Treasury portfolio technical amendments

FSC submission

October 2019

Contents

1 About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in Australia's largest industry sector, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing $3 trillion on behalf of more than 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

2 Introduction

The FSC welcomes the opportunity to make a submission on the draft Miscellaneous amendments to Treasury portfolio laws 2019.

The FSC commends the Government and Treasury for considering and drafting technical amendments to ensure legislation operates as intended. We encourage this to be a regular and ongoing process so that other technical issues are identified and fixed.

The FSC supports the intent of the draft amendments, including the following:

- Clarifying when a person has been 'involved' in a contravention of the SIS Act – see draft Explanatory Memorandum (**EM**) at paragraphs 1.38 and following.
- Amendments relating to Protecting Your Super (see EM at paragraphs 1.42ff).
- Correcting a cross reference relating to legislation requiring employers to report superannuation salary sacrificing through Single Touch Payroll (EM at 1.50ff).
- Amend the meaning of 'taxi' in the FBT Act to align with the GST Act (EM at 1.60ff).
- Amendments to ensure the superannuation downsizer contribution rules work as intended (EM at 1.79ff).

However, the FSC has a number of additional areas where we consider technical amendments to legislation and regulations are warranted; these are detailed in the rest of this submission. The FSC considers many of these amendments are just as important as the amendments proposed in the draft amendments that are subject to the current consultation.

3 Superannuation

3.1 Protecting Your Super

The implementation of the Protecting Your Super (**PYS**) changes was complicated by a significant number of drafting issues in the legislation as passed. Similar issues have been identified with the Putting Members Interests First (**PMIF**) legislation as recently passed by Parliament.

We note APRA has also advised industry that the Government intends to pursue certain amendments to the PYS measures, however these have not yet been legislated.

In addition, a range of further technical amendments should be implemented to improve the operation of PYS and PMIF. These include the amendments listed below.

Issue	Suggested Amendment
Separation of MySuper/Choice products Wording requires choice and MySuper products to be treated separately even when part of one account. This issue is applicable across all PYS and PMIF measures. Particular question re: application of fee cap at exit from a product, even when switching products within one account.	Amend legislation (as indicated in 28 June ASIC note) to remove references to “product” and replace with “account”.
Traditional style products On 28 June 2019, APRA advised industry that the government intends to pursue amendments to PYS to allow for an exemption of traditional style legacy products (including whole-of-life and endowment products) that would result in significant member detriment if insurance was cancelled. The ATO subsequently published updated guidance confirming amendments would also apply to legislation supporting the transfer of inactive low balance accounts to the ATO.	Amend legislation (as indicated in 28 June ASIC note) to explicitly exclude traditional style products. We recommend the amending subsections 68AAA(6) and 68AAB(4) to specifically exclude whole-of-life and endowment products (rather than relying on indirect wording). No changes are required for the provisions regarding members under 25 as these legacy products are closed to new members.

Issue	Suggested Amendment
Customers with active or pending insurance claims There is no protection for customers receiving insurance benefits, or whose claim is being assessed, and who may not presently be making premium payments towards their insurance policy or contributions into their superannuation account. While cancelling insurance due to inactivity or low balance is unlikely to have an impact on the claim itself, it may affect the member's ability to make further claims (eg it is not uncommon for a member receiving Salary Continuance insurance payments to later make a TPD claim or face a higher likelihood of death). Amendments should mirror wording used in Sch 1 of the SIS Regs when referring to SCI/income protection and the wording used in the insurance covenant in subsection 52(7) of the SIS Act when referring to pending claims.	At the end of ss 68AAA(6) and 68AAB(4) add: *"(e) a member who has a temporary incapacity and is receiving a non-commutable income stream from the fund for the purpose of continuing (in whole or part) the gain or reward which the member was receiving from employment immediately before the temporary incapacity; or (f) a member in respect of whom the trustee is pursuing an insurance claim."*
Risk-only super products Risk-only superannuation products involve intentionally structuring insurance into superannuation. These products have a nil balance and as such are not exposed to the risk of balance erosion. Further, the insurance cover held in these products is not allocated on an opt-out basis but rather can only be provided by member election and is usually subject to underwriting. For these reasons, risk-only superannuation products should be exempt from the application of the PYS & PMIF insurance changes with respect to inactive and low balance accounts and accounts held by members under age 25.	Amend subsections 68AAA(6), 68AAB(4) & 68AAC(4) to specifically exclude risk-only products.
Inactivity due to fund being on a contribution holiday Where a hybrid DB/DC fund is in surplus and SG contributions are being made from the fund's reserves, this does not meet the definition of "amount received in respect of a member" and the account is therefore inactive for insurance purposes.	Amend s68AAE to account for circumstances where funds are in surplus.
Providing election notices electronically The Electronic Transactions Regulations currently exclude most notices under the SIS Act as being subject to the application of the Electronic Transactions Act.	Amend Sch 1 of the Electronic Transactions Regulations so that notices under s68AAA of SIS may be provided in electronic format.

Issue	Suggested Amendment
Fee cap calculation in leap years S99G(5) does not account for calculation of fee cap in leap years.	Amend s99G(5) to refer to number of days in the year, rather than 365 days.
Overlap of notifications for inactive and low balance accounts Due to the existing requirement under Corporations Regulations 2001 reg 7.9.44B to issue inactivity notices to members (7, 4 and 1 month prior to expected cancellation of insurance due to inactivity), some members may receive both an inactivity notice and a low balance notice within a short period of time. These notices will refer to different cancellation dates and therefore will likely confuse members, and may cause these notices to be misleading. Transition provisions for PMIF should ensure that members who have already been provided an inactivity notice are not required to also receive a low balance notice.	Amend 68AAB(3) & 68AAC(3) to insert a reference to 68AAA(2). Preferably add a sub-s to 68AAA with equivalent text
Paid up to date We understand the policy intent for PYS and PMIF is that members can continue to be covered up to the date to which they have already paid premiums however this is not clear from the drafting of the legislation.	Amend subsections 68AAA(7) and 68AAB(5) to make clear the intent that a trustee is not required to cease to provide an insurance benefit until the date for which premiums have been paid.
Uncontactable members The Corporations Regulations provide exemptions for communications relating to accounts, including issuing periodic statements, where the trustee has no address or has an incorrect address for the member and after making reasonable attempts has been unable to contact the member. No similar exemption exists for notices relating to the PYS or PMIF notices.	ss. 68AAA & 68AAB of SIS and Corps Reg.7.9.44B & 7.9.44C: Add a new sub-section/subregulation to all 4 provisions based on the equivalent in items 14.1 to 14.4 of Schedule 10A of the Corporations Regulations.

Issue	Suggested Amendment
Insurance elections to continue to have effect following SFT Where a member has provided an insurance election to a fund that is subsequently subject to a successor fund transfer (**SFT**), the election should continue to have effect in the receiving fund to minimise the risk of these members unintentionally losing their insurance benefit. The trustee record that an account/product has reached $6,000 on or after the stocktake date should also be permitted to be transferred and continue to have effect in the successor fund.	Amend PYS legislation to specify that member opt-in elections and record that an account/product has reached $6,000 are considered enduring where a successor fund transfer or intra-fund transfer occurs.
Employer-sponsored exception The wording of the legislation appears to require an employer to notify the fund in respect of each member covered by the premium payment arrangement on a quarterly basis. It seems inefficient for an employer to provide the same notification each quarter in respect of each employee.	Amend subsection 68AAE(1)(c) SIS Act from "<u>the</u> quarter ends after the employer-sponsor notifies the trustee …" to "<u>*a*</u> quarter ends after the employer-sponsor <u>*first*</u> notifies the trustee …"
Timing of right to cease insurance notices A notice confirming that a member has made an election to retain their insurance despite inactivity is currently required to be given to the member within 2 <u>calendar</u> weeks. "Given" is commonly understood to be *received by the member*. This period is too short given Australia Post's standard mail delivery time is 5 <u>business</u> days. This period is further shortened with public holidays and is effectively 2 business days over the Christmas-New Year and Easter-Anzac Day periods. While acknowledging these are important notices, the FSC recommends that the long-standing notification requirement for all other confirmations in reg.7.9.16F(5) of the Corporations Regulations be adopted for these notifications too. That is, "as soon as is reasonably practicable after the transaction occurs."	Corps Reg.7.9.44C(4)(a) substituting "within 2 weeks" with "as soon as is reasonably practicable".

3.1.1 Payment of rebates from a reserve

The ATO's Frequently Asked Questions on PYS[1] says (at 10c) that where a 3% fee cap refund is paid from a reserve, and allocated to a member's account, it will generally be a

[1] See https://lets-talk.ato.gov.au/22361/documents/106138/download

concessional contribution for the member unless it meets one of the exceptions specified in sub-regulation 291-25.01(4) of the Income Tax Assessment Regulations 1997 (**ITAR 1997**).

FSC members consider this to be a significant unintended consequence of PYS. Needing to cater for reporting of fee cap refunds in these circumstances will add a significant administrative burden for funds that need to process cap refunds via a reserve. It also does not meet the policy intent of the fee cap – allowing a rebate system was intended to ease administration of the fee cap, not to create additional consequences for funds and members where this approach is used.

Therefore, the FSC proposes that a technical amendment be made to exclude 3% fee cap rebates from being caught as concessional contributions in any circumstances, for example by adding fee rebates to the exceptions in regulation 291-25.01 of the ITAR 1997.

3.2 Technical tax and super amendments

The FSC made a submission earlier in 2019 advocating for a number of technical amendments to superannuation legislation and regulations, in particular:

- Reform to market-linked pensions – the FSC's preferred approach is to permit these products to be rolled over into more contemporary retirement income stream products where they will be assessed according to the $1.6m transfer balance cap.
- Ensuring death benefit rollovers are not subject to tax.
- Ensuring capped defined benefit income streams subject to a SFT continue to be treated as a capped defined benefit income stream in the successor fund.
- Changing the definition of life-expectancy period for innovative income stream products to account properly for leap years.

The full FSC submission is at Attachment A. The FSC remains of the view that these amendments should occur.

3.3 Inadvertent breaches of the Transfer Balance Cap

A superannuation fund member can trigger an inadvertent breach of the Transfer Balance Cap (TBC) where they transfer assets *in specie* from one fund to another, and the balance increases in the second fund before the member starts a pension in that fund. This is because the TBC calculation in the second fund occurs when the pension starts, not when the balance transfer occurs.

A delay between the cessation of a pension in the first fund and the commencement of the new pension in the second fund can occur for many reasons. For example, an *in specie* transfer of assets might occur from an SMSF first and then the cash might be rolled over shortly afterwards and this delays the start of the new pension. There will always be a delay between the stopping of one pension and the commencement of a new pension.

A similar issue can occur when assets are transferred in cash and interest accrues in between ceasing one pension and starting the next.

A failure to address this issue will adversely affect competition between super funds in relation to members who are at or near their TBC – the TBC calculation will mean many of these members will effectively be stuck in their current fund unless the benefits of transferring to a new fund are substantial, more than enough to offset the cost of a potential breach of the TBC.

The FSC has raised this issue with the ATO and they have indicated they are unable to address this issue administratively. Therefore, the FSC considers a legislative solution is required.

We recommend there should be an amendment to indicate the commencement value of a superannuation pension equals the amount included on the rollover statement if the pension is commenced within a certain number of days from the date of rollover.

4 Tax

4.1 Investment Manager Regime

The FSC has previously raised concerns with the ATO's interpretation of the Investment Manager Regime (**IMR**), see Attachment B.

On 19 July 2017, the Government indicated it will "consult on whether a legislative amendment is required to ensure that the engagement of an Australian independent fund manager will not cause a fund that is legitimately established and controlled offshore to be an Australian resident. Any legislative amendment would be retrospective to apply from the start of the IMR regime in 2015".[2]

This issue remains unresolved and is an important issue for the FSC. We encourage the Government to increase the priority placed on resolving this issue. We note a change to address this issue should be classified as a technical amendment as it will ensure the IMR operates as intended.

4.1.1 IMR treatment of gains on debt funds

Under the IMR, gains such as loan fees, which are common in debt funds, are not exempt from tax, as only gains on disposal are exempt. By contrast, all gains on derivative instruments are exempt, regardless of whether they relate to a disposal of the instrument. This appears to be an oversight that was not raised when the IMR rules were drafted.

We therefore recommend that a technical change be made to provide for an IMR exemption on gains relating to debt.

4.2 Expand AMIT coverage to platforms, wraps and master trusts

In a 19 July 2017 announcement, the Government indicated the following: "While this amendment [relating to single unitholder widely held entities] will not extend to including

[2] See: http://ministers.treasury.gov.au/ministers/kelly-odwyer-2016/media-releases/improving-australias-financial-services-taxation-regime

platforms, wraps or master trusts (commonly referred to as Investor Directed Portfolio Services) in the list of deemed widely-held entities, the Government will consult with industry on broadening the eligibility for these widely held entities to access the concessional tracing rules as part of the Corporate Collective Investment Vehicle public consultation process."[3] (text in square brackets added).

This issue remains unresolved and has not yet been included in the consultation for the Corporate Collective Investment Vehicle. We encourage the Government to progress this issue as well through amendment of the AMIT provisions to avoid further delay.

4.3 Allow AMITs to access rollover provisions relating to CGT event E4

Certain CGT rollover provisions for trusts only operate if CGT event E4 is capable of applying to all of the units and interests in the trust. However, CGT event E4 is no longer available for AMITs, instead AMITs make use of CGT event E10.

Unfortunately, the necessary consequential amendments have not been made to incorporate CGT event E10 in relevant CGT roll-over provisions; as a result AMITs are unable to access these rollover provisions. This puts AMITs at a disadvantage to MITs for no reason other than their election into the AMIT regime.

The CGT relevant roll-over provisions that are not available to AMITs include the following:

- transfer of assets within Trusts (Subdivision 124-N);
- capital gains and losses on demerger (Subdivision 125); and
- transfer of assets between certain trusts (Subdivision 126-G).

We understand the Property Council of Australia has provided drafting suggestions to address this issue.

4.4 Implement foreign exchange hedging regime

The 2016–17 Budget made a commitment to simplified TOFA rules including "A new tax hedging regime which is easier to access, encompasses more types of risk management arrangements (including risk management of a portfolio of assets) and removes the direct link to financial accounting."

A particular priority for FSC members is foreign exchange hedging rules. Under the current rules hedging gains/profits are normally treated as being on revenue account and therefore potentially bear withholding tax. This has been a source of frustration to the industry for many years as such hedging is normally related to the holding of foreign assets which generate income and gains that are exempt from withholding tax. A key principle is that hedging contracts should be taxed the same as the asset they hedge – if the underlying asset is exempt from tax, then so should the hedge.

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[3] See: http://ministers.treasury.gov.au/ministers/kelly-odwyer-2016/media-releases/improving-australias-financial-services-taxation-regime

One of Korea's largest investment managers has specifically raised the issue of Australia's taxation treatment of foreign exchange hedging being a barrier to offering their Australian asset funds in Korean won. Their Korean investors would prefer to bear the foreign exchange risk themselves, by investing into an Australian dollar fund and undertaking their own hedging back to Korean won, as opposed to having the hedging undertaken in the fund. They noted that this was an Australian-specific problem that they did not have when investing in other jurisdictions.

The FSC has previously suggested that Subdivision 230E of the TOFA provisions be clarified to eliminate uncertainty as to its application to passive investment portfolios.

The FSC also suggests there be consideration of a reform to simplify the hedging measures by implementing a 'safe harbour' to recognise hedging gains and losses for tax purposes over say, five years; and consider the legislative changes that will be required due to the interaction between the TOFA provisions and the new accounting standard dealing with hedging (AASB 9).

4.5 Treat gains or losses on bond sales as interest

Gains (or profits) on the sale of bonds normally reflect an interest rate movement, meaning the gains are economically equivalent to interest. However, the gains can be treated as ordinary income for withholding tax purposes and can therefore be subject to withholding tax. This means in particular:

- The withholding tax on interest is 10%, however the bond profit would likely be subject to withholding tax at 15%, which is the rate applying to ordinary income.
- Many bonds are exempt from withholding tax under section 128F, but it is unclear if bond profits on these securities are also exempt.

The FSC therefore recommends that gains or losses on the sale of bonds should be treated the same as interest.

4.6 Widen eligibility for functional currency election

The 2011–12 Budget announced the then Government would allow "certain trusts and partnerships that keep their accounts solely or predominantly in a particular foreign currency to calculate their net income by reference to that currency."

The current Government announced in 2013 it would proceed with this measure[4] and recommitted to this in the 2016–17 Budget. The measure remains unenacted.

