Investment & Financial Services Association Ltd

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18 October 2008

Dr Ken Henry
Chair – Australia's Future Tax System Review
c/o AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

By email: AFTSubmissions@treasury.gov.au

Dear Dr Henry

Re: Australia's Future Tax System review

IFSA welcomes the opportunity to contribute to this major review of the tax and transfer payments system in Australia.

IFSA is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 145 members who are responsible for investing over $1 trillion on behalf of more than ten million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

IFSA's submission is divided into three parts, addressing three challenges facing Australia which the tax-transfer system can play a key role in addressing. The challenges are as follows:

- Improving national saving and sustaining economic growth, in particular to address the decline in the long-term fiscal sustainability of the Australian Government over the next 40 years driven by demographic and other factors.

- The social and economic consequences of Australians not having sufficient levels of insurance cover (either through superannuation and/or directly) to meet their personal liabilities and ensure the financial security of their families in the event of death or sickness, accident or injury.

- Ensuring that tax does not act as a barrier to establishing Australia as a International Financial Services Centre.

The demographic funding challenge – to meet the income needs and other needs of an ageing population – requires action on two fronts: improving national income *and* improving national saving.

Tax reform can improve national income by switching the tax mix from higher efficiency cost taxes to lower efficiency cost taxes. Analysis by Access Economics indicates that replacing higher efficiency cost state taxes with more efficient alternatives could deliver long run economic welfare benefits of between 1 and 2 per cent of GDP. This is the equivalent of gains to household consumption of between $6 to $10 billion and makes state tax reform a major microeconomic-reform-initiative. Encouraging private sector investment in infrastructure could also improve national income.

Australia has a low household savings rate which results in our gross national savings rate ranking 17th out of the 28 OECD countries.

The Australia's Future Tax System review should examine the impact of the tax system on Australia's low level of household saving. IFSA recommends that the review examine the introduction of a statutory rule giving full capital treatment to all investment assets, as distinct from assets deployed in the course of operating a business.

The review should also examine options to encourage higher savings through medium and long-term vehicles. This should include consideration of the extent to which various measures assist those people most at risk of having inadequate retirement savings, including those who spend time away from paid employment, often women for family support reasons; the increasing number of families in small business who do not fully participate in the superannuation guarantee system; and those that are unable to contribute because of substantial periods of ill-health.

IFSA is currently preparing the next version of its Retirement Income and Long-Term Savings policy document. This report will analyse options to increase household and national savings to achieve an adequate standard of living for retirees and to provide for their increasing longevity risk.

Particular attention should be given to recalibrating the tax system to address Treasury's *Architecture of Australia's Tax and Transfer System* estimates that 2.4 million individuals receive little or no benefit from the tax rate applied to their superannuation contributions.

IFSA considers this to be a serious flaw in Australia's taxation arrangements. The situation could be addressed through rebating superannuation contributions tax paid by low income earners. Specifically, the Australian Tax Office could pay an amount equivalent to 15% of the concessional contributions made on behalf of an individual to their superannuation fund. This payment would be made once the individual's income tax return had been assessed and would be means tested. A suggested means testing methodology is detailed in the submission.

The review should recognise that inadequate levels of life insurance has a negative impact on individuals and imposes indirect costs on government through higher spending on social security and other programs. The tax system can play a role in combating underinsurance, in particular through allowing life insurance premiums outside of superannuation to be deductible.

Life insurance stamp duties must be abolished, either as part of comprehensive state tax reform which will deliver significant macroeconomic benefits to the Australian economy, or because they are a nuisance tax which add to the cost of insurance for consumers and contribute to the significance of the insurance gap.

Finally, IFSA considers that the current levels of complexity and operating costs are clearly above that which is optimal for society as a whole. Australia's tax system needs to deliver simplicity and certainty to taxpayers. Many areas of tax legislation generate unnecessary compliance costs and uncertainty, some of which the Australian Government is actively considering. Although addressing specific problems in tax law are not a matter for this review, these should be a priority for all levels of government as they are important issues for the financial services industry.

I look forward to discussing the issues raised in IFSA's submission with yourself and the other members of the Australia's Future Tax System Review Panel. I can be contacted on 02 9299 3022.

Yours sincerely,

Richard Gilbert
Chief Executive Officer

1 IMPROVING NATIONAL SAVING AND SUSTAINING ECONOMIC GROWTH TO COPE WITH AN AGEING POPULATION

The *Intergenerational Report 2007* indicates that demographic and other factors will significantly pressure Australian government expenditure over the next few decades. The Australian Government's fiscal position is projected to deteriorate from a surplus of just over 1 per cent of Gross Domestic Product (GDP), to a 'fiscal gap' of around 3½ per cent of GDP by 2046-47.

The demographic funding challenge – to meet the income needs and other needs of an ageing population – requires action on two fronts: ***improving national income*** *and* ***improving national saving***.

IMPROVING NATIONAL INCOME

Growing the size of the economy can also help address the challenges of an ageing population. A larger economy increases consumption possibilities for both individuals and governments, making government programmes more affordable. Two potential sources of stronger economic growth are tax reform and encouraging increased investment in infrastructure.

Tax reform

Tax reform can improve national income by switching the tax mix from higher efficiency cost taxes to lower efficiency cost taxes. Treasury's *Architecture of the Tax and Transfer System* (the Architecture Paper) identifies that efficiency costs of taxes represent losses to the Australian economy through distorting the decisions of individuals and businesses but does not attempt to rank taxes in terms of their economic efficiency. Modelling of this nature could identify opportunities to boost national income. The Architecture Paper notes that academic studies have identified the efficiency costs of taxation in Australia to be around 6% of GDP.

