

CHAPTER 4 PERSONAL INCOME TAX, TRANSFERS AND SAVING

MAIN POINTS

- > Personal income tax is Australia's largest single source of tax revenue. Australia collects more personal income tax revenue as a proportion of GDP than many other OECD countries but relies less on personal income tax than Canada and New Zealand.
- > Personal income tax revenues have declined as a share of GDP because of cuts in tax rates over the last 2 decades. However, fiscal drag will cause average tax rates and revenues to rise again in coming years unless changes are made to rates or thresholds.
- > The personal tax-transfer system is Australia's main tool for redistribution of incomes and delivery of progressivity to the tax-transfer system as a whole.
- > The combined effect of personal income tax and transfers in particular on work incentives must be taken into account in any reform of either system.
- > There are gaps and complexity in the personal income tax base and scope to broaden this base, especially in relation to aspects of work and fringe benefits tax income and deductions. There is also scope for improvement in taxation of savings and investment including superannuation tax concessions. The Henry Review recommendations to tax saving more consistently under a 40 per cent savings discount and to restructure superannuation tax concessions provide a significant direction for reform.
- > Substantial broadening of the personal tax base could raise sufficient revenue to enable a reduction in tax rates on work and business income, especially on low and middle income earners. This could improve incentives to work and do productive investment.
- > The personal income tax could be made more resilient by simplifying the legal design to reduce planning boundaries in respect of expenses, legal entities and types of income. This could also reduce administrative and compliance costs.

4.1 Trends in the personal income tax

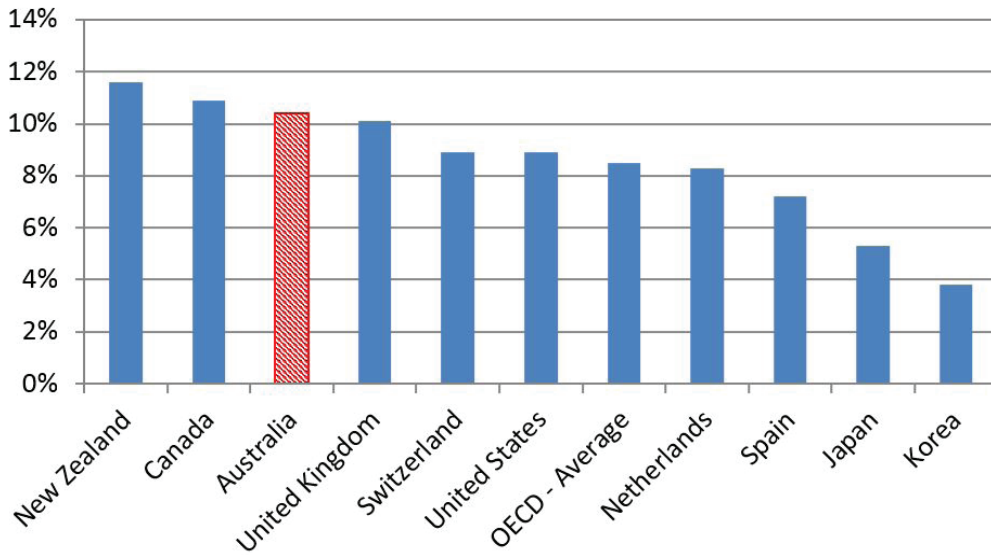
Personal income tax is the largest single source of government revenue in Australia. It comprises (including fringe benefits tax and tax on superannuation contributions) more than 10 per cent of GDP and nearly half of Commonwealth Government taxes. Chart 4.1 illustrates Australia's reliance on personal income tax compared to other countries and the OECD average.

Australia has a similar reliance on personal income tax to Canada, New Zealand and the United Kingdom, but significantly more reliance than Japan, Korea and many European countries. Chart 4.1 excludes social security taxes which operate as a substantial tax on wages in many countries. If those taxes are included as similar to the income tax, Australia is more comparable with other countries. For a comparison including social security taxes, see Chart 3.3.

Chart 4.2 shows a decline in the average tax rate over the last 30 years. This, combined with a lower share of national income derived by workers, is the primary driver of the fall in personal income tax revenues, most notably during the 2000s (PBO 2014a). Governments reduced the personal income tax burden during this period by more than required to return fiscal drag, as discussed in section 4.2 below.

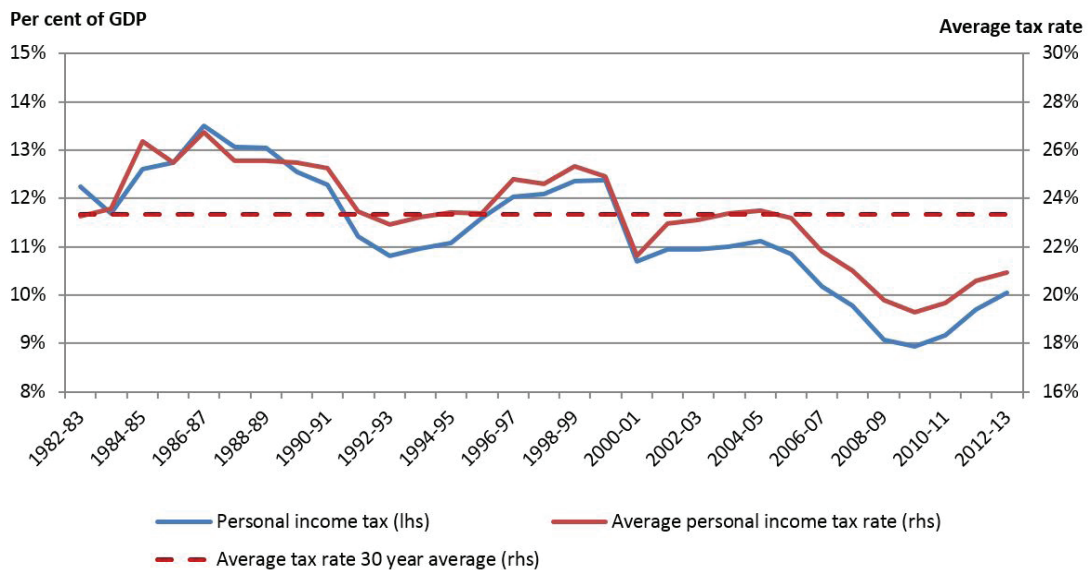
The Henry Review argued that core reform objectives for the personal tax system should be reducing disincentives to work and improving incentives to save through simpler, more transparent policy settings. Tax reform should aim to provide clearer signals to people about the impact of their alternative choices and ease the administrative burden of the tax and transfer system (Henry et al 2010a, 29). The Henry Review also emphasized the importance of fairness to ensuring the personal tax system is legitimate and sustainable.

Chart 4.1: Personal income tax as a percentage of GDP, selected countries



Source: OECD (2014f).

Chart 4.2: Trends in personal income tax revenues and average tax rate



Source: PBO (2014a).

Note: The average tax rate is calculated by dividing personal income tax receipts by taxable income (excluding net capital gains) for individuals.

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The Henry Review argued that fairness could be enhanced by treating activities with the same economic value consistently, facilitating easier choices and ensuring progressivity in final tax outcomes.

These objectives were encapsulated in the following reform directions for the personal income tax:

- > Flatter and lower—but still progressive—statutory personal income tax rates and thresholds on individuals, involving a higher tax free threshold of \$25,000, absorption of the Medicare levy into the statutory rates, the removal of structural offsets such as the low income tax offset, introduction of a standard deduction for work-related expenses and exempting pensions, allowances and transfer payments from tax (Recommendations 2 to 7);
- > taxing most forms of remuneration consistently including taxing fringe benefits at personal marginal rates in the hands of employees, simplifying and limiting deductions and strengthening rules for personal services income (Recommendations 8 to 13);
- > taxing capital gains and investment income, net of deductions including interest on debt, more consistently through a standardised 40 per cent discount against personal marginal rates (Recommendations 14 to 17);
- > maintaining the home exemption in the income tax and capital gains tax. This is because of its special role in facilitating redistribution of income over a person's lifecycle and sustainable responses to the ageing of the population; and

- > fairer taxation of superannuation, and examination of longevity insurance and direct tax policy to increase workforce participation in retirement (Recommendations 18 to 24).

Some reforms were introduced by Governments in the last five years, following these recommendations, in particular concerning the tax rate structure and tax offsets. However, there has not been a major reform of the personal income tax base.

4.2 Personal income tax rates

Australia's statutory personal income tax rates and thresholds are shown in Table 4.1. The Commonwealth Government has enacted a temporary budget repair levy of 2 per cent for incomes exceeding the top threshold of \$180,000, applicable for three years from the 2014-15 year.

A low income tax offset (LITO) provides additional tax relief for taxpayers earning up to \$67,000 in 2013-14. Individuals eligible for the full LITO pay no tax on incomes below an effective tax-free threshold of \$20,542. The withdrawal of LITO increases the effective marginal tax rate for taxpayers earning between \$37,000 and \$66,667, by one and a half per cent above the statutory personal income tax rates.

Table 4.1: 2014-15 Resident personal marginal income tax rates

Taxable income (\$) (tax bracket)	Tax payable (\$) and marginal rate
0-18,200	Nil (tax free threshold)
18,201-37,000	19% of excess over 18,200
37,001-80,000	3,572 + 32.5% of excess over 37,000
80,001-180,000	17,547 + 37% of excess over 80,000
180,000 +	54,547 + 45% of excess over 180,000 + 2% of excess over 180,000 (temporary 'budget deficit levy')

Source: ATO (2014a).

