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Contents

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LexisNexis Butterworths

General Editor's introduction

Dr Helen Hodgson *CURTIN LAW SCHOOL*

Now that the shape of the new parliament is known we can expect to see some movement in relation to some of the election and budget commitments made by the coalition. In the meantime, the expected verbal jousting between the government and the opposition leaves a level of uncertainty that needs to be resolved.

The articles in this edition of the bulletin address three different issues. The first is an analysis of the case of *Devi and FCT*[1], heard earlier this year, in which the Administrative Appeals Tribunal found that the taxpayer was not carrying on a business as a share trader. Paul Kenny sets out the salient facts of the case, and considers the outcome against the criteria set out in other cases and rulings.

In the second article Michael Blissenden reviews the issues around claiming self-education as a tax deduction. At this time of the year many clients will be asking questions around the deductibility of professional education expenses, and Michael reviews the relevant provisions that regulate the deduction that can be claimed. He concludes that there are anomalies and inconsistencies that need to be corrected through legislative change.

Finally John Fickling has written a piece relating to the proposed superannuation changes. As referenced in the opening quote, the proposed reforms are contentious, and regular readers of this bulletin will probably discern that his perspective on the proposed changes differs in some respects from my own views, but he does raise some concerns that are being expressed by financial and tax advisers. A particular concern, which I share, is that the reduction of the contribution caps may have a behavioural effect, in that those Australians who are able to save in excess of these caps will divert their savings into other tax effective investments, thus the revenue savings will be less than expected.

Having said that, I will comment specifically on the reintroduction of the low income superannuation tax offset raised in his article. Although the offset will only make a small contribution to the superannuation accounts of those low income earners who will be entitled to receive it, the basis of the offset lies in the Henry Review,[2] which noted that low income earners pay the same rate of tax on their mandated superannuation guarantee contributions whereas taxpayers in the higher tax rates received an effective tax offset on the amount paid into superannuation. The offset is designed primarily to address this inequity.

However at this stage we have only seen the first tranche of the legislation which deals with some of the less controversial measures. I hope that after the full details of the legislation have been released we will be able to bring you some analysis of the detail.

Dr Helen Hodgson
General Editor
Associate Professor
Curtin Law School
Helen.Hodgson@curtin.edu.au
www.curtin.edu.au

Footnotes

1. *Devi and FCT* [2016] AATA 67.
2. K Henry, J Harmer, J Piggot, H Ridout and G Smith *Australia's Future Tax System: Final Report (The Henry Review)* (2010) Recommendation 18.

Superannuation "reforms": a short sited, silo-based, sledgehammer approach of an unascertained cost to the nation's superannuation system and national economic security?

John W Fickling *WESTERN AUSTRALIAN BAR*

"And so we argued, and so we disagreed — all dedicated intelligent men, disagreeing and fighting about the future of their country, and of mankind. Meanwhile, time was slowly running out."

— Robert F Kennedy, "Thirteen Days", 1968

Introduction

On 3 May 2016 the Turnbull Government handed down its Budget for the Commonwealth Government for the year ended 30 June 2017 (the Budget). That Budget included a superannuation reform package of several measures. The key "taxation" measures, taxation in the sense that they are reported in the Budget papers as increasing revenue, and by a consequence means increased taxation for particular individuals, included in that reform package were as follows:

