

Shifting Geer

Welcome to *Shifting Geer*, Herbert Geer's superannuation and funds management newsletter.

1. APRA AND ASIC UPDATES

1.1 ASIC Class Order [CO 10/1034]: Instalment Warrants

On 25 November 2010, the Australian Securities and Investments Commission (ASIC) registered Class Order CO 10/1034 to declare that an instalment warrant facility that:

- (a) is in a class of financial products that is admitted to quotation on the licensed market operated by ASX Limited;
- (b) is issued by a financial services licensee (the issuer); and
- (c) is a standard margin lending facility,

is not a margin lending facility.

This class order defines an instalment warrant as a financial product where the issuer provides credit to a client to buy one or more marketable securities (including interests in a managed investment product), which the issuer then holds on trust for the client until the client repays the debt incurred, at which time the client then receives full, legal ownership of the marketable security. The definition also requires that the provision of credit is non-recourse.

The Class Order's purpose is to exempt certain types of instalment warrants from certain obligations imposed on margin lenders, in particular new requirements under the Corporations Act 2001 (**Corporations Act**), effective as of 1 January 2011, that require margin lenders to:

- (a) ensure that the margin loan is suitable for the client, and, in particular, ensure that the client can service the margin loan by paying margin calls when due; and

- (b) notify the client of margin calls in a way specified by the *Corporations Act* or notify the client's agent (for example, the client's advisor), where the client has, accordingly, arranged for this.

1.2 ASIC Class Order [CO 10/1219]

On 13 December 2010, ASIC registered Class Order CO 10/1219 for the purposes of facilitating the online delivery of product disclosure statements (PDS), financial services guides (FSG), and supplementary FSGs and statements of advice (SOA).

Currently, a financial services provider must be satisfied on reasonable grounds that the retail client or the client's agent has received the disclosure. This could mean that the provider must have a mechanism to track whether the client has accessed the disclosure on the provider's website. Further, it could be argued that where a provider sends an email to a client with a hyperlink or with a website reference that the disclosure would not have been "sent" to the client because the client would still need to take action to retrieve the disclosure upon receipt of the email.

Under this class order:

- (a) if the retail client or the client's agent agrees, PDSs, FSGs, supplementary FSGs, and SOAs can be made available on a website, maintained by or on behalf of the providing entity, provided that written notification (by paper or email) (**Notice**) to the client or agent is made; and
- (b) the providing entity is not required to satisfy itself that the client or their agent has received the disclosure, subsequent to providing the Notice; however

- (c) a Notice in electronic form informing the client that an SOA is available on a website must not contain a hypertext link to the website (in other words the Notice can only provide the relevant web address, but cannot allow a client to scroll over that address to directly access the website). This requirement is designed to protect clients from potential phishing scams.

Herbert Geer Comment

Financial services providers who wish to take advantage of the class order relief should contact us with respect to implementing any subsequent disclosure strategy.

1.3 **ASIC Regulatory Guide 221: Facilitating online financial services disclosure**

On 13 December 2010, ASIC released Regulatory Guide 221: *Facilitating online financial services disclosure (RG 221)* for the purposes of:

- (a) explaining how ASIC interprets the *Corporations Act* online disclosure provisions;
- (b) describing the relief available under Class Order CO 10/1219; and
- (c) setting out its good practice guidance on online disclosure.

ASIC states that it takes a “technologically neutral approach” to financial services disclosure and does not mandate the online delivery of financial services disclosure.

Online disclosure

RG 221 conveniently lists those disclosures that may be notified or given to a client (subject to the client’s consent) in electronic form as:

- (a) FSGs and SOAs;
- (b) PDSs;
- (c) ongoing disclosure;
- (d) periodic statements;
- (e) annual superannuation information;

- (f) transaction confirmations;
- (g) additional information provided by a superannuation trustee; and
- (h) unsolicited offers to purchase financial products off-market.

Concerns and issues raised by the Regulatory Guide

ASIC warns financial service providers to ensure that any disclosure document can be accessed by a client in the future. There is always the risk that certain web links may expire after a certain period, and financial service providers need to ensure that clients have the ability to save, download or print the disclosure in the future.

ASIC also reminds providers that they need to consider whether industry codes or other legal requirements (eg those under the *Privacy Act 1988* (Cth)) affect how they provide disclosure to clients.

Client consent

RG 221 states the necessity for the provider to ensure that:

- (a) the client or agent has expressly agreed to receive disclosure via the relevant delivery method; and
- (b) the client is clearly aware that if he or she nominates his or her email address that disclosures will be delivered online.

Good practice guidance

Under RG 221, ASIC provides the following good practice guidance:

- (a) disclosure documents should be easy to retrieve and read;
- (b) clients should be able to identify the disclosure;
- (c) providers should use their reasonable efforts to ensure that the client or their agent receives a copy of the disclosure;
- (d) clients should be able to keep a copy so that they can access the disclosure in the future;

- (e) clients should be able to prove which version of the disclosure they relied upon;
- (f) clients should be able to change their mind about receiving disclosures online at any time and at no cost; and
- (g) disclosure documents should be delivered in a way that does not unreasonably expose clients to security risks (eg phishing).

