INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ INC

Submission

to the

Savings Working Group

November 2010

Investment Savings and Insurance Association of NZ Inc.

Introduction

1. The Investment Savings and Insurance Association ("ISI") is the industry association for the companies that issue and manage life insurance, superannuation and managed funds in New Zealand. ISI members are responsible for approximately $50 billion funds under management. ISI members are also the leading providers of KiwiSaver funds and all six default providers are members of ISI.

   A list of members is attached.

2. ISI welcomes the government's recent initiatives on savings and investment. The establishment of the Savings Working Group ("SWG") follows, and can build on, the work of the Capital Market Development Taskforce which reported in December 2009 and the VUW Tax Working Group which reported in January 2010.

3. ISI supports the CMD Taskforce view of the importance of *well-functioning capital markets that can intermediate equity capital from investors to firms*. That is an area in which our members have expertise and an obvious interest. However, we believe that everybody in the community benefits from an economy that has a wide range of opportunities for institutional and private investors to save and expand their wealth. We support the government strategy in engaging with the community to explore available options.

4. ISI agrees with the Treasury view[1] that, while a higher level of national saving is not a goal in its own right, it would mean an increase in the pool of domestic savings and benefits for economic growth. This submission is written on that basis.

5. The bulk of our comments relate to KiwiSaver and the stated aim of the SWG to consider:

   the role of KiwiSaver in improving national saving outcomes. This will include, but is not limited to:
   - *Considering options to improve the operation and outcomes of KiwiSaver. This will include options where KiwiSaver is both voluntary and compulsory; and*
   - *The fairness and effectiveness of current KiwiSaver subsidies.*

   We also take into account the impact of the tax system on the level and composition of national saving and investment decisions, and options for improvement.

6. We would, however, like to make some opening comments about the extent to which incentives, or even compulsion, might contribute to improving national savings outcomes. We acknowledge that research in Australia[2] concluded that

[1] *Saving in New Zealand – Issues and Options*, NZ Treasury, September 2010.
[2] *The Effect of the Superannuation Guarantee on Household Saving Behaviour*, Ellis Connolly, Reserve Bank of Australia Research Discussion Paper, August 2007.

household wealth increased by about 70 to 90 cents for every extra dollar in compulsory pension accounts. In other words, there is an offset of up to 30 cents through reductions in other assets. Notwithstanding that fact, the pool of institutional savings available for investment in Australia has grown enormously and it is that factor, rather than the net increase in the level of national savings, on which we wish to comment.

7. The quality of savings in NZ has been recognised as a problem. New Zealanders have traditionally put a large proportion of their savings into residential property. The reasons behind that may be entirely rational, taking into account bad experiences as a result of investment fads, the stock market crash in the 1980s and the dot com collapse in the 1990s. However, investment that increases the cost of residential property contributes nothing to the economic growth of the country.

8. Even without an increase in the **level** of national savings, policy changes that redirected savings into funds management institutions would improve the **quality** of investment and facilitate investment in productive areas of the economy. Combined with diversification of investment opportunities, which we discuss later, there are likely to be benefits for the capital development of the country as well as improved investment returns for retail investors.

9. We consider that a case can be made for a transition to compulsory membership of KiwiSaver and it is reasonable to expect that the rate of offset would be similar to that found in Australia. However, we also believe there are other aspects of the scheme that could, if amended, increase the flow of savings into KiwiSaver schemes without compulsion. They fall mainly under the headings of investor confidence and investment returns. If membership of KiwiSaver remains voluntary, potential members are likely to be encouraged to join if they are confident of the security of their savings and can see attractive investment performance.

KiwiSaver

10. ISI supports KiwiSaver as the cornerstone of retail savings in New Zealand. We believe that KiwiSaver brings significant current and future value to New Zealand and the rapid take up of KiwiSaver by individual New Zealanders indicates that they have an appetite for the concept of a personal savings and investment account.

11. The global financial crisis and the massive loss of savings with finance company failures in New Zealand has left many potential savers 'gun shy'. ISI endorses the government's recent moves towards improving public confidence in retail investment. We believe that these initiatives have clearly signalled that an increase in confidence in the investment and savings environment is not only necessary, it is essential.

12. We note that the Super System Review in Australia, which tabled its final report[3] in July this year, recognised that benefits to members could be improved through a combination of factors including improvements in governance, efficiency, cost control and investment returns. While the superannuation environment in Australia is far more complex than in New Zealand, there are many similarities between the issues considered by the Review and the regulatory changes currently underway in

[3] *Super System Review – Final Report*, www.supersystemreview.gov.au

New Zealand. Some additional aspects of the Review that could also be considered in New Zealand include:

- requirement for scheme trustees to ensure the scheme has sufficient scale to provide adequate benefits to members
- requirement to provide assistance to members in the 'decumulation' phase.

13. We have already announced work underway towards requiring our member companies to disclose explicitly the cost of advice on investment and savings products, so that consumers will be able to see the advice charge separately from the product costs. We are happy to discuss further whether this requires a regulatory environment, in order for it to apply to the wider industry, but we would strongly promote the light handed regulatory system is by far and away most desirable here, with some very clear guidelines and expectations.

14. Proposed changes to the regulation of KiwiSaver schemes (the Financial Markets (Regulators and KiwiSaver) Bill) should be supported as a step towards increasing the security and transparency of KiwiSaver schemes. ISI is working towards the same goal with the development of industry standards for:
    - Calculation and Disclosure of Fees and Expenses
    - Investment performance Reporting
    - Disclosure of Portfolio Holdings

15. Consistent regulation of schemes and limiting the variation in fee structure will facilitate consumer comparison of schemes while still allowing schemes to compete on returns. We consider that public confidence in KiwiSaver would be improved if all KiwiSaver schemes were required to comply with the same standards that currently apply to default schemes.

16. Specific features of KiwiSaver that could be amended to improve ease of administration/returns to customers include:
    - Regulation of the fee basis to the extent that a single fee is charged for management and administration with additional one-off fees only where they are incurred eg for switching funds
    - Limitation of opportunities for withdrawals from KiwiSaver schemes. That could include either detailed guidelines on consideration of hardship applications or centralisation of hardship withdrawals in a similar manner to the regime in Australia where requests for hardship withdrawals are considered by APRA and scheme trustees are advised whether the application has been approved or denied.
    - Phasing out the first home purchase option so that members default investment option has a risk/return profile appropriate to long-term investment.
    - The administration of transfers between schemes could be improved if it was done via the central administrator (IRD) rather than directly between schemes.
    - Possibly allow employers to contribute at a higher rate without incurring a tax (ESCT) liability.
    - Reduce the complexity with a single rate of tax on investment earnings. As well as making net investment returns easier for scheme members to understand, this would reduce the administration required for investment reporting. It would also remove the current disincentive for KiwiSaver

members with superannuation funds in Australia to transfer them to New Zealand.
- Deferring tax until the retirement income is received – see the following taxation section.

17. A survey carried out by Mercer New Zealand in March 2010[4] reported that the most commonly cited suggestions for changes to KiwiSaver were:
    - reducing tax on investment earnings
    - supporting greater employer contributions
    - encouraging providers to reduce fees.

18. The value of KiwiSaver to the Government could be enhanced by some degree of integration with NZ Superannuation. We acknowledge that current arrangements around New Zealand Superannuation are not included within the terms of reference for discussion as part of this study. However, there appears to be a growing level of acceptance that the age of eligibility for NZ Superannuation will eventually need to be moved from 65 to at least 67. Currently KiwiSaver funds are unable to be withdrawn until the age of eligibility for NZ Superannuation.

19. Public concerns about the later age of eligibility could be alleviated by allowing access to at least a portion of KiwiSaver savings as an income stream from age 55 or 60, possibly with a minimum contribution period. That would encourage accumulation of a pool of savings to fund the period between the date of retirement and the date of eligibility for NZ Superannuation.

20. We believe this facility would cater for those people who are either unable or unwilling to continue in the paid workforce until the age of eligibility for NZ Superannuation. At the same time it would potentially increase the attraction of accumulating savings and contribute to the growth of a domestic savings pool. The benefits of a domestic savings pool have been well canvassed but we consider a key point is that it enables domestic ownership of productive assets and therefore retention of investment returns in New Zealand.