This measure would permit trusts and partnerships to use the functional currency election under Subdivision 960-D Income Tax Assessment Act 1997 (ITAA 1997) when preparing

[4] http://ministers.treasury.gov.au/ministers/arthur-sinodinos-2013/media-releases/integrity-restored-australias-taxation-system

their Australian income tax returns. The current rules without the benefit of the election are very restrictive and result in a high cost of compliance.

This measure is of more importance with the introduction of the AMIT regime and the Asia Region Funds Passport (**Passport**) in order to permit Australian fund managers to attract overseas investors who may wish to invest and receive accounting and tax reports, distributions and capital returns in their own (non-Australian dollar) currency. In particular, this would promote the use by Australian fund managers of multi-class trusts under the AMIT regime, with the ability to offer classes in different currencies.

We note at time of writing no Australian fund has been offered under the Passport regime. Fixing the functional currency issue, the gains or losses on bond sales issue, and the foreign exchange hedging issue (noted above) would reduce the tax-related barriers to the use of Australian funds in the Passport (noting these are not the only issues that could be discouraging Australian domiciled Passport funds).

4.7 Ensure correct Australian taxation of foreign capital gains

The *Burton v Commissioner* decision of the Full Federal Court[5] reduced the taxpayer's Foreign Income Tax Offset (FITO) to the extent the taxpayer was able to use the CGT discount. This decision raises significant uncertainty about the taxation of foreign capital gains, and could easily result in excessive taxation of these gains – an Australian taxpayer could effectively pay a higher rate of CGT on a foreign asset than on a domestic asset.

This runs contrary to a tax policy principle that the Australian tax on foreign income should be no higher than either the foreign tax on the income, or the Australian tax that would apply if the income was only subject to Australian tax.

If the decision is applied to all Australian taxpayers with foreign capital gains, this could substantially increase compliance burdens for Australian-based global funds. The issue would be even more problematic if it is applied to all foreign income, including income that is not from capital gains.

Therefore, the FSC recommends the Government should make a technical amendment to the law to ensure that the Australian tax on foreign source income should not be greater than the higher of (a) the foreign tax on the income; or (b) the Australian tax that would apply if the income was only subject to Australian tax.

4.8 Tax treaty issues

The FSC has for some time noted technical issues with various Australian tax treaties (aka Double Tax Agreements or **DTAs**). These technical issues include the following:

- Ensuring all tax treaties provide treaty benefits to trusts, particularly Managed Investment Trusts (UK, France and India), and to complying superannuation funds (France and USA). The Australia-Switzerland DTA is a benchmark for this.

[5] See https://www.judgments.fedcourt.gov.au/judgments/Judgments/fca/full/2019/2019fcafc0141

  - Ensure the complying Superannuation business of life insurance companies ("VPST" business) and pooled superannuation trusts are treated the same as super funds.
- Allow treaty relief where an Australian resident fund invests into US investments via a Cayman feeder fund.

For more detail please see the FSC 2018–19 Pre-Budget submission.[6]

4.9 Flowthrough tax treatment of foreign trusts (s99B)

Two tax determinations from the ATO (TD 2017/24 and TD 2017/23) mean that foreign trusts are not eligible under Australian tax law for flowthrough tax treatment in certain circumstances. In particular, an Australian resident may not be able to use the CGT discount or offset CGT losses on an Australian asset that is held indirectly through a foreign trust.

This interpretation runs contrary to tax principles. In particular:

- It means an Australian direct investor is taxed differently from an Australian who invests indirectly through a foreign trust. This is inconsistent with the main tax principle of funds management, which is that indirect and direct investment are subject to the same tax.
- In the rest of the tax law, income generally retains its character when it flows through an Australian trust, but the ATO's determinations mean income does not retain its character when it flows through a foreign trust.
- An Australian investing into managed funds in the Passport could be taxed differently depending on where the Passport fund is located, which is contrary to the principles of the Passport.

Further details of the issues with the ATO's approach are contained in the attached submissions from King & Wood Mallesons (Attachment C) and the accounting professional bodies (Attachment D), along with proposed solutions to this issue.

5 Life Insurance

The FSC recommends technical amendments to the Life Act which should serve to improve customer outcomes for the Life insurance sector. In summary:

Issue	Section	Suggested Amendment
Life insurance definition excludes consumer credit insurance (CCI) policies that have a life component	9A(6)	Amend to include CCI
Life insurance definition excludes some policies of less than three years duration	9 and 9A	Amend to allow for shorter duration contracts to be considered life insurance

[6] See https://fsc.org.au/resources/726-2017-12-22-fsc-2019-pre-budget-submission-final-combined/file

Issue	Section	Suggested Amendment
Annuities of any duration to be considered life insurance	9(1)(d)	Amend Life Regs to include annuities of any duration
APRA declaration of annuities as life insurance	12A	Amend to allow APRA to declare annuity characteristics as life insurance
Requirement for endorsement of assignment of policy	200	Remove this requirement
Issues with rules relating to cancellation of insurance contract	210	Make relevant amendments, see Attachment E.
Limits for payment without probate or administration	211 and 212	Need to be increased from \$50,000 to \$200,000 and indexed
Appointment of life insured as policy owner following death of original policy owner	213	Endorsement requirement should be removed and limits need to be increased from \$50,000 to \$200,000 and indexed
Unclaimed monies requirements	216	Streamline the payment mechanism so ASIC pays claimant directly
Move from paper to electronic	221–225	Repeal sections which are in place to deal with a single paper policy document rather than an electronic record
Requirements to keep registers of policies by State	226 and 227	Remove exclusion of the Life Act from the *Electronic Transactions Act 1999* (Cth)
War exclusion	229	Remove requirement for written endorsement of policy document for exclusion

Further details on these recommended technical amendments are in the submission made by the FSC to the Parliamentary Joint Committee on Corporations and Financial Services at Attachment E.

6 Design and Distribution Obligations

The FSC has a number of recommended changes to the legislation/regulations relating to the Design and Distribution Obligations (**DDO**). We will be making a separate submission in relation to these points as part of the current consultation on the DDO regulations.

Attachment A

FINANCIAL SERVICES COUNCIL

Superannuation and tax technical amendments

Submission to Treasury

Contents

1 About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in Australia's largest industry sector, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing almost $3 trillion on behalf of more than 14.8 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

2 FSC general comments

The FSC commends the Government for the changes in the draft legislation and regulations – several of these changes address specific requests by the FSC.

The FSC's comments below are directed at ensuring the draft proposals work as intended with minimum cost to funds and members. All references relate to the exposure draft legislation and regulations unless otherwise specified.

In relation to timing, the FSC notes there is significant urgency in dealing with the regulations amending the life-expectancy period for innovative income stream products discussed in this submission in Section 4.3. This is because these regulations are required to support the new means test rules applying from 1 July 2019. Therefore, the FSC considers these regulations should proceed as quickly as possible, regardless of any additional work required on other parts of the draft legislation and regulations – particularly any work required to consider the changes proposed by the FSC in Section 3.1 of this submission.

As there are a number of successor fund transfers (SFTs) occurring in the industry, it is also important for the regulations relating to SFTs progress without delay.

3 Legislative amendments

3.1 Valuation of market-linked pensions under the transfer balance cap when they are commuted or rolled over, resulting in a nil debit

The FSC supports the intent of these amendments, contained in Schedule 1, Part 1, Item 1 and Item 2 of the exposure draft legislation, including the broadening of the scope to include market linked annuities, and life expectancy pensions and annuities. The industry welcomes this change which will assist to ensure consumers with a variety of different pension products are treated consistently.

We do however have concerns regarding the calculation method for determining the debit value for certain capped defined benefit (**DB**) income streams, outlined below.

The FSC has a concern that the proposed calculation methodology will not address technical complexities and administration issues from the implementation of the Fair and Sustainable Superannuation Reforms – particularly for market linked income streams and (more broadly) legacy pensions. The FSC has raised some of these concerns previously.

The issues with the proposal include:

- As market-linked pensions cannot be commuted back to accumulation or out of the super system, the consumer will be forced to pay excess transfer balance tax on a daily notional earnings amount for an indefinite period of time, including the period after the pension term has ended.
- The proposed approach of using actual income in the calculation methodology for transfer balance cap purposes presents practical problems for super funds and the ATO as currently, for market-linked pensions, there would be no record of total income paid over the product's history.
- The retrospective application of the new calculation methodology creates unnecessary administration issues, additional costs for consumers, and may create adverse outcomes for consumers.
- The effects of using actual income received in the calculation methodology under certain assumptions may lead to perverse outcomes where actual income exceeds the special value. This will depend on how subsection 294-145(6A)(a) is interpreted on a prospective basis. If it results in the cumulative sum of previous income streams benefits that the customer was entitled to receive from the income stream before the start of commutation, which is the approach taken in the draft, then we believe under certain scenarios (i.e. high earnings and commutation occurring over 2 years from the transfer balance) this could result in a negative debit (effectively a credit). This result would penalise a retiree permanently for the solid performance of their fund. We would welcome additional clarity from Treasury on this point.

Preferred approach: We believe it would be preferable to fully address the substantial complexities and technical administration issues that have arisen with legacy retirement products. This would ideally be achieved by introducing an amnesty which would allow these market-linked pensions and annuities to be transitioned into more contemporary retirement income stream products where they will be assessed according to the $1.6m transfer balance cap (**TBC**). That is, the amnesty would allow trustees to commute and recommence these pensions as account-based pensions with the value of the assets which underlie the pension counting towards their TBC.

This approach would provide access to more modern retirement income products for members, promote efficiency and reduce operational risks. This would also reduce the number of legacy products – the problems with legacy products are well known.[1]

[1] The Productivity Commission raised significant concerns with legacy superannuation products in its final report into superannuation. See also the FSC Pre-Budget submission, available from: https://fsc.org.au/resources/resource-detail/?documentid=324ee583-4341-e911-a96b-000d3ae13a46

Market linked income streams were introduced from September 2004 and are now generally closed or no longer offered to new members. These are complex products and it can be difficult for members to understand the operation of these products in detail, particularly how the product is assessed for the TBC – partially because the TBC was not designed with these legacy pensions in mind. These pensions are difficult to administer, explain and advise on. Allowing members of market linked and other legacy income streams to easily transition their benefits into a more modern retirement product such as an account-based pension would provide these members greater flexibility and choice in managing their retirement benefits.

The amnesty would be optional for market linked pensions that have already been commuted.

Second preference: An alternative to the amnesty proposed above is for market linked income streams and annuities that commence after 1 July 2017 to remain as capped DB income streams. This would allow holders of market-linked pensions and annuities to transfer product providers without causing an excess transfer balance account. To be consistent with other capped DB income streams, such as lifetime pensions and annuities, the debit value on rollover would equal the starting special value less previous debits, and the subsequent credit would remain as annual entitlement multiplied by the remaining term. In order to maintain existing rules relating to capped DB income streams, there would be no excess transfer balance amount generated to the extent that the excess is attributable to the capped DB income stream.

Market-linked pensions were originally classified as capped DB income streams and assessed differently under the TBC due to commutation restrictions that apply to these types of income streams – in particular, market-linked pensions are generally restricted from commutations unless the member is rolling over 100% of the benefit to another market-linked pension. While this different treatment may not cause a person to breach the TBC, an individual will be subject to additional taxation rules to ensure that different pension schemes are subject to broadly commensurate tax outcomes.

While this is our second preference as a standalone option, we also note this option could be provided *in addition* to the FSC's first preference option.

Third preference: Amend the calculation to address inclusion of income stream benefits in calculation

If the above solutions are not adopted, then the FSC recommends an amendment to address concerns about the prescribed calculation (for full and partial commutations) relating to inclusion of income stream benefits in the calculation of the transfer balance account (**TBA**) debit. The inclusion of these income stream benefits has the effect of reducing the original TBA credit. We note that no other income stream requires the inclusion of income payments in determining an individual's TBA.

In most cases, income stream providers do not store the original TBA credit value, or any subsequent TBA debit values, for capped DB income streams. Rather these values are calculated at the time reporting is required. Requiring providers to reference these values would unnecessarily increase administration costs. By contrast, the ATO should hold the original TBA credit value in respect of the income stream, as reported by the provider.

Therefore, the FSC submits the TBA debit should not include reference to income stream payments, and should be calculated or automatically processed by the ATO without any need for income stream providers to report this TBA debit, if providers indicate that the relevant capped DB income stream has been commuted in full – potentially under MAAS/MATS reporting.

In instances where there has been a partial commutation of certain capped DB income streams, the FSC proposes that the value of the TBA debit reflect the amount of the superannuation lump sum that results from the partial commutation.

3.1.1 Application date

We also note the amendment technically applies as if the calculation formula applied from 1 July 2017 and every provider should have calculated and reported this value under the revised formula. This raises concerns because penalty interest can apply from the date a TBA balance exceeds a member's TBC. Therefore, we submit that members should not be penalised for breaching their TBC as a result of any re-reporting by Funds or the ATO automatically processing the TBA debit (as under the FSC's preferred model).

This is an important change because it will take some time for providers/the ATO to amend their systems to make the relevant calculations. The longer this takes, the greater the potential penalty interest charge on members, if the calculation shows the member actually breached their TBC at the time they commuted their income stream.

If this issue is not addressed, this will mean the law is changed retrospectively and then some members would be penalised for inadvertent breaches of a retrospective law.

To stop the penalty applying, options include ignoring any excess above the cap due to re-reporting of the TBA debit, or ensuring the TBA debit is only applied to a member's account on the date it reported by the provider/processed by the ATO, and not the date of the commutation.

As the proposed changes are effective from 1 July 2017, they will impact all commutations for the applicable capped DB income stream products already reported. As part of these amendments we would appreciate clarity on how the approach to reporting any amendments to prior commutations will be managed to limit adverse outcomes for members. This should ideally be facilitated by the ATO, with consideration of relief from any applicable reporting timeframes to income stream providers.

3.2 Ensuring Death Benefit Rollovers are not subject to tax

The comments below relate to Schedule 1, Part 1, Item 3 of the exposure draft legislation.

The FSC supports the intent behind this change, which is to remove unintentional tax liabilities on rollover of death benefits. The FSC has specifically recommended this type of change.

However, we have concerns that the proposal does not achieve the intended outcome.

The proposed legislative amendments to s295-190(1) has the effect that an untaxed element generated as part of a death benefit lump sum is not assessable income for the recipient super fund. This results in a 15% tax not being applied to an untaxed element on the receipt of a death benefit rollover. We support this outcome as it ensures the member is not adversely affected by the rollover.

However, no amendment has been proposed to s207-290 in relation to determining the tax components of a death benefit superannuation lump sum. As such, it appears that an untaxed element could still apply under that section. Although any such untaxed element will not be treated as assessable income to the recipient fund, it still implies that the untaxed element is part of the account balance.

This approach does not seem to adequately address the issue of unintentionally taxing recipients of a death benefit income stream. This raises several issues:

- This approach will result in ongoing administration costs and complexity for funds. The fund rolling over the death benefit super lump sum will still be required to calculate an untaxed element, and the recipient fund needs to ensure this is not included in their taxable income.
- Under the draft s295-190(1) untaxed elements that are not produced due to s307-290 must still be included as assessable income to the recipient fund. This suggests that two types of untaxed elements must be recorded by funds.
- All superannuation funds would need to implement system changes to update the SuperStream Rollover message and the Rollover Benefit Statement issued to members to cater for different types of untaxed element which adds significant administrative complexity and costs.
- If the member commences a death benefit income stream, the super fund will be required to withhold PAYG tax from the income stream payments relating to the untaxed element – this runs against the intention of the policy.
    - We note most APRA funds do not operate untaxed schemes, as a result this is likely to lead to the majority of super funds not being able to administer these types of income streams. The unintended consequence is that funds that currently accept death benefit rollovers may no longer be able to do so.

The FSC has previously advocated for an alternative option to address the taxation of death benefit rollovers.

The FSC's preferred alternative is to modify section 307-290 of ITAA 97 to confirm that this section does not apply to require a super fund to determine an untaxed element in relation to the payment of a death benefit superannuation lump sum (from a taxed fund) that is to be rolled over by an eligible dependant to commence a death benefit income stream.

The FSC's preferred option, modifying section 307-290, would provide a better outcome that eliminates the requirement (in the Government's proposal) for the sending fund to calculate an untaxed element that would then need to be excluded from assessable income by the receiving fund. The Government's proposal would create an additional untaxed element to track as part of a member's balance, increasing administration costs — these additional costs are in our view unnecessary.

Only a dependent can now rollover a death benefit and is restricted to only commence an income stream. So arguably there should be no mischief in adopting the FSC's preferred approach on the basis that the recipient is a dependant and is not cashing out the lump sum.

If however the approach in the draft legislation is maintained, then we would request further guidance on how this will affect fund administration and reporting, and whether the Government intends that any income stream payment from an untaxed element after rollover should be subject to tax.

