Submission to the Review of Business Taxation

Association of Superannuation Funds of Australia

April 1999

Executive Summary

ASFA is a non-profit, non-party political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. As such it is the "Voice of Super".

ASFA's 593 constituent members have been estimated to be responsible for around $300 billion of assets, about 80 per cent of the total superannuation funds under management of around $377 billion as at December 1998. ASFA member funds in aggregate also represent around 6.5 million Australians with superannuation. This amounts to the bulk of the working age population and around 80 per cent of Australians with superannuation.

ASFA is able to draw on the expertise and practical experience of its nearly 600 members, its various policy committees and study groups. Over 500 industry representatives attended a recent series of half-day seminars around the nation which focussed on the proposed business tax changes.

Superannuation as part of the finance and business sector

Around $145 billion of superannuation assets are dealt with by investment managers of various types, with another $105 or so billion managed directly. $130 billion of superannuation funds are invested through Life Office statutory funds. Shareholdings by superannuation funds account for around one-quarter of the market capitalisation of the Australian Stock Exchange. Superannuation funds also are significant investors in public unit trusts.

The superannuation sector is large in comparison to other managed investments. In total there is nearly $380 billion in superannuation compared to some $80 billion is in public unit trusts and $17 billion in Cash Management Trusts.

General approach adopted by ASFA

The Discussion Paper notes that submissions may raise possible exceptions to the entity benchmark in relation to collective investment vehicles qualifying for flow-through tax treatment with tax preferred income remaining untaxed in members' hands. ASFA's is one such submission.

ASFA suggests that the Review give particular attention to the practical implications of any of its proposals, and to any transition issues that may arise. If the only "evil" of a tax arrangement is that it does not fit neatly into the preferred classification structure of reform arrangements, this is not sufficient reason to introduce change.

Pooled Superannuation Trusts (PSTs)

ASFA considers that no real case has been made for changing the tax treatment of PSTs. ASFA seeks from the Review strong support for the continuing role for PSTs and abandonment of the tentative position put forward in the Discussion Paper.

Distributing trusts

ASFA recommends that the use of collective investment vehicles based on a trust structure continue to be available to superannuation funds without any adverse consequences such as denial of the flow through of taxation benefits. The use of such mechanisms is not an alternative to the use of corporate structures by funds. The real alternative is that of direct investment by superannuation funds and competitive neutrality demands that superannuation funds continue to be able to make a rational choice between the two structures without distortions due to tax considerations.

The Review proposals as they stand would increase costs and reduce flexibility for superannuation funds. They would not generate extra tax revenue from investments made by superannuation funds.

Superannuation funds use a range of trust and sub-trusts as a means of appropriately diversifying their investments and facilitating movement of contributions into superannuation funds and payments of benefits to members. Trust arrangements also assist in the pooling of funds for investment in infrastructure and venture capital, both of which add to the growth of Australia's economy.

The submission suggest a number of possible mechanisms which would enable trusts which receive superannuation fund investments to satisfy the definition of "widely held collective investment vehicle" given the very numerous members of superannuation funds stand a step behind them. Such investment vehicles should be permitted to flow through tax benefits to the investors, including superannuation funds.

Pension and annuity taxation

An alternative approach and arguably less complex way of ensuring that the tax free treatment of pensions and annuities be restricted to such products would be to require all earnings from assets used to fund these to be segregated from other funds of the provider. Tax could be applied at a punitive rate if such earnings were distributed to other than eligible pension or annuity recipients.

Taxation of earnings allocated to reserves

ASFA recommends that arrangements be developed so that capital guaranteed and/or reserve backed products be taxed on the earnings from reserves at no more than the rate applying to the ultimate investor.

Transitional arrangements

ASFA recommends that capital gains tax (CGT) rollover relief and broader income tax relief be provided for any superannuation fund which restructures its investment holdings as a result of any changes to the taxation of collective investment vehicles.

Such tax relief would be similar to that provided to managed investment funds following the enactment of the Managed Investment Act 1998.

Similar tax relief should also be provided to life companies and policy holders for any tax consequences that might flow from business tax changes leading to superannuation business being moved from life office statutory funds into trust based superannuation funds.

ASFA's Submission to the Review of Business Taxation

1. Superannuation as part of the finance and business sector

Superannuation funds are major players in the Australian investment market. superannuation funds are both important financial organisations in their own right and substantial investors in other investment organisations, entities and financial instruments.

