APPENDIX A: MODELLING TAX EXPENDITURES

This appendix provides an overview of the various modelling techniques used in TES to estimate the value of tax expenditures.

The methods used to calculate the estimates of individual tax expenditures in this statement vary. The appropriate approach is determined by the nature of the tax benchmark, the particular tax concession examined and the availability of data. Data availability is a major factor influencing the reliability of the estimates, and in many cases estimates are not provided due to data limitations.

The approaches used to estimate tax expenditures include aggregate modelling, distributional modelling and microsimulation. The approach most commonly used is distributional modelling, utilising data derived from microsimulation analysis.

A.1 AGGREGATE MODELLING

This approach involves using information on the aggregate volume of transactions to calculate the value of a particular tax concession. Aggregate modelling is an appropriate approach for measuring tax exemptions or concessions where the impact can be represented as a simple proportion of the total transactions concerned. Data sources suitable for aggregate modelling include national accounts data, trade and production statistics, and aggregates derived from administrative databases (such as taxation records).

Aggregate modelling is used typically to estimate tax expenditures for fuel excise. Tax expenditures for exemptions or reduced excise rates can be estimated from statistics on the aggregate volume of fuels produced.

A.2 DISTRIBUTIONAL MODELLING

This approach involves using discrete aggregate data to calculate the impact of tax concessions on particular segments of the economy. Distributional modelling is an appropriate approach for measuring concessions that vary according to the characteristics of the taxpayer. Data sources suitable for distributional modelling include survey data and data derived from administrative databases.

Distributional modelling is used to estimate tax expenditures for personal income tax concessions when the cost is related to a taxpayer’s taxable income. For these concessions, data on income distribution and tax concessions by grade of taxable income can be used to estimate the cost of tax expenditures for those concessions.

A.3 MICROSIMULATION

This approach involves examining detailed datasets, such as taxpayer records, to determine the value of taxable transactions for each taxpayer. The value of the tax expenditure is the difference between the tax paid on those transactions under the concession and the tax that would have been collected under the benchmark. Microsimulation modelling requires either a comprehensive database of all taxpayers or a detailed sample that can represent the population. It must sufficiently detail the value of transactions affecting the calculation of tax liabilities to allow the required calculations.

Microsimulation modelling is used to estimate tax expenditures that closely target particular taxpayer groups (for instance, benefits subject to detailed eligibility tests) and concessions where the payment rate varies considerably according to taxpayer behaviour or circumstance.

Microsimulation modelling can also be used to derive key information, such as average effective tax rates, which can be used in other models that employ aggregate or distributional modelling. This is appropriate for situations where detailed datasets are not available for all items.

APPENDIX B: CONCESSIONAL TAXATION OF FUNDED SUPERANNUATION

B.1 SCOPE

This appendix sets out the estimated tax expenditures related to the superannuation system for 2002-03 to 2005-06 and forward projections for the next four financial years. It also briefly examines some conceptual issues relating to the interpretation of these estimates.

The key features of the taxation of superannuation relate to the treatment of contributions, earnings and benefits. As outlined in the superannuation benchmark in Chapter 4, funded superannuation in Australia can be taxed at three stages:

- when contributions are made to a superannuation fund;
- when investments in superannuation funds earn income; and
- when superannuation benefits are paid out.

The income tax benchmark treatment of superannuation is that *contributions* are taxed like any other income in the hands of the fund member, *earnings* are taxed like any other investments in the hands of the investor and *benefits* from superannuation are untaxed. Any costs associated with superannuation investments are deductible under the benchmark.

Australia's taxation treatment of funded superannuation varies from the benchmark. Contributions and earnings are taxed at a concessional rate compared to the benchmark. Partially offsetting this is the taxation of superannuation benefits. The Government has announced that from 1 July 2007 benefits paid from a taxed source to persons aged 60 or over will be tax free. The tax concessions identified individually in Table B1 should be understood as part of an integrated system. This system is significantly concessional taken as a whole.

The calculation of the estimates requires projections of contributions, earnings and eligible termination payments (ETPs). The estimates use ATO and Treasury projections of contributions, earnings and payouts. They assume that tax is collected from superannuation funds in the year in which the contributions and earnings occur.

B.2 INTERPRETATION

The estimates of the tax expenditures in the forward projections are not necessarily indicative of the cost of the superannuation concessions over the long term. In this context, the current tax concessions will help to reduce budgetary expenses in future years, particularly age pension payments, through encouraging private provision for retirement.

