Friendly Societies of Australia

Submission to the Senate Inquiry into cooperative, mutual and member-owned firms in the Australian economy

1 July 2015

Friendly Societies of Australia Incorporated
Level 11, 35 Clarence Street, Sydney NSW 2000
ARBN 067 828 513

ASG Supporting Children's Education

Australian FRIENDLY SOCIETY

Austock Life

Centuria

FORESTERS Friendly Society

KEYINVEST ESTABLISHED 1878

Lifeplan FUNDS MANAGEMENT
Part of the Australian Unity Group Australian Unity

NOBLEOAK

OVER FIFTY GUARDIAN FRIENDLY SOCIETY LIMITED

sureplan FRIENDLY SOCIETY LTD

Contents

Executive Summary

The Friendly Societies of Australia (FSA) is pleased to contribute to the Senate Economics References Committee inquiry into cooperative, mutual and member-owned firms.

The FSA is the industry association representing 10 of Australia's friendly societies regulated by the Australian Prudential Regulation Authority (APRA), the majority of which are member-owned mutual organisations. FSA members primarily provide financial services, healthcare, retirement living, aged and home care services to some 800,000 members.

Given the sector's customers are also its members, the beneficial owners of the enterprises, the sector is uniquely characterised by:

- prioritising members benefit over profit maximisation;
- conservative business models and prudent risk management;
- addressing important system gaps ignored by mainstream financial institutions to reduce reliance on social welfare, and
- deep community engagement and strong member loyalty.

We believe there is a unique and strong alignment of values between our sector and government that can be further strengthened and a particular set of opportunities exist, as presented in this submission, to solve long term cost-of-living pressures on Australians and deliver a range of improved financial, social and taxation revenue outcomes.

This submission sets out the compelling case for government to partner with us to help enhance Australians' financial capacity to prepare for major life-events in the pre-retirement phase such as home purchase, education, aged care and health expenses. These are significant and growing financial challenges that cannot be solved by superannuation for Australian families. We believe we can work with government to ensure these financial challenges are not relegated to Government to solve alone, but are met through simple incentives to encourage enhanced self-reliance and reduce the culture of entitlement.

By adopting our main recommendations to reduce the tax rate applied to friendly society investment products, introduce a government co-contribution scheme to encourage education savings and restore a tax-free threshold on benefits paid to minors under friendly society scholarship plans, the sector believes the following financial, social and taxation revenue outcomes can be achieved:

- help increase overall national savings by encouraging a savings culture, mindful of the fact that there are multiple life-events to fund, and not just retirement alone;
- increase Australia's education savings pool in view of the long term erosion of education affordability;
- boost private household wealth through a reduction in debt reliance and the smoothing of expenditure on key life-events over time;
- increase the employment opportunities available to Australians by facilitating access to a higher standard of education;
- reduce reliance on government and social welfare by encouraging personal responsibility;
- increase government tax revenue by diverting some discretionary savings away from superannuation (including zero taxed income streams) to a higher tax environment;
- attract new savings if taxed at less than the current 30%, especially on intergenerational transfers; and
- reduce government revenue drain by reducing the level of government funded welfare reliance as a result of more self-provisioning by Australians.

The sector has an evidence-based policy options framework that is outlined in this submission. Our recommendations address medium to longer-term budget risks, and are entirely consistent with the government's aim to promote greater self-reliance among Australians.

This submission has been prepared for the FSA by the Customer Owned Banking Association.

Recommendations

The FSA recommends:

1. that the Committee recognises the policy case for government to actively partner with friendly societies to:
    - promote greater non-superannuation savings among Australians to ameliorate cost-of-living pressures; and
    - support increased savings to improve Australia's education outcomes.

2. that the Committee acknowledges the role friendly societies play in supporting Australians to fund future common and foreseeable life-events through the existing insurance bond framework issued under the Life Act;

3. that the Committee notes that the friendly society investment product framework is a well-developed and purpose-built mechanism that, with only modest changes, will:
    - strengthen the medium-term financial adequacy of a wider group of Australians than the current superannuation system provides for; and
    - increase the range of educational, social and economic opportunities available to Australians through a growing and sustainable savings pool, by:

4. reducing the tax rate applied to friendly society investment products issued under the Life Act from 30% to 20%;

5. introducing a government co-contribution scheme for friendly society scholarship plans for Australian families to assist and encourage this form of discretionary savings;

6. immediately restoring an appropriate tax-free threshold on taxable benefits paid to minors under friendly society scholarship plans which are currently taxed at punitive rates as high as 66% due to an unintended outcome of tax changes by the previous government when it removed access to the low income tax offset; and

7. implementing an improved whole-of-government process, coordinated by the Office of Best Practice Regulation, to ensure alignment between regulations and government programs, particularly for agencies that have no direct responsibilities with financial service providers to avoid administrative failures that prevent friendly societies from competing in government programs.

