SMSF
Owners'
Alliance
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PRE-BUDGET SUBMISSION

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Contents

The SMSF Owners' Alliance Limited is a not-for-profit public company established to represent the interests of trustees and owners of Self-Managed Superannuation Funds (SMSFs). Whilst there are other organisations with similar interests and objectives, SMSFOA's distinction is that membership is strictly limited to the trustees and owners of SMSFs.

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1. Summary

In various submissions to the Federal Government over the last two years, we have set out our views of the issues facing Australia's superannuation system and the self-managed fund sector in particular. We have built a computer simulation model to assess the impact of changes in superannuation tax treatment and the Age Pension structure on this sector and all our observations and recommendations have been fully supported by such detailed modelling.

In our 2013 submission, we expressed strong concern regarding commentary by politicians, public servants and media suggesting that the Government had a "tax revenue" problem – implying that tax revenues were falling short and that more taxes needed to be raised. We submitted a graph discrediting these claims. It showed that the Government did not have a revenue problem. Instead it had a spending problem.

In response to the global financial crisis, the previous Labor Government, on the advice of Treasury, stimulated the economy by a cash handout to taxpayers and rapid spending on new programs (e.g. pink batts and school halls). While this spending may arguably have helped the Australian economy from slipping into a recession, the Government kept on spending at a rate even faster than the record amounts of revenue it was raising. The Government turned the $20 billion surplus it inherited in 2007 to a deficit of over $150 billion by the time it left office in 2013.

In terms of political philosophy it is generally accepted that a Labor Government believes – relative to a Liberal Government – that the Government can and should provide more services to look after Australians. On the other hand a Liberal Government generally believes that, while taking care of the genuinely needy, it should provide the framework and regulations in which society and business can operate effectively, together with the incentive and opportunity for Australians to become self-reliant.

The Labor approach inevitably requires more spending to provide more services to the people it believes need support. This involves raising taxes (now or in the future to repay extra borrowings) to fund the gap between revenue and expenditure. The Liberal approach is to try to get the budget into balance and ideally into a sustainable surplus.

These different approaches create a tension within national economic management, complicated by the positions taken by Senators who hold the balance of power. These Senators were elected by only a very small minority of voters and generally see themselves as representing small interest groups whose immediate objectives may not always sit well with solutions promoting the long-term economic sustainability of Australia. As a consequence, over time a cycle of deficits and surpluses develops involving politically difficult policy choices for Government.

It is surprising that many commentators appear not to appreciate that the operation of Government is generally a zero-sum game. Every dollar or service provided by the Government to a sector of the Australian population has to be paid for by someone – mainly through tax revenues – or someone else has to give up their Government service/benefit to pay for it. Alternatively, the Government borrows more to fund such services and benefits, which just defers the tax burden to future generations.

In this context, the current Government took the right approach in attempting to tackle the expenditure side of the retirement system in last year's Budget.

After last year's Budget, we wrote a research article about superannuation entitled "After the Budget Hysteria" in which we concluded, supported by our modelling, that the Budget proposals would, inter alia:

1. Narrow the retirement funding "gap";
2. Reduce – but not eliminate – the impact of existing contribution caps as a constraint on Australians achieving adequate superannuation savings; and
3. Increase projected lifetime tax payment receipts by the Government.

We concluded that:

"…the changes proposed in the 2014 Budget go a long way towards achieving a more sustainable superannuation system. Government Age Pension costs will be lower and tax receipts higher. Many more individual taxpayers will be able to retire independent of the Government.

The existing system of caps should not constrain most workers who are just commencing their working life from saving enough in super. However, older workers still have a problem unless the higher cap is indexed and workers with broken work patterns are disadvantaged unless a more flexible system of caps is introduced."

However, we are disappointed that Treasury and some parts of the media appear to believe that the current Government continues to have a tax revenue shortfall. This is untrue. Tax revenues may not be enough to cover expenditure but they are at or near historical highs.

The problem continues to be that the Government should spend less, not tax more.

The second section of this submission sets out information in support of this proposition.

Two years ago we also stated in our Pre-Budget submission that:

"Our view is that compulsory superannuation, supported by taxation incentives, has proved to be a very successful retirement savings model in Australia, though there remains room for further evolution of the system. Superannuation has grown into a sturdy pillar supporting the Australian economy. Within the broader superannuation spectrum, SMSFs have proved to be a very viable and popular vehicle for building retirement savings, attracting nearly one million Australians and growing by the day, to take direct responsibility for their welfare in retirement and the later stages of life. Official performance data indicate that the majority of SMSFs are managed in a prudent manner with sound investment strategies that have led them to perform as well or better than professionally managed funds."

