FSC FINANCIAL SERVICES COUNCIL

19 January 2017

Budget Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: prebudgetsubs@treasury.gov.au

FINANCIAL SERVICES COUNCIL PRE-BUDGET SUBMISSION

The Financial Services Council (FSC) has over 110 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, licensed trustee companies and public trustees. The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the third largest pool of managed funds in the world. The Financial Services Council promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The FSC's pre-budget submission makes two recommendations:

1. Policy changes be enacted in this Budget, to ensure Australia will be able to compete in the Asia Region Funds Passport, commencing in early 2017; and

2. Policy changes be made to improve outcomes for life insurance consumers.

We would be pleased to discuss this submission. If you have any questions please do not hesitate to contact me via e-mail at choorweg@fsc.org.ua or by telephone on 02 8235 2519.

Yours Sincerely

CARLA HOORWEG
Senior Policy Manager

FINANCIAL SERVICES COUNCIL

2017-18 FSC Pre Budget Submission

1. MEASURES TO SUPPORT THE ASIA REGION FUNDS PASSPORT

The government has made significant progress on the Asia Region Funds Passport (Passport) with other participating jurisdictions. The Passport is now anticipated to commence in early 2017, with Australia likely to be one of the first two participating jurisdictions to be ready.

We commend this progress and fully support Australia's participation in the Passport.

It is critical, however, that domestic taxation and regulatory changes are put in place so that Australian fund managers can benefit from both the Passport and the recent free trade agreements with Japan, Korea and China.

Australia's ability to successfully compete in this regime remains contingent on two key policy changes:

- introduction of a new collective investment vehicle, and
- development of a competitive withholding tax regime.

In addition, taxation certainty should be provided to ensure that multi-currency class unit trusts can be operated effectively and the benefits of future double taxation treaties should be afforded to all Australian collective investment vehicles.

It is essential that Government decisions are taken on these items as soon as possible so that fund managers and service providers can prepare for the Passport's 31 December 2017 commencement.

Increasing taxation competitiveness – Special withholding tax rate for Passport funds

We acknowledge the government's recent consultation on the withholding taxes applying to collective investment vehicles. Changes to Australia's withholding tax regime are needed to ensure the competitiveness of Australian funds.

The FSC recommended in its submission that a simple, flat rate of withholding tax be available for Australian funds entering the Passport regime. The Passport Rules allow only very simple ('vanilla') investments into equities and interest based products (i.e. bonds and fixed income products). Some of these investments will be made into Australian based assets and others into overseas or global assets.

Detailed examination of these asset types shows that little withholding tax will be earned by the government on ARFP funds, as many of these assets will be either be classified as non-taxable

Australian property under existing domestic tax law, or will be foreign assets that Australia does not tax as a matter of policy.

The complex nature of Australia's withholding tax rules, and the interactions with tax treaty rules, will mean that disclosure of possible tax consequences for foreign investors in a simple and easy to understand manner will be very difficult. The Passport regime is specifically designed for retail investors so the ability to simply explain tax consequences will be a key advantage. Having to identify potential high headline rates and then explain how different types of income are classified and will eventually receive non-taxable status will be a disadvantage for Australian fund managers.

The FSC estimates that the revenue costs to this reform would be insubstantial, while the economic benefits could be substantial. FSC data collections show approximately $5m of non-resident withholding tax is withheld annually by managers operating equity and bond funds. This is because most income in these types of funds ends up falling into existing exempted categories, such as franked dividends or 128F interest.

Using conservative assumptions, the FSC estimates that for every $1 billion in additional funds under management sourced from offshore investors, corporate tax receipts alone would increase by $1.8m which suggests an additional $3.2 billion in offshore funds under management would need to be attracted from an industry worth $US 71.4 trillion (A$ 94.9 trillion) globally.[1]

Changes to withholding tax are an example of a policy initiative which has a low cost but the potential for significant gains in increased economic activity.

RECOMMENDATION: The withholding tax rate for all taxable receipts from Passport funds is reduced from 15% to 0%

EXPECTED BUDGET IMPACT: The FSC is mindful of the potential impact of any policy changes on the Budget, however we expect that a reduced withholding tax rate will have no negative impact on the Budget.