Around $145 billion of superannuation assets are dealt with by investment managers of various types, with another $105 billion or so managed directly. $130 billion of superannuation funds are invested through Life Office statutory funds. The 20 per cent of the total superannuation market provided through Life Office statutory funds makes up around 80 per cent of the business of life companies.

Shareholdings by superannuation funds account for around one-quarter of the market capitalisation of the Australian Stock Exchange. Superannuation funds also are significant investors in public unit trusts. They have significant direct and indirect interests in Australian property. Superannuation funds provide around half of the funds raised each year in the form of venture equity capital for new Australian firms. They also are major investors in new infrastructure projects and in business entities which have purchased infrastructure such as power stations and airports which previously in the public sector.

The superannuation sector is large in comparison to other managed investments. In total there is $377 billion in superannuation compared to some $80 billion is in public unit trusts and $17 billion in Cash Management Trusts.

Other reasons for ASFA making a submission include:

- superannuation is the major savings vehicle for over 8 million Australians. It plays an important public policy and deserves as much recognition as general business tax reform;
- superannuation funds are the only users of Pooled Superannuation Trusts, with changes also proposed in this area;
- superannuation funds currently channel a significant proportion of their investments through investment trusts and like arrangements;
- superannuation funds are large direct investors in property, Australian equities and foreign equities. Changes in the tax treatment of any of these areas impact on superannuation funds; and
- private pensions and annuities are largely funded out of superannuation entitlements, and changes to the tax treatment of such products have the potential to impact on the level and mode of retirement incomes.

2. ASFA Comments on Discussion Paper Proposals

2.1 ASFA's general approach to business tax reform

The Review in the Discussion Paper is seeking to develop proposals which will further an internationally competitive as well as economically efficient business tax arrangements. The Review states that such a system should lead to decisions on business investments which are made on the basis of sound commercial considerations, as free as possible from tax distorting influences, and that where government uses the tax system to further non-tax objectives, such tax incentives be targeted in the most efficient and cost effective manner and be transparent.

The Review has not sought to address issues connected to the taxation of superannuation. However, it should be aware of the public policy reasons for the current arrangements as these are relevant to how the inter-relationship between the taxation of superannuation funds and business and investment entities should work.

Superannuation fund earnings are taxed at the special rate of 15 per cent. This departure from the corporate entity tax rate is a well supported government decision to encourage voluntary savings and member acceptance of compulsory contributions, and to enhance the compounding of retirement savings. As well the fund earnings tax rate is combined with further taxes on contributions and benefits. Given this policy decision it would be perverse if policies then undermined these objectives by adversely affecting the way superannuation funds invest and develop appropriate products.

ASFA notes the Review's retention of an income tax base in its deliberations, and its use of an entity taxation benchmark. The Review also puts forward a view that there should be a primacy of entity taxation over the taxation of ownership interests, with the chief exception put forward of the case of collective investment vehicles (CIVs) that are widely held and that distribute or attribute all of their income annually.

The Discussion Paper notes at Paragraph 55 that submissions may raise possible exceptions to the entity benchmark in relation to collective investment vehicles qualifying for flow-through tax treatment with tax preferred income remaining untaxed in members' hands. ASFA's is one such submission, in particular it raises a number of issues in regard to the treatment of investments made by trust based superannuation funds.

At the outset it should be noted that superannuation funds have a range of characteristics which make them quite different to most other taxpayers and investment or business entities. Relevant characteristics include:

- Superannuation funds are subject to taxation in their own right and do not stand in the place of fund members.
- Superannuation funds are subject to a flat rate of tax.

- The rate of tax is set at a concessional rate in order to support the government's public policy goals of better retirement incomes and reduced future social security expenditures.
- Superannuation funds invest in a range of financial and real investments and invest both directly and through investment managers and other entities.

Even more unusual in the sense of being different from most other entities subject to taxation are Pooled Superannuation Trusts. PSTs need particular attention and care in any proposals for changes in taxation arrangements given that they are both taxable entity in their own right and a conduit for investments on behalf of superannuation funds who receive returns from PSTs on a tax paid basis.

