12 October 2012

The Board of Taxation
c/ The Treasury
Langton Crescent
PARKES ACT 2600

By email: taxboard@treasury.gov.au

Dear Board of Taxation

RE : Post-Implementation Review of Certain Aspects of the Consolidation Tax Cost Setting Process

The Financial Services Council ("FSC") welcomes the release of the Board of Taxation ("BoT") discussion paper on the post-implementation review of certain aspects of the consolidation tax cost setting process, and the opportunity to make submissions on the questions raised by the BoT in the discussion paper.

The FSC represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks. The FSC has 130 members who are responsible for investing $1.9 trillion on behalf of more than 11 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Stock Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The issues canvassed by the discussion paper, whilst having wide implications on the tax consolidation regime for Australian corporate taxpayers, also raise a number of issues which affect life insurers.

This letter addresses issues particular to life insurers (and to some extent general insurers) and provides a number of specific submissions (it does not address all questions of the BoT).

The submission points are summarised as follows:

1 Treatment of liabilities (Chapter 2 of BoT discussion paper):

a. The BoT should confirm which specialist insurance provisions it considers should not be affected by any proposed changes. Particularly, that no changes should occur to:

i. the treatment of policy liabilities in step 2 of the entry ACA calculation where the liabilities are subject to Section 713-520 (or Section 713-580 for step 4 exit ACA calculations); or

ii. the pre or post-joining time treatment of net risk components of policy liabilities of a life insurance company that are subject to Section 713-511 on joining a consolidated tax group (Section 713-565 on exit).

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b. Liabilities within a statutory fund of a life insurance company that relate to policyholder (whether deductible or not in the future) are critical elements of policy liabilities and must continue to be included in ACA calculations to avoid inappropriate outcomes. There should be no change to the existing treatment of such liabilities (deductions to policyholder), as there is no double-count under current law.

2 Policyholder deferred tax liabilities (Chapter 3) – Policyholder DTLs are also a critical element of policy liabilities and must continue to be included in ACA calculations without change. Otherwise, inappropriate outcomes will arise.

3 Liabilities that give rise to a future tax gain or loss and progressive acquisition cases (Chapter 4) – Pre-existing portfolio shareholdings or equity interests held by a life insurance company within its statutory funds should disregarded when considering if a full or progressive acquisition occurs (for the purposes of determining whether to apply Section 705-80).

4 Adjustments to the value of liabilities and interaction with insurance policy liabilities (Chapter 5) – No changes should be made to the treatment of life insurance policy liabilities or assets supporting those policies.

5 Capping tax cost setting for assets of foreign branches of insurance companies (Chapter 6). The law should be clarified to confirm that assets held by foreign insurance branches are either subject to market value capping under Section 705-40 or treated as retained cost base assets which absorb ACA equal to market value (retrospectively since the commencement of tax consolidation in 2002). There is no compelling case to support capping the tax cost setting amount for other capital assets.

Please refer to the Annexure 1 for further details of our submission. The submission points outlined in Annexure 1 only address specific issues for insurance companies that arise out of the preliminary views in the BoT's discussion paper.

More generally, any changes recommended by the BoT as a result of its review should be prospective and only apply to acquisitions or arrangements that commence on or after the date on which any amendments are announced by Government (subject to submission issue #5 in relation to foreign branch asset capping).

If you wish to discuss this submission further, please do not hesitate to contact me on (02) 8235 2519.

Yours sincerely

CARLA HOORWEG
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ANNEXURE 1

All legislative references in the following submission are from the *Income Tax Assessment Act 1997* or the *Income Tax Assessment Act 1936*, unless otherwise stated.

1 - LOSS DUPLICATION FOR DEDUCTIBLE LIABILITIES (CHAPTER 2)

A - Confirmation that no changes are intended for specialist insurance provisions

Chapter 2 of the discussion paper outlines how the existing tax cost setting provisions can give rise to the double recognition of deductible liabilities (to a vendor through reduced proceeds on disposal and to a purchaser through a deduction for the liability when crystallised).

The discussion paper acknowledges that liabilities dealt with by "the specialist insurance provisions" would not need to change but does not specify what legislative provisions have been contemplated by the BoT. Footnote 21 on page 15 and paragraph 2.40 both refer to existing systematic treatment of insurance liabilities.

It is unclear what the BoT contemplates when referring to "specialist insurance provisions" and this should be clarified (see below).