Our opinions remain unchanged. We still believe that the system is fundamentally sound though improvements could be made.

However, we are disappointed that – two years further on – there remains a high degree of uncertainty regarding changes the Government may make to the system and, in particular, whether it will endeavour to raise more taxes from superannuation savings to meet a "perceived" tax revenue shortfall.

Such uncertainty erodes confidence and reduces the effectiveness of the taxation incentives that are in place for superannuation.

Section three of this submission summarises our view of superannuation and comments on some of the "myths" that appear to perpetuate regarding our superannuation system.

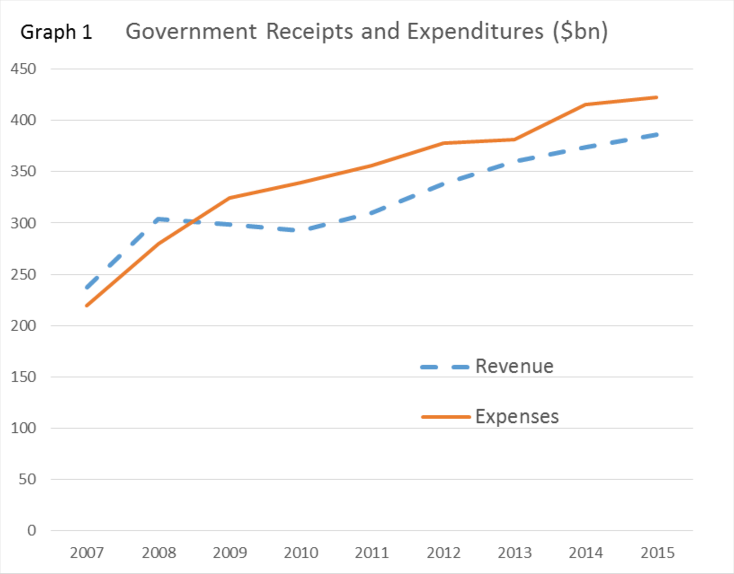
Finally, the last section of this submission covers our views of some related issues that have arisen as a result of the Financial System Inquiry headed by David Murray (FSI).

Whilst performing fairly well, the superannuation system could be improved to more successfully meet the objective of providing a reasonable, fully funded pension to almost all Australians in a sustainable way.

However, any such changes should be considered only as part of a global review of the long-term viability of the system. The impending Taxation White Paper is the most appropriate forum for such a review and not the next Budget. The recommendations of the White Paper, which should cover long-term structural reform of the tax system, should not be pre-empted by Budget decisions based on the perceived need to raise revenue to deal with an over-spending problem.

2. Governments should spend less not tax more

We repeat in Graph 1 below, an update of the graph we prepared two years ago showing Government income and expenses from 2007, extended up to and including the MYEFO estimates for 2014-15.



The dashed line shows Government tax and other revenue and the solid line shows Government expenditure, including the provision of such services as Social Security, Health and Education.

The Budget Papers frequently refer to Government revenue and expenses as a percentage of GDP. Whilst this measure can be a useful long-term benchmark, over-reliance on it can lead to poor policy decisions by encouraging overexpansion of Government expenditure and services in boom times. Government payments are notoriously difficult to reduce and if, in boom times, a Government increases expenditures to maintain its percentage of GDP, then in the inevitable subsequent slowdown it would find it difficult to wind-back such overblown expenditures.

