

1 July 2011

Mr Michael Dalton/ Ms Adriana Siddle
Benefits and Regulation Unit
Personal and Retirement Income Division
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Mr Dalton & Ms Siddle

DEDUCTIONS FOR THE COST OF TOTAL AND PERMANENT DISABILITY (“TPD”) INSURANCE PROVIDED THROUGH SUPERANNUATION CONSULTATION PAPER

The Financial Services Council (“FSC”) welcomes the opportunity to provide a submission on the above consultation paper. This submission is provided in response to the invitation issued by the Government on 16 June 2011 inviting submissions on the issues raised in this consultation paper.

The Financial Services Council represents Australia’s retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks. The Council has over 130 members who are responsible for investing \$1.8 trillion on behalf of more than 11 million Australians. The pool of funds under management is larger than Australia’s GDP and the capitalization of the Australian Stock Exchange and is the fourth largest pool of managed funds in the world. The Council 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 FSC believes that it is important there be an effective system which allows superannuation funds to claim deductions for a portion of the cost of TPD insurance policies based on percentages prescribed in regulations. A requirement for actuarial certificates, particularly across thousands of self-managed superannuation funds would create excessive administration costs for the small amounts of tax being imposed on the non-deductible portion of the premiums. The FSC has reservations as to the effectiveness and correctness of the proposal as set out in the Consultation Paper.

It is important to note that there are three interconnected issues which each impact the efficacy of the Treasury solution. The issues fall under the banners of:

- Standard Deductions
- Policy Disclosures
- Actuarial Certificates

The question of standard deductions is discussed below and the outstanding issues in relation to policy disclosures and actuarial certificates are outlined in the Appendix attached.

Stand Alone Versus Unbundled Policies

The first comment which needs to be made is that the standard deductions only appear to be available where the policies in question provide total and permanent disability (TPD) benefits on a stand-alone basis. Certainly, this is not uncommon.

However, there are a range of policies held by superannuation fund trustees in which risks have been bundled and in relation to which the TPD premiums are not discretely disclosed. For example a single policy might provide benefits for both death and disability risks. Paragraph 12 of the Consultation Paper contemplates this.

We request clarification that the standard deductions will also be available in relation to the cost of TPD insurance in circumstances where the part of the premium for a bundled policy that relates to TPD is separately identifiable. In this regard, the discussion in the Appendix under 'Policy Disclosures' provides further information.

In circumstances where the part of the premium for a bundled policy that relates to TPD is not separately identifiable, it would appear that trustees may continue to require recourse to actuaries. Refer to the discussion on the issues regarding the role of actuaries and actuarial certificates outlined in the Appendix.

It is submitted that the Regulations should specify that the percentages in Paragraph 14 may be based on the cost of the disability rider specified by the relevant life insurer in a bundled policy. This will enable superannuation funds who have bundled policies to use the deductible percentages specified in the Regulations.

To the extent that bundling does not act as a barrier to the standard deduction option, trustees might still wish to engage an actuary if only to satisfy themselves that the standard deduction percentages are appropriate.

Any Occupation Insurance

The FSC supports 100% deductibility for any occupation insurance, and the definition of that term.

Loss of Limb Add-On

The second standard deduction percentage is defined as "any occupation insurance with loss of limb add-on". The definition of this policy type is considered to be clear and appropriate. However, the FSC considers that the deductible percentage (90%) prescribed is too low. In fact, in pricing the "loss of limb add-on" a life office will generally not increase the premium cost above the any occupation definition cost. This fact reflects experience and the overarching belief that someone suffering a "loss of limbs" event would generally be expected to qualify for TPD benefits under the primary "any occupation" definition. The number of times that a person would qualify for a loss of limb benefit without qualifying for a disability benefit is in practice immaterial in the calculation of the premium. As such the extended definition imposes virtually no additional cost in the form of claims experience. Therefore, there is no incremental cost to the premium.

A similar situation can arise where, in response to competitive pressures (such as those created when policies are assessed by ratings agencies), additional "features" are added to the risk definitions. It does not automatically follow that there is an increase in premium referable to those enhancements. "Loss of limb add-on" can be considered to fall within this class of risk.

