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Amendments to Capital Gains Tax Exemption for Compensation and Insurance (Comments on Proposals Paper)

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**Amendments to Capital Gains Tax Exemption
for Compensation and Insurance
(Comments on Proposals Paper)**

By

Ian Gray Solicitor

1. Introduction

On 23 September, 2014, the Treasury published a Proposals Paper with respect to Amendments to Capital Gains Tax Exemption for Compensation and Insurance (“the Proposals Paper”).

The Proposals Paper contains details of proposals with respect to two separate measures.

These Comments deal with the proposals with respect to both issues.

2. Overview with respect to Proposals to Amend Sections 118-37 and 118-300 of the ITAA 1997

2.1 Removal of Uncertainty

The Proposals Paper is designed to remove uncertainty with respect to sections 118-37 and 118-300 of the ITAA 1997.

It is important that any uncertainty or ambiguity be removed. The Proposals are therefore to be commended.

2.2 Previous Comments by Author in 2011

The Annexure to these Comments contains previous Comments made by the Author with respect to a previous Proposals Paper issued in 2011.

Those Comments expressed the view that both sections then had a clear meaning and that the meaning was consistent with the policy goals expressed in the Proposals Paper.

Thus, with one possible exception (TPD Cover held by the Trustee of a Superannuation Fund), it was submitted that the Proposals will not change the effect of the current Legislation.

It was submitted that they would simply remove the scope to argue contrary positions.

These Comments (i.e., the 2014 Comments) adopt a similar view.

2.3 Treasury Endorsement of Existing 2014 ATO Administrative Treatment

The 2014 Proposal goes one step further than the 2011 Proposal and refers to the interpretation of the current Legislation by the ATO.

Paragraph 1.5 states:

“It is intended that trustees or beneficiaries who receive compensation or damages in respect of certain events (such as an injury an individual suffers at work) or in respect of certain policies of insurance (such as illness, injury or death) not be subject to CGT.

“However, the express wording of the relevant provisions in the ITAA 1997 has created uncertainty about this policy.

“This measure confirms the existing administrative treatment in respect of compensation and insurance policies.”

It may be inferred from paragraph 1.5 that:

- The ATO has an existing defined administrative treatment in respect of compensation and insurance policies;
- Treasury endorses that treatment;
- The Proposal is to document the treatment; and
- The Proposal is not intended to change the substantive operation of the Legislation, except insofar as is necessary to achieve this goal.

2.4 Distinction between Death Benefits and Non-Death Benefits

The Author regrets that Treasury has not taken advantage of the opportunity to remedy other concerns about the two sections of the ITAA 1997 (i.e., sections 118-300 and 118-37).

The Proposal preserves the existing distinction between Death Benefits and Non-Death Benefits under Insurance Policies that is implicit in the existence of sections 118-300 and 118-37.

In the Author's 2011 Comments, the Author made the following comments:

“It is submitted that there is no public policy benefit in this distinction.

“If the issues were being considered more broadly from a public policy point of view, it is submitted that the same section and criteria for exemption should apply to both:

- ***Death Benefits; and***
- ***Non-Death Benefits.”***

The Author adheres to this position.

Ultimately, many of the practical problems encountered in the Insurance and Business Succession Planning Industries could be minimised by:

- the removal of the differential treatment of the two types of provision; and
- the identical treatment of both benefits under one provision of the ITAA 1997.

However, the Author of these Comments recognises that this is not within the scope or purpose of the current Proposal.

To this extent, while the Proposal is to be commended insofar as it goes, there is more work to be done in order to improve the substantive operation of the two provisions.

2.5 Purpose of 2014 Comments

The purpose of the balance of the Author's comments is to:

- enhance the drafting of the draft Amendments;
- remove concerns and uncertainty about the drafting; and
- suggest alternatives that might remedy the concern and uncertainty.

3. Different Context and Structure of Sections 118-300 and 118-37

3.1 Section 118-300

Section 118-300 is expressly concerned with the taxation of Insurance Proceeds payable under Insurance Policies.

It assumes that there will be:

- an Insurance Policy;
- an Insurance Company;
- a Life Insured
- a Policy Owner;
- the payment of a claim made by the Insurance Company upon the occurrence of an Insured Event under the Policy;
- the receipt of Insurance Proceeds by the Policy Owner or their Nominee.

Because of this contextual framework, the exemption has been based on Policy Ownership (i.e., “the original beneficial owner” of the Policy).

3.2 Section 118-37

Unlike section 118-300, section 118-37 does not expressly create a contextual framework for the exemption in terms of Policy Ownership.

Its primary concern was the payment of compensation or damages for personal illness or injury.

It assumes that there will be:

- an illness or injury;
- an injured person;
- somebody who has caused the illness or injury or has agreed to indemnify someone against the economic consequences of the illness or injury;
- a claim for compensation or damages by the injured person (or a relative);
- the payment of a claim; and
- the receipt of a compensation or damages payment by the injured person (or a relative).

It is possible that there might be a Policy involved in relation to the payment of compensation or damages claim.

However, the immediate context of the section was the liability for compensation or damages in the law of tort.

This liability would normally arise out of a tortious liability to the injured person, as opposed to a contractual liability under a Policy or Agreement.

The CGT Asset is of a materially different kind.

In relation to section 118-300, the CGT Asset is the Insurance Policy, a contract or “chose-in-action”.

The CGT Event is the disposal of the Insurance Policy, contract or “chose-in-action”.

In contrast, in relation to section 118-37, the CGT Asset is normally the right to make a claim for compensation or damages in tort.

The CGT Event is the satisfaction of this claim by way of a Court order or a voluntary payment of the claim upon acceptance of liability and quantum.

3.3 Implications of Different Context and Structure

The different context and structure resulted in quite different drafting of the basis of the exemptions, even where the underlying CGT Asset in relation to section 118-37 is an Insurance Policy.

It is also the basis for the policy distinction between the treatment of Death and Non-Death Benefits.

3. Section 118-300(1) (Proceeds of Insurance Policies)

3.1 Significance of Use of Term “Original Beneficial Owner”

The original exemption depended in part on the “original beneficial owner” of the Policy.

It is submitted that the language of “beneficial ownership” is a creature of Trust Law.

It envisages that a Policy might be held by a Trustee.

It also implicitly envisages that a Trustee might make a distribution to or at the direction of a Beneficiary, particularly in relation to a Fixed Trust.

3.2 Fixed Trusts

In the case of Fixed Trusts, there is a legal distinction between:

- the Legal Owner of the Trust Property; and
- the Beneficial Owner of the Trust Property.

In relation to a Fixed Trust of a Policy:

- the Policy Owner would be an entity that held the Policy on Trust;
- the Policy would be held for the benefit of a Beneficiary or Beneficiaries; and
- it would normally be expected that the Insurance Proceeds would be distributed to or at the direction of the Beneficiaries.

The focus on beneficial ownership of the Policy entitles such Beneficiaries to a CGT Exemption with respect to the Insurance Proceeds.

This exemption is subject to the proviso that each Beneficiary must be an “original” beneficial owner.