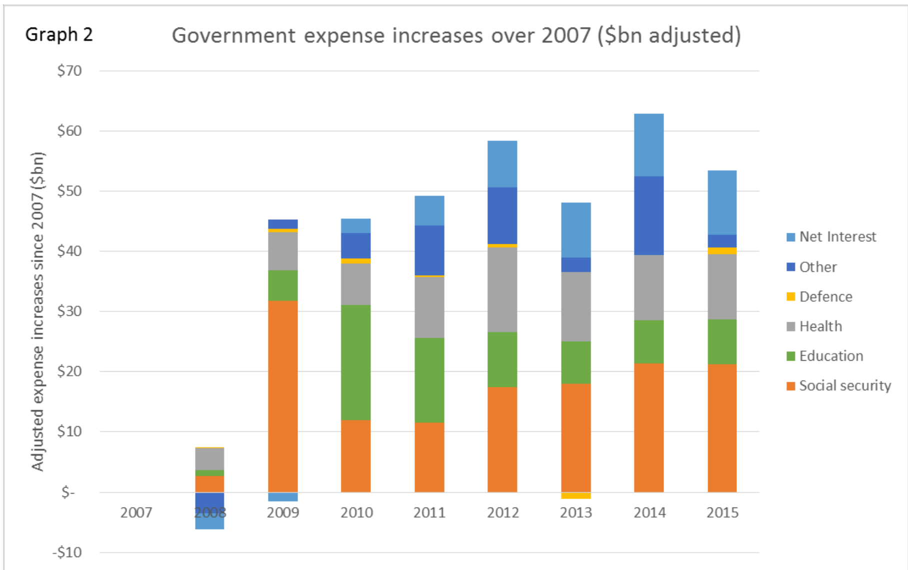
A more fundamental measure of Budget 'performance' such as benchmarking actual expenses against historical performance (after adjusted for inflation and population) should also be considered and reported.

The above graph illustrates the growth in both revenue and expenditure since 2007, a year in which at the time there were many complaints that the Government of the day had overspent. The reality is that both revenue and expenditure have grown strongly since 2007 to record highs.

In response to the global financial crisis, the previous Labor Government, on the advice of Treasury, stimulated the economy by a cash handout to taxpayers and rapid spending on new programs (e.g. pink batts and school halls). While this spending may arguably have helped the Australian economy from slipping into a recession, the Government then kept on spending at a rate even faster than the record amounts of revenue it was raising.

An immediate criticism of the above graph could be that it does not consider inflation, nor the fact that Australia's population in growing and thus placing additional demands on Government. Another very effective measure of budget performance would therefore be to simply compare expenditures with prior years after adjusting for inflation and also for increases in population.

Accordingly, in preparing the second graph (Graph 2 below) we have adjusted historical expenditures to be expressed in 2014-15 dollars and adjusted for increases in population. The increases in the resultant figures from 2007 are then graphed in $billions for Social Security, Health, Education, Defence and Other. We have also shown the Government's net interest expense separately.



This graph clearly illustrates how expenses blew out in 2009 and continued to grow. Although some reductions have been achieved in the current budget, expenditures remain substantially above the level in 2007 - when the Government of the day was criticised for over-spending. This graph also shows the dramatic impact of the Government's growing interest bill.

Income tax revenues are at an all-time high.

Despite the complaints by various interest groups, <u>the facts</u> are that expenditure on Health, Education and Social Security are substantially higher now than in 2007 – even after adjusting for increases in inflation and population.