Each of these recommendations is expanded on below.

Background Information

Refer to Appendices A and B for more information about the sector and types of friendly society investment products.

Terms of Reference

a. *the role, importance, and overall performance of cooperatives, mutual and member-owned firms in the Australian economy;*

Life event savings research

RECOMMENDATION 1 - The FSA recommends:

that the Committee recognises the policy case for government to actively partner with friendly societies to:

- **promote greater non-superannuation savings among Australians; and**
- **support increased savings to improve Australia's education outcomes.**

The Australian Centre for Financial Studies (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.

In August 2011, Professor Kevin Davis, panel member of the recent Financial System Inquiry (FSI), released the ACFS research report *Private Saving: The Role of Life Event Products*[1]. The research showed that individuals face a number of challenges over their lifetime, such as financing education, housing, health and retirement, for which many are unprepared.

The report noted 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.

The report concluded that the insurance bond framework offered by Australian friendly societies under the Life Act 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. Modest reforms to government policy are required to reduce this disincentive.

Policy case for insurance bonds in medium-term financial adequacy

RECOMMENDATION 2 - The FSA recommends:

that the Committee acknowledges the critical role friendly societies play in supporting Australians to fund future common and foreseeable life-events through the existing insurance bond framework issued under the Life Act.

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. The research 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."

---

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

The ACFS report 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 Tax Review 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."[2]

"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."[3]
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".

This theme is consistent with the findings of the recent FSI which "identified a number of taxes that distort the allocation of funding and risk in the economy" including the differential tax treatment of savings.

The Government's current *Re:think Tax Review* discussion paper also notes that "Australian households save primarily through home ownership (43 per cent of total household assets), superannuation (15 per cent of total household assets), and other property, including investment property (15 per cent of total household assets)."

Given this context, the case for reforms to the tax treatment of savings is compelling. The funding of expected pre-retirement life-events such as child care and education and health care, for example, continue to be significant financial challenges for Australians.

These challenges are compounded when almost three quarters of total household assets are held in asset types that cannot quickly or easily be accessed. In general terms, age restrictions on superannuation and transactions costs and the lack of liquidity of property limit the capacity of these assets to fund the life-event spending obligations that will be faced by Australian families.

Because of the long-term nature of saving through superannuation and property investments, it is arguable these asset types cannot, and should not, be used to fund medium-term life-events.

Australia's changing demographics and limitations of superannuation

RECOMMENDATION 3 - The FSA recommends:

that the Committee notes that the investment product framework is a well-developed and purpose-built mechanism that, with only modest changes, will:

- **strengthen the medium-term financial adequacy of a wider group of Australians than the current superannuation system provides for; and**
- **increase the range of educational, social and economic opportunities available to Australians through a growing and sustainable savings pool.**

Inadequate discretionary savings among Australians, driven by current tax arrangements, 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*[4], Australia will have 1.8 million

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

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.

The Government's 2015 Intergenerational Report (IGR) has provided the latest snapshot of Australia's fast changing population. Male life expectancy is projected to increase from 91.5 years today to 95.1 years in 2055, and female life expectancy is projected to increase from 93.6 years to 96.6 in 2055.

The number of Australians aged 65 and over is projected to more than double by 2055 compared with today. In 2055, there are projected to be around 40,000 people aged 100 and over, well over three hundred times the 122 Australians centenarians in 1975.

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.

Superannuation is the primary platform for funding retirement and aged care costs, however this platform alone cannot adequately meet these costs into the future. While more applicable to high income earners, insurance bonds taxed at 20%, instead of the current 30% will, we believe, encourage retirees 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[5], giving them the "time" to take advantage of a ten year investment horizon that is embedded in the structure of insurance bonds.

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. 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 ACFS paper argues 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, and recent major scandals have eroded the public's trust in financial planning generally, 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 product, rather than requiring expensive, on-going relationship advice".

---

[5] ABS 4125.0, Gender Indicators - Australia

Terms of Reference

a. the operations of cooperatives and mutuals in the Australian economy, with particular reference to:

ii. current barriers to innovation, growth, and free competition,

Improving the fairness of the tax treatment of household savings

RECOMMENDATION 4 – the FSA recommends:

Reducing the tax rate applied to friendly society investments issued under the Life Act from 30% to 20%.

