AUSTRALIAN FRIENDLY SOCIETIES ASSOCIATION

Submission to

THE BUSINESS TAXATION REFORM COMMITTEE

Responding to

A PLATFORM FOR CONSULTATION

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FRIENDLY SOCIETIES – A UNIQUE STRUCTURE

Modern Friendly societies have inherited a unique structure. Friendly Societies operate their business through the concept of “benefit funds”. These are discrete funds and operate only one product per benefit fund. All the assets of these funds are kept separate and distinct from all other funds. This system has proven to be very secure and safe and offers Friendly Society members the security of knowing that if one fund has an unsatisfactory investment portfolio, then there is no risk of contamination to other benefit funds. This has meant that, in the case of a Friendly Society finding itself in difficulties, it can be merged with another without risk to each quarantined investment fund. The industry, therefore, has a very sound record of protecting member interests.

As a result of this structure, Friendly Societies have a very open and transparent taxation structure and a very simple operation, which we certainly would wish to continue.

This submission reflects the industry’s desire for simplicity and does so mindful of the Committee’s charter to produce a fair and practicable result.

The following elements appear in Platform for Consultation order.

SUBMISSION TO BUSINESS TAXATION REFORM COMMITTEE

EXECUTIVE SUMMARY

1.0. **CONSOLIDATION (CHAPTER 26)**

1.1-2 AFSA favours the simplicity of Option 2, on the availability of carry-forward losses.

1.3 Loss claims should continue to be reduced by net exempt income, but where net exempt income excludes premium income, to be consistent with the exclusion of investment deposit receipts in loss availability calculations of other investment institutions.

2.0 **TAXATION OF LIFE INSURERS (CHAPTER 34)**

2.1-4 AFSA strongly favours Option 3 to determine taxable income.

2.5 To be consistent with the tax treatment of complying superannuation and normal business of a corporate entity, AFSA believes it to be both consistent and equitable to apply capital gains tax calculations (at an entity level) on relevant investment assets in respect of its eligible insurance business.

To be consistent with the treatment of other financial products, business tax reform (albeit in indirect taxation) should remove existing stamp duty charges (currently charged by the states) on life assurance policies.

To be consistent with the treatment of franked dividends which are paid out of already-taxed entity profits to non-residents, AFSA believes that reversionary bonuses should remain outside the normal operation of non-resident withholding tax – except where the Commissioner specifically directs a resident life insurer to deduct such tax.

2.6-7 AFSA favours a single tax rate change from the existing 33% eligible insurance business rate to a new uniform company rate (we agree with the target 30%) from 30th June, 2000 or whenever the new company rate comes into force.

2.8-10 To facilitate the transfer of benefit fund deferred annuity business to a separate and standalone complying superannuation fund, AFSA seeks rollover relief on asset transfers and a mechanism to provide solvency reserve support to capital guaranteed products.

2.11 To facilitate the transfer of benefit fund superannuation business to a separate and standalone complying superannuation fund, AFSA seeks rollover relief on asset transfers and a mechanism to provide solvency reserve support to capital guaranteed products.

2.12-13 AFSA seeks the retention of current rules relating to the use of franking credits in calculating bonuses for existing policies.

2.14-15 AFSA seeks the availability of the inter-corporate dividend rebate in an imputation regime for new policies, to avoid the possibility of double taxation.

2.16 Franking credit allocation between shareholders and policyholders should be on a regulatory basis.

3.0 **EXEMPTIONS**

AFSA seeks retention of effective exemption on the following non-life and other products.

3.1-5 Income bonds.

3.6-10 Funeral bonds.

3.12-19 Scholarship funds.

THE TAXATION OF POLICYHOLDERS

4.0 **EXISTING POLICIES (CHAPTER 35)**

4.1-2 AFSA prefers and supports the adoption of full grandfathering, retaining the existing rules for existing policies.

4.3-4 AFSA also proposes a means of allowing existing low income policyholders to access the new rebate system (available on new policies).

