The Final Frontier: Non-occupational retirement funding taxation in Australia: hidden equity with occupational retirement funding taxation

Gordon D Mackenzie

Abstract

The Australian Taxation laws now formally recognise retirement funding outside occupational superannuation by giving significant tax incentives to business owners to use the proceeds from the sale of their business to fund their retirement.

At first glance, the maximum tax concessions available to this cohort of taxpayers (up to $6M tax free) seem to breach principles of equity, when considered with the maximum tax concessions that are available to taxpayers under the occupational superannuation retirement funding system (where maximum tax concessions are capped using a fixed dollar contribution level over a person’s lifetime).

But, indeed, is there a breach of the principles of equity?

This paper surveys the tax rules of both non-occupational retirement funding and occupational superannuation retirement funding to determine whether the principle of equity between these two cohorts is breached.

INTRODUCTION

The Australian retirement income system is largely occupational based, principally driven by compulsion on employers to contribute to the superannuation fund of their employees and, consequently, most of the focus on how retirement funding is taxed has been on the taxation of employee superannuation arrangements. There has, to date, been very little focus on the way that non-occupational retirement funding is taxed. In this context, non-occupational retirement funding refers to the way that business owners fund their retirement incomes and, in particular, small business owners.

This paper first reviews the way that occupational retirement funding is taxed and, secondly, how non-occupational retirement funding, using the case of small business owners, is taxed. It then compares the two and identifies five differences in the way that each is taxed that clearly favour the taxation of non-occupational retirement funding over occupational retirement funding and, finally, the paper asks the question of how these differences are justified.

* B Sc LLb (Mon) LLM (Syd) Grad Dip. Securities Analysis F Fin FTIA Senior Lecturer Atax Faculty of Law UNSW. With many thanks to Maureen Noonan, a current student in the Masters by Research program at Atax in the Faculty of Law at UNSW, for valuable comments and assistance with early drafts of this paper. In particular, for very useful insights into the taxation of retirement funding for business owners and how equity between employees and business owners should be measured.
What the paper demonstrates is that small business owners have access to taxation concessions for retirement funding on exactly the same terms as employees and, in addition to that, small business owners have access to CGT tax concessions that are used to shelter from tax profits the disposal of their business assets, and these profits can be used to fund their retirement.

There is now even more favourable (to small business owners) integration between these two types of retirement funding tax concessions than had previously been the case.

Most importantly, the value of those CGT retirement funding tax concessions are significantly greater than the retirement funding concessions that are available to employees.

In addition to the ability to replicate employee retirement funding and the difference in value of the tax concessions, small business owners are preferred, compared with employees, in other retirement funding areas such as:

- Access to their retirement funding, such as the ability to use otherwise dedicated retirement funding assets in their business,
- Better ability to share tax concessions with spouses, and
- The benefit of deferring the tax liability, which facilitates more efficient accumulation.

**EMPLOYEES OR SMALL BUSINESS OWNER**

It is only very recently that a separate class of small business owner taxpayer has been formally recognised in the Australian tax legislation through introduction of a definition of Small Business Entity (SBE). This group of taxpayers is defined in terms of their turnover and, broadly, includes taxpayers who are carrying on a business with a turnover of less than $2m in a year. This group of taxpayers is entitled to tax concessions under the Small Business CGT rules (CGT rules).

Other small business owners than SBE can also benefit from the CGT rules. These include those taxpayers who are individuals owning assets that are used in carrying on a business the value of which is below a certain amount, as well as satisfying defined ownership structures, usually where the ultimate owners are the individual and a spouse.

So, for the purposes of this paper, small business owners are defined as taxpayers who come within those who are able to take advantage of the small business CGT concessions.

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1 See Division 128 Income Tax assessment act 1997
2 Division 152 Income Tax Assessment Act 1997
With respect to the second group of taxpayers being considered in this paper, there are several definitions of “employee” for various purposes of the tax law.\(^3\)

However, a challenge is presented in respect of the definition of employee when what is being discussed are the differences between employee retirement funding tax and that for small business owners because, as will be demonstrated further in the paper, small business owners can also take on the characteristics of an employee for tax purposes.

So, to resolve that challenge, for the purposes of this paper an ‘employee’ is taken to be an individual solely in receipt of salary and wages, and who is not also carrying on a business or otherwise the owner of a business.

**TAXATION OF EMPLOYEE RETIREMENT FUNDING**

Employees fund their retirement through contributions to, and accumulations in, a superannuation fund and this Part of the paper discusses how superannuation funds for employees are taxed.

**Taxation of contributions and earnings**

There are limits placed on the amount of annual contributions that can be made in respect of a member of a superannuation fund. There are broadly two classes of contributions, being concessional and non-concessional contributions, the difference between them being whether they are assessable to the fund or not and there are different limits depending on the type of contribution.\(^4\) In turn, assessability to the fund depends on, very broadly, whether the contributor has received a tax deduction for the contribution.\(^5\)

Amounts in excess of these limits incur additional tax, which, in effect, brings the aggregate tax liability on the contribution to the highest marginal tax rate and the liability is that of the member, not the fund.

