



27 February 2006

Mr Elton Humphrey
Committee Secretary
Senate Community Affairs Legislation Committee
Parliament House
CANBERRA ACT 2600

Dear Mr Humphrey

Ref: Inquiry into Aged Care (Bond Security) Bill 2005, Aged Care (Bond Security Levy) Bill 2005 & Aged Care Amendment (2005 Measures No. 1) Bill 2005

Please find enclosed a submission to your Committee's Inquiry into the above named Bills.

We would be pleased to discuss the submission with you and your Committee should you so wish.

Yours sincerely

A handwritten signature in black ink, appearing to read "Iain Giles", with a horizontal line underneath the name.

IAIN GILES
GENERAL MANAGER – PRODUCTS & DISTRIBUTION

The Selection of Bills Committee referred these Bills after concern about the potential industry liability.

The OFM Investment Group (OFM) supports the Government's policy of strengthening the existing protection of residents' accommodation bonds. To this end, we suggest how this policy can be pursued further with only minor changes to existing rules.

In this submission, we shall:

- Present OFM's experience in the aged care market;
- Show how income bonds can be used to protect accommodation bond balances;
- Outline the benefits of our proposal to residents, aged care providers and Government; &
- Comment on tax implications of existing rules.

OFM's background

OFM has its historical beginnings 26 years ago when the Over 50s Friendly Society was created. OFM continues to specialise in supplying financial solutions to senior Australians, and has over the last 18 months been specifically involved with the aged care industry through

1. The expansion into reverse mortgages. Unlike most in the industry, we lend to fund accommodation bonds for residential aged care thus alleviating the borrower from having to sell their home to enter an aged care facility.
2. The acquisition of a financial planning practice that specialises in the aged care industry. Through this business, we help people plan for the costs of a user-pays aged care system.

Whilst OFM does not directly represent the aged care industry, we are heavily involved in aged care services. In addition to the creation of tailored products for the Industry, OFM, has committed sponsorship dollars to assist the Federal and State chapters of the Aged Care Association Australia Limited. In addition we are the National Sponsor for Total Aged Care Services. These sponsorships are predicated on OFM providing a series of educational seminars and workshops to aged care providers across Australia.

OFM's recommendation – Protect bond balances with 'income bonds'

Under existing rules, aged care providers can voluntarily protect the accommodation bond balances of their residents by investing the monies on behalf of their residents.

In keeping with Government policy, we seek a slight modification to the rules to permit an 'income bond' to hold accommodation bond monies.

An 'income bond' is defined in subsection 995-1(1) of the *Income Tax Assessment Act 1997* as:

- o A *life insurance policy* issued by a *friendly society* under which bonuses are regularly distributed.

An 'income bond' would have the following particular advantages for each party:

1. **Government** would *not* be required to 'step in' to guarantee accommodation bond balances (as the bonds would already be protected from creditors);
2. **Aged care providers** would receive competitive returns on accommodation bond monies (further enhancing the resident care fees and Government subsidies they receive); &
3. **Aged care residents'** accommodation bond balances would be swiftly repaid on death (increasing the benefits to their beneficiaries).

What are 'income bonds'

Income bonds are contracts between an investor (ie the owner(s) of the bond) and the bond's issuer. Technically the contract is a life policy. But unlike a traditional life policy, they have an investment purpose involving regular bonus distributions. These bonuses can be paid out regularly to the bond's owner, or retained within the bond's benefit fund.

As with life policies, there are up to three parties to the contract: the bond owner; the life insured; and, (optional) nominated beneficiaries.

OFM's recommendation on how to structure an income bond

An aged care provider could use accommodation bond monies to take out an income bond on the life of the resident. This bond would be held in trust for the resident, with the resident's estate (or a family member) as the nominated beneficiary.

Parties to the Income bond policy	
Bond owner	Held in trust for the Resident
Life insured	The Resident
Beneficiary	The Resident's Estate or other nominated beneficiaries

Under OFM's suggested arrangement, the aged care provider owns and controls the income bond, holding it in trust for the resident. This means that the bond is not the beneficial property of the aged care provider, and cannot be considered as part of the assets of the aged care provider. However, under the arrangement, it is agreed that the aged care provider becomes (by effective assignment) entitled to all income distributions during the period the income bond is held as an accommodation bond.