Herbert Geer Comment

The good practice guidance contained in RG 221 reflects requirements arising under the new short-form PDS regime and comments made in the Cooper Review. Superannuation Trustees, especially, will need to ensure that all web-based disclosure, or any instructions to members as how to access web-based disclosure, is clear and efficient from the reader's perspective.

The other issue that financial services providers should consider is what action should be taken if disclosure via email to a client results in a "non-recipient" notification" due to either the client providing an incorrect email address or failing to advise the provider of a change to his or her email address.

1.4 ASIC Regulatory Guide 126: Compensation and insurance arrangements for AFS licensees

On 20 December 2010, ASIC released a new version of Regulatory Guide 126: *Compensation and insurance arrangements for AFS licensees (RG 126)* which supersedes ASIC's previous version, dated 26 October 2009.

Section 912B of the *Corporations Act* requires Australian financial services (AFS) licensees to have arrangements for compensating retail clients for losses suffered as a result of certain breaches by the licensee or its representatives. RG 126 outlines ASIC's approach to administering the compensation requirements and determining whether a licensee's professional indemnity insurance cover (PI Cover) is adequate under the Act.

Adequacy of PI Cover

When determining whether a licensee has adequate PI Cover, ASIC recommends that licensees:

- (a) assess the business, including review the business' risk management plans and claims history;
- (b) assess potential liabilities, including worst loss scenarios, the potential for multiple claims to arise from a single event and the number of claims that might be expected during the policy period;
- (c) approach insurers/brokers to determine key policy features, exclusion sand available extensions;
- (d) assess whether the level of cover is adequate;
- (e) assess whether the scope of cover is adequate;
- (f) review the policy terms and exclusions; and
- (g) assess the estimated financial resources that would be required to meet any excess, gaps, or legal fees.

Features of adequate PI Cover

When determining whether a licensee has adequate PI Cover, ASIC recommends the following minimum requirements:

- (a) amount of cover: a limit of at least \$2 million for any one claim with aggregate cover approximately equal to actual or expected revenue up to a maximum limit of \$20 million;
- (b) scope of cover: the policy must indemnify the licensee against liability for loss or damage suffered by retail clients because of breaches of Chapter 7 of the *Corporations Act*;
- (c) exclusions: the policy must not have the effect of excluding:
 - (i) external dispute resolution (EDR) scheme awards;

- (ii) loss caused by the conduct of the licensee's representatives generally;
 - (iii) fraud and dishonesty by directors, employees and other representatives;
 - (iv) claims for misrepresentations about services;
 - (v) claims arising from incidents that have been notified to ASIC; or
 - (vi) awards by state boards and specialist tribunals for claims against trustee companies in relation to their role as guardians and administrators of estates;
- (d) persons covered: the policy must cover the acts of the licensee and all of its representatives (either under the policy or separately covered by a policy under which the licensee has a right of indemnity);
- (e) automatic reinstatements: the policy must include at least one automatic reinstatement (automatic reinstatement means that if the limit of the policy is exhausted before the end of the policy period, the limit of indemnity is reinstated for the balance of the period to cover any new claims that might arise. This is important, as licensees must ensure their PI Cover is adequate at all times);
- (f) excess/deductibles: the excess should be at a level that the business can confidently sustain as an uninsured loss, taking into account the licensee's financial resources;
- (g) legal costs: defence costs must be in addition to the minimum limit or the level of cover must be sufficiently increased to take into account these costs;
- (h) EDR scheme awards: the policy must cover EDR scheme awards;
- (i) fraud/dishonesty/infidelity: the policy must cover fraud/dishonesty/infidelity by directors, employees and other representatives of the licensee;
- (j) approved product list: the policy must cover legitimate switching cases where a client is being switched from a fund or product that is not on an approved product list to another fund or product that is on an approved product list; and
- (k) retroactive cover: if the licensee had an immediately previous professional indemnity insurance policy, the policy must provide retroactive cover to the earlier of:
 - (i) the retroactive date specified in the immediately previous professional indemnity insurance policy; or
 - (ii) the commencement date of the first professional indemnity insurance policy in the series of continuous policies.

1.5 ASIC Regulatory Guide 219: Non-standard margin lending facilities: Disclosure to investors

In November 2010, ASIC released Regulatory Guide 219: *Non-standard margin lending facilities: Disclosure to investors (RG 219)* setting out ASIC's expectations for improved disclosure by financial service providers to retail clients with respect to non-standard margin lending facilities.

Non-standard margin lending facilities

The *Corporations Act* defines a non-standard margin lending facility as a facility under the terms of which:

- (a) a natural person (**the Client**) transfers one or more marketable securities, or a beneficial interest in one or more marketable securities (**the Transferred Securities**) to the provider; and
- (b) the provider transfers property to the Client (**the Transferred Property**) as consideration or security for the Transferred Securities; and
- (c) the Transferred Property is, or must be, applied wholly or partly to acquire one or more financial products, or a beneficial interest in one or more financial products; and

- (d) the Client has a right, in the circumstances determined under the terms of the facility, to be given marketable securities equivalent to the Transferred Securities; and
- (e) if the facility's current loan to valuation ratio (**LVR**) exceeds a ratio, percentage, proportion or level (however described) determined under the facility's terms, then:
 - (i) the Client becomes required to take action; or
 - (ii) the provider becomes entitled to take action; or
 - (iii) another person becomes required or entitled to take action;

in accordance with the terms of the facility to reduce the facility's current LVR.

