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# Tax Laws Amendment (2008 Measures No. 4) Bill 2008

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Economics Section

## Contents

# Tax Laws Amendment (2008 Measures No. 4) Bill 2008

**Date introduced:** 26 June 2008

**House:** House of Representatives

**Portfolio:** Treasury

**Commencement:** The Act commences on Royal Assent. The commencement and application of the Schedules are dealt with in the Main Provisions section of this Bills Digest.

**Links:** The relevant links to the Bill, Explanatory Memorandum and second reading speech can be accessed via BillsNet, which is at http://www.aph.gov.au/bills/. When Bills have been passed they can be found at ComLaw, which is at http://www.comlaw.gov.au/.

## Purpose

There are three Schedules in the Bill and the purpose of the amendments in each Schedule is briefly set out below.

- Schedule 1 amends the *Income Tax Assessment Act 1936* (ITAA 1936) to make private health insurance policy holders, demutualising private health insurers and certain other entities exempt from capital gains tax (CGT) if they receive shares or cash when their not-for-profit insurer demutualises to a for-profit insurer.
- Schedule 2 amends the *Income Tax Assessment Act 1936* (ITAA 1936) to limit the definition of 'family' by changing lineal descendants to children or grandchildren of the test individual or the test individual's spouse. Schedule 2 also limits the ability for family trusts to make a variation to the test individual other than specifically in relation to the 2007-08 income year or in the case of marriage breakdown.
- Schedule 3 makes a variety of minor amendments to remove such things as incorrect terminology, ambiguities in the law, inoperative material and typographical errors.

## Background

As there is no central theme to the Bill, the background to the various measures and the related main provisions will be considered under the amendments proposed by each Schedule.

## Schedule 1—Demutualisation of private health insurers

### Background

A mutual association, such as a private health insurer, involves the policy holders and members of a fund associating together for the common purpose of meeting expenses arising from specified adverse health conditions. Mutual health insurers are *not for profit* associations. The *Private Health Insurance Act 2007* (PHIA 2007) requires that entities carrying on business of health insurance must be registered with the Private Health Insurance Administration Council (PHIAC).

Demutualisation is the process of converting a *not for profit* mutual or cooperative association into a *for profit* public company insurer. In the context of private health insurers, the interests of policy holders or members would be converted on demutualisation into interests in the shareholdings of the public company. The consequence of demutualisation is that the accumulated surplus of the health insurer is distributed to the participants. Under the PHIA 2007 it is a requirement that on demutualisation the financial benefits must be distributed equitably between policy holders and other persons with interests in the health insurer.

Demutualisation of private health funds has been a growing trend in Australia. NIB demutualised on 1 October 2007, followed by MBF which demutualised on 16 June 2008.[1] The board of AHM is currently in talks with Medibank Private whereby the former would demutualise and be acquired by the latter.[2] The proposed amendments will come into affect from 1 July 2007 so these demutualisations would be covered by the CGT exemption.

Division 9AA of the ITAA 1936 provides that any capital gains and losses that arise on the demutualisation of life insurers and general insurers are disregarded. Schedule 2H to the ITAA 1936 gives similar relief to members of other mutual entities that demutualise. This relief does not extend to policy holders and members of health insurers. The measures in the Bill seek to extend this exemption from capital gains and losses to policy holders and persons with other interests on the demutualisation of private health insurers.

The intent to make policy holders exempt from CGT when private health insurers demutualised was announced by former Treasurer the Hon Peter Costello on 17 October

1. Australian Tax Office, 'Demutualisation of Health Insurers', http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/00109665.htm, accessed on 4 August 2008.

2. N. Ahmed, 'AHM board accepts Medibank bid', *Australian Financial Review*, 15 July 2008, p. 19. http://parlinfoweb.aph.gov.au/piweb/TranslateWIPILink.aspx?Folder=pressclp&Criteria=CITATION_ID:6UZQ6%3B, accessed on 4 August 2008.