It may also be noted that creditors of the aged care provider cannot make a claim against the bond because it is trust property held beneficially for the resident.

Benefits to the resident

OFM's proposal offers residents the certainty that their accommodation bond funds are protected – under arrangements which include prudential and solvency standards in relation to a capital guaranteed option.

When an income bond is structured as we recommend below, it is not an asset of the aged care provider. As such, where a provider is unable to meet its financial commitments, the provider cannot draw on the income bond capital amount monies (as they belong to the resident). Further, the income bond is protected from the creditors of the business as they are not business assets, and are also afforded some protection under the provisions of the *Bankruptcy Act 1966* in relation to a life insurance policy (of which an income bond is but one special type).

Where an aged care provider voluntarily enters into an accommodation bond arrangement using an income bond (which is held for the resident), the Government will not need to step in. Where an income bond is structured as we recommend, the accommodation bond funds are already effectively protected from creditors of the aged care provider.

A further advantage to residents is the relative simplicity in administration and speed in processing death benefits. This is a feature unique to life insurance policies – of which income bonds are but one type. Upon death of the resident holder of an income bond, the proceeds can be quickly paid to nominated beneficiaries outside of any Will (this point is explained further below).

Consequences for the aged care provider

Under the existing aged care rules, all earnings from an accommodation bond can be appropriated by the aged care provider. To streamline this process, an income bond can be structured so that the bonuses can be paid directly to the aged care provider along with the monthly retention amount.

Currently, aged care providers are under no compulsion to keep accommodation bond monies separated from other business assets. While they are required to return the initial capital, less a retention amount, the capital does not have to be held in a secure investment environment. This leaves the aged care providers with a range of options of how to use the money.

OFM believes that the monies (especially to the extent of the principal amount) need to be prudently invested for the benefit of the resident. Therefore, they should be invested to protect the accommodation bond's capital, yet in a way that would generate sufficient income to assist with their costs of care ensuring a benefit both the provider and the resident.

Our suggestion contemplates two investment options that could achieve these aims:

1. A 'capital guaranteed' income bond

This would be invested in money market and fixed interest investments, government bonds and bank backed securities, with the aim of providing a high level of capital security with returns roughly in line with inflation.

2. A 'capital secure' income bond

This would be invested in fixed interest securities which provide a reasonable level of capital security and slightly higher returns.

Below we show how an income bond can contribute to the cost of care. In these examples, the earnings are from an assumed \$100,000 accommodation bond.

For a 'capital guaranteed' income bond:

Earnings @ 3% pa	3,000
Retention amount	<u>3,186</u>
Total 'income'	6,186

For a 'capital secure' income bond:

Earnings @ 6% pa	6,000
Retention amount	<u>3,186</u>
Total 'income'	9,186

These returns are before tax; so where the aged care provider is an exempt taxpayer (eg: a charity), there should be no tax liability.

A comment on the tax consequences of accommodation bonds

We read with interest Bernard Pulle's comments¹ on the potential tax consequences of accommodation bonds.

Mr Pulle argues that an accommodation bond has "some of the hallmarks of a statutory trust arrangement over a deposit paid by the care recipient as a condition for admission to residential care service of an approved provider". Further, that the care recipient was potentially liable for personal income tax on the bond's earnings under "the provisions of the *Income Tax Assessment Act 1936* and of section 19".² And that: "It is doubtful whether the net capital gains on the disposal of investments could be appropriated for the provider."

Mr Pulle has highlighted some potential tax complications for both the resident and the aged care provider. A question may be viewed to arise as to whether income earned on an accommodation bond (held by the aged care provider for the benefit of an aged care resident) reflects a situation of:

- an application of income earned by (and hence assessable to) the resident; or
- income properly alienated to (and hence earned by and assessable to) the aged care provider.

This should not be a problem under our proposal.

¹ Pulle, B., *Proposed Changes to Financing Aged Care – Some Tax and Constitutional Issues*, Parliament of Australia.