The above definition is intended to target those arrangements that are not based on a loan agreement, but instead use a type of securities lending agreement (with variations) to achieve a similar economic outcome as would a standard margin lending facility. This type of structure used by lenders such as Opes Prime Stockbroking Limited and Tricom Equities Limited up until 2008 and was typically marketed as a "margin loan", "equity finance" or "securities finance". The key difference between a standard margin lending facility and a non-standard margin lending facility, from the Client's point of view, is that in a non-standard margin lending facility, title to the transferred securities passes out of the Client's hands.

Requirements under RG 219

According to RG 219, ASIC expects that providers of non-standard margin lending facilities will prominently disclose:

- (a) that they are providing a non-standard margin lending facility, and explain how that differs from a standard margin lending facility;
- (b) the issues covered by the tailored disclosure regime for standard margin lending facilities to the extent relevant to the product to which the PDS relates in a clear and concise way;

- (c) who owns the investment, covering the transfer of securities from the client to the provider and the client's right to repurchase equivalent marketable securities;
- (d) any rights that the client has under the facility;
- (e) what the provider will or may do with the transferred securities, including any arrangements that could increase or decrease the risk to the client that the provider will be unable to fulfil a request for repurchase of the transferred securities;
- (f) the risks associated with the client transferring title to their marketable securities;
- (g) explicitly, a statement of the possible circumstances in which the provider might not fulfil a request to return equivalent securities;
- (h) an explanation of the retail client's exposure to counterparty risk (if relevant). The PDS should also provide sufficient explanation to allow the retail client to evaluate the quality of any hedging engaged in by the provider;
- (i) the risk that the client may be exposed to greater than expected loss if, for example, the value of the transferred securities exceeds the value of the transferred property (ie the cash advanced). This must include a clear warning to the client of their responsibility to monitor the margin in both a rising and falling market, as well as a clear statement of the client's right to request either return of some or all of the transferred securities or payment of an additional amount of transferred property; and
- (j) an explanation of the tax consequences of the transaction together with a stark warning that the client should seek tax advice before entering into the transaction.

Where relevant, ASIC expects that the PDS would draw attention to any other key features or risks that would influence the client's decision to purchase the product. For example, if the

legal structure of the transaction is based on a type of securities lending and/or repurchase agreement, ASIC expects that the key elements of that agreement would be disclosed in the PDS in a clear, concise and effective manner.

1.6 **ASIC Regulatory Guide 98: Licensing: Administrative action against financial services providers**

On 18 November 2010, ASIC released a new version of Regulatory Guide 98: *Licensing: Administrative action against financial services providers (RG 98)* which supersedes ASIC's previous version, dated 5 July 2007.

RG 98 provides guidance as to the administrative powers ASIC use to enforce the financial services laws.

ASIC's administrative powers:

ASIC states that its powers to protect investors include the power to apply a variety of administrative remedies where AFS licensees (and those acting on their behalf) breach their legal obligations. The administrative remedies available to ASIC are:

- (a) suspending or cancelling an AFS licence (with or without a hearing);
- (b) making a temporary or permanent banning order preventing a person from providing all or specified financial services;
- (c) varying or imposing further conditions on an AFS licence;
- (d) directing an AFS licensee to provide ASIC with a statement, which ASIC may require to be audited, containing specified information about the business, activities or services provided by the licensee or its representatives; and
- (e) accepting an enforceable undertaking as an alternative to other remedies, where it is considered appropriate to do so.

ASIC's decision to take administrative action:

ASIC states that when making decisions about whether to take administrative action it will consider whether:

- (a) it detects non-compliance by a licensee or by a person acting on its behalf;
- (b) the non-compliance involves serious corporate wrongdoing;
- (c) an achievable or appropriate remedy exists for ASIC to pursue; or
- (d) it considers action is required to protect investors and deter financial services providers from engaging in misconduct.

ASIC details five key factors in deciding whether to take administrative action as:

- (a) the nature and seriousness of the suspected misconduct, including the scope and nature of the misconduct whether the person had relied on professional advice before engaging in the conduct, and the remedies previously applied by ASIC for comparable types of breaches;
- (b) internal controls, including whether the licensee had effective internal procedures to ensure compliance, and whether those procedures were complied with;
- (c) conduct after the misconduct occurs, including the licensee drawing the misconduct to ASIC's attention and the steps the licensee took to mitigate the breach;
- (d) previous regulatory record, including the licensee's general compliance history; and
- (e) mitigating factors such as whether there would be any personal hardship in the event a banning order was to be made.

2. **LEGISLATION**

2.1 ***Superannuation Legislation Amendment Act 2010***

The *Superannuation Legislation Amendment Act 2010* (Cth) received Royal Assent on 16 November 2010 and commenced on 1 December 2010.

2.2 *Income Tax (Transitional Provisions) Regulations 2010*

The *Income Tax (Transitional Provisions) Regulations 2010* (Cth) (**ITTP Regulations**) were registered on 25 November 2010 in response to the *Superannuation Legislation Amendment Act 2010* (Cth). The ITTP Regulations specify the meaning of a "permanent disability" for the purposes of the transitional relief that enables superannuation funds to deduct certain disability insurance premiums for the 2004 through to 2011 financial years.

