Friendly Societies of Australia

2015 'Re:think' Tax Review

A Road Map to Greater National Savings and Increased Budget Revenue

1 June 2015

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Executive summary

The Friendly Societies of Australia (FSA) is pleased to contribute to the Government's 2015 Tax Review. The FSA is the industry association representing 10 of Australia's 12 APRA-regulated friendly societies. Friendly societies assist Australians to plan and set aside personal savings to fund known future life-events through the provision of savings, investment and insurance products known as insurance bonds. Collectively, the sector holds $6.6 billion in assets under management.[1] Information about the sector's history, licensing and regulation can be found at Appendix A.

This submission sets out a positive policy case for incentivising Australians to increase their financial capacity to meet various life-event savings, through a reduction in the tax rate applicable to insurance bonds issued under the *Life Insurance Act 1995* (Life Act).

Insurance bonds primarily take three forms:

- investment bonds (used for a range of life events such as child care and education, home deposits, and health and aged-care costs);
- funeral bonds ;and
- scholarship plans, specifically designed for education savings. (Refer to Appendix B for additional information on insurance bonds.)

Australian families cannot adequately prepare for retirement until they have addressed the range of life-events that will inevitably challenge their savings capacity well before retirement planning becomes a priority for most Australian workers.

A measure that encourages Australians to self-fund various life-events will reduce the wider social security financial burden on government. This is particularly significant in the context of Australia's changing demographics, and given the fact that Australians are living longer, and the ageing population is rapidly growing.

Our case for tax reform will address medium to longer term budget risks, and adequately responds to the need for incentives to encourage people to save for life-events that superannuation savings cannot, or should not, fund.

Additionally, our policy case for tax reform directly addresses the need for a coherent long-term strategy to increase Australia's education savings pool in view of the ongoing and long term erosion of education affordability.

We believe government should recognise the benefits that an increase in medium to longer-term discretionary savings could deliver to society, and implement reforms that will encourage people to utilise specific mechanisms best-suited to the task.

The FSA asserts the insurance bond tax framework is the best mechanism for this purpose and can deliver a range of significant benefits.

Financially, insurance bonds can:

- help increase overall national savings by encouraging a savings culture, mindful of the fact that there are several life-events to fund, and not just retirement alone;
- boost private household wealth through a reduction in debt reliance and the smoothing of expenditure on key life-events over time; and
- increase financial literacy levels across a wide age group due to the planned, intergenerational, discretionary nature of the product.

Socially, insurance bonds and scholarship plans can:

[1] http://www.apra.gov.au/lifs/Publications/Documents/1412-AFSB-June-2014.pdf

- increase the employment opportunities available to Australians by facilitating access to a higher standard of education; and
- reduce reliance on government and social welfare by encouraging personal responsibility.

In terms of tax revenue generation, insurance bonds can:

- increase government tax revenue by diverting some discretionary savings away from superannuation (including zero taxed income streams) to a relatively higher tax environment in a high integrity tax-paid framework;
- attract new savings if taxed at less than the current 30%, especially on intergenerational transfers; and
- reduce government revenue drain by reducing the level of government funded welfare reliance as a result of more self-provisioning by Australians using friendly society insurance bonds.

Finally, our policy case is entirely consistent with the Government's objective to promote greater self-reliance among Australians.

This submission has been prepared for the FSA by the Customer Owned Banking Association (COBA).

Recommendations

The FSA recommends:

1. insurance bonds issued under the Life Act be subject to a reduced tax rate from 30% to 20%;
2. the introduction of a government co-contribution scheme for friendly society scholarship plans for Australian families to assist and encourage this form of savings; and
3. the immediate restoration of an appropriate tax-free threshold on taxable benefits paid to minors under friendly society education savings plans which are currently taxed at punitive rates as high as 66% due to an unintended outcome of tax changes by the previous government when it removed access to the low income tax offset.

At present, Australian families are actively encouraged, through generous tax arrangements and the compulsory nature of superannuation, to prioritise this decades-long savings strategy, with a singular bias and imbalance towards retirement funding. As a result, Australian families have not committed to adequate discretionary savings strategies to fund known pre-retirement life-events over the medium term.

The FSA believes that the insurance bond framework is a well-developed, mature mechanism that, with only modest changes, will:

- strengthen the medium term financial adequacy of a wider group of Australians than the current financial services framework provides for; and
- increase the range of educational, social and economic opportunities available to Australians through a growing and sustainable savings pool.

Life event savings research

The Australian Centre for Financial Studies (ACFS) is a not-for-profit consortium of Monash University, the University of Melbourne, RMIT University and Finsia, specialising in leading edge finance and investment research.

In August 2011, Professor Kevin Davis, panel member of the Financial System Inquiry (FSI), released the ACFS research report *Private Saving: The Role of Life Event Products*[2] commissioned on behalf of the FSA. The research showed that individuals face a number of challenges over their lifetime, such as financing education, housing, health and retirement, for which many are unprepared.

The report noted that the financial challenges that these life-events create can be met, in part, through an adequate, sustainable savings pool, or in other cases, government support. Conversely, a shortfall in these areas will directly impact the range of opportunities available to an individual over their lifetime.

The report concluded that the insurance bond framework, offered by Australian friendly societies, is the best mechanism to prevent medium-term savings shortfalls. However there is a disincentive for low to middle income earners to use these products.

The FSA has developed the policy case to address this disincentive, drawing on the report's recommendations alongside the industry's existing policy priorities.

Policy case for insurance bonds in medium-term financial adequacy

The ACFS research observed that "households face a range of possible life-events, such as education, health, housing and retirement, which can require significant expenditures for which they are often inadequately prepared by way of saving or insurance".

The ACFS suggests that government tax policy can also be structured to influence both savings and the design of financial products to assist people in providing for their own pre-retirement welfare. The research noted that "there has been less attention paid to how government policy can best be designed for assisting individuals in preparing for other life-events. Indeed, the tax incentives given for superannuation may have impeded the development and growth of other financial products well suited for non-retirement life-event preparation".

At a policy level, the ACFS research stated "insurance bonds are a good example of a 'partnership model' in which individuals accumulate savings to meet expenditures and where some government contribution is involved via the tax concessions provided".

"It is also possible for that contribution to be achieved by government matching or co-contributions. However, at the current tax rate applied to friendly societies, the attractiveness of these products to low income individuals as a wealth accumulation vehicle is reduced."

The ACFS report pointed to the insurance bond framework as a long-standing, simple, low-advice mechanism that has the potential to increase household savings and financial wellbeing. However, the ACFS also made the following observation: "The Henry Review (2009) highlighted the lack of neutrality in the tax treatment of various savings products. With the dominance of the superannuation system in public policy, incentives to encourage individuals to be financially self-reliant and plan for the future through non-superannuation vehicles have gradually dissipated".

The Henry Review explains the impact of the tax and transfer system in this and other areas, arguing that "living standards are also undermined by tax settings that discourage people from making choices that would yield greater lifetime wellbeing."[3]

"There [under the tax and transfer system] would be clear incentives for people to improve their lifetime opportunities through workforce participation, investing in education or saving."[4]

[2] Australian Centre for Financial Studies, Private Saving: The Role of Life Event Products
[3] Australia's Future Tax System, Part One, p24

The ACFS research drew a key conclusion that "to enhance the use of this investment vehicle, and also to counterbalance the preferential tax treatment given to a range of other investment strategies, there is merit in considering changes to the current tax and legislative treatment of friendly societies and insurance bonds".

This theme is consistent with the findings of the recent FSI, which "identified a number of taxes that distort the allocation of funding and risk in the economy" including the differential tax treatment of savings.

The Re:think Tax Review Discussion Paper notes that "Australian households save primarily through home ownership (43 per cent of total household assets), superannuation (15 per cent of total household assets), and other property, including investment property (15 per cent of total household assets)."

Given this context, the FSA argues the case for reforms to the tax treatment of savings is compelling. The funding of expected pre-retirement life-events such as child care and education and health care, for example, continue to be significant financial challenges for Australians. These challenges are compounded when almost three quarters of total household assets are held in asset types that cannot quickly or easily be accessed. In general terms, age restrictions on superannuation and transactions costs and the lack of liquidity of property limit the capacity of these assets to fund the life-event spending obligations that will be faced by Australian families.

