RETIREINVEST SUBMISSION

Review of Business Taxation:
A Platform for Consultation

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A. INTRODUCTION

RetireInvest is one of the largest financial planning companies in Australia. Our main client base is retirees and pre-retirees in the medium to low net wealth brackets although we also have a large number of "accumulator" clients who wish to build wealth for their future retirement.

We thank the Ralph Committee for allowing RetireInvest to represent its clients and provide input into the decision making process.

B. EXECUTIVE SUMMARY

RetireInvest is in favour of taxation reforms to improve the equity and simplicity of the Australian taxation system. Reforms to the tax system should encourage savings and investment by at least maintaining the efficiency of investments.

The current taxation system is confusing. RetireInvest supports simplification and equity within the tax system so people can understand their taxation obligations and make a clear assessment of the impact on their situation.

In the current low inflationary environment, retirees rely on investments to produce tax effective returns to generate sufficient income to meet their retirement needs. Many of the options outlined in *A Platform for Consultation* (the Report) would have a detrimental impact on the tax effectiveness of investments for retirees.

This is the group which is already most disadvantaged under the GST proposals. If some important tax arrangements are changed it may create unnecessary hardship for retirees.

Retirees are already significantly affected by the introduction of a GST. Some of the proposals for tax reform could further disadvantage this group.

RetireInvest recommends:

- Capital gains on long term investments require special consideration to encourage savings. The current indexation and averaging provisions should be maintained.
- Only a proportion of the total capital gain should be taxable at marginal tax rates. The taxable proportion should be reduced on investments held for longer periods. The first $10,000 of gains realised in any financial year should be tax free.
- CGT rollover relief should be provided for scrip-for-scrip transactions.
- The CGT retirement exemption should be maintained for small businesses. However, the goodwill exemption should be replaced by a general exemption on 20% of all gains for small businesses.
- Franking credits should be fully refundable.
- The company tax rate should be reduced to 30%.
- Public offer unit trusts should continue to be taxed only in the hands of the investor. The current tax treatment of preferential income should be maintained.
- Employers should continue to be liable for FBT.
- FBT should not be extended to non-taxed benefits provided by companies to shareholders or by trustees to trust beneficiaries.
- Deferred annuities should continue to be taxed under current rules.
- Changes to the taxation of life insurance business should not impact on the pricing structure of annuities.
- The current taxation system of life insurance policies and pooled superannuation trusts should be maintained.

C. CAPITAL GAINS TAX REFORMS

Capital gains should receive concessional tax treatment to encourage investment and savings in long term growth investments. Most countries provide tax concessions for capital gains to encourage investment and savings. In fact, many countries provide a more generous treatment than Australia. RetireInvest believes taxation concessions will promote long term growth investments.

Growth investments require people to invest money for longer terms. They are also exposed to greater risk as they are usually undertaking the business risk of the investment. Tax concessions can compensate by improving effective returns.

Capital gains tax legislation would benefit from simplification. However, the reforms should be revenue neutral for the majority of investors. The Government aim is to be revenue neutral.

Capping the tax rate versus stepped rates

An option in The Report is to cap the capital gains tax rate at 30%. This would only provide taxation advantages for high income earners. Low income earners and retirees would receive little advantage from these measures. If other tax concessions are removed to fund this change low income earners and retirees could be worse off.

To provide equitable relief across the spectrum of income earners, capital gains should continue to be taxed at marginal tax rates. However, the proportion of gain that is taxable should be reduced for long term investments. For example, if an investment has been held for only 1 year, tax could be applied to the whole gain, but if the investment is held for 8 years, tax could be applied to only 50% of the gain. This provides compensation for the long term nature of growth investments equally to all investors.

In addition, the full amount of any realised capital losses which arise should be able to be offset against any assessable income in that year. Unused losses can then be carried forward to offset income in future years.

A $1000 CGT threshold

RetireInvest welcomes any measure aimed at reducing the compliance cost for small investors. The share floats over the last few years has seen a rapid increase in the number of small investors. Many of these are unsophisticated investors with little experience in holding shares. A tax free threshold would relieve them of a significant burden when they eventually realise their gains.