Under the ITTP Regulations, a disability is permanent if:

- (a) it is a disability about which a trustee or an insurer requires reasonable medical evidence before a member is eligible for superannuation benefits conditional on the member's disability; and
- (b) it can be described as being any of:
 - (i) a disability that is likely to result in an inability ever to work in any occupation for which the member is reasonably qualified by education, training or experience (or the ability to work but in a substantially reduced capacity);
 - (ii) a disability that is likely to result in an inability ever to work again in the member's own occupation (or the ability to work but in a substantially reduced capacity);
 - (iii) a disability that results in a substantial reduction in the member's capacity to do one or more daily activities (which are defined as activities that the member needs to do to function every day, which includes using a keyboard) without the assistance of another person, an animal or equipment that alleviates the effect of the disability;
 - (iv) in relation to a member who was engaged in home duties - a disability that is likely to result in an inability ever to engage in the majority of those home duties;

(v) a permanent loss of either or both of:

- (A) the member's sight in one or both eyes resulting in the member being legally blind; or
- (B) the use of one or more of the member's limbs, feet or hands;

(vi) a permanent cognitive impairment that results in the need for the member to be continuously supervised by another person; or

(vii) a terminal illness from which the member is expected to die within 12 months of obtaining the requisite medical evidence.

Interaction with a fund's insurance policy

In the event an insurance policy provides further criteria that a member must meet before successfully claiming a benefit in respect of a permanent disability that has substantially the same meaning as under the ITTP Regulations, those further criteria are to be disregarded so that the relevant disability under the insurance policy is taken to be described as a "permanent disability" under the ITTP Regulations.

For example, if an insurance policy provides that for a member to be eligible for a total and permanent disability benefit:

- (a) the member must have been continuously absent from work through illness or injury for the past 6 months (**Periodic Requirement**); and
- (b) the trustee and insurer must form the view that the member has become incapacitated to such an extent as to render the member unlikely to ever again be able to be employed in any gainful employment,

this description of disability would be a permanent disability under the ITTP Regulations because the Periodic Requirement would be disregarded and the wording used to describe the extent of the disability has substantially the same meaning as under the ITTP Regulations.

2.3 **Tax Laws Amendment (2010 Measures No. 5) Bill 2010**

The *Tax Laws Amendment (2010 Measures No. 5) Bill 2010* (Cth) (**Bill**) was introduced into the House of Representatives on 25 November 2010.

Included in the Bill's proposed amendments to tax law is the inclusion of superannuation fund terminal medical condition insurance policies as a deductible expense under section 295-460 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**) to take retrospective effect as of 16 February 2008. Currently funds can claim deductions with respect to death and permanent and temporary incapacity insurance policies, however no deduction is allowable with respect to terminal medical condition insurance policies.

Resumption of debate over the Bill is expected to commence on or around 21 February 2011.

3. **CASES**

3.1 ***Allen (Trustee), in the matter of Allen's Asphalt Staff Superannuation Fund) v Commissioner of Taxation* [2010] FCA 1276**

On 19 November 2010, the Federal Court upheld the Commissioner of Taxation's (**the Commissioner**) decision that a distribution from a related trust to a superannuation fund was "special income".

The applicants were trustees and members of a self managed superannuation fund (**the SMSF**). They were also the principals of another trust (**the Hybrid Trust**) whose discretionary beneficiaries included the trustee of a fixed trust (**the Fixed Trust**). The SMSF had a fixed entitlement to 100% of the Fixed Trust's income, additionally, one of the trustees (**Mr Allen**) was also the sole director of the Fixed Trust and the Hybrid Trust's corporate trustee.

In an undated and unsigned resolution, Mr Allen, as director of the Hybrid Trust's trustee, purportedly resolved an appropriation of income of the Hybrid Trust which included an amount of \$2,500,005 to the Fixed Trust. Additionally, in an undated and unsigned resolution Mr Allen, as director of the Fixed Trust's trustee, purportedly resolved to appropriate the trust income of \$2,500,005 to the SMSF. This amount was distributed to the SMSF in several instalments prior to the end of the 2003 Financial Year.

Subsequent to the lodgement and amendment of the SMSF's 2003 Financial Year income tax return, the Commissioner assessed the SMSF's share of the distribution from the Fixed Trust as "special income" under section 273 of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**) (now known as "non-arms length income" under section 295-550 of the ITAA 1997).

The Court's decision

The Court held that the words "income derived" under section 273(7) of the ITAA 1936 referred to both statutory income and income according to ordinary concepts. In the circumstances, the Court also considered that the SMSF acquired the fixed entitlement to income and subsequently derived the income under an arrangement, where some or all of the parties were not dealing with each other at arm's length.

In the event that the parties had been at arm's length, there was no evidence to support a finding that the arrangement would have occurred at all and that the SMSF would have derived the income. In other words, the amount of relevant income received that the SMSF received was greater than might have been expected had the parties been dealing with each other at arm's length.

3.2 ***Kestel v Superannuation Complaints Tribunal* [2010] FCA 1300**

On 25 November 2010, the Federal Court dismissed an applicant's claim that she had lodged a complaint with the Superannuation Complaints Tribunal (**SCT**) within time.

