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Autumn Wealth update

This edition covers the following topics:

- Superannuation Proposals
- The Madness of Negative Interest Rates

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Superannuation Proposals

With the Federal Budget fast approaching, there has been considerable speculation about what changes if any, will be made to superannuation. In this article we will cover the following issues:

- Background
- Liberal Party proposals
- Labor Party proposals
- Other proposals
- Actions to consider before Budget Night.

Background

The end of the mining boom and the consequential sharp rise in budget deficits and public debt has highlighted some of the flawed taxation policy decisions that have been made over the last decade. As an example, two of the more controversial decisions that have had led to significant revenue leakages are as follows;

1. **Relaxation of superannuation pension rules that took effect from 1 July 2007 that resulted in tax free income streams[1] for individuals over the age of 60.** Prior to July 2007, individuals drawing a pension from their super funds included the pension income in their assessable incomes but typically received a partial tax deduction before the income was taxed at their marginal rates. They also were typically eligible for a 15% tax rebate. This policy was scrapped in the 2006 budget in favour of a tax-free policy. The new policy was introduced during a time of great economic prosperity driven by both the mining boom and a debt fuelled consumption binge buoyed by strong asset price growth. Although this policy was clearly a tremendous windfall for wealthy retirees at the time, it was fiscally short-sighted. The windfall revenues generated by the mining boom made this policy financially viable at the time but the post-boom costs of this overly generous policy are now being counted.
2. **Change in the tax free threshold from $6,000 to $18,200 that took effect from 1 July 2012.** This policy was introduced as part of the Clean Energy reforms in tandem with the introduction of the Carbon Tax in a bid to mitigate the impact of the tax on low income earners. When the Carbon Tax was scrapped by the incoming Liberal Government the higher tax-free threshold remained, imposing a significant revenue leakage given the very large number of taxpayers that fell within this tax bracket.

To pretend there is an easy answer to fix the debt and deficit woes would be naïve (although getting rid of middle class welfare and clamping down on multinational tax minimisation schemes would be a good start). Attempting to adjust taxation policy without unintended consequences (such as lower growth or public discontent) is never easy.

The incumbent Liberal Government has already ruled out increasing the GST. With high income earners already being slugged up to 49 cents in the dollar, it is unlikely that individual tax rates will change by much. This means that tax deductions (such as negative gearing) and superannuation are likely targets in the upcoming Federal Budget.

Liberal Party Proposals

The Liberal Party have either not yet formulated their proposed changes to superannuation or are unwilling to divulge the details until closer to Budget Night. What has changed recently though is a further delay in the Superannuation Guarantee rate. This was originally supposed to rise to 12% by the 2020 financial year. The current rate of 9.5% will now be frozen until 30 June 2021 and won't increase to 12% until 1 July 2025.

Labor Party Proposals

The Labor Party has two main superannuation proposals, summarised as follows:

1. **It intends to tax earnings of $75,000 or more (per individual) within a super fund in pension phase at 15%.** By way of background, there are two main phases of superannuation. Accumulation phase is when members are usually adding to their super fund and pension phase is when they start drawing an income stream from their super fund. Investment earnings generated by a super fund in accumulation phase are currently subject to a 15% tax rate but earnings in pension phase are tax free. The Labor Party policy would impose a 15% tax when earnings exceed $75,000 per annum. The Party estimates that this measure will affect some 60,000 superannuation account holders (assuming an account balance of $1.5 million or above).

1 Except pensions paid from untaxed sources such as unfunded defined benefit pensions.

2. It intends to reduce the Higher Income Superannuation Charge (HISC) from $300,000 to $250,000.
Currently an individual with an adjusted taxable income of $300,000 or higher pays an extra 15% tax on concessional contributions made to a super fund (on top of the existing 15% tax on such contributions). The Labor proposal would reduce the adjusted taxable income threshold to $250,000.

Other Proposals

A number of vested interests have weighed into this debate but two of the more independent proposals are as follows:

The Henry Review

The last significant independent review of the Australian taxation system was completed in 2010 by Dr. Ken Henry. The report contained 138 recommendations including a number of superannuation proposals, the key ones being Recommendation 18 and Recommendation 19.

- **Recommendation 18**
  Instead of allowing a deduction for pre-tax super contributions, these contributions would instead be included as assessable income and taxed at marginal personal income tax rates. To ensure that an incentive would remain to make contributions, a flat-rate refundable tax-offset for all contributions up to an individual cap of $25,000 (index) would be allowed. The flat rate nature of the tax offset would ensure that higher income earners derived no implied benefit from these contributions.
- **Recommendation 19**
  Halve the tax rate on superannuation earnings from 15% to 7.5% but at the same time bring back the tax on earnings in pension phase (currently nil) to 7.5% as well.

There has been speculation that the Government may consider introducing something similar to Recommendation 18.

