October 2008

Australia's Future Tax System

76707v1

This Report is Rice Warner's Submission to the review of Australia's tax system.

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1. Summary of Key Points

1.1 Life Insurance

1.1.1 Observations

The taxation of life insurance is unnecessarily complex:

- Premiums are tax deductible for business funded from concessional contributions to superannuation but not for Ordinary policies.
- The tax on benefits paid from superannuation policies varies by age, type of benefit and relationship of the beneficiary.
- State stamp duties vary between States and Territories, change frequently and were one of the taxes that should have been removed on the introduction of GST!

1.1.2 Recommendations

We recommend that all life insurance benefits on death, TPD and Trauma be tax-free. However, the deductibility of life insurance premiums should vary.

We recommend that the tax position of life insurance should be the same for Ordinary and Superannuation policies sold to consumers.

We recommend that State and Territory stamp duties be abolished.

1.2 Superannuation

1.2.1 Observations

Women are relatively disadvantaged as (on average) they have shorter working lives but live for a longer time in retirement over which to spend their superannuation. Superannuation support should be provided during periods of child bearing and raising.

Concessional contributions are assessable at 15% tax within a superannuation fund. This means that many low income Australians do not regard superannuation as being concessional.

We regard it as inequitable that the investment earnings of accumulation accounts are taxed whereas pension accounts are tax-free.

1.2.2 Recommendations

We recommend that the government pays a non concessional superannuation contribution of $1,000 as a baby-bonus for mothers. We further recommend that an equivalent bonus be made to all mothers for each year they remain out of the work-force to raise children.

We recommend that contributions for low to middle income earners be treated as non-assessable in a superannuation fund. That is, remove the 15% tax on concessional contributions made on their behalf.

We recommend that investment earnings on accumulation and pension accounts be set at the same rate with a long-term goal of reducing the overall tax to no more than 10% of income.

We recommend that there be rollover relief on accrued capital gains and losses in the event that two superannuation funds merge.

1.3 Retirement Incomes

1.3.1 Observations

- The design of the Age Pension is satisfactory but there is a question mark over its adequacy, particularly for single persons;
- The Age Pension is fair on the whole but there are areas where equity could be improved;
- It is not necessary to increase the current eligible age for the Age Pension;
- Targeting through the means test is inefficient and complex;
- Dependency of retirees in the community grows by age;
- Each year, new retirees are wealthier than those from previous years; and
- Large numbers of retirees appear to spend their superannuation in the first ten to fifteen years of retirement.

1.3.2 Recommendations

We propose a structure to simplify the means-testing and to provide more certainty to retirement incomes. The key points are:

- At retirement age (65), retirees quarantine a superannuation amount (say) $250,000 which will be an exempt asset for the purposes of means-testing.
- Retirees can shift non-superannuation assets to this account at retirement age, provided the total does not exceed $250,000.
- Those who retire later can transfer further amounts (say, $15,000 a year) into their quarantined account.
- Retirees with non-exempt assets must utilise these before being eligible for an Age Pension.
- The value of the family home above (say) $1,000,000 will be a non-exempt asset. We suggest a way of treating this to allow access to the Age Pension without selling the home. The resulting "debt" would be repaid with interest upon death or selling the property.
- Once a retiree has no assets apart from exempt assets (which will usually consist of the exempt superannuation account up to $250,000 and their family home), they will be entitled to a full Age Pension.
- There will no longer be a part Age Pension or any regular means testing, just a straightforward assets declaration on claiming the Age Pension.

2. Introduction

2.1 About Rice Warner

Rice Warner Actuaries is an Australian-owned firm with offices in Sydney and Melbourne. We hold an Australian Financial Services Licence and provide high quality independent advice to participants within the financial services industry.

Our clients include many of Australia's superannuation funds and financial institutions. We also work for industry bodies, government agencies, financial planning groups and fund managers.

A significant part of our consulting work relates to superannuation and retirement incomes. We also undertake considerable research which is used to support our consulting work and our public policy work (including this submission).

More information about our firm is set out on our website www.ricewarner.com.