From 1 July 2009 the maximum concessional contribution, before additional tax is payable, will be $25,000 pa, with transitional arrangements applying to taxpayers over age 50, until 2012.\(^6\)

Funds held in a complying superannuation fund are taxed on income at an overall rate of approximately 15% if an employee uses and accesses their superannuation in line with the framework which implements this policy. This comes about because contributions are taxed at 15% (if a deduction has been claimed by the employer for the superannuation guarantee), and fund income is taxed at 15%. If the fund invests in Australian shares which pay franked dividends, the tax rate on fund income can be

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\(^3\) See for example, Schd. 1 *Taxation Administration Act* and TR 2000/4, as well as s12 *Superannuation Guarantee (Administration) Act* 1992.

\(^4\) Division 292 ITAA97

\(^5\) Division 295 ITAA97

\(^6\) 2009 Federal Budget
reduced below 15%. Once a fund is in pension mode the income or capital gain on assets supporting that pension is 0% taxed.

A one third discount is available for capital gains held by the fund for more than 12 months.

Certain funds are not taxed on contributions or earnings, due to a prohibition in the Australian Constitution. These are funds operated by State or Federal Governments and usually cover public servants. To even things up, benefits paid from such funds are taxed in ways meant to approximate the same overall rate as other funds.

**Taxation of Benefits**

The taxation of benefits depends on several factors including the age the benefit is received at, whether the fund has paid tax or not and if the benefit is a lump sum or pension benefit.

If a person is over 60 when drawdown of accumulated benefits is made, they are non-assessable, exempt income if paid from a fund that has paid tax. In other words, there is 0% tax payable on those benefits.7

If a person is over the preservation age but less than 60, then a lump sum withdrawal from a fund that has paid tax of an amount up to the low rate amount ($145,000 in 2009) is taxed at 0% and any amount above that at 15%. A pension is assessable at the taxpayers marginal rate but with an offset of 15%.

A lump sum withdrawal paid from a taxed superannuation fund below the member’s preservation age is assessable at the taxpayer’s marginal rate but with an offset so that there is a maximum 20% tax paid on the relevant amount. A pension paid in similar circumstances is fully assessable with no offset, unless disablement applies.8

Lump sum benefits paid from funds that have not paid tax are taxed at 15% if received after age 60. Pensions paid in those circumstances are entitled to a 10% rebate.

Lump sums paid before age 60 but above the preservation are 15% taxed up to $140,000 and 30% on the balance up to $1M.

As with all forms of saving, the greatest benefits accumulate over a period of time due to the compounding effect. Modeling done by the Australian Treasury is based on accumulation over 35 years\(^9\). An employee who remains consistently employed for such a working lifetime period can build a reasonable amount\(^{10}\) to fund retirement for a

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7 Whether drawn as a lump sum or a pension.
8 See 301-40 ITAA97
10 Reasonable in this sense meaning a multiple of ordinary average earnings
certain period, or at least to supplement lifestyle on the Age Pension. All the better if salary and benefits consistently increase over that period.

There are, of course, a lot of people who do not work consistently for 35 years. These include substantial sections of the population who perform work outside the paid workforce, or only occasionally, have uneven remuneration patterns, work part –time or work for less than 35 years\(^\text{11}\). Some people work longer than 35 years, but in poorly paid positions with little chance to build adequate retirement funds. In addition, as the Superannuation Guarantee and the existing superannuation regime have been in existence for half that time, there are baby boomers in or nearing retirement age who have only had the benefit of the Superannuation Guarantee for a short time.

There are other assumptions in models used, such as consistent rates of return and economic conditions that are questionable, but comment on which is outside the scope of this paper.

**Transition to retirement benefits**

With the transition to retirement window, a person who is 55 but intending to retire at 60 may continue to work and contribute to their superannuation, while drawing down on a pension from their superannuation and end up with more than they started with. If their income is sufficient to permit an arbitrage of tax rates, the result can be attractive.

If we use the previous example, the person is 55, intending to retire at 60, with a current superannuation account of $300,000, earning $100,000 gross salary per annum, presently receiving the 9% superannuation guarantee and making no voluntary contributions or salary sacrifice. Using one of the many calculators provided by financial planners\(^\text{12}\) if this person salary sacrificed $18,846.15 and drew down $15,000 as a pension from their superannuation fund, they would end up with the same net income, but an additional $1,019.23 in super in year 1 and $12,232.57 at age 60 than without using the transition to retirement strategy.

**Self Managed Superannuation Funds**

Individuals or groups of 4 or less (e.g. families, business partners) are free to establish Self Managed Superannuation Funds.\(^\text{13}\) The fact that 31.5% of all superannuation assets are held by such entities may mean that a lot of people like to manage their own money. It would be interesting to know the profile of persons who have established SMSFs, i.e. whether they are employees, self-employed, small business operators or investors and their reasons for doing so, as this could affect policy choices in future.

These individuals or families are then in charge of their own investment strategies and may have more incentive to contribute. This is particularly suitable to a confident

\(^{11}\) Such groups include homemakers, carers, new migrants, the long term unemployed, disadvantaged and the disabled.


\(^{13}\) S17A SIS Act
individual who is inclined to plan and save voluntarily by way of productive investment, due to the synergies between that and self management of superannuation savings.

Their SMSF can become a family investment fund; a type of family trust with certain estate planning possibilities.