21. The market for 'decumulation' products is underdeveloped in New Zealand at present as there has been no incentive for retirees to forego receiving a lump sum in favour of an income stream. A policy change enabling access to KiwiSaver funds from age 55 or 60 in the form of an income stream would lead to product innovation in that area. We comment further below on some of the difficulties with the provision of annuities in the current environment.

Development of the Annuities Market

22. Action 14 included in the Government's response to the Report of the Capital Market development Force was that the "Government should support the development of the annuities market". The proposed action was to "review the tax treatment and then assess what if any further changes are required".

    As noted in the taxation section of this submission, the review of the taxation of annuities is no longer on the Government's tax policy work programme.

[4] *Securing Retirement Incomes, KiwiSaver Sentiment Study,* Mercer (NZ) Ltd., page 25

23. ISI has long considered that annuities should play a significant role in providing a continued saving in retirement option to individuals as they reach retirement age. An active and viable annuities market is necessary to support KiwiSaver and would ensure the benefits from KiwiSaver are maximised through continued and known saving during retirement.

24. Taxation of annuities is but one part of encouraging an active and viable annuities market. An OECD paper on the development of private annuities in OECD countries uses the example of Australia where a change in the tax treatment contributed to the increased take-up of annuities there in the 1990's.

25. The Capital Market Development Task Force Final Report in December 2009 noted issues other than tax that currently inhibit an active and viable market including:
   - Pricing and adverse selection issues for the private sector;
   - Government intervention including in the form of providing long dated low risk bonds to match risks;
   - Risks otherwise as to where KiwiSaver withdrawals will go.

26. The aligned University of Auckland report "The annuities market in New Zealand" dated October 2009 summarised contributing factors in countries where the annuities market is significant as including:
   - Compulsory annuitisation of part or of all tax subsidised retirement savings;
   - Tax Treatment;
   - Favourable treatment, for example, Australian "age pension" means testing concession.

27. New Zealand barriers to having a viable annuity market can be summarised from that report as including:
   - Taxation treatment;
   - Adverse selection/mortality risk;
   - Inflation/investment risk;
   - Information (education) failures.

28. The New Zealand report contained some factors common internationally as evidenced in an OECD paper for the International Conference on Annuities Markets in Tokyo in January 2009 that listed the determinants of annuities markets as including:
   - "Design of social security system
   - Existence, design and intensity of mandatory saving systems
   - Significance and design of occupational pension plans
   - Tax incentives
   - Strength and stability of regulatory and supervisory infrastructure
   - Reserving requirements and investment regulations
   - Pricing and product design: freedom or limitations
   - The availability of technical information (eg mortality)
   - The level of public trust and confidence
   - The availability of appropriate investments
   - Knowledgeable intermediaries."

29. In summary, ISI recommends that the SWG includes within its recommendations further work on options to develop the annuities market in New Zealand including:

- The required tax reform (referred to elsewhere in this submission, including 'passive' encouragement through EET);
- Consideration of compulsory annuitisation of part of retirement savings on withdrawal***;***
- Education on annuities in conjunction with ISI and other stakeholders;
- Availability of appropriate Government investments for issues to match annuity risk

30. Annuity options should not be limited to the guaranteed income and risk transfer of traditional life insurance issued policies. They need to address those products' shortcomings and public acceptance, and be relevant to New Zealand's overall retirement income framework – including New Zealand Superannuation.

Taxation

31. We would like to reiterate the comments made in our submission to the VUW Tax Working Group in November 2009. A copy of that submission is attached as Appendix 1.

32. ISI would support any recommendations of the SWG to remove tax distortions that impact on individuals' decisions to save and invest. We would also support any recommendations for appropriate subsidies through the tax system to encourage individuals to save.

33. In general terms, economic theory does not favour either savings or consumption. By establishing the SWG, this is clear evidence the Government wishes to improve the New Zealand national savings record. It is appropriate therefore for action to be taken on those aspects of the current tax system that have a negative effect and do not encourage individuals to save.

Distortions

34. The Treasury paper lists a number of options to reduce tax distortions. The attached ISI submission to the Tax Working Group makes comment on the ISI perspective with respect to some of these options, namely that it does not support a dual tax system or comprehensive capital gains tax for reasons stated.

35. With respect to reducing income taxes, indexing for inflation and a discount for interest, ISI broadly support such measures, subject to our concern on the administrative complexity of inflation indexing which is also our concern with a dual tax system.

EET or ttE

36. The Treasury paper highlights targeted tax incentives as an option to subsidise saving, namely an EET basis for taxing retirement saving.

    New Zealand adopted its TTE basis for taxing retirement income in 1988 and has been alone within the OECD with the TTE basis. It is absolutely essential that the SWG reviews the appropriateness of this now. The recent example of the changes to the New Zealand outbound international tax regime to move from a unique New Zealand approach to an approach aligned with other OECD countries in order to be internationally competitive also compels a review of New Zealand's TTE approach. The current New Zealand approach could now be regarded as ttE, in part, given some level of tax exemption for employer contributions to KiwiSaver schemes and the ability of superannuation schemes to access the PIE regime.

An EET approach has some support at a policy level, having regard to externality and moral hazard arguments. EET can also be argued as being an appropriate cash flow basis of taxation.

37. The Treasury paper makes the statement that "international evidence suggests that tax is likely to have only a modest impact on **how much** people save and invest, but that it can have a very significant impact on **how** people save and invest". As we have noted earlier, the quality and longevity of people's saving and investing is a very relevant consideration, particularly where it provides encouragement for locked in savings.

38. We note a "Treasury Report: A synopsis of Theory, Evidence and Recent Treasury Analysis on Saving" from May 2007 that made the statement "There is evidence that participation in saving programmes increases with incentives ….." and cited research from the United States that found participation in and contributions to Individual Retirement Accounts increased as the size of incentives increased.

39. If we turn again to EET regimes internationally, these include France, Germany, Netherlands and the US. While we accept NZ Superannuation could be a differentiating factor with some countries, the use of EET internationally presents a compelling reason for the appropriateness of an EET regime to be considered for New Zealand.

40. In support of an EET regime, we note some analysis undertaken by AMP using a simple life-cycle model that indicates an increase in both personal retirement income and total tax revenue over a life time, resulting from the compounding effect the gross investment returns has on the accumulated lump sum at retirement. Other points raised by AMP with which we agree include:

- EET representing a continuing encouragement and flexibility for KiwiSaver savings;
- EET, in effect, reflecting the reduced income tax rate, inflation indexing, discounting of interest and dual tax system options referred to in the Treasury paper;
- EET providing encouragement to continue savings in retirement;
- Tax base broadening in retirement when the retired make demands on public services such as health;
- Encouragement for Australian superannuation balances to be transferred to New Zealand.

41. While Australia does not have an EET regime, it does have a real ttE regime. Of interest, is the recommendation in the Australia's Future Tax System Report (the Henry Report) for superannuation contributions to be exempt from tax (currently taxed at 15%) and for the tax rate on Australian superannuation scheme income to be reduced from 15% to 7.5%.

42. The recent reductions income tax rates and increase in the rate of GST have moved us closer to an EET regime. However, if a full EET regime for New Zealand in the short term is not considered viable because of the fiscal cost, we recommend that a real ttE option should be robustly evaluated for locked in savings. The Tax Review 2001 noted TtE as a viable concessionary basis involving a lower initial fiscal cost.

43. In summary, we recommend that an EET regime be evaluated for locked in savings and, if fiscal constraints mean this is not possible, at a minimum, a real ttE regime be adopted as referred to above.

Taxation of Annuities

44. Elsewhere in this submission, we have made reference to the need for the Government to support the development of the annuities market. An important element of this is the taxation of annuities.

45. Attached as Appendix 2 is a copy of the section on annuities that formed part of the ISI submission on the Government discussion document: "Taxation of the Life Insurance business: proposed new risks" from 2008. The content of that submission remains relevant and needs to be addressed.

46. The Government's action points to the Report of the Capital Market Development Taskforce included at number 54:

"Consider options that would tax annuities in a similar manner to other substitutable investments to remove a tax distortion that may discourage the development of a domestic annuities market".