2.2 Focus of this Submission

In this submission, Rice Warner has considered several aspects of the tax system which apply to the broad areas where we practice. Consequently, our comments focus on life insurances and the superannuation and retirement income system.

This submission should be read in conjunction with our submission to the Harmer Review of pensions.

This submission was prepared (or peer reviewed) by the following consultants:

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3. Life Insurance

3.1 Products

Life insurance policies can only be issued by life companies registered with (and regulated by) APRA. The industry collectively annotates these products as *risk* business to differentiate them from other policies issued by life companies.

Products can be issued as stand-alone risk policies or as *riders* (additional benefits) on investment or superannuation policies. The life insured is the person whose life is covered and the policy owner is the entity owning the policy and responsible for paying the premiums.

Policies are categorised as Superannuation if issued to the trustees of a superannuation fund or as Ordinary class if not superannuation business.

The key products are:

- Life insurance – protecting against the death of the life insured;

- Total & Permanent Disability – ("TPD") providing payment should the life insured not be able to continue employment as a result of a crippling illness or accident. Where a policy covers death and TPD, the TPD benefit is usually an advance of the death benefit. However, some policies allow payment of the TPD benefit and continuation of the policy covering only life insurance.

- Trauma – this benefit pays an agreed sum on acquiring one of a designated number of medical conditions. Most claims for trauma are paid as a result of heart attacks, strokes, cancers and kidney failure. However, some policies provide cover for many more events.

- Disability income insurance – this benefit, also known as salary continuance cover, provides a regular income to replace up to 75% of salary and, in some cases, funding of missed superannuation contributions, during periods of disablement. The benefit period can range from 2 years through to retirement age.

There are three main distribution channels for the products, namely:

- Retail intermediaries – most retail business is sold through financial planners working for dealer groups;

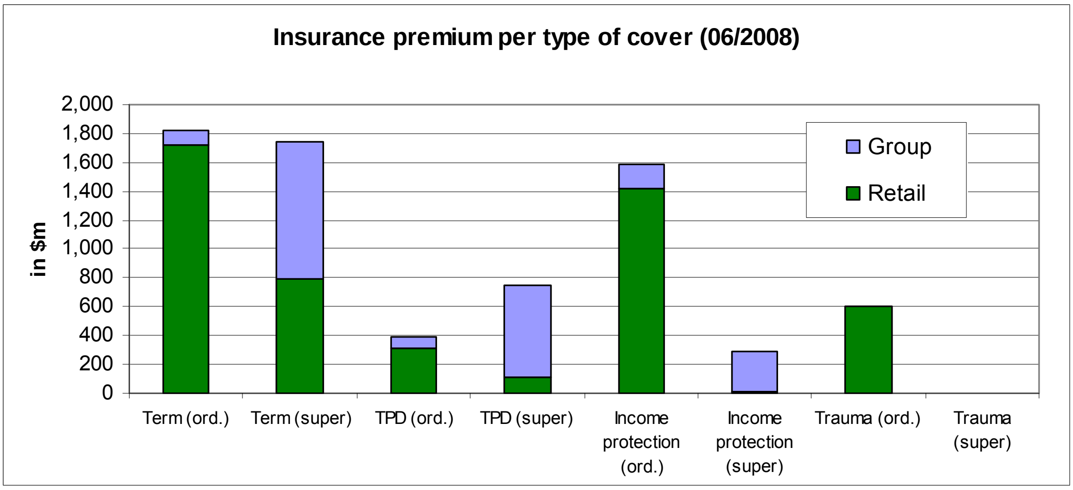
- Direct – About 15% of retail business is sold to customer bases using mail or web as the means of communication; and

- Group – Cover is provided to individuals under group (umbrella) policies. The owners are entities which have a large customer base. The largest policies are those held by trustees of superannuation funds on behalf of their members.

3.2 Market Size

Life insurers collect about $7.2 billion a year in insurance premiums. Graph 1 shows the segmentation of these into product types for group and retail policies.