3.2.1 Death benefit rollover interaction with tax offset

The FSC also has a concern with death benefit rollovers where the deceased was under 60 at the time of death and the beneficiary is under the age of 60 at the time the payment is received.

If the rollover amount relates to a taxed element, then a pension relating to that amount will be included in assessable income and the individual will receive a tax offset equal to 15% of the assessable amount. However, if the rollover relates to an untaxed element, a pension relating to the untaxed element will still be included in assessable income however they will not receive the 15% tax offset.

This implies that the beneficiaries in this latter case could be disadvantaged as a result of the rollover.

This issue should be addressed if the FSC's preferred solution modifying section 307-290 is implemented, as discussed in Section 3.2 above.

4 Regulation amendments

4.1 Fixing the valuation of defined benefit pensions under the transfer balance cap to reflect when pensions are permanently reduced

The FSC supports the intent of these amendments, which relate to Schedule 1, Part 1 of the exposure draft regulations, and notes that the scope has been broadened to include lifetime annuities.

For a reversionary lifetime annuity this means that if the original annuitant dies and annual payments are reduced the transfer balance amount credited to the reversionary will be adjusted for the lower payments. This aligns with the approach applied to lifetime pensions and defined benefit pension schemes.

This change is welcomed by the industry and will assist to ensure consumers with a variety of different pension products are treated consistently.

4.1.1 Issue with certain defined benefit arrangements

The proposed changes appear to still adversely impact members of certain DB arrangements in that they would appear to still be subject to an excess transfer balance for a period of time (based on the value of their initial annual entitlement) before the actual reduction in income stream payments occurs. This may require some members to remove other super monies from the retirement phase (such as an account based income stream if they have any) and be liable for excess transfer balance tax, despite the initial annual entitlement not being permanent.

As the variation in payments for these types of products often applies in cases where a spouse commences receiving a reversionary pension, it is important that this is dealt with appropriately so as not to financially prejudice these members.

Consideration should be given to amending the regulations to allow the special value of the income stream to be determined based on the anticipated reduced amount at the time the income stream is initially valued. Alternatively it may be appropriate to give the Commissioner the power to determine the appropriate credit value, or to waive any excess transfer balance that may arise, taking into consideration the client's circumstances.

In addition, similar to the point raised in Section 3.1.1 of this submission, as the proposed changes are effective from 1 July 2017, they will impact retirement phase events already reported for all applicable income stream products. As part of these amendments we would appreciate clarity on how the approach to reporting any amendments will be managed. This should ideally be facilitated by the ATO, with consideration of relief from any applicable reporting timeframes.

4.2 Maintaining the treatment of market-linked pensions under the transfer balance cap where they have been rolled over, or as a result of a successor fund transfer

The comments below relate to Schedule 1, Part 3 of the Exposure Draft regulations.

Under these proposed changes, where a transfer of a capped DB income stream occurs as part of a successor fund transfer (SFT), the new income stream will continue to be treated as a capped DB income stream in cases where the income stream is a lifetime pension (this was already the case); lifetime annuity; life expectancy complying term pension; annuity (known as 'life expectancy'); or market-linked pension.

The FSC supports the intent of these amendments and notes that the scope has been broadened to include lifetime annuities and life expectancy pensions and annuities, which is a welcome improvement.

This change will assist to ensure consumers with a variety of different pension products are treated consistently.

We do have comments regarding the circumstances in which the provision of transfer balance account reports is required.

4.2.1 Requirement to provide Transfer balance account report

In principle, we consider a SFT should not trigger a requirement to report to the ATO a retirement phase event or entry in the account of a super fund member given it is an involuntary transfer on the part of the member.

Instead, there has merely been a change of Trustee in respect of the Fund.

However, existing rules appear to create a retirement phase event when an SFT occurs.

We consider the existing rules should be amended so that a retirement phase event should not occur. However, if the retirement phase event does occur, then the debit and immediate credit ought to be the same value and therefore cancel each other out, resulting in no change to the member's TBA balance.

4.3 Changing the definition of life-expectancy period for innovative income stream products to account properly for leap years

The FSC supports the intent of these amendments, which relate to Schedule 1, Part 4 of the exposure draft regulations, and notes that this change is required for innovative income stream products to make use of new age pension means testing rules, which will commence on 1 July 2019. Compliance with the innovative income stream regulations is essential for products to be eligible for the new means testing rules, as non-compliance results in punitive means testing treatment for these products.

Unfortunately, the proposed changes do not adequately account for leap years. Leap years do not strictly occur every four years and have adjustment periods that occur.[2]

Instead of attempting to draft rules around the complexity of leap years, we submit the better drafting approach would be for the regulations to refer to ***the actual number of days*** in the life expectancy period.

There should be no concerns with this approach. Annuities are anniversary-based products and using the actual number of days will allow annuities to continue to operate on an anniversary basis, utilising the date of commencement/purchase. Any deviation from the actual number of days will create unexpected outcomes for holders of annuity products.

[2] See an explanation here: https://en.wikipedia.org/wiki/Leap_year

Attachment B

Mr. Andrew Mills
Second Commissioner
Law Design and Practice
Australian Taxation Office

11 May 2017

Sent via email to: Andrew.Mills@ato.gov.au

Dear Andrew

RE: ATO Audit Activity and the Investment Manager Regime

I am writing to you to inform you of recent ATO audit activity which is of significant concern to the FSC members and which we believe is contrary to the policy of the Investment Manager Regime (IMR) contained in Subdivision 842-I of the ITAA 1997.

Background

In 2016 the ATO commenced auditing the tax affairs of a Cayman Limited Partnership (with only non- resident investors (and primarily US based)) which had appointed an Australian investment manager. The ATO has focused on the issue of whether the appointment of the Australian manager and its funds management activities in Australia has resulted in the Cayman LP becoming a resident of Australia for tax purposes thus subjecting its entire taxable income to 30% Australian corporate income tax.

The ATO issued a Position Paper in April 2017 arguing that the Cayman LP was a tax resident of Australia under s 94T of the ITAA 1936 and therefore it was subject to Australian income tax on its worldwide taxable income in relation to the 2010 -2012 years of income. The audit has reached the stage that negotiations have commenced as to how the ATO can take a security interest over the Cayman LP's assets.

It should be noted that but for this "residence issue" the Cayman LP and its investors (whom as noted above are all non-resident investors) would not be subject to any Australian income tax in relation to 2010-12 years by virtue of the fund's income consisting solely of gains on NTAP assets. Had the investors in the Cayman LP directly invested in the same assets, they also would not have been subject to any Australian income taxation. Furthermore, but for the issue of residence of the fund, it would satisfy the requirements of the IMR concessions in s 842-215 of the ITAA 1997.

The ATO's audit activity also appears to be contrary to the policy behind ATO TD 2011/24 in relation to the private equity industry. This Tax Determination provides guidelines under which offshore private equity funds would not be subject to Australian tax provided certain tests were satisfied. This Cayman LP does carry on private equity type investment activities and should but for the "residence issue" satisfy the tests to qualify for the protection from tax offered by ATO TD 2011/24.

The fact pattern of this Cayman LP is very similar to that of many of the offshore funds established by our members and we expect that the issue of income tax assessments to the fund will have the following adverse consequences:

- Negating the benefits achieved to date under the IMR, with adverse international publicity as to the sovereign risk associated with making Australian investments, particularly for foreign funds that appoint Australian investment managers.
- Encourage Australian investment managers of foreign funds to move offshore, with the consequent loss of Australian jobs and associated tax revenue.
- Create uncertainty for auditors of such foreign funds as to whether provisions for Australian tax should be raised under ASC 740-10 and other similar accounting standards.
- Cause foreign funds to reassess whether they should continue with their existing, or indeed undertake any future investments in Australia.

IMR Consultations

The Board of Taxation's August 2011 Report recommended that the IMR address 3 separate issues being (i) the permanent establishment issue, (ii) the residence issue and (iii) the source of income issue.

The IMR as enacted dealt with issues (i) and (iii) but did not address the residence issue, despite numerous submissions that it do so, including those in the FSC's IMR submissions to Treasury dated 1 July 2010, 29 April 2013 and 14 February 2014. The industry took a pragmatic approach at the time of consultations to avoid delaying the implementation of the IMR and did not insist that the residence issue should be dealt with in IMR stages 1-3. However there was a clear policy intent behind IMR that the appointment and use of Australian managers should not create a residence issue.

This gap in the IMR coverage is now creating significant uncertainty for the industry which we wish to resolve as soon as possible. Further the audit of foreign funds, such as the case in point has the potential to significantly raise an alarm to the broader industry. Already we are aware of foreign funds making enquiries as to the ATO approach and whether the Government has now changed its approach.

We would welcome the opportunity to discuss this matter with you at your earliest convenience and will contact you shortly in this regard.

Yours sincerely

S. Premetis

SPYRIDON PREMETIS
Senior Policy Manager
Tax and Economics
Financial Services Council

Attachment C

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3 March 2017

Dear Lyn

Comments in relation to Draft Taxation Determination TD 2016/D4

1 We refer to the Draft Taxation Determination TD 2016/D4 released for public comment on 30 November 2016.

2 We are appreciative of the opportunity to gain an understanding of the Commissioner's proposed reasoning and to provide our submissions in this regard.

Part A - Summary of our submission

3 We suggest that:

(a) the interpretation proposed in TD 2016/D4 is inconsistent with the legislative intention behind the definition of 'net income' in section 95 and the application of Division 855 in relation to foreign trusts;[1] and

(b) the residency assumption in the definition of 'net income' should be applied in the context of Division 855 in determining whether capital gains are included in the 'net income' of a foreign trust.

Consequences of our submission

4 This means capital gains made by a foreign trust should be included in 'net income' (regardless of whether they relate to taxable Australian property) and taxed to the beneficiaries or the trustee (as appropriate) in accordance with Subdivision 115-C of the 1997 Act.

5 The application of the exemptions in Division 855 should then be determined by reference to residency of the relevant beneficiary or trustee, and in the case of beneficiaries, whether the trust is a fixed trust.

Basis of our submission

6 Our submission is made on the basis that:

[1] All legislative references are to the Income Tax Assessment Act 1936 (1936 Act) or the Income Tax Assessment Act 1997 (1997 Act), unless otherwise stated.

(a) (**residency assumption applies broadly**) the legislative intention of the residency assumption in the definition of 'net income' in section 95 is to ensure that the 'net income' captures the whole of the trust's taxable income. The residency assumption is intended to apply for the balance of the tax legislation, including Division 855 (see Part C);

(b) (**unintended extension of exemption to non-fixed foreign trusts**) the Commissioner's interpretation provides an exemption for foreign resident beneficiaries of foreign trusts which exceeds the scope intended by Parliament. This is by appying the Division 855 exemption to non-fixed foreign trusts (see Part D);

(c) (**contrary to flow-through tax treatment**) the Commissioner's interpretation is inconsistent with the 'flow through' tax treatment of trusts by taxing Australian resident beneficiaries on revenue account in relation to a capital gain derived by a foreign trust. Consequently, it gives rise to an unintended disincentive to indirect foreign investment by Australian residents (see Part E); and

(d) (**unintended difference in treatment of foreign trusts**) the Commissioner's interpretation creates an unintended difference in the treatment of investments made through foreign trusts compared to Australian trusts. The legislative intention is that foreign trusts should be subject to the same ordinary trust rules as Australian trusts. The proposed Asia funds passport arrangement is also based on the assumption that the underlying tax treatment for an Australian resident should be the same irrespective of whether they invest through an Australian trust or through a foreign trust (see Part F).

7 The more detailed reasons in support of our submission are set out below.

Part B - Division 855 should not exclude capital gains from the 'net income' of a foreign trust. The capital gain should taxed to the beneficiaries or the trustee (or exempted from tax) according to their particular circumstances

8 We suggest that the interpretation that is consistent with the legislative intention of Division 6 and Division 855 should be as follows:

(a) the residency assumption in the section 95 definition of 'net income' should be applied in determining whether capital gains are included in 'net income' under Division 855. This means that a capital gain made in respect of an asset which is not taxable Australian property should be included in the 'net income' of a foreign trust;

(b) the capital gain should then be taxed to the beneficiaries or the trustee in accordance with Subdivision 115-C of the 1997 Act;

(c) an Australian resident beneficiary should be able to apply the CGT discount in relation to the capital gain and/or offset capital losses if they satisfy the relevant requirements;

(d) a foreign resident beneficiary should be able to disregard the capital gain under section 855-40 if the trust is a fixed trust and the other requirements of the exemption are satisfied. A foreign resident beneficiary should not be exempted from capital gains tax if the trust is not a fixed trust; and

(e) if the trustee is the trustee of a foreign trust, they should be able to disregard the capital gain under section 855-10 if the relevant requirements are satisfied.

9 These outcomes are based on the legislative intention of Division 6 and Division 855 as discussed below.

Part C - The Commissioner's interpretation is contrary to the legislative intention of the residency assumption in the definition of 'net income' in section 95

10 We suggest that the Commissioner's interpretation is contrary to the legislative intention of the residency assumption in the definition of 'net income' in section 95.

11 The residency assumption in the section 95 definition of 'net income' was introduced by the *Income Tax Assessment Amendment Act 1979* (Cth) (**1979 Amending Act**). The Explanatory Memorandum to the 1979 Amending Act indicates that the legislative intention of the residency assumption is to ensure that the section 95 definition of 'net income' captures the whole of the trust's taxable income and is not limited by other rules which seek to limit the taxable income for foreign residents (for example, that foreign residents are only taxed on Australian source income).[2] The Explanatory Memorandum states:

> *However, in Union Fidelity Trustee Co. of Australia Ltd v. F.C. of T. (1969) 119 C.L.R. 177, the High Court held that, in calculating the net income of a trust estate for the purposes of Division 6 of Part III of the Principal Act (the part of the Act dealing with the taxation of trustees and beneficiaries), only income from sources in Australia could be taken into account. Income of a trust estate from foreign sources could not be taxed under that Division as it was derived, but only at the time when a resident beneficiary received the income (section 26(b)). An effect of the decision was that foreign source income could be accumulated by Australian residents in a trust without liability for Australian tax unless and until the trust income was distributed to a resident beneficiary.*
>
> *To overcome the effects of the decision, the Bill proposes three main changes.*
>
> *In consequence of one of them, an Australian resident beneficiary will be taxed under Division 6 on trust income to which he is presently entitled, whether the income has a source in Australia or overseas (clause 12) and the trustee will be taxed on such income where the resident beneficiary presently entitled to the income is under some legal disability, such as being a minor (clause 13). To this end, clause 11 will require that the "net income" of a trust estate be calculated on the same basis as if it were the income of a resident individual.*

12 This legislative intention is also expressed in the Explanatory Memorandum to the *Tax Laws Amendment (2011 Measures No. 5) Act 2011* (Cth) (**2011 Amending Act**), which introduced the current capital gains tax rules for trusts in Subdivision 115-C of the 1997 Act. The Explanatory Memorandum to the 2011 Amending Act (at paragraph 2.9) expressly states that the section 95 definition of 'net income' is intended to apply broadly to capture 'the whole of the trust's taxable income'.

13 The residency assumption in the section 95 definition of 'net income' is intended to apply for the balance of the tax legislation, including Division 855.

14 This view is supported by the Full Federal Court's decision in *Howard v FCT* [2012] FCAFC 149. In that case, the Court considered the application of section 99B to an Australian resident beneficiary who indirectly derived a dividend through two interposed foreign trusts (**Top Trust** and **Bottom Trust**). The dividend in this case was not paid out of Australian sourced profits of the underlying company. The dividend amount would have been excluded from section 99B on the basis that it formed trust corpus, if it were not treated as being attributable to 'amounts derived by the trust estate that, if they had been derived by a taxpayer being a resident, would have been included in the assessable income of that taxpayer'.

15 The Full Court held that:

(a) in determining whether the beneficiary should be assessed under section 99B, the residency assumption required the Court to determine whether the amount received

[2] A similar residency assumption is included the definition of 'trust component' under the new Attribution Managed Investment Trust rules in section 276-265 of the 1997 Act.

by the Top Trust would have been assessable to it, on the assumption that the Top Trust was a resident;

(b) applying that assumption (that the Top Trust was a resident), the Top Trust would have been assessed under section 99B if the dividend would have been assessable to the Bottom Trust, on the second assumption that the Bottom Trust was a resident; and

(c) applying the second assumption (that the Bottom Trust was a resident), the Bottom Trust would have been assessed in relation to the dividend under section 44(1)(a). This is because section 44(1)(a) assessed resident shareholders on dividends paid out of profits derived from any source. Section 44(1)(b), which assesses non-resident shareholders only in respect of dividends paid out of Australian sourced profits, was held to not to apply to the Bottom Trust because it was assumed to be a resident.

