Friendly Societies of Australia

5 February 2014

Ms Luise McCulloch
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Budget Policy Division
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Sent via: prebudgetsubs@treasury.gov.au

Dear Ms McCulloch

2014/15 Budget Priorities: increasing life-event savings and introducing positive tax revenue measures

The Friendly Societies of Australia (FSA) is pleased to make this submission to the 2014/15 pre-budget review process. Through an agreement with the FSA, the Customer Owned Banking Association provides advocacy services for 11 of Australia's 12 APRA-regulated friendly societies.

Recommendations

To better prepare Australians to prudently save and fund typical future life events described above, the FSA recommends:

1. a reduction in the tax rate on friendly society investments from 30% to 20% to increase private savings and enable individuals to better provide for life-events, address the massive lack of tax neutrality in concessions favouring superannuation over insurance bonds, and respond to the fact that Australia's superannuation savings pool of some $1.6 trillion generates, in absolute and relative terms, too little tax revenue from this massive asset pool;
2. the introduction a co-contribution scheme for friendly society education savings plans for low and middle income Australian families to assist and encourage this form of savings; and
3. the immediate restoration of an appropriate tax-free threshold on taxable benefits paid to minors under friendly society educating savings plans which are currently taxed at punitive rates as high as 66% due to an unintended outcome of tax changes by the previous government.

The FSA's recommendations:

- represent a coherent and measured response to structural challenges facing the budget, as highlighted in the recent Mid-year Economic and Fiscal Outlook;
- can assist to manage the growing reliance on government funded welfare due to Australia's ageing population; and
- are tax revenue positive measures, the scale of which will be significantly increased if the recommended tax reduction to the tax rate on friendly society insurance bonds is extended to bonds issued by mainstream life insurance offices.

We believe our recommendations can strongly assist a great number of Australians by offering greater choice to pursue 'self-reliance' options to save and financially provide for their own, and their children's, future life-events. These events include home deposits and ownership, raising and educating children, sinking funds to pay debt, health and aged-care, job loss provisions, private child care funding, and support for aged parents or family members with disabilities.

Our recommendations present the Government with an opportunity to implement positive initiatives that address the nation's debt challenges and deficiencies in the non-superannuation savings pool.

This suite of recommendations will lead to a reduction in government welfare spending, and Australians will be better placed to more adequately fund their future needs. Importantly, an increase in the national savings pool for self-funding of life-events will, we believe, result in increased government revenue given more money will be taxed at 20% in friendly society products, as opposed to funds taxed at 15%, or less, in superannuation.

Professor Kevin Davis, through the Australian Centre for Financial Studies (ACFS), has undertaken preliminary costings of recommendations 1 and 2, and a copy of this research is attached. For recommendation 1, the ACFS has estimated an average annual cost of around $65 million per annum, assuming no change in savings behaviour. The FSA however believes that this recommendation will encourage people to shift savings from superannuation to friendly society products, and once this shift is taken into account, the direct costs are more than fully offset.

In relation to recommendation 2, the ACFS has estimated that the costs will be modest, totaling less than $65 million over the forward estimates to 2017/18 assuming a start date of 1 July 2014.[1] The benefits of a large pool of national education savings could include:

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

Finally, the restoration of an appropriate tax-free threshold on taxable benefits paid to minors under friendly society educating savings plans will have a negligible impact on the budget. The FSA considers that it was unlikely that the small revenue gain from an increased tax rate applicable to these plans was counted by the government at the time the changes were implemented in 2011.

Friendly societies and life-event products

Friendly societies have issued 'self-help' and 'self-provision' savings products since Australia's earliest days. The long-standing friendly society ethos is to ensure all Australians can responsibly plan and set aside personal savings to:

- fund future common and foreseeable life-events, such as those described above;
- help themselves through difficult financial times that inevitably arise at some point in our lives; and
- improve and sustain financial and social standards via self-reliance and a savings culture that does not resort to social welfare dependency in the first instance.