**Access to retirement funds**

Prudential regulation of superannuation funds contain rules that prevent employees directly or indirectly gaining access to accumulated funds prior to permitted release events occurring, such as retirement or death. ¹⁴

The policy behind these rules is self-evident in that the purpose of granting tax concessions for accumulating in a superannuation fund would be defeated if that could be accessed other than during retirement.

Yet, the broad effect of these rules is to lock-in the funding until the employee has reached a certain age, at which time it can be drawn down.

However, as will be demonstrated further, this lock-in effect comes at a cost to the employee in terms of what they could have done with the funds had it not been in a superannuation fund.

**Multiple taxation**

One particular aspect adding to the complexity in taxation of superannuation is the essential multi-stage taxation basis. Prior to 1988, when income from superannuation fund accumulations (contributions and earnings) were not taxable, lump sum benefits (not otherwise concessionally taxed, such as death benefits) up to the low rate threshold were taxed at 15% and above that threshold level were taxed at the standard rate of taxation (30%) on receipt.

However, when superannuation fund accumulations became taxable on 1 July 1988 they were taxed at half the standard rate, rather than at the standard rate. To compensate for advancing half the tax otherwise payable on benefit payments, the tax on benefits payments was reduced. In that case, lump sum benefits below the threshold became tax free and amounts in excess of that taxed at 15%. (Or 20% if received by a member less than age 55).

¹⁴ Part 6 SIS Act 1993 For example, trustees of superannuation funds are prohibited from lending or providing ‘financial assistance’ to employees. Also, trustees are prohibited from buying assets from members, except listed securities at market value and certain other exceptions. There are also restrictions on such retirement funds being used to finance the employer that is contributing to the fund. Clearly, these rules are intended to prevent tax abuse by the employer, where the fund is used to generate tax deductions and as finance for the employer, but they also prevent double risk to the employees. That is, the retirement funds should not be at risk if the employer collapses thereby causing the employee to lose their employment and, also, their retirement funds.
The rates of tax on benefits remained the same where lump sum benefits were sourced from income that had not been taxed in this way.

Effectively, for lump sum benefits half the tax at the standard rate was collected by taxing the fund, which includes taxation of otherwise redirected employment remuneration and accumulated earnings, and the balance collected when benefits were paid.\(^{15}\)

As argued below, advancing half the tax dilutes the value of deferral and, consequently, disadvantages this form of retirement funding compared with other forms.\(^{16}\)

For income stream benefits, income of the fund is exempt from tax but taxed at the individual’s marginal tax rate below age 60. Where a fund has paid tax, the income stream recipient is compensated with a rebate of 15%.

**TAXATION OF SMALL BUSINESS OWNER RETIREMENT FUNDING**

The small business owner is in the enviable position of being able to choose one or more tax preferred retirement funding strategies.

They can make personal tax deductible contributions to a superannuation fund and, in addition, they can, in most cases, organise their affairs to come within the same retirement funding tax concessions that are available to employees (employee superannuation). In addition, there are the CGT concessions.

Taxation of employee superannuation has been discussed previously so, as small business owners can structure themselves to achieve these identical tax outcomes (employee superannuation), the taxation of that will not be reiterated here.

In that case, this part of the paper reviews the taxation of retirement funding for the small business owner from the CGT concessions on disposal of the business.

**Funding retirement through CGT concessions**

This part of the paper explains the CGT concessions available to the small business owner on sale of the business as a form of retirement funding.\(^{17}\)

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\(^{15}\) Of course, from 1 July 2007 no further tax is paid on benefits paid after age 60, either as a pension or lump sum, form a fund that has paid tax, which means that the net tax payable on the benefit is 15%. Further complexity, both in terms of calculation and administration, was introduced by the contributions surcharge that was abolished in respect of contributions made on and after 1 July 2005. *Superannuation Contributions Tax (Assessment and Collection) Act 1997.*

\(^{16}\) Yet another complexity of taxation of superannuation is the special tax treatment given to benefit payments in certain circumstances. For example, benefits paid on death up to a certain level and to individuals coming within a certain class (dependent), are tax free. As are certain amounts paid on redundancy, from certain early retirement funds and the future service part of payments made on retirement caused by ill heath. All these concessions recognise Government policy of not taxing death or invalidity payments and, in the case of approved early retirement funds, that certain types of employment have such demanding physical requirements that age 65 is not a realistic retirement age, such as for airline pilots, for example.
Those CGT concessions are available to a small business owner carrying on the business in their own right and also extend, subject to certain ownership requirements, to the sale of a business carried on through a trust or company.\textsuperscript{18}

**Overview of CGT concessions**

There are four concessions, which are in addition to the generally available discount for capital gains, each of which is generally described as;

1. the 15 year exemption
2. the 50\% reduction
3. the retirement concession, and
4. roll over.\textsuperscript{19}

The format of the CGT Concessions is to articulate three rules (called Basic Conditions for Relief) that apply to each of the four concessions, then describe each of the specific requirements that must be met for the specific concession to apply.\textsuperscript{20} Detail of each of these is contained in Appendix A.

