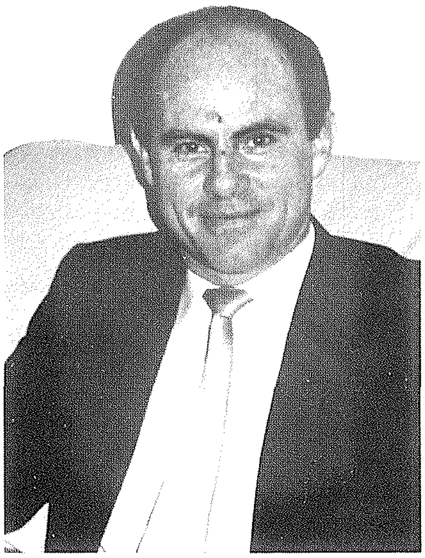
SUPER STRENGTH INVESTMENTS

NEW RULES WON'T HURT THE FIT PLAYERS



by JOHN TROWBRIDGE

Changes in superannuation tax regulations have helped to 'level the investment playing field'. The results will affect a broad range of products and alter the investor's perspective.

On May 25 this year, the Treasurer's announcements included a 15 per cent tax on employer superannuation contributions and superannuation fund investment income; a reduced corporate tax rate, from 49 per cent to 39 per cent; adjustment to life insurance company taxation; and an increased tax rate for friendly societies, from 20 per cent to 30 per cent.

A dramatic "levelling of the playing field"? Perhaps — it depends on how steep the ground was beforehand, how steep you *thought* it was, and how level it is now. And, from a marketing viewpoint, it also depends on how well you can run with the ball!

The common perception has been that superannuation was a vastly better proposition for most higher-income earners than any other conventional form of passive investment. Is this still so, and what is the effect of the May Statement?

Of other investment products, friendly society bonds have had a clear tax advantage over insurance bonds and most unit trusts, although investment requirements restricting friendly society bonds to fixed-interest securities have previously limited their attractiveness. Also, while insurance bonds and unit trusts are now major components of the retail investment market, the attractiveness of insurance bonds relative to various kinds of direct investment and unit trusts is not obvious.

The following products substantially cover the retail investment market:

- Superannuation(with lump sum or annuity benefits)
  - Employer sponsored (employer and employee contributions).
  - Self-employed and "personal superannuation."
  - Roll-over funds (ADFs, RODAs)
- Insurance bonds (with mixed investment portfolio).
- Unit trusts (mixed investment portfolio, Australian shares only, or property only).
- Friendly society bonds (fixed-interest portfolio and now also a mixed investment portfolio).

For all of these products except unit trusts, tax liabilities incurred during the term of the investment are the responsibility of the recipient of the funds; for unit trusts, the investor is responsible for tax liabilities each year. For all except superannuation, the proceeds on realisation are tax-free unless capital gains tax is payable or the holding period is inadequate (for insurance bonds and friendly society bonds, the period is 10 years). In the case of superannuation lump sums, however, a tax (30 per cent previously, now 15 per cent) is payable on proceeds exceeding a threshold which is currently $60,000.

We shall explore how these products previously compared with each other, and how the May Statement changes the equation. Comparisons among different product types are always difficult, but can be made in stages:

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- using some simplifying assumptions to gauge the effects of taxation only, for income earners on the maximum personal income tax rate;
- using similar assumptions, considering income earners on lower personal tax rates; and
- expanding the analysis by reviewing the assumptions and assessing investment prospects product-by-product.

Stage 1: the simplifying assumptions

The simplifying set of assumptions we shall use is:

☐ Investment return is 13 per cent annually before tax, comprising —

— fixed interest : 13 per cent each year

— property: 6 per cent net rental yield, 6.6 per cent capital appreciation*, nil depreciation allowance

— shares: 6 per cent dividends, 60 per cent of which are franked, 6.6 per cent capital appreciation*

** 6 per cent yield and 6.6 per cent capital appreciation compound to a total yield before tax of 15 per cent.*

☐ Indexation for capital-gains tax purposes is 6.6 per cent annually.

☐ Each mixed portfolio comprises 40 per cent shares, 30 per cent property and 30 per cent fixed interest.

☐ All investment income received is reinvested (after paying any taxes).

☐ Commissions and expense loadings are zero.

☐ The investor has a marginal tax rate of 50.25 per cent (including Medicare levy), which we assume for analysis purposes will reduce next year to 40.25 per cent.