Note: Non-residents are not eligible for the tax-free threshold or 19 per cent marginal tax rate and must pay 32.5 per cent to \$80,000 and higher marginal rates above that.

Most taxpayers pay a Medicare levy of 2 per cent of taxable income, increased from 1.5 per cent from 1 July 2014, to assist in funding the National Disability Insurance Scheme. The Medicare levy nominally contributes to funding the costs of public health care, but in practice it provides only a fraction of total Commonwealth Government health costs and is not hypothecated to health expenditure, instead forming part of consolidated revenue. A Medicare levy surcharge of up to 1.5 per cent applies to higher income earners who do not maintain adequate private health insurance coverage. Very low income earners are exempt from the Medicare levy as are Defence Force members and some veterans, non-residents and some other individuals not entitled to Medicare coverage.

Chart 1.1 in Chapter 1 illustrates marginal tax rates and the equivalent average tax rate for individuals. It shows how the average tax rate is always lower than the marginal rate except at very high incomes. This is also illustrated in the following example.

Example

Joe earned full-time average weekly earnings of about \$75,000 this year. After expenses are deducted, Joe has a taxable income of \$70,000. Joe faces a marginal tax rate of 34.5 per cent including the Medicare Levy. Joe's average tax rate is 22.4 per cent including the Medicare Levy.

Jane is a partner in a major law firm. This year, Jane earned \$250,000 in salary and partnership profits, net of expenses (this places Jane in the top one percent of income earners in Australia). Jane faces a marginal tax rate of 49 per cent including the budget deficit levy and Medicare Levy. Jane's average tax rate is 37 per cent.

The Rudd/Gillard Governments increased the tax-free threshold and broadened the personal tax base by more tightly targeting or removing tax offsets. Effective 1 July 2012, the tax-free threshold was increased from \$6,000 to \$18,200, equivalent to earnings of approximately \$350 per week (about 20 hours at the minimum wage).

There were some simplification benefits from these rate structure changes because low earners at or below the new tax-free threshold did not have to file a tax return. The Rudd/Gillard Government estimated up to one million workers potentially benefited in this way, although in practice the number of beneficiaries may be lower. Many low-income workers opt to continue filing tax returns for other reasons, including accessing family payments through the transfer system.

There is also debate about whether such flattening of the rate structure is the most fair or efficient strategy. For example, Apps and Rees (2010) show that it increases marginal and average tax rates on secondary earners with children (mostly women) and this undermines goals to increase workforce participation and may negatively affect tax revenues and economic growth.

The former Government legislated for a second round of tax cuts linked to the CPRS implementation, including a further increase in the tax-free threshold to \$19,400. However, the current Government has opted not to proceed with these second-round tax changes as it has now abolished the CPRS.

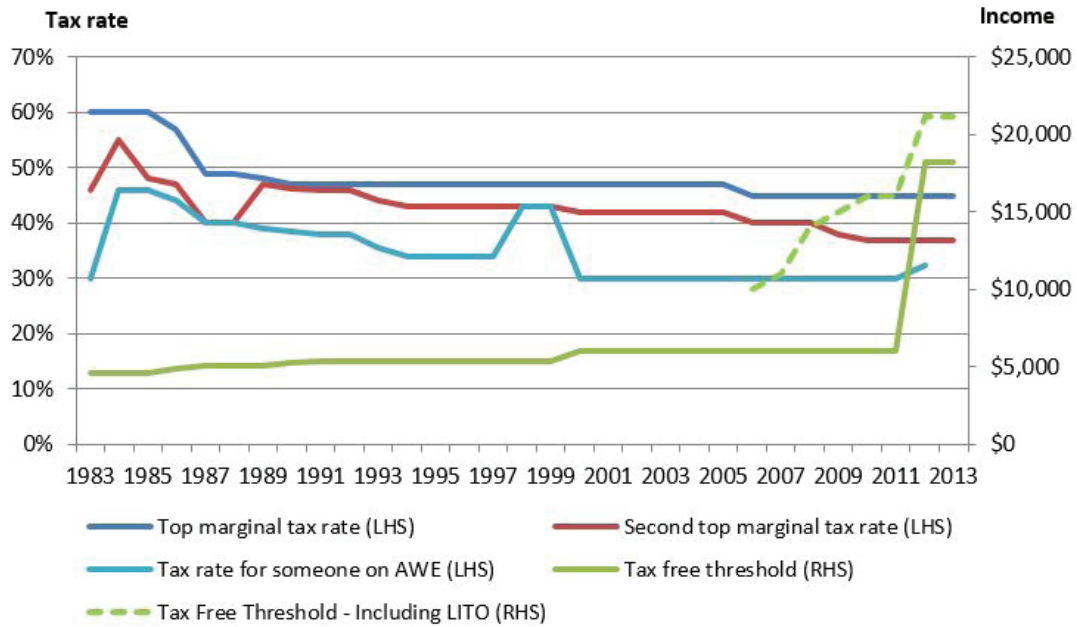
The longer term trend has been to reduce the number of thresholds and rates in the personal tax system, from more than 20 in the early 1970s to only four rate thresholds above the tax-free threshold in the current system. There has also been a significant reduction in the top two marginal tax rates. These trends are illustrated in Chart 4.3.

Australia's top marginal tax rate of 45 per cent excluding the Medicare levy, rising to 47 per cent for 3 years as a result of the deficit reduction levy, is a little higher than the OECD average and relatively high by international standards. This is shown in Chart 4.4. Top marginal tax rates commence at very different thresholds across countries. Chart 4.4 shows, based on the right axis, the AUD equivalent level at which the top marginal tax rate commences in each country (with appropriate estimates for sub-national income taxes).²¹

²¹ Average wages also vary significantly between countries; the average tax rate for the average worker is shown in Chart 4.6.

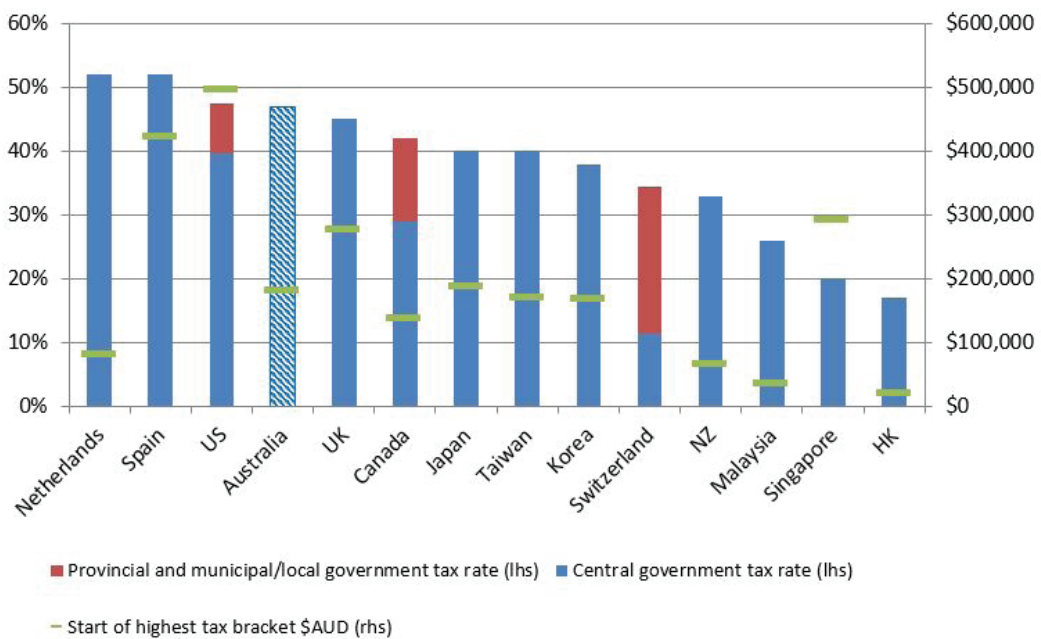
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Chart 4.3: Trends in marginal tax rates



Source: Treasury.
 Note: The dotted line shows the increase in the LITO and its effect on the tax-free threshold.

Chart 4.4: Top marginal tax rate in selected countries



Source: International Bureau of Fiscal Documentation Tax Research Platform (2014); Canada Revenue Agency (2014); KPMG (2014).
 Note: Includes central government tax rates and selected sub-national government tax rates where significant. (a) Canada – example of Ontario; (b) Switzerland – example of Zurich; (c) United States – example of Minnesota.

Dependent and other tax offsets

Some family circumstances are taken into account in the tax law but most family support is in the transfer system. The most significant reform following the Henry Review has been the staged removal and consolidation of complex and out-dated tax offsets. These changes include:

- > phase out of the dependent spouse tax offset in the 2012 Budget by limiting access to dependant spouses born before 1952, abolished from 1 July 2014;
- > consolidate a range of dependency offsets into a single tax offset targeted at taxpayers maintaining a spouse who is invalid or a carer. The single Dependant and Carer Tax Offset now provides tax relief to taxpayers maintaining an invalid or carer spouse;
- > merge the pensioner and senior Australians tax offset in to a single tax offset;
- > phase out Mature Age Worker Tax Offset, subsequently abolished from 1 July 2014;
- > restrict access to the medical expenses tax offset for high out-of-pocket medical expenses through a means test and higher eligibility threshold;
- > abolish the entrepreneurs' tax offset.

