FSC FINANCIAL SERVICES COUNCIL

Federal Budget 2020–21

FSC submission

January 2020

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 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 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 2020–21 Budget.

The FSC's submission in many cases is that the Government should prioritise action on already existing policy commitments. In these policy areas, the Government does not need to make any significant policy announcements – it just needs to increase the priority attached to implementing an existing policy position.

This submission explains how the prioritisation of these issues is important, even essential, to providing improved consumer outcomes (conversely, the ultimate loser from inaction is the consumer). The policy reforms the FSC advocates in this submission should also improve certainty, increase competition, cut red tape and improve productivity. In addition, the Government Budget should benefit in the longer term from reform because the changes advocated by the FSC are likely to:

- increase income and hence tax revenue; and
- improve retirement incomes and therefore reduce the costs of the Age Pension.

In some cases, the FSC recommends the Government refrain from acting – so this again will not require substantial action.

3 FSC Policy priorities

The FSC recommends the Government:

a) Introduce a **comprehensive product modernisation (or product rationalisation) scheme** for legacy products in financial services. The Government has a long-standing commitment, made in 2015 in the Government's response to the Financial

Systems Inquiry (**FSI**),[1] to implement such a scheme for life insurance and funds management, and the FSC advocates for extending this commitment to superannuation. This is discussed further in Section 4 below.

b) prioritise implementing existing commitments, as outlined in Attachment A, to:
   - address **outstanding Investment Manager Regime (IMR) issues** – a commitment the Government made in 2017;
   - **extend the attribution regime** to Investor Directed Portfolio Services – a Government commitment from 2017;
   - Legislate for the **permanent Capital Gains Tax (CGT) rollover relief for merging superannuation funds** – a Government commitment from 2019;
   - **Expand the functional currency election to certain trusts and partnerships** – a Government commitment from 2013; and
   - **fix outstanding issues with the Taxation of Financial Arrangements** – a commitment from 2017.
     - An alternative and simpler approach to improve the competitiveness of managed funds is to implement a 5% rate of Non-resident Withholding Tax (NRWT) on Asia-Region Funds Passport payments, excluding income from Australian real property. The detailed argument for this change is in Attachment B.
   - **Widen the eligibility for the functional currency election** to certain trusts and partnerships.

c) **prioritise tax treaties with Luxembourg and Hong Kong**, addressing financial services issues in existing tax treaties, and ensuring that any new Free Trade Agreements are accompanied by a tax treaty.
   - This would be consistent with the Government response to industry's Action Plan to boost Australian services exports, where the Government committed to "assessing Australia's [tax] treaty network to ensure it remains appropriately aligned to our trading relationships, whilst maintaining tax system integrity" (page 25).[2]
   - As an interim step to negotiating a tax treaty with Hong Kong, the Government should accept that Hong Kong is eligible for Exchange of Information (EOI) country status, which provides for lower withholding tax rates. This should occur as Hong Kong has recently signed the OECD Convention on Mutual Administrative Assistance in Tax Matters,[3] and has implemented various other changes to improve tax transparency and cooperation. We understand EY has made a more detailed submission on this issue.
     - Given it is expected that Australia will have provided EOI status to about 122 countries by January 2020, it is anomalous that residents of

[1] See inquiry recommendation 43 – legacy products, and the Government's response outlined here - https://www.treasury.gov.au/publication/government-response-to-the-financial-system-inquiry/attachment-government-response-to-financial-system-inquiry-recommendations

[2] See: https://dfat.gov.au/about-us/publications/Pages/action-plan-to-boost-australian-services-exports.aspx

[3] See: https://www.info.gov.hk/gia/general/201807/13/P2018071100383.htm

Hong Kong, which is Australia's fifth largest source of investment and our sixth largest trading partner, do not have this status.

d) not proceed with two previously announced proposals – see details in Attachment C:
   - **The proposal to remove the CGT discount at fund level for Managed Investment Trusts (MITs) and Attribution MITs (AMITs) should not proceed**, and instead be replaced with a measure targeted at the small proportion of investors that are inappropriately accessing the CGT discount through MITs and AMITs.
   - the Government should **not proceed with proposed changes to AMIT penalties**.

e) Address a number of technical tax issues, covered in a previous submission of the FSC, at Attachment D, including the following:
   - Allow AMITs to access CGT rollover relief that is available to other trusts.
   - Treat gains or losses on bond sales as interest, given these gains are equivalent to interest in economic substance.
   - Ensure the correct Australian taxation of foreign capital gains.
   - Provide flowthrough tax treatment for foreign trusts.

f) if unfavourable changes occur to the Offshore Banking Unit (**OBU**) regime, place additional priority on the FSC's requested changes outlined above in items (a) to (e).

g) **lower the tax on new investment**. The FSC's preferred approach is a reduction in the company tax rate to 25%, or ideally a lower rate. However, if this reform is not achievable, then the Government should implement one or more alternatives which could include:
   - Providing accelerated depreciation or an investment allowance, as recommended by the Business Council of Australia.[4] Such an approach should not discriminate between types of investment but should be broadly applied.
     - We note an investment allowance is simple to implement for corporate entities. However, for tax flow-through trust structures such as MITs and AMITs, the benefits of the allowance may be 'washed out' through cost base reductions for unitholders upon distributions.
     - Therefore, there should not be a cost base reduction in order for investors through MITs and AMITs to benefit from the allowance.
     - If this does not occur, then direct investment would be preferentially taxed relative to indirect investment, which would operate contrary fundamental tax principles for indirect investment vehicles.
   - A targeted reduction in tax for companies that expand employment.
   - Reducing the taxation on new equity investment such as through an Allowance for Corporate Equity.

h) **Address complexities with the superannuation transfer balance cap** – see Section 5 below.

i) The Intergenerational Report (IGR), due to be released in the middle of this year, should include **estimates of the long-term impact of the superannuation system**

[4] See: https://www.bca.com.au/strong_budget_strong_economy_strong_australia

on the Budget, particularly the Age Pension. This includes the impact on numbers of full and part pensioners and the dollar spending on the Age Pension, and the extent to which superannuation savings will fund other age-related expenses, such as health and aged-care costs, reducing individuals' overall reliance on the Government in retirement.

j) The Government provide **clarity about the development of the Corporate Collective Investment Vehicle** (**CCIV**). This important reform has been significantly delayed and its future is unclear. In addition, the most recent draft of the CCIV rules failed to meet commitments that the CCIV would have equivalent tax treatment to AMITs, and also included the unfavourable tax changes outlined in point d) above.
    - Australia is currently at a disadvantage compared to other countries that have a corporate vehicle for managed funds, particularly in our ability to utilise the Asia-Region Funds Passport. The long-anticipated CCIV would ideally address this problem.

4 Product modernisation

Australians have significant amounts of money trapped in out of date financial products that can result in poor customer outcomes. including high fees and poor returns. Numerous Australians are being substantially disadvantaged by being locked in to these legacy products that lack the better returns, better features and easier access of more modern products. Financial services businesses are unable to move customers into more modern products for reasons including large tax or social security penalties (the numerous reasons for product lock-in are detailed in Section 4.3 below).

Acknowledging this problem, the Government some time ago (2015) announced it would implement a comprehensive product modernisation (or product rationalisation) scheme for legacy products in financial services. The FSC is urging the Government to implement this already existing commitment, which is now clearly overdue.

4.1 Legacy products are an extensive (and expensive) problem

The Productivity Commission in its 2019 report into the superannuation industry[5] highlighted the extent of the problems caused by legacy products in superannuation alone. The Productivity Commission found in 2017:[6]

- there was $162 billion invested in legacy superannuation products, which is 10% of the total assets held in APRA-regulated funds.
- there were 3.2 million legacy member accounts, which is 12% of the total for APRA-regulated funds.

[5] Productivity Commission (2018) *Superannuation: Assessing Efficiency and Competitiveness*, Report no. 91

[6] Productivity Commission (2018), Page 115 except where stated.

    - This implies around 2 million individuals were trapped in legacy superannuation products with poor returns, based on the number of duplicate accounts in 2017.[7]
- Legacy products made up 46% of the assets in the high fee tail of products, with about 2 million member accounts; and almost all legacy products have high fees. The average fee in this tail was 2.2%, which is more than three times the most prevalent (i.e. modal) fee of 0.7% (see page 180 of the report).
- The number of products in the high fee tail has remained steady over time (see page 180 of the report). This implies that it cannot just be assumed that the issue of legacy products will gradually disappear over time (see further discussion in Section 4.4 below).

The figures above do not include legacy products outside of superannuation such as life insurance and managed funds, which are likely to be substantial. Earlier estimates of the extent of the issues are contained in previous FSC submissions[8] and the FSC is planning to conduct a survey of our members to update these figures in 2020.

4.2 Adverse impact of legacy products

There are numerous adverse effects from legacy products. In general, legacy products when compared to modern products can have:

- lower net returns, in many cases resulting in lower retirement incomes.
- higher fees – often significantly higher. The Productivity Commission evidence referred to in Section 4.1 above shows legacy products in superannuation have fees that are more than three times the most prevalent fee rate.
- poorer consumer disclosure and reporting.
- increased likelihood of errors, as many processes have to be completed manually.
- worse regulation for consumer targeting and suitability, as legacy products were sold before the introduction of the Design and Distribution Obligations (DDO) regime.
- worse technology and reduced accessibility, for example they are not accessible through the internet or via apps.
- reduced resilience, as systems are out of date and expensive to maintain.

At an economy wide level, the trapping of consumers in these products:

- reduces financial services innovation:
    - innovation can create legacy products, because a pioneering financial product may have low take up, and as a result be closed to new members. These products will then over time become legacy products – and the lack of a

[7] There were about 1.6 accounts per person in 2017, see: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/Super-accounts-data/Multiple-super-accounts-data/

[8] For example see FSC Pre-Budget submission for 2018–19, available from: https://consult.treasury.gov.au/budget-policy-division/2018-19-pre-budget-submissions/consultation/download_public_attachment?sqId=question.2017-09-12.3768452384-publishablefilesubquestion&uuId=596571344

modernisation scheme will mean customers are trapped in the products and the products eventually become out of date and costly to operate. Businesses can avoid this risk if they avoid innovation.
    - this is especially a problem for long-dated products such as innovative retirement income products which can easily become legacy products if take up is low (see also the discussion in Section 4.4 below).
- adds to product proliferation – this undesirable proliferation is not by consumer choice.
- increases financial system risks.
- reduces competition in financial services, as consumers trapped in legacy products cannot move to competing products.
- reduces scale economies, increasing industry costs.
- reduces the productivity of financial services, dragging down economy-wide productivity.
- reduces savings and wealth.
- increases Government spending on income support, particularly the Age Pension, because of reduced retirement savings.
- reduces tax revenue because lower income/investment returns reduce income tax revenue.