We understand that Treasury's revenue costing methodology compares the impact of a tax rate change to the revenue currently projected in the forward estimates. That is it seeks to quantify the revenue impact on the forward estimates relative to previous estimates of the forward estimates.

Currently it is not possible for Australian fund managers to market to retail clients in the Passport jurisdictions, so no withholding tax is being collected from investors and therefore no actual revenue is currently in the forward estimates of the budget to reflect non-resident withholding tax for these jurisdictions. This means that Treasury's revenue costing

[1] FSC Submission to Treasury Consultation Paper on Collective investment vehicle non-resident withholding taxes, 2 December 2016

FINANCIAL SERVICES COUNCIL

methodology should produce a net revenue gain for setting a 5% flat withholding tax for ARFP funds. If this rate were set more competitively at zero, there would also be no revenue impact as the budget's forward estimates have been determined with zero revenue from Passport participant countries.

Further, the Passport rules limit the allowable investments to securities such as bonds and equities. The only items in such portfolios that could attract withholding tax (WHT) at present are unfranked Australian dividends, which are a minor part of dividends from an Australian portfolio, and any residual 'MIT Fund Payment' amounts, which we expect would be a very small proportion of income due to property not being an allowable investment. No withholding tax is charged on dividends that are fully franked. We expect most bonds would be either Foreign, Government or Corporate paper (s128F) all of which are exempt from withholding tax under the current law.

Further a report by KPMG contained in Appendix A recommends that **all** withholding tax be abolished at the fund level for Passport funds.

The FSC's views is that the full abolition of withholding tax, along with a CIV regime, would place Australian in an excellent position to compete as a funds management centre.

Removing taxation uncertainty

The following items are also important in ensuring Australian based fund managers can capitalise on the Passport initiative.

Item	Description	Comments	Priority
FX hedging treatment	Passport vehicles must receive appropriate treatment under TOFA subdivision 230E in relation to portfolio FX hedging	This issue must be fixed for Passport funds to operate effectively. Without this change it is not possible to operate multi-currency class unit trusts	ASAP
Collateral deposits	Interest on collateral deposits is subject to withholding tax.	FSC expects less than $1million in revenue is collected under this measure.	ASAP
Receive treaty benefits	Future treaty negotiations to contemplate Passport funds so that the receive treaty benefits either under "CIV" provisions or the addition of Passport specific provisions	Treaty benefits should be applied to any new Australian CIVs	Ongoing

We believe these changes can be developed in a way which meets industry's objectives and results in no cost to government revenue.

RECOMMENDATION: Various taxation uncertainties be rectified in a Passport-specific package of taxation law amendments.

EXPECTED BUDGET IMPACT: Unquantifiable. We anticipate that there may be some cost to government revenue on FX hedging items due to timing differences, however we expect that this cost would net out from year to year.

Collective Investment Vehicles ("CIVs")

We acknowledge and welcome the government's announcement in its 2016-17 Budget to introduce a new corporate tax flow-through Collective Investment Vehicle ("Corporate CIV") by 1 July 2017.

A broader range of vehicles is important for attracting investors from foreign jurisdictions. Australian unit trusts are unique and complex vehicles. The new Corporate CIV will be critical to Australia's success in the Asia Region Funds Passport.

It is essential that the 1 July 2017 deadline is met for the Corporate CIV, so that industry has time to understand the new structure before the Asia Region Funds Passport commences on 31 December 2017.

We look forward to Treasury releasing a proposed model for the corporate CIV and to working together to develop the regime in a way that will be simple, effective and workable.

RECOMMENDATION: A CIV regime is legislated as soon as possible which offers a suite of alternative tax flow-through collective investment vehicle structures open to both domestic and foreign investors.

EXPECTED BUDGET IMPACT: Nil. Existing budget commitment.

Conclusions

We believe this package of budget measures has the potential over time to significantly increase the amount of foreign fund inflows received by Australian managers.

It is essential that these tax changes are implemented so that Australian fund managers can take full advantage of the trade opportunities arising from the Asia Region Funds Passport and the recent free trade agreements with China, Korea and Japan.