**Basic conditions for relief**

The three basic conditions for relief are:

- First that a CGT event, within the meaning of that term in the CGT rules, happens and that event would otherwise have resulted in a capital gain.\textsuperscript{21}
- Secondly, that the taxpayer is either a Small business Entity or the maximum net value of the assets (‘NAV’) of the taxpayer, including assets which are brought within

\textsuperscript{17} Div 152 Part3-3 **ITAA97**.
\textsuperscript{18} Access to the CGT concessions does not necessarily require that a business be sold or otherwise disposed of. The CGT concessions are available on other CGT events happening than just a disposal. However, retirement funding by a small business owner is usually achieved by sale of the business. Therefore, the focus of the paper is on sale of the business to access the CGT concessions, rather than any of the other CGT events that are available.
\textsuperscript{19} S152-1 **ITAA97**.
\textsuperscript{20} S152-5 **ITAA97** Also, these rules come with a ‘road map’ about how they relate to each other which shows how best to apply these rules to maximise their value by application of the concessions in the optimal order. Obviously, if the first concession, being the 15 year exemption, is used then there is no need for any further application, as all the gain is exempt.

As already noted, the 50\% reduction can be used in addition to the general 50\% reduction where that is available. The balance of the otherwise taxable gain can then be dealt with under either the retirement concession or the roll over concession or both, to further reduce the taxable gain.

Alternatively, the small business owner could not choose the 50\% reduction but use the retirement exemption instead. This is recommended when a company or trust could make a larger tax free retirement payment under the retirement exemption due to inefficiencies of repatriation of non taxed gains to shareholders, mentioned above.

\textsuperscript{21} S152-10 (b) **ITAA97** The only CGT Event considered here is a disposal by sale.
that calculation by the grouping rules, is less than $6M,\textsuperscript{22}
and
\begin{itemize}
\item Finally, the asset the subject of the CGT event comes within the definition of ‘active asset’.\textsuperscript{23}
\end{itemize}

Those Basic Conditions have a number of effects.

First, they put a cap on the value of the assets (the NAV) of the business that can access the concessions.\textsuperscript{24} That cap is a net value of $6M of assets, which includes assets brought in by the grouping rules, which are explained below.

However, if a capitalisation rate of, say, 7% is assumed, these concessions are available to a business potentially generating $420,000 pa of income.

Of course, a more realistic capitalisation rate for a small business may be in the band 12%-15%, which would mean that a business generating between $720,000 and $900,000 pa of income would be able to access the CGT concessions. So, perhaps the subtitle in the tax law for these rules as “Small Business Relief” is a misnomer.\textsuperscript{25}

The second effect of the Basic Conditions is to limit the concessions to gains from assets that are used in a business and this is achieved by limiting the concessions to assets coming within the definition of ‘active assets’.\textsuperscript{26}

Active assets are defined as those used or held ready for use in the course of carrying on the business, intangible assets ‘inherently connected’ with the business and assets of related parties, which includes controlled companies and trust, and relatives, used in the business.\textsuperscript{27}

Specifically excluded are financial assets such as shares and loans.\textsuperscript{28}

The second and third of these Basic Conditions require some further explanation

The maximum NAV calculation for individuals claiming the concession includes assets owned directly by the taxpayer and of certain third parties (affiliates and entities connected with the taxpayer) but what is interesting about these rules is the list of assets that are excluded from the NAV calculation.

\textsuperscript{22} S152-10(c).
\textsuperscript{23} S152-10 (d).
\textsuperscript{24} In fact, if the taxpayer comes within the definition of Small Business Entity, which is a turnover test, the $6m NAV test does not apply. That means that, in certain circumstances, the gain on assets in excess of $6m are entitled to the concessions.
\textsuperscript{25} Division 152-Small Business Relief \textit{ITAA97}.
\textsuperscript{26} S152-40 \textit{ITAA97}.
\textsuperscript{27} S 152-40 (1) (b) & (c) \textit{ITAA97}.
\textsuperscript{28} S 152-40(4) \textit{ITAA97}.
Specifically, personal use assets and residential property are excluded where the relevant entity is an individual and that is what you would expect where what is being measured are business assets.\(^{29}\)

More to the point is that also excluded are interests in retirement funding assets such as annuities and superannuation fund interests.\(^{30}\)

Therefore, the NAV maximum of $6M is in addition to other retirement funding, such as through superannuation fund, for example. So, where the CGT concessions, both expressly and implicitly, recognise that the disposal of the business is itself retirement funding, there is a clear lack of integration by exclusion of other retirement funding assets from the NAV calculation.

Secondly, the NAV calculation ignores certain assets such as a life insurance policy and a private residence.\(^{31}\)

It is not difficult to see that a person could borrow moneys to increase the liabilities of the business and use the borrowings to acquire a relatively risk free life insurance policy or, indeed, upgrade a residence. The net effect being to increase liabilities but not the assets included in the NAV calculation. Of course, that would be relevant where otherwise the NAV limit would have been breached.

**COMPARISON**

A direct comparison between the tax concessions for employees and small business owners retirement funding is challenging primarily because, as already mentioned, they can overlap. That is, the small business owner is usually able to arrange their affairs to access the tax concessions for employee retirement funding, although the reverse is not true. Indeed, it is this ability to replicate employee superannuation that throws up one of the inequities discussed below.

**Maximum tax concessions**

Nevertheless, the most striking difference between the two systems for taxing retirement funding is the maximum amount of tax concessions that are available to each.