The final two points imply that the lack of a modernisation scheme is likely to have an adverse impact on the Government Budget. While it may appear that a product modernisation scheme would cost the Government money in the short term, in the longer term a modernisation scheme may be a net benefit to the Budget as it will boost tax revenue and reduce Age Pension spending.

We also note that legacy products are more likely to pay commissions until the legislative ending of commissions. A product modernisation scheme would move consumers into products that are highly unlikely to pay commissions. The ending of commissions through product modernisation will reduce fees and improve net returns.[9] In addition, this would avoid the issues that may occur with the legislative ending of grandfathered commissions, including the complexity of redirecting commissions to consumers and the possibility of a legal challenge to the legislation as reported in the media.

4.3 Barriers to product modernisation

It might be thought that financial services businesses could just transfer customers out of inferior legacy products. However, there are various taxes, rules and regulations that prevent this occurring, including:

[9] This is discussed in more detail in the FSC's submission on the Draft Regulations for Ending Grandfathered Conflicted Remuneration for Financial Advisers, available from: https://fsc.org.au/resources/1756-fsc-submission-ending-grandfathered-conflicted-remuneration-for-financial-advisers-13th-may-2019/file

- Legal requirements that stop providers from changing consumer rights without explicit consumer consent. Broadly, superannuation deals with this issue in some circumstances - but this issue is not addressed outside of super.[10]
    - For example, the provisions in individual fund constitutions or policies for a non-super investment product may not allow for transferring customers to another trust or policy.
        - In that case, consent would be required from all customers which would include uncontactable customers.
    - It would be problematic to transfer just the customers who are contactable and agree to the transfer: moving only some customers to modern products might make those customers better off but might make the remaining customers worse off, because high costs are spread over fewer remaining individuals.
- The imposition of Capital Gains Tax (**CGT**) on unrealised gains. This tax can be imposed on the consumers holding the relevant legacy investment product, and also on the vehicle making the investments.
    - The Government has announced the permanent provision of CGT relief for merging superannuation funds, however legislation to enact this has not yet been introduced to Parliament.
        - This CGT relief only exists for transfers that are executed as a 'single arrangement' that occurs within a single tax year. This means relief is not available where there are too many members to transfer in one tranche for operational reasons.
    - The CGT issue remains unaddressed for the modernisation of products within a super fund, for life-backed superannuation products, for life insurance products, and for non-superannuation investments.
    - There is also generally an inability to transfer capital losses to new products.
- State stamp duty on investments that back a product (whether super or non-super). Stamp duty typically applies to land held through unit trusts and companies.
    - The CGT rollover relief for merging super funds noted above does not deal with this stamp duty problem.
- For life insurance bonds, potential for re-starting of the 10 year rule.[11]
- Legal barriers that restrict the ability for product providers to communicate with members of legacy products about contemporary products.
- Possible loss of legislated member elections/decisions, for example binding death benefit nominations and elections as a result of the Protecting Your Super **(PYS)** and Putting Members Interests First **(PMIF)** legislation.
- In some cases, any customer transition to a modern product must be done with client consent, generally based on financial advice. Given the cost of personal advice, this may act as a significant barrier to rationalisation.

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[10] See FSC submission to 2019–20 Budget.
[11] See: https://www.moneysmart.gov.au/investing/complex-investments/investment-and-insurance-bonds

- Loss of grandfathered social security treatment. For example (highlighting added):

> *a person who is an owner of an account-based pension purchased before 1 January 2015 and the holder of a CSHC [Commonwealth seniors health card] on 31 December 2014, will not have their account-based pension included in the income test for as long as they: continue to hold a CSHC,* ***and retain the same account-based pension****.*[12]

To emphasise the points above, product modernisation relating to superannuation still faces numerous barriers even though some components have been addressed.

4.4 The problems of legacy products are unlikely to disappear

There is a perception that legacy products are a 'one off' problem that will gradually solve itself over time, for example as customers of legacy products withdraw remaining balances in the products. As a result, it might be thought that inaction on this issue is less of a concern. However, this view does not fit with the data outlined in Section 4.1 above showing the number of legacy products has not declined over time.

The Productivity Commission has also stated there is "strong risk that the incidence of legacy retirement products will rise".[13] They reached this conclusion because:

- product innovation and policy developments suggest annuities and pooled investments will grow in prominence;
- products will reflect tax and social security policy settings at the time of issuance; and
- as these settings change, or if innovative products fail to gain sufficient interest, some products may become obsolete.

4.5 History of product modernisation proposals

There has been a long-standing recognition of the need for a product modernisation scheme to allow consumers to move from legacy products to newer products. The FSC first put forward a proposal for a product modernisation scheme to the Government in July 2005 and in other forums since then.[14]

As early as 2006, the Productivity Commission recommended product rationalisation in its report 'Rethinking Regulation' stating:

> *"The Taskforce considers that implementing a simplified product rationalisation mechanism that could be applied to the full spectrum of financial products would*

[12] See: https://guides.dss.gov.au/guide-social-security-law/3/9/3/31
[13] See Productivity Commission (2018), page 216.
[14] For example: Phase Two submission to FSI; and Product Rationalisation — Managed Investment Schemes and Life Insurance Products Proposals Paper, 26 February 2010.

> *significantly improve operational efficiency and reduce the operational risks carried by financial entities."*[15]

The Superannuation System Review (**the Cooper Review**) argued in June 2010:[16]

> *The consolidation and rationalisation of legacy products can provide benefits to members, including:*
>
> - *better product disclosure and clearer reporting to members;*
> - *lower costs — as cost savings will be passed on to members;*
> - *enhanced and newer features, for example, BPay, internet/online transactions, investment choice, unbundled offerings, more transparent and easier to understand products; and*
> - *improved service standards through better administration, greater flexibility, fewer systems and processes.*
>
> *Such benefits result principally from greater economies of scale and transfers to more modern and flexible products and systems.*

ASIC made the following submission to the interim report of the Financial System Inquiry (**FSI**) in August 2014:[17]

> ASIC supports renewed consideration of the 2009 proposals on product rationalisation of legacy products by Government.
>
> …
>
> We support an approach developed from the 2009 proposals that provides a streamlined process for product rationalisation involving adequate disclosure and safeguards, without requirements of individual holder assent.

A product modernisation scheme was an important recommendation of the FSI final report in 2014:[18]

> **Recommendation 43: Legacy products**
>
> Introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors.

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[15] Rethinking Regulation: Report on the Taskforce on Reducing the Regulatory Burden on Business (January 2006) See: https://www.pc.gov.au/research/supporting/regulation-taskforce/report/regulation-taskforce2.pdf

[16] https://treasury.gov.au/review/super-system-review

[17] https://download.asic.gov.au/media/2613736/asic-submission-to-the-financial-system-inquiry-interim-report-published-26-august-2014.pdf

[18] http://fsi.gov.au/publications/final-report/executive-summary/#recommendations

In response to the final report, the Government made the following commitment in 2015:[19]

> The Government agrees to facilitate the rationalisation of legacy products, in light of consumer, constitutional and fiscal issues.
>
> It is important that consumers should not be worse off due to any transition to a newer product. Under the existing framework there are possible tax implications of facilitating the transition away from legacy products, which will be explored in the context of the Government's Taxation White Paper process.

ASIC report 466 *ASIC's work to reduce red tape* stated in January 2016:[20]

> ***Legacy product rationalisation***
>
> *Submissions suggested that a process be developed to rationalise legacy products. We agree that this would enable more efficient and up-to-date financial products and services to be provided to consumers, and avoid ongoing operational risk and cost associated with maintaining legacy products and systems. We have suggested implementing a process for legacy product rationalisation that balances the interests of consumers and product and service providers.*

An APRA submission to an Inquiry by the Senate Economics Committee into the *Scrutiny of Financial Advice – Life Insurance* of April 2016 stated:[21]

> *One area of potential change identified by APRA relevant to this Inquiry is the introduction of a mechanism to allow the rationalisation of legacy products to occur more easily…*
>
> *Over time, legacy products become more complex and expensive to administer and may no longer meet the requirements of the beneficiaries…*
>
> *There is a range of very complex legal, consumer and tax issues that arise if a life insurer seeks to move policyholders from a legacy product to a new product, restricting the ability of insurers to close legacy products. The benefits of a simpler, though still robust, mechanism to rationalise legacy financial products has been recognised for some time…*
>
> *APRA continues to strongly support the need to comprehensively address this issue. From the perspective of the product provider, it would help mitigate the increasing operational risk that such products create, as well as improve the industry's operational efficiency. From the consumer perspective, it has the potential to improving consumer*

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[19] https://static.treasury.gov.au/uploads/sites/1/2017/06/Government_response_to_FSI_2015.pdf
[20] https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-466-asic-s-work-to-reduce-red-tape/

outcomes by updating definitions, improving efficiency and administration, and lowering costs.

The final report of an Inquiry by the Parliamentary Joint Committee on Corporations and Financial Services into the Life Insurance Industry stated the following in March 2018:[22]

> ***Recommendation 10.13***
>
> *The committee recommends that the Australian Government introduce legislation to facilitate the rationalisation of legacy products*

The Productivity Commission inquiry into superannuation said the following in 2018:

> *[APRA should] undertake a systematic assessment of the costs to funds of the thousands of legacy products in the superannuation system. If the evidence demonstrates that they represent a significant cost in accumulation, APRA should further refine trustees' obligations for member transfers so these products can be rationalised.[23]*

The Treasury stated the following in a background paper on the life insurance industry, written for the Royal Commission into Financial Services in August 2018:[24]

> *The products that the life insurance industry offers are continually revised and updated. Products are often deemed uneconomic or dated as a result of changes in market structure, government policy or legislation. These legacy products increase costs to insurers, which may be passed on to consumers. They may also increase operational risks in the management of products, which can lead to administrative errors that affect consumers. In rationalising these outdated products consumers and the industry can benefit from new, more efficient products.*
>
> *There are challenges to achieving this rationalisation of legacy products fairly and effectively. For example, a capital gains taxation (CGT) taxing point may arise if life company assets are transferred to another life company or a custodial arrangement as part of the rationalisation.*

Despite these observations, no noticeable progress has been made on a regime for product modernisation.

4.6 FSC's recommended product modernisation solution

The FSC's recommended approach for the modernisation of legacy financial products is:

- a consumer interest test applied at a collective level;
- transfer of non-tax attributes (e.g. social security benefits such as account-based pension 1 Jan 2015 grandfathering);

- roll over of all tax attributes to the new vehicle; and
- no tax implications of the rollover itself (including to the extent possible the removal of any stamp duties on the rollover).

The consumer interest test involves an independent determination that modernisation is in the interests of consumers collectively.

FSC Recommendation: Introduce a comprehensive product modernisation (or product rationalisation) scheme for legacy products in financial services. The Government has a long-standing commitment (made in 2015 in the Government's response to the FSI) to implement such a scheme for life insurance and funds management, and the FSC advocates for extending this commitment to superannuation.