Graph 1. Insurance Premiums



3.3 Taxation of life insurance business

The taxation of life insurance is complex. We have attached a summary as Appendix A. This sets out the general tax position of premiums and benefits.

In addition, life insurance is subject to stamp duties levied by State Governments and Territories. The amounts vary depending on the type of contract and the State or Territory.

3.4 Observations

The current structure of life insurance makes it advantageous to hold most policies within a superannuation structure. As premiums are an allowable expense of a superannuation fund, they are effectively tax deductible for a member if funded from concessional contributions. The removal of Reasonable Benefit Limits from July 2006 allows virtually unlimited benefits paid by tax-deductible premiums. The only practical limitation is that premiums count towards the maximum concessional contributions allowed for a member (except where payment is made by deduction from a member's account balance rather than as a separate contribution).

If a policy is not written within a superannuation fund, the premiums are usually not allowable expenses. Exceptions are premiums paid by individuals or employers for disability income benefits and premiums paid by businesses for shareholder insurance where the proceeds are paid to the shareholder or their dependants rather than to the business.

The situation with benefits is complex. On an ordinary policy where premiums have not been claimed as a tax deduction, the benefit is generally tax-free. In superannuation, the benefit is taxed according to a number of factors including type of claim (Death or TPD benefit) and whether there are dependants or not. For TPD cover the tax also increases with duration of membership.

We conclude that the taxation of life insurance is inconsistent and unnecessarily complicated.

3.5 Recommendations

We consider it would simplify the tax treatment of life insurance if:

- The treatment of life insurance for consumers was similar within and outside superannuation;
- All benefits for consumers were free of tax; and
- The tax-deductibility of premiums varied according to the level of concession (if any) that governments wanted to make from time to time.

As an example, the government could decide to allow a tax deduction for superannuation members for premiums up to $1,000 a year if they have dependants during the financial year of payment.

Individual tax returns would capture the information about dependency and a rebate could be provided to the individual as part of the tax return calculation or it could be paid back to a superannuation fund using the structure of the co-contribution process.

The advantage of this system is that benefit payments would not be subject to tax but the deductibility of premiums could be varied from time to time. Further, the treatment of Ordinary and Superannuation classes would be similar for consumers.

In a superannuation environment, our proposals would also mean there would no longer be a need for funds to carry out complex "anti-detriment" calculations to refund the contributions tax previously charged on risk insurance premiums when the member dies. In fact these calculations are so complex that most insurers do not pay them to the heirs as any refund would be entirely absorbed in covering the administration costs.

Stamp duty on premiums is widely recognised as a nuisance tax which costs as much to administer, across the economy, as it raises in revenue. Although we recognise the challenges in obtaining agreement from the States, it should be abolished.

4. Superannuation

4.1 Equity

Australia has a well-respected superannuation system and its benefits are well documented. It is a system that provides large tax concessions, some of which are clawed back through taxes on the funds and on benefits. In addition, government supports significant expenditure on the aged.

In the next financial year, the costs are estimated by treasury to be:

Table 1. Estimated Costs

Item	Projected Cost ($m) 2009-2010
Total Assistance to the Aged and Veterans	$46,364
Tax Concessions on Superannuation	31,346
Taxation of superannuation funds[1]	(12,508)
Net contribution by Government	$65,202

This contribution is about 7% of GDP showing that there is significant government support for the superannuation system. Nonetheless, the structure could be improved as shown by the following facts:

- More than 80% of people who have attained age 65 receive a full or part Age Pension;
- The Age Pension is considered to be too low, particularly for single pensioners. Yet, the large number of recipients makes it excessive for the benefit to be increased;
- The average retirement benefit is well under $100,000, reflecting that large numbers of older Australians did not build up adequate benefits during their working careers;
- Superannuation taxes are not concessional for low to middle income earners;
- Many Australians do not participate in the system because they are self-employed, unemployed or work part-time;
- There is discriminatory treatment in favour of those who have attained age 60.

4.2 Adequacy

There are many Australians excluded from the compulsory ("SG") system over part of their productive life. The biggest group represents mothers who cease work to bear and raise children. Other groups include carers and those who are disabled or unemployed.