47. ISI is concerned that the required changes to the taxation of annuities are no longer on the Government's tax policy work programme released on 29 October 2010.

The current regime over-taxes annuitants as all annuity earnings during accumulation are taxed at the corporate tax rate of the issuer (life insurer), currently 30% but reducing to 28%.

Tax rate distribution data from Inland Revenue shows that the tax rates of a high proportion of those aged over 65 (the likely group of annuitants) is likely to be 10.5% or 17.5% and not a rate close to 28%.

48. The attached appendix outlines three key guiding principles in designing a tax regime for annuities being:

- The issuer (life insurance) shareholders should be taxed on profits from the annuity business;
- Policyholders in the lower tax bracket should not be over taxed;
- The solution should not be too complex.

49. The attached appendix details two options to reform the taxation of annuities being:

- Low or no tax rate annuity pool (like Australia);
- Shareholder tax credit for tax rate alignment.

50. A third option could be to tax the payment to the annuitant, being the income component only, as is the basis of taxation in the US. This could be complex from a tax compliance perspective and inconsistent with the current approach to tax administration in New Zealand.

51. We recommend that the SWG include the taxation of annuities in its recommendations to the Government as essential support to KiwiSaver and to encourage continued saving during retirement.

Imputation Credits

52. Given the prevalence of Australian based companies with significant New Zealand operations (e.g. the financial services, banking sector, mining), ISI recommends that the SWG endorse the support of the CMD Taskforce for mutual recognition of New Zealand imputation credits and Australian franking credits. Given the relative size of the two financial sectors, New Zealand resident shareholders are unlikely to get anywhere near full credit for New Zealand imputation credits under the present regime for recognition of franking and imputation credits. It is hard to imagine a greater disincentive to investment in Australian companies with significant New Zealand operations (and tax paid) than double taxation of the return on that investment.

53. Mutual recognition of franking and imputation credits requires the agreement of both governments and this has been difficult to achieve. As mutual recognition recognises tax paid to the Australian government, full mutual recognition would also be a greater potential strain on the New Zealand tax base at a time of significant budget deficits. Allowing streaming of New Zealand imputation credits to New Zealand resident taxpayers would:
    - Be consistent with New Zealand's overall imputation regime (which we support but which is unusual internationally);
    - Limit the fiscal risk to the Government;
    - Recognise the contemporary reality of trans-national business, particularly foreign ownership of New Zealand businesses (due in large part to the lack domestic savings and investment);
    - Remove a major tax based discouragement to investment in companies with New Zealand operations, encourage investment in those companies and retention of dividends in New Zealand;
    - Support development of domestic capital markets;

54. Given the significant and increasing foreign ownership of New Zealand business, contributed to, in no small part, by the lack of domestic savings, recognition to domestic taxpayers of the underlying tax paid in New Zealand by foreign based businesses would remove a significant tax-based investment bias. Up to double taxation of final dividends (depending on relative domestic and foreign shareholding) can completely compromise the risk/return arithmetic of inherently risky equity investment.

55. ISI supports urgent development of the imputation regime outlined above as a significant support for the domestic savings and investment market. If Australia will not agree to mutual recognition in the short term, New Zealand needs to go it alone.

Investment and Growth

56. In the recent past assets held on household balance sheets in New Zealand have been heavily weighted towards residential housing. Growth in domestic savings in the form of financial assets will increase the need for diversification of investment opportunities. We endorse the comments of the CMD Taskforce [5] regarding the need for increasing opportunities for public investment into new areas of development, where assets are currently held within private, state or cooperative entities. There is scope for the government to assist with access to investment for example in utilities and primary production and to this end we support the CMD Taskforce recommendations for:
    - central and local government to partially list some of their commercial assets on the NZX, and
    - consideration of a specialist exchange dealing with cooperative enterprises.

57. We suggest that the Government could also consider establishing a fund that would enable private investors and KiwiSaver funds to invest into SOEs, while the Government maintains a controlling interest to ensure New Zealand ownership. The fund could be extended to include infrastructure assets such as roading, rail, airports etc.

58. New Zealand has a poor rate of household investment in the equity sector and this will worsen if shareholders continue selling out of productive assets and putting funds into bank deposits. In order to increase the number of households saving and contributing to financial assets there needs to be investment opportunities that:
    - are simple to understand and to execute
    - provide good returns
    - give investors confidence in the assets they are investing in.

NZ Superannuation

59. It is very unfortunate that the SWG is constrained from considering the parameters of NZ Superannuation and the impact that they have on the level and method of household saving. Removing the effect of NZ Superannuation from the debate on national savings will limit the recommendations that the SWG may otherwise be able to make. In view of the long lead time for retirement planning and the public's need for information, we encourage the SWG to consider at the very least recommending a specific date in the future (maybe 5 years from now) when the transition to a later qualification age for NZ Superannuation should commence. If the age of eligibility is increased (as we believe it inevitably must be), private saving will play an important role in the transition to retirement, relevant to personal health and individual circumstances. Even if this matter is not dealt with by the SWG, ISI members would welcome the opportunity to work closely with the government as a follow up study into possible actuarial models and options that would be fiscally workable.

60. As we have noted earlier in our comments on KiwiSaver, we recommend serious consideration is given to allowing at least a portion of KiwiSaver funds to be accessed as an income stream for retirement before the age of eligibility for NZ Superannuation. We believe that the growing public acceptance of the need for the age of eligibility to be moved to 67 or 68 is limited by concern for the section of the

[5] *Capital Markets Matter*, Report of the Capital Market Development Taskforce, December 2009, p.40

workforce that is effectively 'worn out' at an earlier age. A facility for KiwiSaver funds to provide an income stream for the interim period would reduce the long term fiscal cost of NZ Superannuation and could also be expected to make KiwiSaver more attractive to people who may otherwise opt out.

Risk Management

61. As noted in our comments in respect of KiwiSaver, we believe there is a growing awareness of the need to look at public provision and the incentives for New Zealanders to provide privately for all or part of their retirement funds.

62. There is also an increasing public acceptance of the need for personal responsibility for insurable events. ISI members have expertise in the field of risk management and would welcome the opportunity to assist with further research on opportunities for ensuring that management of risks to property, health (sickness and accident) and future income (pre- or post-retirement) is covered without a necessary increase in the cost to Government.

Education

63. ISI strongly believes that further education is required to create a savings and investment climate in New Zealand. We believe there is a role for the private sector as well as the government in developing an education strategy that excites, informs and makes the general public confident of their financial literacy. ISI is already supporting and providing funding for the Retirement Commissioner's financial literacy strategy and we consider that building on the work of the Retirement Commission is currently the most effective means for the industry to make a contribution in this area. We recommend that the government consolidate funding and responsibility for financial literacy in the Retirement Commission. Currently the Securities Commission also has a remit for investor education, and that is flagged to be picked up by the Financial Market Authority. This is an area where adequate resourcing is essential in order to make a difference and we recommend that government funding should be pooled in one budget.

ISI would be happy to undertake more work with the Retirement Commission to develop a broader base strategy that would encourage and inform the next generation of New Zealanders as to what they can do to make a material difference to their quality of life in the future through savings and investment.

Consultation and Communication

64. ISI believes that extensive consultation and communication with the New Zealand economy and a range of stakeholders is essential if a new investment and savings environment is to emerge. We have touched on a number of areas that we believe would be worth further work and we would be willing to be a strategic partner in any particular consultation; communication or conferencing that you believe would facilitate the outcomes of the SWG.

We are very aware that we probably hold a wide range of data that may be of interest to the SWG. We also have unique skill sets, such as actuarial expertise, if there are tasks that the SWG wishes to undertake. We are happy to collaborate with you if this is of assistance.

Conclusion

65. In conclusion, we see scope for improving national saving outcomes by attention to measures that will increase the quality as well as the level of domestic savings. Policy changes that will direct more savings into institutional investment are likely to improve the quality of investment, coupled with regulation to increase investor confidence in the transparency and comparability of funds and improve investment returns. Specifically:

- consistent regulation of financial services as a means to improve public confidence in retail investment
- streamlining some aspects of the administration of KiwiSaver
- changing the basis for taxing locked-in savings (KiwiSaver)
- Deepening the domestic savings pool through diversification of investment opportunities
- Acknowledgement that action is needed now on likely medium term changes to eligibility for NZ Superannuation. Such changes need to be flagged years before they take effect.