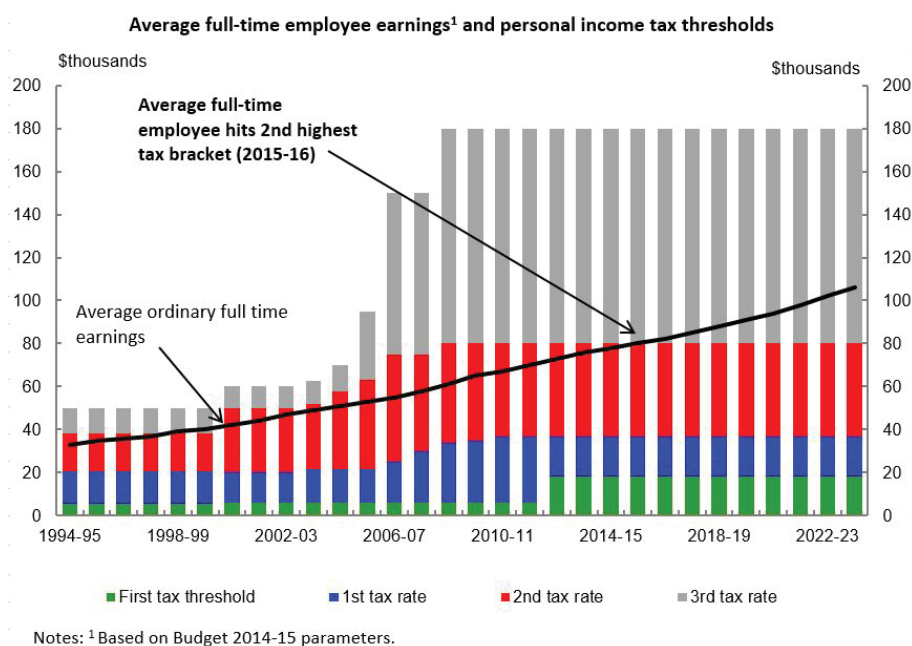
Fiscal drag

Australian personal tax thresholds are not indexed to inflation. Individuals face higher tax rates over time as their nominal wages (and other incomes) rise. This effect is known as *fiscal drag* or *bracket creep*. Historically, Australia has taken the approach of periodic ad hoc adjustments to tax thresholds and rates to address this issue. Most countries in the OECD follow the same approach as Australia by not indexing income tax thresholds. Some countries, including Canada and the United States, index certain tax thresholds for either wage or price inflation.²²

Analysis in the 2014-15 Budget indicates that, without policy change, the effects of fiscal drag will be a major factor underpinning growth in Commonwealth revenues over the next decade (Treasury 2014a). The budget projected that personal tax revenue would exceed 12 per cent of GDP by 2017-18. This would fully claw back all tax cuts provided since the introduction of the GST in 2000.

Treasury estimates that a person on average full-time earnings²³ will be pushed into the second-top 37 per cent tax bracket by 2015-16 and will face an average tax rate of 28 per cent by 2023-24, compared with 23 per cent today (Parkinson 2014). This is shown in Chart 4.5.

Chart 4.5: The effect of fiscal drag



Source: Parkinson (2014, Chart 6).

Note: Based on Budget 2014-15 parameters.

22 See Canada Revenue Agency (2014); Inland Revenue Service (IRS) (US), Revenue Procedure 2013-25.

23 The correct benchmark of earnings for this index is complex. Because many people work part-time, the tax rate that applies to an average worker is lower than the rate that applies to full-time workers. Moreover, the increased prevalence of part-time work will act to decrease the tax rate paid by the 'average' worker.

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Fiscal drag has the potential to affect adversely work participation incentives at the same time as the impacts of an ageing population are being more strongly felt. It may increase incentives for individuals to enter into tax planning arrangements so as to avoid higher marginal rates and it also has the effect of reducing progressivity of the tax structure as low income earners move into higher tax brackets over time.

4.3 The tax-transfer system: interactions and effects

The personal tax and transfer system aims to achieve redistributive outcomes that broadly reflect a ‘commitment to Australian values of fairness and support for those who are disadvantaged’ (Henry et al 2010a, 59), as well as recognition that some level of equalisation of incomes is an important aspect of social cohesion and a marker of national progress. The combined impact of the personal tax and transfer systems is to reduce the final disposable income of higher income households and increase the final disposable income of lower income.

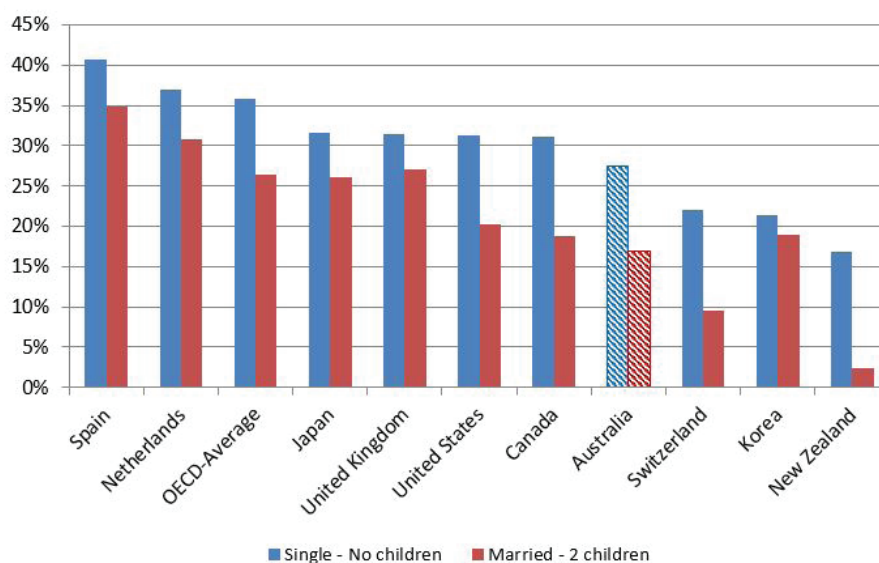
The general features of Australia’s transfer system and its redistributive effects are summarized in section 3.5, while the challenge of inequality is considered in section 2.4. The tax and transfer system historically and today has a

significant effect in reducing inequality. It achieves these objectives at relatively low budgetary cost compared to other nations because Australia has the most targeting of transfer payments in the OECD, as shown in Chart 3.7 above (Whiteford 2014).

However, the tax-transfer system is less redistributive than it was 20 years ago (Herault and Azpitarte 2014, Greenville et al 2013, Whiteford 2013). Changes to the personal income tax have reduced the overall progressivity of the tax system. These include personal income tax cuts and tax threshold increases for the top two brackets between 2003 and 2008 and tax concessions for various forms of saving and investment, especially superannuation and capital gains tax, which favour higher income earners.

In the transfer system, allowances for the unemployed and the sick have been indexed to prices rather than community-wide incomes. This means that the people in these groups have been slipping down the income ladder for the last two decades, relative to others. In the mid-1990s a single person receiving Newstart would have been about \$10 per week (in current terms) below the tenth percentile of the income distribution, but by 2011–12 they would have been close to \$160 below that percentile. Another group who have not enjoyed the general rise in prosperity are lone parents on benefits whose youngest child is aged eight years or more, who now receive Newstart rather than the more generous parenting payment.

Chart 4.6: Average tax burden after transfers for the average worker, selected countries



Source: OECD (2014b).

Note: Figures include income tax plus social security contributions less cash benefits. Australian superannuation guarantee is not included.

Tax burden on the average worker

The OECD indicates that the average tax rate on labour income in Australia was 27.4 per cent in 2013 for an individual, compared to the OECD average of 35.9 per cent (OECD 2014b). A comparison of average tax rates for individuals and families across selected countries is in Chart 4.6. Australia's tax burden on labour income is slightly lower than in Canada, but significantly higher than in New Zealand, especially for families with children.

Workforce participation was a central focus of the Henry Review and, as explained in Chapter 2, is of even greater importance today. Australia's targeted transfer system combined with progressive marginal tax rates creates complexity and challenges for workforce participation.

Effective marginal tax rates

Effective Marginal Tax Rates (EMTRs) are produced by the withdrawal of income support transfers and the LITO as incomes rise, combined with progressive marginal tax rates as earnings increase. EMTRs may be significantly higher than either nominal statutory rates or average tax rates.

The Australian tax and transfer system can produce high EMTRs. The interaction of tax rates and transfers can be difficult to understand because there are many income support transfers which may apply to individuals and households (as shown in Table 3.2). The complexity is compounded by the withdrawal of different income transfers through various income ranges.

There is evidence that high EMTRs have an effect on individuals' decisions about whether and how much they work. Individuals and families making important work and care decisions are aware of the impact on the net wage (their disposable income after taxes and transfers).

Low income earners and women who are secondary earners in a household especially with caring responsibilities have higher labour supply elasticities. They are more sensitive to changes in their tax burden than high income earners and primary earners in a household (e.g. Dandie and Mercante 2007).

Negative incentive effects are likely to be most strongly felt among groups where there is the greatest scope to increase labour market participation to help counter the impacts of an ageing population, particularly women and part-time workers, including those transitioning to retirement.