Exclusions could be minimised if contributions were made on behalf of carers, those on welfare or those who are temporarily out of work.

[1] Including an estimated $2,058m from the superannuation business of life companies.

4.2.1 Savings for Women[2]

The Age Pension is a safety net which alleviates poverty in retirement. On average, women live longer and have less superannuation than men. Hence, they are more likely to receive Age Pension benefits for longer.

The Age Pension alone does not provide a comfortable retirement. More females than males draw a full Age Pension. Society needs to encourage future generations of females to be more self sufficient (and more comfortable) in their retirement years.

In October 2004, we published a newsletter outlining the difficulties many women face in making adequate provisions for their retirement. Women earn less on average than men yet live longer so their superannuation contributions need to be higher to obtain similar levels of retirement benefits.

The position is worse for mothers who have periods out of the work force to bear and raise children. Many also have extended periods of part-time work which may not qualify for SG payments. Single mothers or married women who become divorced will struggle the most as their family income will be low but their costs remain high. We calculate that a mother leaving work to bear and raise two children can lose nearly 30% of her projected retirement income if she rejoins the work force later (and she will lose more if she doesn't return to work).

4.2.2 Financial impact of being female

The table below shows the projected retirement income for a woman at ages 60 and 65 under different scenarios. If she decides to have no children, her annual retirement income will be lower than a male with a similar work pattern, due to her longer life expectancy. Females need to make their pension dollars stretch over a longer period than men.

However, if she has a family, her superannuation suffers significantly with foregone contributions during the periods of broken work service and the possible shift to part-time work while raising her children.

There are a number of strategies which could be implemented to improve a woman's retirement balance.

The first step could be for all young women to pay an extra 2% of their salary into superannuation. In times of low incomes, they can make use of the co-contribution; if they earn above average income, they can swap to salary sacrifice. This simple device can increase their retirement income by up to 30%. However, the earlier they start in their career, the better.

Women could also delay retirement but this will depend on their family circumstances (they may not want to continue working if their partner has retired) and whether paid work is available.

Making use of these voluntary strategies will make a significant difference to the retirement outcome.

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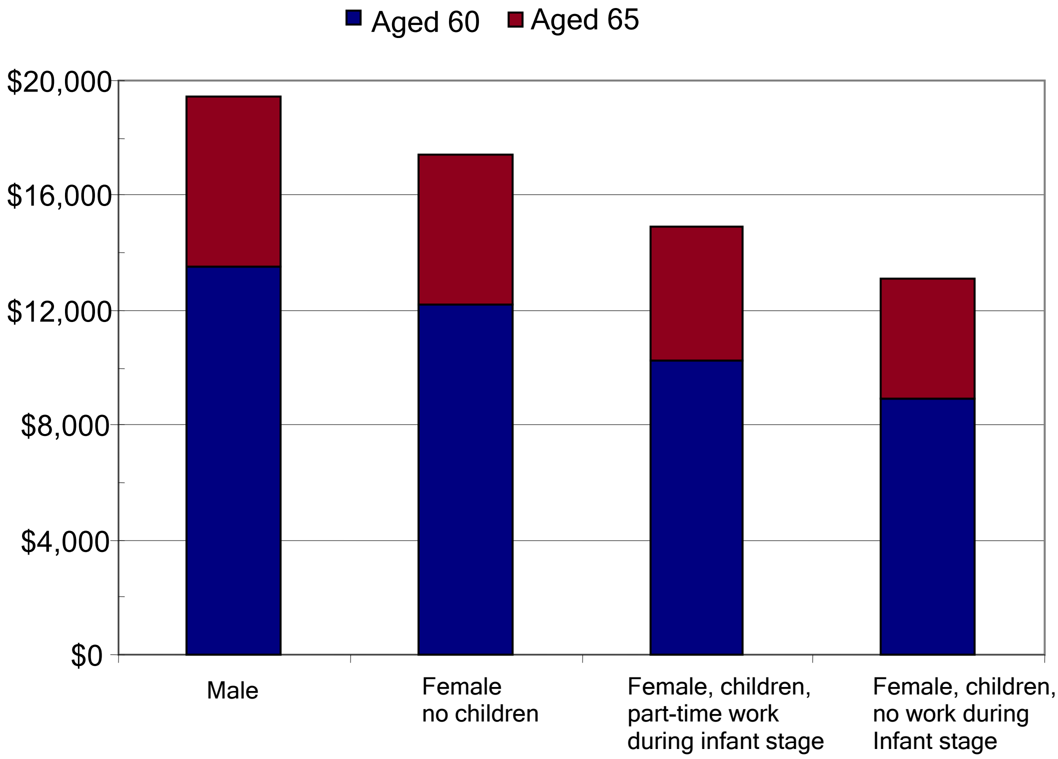
[2] This section has been extracted from our newsletter of November 2007

