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Interest Earnings on ADI Deposits And Australia's Tax and Transfer System

Final Report

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Glossary

ADI	Authorised Deposit-taking Institution
APRA	Australian Prudential Regulation Authority
EMTR	Effective Marginal Tax Rate
CGT	Capital Gains Tax
m.t.r.	Marginal Tax Rate
RSA	Retirement Savings Account

Abacus - Australian Mutuals is the industry association for Australian credit unions and mutual building societies. Credit unions and mutual building societies, like banks, are ADIs regulated by APRA under the Commonwealth *Banking Act 1959*. There are 138 credit unions and mutual building societies around Australia with more than four and a half million members and total assets of more than $65 billion. Credit unions and mutual building societies collectively rank second only to the Commonwealth Bank in their share of the Australian household deposits market and have a long tradition of promoting saving and responsible lending. For more information see **www.abacus.org.au**

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Executive Summary

Abacus – Australian Mutuals, the industry association for credit unions and mutual building societies, commissioned an independent report on the interest earnings on ADI deposits and the Australia's tax and transfer system by the South Australian Centre for Economic Studies.

In 1990, over 30 per cent of the total value of financial asset holdings of Australian households was held in the form of deposits with Australia's ADIs. By mid 2007 that share had fallen to 18.5 per cent.[1]

Australia's ADIs compete vigorously to attract household savings, but they are not on a level playing field when it comes to the real effective rates of taxation applied to investment earnings on ADI deposits as compared with the rates applied to other investment vehicles available to increasingly financially alert Australian households.

Assets whose returns are concentrated in the form of capital appreciation rather than regular and more predictable interest payments are tax advantaged.

Up until the recent outbreak of disturbed conditions across international financial markets, there had been a steady drift of Australian household savings dollars away form ADI deposits. In the absence of reforms to the taxation treatment of interest earnings on ADI deposits, that drift can be expected to resume as soon as the international financial markets situation is perceived to have become more settled.

The decline in ADI deposits as a share of total household financial assets has seen Australia's ADI sector become more reliant on offshore wholesale funding-sources for the money needed to provide home lending to Australia's households. Offshore wholesale funding often involves rollover processes that are fairly short-term. This in turn means that volatility on those offshore wholesale markets has consequences for lending to Australian households by Australian ADIs.

Measures to ease the taxation burden on ADI deposits would increase the amount of domestic funding available to ADIs and reduce the degree of reliance on more volatile offshore wholesale funds markets.

Section 1 explains the facts and figures of the present position in Australia regarding the rates of taxation applied on interest earnings on ADI deposits.

These rates are high in terms of absolute size, exceeding 100 per cent in real effective terms for some ADI deposit holders, depending on their family circumstances and the level of the inflation rate.

Interest earnings on ADI deposits are subject to much higher real effective rates of taxation than are the returns on other types of investments commonly held by Australian households.

Interest earnings on ADI deposits are taxed more heavily in Australia than in any of the nine OECD countries selected by Commonwealth Treasury as being appropriate international comparators.

[1] ABS, *Financial Accounts* (Cat. No. 5232.0), Table 15.

Section 2 presents three proposals for ameliorating the present position of excessively high rates of taxation being applied on interest earnings on ADI deposits in Australia.

The first proposal is for what is described as "a full reform." It would involve a shift in the nature of the Australian income taxation system towards a greater use of the **schedular** approach. This is the preferred approach for tackling the problem.

As the problem of excessive tax rates on interest earnings on ADI deposits is acute, two more simple-to-implement proposals are also put forward. These are presented as two alternative means of providing a more rapid amelioration of the present situation, during the "lead-time" which the Government might view as appropriate for full reform.

Section 2.2 proposes allowing for a temporary period (while Australia's inflation rate is outside the top of the Reserve Bank's target band) a simple halving of the tax that would otherwise be payable on a person's nominal interest earnings on their ADI deposits. This would be akin to providing ADI deposits with the tax treatment currently accorded to financial assets whose return is predominantly in the form of capital gains.

Section 2.3 proposes what might be described as a "half-way" house to the full reform proposal of Section 2.1. This would involve allowing each Australian resident taxpayer above a prescribed age to open a special type of ADI account (a "Seniors' Savings Management Account" or SSMA). Interest earnings credited to SSMAs would be taxed at a flat rate of 15 per cent with this tax collected and remitted by the ADI providing the SSMA.