The taxation treatment of life companies is also of relevance to the provision of superannuation, with the bulk of life company business superannuation related. There is a very real question of whether the appropriate benchmark for the taxation of the superannuation business of life companies is that of a corporate entity or whether the benchmark should be the tax treatment of a superannuation fund.

ASFA suggests that the Review give particular attention to the practical implications of any of its proposals, and to any transition issues that may arise. If the only "evil" of a tax arrangement is that it does not fit neatly into the preferred classification structure of reform arrangements, this is not sufficient reason to introduce change.

This is particularly so if there are costs for business and the community more generally from change. Consistent with the general approach taken by the Review, it should be the financial and economic characteristics of a transaction rather than an artificially strict legal classification of a transaction, which should determine its tax treatment.

The proposals for PSTs and distributing trusts are ones where these practical and policy considerations are very important. There is a potential impact on the administrative overheads faced by funds with a flow-on of the costs to the individuals who in effect are investing/saving through such funds.

2.2 Pooled Superannuation Trusts

Pooled superannuation trusts (PSTs) were created in 1988 in order to assist superannuation funds to meet their taxation obligations in an efficient and effective manner and to provide an efficient investment mechanism for small to medium superannuation funds and indeed for larger funds as well. No compelling or indeed any real reasons have been put forward for discontinuing PST arrangements.

There are some 190 PSTs in operation, with in excess of $30 billion in assets under management. Around 10 per cent of total superannuation assets are invested through PSTs. Several million Australians have an indirect interest in investments made through PSTs given their use by a range of large and small superannuation funds.

The largest PSTs have over $1 billion in assets, with the majority having more than $10 million in assets. Most PSTs are operated by an Approved Trustee within the banking and fund manager industries, followed by those within administration and life company groups. Over 80 per cent of PST assets are directly invested, with a relatively few PSTs acting as an administrative conduit to other managed investments.

Only complying superannuation funds can invest in them. PSTs are a useful investment conduit for a range of superannuation funds because they open up an array of investment opportunities which have greater liquidity and diversity in risk profile. They also provide an opportunity to simplify taxation compliance, particularly for smaller superannuation funds.

PSTs pay tax at the normal super fund rates and stand in the place of individual superannuation funds in regard to the taxation of earnings on an investment. This involves no elements of tax avoidance or minimisation, simply easier tax compliance for small and medium size funds.