The salience of tax rates and the elasticity of labour supply

The behavioural response of an individual to a change in their net wage from an increase or a decrease in taxes depends on the substitution and income effects for that individual. An increase in the marginal tax rate decreases the net reward from work and there is an incentive for the individual to substitute unpaid work or leisure for paid work. This is the *substitution effect*. A decrease in the tax rate may have the opposite effect, providing an incentive for the person to engage in or increase their paid work.

An increase in the tax burden of a person as a result of a higher tax rate may cause him or her to work more in order to be able to purchase the same quantity of goods. This is the *income effect*. A decrease in tax burden may instead provide an incentive for the individual to work less but still be able to purchase the same quantity of goods.

The relative importance of the substitution and income effects determines whether there will be a positive or a negative labour supply impact from a change in tax rates on work. Estimates of responsiveness or *elasticity* of labour supply take into account both of these effects. These estimates measure the percentage change in labour supply of an individual, resulting from a one per cent change in the net wage rate, for example as a result of a tax increase or a tax reduction.

Empirical studies indicate that elasticities of labour supply and sensitivity to changes in tax rates vary substantially across different individuals. The variation depends on factors such as whether an individual is the primary or a secondary earner in a household, and their responsibility to care for example for children (e.g. Dandie and Mercante 2007).

Recent international studies suggest salience of tax rates and transfers varies, as do the costs to individuals of changing behaviour such as work hours. In some circumstances, average tax rates may have more of an impact than marginal rates (see, e.g. Chetty and Saez 2013; Saez et al 2012).

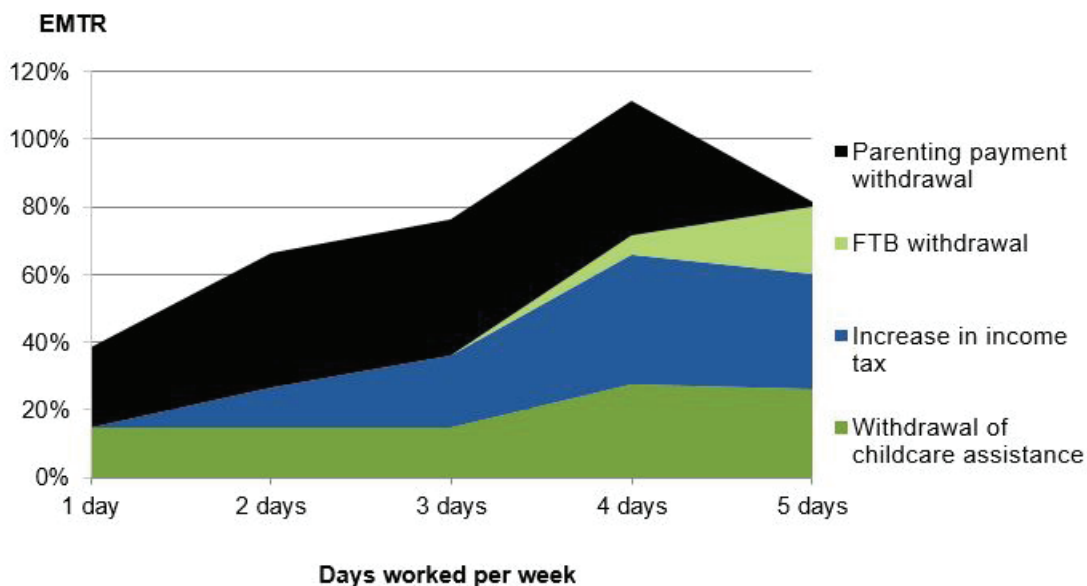
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Chart 4.7, produced by the Productivity Commission, shows an EMTR for an illustrative individual who is a single parent with two children. It includes the combined impact of the progressive marginal tax rate structure, the withdrawal of childcare benefit and childcare rebate and the withdrawal of parenting payment and Family Tax Benefit B. The EMTR can exceed 100 per cent over certain work/wage ranges. That is, the effect of the reduction in income support and childcare payments, combined with marginal tax rates, can exceed the wage that a worker is paid over these ranges. Even at

lower ranges, the EMTR faced by the individual is quite high, ranging from just below 40 per cent to 80 per cent.

These EMTRs do not take account of non-deductible costs such as the excess childcare costs not supported by childcare assistance, or the cost of commuting to work. It is not surprising that a single parent in this situation would choose not to increase her working hours above a maximum of three days per week. Clearly, work does not pay in this case.

Chart 4.7: EMTR for a single parent with two children on \$31.50 hourly wage



Source: PC (2014). Corresponds to Cameo 1 in Box E.3, Appendix E
 Note: \$31.50 hourly wage corresponds to an annual salary of about \$62,000 (full time).

Henry Review recommendations for the transfer system

The Henry Review made numerous recommendations for reform of the transfer system and housing support (Recommendations 82 to 106). Since the Review, many of these recommendations have been progressed and a more detailed review of income support payments, the McClure Review of Australia's Welfare System (McClure et al 2014), has recently reported to government (the report is not yet released). The goals of better work and social outcomes were taken up in the McClure Review.

While noting that the broad architecture of the Australian transfer system is well targeted, the Henry Review identified a number of weaknesses including that the system is overly complex, can treat people of similar means differently, and can result in people making choices that potentially undermine long-term wellbeing, for example through high EMTRs as explained above.

Key structural recommendations of the Henry Review were that there should be three main categories of income support payment:

- > A pension category for people not expected to support themselves through paid work because of their age, a disability or the fact that they are providing full-time care for another person.
- > A participation category for people of working age expected to support themselves through paid work now or in the near future: this would include unemployed people, youth, people who are temporarily incapacitated, people with a partial capacity to work, and people who are the primary carers of dependent children. The rate of payment in this category should provide a basic level of adequacy while maintaining incentives to work. This would be less than the pension rate.
- > Student assistance for people engaged in full-time study.

The Review did not recommend full integration of the tax and transfer systems, given their different objectives. It recommended better coordination to support greater equity between transfer recipients, reducing disincentives to work and underpinning a better client experience of the systems.

Establishing adequacy benchmarks for transfer payments, especially unemployment benefit, would make the system more robust, particularly if the benchmarks were preserved through a common but sustainable indexation arrangement (Henry et al 2010a, 59). The Review noted that indexing all payments to male AWE has been projected to involve a significant increase in budgetary outlays, so it will be necessary for governments to regularly review the appropriateness of this benchmark. The Government proposed in the 2014-15 Budget reducing the indexation of the age pension to prices instead of wages; however, this would lead in the longer term to age pensioners falling further and further behind workers in income; and it seems unlikely that this will pass the Parliament.

The Henry Review also recommended that current income and assets tests for income support payments should be replaced with a comprehensive means test based on a combined measure of employment income, business income and deemed income on assets. The liquid assets waiting period and the sudden-death cut-out that applies to people on certain payments should be removed. These recommendations, if taken up, would reduce high EMTRs in some cases, assisting workforce participation.

Family and childcare policy

There is ongoing public and academic debate about the best way to provide assistance to families with children, evidenced by the contentious issue of how to design and fund an adequate paid parental leave scheme for all who need it. These policy decisions are complex and contested in an era when governments are seeking to reduce expenditures.

The Henry Review recommended that FTB A and B and related benefits should be replaced by a single family payment, covering the direct costs of raising children in a low-income family and assisting parents nurturing young children to balance work and family responsibilities. The rates of payment should increase with the age of the children to recognise the higher costs of raising older children. Assistance for families should also recognise that there are specific circumstances for which additional support is appropriate. The Review recommended that the total amount of family assistance should be withdrawn with a single means test to avoid cumulative withdrawal rates which create unnecessarily high disincentives for parents who are working. A single low withdrawal rate of 15–20 per cent is suggested.

For young people, the Henry Review recommended that youth payments should be the main form of income support from the age of 18 and should reflect the fact that most young people have lower needs than adults but need adequate assistance to participate in education and training. Dependent recipients should be subject to a parental income test consistent with that applying to family payments. Dependent older children for whom a suitable pathway may be leaving school and looking for work or combining part-time work and part-time study should have access to a youth payment, governed by strict participation requirements. Children without financial support from their families should continue to have access to a youth payment, governed by strict criteria.

The Productivity Commission has recently carried out a detailed review of childcare (PC 2014). The McClure Review recommendations on family payments (also reported to government but not yet released) are also relevant.

The Henry Review recommended that Childcare Benefit and Childcare Rebate should be combined into a single payment to parents (or centres) based on a percentage of costs. The payment should provide a high rate of subsidy for low-income families covering most of the costs of child care (up to 90 per cent) and a base rate of assistance for all families participating in work, education or training. The base rate of assistance should be set as a proportion of child care costs, with reference to the marginal tax rate faced by the majority of taxpayers. The full costs of child care should be covered for at-risk children and children facing multiple disadvantages, without participation requirements on parents.

4.4 The personal income tax base

In this section, we discuss the personal income tax as it applies to work and business income including the Henry Review recommendations. We identify gaps and complexities in the tax base that suggest directions for tax reform. We then turn to the tax treatment of personal savings and investment in section 4.4 and retirement saving in section 4.5.

