IFSA Submission

26 February 2010

Product Rationalisation - Managed Investment Schemes and Life Insurance Products Proposals Paper

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1. Executive Summary

IFSA supports the introduction of an effective product rationalisation legal framework.

The approach outlined in the Proposals Paper is, we believe, appropriately focussed on long term fund member and policy holder (**customer**) protection, and on industry efficiency. It ensures that:

1. a financial product to be rationalised meets the criteria of being either subscale and, therefore, uneconomic, or being a legacy product;
2. customer rights are protected; and
3. to the extent that a customer suffers a detriment as a result of rationalisation, there is an entitlement to compensation on just terms.

Background

A comprehensive proposal for financial product rationalisation was first put to Government by IFSA in July 2005. That submission was followed in May 2006 with a regulation impact statement prepared by IFSA.

The current financial services laws render the rationalisation of financial products as either too difficult or too expensive. Customers are effectively locked into outdated or uneconomic financial products and industry participants are locked into outdated technology systems that are increasingly difficult to support.

IFSA's objective in seeking reform is to remove economically inefficient or outdated financial products to provide a better outcome for customers. It should also enable the financial services industry to more easily update technology infrastructure underpinning financial products, and to introduce a simplified, ongoing process to enable customers to be moved from out-of date products (legacy products) to more suitable modern products, without financial detriment to the customer.

The positive implications of an effective product rationalisation regime are better outcomes for consumers resulting from:

(1) improved disclosure;

(2) improved safety;

(3) reduced operational risk;

(4) access to innovative investment opportunities;

(5) enhanced competitiveness; and

(6) cost reduction.

Stage 1 proposals

IFSA notes that it is proposed that product rationalisation be implemented in stages, with Stage 1 dealing with managed investment and life insurance products. IFSA members support the initiative, but note that unless there is some limited extension of Stage 1 within a superannuation context, a large number of products such as life annuities will be excluded from the Stage 1 proposals. Acknowledging that the matter is not currently considered as part of the Stage 1 proposals, the issue is set out in Attachment A to this submission.

IFSA has updated its 2006 estimate of the legacy problem in Australia[1]. In 2006, IFSA surveyed 6 large financial services providers who estimated an aggregate total of $68.6 billion in legacy products. That aggregated estimate, from the same six financial services providers, has today grown to an estimated $92.4 billion of funds under management in legacy products, a significant increase of $23.8 billion.

IFSA believes that the Stage 1 proposals, as outlined, can be improved to achieve a more effective product rationalisation regime. The following provides a summary of recommendations made:

Recommendation 1

IFSA recommends that the product rationalisation regime:

1. provide for the transfer of members from a legacy product to a modern equivalent product; and

2. the provision of member equivalent benefits and/or compensation should be the primary requirements for the rationalisation and transfer.

Recommendation 2

IFSA supports:

1. Stage 1 focus on proposal for the rationalisation of qualifying managed investment and life insurance products; and
2. The extension of the current taxation roll-over relief for superannuation fund mergers beyond 30 June 2011, pending the consideration of superannuation as part of Stage 2 product rationalisation proposals.

Recommendation 3

IFSA agrees on the need for a legacy product test and support an objective set of criteria for that test.

IFSA recommends that there is increased flexibility in the threshold test for the consideration of a financial product as a legacy product.

Recommendation 4

IFSA recommends that**:**

1. where a financial product has been closed to new members for a period of at least 5 years that product should be eligible for rationalisation without any need to satisfy any other criteria ; and
2. the 2 year closed to new investors qualification threshold should be capable of reduction on application by the product provider to ASIC or APRA, as is relevant;
3. where a class of products is identified as a legacy product eg. deferred annuities, it should be determined by regulation or class order to be a legacy product and eligible for rationalisation without any need to satisfy any other criteria.

[1] IFSA Submission to Treasury, 19 May 2006, Regulation Impact Statement Financial Services Industry – Product Rationalisation

Recommendation 5

IFSA recommends that the no disadvantage test be assessed at a group or class level.

