

Executive Summary

Plato specializes in managing Australian equity portfolios for Australian investors, in particular for Australian superannuation funds in both accumulation and pension phase. As such we believe we are well placed to provide an investment perspective on taxation issues relating to superannuation and dividend imputation.

We believe the current taxation settings for superannuation are appropriate. Any move to broadly increase taxes on superannuation will reduce retirement incomes, and the reality is the vast majority of Australians have not saved enough to be self-sufficient in retirement. We do believe, however, that some individuals have much higher superannuation balances than are needed to fund a reasonable retirement and thus receive a disproportionate share of any superannuation tax breaks. We believe the best way to address this going forward would be to place some sort of limit on how much individuals can contribute to superannuation.

We believe the current dividend imputation system serves Australia well, and should be maintained as is. Imputation removes significant distortions that occur in double taxation regimes. Any move to eliminate imputation would increase effective tax rates on Australian investors, particularly superannuation investors, which would lead to reduced retirement incomes for all. We also believe any change would negatively impact corporate behaviour, increasing the incentive for Australian companies to minimise corporate taxes.

Superannuation

The Tax Discussion Paper questions whether the tax arrangements for superannuation are appropriate. We believe the answer to that question is largely yes. In our experience, many overseas investment experts point to the Australia's compulsory superannuation system as being a worldwide model for pension savings. The *quid pro quo* for the compulsory nature of the Australian system is that it is taxed more favourably than other forms of saving. However, before we get carried away with congratulating ourselves on how good our system is, the stark reality is that despite our \$2T in superannuation savings, the average Australian has not saved enough within superannuation to fully self fund their retirement, with most expecting to use the aged pension to supplement retirement income. Accordingly we believe that any broad measure to increase the tax on superannuation either directly (increasing tax rates in accumulation or pension phase) or indirectly (removing dividend imputation or the CGT discount) would only lead to erosion of self funding retirement income streams, putting even more pressure on the aged pension. For instance our modelling suggests that in a worst case implementation of the Murray Inquiry tax observations, an average Australian entering the workforce today could see their retirement income falling by as much as 35%.

There is growing debate and evidence that the tax breaks afforded to superannuation are largely flowing to the highest income earners, with approximately 40% received by the top 10% of households. We don't dispute this fact, but we also believe it is important to understand that the top 10% of the Australian population pay 66% of all tax levied on individuals, after taking into account any tax breaks. One thing that does seem to be missing in this debate is a global comparison of pension schemes. An OECD comparison suggests

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that Australia taxes contributions and accumulation phase investment earnings more highly than the vast majority of private pension schemes in other countries. In fact the global norm is to impose no tax on contributions and no tax on earnings. The difference is that most countries impose some tax on withdrawals, whereas Australia generally does not.

There is evidence that a small number of individuals hold very large superannuation balances. About 2000 SMSFs in 2012/13 were over \$10m, and we estimate the top 0.5% of the Australian population account for about 15% of total superannuation assets, and therefore getting the lion's share of any tax breaks. For complexity and equity reasons, we don't believe taxing high balances or high earnings levels is a viable method of redressing this situation. We believe the simplest way going forward would be to place some sort of reasonable limit on how much is contributed to super over one's lifetime, for under current settings we estimate an individual could amass \$26m in superannuation over a lifetime in real terms, which seems far too generous. For those who already have \$26m in their super account, why not require them to withdraw any excess above a reasonably generous level, with no tax penalties applying.

Dividend Imputation and Corporate Taxation

We believe dividend imputation serves Australia well and should not be changed. We believe much of the discussion and conclusions about possibly amending dividend imputation have been weak and one sided. The Murray Report acknowledged that removing the double taxation of corporate earnings reduced the cost of equity and bias toward debt funding, but stated *"(t)he case for retaining dividend imputation is less clear than in the past."* To us, this statement is not a strong conclusion for the case to abolish imputation. The Murray Report did question the ongoing merits of the dividend imputation system in an open economy and raised the concern that it potentially distorts the allocation of funding. However, we note that the Australian economy was an open economy when imputation was first implemented. Second, we believe any move back toward a double taxation of corporate earnings would increase the cost of equity and reduce after tax returns for Australian investors. Third, whilst the Murray Report discussed the distortions of an imputation system, they did not discuss the distortions of alternative systems, and we believe reverting to any form of double taxation or partial franking system would incur significantly greater distortions than imputation delivers.

In a double taxation system any level of corporate tax is a deadweight cost to running a business, and both corporates and investors will restructure to minimise those costs the best they can. This can clearly be seen by the way that foreign multinationals - who don't benefit from the imputation system - structure themselves to minimise taxation in Australia. If imputation is abandoned or watered down, Australian investors will be in the same position as foreign multinationals. We believe this would significantly increase incentives for Australian companies to offshore activities/profits to low tax regimes and gear up their balance sheets to minimise Australian corporate tax. We don't believe these are good outcomes for Australia. Eliminating imputation would mean that Australian investors would gravitate toward more highly geared companies or trust structures which do not pay corporate tax. In this way a double taxation system favours debt over equity, and trust structures over corporate structures. Slightly lowering corporate tax rates or moving to a partial imputation system would only slightly reduce these incentives.

Response to select questions posed in the Tax Discussion Paper

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

We believe dividend imputation performs an important role in ensuring investor preferences for interest income or dividends are balanced, that is, not distorted. Under an impartial tax system, investors seeking the most favourable tax treatment of their returns should be indifferent between investing in the debt or equity of a company or investing via a corporate or trust structure. Using a simple example in Appendix 1 we demonstrate that a dividend imputation system puts debt and equity on equal footings, removing the distortions of a double tax system which favour debt over equity. We believe this is a strong reason to maintain the current imputation system.

In terms of the allocation of savings between domestic and international equities, there may be a case to argue that the dividend imputation system favours domestic equities over international. The question is, is it Australia's imputation system that distorts investments, or is it that overseas jurisdictions double tax dividends? Either way, we believe it is rational behaviour for Australian investors such as superannuation funds to allocate a little more to Australian shares because the imputation system reduces the effective tax rate on distributed Australian corporate earnings, and less to international equity investments which have higher effective tax rates. We believe it is rational for an investor faced with two investments with similar before tax returns but different after tax returns, to always prefer the investment with higher after tax returns, but diversification benefits may still lead them to hold both assets. We believe institutional investors such as large superannuation funds do take into account differences in after tax returns when allocating between Australian and international equities, but they still hold large investments in international shares. Whilst SMSFs do seem to allocate very little to international shares, we believe this is more to do with the concept of home bias than franking. ATO SMSF statistics indicate that the vast majority of SMSF investments are held in three assets – Australian cash, Australian property and Australian shares.

We also believe that any distortion caused by imputation to favour Australian equities may not be as large as some might think. Imputation systems provide an encouragement for companies to pay out earnings. We believe this is why dividend yields on listed Australian companies are significantly higher than on global equities. On the other hand, foreign companies understand that their investors generally face some sort of double taxation. In double taxation systems corporate tax is a deadweight cost, so companies will take actions to minimise corporate tax payments. They may also set low dividend policies so as to minimise any double taxation of dividends. For instance many US companies pay no dividends, many opting to return cash back to shareholders by way of share buybacks. This may be reflected in investors expecting to receive higher capital gains on shares which generally receive lower effective tax rates, offsetting the lower or even zero dividend yields.

Is the higher payout ratio/dividend yield on Australian stocks a bad distortion in that it might be reducing corporate investment? We do not believe it is.. In fact our own research finds

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that over-investment is a problem not under-investment. The imputation system encourages companies to return earnings back to shareholders, thus making it more likely that a company will need to tap capital markets to make major investments. We believe this provides a strong discipline on companies, leading to companies being more likely to make good capital investments. A double taxation system discourages companies from returning earnings via dividends, and can lead to lazy balance sheets and/or overinvestment.

However, our reading of the Tax Discussion Paper suggests that if the imputation system is abolished, this might be linked to a reduction in the corporate tax rate. For Australian investors, that reduction would actually need to be very large. In fact for companies that fully distribute earnings the fall would need to be 100% because the imputation system essentially means that corporate taxes become a pre-payment of Australian investor tax. For companies such as the large banks which distribute around 75-80% of earnings, the corporate tax rate would need to fall by 75-80% to put Australian investors in the same position. We do not believe Australian corporate tax rates would reduce by anywhere near these amounts. However, any reduction in the corporate tax rate could exacerbate problems associated with the retention of earnings in private companies (refer p62 Tax Discussion Paper).

Offshore portfolio investors would gain from a reduction in Australian corporate taxes, offset of course by any increase in withholding taxes. However, we would not expect a small fall in Australian company tax would be sufficient to offset the negative impact of removing imputation for Australian investors.

