Treasury Technical Amendments
November 2020

FSC Submission – Part 2

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FINANCIAL SERVICES COUNCIL

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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 one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advice licensees 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. Submission

The FSC welcomes the opportunity to make a submission on the draft legislation and Explanatory Memorandum (EM) named Miscellaneous amendments to Treasury portfolio laws 2020 which were released on 21 October.[1]

This submission is in addition to an earlier submission the FSC made on several life insurance specific issues.

2.1. Retrospective change to deny a deduction for temporary incapacity insurance benefits paid from a superannuation fund

*This relates to EM paragraphs 103 to 106, amending section 295-495 of the Income Tax Assessment Act 1997 (**ITAA97**)*

The FSC is concerned that this change is likely to mean some (perhaps many) superannuation funds will have to pay retrospective tax on income protection (**IP**) benefits paid to incapacitated fund members.

Super funds generally treat IP insurance benefits as tax neutral, with some treating the benefits as assessable/deductible and others as non-assessable/non-deductible. The legislative change will have a large adverse effect on funds (and insurance beneficiaries) that take the first approach.

[1] See: https://treasury.gov.au/consultation/c2020-121801

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The ATO has previously provided an opinion that payments to a super fund from temporary incapacity insurance policies are not assessable income to the fund. This is stated in the Minutes of NTLG super technical minutes from June 2009.[2]

However, many superannuation funds have taken a different approach and assumed IP benefits are assessable/deductible. One FSC member has noted the following:

> The ATO says in the NTLG minutes that s.6-5 does not apply to make periodic receipts under a temporary incapacity insurance contract assessable to superannuation funds because CGT event C2 happens to the contract each month the proceeds are received. The ATO states the CGT event C2 each month means s.6-5 is excluded from operation under s.295-285 and that it pushes the monthly receipts onto capital account for the superannuation fund, thereby allowing the s.118-300 CGT exemption for insurance proceeds to be applied.
>
> This ATO logic is a problematic attempt to provide tax neutrality, which is not backed up with a legally binding public ruling. Adopting the same logic to a rental contract over real estate owned by a superannuation fund would mean the monthly periodic rental receipts are taxed at 10% on capital account (after 12 months has elapsed since the contract was made). If this approach were taken consistently, then superannuation funds could ask for a 5% tax refund on most rental income.
>
> The more sensible and robust way to achieve tax neutrality for superannuation funds for temporary incapacity insurance contract receipts is the assessable-deductible approach.
>
> In any event, item 7 of s.118-300 which provides the CGT exemption for superannuation funds for TPD insurance proceeds (and temporary incapacity insurance proceeds if you accept CGT event C2 happens) was only enacted in 2015. Up until then superannuation funds would have been relying on the assessable-deductible approach to achieve tax neutrality whether they realised it or not (or the alternative argument that since a temporary incapacity insurance payment was directly from the insurer to the sick individual, it had nothing to do with the superannuation fund).

In contrast to the view put forward in the NTLG minutes described above, funds that have treated the amount as assessable would have taken this approach under s.6-5, s.20-20 and to a degree s.15-30. On-payment of those proceeds on a periodic basis as temporary incapacity insurance benefits to sick or injured members is tax deductible to the superannuation fund, thus providing the superannuation fund with tax neutrality for the periodic insurance proceeds that it on-pays. This is an approach that is in line with the High

[2] See response to question 1.6.9: Income protection policies tax treatment relating to proceed paid to fund trustee, available at: https://www.ato.gov.au/law/view/document?src=rs&pit=99991231235958&arc=false&start=61&pageSize=10&total=111&num=5&docid=rtf%2Fntlg20090616

Court decisions of *Carapark Holdings Limited v Federal Commissioner of Taxation [1967] HCA 5* and *Federal Commissioner of Taxation v DP Smith [1981] HCA 10*.

The proposed amendment to deny the tax deductions to the superannuation fund will prevent that tax neutrality. The resulting tax on the superannuation fund would mean less is paid to the sick or injured members to support themselves and their family.

Currently, a member receiving IP insurance benefits usually receives 75% of their pre-disability income. If the deduction to the super fund is denied as proposed by this change (while the receipt is taxable to the fund) then the amount received by a member is reduced to 63.75% which is then assessable to the recipient their marginal tax rate. In effect, this would be double taxation on IP benefits for sick Australians, which FSC considers a poor policy outcome.

The proposed amendment should at the very least be accompanied by other appropriate changes to ensure tax certainty and symmetrical treatment of both receipt and payment of insurance benefits. Solely legislating on the non-deductible aspect, without providing binding certainty that the periodic insurance receipts are non-assessable, non-exempt income will create unnecessary tax risk for superannuation funds that does not exist at the moment.

FSC recommendation: The proposed amendment proceed on this basis:

- To maintain tax neutrality for superannuation funds, a tax exemption should be provided to funds for amounts received in respect of or in relation to temporary incapacity insurance policies whether or not a CGT event also occurs in relation to the policy, and whether or not the amount received is on revenue account.
- An explicit tax deduction should be created for superannuation fund administration expenses incurred in managing temporary incapacity insurance claims, because for many funds these expenses are currently tax deductible as being incurred to derive temporary incapacity insurance proceeds that are assessable on revenue account.
- A carve-out from the proposed denial of a deduction for payment of temporary incapacity benefits should be provided where the superannuation fund is self-insured (or otherwise did not receive insurance proceeds to support the benefit payment) and had not claimed a notional deduction for notional premiums under s.295-465(2). Any notional premium deduction needs to be calculated by an actuary, and the actuarial advice cost can be a reason why a superannuation fund may instead prefer to deduct the amount of self-insured temporary incapacity benefits actually paid.
- None of these changes should be made retrospectively, in recognition of some funds currently treating the amounts as assessable/deductible.
- In the event that some super funds may have been inappropriately claiming a deduction for the payment of benefits and not treating the receipt of benefits as assessable, then this should be addressed through a specific measure targeting this exact circumstance and not having broader consequences.
- The ATO should clarify, in the form of public guidance, the tax treatment of the receipt and payment of temporary incapacity benefits by superannuation funds. This guidance should work for funds that have applied the assessable/deductible approach, as well as funds that have applied the non-assessable/non-deductible approach.