Submission

The BoT should confirm that it does not intend to recommend any changes to the treatment of:

- The step 2 allocable cost amount ("ACA") value of any policy liabilities of a life insurance company that are subject to Section 713-520 (which prescribes specific values for such liabilities in the ACA calculation); and

- The pre or post-joining time treatment of net risk components of policy liabilities of a life insurance company that are subject to Section 713-511 on joining a tax consolidated group (as Sections 713-511 and 713-565 already ensure that net risk policy liability movements are subject to tax in the hands of the appropriate party, vendor or purchaser)[1].

B - Potential for inappropriate denial of deductions relating to policyholder on sale of a life insurance company

Paragraph 2.31 of the discussion paper outlines potential options for preventing an acquirer from benefiting from a deductible liability where its economic effect has already been reflected in a vendor's gain/loss on disposal[2].

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[1] Similar appropriate treatment also exists for outstanding claims liabilities and unearned premium reserves of general insurers under Sections 713-710, 713-515 and 713-520. No changes are needed to these legislative provisions.

[2] The four options are: deem an acquiring head company to have assumed the liabilities at their accounting value (Option 1), deny the deduction when the liability is realised post-joining time (Option 2), disregard

In the scenario where a life insurance company is sold and joins a tax consolidated group, none of the discussion paper options are appropriate to the extent that any future deductible liabilities are statutory fund liabilities of a life insurance company that relate to policyholders (i.e. any accrued but not yet incurred accounting expenses, refer to example below). Liabilities of the statutory funds that accrue to policyholders have different economic "owners" to shareholder and do not:

- impact on the value received by the vendor on the sale of shares in a life insurance company where the tax benefit of the future deduction is offset by a liability to policyholder;

- give rise to any benefit to a purchaser (due to the offsetting policy liability).

If any changes were made to the existing treatment of liabilities relating to policyholders there would be an asymmetrical outcome compared to the tax consolidation treatment of certain policyholder assets (which are effectively quarantined from the tax cost setting process)[3].

Any approach recommended by the BoT needs to exclude liabilities that are not economically "owned" by shareholders in order to avoid unfairly penalising policyholders.

Example

Assume that Life Co is a subsidiary of a tax consolidated group and Life Co had the following assets and liabilities:

Assets	**$**	**Liabilities/Equity**	**$**
Shareholder			
Equities (original cost $100 and no change in value)	100	Share capital	100
Policyholder – Complying superannuation class			
Directly held property (original cost $1,000 and no change in value)	1,000	Complying super policy liabilities[4]	915
Deferred tax asset ("DTA")	15	Accrued property repair expenses	100
Totals	**1,115**		**1,115**

For simplicity, the above example ignores the impact of fees.

Life Co is purchased by Company A for $100. Company A is the head company of an existing tax consolidated group.

deductible liabilities at step 2 (Option 3) or give rise to a deemed capital gain to the acquiring head company at the joining time (Option 4).

[3] Certain policyholder assets retain historic tax cost bases (e.g. complying superannuation class and ordinary unit-linked, under Section 713-515). Deductions for liabilities held in these classes should similarly be preserved.

[4] The policy liability is equal to the value of the policyholder assets ($1,015) less the liability for accrued expenses.

Life Co leaves the vendor tax consolidated group with the following CGT outcomes:

ACA Step 1	1,100
ACA Step 4	
Policy liabilities	915
Accrued expenses	85[5]
Total exit ACA	**100**

The vendor has no capital gain or loss on disposal as their capital proceeds ($100) are equal to the cost base in their Life Co shares ($100).

Life Co joins Company A's tax consolidated group with the following tax cost setting outcomes:

ACA Step 1	100
ACA Step 2	
Policy liabilities	915
Accrued expenses	85[6]
Total entry ACA	**1,100**
Allocation[7]	
Directly held property	1,000
Equities	100

Commercially, the purchaser is only buying the shareholder assets ($100 value) and only pays for their value. The accrued expenses are not reflected in the purchase price paid by the purchaser and instead are a key component of the policyholder liability. The existing tax law achieves an appropriate outcome because the accrued expense liability is included in the ACA calculations.

Summary of outcomes

If the purchaser is deemed to assumed the liability for accrued expenses for accounting value (Option 1 in the BoT discussion paper), the tax outcome would not be appropriate. This is illustrated by the table below:

[5] Liability of $100 reduced for future deduction (subsection 711-45(3)).
[6] Liability of $100 reduced for future deduction (subsection 705-75(1)).
[7] There is no allocation to the DTA.