List of ISI Members

ISI MEMBERS

AIA NZ
AMP Financial Services
Asteron Life Ltd
AXA New Zealand
BNZ Investments and Insurance
CIGNA Life Insurance NZ Ltd
Dorchester Life
Equitable Group
Fidelity Life Assurance Co Ltd
FNZ
Gen Re LifeHealth
Hannover Life Re of Australasia Ltd
Kiwibank Ltd
Medical Assurance Society NZ Ltd
Mercer
Munich Reinsurance Co of Australasia Ltd
OnePath
Pinnacle Life
Public Trust
RGA Reinsurance Co. of Australia Ltd
Sovereign Ltd
Southsure Assurance
Swiss Re Life & Health Australia Ltd
TOWER New Zealand
Westpac/ BT Funds Management Ltd

Associate Members

Bell Gully
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Chapman Tripp
Davies Financial & Actuarial Ltd
Deloitte
DLA Phillips Fox
Ernst & Young
InvestmentLink (New Zealand) Ltd
KPMG
Kensington Swan
Melville Jessup Weaver
Minter Ellison Rudd Watts
Morningstar Research Ltd
PricewaterhouseCoopers
Russell McVeagh
Simpson Grierson

Appendix 1

ISI Submission to Tax Working Group

INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ INC

Submission

to

The Centre for Accounting, Governance and Taxation Research - VUW Tax Working Group

November 2009

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Introduction

In a recent speech, the Minister of Revenue outlined the Government's key tax policy objectives as:

1. Better positioning New Zealand in the world economy.
2. Responding effectively to the changing economic and fiscal environment.
3. Maintaining tax revenue.
4. Improving tax administrative systems, so that they can operate more effectively and deliver greater value for money.

Within this framework, the Government's medium term objective is alignment of company, trust and personal tax rates at 30% (the so-called "30/30/30" option). In turn, the Victoria University Tax Working Group (the "Tax Working Group") has been set up to:

> *…test these medium-long term objectives and endeavour to ensure there is broad understanding of what are likely to be seen as key pros and cons of different possible ways of reforming taxes in the medium term and of raising additional revenue to fund suggested tax rate cuts or other changes to the tax system.*[6] .

The Investment, Savings and Insurance Association of New Zealand (the "ISI") believes the taxation of savings forms an important part of the overall puzzle. Our submission is framed around delivering the best opportunities for New Zealand.

The Tax Working Group has a wide range of fiscal matters to consider in any recommendations it makes. These include the need to develop the productiveness of New Zealand's economy, the need to retain a larger proportion of New Zealand's skilled workforce within New Zealand and the need to reduce New Zealand's reliance on foreign capital and investment.

However, as any reforms undertaken will be required to be revenue neutral, careful consideration will need to be given to their impact on the ability of the Government to facilitate its future spending programs. One of the main constraints to development in these areas over the long term is likely to be in the form of increases in Government expenditure and reduction in Government revenue as a result of New Zealand's ageing population.

The ISI considers that ultimately all these factors lead to a consideration of New Zealand savings. Accordingly, we consider that the Tax Working Group must have significant regard to the impact on savings of the recommendations it makes.

Overall, New Zealand's broad based tax system compares well internationally. In general terms, simple rules with broad application have been the preferred policy position for understandable reasons. For example, the limited exemptions to our GST mean that it is well understood, compliance appears to be high and there are not the same issues and avoidance opportunities as in other jurisdictions with complicated exemptions.

However, the current tax framework does not produce consistent results across all forms of investment. As a result, certain investments such as residential housing receives disproportionate investment, partly based on tax considerations, rather than investment being made where is can be most productively employed.

On the basis of both research and the experience of foreign jurisdictions, we consider that the introduction of reforms to both encourage greater savings and provide a "level playing field" for investments will encourage diversification of risk by individual investors resulting in better returns and provide social and fiscal benefits for the New Zealand economy over the long term.

[6] VUW Tax Working Group Scope and Objectives

Dr Ken Henry's 1 October 2009 Address to the Australian Conference of Economists Business Symposium summarised the Australian position thus:

> We have a system for taxing personal capital income that has evolved into something that is, to put it mildly, far from the originally intended ideal.
>
> Further, the case for staying true to that original ideal now appears weak; while the case for moving to the other conceptual ideal is not strong either.
>
> Meanwhile, we have a tax system for household saving that has not been calibrated to address the challenges of population ageing and the financing of unprecedented levels of business investment and infrastructure.
>
> While we can see that we have a system that is ripe for reform, we can also see a complex set of tradeoffs in respect of the choice of the savings base, the choice of rate and the forms in which such a tax might be levied. Judgement is required.

ISI's submission is consistent with this questioning of the current norms for the taxation of savings.

About the ISI

The ISI has 20 investment and life insurance members and 19 associate members. The ISI represents investment and life insurance companies in New Zealand. Member companies manage over $50 billion in savings and provide other financial services on behalf of more than 1,500,000 New Zealand investors and policyholders.

One of the key objectives of the ISI is to work to secure the future of New Zealanders. It does not just represent the interests of its member companies, but works to ensure that New Zealanders are provided with the best options to secure their own future through savings, investment and the protection they receive from insurance.

Saving for retirement

The increased costs associated with an ageing population are well known. Recent forecasts predict that over the next fifty years the proportion of people in New Zealand over the age of 65 will more than double, from 12 percent in 1999 to 26 percent in 2050[7]. These increases are expected to have a significant impact on both Government revenue and spending programmes (particularly health spending) in the future.

To help combat the financial pressure of this potential decline in future revenue and increase in future spending, the New Zealand Superannuation Fund was introduced in October 2001. The aim of this fund was to partially pre-fund this future expenditure now in order to smooth the cost of future Government spending over a longer period of time. New Zealand Superannuation has significant benefits in terms of its simplicity (it is universal and non-means tested) and its ability to alleviate the financial burden on those with low levels of personal savings.

Following the same principles, private retirement savings provides individuals with the opportunity to pre-fund their own future expenditure throughout their working lives. Private retirement planning has the added benefits of providing the individual with greater self reliance and flexibility in when and how they will transition into retirement.

The wider social and fiscal benefits

In addition to the benefits which retirement savings provides the individual retiree and their families, there is a large body of research and evidence to suggest that increased levels of savings in general provides a wide range of greater social and fiscal benefits over the long term (or “externalities” in economic jargon). Recent research undertaken by the New Zealand Treasury[8] suggests that a sustained increase in national savings could significantly enlarge and deepen the New Zealand financial system with knock-on effects for firm growth and productivity.

This is supported by the international experience of countries such as Australia and Chile where long term increases in national savings levels have led to a more robust financial system and sustained economic growth.

The Australian superannuation industry has over A$1 trillion in assets under management, providing a significant pool of capital to Australian (and New Zealand) businesses. In contrast the market capitalisation of the New Zealand stock exchange is around NZ$50b, whereas the stock of residential property is approximately ten times this.

Based on the evidence above and the experience of the ISI, increasing the level of savings by New Zealand households should be encouraged. However, as the choice to save will often come at the expense of an individual’s current living standards, some balance will always need to be achieved between meeting the requirements of the present and those of the future.

New Zealand’s saving record

Based on an analysis of the market, New Zealand currently has a low level of “national savings”[9] (savings by households, businesses and Government collectively) compared with other countries in the OECD. Evidence also suggests that this level of savings is on the decline. Whereas Government savings have appeared strong over the recent past (as

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[7] Stephenson, J & Scobie, G (2002) “The Economics of Population Ageing”, Treasury Working Paper 02/05
[8] Cameron, L, Chapple, B, Davis, N, Kousis, A & Lewis, G (2007) “New Zealand Financial Markets, Saving and Investment”, Treasury Policy Perspectives Paper 07/01
[9] Supra note 3

evidenced by recent Government surpluses), household savings have been reported as very low and in some cases negative[10].