Because of the long-term nature of saving through superannuation and property investments, it is arguable these asset types cannot, and should not, be used to fund medium-term life-events.

Australia's changing demographics and limitations of superannuation

Inadequate discretionary savings among Australians, driven by current tax arrangements, is a major challenge to securing the economic and social wellbeing of individuals and communities.

This challenge will be exacerbated given the dynamic pace of change to Australia's demographics. According to the November 2013 research paper, *Still Kicking*[5], Australia will have 1.8 million people aged over 85 in 2050, one in four people aged over 65 by 2056, one million people with dementia by 2050, and 85,000 more aged care places will be required in the next decade.

The Government's 2015 Intergenerational Report (IGR) has provided the latest snapshot of Australia's fast changing population. Male life expectancy is projected to increase from 91.5 years today to 95.1 years in 2055, and female life expectancy is projected to increase from 93.6 years to 96.6 in 2055. The number of Australians aged 65 and over is projected to more than double by 2055 compared with today. In 2055, there are projected to be around 40,000 people aged 100 and over, well over three hundred times the 122 Australians centenarians in 1975.

The need for Australians to better prepare to support their aged and health care needs in the coming years is critically important. If Australia fails to do so, the demands on the budget, for aged care alone, will be significant, ongoing and growing.

Superannuation is the primary platform for funding retirement and aged care costs, this platform alone cannot adequately meet these costs into the future. While more applicable to high income earners, insurance bonds taxed at 20%, instead of the current 30% will, we believe, encourage retirees to use these products to re-invest a portion of their superannuation income streams, such as pensions and annuities, which cannot be re-contributed to superannuation.

Without such an incentive, savings from superannuation income could be held in other tax structures, reducing government revenue. The medium-term savings vehicle that insurance bonds offer is not irrelevant to this age group. Those who are currently 65 have an average life

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[4] Australia's Future Tax System, Part One, p26
[5] http://www.percapita.org.au/_dbase_upl/Still%20Kicking.pdf

expectancy of 84 for men and 87 for women[6], giving them the "time" to take advantage of a ten year investment horizon that is embedded in the structure of insurance bonds.

In addition, increasing the uptake of insurance bonds will grow Australia's savings pool by capturing funds that cannot be held in superannuation, and may be at risk of not being directed into a structured savings platform. Superannuation also lacks universal coverage across the whole community. This includes no, or limited, coverage for non-working surviving spouse monies, superannuation age limit and work-test related contribution restrictions, and expatriates returning to Australia facing superannuation contribution limits.

The ACFS paper argues that "government regulatory and tax policies should, at least, not impede the development and take-up of financial products which help individuals and families to prepare financially for life cycle events. But also relevant is the view that an 'asset accumulation' approach to welfare policy is worth exploring further, using tax/transfer policies and grants to encourage individuals to accumulate financial assets can lead to greater private responsibility for dealing with possible life cycle events, rather than reliance upon government welfare".

Given financial advice is unaffordable for many people, and recent major scandals have eroded the public's trust in financial planning generally, the FSA argues that insurance bonds issued by friendly societies are, as the ACFS observed, "simple financial products designed to deal with significant life-events, and which can be explained simply to individuals, offer an advantage in that they can be achieved through low-cost, one-off advice associated with that product, rather than requiring expensive, on-going relationship advice".

The FSA believes that the insurance bond framework is a well-developed, mature mechanism that, with only modest changes, will:

1. strengthen the medium term financial adequacy of a wider group of people than superannuation provides for; and
2. increase the range of social and economic opportunities available to Australians through a growing and sustainable savings pool.

[6] ABS 4125.0, Gender Indicators - Australia

Improving the fairness of the tax treatment of savings

RECOMMENDATION 1 – the FSA recommends a reduction in the tax rate on insurance bonds issued under the Life Act from 30% to 20% to increase Government tax revenue, reduce pressure on welfare expenditure and encourage Australians to better prepare for major life-event expenditure in areas such as education, health and aged-care

Given the mandated nature of compulsory superannuation contributions, there is no meaningful competition to superannuation with respect to other long-term savings vehicles available to Australian families. By reducing the tax rate that applies to insurance bonds from 30% to 20%, we believe that enhanced competition can be brought to this market, for the benefit of consumers, in relation to the allocation of funds that are currently earmarked for voluntary superannuation contributions.

At present, Australian families are actively encouraged, through tax arrangements and the compulsory nature of superannuation, to prioritise this decades-long savings strategy, with a singular bias and imbalance towards retirement funding.

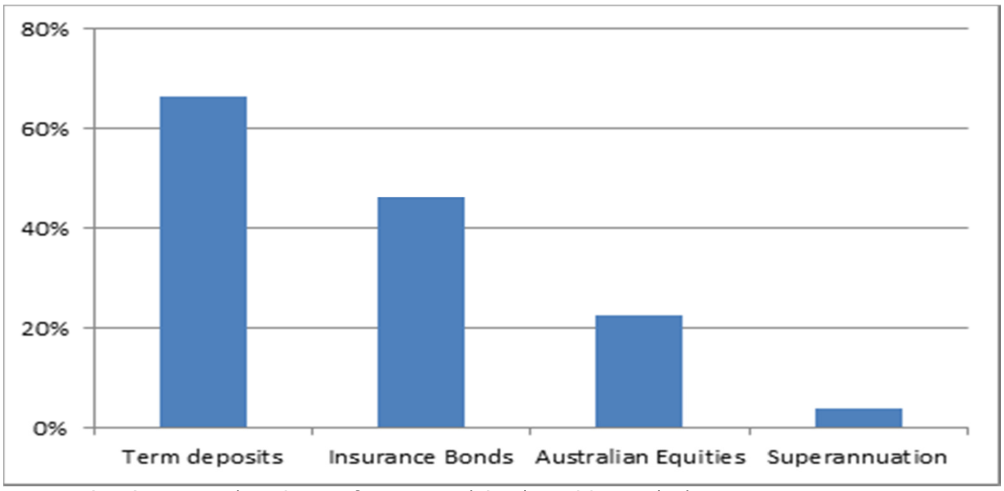
Over recent decades, insurance bonds issued by friendly societies and life offices have been subjected to a major competitive disadvantage relative to superannuation, with respect to the tax rates on both contributions and fund earnings.

While concessional superannuation contributions attract a tax rate, and insurance bond contributions do not, concessional superannuation draws on pre-tax income, whereas insurance bonds draw on after-tax income or savings. Even at 32.5%, the marginal tax rate (MTR) of many working Australians, superannuation contributions enjoy substantial advantages of being generally taxed at less than half that rate, 15%.

Fund earnings in an insurance bond are taxed at 30%, while earnings on superannuation are subject to a maximum tax rate of 15%. The superannuation tax rate on earnings can be reduced to 10% if realised capital gains for assets are held for more than 12 months. The superannuation tax rate can also be reduced to nil, when in pension mode.

Insurance bonds face a far higher real effective tax rate than many alternative savings options, reducing their attractiveness. Table 1 below illustrates the effective tax rates faced by an investor in the main marginal tax bracket of 32.5% across four different savings vehicles.

Table 1: Effective real tax rates



RBA, ABS, ASX, Australian Centre for Financial Studies, COBA calculations

Australian families cannot adequately prepare to fund their retirement until they are assisted to better meet the range of expected life events that will inevitably challenge their savings capacity well before retirement planning becomes a priority. For example, funding child care and education costs are ongoing and significant financial challenges for Australian families' decades before people plan to reduce or cease paid employment.

Insurance bonds offer a platform for financial adequacy throughout an individual's life prior to retirement. However, at the current tax rate of 30%, they lack the universal appeal needed to ensure they are a sustainable option. To ensure competitive neutrality across the sector, we believe that insurance bonds issued under the Life Act should be subject to a reduced tax rate of 20%, which is closer to the 15% tax rate for superannuation, and therefore makes these bonds more competitive across the medium to long term savings market.