Without these changes Australian fund managers will continue to be at a disadvantage despite the hard work that has gone into negotiating promising financial services terms in these agreements.

2. LIFE INSURANCE MEASURES

Removing barriers that restrict Life Insurers from providing targeted rehabilitation payments to get people back to work sooner

The longer an individual is away from work can significantly reduce their likelihood of returning to work which can result in a negative effect on the individual and their family. This is because the longer a person is away from work the higher the likelihood of poorer physical and mental health culminating in more permanent disability, removing them from the workforce. For example, according to the Australasian Faculty of Occupational and Environmental Medicine, if a person is off work for 70 days their probability of returning to work reduces to 35 per cent.

Private personal disability income insurance is a means for individuals to protect themselves from economic losses that arise from both mental and physical disability. However, only viewing this type of insurance as providing income protection ignores the wider benefits that this insurance could provide to consumers, society and public finances.

Current legislative arrangements prevent life insurers from offering targeted rehabilitation benefits in certain circumstances, even when they are considered by the insurer to be relevant, appropriate and necessary to rehabilitate the claimant under a continuous disability policy. Life insurers wish to make targeted rehabilitation payments for medical treatment or therapy that they determine to be relevant, appropriate and necessary to return the claimant to work.

If these restrictions were removed, as proposed by this submission, life insurers would be able to use more effective early claim intervention practices through offering rehabilitation benefits. This would increase an injured person's probability of successful rehabilitation relative to the status quo.

The benefits of higher return to work rates that would eventuate from a targeted adjustment to legislative settings to allow life insurers more flexibility with respect to making rehabilitation payments would promote a more sustainable life insurance industry. Increased return to work rates would translate to a lower claims cost for a disability income protection policy on a net present value (NPV) basis and would allow insurers to have more stable premiums on products.

This potential improvement in the NPV of an insurance policy over its life would incentivise life insurers to invest in more active rehabilitation strategies which would unlock positive externalities. For individuals, higher return to work rates leads to a better outcome on a NPV of lifetime income basis. For government, higher return to work rates will reduce the fiscal costs of the Disability Support Pension and the National Insurance Disability Scheme. By definition, higher return to work rates will translate into higher workforce participation which is a key government objective at a time when the population is aging and the Australian workforce is shrinking.

There is a strong public policy case for making legislative amendment to allow life insurers to offer targeted rehabilitation benefits to rehabilitate the claimant in order to get them back to work under a continuous disability policy.

A higher return to work rate will reduce the fiscal costs of the Disability Support Pension and the National Insurance Disability Scheme.

RECOMMENDATION: The government consider removing legislative barriers restricting life insurers from providing targeted rehabilitation payments.

Agreement with States on Abolition of Inefficient State Taxes

The FSC supports the abolition of inefficient State taxes. This was a core component of the FSC's response to the Federal Government's Tax White Paper, Federation White Paper and Inter-generational Review processes in 2015.

To the extent that changes are made to Australia's taxation system, we encourage the Commonwealth to ensure the States commit to their promise to abolish inefficient taxes. Importantly this commitment should be a focus of any agreement to make changes to the GST.

Backtracking of States on prior commitments has resulted in a patchwork of inefficient, distortionary tax outcomes. These are in turn impacting on areas of the economy with undesirable consequences.

The different treatment of stamp duty on life insurance is an example. We acknowledge this issue is beyond the scope of the Federal Budget, however we make the following observations:

- Each jurisdiction has a different regime for the collection of stamp duty on life insurance policies.
- Individual members of different group insurance products residing in different States must be accounted for by insurers when calculating each member's stamp duty liability, thus creating a substantial and costly administrative burden.
- Each jurisdiction applies different stamp duty rates to life insurance 'policy riders', such as such as trauma and disability cover, despite the fact it is virtually impossible to purchase these 'policy riders' as a stand alone product.
- The cost to collect the tax (cost to insurers and government) in most jurisdictions would comprehensively exceed taxes raised.