Upon the death of a superannuation fund member, the fund's trustee decided to pay the death benefit to the deceased member's children on trust. The applicant, who was the deceased member's wife, wrote to the fund via her lawyer (**the Lawyer**) objecting to the trustee's decision. The trustee subsequently replied (**the Trustee's Response**) to the Lawyer's correspondence on 18 March 2010 stating that the trustee affirmed its decision and that, under section 14(3) of the *Superannuation (Resolution of Complaints) Act 1993* (Cth) (**SRC Act**) the Lawyer had 28 days (**the Relevant Period**), from receipt of the Trustee's Response in which to lodge a complaint with the SCT.

The Court found that the Lawyer received the Trustee's Response on 22 March 2010. On 29 March 2010 the Lawyer replied to the trustee

and also wrote to the applicant, advising the trustee that the Lawyer was waiting upon the applicant's instructions and advising the applicant to instruct him to lodge an objection with the SCT.

On 22 April 2010, the Lawyer lodged an objection, via facsimile to the SCT, however the SCT responded on 29 April 2010 that the Relevant Period (which it calculated commenced as of 24 March) had expired the previous day and therefore the SCT had no jurisdiction to hear the objection.

The Court's decision

The Court noted that the Lawyer advised the trustee that he acted for the applicant and that subsequent correspondence was forwarded to and from the Lawyer in his capacity as such on behalf of the applicant. In these circumstances, the Court could only accept that the Lawyer had the authority to receive all communications from the trustee, as the applicant's agent.

The Trustee's Response was considered to be "written notice" under the SRC Act and, accordingly, the Relevant Period commenced from the date the Lawyer, as the applicant's agent, received the Trustee's Response (as opposed to the date the applicant received notice from the Fund, via her Lawyer). Therefore, the objection was lodged outside the Relevant Period.

3.3 **Commissioner of Taxation v Newton [2010] FCA 1440**

On 21 December 2010 the Federal Court upheld the Commissioner's appeal that the Administrative Appeals Tribunal erred in its interpretation of the meaning of section 12(11) of the *Superannuation Guarantee (Administration) Act 1992* (Cth) (**the SG Act**).

The appeal arises from the Administrative Appeals Tribunal (**AAT**) decision of *Natalie Newton (Trading as 'Combined Care for the Elderly') and Commissioner of Taxation [2010] AATA 725*, as reported in our November 2010 issue of *Shifting Geer* (paragraph 3.6). In that decision, the AAT decided that the taxpayer, who operated a business of providing community support services to the disabled, infirm and elderly, paid workers to "do work wholly or principally of a domestic or private nature" in accordance with the first element of section 12(11). Accordingly, the AAT's decision meant that the taxpayer avoided liability for

payment of the Superannuation Guarantee Charge in respect of 21 workers.

The Court's decision

The Commissioner contended that the AAT erred in holding that:

- (a) section 12(11) merely required an examination of the nature of the work carried out by a worker;
- (b) section 12(11) does not require an examination of:
 - (i) the identity of, or any of the attributes of, the person who pays for the work;
 - (ii) the relationship between the payer and the worker; or
 - (iii) the nature of the work or services that the worker provides to the payer; and
- (c) the circumstances that the payer makes the payment to the worker in the course of a business that the payer carries out is irrelevant in determining whether the worker is paid to do work wholly or principally of a domestic or private nature within the meaning of section 12(11).

In reaching its decision, the Court noted the Commissioner's arguments that:

- (a) if the only enquiry is as to whether the work carried out by a worker is of a private or domestic nature, a wide range of persons who would currently be liable for the superannuation guarantee charge would not have that liability, including those who employ staff to clean rooms in strata title retirement villages, boarding schools or hotels or those who employ nurses and carers;
- (b) further, such an enquiry would mean that certain operators would find themselves liable to the superannuation guarantee charge in respect of certain workers, but not others (for example administrative staff of a nursing home would attract the superannuation guarantee charge, but the cleaners and caterers may not);

- (c) there is obvious policy justification that a householder who employs a nanny or a gardener, for example, on a casual or part-time basis should not be required to undergo the complex administrative burden of determining whether the relevant worker is an employee, independent contractor or was providing services in some capacity in which the superannuation guarantee charge may or may not apply; however
- (d) there is the expectation that businesses would be expected to be in a position to comply with their general taxation and superannuation obligations.

The Court held that the language contained in section 12(11) of the SG Act is unclear, and on balance it considered that there was an error of law by the AAT in construing the provision's meaning. Accordingly, the Court remitted the matter to the AAT for reconsideration.

3.4 ***Apostolovski v Total Risk Management [2010] NSWSC 1451***

On 17 December 2010, the New South Wales Supreme Court awarded a superannuation fund member equitable compensation for loss of \$200,000 plus interest of \$89,571.93 on an overdue total and permanent disability (TPD) benefit payment of \$309,600.

The plaintiff was a member of a standard-employer sponsored superannuation fund who made a claim for TPD benefits on 29 November 2005 and, in a timely manner, provided material and evidence as subsequently requested by the fund's trustee in early March 2006.

On 7 August 2006, the plaintiff's lawyers wrote to the fund, referring to previous correspondence and suggested that they had waited a significant period of time for a reasonable response. In doing so, the lawyers also disclosed the fact that the plaintiff was experiencing considerable financial pressure. On 19 August 2006, the matter was then referred to the fund's current insurer which, on 23 October 2006, responded that the plaintiff was not covered because his injuries (occurring in 1994 and 2000) pre-dated the commencement of cover for him (being 1 July 2005). On 7 November 2006, a fund representative wrote to the plaintiff's lawyers informing them that the current insurer was not at risk but that the previous insurer was and that the fund would refer the claim to the previous

insurer; the fund wrote to the previous insurer on 13 November 2006.