1. The Present Position re Taxation of Interest Earnings on ADI Deposits

The Commonwealth Government's Discussion Paper *Architecture of Australia's tax and transfer system* was released on 6 August 2008. The declared intention of the Discussion Paper is to describe Australia's tax and transfer system "from a factual and analytical perspective" and to provide "comprehensive coverage" of that system.[2]

Chapter 8 of the Government's Discussion Paper is titled "Taxation of Saving and Investment". This chapter makes it clear that the effective rates of taxation applied to interest earnings on ADI deposits in Australia are very high.

- They are high in terms of absolute size.
- They are high in terms of relativity *vis a vis* the tax rates effectively applied to earnings on other types of assets commonly held by Australian households.
- They are high relative to the rates applied in comparable OECD countries.

1.1 High absolute size of tax rates

This stands out starkly from the analysis presented at pages 250 to 252 of the Government Discussion Paper. The Commonwealth Treasury diagram on page 252 indicates that for an Australian taxpayer on the 46.5 per cent marginal tax rate (m.t.r), who receives 6 per cent nominal interest earnings on an ADI deposit of $1,000 at a time when the inflation rate is 2.5 per cent, the real effective marginal tax rate amounts to 79.71 per cent.

This is because the nominal m.t.r. of 46.5 per cent is applied to the full $60 of nominal interest earnings. But of that $60, only $35 represents real income. In the words of Commonwealth Treasury, the other $25 "does not add to the purchasing power of the investor".[3] Thus $27.90 of taxation is imposed on $35 of real income, so that the *real* EMTR is 79.71 per cent.

But as the Discussion Paper goes on to point out, for many Australian families, the situation is even worse than that in terms of the effective level of taxation applied to the interest earnings from their ADI deposits. The Discussion Paper points out that "for a single income couple on average weekly earnings with two children aged three and eight with a personal income marginal tax rate of 31.5 per cent, the combined nominal EMTR on a bank account could be around 56 per cent and the real EMTR could be around 96 per cent."[4]

This higher nominal EMTR arises from the effects of the means testing arrangements for the Family Tax Benefit (FTB) together with the tapered withdrawal of the full Low Income Tax Offset (LITO) from the family, as it earns additional taxable income. For FTB 'B', the phase-down from the "maximum" rate to the "basic" rate is 20 cents per additional dollar of income in the taper range. The LITO phase-out rate is 4c in the dollar. Thus 24 cents of each additional dollar of income is 'clawed-back' via these channels on top of the 31.5 cents paid via the income tax rate-scale, to give an overall nominal EMTR of 55.5 per cent. Using the same assumptions as earlier for the nominal interest rate (6 per cent) and the rate of inflation (2.5 per cent), this produces an overall *real* EMTR of 95.1 per cent. Or if the 55.5 is rounded to 56, the bottom-line becomes the 96 per cent rate cited by Commonwealth Treasury.

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2 Australian Government (2008), *Architecture of Australia's tax and transfer system*, page iii.
3 *ibid*, p. 250.
4 *ibid*, p. 252.

But care needs to be taken in interpreting these real EMTR figures on interest earnings on ADI deposits. Commonwealth Treasury calculated these figures of 79.7 per cent (for the person with nominal m.t.r. of 46.5 per cent who is unaffected by factors other than the published income tax rate scale) and 96 per cent (for the family in the circumstances described above) using an assumed inflation rate of 2.5 per cent and an assumed real interest rate of 3.5 per cent.

- With higher rates of inflation and the *same* real interest rate, the real EMTR figures go higher still;
- With lower real interest rates and the *same* rate of inflation, the real EMTR figures are also raised.

For the present financial year (the twelve months to the June quarter 2009), the Reserve Bank's inflation forecast is 3¾ per cent (both headline and "underlying").[5] And Reserve Bank statistics for the average of 3, 6 and 12 month term deposits with ADIs suggest that a figure of 7 per cent may be the appropriate figure for the nominal rate of interest on ADI deposits for the present financial year.[6]

Using this scenario of a projected inflation rate of 3¾ per cent and a projected real interest rate of 3¼ per cent, the following *real* EMTR figures emerge:

- For the person with nominal m.t.r. of 46.5 per cent who is unaffected by factors other than the published income tax rate scale, the real EMTR becomes 100.2 per cent (compared with 79.7 per cent under the Commonwealth Treasury scenario);
- For the single income couple on average weekly earnings with two children aged three and eight and with an overall nominal EMTR of 55.5 per cent, the real EMTR becomes 119.5 per cent (compared with 95.1 per cent under the Commonwealth Treasury scenario).