Thus, the limitation of the Exemption is designed to discourage the transfer of the beneficial interest in a Policy.

It is acknowledged that there is no express reference to an exemption for the Trustee itself (i.e., the Policy Owner) in the case of a Fixed Trust.

However, it is submitted that no such express mention of the Trustee was required, because of the normal operation of the Legislation with respect to the taxation of Trust Income.

The Trustee itself is not normally taxed, unless there is no Beneficiary who is entitled to the Trust Income.

Here, the Beneficiary or Beneficiaries would have a fixed interest in the Insurance Proceeds.

Thus:

- the Insurance Proceeds would be included in the Tax Return of the Beneficiary or Beneficiaries; and

- the Trustee would not have to include the Insurance Proceeds in its own Tax Return.

It is submitted that it was never necessary to expressly grant the Exemption to the Trustee of a Fixed Trust.

However, to the extent that there has been uncertainty, it is desirable that the uncertainty be removed.

3.3 Discretionary Trusts

In contrast to Fixed Trusts, in the case of a Discretionary Trust, no Discretionary Beneficiary has a Beneficial Interest in the Trust Property.

Thus, there is no distinction between the Legal and Beneficial Ownership of the Trust Property (i.e., the Policy).

The Legal and Beneficial Interests remain united and undivided.

The implication for section 118-300 is that the Exemption is available to the Trustee of the Discretionary Trust as the “Original Beneficial Owner” in its own right.

It is submitted that it was never necessary to expressly grant the Exemption to the Trustee of a Discretionary Trust.

However, to the extent that there has been uncertainty, it is desirable that the uncertainty be removed.

3.4 Distribution of Insurance Proceeds to the Beneficiaries of Fixed Trusts

It is submitted that the focus on the “original beneficial ownership” of the Policy and the normal taxation of Trust Income was adequate to ensure that the Beneficiaries of Fixed Trusts received an Exemption with respect to the Insurance Proceeds.

Again, to the extent that there has been uncertainty, it is desirable that the uncertainty be removed.

3.5 Distribution of Insurance Proceeds to the Beneficiaries of Discretionary Trusts

In the hands of the Trustee of a Discretionary Trust, the Insurance Proceeds would constitute Exempt Income.

The Trustee could either:

- retain the Insurance Proceeds; or
- distribute them to the Beneficiaries.

It is submitted that the Insurance Proceeds distributed to (or received by) the Beneficiaries would retain their character as Exempt Income.

It is submitted that it was never necessary to expressly grant the Exemption to the Beneficiaries of a Discretionary Trust.

However, to the extent that there has been uncertainty, it is desirable that the uncertainty be removed.

3.6 Implications of Use of Term “Original Owner”

The Proposal addresses the perceived uncertainty with respect to the tax treatment of Insurance Proceeds received by the Trustee by substituting the term “original owner” for the term “original beneficial owner”.

To the extent that this Proposal makes it clear that the Trustee (presumably as Legal Owner) is entitled to the Exemption, the Proposal is unobjectionable.

However, it is submitted that it does so potentially at the expense of clarity and certainty with respect to the basis of the Exemption for Beneficial Owners of Policies.

The original exemption:

- focused on the Exemption to which the Beneficial Owner was entitled; and
- assumed that the Exemption would apply to the Trustee or Legal Owner as a result of the normal operation of Trust Tax Law (or it assumed that the Legal and Beneficial Ownership would be united in the case of a Discretionary Trust).

The new Exemption reverses the logic.

It is submitted that this creates new uncertainty, which is discussed below.

3.7 Item 6 of Exposure Draft

In order to deal with the Beneficiary’s entitlement to the Exemption, the Proposal inserts the provision set out in Item 6 of the Exposure Draft:

“Payment to trust beneficiary (or representative) if trustee owns the policy or instrument

- (1A) A *capital gain or *capital loss you make from a *CGT event happening because you receive a *CGT asset from the trustee of a trust is disregarded if:***
- (a) you receive the CGT asset as:***
- (i) a beneficiary of the trust; or***
 - (ii) a *legal personal representative of a beneficiary of the trust; and***
- (b) the CGT asset is attributable to another CGT event and CGT asset to which table item 3 in subsection (1) applies for the trustee.”***

Under the original provision, the Beneficiary derived its Exemption from its (beneficial) ownership of the Policy.

Whether or not the Beneficiary was a “Beneficial Owner” of the Policy would be a matter of standard Trust and Tax Law.

The proposed Amendment retains the criterion of ownership as the basis for the Exemption for the Trustee.

However, it dispenses with it for the purposes of the Beneficiary.

3.8 Problems Created by Drafting of Item 6 of Exposure Draft

Item 6 refers to the receipt of a “CGT Asset” by the Beneficiary from the Trustee.

It is not clear what this CGT Asset is.

Presumably, it can't be the original Policy, because the Policy has been disposed of by virtue of the payment of the claim.

Under the existing Legislation with respect to the taxation of Trust Income, the Beneficiary would normally receive cash attributable to the Insurance Proceeds.

This income would be included in the Beneficiary's Tax Return as a product of the normal provisions dealing with the taxation of Trust Income.

The existing Legislation applies to all Trust Income.

Conceptually, it doesn't require the interposition of a new CGT Asset at the time of distribution of the Trust Income to the Beneficiary by the Trustee.

It's possible that the Beneficiary of a Fixed Trust might have some form of legal right to compel distribution of the Trust Income to the Beneficiary by the Trustee.

However, as far as the Author is aware, such a right has never been called upon to explain or facilitate the normal operation of the taxation Laws with respect to Trust Income.

If the Beneficiary is simply receiving a distribution of cash attributable to the Insurance Proceeds, it is submitted that this provision can be drafted far more simply without needing to establish the existence of a new CGT Asset at the point of distribution.

Further, while it's possible that there might be such a CGT Asset in the case of a Fixed Trust, it's arguable that there will never be such a CGT Asset in the case of a Discretionary Beneficiary under a Discretionary Trust.

It is the nature of a Discretionary Trust that any distribution is made by the Trustee as a result of the exercise of a discretion, not as the result of the performance of a contractual or fiduciary obligation under a chose-in-action or Trust Deed.

It is submitted that the requirement that there be a CGT Asset adds a dimension of difficulty and uncertainty, when it would have only been necessary to refer to a receipt by a Beneficiary of the Trust.

Drafting Suggestion

The same issue arises in relation to Item 3 of the Exposure Draft, which deals with section 118-37.

Although it also refers to a CGT Asset, it adds the language that the CGT Asset is “attributable to compensation or damages that the trustee receives” for the relevant wrong or injury.

As an alternative or complement to the drafting suggested in Paragraph 3.8 below, an identical result could be achieved if:

- the requirement for a new CGT Asset was removed; and
- Item 6 referred to “income received by the Beneficiary attributable to the income received by the Trustee” in relation to the disposal of the Insurance Policy.

3.9 Suggested Alternative to Item 6 of Exposure Draft

In the Author’s 2011 Comments, it was submitted that the position of both the Trustee and the Beneficiaries could be clarified by an extremely simple amendment:

In effect, the Exemption could be expressly extended to both:

- the Legal Owner: and
- the Beneficial Owner.