BOX 1. Stamp Duty on Life Insurance

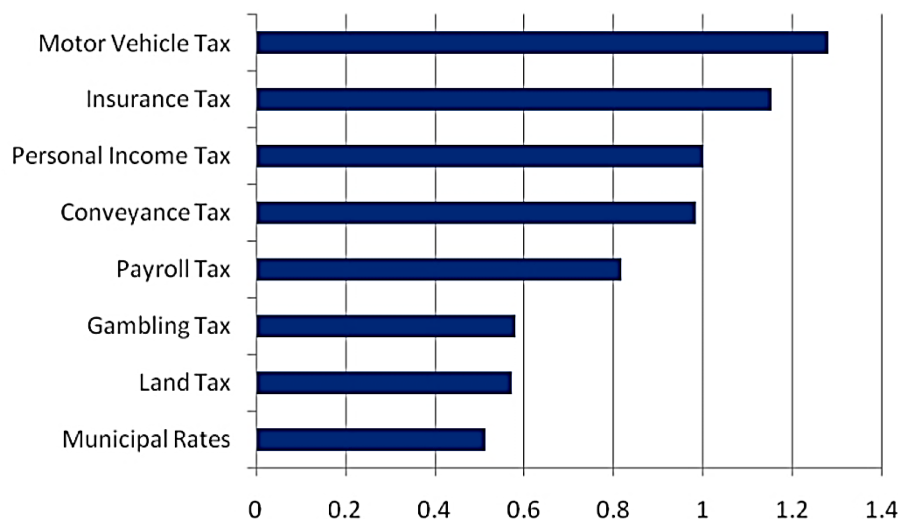
The total amount of State and Territory stamp duty collected on life insurance and life insurance rider benefits amounted to approximately $377 million in 2014, according to an FSC survey of companies representing 80% of life insurance premium currently in-force in Australia. This includes both stamp duty paid on life insurance policies and stamp duties paid at the general insurance rate for life insurance policy riders. This data is presented in Appendix B.

Currently all States and territories have a different rate and basis for levying taxes collected. Some are sum insured based; some are premium based; some have a combination; some have no duty on life insurance but loaded duties on rider benefits; the percentage of rates levied on life rider benefits vary from state to state and product to product.

This creates a productivity drag on life insurers because it necessitates complex assessment processes, legal fees and systems reconfiguration all of which would be simplified under a harmonised system, or not necessary at all if stamp duty was abolished.

According to research by Deloitte Access Economics for the Finance Industry Council of Australia, insurance taxes rank as the second most inefficient of taxes levied by State governments[2] (see Chart 2 below).

Chart 2: General efficiency rankings of State/Federal taxes



Attempts to have a 'uniform' methodology for the raising of the state tax have failed on a number of occasions and Australia is one of the few mature economies that taxes life insurance and life riders instead of giving a tax deduction. Appendix 1 provides a summary of the various stamp duty levies applying to life insurance and associated products in each Australian jurisdiction.

The level of underinsurance of employed people is estimated to be $304 billion per annum[3]. This is a significant level of underinsurance and is especially concerning considering that most working Australians have default life insurance cover held within group schemes in superannuation funds.

Insurance duties ultimately increase the cost of life insurance for Australians. Research undertaken by KPMG for the FSC shows that if Australians were adequately insured, social

[2] Deloitte Access Economics, 2011 Analysis of State Tax Report, pp. 2

[3] KPMG for the Financial Services Council, Underinsurance Disability Protection Gap in Australia, 2014

FINANCIAL SERVICES COUNCIL

security benefits could be reduced by a minimum of $340 million[4] in the first year (before the impact of foregone tax revenue is taken into account).

RECOMMENDATION: Stamp duty on life insurance is an inefficient tax that creates a productivity drag for the life insurance industry. The Federal Government should establish an agreement with the States to abolish inefficient stamp duties through the Coalition of Australian Governments (COAG) processes.