Given the mandated nature of compulsory contributions, there is no meaningful competition to superannuation with respect to other long-term savings vehicles available to Australian families. By reducing the tax rate that applies to insurance bonds from 30% to 20%, we believe that enhanced competition can be brought to savings market, for the benefit of consumers, in relation to the allocation of funds that are currently earmarked for voluntary superannuation contributions.

At present, Australian families are actively encouraged, through concessional tax rates and the compulsory nature of superannuation, to prioritise this decades-long savings strategy, with a singular bias and imbalance towards retirement funding. Over recent decades, insurance bonds issued by friendly societies and life offices have been subjected to a major competitive disadvantage relative to superannuation, with respect to the tax rates on both contributions and fund earnings.

While concessional superannuation contributions attract a tax rate, and insurance bond contributions do not, concessional superannuation draws on pre-tax income, whereas insurance bonds draw on after-tax income or savings. Even at 32.5%, the marginal tax rate (MTR) of many working Australians, superannuation contributions enjoy substantial advantages of being generally taxed at less than half that rate, 15%.

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 on earnings can be reduced to 10% if realised capital gains for assets are held for more than 12 months. The superannuation tax rate can also be reduced to nil, when in pension mode.

Australian families cannot adequately prepare to fund their retirement until they are assisted to better meet the range of expected life events that will inevitably challenge their savings capacity well before retirement planning becomes a priority. For example, funding child care and education costs are ongoing and significant financial challenges for Australian families' decades before people plan to reduce or cease paid employment.

Insurance bonds offer a platform for financial adequacy throughout an individual's life prior to retirement. However, at the current tax rate of 30%, they lack the universal appeal needed to ensure they are a sustainable option. To ensure competitive neutrality across the sector, we believe that insurance bonds issued under the Life Act should be subject to a reduced tax rate of 20%, which is closer to the 15% tax rate for superannuation, and therefore makes these bonds more competitive across the medium to long-term savings market.

Policy case for supporting discretionary education savings

RECOMMENDATION 5 – the FSA recommends:

introducing a government co-contribution scheme for friendly society scholarship plans for Australian families to assist and encourage this form of discretionary saving.

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 an individual 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 socio-economic backgrounds, and beyond what government welfare support can currently sustain. The issue of future government support of education is particularly significant given the recent IGR noted that: "Spending per higher education student, (in today's dollars) is projected to fall from $11,800 in 2014-15 to $9,400 in 2054-55."

Illustrating the size of this challenge, 2014 ABS data revealed that almost 43% of the Australian population, aged 15 to 74 years, have not yet achieved an educational qualification beyond school, and less than 25% of this cohort hold a bachelor degree or higher qualification.[6]

Currently, the friendly society sector manages over $1.8 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 discretionary education savings equates to around $230 for every child and young adult in Australia between the age of 0-24 years[7], providing an insight into how small Australia's discretionary education savings rate is in relative terms.

In the 2012 AMP.NATSEM Income and Wealth Report: *Smart Australians*, education was found to be among the top 15 expenditure items for Australian families and in the previous 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.

The FSA sees a strong case for reforms to Australia's tax system to stimulate structured education saving within the community. Despite active marketing of scholarship plans by friendly societies, this form of savings remains low. By illustration, in 2010-11, Australians households spent around $40 billion on education[8], and we estimate that less than one per cent was met through structured scholarship plans.

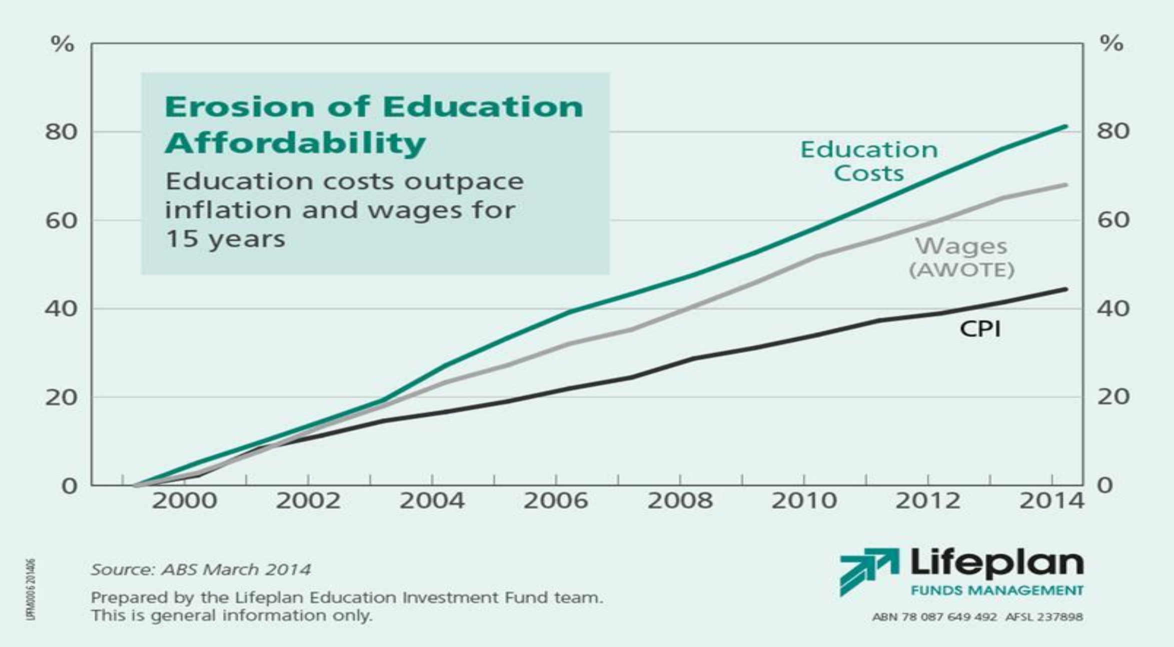
The need for a concerted strategy to increase Australia's structured education savings pool is pressing given the ongoing and long term erosion of the affordability of education, relative to wages growth and consumer price index increases (CPI), as shown below in Table 1.