In the case of an employee funding retirement through a superannuation fund the maximum amount that is taxed concessionally that can be paid from a superannuation fund is capped by the amount of concessional contributions that can be made to the fund. (Non-concessional contributions are ignored as it is assumed that they would be post tax amounts.) From 1 July 2009 that limit is $25,000 pa (indexed) with a transition cap of $50,000 pa for taxpayers over age 50, until the 2012 income year.

\(^{29}\) S152-20 (2)(b)(I) & (ii) ITAA97.
\(^{30}\) S152-20 (2)(b)(ii) ITAA97.
\(^{31}\) S152-20 (2)(v) ITAA97.
On the most generous assumptions of having disposable income over a working life of an amount sufficient to make the maximum concessional contribution (ignoring indexation) and a working life (uninterrupted) of 40 years, the maximum concessional contributions would be $1M. Of course, the actual net amount accumulated would be 85% of that by reason of the 15% tax on those contributions in the fund.

If you take into account the compounding effect of the contributions investment, at a 5% return the benefit would be $2.7m and if paid from a taxed fund over 60, no further tax would be payable.

On the other hand, a small business owner funding retirement through the sale of business assets, assuming the most favourable circumstances apply, is entitled to complete exemption from tax on an otherwise taxable gain of $6M.32

With respect to non-concessional contributions (broadly, contributions that have not been tax deductible), employees are limited to either $150,000 pa or $450,000 over any three year period up to age 65.

Small business owners equally are subject to these limits but, in addition, can contribute up to $1.045m of tax free proceeds from the sale of their business.

**Flexibility: Duplication**

The other striking difference between the two is the flexibility, in terms of options for funding retirement, which are available to the small business owner.

As already discussed, the small business owner is able to access the retirement funding tax concessions through a superannuation fund on identical terms, including the amount of concessional contributions, to that of employees and still have access to the CGT concessions available on sale of their business.

There are only limited legal restrictions on achieving this duplication, which is where the business being carried on was originally owned by the small business owner directly. In that case, it has to be shown that the legal structure used to achieve employee status will be used for sound business or commercial reasons, that there is no income splitting and that the only advantage to be gained is access to greater superannuation benefits.33

Indeed, the CGT rules facilitate achieving employee status by allowing roll over of any otherwise taxable gain on incorporation of a business.34

On the other hand, employees have had the general anti-avoidance provision, Part IVA and its predecessor, applied to them when attempting to assume the tax status of a business from their employment remuneration.35

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32 Such as a zero cost base making the total proceeds otherwise assessable.
33 IT 2503.
34 S122-40 _ITA97_
More recently, specific legislation has been enacted that is directed at preventing them from accessing some of the tax benefits available to small business owners from carrying on a business.\textsuperscript{36}

Nevertheless, the ease with which employee status can be achieved and that lack of full integration simply leads to duplication of the retirement funding tax concessions by small business owners.

Access to retirement funds

Small business owners can access their retirement funding assets before retirement even where their retirement funding is in a superannuation fund.

The importance of access to retirement funding assets is best explained in the context of the underlying policy behind taxation of superannuation funds.

Broadly, tax concessions for superannuation are given for, in effect, committing present income for use in retirement. As noted earlier, there are prudential rules designed to ensure that the accumulation in a superannuation fund is, indeed, used for that purpose and not accessed earlier.

However, committing present income to retirement comes at a cost and that is what could have been done with the funds had they not been committed to a superannuation fund.

The most obvious example is of a person who could have used the money otherwise contributed to a superannuation fund to repay the principal on a mortgage on residential housing. In that case, the cost to the person of contributing to a superannuation fund is the interest that they are incurring in respect of their residential mortgage.\textsuperscript{37}

A paper by Knox highlighted the importance of this aspect in the context of valuing the tax concessions of superannuation funds.\textsuperscript{38} What that shows is that factoring the cost of locking funds away in a superannuation fund can materially reduce the value of the tax concessions.

As noted above, there are restrictions on both direct and indirect access by employees to accumulations in their superannuation fund. However, that is not the case for small business owners in three respects.

First, where the small business owner is using a superannuation fund as a retirement funding vehicle they can, in certain circumstances and in respect of certain types of

\textsuperscript{35} \textit{Tupicoff v FC of T} \textsuperscript{84 ATC} and more recently \textit{Macarthur v FC of T} \textsuperscript{2002 ATC 2212}, and PSI rules at \textsuperscript{Div 84 ITAA 97.}

\textsuperscript{36} \textsuperscript{177A to s177H ITAA36.}

\textsuperscript{37} Economists call this the opportunity cost.

assets (real property used for business purposes), use those assets in their business.\textsuperscript{39} That is achieved by the superannuation fund, say, leasing the asset to the business. Of course, that must be made on arm’s length terms.

The generally accepted explanation for this concession is that this class of asset is low risk assets and, thus, a suitable investment for a superannuation fund.

Nevertheless, the point is that the small business owner in this case is permitted to access their superannuation fund accumulations, most likely funded with tax deductible contributions and where the investment income (rental, say) payable by the business is deductible and taxed at favourable rates in the fund. In addition, the small business owner is using the asset for immediate wealth creation or enhancement.