4.5 AFSA favours and supports a single non-phased Section 160AAB rebate at the new company rate – but introduced one year after the new company rate applies, consistent with past changes in this area

5.0 **NEW POLICIES (CHAPTER 35)**

5.1-5 AFSA favours the flexibility and choices provided in Option 1.

5.6-8 Section 67AAA(2) provision on the denial of deductibility, for interest expenses incurred in the purchase of a Friendly Society "insurance bond", should be repealed.

5.9-12 CGT treatment should be available on any realised growth component.

5.13-15 Policy fees which are assessable to the life insurer should be deductible to the policyholder in the same year, to avoid "blackhole expenditure" outcome.

5.16 It is noted that the distribution of tax-preferred trust income may or may not continue in a new tax system.
If it were to continue, it would seem both consistent and equitable to extend its availability to assessable bonus/growth returns on a policy of life assurance.

6.0 POOLED SUPERANNUATION TRUSTS (CHAPTER 36)

6.1-4 AFSA favours retention of PSTs as a superannuation entity with 15% tax rate.

1.0 **CONSOLIDATION OF CARRY-FORD LOSSES (CHAPTER 26)**

1.1 AFSA favours Option 2 which would allow carry-forward losses to be brought into a consolidated group subject to a modified Same Business Test (SBT).

1.2 AFSA favours Option 2 because of its simplicity. It would remove the constraints imposed by the existing loss transfer rules. Its proposal of a modified SBT relaxes the current law despite the cap on the usage of losses designed to limit the cost to revenue.

1.3 AFSA also considers that loss claims should continue to be reduced by net exempt income, but where net exempt income excludes premium income to be consistent with the exclusion of investment deposit receipts in loss availability calculations of other investment institutions.

2.0 **TAXATION OF LIFE INSURERS – FRIENDLY SOCIETIES (CHAPTER 34)**

2.1 ***AFSA's strong preference is for Option 3, using a combination of approaches to establishing taxable income for risk business (Option 1) and investment business (Option 2).***

2.2 Risk business taxable income would be established via the formula:
Taxable income = Premiums + Management Fees + Investment Income + Other Income – Outlays.

2.3 Investment business taxable income would be established via the formula:
Taxable Income = Management Fees + Investment Income + Underwriting Profit/Loss + Other Income – Outlays.

2.4 Friendly societies would have no difficulty coping with this two-tiered system. Premiums should be readily split between risk and investment. Friendly Societies already operate under a system of multiple taxation rates and have systems in place able to cope. They already account for multiple streams of income and expenditure and accordingly strongly favour Option 3.

CAPITAL GAINS TAX, STAMP DUTY AND WITHHOLDING TAX

2.5 To be consistent with the tax treatment of complying superannuation and normal business of a corporate entity, AFSA believes it to be both consistent and equitable to apply capital gains tax calculations (at an entity level) on relevant investment assets in respect of its eligible insurance business.

To be consistent with the treatment of other financial products, business tax reform (albeit in indirect taxation) should remove existing stamp duty charges (currently charged by the states) on life assurance policies.

To be consistent with the treatment of franked dividends which are paid out of already-taxed entity profits to non-residents, AFSA believes that reversionary bonuses should remain outside the normal operation of non-resident withholding tax – except where the Commissioner specifically directs a resident life insurer to deduct such tax.

RATE CHANGE

2.6 AFSA accepts that Friendly Society eligible insurance business will be taxed at the new uniform entity rate as ultimately established. It strongly favours the 30 per cent rate regarded as desirable by the Government.

2.7 The current Friendly Society rate of 33 per cent is ensured under legislation until 30th June, 1999, and the Government has proposed that this date will be extended until the new entity rate is introduced. Whatever the starting date of the new uniform entity rate, ***AFSA urges that there be only one change in rate from 33 per cent to the new rate and not an up-down movement, which might occur, entailed in a shift to the current company tax rate (36%) followed by a reduction to the new uniform entity rate (recommended to be 30%) when established***. This would totally confuse the market and would be contrary to the spirit behind the legislation freezing the current rate until the completion of the inquiry and the implementation of its recommendations.