It is submitted that:

- this amendment is simple;
- it preserves the existing criterion of ownership;
- it preserves the existing criterion of Beneficial Ownership; and
- it removes the uncertainty with respect to Legal Ownership.

See the suggested wording below from the Author’s 2011 Comments:

Insurance policies		
Item	The * CGT event happens to your <u>interest in rights under this type of policy</u> :	... and you are
1	...	...
2	...	...
3	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	the original <u>beneficial owner of your interest in rights under the policy or instrument</u>
3A	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	the original <u>legal owner of your interest in rights under the policy or instrument</u>
3B	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	A <u>beneficiary of a trust, where the trustee of the trust is the original beneficial owner of an interest in rights under the policy or instrument</u>

4	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	an entity that * acquired your <u>interest</u> in rights under the policy or instrument for no consideration
4A	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	A beneficiary of a trust, where the trustee of the trust acquired its <u>interest</u> in rights under the policy or instrument for no consideration
5	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	the <u>trustee</u> of a * complying superannuation entity for the income year in which the * CGT event happened with respect to its <u>interest</u> in rights under the policy or instrument
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3.10 Multiple Owners of Policies

It is quite common for Insurance Policies to be owned by multiple owners.

For example:

- a Husband and Wife might jointly own a Policy (as a condition of a Loan to fund the purchase of a home or investment property);
- two Tenants-in-Common might jointly own a Policy (as a condition of a Loan to fund the purchase of an investment property);
- a Partnership might own a Key Person Policy to compensate the Partnership for a loss of income as a result of the death of the Life Insured;
- the Continuing Shareholders of a Company might own a Buy/Sell Policy in order to fund the Purchase Price of the Life Insured's Shares upon their Death; and
- a Bank holds a Policy as security for a Loan.

While it might be inferred that each Policy Owner is a Legal Owner of the Policy, it should be made clear that what matters is not:

- the ownership of the Policy; but
- the ownership of "an interest" in the Policy.

3.11 Multiple Beneficiaries of Trusts

Similarly, there are many situations in which there might be:

- one Trustee; and
- Multiple Beneficiaries.

It should be clear that the reference to "the Beneficiary" means "a Beneficiary".

3.12 Ownership of Policies by Partnerships

Previously, it is submitted that the exemption of each Partner of a Partnership-owned Policy derived from their Beneficial Ownership of the Policy as an individual Partner.

Under Item 6, it is submitted that the Partnership itself might be entitled to the exemption.

However, the removal of the language of Beneficial Ownership has left a hiatus with respect to the payment to the individual Partners.

The hiatus has been remedied by Item 6 (possibly inadequately) in the case of Trusts and Beneficiaries.

However, there is no matching provision to deal with Partnerships or any other forms of Beneficial Ownership that might have been embraced by that term.

Again, it is submitted that the criterion of beneficial ownership should be retained.

It is only necessary to add an Exemption for Legal Ownership.

3.13 Security Interest of Bank or Creditor in a Policy

Banks often hold Policies by way of security for Loans to the Life Insured.

These arrangements can be governed by fiduciary obligations.

For example, if the Life Insured has repaid half of the Loan and the Insurance Proceeds exceed the balance, there might be a fiduciary obligation to pay the excess to the Life Insured.

This type of situation would have been encompassed by the criterion of "Beneficial Ownership".

However, it is not clear how it would be addressed by Item 6.

The Life Insured would not constitute an "original owner" of the Policy.

3.11 Change of Trustee of Fixed or Discretionary Trust

In normal commercial practice, it is possible that the Trustee of a Trust might be changed, without changing the Beneficiaries or the beneficial ownership of the Trust Property.

Item 6 would presumably construed so that the replacement Trustee would not be the "original owner"

This would normally be a mechanical change. However, it seems that the replacement Trustee would have to prove that it had not given consideration for the transfer of the Policy, in order to obtain an Exemption at the time of a claim.

3.14 Implications of Requirement of "Original Ownership"

Item 6 places a lot of weight on the criterion of "original ownership".

This derives from the concept of "original beneficial ownership", which is used elsewhere in the Legislation.

However, with the omission of the word “beneficial”, it is submitted that the retention of the word “original” serves no public policy purpose.

What does it matter that the current Policy Owner was not the original Policy Owner?

If the primary concern is the trading of Insurance Policies for consideration, then this issue can be addressed more directly.

For example:

- the Exemption could be made available to any Policy Owner; and
- the exemption could subject to the proviso that it not be available if the current Policy Owner had acquired the Policy from a previous Policy Owner for a payment or consideration.

3.15 Drafting of Item 5 (Superannuation Entity Ownership of Illness or Injury Policy)

Item 5 of the Exposure Draft clarifies the position with respect to Superannuation Entity ownership of Non-Death Benefits, by amending section 118-300, which otherwise deals solely with Death Benefits under Insurance Policies.

It is submitted that the more appropriate section to deal with all illness or injury benefits would be section 118-37.

The description of the Policy in Item 5 refers to “an individual suffering an illness or injury”.

Under section 118-37, the current and proposed Exemptions are tightly restricted to an injured person or relative.

This nexus is retained when a Trustee owns the Policy.

However, Item 5 removes any such nexus.

There is no express requirement that the Policy be with respect to an individual who is a member of the Fund (or a relative).

It is submitted that, by analogy with section 118-37, the Exemption should be restricted to:

- “a member”; or
- “a member or relative of a member”.

4. Section 118-37(1) (Compensation or Damages Payments)

4.1 Suggested Wording of Amendment

Section 118-37 currently refers to:

“compensation or damages you receive for any wrong, injury or illness you or your relative suffers personally”.

In the Author’s 2011 Comments, it was submitted that the public policy goals could be achieved by the following wording:

“your share of any payment that you receive, or a Trustee of a Trust receives on your behalf, as a result of any wrong, injury or illness that you or a relative of yours suffers personally;

“the Trustee’s share of any payment that it receives as a result of any wrong, injury or illness that a beneficiary or a relative of a Beneficiary of the Trust suffers personally”.

4.2 Application of Same Reasoning to Section 118-37

Much of the reasoning in the comments with respect to section 118-300 applies equally to section 118-37.

In particular, it is submitted that the requirement that there be a CGT Asset adds a dimension of difficulty and uncertainty, when it would have only been necessary to refer to a receipt by a Beneficiary of the Trust.

4.3 Use of Word “Receive”

Although Item 3 of the Exposure Draft refers to a CGT Asset, it adds the language that the CGT Asset is “attributable to compensation or damages that the trustee receives” for the relevant wrong or injury.

It is submitted that the word “receive” should be used consistently across the proposed Item 3.

It should refer to the income received by the Trustee or the Beneficiary, as long as the nexus back to compensation or damages applies.

Just as the proposed paragraph (b) refers to “compensation or damages you receive as the trustee of a trust” etc, it is submitted that paragraph (ba) should refer to:

“any income you receive as a beneficiary attributable to any compensation or damages received by the Trustee for any wrong, injury or illness the beneficiary or a relative suffers personally”.