To promote that ethos and personal savings culture, friendly societies commit to:

- providing low-fee savings products that represent good value, are easily understood, meet an express customer need and are inclusive to all levels of society;
- maintaining high customer service standards, given their customers are often also their members;

[1] See Table 13, page 7, *An Education Bond Co-contribution Scheme: Estimating the Budgetary Cost*, 12 December 2012

- furthering the financial literacy of Australians, and educating them about the benefits of prudent medium-term savings and the need for financial security derived from self-generated financial provisions; and
- upholding core friendly society principles of mutual self-help, support and co-operation.

Friendly society licensing and regulation
Friendly societies are licensed financial institutions under the *Life Insurance Act 1995* (Life Act) and are prudentially supervised by APRA. Their products are also subject to ASIC regulation with respect to disclosure and financial service licensing obligations.

All financial friendly societies are registered as life insurance companies under the Life Act, which authorised friendly societies to conduct various classes of life insurance business structured within their corporate entity using the friendly society 'benefit fund' structures. Their products seek to enable individuals to undertake a discretionary, targeted savings strategy mindful of their future life-events.

Please refer to the attached submission for details that support FSA's case for changes to the savings framework that can strengthen the medium and longer-term financial adequacy of all Australians, and increase the range of social and economic opportunities available to them.

Please contact me on 02 8035 8448, or Jim Aliferis, Senior Policy Adviser, on 02 8035 8442 or jaliferis@coba.asn.au to discuss any aspect of this submission.

Yours sincerely

LUKE LAWLER
A/Head of Public Affairs
Customer Owned Banking Association

FSA 2014/15 Pre-Budget Submission

Friendly society savings and insurance products
These products primarily take three forms:

1) insurance bonds used for savings to fund and provide for life-events;
2) funeral bonds to cover future funeral expenses; and
3) scholarship plans which are designed for education savings for the benefit of children nominated under the plans.

Friendly societies are the main issuer of insurance bonds, alongside the larger mainstream life offices, and are the sole issuer of scholarship plans and funeral bonds in the Australian market today.

Overview of friendly society products

Insurance Bonds

These products are also known as investment bonds. They are relatively simple multi-purpose life-event savings vehicles that are used to prepare and lock-in self-funding for a wide range of life-events including: home deposits and ownership, raising and educating children, sinking funds to pay debt, health and aged-care contingencies, job loss provisions, and support for aged parents or family members with disabilities.

Insurance bonds operate under a 'tax-paid' framework, in that earnings within each benefit fund (whether capital or income) are internally taxed at the rate of 30%.

They are growth accumulation investments. They do not distribute assessable income each year - all gains, (both income and capital) are automatically reinvested in each of the bond's benefit fund portfolios. This means the pool of investable funds is bigger, (due to the personal tax savings) and investment compounding benefits are amplified in each portfolio's "tax-paid" investment environment.

The modern insurance bond is typically structured to give investors access to a menu of investment options (often using underlying managed funds.) In comparison to older style single option "capital guaranteed" insurance bonds, this radically changes the bond's performance capabilities.

Modern insurance bonds generally offer a menu of fund investment options that are usually unit linked. It is generally left to investors to construct their bond's own portfolio mix across the options available on the bond's menu. These typically offer varying risk exposure across most investment asset classes.

Insurance bonds are designed for medium to longer-term savings, with a tax incentive to hold a bond for at least 10 years, because the earnings component of withdrawals after that period is tax-free to the investor, although continuing to be tax-paid at fund level.

Any investment growth generated by a bond and accessed in withdrawals prior to the 10 year point is personally tax assessable to the recipient at his or her MTR - and a 30% personal tax offset is available within that period.

Distributions to insurance bond owners, their nominated beneficiaries or via their estates at an insurance bond's maturity due to death (of the nominated life insured) are personally tax-free distributions at any time – pre or post 10 years.

A 125% further contribution rule allows for ongoing contributions into the fund over the life of the bond. Whilst this is designed to encourage ongoing savings, it also operates as a tax integrity measure.