Income from employment and fringe benefits

An Australian resident individual is taxed on all their income sourced from Australia or overseas, from employment or performing services. Most employment remuneration is taxed by employer withholding under the PAYG system. Gifts, inheritances and lottery or prize winnings are excluded and some income support transfers including childcare, family payments and the disability support pension are exempt from income tax. Deductions are allowed for the expenses of earning income and for some other expenses including charitable gifts.

In a comprehensive income tax, in addition to wages, salary and allowances, an individual's assessable income from employment should include the market value of fringe benefits, or non-cash benefits received by them. This supports fairness by ensuring horizontal equity between employees who are similarly situated except for the form of their remuneration. It also ensures that maximum revenue is obtained at lowest possible rates and it minimizes tax planning opportunities available to only some workers and not others, thereby building resilience of the tax system.

Most non-cash remuneration derived by employees or their associates is captured by the FBT. The FBT is levied on employers in respect of fringe benefits provided to current, former and in some cases future employees and associates of employees (such as family members). The introduction of FBT in 1986 contributed substantially to broadening Australia's personal income tax base. FBT is levied at the top marginal tax rate plus the debt levy (currently 47 per cent).

As shown in Table 3.1 above, FBT raised \$3.9 billion in revenue in 2013-14. This is only a fraction of the total \$156.3 billion raised in personal income tax. The FBT operates as a backstop to support the income tax and prevent avoidance of tax on remuneration. The economic incidence of FBT most likely falls on employees in the form of reduced wages.

While the FBT is intended to ensure a broad tax base for employment income, there is an array of tax expenditures including exemptions, concessional valuation rules and concessional tax rates in the FBT Act. The FBT benchmark comprises a tax base that includes all fringe benefits provided to an employee and recognizes a deduction to the employer for the cost of providing fringe benefits and the amount of FBT paid. The TES identifies more than 50 tax expenditures in the FBT (Treasury 2015, Part D).

Examples of FBT tax expenditures include FBT exemptions for recreational and childcare facilities on employer premises; concessional treatment for motor vehicles, meal entertainment and living-away-from-home accommodation; and salary-sacrificing computers and other work-related equipment.

Some concessions, such as the exemption for minor work-related benefits, make sense from an administrative perspective. Others have no such rationale and add substantially to the complexity of the tax system. An industry of advisors that specialize in salary packaging to take advantage of these and other tax planning opportunities has developed over time. High wage employees facing the top marginal rate on their cash salary have a substantial incentive to 'salary sacrifice' into non-cash benefits, converting ordinary wage income taxable at marginal rates into concessional treatment fringe benefits.

FBT salary packaging in the community services sector

The largest revenue foregone in FBT tax expenditures arises for fringe benefits that are either exempt or concessionally taxed for employees in not-for-profit community services, not-for-profit and public hospitals and ambulance services. These tax expenditures are estimated at \$2.7 billion in revenue foregone (see Table 3.3 above; Treasury 2015).

Concessional taxation of salary-packaged fringe benefits operates to some extent as a wage subsidy or lower tax rate for community sector workers. This is of substantial importance to many workers in that sector (NFP Tax Concessions Working Group 2013), and to cost-constrained services, hospitals and ambulances that are operated by not-for-profits or State and Territory governments.

It is a challenge to address the implications for remuneration of workers in the community and health sectors of removing salary packaging of fringe benefits. However, equal treatment of remuneration across all sectors is an important policy goal, and reform in this area would be a substantial simplification that would treat all low and moderate wage earners equally.

The Henry Review recommended that fringe benefits that are readily valued and attributable to employees should be taxed in the hands of employees like other employment income in the PAYG system but that the FBT should remain for more general, difficult to value fringe benefits.

Reforms since the Henry Review have included tightening of FBT concessions for work-related items such as computers and so-called 'in-house' fringe benefits such as staff discounts, living-away-from-home allowances and some motor vehicle fringe benefits. However, there is scope for further base broadening reform of the FBT.

Employee share and option plans

Concessions exist in the tax law for some kinds of employee share and option plans for company employees. These enable some workers to reduce their taxes on remuneration especially through deferred options or shares. They seek to achieve policy goals such as aligning the interests of employees and owners in business investment.

Employee share rules were tightened in 2009, so that the concessions and conditions were fairly limited. The Government proposes to relax these rules so as to encourage remuneration in employee shares or options in particular for start-up or early investment companies (Billson 2014). This may help support innovative companies to invest and employ people in Australia; however, it means that not all workers are taxed equally on the same remuneration. It is a tax expenditure that has a potential economic and revenue cost as it introduces a new tax planning margin into the tax system.

Tax deductions

An individual's taxable income is reduced by allowable deductions, which are primarily expenses incurred in the process of earning assessable income. Australia allows a wide range of deductions compared to other countries, in relation to income derived from employment, business or investments (we discuss investment expenses in section 4.5 below).

There is considerable interpretive flexibility regarding the scope of allowable deductions that has fuelled extensive ATO guidance, audit and litigation over many years. As a matter of principle, the income tax is intended to tax net economic gain and so expenses should be recognised. However, there are trade-offs in respect of complexity, tax planning and fairness of allowing deductions in the tax system.

The value of deductions to the taxpayer increases as their assessable income rises. For the same \$100 expense, a deduction is worth \$49 for an individual facing a 49 per cent marginal tax rate, but only \$19 for an individual facing the 19 per cent tax rate. As marginal tax rates increase, there is a greater incentive for individuals to identify and claim expenses as deductions, creating planning opportunities in the tax system.

PERSONAL INCOME TAX, TRANSFERS AND SAVING continued

Tax statistics indicate that \$19.3 billion in work-related deductions were claimed in the 2011-12 year (ATO 2014c, Table 10). Each expense requires separate identification and record keeping. They also contribute to the heavy utilisation of tax agents for completing tax returns. As the costs of administering one's tax affairs are deductible against one's tax liability, a proportion of these costs are borne by the wider community. More than 75 per cent of individuals relied on a tax agent to file their return and deductions in excess of \$2 billion were claimed by individuals for the cost of managing their tax affairs in 2011-12 (ATO 2014c, Table 10).

The Henry Review identified the breadth and complexity of Australia's work-related deductions as a problem of tax base design and called for a tighter nexus between an expense and its role in generating income (Recommendation 12).

Some options for reform of tax deductions

- > The Henry Review proposed a standard deduction that could be used by most individuals instead of itemizing their expenses (Recommendation 11). The Rudd and Gillard governments canvassed this option but their proposal was heavily criticised as inadequate and overly complex (e.g. Tran-Nam and Evans 2011) and was subsequently abandoned. It could simplify the system but would not broaden the base.
- > Cap tax deductions at a dollar level each year. A Gillard Government proposal to cap self-education expenses deductions at \$2000 on the grounds that they were being excessively utilised by high-income earners was heavily campaigned against and the incoming Abbott Government reversed the policy.
- > The Canadian approach: Employees can only deduct expenses that the employer specifically requires the employee to incur and which are specifically identified in tax law or administrative guidance.
- > New Zealand abolished work-related deductions altogether for employees in 1987, as part of a package of reforms that broadened the base and lowered personal tax rates, while also simplifying the system. Combined with the introduction in 2000 of a pre-filled 'personal tax statement', only around one quarter of New Zealand taxpayers have to file a tax return (Kerr 2012, 472).

Tax structuring using companies and trusts

Tax minimisation may be achieved through the use of income splitting with other individuals (such as family members), or through the utilization of a legal entity to generate a lower tax rate on employment, business and investment income.

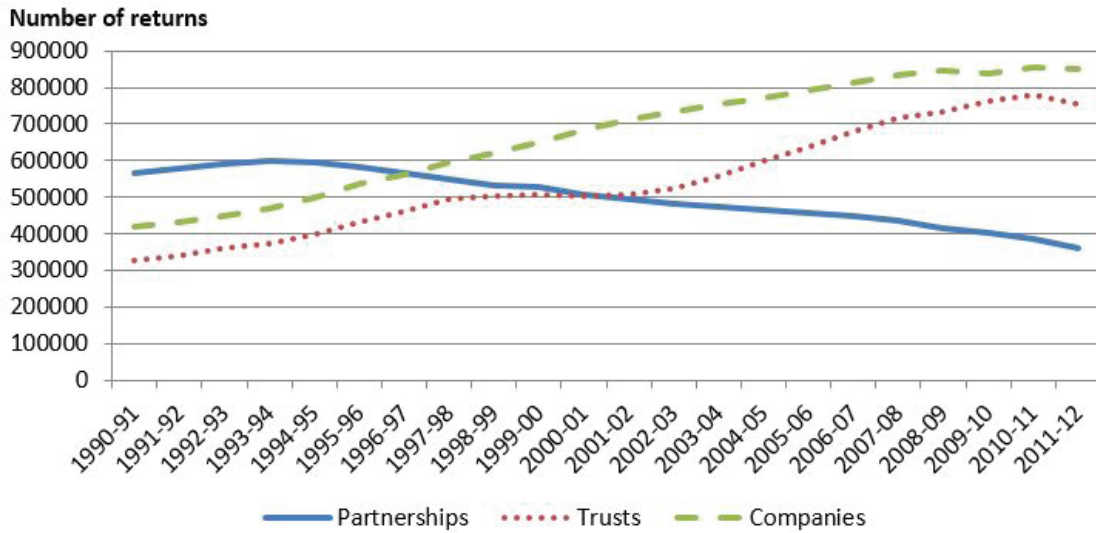
Individuals seeking to operate a business may select from alternative business structures with differing tax consequences, including a sole trader, partnership, company or trust. Many individuals, especially those who are self-employed, have the opportunity to use a company. The gap between this 30 per cent company tax rate and the top marginal tax rate of 49 per cent is a significant driver of tax planning. Other options for individuals include saving in self-managed superannuation funds (SMSFs) taxed at 15 per cent; or using trusts to split professional, business and personal services income among family members, thereby reducing the overall tax paid.