DEFERRED ANNUITIES

2.8 AFSA acknowledges that the effect of applying the entity rate of tax to deferred annuities would be to cause their immediate demise.

2.9 Existing policy holders would be greatly disadvantaged by the changed arrangements if Friendly Societies were unable to transfer their deferred annuity business to other forms of retirement saving without penalty.

2.10 ***AFSA therefore asks that, in order to facilitate the equitable transfer of deferred annuity business to a complying superannuation fund, rollover relief be provided for asset transfers and that a mechanism be provided for solvency reserve support to existing capital-guaranteed deferred annuity products.***

SOCIETY FUND SUPERANNUATION

2.11 ***Similarly, to facilitate the equitable transfer of Friendly Society benefit fund superannuation business to a separate and stand-alone complying superannuation fund, AFSA seeks rollover relief on asset transfers and a mechanism to provide solvency reserve support for existing capital-guaranteed superannuation products.***

FRANKING CREDITS

2.12 The adoption of a new taxing regime for life insurers and their policyholders will require adjustments to the franking credit system.

2.13 ***AFSA favours a status quo situation for existing policies i.e. full grandfathering and consequently seeks retention of the current rules for existing policies***.

2.14 Under the current system Friendly Societies are able to use franking credits internally. Under the new regime these credits will be passed on to the investor.

2.15 This raises the question of ***double taxation***. A Friendly Society investing in a company which, having paid tax, provides franking credits, would then be required to pay tax again on that income.

Accordingly, AFSA considers that an inter-corporate dividend rebate should be incorporated in any imputation regime for new policies.

2.16 ***With respect to the allocation of franking credits between shareholders and policyholders, AFSA believes that a system using the same basis that tax is allocated for regulatory purposes would be appropriate***.

3.0 EXEMPTIONS

NON-LIFE INCOME BONDS

3.1 In July 1996, the Government introduced the social security extended deeming system, simplifying the treatment of pensioner investments in relation to income/asset tests. A single deeming regime has since applied to the financial assets of all means-tested pensioners and other social security/veterans beneficiaries.

3.2 Unfortunately, this did not take into account the different methods of taxation applied to non-taxed and pre-paid tax investments. Investors seeking to obtain at least the deeming rate of return were prone to the perception that pre-paid investments i.e. Friendly Society capital guaranteed bonds, could not match the untaxed bank, building society or unit trust equivalents.

3.3 This clearly disadvantaged Friendly Societies who sought, with Government approval, to gain parity by introducing "income bonds". These were non-life investments whose proceeds were immediately taxed in the hands of the investors.

3.4 Such income bonds were required to be capital guaranteed and to be held solely by Friendly Societies.

See Attachment 3 – Income Bonds: How they operate

3.5 ***AFSA contends that, to maintain this fair and level playing field, Friendly Society income bonds should be treated in the same manner as other widely-held collective investments i.e. unit trusts.***

To facilitate uniform entity taxation, effective investor exemption may be achieved by assessing entity income and by providing a deduction for the income component allocated each year to investor accounts.

FUNERAL BONDS

3.6 Friendly Societies have for some time been providers of funeral bonds to the elderly.

3.7 The bonds, exempt from taxation under Section 50-20 of the *Income Tax Assessment Act 1997*, operate under the strict requirement that the proceeds (and capital) are used for the sole purpose of meeting funeral expenses.

3.8 Tens of thousands of elderly Australians have invested more than $500 million in these special purpose bonds.

3.9 Neither the capital nor proceeds can be accessed until death and the exemption was approved in recognition of the voluntary quarantining of savings for an inevitable event and for no other. Social Security and Veterans Affairs legislation already recognizes these restricting conditions for income/assets test exemption.

See Attachment 2 - Funeral Bonds: How they operate

3.10 In referring to the non-life aspect of Friendly Society business, Chapter 34.5 refers to the uncertainty of its taxation treatment.