Discussions with large superannuation funds and asset consultants lead us to believe that if the dividend imputation system was to be abolished or watered down, Australian superannuation funds would reduce their holdings in Australian companies in favour of overseas investments. This will reduce the demand for Australian shares and likely depress prices. We expect the biggest negative impacts to occur on high yielding stocks like Australian banks, which make up significant portions of typical Australian retail investor and SMSF portfolios. Whilst Australian investors will have reduced demand for Australian stocks, we see no reason why international investors demand will increase. In fact, to the extent that the imputation system reduces withholding taxes, international investors may also face lower after tax returns on Australian shares and reduce their demand accordingly. Ultimately we expect Australian share prices to fall to a level that sets the new market clearing price. We don't believe a fall in the value of Australian shares is good for Australians.

The purpose of the dividend imputation system is to eliminate the double taxation of corporate earnings. Interest paid by a company to its debt holders are made at a pre-tax level. This interest income, received by the investors, is taxed only once at the end investors marginal tax rate. Corporate earnings, on the other hand, are taxed at the company level as the profits are being earned. These profits then have the potential to be taxed a second time when the company delivers returns to its equity holders in the form of dividends. Australia's system of attaching franking credits to profits which have already been taxed at the corporate level ensures the taxes on dividend income are also taxed at the investors' marginal tax rate. In our view it's an elegant solution which achieves this purpose and puts debt and equity investments on an equal tax footing.

Critically any change to dividend imputation has the possibility to generate unintended and perverse behaviour from investors. It's clear that some of those behaviours (such as a preference for companies with higher levels of indebtedness) can be anticipated by following simple models such as those in Appendix 1, but this is by no means an exhaustive survey of scenarios. Other likely outcomes, if the current system was to be changed, would include a greater motivation for companies to establish themselves in a trust structure, or to engage in tax minimisation such as shifting profits offshore. Any change must be properly modelled and thoroughly examined, including consideration of likely reactions by corporate and investors, before being implemented.

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

We believe the answer to the first question is largely yes. In our experience, many overseas investment experts point to the Australia's compulsory superannuation system as being a worldwide model for pension savings. The *quid pro quo* for the compulsory nature of the Australian system is that it is taxed more favourably than other forms of saving. However, before we get carried away with congratulating ourselves on how good our system is, the stark reality is that despite our \$2T in superannuation savings, the average Australian has not saved enough within superannuation to fully self fund their retirement, with most expecting to use the aged pension to supplement retirement income. Accordingly we believe that any broad measure to increase the tax on superannuation either directly (increasing tax rates in accumulation or pension phase) or indirectly (removing dividend imputation or the CGT discount) would only lead to erosion of self funding retirement income streams, putting even more pressure on the aged pension. For instance our modelling suggests that in a worst case implementation of the Murray Inquiry tax observations, an average Australian entering the workforce today could see their retirement income falling by 35% (refer Appendix 4).

There has been a lot of rhetoric on the fairness of the superannuation system played out in the press in recent times. We believe that many of these statements are misinformed and potentially misleading. For example, we believe it is misleading to say franking credits allow superannuation funds to "*avoid paying tax on the dividends they get from listed companies*"¹ (refer Appendix 3A). Franking credits simply represent a credit for Australian company tax already paid by a company.

Superannuation savings are taxed at 15% which is a relatively favourable rate compared to other types of savings. However, in a global context the norm for taxing the equivalent of accumulation phase superannuation earnings is a zero tax rate (refer Appendix 3B).

Some argue that the low tax on superannuation earnings is unfair because the Australians in the highest marginal tax bracket have the most to gain from investing in super (as they have the largest differential between their marginal tax rate and the superannuation tax rate). We believe that it is fair to have a reduced rate of tax for a reasonable level of superannuation because this is the *quid pro quo* for savings being compulsory and unable to be accessed for

¹ "Concessions give retirees zero tax bill" (SMH, p9, 26 May 2015)

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many years.

On the other side of the same coin, many Australians, particularly younger Australians struggling to raise money to buy their first home, may not think it is fair to be forced to save via the superannuation system. Those investors' savings will benefit over time from the favourable tax rate for super and as a result they will enjoy larger retirement incomes later in life.

Due to their greater ability to save, the highest income earners can claim a disproportionate share of the superannuation concessions. The statistic that is often quoted is that the top 10% of households by earnings claim 41% of superannuation tax concessions (refer Appendix 3D). At face value that does not seem fair, but this needs to be put into context. Australia has a highly progressive tax system such that those top 10% of households make an outsized contribution to the total income tax collected. Our estimate is that the top 10% of individual tax payers paid 66% of all income tax collected in 2012-13 (refer Appendix 3D). Furthermore, if those high income tax payers were unable to access concessional tax rates via the superannuation system, the proportion of tax that they would have contributed would have been even greater.

We do find evidence that a small number of individuals hold very large superannuation balances. About 2000 SMSFs in 2012/13 were over \$10m, and we estimate the top 0.5% of the Australian population account for about 15% of total superannuation assets (refer Appendix 3M), and therefore getting the lion's share of any tax breaks. For complexity and equity reasons (refer Appendix 3I and J), we don't believe taxing high balances or high earnings levels is a viable method of redressing this situation. We believe the simplest way going forward would be to place some sort of reasonable limit on how much is placed in super over one's lifetime, for under current settings we estimate an individual could amass \$26m into superannuation over a lifetime in real terms, which seems far too generous (refer Appendix 3G and M). The best place to start in this regard would be to consider limiting the \$180,000 post tax contributions limit. For those who already have \$26m in their super account, why not make them withdraw any excess above a reasonably generous level, with no tax penalties.

The questions of fairness and complexity are discussed in greater detail in Appendix 3.

Q24. How important is the Australia's corporate tax rate in attracting foreign investment? How should Australia respond to the global trend of reduced corporate tax rates?

The Australian corporate tax rate is only one of many factors affecting foreign investment into Australia. When anyone considers investing in Australia versus investing elsewhere in the world, one should analyse the net present value of the net cash flows (cash earnings less cash costs) of doing business in each country. Company tax is a cost of doing business in Australia for foreign investors because foreign investors do not receive direct tax credits for Australian company tax payments. But it is only one of a number of costs. In addition to



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company tax, companies will also look at labour costs, regulatory costs, environmental costs and all other costs of running a business. Australia has high labour costs, high levels of regulation, high environmental standards and is geographically isolated from the rest of the world. Together with somewhat higher corporate taxes, this all adds up to Australia being a costly place to do business for a foreign investor. Recent announcements by Ford, GM and Toyota are evidence of Australia's high cost structure. However, we do not believe that even a zero rate of tax would have stopped these car manufacturers from exiting Australia.

We also note that smart foreign investors use numerous ways to minimize profits generated in Australia. For example, foreign investors can charge high licensing fees on Australian subsidiaries for using technology, patents or brand names, with these fees usually paid to subsidiaries in low tax regimes, or they can finance their subsidiaries with large amounts of debt, with the interest on that debt being deductible by the Australian subsidiary and assessable in a (low tax) foreign country. For these reasons many foreign investors can structure themselves to pay little or no tax in Australia. To the extent that foreign investors can and do minimize Australian corporate tax, they are indifferent as to whether the Australian corporate tax rate is 20%, 25%, 30% or even 50%.

We don't believe modest reductions in Australia's corporate tax rate will significantly increase foreign investment, although it may increase at the margin in some cases. We note that lowering Australian company tax will not greatly impact the returns Australians receive on investments in Australian companies under the dividend imputation system. While a lower tax rate will increase after tax earnings, it will also reduce the value of franking credits refundable to low tax investors by the same amount. Accordingly we see any move to reduce Australian company tax as move that mainly benefits foreign investors, although as noted above, this may be muted.

In Appendix 2 we extend the analysis of Appendix 1 to consider the position of a foreign investor with respect to the current tax framework. Effectively, foreign investors experience a 30% effective tax rate on company earnings which are distributed via fully franked dividends. Foreign investors are taxed more favourably on income generated in the form of both unfranked dividends and interest, and foreign investors are taxed most heavily when their returns are received in the form of fully franked dividends as those dividends are net of Australian company taxes paid.

Assuming a cut in the corporate tax rate amounting to anything larger than a few percentage points is unlikely, these preferences are likely to remain. In order to ensure a foreign investor sees a similar tax treatment for returns from fully franked dividends as from unfranked trust distributions, the corporate tax rate would need to be comparable to the investor's withholding tax rate on dividends (generally 15%). And for a foreign investor to be indifferent (from a tax treatment perspective) between interest income and dividend income, the tax on corporate earnings would need to be comparable to the withholding tax on interest (generally 10%).