Graph 2. Annual Retirement Income (females)



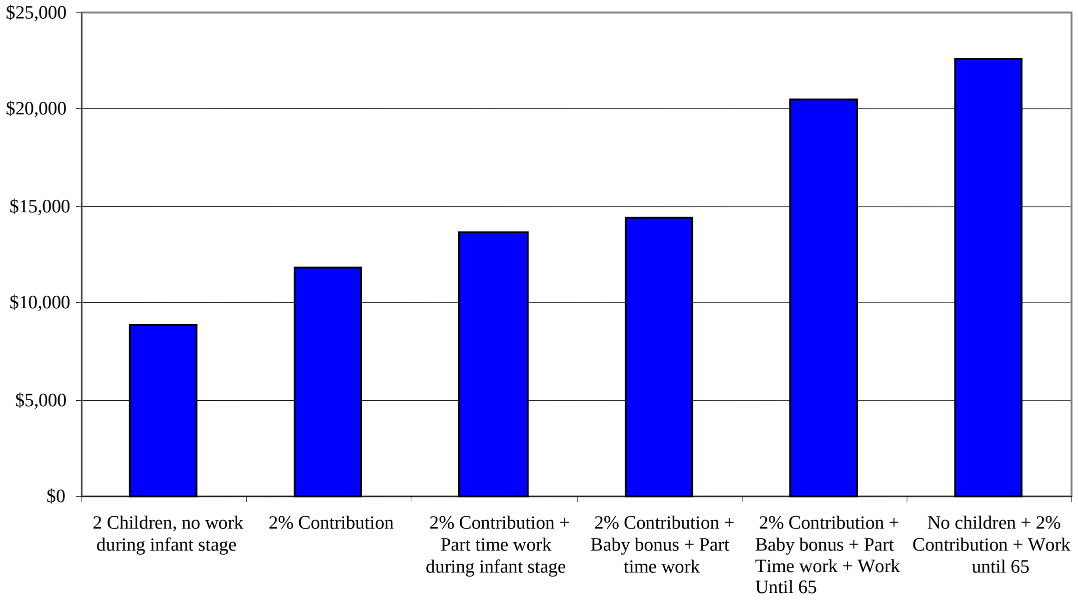
Although females can help themselves by paying extra contributions and/or retiring later, it would be more equitable for the government to provide some additional support for those who have broken work patterns to bear and raise children.

Since mothers suffer financially more than other women, the government could consider allowing families to be eligible for the co-contribution scheme if a mother with dependant children is off work and not employed. The cost of this might be of the order of $100 million a year.

Another initiative might be to provide a "super baby bonus". This amount should attempt to meet the SG contributions foregone during the time off work for motherhood. A suitable payment into the superannuation fund might be $4,000. This would cost the government slightly more than $1 billion a year based on the current number of births (265,900 in 2006).

The table below shows the impact of these proposals on retirement benefits. Clearly, the combination of support from government and personal income sacrifice can make a significant difference to the final benefit. Note that many women will receive a full or part Age Pension in addition to the income shown below.