Recommendation 6

IFSA recommends that:

1. it should not be a requirement to duplicate a right in the transferor product where it is not possible to determine the impact of a right in all circumstances; and
2. compensation, where a right or benefit can be valued, is the appropriate remedy.

Recommendation 7

IFSA recommends that independent experts be determined on the basis of statutory criteria set out in regulations.

Recommendation 8

IFSA recommends that voting requirements set under the product rationalisation regime should be expressed to apply regardless of and in priority to any other requirements at law or under a scheme constitution.

Recommendation 9

IFSA recommends that:

1. an Option D, modelled on section 601NC of the Corporations Act, be incorporated into the production rationalisation methodologies for managed investment schemes.
2. ASIC be notified of the proposed product rationalisation;
3. ASIC have a limited period (14 to 21 days) to review and comment on the rationalisation proposal process and documentation.

Recommendation 10

IFSA recommends that if a scheme has more than one class of unit then, unless the class rights are legally entrenched, all classes should be combined and the percentage of member objections determined as a single group.

Recommendation 11

IFSA recommends that:

1. if a scheme has more than one class of unit then, unless the class rights are legally entrenched, all classes should vote on resolutions put to the meeting as a single group.
2. the quorum requirement should apply to members attending in person or by proxy; and
3. to facilitate member engagement, postal voting should be permitted and votes should be recorded by the meeting chair.

Recommendation 12

IFSA recommends that three alternative processes should be available for the rationalisation of life insurance products. They are:

1. APRA Approval;
2. Court Approval; and
3. A policy holder objection process similar to the member objection models (Options A and B) for managed investment schemes.

Recommendation 13

IFSA recommends that notification to policy holders of a product rationalisation proposal be technology neutral. Product rationalisation information should be either mailed to policyholders or made available to them electronically on a similar basis to that which applies to other communications with policyholders under the Corporations Act.

Recommendation 14

IFSA recommends that:

1. other than in the case of APRA approval of a product rationalisation proposal, documentation should be sent to the regulator only for review and comment;
2. a defined time (14 or 21 days) should be set for APRA review and comment; and
3. where an application is made to APRA for approval any request for additional expert report(s) or reference to the court should be subject to the agreement of the applicant.

Recommendation 15

IFSA recommends that:

1. rollover tax relief automatically apply to a rationalised product; and
2. if time requirements and criteria are to be included in the relevant taxation laws, those requirements should be the same as the requirements determined under the applicable product rationalisation options.

Recommendation 16

IFSA recommends that rollover measures provide for the transfer of the tax attributes of the assets to the recipient entity.

Recommendation 17

IFSA recommends that:

1. the tax attributes of the original investment continue post rationalisation until the investor redeems the investment; and
2. on redemption, the tax rules which would have operated had the investor retained the original investment should then become effective.

Recommendation 18

IFSA recommends that:

1. section 26AH be amended to provide that any transfer of a life insurance policy pursuant to a product rationalisation proposal would not trigger the operation of Section 26AH; and
2. the holding periods for the purposes of this section would include the time the investment was held within both the transferor and transferee entities.

Recommendation 19

IFSA recommends that State Governments be encouraged to introduce provisions in the relevant stamp duties legislation to grant rollover relief for product rationalisation.

2. General

The product rationalisation proposal as outlined is limited and runs the risk of not addressing the legacy issue in some areas of significant need.

Many legacy products were developed and offered under a legislative regime that is very different from today. Rationalisation to a modern equivalent product i.e. the same type of financial product may not be feasible because the modern equivalent may be a different type of financial product.

While acknowledging that the Stage 1 proposals are limited, the rationalisation between different types of superannuation products should be possible. For example the industry has large books of deferred annuity business which should be capable of being transferred into superannuation funds.

IFSA also supports a mechanism which allows life companies to transfer life policies, which contain superannuation style / taxed assets into public offer super funds. The current proposal should provide for transfer of members in a legacy product to the modern equivalent product regardless of product type.

Recommendation 1

> **IFSA recommends** that the product rationalisation regime:
>
> 1. provide for the transfer of members from a legacy product to a modern equivalent product; and
>
> 2. the provision of member equivalent benefits and/or compensation should be the primary requirements for the rationalisation and transfer.