FSC Recommendation: To expedite the rationalisation of a large number of legacy products, the Government should explore the appropriateness of an institutional mechanism (e.g. tribunal) that would allow for expert independent decision-makers to approve rationalisation of products. This would help address the concerns of both consumers and industry by providing greater certainty, transparency and timeliness around a process that has historically proved difficult to negotiate.

The FSC's proposed product modernisation approach, as provided to the Financial Systems Inquiry in 2014, is in Attachment E.

5 Transfer balance cap

5.1 Issue

The superannuation system now has several caps on contributions and a cap on the maximum amount that can be transferred into retirement phase accounts (the Transfer Balance Cap or **TBC**). These caps add substantial complexities to the superannuation system. The upcoming indexation of the TBC is a case in point.

The general TBC is indexed by increments of $100k, but the actual value of the cap will be a different amount below $100k for all individuals who have some money in retirement phase already. Specifically:

- A superannuation fund member who only has $160k in retirement phase has only used up 10% of the $1.6m of the general TBC. So they have 90% leftover of the general TBC. Under the legislation, they have 90% or $90k added to their own personal TBC (taking it up to $1.69m) at that point in time.
- A member who has $1.44m in retirement phase has used up 90% of the $1.6m general TBC. So they have 10% leftover of the general TBC. Under the legislation, then they only get 10% or $10k added to their own personal TBC (taking it up to $1.61m) as at that point in time.

As a result, every person who has entered into retirement phase will have a different and personal TBC.

5.2 Comment

When the Budget measures were introduced, the Government and industry were focussed on delivering the initial transfer balance account values and turning off the monitoring of various contribution caps and transition to retirement income streams (**TRIS**). There was not a need for the Government or industry to focus on the issue of indexation, but this issue is now of more relevance.

The superannuation industry has not in its recent history experienced any caps that vary between individuals in such a way.

In the near future, the ATO will calculate every taxpayer's personal TBC. However:

- The calculation of the TBC is complicated and complexity will increase over time with each indexation of unused caps;
- The situation is difficult to explain to members; and
- The individualised TBC is hard for trustees or financial planners to advise on if they are unaware of a customer's total super balances (e.g. if the customer has accounts with several providers).

There is a particular issue of concern to FSC members if fund members act on a personal TBC calculation if this is based on incorrect data. In some cases, the fund member could be subject to a penalty for an error outside their control. The issue is exacerbated if a customer

has interests in an SMSF (in addition to an APRA regulated fund) which do not need to report as quickly as APRA regulated funds. Some degree of leniency in administration is warranted.

The FSC recommends the Government consider methods for reducing this complexity, for example:

- There could be one indexed TBC for everyone, regardless of when individuals transferred into a retirement phase account, or how much is in the retirement phase.
- As an alternative, the proportionate reduction for unused caps could only apply at the higher end (i.e. those close to the TBC in the previous year), as opposed to the entire retiree population.
- The TBC could be replaced by taxation of income from retirement phase accounts above a high tax free threshold that mirrors the effect of the TBC.

A large majority of retirees will never get close to $1.6m for the proportional reduction calculation to matter, so the current approach is costly and inefficient to administer and calculate for the majority.

6 Attachment A – Existing Government Commitments

The FSC requests the Government prioritise a number of existing commitments, in particular:

6.1 Address outstanding Investment Manager Regime (IMR) issues

From press release of 19 July 2017:

> "The Government is committed to implementing an effective IMR whilst maintaining the integrity of our residency rules. The Government will therefore 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." See: http://kmo.ministers.treasury.gov.au/media-release/064-2017/

6.2 Extend the attribution regime to Investor Directed Portfolio Services

From a press release of 19 July 2017:

> "While this amendment [extending AMITs to single unitholder widely held entities] will not extend to including 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" See: http://kmo.ministers.treasury.gov.au/media-release/064-2017/

6.3 Capital Gains Tax rollover relief for merging superannuation funds

From the 2019–20 Budget:

> The Government will make permanent the current tax relief for merging superannuation funds that is due to expire on 1 July 2020. This measure is estimated to have an unquantifiable reduction in revenue over the forward estimates period.
>
> Since December 2008, tax relief has been available for superannuation funds to transfer revenue and capital losses to a new merged fund, and to defer taxation consequences on gains and losses from revenue and capital assets.
>
> The tax relief will be made permanent from 1 July 2020, ensuring superannuation fund member balances are not affected by tax when funds merge. It will remove tax as an impediment to mergers and facilitate industry consolidation, consistent with the recommendation of the Productivity Commission's final report, Superannuation: Assessing Efficiency and Competitiveness. Consolidation would help address inefficiencies by reducing costs, managing risks and increasing scale, leading to improved retirement outcomes for members.

The FSC notes this relief does not deal with all possible situations where relief is warranted – see discussion in Section 4.3 above.

6.4 Fix outstanding issues with the Taxation of Financial Arrangements

From the 2016–17 Budget:

> The Government will reform the taxation of financial arrangements (TOFA) rules to reduce the scope, decrease compliance costs and increase certainty through the redesign of the TOFA framework.
>
> …
>
> The measure contains four key components:
>
> …
>
> 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.

From a press release of 22 December 2017:

> "Simplification of the Taxation of Financial Arrangements (TOFA) rules was announced in the 2016–17 Budget…The Government will defer the commencement of changes to the TOFA regime and the changes will now commence from income years that begin after Royal Assent. Treasury will continue to engage with stakeholders in the design of the amended rules, and to identify specific aspects of TOFA reform that could be prioritised." See: http://kmo.ministers.treasury.gov.au/media-release/126-2017/

6.5 Functional currency election

The 2011–12 Budget announced:

> The Government will 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 Coalition Government announced it would proceed with this Policy in its announcement of 14 December 2013. See page 4 of:
http://ministers.treasury.gov.au/sites/ministers.treasury.gov.au/files/2019-05/MR008-2013.pdf

7 Attachment B – Withholding tax on payments under the Asia-Region Funds Passport

The FSC considers Australia's current tax system is not competitive in the Asia Region Funds Passport. In particular, the non-resident withholding tax (NRWT) system is complex compared to other Passport countries, as a result of:

- multiple rates;
- complexity and difficulty of determining appropriate rate;
- interactions with tax treaties (including how the treaties deal with trusts);
- no overarching consistent principle of application; and
- relatively simpler approaches in competitor jurisdictions, with Singapore in particular charging a zero withholding tax rate.

The complexity of the application of Australia's NRWT means the possible tax consequences for foreign investors cannot be explained in a simple and easy to understand manner. The Passport is specifically designed for retail investors so the inability to explain tax simply will put Australia at a substantial disadvantage.

Australia's NRWT complexity means comparisons with other jurisdictions are complicated; in general Australia's regime has high headline tax rates, but a variety of exemptions which often means the actual tax paid in Australia is low. As a result, we have a lose-lose situation – a tax system that significantly impedes investment due to its complexity while delivering little revenue (see section on potential budget impact below).

NRWT comparisons are not simple, but generally show Australia is uncompetitive. By contrast, comparisons of company taxes much more clearly show Australia is uncompetitive – Australia has the highest corporate tax rate in the Passport and in some cases the Australian tax disadvantage is large.

Our uncompetitive tax regime is inconsistent with Australia's aspirations of becoming a financial centre and exporting fund management services, particularly to Asia.

Other countries are reducing their NRWT and corporate tax rates over time, making our system more uncompetitive as time passes. Therefore, if Australia does not set NRWT and company tax rates at a competitive rate determined in the appropriate international context, funds will not be invested in Australian vehicles and the ATO will receive 100% of nothing, while Australia will miss out on the revenue, jobs and growth of our funds management industry. The benefits are likely to include back end operations as well as higher value added operations such as investment management.

If Australia is unable to reduce its corporate tax rate, this emphasises the need for other tax settings, particularly NRWT, to be more competitive.

Investors will be choosing Passport products from a number of competing jurisdictions and Australia's current tax system will place Australian funds behind funds from other countries. If tax disadvantages are removed for Australian funds, then Australian fund managers will be

able to compete. In addition, a globally competitive NRWT would address one of the larger barriers to the success of Australia's funds management export industry.

The Passport only allows investments into very simple ('vanilla') products such as listed equities and bonds. This means that income generated by non-resident investors will comprise dividends and interest.

Analysis of these income types shows that little government revenue from NRWT (outside of property) will be received as a result of Passport funds under existing policy settings:

- Just over 90% of Australian top 100 company dividends are franked therefore dividend withholding tax collections will be small. A portion of the remaining unfranked dividend also qualifies for conduit foreign income (CFI) exemption. For example, the unfranked component of AMP's dividends has historically been CFI and therefore withholding tax free.
- Interest will be either overseas sourced or substantially subject to an exemption (under section128F); as a result, it would not be subject to NRWT.
- Capital gains from Australian assets that are not taxable Australian real property are not subject to a withholding obligation when derived by non-residents. The permitted investment class only allows for listed equities which are all treated as non-taxable Australian real property.
    - Note the FSC is not calling for a reduction in the NRWT applying to any property income that might be received by a Passport fund (even though this income would be limited in a Passport fund).
- Some tax treaties may operate to allocate the taxation of gains to the treaty partner.
- Some of the remaining NRWT is inappropriately applied to bond profits and foreign exchange hedging, as detailed in previous FSC Budget submissions.[25]

As a result of these points, a reduction in NRWT on the Passport will have limited budget impact, however it will have significant impact on the ability of Australian managers to market their funds, as it will allow confident statements to be made about the taxation impact of investing in an Australian fund.

We also understand previous costings of this proposal have used data from the ATO's Annual Investment Income Report (AIIR). However, this data is misleading as it combines property income to foreigners and non-property income to foreigners. This means the AIIR data (at least in in its current form) is unlikely to be helpful for this costing.

We expect this change will reduce compliance costs for all funds without property income, as only one rate of withholding tax will apply. A fund with property income might face higher compliance costs from complying with the property-related NRWT, but this will be offset by a reduction in compliance costs from collapsing multiple non-property rates into one rate.

[25] For example see FSC Pre-Budget submission for 2019–20, available from: https://fsc.org.au/resources/1717-2019-20-budget-fsc-submission-combined/file

8 Attachment C – Concerns with existing Government proposals

8.1 CGT at fund level

The 2018–19 Budget announced the Government would remove the CGT at the fund level for Managed Investment Trusts (MITs) and Attribution Managed Investment Trusts (AMITs).[26]

The FSC has major concerns with this proposal.

Most importantly, the policy contradicts the Government's own stated policy goals. The 2018–19 Budget states[27] this proposal is designed to ensure that MITs and AMITs operate as genuine flow through vehicles, so that income is taxed in the hands of investors as if they had invested directly. However, the 2018–19 Budget proposal has the **opposite effect** of this policy goal.