	Vendor	Purchaser
Commercial position	No gain/loss (receives \$100 compared to \$100 original investment)	Pays \$100 for \$100 of shareholder assets Policyholder incurs \$100 of expenses
Tax outcome under existing law	***Appropriate outcome:*** No gain/loss (receives \$100 compared to \$100 cost base – and this does not reflect the future deduction to policyholder)	***Appropriate ACA allocation:*** policyholder assets are retained cost base (\$1,000)[8]. Shareholder assets receive \$100 ACA ***Appropriate recognition of outgoing:*** deduction of \$100 available when expenses are incurred (benefitting only policyholder)
Tax outcome if accrued expenses are deemed to be assumed for accounting value (Option 1 of BoT discussion paper)	***Appropriate outcome:*** No gain/loss (receives \$100 compared to \$100 cost base)	***Appropriate ACA allocation:*** policyholder assets are retained cost base (\$1,000)[9]. Shareholder assets receive \$100 ACA ***Inappropriate recognition of outgoing:*** no deduction available when expenses are incurred

As illustrated by the table above, if Option 1 in the BoT discuss paper is adopted, it would result in the loss of deductions (the economic benefit of which accrue to policyholder) even though neither the vendor nor the purchaser shareholder groups have received benefits for these losses. This is inconsistent with the economic outcomes.

The other options on the BoT discussion paper would all similarly result in no party receiving any benefit from the deduction (Option 2) or other detriments arising that would unduly penalise the

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[8] paragraph 713-515(1)(a). For the purposes of setting the tax cost of reset cost base assets, the retained cost base policyholder assets are deemed to receive \$1,000 of the ACA. This appropriately leaves \$100 of ACA for allocation to shareholder assets.

[9] paragraph 713-515(1)(a). For the purposes of setting the tax cost of reset cost base assets, the retained cost base policyholder assets are deemed to receive \$1,100 of the ACA (paragraph 713-515(2)(a)). This appropriately leaves only \$100 of ACA for allocation to shareholder assets.

purchaser of a life insurance company (through the inappropriate reduction of entry ACA under Option 3 or a deemed capital gain under Option 4).

Shareholder may have to compensate policyholder for the loss of policyholder tax deductions if these options are implemented.

Accordingly, there is a fundamental principle that policyholder related liabilities which affect Life Co's policy liability must be included in ACA calculations (on exit and entry). This equally applies to policyholder related deferred tax liabilities (refer to the example for Issue #2, further below).

Submission

Accordingly, the FSC submits that any liabilities that relate to policyholders of a life insurance company should be excluded from the BoT's proposed solution. This relates to any liability that is held within the complying superannuation class, ordinary class for unit-linked policies or ordinary class for participating policies (to the extent of policyholder interest)[10].

[10] We note that the SEA class is unaffected as it is not entitled to tax deductions.

2 – DEFERRED TAX LIABILITIES (CHAPTER 3)

The BoT's preliminary view in Chapter 3 is that deferred tax liabilities ("DTLs") should cease to be recognised for tax cost setting purposes. This could have significant adverse consequences if DTLs relating to certain policyholders were excluded from the ACA calculation (complying superannuation class and ordinary class unit-linked). This is demonstrated by the following example.

Example

Assume that Life Co had the following assets and liabilities:

Assets	$	Liabilities/Equity	$
Shareholder			
Equities (original cost $100 and no change in value)	100	Share capital	100
Policyholder – Complying superannuation class			
Equities (original cost $1,000 & $100 value increase)	1,100	Complying super policy liabilities[11]	1,085
		DTL	15
Totals	**1,200**		**1,200**

For simplicity, the above example ignores the impact of fees.

Life Co is purchased by Company A for $100. Company A is the head company of an existing tax consolidated group.

If Life Co is a member of the vendor's tax consolidated group, the following CGT outcomes result from the exit:

ACA Step 1	
Shareholder equities	100
Policyholder equities	1,100[12]
ACA Step 4	
Policy liabilities	(1,085)
Accrued expenses	(15)
Total exit ACA	**100**

[11] The policy liability is equal to the value of the policyholder assets ($1,100) less a DTL on the unrealised gain ($100 * 15%) (assuming no CGT discount).

[12] Under section 713-575, which ensures that the Division 711 exit includes $1,100 for the terminating value of the policyholder assets. This is entirely offset at step 4 by the policy liability ($1,085) and policyholder DTL ($15).