Delivering positive tax revenue measures

The FSA contends that a reduced tax rate on insurance bonds will have a net positive impact on government tax generated revenue. We contend that too much of the nation's private savings are being channelled into superannuation for retirement purposes, and not enough savings are allocated to fund more immediate, pre-retirement life-events.

The crux of the argument relies on the simple fact that the bulk of Australia's financial system – that is $1.9 trillion plus of assets in superannuation – generates in absolute and relative terms too little tax revenue from this immense asset pool. Additionally, superannuation does suffer various elements of leakage and the "double dip" by allowing lump sums to be taken and spent, with subsequent demand on the age pension.

We believe diverting a portion of the savings flow away from superannuation and into insurance bonds will immediately deliver additional revenue to government, given the former is taxed at a maximum of 15% and the latter would be subject to a tax rate higher than that, but lower than the current 30%.

Voluntary salary sacrifice contributions (as distinct from compulsory employer contributions) make up a significant proportion of total flows into superannuation, and a proportion of this would be expected to be redirected into life products if the relative tax rates were to change. One estimate, published in 2007, put salary sacrificed contributions to superannuation at $12 billion.[7]

Many Australians will view a smaller tax rate differential between superannuation and insurance bonds as insufficient to lock into voluntary superannuation, which is primarily directed to fund one life-event, namely retirement. In contrast, contributions to an insurance bond are accessible for any number of life-events a person may reasonably expect to encounter.

Generation of new tax revenues

FSA contends that a lower tax rate on new insurance bonds made for intergenerational purposes, such as grandparents establishing insurance bonds for grandchildren should generate new tax revenues for government. These investments might otherwise be lost from the government's tax revenue by estate distribution and spending, or become subject to reduced tax arrangements offered by testamentary and discretionary trusts, for example.

Further, for individuals on higher MTRs, using tax-paid insurance bonds will deliver a markedly improved outcome for government revenue, as opposed to use of tax minimisation strategies such as negative gearing, funds shifted offshore, or possibly tax avoidance.

The FSA considers insurance bonds taxed at 20% instead of the current 30% represent the next best tax arrangement to non-concessional superannuation contributions. Increasing the up-take of insurance bonds will generate a higher rate of return to government, when compared to superannuation tax arrangements.

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[7] ASFA, Employer Contributions to Superannuation in Excess of 9% of Wages, 2010, p3

Given the longstanding and effective nature of tax collection through friendly society investment products, introducing incentives to divert an appropriate portion of discretionary savings away from superannuation and into these products is justified given the improved tax revenue outcome for government.

Due to the rapidly ageing population, people are increasingly downsizing the family home as part of the transition to a retirement village, or aged care accommodation. In light of the capital gains tax-free status of the family home, introducing incentives to use friendly society insurance bonds to save this growing source of funds is, in the FSA's opinion, an entirely reasonable proposition.

As covered earlier in our submission, this policy change would be expected to reduce pressures on government expenditure by increasing incentives for individuals to be better prepared to fund their own life-events, especially the cost of education, home ownership, health and aged care and periods of unemployment, through increased personal savings.

Industry support for a reduction of the insurance bond tax rate

In its October 2008 submission to the Henry Tax Review, the Investment and Financial Services Association (IFSA) recommended "the introduction of a 20% concessional tax rate for life insurance companies in respect of their ordinary life insurance savings policies."[8]

Consistent with the FSA's position, IFSA noted that "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%."[9]

[8] IFSA Submission, Henry Tax Review, page 20
[9] Ibid.

Policy case for supporting discretionary education savings

RECOMMENDATION 2 – the FSA recommends the introduction of a government co-contribution scheme for friendly society scholarship plans to encourage greater discretionary education saving and improved educational outcomes

The FSA believes that education participation rates are a function of access and opportunity, which is driven by individual affordability, means and motivation that comes from an individual having committed a personal financial outlay to support their goals.

A national program of education savings could mitigate, or even overcome affordability problems and make a wide range of education pathways available to more people, regardless of their socio-economic backgrounds, and beyond what government welfare support can currently sustain. The issue of future government support of education is particularly significant given the IGR noted that: "Spending per higher education student, (in today's dollars) is projected to fall from $11,800 in 2014-15 to $9,400 in 2054-55."

Illustrating the size of this challenge, 2014 ABS data revealed that almost 43% of the Australian population, aged 15 to 74 years, have not yet achieved an educational qualification beyond school, and less than 25% of this cohort hold a bachelor degree or higher qualification.[10]

Currently, the friendly society sector manages over $1.8 billion in education savings on behalf of 190,000 students up to tertiary age. Depending on the level of schooling, students can have, on average, $9,000-$14,000 in funds to put towards their education.

These are healthy numbers in real terms however when viewed against the wider population, the current pool of discretionary education savings equates to around $230 for every child and young adult in Australia between the age of 0-24 years[11], providing an insight into how small Australia's education savings rate is in relative terms.

In the 2012 AMP.NATSEM Income and Wealth Report: *Smart Australians*, education was found to be among the top 15 expenditure items for Australian families and in the previous six years, average family spending on preschool and primary school education had risen by 79% and spending on secondary education increased even more at 101%.

The same report showed that the ratio of government to private expenditure on education had increased substantially between 1984 and 2011. In 1991, Australians spent the same amount on their education as government; now, government expenditure is 65% higher than private expenditure (2011) and rising each year.

The FSA sees a strong case for reforms to Australia's tax system to stimulate structured education saving within the community. Despite active marketing of scholarship plans by friendly societies, this form of savings remains low. By illustration, in 2010-11, Australians households spent around $40 billion on education[12], and we estimate that less than one per cent was met through structured scholarship plans.

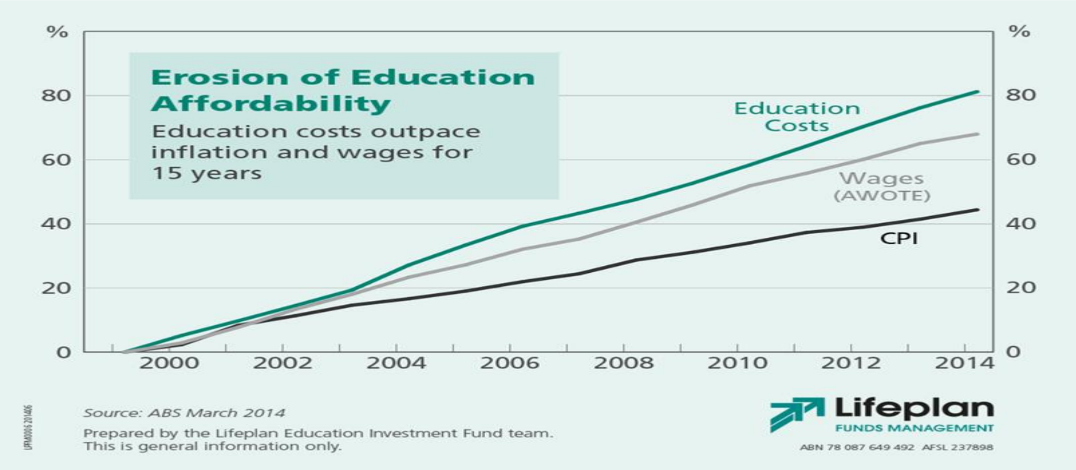
The need for a concerted strategy to increase Australia's structured education savings pool is pressing given the ongoing and long term erosion of the affordability of education, relative to wages growth and CPI increases, as shown below in Table 2.

10 http://www.abs.gov.au/AUSSTATS/abs@.nsf/Latestproducts/6227.0Main%20Features2May%202014?opendocument&tabname=Summary&prodno=6227.0&issue=May%202014&num=&view

11 http://www.aihw.gov.au/WorkArea/DownloadAsset.aspx?id=10737420619

12 http://www.ausstats.abs.gov.au/ausstats/subscriber.nsf/LookupAttach/1301.0Publication24.05.121/$file/13010_2012.pdf – page 452

Table 2: Education affordability relative to wage increases and CPI



Recent media reporting has highlighted the rate of tuition fee increases for some independent schools in 2015 are likely to double last year's increase in the consumer price index[13]. This report is supported by recent modelling undertaken by the Australian Scholarship Group[14] (ASG) that forecasts the cost of private schooling in Sydney, for a child born in 2015, to be $541,275.

