

15 October 2010

Mr Michael D'Ascenzo
Commissioner of Taxation
Australian Taxation Office
GPO Box 9990
Canberra 2601

Dear Mr D'Ascenzo

RE: ATO ID 2010/76 Superannuation benefits: deduction for insurance - increase in the untaxed element

Following the release of the above ATO ID, concerns have been raised about the implications for a not too dissimilar situation that was not covered by the ID.

The purpose of this letter is to:

- seek confirmation from the ATO that Section 307-290 does not apply if there is no insurance at the date of death (and a deduction has not been claimed and will not be claimed under Section 295-470)
- seek reconsideration of the ATO view set out in ID 2010/76 and
- highlight the inequities of the current formula in Section 307-290

The Association of Superannuation Funds of Australia (ASFA) is a non-profit, non-political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. Our membership includes corporate, public sector, industry and retail superannuation funds, and accounts for more than 5.7 million member accounts and over 80% of superannuation savings.

ATO ID 2010/76 addressed the following question:

Does section 307-290 of the *Income Tax Assessment Act 1997* (ITAA 1997) apply to a lump sum superannuation death benefit in relation to which a deduction under sections 295-465 or 295-470 of the ITAA 1997 has not been, and will not be, claimed in the income year in which the benefit is paid but was claimed in an earlier income year?

The question was answered in the affirmative:

Section 307-290 of the ITAA 1997 applies to a lump sum superannuation death benefit where a deduction under sections 295-465 or 295-470 of the ITAA 1997 has been, or is to be, claimed in any income year.

Section 307-290 of the ITAA 1997 sets out the circumstances in which an untaxed element arises.

(1) This section applies to a *superannuation death benefit that is a *superannuation lump sum, in relation to which a deduction has been, or is to be, claimed under section 295-465 or 295-470.

In essence, ATO ID 2010/76 sets out the ATO interpretation of the requirements where the death benefit includes an insured component and the trustee has claimed a tax deduction in a previous year in respect of insurance premiums in respect of the member.

ASFA's concern is with the situation where, although the trustee may have claimed a tax deduction in a previous year in respect of insurance premiums in respect of the member, the insurance cover has ceased and the death benefit does not include an insured component. ASFA considers that in such a case an untaxed element does not (and should not) arise under the current legislation.

Where death benefit no longer includes an insured component

Where there is no insurance cover at the time of death, ASFA considers that any deduction claimed in a previous year (or even in the current year where the cover expired prior to death) is not related in any way to the superannuation death benefit eventually paid.

In such cases, the death benefit is purely an accumulation of contributions with interest (or an entitlement to a defined benefit in a defined benefit fund). If the benefit does not include an insured component it clearly bears no relationship with any current or previous insurance or with any previous deduction. In other words, as the death benefit no longer includes any insured component on which a deduction has been allowed, Section 307-290 has no application and the untaxed element is zero.

ASFA understands that this is a widely, if not universally, accepted view in the industry.

It is also an equitable and logical outcome which we believe is consistent with the original intention of the untaxed element of death benefits when the initial legislation was introduced in 1988. The formula used to calculate the untaxed element (in Section 307-290) is very similar to the formula which applied from 1988 in the Income tax Assessment Act 1936. This formula was originally designed to approximate the amount of insurance included in the member's death benefit. This indicates to us that the original intention of the untaxed element was that it only apply where insurance existed at the time of death.

More detail on this aspect is included in Appendix 1.

Potential outcome

Should the ATO disagree with our view and consider that an untaxed element applies in circumstances where there is no insurance benefit paid, this will place trustees in a quandary (if a deduction has been claimed in an earlier year). Trustees who act in the best interests of members would need to consider advising members for whom insurance has ceased to transfer their benefit to another fund. This, while overcoming the issue, would result in greater inefficiency in the system and a proliferation of multiple accounts.

ASFA understands that many (if not all) funds currently consider that an untaxed element does not need to be determined where there is no insurance in place at the time of death. We also understand that these funds would generally not claim a tax deduction under section 295-470.

Further, we understand that many superannuation funds may not have maintained the records necessary to determine whether a deduction has been claimed in a prior year. For example, a member's insurance cover may have ceased 20 years earlier and records of whether insurance existed and whether a deduction was claimed may not be available. (This situation would be reasonably common in an employer default fund with automatic insurance coverage but with the option to 'opt-out' where members who 'opt-out' generally do so after the cover has commenced but within a short period of joining the fund.) These administrative issues would be further complicated by fund mergers where details of insurance and deductibility prior to merger may be particularly difficult to find.

Should it be necessary for an untaxed element to be determined where a deduction for an insurance premium has been claimed in a previous year (but where there is no insurance cover at the time of death), then such a requirement will encourage funds (at least small funds) to consider claiming a deduction under section 295-470 in respect of any death benefit which becomes payable.

Where death benefit includes an insured component

Our analysis of the case where there is no insurance at the time of death has also raised doubts concerning the ATO's decision in ID 2010/76.

Our analysis also indicates that significant inequities can arise due to the operation of the formula in Section 307-290.