Tables 1.1 and 1.2 illustrate how the real EMTR calculations are affected by differing inflation and real interest rate combinations. Table 1.1 looks at the case of the person with nominal MTR of 46.5 per cent in more detail. Table 1.2 provides the parallel information for the family in the circumstances assumed in the Government Discussion Paper.

SACES suggests two points should be borne in mind when considering Tables 1.1 and 1.2:

- Since an inflation rate of 2.5 per cent p.a. represents the mid-point of the RBA's target range, it is probably reasonable to take that figure as the medium-term "norm" to which we will revert following "disturbances" of a temporary nature. *But* the Reserve Bank forecasts published in the August 2008 *Statement on Monetary Policy* have Australia's inflation rate remaining above that figure throughout the entire forecast period (to the end of 2010). Thus when considering the situation in the present financial year and in 2009/10, it would be reasonable to think in terms of an inflation rate figure greater than 2.5 per cent.
- When Australia's inflation rate was successfully being held in the middle of the RBA's target range, nominal interest rates on ADI deposits were typically not as high as 6 per cent. Table 1.1 shows that if a 2.5 per cent inflation rate is paired with a nominal interest rate of 5.5 or 5.0 per cent, the real EMTR facing the 46.5 m.r.t. taxpayer rises substantially above even the high 79.7 per cent of the Commonwealth Treasury scenario. And Table 1.2 shows the same pattern for the case of the single

[5] Reserve Bank of Australia, *Statement on Monetary Policy, 11 August 2008*, p. 62.
[6] *ibid*, p. 43-44.

income family on average weekly earnings with two children. In this case even the 5.5 per cent nominal interest rate scenario leaves the family with a real EMTR in excess of 100 per cent.

Table 1.1
Real Effective Marginal Tax Rate (Per cent) on Interest Earnings on ADI Deposits
(Taxpayer with Nominal MTR of 46.5 per cent)

Rate of Inflation (Per cent)	Nominal Rate of Interest (Per cent)				
	5.0	**5.5**	**6.0**	**6.5**	**7.0**
2.5	93.0	85.3	**79.7***	75.6	72.3
2.75	103.3	93.0	85.9	80.6	76.6
3.0	116.3	102.3	93.0	86.4	81.4
3.25	132.9	113.7	101.5	93.0	86.8
3.5	155.0	127.9	111.6	100.8	93.0
3.75	186.0	146.1	124.0	109.9	**100.2****
4.0	232.5	170.5	139.5	120.9	108.5

Note: * Corresponds to Treasury scenario at pages 251-252 of *Architecture of Australia's tax and transfer system.*
** SACES scenario for 2007/08 (see text).

Table 1.2
Real Effective Marginal Tax Rate (Per cent) on Interest Earnings on ADI Deposits
(Taxpayer with Nominal MTR of 55.5 per cent)

Rate of Inflation (Per cent)	Nominal Rate of Interest (Per cent)				
	5.0	**5.5**	**6.0**	**6.5**	**7.0**
2.5	111.0	101.8	**95.1***	90.2	86.3
2.75	123.3	111.0	102.5	96.2	91.4
3.0	138.8	122.1	111.0	103.1	97.1
3.25	158.6	135.7	121.1	111.0	103.6
3.5	185.0	152.6	133.2	120.3	111.0
3.75	222.0	174.4	148.0	131.2	**119.5****
4.0	277.5	203.5	166.5	144.3	129.5

Note: * Corresponds to Treasury scenario at pages 251-252 of *Architecture of Australia's tax and transfer system.*
** SACES scenario for 2007/08 (see text).

Table 1.3 provides the same type of information as that in Tables 1.1 and 1.2, but for the case of the taxpayer with an overall nominal effective marginal tax rate of 31.5 per cent. With the Commonwealth Treasury scenario assumptions for the inflation rate (2.5 per cent) and the nominal interest rate on ADI deposits (6.0 per cent), the *real* EMTR is 54 per cent. Under the SACES scenario for 2008/09 that figure becomes 67.9 per cent. Those are very high figures for middle-range taxpayers, even where their circumstances are such that other factors are not boosting their nominal EMTR above the 31.5 figure from the published income-tax rate scale.

