BANK OF PAPUA NEW GUINEA

SUBMISSION TO THE TAX REVIEW COMMITTEE

ON

TAXATION IN SUPERANNUATION AND LIFE INSURANCE

9 MAY 2014

1) INTRODUCTION

This paper aims to bring to the attention of the Taxation Review Committee (TRC) issues relating to taxation in the superannuation and life insurance industries. This paper is in two parts and will firstly raise taxation matters concerning the superannuation industry and secondly, will highlight taxation matters pertaining to the life insurance industry.

2) SUPERANNUATION

The Papua New Guinea (PNG) superannuation system now has 570,119 members with total assets in excess of K8.6 billion as at 31 December 2013. The superannuation system is a source of pride for the government, employers, the members of the funds and the country as a whole. It provides the country with an enormous pool of investible funds that offer the potential to generate wealth and prosperity for our economy.

PNG has two pillar retirement systems: mandatory savings enforced through the *Superannuation (General Provisions) Act 2000* (Super Act) and Voluntary savings. The superannuation system is still yet to achieve its most important objective which is to deliver an adequate income in retirement for the members of the superannuation funds.

Some of this shortcoming is explained by the issues surrounding the previous National Provident Fund and the relative youth of the current system, with the members who are now approaching retirement having only received superannuation contributions for a limited portion of their working lives.

In addition, the superannuation system has been utilised to provide unemployment benefits for those members who experience unemployment during their working lives. The system has also been utilised to provide housing finance for members. Whilst access by members to both the unemployment and housing loans benefits is a desirable social benefit, it does represent leakage to the superannuation system, and ultimately reduces the capacity for the system to generate sufficient retirement incomes for members.

The current policy settings will not of themselves deliver an adequate level of income to the majority of those retiring over the next 20 years that we, as a nation, are aiming to achieve.

The superannuation system, as measured by a pool of assets, looks healthy. The K8.6 billion held has increased by an average rate of 12.25% over the past ten years, and funds are continuing to post good annual returns.

Growth is expected to continue over the next 20 years with the continuing growth of superannuation assets being underpinned by compulsory contributions by both employers (8.4%) and members (6%). The recent amendments to include all employers with 10 or more employees will also increase the percentage of the working population which is covered. The projections show the pool of assets growing to over K1000 billion by 2034.

The Bank hereby submits the following list of issues and recommendations on paragraph 3-16 below for the TRC's consideration:

3) ADEQUACY OF CONTRIBUTIONS

It is recommended that the TRC consider whether the current combined minimum level of member and employer contributions of 14.4% is adequate to enable the members to receive a reasonable level of income following their retirement.

At present there is considerable leakage from the superannuation system in the form of housing advances and unemployment benefits. Whilst these are valuable social benefits, it does impact on the ability of members to attain adequate levels of overall superannuation prior to retirement.

It is therefore recommended that the TRC consider increasing the level of employer and member contributions to a higher level of around 18% in total.

4) ADEQUACY OF ACCESS TO SUPERANNUATION IN THE COMMUNITY

Whilst the recent amendments to include all employers with 10 or more employees will increase the percentage of the working population which is covered by superannuation, the system does not cover all employees and is currently open to abuse.

It is recommended that the TRC consider the benefits which would be derived by extending compulsory superannuation to <u>all</u> employees of <u>any</u> employer and also the benefits which would be derived by removing the current three month period which applies before contributions must commence.

To apply this to all employees working a minimum number of hours would be expensive for the employer and a deterrent to casual employment.

It is therefore further recommended that the superannuation must apply to all employers for any employees:

a) who is aged 18 years or over and the employee earns K450 or more (before tax) per month; and
b) who is under 18 if:
    i) the employee earns K450 per month; and
    ii) the employee works more than 30 hours in a week.

Such a move would significantly increase the percentage of the population covered, and the removal of the three month period which applies before contributions must commence will reduce the scope for abuse of the system which currently occurs.

This increase in superannuation cover, regardless of the total number of employees, will have flow on benefits such as access to housing and unemployment benefits for all employees and their families and will extend the coverage of both superannuation and life insurance (*see item 16 regarding compulsory life insurance below*) to the entire working population. This extended coverage would have significant social and economic benefits for the country.

5) AGE OF RETIREMENT

It is recommended that the TRC consider whether the current retirement age of 55 should be increased to a higher level. The mortality rates within the employed population are increasing with access to better health care and government services.