One theme within the Tax White Paper is that the current imputation and corporate tax system does nothing to encourage foreign investment. The imputation system was never designed to encourage foreign investment, although at the margin it does reduce the taxation on foreign

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investors to the extent that no withholding tax is levied on fully franked dividends. The imputation system certainly doesn't discourage foreign investment. Lowering corporate tax rates should encourage greater foreign investment, but this need not be linked to abolishing imputation. If corporate tax rates were lowered, franking credit rebates to low tax investors would naturally fall in tandem with the fall in the tax rate. We think that there are other areas which could better attract foreign investment – such as reducing government regulation and red tape and abolishing or reducing payroll taxes which simply make Australia's already high labour costs even higher.

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

We answer the first question with a definitive “Yes” and the second with a definitive “No”.

We believe much of the discussion and conclusions about dividend imputation have been weak and one sided. The Murray Report acknowledged that removing the double taxation of corporate earnings reduced the cost of equity and bias toward debt funding, but stated “*(t)he case for retaining dividend imputation is less clear than in the past.*” To us, this statement is not a strong conclusion for the case to abolish imputation. The Murray Report did question the ongoing merits of the dividend imputation system in an open economy and raised the concern that it potentially distorts the allocation of funding. However, we note that the Australian economy was an open economy when imputation was first implemented. Second, we believe any move back toward a double taxation of corporate earnings would increase the cost of equity and reduce after tax returns for Australian investors. Third, whilst the Murray Report discussed the distortions of an imputation system, they did not discuss the distortions of alternative systems, and we believe reverting to any form of double taxation or partial franking system would incur significantly greater distortions than imputation currently delivers.

We believe the dividend imputation system is the most effective way of eliminating the double taxation of dividends, largely reducing the incentives for Australian companies to minimize Australian corporate tax. We believe if the dividend imputation system were scrapped or watered down to only partially refund Australian company tax, this would increase the incentive for Australian companies to minimize Australian company tax. We believe this would lead more companies to offshore their activities/ profits to very low tax countries, in the same way that many foreign multinationals currently do. We do not believe this would be in Australia's best interests.

We also believe that watering down the current dividend imputation system would increase the effective tax rate on Australian equities for Australian investors, reduce after tax returns, and provide strong incentives for taxed investors such as Australian superannuation funds to invest via trust structures rather than via corporate structures, or to gear up corporate structures to minimise Australian company tax payments.

Taking these two things together we believe any watering down of the current imputation



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system would have a contrary effect to that intended, leading over time to significantly smaller Australian company tax collections. For more detail on our analysis of dividend imputation, please refer to Appendix 1. Our answer to Q20 above is also relevant for this question, so instead of reiterating that answer we would refer the reader to Q20 above.

Q51. To what extent are the tax settings (that is, the rate, base and administration) for the GST appropriate? What changes, if any, could be made to these settings to make a better tax system to deliver taxes that are lower, simpler, fairer?

We believe the best way to make taxes lower, simpler and fairer would be to broaden the base of the GST to include all goods and services. This would be fairer and simpler and either allow the GST rate to fall, or if the current GST rate is maintained, allow for the removal or reduction in less efficient taxes such as stamp duty and payroll tax.

Appendix 1. Dividend imputation

At various points throughout the Tax Discussion Paper imputation credits are presented as a cost to government revenue. A good example of the framing appears on page 74 which reads:

“Dividend imputation... involves a significant cost to revenue and may impose more compliance costs to achieve similar outcomes to other jurisdictions.”

We believe that this is the wrong way to view the dividend imputation. Rather than a cost to government revenue, it's important to recognise that imputation credits represent a prepayment of tax by Australian companies on behalf of their shareholders. Under the system, the government collects corporate taxes up front, as profits are earned, and shareholders can use the franking credits generated at some later time to offset their personal Australian tax obligations provided they meet various eligibility criteria.

The dividend imputation system shifts the responsibility for reclaiming tax collections to shareholders and, subtly, this has two positive implications for government revenues. Firstly, franking credits correspond to the nominal amount of tax paid and are not adjusted for inflation or interest. As such, the government retains the time value of money between when the taxes were paid and when the shareholders are able to utilise the credits. That period can conceivably span an indefinite number of years for companies that choose to retain a portion of their profits rather than pay all their profits out as franked dividends. And secondly, certain shareholders, such as foreign investors, who receive franked dividends are unable to utilise the credits. In this case, the government retains the corresponding amount of tax that was prepaid, effectively taxing the ineligible shareholders income at the corporate tax rate of 30%.

Compare this to the case of an investment trust structured so that no corporate tax is paid and instead passes untaxed profits through to the underlying unit holders who then pay taxes on their unfranked distributions. These taxes are not collected until the investors' taxes are finalised and therefore the time value of money works in favour of the unit holders. We would anticipate that a number of companies would restructure themselves to become low or non-tax paying entities if franking was removed. Furthermore, unfranked dividends paid to non-resident investors attract a withholding tax specific to their country of residence. The maximum withholding tax is 30%, which equates to the Australian company tax rate, but generally the withholding tax is significantly below that level. Foreign investors receive more favourable tax treatment of dividends when they are unfranked.

Policy makers must be cognisant that changes to the dividend imputation will likely affect investor preferences towards Australian shares and may encourage alternative business structures. This is easily illustrated via a simple example. Consider three businesses: (1) a company funded with 100% equity, (2) a highly geared company in which interest payments are 80% of its earnings, and (3) an investment trust financed with 100% equity. Hypothetical income statements for the three businesses are presented in Table 1.1. Assuming each company pays all of its post-tax profits out to investors, the lower panel of Table 1.1 presents the pre-tax returns received by the investors under the current dividend imputation system. Under each scenario the total pre-tax return is identical and equal to 100, but the split between cash dividends, franking credits, and interest income varies.

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Illustrative Income Statement	Ungeared Co.	Heavily Geared Co.	Ungeared Trust
Earnings	100	100	100
Interest	-	80	-
Earnings after interest	100	20	100
Tax (30%)	30	6	-
Profit after Tax	70	14	100
Pre-Tax Returns to Investors			
Cash Dividends	70	14	100
Franking Credits	30	6	-
Equity Income	100	20	100
Interest Income	-	80	-

Table 1.1: Income and Pre-Tax returns for three hypothetical businesses.

Next consider two possible policy changes regarding franking credits which have been discussed in recent times. The first, which we'll call "partial franking", works similarly to the current system except it does not allow for a cash refund to be paid to investors who receive more franking credits than their income tax liabilities. The other is the "no franking" case, whereby the imputation system is abolished altogether. Table 1.2 presents the effective tax rate² (ETR) under the current system as well as the two alternatives. This quantity varies by investor as well as by tax regime, and in this analysis we assume all funding (both debt and equity) is provided by investors of the same tax status.

Under the current system the ETRs on the returns to Australian investors depend solely upon the marginal tax rates (MTR) of those investors. The ETRs are the same whether or not the business is a Trust or a regular company, or if the company utilises debt financing in addition to equity. This neat quality, however, is not preserved under the rule changes described above. The "partial franking" policy change would affect the ETR paid by investors with marginal tax rates below the company tax rate of 30%, pension and superannuation investors. For these investors, disallowing franking credit refunds serves to increase the ETR on earnings from Ungeared Co. to 30%. As seen by the differential between the ETR for Ungeared Co. and Heavily Geared Co., companies can choose to increase their tax effectiveness for low MTR investors by increasing the amount of debt that they hold. An unintended consequence would be to attract pension investors into highly leveraged investments.

Similarly, abolishing franking credits altogether serves to increase the ETR on Ungeared Co. relative to the other two fictional companies but, unlike the "partial franking" case, in the "no franking" scenario all tax rates are affected. In particular, the ETR for Ungeared Co. rises to 64% for individuals in the highest marginal tax bracket. Thus the elimination of dividend imputation would result in the dividends from companies with low levels of gearing becoming extremely highly taxed. Companies with low levels of gearing are often smaller emerging businesses and an unintended consequence would be to discourage investors from investing equity in these businesses.

² We define the effective tax rate as the proportion of company earnings which are collected as taxes including income tax and franking credits at the investor level.