The Architecture Paper notes that Australia has a higher reliance on capital taxes than other countries. Given Australia is a small, open economy which imports capital from the rest of the world, it is likely that taxes on capital would have a higher efficiency cost than other taxes. The Architecture Paper acknowledges that this is a widely held view in academic circles. A full analysis of this nature may need to allow for the likelihood that location-specific rents in respect of Australia's mineral resources attract capital to this country.

The Finance Industry Council of Australia (FICA)[1] commissioned Access Economics to gauge the benefits to the national economy from replacing inefficient state taxes with more efficient alternatives. The *Analysis of State Tax Reform* report, prepared by Access Economics, states that reforming state taxes could produce gains to the national economy the equivalent in scale to the microeconomic reforms of the past two decades.

According to Access Economics, replacing inefficient state taxes with more efficient alternatives could deliver long-run economic welfare benefits of between 1% and 2%

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[1] FICA is a body comprising the Australian Bankers Association (ABA), the Australian Finance Conference (AFC), the Financial Planning Association (FPA), the Insurance Council of Australia (ICA), the Australian Financial Markets Association (AFMA) and the Investment and Financial Services Association (IFSA)

of GDP. This is the equivalent of gains to household consumption of between $6 and $10 billion - making state tax reform a major microeconomic reform initiative.

The report also undertakes a costing of state tax reform. The up-front cost to the states of tax reform is estimated to be $15.2 billion, with property and insurance stamp duty reform taking up the greatest share of the cost at $13.2 billion.

Efficiency gains from reforming state taxes would generate additional revenue gains of $5.7 billion, leaving the 'net cost' of state tax reform to be $10.5 billion after taking into account these second round effects. Of the $5.7 billion in additional revenue, some $4.6 billion would accrue to the Australian Government, particularly in greater personal and company tax takes.

The extent of the Australian Government revenue gains arising from the efficiency dividend of state stamp duty reform, clearly suggests that the Australian Government has a major role to play in reform of state taxes.

The report also discusses less comprehensive approaches to state tax reform.
A more targeted reform option would be to reform state business taxes only. This approach would have a net cost of $2.6 billion.

The full Access Economics *Analysis of State Tax Reform* report is at Appendix A.

Recommendation 1 – IFSA recommends that the Review Panel identify options to replace economically inefficient taxes with more efficient taxes.

Increasing investment in infrastructure

The Rudd Government has emphasised that the lack of investment in infrastructure in Australia is a drag on economic growth, holding back productivity and adding to inflationary pressures.

The Hawke-Keating Government implemented a regime for encouraging investment in infrastructure. This regime contained within Division 16L of the *Income Tax Assessment Act 1936*, provided for tax exemption or a tax rebate, provided the investment was the subject of a Development Allowance Authority. The scheme has not been operational for a number of years. It may however be timely to consider its reintroduction for the following reasons:

- The Rudd Government has highlighted the need for increased expenditure on infrastructure in Australia
- With global credit markets in turmoil it is increasingly difficult to obtain debt funding for such projects
- Australia may be about to enter an economic downturn and increased expenditure on infrastructure could counter this to some extent

In order to limit the possibility of abuse of such investments, the tax exemption for earnings should not be replicated and the previous rebate election limited to 15% of income.

It is acknowledged that many of the projects developed under the original Division 16L made excessive use of gearing. Accordingly it is suggested that any revival of the regime should contain strict debt restrictions. One example is a debt to equity ratio not exceeding 1 to 1.

Recommendation 2 - IFSA recommends that the Review Panel examine the introduction of a revised Division 16L to assist in encouraging Australia's long term investment vehicles to provide capital for Australia's long term infrastructure projects.

IMPROVING SAVING

Australia has a low level of national savings relative to other OECD countries. Australia ranks 17th out of the 28 OECD countries in terms of our gross national savings rate.

Australia's poor savings performance has led to IFSA commissioning research on Australia's national saving to drive national debate and policy development in this area.

In the first stage, IFSA commissioned Dr Vince Fitzgerald and the Allen Consulting Group to analyse Australia's national savings. The *Australia's National Savings Revisited – Where Do We Stand Now* report, published in August 2007, found that Australia's national saving (by all sectors combined) is lower as a percentage of GDP than in the past. This is despite higher contributions from governments and business. Household saving is the culprit – it essentially collapsed as we moved into this decade, over most of which it has been negative on a net basis, associated with a full-blown household debt binge.

In the second stage, IFSA commissioned EconTech to model the economic effects of a significant increase in household saving on the Australian economy. *The Economic Impact of National Saving* report, published in July 2008, found that the main economic argument for increasing national saving continues to be from an intergenerational equity perspective. By saving more today, individuals are able to enjoy a higher standard of living during retirement without placing a burden on later generations.

The report also finds that a significant increase in household saving, equivalent to about 2 per cent of GDP can also have significant beneficial economic effects. Based on the macroeconomic environment at the time of the report, the beneficial effects include:

- Moderating consumption growth, lowering short term interest rates by an estimated 0.9 per cent in 2010-11.
- Reducing Australia's reliance on foreign capital with projected foreign liabilities at 15 per cent of GDP lower in the longer term.
- Reducing Australia's current account deficit, with the reduction peaking at 2.4 per cent of GDP in 2011-12.
- Boosting investment in the medium term, including potentially reducing bottlenecks in the key infrastructure industry of transport.

While the sub-prime crisis has decreased the availability of credit over the past year, it remains unclear whether this will flow into significantly higher savings by Australian households. The extremely low levels of household savings experienced in the United Kingdom and the United States are widely considered to be a major contributor to the current global economic problems. This further heightens the need for the government to re-examine Australia's savings performance, through short, medium and long-term vehicles.

IFSA considers that examining household saving should be a key objective of the Australia's Future Tax System review.

The Architecture Paper notes that Australia collects a higher proportion of its total tax through taxes on capital than any other OECD country.

While initiatives such as the First Home Saver Account are a positive step with regard to long-term savings, there needs to be greater attention given to short to medium term savings.