Unfortunately, this measure adds complexity to the system. A $1,000 threshold is not substantial enough to warrant this extra complexity. The tax-free threshold should be set at $10,000 per financial year.

There have been concerns expressed that the threshold would cause churning of investments. Countries such as the UK which allow a tax free threshold, introduced it at low levels. The UK has subsequently increased the threshold to £12,000. It appears that the UK did not find churning to have a substantial impact on the revenue situation. In addition, transaction costs will tend to discourage churning.

Rollover relief

Where mergers occur with a scrip-for-scrip transaction, RetireInvest supports CGT rollover relief. Investors should not be disadvantaged when business decisions over which they have no control are made, but they are forced to pay a tax penalty.

Where new scrip is provided, people often do not have funds available to pay the tax liability. The sale of shares incurs transaction costs, which in turn erodes the value of their income going forward.

Averaging

RetireInvest believes averaging provisions should be retained. Capital growth is not like interest income which can be paid each year and once paid, is a guaranteed return to the investor. Capital gains may accumulate over a period of several years. It is not always possible to redeem them each year due to fees, fluctuations in the market and liquidity issues.

If averaging did not exist, adding these amounts to income in the year of realisation may push the person into a higher tax bracket due to the progressive nature of the personal income tax system. This is an unfair situation. Averaging allows some equity.

One option to deal with this problem is to tax gains on an accrual basis. However, this option is not preferred because in practice this system is too complicated and creates extra expenses for clients. Obtaining accurate and objective valuations each year may be difficult and expensive. The fluctuating nature of growth markets means that one day's difference could create a very different result for the client. Therefore, it is recommended that an accruals basis should not be adopted.

RetireInvest recommends growth assets for an investment horizon of at least 5 years. Therefore averaging needs to be maintained under the current 5 year rule. Two years is not a realistic accrual period for these gains.

Indexation

It is recommended that indexation be maintained in the CGT legislation to encourage investment in growth options. Some of the gains achieved are merely compensation for inflationary increases. To tax these amounts is effectively taxing the investor's capital.

Utilising Losses

Under the current taxation law, capital gains are taxed as income. However, losses are not considered to be deductible against other income. This is an anomaly in the Law which should be corrected.

To encourage economic decisions which are not biased by taxation considerations it is recommended that realised losses be allowed to be offset against any assessable income. This is simpler than carrying forward losses at a nominal interest rate or carrying back losses to offset earlier gains.

Quarantining past and future losses on shares and units in trusts to only offset gains on these assets adds complexity to the CGT system. It may also bias investment decisions. This could contravene the principle of adequate diversification. Investors may choose investment classes just to utilise these losses. It is preferred that investors should be able to fully utilise losses regardless of the type of investment they were incurred in.

CGT Provisions for Small Business

RetireInvest recommends that the CGT retirement exemption be retained. It was only recently introduced by the government and recognises that self-employed people and small business operators build up their retirement benefits within their business rather than in a superannuation fund.

This imposes greater risks than for someone who uses superannuation. Superannuation provides protection against bankruptcy. Business equity does not. If the capital gains on a small business are taxed, the owners are then also penalised by higher taxation on the return or equity.

However, the CGT goodwill exemptions provide some relief but are an extremely complicated area. Opportunities are created for people with better taxation advice to construe gains as goodwill to achieve a tax concession. RetireInvest supports the proposal to apply a general exemption of 20% on all capital gains. This system would also be simplified if the criteria and thresholds were aligned with the CGT retirement exemption.

D. TAXATION OF TRUSTS AND COMPANIES

Public offer unit trusts are different structures to companies and discretionary trusts. Public offer unit trusts are transparent structures without the type of taxation minimisation strategies associated with discretionary trusts and private companies. Income share and taxation obligations are always clearly identifiable without any area for discretion or profit retention. Taxing these investments in the same manner as a company would create further complexity and disadvantage investors.

Refunding franking credits

RetireInvest supports the proposal to allow imputation credits to be fully refundable. This is a logical progression in moving towards an integrated tax system.

Prudent financial planning for retirees involves investing in growth assets. This ensures their capital continues to provide an income stream which maintains its purchasing power. Investing in shares or in managed investments which purchase shares may achieve this aim.