16 The Court (at paragraph 49) considered that 'this is the orthodox understanding of the way in which the trust provisions in Division 6 of Pt III of the Act operate'. The Court observed that that:

> *But the basic point it illustrates remains sound: Div 6, and its various hypothetical taxpayers, operate on an assumption that the fictions thereby engendered are to be assessed for tax under the balance of the Act.*

17 The Court's reasoning in *Howard* is supportive of our submission for the following reasons:

(a) the Court's reasoning stipulates that the assumptions created by Division 6 are intended to operate for the balance of the tax legislation. This means that the residency assumption required to be made for section 95 'net income' should apply for determining the application of Division 855 (in the same way that the residency assumption in section 99B applied determining the application of section 44); and

(b) the contended outcome should not prevented by any principle of statutory interpretation (including the Commissioner's proposed analysis in TD 2016/D4). In *Howard*, the general residency assumption in section 99B (which applies to all forms of income) took precedence over the specific rule in section 44(1)(b) (which sought to tax non-residents only in respect of dividends paid out of Australian sourced profits).

18 For the reasons above, we suggest that it is inconsistent with the legislative intention of the residency assumption to not apply the assumption in applying Division 855. As discussed above, whether the capital gain is eligible for the Division 855 exemption should then be determined by reference whether the capital gain is taxed to a beneficiary or the trustee under Subdivision 115-C and whether that relevant taxpayer satisfies the requirements of an exemption in Division 855. The legislative intention is not to exclude the capital gain from 'net income' at the outset.

Part D - The Commissioner's interpretation provides an exemption for foreign resident beneficiaries of foreign trusts which exceeds the scope intended by Parliament

19 We also suggest that the Commissioner's interpretation provides an exemption for foreign resident beneficiaries of foreign trusts which exceeds the scope intended by Parliament.

20 On the Commissioner's view in TD 2016/D4, a capital gain that does not relate to taxable Australian property would be excluded from the foreign trust's net income by the application of section 855-10.

21 This means that where the beneficiary of the trust is a non-resident (to whom section 99B would not apply), the capital gain would not be taxed to the trustee nor to the non-resident beneficiary. This outcome would apply regardless of whether the foreign trust is a fixed trust.

22 This is contrary to the legislative intention behind the specific exemption for foreign resident beneficiaries in section 855-40. That section was a rewrite of the rule in former Subdivision 768-H. The Explanatory Memorandum to the *New International Tax Arrangements (Managed Funds and Other Measures) 2005* (Cth) (which introduced the rules in former Subdivision 768-H) states (at paragraph 1.3) that the intention of the rules was to align 'the tax treatment of foreign residents that invest in fixed trusts on the one hand, with the tax treatment of foreign residents that invest directly in assets (in Australia or abroad) on the other'.

23 Whilst a purpose of the rules was to remove impediments to the international competitiveness of the Australian funds management industry (see paragraph 1.2 of the Explanatory Memorandum), the application of the fixed trust requirement was not limited to Australian resident trusts.

24 It was never the legislative intention to provide an exemption for foreign resident beneficiaries where the trust is not a fixed trust.

25 The Commissioner's interpretation would effectively open the Division 855 exemption to the foreign resident beneficiaries of non-fixed foreign trusts.

26 For the reasons above, we suggest that the Commissioner's interpretation provides an exemption for foreign resident beneficiaries of foreign trusts which exceeds the scope intended by Parliament.

Part E - The Commissioner's interpretation is inconsistent with the 'flow through' treatment of trusts and consequently gives rise to an unintended disincentive to indirect foreign investment by Australian residents

27 We also suggest that the Commissioner's interpretation would be inconsistent with the 'flow though' treatment of trusts and consequently gives rise to an unintended disincentive to indirect foreign investment by Australian residents.

28 The High Court in *FCT v Bamford* [2010] HCA 10 endorsed the 'flow through' tax treatment of trusts under the Australian tax law. The Court cited (at paragraphs 20 and 21):

> *the trust could be treated as a mere conduit through which the beneficiaries under the trust receive income.*
>
> ...
>
> *This second approach was implemented by Div 6.*

29 The flow-through tax treatment of trusts is also supported by:

(a) the CGT rules applicable to trusts in Subdivision 115-C introduced by the 2011 Amending Act. The Explanatory Memorandum to the 2011 Amending Act (page 3) stipulates that the legislative intention is to ensure that capital gains and franked dividends can be effectively streamed to beneficiaries specifically entitled to them. This is consistent with trusts being subject to 'flow-through' treatment for tax purposes; and

(b) the withholding tax rules in section 128A(3) of the 1936 Act which deem a beneficiary presently entitled to income from a trust to have derived in the income for the purposes of the withholding rules. The flow-through approach is applied by the ATO in ATO ID 2008/61 in the context of a beneficiary deriving income through a foreign trust.

30 The approach suggested in TD 2016/D4 and TD 2016/D5 is inconsistent with the 'flow through' tax treatment of trusts. This is because a capital gain, not relating to taxable Australian property, which is distributed by a foreign trust to an Australian resident investor (or

otherwise applied for the benefit of the investor) would be taxed revenue account under section 99B and not on capital account, on the view expressed in TD 2016/D5.

31 Consequently, an Australian resident investor would suffer a disadvantage from investing into a capital asset that is not taxable Australian property through a foreign trust. This is because if they had invested into the underlying asset directly, they would make a gain on capital account under Part 3-1 of the 1997 Act. This means they would be eligible to offset capital losses and apply the CGT discount (if they satisfy the relevant requirements). The approach suggested by the Commissioner in relation to the same investment made through a foreign trust denies them this outcome.

32 For this reason, we suggest that the Commissioner's interpretation is inconsistent with the 'flow though' treatment of trusts, and consequently gives rise to an unintended disincentive to indirect foreign investment by Australian residents.

Part F - The Commissioner's interpretation creates an unintended difference in the treatment of foreign trusts compared to Australian trusts

33 We suggest that the Commissioner's interpretation would create an unintended difference in the treatment of foreign trusts compared to Australian trusts.

34 Former sections 96A to 96C of the 1936 Act contained special rules which treated non-resident trust estates differently to resident trust estates for Australian tax purposes. Amongst other things, section 96B contained the deemed present entitlement rule for beneficiaries of non-resident trust estates.

35 These provisions were repealed by the *Tax Laws Amendment (Foreign Source Income Deferral) Act (No. 1) 2010* (Cth) (**2010 Amending Act**).

36 The Explanatory Memorandum to the 2010 Amending Act stated:

> *1.9 In the absence of the FIF and deemed present entitlement rules, resident beneficiaries holding interests in foreign trusts will need to turn to the ordinary trust rules contained in Division 6 and the transferor trust provisions in Division 6AAA in order to determine their tax obligations. The ordinary trust rules will also continue to apply in precedence to the transferor trust rules.*

37 Contrary to the legislative intention that foreign trusts should be subject to the same ordinary trust rules as Australian trusts, the Commissioner's interpretation creates a different outcome for investments made through foreign trusts. This is because:

(a) an Australian resident investor who invests in a capital asset which is not taxable Australian property through a foreign trust will be assessed on revenue account under section 99B in relation to a capital gain made from the disposal of the asset; and

(b) in contrast, the same investor making the same investment through an Australian trust will be assessed on capital account under Subdivision 115-C, and entitled to apply the CGT discount and offset capital losses (if they satisfy the requirements).

38 The proposed Asia funds passport arrangement is also based on the assumption that the underlying tax treatment for an Australian resident should be the same irrespective of whether they invest through an Australian trust or through a foreign trust. The Commissioner's view may result in the tax treatment for Australian residents investing through a foreign trust being less favourable than investing through an Australian trust.

Part G - Conclusion

39 For the reasons above, we suggest that the Commissioner's interpretation in TD 2016/D4 is contrary to the legislative intention and should be reconsidered.

40 Please let us know if it would be helpful to discuss any aspect of this submission.

Yours sincerely,

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This communication and any attachments are confidential and may be privileged.

JOINT SUBMISSION BY

**The Tax Institute, Chartered Accountants Australia and New Zealand,
Tax and Super Australia, CPA Australia and
Institute of Public Accountants**

Draft Taxation Determination TD 2016/D4

Income tax: does the residency assumption in subsection 95(1) of the Income Tax Assessment Act 1936 (ITAA 1936) apply for the purpose of section 855-10 of the Income Tax Assessment Act 1997 (ITAA 1997), which disregards certain capital gains of a trust which is a foreign trust for CGT purposes?

AND

Draft Taxation Determination TD 2016/D5
Income tax: where an amount included in a beneficiary's assessable income under section 99B(1) of the Income Tax Assessment Act 1936 (ITAA 1936) had its origins in a capital gain from non-taxable Australian property of a foreign trusts, can the beneficiary offset capital losses or a carry-forward net capital loss ('capital loss offset) or access the CGT discount in relation to the amount?

Date: 10 March 2017

The Professional Bodies welcome the opportunity to comment on Draft Taxation Determination TD 2016/D4 and Draft Taxation Determination TD 2016/D5 ("the Draft Determinations").

GENERAL COMMENTS

Any interpretation of the tax laws should be consistent with the express purpose or objects of those laws. In this regard, it is useful to note that the purpose of s 115-215 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**) is set out in s 115-215(1) in the following terms:

> **SECTION 115-215 Assessing presently entitled beneficiaries**
> **Purpose**
> 115-215(1) The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's *capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:
> (a) the beneficiary can apply *capital losses against gains; and
> (b) the beneficiary can apply the appropriate *discount percentage (if any) to gains.

The object of Subdivision 855-A – entitled "Disregarding a capital gain or loss by foreign residents" – is similarly set out in s 855-5 in the following terms:

> **Subdivision 855-A - Disregarding a capital gain or loss by foreign residents**
> **SECTION 855-5 Objects of this Subdivision**
> 855-5(1) The objects of this Subdivision are to improve:
> (a) Australia's status as an attractive place for business and investment; and
> (b) the integrity of Australia's capital gains tax base.

It can therefore be seen that both s 115-215 (the purpose of which is to assess presently entitled beneficiaries) and Subdivision 855-A (the purpose of which is to disregard capital gains or losses of non-residents as evident from its title and express objects) focus on the assessment or non-assessment as the case may be of beneficiaries of trusts.

Section 115-215 especially is intended to assess beneficiaries in an "appropriate" way, including applying the CGT discount if it is relevant.

Furthermore, in our opinion, the policy underlying the interpretation of the matters covered by the two Draft Determinations should be that a taxpayer gets the same tax outcomes whether or not capital gains are received by an Australian resident via an Australian trust or a foreign trust.

We also believe the Draft Determinations do not properly apply s 99B and the reasoning for including the full amount in the beneficiary's assessable income is critical. We believe the Draft Determinations should be withdrawn and the application of s 99B be properly addressed in the revised Draft Determinations.

Character retention

The conduit approach (pursuant to which income retains its character through a trust) was articulated by the High Court in *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598.

The conduit approach, which underpins the taxation of trusts, has the effect that:

- a capital gain derived by a foreign trust retains its character on distribution to an Australian resident investor; and
- an Australian resident investor (individual, complying superannuation fund, trust) is entitled to the CGT discount and is entitled to offset capital losses against such capital gains.

The Commissioner's view in Draft Determinations D4 and D5 that a capital gain does not retain its character through a trust – especially in relation to gains which are distributed by a trust in the same year as that in which they are made – cannot be sustained, given that it contravenes the fundamental principle that income retains its character through a trust.

SPECIFIC COMMENTS

TD 2016/D4

In our opinion, the tax outcome described in Draft Determination D4 is not consistent with the stated intention[1] of the provisions of the tax law relating to the assessment of capital gains in the hands of trust beneficiaries. This is especially the case where the gain made by a foreign trust is distributed to an Australian beneficiary (ie, that beneficiary is made presently entitled to it) in the same financial year as that in which it is made.

There is no tax mischief in that context and we question why, as a matter of policy, an Australian beneficiary should be taxed differently if the capital gain in question had instead been made by an Australian trust and distributed to the same Australian beneficiary in the same financial year, or the next, as was described in the example involving The Kiwi Trust.

Remembering the object of Subdivision 855-A mentioned above, we submit that interpreting s 855-10 as described in Draft Determination D4 is contrary to the object of "improving … Australia's status as an attractive place for business and investment[2]" when a simpler, purposive approach such as that described below could achieve a consistent and, we submit, more appropriate outcome.

[1] Refer to the 'Guide' box at Subdivision 115-C of ITAA 1997

[2] Section 855-5(1)(a)

Perspective

In our opinion, a result matching the purpose described in s 115-215(1) could be achieved if one considered that:

- the s 95[3] residency assumption was applied to calculate the trust's net income;
- the machinery provisions (eg, of s 97) then applied to determine in whose hands that net income was assessable; and
- only then would s 855-10 be applied ***from the perspective of the beneficiary***.

We note that s 855-10 does make specific reference to disregarding a capital gain of "a trustee of a foreign trust for CGT purposes". However, as an operative provision, this should only apply in situations where the trustee would prima facie be assessed on that capital gain (e.g. where no beneficiary is presently entitled to it).

This important matter of applying s 855-10 and s 95 from the perspective of the beneficiary is consistent not only with:

- how the title of Subdivision 855-A directs and informs the reader (referring as it does to gains made "by foreign residents" and not just to gains made by trusts that are foreign trusts for CGT purposes); and
- how the machinery provisions of Division 6 and Subdivision 115-C operate together to apply any CGT discount at the beneficiary level; but also
- the general principle that trust income should retain its character as it flows through a trust.

Broader application

A parallel can be seen between the Controlled Foreign Company (**CFC**) residency assumption in s 383 of the ITAA 1936 and that in s 95. The residency assumption uses similar language for the purposes of calculating the attributable income of a CFC – "the eligible CFC is a taxpayer and resident" – which is comparable to the wording used in s 95 for the purposes of determining net income: "as if the trustee were a taxpayer and a resident". If s 383 were interpreted in the way proposed in Draft Determination D4 for s 95 and s 855-10, a CFC could never derive attributable income in relation to gains from non-TAP assets. This is clearly not the intended outcome nor an appropriate one.

No conflict

In our opinion, there is no conflict between s 95 and s 855-10. Both provisions are specific to their own purposes and context: s 95 to the calculation of a trust's net income for the purpose of assessing presently entitled beneficiaries and s 855-10 to "disregarding a capital gain or loss by foreign residents".

Section 855-10 should operate to disregard capital gains or losses made by a **trustee** and not beneficiaries. Section 855-10 reads:

> **SECTION 855-10 Disregarding a capital gain or loss from CGT events**
> **855-10(1)**
> Disregard a *capital gain or *capital loss from a *CGT event if:
> (a) you are a foreign resident, or the **trustee** of a *foreign trust for CGT purposes, just before the CGT event happens; and
> (b) the CGT event happens in relation to a *CGT asset that is not *taxable Australian property. (Emphasis added)

A resident beneficiary is taxed by reference to the s 95 net income of a trust estate. The two provisions have quite different functions, so there is no inconsistency between s 855-10 and

[3] *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**)

s 95. It follows that the argument in paragraph 11 of Draft Determination D4 that s 855-10 ‘would have no operation at all in relation to foreign trusts’ cannot be sustained.

This approach also makes sense as it should mean that resident and non-resident beneficiaries would be in the same position as if they had owned the asset directly.

Even if there were a conflict between the two provisions (which there isn’t), we consider that it is not a matter of working out which provision overrides the other; instead, the purposive approach described above achieves appropriate outcomes. As mentioned above, it cannot be said that one is a general provision and the other is specific; accordingly, one does not necessarily override the other without due consideration of legislative purpose.

The inappropriateness of the tax outcome from the position put forward in Draft Determination D4 is illustrated further in the example below.

> *Example: Industry Super*
>
> Industry Super, a public-offer superannuation fund, offers its members an investment choice of foreign property. Those foreign property investments are placed through foreign-resident unit trusts which receive rental income each year and make capital gains when properties are sold.
>
> The foreign-resident unit trusts distribute their net rental income and capital gains each year and do not accumulate any income or gains.
>
> Using the words of s 115-215(1), an “appropriate” way to assess the net rental income and capital gains is for Industry Super to be assessable on those amounts in the year they are derived/made by the foreign-resident unit trusts at the tax rates applicable had those unit trusts instead been resident in Australia. Otherwise, there would be created an inappropriate and unwarranted bias towards investing in an Australian entity when that can be difficult to do in some countries.
>
> That bias might also render certain investments effectively “off limits” to Australian superannuation funds, hindering their ability to pool their investments with non-Australians and thereby benefit from economies of scale.