Chart 4.8 reveals that the number of companies and trusts filing tax returns has more than doubled in the last two decades, which may be an indicator of increasing tax planning. The number of SMSFs has also dramatically increased in recent years. There are now more than 500,000 SMSFs with nearly 1 million individual members.

Companies and trusts can be combined to achieve a lower tax rate on income while ensuring maximum flexibility. An illustrative business structure aimed at maximising tax benefits derived from differences in the taxation treatment of different entities is presented in Chart 4.9.

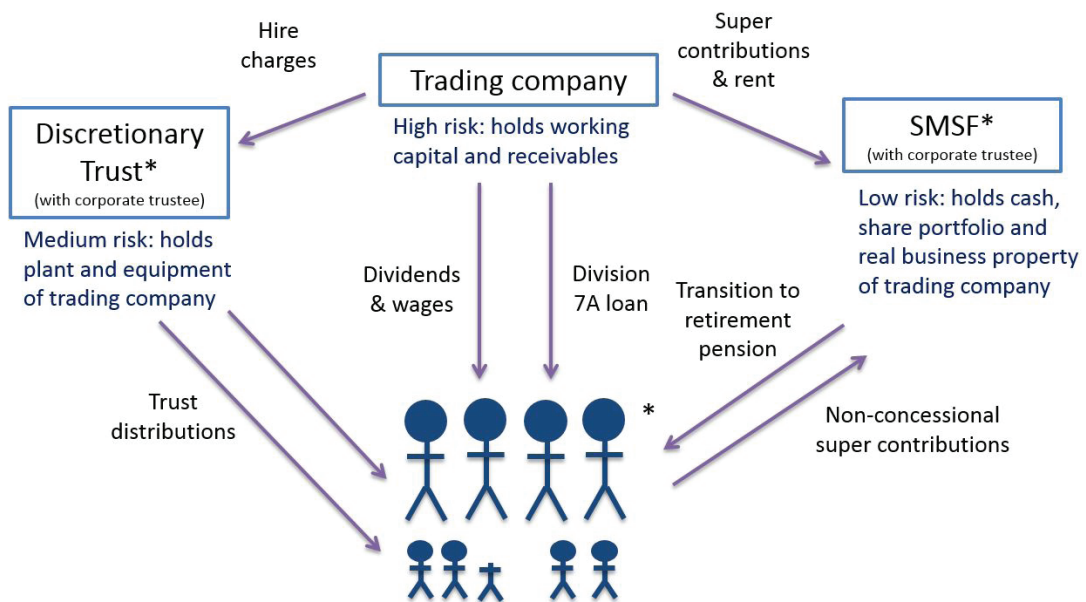
In this example, a business owner establishes a family discretionary trust as a shareholder in a business company, with trust profits distributed selectively to spouses or family members facing lower marginal tax rates. A SMSF may receive salary sacrificed superannuation contributions from the business and may hold debt-funded investment in the real property of the business, generating interest deductions and a rental return. In addition, a company could be used as a trust beneficiary 'bucket company' to cap taxation at 30 per cent, deferring the application of higher marginal tax rates until funds need to be distributed to the owners (not shown in illustration below).

Chart 4.8: Trends in legal entities filing tax returns



Source: ATO (2014c).

Chart 4.9: Illustrative diagram of a small business structure



Source: Treasury.

PERSONAL INCOME TAX, TRANSFERS AND SAVING continued

This kind of tax structuring is legal and widespread. However, where a taxpayer has a dominant purpose of obtaining a tax benefit by tax structuring, specific or general anti-avoidance tax rules may apply. For example, individuals who establish a company to provide their own personal services may be required to pay tax on the income attributed to them by specific rules.

Australia's general anti-avoidance rule in Part IVA of the Income Tax Assessment Act 1936 is widely considered to be quite robust. However, administering anti-avoidance rules is complex and resource-intensive for the tax administration and for individual taxpayers, as well as generating uncertainty. Ideally, tax law design would aim to ensure that widespread tax minimization practices are stopped by reforms to basic tax rules wherever possible.

If tax avoidance becomes widespread, this reduces the progressivity of the personal tax system and narrows the tax base, leading to higher statutory tax rates than would be necessary in the absence of tax planning opportunities. It may give rise to a number of costs borne by the whole community, including:

- > additional tax compliance and administrative costs;
- > efficiency losses through tax-driven distortions of decisions about business structures and modes of work, saving and investment;
- > the generation of wasteful and excessive profits, or 'economic rents' for facilitators of tax planning arrangements including in the professional advice industry; and
- > actual and perceived unfairness which may undermine voluntary compliance.

New empirical research into tax elasticity

New studies undertaken in other countries using administrative tax return data provide evidence that taxpayers engage extensively in tax planning and other behavior so as to reduce their tax burden (Creedy and Gemmell 2014; Slemrod and Gillitzer 2014). This research about the *elasticity* of responses to taxable income and rates is important in understanding behaviour of taxpayers in the tax system and in identifying weak points and priorities for tax reform.

For example, a recent New Zealand study examined changes to taxpayer behaviour in response to tax rate changes. New Zealand reforms in the 1980s aligned the top personal tax rate and the tax rate for trusts and companies at 33 per cent. Changes introduced from 2001 subsequently increased New Zealand's top marginal tax rate to 39 per cent and lowered the company tax rate to 30 per cent. Empirical evidence from 2002, 2005 and 2007 indicates that individual taxable income was abnormally clustered at amounts just below the top marginal rate threshold compared to 1999 when tax rates were aligned (Benge and Holland 2010; New Zealand Inland Revenue Department 2008).

In a UK study, a new 50 per cent income tax rate introduced in 2010 elicited a substantial behavioural response from high-income earners, including bringing forward the realisation of income (so it would be taxed at a lower rate), moving income overseas and converting it into other forms. As a result, the underlying revenue yield from the new tax rate was estimated at 83 per cent less than originally forecast (HMRC 2012).

Very little research into tax responsiveness has been carried out in Australia. To carry out research into the responsiveness of taxpayers to tax planning margins, changes in tax rates or concessions in the tax base, researchers require access to tax administrative data including panel data sets over a period of years of confidentialised unit record files. The TTPI aims to work with government agencies to ensure that such research is feasible, while respecting privacy and security of taxpayer information.

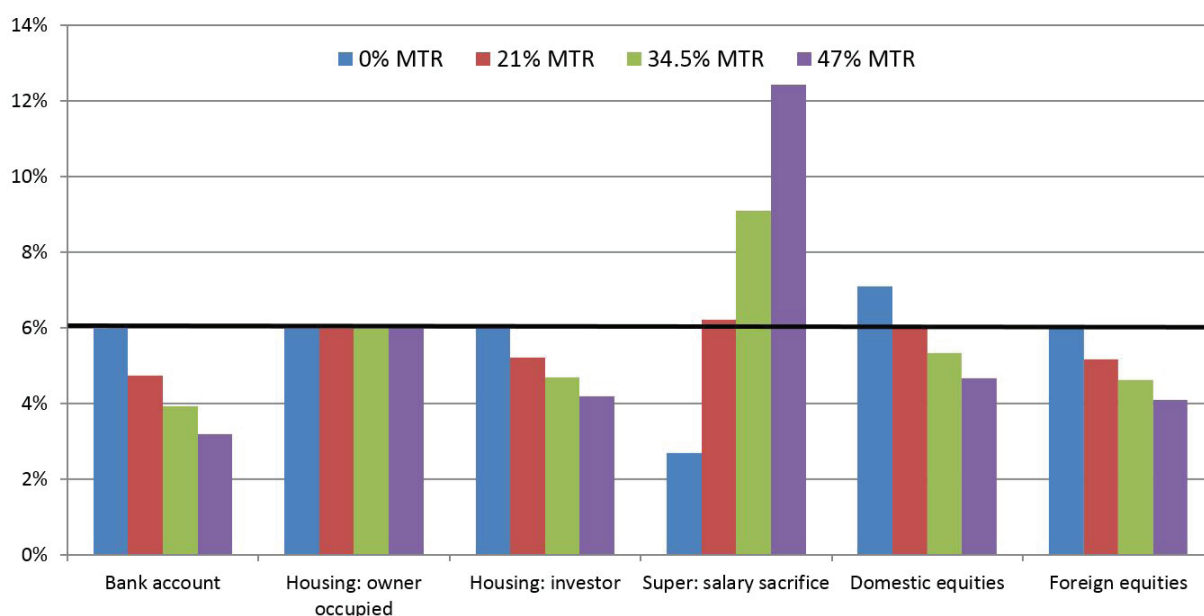
4.5 Personal taxation of saving and investment

Different forms of personal savings and investment such as financial bank deposits, shares, the family home (main residence), investment real estate and superannuation, are taxed in diverse ways. As a result, the after-tax return to different forms of saving varies dramatically, depending on the type of investment and tax bracket of the investor.