Preferred alternative argument to that in ID 2010/76

The ID considers whether a deduction claimed in a previous year can be taken into account. However it does **not** consider whether any deduction claimed in a previous year was *in relation to the superannuation death benefit* eventually paid. Our concern relates to cases where deductions have been claimed for insurance premiums.

We accept that there is a reasonable argument that Section 307-290 applies if:

- a deduction has been or is being claimed under Section 295-470; or
- if there was insurance at the time of death and a deduction was made in respect of the premium paid for the insurance policy proceeds (i.e. the premium paid in respect of the year of death). Because the payment of death benefits to the ultimate beneficiaries can take several months, the payment can often occur in a year that is different to the year in which the premium is paid (and the deduction claimed). It may also be possible for a premium to be paid in advance and a deduction claimed in an earlier year. Thus it is important that the legislation is flexible enough to allow for deductions claimed in earlier years (in relation to the premium payable in respect of the year of death).

Our major concern with ID 2010/76 is that Section 307-290 only applies if a deduction has been claimed *in relation to the superannuation death benefit*. In reality, the deduction is claimed in respect of the insurance premium – not the superannuation death benefit. We can only accept that there is a relationship where a deduction was claimed for the premium relating to the sum insured that was actually included in the death benefit. (However there is also an argument that Section 307-290 can never apply in relation to insurance premium deductions.)

However deductions for insurance premiums in respect of insurance applicable in a previous year (in which the member did not die) are a different issue.

ASFA considers that any deduction for an insurance premium which provided insurance cover which was not claimed (because the member did not die during the period of cover), cannot be considered to be in relation to the superannuation death benefit that was actually paid (in a later year).

We therefore consider that a better interpretation of the legislation is that Section 307-290 only applies when a deduction has been claimed for the insurance premium which was relevant to the sum insured being paid. It should not apply to deductions for premiums paid in respect of insurance relating to earlier years.

We admit that such an interpretation would enable trustees to avoid creating an untaxed element by not claiming a deduction in respect of the deceased member in the year of death. We believe that this problem should be fixed by legislative change rather than by applying an interpretation of the legislation which is open to challenge.

However, such an interpretation would continue to minimise the risk of a trustee manipulating tax deductions by claiming a deduction in respect of the death benefit (rather than the premium) in the year of death.

Our preferred alternative interpretation would also be consistent with our views in relation to death benefits where there is no insured component.

As stated earlier, ASFA seeks from the ATO:

- confirmation of our interpretation that Section 307-290 does not apply if there is no insurance at the date of death (and a deduction has not been claimed and will not be claimed under Section 295-470)
- reconsideration of its views in relation to the situation set out in ID 2010/76 taking into account the issues raised above. (ASFA consider that deductions relating to premiums for periods prior to the period of death should be ignored.)

ASFA intends to separately highlight to Government the inequities of the current formula in Section 307-290 and encourage amendments which will equate the untaxed element to the amount of the sum insured.

ASFA notes that the determination of the untaxed element is just one example of the huge complexities resulting from the tax applicable to some death benefits. It is ASFA's view that tax on death benefits be removed.

Yours Sincerely

David Graus

General Manager, Policy and Industry Practice

APPENDIX

Inequities in Section 302-290 formula

The concept of untaxed elements was originally introduced in 1988 when contribution tax was introduced. The formula which specified the untaxed element was designed to provide an approximation to the insured amount. It was based on the insurance that would have applied in a standard defined benefit fund (common at that time). It was considered that, as the insurance premiums had been eligible for a tax deduction, any resultant sum insured included in the benefit should be taxed at the rates that applied before the introduction of contribution tax.

This was not inappropriate. Across a large body of members, insurance premiums can be considered to be an approximation to the amount of claims paid in respect of that year (ignoring administrative costs, profit margins and the need to reserve for claims incurred but not yet paid). In other words, if it could be assumed that all death benefits would be taxable, the higher tax on the untaxed element would approximately offset the tax deduction for insurance premiums.

At the time, the formula provided a reasonable estimate of the amount of insurance.

However, since 1988, the industry has changed with the dramatic decline in the number of defined benefit arrangements, the extension of superannuation to almost the whole work force and the greater retention of superannuation on leaving employment due to preservation requirements.

In 2010 the level of insurance applicable in practice is much more flexible and generally bears no relation to the formula in Section 307-290.

This can lead to a very high untaxed element (relative to the insured amount) in cases where there is a very low level of insurance. Conversely there will be examples of very low amounts of untaxed element (relative to the insured amount) where the member has a very high level of insurance.

We consider that this is inequitable and we encourage the ATO to raise this issue with Government with a view to changing the formula in Section 309-290 so that the untaxed element becomes the sum insured where the benefit is insured through a normal insurance only policy. The current formula could remain for the rare cases where endowment assurance or whole of life policies are used and for deductions claimed under Section 295-470.

We note that a similar approximation to the insured amount was made in the formula set out in the Explanatory Memorandum (issued in 1988) relating to the anti-detriment payments on death. We note that the ATO has decided to vary that formula so as to exclude from the calculation the actual amount of insurance included in the death benefit (refer to ATO ID 2007/219 and previously ID 2006/290).

We consider that a similar amendment to the formula in Section 307-290 would be more equitable and is desirable.