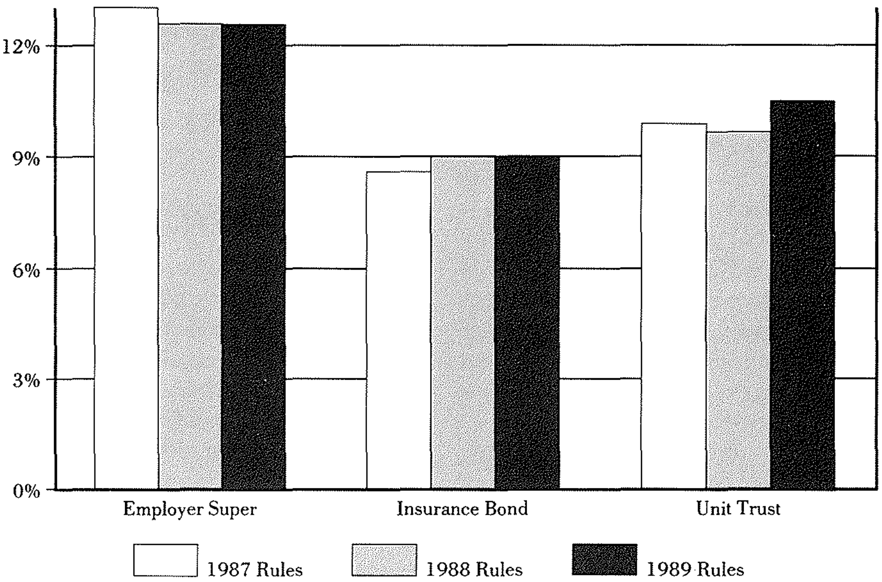
☐ All taxes are payable immediately the transaction giving rise to the tax liability occurs.

The first comparison we can make is on **net investment returns**. Three examples are illustrated in Graph 1 and figures for the full product range we are considering are in Table 1.

The figures indicate a clear advantage for superannuation over other products. They also illustrate an advantage for unit trusts over insurance bonds.

The illustration of relative after-tax yields is an introduction to the effects of taxation. But it is incomplete because it relates only to the investment of after-tax income. A further comparison from an individual investor's viewpoint is the **accumulated amount available** after 10 years from an initial investment equal to the proceeds from $100 of pre-tax income. Again, three examples are illustrated in Graph 2, and figures for the full product range given in Table 2.

Graph 1: Examples of relative after-tax yields



N.B. Each product here has the same mixed investment portfolio.

Table 1: Net investment returns

	After-tax yields %			Equivalent tax rates %		
Product	1987	1988	1989	1987	1988	1989
Superannuation+						
fixed	13.0	11.1	11.1	0	15	15
mixed	13.0	12.6	12.6	0	3	3
Insurance bond*						
mixed	8.4	8.8	8.8	35	33	33
Unit Trusts						
mixed	9.5	9.3#	10.2	27	29	21
equities	11.6	11.0#	11.9	11	15	9
property	9.8	9.8	10.4	25	25	20
Friendly society						
fixed	10.4	9.1	9.1	20	30	30
mixed	—	11.2	11.7	—	14	14

+ Employer and employee superannuation contributions each bear the same taxes on investment income.
* Insurance bond figures assume that capital gains are realised at the end of 10 years.
\# The reduction for unit trusts from 1987 to 1988 occurs because personal tax rates are unchanged and franked dividend income is worth less than previously due to the reduced corporate tax rate.

Note that the figures are hypothetical for several reasons — one important reason is simply that the rules of 1987 and 1988 will not persist unchanged for 10 years!

The primary cause of the figures for insurance bonds being lower than for unit trusts with the same investment portfolio is that life insurance companies do not receive the benefit of indexation for capital-gains tax purposes, whereas all other products shown in the table do.

We can now make some useful observations on the relative 10-year tax effectiveness of different products, recognising of course that we are still working with simplifying assumptions (including using the maximum personal income-tax rate and nil commissions or expenses):

1. For employer superannuation contributions, the new rules cause some reduction for a fixed-interest portfolio, but where franked dividends and capital appreciation are available, there may be a negligible difference between the old and the new.

2. Employee superannuation contributions are an inferior proposition to employer-sponsored superannuation.

3. Employer-sponsored superannuation (including self-employed contributions and "personal superannuation") continues to be the most attractive form of passive investment.

4. Non-superannuation forms of investment will improve significantly if the top personal tax rate is reduced from 49 per cent to 39 per cent (insurance bonds and friendly society bonds will improve about 20 per cent, and unit trusts nearly 30 per cent).