It was not until 12 November 2010 (five days before the trial hearing dates) that the trustee accepted the plaintiff's claim for TPD benefits. Accordingly, the plaintiff sought to claim interest on the TPD benefit payment and damages. Due to the trustee's delay, the plaintiff had to rearrange his financial affairs in order to meet certain mortgage repayments and was additionally liable for legal fees in excess of \$60,000 in order to pursue the claim.

The Court's decision

In considering the facts, the Court acknowledged that it could not nominate a finite date by which the fund should have finalised its investigations and obtained the trustee's decision on the claim. However it ruled that, by at least 7 September 2007, the trustee, through its agents, should have come to a decision, and accordingly should have exercised the degree of skill and care as required by section 52(2)(b) of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS). It is worth noting that the plaintiff and his lawyers wrote in excess of 25 letters to the fund from March 2006 through to November 2009, also advising that the plaintiff was in desperate need of monies properly owing to him by the fund.

Accordingly, the Court ruled that the breach of a SIS covenant entitles the person who suffers loss or damage to recover that amount, under section 55(3) of SIS. Further, the Court rejected the trustee's submission that section 310 of SIS, which grants courts the power to relieve superannuation officials from liability in certain circumstances, should apply. The Court noted that section 310 applies to individuals only, and not entities.

The Court awarded the plaintiff \$89,571.93 interest on the overdue TPD benefit payment, calculable from 7 September 2007 and equitable compensation of \$200,000. The effect of the Court's order is that the trustee is liable for the amount of \$289,571.93 as a result of its "gross delay" in honouring the member's claim. This additional amount payable to the member represents 93.5% of the TPD payment he was subsequently entitled to receive.

Herbert Geer Comment

This appears to be the first court decision involving the awarding of equitable

compensation on top of interest for undue delay by a superannuation trustee.

3.5 **Heinrich and Commissioner of Taxation [2011] AATA 16**

On 17 January 2011, the AAT ruled that accrued annual and long service leave entitlements which were paid by an employer as a lump sum do not form part of an employee's salary sacrifice arrangement.

In or around 2005, the applicant entered into a salary sacrifice arrangement with his employer, however this arrangement did not extend to the sacrifice of the applicant's annual and long service leave entitlements. In 2009, the applicant resigned from his employment due to medical reasons and his entitlements to the accrued annual and long service leave were paid out in a lump sum.

The AAT's decision

The AAT considered the scope of sections 83-10 and 83-80 of the ITAA 1997 which governs the taxation assessment of unused annual and long service leave payments. In light of these provisions, the Commissioner contended that:

- (a) a salary sacrifice arrangement cannot apply to benefits that have already accrued. In other words, had the applicant previously agreed that any future annual leave or long service benefits would also be, wholly or partly, sacrificed it would be arguable that these benefits could have been sacrificed, and therefore would not have attracted any taxation liability under the ITAA 1997; and
- (b) once the payments are made, the taxation treatment is fixed.

Accordingly, the AAT found that the applicant had not sacrificed his right to annual and long service leave payments and had received payment of these benefits upon retirement, thereby exposing them to taxation treatment under the ITAA 1997.

3.6 **Superannuation Complaints Tribunal D10-11\047**

On 15 December 2010, the SCT set aside a trustee's decision refusing to compromise a member's claim in relation to loss allegedly

arising from the trustee's actions in treating the member's crystallised defined benefit as invested in the fund's growth investment option between the member's date of retirement and date of rollover of the member's account.

On 12 October 2008 the member was made redundant, and as a result of his redundancy and subsequent retirement satisfying a condition of release, his defined benefit crystallised. The member subsequently informed the trustee that he had retired and proposed to rollover his benefit to another fund. The member was of the understanding that the defined benefit would be held uninvested until rollover and he continued to obtain periodic statements and website information which reassured him that this was the case.

Following the fund's receipt of the final employer contribution late in December 2008 the Member lodged a rollover application which was processed by the trustee on 25 February 2009. It was upon receipt of his rollover benefit statement and exit statement that the member discovered that his defined benefit had been treated by the trustee as held in his existing separate accumulation account with the Fund and invested in the growth investment option between the date of his retirement and the date of rollover. During this period the defined benefit amount was reduced through application of negative investment returns. The member lodged a complaint with the trustee alleging that its action in treating the defined benefit sum as invested in his accumulation account was undertaken without his consent or authority. The trustee rejected the member's request that the negative returns be reversed.

The SCT's decision

The issue arising before the SCT was not the manner in which the member's defined benefit was calculated but the way in which it was treated by the trustee between the date of employment termination and the date of rollover.