Table 1.4 illustrates the real EMTR corresponding to a nominal tax rate of 15 per cent under different inflation rate and nominal interest rate pairings. The figures in this table are relevant to the Seniors' Savings Management Accounts (SSMAs) proposal outlined in Section 2.3 below. In a nutshell, access to an SSMA arrangement would allow an SSMA holder to face a real EMTR of 25.7 per cent on the interest earnings on their SSMA under the Commonwealth Treasury scenario assumptions for the inflation rate and the nominal interest rate. And under the SACES scenario for 2008/09 that figure becomes 32.3 per cent.

Table 1.3
Real Effective Marginal Tax Rate (Per cent) on Interest Earnings on ADI Deposits
(Taxpayer with Nominal MTR of 31.5 per cent)

Rate of Inflation (Per cent)	Nominal Rate of Interest (Per cent)				
	5.0	**5.5**	**6.0**	**6.5**	**7.0**
2.5	63.0	57.8	**54.0***	51.2	49.0
2.75	70.0	63.0	58.2	54.6	51.9
3.0	78.8	69.3	63.0	58.5	55.1
3.25	90.0	77.0	68.7	63.0	58.8
3.5	105.0	86.6	75.6	68.3	63.0
3.75	126.0	99.0	84.0	74.5	**67.9****
4.0	157.5	115.5	94.5	81.9	73.5

Note: * Corresponds to Treasury scenario at pages 251-252 of *Architecture of Australia's tax and transfer system.*
** SACES scenario for 2007/08 (see text).

Table 1.4
Real Effective Marginal Tax Rate (Per cent) on Interest Earnings on ADI Deposits
(Taxpayer with Nominal MTR of 15 per cent)

Rate of Inflation (Per cent)	Nominal Rate of Interest (Per cent)				
	5.0	**5.5**	**6.0**	**6.5**	**7.0**
2.5	30.0	27.5	**25.7***	24.4	23.3
2.75	33.3	30.0	27.7	26.0	24.7
3.0	37.5	33.0	30.0	27.9	26.3
3.25	42.9	36.7	32.7	30.0	28.0
3.5	50.0	41.3	36.0	32.5	30.0
3.75	60.0	47.1	40.0	35.5	**32.3****
4.0	75.0	55.0	45.0	39.0	35.0

Note: * Corresponds to Treasury scenario at pages 251-252 of *Architecture of Australia's tax and transfer system.*
** SACES scenario for 2007/08 (see text).

1.2 High tax rates relative to other assets held by Australian households

This point is also illustrated very clearly in the analysis presented at pages 250 to 252 of the Government Discussion Paper. The Commonwealth Treasury analysis is carried out in two stages.

- First it is noted that even if the inflation rate were zero, there are features of Australia's taxation system that lead to the investment earnings on a number of other types of investments commonly made by Australian households being taxed at lower effective tax rates than is the situation for interest earnings on ADI deposits.
- Second it is shown how even at a low rate of inflation (2.5 per cent), these discrepancies between nominal EMTRs are expanded into yet bigger discrepancies between the real EMTR on interest earnings on ADI deposits and the real EMTRs applied to investment earnings on a range of alternative household investment (or savings) vehicles.

The bottom line, to quote from the Government Discussion Paper, is that: "Relative to interest bearing deposits, owner-occupied housing, rental properties, listed shares and concessional (pre-tax) contributions to superannuation are favourably taxed."[7]

[7] Australian Government (2008), p. 251.

The analysis presented in the Discussion Paper seeks to compare like with like by adopting a common set of assumptions for the various household investment alternatives considered. In each case the nominal investment earnings are 6 per cent per year, the inflation rate is 2.5 per cent, a continuous holding period of seven years is assumed, and the focus is on an individual with a nominal m.t.r. of 46.5 per cent who is unaffected by factors other than the published income tax rate scale.

As was noted in Section 1.1, the real EMTR on interest earnings on an ADI deposit under these circumstances is 79.7 per cent. The Government Discussion Paper reports the equivalent figure for investing in the owner-occupied home at around 29.4 per cent (driven by the effects of conveyancing duty and local government rates). For a "geared" investment in rental property (with 70 per cent of the investment funded from borrowings) the real EMTR is lower still. For a "geared" investment in listed shares it is lower again. And for the superannuation case it is *minus* 105 per cent.[8]

The factors driving these substantial discrepancies in the real EMTR's applying to investment earnings on differing types of household asset-holdings can be summarised as:

- the period-by-period "current" returns from owner-occupied housing and from other personal use assets such as vehicles are not subject to Australian income tax;
- the component of investment earnings which takes the form of capital gain rather than "current income" is typically subject to lower nominal income tax rates than is *normal* income (and to a rate of zero for the principal residence of an owner-occupier);
- there are special taxation concessions for superannuation; and
- the higher the rate of inflation and the lower the real rate of interest paid on borrowings, the bigger becomes the effective tax break to be had from a geared investment into an asset producing taxable income.