For many investors, especially but not limited to, older Australians, insurance bonds have a 'set-and forget' appeal – with tax payments and reporting (of on-going bond earnings growth) taken care of by the friendly society.

Funeral Investment Bonds are a special dedicated-purpose products designed to accumulate funds to pay for a funeral. Funeral bonds are sometimes assigned to a Funeral Director as part of a fixed price funeral plan.

Funeral Bonds are also tax-paid and generally provide capital guaranteed benefits, but with limits on contribution amounts (under the sole purpose test for tax purposes, and under prescribed annually-indexed thresholds for social security means test purposes), with the amount of the bond only accessible and paid on death of the life insured to fund a funeral.

Unlike insurance bonds, they operate under a 'tax debt model' whereby on-going earnings are taxed at fund level, and the earnings component of the funeral benefit, when paid out, is provided a deduction, which effectively increases the value of the benefits paid, by the tax benefit value of the claimable deduction. The earnings component of benefits received by an entitled recipient (typically the trustee of an estate) is assessable.

Where benefits are paid to a Funeral Director instead (via assignment or nomination) tax is payable as a business receipt. Transitional tax rules apply in the case of funeral bonds issued prior to 1 January 2003.

Scholarship Plans, also known as education savings plans, are special purpose products. Plans operate subject to a sole purpose tax test, and contributions are made to help fund the education expenses of nominated students.

Unlike insurance bonds, but like funeral bonds, they operate under a 'tax debt model' whereby on-going earnings are taxed at fund level, and the earnings component of benefits paid out is provided a deduction , which effectively increases the value of the education benefits paid, by the tax benefit value of the claimable deduction. The earnings component of benefits received by an entitled recipient, typically the student, is assessable.

Transitional tax rules apply in the case of scholarship plans issued prior to 1 January 2003.

Scholarship plans have a tax treatment more equitable for people on lower incomes and are more popular among this demographic. A 2008 study undertaken by the largest issuer of scholarship plans in Australia, Australian Scholarships Group, showed that:

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

Life-Event Savings – ACFS Research Paper

In August 2011, the *Australian Centre for Financial Studies* (ACFS)[2] released a research report *Private Saving: The Role of Life Event Products*[3] commissioned on behalf of the FSA. Life-event challenges include financing education, housing, health and retirement.

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

Importantly, and in line with this submission, the report concluded that the insurance bond (Investment Bond) framework, offered by Australian friendly societies, is the best mechanism to prevent medium-term savings shortfalls. However, there is a disincentive for low to middle income earners to use these products.

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

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[2] The ACFS is a not-for-profit consortium of Monash University, the University of Melbourne, RMIT University and Finsia, specialising in leading edge finance and investment research.

[3] Australian Centre for Financial Studies, [Private Saving: The Role of Life Event Products]

Policy case for insurance bonds in medium to long-term financial adequacy
The ACFS research observed that "*households face a range of possible life events, such as education, health, housing and retirement, which can require significant expenditures for which they are often inadequately prepared by way of saving or insurance".*

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

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

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

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

The Henry Review, in its report to Government in December 2009 explains the impact of the tax and transfer system in this and other areas, arguing that *"living standards are also undermined by tax settings that discourage people from making choices that would yield greater lifetime wellbeing"*[4].

"*There* [under the tax and transfer system] *would be clear incentives for people to improve their lifetime opportunities through workforce participation, investing in education or saving".*[5]

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

Challenges of Australia's changing demographics
The FSA contends that inadequate discretionary savings among Australians is a major challenge to securing the economic and social wellbeing of individuals and communities.

This challenge will be exacerbated given the dynamic pace of change to Australia's demographics. According to the November 2013 research paper, *Still Kicking*[6], Australia will have 1.8 million people aged over 85 in 2050, one in four people aged over 65 by 2056, one million people with dementia by 2050, and 85,000 more aged care places will be required in the next decade.