TD 2016/D5

The conclusion drawn in Draft Determination D5 that the amount is included in assessable income under s 99B(1) would seem to be incorrect. There is no provision of the tax law that requires the hypothetical resident taxpayer to include the amount (being the capital gain derived by the trustee) in assessable income on the assumption that the hypothetical taxpayer had derived it. The hypothesis posited by both s 99B(2)(a) and s 99B(2)(b) is similar and preserves or retains the character of ‘the amount’ under consideration – thus, the capital gain derived by the trustee is assumed to have been derived by the hypothetical resident taxpayer (see *Howard v FCT* [2012] FCASFC 149 at [48]). Being capital, it is not included in assessable income by sec 6-5. Whilst details about the amount are known, as noted in both the *Union Fidelity* case[4] and *Howard*, no other fact is known about the taxpayer other than residence. Thus, it cannot be concluded that the TOFA provisions would make the capital gain assessable income. Part 3-1 does not include a capital gain in assessable income. Rather, s 102-5 includes the taxpayer’s ‘net capital gain’ in assessable income and this is calculated in accordance with the method statement in s 102-5(1). To calculate a net capital gain, the following details need to be known: (i) details of the taxpayer’s capital losses of the year and the choice of applying them to reduce capital gains made in the year (step 1, note 1); (ii) details of disregarded gains (step 1, note 2); (iii) unapplied net capital losses of prior years (step 2); (iv) discount capital gains (step 3); and (v) capital gains qualifying for small business tax concessions (step 4). As was the case in *Union Fidelity* (per Barwick CJ

[4] Union Fidelity Trustee Co of Australia Ltd v Federal Commissioner of Taxation 69 ATC 4084

at 4086), if nothing is known as to these matters, it cannot be the case that the amount will be included in the hypothetical taxpayer’s assessable income.

The Commissioner’s preferred interpretation of s 99B as put forward in Draft Determination D5 produces the absurd result that a capital gain distributed by a foreign trust to a resident individual would not benefit from the CGT discount when, had the same non-TAP asset been sold by a resident trust and the resulting capital gain distributed to the same resident individual, the contrary would have happened.

The Commissioner cites the *Union Fidelity* case as authority for his view that the hypothetical taxpayer posited by s 99B(2)(a) and (b) is a non-specific taxpayer in a non-specific year of income.

This reliance is misplaced.

In fact, the quoted passage from *Union Fidelity* at paragraph 17 of Draft Determination D5 deals with the s 95 definition of *net income of a trust estate* which was quoted by Barwick CJ as follows:

> The definition of "the net income of a trust estate" is to be found in s. 95 and is as follows-
> " ‘The net income of a trust estate' means the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income, less all allowable deductions, except the concessional deductions and except also, in respect of any beneficiary who has no beneficial interest in the corpus of the trust estate, or in respect of any life tenant, the deduction of such of the losses of previous years as are required to be met out of corpus."
> ………
>
> The effect of the definition of the net income of the trust estate in s. 95 is that the provisions of the Act are to be applied to the actual income of the trust estate ***as if it were the income of an individual deriving it***. From the actual income of the trust estate there are abstracted all sums which can be seen to be assessable income. For the purpose of this abstraction or computation the only fact which is relevantly known is that the trustee, as a taxpayer, has derived the income. The residence of the trustees, or of any one of them, if there be more than one cannot afford a reason for varying the net amount of the income of the trust estate according to the accident of the trustee's residence in the year of tax. Its irrelevance is emphasized when the possibility of diverse residences of several trustees is contemplated. (Emphasis added)

When seen in context, the last passage quoted by the Commissioner can be seen to relate to the wording of s 95 that appeared shortly before.

It can also be seen that s 95 at the time only referred to “the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income”. No mention of an “individual” appears in that definition. Despite this, the High Court said at paragraph 6 of the *Union Fidelity* judgement that “the provisions of the Act are to be applied to the actual income of the trust estate as if it were the income of an individual deriving it.”

The *Union Fidelity* case therefore – instead of supporting the Commissioner’s position – actually contradicts it and requires the enquiry under s 99B(2)(a) and (b) to be made on the basis that the hypothetical taxpayer were an individual.

Ambit of section 99B

The statutory context and legislative purpose of section 99B was summarised by Hill J, in *Traknew Holdings Pty Ltd v FCT* 91 ATC 4272, as follows:

59. The application of s.99B also presents difficulty. Literally, the section is capable of applying in the circumstances of the present case. However, the section was not enacted to render assessable payments or applications to the benefit of discretionary beneficiaries. Such payments or applications were already made assessable income by force of s.97 alone or in combination with s.101, leaving aside a case where s.98 applies but the presently entitled beneficiary is under a legal disability where the trustee is assessable.

60. **The provisions of s.99B can only be understood in their historical context.** The need for some such provision was discussed by the Taxation Review Committee (the Asprey Committee) in its report of 31 January 1975. The problem exposed by cases such as *Union Fidelity* was that ss.99 and 99A had no application where accumulated income was derived from a source outside Australia. If the trust income was accumulated and became capital, its subsequent receipt by a beneficiary was neither assessable income under ss.25 or 26(b). Section 99B together with ss.99C and 99D were introduced into the Act by the Income Tax Assessment Amendment Act No.5 of 1978. As the Explanatory Memorandum circulated with that Act discloses to deal:

> "... primarily with the receipt by resident beneficiaries of distributions from non resident trust estates of previously untaxed foreign sourced income."

61. The Explanatory Memorandum makes the following relevant comments on s.99B:

> "The proposed section 99B will require the inclusion in a beneficiary's assessable income of amounts paid to or applied during a year of income for the benefit of a resident beneficiary where that amount represents trust income of a class which is taxable in Australia but which has not previously been subject to Australian tax in the hands of either the beneficiary or the trustee. It will normally apply where accumulated foreign sourced income of a non resident (or of a resident trust estate that previously was not able to be taxed in Australia in the light of the Union Fidelity decision) is distributed to a resident beneficiary."

62. **It is not necessary to decide for the purposes of the present case whether the extreme width of s.99 B and associated sections require it to be read down having regard to the obvious legislative purpose in enacting it**. (Emphasis added)

Hill J noted the "*extreme width*" of s 99B, and "*having regard to the obvious legislation purpose in exacting it*".

Coupled with the principles of statutory construction, most recently outlined by the High Court in *Commissioner of Taxation v Unit Trend Services Pty Ltd* (2013) 250 CLR 523, it is submitted that the Commissioner's view in Draft Determination D4 and Draft Determination D5 cannot be sustained.

In particular, the Commissioner's view in Draft Determination D4 and Draft Determination D5:

- is inconsistent with the views expressed by the courts (including the statutory fictions created by Division 6);
- is inconsistent with the statutory context and purpose of s 99B;
- is inconsistent with the language and purpose of the entire tax legislation, including the conduit approach to the taxation of trusts;
- is inconsistent with the policy principles underpinning the taxation of trusts; and

- results in unfair outcomes, including the denial of the capital gains tax discount and the ability to offset capital losses against capital gains in respect of certain resident investors (who would otherwise obtain such entitlement under the tax rules).

These matters are discussed further below**.**

Residency assumption

The assertion expressed by the Commissioner in Draft Determination D4 that the residency assumption in s 95(1) does not apply for the purpose of s 855-10, is inconsistent with the views expressed by the Full Federal Court (Middleton, Perram and Dodds-Streeton JJ) in *Howard v Commissioner of Taxation* [2012] FCAFC 149 (**Howard**).

The Full Federal Court in *Howard* affirmed the view, expressed by the High Court in the *Union Fidelity* case, that the statutory fictions created by Division 6 (in that case, a hypothetical treatment of a non-resident trust as an Australian resident) are carried through for the purpose of assessment for the entire tax legislation (paragraphs 40 – 49):

> 40. There, having grasped the initial hypothetical transformation of the Esparto Trust estate into a resident taxpayer, one is now required (as part of that hypothesis's inevitable working through) hypothetically to treat the Juris Trust estate as a resident taxpayer and to ask whether the amounts received by it would have been included in such a resident taxpayer's assessable income.
> ….
> 49. …It is true, no doubt, that s 95 is not the same as s 99B(2)(a) and it is certainly correct that Div 6 has received many amendments since the time of Union Fidelity. But the basic point it illustrates remains sound: **Div 6, and its various hypothetical taxpayers, operate on an assumption that the fictions thereby engendered are to be assessed for tax under the balance of the Act**. Mr Howard's submission that statutory fictions must be closely confined to the domain of their operation is, of course, correct. The difficulty, however, lies in the fact that that domain in the case of Div 6 generally, and in the case of s 99B(2)(a) in particular, is the whole Act. Once that is accepted, Mr Howard must be brought to s 44(1) on the hypothesis demanded by s 99B(2)(a) and no other; i.e., there must be an assessment of whether a resident taxpayer who derived the amounts received by the Juris Trust estate would have been required to include the amounts in its assessable income. Once that is accepted, s 44(1), together with s 159GZZZP(1), take their inevitable course and s 99B(2)(a) conveys that result through the overlying layers of trusts back to Mr Howard. That is the end of the matter. (emphasis added)

It follows from the Full Federal Court decision in *Howard* that the residency fiction in subsection 95(1) is carried through for the purpose of assessment for the whole of the tax legislation, and applies for the purpose of section 855-10.

Catch-all provision

The Full Federal Court in *Howard* re-affirmed the view that section 99B was introduced as a 'catch-all' provision, with residual effect after the primary operation of section 97:

> 51. …It is not necessary for us to do so because whatever is not included under s 97 will, by reason of the foregoing conclusion, be included by the necessary operation of s 99B(2)(c). **That provision is a catch-all** and, if necessary, as such is apt to catch the whole of the distribution to Mr Howard even if it be not brought to tax under s 97. It is likely, however, that Mr Howard's argument about the operation of s 97 likewise proceeds in disobedience to the similar express hypothesis demanded by s 99B(2). (emphasis added)

The statutory construction of s 99B as a residual, catch-all provision has implications for Australian resident investors taxed on a present entitlement basis under section 97. In particular:

- Australian resident investors which invest offshore through a non-resident trust, and assessed on a present entitlement basis in respect of that non-resident trust, will not be subject to the operation of s 99B (pursuant to the carve-out in s 99B(2)(c)); and
- there should be no residual operation of s 99B, given that the amounts would already be taxed in Australia. This outcome is consistent with the legislative purpose of s 99B as a catch-all provision as outlined above.

Section 99B and capital gains tax

The Commissioner expressed the view in paragraph 9 of Draft Determination D5 that "An amount attributable to the capital gain may nonetheless be assessable to the beneficiary under subsection 99B(1) of the ITAA 1936."

The intention of Parliament in relation to capital gains (exempt from tax when s 99B was introduced into the tax regime) is described in the Explanatory Memorandum to *Income Tax Assessment Bill (No 5) 1978* (which introduced section 99B – see page 28 of the Explanatory Memorandum):

> Proposed <u>sub-section (2)</u> modifies this general rule and will have the effect that the amount to be included in assessable income under sub-section (1) is not to include anything that represents either –
> …
> - amounts - such as capital gains, or ex-Australian income taxed abroad and exempt from tax under section 23(q) of the Principal Act – that would not be included in assessable income if derived by a resident taxpayer (paragraph (b))…

Relevantly, since the introduction of the capital gains tax regime in 1985, in the ordinary case, there would be no need for s 99B to be triggered, given that such amounts would already be taxed in Australia through the combined operation of the capital gains tax rules and Division 6.

Presumably it is not the purpose of s 99B to override specific (and subsequent) CGT exemptions (such as that provided for life policies under Item 3 of the Table in s 118-300(1) in respect of life policies held by trustees, and the flow-on exemption for beneficiaries of that trust under s 118-300(1A)).

Similar observations may be applicable to the small business CGT concessions. If a CGT concession is available under Division 152 to a resident individual where he or she receives a distribution from an Australian trust then it should also apply to a resident individual who receives such a distribution from a non-resident trust.

We consider the better course of action to be to withdraw the Draft Determinations. However, if contrary to that they were finalised, the Determinations should confirm that CGT exemptions that would apply to resident taxpayers are not disregarded when applying s 99B.

Nature of amounts assessable under s99B

Even if it were correct to treat amounts of capital gains that are assessable to beneficiaries pursuant to s 99B as assessable income other than a discount capital gain (which it is not), applying the beneficiary-centric approach described under heading 2.1 above should result in an appropriate amount of assessable income in the beneficiary's hands. For example, a resident individual beneficiary receiving a distribution out of trust corpus representing a previously accumulated capital gain should be assessable on the same amount that they would have been assessable on had they made the capital gain personally.

Policy considerations

The main policy principle underlying the taxation of trusts is that there should not be significant distortion between the tax outcomes as between direct and indirect investment: refer to Policy Principle 1, as articulated by the Board of Taxation in its Discussion Paper, *Review of Tax Arrangements Applying to Managed Investment Trusts* dated October 2008, as follows:

> 1.6 The broad policy framework for the taxation of trusts is to tax the beneficiary on its share of the net income of the trust, so that the trustee is only taxed on income that is not taxable in the hands of beneficiaries. Within this framework, the Board should ideally develop options for reform with taxation outcomes that are broadly consistent with five key policy principles:
>
> *Policy Principle 1*
> The tax treatment for trust beneficiaries who derive income from the trust should largely replicate the tax treatment for taxpayers as if they had derived the income directly."

In addition, a policy goal governing the tax rules relating to outbound investments is that tax distortions, between direct and indirect offshore investments, should be removed to ensure a competitive framework within the Australian managed funds industry. This policy principle was articulated in the Supplementary Memorandum to *Taxation Laws Amendment Bill (No.4) 1998* as follows:

> 1.28 If an exemption were not provided, direct investments in REITs may be treated more favourably than indirect investments in REITs managed by Australian collective investment funds. This is because the indirect investments would continue to be subject to accruals taxation under the CFC measures whereas direct investments are likely to be exempt from accruals taxation following the proposed exemption from the FIF measures for US FIFs. Indirect investments would therefore continue to be subject to additional tax and compliance cost burdens associated with accruals taxation while direct investments in REITs would no longer be accruals taxed under the FIF measures.
>
> 1.29 Less favourable treatment of REITs managed by Australian collective investment funds could have a significant impact on their ability to compete. In this regard, direct investments in REITs are a close substitute for indirect investments in REITs managed by Australian funds.
> …
> 1.41 The implementation option is considered the only effective means of achieving the policy objective of ensuring that Australian collective investment funds remain competitive with US funds in attracting and managing Australian investment in REITs without giving rise to significant tax deferral opportunities. The option is expected to lead to an overall reduction in compliance costs for Australian collective funds that manage REITs.

The Commissioner's view in Draft Determination D4 and Draft Determination D5 cannot be sustained since it contravenes the above policy principles for the following reasons:

- certain taxpayers, who are eligible for the capital gains tax discount in respect of direct ownership of foreign assets, would not be entitled to the capital gains tax discount if the investment were made through a foreign trust; and

- there would be distortions between the tax outcomes under a direct and indirect investment in foreign assets.

Need for legislative amendment

We note the Commissioner's concern expressed in paragraph 19 of Draft Determination D5 that resident companies might be able effectively to benefit from the application of the CGT discount and agree that this would be an inappropriate outcome. However, we consider that *Alternative View 2* described in paragraphs 24 to 27 of Draft Determination D5 to present an approach which would produce an outcome more consistent with the policy inherent in Division 115 described above in response to Draft Determination D4.

In the absence of applying a beneficiary-centric approach such as that described in *Alternative View 2*, the possible ability of a corporate beneficiary effectively to benefit from the CGT discount is an inappropriate outcome and should properly be addressed by legislative amendment instead of administrative treatment by the Commissioner.

12 November 2017

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Dear Dr Hodder

Submission to review and refresh regulatory requirements applying to the life insurance industry

The Financial Services Council (FSC) would like to thank the Committee for the opportunity to provide this submission to review the *Life Insurance Act 1995* (Cth) and the *Insurance Contracts Act 1984* (Cth), being the primary legislation affecting the life insurance industry, to ensure that they remain relevant to current and emerging industry practice.

In addition, we included the FSC Treasury submission that was lodged in December 2016 outlining issues under the *Life Insurance Act 1995* (Cth) and the *Insurance Contracts Act 1984* in relation to the cancellation of life risk contracts of insurance for non-payment of premium. For your convenience, we attach that submission as an addendum to this submission (see Addendum 1).

The FSC has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, licensed trustee companies and public trustees. The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the third largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

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Should you wish to discuss this submission further please do not hesitate to contact me on .