Secondly, only two of the CGT concessions available to the small business owner require that they retire after age 55, with the other two of the four concessions not being dependant on having retired. That means that assets that are otherwise being used to fund retirement can be disposed of at any time, in those later two cases. In other words, there is no lock-in cost, as is the case for accumulations in a superannuation fund for employees.\textsuperscript{40}

Thirdly, because this form of retirement funding is characterised as a capital gain it, subject to having held the asset for at least 12 months, entitles the small business owner to 50% discount on assessable gains again without any restriction on it being held until retirement.

Finally on this aspect, the age at which employees can access superannuation fund benefits (the preservation age) is increasing, depending on the date of birth of the employee but that is not the case for small business owner CGT concessions that are retirement dependant, which is fixed at 55 years regardless of when they were born.\textsuperscript{41}

\textbf{Income splitting with spouses}

A spouse of a small business owner can obtain a similar tax effect to that which the owner can achieve through the CGT concessions. That is, where the CGT concessions is available in respect of a share or trust interest, provided that one of the spouses is a controller, and assuming that the 80% active asset test is met, the spouse of the controller can also access the CGT concession in respect of their share or trust interest by reason of the spousal relationship.

\textsuperscript{39} S 71 \textit{SIS Act}.
\textsuperscript{40} It could be argued that those last two non-retirement dependant CGT concessions are not related to retirement funding at all as they are generally available. However, small business owners see the disposal of their business as retirement funding, so even these non-retirement related CGT concessions will be used to shelter gains for retirement funding anyway. On that view, the two retirement dependant CGT concessions are, therefore, best viewed as additional concessions for retirement funding, with the additional requirement that the individual must have retired to get them.

\textsuperscript{41} SIS Regs 6.01. Indeed, there is discussion that it move to age 67 – see Australia’s Future Tax System: The retirement income system: report on strategic issues May 2009
On the other hand, there are only three circumstances where an employee can share the tax effects of their superannuation funding with a spouse. First, when the employee dies and the proceeds are paid to a spouse, in which case the recipients will receive the amount tax free. 42

Secondly, where there is a matrimonial separation and the retirement funding is split between the ex-partners in which case both partners will have separate maximum concessionally taxed amounts (RBLs).43

Finally, through splitting the prior year’s contribution.44

Of these three concessions only the last is comparable to the income splitting available under the CGT concessions because it is not dependant on death or divorce.

Again the difference in magnitude between the two is striking. On the best assumptions in both cases, a spouse can receive up to $3M tax free under the CGT concessions, against a maximum, under the employee superannuation concessions, of 85% of prior year concessional contributions.

Of course, to the extent that the small business owner is using a superannuation fund as a retirement funding vehicle they also have access to the sharing of income concessions from income splitting plus sharing tax concessions in the case of death and divorce on exactly the same terms as do employees.

**Deferral: Taxing points**

Broadly, a taxing point is the event or circumstance that triggers a liability for tax. Examples in this context include such events as realisation (disposal) for the CGT concessions or the tax of superannuation funds on certain contributions and on their annual income when received.

The criticality of this issue is its relevance to the deferral of tax, which, as noted already, is one of the two tax concessions given to superannuation funding (in addition to zero or lower tax rates on benefits).

In this case, a small business owner funding their retirement through sale of the business has only one taxing point, which is on disposal of the business. Whereas employees are taxed on contributions and accumulated earnings, as well as, in some cases, on benefit payments from the superannuation fund.

The advantage of one taxing point is simply that it maximises the value of deferral of tax. For the small business owner the accumulation, represented by growth in value of the business, is effectively compounding tax-free until disposal.

42 That also includes a child or someone who can establish an interdependency relationship with the employee. S6.01 SIS Act.
44 Div 6.3 SIS Regs. Splitting, after May 2008 is only available in respect of prior year taxable contributions.
Superannuation funds on the other hand, have three taxing points and so are a far less efficient savings vehicle in terms of deferral.

**HORIZONTAL EQUITY AND EFFICIENCY**

This paper proceeds on the basis that employees have only one tax preferred retirement income funding vehicle, being a superannuation fund, but small business owners can utilise a superannuation fund on exactly the same terms as an employee as well as utilise the CGT tax preferences on disposal of their business assets.

However, is this comparison between retirement funding using a superannuation fund and retirement funding using the CGT concessions valid?

Certainly, the accumulation of wealth, either in a superannuation fund or as the value of a business, can serve the same purpose of funding retirement. However, is there a conceptual difference between the two that explains the difference in taxation?

Employees using a superannuation fund for retirement funding (and, indeed, the small business owner funding retirement through a superannuation fund) are deferring current income. That is essentially the major tax benefit of superannuation, together with a potentially preferential rate (30% in aggregate above the low rate threshold) for lump sum benefits and assumed lower marginal tax rate when paid as an income stream.

On the other hand, the sale of a business by the small business owner to fund retirement is capitalising future income of the business on the basis that the value of a business, in excess of tangible assets, is essentially the capital value of its future income.

Should that make a difference in the way that they are taxed? Is it reasonable to tax deferred income differently to future income, for retirement funding purposes?

Perhaps the answer is that taxation of income and capital gain is different anyway. That is, capital gains generally are taxed differently and, indeed, concessionally for individuals, trusts and superannuation funds, compared with non-capital gains income.