4 Australia's Future Tax System, Part One, p24
5 Australia's Future Tax System, Part One, p26
6 http://www.percapita.org.au/_dbase_upl/Still%20Kicking.pdf

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

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

Given financial advice is unaffordable for many people, the FSA argues that Insurance Bonds issued by friendly societies are, as the ACFS observed, "*simple financial products designed to deal with significant life events, and which can be explained simply to individuals, offer an advantage in that they can be achieved through low-cost, one-off advice associated with that products, rather than requiring expensive, on-going relationship advice".*

The FSA believes that the insurance bond framework is a well-developed, mature mechanism that, with an easily implemented and straight forward tax-rate adjustment, will:

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

Recommendation 1 - reduce the tax rate on friendly society investments from 30% to 20%

Friendly society (and mainstream life office) insurance bonds over recent decades have been subjected to major competitive disadvantage relative to superannuation with respect to the tax rates on both contributions and fund earnings.

Contributions to an insurance bond have already been taxed in the hands of individual. Even at 32.5% (the main marginal tax rate (MTR) of many working Australians), superannuation contributions enjoy substantial advantages of being taxed at less than half that rate, 15%.

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

Our recommended 20% tax rate on earnings lies sufficiently below the main MTR of most working Australians and above the maximum superannuation rate of 15%. It will widen the attractiveness of insurance bonds to virtually everyone above a minimum wage – currently $32,354.40[7].

Insurance bonds offer a platform for financial adequacy throughout the life cycle as well as prior to retirement, however at the current tax rate of 30%, lack the universal appeal needed to ensure they are a sustainable option.

History of tax rate adjustments to attract savings to insurance bonds

Friendly society issued insurance bonds are taxed under the life insurance fund tax rate specified in Section 23A of the *Income Tax Rates Act 1986*. Since the early 1980s, there have been substantial changes to the tax treatment of friendly societies. The tax treatment of friendly societies remains at a competitive disadvantage relative to other savings products. Precedents exist to reduce the life insurance tax rate, as shown in the table below.

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5. Currently, the full-time minimum wage is **$16.37** per hour or **$622.20** per week.
Source: http://www.fairwork.gov.au/pay/national-minimum-wage/pages/default.aspx.

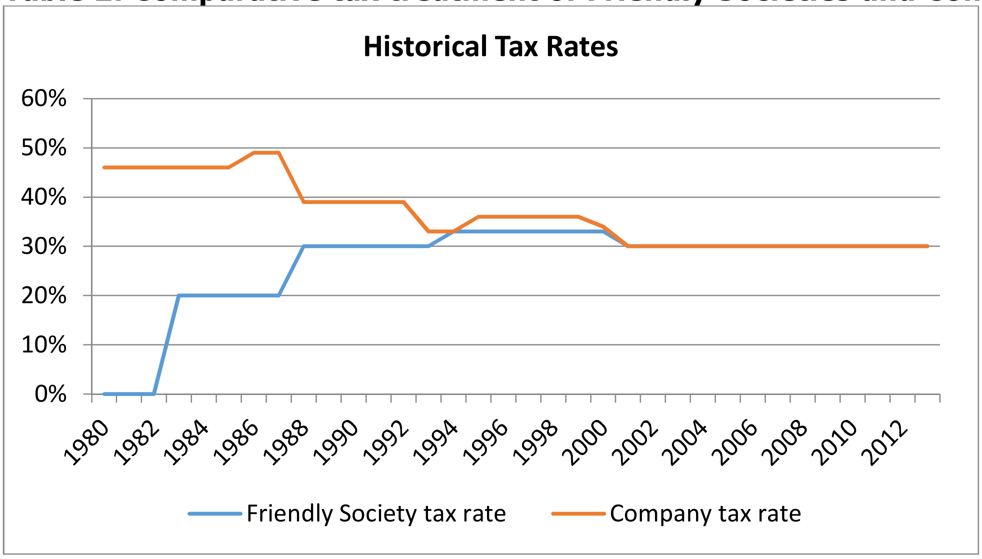
Table 1: Taxation of Friendly Societies

Period	**Tax Rate** (Life Insurance and corporate funds)	**Tax Rate** (Complying superannuation and deferred annuity funds)	**Tax Rate** (Immediate annuity and superannuation pension funds)
Until 1982-83	Zero	Zero	Zero
1983-84 to 1987-88	20%	Zero	Zero
1988-89 to 1993-94	30%	15%	Zero
1994-95 to 2001	33%	15%	Zero
2001-02 onwards	30%	15%	Zero