Yours sincerely

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SUGGESTED MODIFICATIONS TO THE LIFE INSURANCE ACT 1995 (CTH)

While the *Insurance Contracts Amendment Act 2013* (Cth) significantly amended the *Insurance Contracts Act 1984* (Cth) (**ICA**) to respond to market developments and judicial decisions since its enactment, updates to the *Life Insurance Act 1995* (Cth) (**Life Act**) to address developments in the life insurance industry have not been forthcoming.

This has meant that there are a number of provisions in the Life Act which are outdated and not relevant to the way that life insurance contracts are administered in 2017. For example, if a policy owner notifies a life insurer that they do not have a copy of a policy document and wish to be issued with a replacement, the Life Act requires the life insurer to place an advertisement in the local newspaper at least 10 days before issuing a replacement policy document to mitigate the risk that the policy may have been transferred to someone else. This is despite the fact that all life insurers maintain electronic records of policies, including details of the policy owner. Strict adherence to these provisions causes significant detriment to consumers, as they are required to wait over 10 days for a replacement policy document which could actually be provided in a matter of minutes.

Such outdated requirements should be contrasted against initiatives of the life insurance industry to commit to more efficient timeframes in responding to consumers, such as the implementation of the Life Insurance Code of Practice, which sets out strict timeframes in relation to claims handling practices.

We submit that there are a number of sections of the Life Act which should be amended immediately to allow the life insurance industry to focus on providing high levels of service for consumers.

Other suggested amendments may require additional consultation.

In Schedule 1 of this submission, we have highlighted those changes that we consider can be implemented without consultation, while highlighting other changes which may require additional consultation.

PROPOSED AMENDMENTS TO THE LIFE ACT

DEFINITIONS OF LIFE POLICY AND CONTINUOUS DISABILITY POLICY SHOULD BE EXPANDED

Sections 9 and 9A of the Life Act set out the definitions of a 'life policy' and a 'continuous disability policy', which in our view are restrictive as they exclude the following contracts of insurance (amongst others):

- consumer credit insurance (CCI) policies (section 9A(6)), which typically include both life insurance and general insurance cover;

- income protection (disability) policies, which are less than three years' duration (section 9A(1)); and
- accidental death and specified sickness policies, which are less than one year's duration (section 9(2)).

This demarcation has restricted life insurers from providing such cover. As a result, such cover is often not provided, or provided in conjunction with an authorised general insurer. This has limited product innovation, efficiency and competition.

In addition, these restrictions have resulted in general insurers writing policies which are inherently similar to life insurance, and require some assessment of an applicant's risk of mortality or morbidity, without the need to adhere to the legislative and regulatory requirements applying to life insurers. Assessment of an applicant's mortality or morbidity is clearly within a life insurer's core business and not the business of a general insurer. Accordingly we see no reason why life insurers are not permitted to write business of this type.

If the definition of a life policy was amended to allow life insurers to write policies in the above instances, it would allow for greater product innovation in certain areas, for example linking short term disability policies with death policies, or offering these policies through superannuation.

A practical example is illustrated in the case where disability and accidental death insurance is required for contractors on a building site. In this instance, there is likely to be a specific need for insurance to be applicable for a short time frame until completion of the building project (which may be less than 12 months, or up to 2 years). The current definition of life policy, including a continuous disability policy, would result in this insurance falling outside the scope of the Life Act in relation to the continuous disability cover, but within the scope of the Life Act in relation to the death cover. The Life Act currently defines continuous disability policies as life policies only where the term is <u>more than three years</u>. Accordingly, it is recommended that the term in continuous disability policies be removed to include all circumstances which require an assessment of an applicant's risk of mortality or morbidity regardless of the duration of the insurance contract.

RESTRICTION ON ANNUITIES UNDER SECTION 9(1)(D) AND THE LIFE INSURANCE REGULATIONS SHOULD BE REMOVED

The section 9(1)(d) Life Act definition of 'life policy' includes 'a contract that provides for the payment of an annuity for a term not dependent on the continuance of human life but exceeding the term prescribed by the regulations…' Currently, Regulation 2.01 of the Life Insurance Regulations 1995 (Cth) (**Life Regs**) prescribes a term of 10 years.

We submit that the specified ten year annuity period is out of step with the current annuity market expectations where consumers can purchase annuities which are shorter than ten years in duration.

The proposed amendment is also consistent with declarations made by APRA under section 12A of the Life Act, whereby APRA can declare that an annuity with a term of ten years or less can be life insurance business. This declaration has been provided to a number of life insurers who currently issue annuities.

It is recommended that Regulation 2.01 be repealed, and section 9(1)(d) be amended so that any annuity for a term not dependent on the continuance of human life falls within the definition of a 'life policy'.

In defining the scope of annuities which constitute life policies, we suggest that regard is had to the meaning of annuities as set out in Regulation 1.05 of Superannuation Industry (Supervision) Regulations 1994 (Cth) (**SIS Regulation**) so that clarity and consistency is achieved in relation to annuities constituting life insurance policies. Ideally, life insurers should be permitted under the Life Act to issue any annuity within the meaning of SIS Regulation 1.05.

APRA DECLARATION THAT INSURANCE OR ANNUITY BUSINESS IS LIFE INSURANCE BUSINESS

Section 12A provides APRA with the power to declare that business relating to the payment of annuities is life insurance business for the purposes of the Life Act where such business is "insurance business".

It is recommended that consideration be given to broadening the power granted to APRA to provide it with additional flexibility given the current interest in the development of retirement income products by life insurers and the government. For example, this section should be amended so that APRA has the power to declare that business that shares some of the characteristics of annuities can be declared to be life insurance business, regardless of whether such business is "insurance business". Ideally, life insurers should be permitted under the Life Act to issue any annuity within the meaning of SIS Regulation 1.05.

MORTGAGING THE ASSETS OF A STATUTORY FUND

Section 38(3) of the Life Act provides that a life insurer must not mortgage or charge any of the assets of a statutory fund save for three exceptions.

The prohibition on mortgaging of statutory fund assets in section 38(3) of the Life Act is out-dated because it has not kept pace with current developments in:

- collateral management practices of life insurers when exposed to potential credit risks of reinsurers; and
- prudential standards that prescribe risk-based capital requirements.

Collateral management

When entering into reinsurance arrangements, a life company is exposed to the credit risk of the reinsurance company. For example, consider where Company A is exposed to the credit risk of Company B. Company A, as a prudent life company, could reasonably expect that any material credit exposure it has to Company B is supported by collateral. A common form of posting collateral, which is used in similar jurisdictions, is for Company B to put assets into a trust or account and provide Company A with security over that trust or account.

Unfortunately this approach is unavailable to Australian life companies because it is in breach of the prohibition on mortgaging the assets of the statutory fund of Company B.

In order to address this, life companies have developed structures to address the security needs of their counterparties. However, these have disadvantages when compared to the more common approach. These structures include:

- Title transfer: Under this approach, the ownership of the collateral assets is actually transferred from Company B to Company A. This puts Company B in a worse credit position because it no longer has any claim on the assets. In a default of Company A, Company B will rank as an unsecured creditor over the collateral assets (remembering that Company A can similarly not provide security on the transferred assets back to Company B).
- Funds withheld: Under this approach, Company A only pays a portion of the premium to Company B, and withholds an amount for its credit exposure. This is effectively another form of the title transfer approach and results in the same disadvantages.

The restrictions on the more common collateral structures place Australian life companies at a competitive disadvantage against life companies based in other jurisdictions because they are unable to enter into the more common collateral arrangements.

Risk based capital requirements

Following significant developments in the life insurance market over many years, life companies are now subject to a number of prudential standards set out by APRA that prescribe risk-based capital requirements.

As a risk-sensitive measure, the regulatory capital requirements contemplate a life company's gross exposure to risk, and will automatically adjust to consider any additional risk arising from the mortgaging of statutory fund assets.

Further, this level of capital represents the regulatory minimum. Under prudential standards, life companies are also required to have in place an internal capital adequacy assessment process (**ICAAP**) that is appropriate to the life company's size, business mix and complexity of its operations.

The ICAAP requires, inter alia, a strategy for ensuring that adequate capital is maintained over time, including specific capital targets set in the context of the life company's risk profile, the Board's risk appetite and regulatory capital requirements. This strategy will contemplate how capital is managed, including any risks arising from the mortgaging of statutory fund assets.

Under Prudential Standard LPS114 Capital Adequacy: Asset Risk Charge (**LPS114**), the calculation of the Asset Risk Charge specifically contemplates a life company investing in trusts or controlled investment entities that are geared. A footnote clarifies that a trust or entity may be geared through borrowings or through the use of derivatives. Therefore, the regulatory framework contemplates that a life company may hold geared investments, and that they are appropriately dealt with through capital standards. However, the prohibition on mortgaging of the assets of a statutory fund means that structures must be put in place to achieve this outcome. The prohibition therefore leads to additional costs in order to achieve a geared investment that could be undertaken directly in the statutory fund.

In response to the view that the regulatory framework allows investment into a geared entity, it could be argued that holding any geared investment in a trust or entity protects the statutory fund because losses are limited to the investment in the fund. However under section 38(6) of the Life Act, the assets of a statutory fund are available to meet a liability of a life company under a contract of guarantee if the contract of guarantee was entered into in connection with an investment of assets of the fund. That is, a life company may guarantee the performance of a geared trust or entity, resulting in the same effective exposure as if the gearing were directly in the statutory fund. In any case, a mortgaging of assets can be structured on a non-recourse basis in the statutory fund which limits the exposure to the investment amount.

A life company is also required to maintain a risk management framework that is appropriate to the size, business mix and complexity of the institution. Again, this risk management framework will contemplate any risks arising from the mortgaging of statutory fund assets.

Superannuation funds also have had less restrictive requirements in relation to asset security. Amendments to the *Superannuation Industry (Supervision) Act* (**SIS Act**) in 2010 have allowed superannuation funds to enter limited recourse borrowing arrangements on the security conditions set out in sections 67A and 67B of the SIS Act. This demonstrates the growing acceptance of the mortgaging of assets as a valid investment strategy where an appropriate risk management framework is in place.

Overall, the comprehensive framework for risk and capital that has been introduced in the life insurance market over the last 20 years means that the risks associated with mortgaging of assets of a statutory fund are addressed through other means, and the prohibition in the Life Act is no longer required.

We therefore recommend that the prohibition on mortgaging of the assets of a statutory fund, as set out in subsection 38(3) of the Life Act, be amended so that such arrangements may be allowed in accordance with APRA prudential standards.

REQUIREMENT FOR ENDORSEMENT TO BE MARKED ON THE POLICY DOCUMENT FOR SUCCESSFUL ASSIGNMENT SHOULD BE REMOVED (SEE ADDENDUM 1)

Section 200 of the Life Act provides that an assignment of the policy is not effective unless a memorandum detailing consent of the old policyholder, new policyholder and insurer is “endorsed” on the policy.

The endorsement requirement should be removed as any assignment needs to be notified to the life insurer and recorded in their system.

Prior to life insurers keeping very sound electronic records, it was very important for policy owners to keep the original insurance policy document but this is not the case in 2017. Everything is stored electronically so that the requirement for each party to mark a policy is out-dated.

Completion of the memorandum should be sufficient as long as a copy is given to the affected persons and recorded in the life insurer’s systems.

We recommend that the requirement to register the assignment under section 200(1)(d) be amended to allow the assignment to be otherwise recorded on the system of the life insurer.

Requirement for paper notices of non-forfeiture

Section 210(5) sets out the process a life company must follow in order to validly forfeit a policy of life insurance. This provision originates from a time when life policies were typically whole of life and endowment policies, with an asset value constituting property that could be ‘forfeited’. Current risk policies differ, as they do not have any value at the end of each period covered by a premium, and the life company’s promises only continue to be effective if the next premium is paid on time.

Other elements of this submission deal with the current uncertainty about whether the impending forfeiture notification process under section 210(5) applies to risk only policies (as well as to policies with an asset value) or whether they are covered by sections addressing policy cancellation in the ICA. The issue raised here is unrelated to that uncertainty, and should be considered for reform irrespective of how that uncertainty is ultimately resolved.

Following legislative reform in 2013, which removed the exemption of the ICA from *Electronic Transactions Act 1999* (Cth) (**ET Act**), notices given under section 59 of the ICA may be given electronically where the policy owner has consented to the information being given that way. This is because Section 9 of the ET Act allows for written notices to be given in electronic form where the person receiving the notice has consented to it being given in that form. However, that is not the case for notices given under section 210(5) of the Life Act, which serve the same purpose, because the Life Act remains exempted from the ET Act.

We submit that there is no justification for this difference, and that the ETA should be amended to allow notices given under section 210(5) of the Life Act to also be given electronically. Doing so would provide the opportunity for process simplification, faster communication, improved reliability of communication and technological neutrality with the process permitted by section 59 of the ICA.

LIMITS NEED TO BE INCREASED FOR CIRCUMSTANCES WHERE BENEFITS CAN BE PAID TO FAMILY MEMBERS WITHOUT PROBATE OF ADMINISTRATION

Currently sections 211 and 212 of the Life Act allow an insurer to pay to a surviving spouse and other relatives an amount up to $50,000 under a life policy without a grant of probate or letters of administration. The Supplementary Explanatory Memorandum to the *Life Insurance Bill 1994* (Cth) outlines the section as allowing life companies to pay “small claims”.

The rationale is that in the case of most small estates where there is no will, the surviving spouse will likely be the main beneficiary on intestacy. Further, considerable administrative difficulties are often encountered to secure grants of probate or letters of administration which can result in considerable delays in the payment of the life insurance death benefit.

The limits set in the Life Act have not been increased in over 20 years so have not kept pace with inflation and the increases in average sum insured amounts.

The Reserve Bank of Australia’s inflation calculator indicates an inflation rate change of 67.3% over 21 years, with an average annual inflation rate of 2.5%. Accordingly, the amount of $50,000 in 1995 is equivalent to the amount of $83,642 in 2016.

We recommend that the limit be raised to $100,000 or $200,000 and the section include a CPI indexation factor to ensure that the limit keeps pace with inflation.

LIMITS NEED TO BE INCREASED WHERE LIFE INSURER CAN APPOINT A LIFE INSURED AS POLICY OWNER OF THE POLICY AFTER THE ORIGINAL POLICY OWNER HAS DIED

Section 213 of the Life Act allows life companies to make a life insured a policy owner, if the original policy owner has died and the life insured satisfies the life company that they would be entitled to the policy proceeds under the policy owner's will or probate rules. The policy amount must be less than the prescribed amount of $25,000.

Once the life company is satisfied that the requirements are fulfilled, the life company must endorse on the policy a declaration that the life insured is the owner of the policy and can benefit from the proceeds.

The requirement to specifically endorse on the policy can increase administrative burdens and costs on life companies and the life insured.

To simplify the process for the applicant and the life company, a recommendation is made to instead allow for the transfer of ownership to be recorded in some form (i.e. in the electronic records of the life insurer).

We recommend that to maintain consistency across the Life Act and to cater for the increases in inflation and in average sum insured amounts, as discussed above, the prescribed amount be increased from $25,000 to $100,000 or $200,000 and the section include a CPI indexation factor to ensure that the limit keeps pace with inflation.

UNCLAIMED MONIES PROCESS SHOULD BE STREAMLINED

Section 216 of the Life Act provides that where the life insurer has paid unclaimed money to ASIC, a claimant must contact the relevant life insurer when they become aware of unclaimed money. The life insurer then contacts ASIC, to request return of the unclaimed money to the life insurer by a one off request.

The claimant then waits for payment for around 28 days from the date the life company lodges the request. Claimants find such delays unacceptable. Some companies therefore fund the repayment from their own reserves while waiting for the money from ASIC to enable prompt payment.

The life insurer is clearly best placed to verify that the claimant is in fact the policyholder (or otherwise entitled to the money where the policy holder has died), to identify the claimant and to obtain bank account details for the payment to be made – this is not something ASIC can efficiently do. However, the current process causes unnecessary double handling of money and delay – ASIC makes the payment to the life insurer, and the life insurer then pays the claimant.

We recommend that the life insurer notify ASIC after customer identification has occurred, and to advise the bank account details for ASIC to make the payment directly. In the FSC's view, it would be more efficient for ASIC to pay the claimant directly using payment details advised by the life insurer, and unlikely to result in additional work for ASIC as it is already making the payment to the life insurer.

MODERNISATION OF THE LIFE ACT FROM PAPER TO ELECTRONIC INCLUDING REMOVAL OF ARCHAIC EVIDENTIARY REQUIREMENTS

Sections 221-225 of the Life Act constitute Part 10, Division 7---Lost or destroyed policy documents. These sections are in substantially similar form to provisions in the predecessor legislation, the *Life Insurance Act 1945* (Cth). In our view these provisions and the governance they mandate for the process for replacing lost or destroyed policy documents is out-dated and unduly cumbersome for modern requirements. The process can be lengthy and involve consumer cost. Examples of the out-dated nature of these provisions are set out below.