Superannuation is clearly the pre-eminent vehicle for Australians to save for their retirement. Further initiatives should be explored to ensure superannuation arrangements deliver an adequate retirement income for more Australians.

Taxation of savings

A significant issue in the taxation of saving and investment is that the current tax system fails to properly distinguish between two different economic activities that both go by the name 'investment'. This is creating distortions in the economy.

The response that is urgently needed is a statutory rule giving proper capital treatment to all investment assets, whether they are held through an intermediary or not.

When a person has capital, they need to generate an appropriate return on that capital in order to maintain and grow their wealth. This is called 'investing'. It is the activity of acquiring assets that will generate a return.

In contrast, a business requires some capital in order to operate but, to maximise its profit, the business minimises the amount of capital it uses. For a business, there is a cost to having capital. The business deploys its capital in various ways, only one of which is acquiring assets such as plant, land and intellectual property. This acquisition of assets is also often called 'investment'.

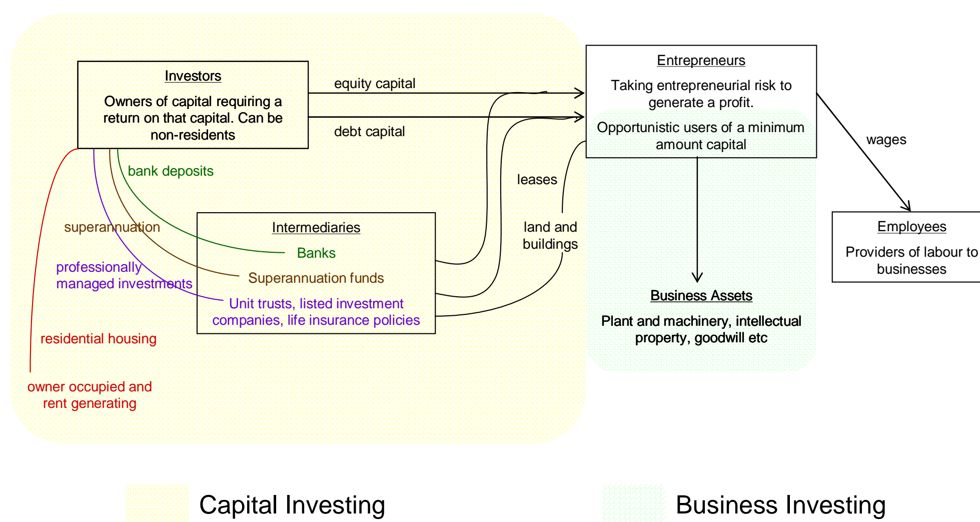
The chapter 'Taxation of Saving and Investment' in the Architecture Paper intermingles discussion of these two activities and this is symptomatic of the confusion in the current tax system. There are different drivers to these two activities and different outcomes. It is not necessarily the case that they should be taxed the same.

For the sake of clarity we will refer to the first activity as 'capital investing' and to the second activity as 'business investing'.

Capital investing is the deployment of a given amount of capital. The activity exists because the capital exists. Assets are acquired because that is the only way to generate a return. Business investing is an entrepreneurial activity that takes in the minimum amount of capital it can get away with. Assets are only acquired where they increase the profitability of the business. Capital investing is seeking returns on capital as a factor of production. Business investing is applying various factors of production, including capital, in the optimal quantities to generate a profit.

Business investing is dependent on capital investing as set out in Figure 1.

Figure 1: Flow of Capital in the Economy



This diagram is necessarily simplified. In reality, there is much more interconnection. For example, banks are both intermediaries and entrepreneurs. Employees can be investors and entrepreneurs at the same time. The diagram also leaves out various financial markets like the futures market that to some extent functions as capital investment and to some extent as business assets.

One source of confusion in the tax system is the role of intermediaries. A great deal of capital investing is done via the common intermediaries shown in Figure 1. Economically this does not change the nature of the activity. It is still capital investing. Yet our tax system so often changes the tax treatment when an intermediary is used.

The Architecture Paper notes that ultimately individuals (rather than business) own factors of production, including capital, and therefore when you remove the veil of these intermediaries it is ultimately individuals who bear the burden of taxation.

The entrepreneurs carrying on businesses represented on the right hand side of Figure 1 can be individuals or groups of individuals operating in partnership. Often they will operate the activity through a company. When the entrepreneur has their own capital they can take on the role of equity investor in the company while the company takes on the role of entrepreneur. Many of these companies grow large taking on diversified equity investors. These diversified equity investments are then often listed on a stock exchange to allow the investors to transfer them easily.

Entrepreneurial activities take many different forms. They are a combination of know-how, risk-taking, labour, reputation, assets and many other factors with these factors existing in very many different combinations. It is the combination of these factors that generates the profit.

In contrast, capital investing is no more than the selection of assets. When done properly it is a complicated and sophisticated process requiring expertise, but it is still no more than asset selection.

Getting the right system for taxing capital investing is therefore totally dependent on getting the right system for taxing asset ownership. In taxing business profits, the asset ownership is subsumed into a larger arrangement. The rules for taxing asset ownership when it forms part of a broader business do not need to be justified on a

stand-alone basis. They may be compromised in order to get the best system for taxing the whole of the business profit. Any compromises made though cannot affect the rules for taxing capital investing because the distortions created cannot be offset. The whole of the capital investing activity will have been compromised.[2]

In our current system, there is a common interpretation of the law that capital investing profits can be taxed as business profits. It is debateable whether this is the right interpretation of the existing law or not but it is a flaw in the system that it can even be argued.[3]

This flaw goes back to the time when capital profits were not in the tax base and the courts struggled to draw a line between what was in the tax base and what was not. Since we now have a comprehensive tax base we should not have to suffer from this archaism.