6 http://www.abs.gov.au/AUSSTATS/abs@.nsf/Latestproducts/6227.0Main%20Features2May%202014?opendocument&tabname=Summary&prodno=6227.0&issue=May%202014&num=&view

7 http://www.aihw.gov.au/WorkArea/DownloadAsset.aspx?id=10737420619

8 http://www.ausstats.abs.gov.au/ausstats/subscriber.nsf/LookupAttach/1301.0Publication24.05.121/$file/13010_2012.pdf – page 452

Table 1: Education affordability relative to wage increases and CPI



Recent media reporting has highlighted the rate of tuition fee increases for some independent schools in 2015 are likely to double last year's increase in the CPI[9]. This report is supported by recent modelling undertaken by the ASG[10] that forecasts the cost of private schooling in Sydney, for a child born in 2015, to be $541,275.

A family that builds a 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, 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.

These are significant benefits at an individual level, with flow-on collective benefits for Australian society more broadly. A large pool of national discretionary 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 benefits to Australia from additional investment in education are significant. In the case of higher education, OECD data shows that a dollar invested generates a public return of $6.05 in the case of men, and $4.42 for women[11]. The OECD has also estimated that one additional year of education increases an individual's output by around 6%[12].

[9] Australian Financial Review, 19 January 2015, page 7
[10] ASG *Planning for Education Index* – 20 January 2015
[11] http://www.smh.com.au/national/education/oecd-figures-show-public-benefits-more-than-individuals-from-tertiary-education-20140928-10n6cc.html
[12] http://www.oecd-ilibrary.org/docserver/download/5lgsjhvj7zxw.pdf?expires=1421813190&id=id&accname=guest&checksum=E88FC7185065A747C0F59E6B3581B9DF

<u>*Terms of Reference*</u>
b. the operations of cooperatives and mutuals in the Australian economy, with particular reference to:
iii. the impact of current regulations,

Correcting the unintended consequences of current regulations

RECOMMENDATION 5 – the FSA recommends:

immediately restoring an appropriate tax-free threshold on taxable benefits paid to minors under friendly society scholarship plans which are currently taxed at punitive rates as high as 66% due to an unintended outcome of tax changes by the previous government when it removed access to the low income tax offset.

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 resulted from the removal of the low income tax offset (LITO) from non-work income earned by minors, on 1 July 2011.

The removal of the LITO has seen the tax-free threshold for a child receiving a payment from a scholarship plan reduced from $3,333 to $416. Appendices C and D provides extensive information about the unintended consequences of this reform and policy case for restoring an appropriate tax-free threshold on taxable benefits paid to minors under friendly society scholarship plans.

Coordination of regulation across government

RECOMMENDATION 6 – the FSA recommends:

implementing an improved whole-of-government process, coordinated by the Office of Best Practice Regulation, to ensure alignment between regulations and government programs, particularly for agencies that have no direct responsibilities with financial service providers to avoid administrative failures that prevent friendly societies from competing in government programs.

The regulatory and supervisory powers of APRA and ASIC are well understood by regulated entities. These powers are based on enabling legislation and extensive prudential standards and regulatory guidance issued by the regulators. Regulated entities construct business systems and strategies to comply with these frameworks.

However, the implementation of other government programs can have direct and unintended consequences on business operations of regulated entities. For example, the then Commonwealth Department of Immigration and Border Protection (DIBP) implemented the Significant Investor Visa (SIV) Program on 24 November 2012.