Note: I have omitted the reference to wrong or injury you suffer in your occupation for convenience and clarity only.

In summary, an identical result to the proposed Item 3 could be achieved if:

- the requirement for a new CGT Asset was removed; and

- Item 3 referred to “***any income you receive as a beneficiary attributable to any compensation or damages received by the Trustee for any wrong, injury or illness the beneficiary or a relative suffers personally***”.

4.4 Multiple Policy Owners and Beneficiaries

It should be clear that these exemptions apply equally no matter how many Policy Owners or Beneficiaries there are.

For example, if a Family Discretionary Trust owned a Disability Policy required to fund the repayment of a Bank Loan on the Disability of a Husband and Wife:

- the Trustee should be able to distribute the Insurance Proceeds to the Husband and Wife at its discretion; and
- the Exemption should apply to both Beneficiaries (as long as they are the Injured Person or a Relative).

4.5 Drafting of Item 5 (Superannuation Entity Ownership of Illness or Injury Policy)

As suggested in Paragraph 3.13, it is submitted that the more appropriate section to deal with all illness or injury benefits (including those payable to a Superannuation Entity) would be section 118-37.

The description of the Policy in Item 5 refers to “an individual suffering an illness or injury”.

Under section 118-37, the current and proposed Exemptions are tightly restricted to an injured person or relative.

This nexus is retained when a Trustee owns the Policy.

However, Item 5 removes any such nexus.

There is no express requirement that the Policy be with respect to an individual who is a member of the Fund (or a relative).

It is submitted that, by analogy with section 118-37, the Exemption should be restricted to:

- “a member”; or
- “a member or relative of a member”.

ANNEXURE

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Minor Amendments to the Capital Gains Tax Law (Comments on 2011 Proposals Paper)

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Minor Amendments to the Capital Gains Tax Law (Comments on Proposals Paper)

By

Ian Gray Solicitor

1. Introduction

On 27 May, 2011, the Treasury published a Proposals Paper with respect to Minor Amendments to the Capital Gains Tax Law (“the Proposals Paper”).

The Proposals Paper contains details of proposals with respect to four separate measures.

These Comments are restricted to the proposals contained in Section 4 of the Proposals Paper (CGT Exemption for Certain Compensation and Insurance Payments).

2. Overview with respect to Proposals to Amend Sections 118-37 and 118-300 of the ITAA 1997

2.1 Removal of Uncertainty

The Proposals Paper is designed to remove uncertainty with respect to sections 118-37 and 118-300 of the ITAA 1997.

It is important that any uncertainty or ambiguity be removed.

However, it is the view of these Comments that both sections have a clear meaning and that the meaning is consistent with the policy goals expressed in the Proposals Paper.

Thus, with one possible exception (TPD Cover held by the Trustee of a Superannuation Fund), it is submitted that the Proposals will not change the effect of the current Legislation.

They will simply remove the scope to argue contrary positions.

2.2 Summary of Wording of Suggested Amendments

Section 118-37

It is submitted that the public policy goals could be achieved by the following wording:

“your share of any payment that you receive, or a Trustee of a Trust receives on your behalf, as a result of any wrong, injury or illness that you or a relative of yours suffers personally;

“the Trustee’s share of any payment that it receives as a result of any wrong, injury or illness that a beneficiary or a relative of a Beneficiary of the Trust suffers personally”.

Section 118-300

It is submitted that the public policy goals could be achieved by the following wording of the Table in 118-300:

Insurance policies		
Item	The * CGT event happens to your <u>interest</u> in rights under this type of policy:	... and you are
1	...	...
2	...	...
3	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	the original beneficial owner of your <u>interest</u> in rights under the policy or instrument
3A	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	the original legal owner of your <u>interest</u> in rights under the policy or instrument
3B	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	A beneficiary of a trust, where the trustee of the trust is the original beneficial owner of an <u>interest</u> in rights under the policy or instrument
4	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	an entity that * acquired your <u>interest</u> in rights under the policy or instrument for no consideration
4A	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	A beneficiary of a trust, where the trustee of the trust acquired its <u>interest</u> in rights under the policy or instrument for no consideration
5	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	the <u>trustee</u> of a * complying superannuation entity for the income year in which the * CGT event happened with respect to its <u>interest</u> in rights under the policy or instrument
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3. Relationship Between Sections 118-37 and 118-300 of the ITAA 1997

Sections 118-300 and 118-37 collectively deal with:

- Death Benefits (section 118-300); and
- Non-Death Benefits (118-37).

3.1 Section 118-300 (Death Benefits)

The primary section dealing with Death Benefits is section 118-300.

Its predecessor was section 160ZZI of the ITAA 1936.

The earlier section was originally designed to apply to payments under “policies of life assurance”.

It was originally believed that the section applied to any payment under a policy of life assurance, whether the payment was a Death Benefit or a Non-Death Benefit.

The same view was initially adopted with respect to section 118-300.

However, since its introduction, the Legislation has been interpreted by the ATO (and amended subsequently to confirm the ATO’s interpretation) on the basis that section 118-300:

- applies only to Death Benefits; and
- does not apply to Non-Death Benefits.

3.2 Section 118-37 (Non-Death Benefits)

The ATO’s view made it necessary to determine whether Non-Death Benefits were dealt with by a different section.

The ATO now applies section 118-37 to Non-Death Benefits payable under Insurance Policies.

3.3 Different Exemptions for Different Benefits Payable under Insurance Policies

As a result, the current Legislation applies *different* exemptions and tests to:

- Death Benefits; and
- Non-Death Benefits.

It is submitted that there is no public policy benefit in this distinction.

If the issues were being considered more broadly from a public policy point of view, it is submitted that the same section and criteria for exemption should apply to both:

- Death Benefits; and

- Non-Death Benefits.

3.3 Different Exemptions for Different Benefits Payable to Superannuation Funds

The public policy and drafting issues are further clouded and confused, because the Proposals seek to:

- Apply the exemption in section 118-300 to **both** Death Benefits and Non-Death Benefits in the case of Policies held by Superannuation Funds; and
- Apply the exemptions in the two separate sections to Policies held by any other Policy Owner.

Thus, the Proposals make section 118-300 a complete code for exemptions in the case of Superannuation Funds (regardless of the nature of the Benefit).

In contrast, in the case of any other Policy Owner, the exemptions have to be found in two different sections.

4. Section 118-37(1) (Compensation or Damages Payments)

4.1 Scope of Section

This section concerns compensation or damages payments with respect to a wrong, injury or illness the taxpayer (or their relative) suffers personally.

The section as currently drafted grants an exemption with respect to a payment to:

- The **person** who suffers the injury; or
- A **relative** of the person who suffers the injury.

As a result, the person who suffers the injury does not have to receive the payment.

It is enough that the recipient is a relative of the injured person.

In other words, the **taxpayer** can be either the injured person or a relative.

4.2 Deemed Payments

The word “payment” includes a deemed payment to or receipt by the taxpayer.

In other words, it includes a payment to another recipient, if it is deemed to be “received” by the injured person or a relative of the injured person under section 103-10 of the ITAA 1997.

This section would apply if the payment had been “applied for the [taxpayer’s] benefit or as [they had] directed”.