AFSA urges the immediate removal of such uncertainty. Removal of the exemption would surely involve a breach of faith with a great many elderly Australians. AFSA also believes that the imposition of a new tax on investments available solely for expenses associated with death would not be in keeping with Government philosophy.

3.11 ***Accordingly, AFSA seeks the retention of such exemption.***

To facilitate uniform entity taxation, effective investor exemption may be achieved by assessing entity income and by providing a deduction for the income component allocated each year to investor accounts.

Additionally, at the investor level, death benefit payments should continue to be exempt. This may be achieved by maintaining Section 26AH rules for funeral bonds issued from 1 July 2000 – in other words, by not establishing any "new policy" class.

SCHOLARSHIP FUNDS

3.12 Friendly Societies operate under Section 50-20 of the *Income Tax Assessment Act 1997* (the "1997 Act"). Under this section, Friendly Societies are tax-exempt so long as they are not run for the profit or gain of their members. The life insurance business of Friendly Societies is separately taxed under Division 8A of the *Income Tax Assessment Act 1936*.

Only one Friendly Society currently operates scholarship funds under Section 50-20 of the 1997 Act. The proceeds ***do not flow to members*** but to secondary and tertiary students to assist them in their educational pursuits. To our knowledge there is no other similar product offered in Australia.

See Attachment 1 – Scholarship Funds – How they operate.

3.13 Some 180,000 Australian families (300,000 children) are contributors to scholarship funds which total around $500 million in savings. Contributions average about $10 a week and are often constituted by the diversion of child endowment by parents.

3.14 The scholarship proceeds are confined to and shared by the nominated children and ***cannot be used for purposes other than specified education expenses***. Members (contributors) cannot benefit and the proceeds are effectively quarantined from all other uses.

3.15 The funds are not life insurance policies and have no element of contingency based on the life of a contributing member or dependant. Consequently, they are completely separate from life policies and other benefit funds provided and operated by Friendly Societies and whose proceeds are taxable.

3.16 The function and underlying principle of these funds was incorporated by Governments in the rewritten *Friendly Societies Act of 1997*.

3.17 Consequently, AFSA would view the removal of such exemption as a breach of faith with a great many Australian families who are prepared to sacrifice current expenditure to save for their children's education and future.

3.18 AFSA could understand that their interpretation of such removal would include:-

- The imposition of a tax on education;
- a penalty on long-term saving; and
- a blow to schools and universities already under financial pressures.

3.19 ***Because of the genuine nature of the funds quarantined as they are from other purposes, and their widespread use by so many Australians, AFSA strongly urges the retention of effective tax exemption for this product.***

4.0 THE TAXATION OF POLICYHOLDERS

EXISTING POLICIES (CHAPTER 35)

4.1 ***AFSA considers the advantages of retaining the existing rules for existing policies outweigh the disadvantages.***

Accordingly, AFSA agrees with the proposed retention of the present method of assessing investors under Sections 26AH (inter alia without imputation gross-ups), 160AAB (at a single fixed rate) and Section 160ZZI (CGT exemption).

4.2 A full "grandfathering" of these policies would entail no change in the contract entered into by the provider and the policyholder. Additionally, it would confirm that a policyholder who held an existing life insurance investment policy for more than 10 years would have no present taxation obligation to fulfil.

4.3 However, AFSA can envisage low income policyholders with existing policies, (even beyond 10 years) seeking to take advantage of the new rebate system, available on new policies. In such circumstances, a taxing event could mean a net refund as the rebate may exceed their tax obligation.

4.4 ***To meet this reasonable desire, we envisage that a further contribution of amounts in excess of the current 125 per cent rule would readily achieve the reclassification of an "existing policy" to a "new policy".***

This would, in effect, offer a simple non-disposal alternative without attracting undue tax and transfer costs (arising from a disposal event), thus helping achieve fairness to those on lower incomes, without introducing the complexities and breaches of undertakings which might be attributed to options 2 or 3.