The current retirement age of 55 enables people who are still capable of active employment and contribution to the wealth of the country to leave the workforce. The current retirement age of 55 also means that the period of employment during which a member is able to save for their retirement via employer and member contributions is not as long as it would be if the retirement age was moved to a later age of 60. The move to later retirement ages has been applied throughout the world as the longevity of the population grows.

6) TAXATION ON RETIREMENT BENEFITS

The tax treatment for retirement benefits is very complicated as detailed below:

a) Normal concessional rate is applied – (on the interest and gratuity only).
b) Tax Rate applicable to benefit payments are –
   i) Concessional Rate of 2%;
   ii) Concessional Rate of 8%; or
   iii) Concessional Rate of 15%.
c) Concessional Rate of 2% applies where the payment was –
   i) Accrued prior to 1 January 1993;
   ii) For contributions made by the employer for more than 15 years;
   iii) For contributions made by the employer for more than 7 years, where the employee is no less than 50 years of age;
   iv) For contributions made by the employer for more than 7 years, where the employee is subject to forced early retirement; and
   v) Made as a result of the death or permanent disability of the employee.
d) Concessional Rate of 8% applies when the years of contribution is not less than 9 years and not greater than 15 years. i.e. 9 – 15 years = 8%.
   (Note that if the member is 50 years and over and had worked over 7 years, then he is entitled to a concessional rate of 2% as mentioned above).
e) Concessional rate of 15% applies when the years of contribution is not less than 5 years and not greater than 9 years. i.e. 5 – 9 years = 15%.
   (Note that if the member is 50 years and over and had worked over 7 years, then he is entitled to a concessional rate of 2% as mentioned above).
f) Benefit payments to Defence Force Retirement Benefit Fund members:
   i) Under 20 years of service, tax would be same as above;
   ii) Concessional rate of 2% is applied on the 60% portion which is the state share if eligible for a pension (more than 20 years of service);
   iii) The annual pension apportioned into 60/40 which is the State and Fund portions respectively. The pension is subject to the income tax rule only for 60% portion which is the State share.
   iv) In accordance with the *Income Tax Act 1959*;

(1) If the pensioner has an annual income less than K10,00.00, pension is tax-free;
(2) If the pensioner's annual gross income is more than K10,000.00 but less than K18,000.00, pension is taxed at 22%;
(3) If the pensioner's annual gross income is greater than K18,000.00, pension is taxed at 30%; and

g) And there is a tax of 2% on the benefits paid out if a member dies.

It is recommended that the TRC consider simplifying the current level of taxation on superannuation benefits which are taken as a lump-sum as the complications of the calculations are an administrative cost paid for by all members and are a serious operational risk due to the complexity of the calculations involved.

However, it is recommended that the overall taxation taken from lump sum retirement benefits not be reduced as an inducement to members to take their retirement benefit in the form of a compulsory pension. *See item 8 below for further details.*

7) TAX ON BENEFIT PAYMENTS IF A MEMBER DIES

Currently there is a tax of 2% on the benefits paid out if a member dies.

It is recommended that the TRC consider the benefits of removing the taxation on the benefits of a member who dies as it reduces the funds available to support the dead member's family and it raises little tax income.

8) COMPULSORY PENSIONS

The long standing weakness in the superannuation system is that members take the accumulated balance in their account on retirement as a lump sum. This lump sum is then rapidly dissipated to family and extended family members resulting in the member being unable to derive an income during their retirement.

The significant proportion of superannuation benefits which are taken as a lump sum also has a dampening effect on the level of post-retirement assets held within the superannuation system, and therefore reduces the overall level of superannuation assets held available for investment within the country by the superannuation industry.

If the superannuation system was changed to both mandate and encourage members to take their retirement income in the form of a genuine lifetime term annuity or lifetime pension instead of a lump sum, this weakness in the current system could be addressed. By pooling the retirement savings in a collective term annuity or lifetime pension scheme operated by the Authorised Superannuation Funds (ASF) in this country, the ASFs, which are residents in PNG and are authorised by the Bank of Papua New Guinea (Bank) would be able to pool the longevity risk where the assets, not needed and held in respect of those who die at younger ages, are made available to support continuing income payments, to those who live to a more advanced age.