The policy disadvantages indirect investment by individuals through MITs and AMITs compared to direct investment. It removes the current neutral treatment of individuals and replaces it with a non-neutral treatment. Using the terms from the 2018–19 Budget, under the current tax system MITs and AMITs are taxed as genuine flow through vehicles for individual investors, "so that income is taxed in the hands of investors as if they had invested directly". The proposal replaces this approach with a system that **overtaxes** individuals that invest through MITs and AMITs.

This detrimental proposal would be a key contributor to the increasing adverse policy environment for fund managers noted earlier in this submission.

The specific reasons the proposal overtaxes individuals that invest in MITs and AMITs are:

- In allocating deductible expenses against assessable income components, a MIT or AMIT would be required to allocate deductions against gross capital gains instead of only the assessable discount capital gains component; and
- In recouping prior year or current year revenue losses, the MIT or AMIT would be required to recognise as assessable income the gross amount of the capital gain rather than only the discount capital gain.

A briefing from Greenwoods HSF (see Section 2 of Attachment E) provides an example where:

- an individual would pay no tax if they invested directly; but
- the same individual would pay tax on $500 if they invested in exactly the same way, but through a MIT.

This clearly shows the proposal does not meet the principle of *horizontal equity* which is a long-standing tax policy principle accepted by governments. Broadly, the principle is that

[26] See Budget Paper 2, page 44.
[27] See Budget Paper 2, page 44.

investors should bear the same tax burden regardless of whether they invest directly or indirectly. The proposed measure runs counter to this principle.

8.1.1 Example

Another example is shown below.

Where a MIT / AMIT derives a $100 discount capital gain, but has expenses of $20 that are to be allocated against the capital gain, the difference in the trust net income would be as follows:

Trust level	Current	Proposed
Discount capital gain	100	100
50% discount	50	-
Net gain	**50**	**100**
Expenses	-20	-20
Net income	***30***	***80***

Once the net income is distributed, the impact on an individuals' investor's taxable income could be illustrated as follows (with direct investment included for comparison):

	Invest through MIT/AMIT		Direct
Individual level	Current	Proposed	investment
Distribution	30	80	100
Gross up	30	-	-
Gross gain	**60**	**80**	**100**
1/2 discount	-30	-40	-50
Individual expenses	**-**	**-**	**-20**
Taxable income	***30***	***40***	***30***

The example above equally applies if fund-level expenses are replaced by carry forward revenue losses.

The examples above and in Attachment F show where expenses or carry-forward revenue losses are offset against these discount capital gains at the MIT / AMIT level, the proposed measure will result in members that are entitled to discounting (individuals, complying superannuation funds entities and trusts taxed under Division 6) being worse off under this proposal than if they had invested in assets directly under the same scenario.

8.1.2 Discussion

The current CGT treatment does not always achieve parity between direct investment and investment through a MIT/AMIT; but the proposed change does not achieve this parity either — and for most investors the change moves the treatment further away from parity.

The FSC submits that, across the investment life-cycle of a managed fund, many (perhaps nearly all) AMITs and MITs would allocate expenses, or current year or carry forward revenue losses, against capital gains. This means that the proposed measure will

disadvantage many or all AMITs and MITs relative to direct investment by individuals and superannuation funds.

The proposal also introduces another inconsistency: Division 6 trusts would be able to access the CGT discount, while MITs and AMITs will not. The FSC submits this is inconsistent and confusing and further underlines the concern that this proposal is clearly not meeting the policy intent of ensuring direct and indirect investment is treated similarly.

Another issue will emerge if the proposal is implemented. The allocation of expenses against different types of income has not been definitively addressed since the repeal of section 50 of the Income Tax Assessment Act 1936. That section prescribed an order for the allocation of expenses and was particularly relevant in the context of the former Undistributed Profits tax. Since the repeal there have been miscellaneous rulings and statements to the effect that direct expenses should be allocated to the income to which they relate but that general and surplus direct expenses should be allocated pro rata against taxable income. Whether this is correct and whether any gross or discounted capital gains should form part of this allocation base is an issue that until this proposal did not matter. However, the change, as it is proposed, will force the Government to deliberate and prescribe an outcome. Such an outcome will inevitably have consequences beyond MITs and AMITs.

We note the original exposure drafts of the AMIT legislation included this measure, but it was removed by Treasury during consultation. We understand this change was made because of the concerns raised above in this paper: disallowing the CGT discount at the trust level reduced tax neutrality compared to direct investment.

Given the increased compliance costs from the measure and the distortion in the tax treatment of direct vs indirect investment, the proposed CGT change would likely actively discourage many investors (individuals and superannuation funds) from investing in MITs and AMITs, adding to the competitiveness issues raised earlier in this submission.

The added burden on MITs and AMITs caused by higher taxation and higher compliance costs from these combined proposals means the benefit of reforming and moving out of Division 6 has been considerably reduced — possibly negated. It also is particularly concerning that this change has been proposed after many fund trustees have made the irrevocable election to adopt the AMIT regime.

We note that this measure is ostensibly meant to prevent beneficiaries that are not entitled to the CGT discount from getting a benefit from the CGT discount being applied at the trust level. This would be non-resident investors and corporate investors.

It is not clear why the Government has proposed a measure targeting all investors in AMITs and MITs rather than a measure specifically targeting resident corporations and non-resident beneficiaries. Instead, the Government proposes a measure that will result in individuals and superannuation funds paying an inappropriate amount of tax compared to direct investment.

Additionally, the beneficiaries of apparent concern represent a small proportion of unitholders. According to the ABS, non-government trading companies represent just 1.85% of total investment into managed funds, and foreign investors represent 5.8% of total

investment.[28] Most investment is by individuals, superannuation funds and pension funds. In addition, capital gains are only subject to tax for non-residents when the gains relate to "taxable Australian Real Property" (**TARP**). Other gains are not subject to Australian tax. Hence the supposed mischief relates to a small proportion of the total gains recorded by the fund.

If the Government wishes to address concerns about corporates and non-residents accessing the CGT discount through MITs and AMITs, then we submit there would be value in exploring options that are more targeted at the issue. The FSC has provided a range of options to Treasury and we are willing to discuss these options in more detail. We await further consideration of these options.

Instead of this measure, the FSC is recommending a measure targeted at corporates and non-residents that are accessing the CGT discount through MITs and AMITs.

8.2 Proposed changes to attribution penalties for managed funds

The draft legislation to implement the Corporate Collective Investment Vehicle (CCIV) released in early 2019 contained the proposal for an extension of the penalty for attribution 'unders and overs' that result from a lack of reasonable care. This change will apply both to the new CCIV investment vehicle as well as an existing funds management vehicle, Attribution Managed Investment Trusts (AMITs).

FSC members completely oppose this change. If this penalty remains in the final legislation, it will prove to be a significant disincentive for any fund manager to elect into the CCIV (or AMIT) regime for its funds.

The change in the penalty regime for AMITs was a deliberate decision as part of the AMIT consultation process. Early exposure drafts of the AMIT Regime legislation included administrative penalties relating to 'unders and overs' where there had been a lack of reasonable care. However, this was removed as part of the consultation process in recognition of stakeholder concern about the application of the reasonable care concept.

The absence of the reasonable care requirement in the AMIT rules was not an 'oversight' that requires correction. It was a deliberate change based upon consultation on that point, recognising commercial factors particular to the industry. Changing the penalty regime for the CCIV and AMIT regime without evidence of the need for this requirement would be ignoring this consultation.

We also note the alleged mischief from attribution 'unders and overs' is negligible. AMITs and CCIVs are, in general, not meant to be taxpaying entities; and any unders or overs would be expected to largely cancel out over time. As a result, the amount of tax at risk over time is very small.

[28] ABS Managed Funds, September 2018, table 9.

Penalties in the tax system should be proportionate – an approach that should apply across all government policy. However, in this case, proportionality does not apply. A potentially substantial penalty is being applied in relation to a negligible tax liability.

The non-zero risk of a reasonable care penalty will be a further discouragement from foreign investors using CCIVs and AMITs compared to other international vehicles, particularly vehicles in the Asia Region Funds Passport. For Australian taxpayers, it will discourage the use of CCIVs and AMITs compared to other vehicles such as Listed Investment Companies (LICs) and non-AMIT trusts.

We understand the main argument in favour of the proposed change is that it will mean the same tax penalty regime will apply to all Australian taxpayers. However, this argument is without substance:

- AMITs and CCIVs could be penalised for attributing *too much* assessable income to investors. It appears CCIVs and AMITs would be the only classes of taxpayer subject to reasonable care penalties where there has been no tax shortfall. If the goal is to be consistent, then this would lead to another impractical conclusion: penalties should apply to *all* taxpayers who pay too much tax (a conclusion that fund managers would oppose).
- AMITs currently have (and CCIVs will have) substantially different administrative rules for income tax compared to other taxpayers. In particular, other taxpayers (in general) do not use estimates to calculate taxable income in one tax period and then 'true up' the estimates in a later period.[29]
    - Other taxpayers could be penalised for using this approach as they are not permitted to use 'unders and overs' that is central to the attribution system. Again, if the goal is for the administration of income tax to be consistent across all taxpayers, then this would lead to the impractical conclusion that *no* taxpayers should be able to use 'unders and overs' (again, a conclusion that fund managers would naturally oppose).

The points above lead to the conclusion that AMITs and CCIVs *are* different from other taxpayers – and so therefore the consistency argument for penalties fails.

We also note the following:

- Evidence has not been presented showing the current approach, involving penalties for errors due to recklessness alone, is not working adequately.
- It has not been shown that the addition of this new penalty is of net benefit, noting the costs of the new penalty system, including added costs and uncertainty.
- The proposal will strongly discourage investment into assets that are more likely to produce 'unders and overs' such as property. Investment managers may just not

[29] Taxpayers can amend earlier year returns, but this is quite different from carrying forward the differences between estimated and actual figures and offsetting these against future year returns.

want the risk of being confronted with a penalty for using the 'unders and overs' provisions.

- the ATO has released guidance on acceptable practice for making attribution estimates for AMITs.[30] If the threshold for AMIT penalties is lowered, then either:
    - the ATO guidance will change, in which case the law change will trap otherwise acceptable AMIT practices, highlighting the FSC concerns raised above; or
    - the ATO guidance will not change, in which case it is unclear why the law change was required.

We also strongly object to the retrospective nature of this proposal on MITs that have already elected into the AMIT regime and are unable now to exit this regime due to the irrevocable election made at the time. Arguably, there would not be a retrospective element to the proposal if AMITs were able to exit the regime, but the fact that there is no possibility of exit means the proposed penalty change operates to some extent retrospectively on AMITs that are now in the regime.

Furthermore, if MIT operators had the benefit of hindsight that the reasonable care test would be inserted at a later date, then it would have been a significant factor impacting the decision to elect into AMIT. Changing the penalty regime after the decisions is moving the goalposts after the game has started.

Therefore, if the change in the penalty regime is retained in the final CCIV legislation, then the FSC recommends that AMITs be provided with the option to leave the attribution regime to ensure the retrospective element of the proposal is removed.