- Firstly the life insurer has to be satisfied as to consumer evidence of loss of a policy document. If it isn't, an application can be made to court, on failure of the life insurer to issue the policy document (section 221). A replacement policy document must as far as possible copy the original, include any endorsements and state the reasons for its issue (section 222).

- If the claim value is in excess of $25,000 on the replaced policy, the life insurer is required to give notice of intention to issue a replacement policy document by way of newspaper advertisement (section 223) (see Addendum 2). This can be in a newspaper circulating in the district in which the policy owner resides or the district in which the insurer considers the original policy document to have been lost or destroyed. The applicant bears all the costs of advertisement and issue of the policy document, and they have to be paid up front (section 223(4)). The Part 10, Division 8 register must be updated to reflect the issue of the replacement policy document and the reasons for it.

- Similar advertising requirements apply in the case of loss or destruction of the original policy document where a claim under the policy is made under section 211, 212 or 213 (section 224).

Technological advances have meant that the print media has far less significance as a news channel than when the Life Act commenced. The requirement for advertising serves no useful purpose, involves consumer expense, and means a lengthy wait for a policy owner when in reality, without the Part 10, Division 7 requirements, the request could be dealt with in a matter of minutes.

In the 22 years since the current Life Act commenced, technological advances have greatly reduced the reliance on paper as the sole source of identification and evidence of a life insurance policy. The concept of a lost or destroyed policy document has ceased to be relevant, and there is no legislative or economic basis for retaining Part 10, Division 7 in the Life Act. To overcome this, life insurers should maintain their own records of policy documents they issue electronically. Section 74 of the ICA requires insurers to provide to insureds a statement of all the provisions of the contract on request. Failure to do so is an offence attracting 300 penalty units. We feel the law here adequately protects consumers.

We recommend the repeal of Part 10, Division 7 for sound legislative and consumer reasons. The widespread use of e-technology across all forms of business activity has rendered the paper-based thrust of Part 10, Division 7 anachronistic. The onus is on insurers to maintain availability of policy terms.

Requirement to keep registers

Part 10, Division 8 of the Life Act requires insurers to keep registers of policies by state and to amend registers when policies move between states (at the cost of the policy owner). In our view, the Life Act provides little guidance as to the structure and form of the register, and currently there is ambiguity as to whether an electronic register would be permissible under the Act. We believe the provisions should be modernised to allow for electronic registers.

Sections 226 and 227 of the Life Act require life insurers to register life insurance policies by state, keep registers of policies according to state, and to amend registers when policies move between states (at the cost of the policy owner).

The process has led to regulatory complexity and increases in unnecessary burdens and costs for the life insurer and the policy owner and is out of date given life insurers keep all records electronically, including the addresses of all policy owners.

Section 12 of the ET Act allows for the recording of information in electronic form and would undoubtedly allow for administrative simplification if implemented in the context of sections 226 and 227 of the Life Act. Nevertheless, the Life Act is presently excluded from the ET Act under the Electronic Transaction Regulations 2000 (Cth) (**ET Regs**).

We recommend that the ET Regs be amended to remove the Life Act from the exclusions under the ET Act to provide certainty that electronic records maintained by the life insurer would suffice as an accurate record.

WAR EXCLUSIONS VOID UNLESS WRITTEN ON THE POLICY DOCUMENT AND SIGNED BY THE POLICY OWNER

Section 229 of the Life Act makes war exclusions for death cover void unless there is written on the policy document an acknowledgement signed by the person to whom the policy is issued that the policy is subject to the term or condition.

The provision is historical and is no longer in keeping with current practice. A requirement for a signed acknowledgement on the policy document does not work with the way insurance policies are sold and administered today. Most applications are completed electronically and any exclusion is provided in either the product disclosure statement (**PDS**) or in the policy schedule. The PDS must be provided prior to sale and any additional exclusion applied at underwriting needs to be agreed by the policy owner.

We recommend that this section be repealed or amended to ensure that it is line with current practices.

CONCLUSION

It has been over 22 years since the Life Act replaced the *Life Insurance Act 1945* (Cth) and in that time technological advancements have been significant. The Life Act has not kept pace with those advancements and contains requirements that if strictly followed, will cause significant detriment to consumers, in terms of the time it takes to receive replacement policies and the angst associated with out-dated processes. Consumers are often asking for this information in their time of need, so mechanisms which provide barriers to providing consumers with peace of mind should be removed.

Similarly, the level of scrutiny on life insurers by regulators has increased significantly, including the requirement to comply with APRA's Prudential Standards, so some of the protectionist measures in the Life Act are no longer required. If anything, they can stifle a life company's ability to keep pace with collateral management which may be required in arrangements with reinsurers.

We understand that some of these proposals are not straightforward and that Treasury may seek input from other stakeholders before making these particular changes. We agree that this may be appropriate for the more complicated changes but for the majority of the suggested changes, the amendments can be made immediately given that there is no sound basis for keeping many of the out-dated provisions of the Life Act.

SCHEDULE 1 – TABLE OF SUGGESTED AMENDMENTS TO THE LIFE ACT

ISSUE	SECTION	SUGGESTED AMENDMENT	CONSULTATION REQUIRED
Life insurance definition to include policies less than three years duration	9 and 9A	Amend to allow for shorted duration to be considered life insurance	Likely consultation with general insurers
Annuities of any duration to be considered life insurance	9(1)(d)	Amend Life Regs to include annuities of any duration	No
APRA declaration of annuities as life insurance	12A	Amend to allow APRA to declare annuity characteristics as life insurance	Yes, but part of current discussions
Mortgaging assets of a statutory fund	38(3)	Remove restrictions	Yes
Requirement for endorsement of assignment of policy	200	Remove this requirement	No
Limits for payment without probate or administration	211 and 212	Need to be increased from $50,000 to $200,000	No
Appointment of life insured as policy owner following death of original policy owner	213	Endorsement requirement should be removed and limits need to be increased from $50,000 to $200,000	No
Unclaimed monies requirements	216	Streamline the payment mechanism so ASIC pays claimant directly	No
Move from paper to electronic	221-225	Repeal sections which are in place to deal with a single paper policy document rather than An electronic record	No
Requirements to keep registers of policies by State	226 and 227	Remove exclusion of the Life Act from the	No

		Electronic Transactions Act 1999 (Cth)	
War exclusion	229	Remove requirement for written endorsement of policy document for exclusion	No
Use of statutory funds	78-80	Are statutory funds in all cases appropriate? Further consultation is required.	Yes

SCHEDULE 2 – AMENDMENTS TO REMEDY POLICY CANCELLATION ISSUE

LEGISLATION OR REGULATION	SECTION	SUGGESTED AMENDMENT	CONSULTATION REQUIRED
Life Insurance Regulations	New	Include a Regulation to make it clear that section 210(5) of the Life Act only applies to life investment products and not life risk insurance products.	Consultation with Treasury, ASIC and APRA has already occurred.
Insurance Contracts Act	59A	Make it clear that the ICA provides cancellation rights for non-payment for premiums providing that the life insurer has complied with section 59	As above.
Insurance Contracts Act	63	Removal of the note which currently causes confusion.	As above.

ADDENDUM 1 – BRIEFING PAPER FOR TREASURY - CANCELLATION OF LIFE RISK CONTRACTS OF INSURANCE

12 December 2016

1. Overview of issues

We thank Treasury for the opportunity to provide this briefing paper.

In this paper, we:

- outline issues under the *Insurance Contracts Act 1984* (**ICA**) and the *Life Insurance Act 1995* (**LIA**) in relation to the cancellation of life risk contracts of insurance for non-payment of premium. In particular, the life insurance industry and the Financial Ombudsman Service (**FOS**) have differing views as to which Act applies to the cancellation of life risk contracts of insurance for non-payment of premium, and
- submit that Treasury should seek legislative amendment to resolve these issues.

The issues are obviously of considerable importance to the life insurance industry, and for holders of life risk contracts of insurance.

2. Summary of differing views taken by the life insurance industry and FOS

The FSC's and its life insurance members' view is that the correct procedure for cancelling a life risk contract of insurance for non-payment of premium is set out in section 59 of the ICA. This view is supported by commentary provided by Ian Enright and Rob Merkin in *Sutton's Law of Insurance in Australia* (Thomson Reuters, Sydney, 4th ed, 2015) (**Sutton's Law of Insurance in Australia**), and legal opinions from Mr Ian Jackman SC, dated 26 November 2015 and 15 December 2015 (collectively, **Jackman Opinion**)(attached).

We understand that FOS's view is that the correct procedure for cancelling a life risk contract of insurance for non-payment of premium is set out in section 210(5) of the LIA[1]. FOS's view is supported by Stanley Drummond, currently a partner at Thomson Geer, in an article published in 2007 in the *Insurance Law Journal*[2] (attached) and in *Wickens The Law of Life Insurance in Australia*, which is edited by Stanley Drummond (**Drummond View**).

3. Outline of issues under the ICA and the LIA

Prior to amendments made by the *Insurance Contracts Amendment Act 2013*, the ICA did not impose any restrictions on the circumstances in which an insurer could cancel a life risk contract of insurance. As such, an insurer could cancel a life risk

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[1] FOS has applied section 210(5) of the LIA to life risk contract of insurance in the following cases:

- FOS Determination 351351 (20 April 2015),
- FOS Determination 355625 (11 February 2015), and
- FOS Determination 278157 (12 December 2013).

[2] "Which cancellation procedure for contracts of life insurance?" (2007) 18 *Insurance Law Journal* 153.

contract of insurance in accordance with its rights under the policy terms, the common law, or the LIA.

However, from 28 June 2013, amendments made by the *Insurance Contracts Amendment Act 2013* apply to life risk contracts of insurance entered into after the commencement of those amendments.

In particular, new section 63 provides:

(1) Except as provided by this Act, an insurer must not cancel a contract of general insurance.

(2) Except as provided by this Act or section 210 of the Life Insurance Act 1995, an insurer must not cancel a contract of life insurance.

Note: Section 210 of the Life Insurance Act 1995 deals with cancellation of a contract of life insurance because of non-payment of premium.

(3) Any purported cancellation of a contract of insurance in contravention of subsection (1) or (2) is of no effect.

There are differing views as to whether section 63(2) acts as a code as to the circumstances in which a contract of life insurance can be cancelled, or only as to the procedure which must be followed when a contract of life insurance is cancelled. If section 63(2) acts as a code as to the circumstances in which a contract of life insurance can be cancelled, the effect of new section 63(2) is that a contract of life insurance can **only** be cancelled in the following circumstances - as provided by:

- the ICA, which only provides for cancellation if an insured has made a **fraudulent claim** (section 59A(1)); and
- section 210 of the LIA, which only provides for forfeiture of ***certain*** contracts of life insurance due to **non-payment of premium** (section 210(5)).

At issue, is whether section 210 applies to ***all*** contracts of life insurance or only contracts of life insurance which have an ***investment*** component.

Division 4 of the LIA (which includes section 210) relevantly provides:

Division 4—Surrender values, paid-up policies and non-forfeiture of policies

206 Application of Division

(1) Subject to subsections (2) and (3), this Division applies to all policies.

(2) This Division does not apply to policies declared by the regulations to be excluded from the operation of this Division.

(3) The regulations may provide that this Division applies to a class of policies subject to specified modifications. If such provision is made, this Division applies to the class of policies accordingly…

210 Non-forfeiture of policies in certain cases of non-payment of premiums

(1) A policy is not liable to be forfeited only because of the non-payment of a premium (the overdue premium) if:

(a) at least 3 years' premiums have been paid on the policy; and

(b) the surrender value of the policy exceeds the total of:

(i) the amount of the overdue premium; and

(ii) the total of any other amounts owed to the company under, or secured by, the policy.

(2) For the purposes of paragraph (1)(b), the surrender value of the policy is to be worked out as at the day immediately before the day on which the overdue premium falls due.

(3) Until the overdue premium is paid, the company may charge interest on it on terms not less favourable to the policy owner than such terms (if any) as are prescribed by the regulations.

(4) The overdue premium and any unpaid interest charged on it are taken, for the purposes of this Act, to be a debt owing to the company under the policy.

(5) A life company may only forfeit a policy because of the non-payment of a premium if:

(a) the company has given the policy owner a written notice:

(i) setting out the amount of the premium and the day on which it became, or will become, due; and

(ii) stating that the policy will be forfeited at the end of 28 days after the giving of the notice or 28 days after the day on which the premium became, or will become, due, whichever is the later if the amount due to the company has not been paid; and

(b) at least 28 days have elapsed since:

(i) the day on which the notice was given; or

(ii) the day on which the premium became due;

whichever is the later.

The Drummond View (expressed in his article in the Insurance Law Journal) is that, *"There are presently no exceptions or modifications in the Regulations to the forfeiture procedure in s 210(5). That procedure therefore applies to all life policies that are forfeited for non-payment of premiums."*

However, both Sutton's Law of Insurance in Australia and the Jackman Opinion consider that section 210 of the LIA ***only*** applies to life insurance contracts of insurance that have an investment component, and not life risk contracts of insurance.

Sutton's Law of Insurance in Australia relevantly notes at 12.250:

> *Remarkably and unnecessarily, [the Insurance Contracts Act 1984] omits the failure to pay premium as a ground for cancellation on the basis that this ground is the subject of the Life Insurance Act 1995 s210. The better view is that s210 applies only to a policy with a surrender value. A surrender value is in an investment life insurance only.*

The Jackman Opinion dated 10 November 2015 notes:

> 2. *In my opinion, sub-section 210(5) applies only to investment-based policies, and does not apply to policies with no investment component…*
>
> 17. *First, sub-section 210(5) itself is confined to the concept of "forfeiting" a policy. As a matter of ordinary legal language, "forfeiture" refers to the loss or determination of a proprietary interest or right, rather than merely contractual rights: Legione v Hately (1983) 152 CLR 406 at 445 (Mason and Deane JJ); Kostopoulos v G. E. Commercial Finance Australia Pty Ltd [2005] QCA 311 at [53] (Keane JA, with whom McMurdo P and Dutney J agreed); Westminster Properties Pty Ltd v Comco Constructions Pty Ltd (1991) 5 WAR 191 at 197-8 (Malcolm CJ), 202-6 (Kennedy J). The more general term "cancellation" is apt to refer also to the termination of contractual rights. The distinction is preserved in the language of sub-section 59(3), which is part of a section dealing with cancellation, and recognises expressly that sub-section 210(5) is concerned with life policies that may be "forfeited".*
>
> 18. *Second, sub-section 210(5) must be read in the context of section 210 as a whole, which begins in sub-section (1) with the forfeiture of policies where the "surrender value" exceeds the total of overdue premiums and any other amounts owed under the policy. As it is sub-section (1) which provides for the circumstances in which a policy is liable to be forfeited for non-payment of a premium, it is necessarily to be read together with sub-section (5) which provides the procedure for forfeiture for non-payment of premium. The section, read as a whole, is not concerned with risk-only policies, as they do not have any surrender value.*[3]

Both Sutton's Law of Insurance in Australia and the Jackman Opinion then conclude that it would be an absurd result if life risk contracts of insurance could not be cancelled for non-payment of premium.

Sutton's Law of Insurance in Australia relevantly notes at 12.250:

> *The mystifying consequence would be that there is no right to cancel a life [risk] insurance contract for failure to pay the premium and the absurdity of such a result would persuade a court to embark on the necessary intellectual gymnastics to avoid it.*

The Jackman Opinion dated 10 November 2015 goes further, arguing that section 59A of the ICA does not operate as a code in relation to the cancellation of contracts of life insurance. The Jackman Opinion provides:

> *25 … it might be argued that section 59A of the ICA operates as a code in relation to the cancellation of contracts of life insurance which are not capable of being forfeited under sub-section 210(5) of the Life Act, in the same way that section 60 acts as a code in respect of the circumstances*

[3] We consider that the Drummond View is mistaken in advancing the argument that "forfeiture" includes a cancellation where there is no proprietary interest or right in the subject matter of the contract, such as a life risk contract of insurance. The authorities as to the meaning of "forfeiture" in various contexts arrive at the opposite conclusion. Indeed, this is the approach in section 210(5), where there is reference to "forfeiture" of a policy having a surrender value, which clearly is a proprietary interest or right. Unfortunately, this is an error the drafter of the 2013 ICA amendments appears to have fallen into, as the note to section 63(2) of the ICA provides, "*Note: Section 210 of the Life Insurance Act 1995 deals with **cancellation** of a contract of life insurance because of non-payment of premium" (our emphasis).* Section 210, however, is quite clearly expressed to deal with the **forfeiture** of life insurance contracts.