4.3 No Reference to Insurance Policies

It is important to recognise that section 118-37 does not expressly mention Insurance Policies.

The section has a broader application than Insurance Policies.

In a way, its primary focus was always the CGT liability with respect to compensation or damages payments arising from injuries suffered in accidents such as:

- motor vehicle accidents; or
- workplace accidents.

The compensation or damages payments in these cases might derive from legal proceedings or the settlement of a claim out of court.

In a sense, section 118-37 might apply where the payment was made as a result of any of the following obligations:

- an obligation in tort or under the law of negligence;
- an obligation under a contract;

- an obligation under an Insurance Policy;
- a statutory obligation; or
- an obligation under a judgment made by a Court.

It was not necessary that there be an Insurance Policy in place or that the payment be made pursuant to a claim under a Policy.

As a result, the section does not grant the exemption on the basis of ownership (whether legal or beneficial ownership) of the Policy.

It is totally silent and neutral with respect to policy ownership.

As a result, the considerations that apply to this section are different to those that apply to section 118-300.

4.4 Application to Insurance Policies

Nevertheless, for the reasons mentioned in Part 3 of these Submissions, section 118-37 is now the primary source of an exemption for Non-Death Benefits payable under Life Insurance Policies.

It is important to recognise that this section only applies to the Non-Death Benefits payable under Insurance Policies.

It does not apply to Death Benefits.

4.5 How the Existing Section Applies to Insurance Policies

As mentioned above, the section does not define the exemption in terms of Policy Ownership.

What is required is a “payment” to either:

- The *injured person*; or
- A *relative* of the injured person.

The most obvious manner in which this requirement could be satisfied is if the **Policy Owner** is:

- The injured person; or
- A relative of the injured person.

In other words, the requirement would be satisfied if the Policy Owner is:

- The Life Insured; or
- A relative of the Life Insured.

4.6 How the Existing Section Applies to Co-owned Insurance Policies

Because the exemption applies to the payment received or deemed to be received by a Taxpayer, it is also submitted that the exemption applies where the Policy is co-owned.

In other words, it would apply if the individual Policy Owners or Taxpayers are:

- The injured person **and** one or more relatives of the injured person; and
- Two or more relatives of the injured person.

In other words, the exemption granted by the section extends to co-ownership of a Policy by two or more Policy Owners, provided that the co-owners are:

- the injured person; and/or
- relatives of the injured person.

It is submitted that this interpretation applies, regardless of whether the method of co-ownership is:

- A General Law Partnership;
- A Tax Law Partnership;
- A Limited Partnership; or
- Any other form of co-ownership that does not constitute a “Partnership” as defined in section 995(1) of the ITAA 1997.

4.7 How the Existing Section Applies to Insurance Policies Owned by Trusts

One of the Proposals is designed to clarify the situation where a Policy is owned by a Trustee.

It is desirable that this clarification happen.

However, it is important to state that the perceived uncertainty about this issue result from a misinterpretation of the Tax Legislation, even if it is desirable to avoid it.

TD 14

The Proposals Paper refers to Taxation Determination TD 14.

It states that this Determination extended the exemption to compensation payments “when paid to trustees on behalf of the beneficiary who suffered the wrong, injury or illness”.

It then states that:

“... subsequent changes to the tax law have meant that TD 14 is no longer effective.”

There is no mention of what these changes are.

Difference between Sections 160ZB and 118-37

TD14 was issued on 10 September, 1991 with respect to section 160ZB(1), the predecessor to the current section 118-37.

There is one material difference between the two sections.

The original section only exempted a payment to the injured person.

It did not contain any exemption for a payment to a relative of the injured person.

Application of TD 14 to Section 160ZB

TD14 therefore stated that the exemption applied to payments to:

- The holders of Policies in respect of injuries to themselves; and
- The trustee for a taxpayer who has been injured.

Application of TD 14 to Section 118-37

When the section was replaced by section 118-37, the same view would have extended the exemption to:

- A taxpayer who had been injured;
- A Trustee for a taxpayer who had been injured;
- A relative of a taxpayer who had been injured; and
- A Trustee for a taxpayer who was a relative of a person who had been injured.

Application of Section 96

It is submitted that the above application of sections 160ZB(1) and 118-37 is in fact an unexceptional application of the normal tax treatment of Trusts.

A Trust is not an assessable entity for tax purposes.

Section 96 provides that, except as provided in the Act, a Trustee is not liable as trustee to pay income tax upon the income of the trust estate.

In general, a Trustee would only be assessable on income to which no Beneficiary of the Trust was presently entitled.

Where there is a presently entitled Beneficiary, that Beneficiary is the relevant taxpayer.

Any exemption applies to the Beneficiary as taxpayer, regardless of whether the Insurance Proceeds have been:

- paid directly to the Beneficiary by the Insurance Company; or
- paid to the Trustee and then distributed by the Trustee to the Beneficiary.

Provided that the Insurance Proceeds have been distributed to the Beneficiary (and not withheld from distribution by the Trustee), then the Trustee cannot be liable to pay income tax with respect to the Insurance Proceeds, because of the operation of section 96.

When the Insurance Proceeds are included in the assessable income of the Beneficiary, the exemptions apply on the basis of whether they are compensation or damages with respect to:

- the Beneficiary (under section 160ZB); or
- the Beneficiary or a relative of the Beneficiary (under section 118-37).

Distribution by Trustee to Beneficiaries

It does not matter that the Insurance Proceeds were previously received by the Trustee (in its capacity as trustee).

Indeed, it is submitted that the *distribution* by the Trustee to the Beneficiary is itself a payment by way of *compensation or damages*, regardless of the character of the payment in the hands of the Trustee.

Neither section requires the compensation or damages to be sourced from an Insurance Company or to be a benefit payable under an Insurance Policy.

It is sufficient that the payment is payable as a result of an injury.

Absolute Entitlement Trusts

The above analysis applies to a simple Fixed Trust.

The exemption for the Trustee follows from the “present entitlement” of the Beneficiary.

In order to obtain the exemption, it is not necessary to establish that:

- the Policy is owned by an Absolute Entitlement Trust; or
- the Beneficiary is “absolutely entitled” to the Policy (or an interest in rights under a Policy) as against the Trustee within the meaning of section 106-50 of the ITAA 1997.

The exemption follows from the normal application of section 96 of the ITAA 1936.

However, obviously, if the Trust was an Absolute Entitlement Trust, it would obtain an exemption for both the Trustee and the “absolutely entitled” Beneficiary.

2005 Draft Losses and CGT COE Discussion Paper

The above analysis is consistent with the taxation of Trustees and Beneficiaries.

In October, 2005, the Losses and CGT Centre of Expertise published a draft Paper that set out its views at the time.

While the draft Paper finds certain inconsistencies in its previously published precedential material, it came to a similar conclusion.

However, it is the inconsistencies identified in the draft Paper that have led to the initiatives identified in the current Proposals Paper:

“Application of section 118-37 to trustees

Section 118-37 appears clear on its face. The exemption in section 118-37 does not appear to apply to a trustee of a trust (including a trustee of a superannuation fund) in respect of compensation received in his or her capacity as trustee.