[30] ATO LCR 2015/10 Attribution Managed Investment Trusts: administrative penalties for recklessness or intentional disregard of the tax law - section 288-115 See: https://www.ato.gov.au/law/view/document?DocID=COG/LCR201510/NAT/ATO/00001&PiT=99991231235958

FSC FINANCIAL SERVICES COUNCIL

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 "the quarter ends after the employer-sponsor notifies the trustee …" to "*a* quarter ends after the employer-sponsor *first* 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 calendar 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 business 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.

PRODUCT RATIONALISATION WORKING GROUP PROPOSAL
PROPOSED PRODUCT RATIONALISATION MECHANISM

1. FINANCIAL PRODUCT RATIONALISATION SCENARIOS

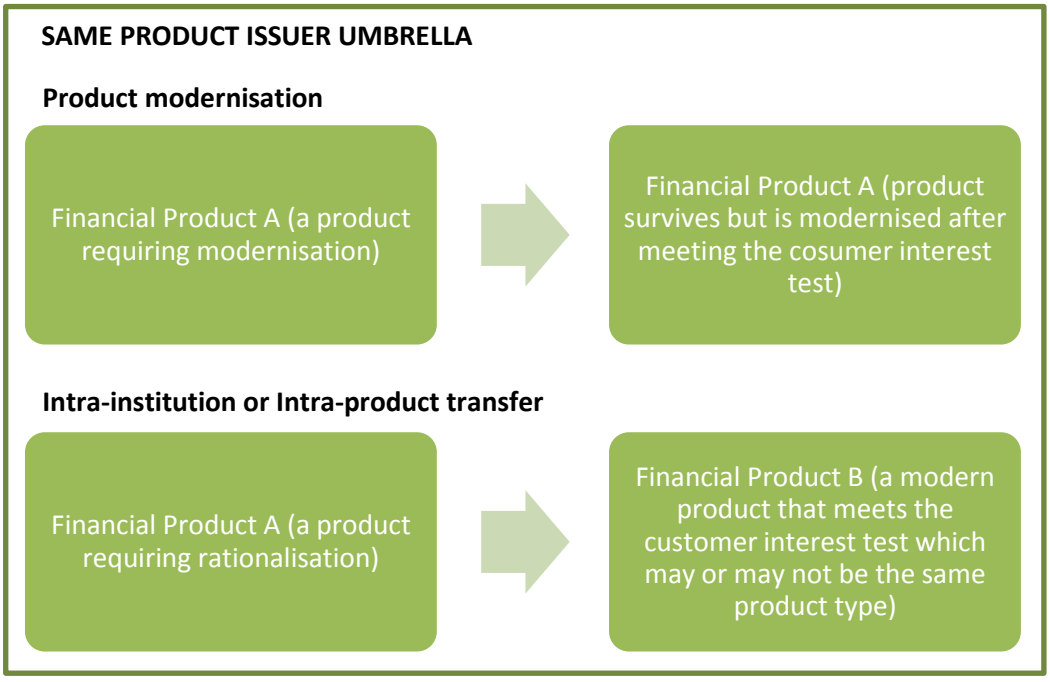
Under Part 9 of the Life Insurance Act 1995 (Cth) and the Financial Sector (Business Transfer and Group Restructure) Act 1999 (Cth), there is a process for the merger of the statutory funds of two life companies or the transfer of part of the life insurance business between them however this is too complex and expensive for wide scale use.

Enabling consumers to move into a more competitive, efficient and modern product will improve competition and efficiency in the industry. In practice, achieving this outcome may involve the transfer or simplification of a financial product under a range of different scenarios. The FSC has captured these scenarios below and believes all can be achieved by leveraging the common framework proposed above. We would be pleased to provide more detailed information and also to elaborate further on being able to transfer consumers between product types which would provide positive consumer and industry outcomes.

a. Internal simplification

This scenario involves:

- Transferring a consumer from one product to another issued by the same product issuer; or
- Leaving the consumer in the product they are currently in and changing it, or an underlying structure which supports the product, such as an investment structure.

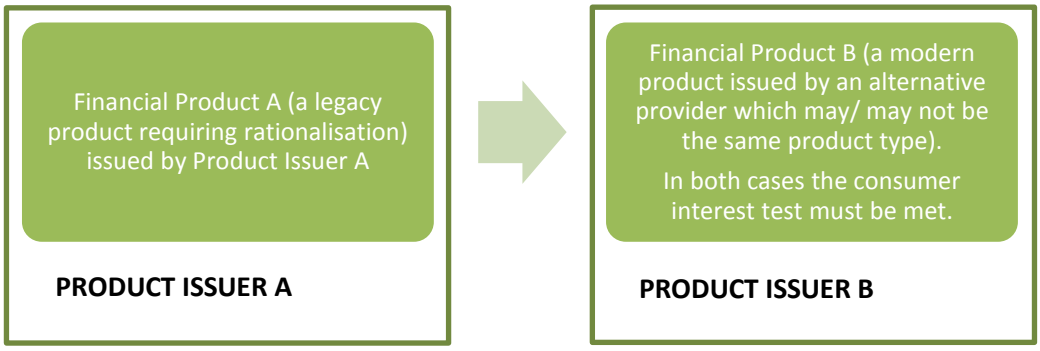


b. External simplification

This scenario involves:

- Transferring a consumer from one product to another issued by a different product issuer, whether that product is of the same kind or a different financial product. In practical terms this could be a life product to life product transfer or the transfer from one financial product to another financial product; or
- Substituting the current product issuer for another product issuer.

Inter-institution transfer or Inter-product transfer



c. Termination of product

When a product is no longer economically viable and has a very small number of remaining customers, a product provider can either terminate a product on the basis of the interests of consumers (returning their monies) or transfer the client(s) to a substitute product.

This mechanism would obviate the need to increase fees to in order to pass on the high costs of operating legacy products and the continuing cross-subsidisation of legacy products by the majority of consumers who are invested in contemporary products. This termination mechanism should be able to be exercised unilaterally by the product issuer and override any individual arrangements between the product issuer and the client.

2. APPLICATION OF TEST UNDER DIFFERENT PRODUCT TYPES

a. Life Insurance

Life Insurers cannot rationalise products under the current legislation, which requires the life insurer to ensure each individual policyholder is no worse off under any individual policy condition, despite such change being:

- In the **interest of the majority** of consumers.
- **As an overall package** of benefits and services, in the interests of an individual consumer, despite an individual condition being less advantageous.

While in theory consumer consent could be obtained to upgrade consumers, this is impractical. Under Part 9 of the Life Insurance Act 1995 (Cth) there is a process for the merger of the statutory funds of two life insurance companies. However, this provides limited practical benefit even in a merger (as only minor changes can be made) and does not assist a life insurer rationalise its own portfolio.

Over time and to meet prevailing market needs, a life insurer may have issued hundreds of individual products, which may also have been further customised for individual customers. Given the significant variation between policy terms, life insurers are effectively locked out from upgrading consumers to modern products as the current exercise of ensuring all consumers are no worse off is too arduous and unsustainable for life insurers to participate in.

The lack of a product rationalisation framework for life insurance is a significant barrier to product innovation in life insurance because life insurers don't want to be left with small portfolios of policies from innovation initiatives which are costly to administer. This stifles product innovation and in fact makes innovation very difficult. Ultimately the consumer loses as a result

Reinsurers also play an important role in the viability of any future rationalisation framework as should they reinsure the policy, they would need to consent to changes. Reinsurers should provide consent on the basis of independent actuarial advice confirming that they are not materially impacted.

Recommendation:

1. Amend the Insurance Contracts Act to allow life companies to unilaterally amend policy terms where a consumer interest test is satisfied when comparing the overall bundle of benefits the consumer currently has versus the proposed changes.
2. If a reinsurer is involved, independent actuarial advice should be sought prior to the action that confirms reinsurers are not materially impacted by product rationalisation and if so, they should provide consent to the change.

b. Managed Investment Schemes and IDPS

Many organisations operate managed investment schemes (registered or unregistered) which, due to their size or numbers of members are no longer efficient to operate. This may arise because a scheme is closed to new members and over time redemptions have reduced the size of the scheme (but the cost base has stayed the same or increased) or because mergers have resulted in duplication in the investment strategies of funds in the group.

For example, post merger a group may operate two emerging markets funds and it would be more efficient (and cost savings could be passed on to investors) if the funds could be merged.

It is difficult under the current legal framework to transfer investors from inefficient schemes to more modern or more sufficient schemes. For registered and unregistered schemes generally a 'trust scheme' is needed which requires meetings to be convened and generally requires applications to court for judicial advice, the outcomes of which are uncertain and the costs of which can be significant.

If transfers are not viable the only other real alternative is termination. Again, the outcome may be uncertain and the costs may be significant as a meeting may be required to amend the trust deed or seek member approval (a meeting is mandated by the Corporations Act for a registered scheme) and judicial advice may be needed. The termination of the fund may also crystallise any capital gains for the investor.

As these managed investment scheme problems arise in relation to all types of schemes the FSC proposes that the solution be made available to all categories of managed investment scheme, including:

- IDPSs, which are generally classified as unregistered managed investment schemes (because investors have the expectation of cost savings or access to investments that would not otherwise be available to them and are exempted from registration where they meet certain conditions); and
- IDPS-like schemes which operate similarly to IDPSs but are registered managed investment schemes.

Recommendation:

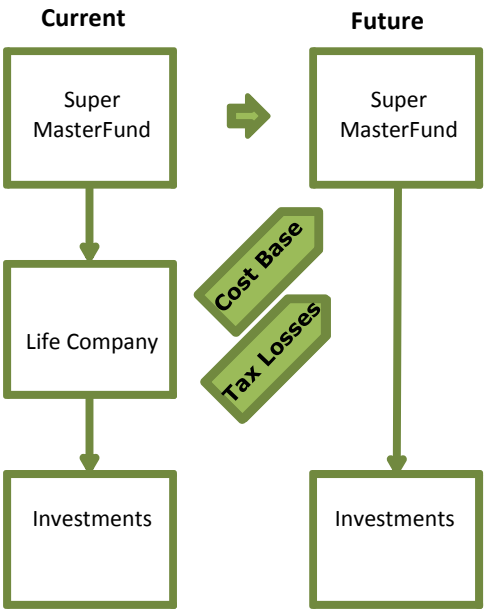
3. Permit the transfer of all the members from a legacy scheme (e.g. a scheme that is economically inefficient or out-dated) to another fund where the responsible entity or trustee considers on reasonable grounds that those transfers are in the interests of those members as a whole.
4. Introduce a more streamlined regulatory regime for the transfer of REs within a corporate group.

c. Underlying Structures

Facilitation of transfers between investment portfolios applicable to a financial product should apply to both life-backed investment portfolios as well as investment portfolios structured as managed investment schemes or pooled superannuation trusts. Such facilitation would allow for a transfer between portfolios without consent of affected investor(s) but subject to the consumer interest test.