Further, the estimates in Table B1 cannot be interpreted as a time series of the ongoing revenue savings that could be obtained if the superannuation concessions were eliminated. This is because the increase in tax revenue arising from the elimination of the tax expenditure with respect to a particular year would cause the superannuation tax base to be smaller for the next year. For example, if contributions and fund earnings in 2004-05 had been taxed according to the superannuation benchmark, superannuation fund assets and fund earnings in 2005-06 would be lower than if the concessional tax treatment had applied in the previous year.

In addition, changes to the taxation of superannuation could be expected to have behavioural impacts, to the extent that people may alter their saving behaviour as a result. The estimated cost of the superannuation tax expenditures assumes no behavioural change involving either the portfolio composition of savings or the saving rate more generally.

B.3 ESTIMATES

The separate components of the overall superannuation tax expenditure which are listed in Table B1 are explained further below.

1 CONCESSIONAL TAXATION OF EMPLOYER CONTRIBUTIONS

The benchmark treatment for contributions by employers to superannuation funds is that they are taxed like any other income in the hands of the employee (that is, contributions are taxed at the employee's marginal tax rate) and are deductible to the employer.

Currently, employer contributions, after certain costs of the superannuation fund are deducted, are taxed at a concessional rate of 15 per cent. Under current arrangements employers are entitled to a deduction for contributions up to an employee's age-based limit. Employers are not entitled to a deduction for contributions in excess of this limit.

From 1 July 2007, age-based limits will be removed, and all employer contributions will be deductible. Concessional deductible contributions subject to the 15 per cent tax rate will be limited to $50,000 per annum for all individuals, subject to transitional arrangements. Contributions above this limit will be taxed at the top marginal tax rate.

The superannuation surcharge for higher income earners also applied to some contributions in 2004-05 and earlier financial years. The maximum surcharge rates were reduced from the original 15 per cent to 14.5 per cent in 2003-04, and to 12.5 per cent in 2004-05. The surcharge was abolished with effect from 1 July 2005.

In any particular year, the application of the benchmark treatment rather than the concessional tax rates to these contributions would increase tax revenue by the amounts indicated.

2 DEDUCTION FOR NON-EMPLOYER SPONSORED CONTRIBUTIONS

Currently, eligible self-employed persons receive a full tax deduction for the first $5,000 of contributions plus 75 per cent of any remaining contributions up to a maximum deduction equal to their age-based limit. For the purposes of this deduction, self-employed persons are those who generally have little or no employer superannuation support. Under the benchmark, contributions by the self-employed to superannuation funds are not deductible on the basis that the contributions are not outgoings.

From 1 July 2007, age-based limits will be removed and self-employed persons will be entitled to a full deduction for all contributions they make to a superannuation fund.

Concessionally taxed deductible contributions will be limited to $50,000 per annum subject to transitional arrangements. Contributions above this limit will be taxed at the top marginal tax rate.

If the level of contributions made by the self-employed was maintained, but the contributions were not deductible, revenue would be higher by the amounts indicated.

3 CONCESSIONAL TAXATION OF FUND EARNINGS

The benchmark treatment for the earnings of superannuation funds is that they are taxed like any other income in the hands of an investor (that is, earnings are taxed at the investor's marginal tax rate). The earnings of complying superannuation funds, after certain costs of the funds are deducted, are taxed at a concessional rate. The tax rate is 15 per cent for the accumulation phase. Complying superannuation funds are entitled to refunds of excess imputation credits attached to dividends payable to the fund.

For financial year 2007-08 and later years, this item also includes the concessional taxation of fund earnings on funded pensions for persons aged 60 or over (for earlier years all pension related items are included in Item 7 in Table B1).

Item 3 (in Table B1) reflects the extra tax that would be collected if superannuation earnings were held constant, but were taxed at the personal tax rates of members rather than fund rates.

4 MEASURES FOR LOW-INCOME EARNERS

Low-income earners receiving superannuation support were eligible for a tax rebate on personal superannuation contributions made to a superannuation fund before 1 July 2003. The low-income earners' rebate was based on the annual contribution made by the low-income earner. Where the taxpayer's annual income was $27,000 or less, the rebate was 10 per cent of the lesser of the annual contribution made and $1,000.