However, statements of the Tax Office’s practice must be considered.

Taxation Determination TD 14 states that payments made under an accident and health assurance policy to a trustee for a taxpayer who has been injured will not give rise to either capital gains or losses.

TD 14 is very brief and contains no explanation or examples from which any contextual argument can be drawn as to its application. Originally, it was thought that TD 14 was limited (and intended to be limited) in its application to trusts set up to provide for the care of an injured person. This was the view expressed in the discussion paper in relation to buy-sell (business succession) agreements.

It has also been suggested that TD 14 may have been overridden by Taxation Ruling TR 95/35 (or, by implication, by Taxation Determination TD 95/43).

TR 95/35 (paragraph 22) provides that compensation received by a company or trustee for any wrong or injury suffered by the company or trust does not fall within the scope of the exemption provided by subsection 160ZB(1) (the equivalent provision in the ITAA 1936). The explanation to the ruling (paragraph 216) states more directly that compensation received by a trustee in his or her capacity as trustee does not fall within the scope of the exemption.

*TR 95/35 does not supersede TD 14. While the explanation in the ruling (paragraph 216) could be read as appearing to override TD 14, the actual ruling (paragraph 22) does not, and the explanation part must be read in the context of the ruled part. **Paragraph 22 says that the personal injury exemption does not extend to any wrong or injury suffered by a company or trust. Where the explanation says that the exemption is limited in its application to wrongs or injuries suffered by individuals, and compensation received by a trustee, in his or her capacity as trustee, does not fall within the scope of the exemption, this is in the context of a payment relating to a wrong suffered by the trust rather than a wrong or injury suffered by an individual where a trustee receives the payment.***

Further, had TR 95/35 intended to override TD 14 then it would have done so by way of formal withdrawal. Instead of which, the ruling says, at paragraph 215, that it considers the potential width of the exemption in the determination.

Similarly, TD 95/43 says that a sum received by a taxpayer under a trauma insurance policy is an exempt capital gain under subsection 160ZB(1) if the person who received it is the insured person or the spouse of that person. It should not be read into this that if such a payment were received by a trustee, including a superannuation fund trustee, it would not qualify for exemption, as TD 14 already indicates that it would be exempt. However, TD 95/43 makes it clear that, for example, a payment received by a third party who had taken an assignment of the rights under

the policy would not be exempt. (The TD also clarifies that a trauma event is an 'injury' for the purposes of subsection 160ZB(1) of the ITAA 1936).

Accordingly, the Tax Office will apply TD 14, to treat payments under a policy of insurance to trustees as exempt provided that the requirements of section 118-37 are satisfied in respect of the beneficiary (that is, any benefits paid under the policy are intended to be provided to the beneficiary as compensation for any injury or illness the beneficiary or their relative suffers personally)."

4.8 Application to Discretionary Trusts

Where the Trust that holds the Policy is a Fixed Trust, there will be no question that the Beneficiary is presently entitled to the Insurance Proceeds.

However, there could still be an uncertainty where the Trust is a Discretionary Trust.

In the case of a Discretionary Trust, the Trustee would be the beneficial owner of the Policy and the Insurance Proceeds.

It is not necessarily under any contractual or fiduciary obligation to distribute the Insurance Proceeds to the Beneficiary.

If the Trustee elects to retain the Insurance Proceeds and not distribute them to the Beneficiary, then it cannot be said that the Beneficiary has received any payment, let alone a payment by way of compensation or damages.

One response would be to say that a Policy held by a Discretionary Trust should not be entitled to the exemption in any circumstances.

However, if the Trustee elects to distribute the Insurance Proceeds to a presently entitled Beneficiary, then it is submitted that the situation is no different than a Fixed Trust.

It is therefore submitted that a Beneficiary who receives a distribution of the Insurance Proceeds from the Trustee of a Discretionary Trust should be entitled to an exemption, provided that the Beneficiary is:

- The ***injured person***; or
- A ***relative*** of the injured person.

4.9 Application to Multiple Beneficiaries

Because the exemption to the payment received or deemed to be received by a Taxpayer, it is submitted that it makes no difference to the application of the section whether there is:

- one presently entitled Beneficiary; or
- multiple presently entitled Beneficiaries.

Therefore, it is submitted that the exemption applies and should apply where the individual Beneficiaries are:

- The injured person **and** one or more relatives of the injured person; and
- Two or more relatives of the injured person.

Item 4.1 of the Proposals Paper seems to suggest that the section should be extended to a payment to a Trustee on behalf of an “**individual Beneficiary**’.

It is not clear whether this Proposal is intended to deny the exemption to Trustees where there are multiple Beneficiaries.

However, it is submitted that there is no public policy justification for a differential treatment of single and multiple Beneficiaries.

4.10 Public Policy Arguments

As mentioned above, the section is not drafted in terms of Insurance Policies or Policy Ownership.

It is submitted that there are no public policy reasons why a payment to an individual who is the injured person or a relative of the injured person should depend on the method of ownership of the Policy.

The exemption should be applied at the level of the relevant taxpayer.

As long as the taxpayer is the injured person or a relative, that should be sufficient.

4.10 Application to Trustee

As mentioned above, Item 4.1 of the Proposals Paper suggests that the section should be extended to a payment to a Trustee on behalf of an “individual Beneficiary’.

Not only is it important that the position of each Beneficiary be determined, it is important that the position of the Trustee be determined as well.

Normally, where Beneficiaries are presently entitled to the whole of the Insurance Proceeds, there would be no Insurance Proceeds that would be assessable in the hands of the Trustee in its own right.

This would apply where:

- the Trust was a Fixed Trust; or
- one or More Beneficiaries were presently entitled to the whole of the Insurance Proceeds in the case of a Discretionary Trust.

However, it might not apply in the case of a Discretionary Trust, if there were any Insurance Proceeds to which no Beneficiary was presently entitled.

If the Trustee failed to take action to distribute the Insurance Proceeds to a Beneficiary, it might mean that the Trust itself required the Insurance Proceeds to meet a liability of the Trust.

For example, the Discretionary Trust might wish to repay a Loan from a Bank incurred on behalf of the Trust out of the Insurance Proceeds.

Rather than distribute the Insurance Proceeds to a Beneficiary and borrow them back, it might wish to retain the Insurance Proceeds and repay the Creditor (without incurring a liability under a substitute Loan Account with a Beneficiary).

In this case, the Trust would be using the Insurance Proceeds to meet its own liability.

Thus, under the current drafting, it is arguable that the payment would not have been made to a Beneficiary.

However, in contrast, it is arguable that the payment would be made for the ultimate benefit of one or more Beneficiaries of the Discretionary Trust.

As a result, it is submitted that there are public policy reasons why the exemption should be extended to the Trustee of a Discretionary Family Trust (not just a Fixed Trust).

It might be necessary to limit the exemption to situations where the Benefit was ultimately for the benefit of the Life Insured or a relative.

In other words, it would not be available to a Discretionary Beneficiary who was not the Life Insured or a relative.

