on their superannuation savings. Over time, the proportion of pensioners receiving a full-rate of Age Pension is expected to decline, and superannuation balances for low- and middle-income earners will make up a larger part of their retirement incomes.

Individuals on high incomes will generally receive minimal or no Age Pension, given it is subject to income and asset tests.

### Discussion questions:

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

73 Australian Government 2015, *Income support customers, a statistical overview 2013*, statistical paper no. 12, Department of Social Services, Canberra; and ABS 2014, *Demographic Statistics, June 2014*, cat. no. 3101.0, ABS, Canberra.

## 4.3: Alternative approaches to taxing income from savings

In the past, suggestions have been made for broad-based, lower rates of tax on income from savings (with separate arrangements for owner-occupied housing and superannuation). The objective of these arrangements is to achieve a more neutral treatment of savings vehicles leading to a better allocation of domestic saving.

As an example, the Australia's Future Tax System report recommended providing a 40 per cent savings income discount to individuals for non-business related interest income; residential rental income (including related interest expenses); capital gains (and losses); and interest expenses related to listed shares.<sup>74</sup>

In contrast, some countries adopt a schedular system under which various types of income from savings are taxed separately to other income, and are taxed at relatively low, flat rates. One type of schedular system is the dual income tax (DIT) system (Box 4.4). Because a DIT system separates the labour and capital income tax bases, allowable deductions relating to capital income can only be deducted against other capital income. Variants of the DIT system have been operating in Norway, Finland, Sweden and Denmark for the last 20 years.

### Box 4.4: Norway's Dual Income Tax System

In the late 1980s Norway's savings levels were low, the return to investment was low, and the investment allocation was seriously distorted. There was a strong concern that the tax settings induced excessive borrowing for socially unprofitable investment. The introduction of the dual income reform in 1992 was to achieve a moderate taxation of capital income that is also neutral in a broad sense, while maintaining the distributional role of the progressive tax on labour income.<sup>75</sup>

These days the two pillars of Norway's income tax system consist of a progressive labour income tax schedule, with a base rate of 32.1 per cent and top marginal rate of 47.2 per cent, and a 27 per cent flat capital income tax rate for interest, rental income, royalties and capital gains.<sup>76</sup>

Australia has a similar approach in relation to the taxation of superannuation and the treatment of capital gains and losses. Generally, however, such an approach makes the tax system more complex.

74 Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra.

75 Christiansen, V 2004, *Norwegian Income Tax Reforms*, CESifo DICE Report 3/2004.

76 Nordisk e-tax 2014, *Norway — Tax rates and limits*, viewed 08 December 2014: [www.nordisketax.net/main.asp?url=files/nor/eng/i07.asp](http://www.nordisketax.net/main.asp?url=files/nor/eng/i07.asp).

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## 4.4: Estate taxes

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Estate taxes are not currently levied in Australia. They were levied by both the Commonwealth and States in the past but were progressively scrapped in all jurisdictions. Internationally, estate taxes usually take the form of estate and gift taxes on accumulated gifts and inheritances, although some countries (for example, France and Switzerland) also levy annual wealth taxes. These taxes generate relatively little revenue. For example, Belgium, with the highest reliance on estate, inheritance and gift taxes in the OECD, raised only 1.4 per cent of total tax revenue from these taxes in 2012.<sup>77</sup> Furthermore, such taxes can be difficult to administer effectively.

Estate taxes may influence the savings decisions to leave an inheritance, but would not be expected to affect the savings decisions to fund an adequate retirement.<sup>78</sup>

### Discussion questions:

23. What other ways to improve the taxation of domestic savings should be considered? How could they be applied in the Australian context?

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<sup>77</sup> OECD 2014, *Revenue Statistics 2014*, OECD, Paris.

<sup>78</sup> Australian Government 2010, *Australia's Future Tax System Review* (Henry Tax Review), Australian Government, Canberra.