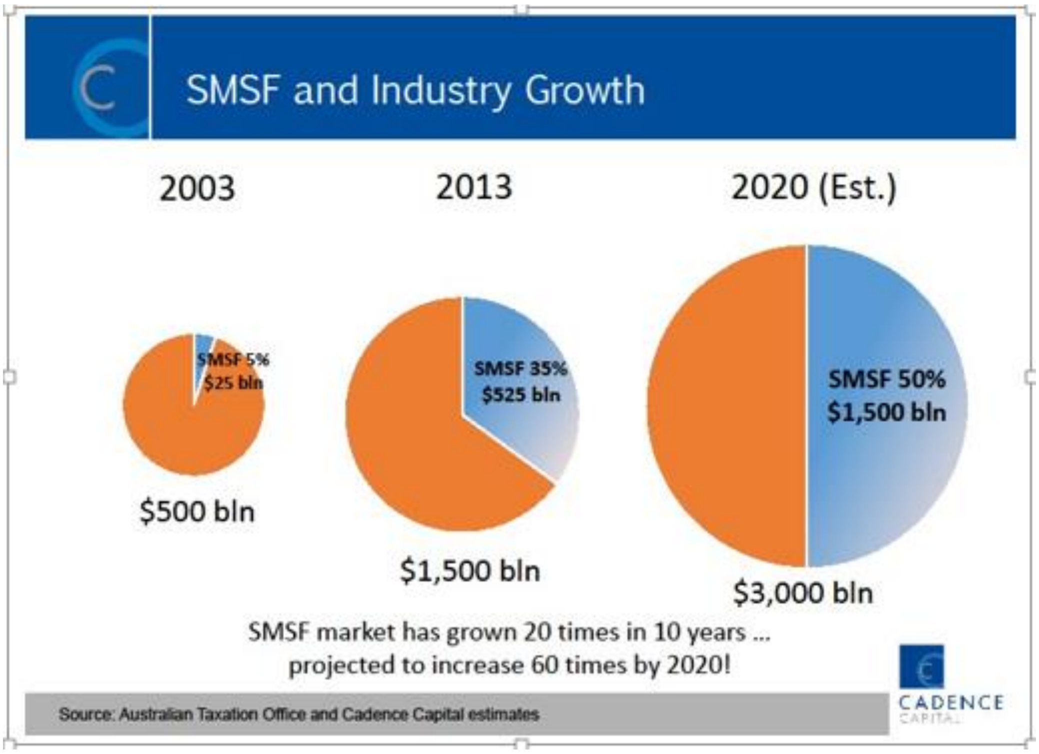
3. Dispelling the 'myths' about SMSFs

SMSF's have become the driving force in Australia's superannuation system. They hold the largest slice of all superannuation assets (31%) compared to retail funds (26%) and industry funds (20%) according to APRA's 2013 annual statistics.

And they are growing faster. In the five years to June 2013, the ATO reports SMSF assets grew by $175 billion accounting for more than half of the growth of the superannuation sector.

The seemingly inexorable rise of self-managed funds is the most striking dynamic of Australia's superannuation system. More so because the rise of self-managed superannuation has been driven by the choice and determination of individuals rather than by government policy direction.

As impressive as these numbers are, they are set to get a lot bigger. At a recent SMSFOA seminar, the CEO of a leading listed investment company, Cadence Capital, predicted that half of the superannuation pool would be held by SMSFs by 2020.



The dramatic success of self-managed funds is driven by the strong desire of the people who set them up to take control of their own retirement savings and make their own investment decisions.

And they mostly get those decisions right with a return on assets performance comparable to the returns achieved by the professional managers of retail and industry funds.

Other reasons for the popularity of SMSFs are the flexibility they allow to change investment mix easily and avoidance of the high fees charged by the large APRA-regulated funds.

Self-managed superannuation works because people take responsibility for building their own retirement savings. They take prudent investment decisions because it's their money and their future.

Self-managed funds are the only type of funds that have been successful in substantially realising the vision set for Australia's superannuation system - to enable people to make themselves financially independent in retirement and avoid reliance on the age pension.

Generally SMSF members are achieving this goal while the members of the large industry and retail funds are not. The average balance in a self-managed fund account is over $500,000 compared with average account balances in industry and retail funds of less than $30,000.

The higher balances in SMSFs result from people maximising their concessional and non-concessional contributions and from the returns generated by their assets. Yet self-managed superannuation is not just for the higher paid. ATO statistics show that 66% of SMSF members are on incomes of less than $80,000.

One important outcome of self-managed superannuation is enabling a generation of Australians to fund their retirement and old age within their own lifetime, instead of leaving a pension tab on the table for the next generation to pick up.

The fact that a million Australians, with more joining every day, are willing and capable or taking charge of their retirement savings, and doing a good job of it, is to be applauded.

However, the success of SMSFs is not lauded by everyone.

It's said that self-managed funds are driving up property values, distorting capital allocation, investing too conservatively, investing recklessly, straining the budget, getting an unfair tax advantage and are costly to run.

We challenge each of these claims as they are often driven by ideology, or self-interest or are just plain wrong.

Super is an unfair tax break

Take the claim that SMSFs are used to gain an unfair tax advantage, a claim with which Treasury appears to sympathise.

Members of self-managed funds are subject to exactly the same tax rules as members of managed funds.

Critics point out that the top 20% of income earners get the lion's share of super tax concessions but they don't always acknowledge that the top 20% also pay the lion's share of income tax. The FSI Report neglected to mention this very relevant fact. We discuss tax equity further in Section 4.3.

A progressive income tax system is used to re-distribute wealth in a fair and equitable manner. It does not follow that retirement incomes should also be taxed progressively. What people manage to save for their retirement, having paid tax throughout their working lives, is their money and should not be 're-distributed' to others who have not saved as much. Of course, higher income earners have the capacity to save more, but they also pay much more in tax along the way.

Super tax concessions cost too much

Take the claim that super tax concessions are an unsustainable drain on the budget.