The FSA contends that a family that builds a sustainable pool of education funds can increase their financial adequacy, and in turn:

- provide a family member with a higher level of education, such as a tertiary degree, that may otherwise have been unaffordable;
- unlock new education pathways, such as TAFE study or vocational education and training;
- increase a family member's level of education support such as tutoring, coaching or exam preparation;
- relieve financial pressure by using savings to cover ancillary education costs (such as uniforms, travel or textbooks) or smoothing the impact of education costs over time; and
- encourage families to diligently plan and budget for the education funding of their children.

These are significant benefits at an individual level, with flow-on collective benefits for Australian society more broadly. A large pool of national discretionary education savings could potentially:

- boost Australia's long-term education capacity;
- increase workplace productivity and participation rates;
- up-skill Australia's workforce; and
- widen employment opportunities and subsequent earnings capacity.

The benefits to Australia from additional investment in education are significant. In the case of higher education, OECD data shows that a dollar invested generates a public return of $6.05 in the case of men, and $4.42 for women[15]. The OECD has also estimated that one additional year of education increases an individual's output by around 6%[16].

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[13] Australian Financial Review, 19 January 2015, page 7
[14] ASG *Planning for Education Index* – 20 January 2015
[15] http://www.smh.com.au/national/education/oecd-figures-show-public-benefits-more-than-individuals-from-tertiary-education-20140928-10n6cc.html
[16] http://www.oecd-ilibrary.org/docserver/download/5lgsjhvj7zxw.pdf?expires=1421813190&id=id&accname=guest&checksum=E88FC7185065A747C0F59E6B3581B9DF

Co-contribution scheme framework

Given that current and projected budget conditions make it challenging for the government to commit to increased long term funding of education, and the current public debate concerning the funding of the tertiary sector, the FSA believes the timing is right for the introduction of a program that will promote greater self-reliance in terms of future education costs.

The objective of this proposal is to focus public attention on the benefits of education savings and provide an incentive that increases household savings activity. The scheme would be available to all households that make contributions to a scholarship plan[17] issued by a friendly society and would adopt the basic characteristics of a contribution amount, a cap on contributions and eligibility rules.

Increasing education participation rates

A much larger pool of savings for education funding could emerge within a relatively short time. This will help promote education participation rates, particularly among low and middle income households, and widen the range of education pathways available to young adults when their plans mature.

A scholarship plan owner could participate in the scheme on a child-by-child basis over a fixed five-year period, that commences within the first two years after the birth of a child, with government matching, dollar-for-dollar, annual contributions up to a maximum of $500 per year.

Target post-secondary education

The scheme could specifically target post-secondary education, be that tertiary study, TAFE or other forms of skills and vocational training. This can be achieved by preserving the co-contribution made by government (both the capital and income component) until the time the student beneficiary reaches a minimum school leaving age of 17.

By increasing the uptake of scholarship plans, we believe that more Australians will be motivated and encouraged, and have the financial means, to achieve further educational outcomes.

Primary and secondary education is accessed through the public education system, and therefore less of a "barrier to entry" or needing more encouragement and support, unlike post-secondary education options. The FSA believes that the benefits of such a scheme is likely to be more pronounced for lower socio-economic groups, given that means to pursue higher education are expected to be more limited. The focus on post-secondary education will also assist a long term–planning horizon for improving national educational outcomes.

Scheme integrity

There should be no restrictions on withdrawing at an earlier time the personal contributions made by the plan owner. However, creating a 'lock-in' period of a proportion of these savings, over a child's entire schooling life, will allow sufficient time for the amount of the co-contribution to generate a sufficient amount of earnings.

The integrity of the scheme would be maintained via the existing ATO-defined 'sole purpose test' for friendly society scholarship plans, which removes the existing concessional tax treatment on earnings if they are not used for legitimate education expenditure.[18]

There are other considerations that would need to be discussed with industry as part of a consultation process, such as entry and exit rules, particularly around any unused contribution amounts, timing and eligibility.

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[17] As defined under the *Income Tax Assessment Act* 1997 subsection 995-1(1)

[18] Section 995.1 of the *Income Tax Assessment Act 1997* defines a scholarship plan as a life insurance policy issued by a friendly society for the sole purpose of providing benefits to help in the education of nominated beneficiaries. If the earnings under these plans are not used for legitimate education expenses, then the 30% tax paid at a fund level applies to these earnings and is assessed in the hands of the parent investor, not the child. Where the investor is on a higher tax bracket than 30%, further tax is payable

The FSA reiterates that the existing tax regime specifically established scholarship plans back in 2003, and is well-placed to address any major tax integrity concerns and facilitate a relatively easy design and implementation phase for the scheme.

Success of other Government co-contribution schemes

If incentive-based reforms are successful in encouraging a higher rate of private, discretionary savings to fund education expenses, it is reasonable to expect a commensurate easing in household financial pressure and a gradual fall in reliance on government support for education.

Government co-contribution schemes are driven by these principles and have been used as a 'stimulus' in a number of areas of national concern, including superannuation, health, retirement and housing, however one is yet to be considered for education.

The success of the superannuation co-contribution scheme indicates that Australians are likely to respond to a similar scheme for education. Over the three years from 2008-2011, 1.35 million Australians on low to middle incomes utilised the super co-contribution scheme, a significant response given the long-term nature of retirement savings.

Scholarship plans are medium-term discretionary savings vehicles. This means that people using these vehicles will realise the benefits of their investment earlier than superannuation, have active control over their savings, and therefore have a greater level of personal commitment. The FSA believes this will have a significant influence on the success of an education co-contribution scheme, perhaps even greater than that seen with superannuation, in relative terms.

RECOMMENDATION 3 – the FSA recommends the immediate restoration of an appropriate tax-free threshold on taxable benefits paid to minors under friendly society scholarship plans which are currently taxed at punitive rates as high as 66% due to an unintended outcome of tax changes by the previous government when it removed access to the low income tax offset

The lack of any meaningful tax-free threshold and the high rate of tax on income earned by minors from scholarship plans is an unintended consequence that resulted from the removal of the low income tax offset (LITO) from non-work income earned by minors on 1 July 2011.

The removal of the LITO has seen the tax-free threshold for a child receiving a payment from a scholarship plan reduced from $3,333 to $416. Appendix C provides a diagram that sets out how this takes effect.

Unintended consequences of government tax reform

As a result of the LITO reforms in 2011, the tax rate applied to earnings from scholarship plans has increased from 0% to 66% for earnings between $416 and $1,307, and from 0% to 45% on all earnings above that. At the time of the change, nearly 60,000 Australian children under the age of 18 had in place a family-sponsored scholarship plan accumulating education savings on their behalf.

These plans were established by families on the understanding that the government's concessional tax treatment would remain, only to later find that the final earnings payment would be much lower should they decide to withdraw.

Monitoring undertaken by industry between 1 July 2011 and 30 June 2012 points to a concerning spike in plan closures, along with substantially slower product take up. One fund with around 6,500 members saw 600 investors withdraw completely in the first 12 months after the tax changes, and experienced a drop of 33% in new members over the same period, well outside normal behaviour patterns.

The dramatic reduction of the LITO will continue to have a disproportional negative impact low income Australian households. A 2008 study undertaken by ASG found that:

- only 2.3% of new members had a household income of over $100,000; and
- 68.7% of new members had a household income between $52,500 and $78,800.

Generally, earnings cannot be drawn down for years after a plan is established with an initial investment. Where early draw-downs may be possible, the growth earned is generally insufficient until several years have passed. For this reason, and because scholarship plans can only be used to meet education costs, they cannot be used as income splitting vehicles to minimise tax liabilities.

While ASG is the largest provider of scholarship plans in Australia, they are also offered by Australian Unity. Centuria Life commenced offering these plans three months prior to the changes but has since closed this product line due to changes to the LITO.