Retired people generally have lower incomes and are not always able to fully utilise the franking credits. Therefore they effectively pay a penalty tax on this income which is above their marginal tax rate. This has been a disincentive for retirees to invest in shares. The taxation system biased the economic decisions of these investors.

The full refundability of franking credits will improve the position of retirees and provide some compensation for the introduction of a GST.

Company tax rate

A lower company tax rate is an objective which moves towards a more integrated tax system and is supported by RetireInvest. Tax rates of companies and individuals should be aligned to achieve tax neutrality. Reducing the company tax rate to 30% brings it into line with the individual marginal tax rate which is forecasted to apply to 81% of the population.[1]

Taxation of trusts and preferential income

Reforms are needed in the area of trust taxation to ensure these structures are not used for tax avoidance. Under current taxation law, public offer unit trusts do not provide scope for tax avoidance. They are transparent investments and each person's entitlement and liability is clearly identifiable. Therefore, it is not necessary to tax public offer trusts (collective investment vehicles) in the same way as companies.

RetireInvest supports the Government's announcement for flow through taxation of collective investment vehicles. This avoids issues which would arise regarding cash flows for investors and timing of refunds. It maintains a simpler system. However, concerns still exist with proposals for changes to the treatment of preferential income.

Property trusts pose a particular concern due to the nature of this type of investment. The Report states:

> "It is important to the efficient operation of business that taxpayers are able to choose the business vehicle that is most appropriate to their needs from a commercial perspective, without bias from the business tax system. To this end, the business tax system should operate in a neutral fashion across business entities ..."[2]

The current taxation status of tax free and deferred income should be maintained. However, changing the tax treatment of preferential income flowing through trusts, particularly property trusts, would not achieve this aim. A person who holds property in their own name would receive greater tax concessions than a person holding the same property through a trust. this runs against the principle above.

If tax free and tax deferred income is treated as taxable income to the trust, problems would be created for existing investors. The main issues are:

i) Retirees rely on the fact that in the current low inflation environment, property trusts are one of the only tax effective high yielding investments available to investors. Removing the tax concessional nature of some of the income would reduce effective returns.

ii) If property trusts are taxed like a company, international investors may not be attracted to these investments because they cannot take advantage of franking credits. This could cause the value of property trusts to fall which is unfair to investors who have been in these investments for a long time. The change in taxation laws could therefore result in a capital loss for them.

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[1] *A New Tax System*, at page 47.

[2] *A Platform for Consultation*, at page 47

The current tax treatment of trusts is a model which is well regarded by international standards. In fact, it is a model which other countries are looking to adopt into their own taxation systems. It therefore seems a shame to abandon a system that is currently working effectively.

Flow through of taxation liability should extend to foreign income derived by resident trusts. If this income is subject to taxation in the trustee's hands, non-resident trusts would become more attractive. This is again a situation where taxation considerations impact on portfolio diversification.

Greater franking credits may require people to submit taxation returns just to claim their credits back which could result in extra expense and complication. It may also likely result in timing implications and delays to cash flows.

E. FRINGE BENEFITS TAX (FBT)

FBT for Benefits Provided to Members and Associates

RetireInvest recommends against the extension of FBT to non-taxed benefits provided by companies to their shareholders or by trustees to trust beneficiaries. This would create unfair situations for many people, especially those in rural areas. In many cases, the homes and cars of farmers are owned by family trusts. These trusts allow for genuine business succession planning. If these assets become taxable fringe benefits, it could create hardship.

Taxing FBT in the hands of the employee

This change could create problems for people in weaker bargaining positions or who have little understanding of the issues. Salaries would need to be renegotiated with employers to ensure the employee is in a revenue neutral position.

This should not create a problem for benefits that are specifically included in current salary packages but for many fringe benefits this may not be easy to determine.

F. TAXATION OF LIFE INSURANCE BUSINESS

Deferred Annuities

RetireInvest believes is no reason why superannuation business run through a life insurance company should be taxed differently to a superannuation fund or Retirement Savings Account (RSA). Deferred annuities are legitimate superannuation investments used for the rollover of eligible termination payments.