2007.[3] After the change of government, the policy was announced by Assistant Treasurer the Hon Chris Bowen on 26 February 2008.[4]

## Position of significant interest groups/press commentary

The changes to CGT in relation to demutualisation of health funds come at a time where consolidation of funds is an increasing occurrence, as reported in *The Age* on 23 July 2008:

> Consolidation of the fragmented $11 billion industry is on the cards, and the changes to the Medicare surcharge announced in last month's budget could hasten the process. Just last week the new face of Bupa Australia was launched after the HBA and Mutual Community owner completed its $2.41-billion buy-out of MBF, and there are whispers of other deals in the pipeline. It's the long tail of the 37 health insurance funds - those specific to a particular region or occupation - that have the bigger players salivating.[5]

When originally announced, the CGT changes were welcomed by the only listed health insurer at the time:

> In an announcement made less than an hour before the government went into caretaker mode yesterday, Treasurer Peter Costello said the government intended to amend income tax laws to "provide certainty" to policyholders.
>
> …
>
> NIB chief executive Mark Fitzgibbon welcomed the announcement. "We believe if a member is giving up a right, he or she should get a cost base equivalent to the value of that share." he said.[6]

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3. P. Costello (former Treasurer), *Demutualisation of Health Insurers*, media release, Melbourne, 17 October 2007. http://parlinfoweb.parl.net/parlinfo/Repository1/Media/pressrel/8BMO60.pdf accessed on 1 August 2008.

4. C. Bowen (Assistant Treasurer), *Demutualisation of Health Insurers*, media release no. 13, Canberra, 26 February 2008. http://parlinfoweb.parl.net/parlinfo/Repository1/Media/pressrel/2JRP60.pdf accessed on 1 August 2008.

5. A. Sharp, '$300m AHM bid sign of health', *The Age*, 23 June 2008, p. 1. http://parlinfoweb.parl.net/parlinfo/Repository1/Media/npaper_4/QPSQ61.pdf, accessed on 4 August 2008.

6. J. Breusch, 'Plan to protect policyholders', *Australian Financial Review*, 18 October 2007, p. 10. http://parlinfoweb.aph.gov.au/piweb/TranslateWIPILink.aspx?Folder=pressclp&Criteria=CITATION_ID:6OMO6%3B, accessed on 4 August 2008.

## Financial implications

*Financial impact*: This measure will have these revenue implications:

| *2007-08* | *2008-09* | *2009-10* | *2010-11* | *2011-12* |
|---|---|---|---|---|
| Nil | Nil | –$2m | –$1m | –$1m |

Source: Explanatory Memorandum to the Bill, page 3.

## Main provisions

**Item 11** of **Schedule 1** inserts Part 3.32 titled – 'Co-operatives and mutual entities' - to the *Income Tax Assessment Act 1997* (ITAA 1997). **Proposed Division 315** of Part 3.32 sets out the taxation consequences of the demutualisation of private health insurers.

**Proposed Subdivision 315-A** provides that policy holders, demutualising health insurers and certain other entities can disregard capital gains and losses arising under a demutualisation.

### Taxation consequences for policy holders

**Proposed section 315-5** provides that a capital gain or capital loss of an individual from a CGT event that happens in relation to a CGT asset be disregarded if:

(a) the CGT event happens under a demutualisation to which this Division applies; and
(b) the individual is, or has been, a policy holder (within the meaning of the *Private Health Insurance Act 2007*) of, or another person insured through the demutualising entity, ie the demutualising health insurer, and
(c) the CGT asset is covered by **proposed section 315-20**.

### CGT assets that are covered by the CGT concession

**Proposed section 315-20** covers the following CGT assets:

(a) an interest in the demutualising health insurer as a policy holder,

(b) a membership interest in the demutualising health insurer,

(c) a right or interest of another kind in the demutualising health insurer, and

(d) a right or interest of another kind that arises under the demutualization.