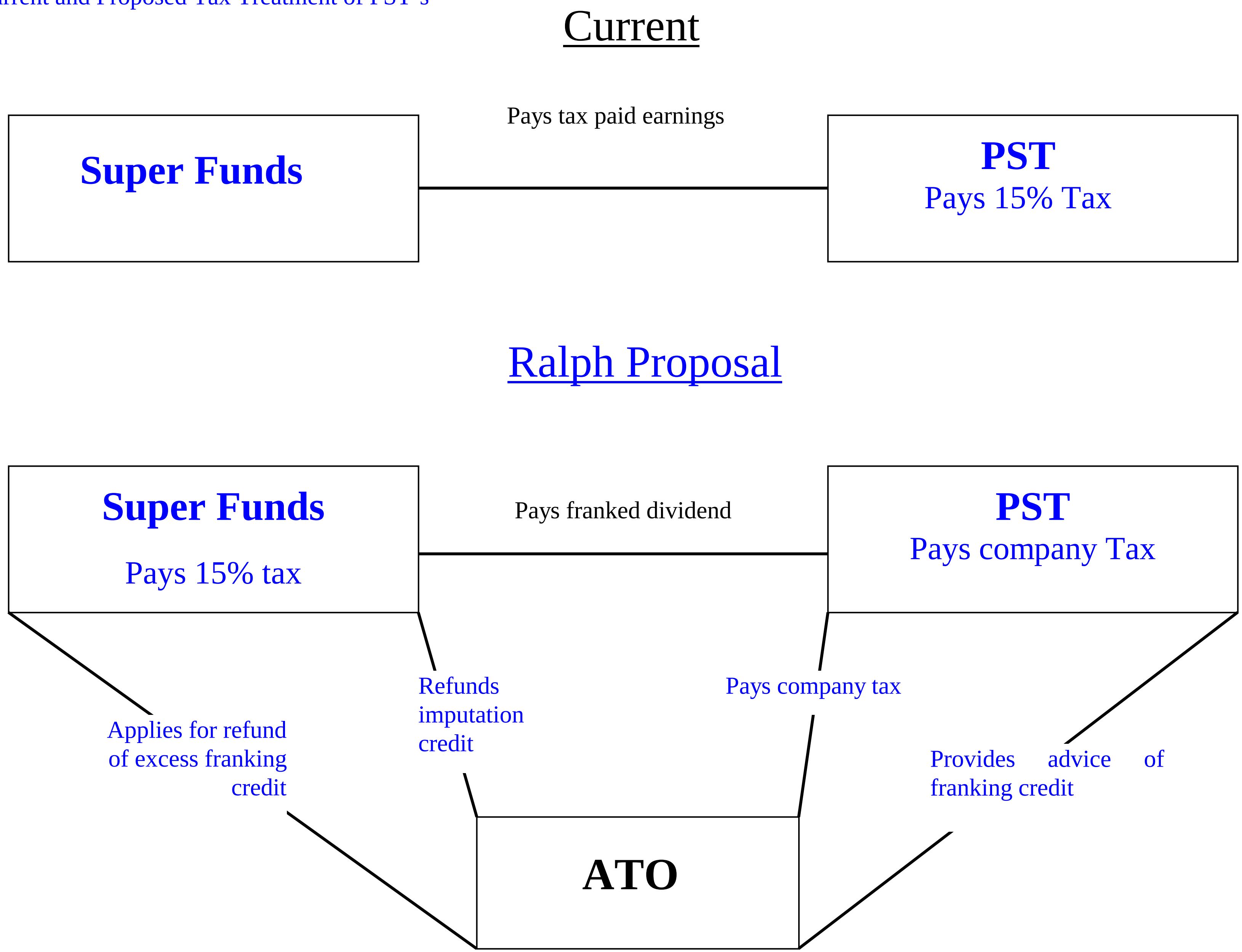
PSTs also play an important role in facilitating investment choice by superannuation funds, allowing access to a range of categories of investment, diversification of risk and professional investment management at wholesale levels of management expense charges. For a super fund offering investment choice PSTs are flexible and efficient tools for achieving this. The Government supports greater choice by superannuation fund members, and any move to remove a mechanism which facilitates choice should not be a decision taken lightly.

It should also be noted that Part IX of the Tax Act applies to both superannuation funds and PSTs, and that both are subject to the Superannuation Industry (Supervision) Act. PSTs should be regarded as part of the superannuation system rather than as a collective investment vehicle similar to a public unit trust.

On the face of it the only shortcoming of PSTs is that their existence cuts across the classification lines proposed in the discussion paper. However, as noted above this is not a sufficient reason to justify their abolition. As well, continuance of PSTs in no way compromises the adoption of other tax proposals being considered by the Review. Superannuation is the only area where the ultimate taxable entity faces uniform tax rates. At Paragraph 38 of the Discussion Paper it is noted that where the tax treatment of an entity and its beneficial owner is identical or very similar, the point at which tax is imposed turns more on practical and administrative considerations rather than any grand principles. This is particularly relevant to superannuation funds and PSTs, given both are taxable at a flat rate of 15 per cent.

As indicated in Figure 1, the approach proposed in the Discussion Paper would involve a considerable degree of complexity compared to the current approach. The taxation of superannuation is complex enough without having new layers of complexity imposed. As well, there would be no additional revenue raised if the proposal were implemented, leading to a negative sum outcome for both funds and government given the additional administration and transaction costs involved

Figure 1: Current and Proposed Tax Treatment of PST’s



The strength of the arguments summarised above has been reflected in the strong and uniform rejection of the Discussion Paper proposals in regard to PSTs by the financial sector.

ASFA seeks from the Review strong support for a continuing role for PSTs and abandonment of the tentative position put forward in Discussion Paper 2.

2.3 Distributing trusts

Many superannuation funds make use of trust based arrangements as mechanisms for their wholesale investments. Money is invested through property and share trusts, with currently a full flow through to the super funds of the income and tax obligations of those investments. Superannuation funds are in themselves a collective investment vehicle, but the use of other collective investment vehicles can be efficient and effective means for further diversifying risks, minimising costs and maximising returns.