1. introducing a $1.6 million cap on the total amount a retiree can have in the tax-free pension balance of his or her superannuation fund (thereby effectively limiting the quantum of tax-free pension the person can receive), which is "estimated" to have a gain to the revenue of $2 billion over 4 years according to Budget Paper No 2 (referred to in this paper as "item 1" or the "$1.6 million tax-free cap");[1]
2. removal of the transition to retirement pension that persons approaching retirement could set up to receive a tax-free pension stream from their superannuation fund, apparently worth $640 million of increased taxes over 4 years according to Budget Paper No 2 (referred to in this paper as "item 2" or "the transition pension abolishment");[2]
3. for concessional contributions, increasing the rate at which superannuation contributions are taxed by imposing an effective rate of 30% contributions tax (instead of 15%) when an individual's income exceeds $250,000 (down from $300,000); and further imposing an annual concessional contributions limit of $25,000 (down from $30,000 for individuals under 50 and $35,000 for individuals over 50). The increased limitations upon contributing to the superannuation system will apparently have a revenue benefit of $2.5 billion increased taxes over 4 years according to Budget Paper No 2 (referred to in this paper as "item 3" or "the reduction in concessional contribution caps");[3] and
4. for non-concessional contributions, introducing a lifetime cap on non-concessional contributions of $500,000 into superannuation funds, backdated to include all contributions from 1 July 2007 onwards, apparently worth increased taxes of $550 million over 4 years according to Budget Paper No 2 (referred to in this paper as "item 4" or "the lifetime non-concessional contribution cap").[4]

There are other reforms which have a very slight revenue benefit which can be observed between pp 25 and 30 of Budget Paper No 2 and which need not be commented upon here.[5] All the reforms here are contained as conceptual reforms in Budget Paper No 2 and presently do not exist in legislation. As a result at the time of writing little can be said about the mechanics of the reforms. Almost 4 months after the Budget, despite the reforms being of significant national importance, no draft legislation has been released.

Item 1 and item 2: increased taxation for monies already in the superannuation system

As can be observed from the above four items, items 1 and 2, which relate to tax-free pensions of individuals approaching retirement or who are already retired, effectively propose increasing taxes on the earnings of monies already in the superannuation system. What this means is that these individuals will now pay 15% income tax on taxable income from 1 July 2017 within their superannuation fund on earnings which are effected by the reforms (ie earnings from assets allocated to their superannuation fund pensions) rather than 0% income tax on those earnings. Even then, in respect of item 1, people receiving tax-free pensions from their superannuation fund will still be able to have up to $1.6 million in what is effectively a tax-free asset pool. The way the author sees these reforms at item 1 and item 2 is that they are an increase in the tax rate on monies already within the superannuation fund system. If the Turnbull Government believes it can increase the taxation rate upon earnings already within the superannuation system without damaging the long-term confidence in the system, then that is a matter for the Turnbull Government as a duly elected government, subject to being able to obtain the approval of the parliament. I do not make any further comment on reforms listed at item 1 and item 2.

Item 3 and item 4: attacks on the working age generation contributing money into the superannuation system

What this article focuses upon is item 3 and item 4 which are labelled as "taxing" measures but more specifically reforms which are a direct attack upon being able to contribute monies into the superannuation system. For readers not overly familiar with the superannuation system, broadly speaking, there are effectively two ways a person can get money into the superannuation system:

- First, by deductible contributions made by the individual or their employer which are known as "concessional contributions". Individuals who make such contributions, broadly speaking, won't be taxed upon the income used to make such contributions, such that instead of paying tax at their marginal taxation rates on the income contributed, the money is contributed gross into the superannuation fund where it is presently effectively taxed at 15% (for individuals earning less than $300,000) or 30% (for individuals earning more than $300,000). Item 3 attacks the ability of individuals to transfer money into superannuation system using this method by reducing the annual limit on such contributions to $25,000 (down from $30,000 for individuals under 50 and $35,000 for individuals over 50). It also attacks the ability of individuals to transfer money into the superannuation system when they earn between $250,000 and $300,000 per year by taxing those contributions not at 15% (as is the case for individuals earning less than $250,000 per annum) but at 30%. The Treasury hasn't explained how this will raise $2.5 billion of revenue but one can only guess that the idea is that individuals will contribute less money into the superannuation system and keep more for themselves which will be taxed at higher marginal rates. Of course people earning between $250,000 and $300,000 may be willing to pay the increased 15% tax on contributions they make which would involve increased tax on contributions. But this measure is mostly about reduced contribution limits for everyone else. Now if some or substantially all of this money is instead substituted and deployed into assets that will generate tax losses (such as rental properties) then the Treasury's projections may under deliver for the revenue, but the consequence will be less money going into the superannuation system.
- Second, by non-deductible contributions made by the individual which are non-deductible. Very broadly speaking, the rules are present that an individual may contribute up to $180,000 of non-deductible "non-concessional" contributions to their superannuation fund every year. There is a rule which allows 2 years to be brought forward such that instead of making $180,000 every year an individual can choose to make $540,000 of contributions every 3 years. Item 4, the lifetime non-concession contribution cap, attacks the ability of individuals to transfer money into the superannuation system by imposing a vastly reduced lifetime limit of $500,000. The Treasury hasn't explained how this attack on individuals transferring money into the superannuation system will benefit the revenue (by $550 million over 4 years as it has estimated) but one must guess that the Treasury thinks that if people don't contribute their money into superannuation they will keep it outside the superannuation system and pay more tax on it over time. This of course is just an "assumption" and if individuals instead put it into rental properties, they may well generate negative gearing tax losses which reduces the revenue or if individuals invest this money into a larger more expensive principal residence, broadly speaking, that principal residence will generate no tax revenue for the Commonwealth Government during its ownership or when it is sold (the gain being tax-free). The item 4 reform may also increase the burden on the age pension welfare payment; that is it may encourage individuals nearing retirement to retain their principal residence and go onto the age pension welfare payment rather than downsizing and seeking to self-fund their own retirement through making a significant contribution to the superannuation system which is currently possible.