The program aims to provide a new visa pathway for migrant investors coming to Australia, and requires a $5 million investment by the visa holder in a range of complying investments, including ASIC regulated managed funds with a mandate for investing in Australia.

At the time, the FSA argued that insurance bonds issued by friendly societies were not only within the spirit of the Government's intention for complying investments, but did have other qualities that enhance their suitability with respect to the SIV program.

In this respect, friendly society insurance bonds are:
- regulated by ASIC and APRA;
- managed by Australian financial services licensees that have a mandate to manage funds in Australia;
- subject to the same product disclosure regime under the *Corporations Act 2001* that applies to managed fund investments; and

- compliant with SIV program investment requirements of at least $5 million for a minimum period of four years.

Because the DIBP did not consult with friendly societies prior to commencing the SIV program, societies were excluded from the program because of a misalignment of the requirements of the *Corporations Act 2001* and the definition of a managed fund within enabling regulations introduced in late 2012. This policy oversight resulted in friendly societies having to turn away prospective investors, representing a loss of tens of millions of dollars of investment to the sector.

The FSA was pleased that corrective regulations came into effect on 12 December 2014 to enable the participation of its members into the SIV program. However we contend that the implementation of an improved whole-of-government process to ensure alignment between regulations and government programs would have prevented the need for protracted discussions with several agencies and the office of the Assistant Minister for Immigration and Border Protection to rectify what was clearly an administrative oversight.

Because of the failure of government regulation coordination, in this case, the entire friendly society sector was excluded from competing in the SIV market for two years for no sound policy rationale. We seek to ensure that this experience is not repeated in future government programs.

Conclusion

This submission sets out the policy case for promoting increased life-event savings.

The policy settings to help fund one life-event, namely retirement, are already in place, via the superannuation regime. We believe it is now time that incentives be implemented to promote life-event savings. We contend that Australians cannot adequately prepare for retirement, possible decades into the future, until a range of unavoidable life-events are first addressed.

Our case for modest policy reforms addresses medium to longer-term budget risks, and adequately responds to the need for incentives to encourage people to save for life-events that superannuation savings cannot fund.

Our main recommendations to reduce the tax rate applied to friendly society investment products, introduce a government co-contribution scheme to encourage education savings and restore a tax-free threshold on benefits paid to minors under friendly society scholarship plans represents a measured approach that will deliver a broad range of improved financial, social and taxation revenue outcomes.

These recommendations can help, over time, reduce Australians' reliance on government welfare support in the first instance. This is particularly significant in the context of Australia's changing demographics, and people are living longer and the ageing population is rapidly growing.

Our case for tax reform directly addresses the need for a coherent long-term strategy to increase Australia's education savings pool given the ongoing and long term erosion of education affordability.

Finally, our policy case is entirely consistent with the Government's objective to promote greater self-reliance among Australians.

To discuss any aspect of this submission please contact:

Luke Lawler Head of Public Affairs, COBA	**Friendly Societies of Australia** Level 11, 35 Clarence Street, Sydney NSW 2000 GPO Box 4686, Sydney NSW 2001

Appendix A – Background information to the friendly society sector

History and purpose

First established by community groups in the 1830s, friendly societies have evolved into member-focused providers of financial services, healthcare, retirement living, aged and home care services, transport, pharmacies and other fraternal services that help Australians become financially independent and better prepared for life-events through the provision of savings, investment and insurance products.

The sole focus of friendly societies is to assist and promote Australians to:

- fund future common and foreseeable life-events, such as 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;
- better prepare for difficult financial times that inevitably arise at some point in their lives; and
- improve and sustain financial and social standards via self-reliance and a savings culture that does not resort to government social welfare dependency in the first instance.

To promote this 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 exceptionally high standards for members, centred around honesty, integrity and ease of access;
- 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 principles of mutual self-help, support and co-operation.

Given the current structural challenges faced by the federal budget, and growing pressure on Australian family budgets, we believe friendly societies have the proved business model that is entirely consistent with the Government's objective to promote greater self-reliance among Australians.

Size and nature of the FSA's membership

FSA members serve the savings, investment and insurance needs of more than 800,000 Australians.[13] As at June 2014, the sector held $6.6 billion in assets under management, up from $6.2 billion at the close of the previous APRA reporting period[14]. FSA members manage approximately 85% of these funds.

The APRA-regulated sector is diverse in nature. Australia's largest friendly society is Australian Unity / Lifeplan Australia Friendly Society with funds under management of almost $2 billion and 169,000 customers. The smallest is NobleOak Life Limited with about $25 million funds under management, serving approximately 40,000 customers.