On that view, the CGT concessions that are available to a small business owner for retirement funding are no different in concept to the existing system generally where income from capital gains is taxed at a different rate to other income.

That analysis also resurrects all the policy debates that occurred when the general CGT discount was enacted in 1999 with one variation. In this case the additional concessions granted by the CGT concessions just accentuate the equity breaches argued in that debate.

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45 “In summary therefore, the recent CGT changes considerably diminish the equity of the Australian taxation system” CC Evans, “Taxing Capital Gains: One step forward two steps back” Journal of Australian taxation (2002) 5(1) p181.
As observed elsewhere in respect of three of the CGT concessions (the 50% reduction, retirement and 15 year concession):

“The Ralph review rationalised those three concessions as necessary ‘to provide small business people with access to funds for retirement and expansion’. Those three concessions are discriminatory, as capital gains realised from the sale of assets of small businesses are (pursuant to those three concessions) effectively taxed at a rate of income tax much lower than that at which other forms of capital gains (or any other taxable income) are taxed. Those three concessions thus violate horizontal equity”.

That is equally true in respect of essentially tax preferred superannuation funding.

Nevertheless, the forgoing demonstrates that the tax burden of small business owners and employees with the same economic resources is not equal once the retirement funding tax concessions are factored in.

Primarily, this inequity results from the form in which they hold their wealth or economic resources: as a business asset or in the capacity as an employee.

However, the inequity is exacerbated when you consider how small business owners can use a superannuation fund as a retirement funding vehicle on exactly the same terms as an employee yet also utilise significantly large CGT concessions that are also expressly intended for retirement funding.

That duplication, together with comparatively better access to retirement funding assets, income splitting with a spouse and more efficient accumulation, also has the effect of distorting the form in which retirement funding assets are held in favour of small business assets.

In that regard, the principle of efficiency in the tax system (neutrality) is equally breached.

The question then is whether there this any valid policy reason for the lack of horizontal equity and efficiency breaches in taxing retirement funding between employees and small business owner?

It may be argued that the small business owner takes more financial risk in conducting their own business than is the case for employees. Also, that their personal assets may be at risk. In that case, perhaps, they should be rewarded for assuming that risk through tax concessions in the tax system.

Alternatively or in addition, it could be argued that the small business owner should be entitled to more tax support as they help the Australian economy grow by employing others.

Perhaps the answer to the differences is contained in the recent discussions about application of the Superannuation Guarantee to business income in the report on Strategic issues released in May this year.

In that case the panel argued ‘The superannuation guarantee, since inception, has not been applied to business income. The reluctance to extend the superannuation guarantee to small business recognises the diversity in the small business sector, its varying capital, liquidity and investment needs. While small business people and the self employed should make provision for their retirement, the costs of compulsion may be higher for that sector than for employees. Many small business people have alternative strategies for saving for their retirement, often with different time profiles than those applying to employees.’

It seems that these arguments apply equally to the taxes on funding retirement—they way that business owners retirement funding is taxed simply reflects ‘the diversity in the small business sector, its varying capital, liquidity and investment needs’ and, the differences can therefore be justified.

**CONCLUSION**

The public debate about tax concessions supporting retirement funding has largely revolved around tax inefficiencies in superannuation funding caused by the three taxing points at contributions, earnings and benefits.

Yet, it is generally accepted that small business owner views the value of their business as a retirement asset. That is now recognised in the CGT concessions and has presented the opportunity of comparing the tax concessions given to them for retirement funding, including the value of those concessions, against that which is given to employees.

One challenge in such a comparison is that small business owner can assume the tax status of an employee and the corresponding retirement funding concessions, thereby making it difficult to isolate the tax concessions for employees.

This was resolved by classifying employees in terms of individuals who are in receipt of wages and salary but otherwise not carrying on a business.

The classification of small business owner for these purposes, on the other hand, simply uses the definition of that in the CGT rules. That definition is expressed in terms of business value and ownership structure.

Employees fund their retirement through a superannuation fund and are only preferred through discounted tax rates and deferral of tax if benefits taken before age 60.

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47 Australia’s future tax system the retirement income system: Report on strategic issues May 2009 P12
The regulatory environment supporting the tax concessions for employees requires that the funds be committed to retirement and not be accessed any earlier. That comes at a cost to the employee in terms of what they could have done with the funds had they not contributed the money to a superannuation fund. The most obvious example of such a cost is the interest incurred on a residential mortgage which otherwise would have been repaid had the contribution to the superannuation fund not been made instead.

As already noted, small business owners are able to assume the tax characteristics of employees and, thereby, identical retirement funding tax concessions to employees.

In addition to that flexibility, they now have four specific CGT concessions that are in addition to the general CGT concession. All these can be used to shelter from tax any gains on disposal of their business, which gains can be used to fund their retirement.

There are three threshold tests (Basic Conditions) that need to be satisfied to access the specific concessions. One of these in particular (the NAV), demonstrates a clear lack of integration between these rules and superannuation funds in that it specifically excludes from the valuation calculation other forms of retirement funding assets that the taxpayer may own.

The most striking difference between the two sets of tax rules for retirement funding is the value of the tax concessions given to the small business owner—up to $6M of otherwise assessable gain completely exempt.