The fact that capital gains on a household's holdings of financial assets are subject to income tax at half the normal nominal EMTR, where the holding period exceeds twelve months, has an important impact on real EMTRs for those financial assets whose overall return is concentrated in capital appreciation rather than distributions of "current income". In the Government Discussion Paper analysis, the listed share calculations were based on a share with a fifty-fifty split in its overall 6 per cent per annum yield between dividend distributions and capital growth. And an inflation rate of 2.5 per cent per year was assumed. If the overall return is concentrated more heavily in the capital growth component, the real EMTR becomes lower. With a seven year holding period of a financial asset whose 6 per cent per year return is entirely in the form of capital gain, the real EMTR is 37.2 per cent for an individual with a nominal EMTR of 46.5 per cent. That is a far cry from the 79.7 per cent real EMTR applied to the interest earnings of the ADI deposit held by the same individual. And this is *without* any gearing being assumed.

[8] Ibid, p. 252. The Discussion Paper points out that since superannuation investments typically have much longer holding periods, this figure needs to be interpreted with care. For a holding period of 20 years, the real EMTR is altered to a still very attractive *minus*26 per cent.

1.3 High tax rates *vis a vis* comparable OECD countries

The Government Discussion Paper focuses on nine of Australia's fellow member countries of the Organisation for Economic Cooperation and Development (OECD) for international comparisons purposes. The nine are: Canada, Ireland, Japan, the Netherlands, New Zealand, Spain, Switzerland, the United Kingdom and the United States. These nine were selected "because they are broadly similar to Australia in terms of their overall tax to GDP ratio and the role of the government sector in their economies."[9]

At page 209 of the Government Discussion Paper, Chart 5.9 indicates that looking at the highest nominal income tax rate which personal taxpayers face on the interest earnings on ADI deposits, Australia's rate is the highest among all the OECD comparators, and is more than 12 percentage points above the average.

- Five of the OECD comparators, like Australia, treat interest earnings on ADI deposits in the same way as "ordinary personal income" from working. They are Canada, New Zealand, Switzerland, the United Kingdom and the United States.
- Ireland, Japan, Spain and the Netherlands have income tax systems which embody special provisions to address the problems associated with subjecting interest earnings to the same nominal m.t.r. as is applied to the individual's ordinary income from working. (This is discussed further in Section 2 below.)

1.4 Consequences of high tax rates on interest earnings on ADI deposits

The consequences for the Australian community of the situation described in Sections 1.1 and 1.2 above can be viewed as falling into two categories:

- For those with relatively high levels of wealth and income, who are either financially sophisticated themselves, or who are happy to pay for good quality financial advice and who are not highly risk-averse, the main response is likely to be in terms of the pattern of their wealth-holdings. They are likely to economise on their holdings in the asset categories attracting the highest EMTRs (i.e., ADI deposits) and put correspondingly higher proportions of their wealth and new saving into the relatively tax-advantaged vehicles, other things being equal.
- For those with relatively lower levels of wealth and income, who are financially unsophisticated and unwilling (or unable) to pay for good quality financial advice, or who are simply highly risk-averse, the main response is likely to be somewhat different. They are likely to continue to maintain substantial portions of their non-housing wealth holdings in ADI deposits, despite the high real EMTRs applying. Where ADI deposit holdings are pruned-back on, the money is less likely to find its way into alternative categories of financial assets and more likely to find its way into additional spending on goods and certain types of services. Personal use assets such as vehicles and other consumer durables attract taxation and transfer system treatment akin to that of owner-occupied housing, as the Government Discussion Paper points out on page 250. Even simply maintaining a better-stocked pantry is one way of insulating oneself from the full consequences of real EMTRs in excess of 100 per cent on the alternative of earning interest in a higher ADI deposit balance. Or one can alter the timing of buying replacements for ageing consumer durables.

[9] The same nine OECD comparator countries were focussed upon in the 2006 Australian Government Report *international Comparison of Australia's Taxes*. This quote is taken from page xv of that earlier Report.