When the capital gains tax rules were introduced, the statutory rule that taxed capital investing profits where the asset was acquired for resale at a profit was removed.[4] The idea was that the capital gains tax rules were the appropriate rules for capital investing profits. What went wrong is that the legislation did not deal with the argument that the general assessing provision[5] could tax these profits. The legislators at the time may have taken the view that this was not required because the general assessing provisions do not work this way. Whether that was their view or not, there are now people who disagree.

Capital investors continue to this day to struggle against an interpretation that their profits are sometimes business profits. This is a controversy currently being played out between the Australian Taxation Office (ATO) and the publicly offered unit trusts leading to significant compliance costs and loss of investor confidence.

The worst aspect of this is that the ATO is only seeking to apply this interpretation to some forms of capital investing. If this interpretation is allowed to stand then there will be significant distortions to economic behaviour. Specifically, the ATO interpretation will drive capital investors to use less sophisticated investment strategies and to not use professional investment expertise. The ATO interpretation denies capital gains tax discounts to some forms of capital investing which is too big a detriment to be ignored.

For example, one feature of the income tax legislation is that the majority of superannuation investments are deemed to be on capital account. However, this provision only applies to assets held directly by a superannuation fund or virtual pooled superannuation trust (VPST). Assets held indirectly are outside the scope of

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[2] One view is that business assets fall into three categories: wasting assets, trading stock and capital assets, with many businesses having few or no capital assets. It would follow that a pure system for taxing entrepreneurial profits would include treating the profits on capital assets consistently with the assets held in a capital investing activity.

[3] A technical analysis showing that this interpretation is contrary to the case law can be provided on request.

[4] Section 25A *Income Tax Assessment Act 1936*, previously section 26(a). The section was not repealed but it ceased to apply to sales of property, meaning that it ceased to apply to capital investing.

[5] At the time section 25(1) *Income Tax Assessment Act 1936*, not section 6-5 *Income Tax Assessment Act 1997*.

this deeming provision. Most super funds (retail, industry, corporate and government) invest through wholesale unit trusts. If wholesale unit trusts are required to recognise profits on revenue account rather than capital account it will effectively mean an increase in the tax rate applicable to super funds.

A secondary effect of the ATO interpretation that will become important in the future is that it denies the capital gains tax jurisdictional rules to non-resident investors, subjecting them instead to higher levels of Australian withholding tax than they would experience investing in other countries. If the ATO interpretation is allowed to stand then Australia has no chance of establishing itself as a regional or global funds management centre.

The solution that is required is a statutory rule that profits from capital investing are subject to the capital gains tax rules no matter what investment strategy is used.

Further, the statutory rule needs to provide that the capital gains tax rules apply no matter what intermediary is used. The ATO currently denies capital gains tax treatment to most listed investment companies even though they are merely intermediaries. Similarly, it denies capital gains tax treatment to life insurance companies even though certain life insurance policies are no more than intermediary contracts. These types of policies are discussed further in Appendix B.

The most important thing is that all capital investing is taxed consistently, subject only to explicit Government policy initiatives.[6] This will do the most to eliminate unwanted distortions in economic behaviour. Beyond this, there are certain principles that make for a better system:[7]

- A realisation basis is the only practical approach to unpredictable profits. This is what we currently have and after many years of consultation, this is what will be retained after the introduction of the new Taxation of Financial Arrangements legislation.

- It is not appropriate to tax increases in asset values that are attributable to inflation. In 1999 the specific inflation adjustment in the capital gains tax rules, which was called indexation, was replaced with a discount to the tax rate.[8] The discount currently applies to some but not all forms of capital investing. When the capital investment is intermediated by a company the discount is only available in limited circumstances. There needs to be an inflation adjustment for all forms of capital investing.

- The current system has a principle of quarantining losses arising under the capital gains tax rules so that they can only be used against gains

[6] For example, reduced tax rates on superannuation to promote planning for retirement and self-sufficiency in retirement is an explicit Government initiative.

[7] The references are *Capital Gains Taxes: Treasury Taxation Paper No. 10*, November 1974, Commonwealth of Australia, AGPS, Canberra; *Taxation Review Committee: Full Report*, Chapter 23, January 1975, Commonwealth of Australia, AGPS, Canberra; 'Section 26(a) and Section 26AAA of the Income Tax Assessment Act', *Taxation Review Committee: Commissioned Studies*, January 1975, Commonwealth of Australia, AGPS, Canberra; *Reform of the Australian Tax System: Draft White Paper*, Chapter 7, June 1985, Commonwealth of Australia, AGPS, Canberra.

[8] The discount does more than just adjust for inflation. It plays a further function of providing an incentive to save.

arising under the same rules. There is no economic justification for this. The justification is behavioural. The theory is that there would be too much revenue lost through taxpayers crystallising losses under these rules before year-end to offset against salary and other income. Consideration should be given to whether this is a strong enough reason to quarantine losses in this way.

- Australia's rules cannot be harsher than the rules in other jurisdictions or we will have no chance of establishing ourselves as a regional funds management centre.

Recommendation 3 - IFSA recommends introducing a statutory rule to Australia's taxation system, that profits from capital investing are subject to the capital gains tax rules no matter what investment strategy is used.

Medium term savings

IFSA recommends medium-to-long-term-savings needs to be encouraged in an environment outside superannuation, in a tax efficient manner. Such an environment would facilitate savings for essential living requirements such as funding education expenses for children. There are a number of options which could be devised for this purpose.

An example of an existing savings vehicle that could be significantly enhanced to achieve a flexible medium-term savings vehicle are life insurance bonds. A range of proposals which could improve the attractiveness of life insurance bonds are at Appendix B. Any reforms should be pursued in conjunction with expanding the range of providers who can offer life insurance bonds or similarly styled investments beyond life companies.

Initiatives of this nature would encourage taxpayers to plan for medium-term-investment events and fill the gap between the First Home Saver Account scheme and superannuation. It would encourage a culture of saving and capital retention.