Where a disclosure is made by a life company as per item 5 of the Table in s.295-465(1), the amount of the deduction is "The part of a premium that is specified in the policy as being wholly for the liability to provide benefits referred to in section 295-460." If, in its factual premium construction, a life company ascribes no additional cost to the extended "loss of limb add-on" then the whole of the premium should be deductible.

Similarly if a life office actuary were to provide a certificate and had knowledge of the specific pricing construction it too would be correct in certifying that the whole of the premium should be deductible.

While there might obviously be some small differences between life offices, it is generally accepted that the chance of claiming only under the loss of limbs clause without being able to meet the “any occupation” definition is so small that the definition is included as standard on the vast majority of any occupation policies in the market place with no additional cost. The additional premium referable to the “loss of limb add-on” benefit would not exceed 0.5% of the TPD premium (and would often be 0%).

In these circumstances the FSC believes that the standard deductible portion of premiums should be raised to 99.5% if not 100%. In considering the streamlined percentage, the FSC urges Treasury to consider not only the very small chance of claim that accompanies the loss of limb add-on, but also the impact on the vast majority of Australians who currently hold TPD with an any occupation definition.

Own Occupation Insurance

We believe that own occupation has been adequately defined. However, again the proposed standard deduction percentage is considered low. Surveys amongst FSC members indicate own occupation loadings in retail insurance varying between 40% and 50% above the applicable any occupation premium. Therefore, the 60% deductible portion figure contained in Paragraph 14 of the Consultation Paper does not reflect commercial reality. It is important to ensure that this percentage is set at a rate which is fair to superannuation trustees and members, and also reflects accurately the additional cost of own occupation insurance cover. If this percentage is set at a level which does not reflect commercial reality, TPD insurance offerings could be dropped, or cover reduced. This would be disadvantageous to the members of superannuation funds, and would exacerbate the existing chronic under insurance in Australia.

The FSC submits that the specified deductible percentage should be in the region of 70% of the total premium, as this figure more closely matches the commercial reality of the structure of TPD premium pricing in Australia. For example, if an own occupation premium is \$100, a 40% loading will result in an own occupation premium of \$140. The deductible portion in this case would be 71.42%.

In relation to own occupation with loss of limb add-on, we refer you to the previous points raised which emphasised that the add-on cost is in the range “negligible to nothing”. The loss of limbs add-on is also standard on most own occupation policies. As such, the deductible portion of own occupation with loss of limb add-on should be effectively the same as own occupation (without the add-on).

Inability to Perform Activities of Daily Living Insurance

Inability to perform activities of daily living (ADL) is again appropriately defined. However, it is rarely offered as a stand-alone TPD definition. As such it is not expected to have much (if any) application if included in the table. The same comments apply to the ADL with loss of limb add-on.

ADL is more frequently included as part of a string of TPD definitions – of which any occupation is the primary definition. Much like loss of limbs, the increased chance of claim and premium portion referable to this definitional risk is close to zero. Further, it is more often the case that the definition is accompanied by the words “and is unlikely ever to work in any occupation for which the member is so qualified.” In other words, this is really an “any occupation” definition but built into situations where the insured might not actually be in paid or regular employment (e.g. itinerant workers and those engaged in home duties). In the matter of home duties it needs to be remembered that non-working spouse members have been increasingly encouraged within superannuation and they are also capable of being insured referable to those memberships. But the test is still a valid work capability test.

In a draft tax ruling TR 2010/D9 issued by the Commissioner of Taxation for comment on 15 December 2010 the deductibility of ADL cover (referred to alternatively as loss of independence) in the context of an any occupation policy was discussed at paragraphs 78 to 84. Significantly, the Commissioner has expressed the clear view that that risk add-on would be fully deductible without the need to have recourse to an actuary.

Inability to Perform Activities of Daily Work

The Consultation Paper contains no reference to another common test being “inability to perform activities of daily work” (ADW). The comments outlined above in relation to the “inability to perform activities of daily living” also apply to the “inability to perform activities of daily work” test. The FSC submits that a premium in respect of a policy containing an inability to perform activities of daily work test should also be fully deductible without the need to have recourse to an actuary.