The Discussion Paper takes as its reference point a corporate entity as the appropriate taxing point for much of business and investment activity in the economy, with full imputation the extent to which flow through of tax paid at the corporate level is proposed. The conduct of business and investment activity through discretionary trust structures is seen as producing less tax revenue, including greater flow through of tax benefits and deferrals, than such activities conducted through a corporate structure. The remedy proposed is to remove any tax advantages of this approach compared to using a corporate structure for conducting business.

The Discussion Paper argues that the corporate benchmark is the most appropriate for business activity, but acknowledges that it will not always be appropriate for investment activities. This principle has gained Government endorsement in the decision that Cash Management Trusts will continue to have flow through tax treatment. ASFA understands that consideration is also being given to other widely held distributing trusts having similar treatment. The definition put forward is that a unit trust is widely-held unless 20 or fewer persons hold 75 per cent or more of the beneficial interests in the income or property of the trusts.

However, the definition in the discussion paper of widely owned distributing trusts is narrow, and many collective investment vehicles used by super funds will on current indications have little chance of being exempted. For example, where an office building is owned by means of a property trust by 6 major superannuation funds with some millions of members, on the definition proposed this would not be regarded as a widely held trust. Inequities, complexity and additional costs would result for individual fund members, particularly those who entered or left a fund after corporate tax had been paid but before an imputation credit had become available. Little if any extra taxation revenue would be gathered if proposal went ahead.

Currently, section 102P of the Income Tax Assessment Act 1936 defines a trust as a public unit trust provided it meets either the test above (20 person/ 75 per cent holding test) or there is 20 per cent ownership by superannuation funds and other tax exempt entities.

The retention of the something like the second limb of this definition is crucial for superannuation funds to remain attracted to trust type investments.

The use of trust arrangements is not an alternative to the use of corporate structures by funds. The real alternative is that of direct investment by superannuation funds.

If flow through of tax benefits is denied and complicated refund or imputation processes are put in place, such a regime would favour direct investment by superannuation funds over collective investments. In order to gain full flow through of depreciation and capital gain provisions super funds will need, for instance, to hold property investments directly rather than through a property trust. The net impact of this would be higher costs for funds, less flexibility and fewer opportunities for risk diversification and sharing.

One of the primary purposes of the Review of Business taxation is to make sound commercial decisions free for possible tax distorting influences. It would be a blatant disregard of this purpose for superannuation funds to be forced into direct investments as the only way of avoiding inappropriate and costly tax withholding arrangements.

It would also be inexcusable if superannuation funds, which hold a large and growing base of productive capital were effectively prohibited from pooling small amounts of this capital for enterprises which add to the growth of Australia's economy. Superannuation funds are vehicles which have been willing to invest amounts in a range of infrastructure projects and venture capital, but very few superannuation funds could commit to singularly financing and facing the risks of one of these projects alone.

ASFA suggests that in addition to Cash Management Trusts and widely held distributing trusts (if the latter are to be given flow through treatment), that distributing trusts which distribute to complying superannuation funds also be given similar treatment.

The Review should appreciate that a superannuation fund investment in a trust also usually involves that trust itself using a range of wholesale products and sub-trusts as a means of appropriately diversifying and allowing movements in and out of the trust and sub-trusts without unnecessary asset sales. All of these related holdings need to be recognised as widely held for the superannuation fund's purpose.

Various mechanisms could provide trusts which receive superannuation fund investments with a widely held collective investment vehicle tag such as -

(i) recognition of the ultimate member ownership of superannuation funds as sufficient to meet the 20 person/75 per cent holding test;

(ii) retention of the second limb of the current public unit trust test;

(iii) a schedular approach listing superannuation funds as an entity (cash management trusts might be another) which is widely held.

Any of these mechanisms would be would be consistent with the principle put forward in the Discussion Paper given that the very numerous members of superannuation funds stand a step behind them. Distribution to superannuation funds should be taken as giving a distributing trust the widely held character which the Discussion Paper accepts to be a relevant factor in determining flow through treatment.

ASFA recommends that the use of collective investment vehicles based on a trust structure continue to be available to superannuation funds without any adverse consequences such as denial of the flow through of taxation benefits. In essence ASFA suggests that if a definition of widely held trust is to establish whether flow through benefits are available then the number of members of each superannuation fund should be taken into account in establishing whether the trust is widely held.