The annual Tax Expenditures Statement which estimates the amount of revenue foregone by various tax incentives is used by some commentators to claim that superannuation tax concessions are costing the budget too much and should be reduced. A cost of $32 billion (based on the 2012 TES) is often quoted to illustrate the supposed cost to the budget. This is derived by wrongly adding the estimated value of the concessions on contributions and fund earnings. It is then claimed this is the measure of tax that could be raised if the super tax concessions were reduced or removed.

It is not.

If the tax concession on contributions was reduced, less money would flow into super, fund earnings would be lower and the revenue collected from earnings would be less. Further, because superannuation savings would be lower, there would be a greater call on the Age Pension funded off the budget.

We believe that Treasury now understand this issue. In our view, Treasury should therefore now clearly warn in the TES that the two elements of superannuation tax concessions can not be added together to estimate the cost to the budget. It should also be best practice for a report such as the TES to identify budget savings that result from a tax concession. Treasury's TES does not do this. It does not refer to the cost of the Age Pension that would result from any action taken to reduce or eliminate the effectiveness of the superannuation system.

Tax incentives to save for retirement are sensible policy because in the long run it's cheaper than paying out the Age Pension. If super tax incentives are reduced, less will be saved, fewer people will be financially independent and more will have to rely on a full or part taxpayer-funded pension.

The cost of running an SMSF

It's claimed SMSFs are too costly to run. It's true that a relatively low account balance in a self-managed fund will cost more to administer than one held in a managed fund. But above around $100,000, costs are comparable or much lower. Two thirds of self-managed funds have an operating expense ratio to assets of less than 1% and 40% have an expense ratio of less than 0.25%.

It is not just a question of cost. The main reason people set up self-managed funds is to take control of their savings and more are doing so relatively early in their working lives. They make a commitment to save and as they build their assets, the relative cost of running their fund comes down. They are being helped by the emergence of a range of low-cost, online fund management service providers.

The real cost issue in superannuation is the level of fees charged by the large industry and retail funds which are estimated to have consumed a quarter of these funds' returns in the past decade, a cost borne by their members.

SMSF investment fuels house prices

Another common criticism of SMSFs is that they drive up residential property prices through highly leveraged investment. But no hard evidence is presented to back up this claim. Very low interest rates and an inadequate supply of new housing are more likely fuelling house and apartment prices. SMSFs actually put quite a small proportion of their assets into residential property as we point out in Section 4.5.

SMSF are too cautious investors

It's said, usually by investment advisers, that SMSFs are too conservative in their asset allocation. In particular, they are missing out on better sharemarket performance overseas. It is true that SMSF trustees appear to be more conservative, evidenced by the large percentage of their portfolios (30%) invested in cash at a time of low interest rates; an equally large percentage (30%) invested in Australian shares and a very low proportion (0.39%) invested in international shares at a time when they are outperforming Australian share prices. Oddly, SMSF investors are still managing to deliver satisfactory returns. The latest ATO annual statistical report stated:

"In 2012–13, estimated return on assets for SMSFs was positive (10.5%), the highest over the five-year period, and in positive terms for the fourth consecutive year. The trend in estimated returns is consistent with that for APRA funds of more than four members." Self-managed funds – a statistical overview 2012-13, Australian Taxation Office.

ATO fund performance statistics show that over 5 years, with some ups and downs, SMSFs generally do as well as the large APRA-regulated funds.

SMSFs invest too much in blue chip shares and distort capital allocation by companies

SMSFs invest heavily in listed shares and favour companies that deliver franked dividends. As do other investors including the large industry and retail funds. SMSF trustees have a legal responsibility to manage their fund in the best interests of its beneficiaries. It makes sense for them to favour listed companies that deliver solid and dependable dividends on which tax has been paid.

It’s the responsibility of company directors to decide how profits are to be distributed and striking a balance between returns to shareholders and the capital needs of the company.

To conclude this section, it's important that Government policy decisions are based on reality and hard facts, are well-targeted and proportionate to the identified issue.

In considering the report of the Financial System Inquiry and, in due course, the forthcoming Tax White Paper, Treasury and the Government should reflect on the singular success of self-managed funds in achieving the objectives of the superannuation system, appreciate the motivation of people who set them up and recognise the social and economic benefits they deliver.

4. Issues arising from the Financial System Inquiry

There are some issues that arose as a result of the Financial System Inquiry (FSI) which impact the effectiveness of Australia's retirement system. These issues are properly addressed as part of the impending Taxation White Paper and not in the Budget. However, we cover them here for the record.