New Zealand's savings deficit has contributed to our consistent net balance of payments deficits, the net external indebtedness and a high reliance on foreign savings[11]. The flow on effects of this are a high level of foreign ownership of assets and a higher risk premium on New Zealand investments (reflected by relatively high interest rates by world standards, and consequently high exchange rates as foreign investors increasingly look at high yielding foreign currencies like the NZD). The result is a high cost of capital for New Zealand firms and shallow capital markets due to a lack of domestic capital to fund New Zealand businesses.

This is expressed in a comparison between New Zealand's Gross Domestic Product (GDP) and its Gross National Income (GNI). The wide gap between these two measures is evidence that overall a large proportion of the income from which New Zealanders produce as a nation is going offshore.

Combined, these factors indicate that New Zealanders have too low a level of national savings and, as a result, do not currently enjoy the full benefits of what they produce.

We do not believe that the Government sponsored superannuation will be enough to facilitate the high living standards New Zealanders will expect during retirement, particularly as contributions to the New Zealand Superannuation Fund have been suspended for the foreseeable future. The key change has been the Government's fiscal position, going from a surplus of around $2.5 billion in 2008 to a deficit of over $10 billion in 2009. Going forward Government is expected to be a net borrower to the tune of around $250 million a week.

This puts the onus on private retirement savings to bridge the income gap during retirement.

A recent Government focus on encouraging national savings has resulted in the introduction of KiwiSaver and portfolio investment entities, introduction of the Retirement Commission's financial education campaign and a regulatory review of financial products and providers[12]. These initiatives have been widely seen as positive moves towards encouraging individuals to save.

Development of New Zealand's financial system

As important a consideration as the quantity of New Zealand's savings is the quality of New Zealand's savings.

Along with a comparatively low level of national savings, New Zealand also has a disproportionate amount invested in lower productivity investments. As a result, with the exception of New Zealand's banking system, many areas of the financial markets (such as equity, venture capital and debt markets) remain relatively under-developed. This is due mainly to both this low level of national savings but also to a relatively high cost of capital. There is significant research and evidence to suggest that this under-development is creating a constraint on the growth and performance of the New Zealand economy.

The strength of New Zealand's banking system, places New Zealand's banks as the single largest direct provider of debt finance. As recent experience has shown, the banks themselves rely on the provision of credit from foreign rather than New Zealand savers to finance their lending. In comparison, markets for additional equity and other forms of finance are small and lacking in depth and liquidity. As a result, New Zealand companies have very little alternative when it comes to arranging finance and this has resulted in an increasing dependency on ultimately foreign sourced investment and savings.

[10] Hodgetts, B Briggs, P & Smith, M (2006) "Household Savings and Wealth", Economics Department, Reserve Bank of New Zealand, Wellington
[11] Supra note 3
[12] Whitehead, J (2007) "Treasury Report: A Synopsis of Theory, Evidence and Recent Treasury Analysis on Saving" Report: T2007/654

Another feature of New Zealand's financial system is a disproportionate investment in the residential housing sector (especially by individuals). Along with other socio-economic factors, this behaviour is currently encouraged through a comparatively favourable tax system on housing income.

The dominance of residential property in New Zealand households' balance sheets has resulted in less domestic capital being available to invest in New Zealand businesses. The gap is currently being filled by foreign lenders and equity. The New Zealand managed funds sector, as noted in the Treasury's research, provides an important alternative to foreign ownership of assets.

This bias towards a small number of sectors discourages competition and diversification of investment increasing the cost of capital. This in turn hampers growth opportunities of New Zealand companies.

We consider that an increase in the level of national savings and a focus on the development of New Zealand's financial system (in particular the encouragement of institutional investors such as superannuation funds) is likely to create a number of benefits to the economy such as:

- Development of greater financial literacy amongst investors and a framework that favours the accumulation of long-term capital;
- Fostering of competition for savings thereby lowering management fees and the cost of capital;
- Promotion of financial innovation creating new securities and products in order to diversify portfolio risks;
- Promotion of greater market discipline and stronger corporate governance through investor demands for greater transparency and accountability.
- An increase in domestic investment and New Zealand ownership of New Zealand based firms, helping address concerns around "hollowing out";
- Greater portfolio diversification through increased ownership of offshore assets;
- A potential reduction in the current account deficit and the exchange rate benefitting exporters;
- A reduction over time in New Zealand's external liabilities, reducing New Zealand's risk premium and reducing credit supply risk in difficult financial times (i.e. where investors demonstrate home country bias). Overall this results in a reduction in the cost of capital; and
- A reduction in the tendency of the housing market to overheat and create excess demand and rising debt in the economy.

The Australian experience is instructive. Following the introduction of its compulsory superannuation regime, the increase in national investment in superannuation funds has led directly to some concrete benefits to Australia's wider economy. These include the evolution of new and innovative investment classes, an increase in financial literacy amongst savers, the development of a robust regulatory environment and overall sustained economic growth. This has been most recently evidenced by the comparative success with which Australian firms have been able to re-capitalise in the recent financial down-turn.[13] The increase of investment into more productive types of investment by definition means that those funds are being used more productively in the economy.

[13] Bowen, Hon Chris, (2009) "Launch of ASFA's better living standards and a stronger economy: the role of superannuation in Australia' report", Speech, 21 October 2009

Increasing savings would have flow on effects throughout New Zealand's economy affecting not only returns on savings, but also the development of greater and more diverse sources of New Zealand capital and the creation of jobs.

These conclusions are also supported by a recent Treasury Policy Perspectives paper[14] which reports that the development of these under-developed areas of our financial system is likely to directly result in increases in the performance of New Zealand's economy in a similar manner to Australia's experience.

As such, in order to provide the greatest benefit to New Zealand's economy, any programme designed to increase the quantity of national savings must also look to increase the quality of savings through the development of New Zealand's financial system.

As it plays an important part in the decision making process, any policy designed to diversify and develop the financial market will need to consider the impact that taxation has on investment decisions.

Summary

The reliance on residential property investment is not desirable from a macroeconomic risk perspective as Zealand's economic performance is highly correlated with the New Zealand housing market; nor does it make good sense from a household risk diversification perspective to have very little exposure to financial assets, other than bank accounts.

Any tax reform undertaken should focus on encouraging both an increase in the level of national savings and a diversification of investment. The encouragement of this behaviour will have the effect of not only developing under-developed sectors of New Zealand's financial system, but also result in significant wider social and fiscal benefits to New Zealand's economy.

However, tax incentives should not be viewed as the sole influence on investment decisions and there is an important role for the investment industry to play in this regard. Members of the ISI in particular have a role in marketing their investments to focus on the benefits of their investments including a reduction of risk through investment diversification and fund manager expertise. Most importantly, in order to compete with the perceptions of other investments such as residential housing, this focus needs to be on the greater long term gains to be had from such investments.

We consider the current taxation of investments and potential reforms in further detail below.

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[14] Supra note 3 at page 16

The taxation of savings

Broadly, New Zealand has traditionally followed a "TTE" (Tax-Tax-Exempt) approach to the taxation of savings. Namely, savings are generally funded out of post tax income (T), returns on savings are taxed (T) and withdrawals of savings are tax-free (E). The policy underpinning this treatment has been to apply a neutral treatment across the different forms of savings and to tax income from savings identically to other forms of income such as business income[15].

However, recent research into the make up of New Zealand's taxation system has shown that this approach is not applied across the board to all sources and methods of savings income creating distortions in investment decisions[16].

Direct versus indirect investment

Where an individual invests through a collective investment vehicle (such as a unit trust or superannuation fund), it will generally be the intermediary's business practices which will determine whether gains from an investment are taxable income for tax purposes. However, were the individual to undertake the investment themselves it will often produce a better tax result. This creates a distortion away from the use of intermediaries by lenders/savers and toward investments made directly, or structured in such a way as to appear to be direct [17].

The benefits of investing through collective investment vehicles over direct investment are well known. This includes the ability of investors to reduce risk by taking a share in a diversified investment portfolio and benefit from the expertise of professional investment managers to gain a better return. Accordingly, the need to counter this disparity between the taxation of direct versus indirect investment was a driving force behind the introduction of the portfolio investment entity ("PIE") regime.