Table 1.5 summarises the most up-to-date ABS statistics on the pattern of ADI deposit holdings in terms of levels of income and of wealth in Australia. Clearly when Australian households are "ranked" in terms of their net wealth, it is the lowest 20 per cent who hold far greater proportions of their wealth in ADI deposits than is the case higher up the wealth scale (see column 2 of Table 1.5). When Australian households are "ranked" in terms of their gross incomes, the concentration of high ADI deposit weightings in the lowest quintile is not so apparent. But here the much greater weighting of ADI deposits in the wealth holdings of the lowest 40 per cent of income-earners compared with the highest 40 per cent is readily apparent.

Table 1.5
Proportion (Per cent) of Total Household Assets Held in ADI Deposits, 2005/06
By Level of Gross Household Income and By Level of Household Net Worth

	Gross Income	Net Wealth
Lowest Quintile	5.2	6.8
Second Quintile	5.3	3.9
Third Quintile	3.8	3.3
Fourth Quintile	3.1	3.8
Highest Quintile	3.3	3.8
All Households	3.8	3.8

Source: ABS, *Household Wealth and Wealth Distribution* (Cat. No. 6554.0). Tables 6 and 10.

Table 1.6 presents data drawn from Income Taxation returns statistics. Here the focus is on interest earnings as a proportion of total income, rather than on deposit holdings as a proportion of total assets. And in the case of these Taxation returns data it is not possible to identify separately interest earnings on ADI deposits from interest earnings from other sources. Nevertheless, the pattern for income levels up to $100,000 reinforces the picture presented in Table 1.5, while the figures for the highest income brackets are likely to be affected by interest earnings on categories of financial assets more "sophisticated" than ordinary ADI deposits.

Table 1.6
Gross Interest Income* declared on individuals' income tax returns as percentage of
Individuals' total income declared 2005/06, by income bracket

Income bracket ($)	Percentage
6,001 to 15,000	4.3
15,001 to 20,000	3.8
20,001 to 25,000	3.4
25,001 to 30,000	2.7
30,001 to 40,000	1.9
40,001 to 50,000	1.6
50,001 to 60,000	1.4
60,001 to 80,000	1.4
80,001 to 100,000	1.6
100,001 to 150,000	1.8
150,001 to 500,000	2.0
500,001 to 1,000,000	2.0
1,000,001 or more	1.8

Note: * This includes interest earnings on debentures and bonds as well as on ADI deposits.
Source: Australian Taxation Office, *Taxation Statistics 2005-06*, Table 14.

In summary, the likely consequences of taking no action to address the present taxation treatment of interest earnings on ADI deposits are:

- **inequity problems.** Those bearing the brunt of the high real EMTRs on interest earnings on ADI deposits are *not* those Australians with the greatest capacity to pay tax. They are disproportionately lower-middle to middle income Australian working families and Australian households headed by a person who is near or above 60 years of age (see Table 1.7) ─ holding a modest overall level of wealth but financially risk averse.
- **a shortage of deposit funding for ADIs.** In recent months this has been disguised to some extent by a flight from more risky categories of financial assets by some Australian wealth-holders.
- **a perverse macroeconomic effect on household consumption-spending.** The high pressure of aggregate demand in the Australian economy puts upward pressure on inflation and nominal interest rates. But the higher inflation and nominal interest rates increase the real EMTRs on interest earnings on ADI deposit holdings. This causes some Australians of lower to middle income/and wealth to shift away from ADI deposit holdings into goods, which serves to maintain the level of demand pressure in the economy.

Table 1.7
Total Household Deposits-Holdings with ADIs, 2005/06
Breakdown by age of "reference person" in Household

Age of "reference person"	Percentage of Total ADI Deposits
15-24	1.1
25-34	6.9
35-44	12.9
45-54	20.0
55-64	23.2
65-74*	17.0
75+*	18.7

Note: * These ABS statistics cover Australians who live in self-contained "dwellings', the definition of which requires both cooking and bathing facilities for the sole use of that "dwelling". The ABS estimates that about 7 per cent of Australians aged 65 and over live in different types of accommodation. This means the proportion of total personal deposit holdings with ADIs held by the over 65s is somewhat greater than the 35.7 per cent appearing in the table (ABS, Cat. No. 6554.0, pp. 61-62).

Source: ABS, *Household Wealth and Wealth Distribution*, (Cat. No. 6554.0), Table 22.