Recommendation 4 - IFSA recommends the tax system encourage medium term savings through appropriate vehicles.

Long-term savings

Improving long-term savings can help address the challenges of an ageing population. An increase in the current level of national saving allows for higher living standards during retirement. By increasing their savings levels, individuals are able to fund a higher level of consumption in the future. As well as enabling retirees to enjoy a higher standard of living, this additional saving reduces pressure on future age pension and health and aged care expenditure by governments.

IFSA is currently preparing the next version of its Retirement Income and Long-Term Savings policy document. The report will analyse options to increase household and national savings to achieve an adequate standard of living for retirees and to provide for their increasing longevity risk.

Many of the policy changes to address this challenge will take time to have effect. Therefore steps need to be taken as soon as possible to address challenges we will face in 30 to 40 years time.

IFSA recommends the Review Panel place boosting Australia's long-term savings at the top of the agenda for this review. This should include consideration of the extent to which various measures assist those people most at risk of having inadequate retirement savings, including those who spend time away from paid employment, often women for family support reasons; the increasing numbers of families in small businesses who do not fully participate in the superannuation guarantee system; and those that are unable to contribute because of substantial periods of ill health.

An immediate priority is the lack of concessional tax treatment on superannuation contributions for low income earners.

The Architecture Paper estimates that, based on the 2008-09 tax rates, around 1.2 million individuals do not receive a personal income tax benefit from the tax rate applied to their concessional superannuation contributions. And that a further 1.2 million individuals only have a concession equivalent to 1.5 percentage points (i.e. the Medicare levy).

IFSA considers this to be a serious flaw in Australia's taxation arrangements. The situation could be addressed through a rebating of superannuation contributions tax paid by low income earners. Specifically, the Australian Tax Office could pay an amount equivalent to 15% of the concessional contributions made on behalf of an individual to their superannuation fund using the same administrative system as the highly successful Super Co-contribution scheme. This payment would be made once the individual's income tax return had been assessed and would be means tested.

A suggested means testing methodology is to cap the entitlement at $1,000. The maximum entitlement payable at income levels below the 30 per cent tax threshold (i.e. $37,000 from 1 July 2010). The maximum entitlement would be phased out at 5 cents per dollar of income resulting in an upper threshold of $57,000. The lower threshold should increase in line with the 30 per cent tax threshold.

Other policy options that should be under consideration include:

- 'Soft compulsion' – requiring employees to contribute 1% of their gross income from employment to superannuation, either on a pre-tax or an after-tax basis. This would increase progressively to 3% over time. Individuals would be able to opt-out, that is, employees would be able to instruct their employer to pay this money directly to their bank account.

- Increasing the Super Guarantee to 12% in 1% increments which would deliver a similar outcome to 'soft compulsion' at a lower compliance cost for the economy as it would better leverage existing mechanisms.

- Allow all individuals to claim a tax deduction on personal superannuation contributions (currently limited to individuals who are not employed or are substantially self-employed). Contributions for which a tax deduction is claimed would be subject to 15% tax in the hands of the fund trustee, up to the relevant contribution cap.

- Introduce simple and consistent rules to provide individuals with a tax deduction for their financial advice. The *Value of Advice* report, prepared by Rice Warner actuaries for the Financial Planning Association, demonstrates the significant financial value and wealth effect of financial advice for a range

of individuals and families at different life stages, especially for complex matters such as planning for retirement[9].

Recommendation 5 – IFSA recommends that the Review Panel consider options for boosting Australia's long-term savings, in particular for the 2.4 million individuals who receive little or no benefit from the tax rate applied to their superannuation contributions.

[9] 9[1] Rice, M, RiceWarner Actuaries, "Value of Advice", report prepared for the Financial Planning Association, February 2008.

2 THE SOCIAL AND ECONOMIC CONSEQUENCES OF AUSTRALIANS NOT HAVING SUFFICIENT LEVELS OF INSURANCE COVER

SOCIAL AND ECONOMIC CONSEQUENCES OF THE INSURANCE GAP

Long-term changes to the superannuation system by successive governments have established a firm platform from which to grow retirement wealth. However, parallel rises in household debt combined with significant market volatility has increased the financial vulnerabilities facing the average Australian today.

There are also very real health and wellbeing vulnerabilities facing Australians.

Research conducted by AMP in March 2003, using Australian Government and Australian Bureau of Statistics data, revealed that around half of Australians over 30 suffer from at least one 'Priority Condition' that can lead to long-term disability and consequently, a long-term loss of income.

An AMP.NATSEM (National Centre for Social Economic Modelling) Income and Wealth Report entitled *Health and Income in Australia* showed that 53% of Australians over 30 suffered from one of the Government's seven priority conditions identified under its National Health Priority Areas, being:

1. Asthma.
2. Cancer.
3. Cardiovascular Health.
4. Diabetes.
5. Injury.
6. Mental Health.
7. Arthritis and Musculoskeletal conditions.

Life insurance protects the financial prospects of Australians during difficult times. Whether a person suffers a critical illness, injury or dies, life insurance provides financial assurance. However, not nearly enough Australians are adequately insured.

Successive IFSA research conducted over the past three years has revealed that the majority of Australians do not have sufficient levels of life, trauma and income protection insurance. These products provide a valuable source of funds in the form of a lump sum payment or regular income stream in the event of death, chronic illness or injury to an income earner or stay-at-home parent.

Without appropriate insurance, families and individuals can suffer severe financial hardship. The prevalence of those conditions that can lead to a loss of income is on the increase, with rises in cancer rates, diabetes and heart conditions caused by obesity.

There is an embedded belief within society that the social security system is the primary mechanism that protects people during tough times.

While it's true that the intention of Australia's public welfare system is to help those who find themselves in a position of relative poverty, it is important to note that social security mechanisms are designed to provide for only a very basic standard of living rather than maintaining a family's previous lifestyle.

