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14 April 1999

The Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Sir

SUBMISSION TO THE REVIEW OF BUSINESS TAXATION

Attached is Citicorp Life Insurance Limited's submission to the above review.

The submission deals with various matters contained in Chapters 15 and 34-37.

Should you have any questions concerning this submission please contact:

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We would be happy to expand on any of the issues raised if requested.

Yours faithfully

PHILIP BARLIN
Tax Counsel

SUBMISSION OF CITICORP LIFE INSURANCE LIMITED TO THE REVIEW OF BUSINESS TAXATION

Citicorp Life Insurance limited has five areas of concern.

1. The commencement date for any changes to the taxation of life insurance companies.

2. Ensuring the interest deduction for annuity products adequately allows for indexed annuities.

3. The consequences of the life company changes for investors in deferred annuities.

4. The cessation of contributions tax transfers to Pooled Superannuation Trusts.

5. Ensuring the existing flow through tax regime continues for wholesale unit trusts as well as for retail unit trusts.

1. The commencement date for the life company changes.

Chapter 34 contains a proposal to replace the current class of business method of taxing life insurance companies with a system whereby all income is taxed at the corporate rate of tax. At paragraph 34.9 it is stated that this new system will apply from the 2000-2001 income year.

It is submitted that a commencement date based upon income years would create inequities between insurers and consequent distortions in the insurance market place. It is suggested that the changes be implemented from a common start date of 1 July 2000.

Life insurance companies in Australia have a variety of year ends. Many have adopted a 31 December year end in lieu of the following 30 June, some have a 30 June year end and others have a 30 September year end in lieu of the preceding 30 June. A commencement date based upon income years would subject some insurers to the new regime up to nine months prior to others.

It is the Government's expectation that approximately $600 million will be raised per annum from these measures. This represents a significant impost on life insurers and it would be inequitable to impose that impost on some before others.

In the risk insurance area premium rates are based upon actuarial advice. Such advice is principally based upon the life expectancies of the insured population and existing financial reserves. One likely consequence of the proposal to tax risk business on an underwriting basis will be to reduce reserves as monies will be used to pay additional tax. Such a diminution in reserves would force life insurers to increase premium rates. It would be inequitable for some insurers to be forced to increase their rates up to nine months prior to others.

In the superannuation area a very large proportion of each year's business is written in June. Notwithstanding the comments in paragraph 34.61 about accelerated refund procedures for excess imputation credits it is <u>highly</u> unlikely that such procedures will be legislated and in place by the first half of the year 2000. Consequently those consumers investing superannuation monies in early balancing life companies will potentially suffer a disadvantage. This disadvantage will be equal to the loss of earnings on monies not yet refunded. Given this, early balancing life companies will be a less attractive repository for superannuation monies than 30 June or late balancing companies.

Further, if the changes were to be implemented based upon income years then life insurance operations who have year ends prior to 30 June 2000 will be unable to accept section 275 contributions tax transfers from company and "DIY" superannuation funds, thus diminishing the range of investment choices for such funds.

Therefore on the grounds of equity between life insurers and the desirability of not creating distortions in product pricing this proposal should commence for all life insurers from 1 July 2000 **not** from the beginning of the 2000 / 2001 income year.

2. Interest deductions in respect of annuities

We are concerned that the discussion in paragraphs 34.43 to 34.55 does not adequately address "indexed or increasing annuities". Under regulation 1.05 of the Superannuation Industry (Supervision) Regulations it is possible to offer an annuity product where the annual payment increases in line with inflation or by 5%, whichever is the less.

It is our suggestion that the wording of any legislative provisions for determining interest deductions for fixed term annuities needs to be sufficiently flexible to allow a deduction for the proper interest component in the case of increasing annuities

Included in appendix 1 are illustrations for three annuities two of which are increasing annuities. These may be useful to you in developing your methodologies.

We agree with the proposal in 34.51 that the interest component of an allocated product should be based upon the amount credited to the account in the year. Any proposal to only allow a deduction for that proportion taken as income should be avoided as it will ultimately result in diminished income streams for those holding allocated pensions and allocated annuities.