This was illustrated in the Henry Review with a stylised example of the after-tax return for an investment returning 6 per cent in various sectors (Henry 2010a, Chart A1-22). A similar example was provided in the Murray Financial Systems Inquiry Interim Report (Murray 2014a). This is reproduced in Chart 4.10.

Chart 4.10 shows that for most savings vehicles, as expected, taxation would reduce the after-tax return in line with the applicable individual tax rate. However, some investments are not taxed at all (such as the family home), while salary-sacrificed superannuation actually increases the after-tax return (i.e. provides a subsidy) for this type of investment. This stylised example does not take account of the tax deduction for interest on borrowing, or gearing investments that are purchased to gain assessable income, which also has a significant effect on the after-tax return to various forms of investment and can shelter other income from tax.

Chart 4.10: After-tax return to a 6 per cent returning investment



Source: Murray (2014a), Chart 3.2.

PERSONAL INCOME TAX, TRANSFERS AND SAVING continued

The Murray Inquiry into the Financial System concluded that the unequal treatment of different forms of saving 'distorts the asset composition of household balance sheets and the broader flow of funds in the economy'. It recommended a more neutral taxation treatment for consideration in the government's Tax White Paper process (Murray 2014b, Appendix 2).

As a consequence of the exemption or low taxation of returns to saving in the home and superannuation, the personal tax system is really a hybrid income-consumption tax base. It exhibits features of a consumption or expenditure tax in its treatment of these forms of household saving (Heferen 2012; Freebairn 2014).

A comprehensive income tax would tax all real returns to saving equally when they are derived. A comprehensive expenditure tax would not tax saving at all, but would tax all consumption when it occurs. On this basis, applying an income tax to the nominal return to saving overtaxes this deferred consumption (saving) relative to current consumption (e.g. Sorenson and Johnson 2010, 207).

Over the lifecycle, if all saving by an individual is deferred consumption, these two approaches would be equivalent from efficiency and equity perspectives. However, savings may be set aside for reasons other than future consumption. Wealth accumulation may be an end in itself, or aim to leave a bequest to children.

Not all individuals have the opportunity to save and many low income people effectively have no net assets and must spend all of their current income. The distribution of savings is highly unequal across the household income distribution. Chart 2.8 demonstrates that more than sixty percent of household assets are owned by the top 20 per cent of households, while the bottom 40 per cent own just over 5 per cent of household assets. Australia does not tax inheritance or most superannuation payments on retirement or death, so the tax system treats savers much more generously than those who cannot save. In this context, levying tax on savings income has been an important equity feature of the tax system.

Henry Review recommendations for saving

There are many possible approaches and diverse views about what is the best way to tax savings. On the basis that Australia's personal income tax should be broad-based, robust and efficient, the Henry Review recommended that the net return to saving should be taxed more consistently at individual marginal rates. However, it recommended that a lower rate be applied than for work and active business income and that the main residence remain tax-exempt.

Recommendation 14 (Henry et al 2010a):

Provide a 40 per cent savings income discount to individuals for non-business related:

- > Net interest income;
- > Net residential rental income (including related interest expenses);
- > Capital gains (and losses) ;and
- > Interest expenses related to listed shares

An approach such as the Henry Review proposal would provide a more consistent and fairer taxation of the return to savings. It would move Australia towards a 'dual income tax' model that taxes the return to savings at a lower, but comprehensive rate compared to the taxation of work and business income (Sorenson and Johnson 2010). This approach generates its own tax planning margins, especially incentives to convert work or business income to lower-taxed savings income. To some extent, these incentives already exist in Australia's tax system because of the lower taxation of capital gains.

Interest on bank deposits

Interest on financial deposits in banks and other deposit-taking institutions is taxed in the same way as income from work, at the taxpayer's marginal tax rate. However, the impact of inflation means the effective income tax rate on interest income is higher than the statutory rate (Freebairn 2014, 5). This acts as a significant disincentive to holding savings in deposits compared with other more tax advantaged savings vehicles. It is unfair because it penalises low income people whose only saving opportunity is in a financial deposit.

Dividends

Dividends are taxed at full marginal tax rates. However, dividends paid out of taxed Australian company profits to Australian shareholders may benefit from an imputation credit for company tax paid. This makes Australian company dividends an attractive investment for many individuals, as illustrated in Chart 4.10. Company-shareholder taxes are discussed in Chapter 6.

Capital gains

Capital gains tax (CGT) is levied as a component of income tax on realised gains made on the sale of assets such as shares or property. The introduction of CGT in 1985 represented a significant broadening of the personal income tax base, although the protection of pre-1985 capital gains generated complexity in the system and has likely reduced revenues. Net capital losses can only be utilised to offset other capital gains and are not able to be deducted against other forms of taxable income.

Most countries comparable to Australia have a capital gains tax, with the notable exception of New Zealand. When introduced, capital gains were taxed at the marginal tax rate with an adjustment for inflation. From 1999, CPI indexation was replaced with a 50 per cent CGT discount for gains on assets that have been held for longer than 12 months, following a recommendation of the Review of Business Taxation (Commonwealth of Australia 1999).

The TES estimates the annual revenue foregone from the CGT 50 per cent discount to be \$5.8 billion (Table 3.3; Treasury 2015). The Henry Review recognizes this as likely to be over-generous and recommends reducing it to 40 per cent and applying this consistently across various savings vehicles.

The CGT is a relatively volatile source of taxation revenue and CGT revenues have still not recovered from the effects of the GFC. CGT receipts were 0.46 per cent of GDP in 2012-13, down from a peak of 1.56 per cent of GDP in 2007-08. Even as asset prices have recovered, carried forward capital losses built up during the GFC are utilised to offset more recent capital gains (Clark and Hollis, 2013; PBO 2014a, 23). Nonetheless, the uneven distribution of capital gains between rich and poor provides a significant reason to levy tax on capital gains for reasons of fairness. Taxing capital gains is also important as it reduces planning margins (e.g. conversion of income to capital gain), protecting the broad income tax base and supporting resilience of the system.

Home (main residence) exemption

The home has a particular role in consideration of saving. By far the largest component of Australian household wealth is real estate, including the family home and investment real estate which comprise about 60 per cent of all household wealth (Finlay 2012).

Investment in the home is made with after-tax income. However, as illustrated in Chart 4.10, the return to owning your own home is entirely exempt from tax. There is no income tax on the annual benefit from living in your own home (instead of paying rent), called *imputed rent*,

and no tax on capital gains from sale of your home. Correspondingly, tax deductions for expenses such as mortgage interest and repairs and maintenance are not available for owner-occupied housing. This treatment is termed a 'pre-paid consumption tax model' that ensures effective tax rates on capital income from owner-occupied housing are close to zero (Freebairn 2014).

The TES estimates that the combined value of home ownership tax expenditures exceeds \$45 billion (see Table 3.3 above; Treasury 2015). The home is also exempt from assets tests for transfer payments, most notably the age pension.

The long-standing generous treatment of home ownership has historically been considered one of the central tenets of the 'Australian promise' that has encouraged high levels of home ownership and underpinned household wealth in Australia (Wood et al 2008). It has been criticized as leading to over-investment in owner-occupied housing in Australia (Abelson and Joyeux, 2010; Productivity Commission 2004); as unfair to those who cannot afford a home; and as undertaxing speculative gains at the top of the income distribution.

Rental losses

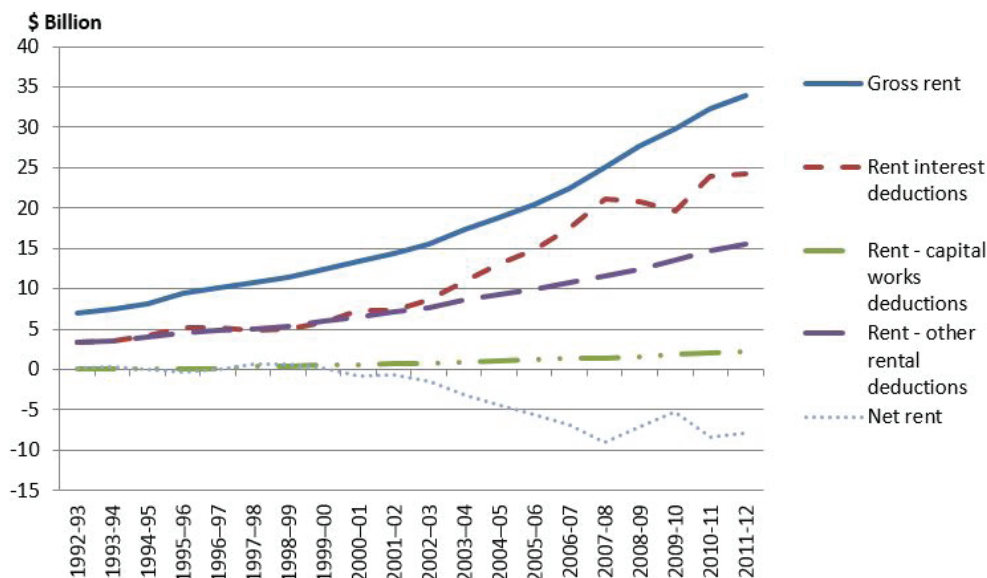
The deductibility of net losses on rental real estate or shares to shelter other work or business income from tax is commonly known as negative gearing. Interest and other expenses in excess of returns on the asset (rental or dividend income) are fully deducted against other income of the taxpayer, thereby reducing their overall tax paid. The property may subsequently be sold with only half of any capital gain subject to tax.