The social costs of underinsurance

Without adequate insurance, a sudden death, sickness or injury to a primary income earner can create serious social problems.

Financial pressures create sharp decreases in living standards and the loss of future educational opportunities for children. They force families to liquidate savings, assets and investments that were specifically established to increase the opportunities and choices available in the future.

Financial pressures can also trigger marriage break downs, reduce self-esteem and prevent many Australians from realising their dreams and aspirations.

The social cost to families from underinsurance is not just immediate; it is also generational. Significant and long-term falls in household income reduces the ability of parents to fund high quality education and healthcare for their children, which in turn leads to lost future opportunities.

The economic costs of underinsurance

Underinsurance also brings with it two significant economic costs:

1. Social security payments – without insurance, people rely on welfare during tough times. Underinsurance increases government expenditure in areas such as family tax benefits, disability support pensions, sickness allowances, widow/bereavement payments, parenting payments and carers allowance.
2. Taxation – without insurance, household income falls below average standards. This leads to changes in spending patterns.

The life insurance industry acts as a safety net between income and reliance on social security. For example, income protection insurance pays a regular source of income should a person suffer long-term illness or injury. Adequate levels of insurance within the Australian community would reduce the Australian Government's expenditure on the Disability Support Pension.

There are other compelling economic benefits delivered by adequate levels of insurance, in that:

- life insurance maintains household income when a primary income earner dies, suffers a critical illness or long-term injury;
- this creates equivalency between household spending patterns before and after the death/disability of the income earner; and,
- the effect on government taxation receipts is reduced due to the limited change in spending patterns.

Life insurance plays a comparable role to superannuation in that it acts as a surrogate safety net between reliance on personal income and reliance on social security.

HISTORY OF LIFE INSURANCE TAXATION IN AUSTRALIA

The specific nature of life company taxation is not addressed in the Architecture Paper. A summary of the involved history and evolution of the taxation of life insurance in Australia is at Appendix C. The summary demonstrates clearly that life

insurance companies occupy a unique space in Australian taxation history. As a result, the taxation of life insurance companies and policyholders needs to be considered in light of the particular and unique characteristics of these institutions and of the multi-functional role insurance policies have played in the Australian investment and insurance sphere.

SPECIFIC TAX PROPOSALS

IFSA believes that it is not feasible or desirable for governments alone to fund the day-to-day-lives of Australians who have suffered a dramatic and sudden loss of income due to death, sickness or injury. The tax system has historically recognised the unique role that life insurance plays. The Rudd Government has also recognised this fact through the establishment of the Disability Investment Group which is examining policy options to increase private sector funding support to the disabled.

IFSA believes that a balanced set of social policies and initiatives by government and industry is needed to safeguard Australia's financial future.

Protection of wealth is as important as building wealth. IFSA believes the protection gap - a measure of the level of underinsurance in Australia – is as significant as the retirement savings gap. Addressing the insurance gap will deliver three substantial benefits to the nation:

1. **Adequate insurance is good for families** – life insurance provides a layer of protection against financial pressures.
2. **Adequate insurance is good for the economy** – life insurance keeps Australians out of social welfare.
3. **Adequate insurance is good for personal wealth** – life insurance prevents the liquidation of savings and assets during hard times.

IFSA recommends that the Australia's Future Tax System review panel adopt the following proposals to improve the accessibility and affordability of life insurance to help address the protection gap.

Improving the affordability and accessibility of insurance

Insurance should be encouraged both inside and outside of superannuation and, as consumers' insurance needs differ, it is important to give consumers alternative ways of accessing life insurance to help mitigate their risks.

Within superannuation, the provision of death and limited forms of Total Permanent Disability (TPD) and income protection benefits for members are permitted under the *Superannuation Industry (Supervision) Act 1993* and these can potentially be funded via insurance.

Superannuation fund trustees finance the cost of insurance cover for members from contributions which may or may not be concessionally treated for tax purposes. For death cover the cost of premiums is deductible to the superannuation fund trustee and the proceeds are tax free in the hands of the trustee. For the various types of disability insurance the tax treatment of premiums and proceeds varies and in some areas is unclear under the current law. The tax treatment of benefits paid by the trustee is dependent on a number of factors including age, category of beneficiary and form of benefit payment.

The existing rules enable a large number of Australians to access group life insurance which is competitively priced and is often not subject to underwriting (up to specified sum insured limits). Therefore, the existing rules can be regarded as sensible encouragement to help mitigate the important social policy concerns that flow from underinsurance in Australia. However, in IFSA's view there is a clear need to both

- reduce complexity of existing rules; and
- extend and clarify the scope of tax concessions, and extend the ability for funds to provide, benefits financed by various types of commonly sought after disability insurance cover.

The Review should consider options to expand the scope of insurance available within superannuation.

Outside of superannuation, there is generally no tax deduction for death and TPD cover. In some circumstances, an individual may prefer to have insurance outside of superannuation. For example:

- Group schemes have standard terms, where as individual cover taken outside superannuation can be tailored to the individual's needs – offering those with riskier professions or activities the opportunity to obtain bespoke cover. Examples include the Australian Defence Force Reserves who are not covered under all the group schemes currently available.

- Once an individual policy outside superannuation has been underwritten the insured person is guaranteed continuous cover as long as the contract remains in place, regardless of any events that may subsequently render the person uninsurable.

IFSA considers that there should be incentive to effect insurance outside of superannuation as well as inside it, and that this would be best achieved by allowing tax deductibility for life insurance and TPD premiums outside superannuation. Claim proceeds should also be treated consistently under both structures. An alternative to the tax deduction would be granting a rebate against the consumer's tax liability.

Consistency of tax treatment of life insurance inside and outside superannuation will ensure that tax is not a factor in the consumer's decision to have life insurance inside or outside superannuation. This choice should be driven by the consumer's circumstances.