Appendix D provides further information on distribution and age pattern of these products since the LITO reduction.

Policy intent of low income tax offset reforms

While the original policy intent was sound – to prevent high income earners from accessing the tax offset via the transfer of income to a child – the changes have triggered a major jump in a minor's tax rate, on any income[19] they withdraw from a scholarship plan.

[19] Where assessable in the hands of a student who is a minor (under Division 6AA rules) and not in the hands of a sponsoring adult - *Tax Laws Amendments (2011 Measures No 4) Bill 2011*, Explanatory Memorandum, ch2.

The FSA argues that the drastic reduction in the LITO on income derived from scholarship plans does not align with the policy objective of the original proposal. At the time the reform was passed through Parliament, the explanatory memorandum to the Bill[20] set out the intent of the reform, which the FSA fully supports:

> *2.5 The aim of these rules is to discourage income splitting within families by directing income from adults to children to avoid higher marginal tax rates.*
>
> *2.6 In recent years the low income tax offset has increased significantly as a means of providing targeted tax relief to low-income earners. The low income tax offset has been available to all taxpayers with incomes below its cut-out threshold, including minors. An increasing amount of distributions from discretionary trusts have subsequently taken advantage of this concession to direct an increasing amount of income from adults to minors in order to minimise tax. There is a significant spike in distributions from discretionary trusts at around the point where the effective tax-free threshold for minors has applied in each recent tax year, and that spike has moved broadly in accordance with increases to the effective tax-free threshold for minors.*
>
> *2.7 Removing the eligibility of minors to use the low income tax offset to reduce tax payable on their unearned income will discourage families from splitting income with their children — protecting the integrity and improving the fairness of the income tax system.*

It is not possible for a parent to use an education savings plan to "avoid higher marginal tax rates" and thereby reduce tax, simply because they can only use the income from the plan solely for education purposes in order to retain the tax benefit. Indeed, the vehicles targeted under the government's policy measure are clearly discretionary trusts.

Previous tax arrangements

Prior to 2003, growth within a scholarship plan fund was untaxed, allowing a larger pool of education benefits to be available to fund a student's education expenses.

This fund-level tax exemption was removed on new scholarship plans from 1 January 2003. Friendly societies then became subject to an effective tax rate of 30%. To prevent an unfair double taxation regime from applying, special fund deduction rules were introduced for scholarship plans in recognition of the valuable role they play in encouraging education savings. This had the effect of restoring the untaxed distribution value – although the timing difference between annual fund tax and back-end tax deduction recovery had the effect of reducing the value of education benefits paid.

Apart from the diminished value of education benefits paid on 'post 31 December 2002' scholarship plans, the disclosed explanation of how tax worked on these products diminished their appeal to some extent.

Regardless, the 2003 changes allowed tax to apply in line with the economic substance of the arrangement and ensured the special purpose nature of these products was recognised whilst protecting the integrity of the tax system through a sole purpose test.

The papers below set out the government's rationale behind upholding tax concessions for scholarship plans, a rationale which we believe should continue to be recognised through the restoration of the previous LITO:

- *Taxation Laws Amendment Bill (No. 6) 2002 Second Reading Speech* dated 19 September 2002 – this sets out the intention to provide concessional tax rules for special purpose friendly society products, including scholarship plans.

[20] http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r4586_ems_6886c832-17fb-44ee-a184-ec95e5843882/upload_pdf/355849.pdf;fileType=application%2Fpdf

- *Explanatory Memorandum to TLAB6-2002* – sets out much of the rationale, particularly paragraphs 3.1, 3.5, 3.7, 3.14, to 3.18 and 3.29 to 3.34.
- *ATO Fact Sheet for Scholarship Plans* – specially developed in 2003 to recognise and emphasis the special purpose nature of these plans and the sole purpose test.

The removal of the LITO is a very unfortunate outcome for thousands of Australian families. Scholarship plans are unique given they are the only dedicated education savings vehicle in the market today, and by law, can only be offered by a friendly society. Their tax integrity is upheld through the ATO's sole purpose test that removes any taxation concessions if earnings are not used for their intended education purposes.

The FSA contends that the government should announce a new tax-free threshold for these vehicles as a priority, set at $3,333 (the same as originally applied) and indexed annually in line with the CPI for education.

We believe the cost to the budget revenue from this change would be negligible. The flow-on adverse impact on scholarship plan earnings of the LITO changes was an unintended consequence of reforms to other areas of the taxation framework. The FSA believes that it is unlikely that the small revenue gain from an increased tax rate applicable to these plans was counted by the government at the time the changes were implemented.

The FSA believes there are no further revenue implications under this proposal.

Conclusion

This submission sets out the policy case for promoting increased life-event savings.

Australians should be encouraged to increase their financial capacity to save for various life-events, through a reduction in the tax rate of insurance bonds to 20%. The policy settings to help fund *one* life-event (retirement) is already in place, via the superannuation regime.

A measure that encourages Australians to self-fund various life-events will reduce the wider social security financial burden on government. This is particularly significant in the context of Australia's changing demographics, and given the fact that Australians are living longer, and the ageing population is rapidly growing.

Our case for tax reform addresses medium to longer term budget risks, and adequately responds to the need for incentives to encourage people to save for life-events that superannuation savings cannot, or should not, fund.

Additionally, our case for tax reform directly addresses the need for a coherent long-term strategy to increase Australia's education savings pool given the ongoing and long term erosion of education affordability.

Finally, our policy case is entirely consistent with the Government's objective to promote greater self-reliance among Australians.

To discuss any aspect of this submission please contact:

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Appendix A – Background information to the friendly society sector

History and purpose
First established by community groups in the 1830s, friendly societies have evolved into customer-focused financial service providers that help Australians become financially independent and plan for life-events through the provision of savings, investment and insurance products.

The sole focus of friendly societies is to assist and promote Australians to:
- fund future common and foreseeable life-events, such as home deposits and ownership, raising and educating children, sinking funds to pay debt, health and aged-care, job loss provisions, private child care funding, and support for aged parents or family members with disabilities;
- better prepare for difficult financial times that inevitably arise at some point in their lives; and
- improve and sustain financial and social standards via self-reliance and a savings culture that does not resort to social welfare dependency in the first instance.

To promote this ethos and personal savings culture, friendly societies commit to:
- providing low-fee savings products that represent good value, are easily understood, meet an express customer need and are inclusive to all levels of society;
- maintaining exceptionally high standards for customers, centred around honesty, integrity and ease of access;
- furthering the financial literacy of Australians, and educating them about the benefits of prudent medium-term savings and the need for financial security derived from self-generated financial provisions; and
- upholding core principles of mutual self-help, support and co-operation.

FSA members serve the savings, investment and insurance needs of more than 800,000 Australians.[21] Collectively, the sector holds $6.6 billion in assets under management. The sector is diverse in nature – Australia's largest friendly society is Lifeplan Australia Friendly Society with funds under management of almost $2 billion and 169,000 customers. The smallest is NobleOak Life Limited with about $25 million funds under management, serving approximately 40,000 customers.

Licensing and regulation
Friendly societies are licensed financial institutions that are prudentially regulated by APRA under the *Life Insurance Act 1995*. Their products are also subject to ASIC regulation with respect to disclosure and financial service licensing obligations under the *Corporations Act 2001*.

All APRA-regulated friendly societies are registered life insurance companies under the Life Act, which authorises them to conduct various classes of life insurance business structured within their corporate entity using the friendly society 'benefit fund' structures.

[21] COBA estimate

Appendix B – Types of Insurance Bonds

Investment bonds are multi-purpose savings vehicles that are used to prepare for a wide range of life-events, such as funding education costs, house deposits, and health and aged-care costs.

They also have a number of strategy-based applications, such as pre-emptive intergenerational wealth transfer and estate planning through the ability to nominate beneficiaries. On death, the balance of the bond is paid tax-free directly to the beneficiary rather than to the estate, avoiding potential disputes and claims from third parties.

Investment bonds are similar in form to a managed fund, except they are 'tax paid', in that earnings within the fund are taxed at the rate of 30%, and non-distributing, with after-tax returns reinvested into the fund.