If the item 3 (reduction in concessional contribution caps) and item 4 reforms be targeted to reduce any rorting at the margin (the specifics of which, and how these measures address that, have not been explained by the Turnbull Government), rather than being specific and targeted, they hit the entire working age generation with a sledgehammer. Furthermore, if the problem of the superannuation system be concerned with the large balances of a few holding their assets in tax-free pensions (which are addressed by the reforms labelled item 1 and item 2 in the introduction to this article) one wonders why there is the need for the further broad-ranging universally affecting sledgehammer approach of item 3 and item 4.[6]

If there be any doubt, what is being contended here, by the author, is that item 3 (reduction in concessional contribution caps) and item 4 (the lifetime non-concessional contribution cap) are attacks upon the present working age generation and future generations to contribute to the superannuation system on the same basis that past generations have done so.

Do the numbers add up for the working age generation?

At this point it is important to note that the superannuation system is intended for individuals to build a retirement fund so that they can live off that fund in retirement. That is intended to benefit the Commonwealth Government and the nation so that the Commonwealth Government need not pay that individual an age pension each and every year after that individual turns 65. Based upon current life expectancy estimates in excess of 80 years for both males and females, that retirement if it commences at age 65 is *expected* to last at least 15 years — that is from 65 to 80.[7] If someone is going to be self-sufficient living off their own income during that period, particularly in times of low asset yields, they are going to need a *very large superannuation balance* at retirement. If annual asset yield is 3% (ie the return from the superannuation fund per annum), a $50,000 annual income requires a $1.667 million fund balance.[8]

The question then, is how on earth are the working age generation, and future generations, going to get at least $1.667 million into their superannuation fund under the proposed Turnbull Government reforms. Once the $500,000 lifetime non-concessional contribution cap is used up, there will be a requirement of $1.167 million remaining. If this is to be contributed over a 40 year working life then this would require contributions of $29,175 each and every year *after tax* which would be rather difficult because the Turnbull Government reforms proposes an annual pre-tax concessional limit of $25,000 which is reduced post-contributions-tax to $17,500 or less. As the reader can observe, if the reader is of working age, the reader must already be wondering how he or she can possibly get the necessary balance of $1.667 million. Now the Treasury might say that asset inflation overtime will mean the investments of superannuation funds will increase over time (such as shares) but the working age reader would have to be far from certain that this would occur.