These initiatives would encourage more access to life insurance, and provide social policy benefits to Australia in the longer term.

Recommendation 6 – IFSA recommends that there be further encouragement for Australians to effect life and disability insurance cover both inside and outside superannuation, in particular through full deductibility of life insurance premiums outside of superannuation.

Life Insurance Stamp Duty

As discussed above, there are significant microeconomic reform benefits from abolishing inefficient state taxes. Whilst IFSA strongly supports broad reform of state taxes, the case is most compelling for life insurance. If fiscal necessity imposes

limitations on the capacity or timetable to reform state taxes, IFSA recommends that the first priority be the abolition of insurance duties, in particular on life insurance.

Life insurance duty typically makes up a small component of total insurance duty. For example, an October 2007 report by the NSW Independent Pricing and Regulatory Tribunal *Review of State Taxation Other Industries — Issues Paper* indicates that life insurance duty will generate approximately $19.7 million in NSW in 2007/08, making up a small component of total insurance duty in NSW. It is 3.2% of total insurance duty levied by NSW; and only 0.1% of NSW own-source revenue in 2007/08. It is less than 0.05% of NSW's total revenue of $45 billion in the same year. The situation in most other states would not differ markedly from that in NSW. The key exception is in WA, where stamp duty on life insurance has been abolished – but where life insurance riders are subject to stamp duty at general insurance rates.

IFSA believes that the cost of maintaining the current system for industry and government represents such a large proportion of the revenue collected that stamp duty on life insurance can be considered a nuisance tax.

The different obligations under the various stamp duty legislation across the states impose a huge administrative burden on IFSA members, who operate at a national level. This is overlaid with the need to comply with the varying administrative and interpretative practices of revenue authorities, which further complicates the assessment of stamp duty liabilities. Lastly, the cost of audit activity for government is both unproductive and impacts on revenue to the extent to which the revenue generated is probably negligible.

In addition, taxes on insurance act as a disincentive for individuals and businesses to insure. In general, IFSA notes that tax rates for life insurance are lower than for general insurance, because legislatures across Australia have traditionally recognised these arguments as being even stronger for life insurance than for general insurance.

The effect of continuing to tax life insurance (and indeed to tax some forms of life insurance at the higher rates applicable to general insurance duty) is to discourage insurance and encourage under-insurance; as well as penalising those who are prudent enough to make provisions for dependents and invest in superannuation for retirement on their own behalf.

Recommendation 7 – IFSA recommends that life insurance duty, including duty on life insurance riders (i.e. additional benefits included in life insurance policies covering events such as trauma and total and permanent disablement, etc.) should be abolished as soon as possible.

3 ENSURING THAT TAX DOES NOT ACT AS A BARRIER TO ESTABLISHING AUSTRALIA AS A INTERNATIONAL FINANCIAL SERVICES CENTRE

If Australia is to compete with the other major international financial centres, it is imperative that there is certainty about the operation of Australia's tax laws as they impact upon non-resident investors.

It is also imperative that non-resident investors suffer no additional tax impost by virtue of investing through an Australian resident fund than would have been the case had they invested in the underlying assets directly or through one of the other international fund centres.

These issues are separate from the 2008 Budget withholding tax measure as they relate to factors which impact on the *choice of the domicile* of the fund (managed investment trust) through which foreign investors will invest rather than the *choice of assets* (Australian shares etc) in which they will invest.

These issues were prominently raised at the Australian Financial Services Hub Summit on 31 July 2008.

In this context, IFSA has made a number of submissions to the Board of Tax setting out a range of issues relating to Australia's tax law and the administration of that law which needs to be addressed before Australia can seriously compete with the established international fund centres.

Specifically, IFSA has provided a detailed submission in response to Board of Tax reviews covering the Anti-Tax-Deferral Regimes and will participate in the review of the tax arrangements applying to Managed Investment Trusts. IFSA has also recommended the introduction of a 'fund manager exemption' to ensure that non-resident investors do not create a taxable presence in these jurisdictions merely by virtue of having appointed a local fund manager. Such an exemption has been introduced in the United Kingdom and Hong Kong and is under consideration in Japan.

IFSA is firmly of the view that these Board of Tax reviews should carry on independently of the Australia's Future Tax System review process. These reviews would only be delayed or subsumed by other issues if they were included as matters for further consideration by the Review Panel.

APPENDIX A

ACCESS ECONOMICS *ANALYSIS OF STATE TAXES* REPORT

The Access Economics *Analysis of State Taxes* report is available at
http://www.ifsa.com.au/Media%20Releases/AE-FICA%20Final%20April%20clean.pdf

APPENDIX B

IMPROVING THE TAXATION TREATMENT OF LIFE INSURANCE BONDS

Currently, section 26AH of *Income Tax Assessment Act 1936* (the ITAA 1936) allows for the taxation of reversionary bonuses[10] received under short-term life assurance policies or investment bonds. Bonuses received within eight years of the commencement of the policy are assessed in full. Where amounts are received in the ninth year – two thirds is assessable. For amounts received in the tenth year – one third is assessable. After 10 years, the bonus is tax-free.

Where amounts are included in assessable income, section 160AAB allows for a rebate of tax in respect of the policies issued by a life assurance company at a rate of 30%. The rebate can also be used to offset tax on assessable income from other sources. However, the rebate cannot exceed the total tax payable (ie not refundable)[11].

Within the life company the investment earnings backing *investment policies* are taxed at 30% (corporate tax rate). Similarly, any investment assessment backing ordinary investment policies (ie not superannuation or pension), are treated on *revenue account* and also taxed at 30%. Accordingly, the potential capital gains tax (CGT) *discount* concessions available if the investments were held directly by investors, are not available. This is a disincentive to use life insurance policies for savings, versus direct investment or managed investment schemes.