A complete of the FSA membership can be found at this link - http://www.customerownedbanking.asn.au/members/friendly-societies/friendly-societies-of-australia

Friendly society licensing and regulation

Friendly societies which offer investment products are licensed financial institutions that are prudentially regulated by APRA under the Life Act. Their products are also subject to regulation by the Australian Securities and Investment Commission (ASIC) with respect to disclosure and financial service licensing obligations under the *Corporations Act 2001.*

All APRA-regulated friendly societies are registered as life insurance companies under the Life Act, which authorises them to conduct various classes of life insurance business structured within their corporate entity using the friendly society 'benefit fund' structure.

[13] Customer Owned Banking Association estimate
[14] http://www.apra.gov.au/lifs/Publications/Documents/1412-AFSB-June-2014.pdf

Mutuals across the Australian economy

In its 2012 research paper, *Who knew Australians were so co-operative?*, The Australian Institute noted that "eight in every ten Australians are a member of a co-operatively owned, or mutually owned enterprise such as a road side assistance organisation, a mutually owned bank or a consumer cooperative."

The research paper estimated some 13.5 million Australians were members of more than 1,700 mutuals and cooperatives, and the top 100 of these institutions having turned-over $17 billion in 2011.

"Despite the widespread membership of co-ops, and the size and economic significance of the sector, community awareness of the sector runs far behind community reliance on the sector. Indeed, according to a survey conducted by The Australia Institute despite the fact that 79 per cent of people are members of a co-op only three in ten Australians could name a co-operative or mutually owned enterprise and only 16 per cent of Australians believe that they are a member of one."

In celebration of Australian Unity's[15] 175th anniversary, Alex McDermott was commissioned to explore the history of this institution in his chronicle *Of no personal influence… How people of common enterprise unexpectedly shaped Australia.*

In this work, McDermott also noted "that only 16 percent of people *realise* that they belong", but offered the view that it was "clear evidence that mutuals gain members and customers not only through the appeal of their social values, but through the value of the products and services they create."

[15] Ranked 6th largest Australian mutual enterprise by turnover with a gross turnover $1,146,136,000 (FY2012/13): 2014 National Mutual Economy Report;

Appendix B – Types of friendly society investment products

Investment bonds are multi-purpose savings vehicles that are used to prepare for a wide range of life-events, such as funding education costs, house deposits, and health and aged-care costs.

They also have a number of strategy-based applications, such as pre-emptive intergenerational wealth transfer and estate planning through the ability to nominate beneficiaries. On death, the balance of the bond is paid tax-free directly to the beneficiary rather than to the estate, avoiding potential disputes and claims from third parties.

Investment bonds are similar in form to a managed fund, except they are 'tax paid', in that earnings within the fund are taxed at the rate of 30%, and non-distributing, with after-tax returns reinvested into the fund.

They can be capital guaranteed through investments in cash and other conservative investments, or unit linked where investors' funds are pooled together in order to provide individuals with access to investment opportunities that may not otherwise be available to them.

Investment bonds have features that shape their longer-term, savings-based nature, most notably a 10-year holding period, where accumulated capital and earnings are accessible tax-free after ten years. A 125% contribution rule allows for ongoing contributions into the fund over the life of the bond.

Funeral bonds are also 'tax paid' investment bonds but without specified limits on contribution amounts, other than for means testing for pensions, and a reasonable purpose limitation, with the amount of the bond paid only on death of the bond holder.

All funds are paid on behalf of the estate to a nominee, or directly to the estate, or to a funeral director via assignment. Tax is payable by the estate, if assessable, or by the funeral director on earnings, less a 'termination bonus' that equates to the tax paid by the fund.

Scholarship plans are a variant of an investment bond but with a specific tax treatment under the *Income Tax Assessment Act 1997*[16] (ITAA). They are specific purpose life-event savings vehicles used to fund the education expenses of children across all levels of schooling, from primary through to secondary, or adults pursuing tertiary or skills based qualifications, and carry all of the benefits of investment bonds.

Under tax law, scholarship plans can only be established by a friendly society regulated under the Life Act. As the fund is designed specifically for education, it fulfils the requirements of a 'scholarship plan' under the ITAA. This allows the fund to receive concessional tax treatment, in the form of a rebate on the 30% tax paid at the fund level, which in turns optimises the child's scholarship benefit.

[16] Income Tax Assessment Act 1997 subsection 995-1(1)

Appendix C – Low Income Tax Offset: unintended consequences and case need for reform

Unintended consequences of government tax reform

As a result of the LITO reforms in 2011, the tax rate applied to earnings from scholarship plans has increased from 0% to 66% for earnings between $416 and $1,307, and from 0% to 45% on all earnings above that. 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.