Rice Warner

Rice Warner is firm of respected independent actuaries and consultants. Key features of their recent submissions to Treasury are as follows:

- Imposing a lifetime cap on non-concessional contributions to super of $500,000. (Currently there is a $180,000 cap per annum and you can bring forward up to 2 years' worth in advance under certain circumstances)
- Reduce the current level of minimum withdrawals from pension by 25% to as much as 50% to allow members to decrease their drawdowns and improve the longevity of their superannuation pension.
- Have a uniform tax rate of 12% on earnings within both accumulation and pension accounts.
- Recommend a 20% rebate on marginal tax rates for concessional contributions. (This is similar to Recommendation 18 under the Henry Review).

Actions to consider before Budget Night

Superannuation remains the most tax effective investment structure available for most individuals and we believe it will remain that way. Nevertheless there is no doubt that the generous tax concessions currently available are under threat. Just in case the Government does decide to limit contributions and/or their tax deductibility, **we would recommend taking advantage of the existing contribution caps before Budget Night.** As a reminder, these limits are currently as follows:

Concessional Contribution Cap - year ending 30 June 2016

Age	FY2016
Under 50	$30,000
50+	$35,000

Note: Contributions are subject to specific rules. We recommend you seek advice before making any contribution.

Non-concessional Contribution Cap – year ending 30 June 2016

Age	FY2016
Under 65	$180,000 (note 1)
65+	$180,000

Note 1: Individuals under 65 years of age may be able to bring forward a further 2 years' worth of contributions (a total of $540,000 in one year). An individual who made a contribution of $540,000 in year 1 would not be able to make a further non-concessional contribution until year 4. Contributions are subject to specific rules. We recommend you seek advice before making any contribution.

Martin Fowler, Partner

The Madness of Negative Interest Rates

In parts of Europe (including Switzerland, Sweden and Denmark) and in Japan a strange phenomenon of negative interest rates has arisen. Central banks and some commercial banks are charging depositors to hold their funds (not just borrowers). Instead of receiving interest income, depositors are being charged as interest rates are less than zero. This phenomenon defies conventional wisdom and raises a number of questions, as follows;

1. **Why would someone deposit their money in a bank if they were being charged for the privilege?**
   There are several reasons why a depositor may be willing to accept less than zero interest (i.e. pay the bank). Firstly, there is the storage issues associated with holding physical cash. A bank account avoids the worry of having your cash stolen. Secondly, if inflation is less than the cash rate then your real rate of return is still positive (e.g. If inflation is negative 2% and the interest rate is negative 1% p.a. then the real, or inflation adjusted, rate of return is still 1% p.a.). Thirdly, currency speculators may not be so concerned about negative rates on deposits if they believe the exchange rate gains on currency translation more than offset the cost of the deposits.
2. **Why are rates negative in the first place?**
   Central Banks use interest rates as a tool to influence economic growth and control inflationary pressures. If growth is too strong and inflation is rising then central banks would usually increase interest rates. Higher interest rates typically discourage investment, reduce profits and disposable incomes, all of which act to slowdown the rate of growth. Lower rates usually have the opposite effect. However, despite low interest rates, the growth outcomes desired by a number of countries have not eventuated. Desperate times call for desperate measures. When everything else has failed central banks have resorted to unconventional methods to attempt to stimulate growth including quasi money printing (quantitative easing) and negative interest rates.
3. **Are negative interest rates good policy?**
   The true test of any policy is its effectiveness. The recent experiences would suggest that negative interest rates have helped devalue the currencies of the countries that have adopted this policy. A lower exchange rate has helped improve the competitiveness of their export industries but this alone has to date not been sufficient to ease deflationary pressures, encourage new investment and stimulate growth. Economic theory suggests that interest rate changes typically act with a lagged effect.

   It could be argued that insufficient time has elapsed to pass judgement on the success of negative rates. What is clear is that the longer negative rates are in place, potentially the more damage could be done. In the short term lower interest rates are typically a net positive for an economy as it can encourage investment and consumption. However, if individuals think low interest rates are likely to be a long term phenomenon then this can actually encourage greater savings (and far less spending) to compensate for the lower return.

   Example: A conservative individual (cash only investor) who wants to generate a $50,000 income stream would need to accumulate $1,000,000 if interest rates were at 5% p.a. If there was an expectation that rates were going to stay anchored at 1% p.a., then an individual would need to save $5,000,000 to generate the same $50,000 income stream.

The above example highlights the dangers of anchoring long term interest rate expectations at very low or even negative levels. A long term environment of high savings and low spending creates significant economic challenges. Higher savings implies lower consumption, lower corporate profits, lower growth and higher unemployment. Negative rates also destabilises the long-term model of banks, insurance companies and pension funds, among others. It is for these reasons that negative rate policies may well prove to be madness.

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