Inability to Perform Domestic Duties

The Consultation Paper also contains no reference to another common test being “inability to perform domestic duties”. The comments outlined above in relation to the “inability to perform activities of daily living” also apply to the “inability to perform domestic duties” test. The FSC submits that a premium in respect of a policy containing an inability to perform domestic duties work test should also be fully deductible without the need to have recourse to an actuary.

In draft tax ruling TR 2010/D9 the deductibility of domestic duties cover in the context of an “any occupation” policy was discussed at paragraphs 60 to 66. Again, the Commissioner of Taxation has expressed the clear view that that risk add-on would be fully deductible without the need to have recourse to an actuary.

Other 'Add-ons' to TPD policies

There are certain other ‘add-ons’ available in relation to some TPD policies either as included features or as options for which an additional premium applies. These add-ons do not involve the payment of any benefits, but rather provide for either a waiver of a premium or a waiver of underwriting for future increases to sums insured (or both) if specified events occur.

Some examples of such ‘add-ons’ are:

- An option to have the TPD premium waived if the insured person suffers temporary disability,
- Where TPD cover is linked to death cover - an option that reinstates the death cover within a certain period after it was reduced by the payment of the TPD benefit, without the need for medical underwriting and provides a waiver of a premium otherwise payable on the reinstated death cover, for a term agreed in the policy, for example, for life or to age 65,
- An option that allows the policy owner to increase the sum insured without the need for medical underwriting upon the occurrence of certain life events such as getting married or having a baby.

In some cases, the insurer will not charge an additional premium for such features or options. In other words, the premium would be the same if the feature or option was not built into the policy. In these cases we submit that the inclusion of these features or options should not impact on the amount of the premium that can be claimed as a deduction.

In cases where an additional premium is charged for such a feature or option, we consider that the Regulations should make it clear that the applicable standard deduction percentage (based on the TPD definition to which the premium relates) would also apply to the additional premium charged for the feature or option. This is on the basis that these features or options relate to a waiver of a premium and/or underwriting requirements and do not involve the payment of any benefits by the insurer that would fall outside range of benefits referred to in section 295-460.

FSC View on Policy Type and Deductible Percentages

Against the background provided, the FSC believes that there should be only two (or at most four) Policy types described in the Table at paragraph 14 of the Consultation Document. The preferred definitions would be –

- “any occupation”, defined to include any or all of loss of limb, ADL, ADW and domestic duties add-ons. The standard deductions for this definition should be prescribed as 100%; and
- “own occupation” (again including the four add-on definitions) to be deductible at a standard rate of deduction percentage of 70%.

If this simplistic but realistic approach is not acceptable, then any occupation stand alone and own occupation stand alone could be included as variants. However, the FSC would not support a view that “add-on” risks have other than a negligible impact on deductibility.

If the percentages provided in the Regulations are too low, the larger funds will simply resort to an actuarial certificate. The smaller funds will not find it economical to do so. For them, the cost of the actuarial certificate will exceed the part of the deduction that the policy underlying the legislation intends them to have, and this will be denied by the Regulations as proposed.

We believe that it would be inappropriate for regulations to deny intended deductions by taking advantage of high compliance costs when merely setting accurate percentages could deliver the intended policy outcomes. It is even more inappropriate when smaller funds are being denied the intended deductions, while the large funds will still be able to claim them.

We thank you for the opportunity to submit on this important topic and invite any further enquiries which might lead to developing a robust and administratively workable solution to the premium deduction issue.

If you have any questions regarding the FSC’s submission, please do not hesitate to contact Pravin Madhanagopal or myself on (02) 9299 3022.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Martin Codina', written over a horizontal line.

MARTIN CODINA
Director of Policy

APPENDIX

POLICY DISCLOSURES

This matter is addressed in the FSC submission because by Item 5 of the table in section 295-465 (1) of the Income Tax Assessment Act 1997 (the Act) a complying superannuation fund can deduct:

“The part of a premium that is specified in the policy as being wholly for the liability to provide benefits referred to in section 295-460.”