For example, “life-backed superannuation product” is a commercial term that describes a superannuation fund offering super products with investment options invested through an investment policy from a life insurance company. The investment policy comprises of investment options similar to those offered by the superannuation fund.

The life insurance company invests the moneys “assigned” to those investment options under the investment policy under a mandate which supports the investment aims of the corresponding option offered by the super fund (e.g. growth option, conservative option, or in the case of the default fund, the life company would commonly invest the moneys assigned to either a balanced investment option or the appropriate life cycle options).



For many providers, the investment structure of life-backed superannuation products is a legacy of retail funds seeking to utilise benefits associated with the life insurance structure which were of greater benefit historically than today. For many providers, these benefits have now been eroded however the trustee and consumers remain “trapped” in the life policy structure which now results in an unnecessary impost of inefficiency, additional cost and red tape. Importantly, our proposal mirrors that of the existing rollover relief for the merger of superannuation funds, so is building on an already established framework.

Recommendation:

5. Having met the consumer interest test, the transfer of investment portfolios including life backed superannuation products to a modernised regime should involve:

a. Members are switched from an investment option under a life policy to which they are invested into a corresponding investment option that is offered in the new directly investing product in the same superannuation fund.
b. The manager of the investment option (in the case of life policy, the life company) disposes of the assets (the units in investment trusts)
c. The superannuation MasterFund will withdraw its investment policy with the Life Company.
d. The Superannuation MasterFund will acquire the same units in investment trusts, as disposed of by the manager of the investment option.
e. The rationalisation mechanism should operate without tax consequences.

6. Having met the consumer interest test, the transfer of life company superannuation annuities to a modernised regime (a regulated superannuation fund) should involve:

a. Policyholders switched from an investment option under the superannuation policy to which they are invested into a corresponding investment option that is offered in the superannuation fund.
b. The life company transfers the assets to the trustee of the superannuation fund.
c. The policyholder's rights under the superannuation annuity are extinguished and replaced by an interest in the superannuation fund.
d. The superannuation fund will acquire the same units in the investment trust as disposed by the life company or acquire an investment-only policy with the life company relating to the same investment options.

3. OTHER CONSIDERATIONS

Overall the super mechanism works well from a consumer and product issuer perspective and has been used considerably by the industry in recent years to the benefit of all industry stakeholders.

Although it is outside of the scope of the FSI Panel's recommendation, which deals exclusively with life insurance and managed investment scheme legacy books and underlying structure rationalisation, there is scope to revisit one element of the current superannuation rationalisation mechanism.

Allowing holders of a term allocated pensions (TAPs) and other exempt pensions to easily commute their benefits into an account-based pension where they no longer receive any social security benefit from maintaining the pension would be a valuable improvement to the existing regime.

This would provide existing TAP and other pension holders with greater flexibility and choice in relation to how they can manage their retirement benefits.

GREENWOODS + HERBERT SMITH FREEHILLS

TAX BRIEF

8 May 2018

Budget 2018-19

The Budget has become like Christmas – it is a season, not an event. This year's Budget Season began in mid-April with the regular and strategic placement of good news stories (and definitely no bad news stories): no increase to the Medicare levy, personal income tax cuts for low income earners, tax reductions for higher income earners but spread over a longer time frame, incentives for the film industry (and yet another attempt to tweak the R&D tax incentive), changing the excise system to benefit brewers of craft beer, a Taskforce to crack down on illegal tobacco sales, big spending on infrastructure (including more money for hospitals in WA), new drugs added to the Pharmaceutical Benefits Scheme, more spending on the aged, and so on. Budget Season will continue for a few weeks yet as the Government tries to impress upon us the messages it wants us to remember. This Tax Brief outlines the tax components of the Budget, both the good news and the bad.

1. Corporate tax

In April, the Treasurer revealed that tax receipts from July to December 2017 were $4.8bn higher than expected, and of that, almost $3bn was due to higher than expected company tax collections. Notwithstanding that surprise, the Government has announced a series of measures which will increase corporate tax revenue.

1.1 Digital economy

Towards the end of his speech the Treasurer alluded, ever so briefly, to his earlier statements to make sure companies in the digital economy pay 'their fair share of tax,' if necessary by unilateral action pending a multilateral resolution. He indicated that a Discussion Paper on options for taxing the digital economy will be released 'in a few weeks' time.'

This is likely to include the options that the EU announced in March 2018 of developing in the longer term rules to be incorporated in tax treaties for a 'virtual permanent establishment' in the countries of the users of digital platforms and attributing some of the platform owner's profits to those countries. In the interim, the EU proposed an interim digital tax of 3% on revenues of large companies involved in (i) selling online advertising space (such as Google and Facebook); (ii) digital intermediary services (which allow users to interact with other users to facilitate the sale of goods and services between them (such as Uber or Airbnb); or (iii) the sale of data generated from user-provided information (such as Palantir).

In March the OECD said its work on these issues would be completed in 2020 but more recently the OECD has shifted the date to 2019.

1.2 Valuation of assets for thin capitalisation purposes

The thin capitalisation rules will be amended to require entities to align the value of their assets for thin capitalisation purposes to the values used in their financial statements. There is currently some flexibility in the thin capitalisation rules to use asset values that are not contained in an entity's financial statements. In this regard, the ATO has been actively reviewing taxpayers who revalued their assets after the 2014 changes to the thin capitalisation rules (which reduced the safe harbour debt threshold to a 1.5 to 1 debt to equity ratio). The Government must consider that the robust review that comes with the preparation of financial statements affords additional integrity in this area. This measure will apply to income years commencing on or after 1 July 2019.

1.3 Classification of consolidated entities for thin capitalisation purposes

Foreign controlled Australian consolidated entities and multiple entry consolidated groups that control a foreign entity will now be treated as both outward and inward investment vehicles for thin capitalisation purposes. This will overcome a curiosity under the current thin capitalisation rules where these consolidated entities are deemed to be outward investment vehicles and different tests therefore apply. This change will apply for income years commencing on or after 1 July 2019.

1.4 'Significant global entity' definition

The definition of a 'significant global entity' ('**SGE**') will be broadened 'to ensure that Australia's multinational tax integrity rules operate as intended.'

SGEs are subject to the Diverted Profits Tax rules, the Multinational Anti-Avoidance Law and the Country by Country reporting obligations. While not mentioned in the Budget measures, any amendment to the SGE definition will presumably also have an impact on the increased penalty regime applicable to SGEs and the General Purpose Financial Statements lodgement obligations.

Under the current rules, an entity is regarded as a SGE for a particular income year if it satisfies one of the following:

- the entity is a 'global parent entity' ('**GPE**') with 'annual global income' of AUD$1bn or more; or
- the entity is a member of a group of entities consolidated for accounting purposes and the GPE of the consolidated group has annual global income of AUD$1bn or more.

The Government's proposal is to broaden the current definition to include members of large multinational groups headed by private companies, trusts and partnerships. It will also include members of groups headed by investment entities that may not otherwise be currently captured as they are not permitted to consolidate for accounting purposes.

For example, the new definition may have an impact on global funds including real property and private equity funds that currently may not be required to consolidate their Australian investments for accounting purposes.

The new measure will apply to income years commencing on or after 1 July 2018.

1.5 Tax consolidation

Budget Paper No 2 re-announced two changes already enacted by the *Treasury Laws Amendment (Income Tax Consolidation Integrity) Act 2018* which received Royal Assent in March this year. That is, the announcement reflects current law, not proposed changes. This is somewhat odd. The Budget will often recap announced but unenacted measures, but these measures have already been enacted.

The 'churning measure' ensures the consolidation tax cost setting rules will not apply to reset the tax cost of assets held by a non-land rich entity that joins a consolidated group or MEC group after being transferred from a non-resident entity who is not taxed on the transfer. This measure was clarified as requiring 50% common ownership within the previous 12 months based on an associate-inclusive test.

However, this clarification was amended so that it only took effect from introduction of the Bill on 15 February 2018. For the period from 14 May 2013, the test is not associate-inclusive.

The highly convoluted (and unworkable) transitional rule initially proposed for the removal of deferred tax liabilities ('**DTLs**') from an entity's exit tax cost setting calculation was removed. The enacted measure removed DTLs from both entry and exit amounts from the date of introduction of the Bill on 15 February 2018.

1.6 Denying deductions for costs of holding vacant land

The Government will deny deductions for expenses associated with holding vacant land, whether the land is for residential or commercial purposes. Deductions which have been denied will not be able to be carried forward for use in later income years but will be included in the CGT cost base of the asset.

The measure will not apply to expenses associated with holding land:

- that are incurred after any property constructed on the land is complete and available for rent; or
- where the land is being used by an owner to carry on a business.

The Budget Paper says somewhat cryptically, that '*the carrying on a business test will generally exclude land held for commercial development*.' It is not clear whether the Budget Paper is trying to say:

- '*the carrying on a business test will generally exclude* [from this measure] *land held for commercial development*' and sale; or
- '*the carrying on a business test will* [not extend to] *land held for commercial development*,' even if the land is being developed for sale.

On the other hand, it may be trying to say, if the land is being developed for retention and lease, then '*the carrying on a business test'* will not be met and so the measure would apply.

Further clarification will be required about the scope of the measure given its potential impact. The measure will take effect from 1 July 2019.

2. Managed investment trusts and AMITs

2.1 CGT discount

The Government proposes to prevent Managed Investment Trusts ('**MITs**') and Attribution MITs ('**AMITs**') from applying the 50% capital gains tax discount at the trust level. This measure will apply to payments made from 1 July 2019.

The measure is directed at Australian resident companies that are beneficiaries of MITs and AMITs. They can, at present, effectively access the CGT discount where deductions (such as interest) are offset against capital gains, even though companies are not meant to enjoy CGT discount. For example, if a trust has a gross, discountable capital gain of $1,000 and interest deductions of $500 it will have net income of nil:

Gross capital gain	1,000
CGT discount	(500)
Interest deductions	(500)
Net income	0

This means that an Australian resident corporate beneficiary would have no taxable income despite the fact that, if it had derived and incurred those amounts directly, it would have had taxable income of 500. Further, at least in the case of a MIT, the trust could distribute $500 as a CGT concession amount with no cost base adjustment for the corporate or non-resident beneficiary.

While the proposed measure may be considered an appropriate outcome for Australian resident corporate beneficiaries, this represents the classic 'sledgehammer to crack a nut' response. The proposed position will put all *other* Australian resident beneficiaries in a worse position than they would have been if they had made a direct investment. Using the example above, an Australian resident individual would have no taxable income if they made the relevant investment and borrowed themselves. However, if that person invests through a MIT, the position of the MIT will now be:

Gross capital gain	1,000
Interest deductions	(500)
Net income	500

The Australian resident individual will now include $500 in their assessable income. While that $500 may qualify for the CGT discount, some tax will be payable in circumstances where no tax would be payable if a direct investment would be made.