Effective Tax Rates			
Pension Investor: Tax Rate 0%			
Imputation Policy	Ungeared Co.	Heavily Geared Co.	Ungeared Trust
Current System	0%	0%	0%
Partial Franking	30%	6%	0%
No Franking	30%	6%	0%
Superannuation Investor: Tax Rate 15%			
Imputation Policy	Ungeared Co.	Heavily Geared Co.	Ungeared Trust
Current System	15%	15%	15%
Partial Franking	30%	15%	15%
No Franking	41%	20%	15%
Company: Tax Rate 30%			
Imputation Policy	Ungeared Co.	Heavily Geared Co.	Ungeared Trust
Current System	30%	30%	30%
Partial Franking	30%	30%	30%
No Franking	51%	34%	30%
High MTR Individual: Tax Rate 49%			
Imputation Policy	Ungeared Co.	Heavily Geared Co.	Ungeared Trust
Current System	49%	49%	49%
Partial Franking	49%	49%	49%
No Franking	64%	52%	49%

Table 1.2: Proportion of company earnings which are ultimately collected as tax.

The elegance of the current dividend imputation system is that it ensures taxes are levied at the marginal tax rate of the end investor. In our view, this makes the dividend imputation system a world leader. Partial imputation adds complexity and has the potential to change company behaviour and steer pension phase and superannuation investors into much riskier, highly leveraged stocks. Abolishing franking credits altogether might simplify the system but that would also distort investor preferences for different types of share investments and provides a strong incentive for Australian-owned companies to avoid or minimise tax paid in Australia.

Appendix 2. Encouraging non-resident investors

Returns to foreign investors in Australian businesses face Australian withholding taxes which vary depending upon the country the investor resides in. The standard rates of withholding tax are 30% for dividends and 10% for interest income. If the country has a tax treaty with Australia then the rate of withholding tax on dividends reduces generally to 15%³. Importantly, the franked component of dividend income to non-resident investors is exempt from withholding tax.

Effectively, foreign investors experience a 30% effective tax rate tax on company earnings which are distributed via fully franked dividends. To see this we extend the illustrative example from Appendix 1 to consider the returns to foreign investors. Table 2.1 displays the results. All companies start with \$100 in earnings before interest and taxes. Ungeared Co. paid tax at the 30% corporate tax rate leaving \$70 for distribution to shareholders in the form of a fully franked dividend. In contrast Heavily Geared Co. paid only \$6 in corporate tax as a result of the tax shield offered by its interest expense. Its free cash flow to investors comprises of a fully franked dividend of \$14 and \$80 in interest payments. Since both the dividends from Ungeared Co. and Heavily Geared Co. are fully franked they are exempt from withholding taxes. If interest income generated by Heavily Geared Co. attracts a 10% withholding tax then the effective tax rate for Heavily Geared Co. is 14%, which compares to 30% for Ungeared Co.

	Ungeared Co.	Heavily Geared Co.	Ungeared Trust
Dividends	70	14	100
Interest Income	-	80	-
Investment Income	70	94	100
Withholding Tax on Dividends	-	-	15
Withholding Tax on Interest	-	8	-
Total Australian Taxes	-	8	15
Total Earnings after Tax	70	86	85
Effective Tax Rate	30%	14%	15%

Table 2.1: Proportion of company earnings to foreign investors which are ultimately collected as tax.

Turning now to the Ungeared Trust we note that since it does not generate franking credits, the effective tax rate for foreign investors in this vehicle simply equates to the withholding tax specific to the country of the investor. In the table we've assumed the withholding tax is 15%.

It's clear from this simple example that foreign investors are taxed more favourably on income generated in the form of unfranked dividends and from interest. Foreign investors are taxed most heavily when their returns are received in the form of fully franked dividends as those dividends are net of Australian company taxes paid. The abolition of the imputation system will do nothing to change this situation as it's a function of the differential between the Australian company tax rate and the withholding tax rates negotiated with each respective country.

³ Source: comparativetaxation.treasury.gov.au/content/report/html/12_Chapter_10-03.asp



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Lowering the corporate tax rate was one option proposed in the Tax Discussion Paper that could be used to attract foreign investors. Adjusting the corporate tax rate does not have a direct impact on dividend income to Australian investors as the current dividend imputation system ensures taxes on dividends are levied at the individual investor's marginal tax rate. Lowering the corporate tax rate would increase the returns to investors who do not benefit from the imputation system, such as offshore investors, and therefore would make Australian equity investments look more attractive. Due to the relatively low withholding taxes on interest earnings, foreign investors may view returns on lending as more attractive than equity investing.

The argument to lower the overall tax rate uses the rationale that since the tax rate in some foreign countries is lower than Australia's, this encourages companies with global supply chains to shift their earnings into those countries. However, if we, as well as other major Western countries were to reduce our tax rate, we believe this further encourages a 'race to the bottom' with most countries likely to reduce their company tax rates in order to appeal to global multinationals, and possibly resulting in almost no tax being paid by these companies. In contrast, Australia should work with foreign countries to create a global tax system where global companies pay their fair share of tax and promote Australia as a destination for foreign capital based on the skills and innovation of our workers as well as the strength of our systems and the ease of doing business. In short, we believe multinationals should be required to pay a fair share of their tax for earnings generated within Australia, rather than being given further reward for lobbying governments globally and shopping for tax jurisdictions opportunistically.

Appendix 3. On the question of fairness in the superannuation system

Discussing the fairness of superannuation depends very much on personal views on what is fair. We believe there has been significant hyperbole about the fairness of superannuation in the media. For example in “Concessions give retirees zero tax bill” (SMH, p9, 26 May 2015) the following comments highlight much of the debate about the fairness of superannuation:

- 1) *“The cost to the budget of giving tax breaks to self-managed super funds has soared in the past year.”*
- 2) *“Australian Taxation Office data, analysed by Fairfax Media, shows 300,000 self managed superannuation funds (SMSFs) legally eliminated or reduced their tax bills in 2012-13, the most recent year for which data is available.”*
- 3) *“The two major tax breaks offered to about half a million SMSFs come through franking credits – which allow the funds to avoid paying tax on the dividends they get from listed companies – and exemptions for taxpayers whose super funds are funding their pension income.”*
- 4) *“The Australia Institute’s modelling on superannuation tax concessions shows that the benefits of super tax concessions are mainly accruing to the top 10 per cent household, who claim 41% of the tax concessions, worth \$12.2 billion.”*
- 5) *“(Australian) Institute executive director Richard Dennis said the government needed to reconsider its position (on superannuation). “The whole system is a mess – it’s neither simple nor fair.” “And income from superannuation should be taxed at your full marginal rate.”*

These comments illustrate some common arguments about the fairness of superannuation, and in particular SMSFs. We believe that many of these statements are misinformed and potentially misleading.

Let us address some areas of fairness and complexity.

A. Is it fair that superannuation funds use franking credits to “avoid” paying tax on dividends?

We believe it is misleading to say franking credits allow superannuation funds to “avoid paying tax on the dividends they get from listed companies” (refer 3 above). Franking credits simply represent a credit for Australian company tax already paid by a company, thus they are receiving a credit for tax already paid, not avoiding tax. The dividend imputation system is an elegant way of ensuring Australian investors are not double taxed on corporate income, which was the case before it was introduced, effectively meaning a superannuation investor pays tax at either 15% in accumulation and 0% in pension mode. And not all dividends are franked. Some Australian companies pay unfranked dividends, and all foreign companies pay unfranked dividends, so these will be subject to taxation.



B. Is it fair to tax retirement savings at lower rates than normal individual marginal tax rates?

Is it fair that Australia's superannuation saving system is a compulsory savings system?

The *quid pro quo* for the fact that superannuation savings are compulsory and locked up for many years is that it is taxed more favourably than other forms of savings or income. Many Australians, particularly younger Australians struggling to raise money to buy their first home, may not think it is fair to be forced to save via the superannuation system for their retirement in 30-40 years' time, but they have no option. The compulsory nature of superannuation seems to be something that most commentators have conveniently ignored.

The alternative for some people is the aged pension provided by the government, and the government pays no tax. Under the aged pension, the government essentially saves and pays retirement incomes for those who haven't saved for themselves. The government doesn't pay tax on its earnings, so why should those people who save for their own retirement and don't claim the aged pension have to pay taxes on their retirement earnings?

Most overseas private pension systems don't tax retirement savings. One thing that surprises us in the superannuation debate is that there is very little discussion about what happens in other countries. This is surprising because in our experience many overseas experts point to the Australian system as being a model for pension savings. Yoo and de Serres (2004)⁴ reviewed the tax treatment of private pension savings schemes across OECD countries. Whilst somewhat dated, Yoo and de Serres find (Table 3.1, Panel A) that 25 of 30 OECD countries do not tax earnings on pension savings schemes at any time (that is in both accumulation and pension periods). They also find that 25 out of 30 countries do not tax pension contributions, although it is not necessarily the same 25 countries that don't tax earnings. Australian and New Zealand stand out as the only 2 countries that tax both contributions and earnings, although Australia does not tax earnings once in pension mode. So from that respect Australia's current position of taxing both pre-tax contributions and earnings in accumulation mode seems unfair compared to most other countries. The big difference is, however, that Australia now does not tax retirement incomes generated from pension savings, whereas 27 of the 30 countries in the Yoo and de Serres study did tax retirement incomes in 2004.