3. Proposed Product Rationalisation Mechanism

3.1 Superannuation products

IFSA notes the deferral of superannuation funds and friendly society funds from the first stage of the product rationalisation proposal. While we acknowledge that there are existing arrangements for rationalisation, it is, we believe, important that a consistent set of rules apply across the rationalisation of different types of financial product and that legislative barriers such as taxation are addressed.

While IFSA supports the Stage 1 focus on legislative arrangements for the rationalisation of uneconomic and out of date managed investment and life insurance products, the current taxation roll-over relief for superannuation fund mergers should be extended beyond 30 June 2011, pending the consideration of superannuation as part of Stage 2 proposals.

Recommendation 2

> **IFSA supports**:
>
> 1. Stage 1 focus on proposal for the rationalisation of qualifying managed investment and life insurance products; and
>
> 2. The extension of the current taxation roll-over relief for superannuation fund mergers beyond 30 June 2011, pending the consideration of superannuation as part of Stage 2 product rationalisation proposals.

3.2 Common Elements: Legacy Product, Taxation Relief And No Disadvantage, Tests

3.2.1 Legacy product test

The aim of a financial product provider in rationalising financial products is to remove economically inefficient or outdated financial products to provide a better outcome for customers. Allowing customers to rollover their investment into a more competitive, efficient, and modern product (or be compensated for the termination of an economically inefficient product) will improve competition and efficiency in the industry.

Recommendation 3

IFSA agrees on the need for a legacy product test and support an objective set of criteria for that test.

IFSA recommends that there is increased flexibility in the threshold test for the consideration of a financial product as a legacy product.

Threshold test

The legacy product test criteria are weighted heavily towards reliance on historical data (e.g. figures based on comparisons over the life of the product). For many companies with a significant number of legacy products, and particularly those where many of those products have come as a result of past merger and acquisition activity, such data is either non-existent or not readily available. In addition, some of the objective tests do not fit with expense allocation that typically occurs in the life insurance environment. Where a financial product has been closed to new members for a period of at least 5 years that product should be eligible for rationalisation without any need to further satisfy any criteria – where a financial product has been closed for at least 5 years, other than a product with a specified fixed term, economic, currency and efficiency criteria should be deemed to have been met.

The issue of whether a financial product is uneconomic, outdated and inefficient is a matter of fact. The proposed legislation should include a mechanism that allow rationalisation of a financial product that had not been closed for 2 years but where the case for rationalisation under the criteria is proven and is approved by the relevant regulator. Additionally, classes of product could be classified as legacy products eg. deferred annuities, by regulation or class order.

Recommendation 4

IFSA recommends that:

1. where a financial product has been closed to new members for a period of at least 5 years that product should be eligible for rationalisation without any need to satisfy any other criteria ; and
2. the 2 year closed to new investors qualification threshold should be capable of reduction on application by the product provider to ASIC or APRA, as is relevant;
3. where a class of products is identified as a legacy product eg. deferred annuities, it should be determined by regulation or class order to be a legacy product and eligible for rationalisation without any need to satisfy any other criteria.

Proposed Criteria and tests

IFSA members recommend that the criteria be expressed in the following manner:

A product is a legacy product and available for rationalisation if:

1. the product has been Closed[2] to new investors for a period of 5 years or more; or
2. the product has been Closed to new investors for a period of 2 years and meets one of the following criteria:
   a. The product is an Outdated Product.

      An Outdated Product is one which, in its entirety or part thereof, (e.g. a feature) has become superseded by way of legislative or regulatory change and rationalisation of the product would enable the transfer of members/policyholders into a current product with more relevant features, services and/or benefits (financial and/or non financial) to members/customers; or