Whilst the trustee stated that, after crystallization, a benefit is converted to an accumulation account at the event date (termination) and invested in a member's elected investment option and that process of applying investment earnings based upon the member's investment choice has been consistently applied to all defined benefit members, the SCT noted the following issues:

- (a) there is no evidence that the member was told of such a policy. The fund's PDS provided a summary of the way in which a retirement benefit is calculated with respect to defined benefit members. However, the PDS failed to state that a defined benefit amount will be credited to an existing accumulation account;
- (b) a Member Investment Choice Booklet (**Booklet**) stated that member investment choice only applied to members' accumulation accounts (with respect to those members holding both defined benefit and accumulation interests). Further the Booklet failed to suggest that a crystallised defined benefit entitlement would be credited to an existing accumulation account and, therefore the implication from this was that, in the absence of a specific choice by a member, no funds other than normal accumulation account contributions would be allocated other than to the balanced option. This assumption was supported by statements contained on the fund's website;
- (c) the fund's website continued to reflect the impression that the member's defined benefit amount was intact; and
- (d) the member's defined benefit amount was significantly higher than the existing accumulation account balance so that to presume, without specific authorisation, that the member would make the same investment choice in relation to such a significant sum was not reasonable.

Accordingly, the SCT's view was that the member was entitled to assume, in the absence of his specific authorisation to the contrary, that no investment decision would be made in relation to his defined benefit entitlement.

In response to the trustee's contention that to freeze a defined benefit until finalisation would place the investment risk with other members; the SCT noted that the trustee provided no rationale for such a statement and the SCT could not see how treating a sum to which a member is presently entitled as uninvested pending payment to a member could prejudice other members.

In setting aside the trustee's decision, the SCT substituted its own decision that the trustee compromise the member's claim as follows:

- (a) the trustee was directed to pay to the member an amount representing the difference between the amount of his rollover benefit at 25 February 2009, and the amount which would have constituted his total rollover benefit had his defined benefit component of been retained without investment earnings between crystallisation of the defined benefit on 12 October 2008, and rollover on 25 February 2009; and
- (b) the trustee was further directed to pay an amount representing interest on the additional sum due at the rate which would have accrued on that sum in the member's hands between 25 February 2009 and the date upon which payment is made.

3.7 *Superannuation Complaints Tribunal D10-11036*

On 15 December 2010, the SCT affirmed a trustee's decision to neither backdate a member's pension benefit claim nor to compensate the member for financial loss due to a failure by the trustee to backdate his benefit, despite the member's claim that his application to receive a pension benefit was delayed after relying on incorrect advice from the fund's personnel that his application would be backdated.

The member intended to switch his superannuation interest from the fund's accumulation account to its pension account and to commence his pension the day after he turned 55 years (23 August 2007). However, due to the member's claims that he received incorrect advice received from the fund, thereby delaying the date that he applied to receive a pension income stream, the member was unable to commence a pension income stream until 12 November 2007. On the basis that the member had planned his financial affairs on the purported advice obtained from the fund the member sought compensation for 81 days lost fortnightly pension instalments to the approximate value of \$14,000, plus interest based upon the fund cash rate.

The SCT's decision

The SCT upheld the trustee's decision. It is worth noting that in this matter evidence to support certain disputed facts and contentions, from both sides, was missing or unreliable.

The SCT was sympathetic to the member's situation and found no reason to doubt his version of all the events suggesting that he had received incorrect advice and had relied on that advice. However, the member could not demonstrate that he had incurred any financial loss, especially as his calculated fortnightly pension payments were higher than they would have been had his pension commenced on 23 August 2007.

4. OTHER RECENT DEVELOPMENTS

4.1 *Mid-Year Economic and Fiscal Outlook 2010-11*

The Federal Government has stated in its Mid-Year Economic and Fiscal Outlook for the 2011 financial year that it will allow court orders under State and Territory legislation for the confiscation of the proceeds of crime to apply to superannuation assets. This measure will ensure that superannuation funded directly with the proceeds of crime is recoverable by a court.

The measure was originally reported in the Federal Government's Economic Statement 2010.

4.2 *Investment Manager Regime*

On 19 January 2011, the Federal Government announced amendments to the income tax treatment of investment income of foreign funds, which will make it more likely foreign-based funds will use Australian-based fund managers.

A foreign managed fund broadly has the following features:

- (a) it is not an Australian tax resident;
- (b) it is widely held (and not closely held);
- (c) it undertakes passive investment; and
- (d) it does not carry on or control a trading business in Australia.

The Federal Government proposes to specifically define the meaning of a foreign managed fund.

Under the proposed amendments, income from relevant investments of a foreign fund, that is taken to have a "permanent establishment" in Australia, will be exempt from income tax for the 2011 Financial Year moving forwards. This change will align Australia's taxing rules with international practice, such as the United Kingdom's Investment Manager Exemption.

The amendments address a key finding of the *Australia as a Financial Centre* report (known as the Johnson Report) that the tax law discouraged the use of Australian-based investment advisers. Currently, Australia's taxing rules not only tax the fees earned by the intermediary, but can potentially tax the investment income of the fund even when the investor has no real presence in Australia. This places Australian fund managers at a disadvantage to foreign funds to the extent that engaging a foreign fund manager would result in the investment income of the fund not being taxed.

Amendments where a foreign managed fund has a permanent establishment in Australia

The amendments are designed to address the situation where a foreign managed fund is taken to have a permanent establishment in Australia because of the existence of an Australian intermediary that is a dependent agent, branch or subsidiary of the foreign fund. In this case, potentially all or a part of the investment income (including capital gains) of the foreign fund may become attributable to the permanent establishment and be subject to tax.