2. Proposals for Ameliorating the Present Position

It has long been recognised that in an income taxation system that attempts to treat each dollar of a person's income in the same way as any other dollar of that person's income, a rise in the rate of inflation above virtually negligible levels can start to cause significant problems for the real effective rates of taxation imposed on ordinary interest earnings.

The Australian Government Discussion Paper released on 6 August 2008 described the Asprey Report of 1975 as Australia's "last fundamental review of the tax system."[10] The Asprey Report continues to enjoy a well-deserved high status among analysts and commentators on taxation policy in Australia.

Paragraph 9.78 of the Asprey Report stated: "the Committee considers that some form of concessional treatment should be provided for taxpayers in receipt of interest income."[11] The Asprey Committee gave some consideration to a thoroughgoing indexation approach to tackling this issue, but did not embrace that approach. Instead, it recommended that further consideration be given to measures that would not substantially add to the complexity of the nation's income tax system (as would thoroughgoing indexation), referring to these simpler-to-implement approaches as "*ad hoc* adjustments."

SACES agrees with the view that to attempt to address the issue of excessively high real EMTRs on interest earnings on ADI deposits via a thoroughgoing conversion of the whole tax system from a "nominal" basis to a "real" basis would not represent a wise approach. The remainder of this section focuses on approaches to ameliorating the present situation which would be simpler to implement and administer, and simpler for taxpayers to comprehend and comply with.

2.1 A full reform

In the Australian Government's 2006 Report on *International Comparisons of Australia's Taxes*, there is a discussion of the fact that there are two general approaches available for the taxation of a person's investment earnings, as distinct from their income from working:

A. treat investment earnings as ordinary income, aggregate the two and subject to a single personal rate scale;

B. "separate capital income from ordinary income, and tax it at different rates ─ so-called schedular taxation."[12]

While these two "general approaches" can be regarded as two "pure" (or "ideal") types, most countries have an income taxation system which in effect represents some form of amalgam of the two.

We normally think of Australia's system as being of Type A. But the treatment of investment earnings associated with superannuation, since the implementation of the most recent round of superannuation reforms, is now almost entirely separated from the taxation treatment of the remainder of a superannuation-fund-member's personal income. In effect we now have a separate "schedule" ─ to use the taxation jargon ─ for superannuation income. And the new

[10] Australian Government (2008), p. 5.

[11] Asprey, K. (Chairman), Lloyd, J. Parsons, R. and Wood, K. (1975), *Taxation Review Committee*, Full Report, AGPS, Canberra, p. 129.

[12] Australian Government (2006), p. 101.

First Home Saver Accounts (FHSA) arrangements can be thought of as sitting inside that schedule rather than in the "mainstream" schedule.

In addition to this separate schedule for superannuation, it would be possible to view the taxation treatment of income from investment in owner-occupied housing as representing in *de facto* terms a further separate schedule.

As was noted in Section 1.3 above, of the nine OECD comparator countries considered in the Government Discussion Paper, four have what amounts to a scheduler approach to the treatment of individuals' interest earnings. This boils down to a flat rate of tax collected and remitted by the entity which is the payer of the interest. The recipient of the remaining "after-tax" interest earnings typically is not required to declare that income on their own personal income tax return and there is no second layer of tax collection to bring the rate collected into line with the individual's m.t.r. on their "normal" income. These type of arrangement thus add to the simplicity of administration and compliance in the income taxation system.

One possible approach for Australian would thus be to shift Australia's income taxation system further along the spectrum towards a *schedular* system.

This could take the form of a separate schedule for the taxation of interest on ADI deposits with a flat rate of tax at 20 per cent or lower as in Ireland, Japan and Spain.

Or it could take the form of a new schedule covering a broader grouping of investment earnings categories (interest plus income from rental properties, perhaps) as in the Netherlands and in the taxation system of the Scandinavian countries.

2.2 A mechanism for immediate relief

To implement a proposal of the type outlined in Section 2.1 would clearly require considerable lead-time, and the Government may view a full scale reform of that type as needing to be considered as part of the broader Australia's Future Tax System (AFTS) Review process.

But given the extreme nature of the real EMTRs currently applying to interest earnings on the ADI deposit holdings of many low to middle income families in Australia, SACES would argue that consideration should be given to some readily-implementable measures which would provide immediate amelioration of that situation.