Life Co joins Company A's tax consolidated group with the following tax cost setting outcomes:

ACA Step 1	100
ACA Step 2	
Policy liabilities	1,085
DTL on policyholder assets	15[13]
Total entry ACA	**1,200**

Commercially, shareholder is only buying the shareholder assets ($100 value) and only pays for their value. The existing tax law achieves an appropriate outcome however, if the policyholder DTL were not included in the ACA calculation the tax outcome would not be appropriate. This is illustrated by the table below:

	Vendor	**Purchaser**
Commercial position	No gain/loss (receives $100 compared to $100 original investment)	Pays $100 for $100 of shareholder assets
Tax outcome under existing law	***Appropriate outcome:*** No gain/loss (receives $100 compared to $100 cost base)	***Appropriate ACA allocation:*** policyholder assets are retained cost base ($1,000)[14]. Shareholder assets receive $100 ACA
Tax outcome if policyholder DTL is excluded	***Inappropriate benefit to vendor:*** $15 capital loss (receives $100 compared to $115 cost base)[15]	***Inappropriate ACA allocation:*** Only $1,185 of ACA exists, giving $1,000 to retained cost base policyholder assets but only $85 for shareholder assets.

As illustrated by the table above, the shareholder assets would only receive $85 of ACA.

This inappropriately reduces ACA for shareholder assets and is inconsistent with economic outcomes. For the same reasons, it would also reduce ACA available to non-unit linked ordinary class policyholder assets (not shown in the above example).

[13] There is no re-iteration for the DTL under subsection 705-70(1A) as the related asset is a retained cost base asset within the complying superannuation class (paragraph 713-515(1)(a)).

[14] paragraph 713-515(1)(a). For the purposes of setting the tax cost of reset cost base assets, the retained cost base policyholder assets are deemed to receive $1,100 of the ACA (paragraph 713-515(2)(a)). This appropriately leaves only $100 of ACA for allocation to shareholder assets.

[15] If the policyholder DTL is excluded from exit ACA calculation, there would be no change to the purchase price (as the purchaser is only paying for the shareholder assets). However, step 4 would not subtract the $15 DTL.

Consequences for ordinary class participating policyholders

Excluding DTLs from ACA calculations would also cause inappropriate outcomes for ordinary participating policyholders, inconsistent with commercial outcomes.

On the acquisition of a Life Co, a purchaser will only pay for the value of shareholder assets and future shareholder profits/goodwill. The majority (approximately 80%) of the value of statutory fund assets and related DTLs of ordinary participating business will be reflected in offsetting policy liabilities[16] and will therefore not affect the purchase price for shares in Life Co.

Accordingly, the BoT's analysis does not apply to ordinary participating business DTLs to the extent they relate to policyholder. Those DTLs are reflected in policy liability amounts and should be carved out of any changes recommended by the BoT.

Submission

In response to Questions 3.1(a) and (b) of the BoT discussion paper, the FSC submits that as DTLs referable to policyholder are reflected (by reducing) the value of insurance policy liabilities which are specifically dealt with in the ACA steps via specialist insurance provisions, removing these DTLs from the ACA steps distorts the tax outcomes. Accordingly:

- complying superannuation class and ordinary class unit-linked DTLs should not be removed from the ACA calculations (for the reasons illustrated by the above example).

- DTLs relating to policyholder ordinary class participating business should also not be removed from the ACA calculations to the extent that they relate to policyholder as such DTLs are not relevant to the price paid for shares in a life insurance company (which only reflect shareholder assets, profits and goodwill). For compliance simplicity, 80% of ordinary class participating DTLs should be included ACA calculations.

On the same principle that specialist insurance provisions have been acknowledged in paragraph 2.40 of the BoT's discussion paper, Chapter 3 of the discussion paper (and specifically the comments in paragraph 3.19) need to be clarified to reflect the above, i.e. by acknowledging the operation of specialist insurance provisions which mean that no changes are needed to the treatment of policyholder DTLs.

More generally, the BoT should not recommend any changes to the current ACA treatment (inclusion) of DTLs relating to tax other than deferred tax liabilities for Australian income tax on assets that are reset under tax consolidation.

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[16] Due to the allocation of participating business profits/losses on an 80/20 basis between policyholder and shareholder under Section 60 of the *Life Insurance Act 1995*.