Monitoring undertaken by industry between 1 July 2011 and 30 June 2012 points to a concerning spike in plan closures, along with substantially slower product take up. One fund with around 6,500 members saw 600 investors withdraw completely in the first 12 months after the tax changes, and experienced a drop of 33% in new members over the same period, well outside normal behaviour patterns.

The dramatic reduction of the LITO will continue to have a disproportional negative impact low income Australian households. A 2008 study undertaken by ASG found that:

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

Generally, earnings cannot be drawn down for years after a plan is established with an initial investment. Where early draw-downs may be possible, the growth earned is generally insufficient until several years have passed. For this reason, and because scholarship plans can only be used to meet education costs, they cannot be used as income splitting vehicles to minimise tax liabilities.

While ASG is the largest provider of scholarship plans in Australia, they are also offered by Australian Unity. Centuria Life commenced offering these plans three months prior to the changes but has since closed this product line due to changes to the LITO.

Policy intent of low income tax offset reforms

While the original policy intent was sound – to prevent high income earners from accessing the tax offset via the transfer of income to a child – the changes have triggered a major jump in a minor's tax rate, on any income[17] they withdraw from a scholarship plan.

The FSA argues that the drastic reduction in the LITO on income derived from scholarship plans does not align with the policy objective of the original proposal. At the time the reform was passed through Parliament, the explanatory memorandum to the Bill[18] set out the intent of the reform, which the FSA fully supports:

> *2.5 The aim of these rules is to discourage income splitting within families by directing income from adults to children to avoid higher marginal tax rates.*
>
> *2.6 In recent years the low income tax offset has increased significantly as a means of providing targeted tax relief to low-income earners. The low income tax offset has been available to all taxpayers with incomes below its cut-out threshold, including minors. An increasing amount of distributions from discretionary trusts have subsequently taken advantage of this concession to direct an increasing amount of income from adults to minors in order to minimise tax. There is a significant spike in distributions from discretionary trusts at around the point where the effective tax-free threshold for minors has applied in each recent tax year, and that spike has moved broadly in accordance*

[17] 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 4) Bill 2011*, Explanatory Memorandum, ch2.
[18] http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r4586_ems_6886c832-17fb-44ee-a184-ec95e5843882/upload_pdf/355849.pdf;fileType=application%2Fpdf

with increases to the effective tax-free threshold for minors.

2.7 Removing the eligibility of minors to use the low income tax offset to reduce tax payable on their unearned income will discourage families from splitting income with their children — protecting the integrity and improving the fairness of the income tax system.

It is not possible for a parent to use an education savings plan to "avoid higher marginal tax rates" and thereby reduce tax, simply because they can only use the income from the plan solely for education purposes in order to retain the tax benefit. Indeed, the vehicles targeted under the government's policy measure were clearly discretionary trusts.

Previous tax arrangements
Prior to 2003, growth within a scholarship plan fund was untaxed, allowing a larger pool of education benefits to be available to fund a student's education expenses.

This fund-level tax exemption was removed on new scholarship plans from 1 January 2003. Friendly societies then became subject to an effective tax rate of 30%. To prevent an unfair double taxation regime from applying, special fund deduction rules were introduced for scholarship plans in recognition of the valuable role they play in encouraging education savings. This had the effect of restoring the untaxed distribution value – although the timing difference between annual fund tax and back-end tax deduction recovery had the effect of reducing the value of education benefits paid.

Apart from the diminished value of education benefits paid on 'post 31 December 2002' scholarship plans, the disclosed explanation of how tax worked on these products diminished their appeal to some extent.

Regardless, the 2003 changes allowed tax to apply in line with the economic substance of the arrangement and ensured the special purpose nature of these products was recognised whilst protecting the integrity of the tax system through a sole purpose test.

The papers below set out the government's rationale behind upholding tax concessions for scholarship plans, a rationale which we believe should continue to be recognised through the restoration of the previous LITO:

- *Taxation Laws Amendment Bill (No. 6) 2002 Second Reading Speech* dated 19 September 2002 – this sets out the intention to provide concessional tax rules for special purpose friendly society products, including scholarship plans;
- *Explanatory Memorandum to TLAB6-2002* – sets out much of the rationale, particularly paragraphs 3.1, 3.5, 3.7, 3.14, to 3.18 and 3.29 to 3.34;
- *ATO Fact Sheet for Scholarship Plans* – specially developed in 2003 to recognise and emphasis the special purpose nature of these plans and the sole purpose test.

