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Minor Amendments to the Capital Gains Tax Law (Comments on 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 118-37 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
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