SECTION 160AAB REBATE RATE

4.5 With respect to the prospective change in the company rate of tax (entity rate), AFSA comes down on the side of simplicity. ***We would prefer the rebate rate to be that of the company rate and that there be no phasing in of a stepped rate. As a consequence, the company rate of rebate should apply to bonuses paid after 30th June, 2001 or whenever that rate comes into force.***

The introduction of any lower rebate (as a result of a lower entity tax rate) should be lagged by one year – consistent with past changes, and in recognition that bonuses received generally relate to income earned at the entity level the previous year.

5.0 **NEW POLICIES (CHAPTER 35)**

TAXATION (OPTION 1)

5.1 AFSA is attracted to Option 1. It provides a flexibility not before available to policyholders.

Attachment 4 sets out our proposed operation of Option 1.

5.2 Option 1 provides clear choices for the policyholder who then ultimately becomes responsible for his/her taxation obligation, in the same manner as other investment products which are not taxed at source.

5.3 A very strong advantage is the element of fairness providing scope for low marginal rate policyholders to attract net credits and, potentially, refunds of excess credits.

5.4 Option 1 further enables imputation credits to be accessed annually should the policyholder choose to be assessed annually.

5.5 ***Having carefully considered all three Options, AFSA favours the built-in flexibility and equity of Option 1.***

INTEREST DEDUCTIBILITY

5.6 Existing law provides that no deduction can be made where there is no certainty of assessable income.

5.7 New policies, under the proposed taxation regime, will always be certain of providing assessable income – either year to year or at maturity.

5.8 ***In these circumstances AFSA believes that the Section 67AAA(2) provision on denial of deductibility of interest expenses incurred on borrowings to fund the purchase of a Friendly Society "insurance bond" should be repealed.***

CAPITAL GAINS TAX TREATMENT (INVESTOR LEVEL)

5.9 Under the new regime, Friendly Societies may have the capacity to structure a bond which may contain unrealised growth.

5.10 No tax would occur at the entity or investor level until the growth was later realised.

5.11 Societies could then provide bonuses which would

- contain a rate applying to realised growth; plus
- an element which would be treated as unrealised growth.

5.12 ***In this event, AFSA believes that CGT treatment should be available on the later realised growth component.***

POLICY FEES

5.13 Under current laws, fees incurred by a policyholder qualify for an income deduction provided that they are not of a capital, private of domestic nature.

5.14 ***Under the new regime, AFSA considers that policy fees which are assessable to the life insurer should be deductible to the policy holder in the same year.***

5.15 This would avoid “blackhole expenditure”, an outcome which seem unreasonable.

TAX-PREFERRED INCOME

5.16 It is noted that the distribution of tax-preferred trust income may or may not continue in a new tax system.

If it were to continue, it would seem both consistent and equitable to extend its availability to assessable bonus/growth returns on a policy of life assurance.

6.0 POOLED SUPERANNUATION TRUSTS (CHAPTER 36)

6.1 While AFSA understands that the current taxation treatment of PSTs would be inconsistent with the redesigned imputation system applying to other entities, it believes that PSTs are a valuable link in the retirement saving chain.

6.2 The pooling system has enabled many small and medium sizes superannuation funds to take advantage of the skills, economies of size, etc of PSTs.

6.3 Furthermore, they contribute to the all important element of competition in the retirement savings field – an aim which would lose its vitality if left finally to a few conglomerates.

6.4 ***Consequently, AFSA strongly favours the retention of Pooled Superannuation Trusts*** as ***superannuation entities and, as such, believes they should be taxed at the concessional superannuation rate of 15 per cent.***

ATTACHMENT 1

Scholarship Funds – How they operate

Friendly Societies operate under Section 50-20 of the *Income Tax Assessment Act 1997* (the "1997 Act"). Under this section, Friendly Societies are tax-exempt so long as they are not run for the profit or gain of their members. The life insurance business of Friendly Societies is taxed under Division 8A of the *Income Tax Assessment Act 1936*.