   b. The product is an Unviable Product. An Unviable Product is one which meets the following criteria:
      i. the total number of product holders or members at the date the application for a rationalisation occurs is 50 per cent less than the largest total number or product holders over the course of the life of the product;
      ii. the product provider has incurred a Material Net Operating Loss on the product to be rationalised or can demonstrate that such a loss is likely to occur. A Material Net Operating Loss means the indirect cost ratio of the product (as set out in item 104 of Schedule 10 of the *Corporations Regulations*) for the most recent periodic reporting period is more than 25 per cent higher than the indirect cost ratio for the financial year the product was last offered to new policy owners or members;
      iii. where the fees able to be charged are fixed, the ratio of fees to expenses has fallen by more than 25 per cent after the closure of the product to new investors; or
      iv. the product rationalisation or the product rationalisation program will result in the decommissioning of an underlying administration system or linked (interrelated) system.
   c. The rationalisation of the financial product would be Materially Advantageous to clients as certified by an independent expert. Materially Advantageous means the new product would enable the provision of a more efficient and cost effective product for the member;

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[2] Definition of "Closed" – A financial product is deemed to be closed once the trustee / operators have ceased to accept any new Clients (not including a residual or reversionary beneficiary) in accordance with the relevant and applicable legislative and constituent document requirements.

3.2.2 Taxation relief test

See Section 4

3.2.3 No disadvantage test

Individual or Group/class level

The Paper proposes that the no disadvantage test apply at individual policyholder or member level. By setting the test at the individual level rather than at a group of policy holders' or members' level, the rationalisation process is likely to be costly, time consuming and result in sub-optimal consumer outcomes.

In a managed investment context, funds are pooled and benefits derived from that pooling. The *Corporations Act* differentiates members on a class basis and not an individual basis. While life insurance policy holders have individual contractual rights against the life company as specified in their insurance policy, those policies are generally standardised and can be grouped at the policy holder level as grouped members and policy holders have the same rights. Financial products to which these proposals will apply are standardised offerings to individuals within a group or class. The assessment of rights, obligations and benefits should be made at that group or class level.

As in Part 9 of the *Life Insurance Act 1995* and successor fund transfer processes of Part 18 of the *Superannuation Industry (Supervision) Act 1993*, the value of the benefits would be:

- determined as at the Transition Date;
- based on the monetary benefits and rights enjoyed by the consumer as at the Transition Date (rather than intangible product features, unless these represent a monetary benefit or right);
- determined as the accrued value of those benefits (which we will call the Accrued Value);
- calculated by an independent expert.

For managed funds products, the "no disadvantage test" for funds should be limited to an analysis of member rights as a class or classes under the Scheme Constitution (consistent with section 601GC(1)(b) of the *Corporations Act*), and any legally binding representations made by the responsible entity (e.g. via the Product Disclosure Statement) which would be actionable by affected members if the rationalisation proposal were to be implemented.

Recommendation 5

IFSA recommends that the no disadvantage test be assessed at a group or class level.

Replication of Rights

The proposal to require replication of a right in a new product where it is not possible to determine the impact of the loss of the right is likely to create a significant barrier to rationalisation and result in increased complexity in the end product. Where it is not possible to determine the impact of a right, the loss of the right should be assumed to have a NIL impact unless proven otherwise.

An example of a NIL impact right may be where the 'right' relates to historic methods of calculating unit prices (e.g. historic rather than future pricing), asset values (e.g. gross versus net), or other incidental differences (e.g. transaction cut off times). An example of a NIL impact right subsequently shown to be significant would be for a policyholder in a life insurance risk product:

(a) where the relevant policy terms relating to entitlement to a financial benefit has been altered as a result of the rationalisation;

(b) the person has suffered an underwriting event; or

(c) the event is not covered under the current policy terms or is covered on less favourable financial terms but was covered under the previous policy terms. In such case the Specified Risk Client would be entitled to claim within the Claim Period on the basis that it commenced from the date of the underwriting event.

Recommendation 6

IFSA recommends that:

1. it should NOT be a requirement to duplicate a right in the transferor product where it is not possible to determine the impact of a right in all circumstances; and
2. compensation, where a right or benefit can be valued, is the appropriate remedy.

In all cases, product providers would be required to make a comprehensive assessment of the rights and obligation in relation to the particular product. The following table provides an example of a verification checklist.