C. Is it fair to single out SMSFs?

We believe that to focus on SMSFs alone is incorrect and unfair. We note that the same tax rules apply to both SMSFs and all other superannuation funds. Whether a superannuant is in an SMSF, an industry super fund, a retail super fund, or a government super fund, the tax treatment is the same.

D. Is it fair that the top 10% of households claim 41% of superannuation tax concessions?

Whilst we do not dispute the fact that the highest income earners can claim a disproportionate part of superannuation tax concessions, we think this needs to be put into perspective. We analysed the 2012-13 Taxation statistics and find that the top 10% of individual taxpayers pay

⁴ OECD Economic Studies No. 39, 2004/2 "Tax Treatment of Private Pension Savings in OECD Countries".



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43% of all income tax paid by individuals, which appears pretty much in line with the tax concessions number, although we note that we used individual tax numbers not household tax numbers. However, only 41% of the Australian population (we assume 23m for Australia's population in 2013) actually pays individual income tax. If we take the highest tax paying 10% of the total population, that is the top 2.3m taxpayers, we find they pay 66% of all individual income tax (\$102B out of total take of \$155B in 2012-13). One should also note that these numbers are after any tax concessions from superannuation. If top tax payers were denied superannuation concessions they'd be paying an even higher percentage of total taxes. This leads us to ask the following question:

E. Is it fair that the top 10% of individuals pay 66% of the total individual tax pool after claiming superannuation tax concessions?

This is not really a question for superannuation, but we believe it is important to understand who actually does pay the vast majority of taxes in Australia, and should be understood when people are debating superannuation tax concessions.

F. Is it fair that someone can save \$3.5m in superannuation from before tax contributions?

Currently Australians can contribute \$30,000 pa from before tax earnings into superannuation up to age 49 and \$35,000 from age 50⁵. We calculate that using reasonable earnings assumptions someone who contributed these maximum values each year of their working life into superannuation can save approximately \$3.5m in superannuation in real terms (that is in today's dollars) by the time they retire. This number includes both the initial capital contributions and the earnings on those contributions. Net of the 15% contributions tax, contributions represent approximately 1/3 of the retirement balance, with investment earnings representing the balance. A couple both doing the same maximum contributions could amass approximately \$7m in superannuation by the time they retire. Of course, this assumes someone has the capacity to make these large contributions throughout their entire working life, which would be unlikely to be the case for the vast majority of Australians. Only very highly paid individuals could afford to contribute \$30,000 pre-tax in their very first year of working and every year thereafter. If we assumed a more reasonable assumption that someone can only afford the statutory minimum compulsory superannuation contribution of 9% (on a starting salary of \$50k growing at 1%pa in real terms) up to the age of 49, and only starts saving the maximum contribution from age 50, then retirement balances would only accrue to around \$1.2m in today's dollars⁶.

G. Is it fair that someone can save \$26m in superannuation from both before tax and post tax contributions?

In addition to before tax contributions, Australians are also able to contribute \$180,000pa in

⁵ We use the same assumptions as used in Plato's (2014) paper "Murray report on tax could deal harsh blow to pensioners" based on existing tax rates for superannuation. We assume a working life is 45 years, starting work at age 22.

⁶ All our calculations in terms of modelling retirement balances are conducted in real terms.



post tax savings into superannuation. Whilst very few individuals could afford to contribute \$180,000pa into superannuation throughout their working life, were they able to do so, we estimate they could save approximately \$26m in superannuation in real terms by the time they retire. If we assumed a more reasonable assumption that someone can only afford the statutory minimum compulsory superannuation contribution of 9% (on a starting salary of \$50k growing at 1%pa in real terms) up to the age of 49, and only start saving the maximum pre- and post- tax contributions from age 50, then retirement balances would only accrue to around \$5m, still a tidy sum but nothing like the \$26m number.

H. Is it fair that someone with \$26m in superannuation pension mode can draw-down a tax free pension of at least \$1.3m pa and pay no tax on the investment earnings of their superannuation balance?

By law a superannuant must draw down a minimum of 5% (and higher based on age) when in full retirement mode. For a \$26m balance this equates to a minimum drawdown of \$1.3m pa of retirement income, and this income is currently not taxed in the hands of the individual. At the same time, as the superannuant is retired the superannuation fund is in zero tax pension mode so it doesn't pay any tax on the members investment earnings. For a \$5m balance this equates to a minimum \$250,000pa retirement income, whilst a \$1.5m would equate to a minimum \$75,000pa retirement income. Whilst some might argue if you saved that much money you should deserve to reap the benefits in retirement, many might believe it is unfair to draw down very large tax free retirement income streams when the underlying superannuation assets are also free of tax.

I. Would it be fair and simple to tax retirement earnings above \$75,000?

The Shadow Treasurer Chris Bowen has announced a policy of taxing the earnings of superannuation accounts of retirees (which are currently tax free) at the rate of 15% for earnings above \$75,000. *"The party estimates that would affect about 60,000 people with superannuation balances over \$1.5m and raise \$9.2 billion in the 10 years to 2026-27."*(abc.net.au) On the face of it, this may sound like a reasonable solution. However, we believe the devil is in the detail, and such a proposal may be neither fair nor simple. Let us first start with simplicity. Whilst it might sound easy to tax super earnings at 15% over \$75,000 in pension mode, there is one big problem in doing so. The average Australian is a member of more than one superannuation fund. One would need to aggregate up individual accounts to levy tax, and no such system exists to do so. Very significant costs would be needed to build systems to aggregate superannuation earnings across superannuation funds, otherwise one could simply avoid paying this tax by split funding pension phase super into many small accounts at different funds.

There is also one other difficulty in taxing earnings – how does one define earnings? We have assumed in our analysis below that one taxes the actual annual investment returns of a fund, the returns that are reported to investors. However, tax is normally levied on taxable income, and taxable income may be very different to actual returns. Returns include income received and capital gains (realised and unrealized). Taxable income generally includes income received and realised capital gains, but not unrealized gains. Timing mismatches can mean that taxable income can be very different to actual returns.

One needs to very clearly consider how a threshold works. Is the threshold at the individual level or at the couple level? If set at the individual level, the system would favour couples with evenly split balances, yet industry statistics show the norm is that women hold much lower balances on average than men, partly due to family responsibilities. We believe couples would need to be able average superannuation balances between them, or the threshold should be set on the combined superannuation balance of a couple. However, if like the aged pension rules, the couple threshold is less than twice the individual threshold, there may be incentives for couples to divorce simply to avoid superannuation threshold taxes

Now let us turn to fairness. We believe the estimates of this tax only affecting “60,000 people with superannuation balances over \$1.5m” vastly underestimate the likely impact of this proposal. If one earns \$75,000 from a \$1.5m investment, which equates to a 5% pa return. We believe that a 5% return is significantly less than what most superannuation funds earn. The Super Guide website presents information on superannuation returns. For the 10 years to 31 December 2014 the top 10 performing superannuation funds earned more than 7% pa. The top 10 performers included Australia’s largest superannuation fund Australian Super. Australian Super’s Balanced Fund earned 7.3%pa over the 10 year period, and this is the return for their accumulation option which is already taxed at 15%. To investigate Australian Super’s Balanced Pension returns, we downloaded actual returns from the Australian Super Website for years from 2009 to 2014. Table 3.1 summarises those returns. Whilst the average return over those 6 years was 7.4%, the actual returns varied year to year from -13.23% in 2009 to +17.17% in 2013. Using these actual returns we calculate at what investment balance one would start paying the proposed tax each year, and the quantum of earnings and tax paid on investment balances of \$500,000, \$1m and \$1.5m.

Table 3.1 shows that in a good year for investment returns, balances below \$500,000 would pay the pension tax, which means far more than 60,000 pensioners will be impacted by this tax. For a \$500,000 balance one would earn less than \$37,000 on average across the 6 years, but due to high earnings in the last 2 years would pay over \$2,300 in tax or on average \$388 pa in tax. For a \$1m balance one would earn just a little less than the proposed \$75,000 tax threshold on average, but due to earnings fluctuations would actually pay \$6,505 pa in tax on average, which equates to a 9% tax rate on total average earnings – earnings which average less than the minimum tax threshold. For a \$1.5m balance one would earn approximately \$110k pa, or around \$35k more than the tax threshold, but due to earnings fluctuations would actually pay \$13,508 pa in tax on average, which equates to a 38% tax rate on total average earnings over \$75,000.