Source: Australian Centre for Financial Studies, Private Saving: The Role of Life Event Products

Note the tax treatment of friendly societies is uncoupled to the tax rate applied to Australian companies. While both are currently coincidently taxed at 30%, there has been a significant difference in applicable rates in the past, as shown in Table 2. The case to reduce the tax rate that applies to friendly society life insurance business should have no bearing on discussions about the adequacy of the current company tax rate.

Table 2: Comparative tax treatment of Friendly Societies and Companies



Source: COBA, January 2014

The FSA contends that a reduced tax rate of 20% should equally apply to all friendly society product categories, given they are all tax-paid life-event products.

To ensure competitive neutrality across the sector, we believe that Insurance Bonds issued by the mainstream life offices under the Life Act should also equally be subject to such reduced tax rate.

Positive tax revenue measures

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

The crux of the argument relies on the simple fact that the bulk of Australia's financial system - that is $1.6 trillion plus of assets in superannuation – generates in absolute and relative terms too little tax revenue from this massive asset pool. Additionally, superannuation can suffer various elements of leakage and can also suffer the "double dip" by allowing lump sums to be taken and spent, with consequent demand on the age pension.

We believe diverting a portion of the savings flow away from superannuation and into insurance bonds will immediately deliver additional revenue to government, given the former is taxed at a maximum of 15% and the latter would be subject to a 20% tax rate.

Voluntary salary sacrifice contributions (as distinct from compulsory employer contributions) make up a significant proportion of total flows into superannuation, and a proportion of this would be expected to be redirected into life products if the relative tax rates were to change. Salary sacrificed contributions to superannuation were estimated to total $12 billion in 2007.[8]

It is not unreasonable to expect that changing the tax treatment of life products would result in some reallocation of savings away from voluntary superannuation and towards life products. If this policy shift resulted in say just 2.5% of voluntary salary sacrificed contributions being redirected to life products, we estimate that the positive impact on the Budget would be around $75 million per annum, more than fully offsetting the direct cost of the policy.

We estimate that this policy change would result in the following savings to the Budget bottom line over the forward estimates:

Table 3 – Budget impact of reducing tax rate to 20% from 1 July 2014

	2013-14	2014-15	2015-16	2016-17	2017-18
Direct cost	0	-64.1	-66.7	-69.3	-72.1
Offsetting saving	0	75.2	80.2	83.4	86.7
Net saving	0	11.1	13.5	14.1	14.6

Generation of New Tax Revenues

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

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

While more applicable to high income earners, insurance bonds taxed at 20% will, we believe, encourage retired people to use these products to re-invest a portion of their superannuation income streams, such as pensions and annuities, which cannot be re-contributed to superannuation.

Without such an incentive, savings from superannuation income could be held in other tax structures, reducing government revenue. The medium-term savings vehicle that insurance bonds offer is not irrelevant to this age group. Those who are currently 65 have an average life expectancy of 84 for men and 87 for women,[9] giving them the "time" to take advantage of a ten year investment horizon.

In addition, increasing the uptake of insurance bonds will grow Australia's savings pool by capturing funds that cannot be held in superannuation, and may be at risk of not being directed into a structured savings platform.

[8] ASFA, *Employer Contributions to Superannuation in Excess of 9% of Wages, 2010, p. 3.*
[9] ABS 4125.0, Gender Indicators - Australia

Superannuation also lacks universal coverage across the whole community. This includes no, or limited, coverage for non-working surviving spouse monies, superannuation age limit and work-test related contribution restrictions, and expatriates returning to Australia facing superannuation contribution limits.