Feature (where applicable)	**Sub category (where applicable)**	**Existing product**	**New product**
Fees (min/max)	Annual		
	Monthly		
Product risks			
Unit pricing/valuation			
Taxation arrangement			

Investments	Strategy		
	Restrictions		
	Benchmark		
Online access			
Transacting (frequency, limits)	Applications		
	Withdrawals		
	Other		
Existing benefits			
Future benefits			

3.3 Managed Investment Schemes

The proposed product rationalisation framework for managed investment schemes will improve the position of responsible entities and unitholders in relation to legacy products. We note that under the existing law, and within the existing legal framework, a responsible entity is required to act in the best interests of unitholders.

Against that background, we make the following comments on the proposed rationalisation framework for managed investment schemes.

General Comment

The responsible entity should only be required to demonstrate that affected members, as a whole, will not be disadvantaged under a product rationalisation proposal. As noted in section 3.2.3, the "no disadvantage test" should be limited to an analysis of member rights under the constitution (consistent with section 601GC(1)(b) of the *Corporations Act*) and any legally binding representations made by the responsible entity (eg via the PDS) which would be actionable by affected members if the rationalisation proposal were to be implemented. Adverse affectation of such rights or representations could be managed by compensation.

Independent Expert

The set of criteria to qualify as an independent expert should be designed to include the type of experts that (as is currently the case), the responsible entity appoints in the course of its own "best interests" analysis of a rationalisation proposal. Currently legal, tax and other independent experts would typically be retained by a responsible entity considering a rationalisation proposal. Statutory criteria for determining expert types and qualification should be made.

<u>Recommendation 7</u>

IFSA recommends that independent experts be determined on the basis of statutory criteria set out in regulations.

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Conflicting voting rights

Voting requirements set under the product rationalisation regime should be expressed to apply regardless of, and in priority to, any other requirements that would otherwise have arisen at law (eg section 601GC) or under a scheme constitution (other than a restriction in the form of legally entrenched class rights). "Legally entrenched class rights" means rights which attach to a class of a unit which can only be amended if any procedure in the constitution for varying or cancelling class rights is followed: see ASIC Class Order 98/60.

Recommendation 8

IFSA recommends that voting requirements set under the product rationalisation regime should be expressed to apply regardless of and in priority to any other requirements at law or under a scheme constitution.

Rationalisation options (Option D)

IFSA recommends a fourth option (Option D) be introduced. Option D would be modelled on section 601NC of the *Corporations Act* which permits a responsible entity to wind up a scheme where the scheme's purpose has been accomplished or cannot be accomplished. The section relies on the responsible entity of a scheme acting in the best interests of members and consulting with those members. The section itself could be applied to sub-scale or uneconomic products and where relevant, could arguably be extended to legacy products. The section, however, does not anticipate members being rolled over into another investment arrangement.

Section 601NC(2) provides that:

> "(2) The responsible entity must give to the members of the scheme and to ASIC a notice in writing:
>
> (a) explaining the proposal to wind up the scheme, including explaining how the scheme's purpose has been accomplished or why that purpose cannot be accomplished; and
>
> (b) informing the members of their rights to take action under Division 1 of Part 2G.4 for the calling of a members' meeting to consider the proposed winding up of the scheme and to vote on any extraordinary resolution members propose about the winding up of the scheme; and
>
> (c) informing the members that the responsible entity is permitted to wind up the scheme unless a meeting is called to consider the proposed winding up of the scheme within 28 days of the responsible entity giving the notice to the members.
>
> (3) If no meeting is called within that 28 days to consider the proposed winding up, the responsible entity may wind up the scheme. "

We consider that an Option D modelled on the section 601NC requirements could be included to provide for ASIC review and comment on a proposed rationalisation before notification is given to members.

ASIC should be notified of a product rationalisation proposal but not be required to approve a proposal. We recommend that there be a defined time (14 or 21 days) for ASIC to provide its review and comments so that the rationalisation mechanism can

operate smoothly. A requirement similar to that under section 220 of the Corporations Act may be appropriate.

Recommendation 9

IFSA recommends that:

1. an Option D, modelled on section 601NC of the Corporations Act, be incorporated into the production rationalisation methodologies for managed investment schemes.
2. ASIC be notified of the proposed product rationalisation;
3. ASIC have a limited period (14 to 21 days) to review and comment on the rationalisation proposal process and documentation.