This negative outcome will also apply for complying superannuation funds. Again, using the example above a direct investment would produce the following result:

Gross capital gain	1,000
CGT discount	(333)
Interest deductions	(500)
Net income	167

Under the proposed change, the complying superannuation fund would have net income of $500, reduced to $333 after the CGT discount. In effect, the rate of taxation has been doubled on a complying superannuation fund in this example.

These examples show that the Government's statement that, '*this integrity measure will ensure that MITs and AMITs operate as genuine flow-through tax vehicles, so that income is taxed in the hands of investors, as if they had invested directly*,' is simply not correct for Australian resident beneficiaries.

In the case of non-resident beneficiaries of MITs and AMITs, the effect of the CGT discount is already reversed in calculating the amount of income to which MIT withholding tax applies. Thus, even under current law a non-resident beneficiary would be subject to withholding tax on its share of the gross $500 income in the example set out above.

Given that Australian resident corporations make up a tiny proportion of the overall investment in MITs and AMITs, it must be wondered whether Australian resident individuals and complying superannuation funds should have to pay an inappropriate amount of tax to address the perceived windfall for Australian resident corporations. It is not clear why the Government has avoided specifically targeting Australian resident corporations and instead used the blunt instrument of changing the calculation of net income at the trust level.

Aside from the substance of the proposed change, the application date of the measure is also problematic. The Government has stated that the 'measure will apply to payments made from 1 July 2019.' Just what this means is unclear since:

- beneficiaries of AMITs are subject to tax on an attribution basis, which is unrelated to whether there are any payments made by the AMIT; and
- beneficiaries of MITs are subject to tax on their share of the net income of the trust for the year as a whole, regardless of when distributions are made. It is not clear how the Government considers

that resident beneficiaries of MITs will be taxed for the year ending 30 June 2019 where some distributions are made before and some after 30 June 2019.

It is to be hoped that, at a minimum, the proposed measure will not apply to payments that relate to an income year that commences before 1 July 2019.

2.2 Expanded list of countries for reduced MIT withholding tax

A concessional rate of withholding tax (15%), currently applies to 'fund payment amounts' made to unitholders in a MIT that are resident in an 'information exchange country' listed in the regulations. There are currently 60 countries on this list but it has not been updated since 2012.

The Government announced that it will update the list of countries to include 56 additional jurisdictions that have entered into information sharing agreements since 2012. This updated list will be effective from 1 January 2019.

The announcement does not include the list of countries and it is not entirely clear what criterion the Government is using to identify the selected countries:

- if the requirement is that the other country *automatically* exchanges information with Australia, then it should extend to countries with which Australia has a comprehensive bilateral income tax treaty plus other countries which have signed the multilateral *Convention on Mutual Administrative Assistance in Tax Matters*, and in either case have signed the multilateral Competent Authority Agreement or a bilateral Competent Authority Agreement for Automatic Exchange of Information);

- if the requirement is the other country only exchanges information *on request* (which seems currently to be the case) then this would include any countries with which Australia has a comprehensive tax treaty or a Taxation Information Exchange Agreement, or that have signed the multilateral *Convention* but only exchange information on request.

Whatever the answer to that question, it is worth noting that Luxembourg will now be added to the list and Hong Kong remains a notable omission from the list.

2.3 Stapled structures

The Budget repeats the media release by the Treasurer on 27 March 2018 that the Government will introduce a package of measures to address the perceived integrity risks posed by 'stapled structures.' Broadly speaking, the following measures are being proposed:

- applying a 30% MIT withholding tax rate to distributions derived from trading income that has been converted to passive income (usually rent) using a MIT. Certain exemptions will apply for nationally significant infrastructure projects and for third party rents;

- thin capitalisation amendments to prevent double gearing structures. This will be achieved by lowering the associate entity threshold from 50% to 10%;

- limiting the foreign pension fund and sovereign immunity exemptions from withholding tax to portfolio investments only (that is, interests in the entity of less than 10%); and

- preventing agricultural MITs from accessing the 15% concessional MIT rate.

The thin capitalisation changes will apply from 1 July 2018. All other changes will apply from 1 July 2019 with a transitional period of at least seven years.

Our Tax Brief available **here** provides further details regarding these measures.

3. Small business measures

3.1 Extending the $20,000 instant asset write-off for small business

In the 2015-16 Budget the Government introduced a small business depreciation concession for assets costing less than $20,000. The measure was due to expire on 30 June 2017 but was extended in last year's Budget to expire on 30 June 2018. This year's Budget announces that it will be extended again to expire in 30 June 2019 at a cost to revenue of $550m. Small businesses with aggregated annual turnover of less than $10m can immediately deduct the cost of assets costing less than $20,000 which are first used or installed ready for use by 30 June 2019. From 1 July 2019, the immediate deductibility threshold will revert to $1,000.

Assets costing more than $20,000 can be put into a pool and depreciated at 15% in the year first included and 30% in subsequent years. If the pool balance falls below $20,000 before 30 June 2019, the balance can be immediately deducted. From 1 July 2019, the pool balance threshold will revert to $1,000.

The rules which prevent small businesses from re-entering the simplified depreciation regime for five years if they opt out will continue to be suspended until 30 June 2019.

3.2 Amendments to Division 7A – unpaid trust entitlements

It has long been the view of the ATO that an amount to which a company that is a beneficiary of a trust is presently entitled, but which has not been paid to the company (an unpaid present entitlement or '**UPE**') should attract the application of Division 7A. The theory is that the amount represents a loan by a private company to the trustee of the trust (usually, an associate of a shareholder of the company) but a loan which is typically not appropriately documented and so not immune from challenge under Div 7A.

While the Commissioner had applied concessional treatment in some circumstances, from 1 July 2019, a new measure will 'clarify' that a UPE to a company beneficiary will be treated as a dividend under Div 7A unless a complying loan agreement has been entered into.

3.3 Delayed Div 7A amendments

In addition, the Government announced a deferred start date of 1 July 2019 for compliance-focused amendments to Div 7A that were announced in the 2016-17 Budget. Some of the main elements of the proposal include:

- a mechanism to amend without penalty arrangements which 'inadvertently' trigger the application of Div 7A;
- amended documentation requirements for Div 7A loans; and
- new safe harbour rules aimed at preventing the application of Div 7A in circumstances where an asset is provided for use by a company to a shareholder or associate.

A single package which combines all the Div 7A amendments will be enacted.

3.4 Removing small business CGT concession for partnership assignments

Partners who alienate their income by creating, assigning or otherwise dealing in rights to the future income of a partnership (including so-called *Everett* assignments) will no longer be able to access the small business capital gains tax concessions in relation to these transactions.

The Government has become convinced that some taxpayers, including large partnerships, are able to access these concessions inappropriately in relation to the assignment to an entity of a right to the future income of a partnership, without giving that entity any role in the partnership.

In recent times the ATO has withdrawn its guidelines in relation to income splitting in professional firms (including *Everett* assignments) due to concerns regarding 'high risk' arrangements. The ATO is still formulating revised guidelines.

4. Personal income tax measures

4.1 Staggered reductions to personal income tax rates

The centrepiece of the Budget, so far as the Government is concerned, is the personal income tax cuts. While there is a modest tax cut scheduled to start on 1 July 2018, the most significant cuts are staggered over the period until 2024 – that is, after both the 2019 election and the election after that! The Treasurer promised that these measures would be legislated immediately (one can hear the faint echo of Paul Keating prior to the 1993 election declaring that his tax cuts were 'L-A-W'), but clearly these measures are subject to the vicissitudes of the election cycle.

The new rates and thresholds would be:

	Current rates 2017-18	**Stage 1 2018-19 to 2021-22**	**Stage 2 2022-23 to 2023-24**	**Stage 3 2024-25**
Tax-free amount	$18,200	$18,200	$18,200	$18,200
First rate, income between	19% $18,201 to $37,000	19% $18,201 to $37,000	19% $18,201 to $41,000	19% $18,201 to $41,000
Second rate, income between	32.5% $37,001 to $87,000	32.5% $37,001 to $90,000	32.5% $41,001 to $120,000	32.5% $41,001 to $200,000
Third rate, income between	37% $87,001 to $180,000	37% $90,001 to $180,000	37% $120,001 to $180,000	45% $200,001 and above
Fourth rate, income between	45% $180,001 and above	45% $180,001 and above	45% $180,001 and above	

These tax cuts come at a cost of over $13bn over the four year forward estimates.

Increased Medicare levy threshold. The Budget repeats the Government's decision to increase the various Medicare levy thresholds for the 2017-18 income year.

Extra ATO funding. The Budget also announces that the Government will give the ATO an extra $130m 'to increase compliance activities' focussed on individuals. The ATO is clearly concerned about the increasing cost of employee deductions and appears to have formed the view that tax agents are not an effective bulwark against incorrect claims. Part of the money will be devoted to continuing some of the ATO's income matching programs and other measures such as '*improving real time messaging to tax agents and individual taxpayers to deter over-claiming of entitlements …*'

The Budget estimates that for an outlay of $130m, the ATO will generate additional revenue of $1.1 billion.

4.2 Increase to the LITO

The Government's decision that the Budget would offer tax cuts to low income earners was leaked some time ago; over the weekend, it was revealed the mechanism for doing this would involve something similar to the Low Income Tax Offset ('**LITO**').

The Government has decided to supplement the LITO with another tax offset, the 'Low and Middle Income Tax Offset' ('**L&MITO**'), which will operate for four years, from 2018-19 to 2021-22.

LITO. The current LITO is valued at $445. It is payable in full until the taxpayer's taxable income reaches $37,000 at which point it is withdrawn at the rate of 1.5c for every extra dollar of taxable income and ceases entirely by $66,667.

From 1 July 2022, the government is proposing:

- taxpayers with taxable income up to $37,000: the LITO would increase to $645;
- taxpayers with taxable income between $37,001 and $41,000: the $645 tax offset is withdrawn at the rate of 6.5c for every extra dollar of taxable income;
- taxpayers with taxable income above $41,000: the tax offset is withdrawn at the slower rate of 1.5c for every extra dollar of taxable income and ceases entirely by $66,667.

L&MITO. This tax offset works in these stages:

- taxpayers with taxable income up to $37,000: they will receive an additional tax offset of $200;
- taxpayers with taxable income above $37,000 but less than $48,000: the $200 tax offset will *increase* at the rate of 3c per dollar of extra taxable income up to a maximum of $530. (Presumably this counters the *reduction* to the LITO occurring over part of this income range);
- taxpayers with taxable income between $48,001 and $90,000: these taxpayers will receive the maximum tax offset of $530;
- taxpayers with taxable income above $90,000: the $530 tax offset is withdrawn at the rate of 1.5c for every extra dollar of taxable income and ceases entirely by $125,333.

From the Government's point of view, there would seem to be several benefits from delivering the tax cut in this way: unlike an increase to the tax-free threshold or a reduction in the bottom rates, the benefit is delivered only to people whose taxable income is low, it does not affect PAYG collections, it can only be accessed by people who go to the trouble of filing an income tax return, and there is a lot of wastage (the LITO is not refundable, can't be transferred and can't be carried forward, and one assumes the L&MITO will follow the same pattern).