Graph 3. Ways to Improve Annual Retirement Income for Females



4.3 Tax Issues

4.3.1 Tax treatment of contributions

Those contributions which are claimed as a tax-deductible expense are known as *concessional contributions* (previously "deductible contributions"). These contributions are sourced from:

- Employers, being payments made under the Superannuation Guarantee legislation;
- Employers, being additional contributions made generally or as "salary sacrifice" contributions as part of an employee's remuneration package; and
- Self-employed people, who can claim contributions made to superannuation.

The overall concessional contribution limits are capped at $50,000 p.a. per member. However, there is a short-term limit of $100,000 p.a. for those over age 50. This expires in the 2011-2012 financial year.

Members may make further contributions which are not concessional. These are limited to $150,000 a year (or $450,000 over a three year period).

Concessional contributions are taxed at 15% as they are treated as assessable income within the superannuation fund. This structure was established 20 years ago by "advancing" part of the tax which then applied to benefits.

As this tax is above or equal to the personal marginal tax rates of many Australians, there is no particular (tax) advantage in them making contributions. Effectively, the 9% employer contribution is reduced to 7.65% by this tax.

There is general acknowledgement that, subject to affordability, the 9% contribution should be raised to a higher level somewhere between 12% and 15% of wages. If the tax on contributions were removed for low income earners, this would provide an immediate increase in the company contribution rate of 1.35% of salary.

The tax could be rebated using the current co-contribution mechanism for identifying eligibility.

We note that the cost of such a measure would be several billion dollars a year and this will be a consideration in setting the parameters for eligibility.

4.3.2 Tax treatment of investment earnings

The May 1988 Economic Statement introduced a number of tax changes, including the taxation of investment earnings of superannuation funds at the rate of 15%. The rate paid by funds is lower due to allowable expenses (fees and insurance premiums), imputation credits on franked dividends and a concessional rate of 10% on capital gains investments held for at least 12 months.

The investment income remained untaxed on all pension accounts including assets backing annuity portfolios.

The introduction of "Transition to Retirement" means that older working Australians are able to shift their super fund assets into pension products which are tax free. This discriminates in favour of older Australians. Together with tax-free benefits over age 60, the advantages provided to pensioners are extraordinarily generous relative to the position of other tax payers.

If the tax on investment earnings were the same over all accounts, it would improve equity and simplify the administration of superannuation. For example, it would not be necessary to hold separate accumulation and pension accounts during the Transition to Retirement years, nor would it be necessary to create separate investment records for holdings in taxable and tax-free units.

As the baby-boomer generation retires, there will be a major shift in assets into pensions. We estimate that 40% of all funds will be held in pension accounts in 15 years time. This will lead to a significant growth of assets with a tax-free status.

It would be more equitable to equalise investment taxes over a person's life and to have a single rate of tax on accumulation and pension accounts. By including pensions, the long term rate could be reduced to less than 10% without impacting on revenue collection.

There would be significant transitional arrangements in respect of current pensions. We have also recommended a change to the Age Pension structure and the establishment of some tax-free accounts as part of this change (see next section).

4.4 Fund mergers

Mergers of superannuation funds have been frequent in recent years and the pace of consolidation is likely to be maintained. For example there are now only 75 industry funds and we expect the number to reduce to less than 50 over the next 2 to 5 years.

Currently, the transfer of funds under the successor fund transfer arrangements results in a crystallisation of capital gains for tax purposes and the inability to utilise past tax losses.

This serves as a dis-incentive to merge and can result in members missing opportunities to benefit from the economies of scale which can accrue from fund mergers.

We recommend that capital gains tax rollover relief and the carrying forward of tax losses be granted in such circumstances.

4.5 Proposed Changes

We recommend that the government pays a non concessional contribution of $1,000 as a baby-bonus for mothers. We further recommend that an equivalent bonus be made to all mothers for each year they remain out of the work-force to raise children.

We recommend that contributions for low to middle income earners be treated as non-assessable in a superannuation fund. That is, remove the 15% tax on concessional contributions made on their behalf.

We recommend that investment earnings on accumulation and pension accounts be set at the same rate with a long-term goal of reducing the overall tax to no more than 10% of income.