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

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

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

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

As covered earlier in our submission, this policy change would be expected to reduce pressures on government expenditure by increasing incentives for individuals to be better prepared to fund their own life-events, especially the cost of education, home ownership, health and aged care and periods of unemployment, through increased personal savings. Reducing reliance on government services and safety nets is consistent with the themes expressed in the Treasurer's speech, *The End of the Age of Entitlement*[10].

The potential scale of government revenue increase can be enhanced if the recommended measure to reduce the insurance bond tax rate equally applied to mainstream life offices which also issue Insurance Bonds.

Recommendation 2 - introduce a co-contribution scheme for friendly society education savings plans

The FSA sees a strong case for a government co-contribution scheme that stimulates education saving within the community. Despite active marketing of Scholarship Plans by the friendly society industry, this form of savings remains low.

By illustration, in 2010-11, Australians personally spent around $36 billion on education[11] but only a fraction of that ($270 million[12] or 0.8%) was met through structured education savings plans.

The objective of this proposal is to focus public attention on the benefits of education savings and provide an incentive that increases household savings activity.

[10] http://www.joehockey.com/media-files/speeches/ContentPieces/100/download.pdf
[11] ABS
[12] Total earnings paid to scholarship plan beneficiaries, 2010

The scheme would be available to all households that make contributions to a scholarship plan[13] issued by a friendly society and would adopt the basic characteristics of a contribution amount, a cap and eligibility rules.

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

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

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

There should be no restrictions on withdrawing personal contributions made by the plan owner at an earlier time. Scholarship plans are designed to fund education expenses across all levels of schooling and this flexibility must be maintained.

However, creating a 'lock-in' period of a proportion of these savings, over a child's entire schooling life, will allow sufficient time for the amount of the co-contribution to generate a sufficient amount of earnings.

The integrity of the scheme would be maintained via the existing ATO-defined 'sole purpose test' for friendly society Scholarship Plans, which removes the existing concessional tax treatment on earnings if they are not used for legitimate education expenditure.[14]
There are other considerations that would need to be discussed with industry as part of a consultation process, such as entry and exit rules (particularly around any unused contribution amounts), timing and eligibility.

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

There are several compelling reasons to introduce incentive-based measures that encourage education saving. A family that builds a sustainable pool of education funds can increase their financial adequacy and in turn:

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

[13] As defined under the *Income Tax Assessment Act* 1997 subsection 995-1(1)
[14] Under tax law, if the earnings under these plans are not used for legitimate education expenses, then the 30% tax paid at a fund level applies to these earnings and is assessed in the hands of the parent investor, not the child. Where the investor is on a higher tax bracket than 30%, further tax is payable.

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

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

The FSA believes that education participation rates are a function of access and opportunity, which is driven by individual affordability, means and motivation that comes from having committed a personal financial outlay to support their goals. A national program of education savings could mitigate, or even overcome affordability problems and make a wide range of education pathways available to more people, regardless of their socioeconomic backgrounds and beyond what government welfare support can currently sustain.

Illustrating the size of this challenge, 2011 ABS Census data reveals that half the Australian population had not yet achieved education qualifications beyond high school and 17% held a bachelor qualification.

Currently, the friendly society industry manages over $1.6 billion in education savings on behalf of 190,000 students up to tertiary age. Depending on the level of schooling, students can have, on average, $9,000-$14,000 in funds to put towards their education.

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

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

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

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

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

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

Education savings are medium-term, discretionary savings vehicles. This means that people using these vehicles realise the benefits of their investment earlier than superannuation, have active control over their savings and therefore have a greater level of personal involvement.

The FSA believes this will have a significant influence on the success of an education co-contribution scheme, perhaps even greater than that seen with superannuation (in relative terms).

Recommendation 3 - immediately restore an appropriate tax-free threshold on taxable benefits paid to minors under friendly society educating savings plans
The lack of any meaningful tax-free threshold and the high rate of tax on income earned by minors from Scholarship Plans is an unintended consequence that stemmed from the removal of the low income tax offset (LITO) from non-work income earned by minors in 2011.