Further, individuals in the earlier years of their working life are unlikely to be able to afford to contribute up to $25,000 per annum into superannuation due to lifestyle choices and dependent children. The current superannuation system addresses this because it allows annual non-concessional contributions of up to $180,000, so that people approaching retirement, who no longer have dependent children can use the non-concessional contributions cap over the last 5–10–15 years of their working life to transfer money into superannuation to fund their retirement. The proposed Turnbull Government reforms provide no answer how this will be done in the future. The author's point the proposed Turnbull Government superannuation reforms in item 3 and item 4 just don't add up to a viable superannuation system for the working age generation. Each and every working age generation Australian with aspirations of funding their own retirement through the superannuation system should have the utmost concern as to the proposed reforms in item 3 and item 4, and in particular item 4, the lifetime non-concessional contribution cap which shuts down the ability to do what has been done by prior generations to transfer sufficient funds into the superannuation system in the years leading up to retirement.

The author would also hope that the Treasury at this point might also be concerned because the superannuation system for future generations may mean that rather being effective at phasing out the age pension welfare payment, it will be made entirely ineffective in keeping retirees off the age pension welfare payment and so there will be a long term failure of the superannuation system to reduce the dependency rates on the age pension welfare payment, which are currently at around 80%, but with the population *over 65* to go from approximately 3.2 million people in 2012 to approximately 5.7 million people in 2030, if the dependency upon the age pension welfare payment not be reduced by the superannuation system, the extreme consequences for the Commonwealth Budget are obvious.[9]

The author suggests that the reforms at item 3 and item 4 are on their face very short sighted reforms designed to shut the door of the superannuation system for the working age generation, with the sole purpose of seeking to be seen to be doing something to attempt to fix broader current revenue problems caused by persistent failure over successive Commonwealth governments to balance the budget at the expense of the long term vision of the superannuation system. To put these two reforms in context, item 3 (reduction in concessional contribution caps) and item 4 (the lifetime non-concessional contribution cap) will according to the Treasury raise $3.05 billion in revenue over 4 years while the Turnbull Government, according to Budget Paper No 1 will run $67 billion in budget deficits over that same period.[10] And if the Commonwealth Budget is incurring $67 billion in budget deficit over 4 years when there are 3.2 million people over 65, what happens when it increases to 5.7 million people over 65 as the Australian Bureau of Statistics (ABS) predicts?[11]

Treasury has done nothing in Budget Paper No 2 to explain what the long term effects on the superannuation system will be of the reforms of item 3 (reduction in concessional contribution caps) and item 4 (the lifetime non-concessional contribution cap). The author suggests that the Treasury must be called upon by the parliament at the earliest to provide this explanation. The author suggests a senate inquiry is absolutely necessary before any of these reforms be implemented, and that inquiry may well be the most important inquiry of the senate in a generation.

The Low Income Superannuation Offset (LISTO) reform: taxing the superannuation system to fund a socialist leaning policy which will make no real difference to the future age pension welfare payment choices of low income earners

Furthermore, at this point it is worth saying something about one of the other so-called reforms to superannuation that is being apparently funded by the savings in items 1 to 4 set out above in this paper, being the LISTO which will effectively reduce superannuation contributions tax for low income earners (those earning up to $37,000 per annum) by up to $2,000 over 4 years ($500 per year). This reform will cost the federal budget $1.6 billion over 4 years.[12] However it is common sense that people earning less than $37,000 per year, if those low income continues during their working life are not going to suddenly at the end of their lives be able to self-fund their retirement *just because of* the government reducing the tax in their superannuation fund by $500 per year (amounting up to $20,000 over their working lives). Rather, low income earners are all things being equal, likely to qualify for the age pension welfare payment, regardless of an increased $20,000, at the end of their working lives as their superannuation funds are unlikely to be significant enough for them to do otherwise. So in effect, this author would suggest, that the Turnbull Government in pursuing this socialist leaning reform known as LISTO is taking away from people's superannuation balances in items 1 to 4 who might make a real difference to the future costs of the age pension welfare payment and the finances of the Commonwealth Government by staying off it (therefore saving the nation $25,000 or more in age pension welfare payments per individual each year during their retirement) for the misguided socialist leaning policy of seeking to bolster the low superannuation balances of low income earners, who, all things being equal (except in cases at the margin), will make no difference to those people's likelihood of going onto the age pension welfare payment in retirement.