IFSA recommends the following amendments be considered to boost the use of insurance bonds for medium to long term savings:

1. The introduction of a 20% concessional tax rate for life insurance companies in respect of their ordinary life insurance savings policies. Such a tax concession would encourage medium-to-long-term savings but not detract from the additional tax concession of long-term superannuation savings, which is taxed at 15%. The current 30% tax rate applicable is no longer appropriate given the movement in tax bands and the fact the majority of Australians now pay tax at a rate of 30% or less. Previous research has indicated the tax rate for a larger proportion of investment policy holders is substantially below 30%.

2. As per the discussion in the main body of the submission under Taxation of Savings, IFSA recommends the CGT treatment of investment assets be extended to assets supporting life investment policies. This would avoid the current disparity between direct versus life insurance investments. This would not affect the assets held by life companies to meet their risk obligations or capital adequacy obligations, which would continue to be held on revenue account. Financial Advisors have commented that this is currently one of the main obstacles of their clients' use of life insurance bonds as a savings vehicle.

3. IFSA recommends that the rebate available in respect of life insurance policy receipts be changed to refundable offsets. Currently, if the rebate available is greater than tax payable by the individual on their total assessable income, the balance is not refundable. This effectively results in taxation above the marginal tax rate and again discourages their use for medium-long term savings. The

[10] Reversionary bonuses are bonuses paid on maturity, forfeiture or surrender of a policy.
[11] section 160AD ITAA 1936

adoption of this recommendation provides a level playing field relative to superannuation and unit trusts.

4. To ensure the attractiveness of life insurance savings to meet the medium savings needs, consideration should be given to reducing the 10 year investment requirement to 8 years. Bonuses received could then be assessable as follows:

   - fully assessable if received within 6 years;
   - two-third assessable if received in 7th year;
   - one-third assessable if received in 8th year;
   - tax-free after 8 years.

5. The remaining features and treatments would also need to be retained to ensure their attractiveness. For example, exemption from tax where amounts received as a result of death, accident, illness or other disability, and premiums may be increased by 25% each year.

APPENDIX C

THE HISTORY OF LIFE INSURANCE TAXATION IN AUSTRALIA

Life insurance company level

At the life insurance company level, companies were effectively exempt (under Commonwealth legislation) from income tax on premiums received from policyholders since before 1936 until 2000. Since 2000, the investment component of premiums has effectively been exempt. Conversely, no deductions were generally allowed for benefits paid out to policyholders, or costs associated with obtaining premiums. Investment income has been included in assessable income (and outgoings incurred in gaining this income have been deductible) over the same period of time.

This unique separation of activities, and framework for taxation, is significantly different from the manner in which other vehicles that conduct investment activities (such as companies, trusts and superannuation funds) have been taxed.

Under Commonwealth taxation legislation preceding the *Income Tax Assessment Act 1936,* a life insurance company was entitled to a deduction determined by reference to its "valuation of liabilities". This deduction was endorsed by the report of the Ferguson Commission.[12] The allowance of this deduction represented a recognition of the unique characteristics and taxation profile of life insurance companies. This deduction was subsequently pared back in 1974 and 1975 and then removed altogether in 1982.

The Ligertwood Committee recommended the grant of an exemption to life insurance companies on their income derived from investment in superannuation funds, which was subsequently enacted into law in 1961. This exemption represented a concession to life insurance companies to create a level playing field with superannuation funds, and has survived incarnations and remained consistent with the taxation of superannuation funds to become the new 'virtual PST' rules in Division 320.

Both the Campbell Committee Report in 1981 and the Treasury's Confidential Consultative Document published in 1989 considered whether, on the basis that life insurance companies are taxed under the 'trustee principle', the company tax rate really represents the most appropriate rate at which to tax the income of a life insurance company. The Treasury Consultative Document canvassed potential alternatives, including the marginal tax rate applied to a multiple of the average male ordinary time earnings.

In addition, the Treasury Consultative Document endorsed the addressing of issues in relation to loss transfers to and from life insurance groups, which primarily arose as a result of rules that required transferred losses to be applied against the significant amount of income treated as exempt (e.g. premiums) before assessable income.

IFSA considers that the current taxation arrangements for life insurance companies in Division 320 of the *Income Tax Assessment Act 1997* are appropriate. A key

[12] The Ferguson Commission noted that "a life assurance company should be taxed on the basis of its investment income, which cannot be correctly determined without providing for the interest assumed to be earned on the investments set aside to provide for the payment of the liabilities of the company to its policy-holders."

outstanding issue is that life insurers are awaiting legislation to implement some pieces of the policy framework which were settled at the time. In terms of the underlying principles in Division 320, IFSA recommends explicit policy recognition of the intent to treat virtual pooled superannuation trusts effectively as separate taxpayers throughout company taxation law. This generally occurs at the moment, but is considered on a measure-by-measure basis.

Individual level

At the individual level, some form of concession to individuals in respect of their life insurance premiums was granted since before the introduction of the *Income Tax Assessment Act 1936.* This capped deduction was subsequently available under s.160(2)(f) from 1936 and then expanded to other forms of insurance in the form of s.82H (in 1950). The cap was also increased when s.160(2)(f) was repealed and s.82H was introduced.

This deduction was made available in recognition of the public good provided by life insurance companies (in the form of relief for the dependants of insured persons and long-term-savings). The deduction was subsequently removed in 1976 as a part of cost cutting measures employed by the government of the time. However, the original policy reason for the deduction was never denied.

For a brief period between 1976 and 1985 a concessional rebate was available under s.159R if the total medical, funeral, super contribution, life insurance premium and education expenses of the taxpayer exceeded the specified threshold.

In addition, where bonuses have been taxed in the hands of policyholders (as from 1982 under s.26AH), policyholders have been entitled to a rebate which is intended to approximate the tax paid by the life insurance company in respect of the same income.