They can be capital guaranteed through investments in cash and other conservative investments, or unit linked where investors' funds are pooled together in order to provide individuals with access to investment opportunities that may not otherwise be available to them.

Investment bonds have features that shape their longer-term, savings-based nature, most notably a 10-year holding period, where accumulated capital and earnings are accessible tax-free after ten years. A 125% contribution rule allows for ongoing contributions into the fund over the life of the bond.

Funeral investment bonds are also 'tax paid' capital guaranteed investment bonds but without specified limits on contribution amounts, other than for means testing for pensions, and holding periods, with the amount of the bond paid only on death of the bond holder.

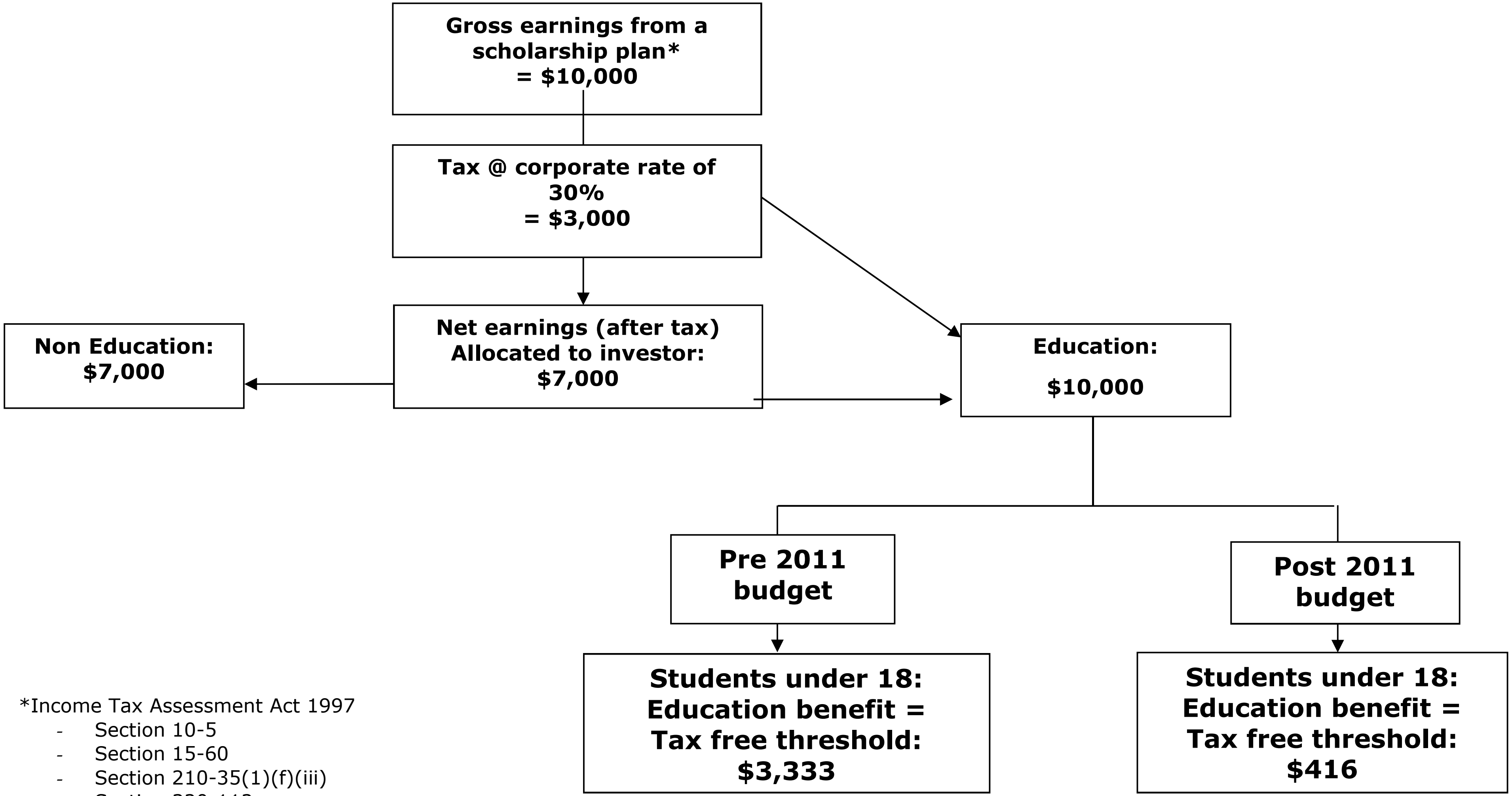
All funds are paid either to the estate or a funeral director via assignment, and tax is payable by the recipient on earnings, less a 'termination bonus' that equates to the tax paid by the fund.

Scholarship plans are a variant of an investment bond but with a specific tax treatment under the *Income Tax Assessment Act 1997*[22] (ITAA). They are specific purpose life-event savings vehicles used to fund the education expenses of children across all levels of schooling, from primary through to secondary, or adults pursuing tertiary or skills based qualifications, and carry all of the benefits of investment bonds.

Under tax law, scholarship plans can only be established by a friendly society regulated under the Life Act. As the fund is designed specifically for education, it fulfils the requirements of a 'scholarship plan' under the ITAA. This allows the fund to receive concessional tax treatment, in the form of a rebate on the 30% tax paid at the fund level, which in turns optimises the child's scholarship benefit.

[22] Income Tax Assessment Act 1997 subsection 995-1(1)

Appendix C - Example scholarship plan, operation and tax changes



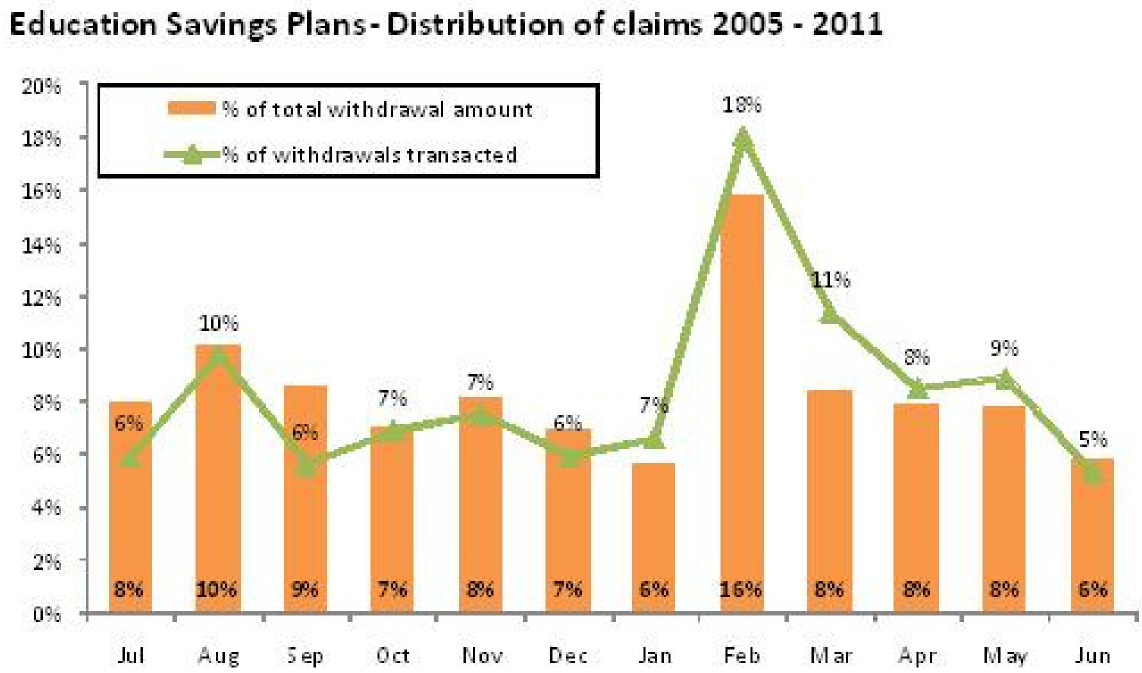
*Income Tax Assessment Act 1997

- Section 10-5
- Section 15-60
- Section 210-35(1)(f)(iii)
- Section 320-112
- Section 995 -1(1) definition of Scholarship plan.