We recommend that capital gains tax rollover relief and the carrying forward of tax losses be granted when superannuation funds merge.

5. The Age Pension

5.1 Summary of Submission to Harmer Review

Superannuation is a part of the overall retirement income system. It needs to be considered in the light of the Age Pension structure. We have made a separate submission to the Harmer review and that submission should be read in conjunction with this one. Our key points are:

- It is not necessary for Australia to set up a universal (non-means tested) Age Pension.
- It is not necessary to increase the eligibility age for the Age Pension beyond age 65.
- Means testing is complex and invasive. It is desirable to change the structure to something more equitable and simpler.
- The Preservation Age for superannuation benefits should be gradually increased to age 65.
- We should encourage people to use their superannuation benefit and other assets before they become eligible for any Age Pension benefit. This would mean that means testing need only be done when someone has spent their superannuation and first becomes eligible for social security.
- Some superannuation (say, $250,000 per retiree) would be placed in an exempt pension account (a "quarantine account"). This (together with tax-free earnings on the account) could be used at any time and would not be taken into account for Age Pension purposes.
- Retirees who continue working past age 65 (probably up to age 70) would be allowed to top up their exempt account by up to (say) $15,000 a year. This would provide a larger quarantined account by the time they retire.
- The Age Pension could also be deferred for those with homes exceeding (say) $1 million. People in this position should be deemed to have available funds of the amount above $1,000,000 which should be utilised first. Those people in this situation, who did not want to sell their home but wanted to draw a pension, could effectively take a loan akin to a reverse mortgage – but from the government. This would provide an income stream without forcing the sale of the family home. The loan would be repaid from the estate on death, or earlier if the family home is sold.
- This structure means that it would not be necessary to do any means testing until people became eligible for the pension. At that point, the test would be simple to apply as it would be a simple assets test.
- There is a community push for the Age Pension amount to be raised by 20% for single pensioners (to 30% of MTAWE). In order to target this increase properly, it could be structured as a supplementary amount subject to certain rules. For example, this increase could be tied to Community Service (including unpaid charitable work) for those between ages 65 and 75. The service could be for 50 days over 12 months. In this way, the community would obtain some benefit from the additional funds spent by government.

Appendix A. Summary of the Tax treatment of insurance provisions

Private Sector Superannuation Business

Death & TPD Cover

Premiums

Premiums are tax-deductible to the fund, which effectively means the portion of the employer contribution that covers the premium is tax free.

Stamp duty is payable by the insurer. However, the amount of duty is generally absorbed in the premium charged.

Premiums may be paid out of superannuation contributions. Employer contributions are subject to payroll tax.

Lump Sum Death Benefits

On Death in service or TPD, the member's benefit will generally consist of a portion funded by the superannuation fund (generally the member's account balance) in addition to the insurance benefit.

The tax treatment of death benefits depends on whether the beneficiary is classed as a dependant for tax purposes. A dependant includes any spouse (including de facto) or former spouse of the member, any child of the deceased under age 18 (including adopted child or stepchild), anyone financially dependant on the deceased or anyone with an "interdependency" relationship with the member (as defined in the tax legislation).

Death benefits paid to dependants are tax-free. Death benefits paid to non-dependants may have a tax free (the component financed by the post-tax contributions and the pre 1 July 1983 component) and a taxable component. The tax-free component is not assessable. The taxable component is subject to 15 per cent tax (plus the Medicare levy).

Lump Sum TPD Benefits

Above age 60 the whole benefit is payable tax free. Below age 60 the benefit may have a tax-free and a taxable component. The tax-free component may include the same elements as the death benefit (above) but also an Invalidity Component.

The Invalidity Component is determined as the portion of the TPD benefit relating to future service to the member's normal retirement age.

The taxable component is taxed in the same manner as other lump sum superannuation benefits.

Trauma Cover

Trauma cover is not usually provided in superannuation funds as the fund trustee may insure the benefit but the benefit may not be paid to the member until a condition of release is satisfied.