However, certain players in the superannuation industry, are going to be relative winners from this reform because it will mean for corporate superannuation funds and industry superannuation funds who tend to hold the super fund balances of low income earners, who with the benefit of holding hundreds of thousands of such accounts for low income individuals will benefit from increased balances (increased by $500 per annum because of reduced taxation), in the aggregate, upon which they can manage and impose management fees upon calculated as a percentage of the balances they hold. It may also provide the opportunity to also charge such increased insurance premiums against such balances.

If the working age generation be expendable, what about the nation's economic security?

At the end of March 2016, the nation's total superannuation assets amounted to $2.032 trillion ($2 trillion rounded).[13] To put this in perspective, the ABS reported in March 2016 that the value of the nation's housing stock was valued at $5.931 trillion ($6 trillion rounded).[14]

Australia's status as a capitalist society is enshrined in the Constitution by the guarantee against the Commonwealth being able to acquire property except on just terms.[15] As a capitalist society, ongoing freedom and security as a nation is linked to significant wealth being in the hands of Australian citizens (and to a lesser extent, the Australian government) vis-à-vis foreign ownership. Increased foreign ownership means foreign outflows of income from assets. Nothing the author says here should be taken to oppose foreign ownership; the only point made is that what is foreign owned is not within Australia's economic security envelope and the income from assets that is foreign owned does not accrue to Australian citizens; the right (although unascertainable) balance is key. As a nation, Australian's significant and substantial ownership of the housing stock is important to ongoing economic security as a nation. If a government did something to undermine that security by changing the tax status of the principal residence there would be significant systemic implications.

Superannuation, though not as large as the nation's housing stock of $6 trillion is still an incredibly significant asset pool at $2 trillion. It stands to reason that because a significant quantum of the nation's wealth is tied up in this asset pool, the superannuation pool contributes to the economic security of the nation — in the ownership of assets that would otherwise be foreign owned, in the receipt of income from those assets where that income would otherwise flow overseas. In this respect, as indicated earlier, the Treasury has done nothing in Budget Paper No 2 to explain what the long term effects on the superannuation system and in consequence, the nation's economic security will be of the reforms of item 3 (reduction in concessional contribution caps) — and item 4 (the lifetime non-concessional contribution cap). What if there is long term decline in confidence in the superannuation system as a result of the reforms which largely shut the door to the working age generation? What will be the consequences? These are questions of the greatest national importance which are at least as equally important as the short-term revenue agenda of the Commonwealth Government.

While this has been written without reference to other sources, the author finds what has been written above largely here also in agreement with what was written by the Association of Superannuation Funds of Australia (ASFA) who wrote in their June 2015 research report titled *Superannuation and the economy*:[16]

> An important factor, along with the general health of Australia's financial system, in mitigating the risk of foreign liabilities is having sources of capital available from Australian superannuation funds. Not only does this domestic source of capital reduce the vulnerability of firms to foreign shocks, but it reduces the risk premium foreign investor's demand when investing or lending to Australian firms (FSC, 2014). Easier access to domestic capital for local investment projects can thus also increase investment, and result in greater long-term output and growth.
>
> …
>
> Commentators have already predicted that Australia's superannuation savings will result in a reversal of the current account deficit, with Australia becoming a net lender (Blythe, 2014). Recent data suggesting a narrowing of the Australian current account deficit is consistent with this prediction (ABS, Cat No. 5302).

In more recent days, perhaps as a consequence of the inevitable future pressure from newly elected representatives of right leaning and populist parties who will inevitably continue to place pressure on the Turnbull Government during the next 3 years and perhaps beyond, as well as reasons not presently known to the author, the Turnbull Government has indicated its intention to deny the acquisition of key infrastructure assets by one or more foreign investors connected with foreign sovereigns, which possibly brings this article to a crux across two issues. As a broad statement, it can be said that foreign purchasers of infrastructure assets (particularly foreign sovereign purchasers) will be able to find ways to pay very minimal tax upon those assets — through repatriation of monies in the form of interest (through seeking a 0% interest withholding tax rate) and capital-first repayments where the existence of taxable profits from such assets are deferred for years if not decades by the tax depreciation deductions purchasers may receive. Offshore pension funds who purchase Australian infrastructure assets, which are often tax exempt organisations (unlike superannuation funds in Australia), will always seek to structure their affairs to pay the least amount of tax possible as it represents a dead weight loss in the return to their members (as there is no home country foreign tax credit benefit). In summary, offshore purchasers of infrastructure assets will always find ways to minimise their tax.