4.11 Policies Owned by Trustees of Superannuation Funds

As currently drafted, the section makes no reference to the Trustee of a Superannuation Fund.

In contrast to a non-Superannuation Trust, a Superannuation Fund is an assessable entity.

When a distribution is made by the Trustee to a Member of the Fund, there is a transaction between two different assessable entities.

As a result, the payment of the Insurance Proceeds by the Insurance Company to the Trustee of the Superannuation Fund is not a payment directly or indirectly to the Member.

Therefore, it is submitted that section 118-37 as currently drafted does not extend the exemption to Insurance Proceeds payable to the Trustees of Superannuation Funds.

However, rightly or wrongly, this is not how the law has been administered by the ATO.

To date, the ATO has applied the exemption to the Trustees of Superannuation Funds.

Therefore, one of the purposes of the Proposals Paper is to create an express statutory justification for past ATO practice.

The proposals will be dealt with in the next section of this Paper, because it is proposed that they be implemented by way of an amendment to section 118-300 (rather than section 118-37).

This proposal should not prejudice the application of the existing section to other situations in the manner described above.

4.12 Suggested Wording of Amendment

As mentioned above, the section is not drafted in terms of Insurance Policies or Policy Ownership.

The current section refers to:

“compensation or damages you receive for any wrong, injury or illness you or your relative suffers personally”.

It is submitted that the above public policy goals could be achieved by the following wording:

“your share of any payment that you receive, or a Trustee of a Trust receives on your behalf, as a result of any wrong, injury or illness that you or a relative of yours suffers personally;

“the Trustee’s share of any payment that it receives as a result of any wrong, injury or illness that a beneficiary or a relative of a Beneficiary of the Trust suffers personally”.

5. Section 118-300(1) (Proceeds of Insurance Policies)

5.1 Scope of Section

Unlike section 118-37, section 118-300 expressly concerns the tax treatment of Insurance Proceeds payable under Insurance Policies.

Also, unlike section 118-37, the exemption depends on the ownership of the Policy.

In particular, the relevant exemptions are only available to:

- a taxpayer who is the “original beneficial owner” of the Policy;
- a taxpayer who was not the “original beneficial owner” of the Policy, but did not acquire its interest for any payment or other consideration; or
- the Trustee of a complying Superannuation Fund.

5.2 “Your Interest in Rights under a Policy”

The above summary makes it clear that the section is concerned with the beneficial ownership of a Policy.

However, the prefatory words to the section also indicate that the relevant CGT Asset is not the Policy as a whole, but “your interest in rights” under the Policy.

Thus, the section expressly recognises that there can be multiple interests in the one Policy.

As a result, there can be:

- multiple owners of the one Policy; and
- therefore, multiple “beneficial owners” of the one Policy.

This could apply if a Policy was owned by:

- A Fixed Trust with two or more Beneficiaries;
- A General Law Partnership;
- A Tax Law Partnership;
- A Limited Partnership; or
- Any other form of co-ownership that does not constitute a “Partnership” as defined in section 995(1) of the ITAA 1997.

5.3 Beneficial Ownership

The concept of “beneficial ownership” is a creature of Equity or Trust Law.

It envisages that there might be a distinction between the Legal and the Beneficial Ownership of the Insurance Policy.

Fixed Trusts

In the case of a Fixed Trust:

- The Trustee will be the Legal Owner of the Policy; and
- The Beneficiaries will collectively be the Beneficial Owners of the Policy.

Discretionary Trusts

It is generally accepted that the situation is different in the case of a Discretionary Trust.

A Discretionary Beneficiary does not have any beneficial ownership of an asset of a Trust, at least until the Trustee has made a decision to distribute the asset to the particular Beneficiary.

As a result, pending such a decision, the Legal and Beneficial Ownership is not segregated and remains whole.

In such cases, the Trustee will be the “Beneficial Owner” of the Policy.

In these cases, it is accepted that the Trustee would be entitled to the exemption.

Upon distribution of the Insurance Proceeds to the Beneficiaries of the Trust, they would normally be exempt from Income or Capital Gains Tax in the hands of the Beneficiaries pursuant to section 97(1)(b) of the ITAA 1936.

5.4 How the Existing Section Applies to Insurance Policies Owned by Trusts

One of the Proposals is designed to clarify the situation where a Policy is owned by a Trustee.

It is desirable that this clarification happen.

However, it is important to state that the perceived uncertainty about this issue result from a misinterpretation of the Tax Legislation, even if it is desirable to avoid it.

A Trust is not an assessable entity for tax purposes.

Section 96 provides that, except as provided in the Act, a Trustee is not liable as trustee to pay income tax upon the income of the trust estate.

In general, a Trustee would only be assessable on income to which no Beneficiary of the Trust was presently entitled.

Where there is a presently entitled Beneficiary, that Beneficiary is the relevant taxpayer.

Any exemption applies to the Beneficiary as taxpayer, regardless of whether the Insurance Proceeds have been:

- paid directly to the Beneficiary by the Insurance Company; or

- paid to the Trustee and then distributed by the Trustee to the Beneficiary.

Provided that the Insurance Proceeds have been distributed to the Beneficiary (and not withheld from distribution by the Trustee), then the Trustee cannot be liable to pay income tax with respect to the Insurance Proceeds, because of the operation of section 96.

Thus, if there are no Insurance Proceeds included in the assessable income of the Trustee, there is no need to apply the exemption under section 118-300 to the Trustee.

There is no assessable income upon which the Trustee can incur a tax liability.

Instead, the exemption will apply to the Beneficiaries as “original beneficial owners” of the Policy.

It does not matter that the Insurance Proceeds were previously received by the Trustee (in its capacity as Trustee).

Nevertheless, to the extent that the Proposal is designed to confirm that the payment to the Trustee is not subject to CGT, it is desirable to remove any doubt or uncertainty, as long as there are no inadvertent or incidental changes to the operation of the section.

Absolute Entitlement Trusts

The above analysis applies to a simple Fixed Trust.

The exemption for the Trustee follows from the “present entitlement” of the Beneficiary.

In order to obtain the exemption, it is not necessary to establish that:

- the Policy is owned by an Absolute Entitlement Trust; or
- the Beneficiary is “absolutely entitled” to the Policy (or an interest in rights under a Policy) as against the Trustee within the meaning of section 106-50 of the ITAA 1997.

The exemption follows from the normal application of section 96 of the ITAA 1936.

However, obviously, if the Trust was an Absolute Entitlement Trust, it would obtain an exemption for both the Trustee and the “absolutely entitled” Beneficiary.

5.5 Application to Discretionary Trusts

Where the Trust that holds the Policy is a Fixed Trust, there will be no question that the Beneficiary is presently entitled to the Insurance Proceeds.

However, there could still be an uncertainty where the Trust is a Discretionary Trust.

A Discretionary Beneficiary does not have any beneficial ownership of an asset of a Trust, at least until the Trustee has made a decision to distribute the asset to the particular Beneficiary.

As a result, pending such a decision, the Legal and Beneficial Ownership is not segregated and remains whole.

In such cases, the Trustee will be the “Beneficial Owner” of the Policy.