ASFA recommends that the use of collective investment vehicles based on a trust structure continue to be available to superannuation funds without any adverse consequences such as denial of the flow through of taxation benefits. ASFA suggests that if a definition of widely held trust is to establish whether flow through benefits are available then the number of members of each superannuation fund should be taken into account in establishing whether the trust is widely held.

The use of trust arrangements is not an alternative to the use of corporate structures by funds. The real alternative is that of direct investment by superannuation funds.

If flow through of tax benefits is denied and complicated refund or imputation processes are put in place, such a regime would favour direct investment by superannuation funds over collective investments. In order to gain full flow through of depreciation and capital gain provisions super funds will need, for instance, to hold property investments directly rather than through a property trust. The net impact of this would be higher costs for funds, less flexibility and fewer opportunities for risk diversification and sharing.

Inequities, complexity and additional costs would result for individual fund members, particularly those who entered or left a fund after corporate tax had been paid but before an imputation credit had been received. Little if any extra taxation revenue will be gathered if the proposal goes ahead.

ASFA suggests that in addition to Cash Management Trusts and widely held distributing trusts (if the latter are to be given flow through treatment), that distributing trusts which only distribute to complying superannuation funds also be given similar treatment. This would be consistent with the principle put forward in the Discussion Paper given that the very numerous members of superannuation funds stand a step behind them. Distribution to superannuation funds should be taken as giving a distributing trust the widely held character which the Discussion Paper accepts to be a relevant factor in determining flow through treatment.

2.4 Pension and annuity business

The proposals in the Discussion Paper relating to the tax treatment of pensions and annuities provide some reassurance to recipients of such payments as their effect will be that the income underlying them will continue to be tax free.

However, the mechanisms proposed in the Discussion Paper would achieve this at the cost of some complexity and the requirement for new and different actuarial calculations. The "evil" that is sought to be addressed appears to be that life companies and funds may have had actuarial reports which apportion more assets than actually has been necessary as the funding base for pensions and annuities.

An alternative approach and arguably less complex way of ensuring that the tax free treatment of pensions and annuities be restricted to such products would be to require all earnings from assets used to fund these to be segregated from other funds of the provider. Tax could be applied at a punitive rate if such earnings were distributed to other than eligible pension or annuity recipients.

2.5 Taxation of earnings allocated to reserves

The proposals in the Discussion Paper would make the retention of earnings in life company reserves for the purpose of smoothing out returns relatively unattractive in taxation terms. Such earnings would be taxed at the corporate tax rate. Given that superannuation funds are taxed at 15 per cent rather than the company tax rate any investment which has tax imposed in whole or part at the corporate rate becomes unattractive. The Review should be aware that its proposals would in effect lead to a demise of investment products offered by life companies which have smoothed returns.

The proposal would also make other products which are reserve or balance sheet based more expensive. These typically are capital guaranteed products offered by life companies.

ASFA accepts that there should be a level playing field for investment products. However, arguably the Discussion Paper proposals would be given an adverse tilt away from reserve backed products offered by life companies. A conjunction of unfavourable tax treatment and low interest rates could see such products largely disappearing from the market despite their meeting the investment needs of some individuals.

ASFA recommends that arrangements be developed so that capital guaranteed and/or reserve backed products be taxed on the earnings from reserves at no more than the rate applying to the ultimate investor.

In the case of reserve backed investments products provided to superannuation funds the relevant tax rate on earnings on reserves would be 15 per cent. If reserves were distributed to other than a superannuation fund then a punitive taxation rate could be applied.

2.6 Transitional issues

Major transitional problems could be faced by superannuation funds and by life insurance companies if certain of the Discussion Paper proposals in regard to the taxation of collective investment vehicles and life insurance companies were implemented.

In the case of property and other like trusts which were no longer able to flow through tax benefits many of these funds would be terminated or superannuation funds would liquidate their financial interest in them. Instead superannuation funds would hold the underlying investments directly.

ASFA recommends that capital gains tax (CGT) rollover relief and broader income tax relief be provided for any superannuation fund which restructures its investment holdings as a result of any changes to the taxation of collective investment vehicles.

Such tax relief would be similar to that provided to managed investment funds following the enactment of the Managed Investment Act 1998.

Similar tax relief should also be provided to life companies and policy holders for any tax consequences that might flow from business tax changes leading to superannuation business being moved from life office statutory funds into trust based superannuation funds.