That inequity is compounded when one considers that small business owners are able to assume the tax status of employee and, consequently, identical retirement funding tax concessions. Importantly, that ability to assume employee status creates greater options and duplication for funding retirement that are not available to employees.

As already noted, employees are limited to funding retirement through a superannuation fund and that comes at a cost of locking the funds in until retirement.

Only two of the four CGT concessions available to small business owners are dependant on retirement after a certain age. The other two are not retirement dependant, which mitigates the cost of lock-in by being able to access retirement funding assets, in the form of the value of the business, at any time.

Recent amendments that allow employees to split the prior year's contributions with their spouse has redressed some of the inequity which previously existed where small business owners were able to share the tax concessions available to them through the CGT concessions with a spouse.

In any case, the value of the concessions that can be split with a spouse through the CGT concessions are substantial compared with those available through contribution splitting.
That again raises the issue that small business owners are able to structure themselves into employee status which, in this case, gives them access to contribution splitting anyway.

Finally, small business owners funding retirement though the CGT concessions have only one taxing point on disposal, which maximises the value of the deferral of tax. In the case of employees, having three taxing points reduces the value of tax deferral.

Overall, these differences in retirement funding taxation are largely a function of the CGT concessions for small business owners using a capital gains basis for taxation, which are preferred in terms of rates and deferral anyway.

On the other hand, superannuation funding is advantaged by deferral of income and reduced rates on lump sum benefits.

On that analysis, the explanation of the differences in taxation is relatively straightforward and largely consistent with current taxation policy and it also raises the same equity arguments about the way that capital gains are taxed compared with income.

But that does not explain the other tax support offered to the small business owner, but not employees, such as access to their retirement fund assets when employees’ assets are locked-in, better ability to split concessions with spouses and, most importantly, the ability to replicate employee retirement funding concessions at the same time with minimal integration.

Nevertheless, the overall concessions available to the small business owner are generous and should be included in the current debate about the adequacy of retirement income support, either as a model which all taxpayers should have access to or as an excessive tax expenditure which should be reigned in to fund greater support for employees.
APPENDIX A

SMALL BUSINESS OWNER CGT CONCESSIONS

15-Year Exemption

In the 15-year asset exemption, any otherwise taxable gain is ignored where the asset, which would otherwise have generated that taxable gain on disposal, has been owned continuously for at least 15 years. In that case, an individual claiming the concession must also have retired after age 55 or become permanently incapacitated.48

50% Reduction

In this case, subject to all relevant conditions being met, 50% of the otherwise taxable gain on sale of the active asset is ignored.49

This 50% reduction can be in addition to the general 50% reduction in the assessable gain, resulting in only a net 25% of the gain being taxed.50

Also, any net gain after applying both these reductions can be dealt with under the retirement or roll over concessions or both, to make this concession more efficient.51

The 50% reduction offered by this concession is not mandatory.52 Therefore the small business owner can chose not to apply it and deal with the otherwise taxable gain through one of the other concessions, specifically the retirement exemption.53 This route would be used in dealing with any inefficiency through distributing non-taxed gains through a company.54

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48 S152-105 ITAA97. The same effect of ignoring the gain completely can be achieved where the asset is owned by a company or trust, subject to satisfaction of the two additional Basic Conditions mentioned above, and where it pays the otherwise taxable gain to an individual who retires after age 55 or becomes permanently disabled.

Where the concession is being claimed by an individual in these circumstances there is the additional requirements that an individual had a certain level of control of the trust or company for the required period, although there does not have to be a coincidence of individuals, if there has been more than one controlling individual over the 15 year period.

The 15 year holding period is deemed to continue where the active asset has changed through matrimonial break down or compulsory acquisition.

Where a company sells the active asset, it is allowed up to two years to distribute the proceeds to shareholders and still be entitled to the concessions for the individuals, although there is a requirement in that case that the proceeds be pro rated between the owners based on equity interests.

49 S152-205 ITAA97.
50 Ibid.
51 S152-210 ITAA97.
52 S152-220 ITAA97.
53 See note to 152-220 about more efficient to use retirement exemption.
54 Caused by inability to pay a franked dividend.
It is not dependant on the individual retiring or becoming disabled. Nor is it dependant on the length of ownership of the assets.

Retirement Exemption

A small business owner can chose to apply up to $500K of otherwise taxable gain from sale of the business as dedicated retirement funding. In that case, the amount of the gain is not taxed at all. The limit of $500K is a lifetime limit.

Roll Over

The last of the four concessions allows the small business owner to ignore the otherwise taxable gain generated by sale where the proceeds are applied towards a replacement asset within the period of one year before and two years after the disposal.

The effect is that the gain is ignored at that point and the first element of the cost base for the acquired replacement asset is reduced by the amount of the gain rolled over. This has the effect of deferring taxation of the gain as, when the replacement asset is disposed of, any gain, including that which was rolled over, will be recognised (assuming that the asset has not gone down in value).

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55 S152-300 ITAA97.
56 S152-320 ITAA97 The exemption is available simply by the taxpayer notifying the ATO of that choice on retirement after age 55. Where the person is younger, the amount has to be placed in a retirement savings vehicle until age 55, when it will be paid tax free.
57 Subdivision 152-E ITAA97.
58 S152-210 ITAA97.