One approach would be for the Government to announce that for 2008/09 and 2009/10, during which the country's inflation rate is expected by the Reserve Bank to remain outside the normal target band of 2 to 3 per cent per year, interest earnings on ADI deposits held by individual Australian resident taxpayers will be subject to the same tax treatment as is currently enjoyed by capital gains on assets held for longer than twelve months. That is: the taxpayer would calculate the gross nominal interest earnings, deduct any allowable deductions incurred in earning that income, divide the result by two, and be taxed at their normal nominal m.t.r. on the resulting one half of the total nominal net investment income derived.

The proposal outlined above has the attractions of

- being straightforward to implement;
- being of a temporary nature with an easily-understood explanation of why a temporary change of this nature is called for; and
- being seen to provide a greater similarity of treatment between the person who holds an ADI deposit and the person who chooses instead to invest in capital-growth assets.

2.3 Seniors' Savings Management Accounts (SSMAs)

As an alternative to the proposal outlined in Section 2.2, it is suggested that consideration be given to allowing each resident Australian taxpayer who is above a specified age to operate a deposit account with an ADI (one such account only per individual), which has its interest earnings subject to a flat 15 per cent rate of tax which is collected and remitted by the ADI. As far as the individual's own personal income tax return purposes are concerned, that is then the end of the matter.

While this proposal only partially addresses the overall problem of excessively high real EMTRs on interest earnings on ADI deposits in Australia, it has the attractive features of:

- requiring only **minimal changes to the present architecture** of Australia's income taxation system;
- being **fully compatible with** a shift to converting Australia's present income taxation system to one based on a schedular approach;
- the portion of the Australian population for whom the excessively high real EMTR problem is addressed under this proposal holds at least half of total personal deposits with ADIs in Australia (see Table 1.7). Thus **the part of the problem that is addressed under this proposal is a substantial part of the problem.**

Government authorisation of ADI's offering Seniors' Savings Management Accounts with interest earnings subject to a flat 15 per cent tax rate would require only minimal changes to the present architecture of Australia's income tax system because the rules currently in place for Retirement Savings Accounts (RSAs) effectively already allow such an arrangement for certain categories of over 60 year olds.

- The investment earnings on an RSA are taxed at the rate of 15 per cent in the hands of the provider of the RSA;
- For an Australian who is over 60 and who is retired, money can be withdrawn from an RSA in "lump sums" of any size, and with any frequency, without this triggering any additional taxation consequences for the RSA holder;
- For an Australian who is over 60 and under 65, money can be deposited into the RSA, as "non-concessional" contributions, at any time and with any frequency (but subject to an aggregate cap of $150,000 per financial year) without this triggering any additional taxation consequences for the RSA holder or for the RSA provider;
- For an Australian who is over 65 but under 75, the same situation as described in the above dot point prevails **provided** that the RSA member satisfies a "work-test". This requirement is satisfied for the whole of a financial year once the RSA member has worked for at least 40 hours during a period of 30 consecutive days in that financial year.

One way of giving effect to a government authorisation of the broader SSMA accounts system proposed in this section would be for the Government to liberalise the present RSA rules by:

(a) eliminating the work-test requirements at present imposed on 65 to 74 year olds, in regard to "non-concessional" contributions into RSAs;

(b) eliminating the requirement to be "retired" at present imposed on 60 to 64 year olds, in regard to the withdrawal from RSAs of monies corresponding to "non-concessional" contributions;

(c) allowing Australians aged 75 and over to make "non-concessional" contributions into RSAs on the same basis as 74 and 73 year olds.

SACES recommends, however, that SSMAs be afforded a separate official recognition from RSAs. This would help make it clear to users that SSMAs are about "non-concessional" contributions (i.e., contributions made from **after-tax** money) only, and would not qualify for superannuation co-contribution treatment. The administration of RSAs is rendered complex in certain respects by the fact that RSAs are an integral part of the nation's overall superannuation system. The essence of the SSMA proposal is that SSMAs would attract the same 15 per cent flat tax rate at present applied to investment earnings accruing on RSA monies, but otherwise the SMA would operate (for those Australians qualified to hold one) in a simple and streamlined way as possible. With the exception of some cap on the aggregate deposits allowed to be made into an SSMA per financial year, it should be possible to allow an SSMA to operate as simply as an ordinary ADI deposit account.

If SSMAs were provided with a separate official recognition from RSAs, and all monies paid into them were "non-concessional" (or *after tax* money) with no qualification for co-contribution-type treatment, it is recommended that the qualifying age for being permitted to open and operate an SSMA should be somewhat below 60 years of age. Preferably it would be the person's 55^{th} birthday.