4.1. Superannuation system objectives

We agree with the observation in the FSI Final Report that the objectives of the superannuation system need to be clarified. It is strange that such a large and complex system, with a profound influence on the welfare of most Australians and the national economy has developed without an over-arching statement of purpose and objectives.

In particular, we agree that it would assist stability and confidence if the Government committed to a set of objectives and guiding principles with respect to our retirement system.

We would however caution against the Government introducing an overly prescriptive or simplistic approach to superannuation in the interests of protecting those who have no knowledge of or interest in establishing self-reliance through superannuation. Such an approach can disadvantage those in Australia who do have the capability and commitment to secure their financial independence in retirement and reduce their dependence on and cost to the Budget.

We note that the FSI supports the "3-pillar" structure of our superannuation system. Both the Henry and Cooper reviews suggested that such system should meet the following retirement objectives as proposed by the World Bank:

- Through a combination of compulsion and incentives allow most taxpayers to retire on a privately-funded pension at a reasonable Replacement Rate; and
- Provide a Government-funded pension only as a 'back-stop' for a minority of taxpayers who for whatever reason have been unable to achieve this objective.

The rationale for encouraging retirement savings with tax incentives was well expressed in Henry's 'Australia's Future Tax System' review:

"The essential reason for treating lifetime, long term savings more favourably is that income taxation creates a bias against savings, particularly long-term savings. Taxes on savings income, including the taxation of inflationary gains, can discriminate against taxpayers who choose to defer consumption and save. The longer the person saves and reinvests, the greater the implicit tax on future consumption….These individuals pay a higher lifetime tax bill than people with similar earnings who choose to save less."

The Replacement Rate is a widely accepted term meaning the pension as a proportion of a person's pre-retirement income or, as Henry put it, the Replacement Rate "compares a person's spending power before and after retirement." It is generally accepted internationally that in an equitable and advanced society taxpayers should expect to retire on a pension that bears a reasonable relationship to their income before retirement.

4.2. Limitations on superannuation

We agree that there need to be constraints to avoid abuse of tax concessions. At present there are constraints on contributions to superannuation. We do not necessarily agree that a fixed annual dollar contribution limit is equitable when dealing with people on different incomes trying to achieve funding for a pension at a reasonable Replacement Rate. However, if such constraints are to be retained there is an equity issue that needs to be addressed.

The existing system of annual dollar limits on contributions discriminates against women, the self-employed and others who may have broken or volatile work patterns during their working life.

We have previously proposed that the Government allows a system of "rolling" contributions caps, similar to the contribution limits that apply to non-concessional contributions. This would be fairer and assist women, self-employed and others with disrupted work patterns.

An alternative worthy of serious consideration is a lifetime AWE indexed contributions cap which would be more equitable.

4.3. Equity in superannuation

The FSI suggested that the existing system of tax concessions favoured high income earners who would in any event be "likely to have saved sufficiently for their retirement, even in the absence of compulsory superannuation or tax concessions." However, there is no evidence presented to support the FSI's observation and we would dispute it.

The fundamental purpose of the superannuation system is, or should be, to enable as many Australians as possible to be financially independent in retirement and enjoy a standard of living based on the widely accepted concept of a Replacement Rate (see 4.1). Those who achieve this goal will not be a burden on the Age Pension budget.

Our modelling has shown that "spending" a dollar on superannuation tax concessions is a more effective use of Government funds that paying out an Age Pension. The former encourages taxpayers to forego consumption during their working life in order to provide for their retirement. Most of the funds in superannuation are an individual's contributions. The tax concession comprises only approximately 10% of a superannuation-sourced pension, whereas the Government pays 100% of an Age Pension. An efficient superannuation system makes economic sense.

Even if there was a flat income tax rate, Australians on higher incomes would contribute more in income taxes to support those on lower incomes. The combination of our progressive rate income tax system and welfare structure exaggerates this to a dramatic extent.

However, the retirement system should not be another mechanism for redistribution of wealth in addition to existing transfer mechanisms, notably income tax and social welfare payments.

The reality is that although the dollar benefit of the tax concession on higher income earners is higher than the dollar benefit to others, this is because they are paying more tax! Even after the tax concession, those on higher incomes are still paying a higher rate of tax and therefore substantially higher actual tax dollars than those on lower income. It is no different to saying that the benefit of a tax deduction to someone on a higher marginal tax rate is worth more than the same deduction for someone on a lower marginal tax rate.

