TAX DISTORTIONS AND RETAIL INVESTORS

While tax distortions are traditionally measured using marginal tax rates, or real effective tax rates (Henry Review Panel), empirical studies have identified six margins where tax affects investment decisions. Measuring selected Australian savings vehicles against those margins highlights tax distortions affecting retail investor behaviour. These findings have significance for tax policy makers and financial institutions, and for the current policy debate about the standards of tax knowledge mandated for financial planners and the exemption from financial advice licensing for tax professionals.

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tax rate, a defined asset holding period, an assumed inflation rate, a given level of leverage (where applicable), and independently of other asset holdings. However, understanding how tax affects decisions about asset allocation (including methods of holding and financing assets, and trading decisions) requires consideration of more than the RETR.

Poterba (1999) studied US household savings data to understand the behavioural effects of tax and determine the efficiency of the tax rules. The study sought to explain stylised patterns emerging from the behaviour and how tax incentives for portfolio assets affected interpretation of empirical results on non-tax variables. To undertake analysis of the data, he identified six margins along which investor behaviour with respect to tax could be considered. They are:

- Asset selection — which assets to hold;
- Asset allocation — how much to invest in each asset;
- How much to borrow;
- Asset location — legal structure within which to hold the asset;
- Whether to use a financial intermediary; and
- When to trade the asset.

The purpose of this paper is to categorise selected Australian savings vehicles along those six margins in order to examine tax distortions. This data can then be used to inform tax policy makers about the efficiency of the savings vehicles.

In addition, because those categories or margins overlay portfolio management concepts to taxation, it can be used to inform two current policy debates. The first is a debate about the minimum standard of tax knowledge that financial planners must have, and the second is about resolving the regulatory overlap between tax accountants advising on tax efficient savings structures and financial planners advising on tax efficient investments (Shorten 2011).

While the Poterba study excluded non-financial assets and structured financial products, these are included in this paper because of the importance of owner-occupied housing, business assets, rental housing and structured financial products as savings vehicles for Australians.

This paper demonstrates that tax rules distort the way that individuals invest by using six ‘margins’ as used in the Poterba study, suggesting that policy makers consider reforming the tax rules to prevent these distortions.

Asset selection

Asset selection means which assets retail investors will hold as part of their portfolio, and Poterba (1999) observed that asset selection is largely a function of the marginal rate of tax (MTR).

The Panel considered the taxation of a limited number of savings vehicles in terms of their tax neutrality by comparing their respective RETRs, which emphasised the tax distortions and, implicitly, their attractiveness as an asset class to retail investors. For the savings vehicles that were compared, the Panel observed that interest has the least favoured tax treatment. In contrast, shares benefited from the CGT discount and domestic shares from imputation credits. Rental properties benefited from the immediate use of losses but deferral of tax on gains, with their attraction further ‘driven by the CGT discount and exacerbated by leverage’ (AFTS 2010). Owner-occupied housing was zero taxed. These non-neutral treatments resulted in the recommendations of the Panel already mentioned.

Perhaps the most important tax preference of an asset class is shares in Australian companies that pay franked dividends. Broadly, Australian taxes paid by companies are imputed to shareholders who must include them as income but are entitled to a tax offset equal to the amount of the included credit. As the imputed tax credit is 30 per cent, shareholders whose MTR is equal to or less than that pay no tax on the dividends and are entitled to a refund if they are in tax loss: this makes these shares particularly attractive to superannuation funds. In addition, Australian shares benefit from the tax efficiencies associated with buybacks, where subscribed capital can be returned as an imputed dividend, with a potential tax loss.

As a way of mitigating the over-taxation of interest, the Government announced in the 2010–2011 Budget a 50 per cent tax discount on up to $1000 of interest earned by individuals on bank deposits.

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More recently, the finance markets have developed structured tax efficient retail investments, for example REITs (real estate investment trusts), that use borrowed funds to distribute tax-deferred, rather than taxable, REITs (real estate investment trusts), that use borrowed structured tax efficient retail investments, for example More recently, the finance markets have developed structured tax efficient retail investments, for example REITs (real estate investment trusts), that use borrowed funds to distribute tax-deferred, rather than taxable, REITs (real estate investment trusts), that use borrowed

Asset allocation
Asset allocation refers to how much of a portfolio is invested in each type of asset. Australia has a very high level of owner-occupied housing. Indeed, ‘66 per cent of the wealth at the fifth decile of the 65 and over age’ is in that asset class, although it is not clear whether that high rate reflects the way that it is taxed (no relief for interest or maintenance costs and proceeds on sale tax free) or whether it reflects its exclusion from the age pension means testing (Disney 2009).