While the original policy behind this measure was sound (it would prevent high income earners from accessing the tax offset via the transfer of income to a child), it triggered a major jump in a minor's tax rate on any income[15] they withdrew from a scholarship plan.

On 1 July 2011, the tax rate increased from 0% to 66% for earnings between $416 and $1,307, and from 0% to 45% on all earnings once total income went above that. This has a significant impact on students who are taxed on benefits received from a friendly society scholarship plan. At the time of the change, nearly 60,000 Australian children under the age of 18 had in place a family-sponsored scholarship plan accumulating education savings on their behalf.

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

Industry evidence between 1 July 2011 and 30 June 2012 points to a concerning combination of a spike in plan closures and substantially slower product take up. One fund with around 6,500 members saw 600 investors withdraw completely in the first 12 months after the changes, and experienced a drop of 33% in new members over the same period, well outside normal behaviour patterns. This is further strong evidence that Australians are responsive to tax changes, whether they provide an incentive, or as was the case in 2011, a disincentive.

There are only two friendly societies that offer scholarship plans in Australia. A third had commenced offering such plans three months prior to the changes but has since closed this product line.

The FSA believes that the future of scholarship plans in the under 18 year old market is under a cloud, and the specific tax benefits introduced by government years ago have been all but reversed.

This is a very unfortunate outcome for thousands of Australian families. Scholarship plans are unique – they are the only dedicated education savings vehicle in the market today, and by law[16], can only be offered by a friendly society. Their tax integrity is upheld through a sole purpose test that removes any taxation concessions if earnings are not used for their intended education purposes.

With the LITO all but removed, government should announce a new tax-free threshold for these vehicles as a priority, set at $3,333 (the same as originally applied) and indexed annually in line with the CPI for education.

We believe the cost to the budget revenue from this change would be negligible. The flow-on adverse impact on scholarship plan earnings of the LITO changes was an unintended

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[15] Where assessable in the hands of a student who is a minor (under Division 6AA rules) and not in the hands of a sponsoring adult - *Tax Laws Amendments (2011 Measures No $) Bill 2011*, Explanatory Memorandum, ch2.
[16] Section 995.1 of the *Income Tax Assessment Act 1997* defines a scholarship plan as a life insurance policy issued by a friendly society for the sole purpose of providing benefits to help in the education of nominated beneficiaries.

consequence to reforms to other areas of the taxation framework. The FSA believes that it is unlikely that the small revenue gain from an increased tax rate applicable to these plans was counted by the government at the time the changes were implemented.

Therefore, the FSA believes there are no further revenue implications under this proposal.

Conclusion

This submission presents targeted, fiscally-responsible policy measures that if adopted, will improve the financial and social wellbeing of individual Australians.

These initiatives will also reduce the financial burden on government to provide a range of services into the future. This is particularly significant in the context of Australia's changing demographics, and given the fact that Australians are living longer, and the ageing population is rapidly growing.

The FSA believes government should recognise the benefits that an increase in medium to longer-term savings could deliver to our society, and implement reforms that will encourage people to utilise specific mechanisms best-suited to the task. We believe the insurance bond tax framework is the best mechanism for this purpose, and can deliver significant benefits across a number of levels.

Financially, insurance bonds can:

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

Socially, insurance bonds can:

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

In terms of tax revenue generation, insurance bonds can:

- increase government tax revenue by diverting some discretionary savings away from superannuation (including zero taxed income streams) to a much higher-integrity 20% tax-paid framework;
- attract new savings at the 20% tax-paid rate - especially on intergeneration transfers; and
- improve government revenue drain by reducing the level of government funded welfare reliance as a result of more Australians by self-provisioning using friendly society life-event products.

The FSA contends that its recommendations will address medium to longer term budget risks, and adequately respond to the need for incentives to encourage people to save for life-events that superannuation savings cannot fund.

To discuss any aspect of this submission please contact:

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