The PIE rules were introduced as part of the KiwiSaver initiative to encourage (or at least not discourage) an increase in savings through managed funds. The rules included an exemption from tax on gains in certain Australasian equity investments to mimic the result which direct investment might produce. To encourage a greater level of investment, the rate of tax on investments in PIEs was aligned with individual marginal tax rates capped at 33% (now 30%) providing a perceived saving to those on the higher individual marginal tax rates. In addition, the PIE income is excluded from an individual's taxable income meaning it does not impact transfer payments and certain social assistance regimes. These changes have been widely seen as a positive development encouraging an increased level of national savings and reducing the bias between individual and direct investment in a large number of investments.

However, outside the PIE rules, there is still a large disparity between the taxation of direct and indirect investments. This is especially true in respect of the application of the distinction between capital and revenue property where the operations of the intermediary (e.g. a company) can produce a different result to what an investor in their own name would face. This is discussed in further detail below in respect of investment in residential housing.

Investment in residential property

As discussed above, a large proportion of New Zealand household savings are invested in residential housing. Whereas the OECD average is less than 50%, New Zealand households currently hold over 70% of their assets in some form of residential property[18].

Although there are a large number of considerations governing investment decisions, the comparative taxation of income from different investments is likely to have a significant

[15] Treasury (June 2001) "Executive Summary – Issues Paper – Tax Review 2001"
[16] Supra, note 3
[17] Claus, I, Jacobsen, V and Jera, B (2004) "Financial systems and economic growth: An evaluation framework for policy" New Zealand Treasury working paper: 04/17
[18] Supra, note 10

impact on these decisions. In particular, with residential property, the relative light taxation of such investments.

The popular mis-conception is that New Zealand does not have any capital gains taxes. However, in practice a significant amount of capital gains in New Zealand are effectively classified as taxable income through the operation of tax legislation. Accordingly, as increases in the value of residential housing are generally treated as tax-free to household investors, this represents a significant tax advantage for investors (i.e. the difference between tax at 0% and 38% – the top marginal tax rate). In contrast, investments in shares are comprehensively taxed, via the company tax base (i.e. the underlying earnings are taxed as they accrue, and this should be reflected in a lower company share price).

In addition to this benefit, the availability of tax deductions for depreciation and the ability to negatively gear residential properties has resulted in a large percentage of New Zealand's investment base (over $200 billion in assets) generating negative taxable income (losses). In essence the Government is paying out refunds on these investments notwithstanding the investments are generally cash-flow and return positive (i.e. once the capital gain is also taken into account).

There is evidence to support that this treatment of home ownership encourages distortions in the investment behaviour of savers at the expense of other types of investment.

Where to from here?

As outlined above, tax is one of several factors which will influence people's savings decisions; both how much they will save and the form in which they will save[19]. Given the afore-mentioned benefits which are likely to flow from both an increase in national savings and development of under-developed sectors of New Zealand's financial system, any policy change will need to focus on both encouraging further investment and further diversification of investment such that funds are able to be allocated to their most productive use (not the most productive tax use).

Increasing national savings

Non-tax drivers

We outline below some of the non-tax options, which may be complementary to any tax reform.

The introduction of KiwiSaver has been a positive step towards improving the level of New Zealand's national savings. However, in its current format, it is questionable whether it will deliver the increase in national savings required to meet the future demand of New Zealand's ageing population.

The experience of countries such as Australia and Chile shows that a sustained increase in the level of national savings can have a positive impact on both the country's current financial systems and their ability to meet their future expenditure. Accordingly, in order to achieve these benefits further or stronger pro-saving action is now justified[20].

An important consideration in any reform is the recent agreement between New Zealand and Australia in respect of transfers of retirement saving between certain Australian superannuation funds and New Zealand KiwiSaver funds. The closer our superannuation systems and investment taxation rules are aligned, the easier and more broadly such a transfer system is likely to operate. Any perceived tax disadvantage will reduce the prospects for the savings to migrate to New Zealand.

One policy option often debated is whether New Zealand should introduce some form of compulsory superannuation savings. Although KiwiSaver introduced a level of "soft compulsion" towards superannuation savings, it stops short of requiring individual savers to save. Investors are also able to take indefinite "contribution holidays", which is also likely to impact the level of savings over the long term. The introduction of compulsory superannuation savings in Australia has seen a sustained increase in the level of national savings and a strengthening of the Australian economy as a whole.

In the New Zealand environment, the introduction of compulsory superannuation would help accelerate the investment needed to develop the financial system. However, if such a reform were not desirable, an alternative method would be to require some greater form of "lock in" of savings. Requiring this focus on long term investment would have benefits both in the ability of the investments to provide long-term returns to savers and in maintaining a higher level of national savings overall.

In the event that compulsory superannuation or some greater level of investor "lock in" were to be introduced, careful consideration would need to be applied to the rate of taxation and levels of contribution required from individuals.

[19] Supra, note 10
[20] Supra, note 7 at page 4

Tax drivers

Our experience is the tax system does drive behaviour. For example, in overseas jurisdictions taxpayers will look to make end-of-year decisions based on the tax incentives available. Where savings investments are tax favoured, they will capture the taxpayer's dollar.

No single tax reform should be viewed in isolation and care should be taken to evaluate the impact on the ability of individuals to save as the result of other potential policy changes such as changes to the rate of GST or personal income tax rates.

New Zealand stands out in not comprehensively reducing or deferring taxation on savings, particularly retirement savings. The taxation of savings at marginal taxation rates has been (and to a large extent still is) the normative policy position in New Zealand.

In the Tax Working Group background papers released to date, there is virtually no discussion of the disincentive effects of a 38%, 33% or even 30% tax rates on the return to savings, particularly long-term savings and the risk/return trade-off. The ISI believes that this is an area that requires careful consideration.

Australia's retirement savings model contains significant tax benefits, including a 15% tax rate on retirement savings in managed funds. This compares with 30% under the PIE rules. In the context of Trans-Tasman superannuation portability, it begs the question why New Zealanders with Australian superannuation savings would ever choose to transfer their savings to New Zealand, with the current tax disincentives.

What is the appropriate rate to tax the return to capital? Other countries have answered this implicitly through deferring tax on retirement savings and lower company tax rates. It is well established economic theory that taxing capital at high rates is distortionary, much more so than say directly taxing labour (which will end up bearing the tax burden in any event).

There is therefore strong support for lowering the tax rate on capital (and we note the Government has signalled changes in this general direction already (e.g. the proposed Approved Issuer Levy changes)) recognising the importance of reducing the cost of capital for New Zealand firms.

From a broader perspective, a current disincentive to savings in New Zealand is the focus on taxing income from savings now rather than deferring tax until the revenue earned aligns with the future expenditure it is designed to offset. The effect of this approach is to inflate Government revenue now at the expense of a balanced inter-temporal view of Government expenditure. Unlike the approach of many overseas jurisdictions where savings revenue is matched against future expenditure, this current approach taxes the inflation component of long term investment and makes other options such as investment in residential housing comparatively more attractive.

Taxing the inflation component of long-term savings is a major concern. Given the long-run nature of retirement savings, inflationary gains could make up a significant component of the return to savings (much more so than taxing, say, current nominal employment earnings). Taxing this return on retirement savings (particularly when other investments face a lower or no tax liability on inflationary gains) shifts the playing field in favour of these lower taxed investments. This is not a desirable outcome.

We believe that the deferral of taxation on savings until retirement aligns taxation revenue with the increasing Government health care and pension costs associated with an ageing population. Not recognising the income deferral aspect of retirement income inflates the present value of taxation revenue at the expense of a balanced, inter-temporal, view of future Government costs.

Taken overall, this suggests that a lower tax rate on savings is justified.

Development of New Zealand's financial system

As discussed above, a tax system that biases investment away from more profitable (from a national standpoint) but more heavily-taxed investments will stunt national income and hence savings[21]. As there are significant benefits to be gained from encouraging a broad range of investment, any policy change should provide as level a playing field as possible for all types of investment.

As outlined above, there are currently disparities in the New Zealand system between the taxation of various savings investments. Accordingly, in order to achieve this "level playing field" either those investments currently receiving favourable tax treatments need to be taxed more or those investments currently disadvantaged need to be taxed less. In practice, it is likely that a mixture of these approaches is likely to achieve the best result. Any policies introduced will need to be balanced and not at the expense of the need to encourage a higher level of national savings. New Zealand's system currently compares well internationally with relatively simple rules with broad application. From a compliance point of view, this approach is to be encouraged in any changes made.