Acquisition of owner-occupied housing has immediate tax inefficiencies in that non-deductible interest on funds used to acquire it has to be paid with after-tax income. Arguably, it is more tax efficient to retire non-deductible debt than contribute to a superannuation fund, thereby distorting what part of a portfolio is allocated to either (Knox 2003).

Financial institutions have attempted to exploit this distortion by offering a ‘split’ loan whereby part of it funded domestic housing and the other part funded an income producing investment, where the borrower could aggressively pay down that part for housing and defer repayment of that part for investment. This was subsequently disallowed by the High Court (Firth 2002).

However, the tax wedge between contributing to a superannuation fund or financing owner-occupied housing has, in principle, been mitigated by the First Home Owners Savings Accounts scheme. Under this scheme, depositors who contribute up to $5,500 under certain terms to an account that will be used to purchase a first home will be eligible for a Government contribution of $935 and earnings on the account are taxed at 15 per cent. If the funds are not used to acquire a house, they must be transferred to a superannuation fund.

Yet, notwithstanding the Government bonus and a tax rate equivalent to superannuation, they have not proved attractive as only 19 ADIs offer them and, as at 2010, there were only $110 million in 22,600 accounts, compared with the forecast of $6.5 billion by 2012 when introduced. This lack of attractiveness, however, has been attributed to the four-year lock-in requirement, rather than to tax factors (Johnson 2009).

Many households are also business owners and there are four tax features that influence the allocation of a portfolio to assets used in a business. First, business owners are outside the compulsory superannuation contribution system leaving them to use funds that otherwise would have been contributed to superannuation to acquire business assets.

Secondly, the Australian taxation system gives significant concessions on the sale of business assets provided that the owners’ total CGT (capital gains tax) assets are less than $6 million (or turnover is less than $2 million p.a.). Where these businesses are taxed, it is on a realisation basis, which provides tax deferral benefits and, also, efficiency benefits arising from the ability to control when the tax is paid.

Thirdly, the tax system implicitly recognises that business assets are a form of retirement funding and, in that regard, it integrates the taxation of business assets with the superannuation system. Business owners are given generous tax concessions in the form of increased contributions limits if they apply the non-taxable proceeds of the sale of their business assets to a super fund, implicitly suggesting that business owners should invest in business assets first and catch-up on superannuation later.

Fourthly, regulatory concessions allow business owners to transfer their business premises to their superannuation fund provided it is a self-managed superannuation fund (SMSF). This means that the business owner is then paying rent deductible at their MTR to their superannuation fund that is taxed at 15 per cent.

Finally, Australian superannuation funds have one of the highest allocations to equities among OECD countries. This is due to the previously mentioned attraction of imputation credits and the CGT discount. Indeed, such an allocation on the basis of preferential tax outcomes has been seen as ‘a questionable practice’ in terms of appropriate asset/liability management practices (Bateman and Kingston 2010).

How much to borrow
Treasury estimates that 70 per cent of rental accommodation provides a tax loss for owners. Australia is unique in that any annual tax loss from owning rental accommodation (where the interest and maintenance expenses exceed the rental income — negative gearing) can be offset against any other class of income (AFTS 2010). The United Kingdom, for example, requires that such annual tax losses be carried forward and offset only against the sale proceeds.

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able to access imputation credits. The Panel commented that negative gearing leads to taxpayers taking on excessive risk and distorts the allocation of resources in the economy (AFTS 2010).

Borrowing for the tax preference also seems to play a large role in structured retail investment products, such as agribusiness schemes and instalment warrants. In the case of agribusiness schemes, which is where the investor leases a small parcel of land and engages the promoter to plant, maintain, harvest and sell trees, the promoter often lends the investor part of the cost to establish the scheme and pay the first year's maintenance fees.

Instalment warrants, which are effectively deferred equity purchase agreements with the purchaser entitled to the imputation credits before the loan has been repaid, is an example of a tax distortion that was corrected in the 2011 Budget. The cost of the put option that protected the borrower against a fall in value of the asset had been included as part of an undifferentiated fee, including interest, which was fully deductible. Had the option cost not been 'wrapped-up' with the interest payment, the tax result would have been different (Brown and Davis 2005).

