10 October 2017

Steele Broderick
Corporate and International Tax Division
The Treasury
Langton Crescent
Parkes ACT 2600
By email

Consolidation Integrity Measures Exposure Draft for Treasury Laws Amendment (2017 Measures No 9) Bill 2017

The Financial Services Council (FSC) welcomes the opportunity to make submissions on the draft legislation to relating to Exposure Draft for the *Treasury Laws Amendment (2017 Measures No 9) Bill 2017: Consolidation* (the ED), which contains draft legislation implementing a number of integrity measures relating to the tax consolidation regime.

The FSC has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia’s GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

The measures contained in the ED, whilst having wide implications on the tax consolidation regime for Australian corporate taxpayers, raise a number of issues which affect life insurers.

In particular, the proposed changes relating to the treatment of deductible liabilities and deferred tax liabilities for tax consolidation cost setting purposes, if implemented in their current form, will result in unintended consequences that affect policyholder interests.

Our submission points are summarised as follows:

1 Deductible liabilities – Part 1 of ED

Liabilities within a statutory fund of a life insurance company that are included in the calculation of policyholder liabilities (e.g. unit linked policy liabilities) must continue to be included in ACA calculations to avoid inappropriate outcomes. This reflects existing legislative policy which recognises that shareholders in a life insurance company receive no benefit from deductions arising in respect of such liabilities and effectively quarantines those liabilities in an ACA calculation by treating supporting assets as retained cost base assets. There should be no change to the existing treatment of such liabilities (deductions benefitting policyholder), as there is no double-counted benefit under current law.

2 Deferred tax liabilities – Part 2 of ED

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.

Please refer to Appendix 1 for further details of our submission, including examples. These issues were identified in the FSC's submission to the Board of Taxation's Post-Implementation Review of Certain Aspects of the Consolidation Tax Cost Setting Process dated 12 October 2012 (a copy of the FSC's submission is enclosed). These submission points only address specific issues for life insurance companies that arise out of the proposed changes in the ED.

We would be happy to discuss this submission; I can be contacted on (02) 9299 3022.

Yours sincerely,

[signed]

Michael Potter
Senior Policy Manager

Appendix 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 – Deductible liabilities

Part 1 of the ED introduces measures to exclude deductible liabilities from a joining entity's entry ACA calculations.

This measure is intended to address a perceived double benefit that arises referable to these deductible liabilities, which was identified in the Board of Taxation (BoT) Report Post Implementation Review of Certain Aspects of the Consolidation Tax Cost Setting Process dated April 2013.

As noted in paragraphs 2.4 and 2.5 of the BoT Report, the issue arises as a result of the difference in treatment between assets and liabilities on consolidation as the tax base of assets are reset whereas the value of liabilities are not.

In a non-life insurance company scenario, this can result in the recognition of unrealised gains and losses of liabilities at both the shareholder level and at the entity level on payment of the liability.

The reasoning in the BoT Report is cited by the draft Explanatory Memorandum to the ED at paragraph 1.16 to provide context to the measures in the ED.

The inappropriate outcomes do not arise for liabilities of a life insurance company that are statutory fund liabilities relating to policyholders (i.e. any accrued but not yet incurred accounting expenses that are components of a policy liability calculation, refer to example below).

Liabilities of the statutory funds that accrue to policyholders have different economic "owners" to shareholder and do not impact tax outcomes at the shareholder level. The liabilities do not:

- impact on the value received by the vendor on the sale of shares in a life insurance company because the tax benefit of the future deduction is offset by a liability to policyholder;
- give rise to any benefit to a purchaser in the ACA calculation as the liability reduces policy liabilities which are also included at Step 2 of the ACA calculation.

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[1]). That is, the difference between tax consolidation outcomes for assets and liabilities do not arise under current law for policyholder assets and liabilities as neither are impacted by tax consolidation.

[1] 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.

Example

Assume that Life Co had the following assets and liabilities:

Assets	$	Liabilities/Equity	$
Shareholder			
Cash	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[2]	915
Deferred tax asset ("DTA")	15	Accrued property repair expenses[3]	100
Totals	**1,115**	**Totals**	**1,115**

For simplicity, the above example ignores the impact of fees, and assumes the only shareholder asset is cash.

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

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. Under the proposed measures in the ED, the following tax cost setting outcomes would arise:

ACA Step 1	100
ACA Step 2	
- Policy liabilities	915
- Accrued expenses	0[4]
Total entry ACA	**1,015**
Allocation	
Directly held property	1,000 (retained cost base asset under Section 713-515)
Cash	100
	1,100
CGT event L3 capital gain	85

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 (reducing) the policyholder liability.

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

[3] Assuming accrued expenses are not yet incurred for tax purposes.

[4] Excluded as a deductible liability under the proposed measures in the ED.

The measures in the ED result in the purchaser recognising a gain of $85 at the joining time (as a result of an ACA shortfall) which is inconsistent with the economic result of the transaction. If the life insurance company had other shareholder assets other than cash, these measures would result in insufficient ACA being allocated to these assets.

The existing tax law achieves an appropriate outcome because the accrued expense liability is included in the ACA calculations at Step 2 ($85, representing the liability of $100 reduced for the future deduction under subsection 705-75(1)), resulting in total entry ACA of $1,100. This is illustrated in the table below.