In the case of CGT assets of a deceased person **proposed section 315-10** extends the CGT concession to a legal personal representative of a policy holder or beneficiary in respect of a health insurance policy.

#### Demutualisations to which proposed Division 315 apply

**Proposed section 315-20** provides that Division 315 applies to the demutualisation of a private health insurer that satisfies the following conditions:

(a) Prior to its demutualisation, the private health insurer was a tax exempt entity by virtue of being a tax exempt private health insurer whose business was for non-profit (**proposed subparagraph 315-15(a)(i)**).
(b) The private health insurer is not registered under Part 3 of the *Life Insurance Act 1995* (**proposed subparagraph 315-15(a)(ii)**).
(c) The private health insurer does not have capital divided into shares.

In addition, the demutualising private health insurance entity must have applied and become registered as a for profit insurer under the PHIA 2007 (**proposed paragraphs 315-15(b)** and **(c)**).

### Taxation consequences for demutualising health insurer

#### Disregard capital gain or loss

**Proposed section 315-25** provides that that the capital gain or loss of an entity from a CGT event be disregarded if:

(a) The CGT event happens under a demutualisation to which Division 315 applies, and
(b) The entity is a demutualising health insurer.

### Taxation consequences for other entities

Other entities established for the purpose of participating in a demutualisation to which Division 315 applies and which are not trusts for lost property holders can also disregard capital gains and losses in certain circumstances (**proposed section 315-30**).

### Cost base of certain shares and rights in private health insurers

**Proposed Subdivision 315-B** deals with the ascertainment of the cost base and acquisition time of demutualisation assets.

#### What are demutualisation assets?

**Proposed section 315-85** defines the type of assets covered by **proposed Subdivision 315-B**. They include:

- a share or a right to acquire a share in the demutualising health insurer (**proposed subparagraphs 315-85(1)(a)(i)** and **(ii) respectively**) , or
- a share in an entity that owns all of the shares in the demutualising health insurer or a right to acquire a share in such an entity insurer (**proposed subparagraphs 315-85(1)(a)(iii)** and **(iv) respectively**).

In addition, **proposed paragraph 315-85(1)(b)** requires that the share or right must be issued under a demutualisation to which **proposed Division 315** applies. Further, such a share or right must be issued in connection with:

- the variation or abrogation of rights attaching to or consisting of a CGT asset covered by **proposed section 315-20** (**proposed subparagraph 315-85(c)(i)**) or
- the conversion, cancellation, extinguishment or redemption of such a CGT asset (**proposed subparagraph 315-85(c)(ii)**).

**Proposed subsection 315-85(2)** excludes a right to acquire a share in an entity if the holder must pay an amount to exercise the right.

**Proposed subsection 315-85(3)** also excludes assets that are not issued simultaneously to an entity that is a participating policy holder or to a trustee of a lost policy holders trust.

A participating policy holder as defined in **proposed section 315-90** is an individual who is or has been a policy holder within the meaning in PHIA 2007 or another person insured through the demutualising health insurer and is entitled under the demutualisation to an allocation of demutualisation assets.

### How is the cost base and time of acquisition of demutualisation assets determined?

The cost base and reduced cost base will be the market value of the asset on the day of issue, and will be taken to have been acquired on that day (**proposed subsections 315-80(1)** and **(2)**).

### Non-CGT or general taxation consequences of the distribution to an entity of a demutualisation asset or cash payment

**Proposed Subdivision 315-F** covers the non-CGT or general taxation consequences ie whether the amounts received by entities on demutualisation will be taxable under the other provisions of the ITAA 1936 or the ITAA 1997. **Proposed subsection 315-310(1)** provides that on a demutualisation when a private health insurer distributes its mutual surplus in the form of a demutualisation asset or a cash payment to an entity, such distributions are 'not assessable and not exempt income' if:

(c) the amount would otherwise be ordinary income or statutory income, or
(d) the amount is paid in connection with:

(i) the variation or abrogation of rights attaching to a CGT asset covered by **proposed section 315-120**, or

(ii) the conversion, cancellation, extinguishment or redemption of such a CGT asset.