Asset location

Asset location refers to the legal structure within which the assets in a portfolio are held. In the Australian context, the most obvious tax aspect influencing where assets are held is the tax preferences given to superannuation funds (although the ability to use the tax benefit is limited by the contribution caps). 1 Indeed, for an investor over age 60, a superannuation fund that has paid tax and is now paying a pension is, in effect, a tax-free savings vehicle with neither personal MTR would borrow in the fund rather than borrow directly? The reason is that while the tax savings from the interest deductibility will not be as great inside the fund as if the borrowings were direct, any gain when the asset is disposed of will only be taxed at 10 per cent or zero. This is preferable to a 50 per cent CGT discount even if the individual is in a moderate or high tax bracket at the time of disposal.

There are three other distortions associated with the use of a superannuation fund.

First, investors only gain access to the Government co-contribution if a contribution is made to a superannuation fund.

Secondly, the contributor can redirect employment income (otherwise taxed at their MTR) which is taxed at 15 per cent and with no fringe benefits tax liability (salary sacrifice).

Finally, superannuation funds can be used to transfer prior-year contributions from one spouse to another without incurring tax so that sacrificed salary in one year can be transferred to a spouse tax-free in a subsequent year. Internal reallocation of fund assets to spouse's accounts are also non-taxable.

Financial Intermediary

A key decision for investors is whether to use a financial intermediary or to invest directly.

Largely, the choice of using a financial intermediary, rather than investing directly, is determined by non-tax issues such as the Management Expense Ratio (MER), ease of investment and access to otherwise inaccessible asset classes.

However, there are several tax aspects that influence the decision about whether to use a financial intermediary. The first is with respect to the efficient use of tax losses in a portfolio, where tax losses in a portfolio held directly can be used more efficiently, compared with their use in a portfolio held by a financial intermediary. A fund manager, for example, will not have regard to the individual investor's tax situation when managing the fund's tax losses.

Secondly, the tax characterisation of disposals can change in a financial intermediary (although this is under review (Exposure Draft)). For example, gains on disposal in a financial intermediary may not be entitled to the CGT discount, whereas there is a very low risk of that in a portfolio held directly.

Thirdly, the tax efficiency or otherwise of a financial intermediary is opaque as they report their returns pre-tax. However, that is currently changing with a number of fund managers now reporting returns to investors on an after-tax basis.

Finally, a tax preference which favours the use of financial intermediaries is re-emerging in the form of insurance bonds (Davis, Ralston & Higgins 2011). These are the only investments available in Australia that have rolled-up earnings at the corporate tax rate. This is attractive to investors who do not need annual distributions and who would otherwise be taxed at a MTR above that.

One particular issue that needs further research is whether there is any tax aspect that affects the choice between using a public offer superannuation fund rather than a SMSF. While a SMSF is technically not a direct investment,
because the trustees who manage the investment and the investors are the same people, it is, in effect, a direct investment. The tax laws do not discriminate between SMSFs and other types of superannuation funds, but regulatory laws do. The ability of a super fund to hold the contributor’s business assets is not available to super funds run by financial institutions, only SMSFs. Generally, the reason for investors to use a SMSF revolves around control of the investment, rather than the tax effect (SPAA/Russell 2011).

When to trade

Obviously the entitlement to the 50 per cent CGT discount (or 10 per cent nominal discount for a superannuation fund) depends on the asset having been held for at least 12 months. More importantly with respect to CGT, because it is a realisation-based tax, is the ‘lock-in’ effect where an investor will be reluctant to trade an asset because of the tax that will become payable.

Perhaps another tax aspect that impinges on the decision about when to trade is the MTR of the investor. The maximum value of negative gearing, for example, is achieved where the deductions are claimed when the investor has a high MTR and the tax on the sale is paid when the investor’s MTR is low (such as when they have left the workforce or a superannuation fund is in pension mode).

Conclusion

Tax distortions are traditionally measured by reference to MTR or, in the case of the Panel, RETR. However, this paper demonstrates that tax distortions of selected savings vehicles are also evident when viewed through the six margins identified by Poterba.

Clearly, viewing tax distortions in this way is important for tax policy makers, but given the interplay between investment management practices and tax efficient investment practices in these margins, this approach also has important implications for the public debates about the standards of tax knowledge mandated for financial planners and the exemption from financial advice licensing for tax professionals. It also has particular relevance for financial institutions in designing products for retail investors.

Notes

1. The inequity for superannuation contributors whose MTR is 15 per cent or less is in the process of being resolved (Treasury 2011).

2. In addition, an investor can borrow on a full-recourse basis and then on-lend the funds to the superannuation fund on a non-recourse basis as a method for getting around the contribution limits. The increase in the value of the asset accrues to the account of the superannuation fund but the credit risk on the borrowing resides with the investor.

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