Although superannuation funds and RSAs are now able to retain benefits that have been paid to a member, the structure of deferred annuities provides some features which are not available in superannuation funds. This provides strategic advantages to many clients.

For example, the payment of death benefits from superannuation funds is subject to the discretion of the trustee. This can create problems with estate planning, particularly in second marriage families. Estate planning has certainty with deferred annuities. The life insurance company will pay benefits directly to a nominated beneficiary or to the estate if no nomination is made. There is no discretion. The investor has full control over the direction of his/her death benefits.

Alternatively, a deferred annuity allows the nomination of a reversionary beneficiary. This beneficiary is able to retain the funds in the superannuation environment upon the death of the original owner. This provides the spouse with the opportunity to purchase an income stream upon their retirement. Encouragement of income stream purchases is in line with Government retirement income policy.

Deferred annuities therefore allow the removal of some discrimination with spouse contributions. Spouse contributions to superannuation allow a person who is a member of a couple to accumulate superannuation benefits without the nexus to the workforce. However, a widowed person is discriminated against as they can only contribute to superannuation if they have the necessary workforce experience. If they are nominated as a reversionary annuitant on a deferred annuity. This discrimination is effectively removed.

If superannuation business of life insurance company is taxed differently to superannuation funds, this will impact upon the returns of deferred annuities and make them uncompetitive. Life companies should be able to continue to offer deferred annuities under the same tax structure as superannuation funds.

Taxation of annuity business profits

Government policy has been to encourage people to invest into lifetime guaranteed or life expectancy income streams to ensure retirement savings provide an income for life. This was evident in the 20 September 1998 changes to the social security assessment of income streams.

However, proposals to tax the profits of life insurance businesses will have a serious impact on the income provided on these investments.

The proposals will affect the pricing structure, resulting in lower returns on these investments. This is a particular concern in the low inflationary environment where returns on these investments are already poor. In a lifetime guaranteed income stream with CPI indexed payments a person would need to live for at least their life expectancy just to have their capital returned. They only start to receive a return on their capital after they reach their life expectancy. It is for this reason RetireInvest recommended in submissions to social security an asset test exemption be allowed for a non-commutable market linked income stream.

For example, a 65 year old male has a life expectancy using Australian Life Tables of 15.41 years. He invests $100,000 into a single life annuity with CPI indexation and a 10 year guarantee period. Based on current earnings and inflation rates, it would take 14 years and 8 months to receive just his initial capital back as income from the annuity. He is just 8 months short of his life expectancy and has not started to receive a return on his investment.

If the taxation changes result in a lower income payment being offered by life companies, this situation will be even worse. It would create no incentive for people to purchase these investments. While we understand it is important to ensure life companies are not obtaining an undue advantage from tax free profits on this business, the effects on investors (who are primarily retirees) must be considered. Concessions should be given to the profits on surpluses which are held to cover income obligations of the life company.

Life Insurance Policies

RetireInvest believes the current system of taxation should continue to apply to insurance policies. To introduce a franking credit system similar to companies would create unnecessary complexities. Bonuses and returns accumulate in life insurance policies. To tax the returns to the investor each year would increase the complexity of the tax system.

Taxation should continue to be levied on the life insurance company, but at the reduced company tax rate of 30%. Taxation should only be levied on the investor if they make a withdrawal within 10 years.

Many retirees have invested in insurance policies as a simple means of investing for their grandchildren. If changes are made to the taxation of insurance policies, it is important that the current taxation status of these investments should be maintained.

Pooled Superannuation Trusts

Pooled superannuation trusts (PSTs) should be exempt from the entity tax regime proposed for other investments. Only superannuation funds can invest in these trusts. As the superannuation fund trustee is the investor, the tax rate currently levied on the trust is effectively at the investor's marginal tax rate.

Self-managed superannuation funds is a growing area. These funds provide advantages to accumulate retirement funds for many people. The concern is that the administration and compliance requirements are onerous. PSTs help simplify this process for small funds by reducing some of the tax administration for the trustee.

It is recommended that the current taxation system should continue to apply to these trusts.