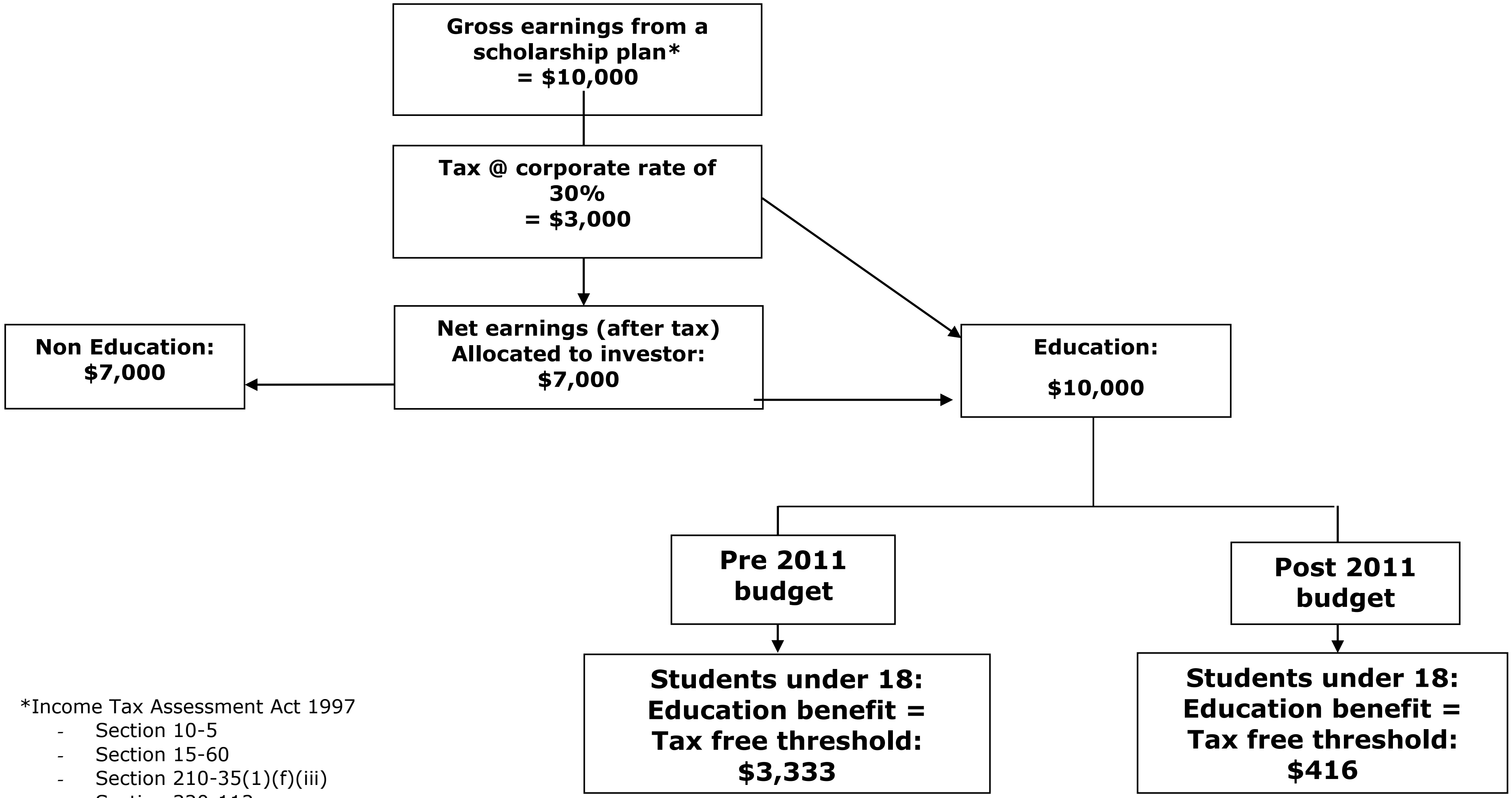
The removal of the LITO is a very unfortunate outcome for thousands of Australian families. Scholarship plans are unique, given they are the only dedicated education savings vehicle in the market today, and by law, can only be offered by a friendly society. Their tax integrity is upheld through the ATO's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

The FSA contends that 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 budget revenue from this change would be negligible. The flow-on adverse impact on scholarship plan earnings of the LITO changes was an unintended consequence of 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.

The FSA believes there are no further government revenue implications under this proposal.

Appendix D - Example scholarship plan, operation and tax changes



*Income Tax Assessment Act 1997

- Section 10-5
- Section 15-60
- Section 210-35(1)(f)(iii)
- Section 320-112
- Section 995 -1(1) definition of Scholarship plan.