In respect of the taxation of residential housing, external commentators such as the OECD have recommended the introduction of both a tax on capital gains and the value of occupancy (imputed rental) for owner-occupied homes[22]. Given the current favourable treatment and the comparatively high reliance by households on this single type of investment, some level of additional taxation is required to assist savers in making more balanced investment decisions. Possible options for reform are outlined in paragraph 4.3.2 below

The PIE and KiwiSaver changes discussed above were positive steps towards providing tax incentives towards other types of investment but further tax reform is needed to encourage investment and develop New Zealand's financial system.

Tax Working Group considerations

We understand that the Tax Working Group is currently considering a wide collection of options for tax reform affecting many aspects of New Zealand's economy. We appreciate that any recommendations will need to balance competing requirements. We have not undertaken that overall exercise. We comment on a number of these options which the ISI views as having a specific impact on savings.

Goods and Services tax

As GST is widely considered an "efficient" tax, it is an obvious candidate for increasing Government revenue (or keeping revenue constant in conjunction with other reforms).

However, any such reform, will need to consider the impact of the change to the rate of GST on savings.

All things being equal, an increase in the rate of GST will increase costs. Accordingly, we expect any increase in the rate of GST will be combined with adjustments to compensate those affected.

However, any increase in the rate of GST will increase the overall cost of saving for investors as intermediation costs will increase. One potential solution would be to introduce a reduced input tax credit system similar to Australia's as part of any overall package. This may help balance both the need to protect Government revenues with the need to encourage savings.

Accordingly, any change to the rate of GST implies that consideration must also be given to the GST base, in particular, the deductibility of GST paid.

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[21] Supra, note 10
[22] Supra, note 10

Taxation of real property

Where there appears to be the greatest economic distortion in investment in real property is where investment is made in less productive areas with lower than expected tax revenues. This is most noticeable in respect of investment in residential rental property.

The Tax Working Group has recently considered a number of potential reforms to counter this distortion such as the introduction of a general capital gains tax, introduction of a land tax, introduction of a Risk Free Return Method ("RFRM"), denial of interest deductions and a denial of depreciation deductions.

Capital gains tax

The ISI is cautious on the issue of applying a comprehensive capital gains tax which could result in discouraging investments which are not the intended target of such reform. We consider that a capital gains tax targeted towards residential property will be difficult to apply and may cause boundary issues as to where specific exemptions apply. In addition we consider that the risk in applying a capital gains tax solely to residential rental property would be that as only part of New Zealand's asset base would be covered by this tax, this could result in an equal distortion away from this investment type. On this basis, the ISI does not view a capital gains tax as providing a useful solution and considers other options may be better suited to addressing this distortion.

Land tax

The introduction of a land tax is likely to have a wider impact than on just those investments which are the target of such a reform. However, any exemptions to narrow the effect of the tax are likely to reduce the efficiencies of such a regime and its ability to generate taxation revenue. Given the overall impact that such a regime would have on the asset bases and balance sheets of the country and individual businesses, we consider that a land tax is not a preferred option.

Risk free return method

The introduction of an RFRM would deem a risk free rate of return to be income of an investor based on the net market value of their investment. The effect of a net-of-debt valuation would be to allow a deduction for interest expenditure (at the risk free rate) but deny all other deductions for expenditure incurred by the investor.

In the residential rental context, this approach has some appeal and if properly implemented would operate to reduce the current tax distortion towards this method of investment. However, as this method would create a deemed return for investors even in a declining market, there are likely to be practical difficulties around the "saleability" of such a reform.

ISI's comments are based on investor reaction to the FDR rules and how they apply to them.

Denial of interest deductions

As a large proportion of real property is debt financed it makes economic sense that interest deductions are allowed. This properly reflects, in the tax base, the returns to equity and debt from real property investment. If there are concerns around the gearing of property investment, these concerns are better targeted through commercial and regulatory capital and gearing requirements rather than tax legislation.

We therefore do not support the denial of interest deductions.

Denial of depreciation deductions

A depreciation deduction is allowed on the basis that the property held declines in values while used to produce income. The assertion for real property is that repairs and maintenance expenditure maintains the value of the property (i.e. so that it does not decline in value). This means that depreciation should not be allowed.

However, to the extent that the property does not increase in value, actual expenditure should be allowed. The current rules allow this to the extent the expenditure is classified as revenue repairs and maintenance expenditure. To the extent, the expenditure is classified as capital, a deduction is denied.

Investments in real property can be broadly divided into three groups; residential rental property, industrial property and commercial investment property.

Residential rental properties are often a single investment used to derive rental income for their investor. As, historically, the value of these properties has increased overtime these investments have often been later sold for a capital gain. Given these investments generally increase in value, there is no justification for allowing a depreciation deduction. In the absence of a comprehensive capital gains tax, allowing depreciation loss deductions for residential rental buildings does not represent a coherent approach and encourages tax mitigation techniques. (The relative values of land and buildings can be manipulated to meet the non-taxable land/taxable buildings border).

Industrial property is more properly viewed as merely a requirement of a company's business or an investment in future revenues rather than as an investment in itself. The property is used in order to generate the income of the business which is subject to tax.

Commercial property is in practice usually aggregated in a unitised or traded investment vehicle rather than held as a single investment. Accordingly, the gains from this investment usually make up part of a portfolio return to a wide number of investors and contribute to the economy's savings and productive capacity.

As commercial and industrial property investments contribute to New Zealand's productive capacity, and do not produce the same investment distortion as residential rental properties, depreciation deductions should be retained for these investments.

Further, denying depreciation for these investments would lead to practical issues around the application of the capital/revenue distinction. A consequence of denying depreciation is that expenditure which maintains the value of the property should be deducted. Some of this expenditure will be classified as capital expenditure due to the historical tests applied to determine revenue versus capital maintenance expenditure. Redrawing the revenue border will create uncertainty.

We consider that depreciation deductions should be allowed for industrial and commercial real property investment. However, on the basis that depreciation deductions are not reflective of the decline in value of residential rental investment (and therefore that the tax base is understated), depreciation deductions can be denied for residential rental properties.

Summary

We consider that either the introduction of a RFRM or denial or depreciation deduction for residential rental property investments is likely to have the greatest impact on reducing the distortion towards investment in residential property.

Nordic or dual tax systems

We understand that the Tax Working Group is also considering the merits of a "Nordic" tax system where capital and labour income are taxed at different rates (usually capital at a lower rate).

Lowering the rate of tax on savings should encourage an increase in the level of national savings. However, in practice, these regimes can be complicated to implement and administer.

To a certain extent the benefits of such a system are already present in the New Zealand savings system through the PIE regime. As individual investors are effectively taxed at their marginal tax rates (capped at 30%) and PIE income is not taken into account in determining social assistance, this effectively creates an immediate tax benefit towards the accumulation of savings. If further incentives are required, these would be better achieved by creating further specific benefits, combined with either greater “lock-in” requirements or compulsory superannuation.

Single economic markets

We recommend that any reforms undertaken should be balanced with the ongoing goal of closer economic relations with Australia. The ISI supports these aims and considers that many benefits would flow to New Zealand’s economy from mutual recognition of savings regimes. Accordingly, any tax reform in respect of investment, should consider issues such as the portability of superannuation schemes between New Zealand and Australia and mutual recognition of imputation credits/franking credits.

Annuities and income streams during retirement

As important a consideration as the accumulation of retirement savings is the tax treatment when these savings are drawn down (i.e. the period after accumulation). Although the taxation of specific investments is likely to be at a level too detailed for the Group, the taxation of annuities and, more generally, income streams during retirement is a specific issue that needs to be addressed.

The implementation of KiwiSaver and a focus on savings should produce over time significant funds for investors. It is important that the tax system does not discourage the continued investment of those savings until they are needed for retirement consumption.

Depending on individual circumstances and needs, different retirees will need differing levels of income as they transition towards retirement. It is important that the tax system recognises the deferred consumption of this capital so as to not hamper this flexibility or discourage long term savings. The tax system can also play its part in encouraging income streams in retirement rather than large lump-sum consumption expenditure.