> *pursuant to which a contract of general insurance can be cancelled. In my opinion, that is a highly improbable construction of section 59A. Section 59A refers to only one ground for cancellation, namely the insured making a fraudulent claim, in contrast to the broad range of grounds under section 60. It would be absurd for the legislature to have intended that there could be no right of cancellation on other grounds, such as failure to comply with the terms of the contract…*

However, the issue of whether or not section 59A of the ICA operates as a code in relation to the cancellation of contracts of life insurance has been left open to differing views because of the recent amendments to the ICA. The situation is perhaps best summed up in an address by the Hon. Michael Kirby AC CM to the Australian Insurance Law Association's National Conference on 19 September 2014 ("Insurance Contract Law Reform - 30 Years On", (2014) 26 *ILJ*, pp. 1-18)(attached):

> *Until 28 June 2013, the ICA had no cancellation grounds for life insurance. However, the Insurance Contracts Amendment Act 2013 (Cth) makes the ICA a complete code for the cancellation of life insurance contracts. It allows cancellation only for fraud… There is no right to cancel for any of the other grounds permitted for general insurance. For example, there is no clear (certainly no express) right to cancel even for non-payment of premiums. The Life Insurance Act 1995(Cth) affords no salvation here. This is because it probably applies to investment life contracts only…*
>
> *The legitimate question is presented as to what are the appropriate grounds for the cancellation of a life insurance contract? It would seem appropriate that those grounds should be the same, or so far as applicable similar, to the grounds for cancellation of policies of general insurance. If that view were adopted, the harsh and unfair exception in section 59A(2-5) would also be removed; as there is no equivalent provision applicable to general insurance contracts.*

Our view, supported by the Jackman Opinion, is that in such a case in order to avoid a lacuna, the general law must have some operation to "save" the essence of the contract, ie cover will continue to be provided in return for payment of premiums. Thus, the contractual terms as to cancellation must apply and there is nothing in the current drafting of the LIA or ICA which prevents a **life risk contract of insurance** being cancelled in accordance with the terms of the contract for non-payment of premiums.

4. Legislative amendment to resolve these issues

We submit that the above issues could be resolved, to remove all doubt, by:

- inserting a new regulation into the *Life Insurance Regulations 1995*, which would clarify that section 210(5) of the LIA only applies to investment life insurance policies, and
- modifying section 59A of the ICA (which sets out the circumstances in which a contract of life insurance may be cancelled) and section 63 of the ICA, so that the ICA provides an express right to cancel a life risk contract of insurance for non-payment of premium.

5. Inserting a new regulation into the *Life Insurance Regulations 1995*

Background

As noted above, section 206 of the LIA provides that Division 4 of Part 10 of that Act (which includes section 210(5)) applies to "all policies", other than "policies declared by the regulations to be excluded from the operation of this Division."

Prior to its repeal in 1998, regulation 10.03 of the *Life Insurance Regulations 1995* provided:

> *Division 4 of Part 10 of the Act (relating to surrender values, paid-up policies and non-forfeiture of policies) does not apply to the following life policies:*
>
> *(a) a contract for the payment of an annuity (except a deferred annuity during the period of deferment) for a term dependent on human life;*
>
> *(b) a policy of insurance against contingencies that may or may not happen, other than:*
>
> *(i) a policy providing for the payment of a sum of money if the life insured by the policy survives a period specified in the policy; or*
>
> *(ii) a policy:*
>
> *(A) the term of which exceeds 10 years; and*
>
> *(B) under which premiums are paid at a level rate throughout the term; and*
>
> *(C) under which the age of the life insured is 71 years or older at the end of the term;*
>
> *(c) an investment-linked contract.*

The Explanatory Statement relevant to this Regulation (Statutory Rules 1995 No. 141) provided:

> *Division 4 of Part 10 of the Act sets out the requirements for surrender values, paid-up policies and non-forfeiture of policies. There are certain life policies for which the requirements of Division 4 of Part 10 of the Act are inappropriate. In the broad, policies with no investment element, where the policy owner has no expectation of a return on early termination of the policy, require no provisions in respect of surrender values, paid-up policies or non-forfeiture of policies.*

The Explanatory Statement to the regulation repealing regulation 10.03 indicates that regulation 10.03 was repealed on the basis that (perhaps erroneously) it was no longer necessary given that new actuarial standards in respect of minimum surrender values came into effect from 30 June 1998.

Proposed regulation

In order to clarify that section 210(5) of the LIA does not apply to life risk contracts of insurance, we propose that a new regulation could be inserted into the *Life Insurance Regulations 1995* along the following lines:

Section 210 of the Act (relating to non-forfeiture of policies in certain cases of non-payment of premiums) does not apply to a life policy which provides for the payment of a benefit only on:

(1) the death of a person or on the happening of a contingency dependent on the termination or continuance of human life;

(2) injury to, or disability of, the insured as a result of accident or sickness; or

(3) the insured being found to have a stated condition or disease,

and which is not a contract referred to in paragraph (f) or paragraph (g) of section 9(1) or a sinking fund policy.

6. Amending the ICA

In order to clarify that the ICA provides an insurer with a statutory right to cancel a life risk contract of insurance for non-payment of premium, and thus that the correct procedure for cancelling a life risk contract of insurance for non-payment of premium is set out in section 59 of the ICA, we propose that sections 59A and 63 of the ICA be amended along the following lines (amendments struck through/underlined):

59A Cancellation of contracts of life insurance

(1) An insurer under a contract of life insurance ~~(the first contract)~~ may cancel the contract if<u>:</u>

<u>(a) the insured has failed to comply with a provision of the contract with respect to payment of the premium (other than in relation to a contract of life insurance that may be forfeited under the Life Insurance Act); or</u>

<u>(b)</u> the insured has made a fraudulent claim:

(~~a~~<u>i</u>) under the ~~first~~ contract <u>(the first contract)</u>; or

(~~b~~<u>ii</u>) under another contract of insurance with the insurer that provides insurance cover during any part of the period during which the first contract provides insurance cover.

(2) If an insurer has cancelled a contract of life insurance under subsection (1)<u>(b)</u> because of a fraudulent claim by the insured under that contract, then, in any proceedings in relation to the claim, the court may, if it would be harsh and unfair not to do so:

(a) disregard the cancellation of the contract; and

(b) order the insurer to pay, in relation to the claim, such amount (if any) as the court considers just and equitable in the circumstances; and

(c) order the insurer to reinstate the contract.

(3) If an insurer has cancelled a contract of life insurance (the cancelled contract) under subsection (1)<u>(b)</u> because of a fraudulent claim by the insured under another contract of insurance with the insurer, then, in any proceedings in relation to the claim, the court may, if it would be harsh and unfair not to do so:

(a) order the insurer to pay, in relation to the claim, such amount (if any) as the court considers just and equitable in the circumstances; and

(b) order the insurer to reinstate the cancelled contract.

(4) If an insurer has cancelled a contract of life insurance under subsection (1)(b), then, in any proceedings in relation to the cancellation, the court may, if it would be harsh and unfair not to do so, order the insurer to reinstate the contract. This subsection does not limit, and is not limited by, subsection (2) or (3).

(5) In exercising the power conferred by subsection (2), (3) or (4), the court:

(a) must have regard to the need to deter fraudulent conduct in relation to insurance; and

(b) may also have regard to any other relevant matter.

63 Cancellations of contracts of insurance void

(1) Except as provided by this Act, an insurer must not cancel a contract of general insurance.

(2) Except as provided by this Act or section 210 of the Life Insurance Act 1995, an insurer must not cancel or forfeit a contract of life insurance.

Note: Section 210 of the Life Insurance Act 1995 deals with ~~cancellation~~ forfeiture of ~~a~~ certain contracts of life insurance because of non-payment of premium.

(3) Any purported cancellation of a contract of insurance in contravention of subsection (1) or (2) is of no effect.

ADDENDUM 2 - REPEAL OF SECTION 223 OF THE LIFE INSURANCE ACT 1995

5 May 2016

Red Tape Repeal
The Hon. Kelly O'Dwyer MP
Assistant Treasurer
PO Box 6022
House of Representatives
Parliament House
Canberra ACT 2600

Delivered by email: kelly.odwyer@aph.gov.au

Dear Assistant Treasurer,

The Financial Services Council (FSC) welcomes the opportunity to provide a recommendation to the Federal Government's Red Tape Reduction Agenda for repeal of Section 223 of the Life Insurance Act 1995, in particular the requirement to advertise before issuing a replacement policy. This would absolve life insurers of the existing redundant administrative and cost burdens which does not result in measurable consumer benefit.

The FSC represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, trustee companies and public trustees. The Council has over 125 members who are responsible for investing more than $2.3 trillion on behalf of 11 million Australians.

Current Legislative Requirements

The FSC advocates for the complete repeal of Section 223 of the Life Insurance Act 1995, which outlines a life insurers' obligations with respect to notices that must be placed before issuing replacement policy documentation.

Some of the requirements associated with this for life insurers are:

- Preparing correspondence for newspaper advertisements
- Collecting a replacement policy fee

- Managing the 10 day waiting period
- Mailing the client

The minimum 10 day waiting period (in which the insurer must notify its intention to replace a policy document) is regularly the subject of customer complaint.

Legislation to be repealed

223 Notice before issuing replacement policy document

(1) This section applies if the amount of the net claim value of a policy at the date the replacement policy document is issued is more than $25,000 or such other amount as is prescribed.

(2) For the purposes of subsection (1), the net claim value of a policy at a particular time is
the amount calculated according to the regulations.

(3) At least 10 days before issuing the replacement policy document, the company must give notice of its intention to do so:

(a) in a newspaper circulating in the district in which the owner of the policy resides; or

(b) if a person claiming the benefit of section 211, 212 or 213 applies for the replacement policy document—in a newspaper circulating in the district in which the deceased policy owner ordinarily resided at the time he or she died; or

(c) in a newspaper circulating in the district in which the company considers the original policy document to have been lost or destroyed.

(4) The applicant for a replacement policy document must meet all the expenses of the advertisement and of the issue of the replacement policy document. The expenses must be paid at the time the person asks the company to issue the replacement policy document.

(5) After a replacement policy document has been issued, the company must arrange for the following details to be entered in the appropriate register kept under Division 8:

(a) the fact that a replacement policy document has been issued;

(b) the reason for the issue of the replacement policy document.

For convenience we refer to section 223 for balance of this letter as “the advertising requirement”.

BACKGROUND

The advertising requirement is triggered when a consumer is unable to produce a policy document. As the Life Insurance Act 1995 requires the policy document to be "endorsed" in certain claims circumstances such as upon the death of the policy owner who is not the life insured[4] or transfer of ownership of the policy[5], life insurance companies require the consumer to return the policy document. If the consumer is unable to produce the policy document, the life insurance company is able to issue another replica policy document, but only after the advertising requirement has been complied with.

<u>Previous Legislation</u>

The advertising requirement mirrors the same requirement in the Life Insurance Act 1945, which was the predecessor to the current Life Insurance Act 1995 (the 1945 Act). In the 1945 Act[6], a life insurance company was similarly required to advertise when a consumer had lost or destroyed the policy document. The requirement in the 1945 Act made sense in the context of the time:

(i) Firstly, in the absence of computerised technology, the policy document issued by the life insurer comprised one document which served as the contractual document for the entire duration of the policy. The policy document was often on A3-sized (or comparatively large-sized) parchment.

This reflected the relative lack of sophistication of insurance products at the time, where a consumer is likely to be covered for one type of insurance only (such as death cover only) for the entire duration of the policy.

In the event that the ownership of the policy was transferred to another person, the policy document was physically stamped or endorsed with details of the new owner. For example, if a policy ownership was transferred to **seven** different persons in succession during the duration of the policy, the policy document would have (at least) **seven** endorsements on the document itself with details of each owner. Again, until computerised technology became available, the physical endorsement on the policy document was one of the limited means of proving who was the owner of the policy at a particular point in time;

(ii) Secondly, newspapers were the most likely method by which the general

[4] S213 Life Insurance Act 1995 (Cth)
[5] s200 Life Insurance Act 1995 (Cth)
[6] S119 Life Insurance Act 1945 (Cth)

public could be notified.

The advertising requirement was a means of mitigating risks that arise if the policy document could not be produced by the consumer. This risk is the primarily that the policy might have been assigned to another person.

Changes arising from technology and other law

The advertising requirement in current times has become unnecessary and anachronistic. This is because of changes in the way life insurance companies issue policies to consumers and changes to processes with the development of technology and application of more robust financial services law.

Policy documents no longer comprise the one document that lasts for the entire duration of the policy. The standard insurance industry practice is to issue a policy document at the commencement of the policy, and each year issue a policy schedule which brings up to date the terms that apply to the policy – this includes updated information on the benefit amount, and the premium payable for the year. A policy schedule may also be issued at any time if the consumer has made changes to the policy, such as adding additional types of cover to the policy. The policy schedule comprises part of the insurance contract (or policy document).

The fact that policy schedules may be issued annually and at any time reflects the advent of computer technology and computerised record-keeping. It also reflects the sophistication of insurance products and the greater variety of types of insurances that are now available than during the time of the 1945 Act. With that came the ability of the consumer to transact on their policy as frequently as they required, such as by increasing their benefit amount, adding additional types of insurances on the one policy or even adding another life insured under the same policy.

Insurance companies also issue annual policy schedules as a means to comply with robust financial services laws. For example, annually-issued policy schedules are the means by which insurance companies provide advance notice, as required under the Corporations Act 2001, of premiums and fees that will be payable for the coming year.

Details about the policy and ownership are also now fully recorded in specialised and sophisticated computer systems (many insurance companies use systems specifically programmed for insurance purposes). This includes the change of ownership of the policy.

Over time, the need to advertise a lost policy has become unnecessary as the policy document no longer serves as the primary record of ownership of the policy, as it did in the past. Records of ownership are stored in the computerised systems of the life insurance company (in compliance also with record-keeping obligations in financial services law). Therefore, there is now little or no risk arising from a lost policy document as all details relevant to a consumer's policy are stored by the insurance company.

Negative Consumer Impact

Newspaper advertising as a means of giving notice is also anachronistic. As stated above, there is no need for it as there is little risk arising from a lost policy document.

In any event, it is our belief that notices in the newspapers are in reality useless as such notices are unlikely to be read by any person. A recent informal survey of representatives of our life insurance members suggests that there has never been response to a newspaper advertisement in relation to a lost policy.

Newspapers do not fulfil the central communication role to the extent they once did. In 2003, the annual readership of the Monday to Friday edition of the Sydney Morning Herald was 900,000, and the readership of The Age was 687,000.[7] By 2015, the readership for the Sydney Morning Herald was 514,000 (a reduction of 43%), and the Age 475,000 (a reduction of 31%).[8] At the same time the Australian population increased from 20,008,700 in December 2003[9] to 23,781,200 in June 2015.[10]

Not only have has newspaper readership declined in absolute terms, but it has suffered an even greater reduction in readership as a proportion of the population. In this context there is a significantly decreased public utility to newspaper advertising of lost policies, and the advertising requirement does not achieve the protective purposes for which it was designed.

Importantly, the expense associated with advertising a lost policy in a newspaper is charged back to the consumer. As we have stated above[11], one of the triggers for producing a policy document (and advertising if it cannot be produced) is in certain claims circumstances, specifically death claims. We submit that it is inappropriate for a consumer (or dependants) and life insurance company to be required to bear the expense of advertising that does not serve any beneficial purpose. It is even more inappropriate that this expense should occur that the time of a death claim, when a consumer's dependants are possibly least able to afford it. It is also inappropriate that the payment of a death claim should be delayed by advertising a lost document where such advertising serves no beneficial purpose.

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[7] Danielle Veldre, 'Newspapers feel the heat', B&T Weekly, (Sydney) 28 November 2003, 20.
[8] Roy Morgan, Australian Newspaper Readership, 12 months to December 2015, December 2015, Roy Morgan Research <http://www.roymorgan.com/industries/media/readership/newspaper-readership>
[9] Australian Bureau of Statistics 3101.0 - Australian Demographic Statistics, Dec 2003
[10] Australian Bureau of Statistics 3101.0 - Australian Demographic Statistics, Jun 2015
[11] See first paragraph of "Background" information.

Compliance costs set to increase

The industry has a large number of endowment policies that will mature over the next **five** years. This maturation will significantly increase the regularity by which life insurers must complete the Section 223 process. It is envisaged that the number of requests for policy replacements for this period may increase by 50 per cent.

We thank you for the opportunity to provide material for this process and look forward to assisting you with more detailed feedback if and when required. Should you have any questions about this submission we encourage you to get in contact with Jesse Krncevic at or on
.

Yours Faithfully,

ANDREW BRAGG
Director Policy & Global Markets