3.3.1 Option A – Member objection model

If a scheme has more than one class of unit then, unless the class rights are legally entrenched (i.e. if the Scheme constitution requires a class vote on a proposal to amend class rights - see ASIC Class Order 98/60), all classes should be combined and the percentage of member objections determined as a single group. Where class rights are legally entrenched, a meeting of those class holders is required.

Recommendation 10

IFSA recommends that if a scheme has more than one class of unit then, unless the class rights are legally entrenched, all classes should be combined and the percentage of member objections determined as a single group.

3.3.2 Option B – Ordinary resolution of meeting of members

As in Option A, if a scheme has more than one class of unit then, unless the class rights are legally entrenched (i.e. if the Scheme constitution requires a class vote on a proposal to amend class rights - see ASIC Class Order 98/60), all classes should vote on resolutions put to the meeting as a single group.

The proposal states that 'a quorum requirement will apply to the meeting of members requiring **a certain number, or percentage of members** in each class **to attend** in order for the resolution to be passed." While we accept that 10% by value is an appropriate quorum requirement, the requirement should be for the attendance of "**members in person or by proxy**". To facilitate and accommodate member engagement the meeting should also provide for postal voting and votes should be recorded by the meeting chair.

Recommendation 11

IFSA recommends that:

1. if a scheme has more than one class of unit then, unless the class rights are legally entrenched, all classes should vote on resolutions put to the meeting as a single group.
2. the quorum requirement should apply to members attending in person or by proxy; and
3. to facilitate member engagement, postal voting should be permitted and votes should be recorded by the meeting chair.

3.4 Life Insurance Products

The primary protection for policyholders are the duties that are imposed under the law and at common law for life insurers and their directors both to give priority to the interests of current and potential policyholders and to act with the utmost good faith[3]. In the context of a proposed product rationalisation, life insurers will be required in all instances to develop any proposals for the rationalisation of life products consistent with these requirements (and any other qualifying threshold test and criteria). Life insurers continue to be subject to the general supervision of the regulators in respect of any product rationalisation.

IFSA supports the APRA Approval process for simple product rationalisations and the Court Approval process for more complex product rationalisation proposals. The arrangements should, in our view, be expanded to provide a third option that would provide policy holders a more direct opportunity to consider and to approve a proposed product rationalisation recommendation by the life insurer. The option could be modelled on the member objection options (Options A and B) for managed investment schemes.

Recommendation 12

IFSA recommends that three alternative processes should be available for the rationalisation of life insurance products. They are:

1. APRA Approval;
2. Court Approval; and
3. A policy holder objection process similar to the member objection models (Options A and B) for managed investment schemes.

Communication with policyholders

Whatever process selected, notification and a detailed summary of the rationalisation proposal will be communicated to policyholders by the life insurer. The information provided will need to be sufficient to enable a reasonable policyholder to understand the proposal and how they may be affected by the proposed product rationalisation. The notification should include a statement that the required legal threshold requirements for rationalisation have been satisfied and confirmation that the policyholder may obtain a copy of the full rationalisation proposal on request.

The proposals paper appears to limit notification through post and via email (where the policy has agreed). Communication should be technology neutral and as agreed with the policy holder.

Recommendation 13

IFSA recommends that notification to policy holders of a product rationalisation proposal be technology neutral. Product rationalisation information should be either mailed to policyholders or made available to them electronically on a similar basis to that which applies to other communications with policyholders under the Corporations Act.

[3] Section 13 of the *Insurance Contracts Act* 1984 (Cth) Act implies into every contract of insurance a provision requiring each party to it to act towards the other party, in respect of any matter arising under or in relation to it, with the utmost good faith. Accordingly, both the insurer and insured have a contractual obligation to comply with a duty of utmost good faith.

3.4.1 Application to APRA

Other than in the case of APRA approval where simple case criteria are satisfied, product rationalisation documentation should be sent to the regulator prior to issue to policy holders and/or the Court for review and comment only by the regulator.