At the same time state governments in Australia will want to sell off developed infrastructure assets to fund new infrastructure asset spending and will be looking to the Turnbull Government to answer the question of who is going to purchase their developed infrastructure assets? The question must therefore be asked, if the purchasers of such assets are not going to pay much tax, then what downside is there to the revenue if it is Australian superannuation funds buying these assets which has the incidental benefit that Australian superannuation fund purchaser of infrastructure assets will keep income flows from those assets and reinvest those funds for the benefit of the superannuation fund members (and the benefit of the Commonwealth Budget in future by reducing reliance on the age pension welfare payment). This, the author suggests, is the real issue for the Turnbull Government to find a solution to. Indeed the reforms at item 1 and item 2 — limit the tax-exempt status of superannuation earnings — may well encourage superannuation funds to seek out investments with a lower tax incidence, such as infrastructure investments (rather than being ambivalent to an investment's tax profile).[17] In particular, the author suggests, the real issue for the Turnbull Government to resolve is to ascertain:

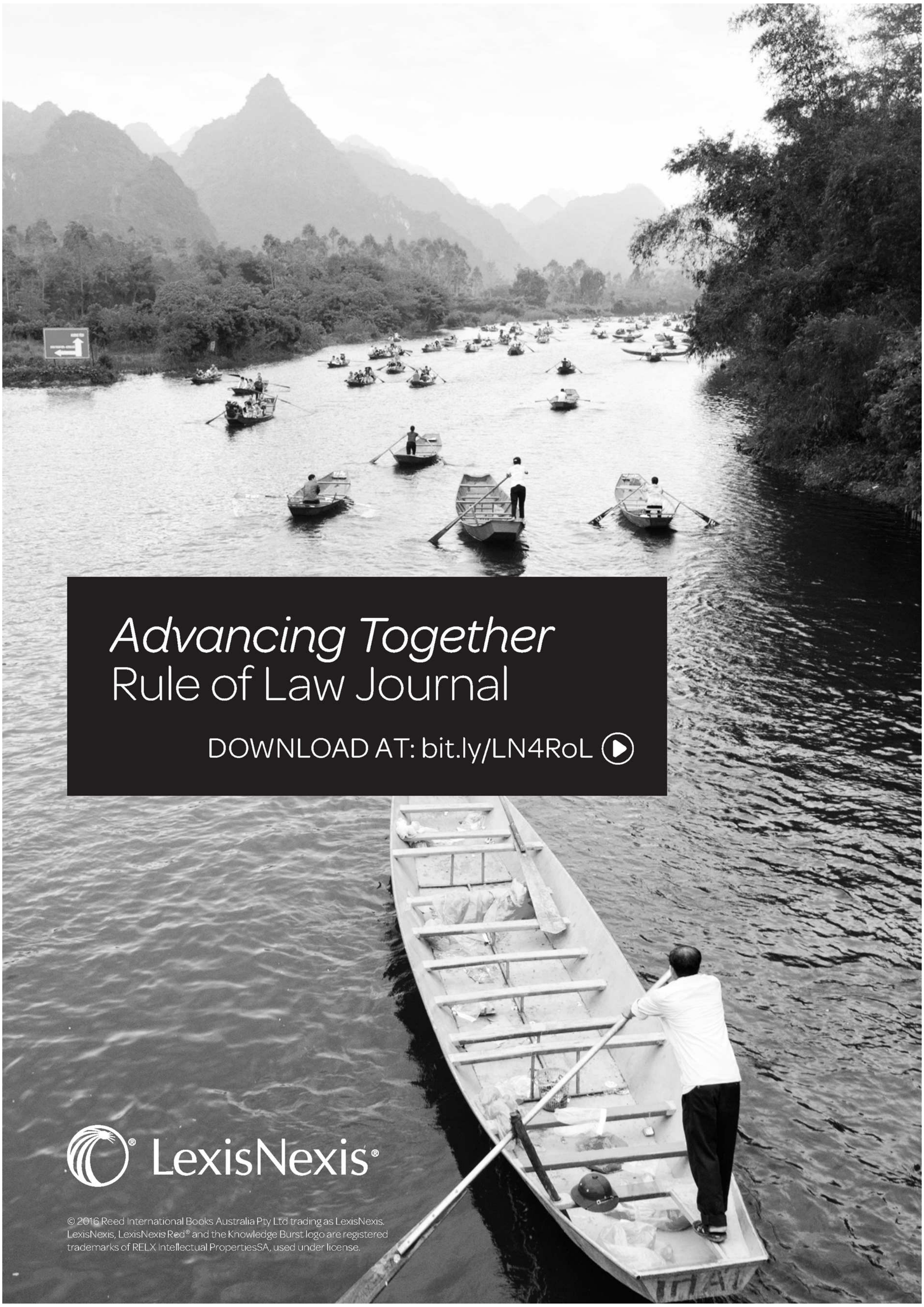
- why aren't the nation's superannuation funds the leading bidders for key infrastructure assets; and
- why aren't all forms of superannuation funds — including self-managed superannuation funds more heavily invested in infrastructure assets with the asset classes' long-tailed income stream benefits