Significantly, there is no need to have recourse either to a certifying actuary or the proposed standard deduction percentages if the issuing life office has made appropriate disclosures. Indeed, in the Explanatory Memorandum (Main Features section) to *Taxation Laws Amendment Act (No.3) 1990* (referable to the predecessor deduction section – s.279 of the Income Tax Assessment Act 1936) it was stated –

“This Bill will give effect to the proposals announced on 14 February 1990 to ease the operation of the provisions of the Income Tax Assessment Act which require an actuary to certify the amount of particular deductions or exemptions that may be claimed by a complying superannuation fund. “

Clause 7 of the Consultation document itself qualifies the need to have recourse to actuarial certification by recognising that this only arises if the deductible part of the premium is not specified in the insurance policy

Thus, it is important that life offices be given appropriate opportunity to make disclosures (should they so choose) in a manner which will satisfy Item 5 of the table. In fact, a life office is the best placed party to determine the deductible portion of a premium as it was responsible for setting the price.

It is submitted that the legislation does not require that each element insured under the policy be separately priced – although that would certainly be one form of disclosure. Support for this view is again provided in the wording of the Explanatory Memorandum (Clause 27 Notes) to *Taxation Laws Amendment Act (No.3) 1990* where it was stated -

“Where the whole or part of the premium referable to death or disability cover is specifically identified in the policy (e.g. an unbundled policy) the fund is entitled to a deduction equal to the amount identified (paragraph (c)) also without need for an actuary's certificate.”

A narrow interpretation of this sentence would be to require the policy to be unbundled. This appears to be the view adopted by the Commissioner in his draft taxation ruling TR 2010/D9 which was issued on 15 December 2010 for public comment. However, it is submitted that the choice of “e.g.” rather than “i.e.” in the above Explanatory Memorandum extract was intended to demonstrate that other policy types (potentially including bundled arrangements) would not automatically fall outside the intended scope of the provision.

This point is significant as bundled policy arrangements are certainly the more common form of offering in relation to policies subscribed by superannuation fund trustees.

Assuming that issuing life companies are prepared to make the disclosure, it would seem that a statement “in the policy” which disclosed “the part of a premium that is ... wholly for the liability to provide benefits referred to in section 295-460” would remove the need for a trustee policyholder to seek independent actuarial advice in the matter of premium deductibility.

This then raises the significant questions of what form or forms of disclosure are acceptable – i.e. need it be a dollar based disclosure or, and this is the industry's preferred option, would it be sufficient for the company to attest that a given percentage of premium is referable to s.295-460 risks. The preference for percentage based disclosures reflects the fact that superannuation trustees generally offer insurances to their members via single/master policies. So the annual

dollar premium expense arising in relation to that policy cannot be determined in advance as it will be impacted, among other things, by new members being added to the policy during a year and other members ceasing cover. However, the deductible percentages of premium dollars will be constant.

Given that the approach proposed in the Consultation document is based on percentages it is hoped that life office disclosures which adopt actual pricing percentages should also be regarded as acceptable.

Finally, and perhaps most importantly, the matter which needs consensus is the interpretation of the words "in the policy". It is submitted that the word "policy" in the Legislation refers to the "contract" itself. (Refer to National Mutual Association of Australia v FC of T (1959) 102CLR29).

In essence, the policy is a document which sets out terms of contract between the insurer and the policy owner. Importantly, the policy document itself does not contain pricing data. Therefore it seems clear that the intention is that those words be read more broadly as to do otherwise would be to deny any application to item 5.

For a policy issued to an individual, a policy schedule may be provided after the cover has been effected. The schedule contains specific data referable to the insured and is "joined" to the policy frequently both literally (stapled) and in the more traditional legal sense. In a bundled arrangement there would normally be no pricing dissection of the separate risks – however, there would seem to be no reason for a deductibility statement not to be incorporated in the policy schedule.

A product's Policy Disclosure Statement (PDS) is more than a pre-policy, marketing document. It also becomes joined to the policy in a legal sense in that statements within that document become a part of the basis of contract when the policy is accepted. To that end, if a PDS disclosed a deductible premium percentage it is submitted that there has been disclosure "in the policy".

In a wholesale environment the disclosures and documents are more commonly via quotation documents and exchanges of letters while the policy conditions (including pricing) are being settled. Again, these documents would seem to be appropriate disclosure points for the purposes falling within the definition of "in the policy".