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Year	Australian Super Balanced Pension Return	Balance needed to generate \$75,000	Earnings of \$500,000	Tax on Earnings on \$500,000	Earnings on \$1m	Tax on Earnings on \$1m	Earnings on \$1.5m	Tax on Earnings on \$1.5m
2009	-13.23%	NA	-\$ 66,150	\$ -	-\$ 132,300	\$ -	-\$ 198,450	\$ -
2010	11.92%	\$ 629,195	\$ 59,600	\$ -	\$ 119,200	\$ 6,630	\$ 178,800	\$ 15,570
2011	11.00%	\$ 681,818	\$ 55,000	\$ -	\$ 110,000	\$ 5,250	\$ 165,000	\$ 13,500
2012	1.49%	\$ 5,033,557	\$ 7,450	\$ -	\$ 14,900	\$ -	\$ 22,350	\$ -
2013	17.17%	\$ 436,808	\$ 85,850	\$ 1,628	\$ 171,700	\$ 14,505	\$ 257,550	\$ 27,383
2014	15.93%	\$ 470,810	\$ 79,650	\$ 698	\$ 159,300	\$ 12,645	\$ 238,950	\$ 24,593
Average	7.4%	\$ 1,016,260	\$ 36,900	\$ 388	\$ 73,800	\$ 6,505	\$ 110,700	\$ 13,508

Table 3.1: Estimated impact of a 15% tax on investment earnings over \$75,000.

Source: Plato, www.australiansuper.com

We have shown that taxing volatile investment earnings above a threshold amount can have quite startling impacts, imposing taxes on investors with much smaller balances than expected. Is it fair to impose a tax on otherwise tax free pension savings of less than \$500,000 because they had a good year? One could use some sort of smoothing mechanism to average out returns over say 5 or 6 years, but this would impose much greater complexity to the equation, and would still likely lead to balances of \$1m rather than \$1.5m being impacted by a tax on earnings greater than \$75,000.

J. Would it be fair to tax earnings on large superannuation balances more highly?

The Murray Report discussed a number of options to levy additional earnings tax on superannuation account balances above a certain limit. The report did discuss the likely high compliance costs associated with doing this but still concluded that there may be ways to minimise those costs. We believe any such system will impose significant costs on superannuation funds for the same reasons as discussed in I above. We also believe there are a number of issues raised by any such move. Philosophically, one is changing the goalposts. Individuals save for retirement based on a set of rules and then those rules are changed. However, we believe the most significant issue is how much is enough? What is a reasonable retirement balance? We think this is an actuarial question not a tax question, and the answer in reality should depend on individual circumstances. However, we believe using individually tailored actuarial thresholds would not be a workable solution. We would expect any thresholds to be commonly set as is the case with aged pension asset rules. We believe setting a single reasonable level is fraught with inequities such as:

- 1) Longevity risks. Retirees who have a family history of longevity, face greater longevity risk than average and accordingly would need higher than normal retirement balances relative to an average person to provide a self funded retirement. Taxing balances will penalise retirees who expect to live longer than normal;



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- 2) Risk tolerance. Retirees may also differ in respect to their attitude toward taking on investment risk. A very conservative retiree might only be comfortable investing in safe assets such as term deposits and government bonds which generate low returns. Many people might think \$1m is a lot of money. Today a \$1m investment in bonds or cash would only generate around \$30,000 in income before fees, which is actually less than what the current aged pension is for a couple. Conservative retirees need to save more to fund a retirement income stream than would a more risk tolerant investor who invests in a higher earning but more risky investment strategy. Taxing earnings based on balances would therefore penalise conservative retirees;
- 3) Threshold behaviour. Taxing earnings on balances may also have perverse impacts on investors, providing incentives to game the system where investors have balances that are around any threshold level. For instance in a good investment year which might push a retiree's balance over the threshold, there will be incentives to increase withdrawals to such a level that offsets the strong investment returns. However, if those withdrawals are consumed, this strategy may exacerbate sequencing and longevity risk, since for retirees, in a bad investment year, one cannot top up the fund;
- 4) Individual or couple thresholds. As in I above, one needs to very clearly consider how a threshold works. Please refer I above; and
- 5) Age inequities. Someone retiring today at age 65 needs far more savings than someone who is retired and is already 80 or 90 years old, yet we assume any threshold would be a fixed threshold, regardless of age. Arguably any threshold should be higher at age 65 and gradually fall as one ages.

K. Would it be fair to increase taxes on superannuation for all investors to reduce the tax breaks?

Now, with many Australians approaching or having reached the time when they can start to draw on those superannuation savings, there appears to be a growing resentment by some about the “cost to the budget of giving tax breaks to (SMSFs)”. Increasing tax rates on superannuation can have enormous impacts on retirement incomes due to the power of compounding over very long periods. Plato's research finds that a worst case implementation (setting pension tax rates to align with accumulation rates and scrapping dividend imputation and CGT discounts) the Murray FSI observations on superannuation tax could reduce retirement incomes by up to 35% for a worker entering the workforce today. If one were to tax superannuation at marginal individual rates, retirement balances would be significantly lower for anyone who pays tax. For example we have modelled the impact of someone taxed at 34.5% (the rate of tax including medicare levy on those earning between \$37k and \$80k) and on their superannuation earnings, rather than the current 15% during the accumulation mode, and we estimate this reduces retirement income by around 15% for someone entering the workforce today. Retirement income reductions for higher income earners would be even more substantial. Given that the vast majority of Australians haven't saved sufficient money to self fund their retirement, we believe any broad move to increase taxation on super by direct changes (eg taxing pension phase super at 15% or taxing earnings at one's marginal rate) or via stealth (eg, eliminating dividend imputation) will lead to poorer

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retirement income for all, and a greater burden on the aged pension. We also note that taxing superannuation investment earnings at an individual's marginal tax rates would be extremely complex and very costly to implement and is similar to the issues discussed in section I in regard to taxing pensions.

L. Would equating the tax rate between accumulation and pension reduce complexity and increase fairness?

The Murray FSI tax observation discussed equating the tax rates for accumulation and pension to reduce complexity. We believe equating the tax rates would make sense, and would reduce complexity. However, since systems have already been developed for the current situation, we believe any administrative cost savings would be relatively modest. The question then arises as to which tax rate to harmonise to. Based on our modelling we estimate that retirement incomes would fall about 15% if one taxed pension phase superannuation at 15% for someone entering the workforce today⁷. On the other hand if one taxed accumulation at zero per cent then retirement incomes would increase by approximately 15%. We estimate that setting both accumulation and pension tax rates to 7.5% (with 5% for long term capital gains) would generate approximately the same levels of retirement income as the present settings would likely provide. However, please note these calculations are all based on someone entering the workforce today. Anybody currently retired or just about to retire would be worse off if the accumulation and pension tax rates are normalized at 7.5%, because they will not get the benefit of the lower tax rate in accumulation. We estimate that for someone about to retire now, increasing the pension rate to 7.5% would reduce retirement income streams by up to 7.5%. And in fact, anyone already in the superannuation system will be worse off to the extent that they have been paying 15% tax on accumulation earnings.

We also believe that there are significant advantages in not taxing pension assets. In accumulation phase, investors are building up their wealth, can invest for the very long term and have no need for income. In pension phase investors must live off the income from their portfolio, whilst also drawing down on capital, being very cognisant of investment sequencing and longevity risks. We believe these differences mean that the investment strategies for accumulation and pension phase superannuation can be quite different. For instance an investor may invest for growth in accumulation mode, focusing on growth stocks like CSL which have increased in value some 90x over the past 20 years. However, once retired, an investor wants income and with CSL paying just 1.5% dividend yield, it generates very little income. A higher yield stock such as a bank share like Westpac on the other hand pays a 5.5% dividend which is fully franked. As one enters the retirement zone, this may mean that investors may need to significantly change their investment portfolio. If pension investors are not taxed, as is the current case, then there are no tax impediments to rebalancing portfolios to suit the changing needs of retirees. If one taxes pension assets, those taxes can, however, become impediments to investors moving toward an optimal investment strategy for retirees. We also note that it is much easier to run a low turnover buy

⁷ We use the same assumptions as in Plato (2014). Please note that in our calculations we have not allowed for any aged pension, rather we only focus on how much retirement income a superannuant could generate from their own superannuation savings.



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and hold strategy when one is accumulating assets, but when one is in decumulation mode realizing capital gains is much more likely. This translates into the likelihood that reducing capital gains tax in accumulation mode and increasing capital gains tax in decumulation mode may lead to higher levels of capital gains tax being paid overall, something we have not modelled in our estimates above.