Taxation statistics show that the 16.7% of taxpayers who earn more than $80,000 pay 63.6% of the income tax paid by Australians. The 83.2% who earn less than $80,000 pay 36.5% of income tax. The top 2.3% of taxpayers who earn more than $180,000 pay 26.2% of income tax. These figure are <u>after</u> taking into account tax concessions. Source*: ATO Taxation Statistics 2011-12*

One of the issues with our tax and welfare system is that most Australians do not pay any tax net of welfare. They are net recipients of welfare funded by the higher earning taxpayers.

The FSI Report showed that the top two deciles of income earners receive about 57% of total superannuation tax concessions. To present a more balanced picture, it should be pointed out that the top two deciles of income earners pay 64% of income tax revenue. That is, they more than pay their way as their level of super tax concession is actually lower than the proportion of the total income tax which they pay, as we have pointed out in previous reports and elsewhere in this submission.

The ATO statistics clearly show that top 20% of income earners get a share of superannuation tax concessions that is proportionally <u>less</u> than the share of income tax they pay.

It seems entirely logical and fair that the people who pay the largest share of income tax also, as a consequence, get the largest dollar share of superannuation tax concessions even if a lower percentage and is misleading to suggest this is inequitable.

We can illustrate our point that the 'rich' are not benefiting unfairly from superannuation tax concessions by looking at two typical scenarios we published in an earlier Research Paper.
(Refer SMSFOA Research Paper: *After the Budget Hysteria – July 2014* at:
http://www.smsfoa.org.au/images/advocacy_2014/140703_SMSFOA_After_the_Budget_Hysteria.pdf

> Bob is 30 years old and on average earnings. When he retires at 70 he will have paid a total of $1.8m in taxes over his working lifetime after taking into account the $276,000 in superannuation tax concessions he has received whilst contributing into super at the SG level. Although he will have nearly $2m in superannuation on retirement, he will immediately become eligible for part-Age Pension and receive $2.1m in pension welfare during his retirement. Note that not only is his welfare greater than his tax concession, it is also greater than his lifetime tax payments.
>
> This modelling assumes that the planned 2014 Federal Budget changes, and particularly the increase in the pension age to 70, are all implemented. Under the Pre-Budget assumptions Bob would have cost the Federal Government even more in Age Pension.
>
> The partial Age Pension would not only have been significantly higher but he would have run out of his superannuation towards the end of retirement and be forced onto a full Age Pension.
>
> Bob can be compared to Tom, a 30 year-old who is earning three times average earnings. When he retires at 70 he will have paid a total of $8.2million in taxes over his working life after taking into account tax concessions of over $1million. He will be able to fully support himself in his retirement and takes no Government support.
>
> His tax concession is substantially less than the welfare payments and tax concessions paid to Bob who makes no net payment for Government services.

So yes…Tom's tax concession is larger (nearly four times Bob's) but it is less than Bob receives in part-pension payments. Significantly, Tom makes a total contribution to the Federal Government budget of $8.2m which not only pays for Government services but helps pay the shortfall in Bob's Age Pension not covered by his own tax payments.

Without that tax revenue from the higher paid, the Federal Government would not be able to function and maintain welfare payments to those who genuinely need support.

So what is "fair and equitable"? Whatever it is, it has to be viewed from a "whole of life/whole of cost/benefit" basis per person, not just one measure of "superannuation tax concession."

4.4. Dividend imputation

Dividend imputation was introduced, correctly in our view, to eliminate double taxation of corporate profits and remove the distortion that this would otherwise cause in the markets.

It is incorrect to suggest the bond market is disadvantaged because interest payments (coupons) on bonds do not carry tax credits. It ignores the fact that interest payments on bonds are deductible to the issuing corporations, whereas dividends are not, so that the tax impact on cost of capital is neutral with imputation and would be distorted without it.

It is true that imputation encourages investment by Australian taxpayers in domestic equities rather than investment in corporations based in other tax regimes that do not provide a full credit available to Australian taxpayers. However, this is a distortion caused by imperfections in our various tax-treaty arrangements and because we are not allowing a tax credit for tax paid in such countries rather than due to our imputation system.

It is also incorrect to suggest that the availability of imputation credits to superannuation funds may erode a valuable source of Government revenue over time. If the source of revenue referred to is corporation tax receipts then this suggests a misunderstanding of how the imputation system works in aggregate.