Currently one Friendly Society operates scholarship funds under Section 50-20 of the 1997 Act. The proceeds do not flow to members but to secondary and tertiary students to assist them in their educational pursuits. To our knowledge there is no other similar product offered in Australia. The system operates as follows:

The scholarships
Tertiary

To be eligible for a tertiary scholarship or benefit, students need to:

- be nominated by a contributing member (usually but not necessarily a parent) when the contributions commence – at any time before the child's tenth birthday;
- be offered a full time position in an approved course of a university or other approved tertiary institution;
- have commenced the course;
- and be continuing that course by passing each year.

All members contribute the same amount to a pool in the mutual fund for the year in which the children nominated by them will be seeking tertiary entrance, in accordance with a table in the rules. The nomination must be made when contributions commence, but in any event not later than the child's tenth birthday, and is irrevocable. Annual contributions may vary between members, depending on the year of eligibility for which they are contributing and the year in which their contributions commence, but the end result is essentially the same.

Members' contributions are returned in the year of eligibility, or earlier if they decide to cease contributions. However, they receive nothing else from the fund. Their nominated children also receive nothing from the fund if they do not achieve and maintain the academic standard required by the rules of the fund.

Whatever is left in the fund for the particular year of eligibility after members' contributions are refunded (the "accumulated scholarship account") is divided equally between the students who receive a scholarship and paid to them during the first three years of their studies. The contributing members have no control of the allocation of benefits to students. The scholarship ceases if the student drops out.

A child may not be nominated more than once as a potential recipient of a scholarship from a particular fund and, in any event, all eligible students participate equally in the available funds, so it is not possible for a member or anyone else to make an additional “investment” in the fund for the benefit of that child.

All children nominated by members are advised of their nomination and encouraged to pursue the goal of full time tertiary studies, on the understanding that they will receive an independent scholarship allowance from the Society if they achieve that goal. The allowance (as presently projected) is paid over three years and is about $1200 per year in today’s values.

Secondary

Similar benefits, in the form of bursaries, have been introduced more recently for secondary students, on a similar basis. They will become eligible for financial support from a separate fund, in the form of payments towards some of their education expenses, in the final three years of their secondary studies (the non - compulsory years) if they pass each year. The object of those bursaries is to help the students stay at school until they can try for their tertiary entrance qualification.

After the Higher Education Contribution Scheme was established, the Society established a separate fund from which provides benefits to successful students in the same form as the secondary bursaries, to help them pay their HECS fees in advance.

All of the surpluses in the mutual funds are distributed to eligible students who meet the criteria specified in the rules of each scholarship fund. The rules of the Society do not permit any income or surplus to be distributed to contributing members, nor can they withdraw or vary their nominations, once they have been made, and the potential scholarship entitlement of a nominated child is not assignable.

Current tax position

The Society is a registered friendly society under the Friendly Societies Code, is not carried on for the purpose of profit or gain by its individual members and otherwise complies with the special conditions of Section 50-20 of the 1997 Act, to the extent that they apply to friendly societies. Accordingly, the investment income of the scholarship benefit funds, which is accumulated to be distributed as scholarships at the appropriate time, is currently exempt from tax under Section 50-20 of the 1997 Act.

The accumulation of surpluses on a tax-free basis is a critical factor in the quantum of the scholarship benefits which the Society can distribute to eligible students, because the entire surplus in each fund is divided between them. If under the entity tax regime, any part of the surpluses became taxable as income of the Society, the accumulations in the funds will be substantially reduced. In that respect, they are similar to funeral benefit funds, where the quantum of the benefit is dependent on the accumulations and the timing of the payment is entirely dependent on a future contingency.

Where the students receive a living allowance from a scholarship fund on a regular basis, there is a continuing debate between the Australian Taxation Office and the Society as to whether the students can claim an exemption under Section 23(z) of the *Income Tax Assessment Act 1936* (the "1936 Act") (a section which has not yet been rewritten). However, this issue is a matter for the students to resolve with the Tax Office when they lodge their returns and, in any case, very few scholarship students have any significant income from other sources, so the issue is largely academic. Where the benefit is in the form of a payment from the fund of educational expenses actually incurred by the student or as a reimbursement for those expenses, the issue does not arise, because it is not believed to be a payment in the form of income.