3. Deferred annuities

We are concerned that the proposals contained in paragraphs 34.65 to 34.71 fail to take into account the role deferred annuity products have in the superannuation marketplace.

Most monies currently invested in life company deferred annuities have been invested in such a vehicle because of the capital guarantees that these entities provide. It is not possible for PSTs and superannuation funds to provide such guarantees. It is acknowledged that an RSA run by a life company can provide a capital guarantee. However, RSAs were established as <u>low cost</u> short term repositories for small amounts of retirement monies. They were created with the intention that once a reasonable balance was achieved it would be invested in a superannuation vehicle achieving better returns. To effectively force all capital guaranteed annuity monies to be transferred to an RSA would significantly alter the role of RSAs and possibly cause them to cease to be efficient low cost repositories.

It is suggested that the existing regime for life insurers be continued for capital guaranteed deferred annuity products. This is because the continuation of such treatment is nothing more than is intended, in any case, for an RSA run by a life insurer.

Alternatively, and very much as a less satisfactory alternative, the taxation treatment of existing deferred annuity products should be "grandfathered". This is because many of the existing annuity accounts are invested in fixed term arrangements. In order to roll over the monies to a new vehicle these account holders will be required to break the fixed term arrangements they have entered into. This invariably results in a penalty charge from the insurer. Hence in order to not adversely affect existing deferred annuity account holders it will be necessary to provide some form of relief. Such relief would most efficiently be provided through a "grandfathering concession".

4. Section 275 transfers to PSTs

It is submitted that the ability of superannuation funds to transfer their contributions tax liability to a Pooled Superannuation Trust should be retained. That is Option 2 as described in paragraphs 36.8 and 36.9 should be chosen.

The underlying rationale for denying such transfers in the future is to ensure PSTs and life insurance companies are treated in the same manner. However, this ignores the reason that s. 275 transfers are to be denied to life companies. Life companies currently generate imputation credits in respect of all tax paid regardless of whether the tax relates to someone else's money (i.e. superannuation money). The subsequent credits are available to frank dividends paid by the life company. Hence the proposal to prevent s. 275 transfers is designed to prevent the shareholders of life companies benefiting from the tax payable in respect of another's investments.

However, a PST is very much like a superannuation fund. Tax paid does not lead to imputation credits. Hence the perceived mischief is not applicable to a PST. In any case the perceived mischief will be eliminated by the proposed changes to the way franking accounts are kept by life companies.

5. Wholesale unit trusts

It is submitted that collective investment vehicles should continue to be taxed on a flow through basis. The Treasurer has stated his support for this proposition in his 22 February 1999 press release. However, the statements made to date, whilst clarifying the position of retail unit trusts, leave open the position of wholesale unit trusts. It is suggested that such trusts should also continue to be taxed on a flow through basis.

Wholesale unit trusts are fixed unit trusts that make full distributions each year. However, they typically have a very high minimum investment threshold e.g. $100,000. The purpose of these trusts is to enable investment monies to be collected together for more efficient management. So, for example, a particular wholesale trust may manage monies invested from 5-6 retail unit trusts. Similarly a retail unit trust following a “balanced investment approach” may achieve this by investing large sums in 3-4 different wholesale unit trusts which each invest in different asset classes. In addition there are many “dying” retail unit trusts that are too small to efficiently achieve the benefits of investment diversification. The way these trusts satisfy their fiduciary responsibilities is to invest into another unit trust, a wholesale unit trust.

Such wholesale unit trusts may not have 20 direct investors and therefore are unlikely to be “widely held vehicles” as described in paragraph 16.16. *We suggest that some form of “look through” test be adopted in determining whether a wholesale unit trust is widely held.* That is, the 2000 investors in the retail unit trust that invests in the wholesale unit trust would be taken into account for the purpose of determining whether the trust was widely held. Such an arrangement would enable the efficient investing of private monies but would not impede the Review’s thrust for consistent tax treatment between different classes of entity.