The Dictionary definition in subsection 995-1(1) of the ITAA 1997 provides that the expression 'non assessable and non exempt income' has the meaning in section 6-23 of the ITAA 1997. The Australian Taxation Office (ATO) fact sheet on non-assessable non-exempt income (NANE) states:

> Income tax law had always recognised two categories of income – assessable income and exempt income. Amendments to the income tax law have now explicitly recognised a third category of income called 'non-assessable non exempt income' (NANE income).[7]

NANE income is what the law expressly says is neither assessable income nor exempt income as in **proposed subsection 315-310(1)**. NANE income is ignored in working out taxable income and tax losses. NANE income is listed in Subdivision 11-B of the ITAA 1997.

### Application

**Item 12** of **Schedule 1** provides that the amendments made by this Schedule apply in relation to demutualisations occurring on or after 1 July 2007.

## Schedule 2—Family trusts

### Background

Schedule 2F of the *Income Tax Assessment Act 1936* (ITAA 1936) deals with the trust loss measures. Basically, the trust loss measures prevent the transfer of tax benefits on the recoupment of a trust's tax losses to persons who did not bear the economic loss when it was incurred.

Family trusts are considered as 'excepted trusts' for the purposes of the trust loss measures in Schedule 2F. To be eligible to be a family trust the trustee must make a family trust election in respect of an individual (the test individual). When a family trust election is made, distributions can be made to the 'family group' without penalty tax which is currently imposed at the rate of 46.5 per cent.

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7. Australian Taxation Office Fact Sheet on 'Non-assessable non-exempt income' accessed on 26 August 2008 - http://www.ato.gov.au/content/downloads/NANE.pdf.

The Explanatory Memorandum to the Bill at paragraph 2.3 on page 333 states that the changes proposed in the Bill in relation to family trusts was a pre-election commitment of the Government which had been modified subsequently.

> As a pre-election commitment, the Government announced that it would reverse the family trust changes made by the previous government in the *Tax Laws Amendment (2007 Measures No. 4) Act 2007*. However, as some of the amendments introduced in 2007 were largely technical improvements to the trust loss measures, the Government decided not to reverse all of the changes. Instead, only two of the changes will be reversed.

Amendments made in 2007 by the *Tax Laws Amendment (2007 Measures No. 4) Act 2007* (the 2007 amendments) expanded the definition of 'family' to include any lineal descendant of a nephew, niece or grandchild of the test individual. These amendments in the Bill will change the definition of 'family' to limit lineal descendants to children or grandchildren of the test individual or the test individual's spouse.[8]

The 2007 amendments also allowed a one-off variation to the test individual specified in a family trust election. The amendments in the Bill will restrict family trusts from making a one-off variation to the test individual only when there is a marriage breakdown from the 2008-09 income year. However, they will not apply to the 2007-08 income year as announced by the Assistant Treasurer Chris Bowen on 21 July 2008.[9]

### Position of significant interest groups/press commentary

The major criticism of the changes to family trusts has been that they are revoking changes only recently introduced by the Howard government to simplify the system, meaning that people who have changed over will have to revert to their original arrangements.

*The Age* reported on 21 June 2008:

> The Rudd Government has revoked changes made by the Howard government, which allowed the revenue collected by family trusts to be distributed to "lineal descendants". That means, anyone outside the immediate family will have to pay tax of 46.5% on distributions. For those in the know, this is the most controversial change

8. Nephews and nieces still fall within the definition of family but not the children of such nephews and nieces.

9. C. Bowen (Assistant Treasurer), *New tax laws bill introduced*, media release no. 53, 21 July 2008, http://parlinfoweb.aph.gov.au/piweb/TranslateWIPILink.aspx?Folder=pressrel&Criteria=CITATION_ID:B72R6%3B, accessed on 1 August 2008.