[4] KPMG for the Financial Services Council, Underinsurance Disability Protection Gap in Australia, 2014

3. SUPERANNUATION

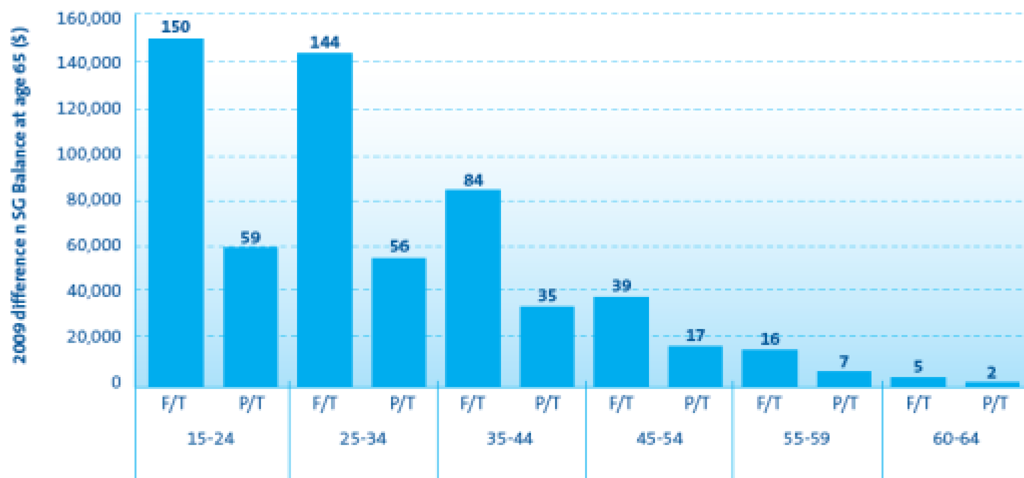
Policy rationale for 12 per cent Superannuation Guarantee Charge

The FSC welcomes the Government's commitment to increase the Superannuation Guarantee Charge (SGC) to 12 per cent. The increase will generate long-term economic benefits and continue to address the national shortfall in retirement savings that is causing Budget challenges for the Government.

Australia currently has a significant 'savings gap,' the difference between the amount required to be saved by the nation as a whole to ensure adequacy in retirement and the amount that will be saved in the superannuation system by the current workforce. Rice Warner Actuaries has determined that under an SGC of 12 per cent the savings gap is over $1 trillion when you take into account those who will live longer than life expectancy.[1]

A University of Canberra NATSEM Report modelled the importance of an increase in the SGC rate to 12 per cent to address the gap by growing individual account balances as shown in Table 1 below.

Table 1 - projected difference in super balance at age 65 by age group and labour force status[2]



Note: The values shown are the projected difference between SG contributions of 12% and 9% per annum until age 65. The projections assume real wages growth of 1% per annum and real superannuation returns of 4% pa.

Source: *NATSEM estimates based on HILDA data.*

Increasing the SGC to 12 per cent achieves a long-term benefit for younger working Australians. Employees aged 15 to 24 will benefit from the increase in the SGC to 12 per cent by the reform adding $150 000 to their retirement savings by age 65. NATSEM concluded that "clearly an

[1] *Longevity Savings Gap Research and Policy Options*, Rice Warner Actuaries, September 2012
[2] NATSEM Report, Saving Tomorrow April 2010

additional $150 000 in superannuation will make a major difference to a person's standard of living in retirement and help reduce the fiscal pressure on future governments."[3]

Impact of two-year delay in SGC rate increase

The proposed two-year delay in the scheduled increase in the SGC, however, undermines the effectiveness of the increase. For those who are likely to retire over the next decade, the delay detracts from the forecast $39 000 increase in individual retirement savings that they would otherwise have accrued.

Significantly, the proposed delay to the phasing in of the Super Guarantee to 12 per cent will result in a cumulative impact of around $40 billion less in super savings in the system over the next seven years.

The FSC strongly recommends that there be no further delays to the increase in the SGC to avoid exacerbating inter-generational pressure on public finances resulting from demographic change in Australia's population.

The Treasury projections outlined in the 2010 Intergenerational Report (IGR) unequivocally demonstrated how the ageing of Australia's population will pressure public finances. The IGR concluded that[4]:

- the ratio of working aged people relative to retired people will halve, from around 5 today to 2.7 by 2050;
- between 2010 and 2050, the proportion of Australians aged 65-84 will double, whilst the proportion of people aged 85 and over will quadruple; and
- the proportion of Australians of working age will fall by seven percentage points to 60 per cent of the total populace in 2050.