2.2. Amendments to superannuation non-arm's length income rule

This relates to EM paragraphs 93 to 99, inserting s.116-30(2C) and s.118-320(2) into the ITAA97

A merger of a superannuation fund typically results in assets of the closing fund being rolled over to the successor fund using the Division 310 CGT relief. That means that the successor fund inherits the cost base for the assets from the closing fund. With rises in the value of assets over time, the market value of the assets at that time of the merger will be above the inherited cost base. Division 310 treats the closing fund as making neither a capital gain nor a capital loss from the rollover of its assets.

Under the rollover in Division 310, the cost base is inherited for segregated current pension assets as well.

Assuming an increase in the value of an asset, when the successor fund eventually sells the segregated current pension assets it will make a larger capital gain than if it had acquired those assets on the open market at the time of the merger, due to the lower inherited cost base.

Currently, s116-320 provides an exemption for capital gains the superannuation fund makes from selling its segregated current pension assets. However, the proposed amendment to s.118-320 to insert sub-section (2) could deny that exemption if the view is taken that the capital gain made by the successor fund is (due to the lower inherited cost base) greater than arm's length. This could particularly occur for the merger of superannuation funds that had the same trustee, so the relevant transactions are between related parties.

This outcome could have a large adverse financial impact on superannuation funds that have already performed fund mergers, and would in effect be a retrospective tax penalty on fund mergers that have already happened. It would also undermine the Government policy in Division 310 of removing CGT cost impediments for future fund mergers (including mergers where the trustee of both funds is already the same). Neither of these outcomes are appropriate.

FSC recommendation: the measure proposed should be deferred and revisited to ensure it does not have any adverse impact on superannuation funds because a fund, prior to the asset sale, was subject to a Successor Fund Transfer.

2.3. Differentiated investment fees in MySuper products

This section refers to paragraphs 47 to 51 of the draft EM

The FSC welcomes the proposed amendments that permit a greater number of differentiated investments fees among different subclasses of members who hold a MySuper lifecycle product, beyond the existing maximum limit of four subclasses. This change would allow the amount of investment fees to be aligned to the actual investment costs borne in relation to various subclasses of a MySuper product.

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In keeping with the policy intent of the proposed amendments, the FSC believes the allocation of investment gains and losses to MySuper members should reflect a fair and reasonable attribution of the investment-related costs of the fund that relate to transaction activity.

However to achieve a fair and reasonable attribution of all investment-related fees and costs across various subclasses of a MySuper product, we submit the draft Bill should also provide for amendments to sections 29VA(5) and (6) of Division 5 of Part 2C of the SIS Act to permit buy-sell spreads and activity fees, as they relate to investment transaction activity in the fund, to also be charged on a fair and reasonable basis, as opposed to the current requirement that they be the same for each member in the MySuper product.

We note APRA's interpretation of the current requirements in respect of the charging of buy-sell spreads has been published as an FAQ on its website, at https://www.apra.gov.au/mysuper-and-eligible-rollover-funds-frequently-asked-questions:

> *60. Where a MySuper product offers a lifecycle strategy, can different buy-sell spreads be charged for each life stage?*
>
> *No. Where an RSE licensee chooses to charge a buy-sell spread, the fee charged must apply to every member of the MySuper product. If this fee is charged as a percentage of a member's account, the percentage charged must be the same for every other MySuper member, regardless of their stage in the lifecycle.*
>
> *Charging a fee on a cost-recovery basis means that the total amount of the fee charged to all MySuper members should recoup the cost incurred by the RSE licensee for providing the services to which the fee relates.*
>
> *It should be noted that an RSE licensee is not required to charge a buy-sell spread. Where a reasonable basis of applying cost recovery cannot be determined, an RSE licensee has the option of charging these costs via the administration or investment fee.*

The fair and reasonable attribution of investment-related costs to MySuper members is difficult to achieve given the above interpretation. Actual investment-related costs vary among subclasses of MySuper members due to the variation in asset allocation among those subclasses. Instead of absorbing the transaction costs of investment activity within an investment fee, the charging of buy-sell spreads permits a trustee to pass on the costs of acquiring and disposing of assets to the subclass of members where the cost is borne, rather than all members, and is therefore a more equitable and transparent mechanism.

Section 29V(4) of the SIS Act defines a buy-sell spread as a fee to recover transaction costs **incurred by the trustee**…" [emphasis added]. There is some doubt as to whether buy-sell spreads can be used to pass on transaction costs to members that are incurred by an underlying investment manager. In order to provide trustees with certainty that transaction costs by third parties (that would otherwise be borne by the fund and affect the return on all members' account balances) can be passed onto members, we submit that the MySuper fee charging rules in respect of activity fees in subsections 29VA(5) and (6) of the SIS Act

should also provide for differential costs to be attributed to members through the charging of an activity fee which represents a fair and reasonable attribution of costs as they relate to the relevant activity.

The charging of buy-sell spreads and activity fees in respect of MySuper members should therefore follow the proposed amendments to the charging of investment fees which would allow the policy intent of the proposed amendments to be fully achieved.

FSC recommendation: different buy-sell spreads and investment-related activity fees for lifecycle MySuper products should be permitted, subject to the existing requirements that the fees represent a fair and reasonable attribution of costs.