Appendix D – Distribution and age patterns

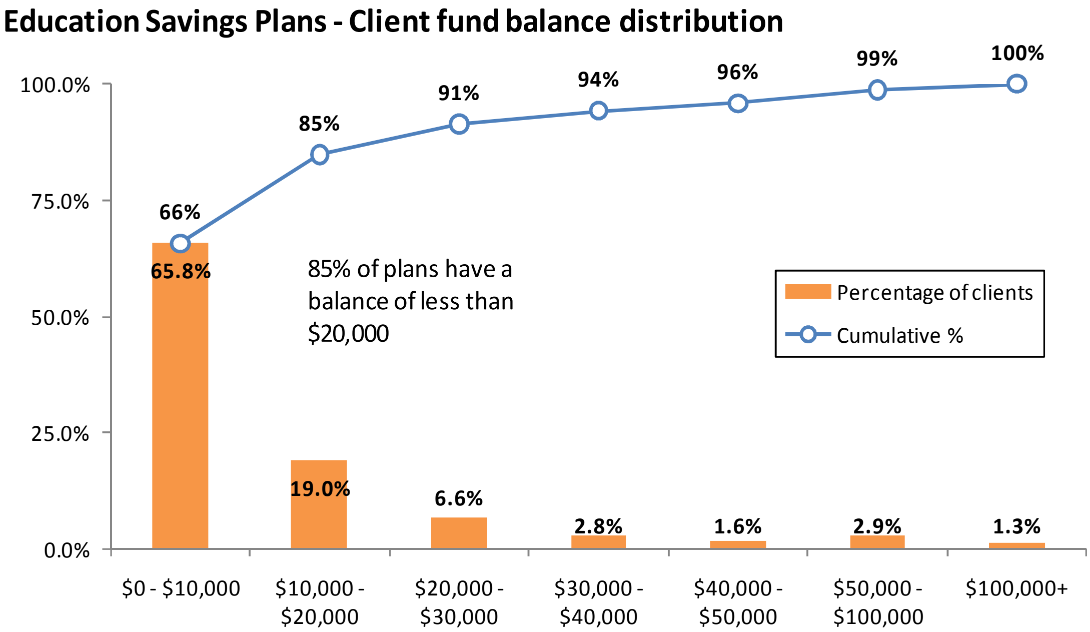
Following is data on plan distributions we believe demonstrates that there is no correlation between the timing nor the amount of plan distributions with changes to the low income tax offset, as the graphs on the following page illustrate.

Figure 1



- The above graph shows the pattern of qualified education withdrawals during each month of the year.
- There is a clear spike in qualified education withdrawals during 'back to school time' in February and to a lesser extent during August.

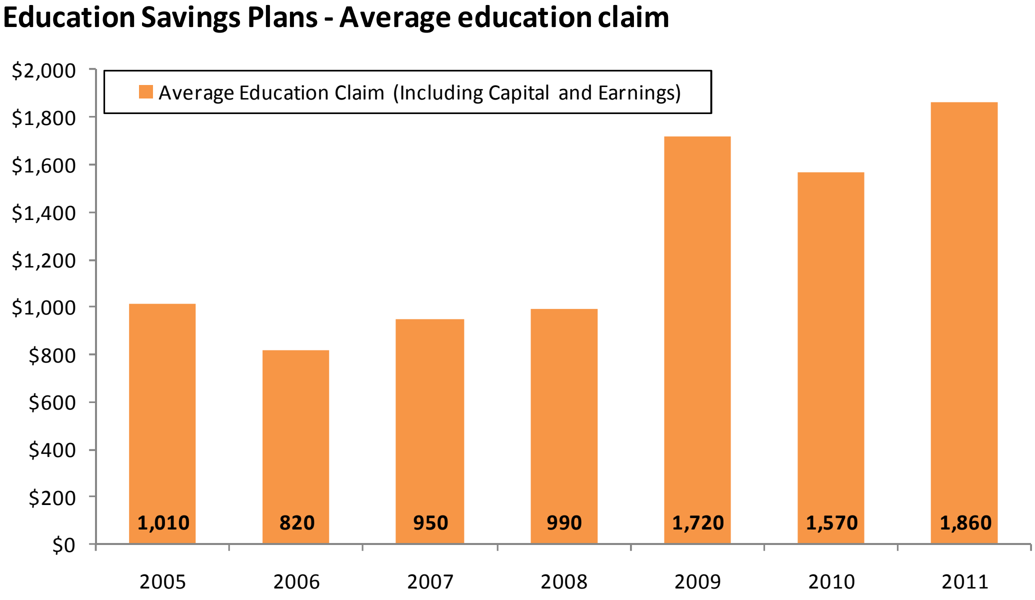
Figure 2



The above graph shows the distribution of Education Savings Plan fund balances.

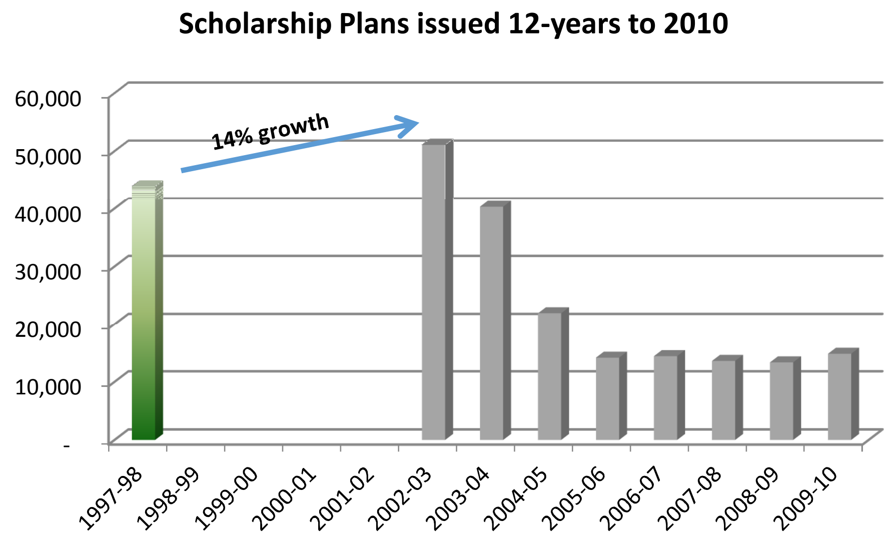
- 85% of plans have a balance less or equal to $20,000.

Figure 3



- The above graph shows the average qualified education withdrawal per plan (inclusive of investor contributions and plan earnings) during each of the financial years from 2005 through to 2011.
- The sample includes education withdrawals for students under and over the age of 18, noting that 96% of plans are held on behalf of minors (students under age 18).
- The graph clearly shows that qualified education withdrawals per plan (inclusive of investor contributions and plan earnings) have been well below the effective tax free threshold of a minor in each financial year.