There are significant benefits to both the members and to the economy of the country in forcing and encouraging retirement savings to be taken in the form of genuine term annuity or lifetime pensions rather than as lump sums. These additional benefits include:

a) The member having a guaranteed income stream in retirement for either a fixed period – for example 15 years (a term annuity) – or until death (a life-time pension);
b) The superannuation fund assets will be retained in the finance system rather than being immediately dissipated after a member retires. This pool of assets will provide the country with an additional pool of investible funds that offer the potential to generate wealth and prosperity for our economy;
c) The requirement that the fund must be resident in PNG and be authorised by the Bank would ensure that the benefits remain in the country and are not transferred for the benefit of another country; and
d) The creation of either term annuity or life time pensions to be provided by an ASF which must be resident in PNG and be authorised by the Bank will ensure that the products are managed for the best interests of the members, are genuine and that the term annuity or lifetime pensions are actually paid and are not subject to poor investment or fraudulent practices. The Bank would have oversight of the pension divisions of each of the ASF and would introduce prudential standards to ensure adequate actuarial input and segregation of risks between the pension section and the accumulation section of each ASF.

It is recognised that the introduction of mandatory term annuity or lifetime pensions instead of the current lump sum option will be resisted by members as the members have become accustomed to taking their retirement benefits as a lump sum. However, the current lump sum option effectively means that the retirement savings are immediately dissipated apart from a very small number of well-informed members who have significant account balances and who use these balances to purchase term or lifetime annuity products from overseas.

The current *Income Tax Act 1959* provides that the income held by ASFs in what are called "Retirement Savings Accounts" (RSA) is tax exempt. However:

i) there is currently no definition of what is an RSA;
ii) failure on behalf of at least one major fund to adequately account for RSA assets and to claim the tax exemption – to the detriment of the members; and
iii) failure on behalf of all funds to give the benefit of the tax free income on RSA assets to the members who have the RSA assets. Rather, if the tax benefit has been claimed, it has been spread to the benefit of all members.

It is recommended that the TRC consider recommending that all benefits above a certain threshold, say K20, 000, must be taken in the form of a term annuity or whole of life pension and that the income held in the ASFs for the payment of these pensions be tax free as currently applies to the RSA accounts. This would have the advantage of enabling the ASFs to provide a higher level of pension payments than would otherwise be the case if the income was taxed.

9) HOUSING ADVANCES

Currently, housing advances paid from members accounts balances held in ASFs to enable an employee to purchase his or her first home are not taxable at the date of the advance provided the cost of the property is K75, 000 or less.

It is recommended that the TRC review this threshold and consider removing it or moving it to a higher level which is more reflective of the actual costs of housing, and will not act as a dis-incentive to people using the advances from the members benefits to acquire what is arguably the single most important asset to enable a sustainable level of living and retirement.

10) CONTRIBUTIONS BY EMPLOYERS TO AN OVERSEAS BASED SUPERANNUATION FUND

Currently, an employer is not entitled to a tax deduction for contributions made to an overseas based superannuation fund.

It is recommended that the TRC does not change this as employers should be encouraged to make contributions to a superannuation fund which is resident in PNG and authorised by the Bank to generate wealth and prosperity for our economy.

11) TAX DEDUCTABILITY FOR EMPLOYER CONTRIBUTIONS

Whilst there are special rules for certain companies including life insurance companies, non-resident insurers, mining, petroleum and gas companies and ship-owners, the calculation of taxable income generally corresponds to accounting income and with regard to superannuation, the employer is permitted to deduct the employer's contributions to a fund which is a resident in PNG and authorised by the Bank. However, this deduction is currently limited to 15% of an employee's fully taxed salary or wages.

It is recommended that the TRC consider increasing the current cap of 15% to a higher level to enable an employer to obtain a tax deduction for employer contributions made in excess of 15% of an employee's fully taxed salary or wages to enable an employer to voluntarily increase the level of contributions being made for employee's to enable the employee's to accumulate adequate savings through their working lives to enable them and their families to live adequately in retirement.

12) TAXATION ON RESIDENT SUPERANNUATION FUNDS

The current tax on ASFs is summarised below:

a) The taxable income of a resident superannuation fund is subject to a rate of tax of 25%;
b) Dividends paid to a superannuation fund qualify for the dividend rebate and are exempt from dividend withholding tax if the fund is an ASF; and
c) Where an employer's contributions to a superannuation fund exceed 15% of an employee's fully taxed salary or wages, the excess contribution is included as assessable income of the superannuation fund. Although, how the superannuation fund is able to assess whether the employer's contributions exceeds 15% of an employee's fully taxed salary or wages is difficult to comprehend.

Investment returns on superannuation assets are a significant contributor to the growth of the superannuation industry. The current tax rate of 25% on all superannuation fund income is an impediment to the rate of growth in superannuation which undermines the most important objective of superannuation which is to deliver an adequate income in retirement for the members of the superannuation funds.