With respect to Australian taxpayers, if it is assumed that all taxed income is distributed over time to shareholders or unit holders, then the only relevant income tax rate is the individual one. From this viewpoint, raising or lowering the corporate tax rate does not change the tax raised by the Government because of imputation. Lowering the corporate tax rate benefits foreign shareholders of Australian companies and thus may attract more investment into this country. The Federal Government's tax receipts from corporations tax is irrelevant.

We would agree that the existence of imputation may bias rational investment towards domestic equities and that may be why SMSF's largest investment category is Australian equities. We would also argue that a high holding of domestic equities – earning over the long term a positive real rate of return and essentially an investment in the Australian economy – provides SMSF beneficiaries with a natural hedge against their retirement expenditure which in most cases would be substantially in Australia and subject to Australian inflation and cost pressures.

We do not agree that the refunding of imputation credits to superannuation funds is a benefit. It is merely refunding tax that has been paid by corporations so that the only relevant tax rate is that of the investor in a corporation's shares. Removing this credit would distort and damage the equity market in that corporation's earnings (dividends) would be paid out of corporate after-tax earnings but interest and coupons payments would be deductible to a corporation with no consequential taxation in a pension superannuation fund. However, we would not agree that a bias towards equities is the sole or even the most important impediment to the development of a retail bond market in Australia as suggested in the FSI report.

On balance, imputation can be considered to be contributing to the development of a strong domestic funding base for our industry and its removal would cause considerably more distortion by re-introducing double taxation and the bias in favour of debt funding.

4.5 Leverage

The FSI recommended that borrowing by superannuation funds via Limited Recourse Borrowing Arrangements (LBRAs) to purchase assets directly should no longer be allowed. In effect, this would apply only to SMSFs, who have the capacity to borrow.

The FSI was concerned that borrowing by super funds would, over time, increase risk in the financial system and that trustees might be forced to sell other assets in the fund to repay lenders, particularly if the loans were covered by personal guarantees. The FSI also noted that the largely unleveraged nature of the superannuation system is an economic stabiliser in global downturns.

We acknowledge these concerns while noting that the issue should be kept in proportion – relatively few SMSFs are geared via LBRAs and the proportion of total superannuation assets covered by LRBAs is tiny.

The latest ATO annual statistical report on SMSFs (2012-13) gives, for the first time, a breakdown of LRBA asset allocations.

Residential property borrowing by SMSFs amounts to $3.4bn or 0.70% of total SMSF assets and 1.38% of SMSFs have a LBRA for residential property.

Non-residential (commercial/industrial) borrowing amounts to $3.9bn or 0.79% of total assets and 0.75% of SMSFs have a LBRA for non-residential property. The average borrowing is $1.03 million.

Borrowing for shares is also relatively small - $420 million in total or 0.08% of total SMSF assets and only 0.01% of SMSFs borrow to buy Australian shares.

In terms of overall investment in property, the ATO's latest annual superannuation statistics show that investment in non-residential (commercial & industrial) property is over three times larger ($58 billion) than in residential property ($17.5 billion). It can be assumed that many of these non-residential properties are related to the business of the SMSF trustees. It makes sense for business owners to be paying rent to their SMSF and building assets in their fund.

The proportion of SMSF residential property assets has held steady at around 3.5% of total assets for the past five years.

Borrowing by SMSFs to purchase property, particularly commercial and industrial, can be a sensible investment decision if the relativities between the value of the asset, rental income and the cost of the loan make it viable over time. Given the constraints on voluntary contributions, borrowing is one way people can build assets in their fund, particularly for late starters.

Instead of a blanket ban on LRBAs, the Government should consider imposing a limit. We suggest borrowings should not exceed 50% of the assets of the fund.

The Government, via APRA, can also encourage lenders to follow conservative credit policies when lending to superannuation funds.

Concerns about property spruikers encouraging people to set up an SMSF in order to purchase a leveraged property asset are part of a wider problem of inappropriate advice and high pressure selling which should be tackled through official regulation, self-regulation and effective supervision of investment advisers and property agents. We note that ASIC has recently taken court action against a property promoter and applaud ASIC's crackdown on unscrupulous advisers and agents giving dubious advice.

Our views on this issue are based on the principle that SMSF owners take responsibility for their own investment decisions and should not be unreasonably or arbitrarily constrained in their choice of assets.