ATTACHMENT 2

Funeral bonds – How they operate

Friendly Societies have traditionally offered funeral policies to their members, in fact, it is one of the main reasons that Friendly Societies commenced operation more than 150 years ago.

A funeral policy can be defined as a policy which provides monies to meet funeral expenses and which provides those monies at a time which is uncertain, that is, upon death.

In recent times many Friendly Societies operate closely with funeral directors and, in some cases, the member chooses the type and cost of their funeral and assigns the funeral policy to the funeral director. In other cases, the policy remains held by the member – so that, after death, the executors or the family can select a funeral director and type of funeral of their choice.

All this has meant that the cost and the trauma faced by families of deceased persons is greatly reduced.

The following are some guideline terms and conditions of funeral policies so that they operate under the tax exemption afforded under Section 50-20 of the 1997 Act:

(1) Entitlement under the policy is occasioned by the death of the member;
(2) The policy cannot be surrendered in whole or in part prior to maturity of the policy;
(3) The policy cannot be charged;
(4) The policy cannot be assigned except to a funeral director pursuant to a fixed price funeral contract or other bona fide funeral or burial contract with a funeral director;
(5) The amount contributed (or the total amount contributed in the event of there being more than one contribution) must not exceed the future reasonable cost of an expected funeral;
(6) A declaration that if the member has effected more than one funeral policy that the total contributions in all such policies does not exceed the future reasonable cost of an expected funeral;
(7) Friendly Societies must use their best endeavours to ensure that the policy proceeds are used to meet funeral expenses and in this regard can call for evidence in the form of receipted accounts which shall be marked as having being duly produced to the Friendly Society;

(8) Funeral expenses shall include only those amounts of money spent directly in connection with the funeral, burial or cremation of a deceased member of a funeral benefit fund.

Funeral expenses can include the following:

(a) the cost of acquiring the burial site and digging the grave (the cemetery fee);
(b) in the event of the member dying at his or her usual place of residence, the cost of transporting the body to the funeral parlour of the funeral director appointed to carry out the funeral;
(c) in the event of the member dying while away from his or her usual place of residence, the cost of transporting the body back to that residence, or to the funeral parlour of the funeral director appointed to carry out the funeral;
(d) the cost of transporting the body back to the place or country of origin of the member;
(e) the professional service fee charged by the funeral director;
(f) the funeral director's fee for preparing the body for interment or cremation including embalming;
(g) the cost of the coffin or casket;
(h) the cost of cremating the body (the crematorium fee);
(i) the cost of provision of a hearse and mourning vehicle;
(j) the clergy offering;
(k) the cost of obtaining statutory certificates;
(l) the cost of death notices;
(m) the cost of floral wreaths.

Friendly Societies have taken the responsibility of ensuring that the funeral policy proceeds are used for the above purposes and have retained funds from the surviving family members when the proceeds are believed to greatly outweigh the cost of the funeral and associated expenses.

ATTACHMENT 3

Income Bonds – How they work

In 1996, the Government introduced the concept of "extended deeming". This meant that social security recipients were assessed for income test purposes on predetermined earning rates set by the (now) Minister for Family and Community Services and amended from time to time in line with interest rates changes.

Friendly Societies have been very popular with pensioners because of the security that the Friendly Society structure offers and also because most of the funds offered are capital guaranteed. Friendly Societies were disadvantaged by "extended deeming" because the deeming rates relate to pre-tax interest rates. Friendly Societies, being taxed at source declare "post-tax" returns. Therefore for Friendly Societies to match the initial low deeming rate of 5% they actually had to earn 7.5%.

To counter this anomaly, and to maintain a level playing field with other pre-tax products, such as unit trusts, and to provide a product that would be attractive to pensioners the "income bond" was developed.