The current tax rate imposed on the ASFs of 25% for contributions by an employer for contributions in excess of 15% of an employee’s fully taxed salary or wages together with the lack of tax deductibility for such contributions for the employer also acts as an impediment and a dis-incentive to employers and to members making additional voluntary superannuation contributions, with the level of voluntary member contributions currently being negligible.

It is recommended that the TRC consider recommending the reduction in the rate of taxable income of a resident superannuation fund from the current 25% to a lower rate to make superannuation and superannuation savings an attractive form of investment and to assist in working towards its most important objective which is to deliver an adequate income in retirement for the members of the superannuation funds.

13) DOUBLE TAX TREATIES

Double tax treaties have been entered into with Australia, Canada, China, Fiji, Germany, Korea, Malaysia, Singapore and the United Kingdom although it is unclear whether Germany has ratified the treaty.

As the ASFs may have up to 35% of the total assets invested overseas, it is highly desirable that the rate of tax applied in the overseas jurisdictions is reflective of the level of tax applying to ASFs which are resident in PNG and which are authorised by the Bank.

In addition, it is recommended that the TRC recommends the extension of the double taxation treaties to the USA and into the new and emerging markets in the Pacific region and in Asia to enable the superannuation industry to diversify asset concentration risks beyond the current range of countries which have double tax treaties in place with PNG.

14) NON-CITIZENS

In general, non-citizens make their own retirement plans through overseas superannuation funds, investment schemes, or do without. As such this country misses out on the tax on the earnings of the employer and employee contributions which would have to be paid if the employers of all non-citizens were required to contribute to a superannuation fund which is resident in PNG and which is authorised by the Bank.

In addition, by not requiring that all the employers of all non-citizens contribute to a superannuation fund which is resident in PNG and which is authorised by the Bank, there is no encouragement for non-citizens to maintain their accounts in this country or to stay longer in the country.

It also makes it difficult for the Bank to determine if all employers are meeting their superannuation obligations under the Super Act if non-citizen employees are exempt.

To be eligible for a tax deduction, it is therefore recommended that all employers be required to contribute to an ASF which is resident in PNG and which is authorised by the Bank and those benefits can only be released by an ASF on proof of permanent departure from the country by the non-citizen.

15) INEFFICIENCIES AND ADDITIONAL ADMINISTRATIVE COSTS CAUSED BY EMPLOYERS PROVIDING INADEQUATE DATA

The failure of employers to provide adequate data to the ASFs to enable the contribution to be linked to the member results in “unallocated contributions”.

Unallocated contributions comprise approximately 140,000 member’s accounts or 28% of all member accounts. Unallocated contributions require the creation of “dummy accounts” within the superannuation fund administration platforms which represent a serious fraud risk with the superannuation system.

But more importantly, “dummy accounts” are a significant cost burden on the entire superannuation system.

It is recommend that where an employer fails to provide the prescribed minimum required bio-data with superannuation contributions, that the employer be penalised by not being able to claim the contributions as a tax deduction.

In addition, to reduce the "unallocated contributions" it is recommended that all employers be compelled to provide the Taxpayer Identification Numbers (TIN's) for all superannuation contributions and that failure to do so would be punishable by a suitable penalty such as a fine and that the Internal Revenue Commission make a concerted effort to ensure compliance.

16) COMPULSORY LIFE INSURANCE

It is recommended that the TRC consider the benefits which may be derived by the members of the ASFs, their dependents, the community and the insurance industry and the economy of PNG by enabling ASF to provide life insurance on an "opt out" basis. "Opt out" means that, all members would be provided with life insurance cover, but that they could complete a written direction to their ASF to "opt out" of the life insurance cover.

This would ensure that a significant percentage of the members of the ASFs and their dependents were provided with the benefits of having life insurance cover. In addition, by requiring that the life insurance cover could only be provided by a life insurance company which is resident in PNG and which is authorised by the Bank. There would be a significant increase in the premiums paid to the life insurance industry in PNG with the consequential benefits for the life industry, the economy and the finance industry overall.

17) LIFE INSURANCE

The life insurance industry in the country is relatively small with 40,713 policy holders and assets of K436m as at 31 December 2013. The introduction of mandatory lifetime annuity or pensions will assist in the growth of the life insurance industry and will enable the more effective penetration of life insurance into the wider population. Life insurance is a valuable social and economic benefit.