The rebate was phased out at incomes between $27,000 and $31,000. The rebate was repealed with effect from 1 July 2003 and replaced with a much more extensive government superannuation co-contribution applying to eligible personal superannuation contributions made on or after 1 July 2003.

For 2003-04, a maximum co-contribution of $1,000 was payable for qualifying low-income earners on annual incomes[1] of $27,500 or less making eligible personal

1 Income in this context is defined as assessable income plus reportable fringe benefits.

superannuation contributions of $1,000 (that is, a matching rate of 100 per cent). The maximum co-contribution was reduced by 8 cents for each dollar of annual income over $27,500, phasing out completely at an income of $40,000.

From 2004-05, a maximum co-contribution of $1,500 is payable for qualifying low-income earners on annual incomes of $28,000 or less making eligible personal superannuation contributions of $1,000 (that is, a matching rate of 150 per cent). The maximum co-contribution reduces by 5 cents for each dollar of annual income over $28,000, phasing out completely at an income of $58,000. The lower threshold will be indexed (with the upper threshold adjusted to maintain the taper range) from 2007-08 onwards.

The co-contribution will be extended to eligible self-employed persons from 1 July 2007 onwards.

The government co-contribution is an expense measure. As such, the co-contribution payments are not included in the TES. The amounts indicated represent the impact of the co-contribution not being taxed, and the value of the rebate prior to 2003-04.

5 SPOUSE CONTRIBUTIONS AND REBATES

An 18 per cent rebate is available for post-tax contributions to the superannuation account of a spouse (where the total of assessable income and reportable fringe benefits for the spouse is less than $13,800). The rebate applies up to a maximum annual contribution of $3,000 where the spouse income is $10,800 or less, with the eligible contribution limit reducing dollar for dollar for each dollar of spouse income above that amount. The amounts reported are the value of the rebate.

6 CAPITAL GAINS TAX DISCOUNTS FOR FUNDS

Capital gains on superannuation investments are taxed. Two-thirds of any nominal capital gain is included in the assessable income of a fund when it disposes of an asset that it has held for at least one year. This measure was introduced in 1999 together with the freezing of indexation in CGT calculations. The effect of this item is in addition to the effect of lower tax rates for superannuation investments reported in Item 3 (in Table B1). The amounts reported reflect the additional tax that would be raised at fund rates on the same investments if total nominal capital gains were taxed instead of discounted gains or gains with frozen indexation.

7 TAX ON FUNDED PENSIONS

Pension and annuity payments received by a taxpayer are included in assessable income and are subject to tax at marginal rates. Annuities or pensions paid from a taxed source to a taxpayer aged 55 or over generally attract a tax rebate of 15 per cent. The tax raised on pensions and annuities reduces the total superannuation tax expenditure, because under the benchmark withdrawals from superannuation are tax-free.

From 1 July 2007, annuity or pension payments from a taxed source will be tax-free for persons aged 60 or over. Pension payments from an untaxed source will be eligible for a 10 per cent tax offset for persons aged 60 or over. From this date, this item relates to the tax on funded pensions for persons under the age of 60.

8 TAX ON FUNDED LUMP SUMS RELATING TO PRE-JULY 1983 SERVICE

The part of a lump sum benefit relating to service prior to July 1983 is taxed at a lower rate. Only 5 per cent of this amount is included in a taxpayer's assessable income and subjected to tax at marginal rates. This more concessional treatment reflects the fact that the current regime for taxing eligible termination payments did not exist before this time and applying the current tax rates to these funded benefits would impose a tax retrospectively. The amounts reported are the tax raised on these lump sums.

From 1 July 2007, the component of a lump sum benefit relating to pre-July 1983 service will be tax-free.

9 TAX ON FUNDED LUMP SUMS RELATING TO POST-JUNE 1983 SERVICE

Funded lump sums are generally taxed at 20 per cent where the taxpayer is aged under 55 years. For taxpayers aged 55 or over, the elements of any lump sum benefit taxed during the accumulation stage are typically taxed at zero per cent up to the lump sum threshold and 15 per cent thereafter. Some superannuation benefits are not taxed during the accumulation phase; for example, because the fund is protected from any taxation by the Australian Constitution. For taxpayers aged 55 or over, elements of a lump sum untaxed during the accumulation stage are typically taxed at 15 per cent up to the lump sum threshold and 30 per cent thereafter. For taxpayers under age 55 the taxation rate on these elements is typically 30 per cent. The amounts reported are the tax raised on these lump sums.