5. The investment superiority of unit trusts over insurance bonds is diminished to some extent.

6. Friendly society bonds continue to have a tax advantage over unit trusts and insurance bonds, but the advantage is much less significant than previously.

Stage 2: personal tax rates below the maximum

Superannuation beneficiaries pay tax of only 15 per cent of their first $60,000 of lump sum, compared with 30 per cent on amounts above $60,000. In both cases a 15 per cent reduction applies to benefits attributable to contributions from 1 July 1988.

It is evident that the first $60,000 of lump sum is a superior investment to all others in our selection of products, and this is so irrespective of the investor's own marginal tax rate.

Personal income tax rates for 1987-88 are:

Income	Marginal tax rate
To $5,100	Zero
To $12,600	24%
To $19,500	29%
To $35,000	40%
Beyond $35,000	49%

For investors whose marginal tax rate is 40 per cent, their investment position is very similar to the one referred to in the graphs as 1989 rules (which are based on a 39 per cent rate).

For superannuation, insurance bonds and friendly society bonds, the tax rate on the "inside build-up" is independent of the investor's own tax rate, in contrast to unit trusts. Since the tax rate on superannuation, at 15 per cent on contributions and 15 per cent on investment income, is lower than the lowest personal tax rate of 24 per cent, superannuation is *always* superior to unit trusts from a tax viewpoint (except where income is below $5,100).

For investors whose marginal tax rate is 24 per cent or 29 per cent, unit trusts are now more attractive than friendly societies.

For investors whose marginal tax rate is 24 per cent or 29 per cent, unit trusts are now more attractive than friendly societies, since these personal tax rates are lower than the 30 per cent rate on the "inside build-up" for friendly societies. In a (theoretical) rational market therefore, where all other things were equal, sales of friendly society bonds should be displaced by sales of unit trusts.

Insurance bonds are theoretically less attractive to investors on the maximum tax rate than unit trusts, because of the lack of indexation of capital gains as previously mentioned. Insurance bonds are therefore even less attractive to investors on lower tax rates (for example, as already noted, the move to a 39 per cent maximum rate, shown in the graph as 1989 Rules, increases the attractiveness of unit trusts over insurance bonds).

Stage 3: consider assumptions against reality

The question of investment returns, and which of fixed interest or equities or property is going to achieve the best rates of return over the period that is relevant to each particular investor, is a major subject in its own right. There will always be variations among fund managers, and there will be a range of attitudes and viewpoints on risk, asset allocation and asset selection, for both fund manager and investor.

I shall leave the subject of investment returns to the experts, since the main purpose of this article is to illustrate to fund managers and investors some of the taxation issues that affect the selection and performance of investment products.

Commissions and expense loadings can have a major effect on the net yield to an investor.

The assumptions that need qualification in the real world are:

- A 10-year investment term: tax rebate conditions on insurance bonds are improved by the May Statement, so some investors may cash in their bonds earlier than they had otherwise planned. Nevertheless, the accumulation comparisons over 10 years are indicative of the comparisons over other time periods (subject to any costs or penalties on sale or surrender).
- Indexation on capital gains: if the actual capital gains are higher than the index, there will be additional taxes; also for insurance bonds, life companies will have varying practices regarding the management of capital gains and the crediting of gains to insurance bonds, which may result in better (or worse) yields for investors than theoretical calculations would suggest.
- Commissions and expense loadings: these can vary by product and by distributor, and can have a major effect on the net yield to an investor. Hence it is possible, for example, that a low-load insurance bond will give a better net result, all other things being equal, than a high-load unit trust.
- Taxation payments: these often occur at dates later than the transactions from which the tax liability arises, thereby reducing to some extent the cost of taxation.

Note also that all of the comparisons and comments already made related to an analytical assessment from the investor's viewpoint of the relative performance of different investment products. They make no reference to investor behaviour or the behaviour of manufacturers and distributors of investment products.

The future marketplace

Some of the features of the current investment product environment appear to be:
- reduced sales of insurance bonds, unit trusts and friendly society bonds since October 1987;
- a strength in the insurance bond market relative to the unit trust market, despite tax disadvantages, which is

founded on product convenience and distribution power;

- hestitation and administrative difficulty for superannuation following the May Statement, leading to some slow-down in superannuation sales;
- a shift to quality and security since October 1987, to the benefit of fixed-interest managers, some of the larger institutions, and also life offices selling capital-guaranteed products (both superannuation and insurance bonds); and
- numerous changes of strategic direction, personnel and ownership among fund managers and distributors.