	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 ED	***Appropriate outcome:*** No gain/loss (receives $100 compared to $100 cost base – and this does not reflect the future deduction to policyholder)	***Inappropriate ACA allocation:*** policyholder assets are retained cost base ($1,000). Shareholder assets receive $100 ACA $85 ACA shortfall – capital gain of $85 arises. ***Appropriate recognition of outgoing:*** deduction of $100 available when expenses are incurred (benefitting only policyholder)
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). Shareholder assets receive $100 ACA ***Appropriate recognition of outgoing:*** deduction of $100 available when expenses are incurred (benefitting only policyholder)

Submission

Accordingly, the FSC submits that any liabilities that relate to policyholders of a life insurance company should be excluded from the measures in the ED and continue to be treated in the same way as currently occurs (i.e. policyholder related deductible liabilities should remain in entry ACA calculations). 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).

2 – Deferred tax liabilities

Part 2 of the ED contains measures proposing to exclude deferred tax liabilities from the entry and exit tax cost setting rules.

The application of these measures to deferred tax liabilities relating to policyholders gives rise to an inappropriate misalignment of tax and commercial outcomes, similar to the outcomes discussed above in the context of deductible liabilities.

This is demonstrated by the following example:

Example

Assume Life Co had the following assets and liabilities:

Assets	$	Liabilities/Equity	$
Shareholder			
Cash	100	Share capital	100
Policyholder – Complying superannuation class			
Directly held equities (original cost $1,000 and $100 value increase)	1,100	Complying super policy liabilities	1,085[5]
		DTL	15
Totals	**1,200**	**Totals**	**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	
- Cash	100
- Policyholder equities	1,100[6]
ACA Step 4	
- Policy liabilities	(1,085)
- DTL	0[7]
Total exit ACA	**115**

The vendor makes a capital loss on disposal as the exit ACA of $115 exceeds capital proceeds ($100). This does not align with the vendor's economic position, as it makes no gain or loss because the

[5] 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).

[6] Under section 713-575, which ensures that the Division 711 exit includes $1,100 for the terminating value of the policyholder assets.

[7] Excluded from Step 4 under the proposed measures in the ED.

shares are only worth the original $100 share capital (the increase in value of the equities held by the life insurance company is entirely offset by the $15 DTL and an $85 increase in policy liabilities).

Life Co joins Company A's tax consolidated group. Under the proposed measures in the ED, the following tax cost setting outcomes would arise:

ACA Step 1	100
ACA Step 2	
- Policy liabilities	1,085
- DTL	0[8]
Total entry ACA	**1,185**
Allocation	
Equities	1,100[9]
Cash	100
	1,200
CGT event L3 capital gain	15

Commercially, the purchaser 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 if policyholder DTL is excluded	***Inappropriate benefit to vendor:*** $15 capital loss (receives $100 compared to $115 cost base)	***Inappropriate ACA allocation:*** Only $1,185 of ACA exists, resulting in a shortfall of $15 and a capital gain.
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). Shareholder assets receive $100 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).

[8] Excluded from Step 2 under the proposed measures in the ED.

[9] 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)).

The life insurance modifications to the consolidation tax cost setting rules ensure that certain policyholder assets (complying superannuation class, SEA and ordinary unit-linked) are not impacted by the consolidation cost setting rules by treating these assets as retained cost base assets.

These modifications also operate to net off the value of these policyholder assets against their corresponding liabilities so as to ensure the tax cost setting for other shareholder assets is not impacted by these policyholder assets.

The need for policyholder DTLs to be recognised in consolidation tax cost setting calculations to achieve the appropriate tax cost setting outcome is acknowledged in the Explanatory Memorandum to the *New Business Tax System (Consolidation and Other Measures) (No. 2) Act 2003*. In the context of policyholder assets supporting ordinary unit-linked assets, the Explanatory Memorandum comments at paragraph 1.42 and 1.43:

> 1.42 The joining life insurance company may also have a deferred tax liability in relation to unrealised gains on assets held to support the net investment component of ordinary life insurance policies. That deferred tax liability is included in the joining life insurance company's liabilities under step 2 of the table in section 705-60 for the purpose of working out its ACA. Therefore, the joining life insurance company's ACA will be the sum of the current termination value of the net investment component of those policies plus the deferred tax liability in relation to unrealised gains on assets held to support those policies.
>
> 1.43 In addition, for the purpose of working out the tax cost setting amounts for reset cost base assets under section 705-35, the tax cost setting amounts for assets held to support the net investment component of ordinary life insurance policies (other than policies that provide for participating benefits or discretionary benefits under life insurance business carried on in Australia) will be the transfer value of the assets just before the joining time. This will ensure that the value of assets held to support the net investment component of ordinary life insurance policies (other than policies that provide for participating benefits or discretionary benefits under life insurance business carried on in Australia) will be offset by the value of liabilities for those policies plus the value of any deferred tax liabilities in relation to those policies. [Schedule 6, item 1, paragraph 713-515(2)(a)]

The need for specific rules addressing policyholder deferred tax liabilities was acknowledged by the BoT in paragraph 3.21 of its report:

> However, during the development of legislation to implement the recommended approach, further consideration should be given to the concerns raised by the Financial Services Council about the impact of removing deferred tax liabilities relating to life insurance policyholder assets.

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[10] and will therefore not affect the purchase price for shares in Life Co.

Accordingly, the uncommercial outcomes initially identified by the BoT and targeted by these measures do not apply to ordinary participating business DTLs to the extent they relate to

---

[10] 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*.

policyholder. Those DTLs are reflected in policy liability amounts and should be carved out of the measures to exclude deferred tax liabilities from tax consolidation calculations.

Submission

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.