There should be a defined time (14 or 21 days) within which that review and comments are to occur to prevent delay in implementing a rationalisation proposal. Once the assessment has been made by the life insurer consistent with the legislated requirements and their obligations at common law, and APRA has been provided with an opportunity to review and comment on the proposed policyholder documentation, the proposal could then be communicated to policyholders.

Where an application is made to APRA for approval, the ability of APRA to request an additional expert report(s) or refer decisions to the court should be subject to the agreement of the applicant. This is consistent with the applicant having an ability to withdraw the request at any time.

Recommendation 14

IFSA recommends that:

1. other than in the case of APRA approval of a product rationalisation proposal, documentation should be sent to the regulator only for review and comment;
2. a defined time (14 or 21 days) should be set for APRA review and comment; and
3. where an application is made to APRA for approval any request an additional expert report(s) or reference to the court should be subject to the agreement of the applicant.

3.4.2 Direct application or referral to Court

The Court approval process is a valuable option for life insurers in undertaking the rationalisation of complex products or where policyholders under a policy holder objection model object to, or do not approve, a product rationalisation.

We note, under the Court approval option, that the court's decision would act as a bar to any claims for compensation by policyholders of the approved rationalised product.

4. Taxation

Taxation is a fundamental consideration and core element of any proposed product rationalisation. The following issues have been identified in relation to the proposals as outlined.

4.1 General

The Need for Automatic Relief

If a Proposal meets the requirements for product rationalisation, the tax relief should follow automatically. We want to avoid the need for automatic application to the Australian Taxation Office (ATO) for a ruling on the tax treatment. Product providers may of course consider a tax ruling to be appropriate in certain circumstances and these providers would apply for a tax ruling.

If a product qualifies as a legacy product and meets all threshold and other criteria requirements, the product should automatically qualify for rollover tax relief. The suggested requirement that a product be closed for five years before it can qualify for tax relief is not appropriate. If a time limit is to be included in the relevant tax rules, that time limit should be consistent with that set under the Legacy Product Test.

It would be practically difficult to rationalise a product which meets the two year test under the Legacy Product Test, but fails the five year period under the Taxation Relief Test. Without tax relief, it would be extremely difficult for a product to meet the No Disadvantage Test required before rationalisation can progress.

Recommendation 15

IFSA recommends that:

1. rollover tax relief automatically apply to a rationalised product; and
2. if time requirements and criteria are to be included in the relevant taxation laws, those requirements should be the same as the requirements determined under the applicable product rationalisation options.

CGT Rollover Relief at the Asset Level

Product rationalisation requires CGT rollover relief at the asset level. This means that there will be no capital gains tax liability on the transfer of the underlying investment assets of the product being rationalised.

The rollover measures would also provide for the transfer of the tax attributes of the assets to the recipient entity. Tax attributes transferred would be:

Cost base:	Future capital gains or losses would be calculated by reference to the cost of the asset in the product being rationalised.
Acquisition Date:	The acquisition date for the purposes of calculating any CGT exemptions would be the date of acquisition to the transferor.

Recommendation 16

IFSA recommends that rollover measures provide for the transfer of the tax attributes of the assets to the recipient entity.

General Rollover Relief

Not all underlying investment assets are held on capital account. Bonds and fixed interest securities are deemed to be on revenue account, and certain other assets such as equities may also be held on revenue account.

Logically, there should be automatic rollover relief for these assets. Treasury is concerned about setting a precedent for rollover relief outside the capital gains tax provisions if it grants general rollover relief outside the tax provisions.

Treasury are considering having the ATO adopting the administrative practice of treating product rationalisation activities on capital account, and therefore applying the CGT rollover relief described above.

The above approach may work in situations where the assets are not deemed to be held on revenue account. Where there is deemed revenue account treatment on transfer, the proposed solution would not work as the transfer pursuant to the product

rationalisation would be on revenue account. It will be necessary to grant specific rollover relief within these deeming sections.

Sections which need specific rollover relief include:

- Sections 26BB and 70B of the Income Tax Assessment Act 1936. These sections deem gains or losses on transfer of certain fixed interest securities to be on revenue account.
- Division 230 of the Income Tax Assessment Act 1997. This division deems certain financial arrangements to be on revenue account and to tax such arrangements on a mark to market or compounding accruals basis.