So whilst there may be administrative efficiencies in harmonizing super and accumulation tax rates, we believe this would unfairly penalize anyone currently in or about to move into pension phase in the near future.

M. Would it be fair to cap how much individuals can put into superannuation?

In F, G and H above we document how some investors can build very large superannuation balances under current system settings. We don't have access to all superannuation information, but we were able to use ATO statistics on SMSFs to get some idea of how many people actually have very large balances in superannuation. Using 2012/13 statistics, some 61,000 SMSFs have balances of over \$2m, out of a total of 504,000 SMSFs. Given that the average SMSF has approximately 2 members, that means around 120,000 Australians have SMSF balances over \$1m. Using the asset ranges of these funds as a guide, we estimate that these 61,000 SMSFs which account for 12% of all SMSFs, represent approximately 48% of the total \$500B invested in all SMSFs. This suggests to us that a relatively small percentage of the Australian population have very large superannuation balances, although we have not been able to estimate the number of Australians who have large superannuation balances in other forms of superannuation such as industry funds or government funds. Our numbers also seem to align fairly well with the previously quoted statistic that approximately 60,000 Australian have pension balances in excess of \$1.5m. We also calculated how much the top 61,000 SMSFs represent as a percentage of the total super pool. In June 2013 total superannuation was \$1.63b (Source APRA), so 61,000 large SMSFs represent around 15% of the total superannuation assets. Assuming 2 members per SMSF, this translates to around 0.5% of the total population of Australia holding around 15% of our superannuation assets, and gaining around 15% of any superannuation tax breaks. Accordingly we believe there may be some merit in considering a cap on how much individuals can put into super. We believe the best place to start would be to consider limiting how much people can save into super, with the biggest factor which can move the dial on superannuation savings being the \$180,000 pa post tax contribution limit.

Appendix 4. Observations on Murray’s “Observations” on Tax on Superannuation: Substantial increases in tax on retirement savings?

The Financial Services Inquiry (FSI) final report (the Murray Report) was handed down by its Chairman David Murray on Sunday December 7. Whilst taxation was not the primary target for the Murray Report it did make a number of “observations” about our taxation regime, particularly regarding the taxation of superannuation. In a nutshell, for superannuation, the Murray taxation observations imply the elimination of dividend imputation, the elimination of the tax discount on long term capital gains (currently 10% tax rate for long term CGT for superannuation compared to the normal 15% income tax rate) and removing the differential tax rate between accumulation (currently 15%) and pension (currently 0%) phase superannuation. Whilst it would be nice to remove the tax on superannuation altogether, we assume the alignment of tax rates means a 15% tax rate for both pension and superannuation phase superannuation. If all these taxation changes were to occur, we estimate they would effectively reduce typical superannuation balanced fund returns by between 0.7% pa and 1.5% pa in accumulation and pension phase, respectively. This would substantially reduce superannuation balances at retirement (we estimate by approximately 23%) and reduce retirement incomes even more substantially (we estimate by approximately 35%) as there is a significantly lower earnings rate in retirement. Alternatively, we estimate that retirement income would last approximately 10 years less if the Murray observations were implemented. These estimated potential tax changes would dwarf the impact of any efficiency gains the Murray Inquiry expected (estimated to improve retirement incomes by 10%⁸). In other words, should the Murray taxation observations be implemented, it would imply a substantial increase in the tax on compulsory retirement savings.

Background

The Murray Report was primarily focused on financial services, including superannuation. Whilst tax considerations were not the primary objective of the Report, in respect to taxation the FSI ‘s terms of reference were stated as:

“6. The Inquiry will examine the taxation of financial arrangements, products or institutions to the extent these impinge on the efficient and effective allocation of capital by the financial system, and provide observations that could inform the Tax White Paper.”

So whilst the FSI has made observations rather than recommendations on taxation, these observations will be inputs to another inquiry. As such, we believe the FSI’s observations are not binding, and if eventually some of these changes are implemented, any changes are likely to be some time away. Nevertheless, we believe it is worthwhile analysing the taxation observations from the Murray Report. We reproduce in full the main observations regarding superannuation in the appendix to this paper, but highlight those main points in Table 4.1 below.

⁸ As disclosed in footnote 6 of Chapter 2, Financial Services Inquiry Final Report.



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Differentiated tax treatment of savings	The tax system treats returns from some forms of saving more favourably than others. The relatively unfavourable tax treatment of deposits and fixed-income securities makes them less attractive as forms of saving and increases the cost of this type of funding.
Negative gearing and capital gains tax	Capital gains tax concessions for assets held longer than a year provide incentives to invest in assets for which anticipated capital gains are a larger component of returns. Reducing these concessions would lead to a more efficient allocation of funding in the economy.
Dividend imputation	The case for retaining dividend imputation is less clear than in the past. To the extent that dividend imputation distorts the allocation of funding, a lower company tax rate would likely reduce such distortions.
Tax treatment of superannuation: Tax concessions	Tax concessions in the superannuation system are not well targeted to achieve provision of retirement incomes. This increases the cost of the superannuation system to taxpayers and increases inefficiencies arising from higher taxation elsewhere in the economy, and the distortions arising from the differences in the tax treatment of savings.
Tax treatment of superannuation: Differentiated tax rates on earnings	Aligning the earnings tax rate between accumulation and retirement would reduce costs for funds, help to foster innovation in whole-of-life superannuation products, facilitate a seamless transition to retirement and reduce opportunities for tax arbitrage.

Table 4.1. The Main Superannuation tax “observations” of the Murray Report

Our interpretation of these observations is as follows:

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- 1) Make a level playing field between debt and equity investments by eliminating the current discounted capital gains tax regime. This would imply that the tax on capital gains for accumulation superannuation would rise to 15% from the current 10% discounted rate.
- 2) Eliminate or reduce the value of dividend imputation.
- 3) Align the tax rates between accumulation and retirement in superannuation. Currently accumulation earnings are taxed at 15% whilst retirement earnings are not taxed. Whilst the Murray review did not mention what the common tax rate would be, given discussions about tax concessions for superannuation we would expect it more likely that this implies moving the tax rate to 15% for all superannuation rather than dropping the rate to zero.

If all these recommendations were implemented, we believe this would significantly increase the tax on superannuation, therefore implying significantly lower net returns. The impact of lower returns would be a reduction in self funded retirement incomes, which appears entirely contradictory to one of the Murray Reports aims which is to boost retirement income.

Modelling the implied taxation changes

In order to assess the impact of any implied tax changes, we put together a simple model of expected returns. The assumptions of the model are as follows:

1. An Australian worker saves 9.5% per annum into superannuation over their working life, from age 22 to retirement at 67, and retires on 60% of final salary;
2. The worker earns \$50,000 at age 22 and experiences a real income growth of 1% pa until retirement;
3. The worker invests in a balanced fund throughout, with the following asset allocation
 - a. 35% Australian shares, with a 9% expected return, 4.5% cash yield, 1.5% imputation credits
 - b. 25% in other growth assets, with a 9% expected return, 2.5% cash yield
 - c. 40% in income assets such as cash and bonds, expected return 5%, all in the form of income.
4. The worker pays 60bp on her superannuation balance
5. 15% contributions tax is paid on annual superannuation
6. We assume inflation is 2.5%, the middle of the RBA's current inflation target

Using these assumptions we modelled the expected returns and real returns after taxes and fees. Table 4.2 summarises the results. We estimate that this typical balanced fund would earn a real return of 4% pa after fees and taxes in current accumulation phase superannuation, and 4.8% pa real return in retirement. Eliminating franking credits reduces accumulation returns to 3.4% pa, and retirement returns to 4.3% pa. Eliminating the CGT discount has a smaller impact, reducing returns for accumulation by approximately 0.1% pa.

All up, if the tax rate became 15% for all super, and both franking and the CGT discount were eliminated, we estimate that returns would fall to 3.3% pa real. This means that accumulations returns would fall by 0.7% pa in accumulation phase, and by a whopping 1.5%

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in retirement phase. These falls would have a substantial negative impact on retirement incomes.