² The corresponding sections in the *Income Tax Assessment Act 1997* are 6-5(4) and 6-10(3).

That is because income generated by the bond during the period as income assignment should not be personally taxable in the hands of the aged care resident. Rather, the earnings flow to the aged care provider – by virtue of being the person who becomes legally entitled to the income, and who would then be the relevant taxpayer.

Entitlement to the distribution of income and capital of an 'income bond' can be determined by the relevant 'approved benefit fund' rules of the friendly society (these rules are required to be approved by the Australian Prudential Regulation Authority under the *Life Insurance Act 1995*).

The proposal therefore seeks to resolve some of the technical issues relating to the appropriation and application of income by establishing that:

- an owner of an income bond is normally entitled to all income generated by the bond – except during the period of residence in an aged care facility and where an agreement provides that, in keeping with normal accommodation bond arrangements, income entitlement becomes assigned to the aged care provider; &
- capital remains available for distribution (after the period of residence in an aged care facility) to the income bond owner – or, upon the bond owner's death, to his/her estate or nominated beneficiaries.

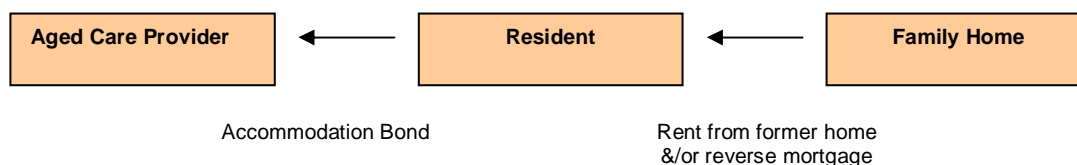
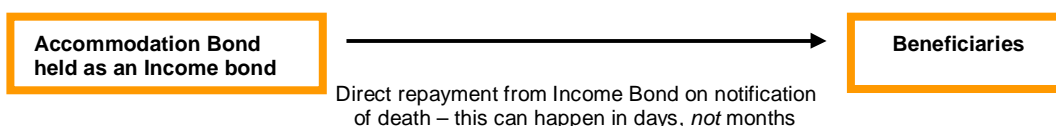
A comment on the proposed changes to the *Aged Care (Amendment No. 1) Bill 2005*

The proposed arrangements would see a major change to the rules about returning accommodation bond balances. Under the proposal, the accommodation bond must be returned within 14 days of the aged care provider being shown probate (or letters of administration) or an interest penalty will be payable.

However, under the alternative arrangement that we propose, the accommodation bond monies (via an income bond structure) will continue to be invested and earn income for the resident's benefit. Further, the balance will be paid out, not on the receipt of probate (which can take months), but on receipt of a certified death certificate. This can save a great deal of time and worry for the beneficiaries of the resident, sidestepping the problems associated with disputed Wills and assisting with costs of the funeral at a normally stressful time.

OFM's proposal will result in a more direct way for accommodation bond monies to be available to a resident's estate or beneficiaries.

Below we compare the current practice with our proposal.

Funding options:**Resident uses the family home to fund accommodation bond****Current Practice:****On death of resident under current policy****Our proposal:****On death of resident under the proposed alternative**

The direct payment of the accommodation bond balance (via an income bond arrangement) to beneficiaries speeds up the process. And where a resident has used a reverse mortgage, it eliminates the time that bond capital is otherwise 'tied up' – and, when applicable, this directly reduces the interest cost to the resident on the reverse mortgage loan balance.

If the Government's aim is to encourage the use of reverse mortgages to meet some of the costs of residential aged care funding, we recommend it considers steps that allow the swift repayment of accommodation bond monies. This is in the interest of residents and their beneficiaries.

Recommendations

OFM recommends the use of income bonds to protect residents' accommodation bond balances. Our proposal offers particularly strong protection of residents' assets and is in line with the policy objectives of the Government.

We applaud the Government's commitment to consumer protection and submit our suggestions for further consideration.

Further Information or Advice

Should the Committee wish to discuss income bonds or the use of reverse mortgages in aged care planning, Benedict Davies, OFM's Technical Services Manager, should be contacted on telephone (03) 9616 6548 or email <mailto:bdavies@ofmig.com.au>