Salary Continuance / Income Protection Cover

Premiums

Premiums are tax-deductible to the fund which effectively means the portion of the employer contribution that covers the premium is tax free.

The insurer is liable for stamp duty on the premium amount, with the amount of duty payable varying by state of residence of the insured member. The amount of stamp duty is passed on to the fund. This may be either through an explicit loading to the premium, or it may be included in the premium charged.

Benefits

Disability Income Benefits are included in the member's assessable income for personal income tax purposes.

Ordinary Business (Non Superannuation)

Death and TPD Cover

Premiums

For personal policies, premiums are not tax-deductible to individuals. If an employer pays the premiums on behalf of an employee, the premiums are subject to fringe benefits tax and are deductible to the employer.

For Insurances on Directors or Employees of a company, the principle is that premiums are tax-deductible where the insurance is designed to replace a revenue item of the company. Therefore, in general, the following applies:

- Key-person Policies: Premiums are fully tax-deductible
- Shareholder Protection Policies: Premiums are not tax-deductible.

For policies owned by employers on the lives of their staff, premiums are tax deductible. Stamp duty is payable by the insurer. However, the amount of duty is generally absorbed in the premium charged.

Benefits

For Personal Policies, benefits are tax-free.

For Insurances on Directors or Employees of a company, the principle is that benefits are taxable where they replace a revenue item of the company. Therefore, in general, the following applies:

- Key-person Policies: Benefits are taxable as ordinary income of the company.
- Shareholder Protection Policies: The tax treatment of the benefits depends on the structure of the cover. Benefits may be tax free or may be subject to capital gains tax.

For employer owned cover on employees, benefit proceeds are assessable to the employed when received. If the employer pays the proceeds on to the disabled employee or the beneficiaries (or estate) of a deceased employee these amounts are usually tax deductible to the employer. When the employers pay a benefit to a disabled employee or a beneficiary, the payment is assessed as an Employment Termination Payment in terms of the Better Superannuation reforms effective from 1 July 2007.

As with superannuation benefits, Employment Termination Payments may have a tax free and a taxable component. The tax free component consists of any pre-June 1983 component and any Invalidity Component (TPD benefits).

For death benefits, the taxable component is taxed as follows:

- Paid to non-dependants:
  - 30% plus Medicare levy for amounts below the employment termination cap; and
  - 40% plus Medicare levy for amounts over the cap.
- Paid to dependants:
  - The 30% rate above reduces to 15%.

For TPD benefits, the taxable component is taxed as follows:

- For recipients below the preservation age:
  - 30% plus Medicare levy for amounts below the employment termination cap ($140,000 in 2007/08 – indexed annually); and
  - 45% plus Medicare levy for amounts over the cap.
- For recipients above the preservation age:
  - The 30% rate above reduces to 15%.

Trauma Cover

Premiums

Premiums are not tax-deductible for personal policies.

Benefits

Benefits are tax-free.

Salary Continuance / Income Protection Cover

Premiums

Premiums for personal policies in disability income products are tax-deductible in the hands of the policyholder.

The insurer is liable for stamp duty on the premium amount, with the amount of duty payable varying by state of residence. The amount of stamp duty is generally passed on to the policyholder through an explicit loading to the premium.

Benefits

Disability Income Benefits are assessable income in the hands of the beneficiary.

Minimum Death Cover in Superannuation Funds

Under the Choice of Fund rules, an employer's default fund must offer a specified minimum level of Death Cover. There is no minimum requirement for disability benefits. Employers who had default funds in operation on 1 July 2005 are exempt until 1 July 2008.

The rules are as follows.

Accumulation Schemes

There is no requirement for employees aged 56 or over.

For employees under 56, the scheme needs to offer Death cover at a premium of at least $0.50 per week, or alternatively, at least the following levels of cover:

Age	Death Cover
20 to 34	$50,000
35 to 39	$35,000
40 to 44	$20,000
45 to 49	$14,000
50 to 55	$7,000

Defined Benefit Schemes

The scheme needs to offer a death benefit with a Future Service Component of at least the amounts set out in the schedule for Accumulation Schemes above.