The rollover relief would require the suspension of the operation of these sections in a product rationalisation situation, and the transfer of the tax attributes of the assets concerned to the transferee entity.

Rollover Relief at the Investor Level

The tax provisions should also provide that there is no tax liability for the investor on conversion of the product being held to the new product under the rationalisation proposal.

The tax attributes of the original investment should continue post rationalisation until the investor redeems the investment. On redemption, the tax rules which would have operated had the investor retained the original investment should then become effective.

Recommendation 17

IFSA recommends thet:

1. The tax attributes of the original investment continue post rationalisation until the investor redeems the investment; and
2. on redemption, the tax rules which would have operated had the investor retained the original investment should then become effective.

Rollover Relief for Insurance Policies

Bonuses from insurance policies are taxed in the hands of investors under the provisions of Section 26AH of the *Income Tax Assessment Act 1936*. The section does not tax recipients if the policy is held for more than ten years. Bonuses in the ninth and tenth years are partly taxable. Bonuses are fully taxable in the hands of investors if redemption takes place within eight years with the investor receiving a rebate to recognise the fact that the investment gains have been subject to tax in the insurance company at the prevailing corporate rate. The Section also contains various rules concerning investors injecting additional funds into their policies.

It is arguable that any product rationalisation involving an insurance policy triggers the operation of Section 26AH, and re-sets the holding period for the purposes of calculating future tax liabilities.

We, therefore, recommend that Section 26AH be amended to provide that any transfer of a life insurance policy pursuant to a product rationalisation proposal would not trigger the operation of Section 26AH and the holding periods for the purposes of this section would include the time the investment was held within both the transferor and transferee entities. For the purposes of reinvestment amounts, these would be calculated by reference to amounts invested in both entities.

Recommendation 18

IFSA recommends that:

1. Section 26AH be amended to provide that any transfer of a life insurance policy pursuant to a product rationalisation proposal would not trigger the operation of Section 26AH; and
2. the holding periods for the purposes of this section would include the time the investment was held within both the transferor and transferee entities.

Stamp Duty

State Governments should be encouraged to introduce provisions in the relevant stamp duties legislation to grant rollover relief for product rationalisation.

Stamp duty would be levied where the underlying asset being transferred is land or shares in a private company. Some, but not all states exempt the transfer shares in unlisted companies from the stamp duty provisions.

The transfer of life policies will be subject to duty in certain states. If the rationalisation involves the cancellation of an existing life insurance policy, and the issue of a new policy, duty is payable in certain states at the rate of 5% of the first year's premium.

Recommendation 19

IFSA recommends that State Governments be encouraged to introduce provisions in the relevant stamp duties legislation to grant rollover relief for product rationalisation.

ATTACHMENT A

Stage 1 - Exclusion of Superannuation

The Paper excludes superannuation funds, and only covers rationalisation of managed funds and life insurance products.

The present proposals do not allow rationalisation between the three basic structures - managed funds, life office statutory funds and superannuation funds. Rationalisation has to be conducted within a single structure and, or example, rationalisation from a life product to a superannuation product would not be permitted.

Products such as deferred annuities are held by life insurers within the Virtual Pooled Superannuation (**VSPT**) Class of a life insurer. These products are essentially superannuation products and the most likely rationalisation of these products would be a transfer to a superannuation fund. Therefore, the Paper in its present form does not assist life insurers in their rationalisation of deferred annuities.

The general proposal to exclude superannuation needs to be refined and, we believe, a case exists to permit life insurance products that are VPST class assets to be expressly made capable of transfer to stand alone superannuation funds.

The justification for the exclusion of superannuation appears to be based on the view that superannuation products have rationalisation rules under the Successor Fund Transfer (SFT) Provisions. This justification is flawed in the following respects.

- The SFT provisions are a creature of the Superannuation Industry Supervision rules. There is no specific relief for SFT under the Taxation Legislation.
- SFT is not designed for rationalisation, of the intra fund type. SFT is designed to allow the merger together of multiple super funds (themselves),not the trustee owned products within a fund.