In these cases, it is submitted that the Trustee would be entitled to the exemption.

Upon distribution of the Insurance Proceeds to the Beneficiaries of the Trust, they would normally be exempt from Income or Capital Gains Tax in the hands of the Beneficiaries pursuant to section 97(1)(b) of the ITAA 1936.

5.6 Proposed Treatment under Amended Legislation

There is some uncertainty about the proposal to amend section 118-300 with respect to Policies held by Trusts.

Treasury Comments on Current Treatment

In the explanation of the current treatment, the Discussions Paper makes the following comment:

“... where the capital gain or capital loss is made by a trustee that holds the policy or instrument on behalf of a beneficiary and is the original owner of the policy or instrument, there is uncertainty over whether the exemption would flow through to the beneficiary.”

This comment seems to deal with the situation where:

- the Trustee is the “original beneficial owner” of the Policy; and
- the Trustee distributes the Insurance Proceeds to a Beneficiary.

Thus, it is concerned with the tax treatment of the Insurance Proceeds in the hands of the **Beneficiary**.

Treasury Comments on Proposed Treatment

In contrast, in the explanation of the proposed treatment, the Discussions Paper makes the following comment:

“The exemption in item 3 in the table in subsection 118 300(1) will be extended to cover capital gains or losses from a policy of insurance on the life of an individual or an annuity instrument held by a trustee (that is not a trustee of a complying superannuation entity) who is the original owner of the policy or instrument.”

This comment appears to be concerned with the tax treatment of the Insurance Proceeds in the hands of the **Trustee**.

IGS Comments

It has been submitted above that, where the Beneficiaries are presently entitled to the whole of the Insurance Proceeds, there will be no Insurance Proceeds that could be assessable in the hands of the Trustee.

However, to the extent that the proposed amendment is intended to remove any doubt, it is a positive initiative to confirm that the Insurance Proceeds would not be assessable in the hands of the Trustee, as long as it is not inferred from the amendment that there was not an exemption under the section prior to its amendment.

Conversely, where the Trustee is the “beneficial owner” of the Policy (e.g., in the case of a Discretionary Trust), the Insurance Proceeds would normally be exempt from Income or Capital Gains Tax in the hands of the Beneficiaries pursuant to section 97(1)(b) of the ITAA 1936.

Nevertheless, it is a positive initiative to confirm that the distribution of the Insurance Proceeds by the Trustee to the Beneficiaries will be exempt.

5.7 Policies Owned by Trustees of Superannuation Funds

As mentioned above, section 118-37 makes no reference to the Trustee of a Superannuation Fund.

As a result, strictly speaking, the payment off a Non-Death Benefit under an Insurance Policy held by the Trustee of a Superannuation Fund would not be exempt under section 118-37.

Item 4.2 of the Proposals Paper proposes to remedy this omission by amending section 118-300 (rather than section 118-37).

If the proposed amendment was made:

- Non-Death Benefits would be exempted under two different sections, depending on the identity of the Policy Owner; and
- Section 118-300 would define an Insurance Policy differently, depending on the identity of the Policy Owner.

5.8 Broader Implications of Proposed Superannuation Fund Amendments

Item 4.2 correctly states that section 118-300 defines the term “policy of insurance on the life of an individual” more narrowly than the same Act defines a “life insurance policy” (which includes a continuous disability policy).

In effect, the proposed amendment:

- preserves the narrow definition of an Insurance Policy for Policy Owners other than Superannuation Funds; and
- adopts a broader definition for Superannuation Funds.

It has to be questioned whether there is any public policy benefit in retaining these anomalies.

Preferred Approach

It is submitted that the better approach would be to:

- adopt the broader definition of “life insurance policy” uniformly across section 118-300;
- make section 118-300 a complete code for the tax treatment of any Proceeds payable under a Life Insurance Policy; and
- allow section 118-37 to apply primarily to compensation and damages payable other than pursuant to Life Insurance Policies.

Clarification of What Benefits are Included in the Definition of “Insurance Policy”

It is important that the definition of a Life Insurance Policy (or whatever term is ultimately used) includes:

- a Death Benefit;
- a Total and Permanent Disablement Benefit;
- a Trauma (or Critical Condition) Benefit; and
- a Terminal Illness Benefit (which is normally treated as a pre-payment of a Death Benefit, as opposed to being treated as a Non-Death Benefit).

5.9 Suggested Wording of Amendment

It is submitted that the amendments should deal with two separate issues:

- the definition of the type of Insurance Policy that is referred to in section 118-300; and
- the identity of the type of taxpayer who is entitled to an exemption.

Definition of “Insurance Policy”

It is submitted that the definition of this term should be amended, so that it is clear that it includes the four Benefits referred to in Item 5.8 above.

Identity of Taxpayer who is Entitled to an Exemption

Section 118-300 currently focuses on “your interest in rights” under an Insurance Policy.

It is submitted that this wording is appropriate and should be retained.

However, when the ownership of the Policy is referred to in the section, it should be clear that the ownership relates to “your interest in the rights” under a Policy.

In other words, there should be no ambiguity or uncertainty with respect to co-ownership of a Policy, either directly or indirectly (e.g., by a Fixed Trust).

Set out below is some suggested wording for the amendments.

It adopts the current framework of the section and the Table within the section.

Thus, it does not attempt to totally redraft the entire section.

Middle Column

It is made clear that the CGT event happens with respect to “your interest in rights under this type of policy”, in conformity with the prefatory words in the section.

Third Column

It is made clear that the ownership applies with respect to “your interest in rights under this type of policy”, in conformity with the prefatory words in the section.

Item 3A

This Item expressly extends the exemption to the “legal owner” of the Policy (in addition to the “beneficial owner” referred to in Item 3).

Item 3B

This Item expressly extends the exemption to a Beneficiary where the Trustee of a Trust is the “beneficial owner”.

Item 4A

This Item expressly extends the exemption to a Beneficiary where the Trustee of a Trust acquired its interest from a previous owner of the rights in the Policy.

Item 5

It is made clear that the ownership of the Superannuation Fund applies with respect to “its interest in rights under this type of policy”, in conformity with the prefatory words in the section.

This removes any doubt that a Superannuation Fund may co-own a Policy with another entity (including another Superannuation Fund).

Insurance policies		
Item	The * CGT event happens to your <u>interest in rights under this type of policy</u> :	... and you are
1	...	...
2	...	...
3	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	the original beneficial owner of your <u>interest in rights under the policy or instrument</u>
3A	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	the original legal owner of your <u>interest in rights under the policy or instrument</u>
3B	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	A beneficiary of a trust, where the trustee of the trust is the original beneficial owner of an <u>interest in rights under the policy or instrument</u>
4	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	an entity that * acquired your <u>interest in rights under the policy or instrument for no consideration</u>
4A	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	A beneficiary of a trust, where the trustee of the trust acquired its <u>interest in rights under the policy or instrument for no consideration</u>

5	A policy of insurance on the life of an <u>individual</u> or an * annuity instrument	the <u>trustee</u> of a * complying superannuation entity for the income year in which the * CGT event happened with respect to its <u>interest</u> in rights under the policy or instrument
6	...	...