By way of example, the current tax rules have not assisted in the development of a fully functioning annuities or income stream market which has discouraged a useful means of drawing down retirement savings. We consider that the tax rules need to clearly provide for taxation on returns of income and not capital when the income amount is paid to an annuitant.

Appendix 2

Excerpt from ISI submission on the Government discussion document: "Taxation of the Life Insurance business: proposed new risks" 2008

Annuities

Paragraph 1.19 of the discussion document states: *"The discussion document does not deal with annuities, which relatively few companies offer today. The government has a clear preference for bringing annuities into the new life rules, but that would raise a number of questions that are outside the scope of this discussion document. Annuities may be dealt with in future considerations."*

ISI considers it unacceptable that this segment of the life insurance market is not included in this review of the taxation of life insurance, the first in nearly 20 years. A contributing reason for the decline in this market has been the tax burden placed on annuities which has resulted in a large portion of annuitants being overtaxed for many years.

ISI is of the view that annuities should play a significant role in providing retirement options to individuals as they reach retirement age. Some action in this regard is necessary to support the Government's KiwiSaver initiative and a strong annuities market would ensure that the benefits gained from the KiwiSaver regime are maximised. International evidence supports this.

The impression given by officials was that changes to the taxation of annuities would be introduced with life insurance tax changes. With this in mind, we discuss below how the taxation of annuities business can be designed.

Background

We provide the following current information (as at January 2008) on the annuities market in New Zealand. The data relates to annuities provided by members of ISI:

- The age profile of current annuitants is as follows:

Age Band	Policy Count
Up to 65	194
66 – 69	155
70 – 74	408
75 – 79	861
80 – 84	1008
85 – 89	441
90 +	196
Other (Joint Lives)	14
TOTAL	**3277**

- The total value of assets currently supporting these annuities is approximately $200 million.

The Government has indicated very strongly that it supports concessions for retirement-related savings, as evidenced by the incentives provided for KiwiSaver. Giving retirees access to a strong competitive annuities market would be a natural flow-on from KiwiSaver. Unfortunately the current regime over-taxes annuitants, with all annuity earnings taxed at the company tax rate when it is clear from the table below that the significant majority of potential annuitants (88%) are in a tax bracket at or below 19.5%.

Tax Rate Distribution for over 65s (numbers in each tax band):

Tax Rate	Number of people	% of over 65s
0%	4,480	0.9%
19.5%	428,840	87.1%
33%	36,440	7.4%
39%	22,470	4.6%
TOTAL	**492,230**	**100.0%**

Source: Inland Revenue

This strongly supports a low tax rate being applied to annuities in general and suggests that the current gross over-taxing of annuities is unjustifiable and needs to be addressed promptly.

Internationally it has been recognised there is a clear link between taxation and a strong annuities market.

Participation rates in annuities could be increased through tax policy. Having regard to this, ISI would support incentivising annuity funds through lower tax rates. An example would be a KiwiSaver deferred annuity fund that is taxed on income at only say 15%, but must purchase an annuity. The benefit of this is that it would:

- Help reduce unit costs
- Help to hedge against natural selection inherent in annuity market (poor health individuals less likely to take an annuity)

Key Principles in Taxing Annuities

In designing a tax regime to support a strong annuities market, ISI considers there are three key guiding principles:

1. Life insurance shareholders should be taxed on profits from the annuity business
2. Policyholders in the lower tax bracket should not be over taxed
3. The solution should not be too complex

Further relevant background information in a life insurance context is that typically:

- annuities are fixed contracts where the investment risk is borne by the shareholders;
- the annuitant receives a regular fixed amount for the duration of his or her (or both) life;
- reserves are set aside to fund future annuity payments and to provide a security margin for the benefits of annuitants;
- any experience gains or losses provide a profit or loss to the shareholder.

Having regard to the above principles, ISI suggests two alternative options for taxing annuities.

Option A – Low Tax Rate Annuity Pool

A separate allocated pool of assets that support annuities would be established, analogous with Australia. Annuities would be locked in.

The Annuitant / Policyholder pool of assets would be taxed on an I – E basis where:

I is income to the Annuitant comprising:

- income earned on annuity fund assets (taxed under the PIE rules where appropriate); and
- transfers to the annuity fund from the life insurance shareholders (eg, increases in reserves).

E is deductible expenses to the Annuitant comprising:

- expenses incurred within the annuity fund; and
- other transfers from the annuity fund to the life insurance shareholder (eg, reserve movements)

Premiums (or the capital cost of annuities) would be received directly into the annuity fund and not be taxable.

Life insurance shareholder income would include transfers from the annuity fund for:

- Establishment costs;
- Commission recovery;
- Servicing fees;
- Reserve decreases.

Deductible life insurance shareholder expenses would include transfers to the annuity fund for reserve increases. The Annuitant / Policyholder pool would be taxed at the lowest individual tax rate (currently 19.5%). This can be justified on the basis that the tax rate must be reasonable to encourage participation rates in annuities to increase. As shown earlier, the large majority of retirees fall within the 19.5% tax bracket.

ISI members do not favour the concept of separate asset pools for annuitants according to their individual tax rate. This is because it would add unnecessary complexity at the time the annuitant moves into a new tax bracket. Either:

- the individual would get penalised when moving to the lower tax rate bracket if no transfers between funds were provided, or
- the guarantees offered at time of purchase could be diminished in value when re-pricing occurs.

ISI's preference is for annuity pool income to be taxed at the lowest individual tax rate with no recapture for individuals on higher tax rates when annuities are paid. If this is not sustainable longer term from a tax policy perspective, some consideration could be given to life insurance companies deducting tax from the non-capital portion of annuity payments, for example, at a rate being the difference between the lowest individual tax rate and the life insurance company tax rate. The non-capital portion could be determined using a table of factors published by the Government Actuary as to the portion of payment attributable to capital over the life of an annuity or a factor set and notified at date of purchase by the life insurance company.

A robust definition for annuities will be necessary. For example, ISI anticipates that allocated annuities and variable annuities would not be included.

Option B – Shareholder Tax Credit for Tax Rate Alignment

Annuity business would all be taxed as shareholder income. Shareholder income would include:

- premium / consideration received for annuity;
- income from assets (taxed under the PIE rules where appropriate);
- transfers from reserves.

Deductible shareholder expenses would include transfers to reserves. This would effectively meet the requirements of principle 1 above. To satisfy principle 2, there would need to be some form of rebate or increase in annuity payments to compensate those annuitants on lower tax rates. Any solution to this should be practical and easy to implement.

It would be necessary to determine a portion of each annuity payment that relates to taxable income. A pragmatic solution to this is to base any calculations on the expected lifespan of the annuitant.

The annuity payment in respect of individuals in lower tax brackets would then be increased by

$$A' = A \times [\, 1 + IP \times \{(1-t')/(1-t)-1\}]$$

Where A is the contracted annuity payment (determined using the company tax rate)

IP is proportion of annuity payment that is deemed to be income distribution

t' is the individuals marginal tax rate

t is the company tax rate.

The increase in annuity payment is provided to annuitants as a proxy for the tax refund they could otherwise be entitled to receive from IRD for tax on account in excess and as such would become a tax credit to the shareholder.

The two discretionary items within these calculations are the reserves and the IP. Both of these could be determined from tables of factors published by the Government Actuary or by a method and assumptions published by the Government Actuary.

A difficulty may arise in determining the correct marginal tax rate for individual annuitants. For a practical solution, the marginal tax rate from their most recently filed tax year would be a reasonable proxy for this.

[An alternative is to provide annuitants with the IP and tax information each year and let them seek refunds directly from IRD where they are on lower tax rates. This would have tax return filing implications.]

Recommendation

ISI strongly recommends that the changes to the taxation of life insurance contain some measures to remove the current tax distortion for annuities and to encourage participation in annuities. This is a necessary extension to the KiwiSaver initiative of the Government.

ISI's preference would be a low tax rate annuity pool as outlined in Option A above. ISI is of the view that no further taxation is necessary. However, if the government is concerned with a small number of individuals who may be advantaged by the low tax rate, we are happy to work with officials to agree a way to limit the potential gains rather than accept the continuation of the over-taxation that currently occurs.