3 – LIABILITIES THAT GIVE RISE TO A FUTURE TAX GAIN OR LOSS (CHAPTER 4)

In Chapter 4 the BoT proposes to remove the Section 705-80 adjustment for unrealised gains and losses in liabilities in “full acquisition cases” (refer to Question 4.2(a)). The BoT also notes that the adjustment should continue to apply in formation cases and “progressive acquisition cases” (refer to paragraph 4.12). It is unclear what threshold is contemplated by the BoT for Section 705-80 to be switched-off.

Life insurance companies will commonly hold portfolio shareholdings/equity interests in a broad range of companies, e.g. most companies listed on the ASX.

If the BoT contemplates that Section 705-80 should only be switched-off for acquisitions that commence from a 0% shareholding, few, if any, acquisitions of listed companies by life insurers (or tax consolidated groups containing a life insurers) would meet the requirement for Section 705-80 to be switched-off, notwithstanding that a “full acquisition” has occurred in effect.

Submission

The FSC submits that portfolio shareholdings/equity interests held by a life insurance company within its statutory funds (whether policyholder or shareholder assets) should be disregarded when considering if a “full acquisition” or “progressive acquisition” has occurred.

4 – ADJUSTMENTS TO THE VALUE OF LIABILITIES (CHAPTER 5)

Chapter 5 of the discussion paper considers issues that may arise where there is no corresponding asset for an accounting liability or no accounting liability for a tax asset. The discussion paper also refers to mismatches between the values recognised for corresponding liabilities and assets (e.g. paragraph 5.7).

The discussion paper proposes changes to achieve mutual recognition of assets and liabilities in the tax cost setting process (paragraph 5.18).

The discussion paper does not mention life insurance companies and it is unclear whether the proposed changes could apply to policy liabilities included at step 2, which can differ to the value of assets held in support of those liabilities due to the actuarial measurement of policy liabilities.

Any changes should specifically exclude policy liabilities (and supporting assets) of life insurance companies given that they are already comprehensively dealt with by the existing step 2 provisions in Section 713-520.

Submission

The FSC submits that no changes should be recommended to the treatment of life insurance policy liabilities or assets supporting those policies.

5 – CAPPING TAX COST SETTING (CHAPTER 6)

Chapter 6 of the discussion paper contemplates capping the tax cost of all assets. The implications of this contemplated approach are not restricted to life insurance companies. Subject to the comments below, the FSC is aware of, and is in support of submissions made by other industry bodies that express support to retaining the approach in the current law (i.e. not capping the allocation of tax cost to capital assets).

Foreign branches of insurance groups

Notwithstanding the FSC's general support for retaining the current tax treatment, a specific issue exists for revenue assets held by a permanent establishment in a foreign country. This has particular importance for insurance groups that operate foreign branches given their large holdings of assets in support of the insurance business. Such assets are held on revenue account under ordinary principles and their tax cost under tax consolidation should be capped at the greater of market value or terminating value under Section 705-40.

Section 705-40 will only apply to assets which are "revenue assets" within the definition in Section 977-50:

> "A *CGT asset is a revenue asset if, and only if:
>
> (a) the profit or loss on your disposing of the asset, ceasing to own it, or otherwise realising it, would be taken into account, in calculating your assessable income or *tax loss, otherwise than as a *capital gain or *capital loss; and
>
> (b) the asset is neither *trading stock nor a *depreciating asset."

The definition in Section 977-50 raises an issue whether assets held by a foreign branch are excluded from the above definition of a "revenue asset" if any gain or loss on disposal would be non-assessable non-exempt income (under Section 23AH). This can vary from year to year depending on the outcome on disposal of any assets.

If foreign branch assets of a life insurer are not "revenue assets" under Section 977-50, the cost setting cap under Section 705-40 does not apply. This is inappropriate from a policy perspective, as it creates an unintended mismatch between how these assets are characterised (that is, whether on revenue or capital account) for consolidation cost setting purposes and their treatment under ordinary principles. The consequential tax cost setting outcomes are also inappropriate as it skews ACA away from the Australian ordinary class assets of a life insurer towards foreign branch assets (or vice versa), notwithstanding that both are held on revenue account under ordinary principles.

Submission

The FSC submits that assets which are revenue in character under ordinary principles and are held by a foreign permanent establishment of a joining entity should be subject to the cap under Section 705-40. The law should be clarified to confirm that capping has applied to these foreign branch assets since the commencement of the tax consolidation regime.

Alternatively, these assets can be treated as retained cost base assets and for simplicity of compliance, they could absorb ACA equivalent to their market value (following the existing precedent for complying superannuation or ordinary class unit linked assets under subsection 713-515(2).