A study of human history reveals a universal desire for security and the quest for security has been a potent motivating force in material and cultural growth. Early societies relied exclusively on family and tribe cohesiveness for their security. In this country, we still rely to a great extent on the wantok system. From the individual's perspective, life insurance offers many advantages:

a) Life insurance guarantees to pay a stated sum to a family on the death of its income earner(s). In so doing, it affords families a measure of protection:

i) against the adverse financial consequences of premature death, gives individuals a greater sense of economic security, and can help reduce worry and distress and thereby increase initiative.

b) No other privately purchased financial instrument can perform this function.
c) Cash value life insurance can serve as a means through which individuals save. Many persons who might not otherwise save consistently will, nonetheless, regularly pay their life insurance premiums; thus, life insurance might constitute a type of quasi-compulsory savings.
d) Life insurance can permit more favourable credit terms to borrowers – both individuals and businesses can decrease the risk of loan default.
e) Life insurance can also minimise the financial disruption to businesses caused by the death of key employees.

Apart from the social role it plays by providing security, access to credit etc - life insurance can also assist economic development in general and the development of financial markets in particular. Because the insurers have thousands of policyholders, insurance companies are able to amass quantities of funds that are important in supporting investment and the national economy. This would also aid the development of the market for long-term government bonds, which greatly expands the options for government debt management.

Therefore, the Bank hereby submits the following list of life insurance issues on paragraph 18-23 below for the TRC's consideration:

18) DEATH BENEFIT

Currently death benefit payments made by an authorised life insurance company are not taxed in the hands of the recipients.

It is recommended that this tax free status remain to encourage people to take out life insurance cover.

19) TAX DEDUCTION ON GROUP LIFE COVER

Currently companies that take out group life cover get a tax deduction as part of their operating expenses and this reduces their taxable income.

It is recommended that this deduction only be allowed where the group life cover is provided by a life insurance company which is resident in PNG and which is authorised by the Bank.

20) KEY MAN INSURANCE

Currently companies that take out "key man" insurance to deal with business interruptions if a key person dies get a tax deduction as part of their operating expenses and this reduces their taxable income.

It is recommended that this deduction only be allowed where the "key-man" insurance cover is provided by a life insurance company which is resident in PNG and which is authorised by the Bank.

Further, any payments made by a life insurer under such a policy are taxable in the hands of the company as normal income.

It is recommended that this tax treatment continue as it encourages employers to cover "key man" risk, but it recognises that the benefit from the policy is assessable income.

21) TAX ON INDIVIDUAL LIFE COVER

Individuals who take individual life cover do not get a tax deduction for the amount of the policy payments.

It is recommended that the TRC consider enabling individual taxpayers who voluntarily take out life insurance cover which is provided by a life insurance company which is resident in PNG and which is authorised by the Bank, to be allowed to reduce their taxable income to encourage individuals to acquire life insurance protection for themselves and their families.

22) LIFE INSURANCE PRODUCTS WITH A SAVINGS COMPONENT

Some life insurance products may be offered which include a savings component. At the moment the income on savings component of such a life insurance policy is taxed in the hands of the life insurer at the normal corporate tax rate.

The following recommendations are made with regard to such life insurance products provided by a life insurance company which is resident in PNG and which is authorised by the Bank:

a) That the life insurer be required to maintain the assets held for the savings component of the life insurance product separately from the other assets of the life insurer;
b) That the income on the assets held for the savings component of the life insurance product be either tax free or concessionally taxed to encourage individuals to purchase such life insurance with an attached savings component;
c) That the life insurers be required to credit to the policy holders account balance the full earnings net of whatever tax rate is determined as being appropriate by the TRC; and
d) That the policy holders of such life insurance products be allowed to drawn down on their savings component for the purpose of assisting with the home purchase or repairs in the same manner as applies to superannuation funds or using it as security for a loan to an Authorised Deposit-taking Institution for such purposes.

The benefits of accepting these suggestions are as follows:

i) It would enable the life insurance companies to offer a life insurance product which had an attached concessionally taxed savings component. This would aid penetration of life insurance and savings into the broader population; and
ii) Enabling the savings component of such a policy to be accessed by the policy holder as a low cost loan for housing using the policy holders own savings would provide additional access to finance in the community.

23) MULTIPLE REGULATORS OF INSURANCE

It is recommended that the TRC consider the benefits which may be derived by the policy holders, the insurance industry and the economy of PNG by having the regulation, licensing and supervision of both life insurance and general insurance consolidated under the Bank of Papua New Guinea.