Allowing a full deduction for expenses including interest, when only half the gain accruing will be taxed on a realisation basis is the main mismatch associated with negative gearing. This tax advantage is not estimated as a tax expenditure, because it is a result of the ordinary income tax law rule that assessable income and deductions are pooled in determining taxable income, in combination with the 50 per cent CGT discount.

More than 1.8 million Australian taxpayers received \$34 billion of rental income for the 2011-12 income year and claimed deductions totalling more than \$41.8 billion against this income. More than half of these deductions were generated by loan interest on rental properties (ATO 2014c). Negative gearing, particularly into real property investments, has become a preferred investment method for higher income earners, either directly or via a self-managed superannuation fund. More than 65 per cent of landlords have net losses that may be used to shelter other sources of income from tax. The growing trend in rental deductions and losses is illustrated in Chart 4.11.

PERSONAL INCOME TAX, TRANSFERS AND SAVING continued

Chart 4.11: Trends in rental deductions and losses



Source: ATO (2014c).

The Murray Inquiry found that the subsidy delivered by this asymmetric tax treatment tends to encourage leveraged and speculative investment in housing, generating a potential source of systemic risk (Murray 2014b, Appendix 2). The Henry Review recommendation for savings taxation would reduce the impact of negative gearing, but would not eliminate it completely. Some have proposed other limits, for example limiting negative gearing only to new housing stock, to encourage increased supply, or quarantining expense deductions to rental income or capital gain.

Wealth taxation

The distribution of net worth is much more highly skewed than the distribution of household income, as shown in charts 2.6 and 2.8. However, when household net worth is ranked by income, net worth is less unequally distributed than income. That is, some lower income households have household wealth. The most likely factor is the lifecycle accumulation of wealth, particularly housing, so that older people who have lower than average incomes in retirement are more likely to own their homes.

Australia does not tax assets as broadly as many other countries. We have no asset taxes, apart from land tax and rates on real property. Estate and gift taxes at State and Commonwealth levels were abolished in the early 1980s. Capital gains tax does not apply to the disposal of assets on death.

The Henry Review recommended further study and consideration of options for a bequests tax (Recommendation 25). The Henry Review also recommended taxing housing through a land tax (Recommendation 52). We return to land tax in Chapter 6.

Capital gains taxed on death in Canada

Canada has a similar CGT to Australia in many respects. However, unlike Australia, Canada taxes accrued capital gains on death of the owner, which is treated as a deemed disposition. The deemed capital gain is eligible for a 50 per cent discount on tax, like other capital gains. In addition, there is a lifetime capital gains exemption of \$800,000 in 2014 and some exemptions for farms passed to children.

See <http://www.cra-arc.gc.ca/tx/ndvdl/lf-vnts/dth/dmd/menu-eng.html>.

4.6 Tax concessions for superannuation

Australia's retirement incomes system combines public provision (the age pension) with private savings through compulsory and voluntary superannuation. Tax concessions for superannuation contributions and earnings are among the largest tax expenditures incurred by the Commonwealth government, estimated to be approximately \$30 billion in revenue foregone against an income tax benchmark (see Table 3.3 above; Treasury 2015). The TES estimates that the combined cost of superannuation tax concessions will exceed \$45 billion by 2015-16 and will continue to grow over the long-term with population ageing and as the superannuation system approaches maturity.

Regulated superannuation funds, including SMSFs, are taxed at a flat rate of 15 per cent on contributions, two thirds of any realised capital gains held for more than a year and investment income. Superannuation funds can utilize exemptions (in the pension phase) and imputation credits on share investments to reduce taxes. Superannuation payouts and investment earnings received after people have retired and are drawing down their superannuation are generally tax-free. Superannuation may be cashed out as a lump sum on reaching retirement age, or may be retained as a pension generating tax exempt returns.

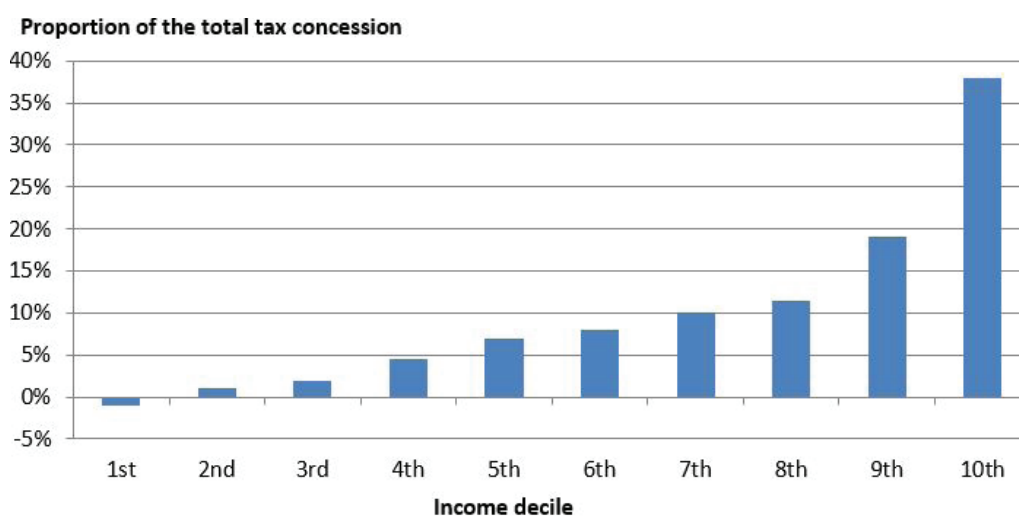
Employees may also make additional pre-tax contributions to superannuation, which are not included in the employee's personal income and are instead taxed in the superannuation fund at 15 per cent. Salary sacrifice arrangements may reduce an employee's taxable income and adjusted taxable income for transfer means testing purposes.

The taxation treatment of superannuation contributions, earnings and payouts is concessional for individuals earning more than the effective tax-free threshold of \$20,542 and increasingly as an individual's marginal tax rate increases. High income earners pay about two thirds less tax on their superannuation than on other sources of income.

In contrast, people earning less than the effective tax free threshold pay more tax on their superannuation contributions than on their personal income from work, while those on low marginal tax rates derive a much lower benefit from superannuation concessions. The bottom 50 per cent of income earners received just 13 per cent of total superannuation tax concessions (Treasury 2012).

The skewed distributional impact of superannuation tax concessions is shown in Chart 4.12, from the Murray Inquiry. It reveals that the bottom 10 per cent is actually made worse off under current superannuation tax arrangements.

Chart 4.12: Distributional impact of superannuation tax concessions



Source: Murray (2014).

PERSONAL INCOME TAX, TRANSFERS AND SAVING continued

The growing cost of tax support for superannuation is not expected to reduce appreciably the extent of reliance on the age pension. The Treasurer recently pointed out that 'despite spending billions of dollars in taxation benefits for superannuation, by 2050 the ratio of Australians receiving a full or part pension will still be around four out of five' (Hockey 2014a). This could be addressed, in part, by rules regulating access to superannuation benefits as a pension, or by changing tax settings.

Superannuation tax reform

There is increasing and widespread acknowledgement of inequities in the superannuation system; however, the pathway to reform is not straightforward. The Henry Review made significant recommendations about superannuation and the Murray Inquiry has also recommended that superannuation tax concessions be reviewed in the Tax White Paper. A key issue in the retirement savings system, including superannuation, is to be clear about the overall purpose of the system and the benchmark against which to assess tax concessions and pension conditions.

Governments have made some ad hoc attempts to address equity issues concerning the distribution of superannuation tax concessions, including introduction of a concessional contributions cap to limit benefits for contributions by high-income earners. Excess contributions were initially taxed at the top marginal rate and this was subsequently revised so that excess contributions are now taxed at the individual's marginal tax rate, plus an interest charge. The Gillard Government introduced a low-income superannuation contribution which would refund contributions tax up to a maximum of \$500 per year so that individuals on annual incomes up to \$37,000 would pay no tax on their superannuation contributions, which is expected to continue until 2017.

The Henry Review recommended abolishing the 15 per cent contributions tax and instead taxing contributions at marginal tax rates with a tax credit of 20 per cent so the majority of taxpayers do not pay more than 15 per cent tax on contributions (2010a, 84). It estimated that this approach would improve fairness and increase aggregate superannuation savings by 17.5 per cent without changing the Superannuation Guarantee rate from 9 per cent. This would result principally from lower income earners receiving a greater tax benefit than under the existing flat rate tax model.

The Review also recommended reducing superannuation earnings tax to 7.5 per cent, aimed at an effective average tax rate on earnings close to zero per cent after accounting for imputation credits for company tax paid on shares held by superannuation funds.

Consistent with the scope of its terms of reference, the Henry Review did not propose changes to the taxation of benefits received in retirement, although it did recommend including superannuation end benefits in the age pension means test on the same basis as other forms of saving (other than the family home).

In aggregate, the Henry Review's recommendations would bring the taxation of superannuation closer to a 'pre-paid' consumption tax treatment like the taxation of owner-occupied housing. This approach would entrench superannuation and savings in the family home as the most tax preferred forms of private saving, when combined with the other Henry Review recommendations for the 40 per cent savings discount, but would remove some of the most extreme inequities in the system.