On the other hand, a tax cut delivered by the LITO and L&MITO is all but invisible to most voters. No-one will see the impact of this tax cut in their pay slip once it begins.

4.3 Increase to Medicare levy cancelled

The biggest single revenue-raising measure in the 2017-18 Budget was the announcement of an increase to the rate of the Medicare levy from 2% to 2.5% from 1 July 2019, a measure which was expected to raise more than $8bn over the forward estimates. And in a break from Treasury tradition, this revenue was actually to be ear-marked to fund the National Disability Insurance Scheme with the Government promising to credit the funds 'to the NDIS Savings Fund Special Account when it is established.'

The Labor party supported the increase to the Medicare levy rate but only for individuals with taxable income above $87,000. The Government was unwilling to compromise and so the package of 11 Bills has been stalled in the Senate for the last 6 months.

It was not surprising when the Treasurer announced in late April that this measure would be scrapped. Not only was the proposal unachievable in the current political climate, it would undermine the Government's preferred message – people should focus on the personal income tax cuts being offered in the Budget, not the tax increase planned for 2019.

5. Superannuation

The Budget announces that the Government will:

- ban exit fees, cap fees for low balance accounts under $6,000, require low balance inactive accounts to be transferred to the ATO and make insurance optional for low balance accounts, inactive accounts and accounts for members aged under 25 years (members will have to 'opt-in' to any insurance component);
- allow new retirees aged 65 to 74 with less than $300,000 in superannuation to make voluntary contributions in the year after they fail the 40 hours in 30 days 'work test';
- require superannuation funds to formulate and offer a comprehensive income in retirement product for members and provide favourable Age Pension means testing for pooled lifetime income stream products;
- allow high paid employees with more than one job that causes mandated contributions to exceed the $25,000 concessional contributions cap to partly opt out of superannuation guarantee;
- adopt compliance procedures to reduce the incidence of employees claiming tax deductions for personal contributions where they have not advised the fund by submitting a valid and acknowledged 'notice of deduction' form (so that the fund is unaware that it has to pay 15% tax on the contribution); and
- increase supervisory levies to pay for increased ATO compliance.

6. Indirect taxes

6.1 Online hotel accommodation providers

Offshore sellers of hotel accommodation such as Wotif, Expedia and Bookings.com that provide Australian hotel accommodation will be required to calculate their GST turnover in the same way as local accommodation providers from 1 July 2019.

As a result, online providers that make sales of hotel accommodation in Australia of over $75,000 per annum will be required to register for GST and charge GST on the sales, capturing GST on their mark-up on the accommodation. The additional GST should only be on the margin as they will also be entitled to claim input tax credits on GST incurred on their acquisitions.

This measure comes after extensive ATO audit activity in the sector which recognised the 'uneven playing field' and also aligns with the move to tax digital supplies from offshore.

The Government estimates that this will raise $15m over the forward estimates period. It will only apply to sales made after 1 July 2019 and so should exclude a hotel stay after 1 July 2019 that was paid for prior to that date. Initially this cost falls on the offshore sellers but will likely be passed on to consumers or back to hotel operators.

6.2 Other online accommodation providers

In addition, the Government has noted a recommendation in the *Black Economy Taskforce Final Report* which suggested it examine how GST should apply to accommodation provided through Airbnb

and similar platforms. The Government response was merely to note that such providers may need to account for GST on those sales where they reach the turnover of $75,000 per annum.

6.3 GST and ABN aspects of phoenix activity

The Government has announced measures directed to combating illegal phoenix activity including extending the Director Penalty Regime to GST, luxury car tax and wine equalisation tax. This measure will make directors personally liable for the company's debts for these taxes.

The Director Penalty Regime currently makes directors personally responsible for PAYG and superannuation guarantee charge, which only has an impact on companies with employees. Extending this regime to GST will affect thousands more companies, and thus many thousand more directors than the current regime. The Australian Institute of Company Directors raised multiple concerns in its response to the Treasury Consultation, noting 'to impose personal liability for corporate breaches occurring at a time when the new director had no actual or legal ability to influence the conduct of the corporation offends a fundamental tenet of the rule of law.'

No details of how these measures will apply has yet been provided but presumably all company directors will now take a keener interest in the GST compliance of all entities for which they have a fiduciary responsibility. This regime will put pressure on in-house tax teams to reassure the Boards of every company in the group that GST has been correctly paid.

The Government also indicates its intention to overhaul the ABN system (including possible renewal of ABNs), a review of the business register and verifying ABNs in electronic payment processing.

7. Tax administration – the Black Economy

The final report of the *Black Economy Taskforce* and the Government's response to 'tackle the black economy' were released together with the Budget papers. The *Black Economy Package* in the Budget contains a number of announcements, mainly directed at tax administration and compliance to assist in revenue recovery, and which follow on from the *Tax Integrity Package* in last year's Budget. The *Black Economy Package* includes the following measures.

7.1 Taxable payments reporting system

The taxable payments reporting system ('**TPRS**') is a transparency measure that requires businesses to report to the ATO all payments they make to certain contractors. From 1 July 2019, the TPRS will be further extended to cover the following industries:

- security providers and investigation services;
- road freight transport; and
- computer system design and related services.

7.2 Cash payment limit

In order to tackle tax evasion and money laundering, a limit of $10,000 for cash payments made to businesses for supplies of goods and services will be introduced from 1 July 2019. An electronic payment method or cheque will be required instead.

Carve outs from this measure are anticipated for consumer to consumer (non-business) transactions, and for transactions with financial institutions (which would still be subject to existing anti-money laundering and counter-terrorism financing reporting requirements).

7.3 Removal of tax deductibility for non-compliant payments

A business that has not withheld PAYG from a payment of employee remuneration, or to a contractor that has not quoted an ABN when required, will not be entitled to claim an income tax deduction for the payment. This measure will apply from 1 July 2019.

This appears intended as a financial deterrent in addition to the existing regime, that already imposes an administrative penalty for failure to withhold when required under the PAYG system. However, as acknowledged by the *Black Economy Taskforce Report*, it requires the non-withholding to be detected, and also for phoenix type activity to be thwarted in order to recover tax shortfalls.

7.4 Government enforcement

Additional funding of approximately $300m over four years will be provided to the ATO 'to implement new strategies to combat the black economy' and 'to support the new multi-agency Black Economy Standing Taskforce', in order to ensure a more coordinated approach to combatting the black economy. This will include increased ATO audit activity, use of improved data analytics and information sharing between Government agencies.

A significant return is forecast to be delivered from this new funding (a gain to revenue of $3bn, and to cash receipts of $2.5bn, over the four year forward estimate period).

7.5 Further action to combat phoenix companies

In December 2015, the Productivity Commission released the *Final Report* from its inquiry into *Business Set-up, Transfer and Closure*.

The first measure announced following the *Report* was the proposed introduction of Director Identification Numbers. This was the subject of a Press Release from the Minister for Revenue and Financial Services on 12 September 2017. In that Press Release, the Minister also referred to 11 other measures to 'deter and disrupt the core behaviours of phoenix operators, including non-directors such as facilitators and advisors' upon which consultation would be sought.

The Budget announcement seeks to implement 6 of those measures (albeit with tweaks). Measures specifically referred to in the Budget Papers are:

1 the introduction of new phoenix offences to target those who conduct or facilitate illegal phoenix activity;

2 prohibiting entities related to the phoenix operator from appointing a liquidator – the Budget announcement differs in that related creditors will be restricted in their ability to vote on the appointment, removal or replacement of an external administrator;

3 preventing directors from backdating their resignations to avoid liability or prosecution;

4 limiting the ability of directors from resigning and leaving a company with no directors; and

5 expanding the ATO's power to retain tax refunds where there are outstanding tax lodgements.

There is still some unfinished business from the 12 September 2017 Press Release and we wait to learn the fate of the remaining measures:

1 the establishment of a dedicated phoenix hotline – the Government refers to a 'new hotline' to report illegal activity in the black economy in its response to the *Black Economy Taskforce Final Report* (both the *Report* and the response were released along with the Budget papers);

2 the extension of the promoter penalty regime to capture advisers who assist phoenix operators – the Government agreed with this measure in principle, and refers to implementing 'a comprehensive package of reforms which focus on deterring, disrupting and penalising those who

engage in illegal phoenixing activity.' This is likely to be part of the new phoenix offences to be introduced as noted above;

3 stronger powers for the ATO to recover security deposits from suspected phoenix operators – perhaps the GST withholding regime on property developers is seen as a 'toe in the water' for this measure;

4 a 'next-cab-off-the-rank' system for appointing liquidators; and

5 allowing the ATO to commence immediate recovery action following the issuance of a Director Penalty Notice.

8. Other measures

TOFA. The Budget confirms the Government's decision, announced in December last year, to defer the start date of measure arising from the project to reform various aspects of the TOFA regime. The project will apparently try to improve the design and functioning of the basic accruals and realisation system, the forex regime in TOFA and the hedging regime in TOFA.

R&D. The Government is trying yet another design for the R&D tax incentive 'to better target the program and improve its integrity and fiscal affordability.' The proposed changes will implement recommendations made in the 2016 *Review of the R&D Tax Incentive*. The changes will apply for income years starting on or after 1 July 2018.

Treatment of concessional loans in entities that become taxable. When a tax exempt entity becomes a taxable entity (eg, a privatisation occurs), the rules in Division 57 operate to deem liabilities held by the entity to have been assumed for a payment equal to the 'adjusted market value' of the corresponding asset in the hands of the person to whom the liability was owed. In the case of a concessional loan, this would likely lead to a market value below the face value of the loan. When the loan is repaid, Division 230 treats the difference between the face value repaid and the market value at the time the entity became taxable as a loss and therefore the entity obtains a deduction for a portion of the principal.

For entities that become taxable after 8 May 2018, a tax deduction will not be allowed for that principal amount by requiring the liability to be valued as if it were on commercial terms.

Revolving trust distributions. The Budget announces that the Government will apply 'a specific anti-avoidance rule that applies to … closely held trusts that engage in circular trust distributions' to family trusts. Just which particular provision the drafters have in mind is not spelt out but the most likely candidate is Div 6D ITAA 1936 – a regime which requires the disclosure of the ultimate beneficiaries of a trust which has as one of its beneficiaries the trustee of another trust. The measure does not start until 1 July 2019 so there is clearly no great urgency to the measure.

Income of minors from testamentary trusts. The Government has announced it will change the taxation of the unearned income of minors received from testamentary trusts. Income from testamentary trusts is currently subject to tax at ordinary rates; that is, the income is not subject to the punitive rates that apply to other types of unearned income of minors. From 1 July 2019, marginal rates will only apply to 'income … from assets that are transferred from the deceased estate or the proceeds of the disposal or investment of those assets …'

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