Manufacturers and distributors of investment products will be keen to ascertain whether future *product demand* will be affected by the tax changes in the May Statement, whether innovative *product design* is now possible or desirable, whether profit opportunities are affected, and whether competition and industry structure will alter.

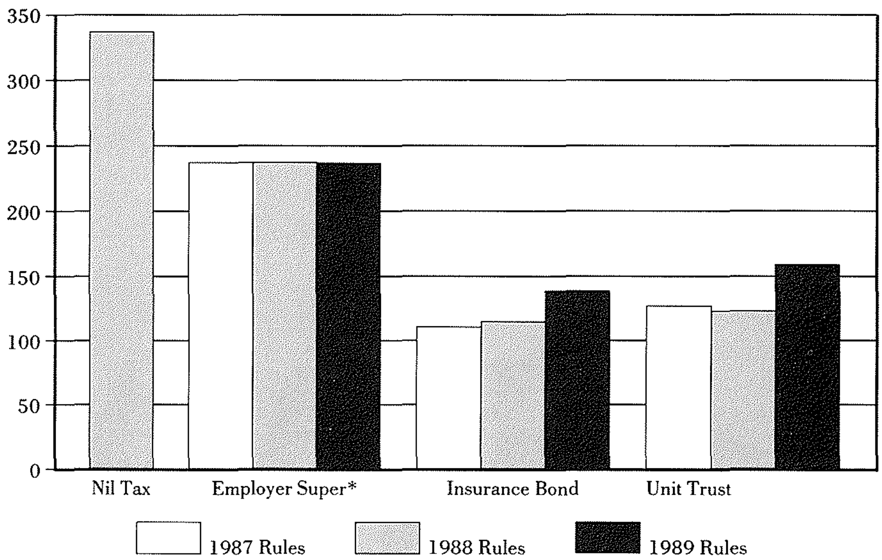
A full assessment of these questions would require further information and analysis. Market statistics and market research on investor preferences are relevant. The investment environment needs to be considered, and the timing and amount of any future reductions in personal income tax rates will also be influential.

Nevertheless, some predictions can be offered with the aid of the analysis and observations already made. My predictions are:

- Continued strength and growth in the superannuation market, but with —
  - a more conservative attitude generally towards investments (notwithstanding the tax attractiveness of franked dividends from equities);
  - greater interest by employers and others in the retirement-support objectives that are fundamental to superannuation; and
  - greater pressure on the commission and expense loadings of providers of superannuation products.
- Some consolidation of the unit trust industry and re-emergence in future years of strong growth of unit trust sales.
- Continued lobbying and ultimate success by the life insurance industry regarding the indexation of capital gains.
- Decline of the friendly society market and its ultimate absorption by other financial services institutions.
- Continued growth of the stronger companies in the life insurance industry (which now includes the major banks), through distribution strength, product diversification (including unit trusts), availability of capital and product design options.
- Emergence of the major banks, including their life insurance and unit trust activities, as major participants in the superannuation and investment product market, at the expense of the smaller members of the life office, unit trust and fund manager fraternity.

Yes, the tax playing field is being levelled, and one consequence is that the institutions with distribution capability and a strong capital base now have a valuable competitive advantage. The mounds and the troughs of regulation would protect the meek in fragmented markets. As the plough of deregulation does its work, however, we should expect to witness survival and prosperity of the fittest and strongest. ☐

Graph 2: Examples of 10-year accumulations (from $100 of pre-tax income)



* Employer super refers here to employer-funded contributions.
N.B. Each product here has the same mixed investment portfolio.

Table 2: Accumulations from $100 of pre-tax income

Product	Accumulated value at 10 Years 1987	1988	1989
	$	$	$
Nil tax#	339	339	339
Superannuation (lump sum benefit exceeding $60,000)			
Employer contributions*			
fixed	238	206	206
mixed	238+	238+	238+
Employee contributions			
fixed	169	142	170
mixed	169	164	197
Insurance bond			
mixed	112	115	139
Unit trusts			
mixed	126	122	160
equities	149	141	184
property	127	127	161
Friendly society			
fixed	134	119	143
mixed	—	145	174

\# Nil tax figures given as a reference — they would only apply to low-income investors buying unit trusts.
* Contributions from self-employed people and from employees contributing to "personal superannuation" up to the $3,000 limit are equivalent to employer superannuation contributions.
\+ It is coincidence that, when we allow for the change from 30 per cent tax on benefits to 15 per cent tax on contributions and 15 per cent tax on benefits, the combined effects of all changes in superannuation taxation have a neutral effect for this mixed portfolio.