> in tax law this year, a change that will affect millions of people who have family trusts attached to small businesses.[10]

Pitcher Partners have been quite vocal about the issue:

> The [former government's] changes followed significant and long standing concerns raised by Pitcher Partners and professional bodies relating to the inequity inherent in the previous provisions and the practical difficulties in complying with them. The representations were not intended to facilitate tax benefits. Rather they were to ameliorate inequities and unfairness flowing out of the provisions. For example it hardly seems fair to effectively preclude trusts distributing to great-grandchildren. Even then it was the view of ourselves and others that the amendments passed through Federal Parliament fell well short of those which were necessary.
>
> …
>
> The practical difficulties that already remain in these provisions are set to be considerably exacerbated, if and when the ALP amendments are implemented.[11]

Originally, there were concerns about the amendments being backdated, as the *Australian Financial Review* reported on 17 May 2008:

> This rule has been backdated to July 1 last year, if budget legislation passes unopposed, so there is no scope to make a quick adjustment to the test person before the above change comes into effect. This also means that people who acted on the basis of the existing law and varied test individuals for the current income year will get a family trust distribution tax liability if they have made distributions outside the family group of the original test individual. Ouch.[12]

However, pressure from industry resulted in changes being exempt for the 2007-08 financial year, as the President of the Taxation Institute of Australia Sue Williamson suggests in the following press release:

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10. V. Burrow, 'Whither wax and wane tax changes?', *The Age*, 21 June 2008, p. 3. http://parlinfoweb.aph.gov.au/piweb/TranslateWIPILink.aspx?Folder=pressclp&Criteria=CITATION_ID:5KSQ6%3B, accessed on 1 August 2008.

11. P. Riley, 'ALP tax policy will have a wide-reaching effect on family trusts', *Contact*, Pitcher Partners, issue 62, 2008, pp. 1-2. http://www.pitcher.com.au/Documents/Publications/Contact%20Magazine%20Issue%2062.pdf, accessed on 1 August 2008.

12. J. Wasiliev & A. Kahler, 'Labor shifts taxation goalposts', *Australian Financial Review*, 17 May 2008, p. 42. http://parlinfoweb.aph.gov.au/piweb/TranslateWIPILink.aspx?Folder=pressclp&Criteria=CITATION_ID:1YGQ6%3B, accessed on 1 August 2008.

> "It is encouraging that the Government moved away from its original intent of introducing retrospective legislation, as many small business people and farmers had acted to the letter of the law regarding Family Trust Elections would have been exposed," Ms Williamson said.
>
> "However we remain disappointed that the Government did not completely rethink its decision in this area and scrap the changes all together."[13]

## Financial impact

This measure will have these revenue implications:

*Financial impact*: This measure has these revenue implications:

| *2008-09* | *2009-10* | *2010-11* | *2011-12* |
|---|---|---|---|
| $1m | $6m | $6m | $6m |

Source: Explanatory Memorandum to the Bill, page 4.

## Main provisions

### Changes to the definition of family in trust loss measures

Subdivision 272-D of Schedule 2F of the ITAA 1936 deals with family trusts. **Item 5** of **Part 2** of **Schedule 2** changes the definition of 'family' in section 272-95 of Schedule 2F of by repealing subsection 272-95(1) and substituting **proposed subsection 272-95(1)** to limit lineal descendants to children or grandchildren of the test individual or the test individual's spouse. This change restores the definition of family for the purposes of the trust loss measures that applied prior to the 2007 amendments.

### Application

**Item 8** of **Part 2** of **Schedule 2** provides that the amendments made by Part 2 apply to assessments for the 2008-09 year of income and later years. This means that the amendments will not be significantly retrospective.