The industry is requesting that, in the interests of ensuring certainty and simplicity and also of limiting the cost burden on superannuants, a wide interpretation of the expression "in the policy" be endorsed. Ideally, the definition should include at least the following –

- **Policy schedules;**
- **PDS;**
- **Quotation documentation and associated correspondence;**
- **"Welcoming" documentation; and**
- **Letters issued specifically to trustee policyholders for the purposes of s.292-465.**

ACTUARIAL CERTIFICATES

Where there has been no appropriate disclosures by a life office item 6 of the table in s.290-465 (1) then allows a deduction for –

"So much of other insurance policy premiums as are attributable to the liability to provide benefits referred to in section 295-460".

Subject to the impacts of the recent amendments contained in Tax Laws Amendment (2011 Measures No.4) Act 2011, s.295-465(3) required that –

"The trustee must obtain an actuary's certificate before the date for lodgement of the fund's income tax return for the income year in order to deduct an amount referred to in item 6 of the table or in subsection (2)."

The industry is concerned that, the bringing into law of the Tax Agent Services Act 2009 may restrict actuaries' abilities to provide the requisite certifications unless the said actuaries were also registered as tax agents. This is on the basis that the certificates would fall within the range of services which constitute taxation advice being advice related to the ability to claim an entitlement under the law (section 90-5(1) of the *Tax Agent Services Act 2009*, and not excluded by the *Regulations*).

While this impediment can be easily remedied by legislating an exemption, there is a further impediment which actuaries not employed in life office activities might suffer in that they do not generally have available to them the data and experience which would enable them to readily prepare a certificate. Thus it would be expected that they would need to have recourse to life office data and consult with those in-house actuaries responsible for pricing.

It follows from the above that it would be preferable and less burdensome if life company actuaries were free to provide certificates to their policyholder clients. Arguably this suggestion is an extension of the previously discussed policy disclosure.

In 1990 the Commissioner of Taxation issued Taxation Ruling IT 2617 "Income Tax: Approved Form of Actuarial Certificates in Relation to the Taxation of Complying Superannuation Funds". The ruling points out that "actuary" is a defined term for the purposes of the Tax laws, currently defined at s.995(1) of the Income Tax Assessment Act 1997 to mean –

"means a Fellow or Accredited Member of the Institute of Actuaries of Australia".

On the face of it, actuaries employed in the services of life offices would be capable of satisfying the definition. However, the question arises whether those actuaries who are best placed to provide the required certificates are precluded from doing so by virtue of their employer relationship. The industry view is that this should not be the case – but the matter has not formally been tested. It will be appreciated that superannuation trustees would need to be satisfied that the certificates they obtained should not be held to be flawed purely because the certifying actuary happened to be engaged in the services of the life office which issued the policy held by the trustee.

Therefore the life industry is seeking assurances that their actuarial staff are not precluded from giving certificates on the bases of either –

- **that in doing so it would be in breach of the Tax Agent Services legislation; or because**
- **the employment relationship with the insurer would be construed as prejudicing or otherwise voiding the validity of the certificate.**

In fact, certain life offices might prefer to provide this service as a more discrete method of premium disclosure, rather than the potentially more public disclosures which might be inferred by the term "in the policy". Depending on the policy relationship value such a service might also be provided without cost to the trustee – which would mean that members' funds were not called on to finance the certification process.

Other aspects of certification which require clarification include –

- Need the certificate prescribe the actual dollar value of the deduction allowable to the trustee, or would it be sufficient/acceptable to provide a certificate based on deductible percentages? IT 2617 prescribes the requirement for dollar values and does not contemplate/address a percentages approach. One argument for percentages is that it would allow the trustee to obtain a certificate in the course of the year of income, rather than waiting until the year had concluded.

- Should the certification be required to be obtained annually? As presently drafted the law would seem to require this. Yet, if a percentages approach was regarded as acceptable then, provided the policy itself did not change, a certificate could have currency for several years. This would also afford the trustees with a level of certainty which would help to simplify administration, reduce costs and ensure better member equity in relation to the after tax costs of their insurances within the superannuation environment. Also it is consistent with reliance on disclosures “in the policy”.

The FSC strongly recommends that actuarial certificates should be capable of being expressed in percentages, allowing them to be obtained in advance of a year end. Further, it recommends that the certificates should only be required to be replaced either when policy conditions are changed, there is a change in policy provider or the expiry of 5 years (whichever is the earlier).