From 1 July 2007, lump sums from a taxed source relating to post-June 1983 service will be tax-free for persons aged 60 or over. Post-June 1983 elements untaxed during accumulation will typically be taxed at 15 per cent for persons aged 60 or over.

10 EXCESS UNDEDUCTED CONTRIBUTIONS

Undeducted contributions are those made from an individual's after tax income. The benchmark treatment of these contributions is that they are taxed like any other income in the hands of the individual (that is, the contributions are taxed at the individual's marginal tax rate).

Prior to the announcement of *A Plan to Simplify and Streamline Superannuation* on 9 May 2006, the tax treatment of undeducted contributions was consistent with the benchmark. Since 10 May 2006, undeducted contributions have been subject to a cap, with contributions in excess of the cap taxed at the top marginal tax rate. The taxation of these excess contributions represents a deviation from the benchmark.

A cap of $1 million applies to undeducted contributions made between 10 May 2006 and 30 June 2007. From 1 July 2007, an annual cap of $150,000 will apply to undeducted contributions, although people under age 65 will be able to bring forward up to two years worth of undeducted contributions. Exemptions to the cap will be allowed for proceeds from the disposal of assets that qualify for the small business CGT concession, up to a lifetime limit of $1 million. Proceeds from a settlement for an injury resulting in permanent disability will also be excluded from the cap.

COMPARABILITY OF ESTIMATES WITH THOSE PUBLISHED PREVIOUSLY

These estimates are comparable with those published in the *2005 Tax Expenditures Statement*. To obtain a comprehensive estimate of the superannuation tax expenditure (that is comparable to the estimates in the *2002 Tax Expenditures Statement* and earlier), C1 and C2 (in Chapter 6) should be added.

New policy measures, such as those contained in the *Simplified Superannuation* reforms and changes to the personal income tax rate scale, have been incorporated into the estimates. Changes to the personal income tax rate scale affect the concessionality of superannuation by changing the benchmark level of taxation against which the tax expenditure is measured.

Each year there are also variations arising from the revision of earnings and contributions estimates. In particular, taxable earnings of superannuation funds are not readily predictable. A major reason is that it lies within the discretion of a fund manager to decide when any accrued capital gains of a fund are realised. In addition, the earnings series is intrinsically volatile, reflecting fluctuations in interest rates and dividends. Fund earnings have been 'smoothed out' for the forward projections.

Table B1: Concessional taxation of funded superannuation[(a)(b)]

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
	$m	$m	$m	$m	$m	$m	$m	$m
Costs								
1 Concessional taxation of employer contributions(c)	5,950	7,950	7,450	8,100	7,650	8,300	9,050	9,550
2 Deduction for non-employer sponsored contributions	320	340	410	530	540	580	740	840
3 Concessional taxation of fund earnings	3,650	5,200	8,550	8,700	8,250	10,150	11,050	12,050
4 Measures for low-income earners(d)	8	6	80	250	300	280	340	360
5 Spouse contributions and rebates	14	12	13	15	15	16	18	20
6 Capital gains tax discounts for funds	210	70	110	510	510	560	620	680
Sub-total	10,150	13,580	16,615	18,105	17,265	19,885	21,820	23,500
Less offsets								
7 Tax on funded pensions(e)	*	*	*	*	*	*	*	*
8 Tax on funded lump sums relating to pre-July 1983 service	-30	-25	-30	-30	-25	0	0	0
9 Tax on funded lump sums relating to post-June 1983 service	-180	-160	-150	-145	-135	-115	-105	-100
10 Tax on excess undeducted contributions(e)	*	*	*	*	*	*	*	*
Sub-total	-210	-185	-180	-175	-160	-115	-105	-100
Total tax expenditures	**9,940**	**13,400**	**16,440**	**17,930**	**17,110**	**19,770**	**21,720**	**23,400**

(a) The concessional treatment of unfunded superannuation (C2) and the concessional treatment of non-superannuation termination benefits (C3) are reported as separate tax expenditures and are not included in this table.
(b) Totals may not sum due to rounding.
(c) Includes the revenue impact of the surcharge on superannuation contributions for high income earners which applied to some contributions for 2004-05 and earlier years.
(d) For 2002-03 this line shows the level of the tax offset available to low income earners who made personal contributions. From 2003-04 the line shows the impact of the government co-contribution being untaxed.
(e) Indeterminate, but likely to be small or insignificant.