13. S. Williamson, *Taxation Institute welcomes Family Trust decision*, media release, Taxation Institute of Australia, 27 June 2008. http://www.taxinstitute.com.au/go/media-releases/taxation-institute-welcomes-family-trust-decision, accessed on 1 August 2008.

## Changes to the variation of a test individual

Subsection 272-80(5A) of Schedule 2F of the ITAA 1936 deals the variation of a test individual. **Item 1** of **Part 1** of **Schedule 2** amends subsection 272-80(5A) to limit it to the income year 2007-08.

Subsection 272-80(5B) of Schedule 2F will be repealed by **item 2** of **Schedule 2** and substituted by **proposed subsection 272-80(5B)** to provide that a variation under amended subsection 272-80(5A) can only be made once and has no effect in respect of the 2008-09 income year or later income years. It also provides that in respect of the 2008-09 income year and later income years, the individual whose family group is to be taken into account in relation to the election is the individual originally specified in the election.

Subsection 272-80(5C) of Schedule 2F provides that a trustee of a trust may vary an election so that a different individual (the new individual) is specified as the test individual under subsection 272-80(3) if an order, an agreement or an made in relation to a marriage breakdown making the individual in control of the trust.

**Item 3** of **Part 1** of **Schedule 2** alters the definition of specified individual in section 272-140 of Schedule 2F by repealing paragraph 272-140(2)(b) in Schedule 2F and substituting **proposed paragraphs 272-140(2)(b)** and**(c)**. It now refers to:

(b) if the family trust election has been varied under **proposed subsection 272-80(5A)**:

   (i) in respect of the 2007-08 income year – the new individual specified in the variation; or

   (ii) in respect of later income years – the individual originally specified in the election, or

(c) if the family trust election has been varied under section 272-80(5C), because of a marriage breakdown, the person most recently specified under that subsection.

### Application

**Item 4** of **Schedule 2** provides that the amendments made by Part 1 apply to assessments for the 2007-08 year of income and later years.

## Schedule 3—Minor amendments

The Explanatory Memorandum to the Bill at paragraph 3.3 on page 39 states that the minor amendments made in Schedule 3 are part of the Government's commitment to the care and maintenance of the taxation laws. Paragraph 3.4 of the Explanatory Memorandum on page 39 states that these amendments deal with issues such as:

- incorrect terminology,
- grammatical or punctuation errors,

- missing asterisks from defined terms,
- inoperative material,
- ambiguities in the law, and
- adding non-operative notes to help readers navigate their way through the law.

It is not within the scope of this Bills Digest to cover the general amendments to ten tax laws made by **Part 1** of **Schedule 3** and the asterisking amendments made by **Part 2** of **Schedule 3**. The reader is referred to pages 40 to 54 of the Explanatory Memorandum for details of these minor amendments.

## Concluding comments

### Complexity of tax legislation and compliance issues

There has been long debate over time on the complexity of Australia's tax laws. The scope of the minor amendments proposed in Schedule 3 illustrate how incorrect terminology, ambiguities in the law and the difficulty of readers navigating through tax law must add to the compliance burden on taxpayers in a self-assessment regime.

The Explanatory Memorandum to the Bill at paragraph 3.2 on page 39, referring to the context of the minor amendments in Schedule 3, succinctly states how these minor amendments might go a fair way to ease this compliance burden.

> Tax legislation is complex and wide-ranging. Therefore errors can occur. Even minor errors can detract from the readability of the taxation laws and can confuse readers, so these errors need correcting.

In the 2008-09 Budget, the Australian Government announced a comprehensive review of Australia's tax system. The first report released by the Review Panel headed by Ken Henry, the Secretary to the Treasury, entitled "Architecture of Australia's Tax and Transfer System" was released on 6 August 2008. The issue of reducing tax system complexity and compliance costs has been highlighted in the discussion paper.

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