and the low tax benefits? If the Turnbull Government find a solution to these issues it may well in a cross-portfolio truly innovative solution of the cabinet be able to put the nation's superannuation system to both preserving national economic security and reducing the reliance on the age pension welfare payment in the years to come.

John W Fickling
Barrister
Western Australian Bar
jwfickling@taxbar.com.au
www.wabar.asn.au

Footnotes

1. Treasury *Budget 2016–17 — Budget Measures* Budget Paper No 2 (May 2016) pp 25–26.
2. Above n 1, p 30.
3. Above n 1, p 28–29.
4. Above n 1, p 27.
5. Treasury *Budget 2016–17,* above n 1.
6. It is an open question why if the tax rates upon income within the superannuation system are being changed by item 1 and item 2 why the reforms of item 3 and item 4 are also necessary; there is the appearance of trying to fix one problem with two very broad, sledgehammer type, solutions.
7. Australian Bureau of Statistics (ABS) "3302.0 — deaths, Australia, 2014" media release (12 November 2015) at www.abs.gov.au/ausstats%5Cabs@.nsf/mediareleasesbyCatalogue/F95E5F868D7CCA48CA25750B0016B8D8?Opendocument.
8. If rather than living off income the individual lives off the capital balance, what happens if they live to 90 or 100?
9. ABS "3222.0 — population projections, Australia, 2012 (base) to 2101" media release (26 November 2013).
10. Treasury *Budget 2016–17 — Budget Strategy and Outlook* Budget Paper No 1 (May 2016) pp 3–10.
11. Above n 9.
12. Above n 1, p 28.
13. Association of Superannuation Funds of Australia (ASFA), *Superannuation Statistics*, March 2016, accessed 31 May 2016, www.superannuation.asn.au/resources/superannuation-statistics.
14. ABS "6416.0 — residential property price indexes: eight capital cities, Mar 2016" media release (21 June 2016) at www.abs.gov.au/ausstats/abs@.nsf/mf/6416.0.
15. Commonwealth of Australia Constitution Act, s 51(xxxi).
16. ASFA *Superannuation and the economy* (2015).
17. It may well be that the removal of the 0% tax rate, partially remedied by proposed reform item 1 and item 2 set out in the introduction, may make infrastructure assets with their relatively reduced tax incidence more attractive to superannuation funds over and above other higher tax asset (such as residential property investments).



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