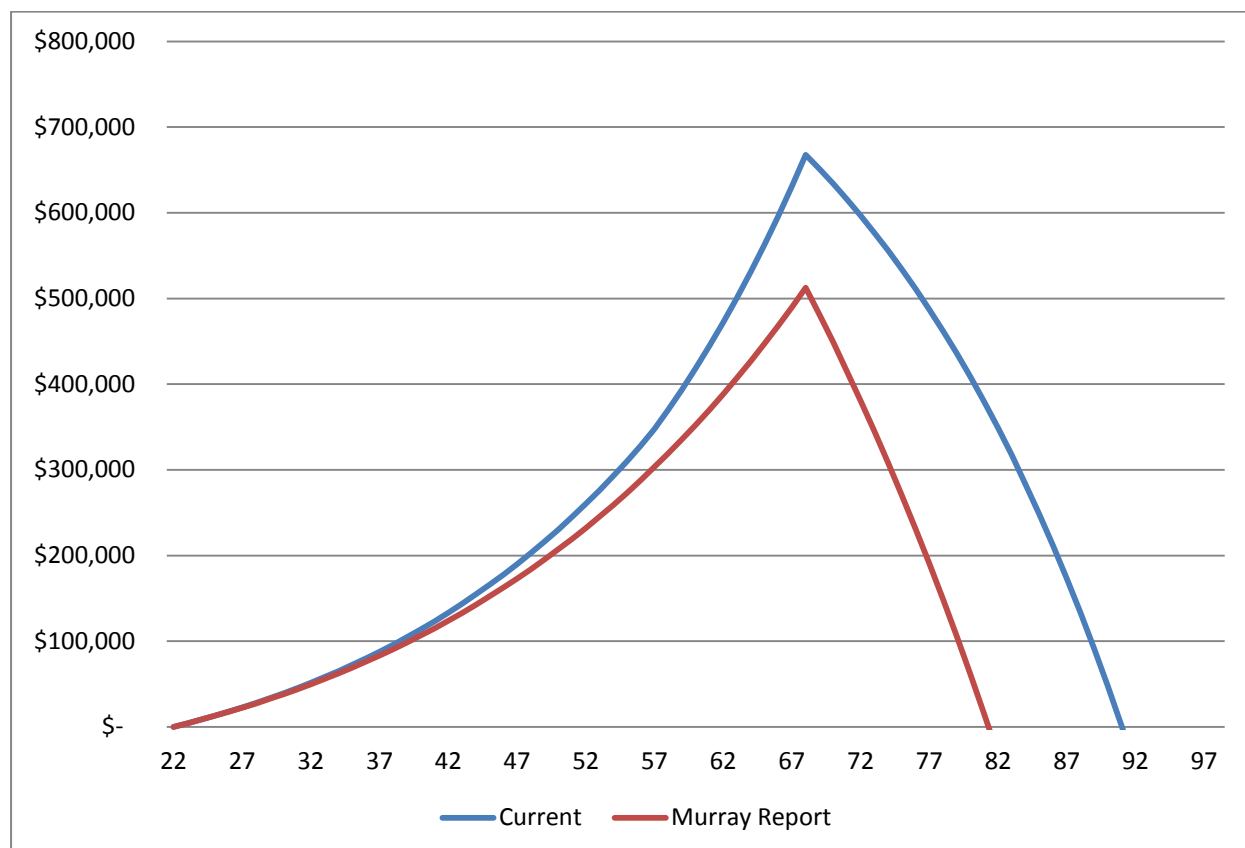
Table 4.2. Estimated after tax earnings on a typical balanced fund for various tax scenarios

	Nominal Net Earnings Rate	Real Net Earnings Rate
Current Accumulation (15%)	6.5%	4.0%
Current Retirement (0%)	7.3%	4.8%
15% No Franking	5.9%	3.4%
15% No Franking or CGT Discount	5.8%	3.3%
0% No Franking	6.8%	4.3%

To estimate the impact of these returns on retirement savings and income, Figure 1 plots the expected retirement balance using earnings based on current tax rates and on the 15% No Franking or CGT Discount tax scenario. In real dollars, we estimate the Murray tax scenario reduces a typical superannuation balance at retirement by approximately 23%, from \$668k using current tax rates to \$513k. We also estimate that the Murray scenario would reduce the retirement income by approximately 10 years, from age 92 under current tax rates to age 82. Alternatively, if one wished to receive a lower level of retirement income up to the same age as the current scenario, we estimate retirement income would be 35% lower in real terms up to age 92 under the Murray scenario. In conclusion, we expect the Murray tax scenario for superannuation would substantially reduce retirement income.

**Figure 1. Estimated retirement savings balances for a typical worker in real \$:
Current tax regime versus Murray “observations” regime**

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Appendix – Main Taxation Findings from the Financial Services Inquiry

Reproduced from Appendix 2: Tax Summary <http://fsi.gov.au/publications/final-report/appendix-2/>

Differentiated tax treatment of savings

The tax system treats returns from some forms of saving more favourably than others. For example, interest income from bank deposits and fixed-income securities are taxed relatively heavily. This distorts the asset composition of household balance sheets and the broader flow of funds in the economy.

To the extent that tax distortions direct savings to less

productive investment opportunities, a more neutral tax treatment would likely increase productivity.

The relatively unfavourable tax treatment of deposits and fixed-income securities makes them less attractive as forms of saving and increases the cost of this type of funding.

Negative gearing and capital gains tax

Capital gains tax concessions for assets held longer than a year provide incentives to invest in assets for which anticipated capital gains are a larger component of returns. Reducing these concessions would lead to a more efficient allocation of funding in the economy.

For leveraged investments, the asymmetric tax treatment of borrowing costs incurred in purchasing assets (and other expenses) and capital gains, can result in a tax subsidy by raising the after-tax return above the pre-tax return. Investors can deduct expenses against total income at the individual's full marginal tax rate. However, for assets held longer than a year, nominal capital gains, when realised, are effectively taxed at half the marginal rate. All else being equal, the increase in the after-tax return is larger for individuals on higher marginal tax rates.

The tax treatment of investor housing, in particular, tends to encourage leveraged and speculative investment. Since the Wallis Inquiry, higher housing debt has been accompanied by lenders having a greater exposure to mortgages. Housing is a potential source of systemic risk for the financial system and the economy.

Dividend imputation

The case for retaining dividend imputation is less clear than in the past. To the extent that dividend imputation distorts the allocation of funding, a lower company tax rate would likely reduce such distortions.



By removing the double taxation of corporate earnings, the introduction of dividend imputation (in 1987) reduced the cost of equity and the bias towards debt funding. This contributed to the general decline in leverage among non-financial corporates.

However, the benefits of dividend imputation, particularly in lowering the cost of capital, may have declined as Australia's economy has become more open and connected to global capital markets. If global capital markets set the (risk-adjusted) cost of funding, then dividend imputation acts as a subsidy to domestic equity holders. That would create a bias for domestic investors, including superannuation funds, to invest in domestic equities. Imputation provides little benefit to non-residents that invest in Australian corporates.

For investors (including superannuation funds) subject to low tax rates, the value of imputation credits received may exceed tax payable. Unused credits are fully refundable to these investors, with negative consequences for Government revenue.

Mutuals cannot distribute franking credits, unlike institutions with more traditional company structures. This may adversely affect mutuals' cost of capital, with implications for competition in banking.

Tax treatment of
superannuation: Tax
concessions

Tax concessions in the superannuation system are not well targeted to achieve provision of retirement incomes. This increases the cost of the superannuation system to taxpayers and increases inefficiencies arising from higher taxation elsewhere in the economy, and the distortions



arising from the differences in the tax treatment of savings. It also contributes to the broader problem of policy instability, which imposes unnecessary costs on superannuation funds and their members and undermines long-term confidence in the system (see *Chapter 2: Superannuation and retirement incomes*).

Tax treatment of superannuation:
Differentiated tax rates on earnings

Earnings are taxed at 15 per cent in the accumulation phase, but are untaxed in the retirement phase. This can act as a barrier to funds offering 'whole-of-life' superannuation products and increases costs in the superannuation system.

Aligning the earnings tax rate between accumulation and retirement would reduce costs for funds, help to foster innovation in whole-of-life superannuation products, facilitate a seamless transition to retirement and reduce opportunities for tax arbitrage (see *Chapter 2: Superannuation and retirement incomes*).

About Plato Investment Management

Plato Investment Management ('Plato') is an Australian owned boutique Australian equities manager specialising in after tax management for accumulation and pension phase superannuation. The firm was founded in 2006 and is majority owned and operated by its investment staff. Plato is supported by its minority equity owner, Pinnacle Investment Management Limited ('Pinnacle'), an Australian multi-affiliate investment management firm.

Plato's philosophy is centred on the belief that the market is a complex, adaptive system and is therefore never fully efficient. These market inefficiencies are derived from informational, behavioural and structural (e.g. tax) sources. Some of these sources of return are exploited on a long-term, strategic time horizon and others are extracted on a short-term, tactical basis. Plato's investment process can be best characterised as a "systematic implementation of fundamental ideas".

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