Benefits under the "income bond" are in the form of bonuses declared as a result of the Fund being invested mainly in interest bearing deposits and securities. Friendly Societies do not pay tax on investment earnings but the income bond bonuses declared each year are immediately taxable in the hands of the member, at their marginal rate of tax.

Bonuses may be reinvested in the fund but tax is still immediately payable by the member if they choose this option.

Income bonds are capital guaranteed and members can access their funds at any time either in full or in part. On redemption or maturity members are entitled to receive their share of the fund including reinvested bonuses. For capital gains tax purposes, reinvested bonuses are taken to have been adding progressively to the cost base of the investment, and so no taxable capital gain arises on maturity or redemption.

The end result is a simple product for investors seeking capital security and certainty in his/her taxation position.

ATTACHMENT 4

TAXATION REGIME FOR NEW POLICIES:
A SUGGESTED OPERATION OF *OPTION 1*

AFSA agrees that, for reasons of consistency, efficiency and equity, a new policyholder should be given the option to decide if an allocated bonus is to be assessed (at the investor level) either in the year of allocation or in the year of policy withdrawal. This is in accord with the Government's already-stated objective.

The Principles

To be ***consistent*** with the position of other investment products, which provide an assessable return, the obligation to declare an assessable amount in an income tax return should fall on the investor.

An ***efficient*** operation of this tax arrangement would relieve the product provider's administration system of the onerous obligation of maintaining on-going records of each investor's accruing assessment position. In any event, it would seem inappropriate for a product provider to maintain records in relation to the personal tax affairs of an investor.

The principle of ***equity*** would suggest that an investor should determine whether to declare an allocated bonus in a particular year or in the year of withdrawal – with regard to the investor's own tax position.

The Situation

At the entity level, realised investment earnings are taxed each year and the entity's franking account credited with the tax so paid.

The bonuses which are allocated each year (in the case of account-based policies) and effectively allocated every pricing day (in the case of unit-linked policies) are broadly calculated with reference to both realised and unrealised earnings and subtracted by accounting tax and on-going fees.

The accounting tax is based on tax-effect accounting principles, and relates to both realised and unrealised entity level earnings.

Accordingly, the franking credits which relate to a particular bonus allocation (to an investor's policy) may well be under-franked, if the bonus includes underlying unrealised earnings.

Proposed Assessable Amount

Ignoring any policy contract arrangement which may include a separate growth component (to normal bonuses), AFSA believes that

(a) annual policy statements should separately indicate the realised and unrealised components of a bonus allocation,

(b) the realised component (= assigned amount, for tax purposes) should be accompanied by an advice of its associated franking credit allocation, and

(c) the policyholder should then determine if

  (i) this realised component is to be returned as assessable income for the year (in which case the associated franking credit would also be claimable)

  or

  (ii) this realised component is to be returned in the year of withdrawal (in which case the associated franking credit would also be claimable only in the year of withdrawal).

Tax compliance would then be a matter for the investor and the Australian Taxation Office, and should not have to ordinarily involve the product provider (other than to provide policy and policy statement details).

The Result

The above simple proposal would obviate the need to create two separate types of policies, ie. one type of policy for annual assessment and another type of policy for withdrawal year assessment – and the potential disclosure and representation problems a twin-policy situation might create for investors who might later believe they were not adequately informed as to which type of policy might have been better for them.

Withdrawals and Part-Withdrawals

If an investor were to make a withdrawal, any realised bonus amount which had not been previously returned as assessable should become assessable in the year of withdrawal.

If an investor were to make a part-withdrawal, any realised bonus amount which had not been previously returned as assessable should become assessable in the year of part-withdrawal – to the extent to which it relates to the proportion of the part-withdrawn amount to the policy's pre-withdrawal total surrender value (ie. in accordance with the formula prescribed in *Taxation Ruling IT 2346*). An appropriately designed tax return (or Tax Pack) should assist the investor (and the ATO) in calculating that figure.

Separate Growth Component

If a particular policy contract were to ascribe a separate growth component (to normal bonus allocations), any such realised growth component should be separately assessed under capital gains tax rules – where the policy investment value equals the cost base.