Conversely, had the foreign fund engaged a foreign fund manager, no Australian tax would have applied to the investment income of the fund, except to the extent that income was otherwise taxable (for example, because it was sourced in Australia).

Australia will only tax the arm's length fee for services provided by the Australian intermediary.

Relevant investment income

The proposed amendments cover the income, gains and losses arising from the following investments by foreign managed funds:

- (a) portfolio interests in companies (including companies listed on the Australian Securities Exchange), portfolio interests in other entities (including units in a unit trust) and bonds, except to the extent the amount gives rise to a withholding tax liability; and
- (b) financial arrangements (for example, derivatives) and foreign exchange transactions, except to the extent they are in respect of an underlying interest that is otherwise taxable (such as taxable Australian property).

4.3 **Wholesale and Retail Clients Future of Financial Advice Options Paper**

On 24 January 2011, the Federal Government released an options paper (**the Options Paper**) for the purpose of reviewing the distinction between retail and wholesale clients under Chapter 7 of the Corporations Act.

During the recent global financial crisis, it became apparent that many investors categorised as “wholesale clients” under the Corporations Act lacked the relevant experience to invest in the complex financial products that they were able to access on the wholesale market. Accordingly, the Options Paper considers the appropriateness of the distinction between wholesale and retail clients in light of such recent experience and on the basis that the relevant asset value thresholds (\$500,000) used by the Corporations Act to categorise and differentiate retail and wholesale clients have diminished in real terms with inflation. However, the Options Paper will not consider the present distinction between wholesale and retail clients with regard to insurance contracts.

The main motivation for drawing the distinction between retail and wholesale clients was to identify those considered in need of regulatory protection, as well as the desire to allow certain clients to participate in wholesale markets, which tend to trade more complex financial products. As the Options Paper notes, there is not necessarily a positive correlation between the size of an individual’s asset holdings and financial literacy. Accordingly, using wealth as a proxy of financial literacy will not be suitable in every case.

Important considerations identified in the Options Paper

The Options Paper identifies the following as important in reviewing the tests to distinguish wholesale clients from retail clients:

- (a) providing adequate protection and disclosure to clients who need it;
- (b) ensuring that any test takes into account clients’ financial literacy, including their ability to assess the merits, value and risks associated with particular financial products, as well as understanding their own information needs and the adequacy of information provided by the intermediary;
- (c) whether a client is willing and able to pay for professional advice;
- (d) ensuring that the investor is fully aware or informed of their status as a retail or wholesale client;
- (e) encouraging efficiencies in the financial services industry;
- (f) ensuring that any regulation which prohibits or limits access to certain wholesale products is justified;
- (g) ensuring that the test is easy to use, clear and as objective as possible to give industry sufficient certainty;
- (h) ensuring there is some consistency throughout the Corporations Act;
- (i) ensuring that the test will remain relevant with time; and
- (j) considerations of international consistency.

The various options

The Options Paper provides the following four options:

- (a) Option 1: retain and update the current system:

This option provides a number of variants:

- (i) the current threshold under section 761G of the Corporations Act should be updated so that an investor would be classified as a wholesale client if he or she held assets to the value of \$1,000,000;
 - (ii) an indexing mechanism could be introduced to ensure that the three wealth and product value threshold tests under section 761G(7) of the Corporations Act and associated regulations continue to remain relevant over time;
 - (iii) an individual's illiquid assets should be excluded from the net asset wealth threshold test (this would remove investor's primary residences and superannuation assets from any calculations);
 - (iv) the process by which an investor is deemed to be a wholesale client as a result of that investor's assets appreciating in value beyond, or a qualified accountant providing a certificate stating that the client's net assets or gross income equals or exceeds, the relevant threshold should be amended so that an investor must specifically acknowledge instances when they will be classified as a wholesale client and ensure that they understand they will not receive the benefit of protections provided to retail clients;
 - (v) clients must meet at least 2 out of 3 threshold tests, rather than just the one test;
 - (vi) certain complex financial products should, themselves, be subject to certain regulatory or protective requirements, rather than necessarily placing these requirements solely on the investor's own thresholds; and
 - (vii) the sophisticated investor test, under section 761GA of the Corporations Act, could be repealed whilst simultaneously strengthening the wealth threshold tests under section 761G(7), thereby removing the need for a subjective test to determine if investors are classified as wholesale clients;
- (b) Option 2: remove the distinction between wholesale and retail clients :
- This option proposes that all investors (with the exception of professional investors, as defined under the Corporations Act) would receive those protections currently afforded to retail clients. The effect of this option is to ensure consistency and simplicity throughout the Corporations Act by removing often arbitrary distinctions that can be difficult to administer.
- (c) Option 3: introduce a "sophisticated investor" test as the sole way to distinguish between wholesale and retail clients:
- This option recognises that a true measure of financial literacy should be used to most accurately distinguish retail clients from wholesale clients as the distinction based on wealth is arbitrary. Accordingly, it is the level of knowledge and experience one has, rather than the level of wealth, that should determine the level of regulatory protection that should be provided to certain clients under the Corporations Act; and
- (d) Option 4: do nothing:
- This option proposes that the existing tests and thresholds remain.

The Federal Government invites all interested parties to provide comment by 25 February 2011.

**These articles were produced by Herbert Geer.
They are intended to provide general information in summary form on legal issues.
The contents do not constitute legal advice and should not be relied upon as such.**

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