These demographic changes will generate the problem of a shrinking tax base compounded by increased spending on health and pension costs. Health costs will almost double by 2050 to 27 per cent of GDP while pension costs are expected to rise from 2.7 per cent to 3.9 per cent of GDP over the next 40 years.

Any shortfall in retirement savings arising from the delayed increase in the SGC increases the number of retirees who will receive the age pension, and increase the amount of age pension they will be paid over their retirement. It will therefore accentuate the impact of the aging population on the Government and future tax payers.

[3] NATSEM Report, Saving Tomorrow April 2010 at 24

[4] The 2010 Intergenerational report, The Treasury - http://www.treasury.gov.au/igr/igr2010/

SGC impact on the economy

There is no evidence to support the proposition that the increase to the SGC is a tax on business or negative for business generally. The implementation schedule was specifically designed to allow employers to take the increased SGC contributions into account when negotiating future wage settlements, ensuring that the incidence will largely fall on individuals.

The experience following the introduction of the SGC and during the increase to 9 per cent shows that business conditions in Australia actually improved significantly:

- Profits as a share of GDP increased during this period, growing from around 6 per cent of GDP in the early 1990s to around 8 per cent in the early 2000s.
- At the same time, productivity rose as real unit labour costs fell.
  - The decline in real unit labour costs was particularly pronounced between 1998 and 2003 when the SG rose from 6 to 9 per cent.
- The unemployment rate declined steadily to its lowest level in decades.

There is also a significant positive impact on the economy of increasing the pool of national savings. Superannuation stabilised the Australian economy during the financial crisis by providing a domestic pool of funds on which Australian businesses were able to draw.

It is estimated that Australia accounted for $90 billion or 10 per cent of the world's total recapitalisation in 2009 allowing Australian businesses to be less reliant on the vagaries of international credit markets.

RECOMMENDATION: The Government fully implement its committed increase in the Superannuation Guarantee Charge to 12 per cent by 1 July 2021 in order to minimise the negative impacts of the delay on employee's retirement savings and the economy.

FSC FINANCIAL SERVICES COUNCIL

Appendix A – KPMG Report: Asia Region Funds Passport, Comparison of Withholding Taxes

Attached

FINANCIAL SERVICES COUNCIL

Appendix B – Survey of FSC members showing distribution of life insurance stamp duty revenue, 2015

Stamp Duty Paid by FSC Life Insurance Members 2010 - 2014

	Annual Life Insurance Duty Paid					Annual General Insurance Duty Paid				
	2010	2011	2012	2013	2014	2010	2011	2012	2013	2014
New South Wales	$17,006,608	$19,881,532	$19,978,461	$19,255,442	$27,299,569	$26,247,441	$31,190,053	$39,546,978	$42,702,304	$51,761,022
Victoria	$11,867,118	$10,280,391	$12,209,667	$13,437,337	$12,825,900	$46,465,975	$54,409,418	$61,306,590	$67,179,988	$81,916,891
Queensland	$8,831,702	$8,412,589	$11,675,128	$9,355,098	$14,474,921	$26,539,431	$34,920,524	$41,256,093	$43,988,409	$54,116,581
Western Australia	$1,483,479	$1,655,652	$1,837,685	$2,357,579	$2,365,430	$34,256,606	$41,657,198	$49,449,773	$57,942,289	$72,764,872
South Australia	$4,637,935	$5,057,316	$5,152,455	$5,540,665	$4,828,364	$18,528,472	$24,688,825	$31,423,548	$34,117,888	$41,841,075
Tasmania	$744,670	$748,273	$777,495	$830,759	$1,221,473	$2,751,962	$3,087,320	$3,487,027	$4,327,539	$4,939,149
Northern Territory	$609,383	$492,755	$571,642	$758,676	$1,082,748	$2,058,015	$2,524,872	$2,958,447	$2,982,173	$3,292,133
Australian Capital Territory	$550,114	$535,466	$585,960	$489,066	$627,586	$3,172,982	$3,409,585	$3,707,691	$3,110,168	$2,636,025
Total Paid	**$45,731,008**	**$47,063,973**	**$52,788,493**	**$52,024,623**	**$64,725,992**	**$160,020,885**	**$195,887,795**	**$233,136,146**	**$256,350,758**	**$313,267,748**