Figure 4



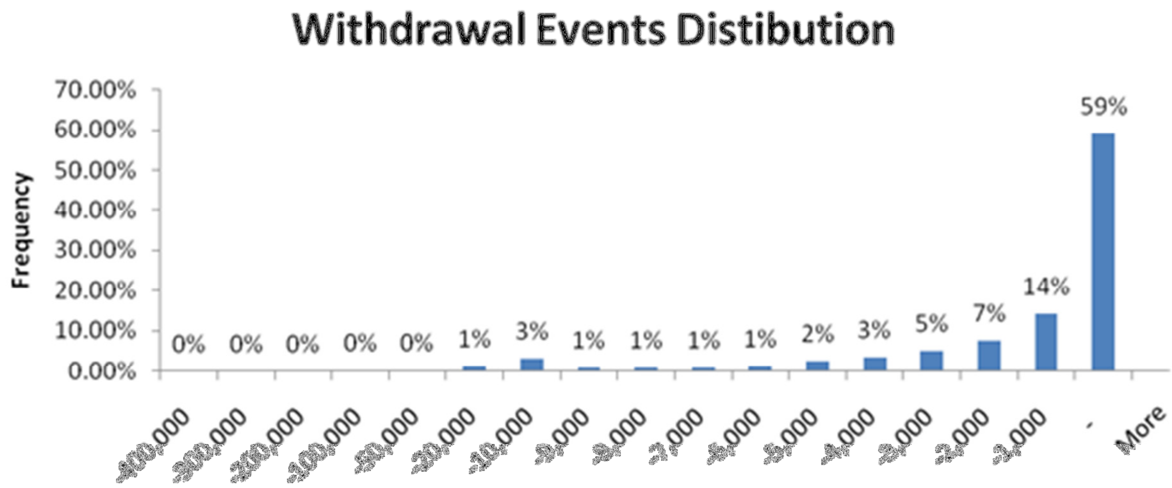
Notes/Source: Plans issued by Australian Scholrships Group

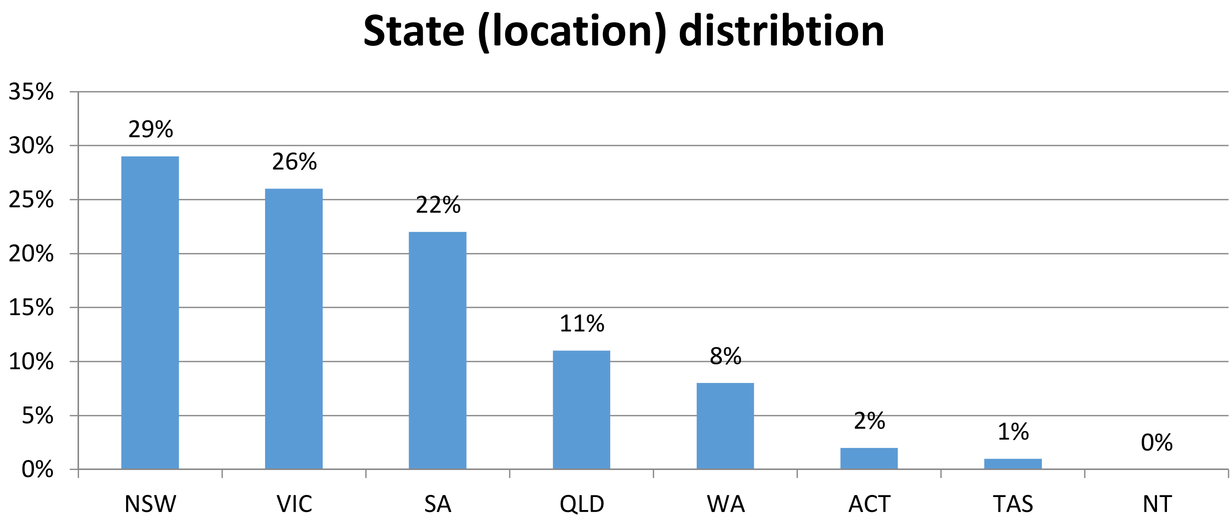
An analysis of the product take up of the largest provider of scholarship plans in Australia, Australian Scholarships Group, shows a 14% increase in product take up in the five years prior to 2003 which was then followed by an average annual decrease of around 30% per annum up until recently. The graph above illustrates this point.

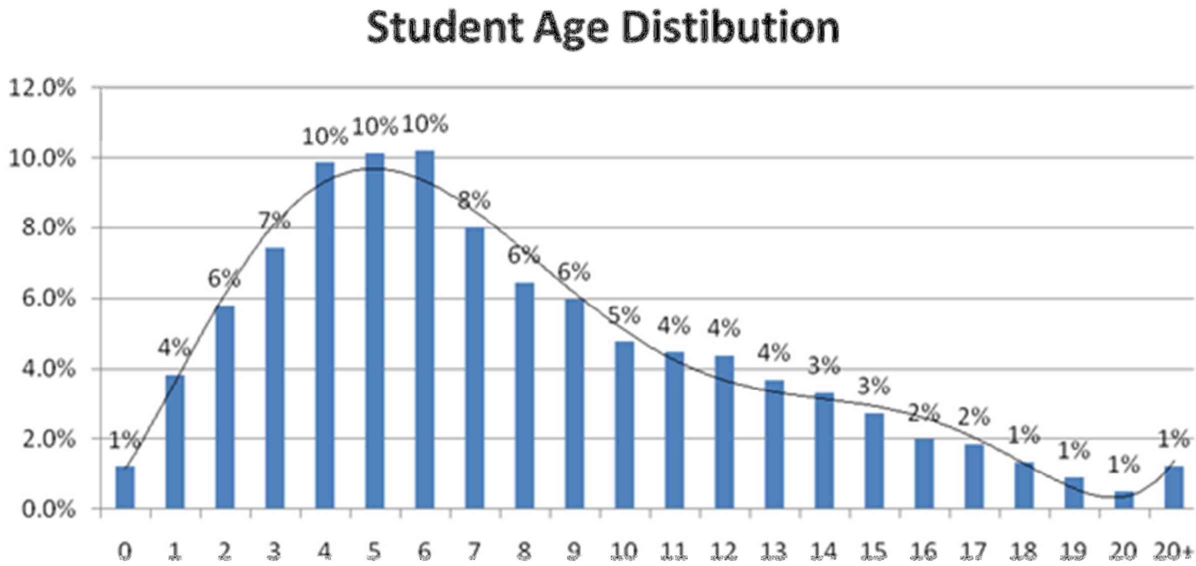
This was in part influenced by the increase in complexity caused by transferring the tax liability from the parent to the child, notwithstanding that tax concession being preserved.

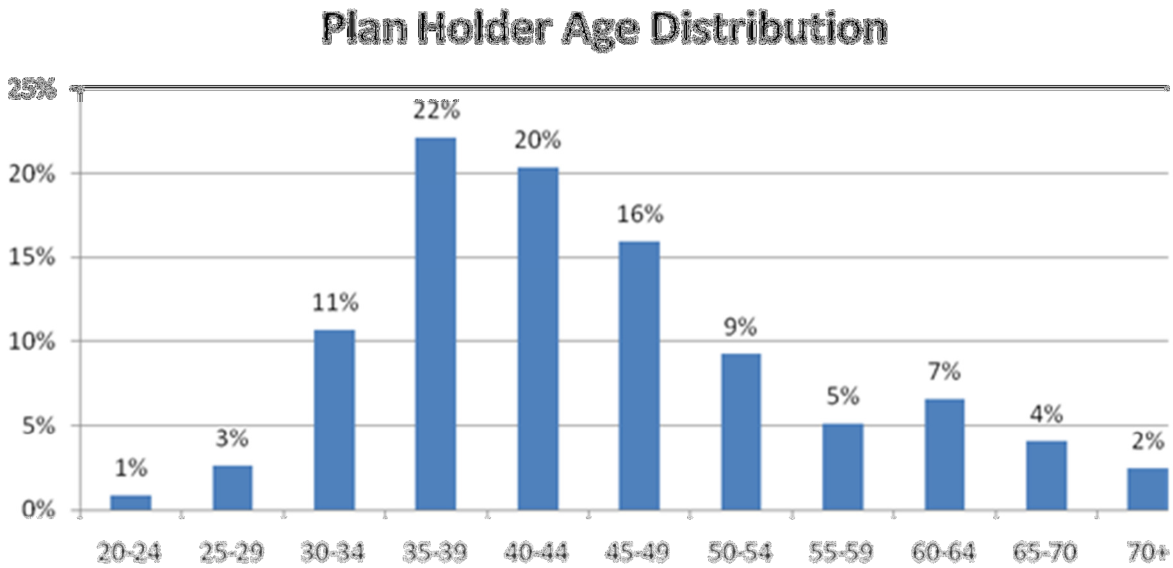
The key point to draw from this graph is that the industry is seeing rates of decline in product take up that is out of step with any notion that they are used for the purpose of minimising taxation. These rates of decline also highlight the critical need to encourage people to save for their future education using these products, rather than discouraging them, through the drastically reduced LITO.

Industry Data
Below is a series of graphs providing additional information on age and state distribution of scholarship plans.









Source: Australian Unity/Lifeplan