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Tax Laws Amendment (2009 Measures No. 4) Bill 2009

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Contents

Tax Laws Amendment (2009 Measures No. 4) Bill 2009

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Portfolio: Treasury

Commencement: Royal Assent for Schedules 1, 3, 4 and the majority of Schedule 5.

For Parts 1 & 3 of Schedule 2, 1 October 2009.

For Part 2 of Schedule 2, 1 January 2010.

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/.

The amendments made in this Bill cover a number of unrelated matters. Accordingly, each schedule will be treated as separate matter in this particular digest.

Schedule 1 - Research and development

Purpose

Schedule 1 amends the *Income Tax Assessment Act 1936* (ITAA 1936) to increase the limit on research and development (R&D) expenditure for eligibility for the R&D tax offset from $1 million to $2 million.

Background

Policy context

During 2008 the Rudd Government formally reviewed the national innovation system. The report of that review (known as the Cutler Review) recommended that the current tax offset scheme be replaced by a simpler tax credit system.[1]

1. Dr T Cutler, *Venturous Australia – Building strength in innovation*, Canberra, 28 August 2008, p. xiii, and pp. 106 to 107, viewed 14 July 2009, http://www.innovation.gov.au/innovationreview/Documents/NIS_review_Web3.pdf

In the 2009–2010 Budget, the Government announced that it will replace the existing R&D Tax Concession with a simplified R&D Tax Credit (offset) starting from the 2010–2011 year.[2] This new tax credit will not be refundable, as the existing tax offset is.

As a transitional measure for 2009–2010, the R&D expenditure limit for the existing R&D Tax Offset will be increased from $1 to $2 million. The Government has stated that this limit will not apply from the 2010–2011 year; however no 'sunset' clause is in this Bill.[3] This transitional measure is the subject of this particular amendment.

What is the R&D tax offset?

Certain small companies can choose to claim a refundable tax offset instead of an R&D deduction. The choice must be made in the company's tax return for the year or by written notice to the Commissioner within the normal time for the amendment of tax assessments.

Companies with an annual R&D group turnover of less than $5m who spend between $20 000 and $1m a year on R&D are eligible to claim this offset.[4] Companies in a tax loss situation will derive an immediate benefit from claiming the tax offset, whereas a deduction would have to be carried forward to later years.[5]

What is a refundable tax offset?

Where a tax offset is subject to the refundable tax offset rules, the amount by which it exceeds the amount of a relevant income tax liability may be refunded to the taxpayer.

Why undertake this transitional measure?

In his secondreading speech the Minister Assisting the Finance Minister on Deregulation, Craig Emerson MP, noted that:

> One of the requirements for the R&D tax offset is that the company has no more than $1 million of eligible R&D expenditure, subject to grouping rules. If the company's expenditure exceeds $1 million, they are not eligible to claim the offset. The $1 million cap means that some companies keep their expenditure below this level in

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2. W Swan MP, Treasurer and Senator K Carr, Minister for Innovation, Industry, Science and Research, *R&D tax credit to boost business investment*, media release, No. 62, Canberra, 12 May 2009, viewed 14 July 2009 http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/062.htm&pageID=003&min=wms&Year=&DocType=0

3. Australian Tax Office, 'Research and Development Tax Credit (Offset)', *Information Sheet*, viewed 14 July 2009 http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/00193778.htm

4. The term 'annual R&D group turnover' is defined in section 73K ITAA 1936.

5. *2009 CCH Australian Master Tax Guide*, Topic 20-215 - R&D tax offset for small companies.

order to claim the R&D tax offset—a perverse outcome, given that the purpose of the tax concession is to encourage R&D.

This measure lifts the expenditure cap from $1 million to $2 million. This will provide a further boost to small pre-profit companies in research intensive industries, ahead of the introduction of the new R&D tax incentive in 2010-11. It also mitigates the incentive for firms to keep their R&D spending below the current expenditure cap.[6]

Basis of policy commitment

This measure was announced jointly by the Treasurer and the Minister for Innovation, Industry, Science and Research on 12 May 2009.[7]

Position of significant interest groups/press commentary

The Australian Computer Society had called for the $1 million threshold for the current R&D tax offset to be doubled.[8] This position was also taken by AusBiotech, a body representing Australian Bio-Technology companies.[9] No doubt these organisations would support this particular amendment.

Press reporting has ignored this particular amendment, though it has been critical of the proposed changes for 2010–2011for not being exactly in line with the recommendations of the Cutler Review.[10]

Coalition/Greens/Family First/Independents policy position/commitments

The Opposition and minor parties have not addressed this particular issue as at the date of writing.

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6. C Emerson MP, Minister Assisting the Finance Minister on Deregulation, 'Second reading speech: Tax Laws Amendment (2009 Measures No. 4) Bill 2009', House of Representatives, *Debates*, 15 June 2009, p. 7.

7. W Swan MP, Treasurer and Senator K Carr, Minister for Innovation, Industry, Science and Research, *R&D tax credit to boost business investment*, media release, No 62, Canberra, 12 May 2009, viewed 14 July 2009 http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/062.htm&pageID=003&min=wms&Year=&DocType=0

8. 'Double R&D tax offset threshold, ACS', *Electronics News*, 19 June 2009, viewed 14 July 2009, http://www.electronicsnews.com.au/Article/Double-R-D-tax-offset-threshold-ACS/174332.aspx

9. AusBiotech, *Federal Budget 2008-09*, media release, 7 May 2008, viewed 14 July 2009 http://www.ausbiotech.org/data/downloads/May%207%20-%20Budget%202008-09.pdf .

10. M Skulley, 'Research tax break for small firms', *Australian Financial Review*, Budget Supplement, 13 May 2009, p. 11.

Financial implications

The following table sets out the financial implications of the proposed measure.

Table 1: Financial implications of increased expenditure limit for R&D Tax Offset

Year	2008-09	2009-10	2010-11	2011-12	2012-13
Impact $m	nil	-120	55	nil	nil

Source: Explanatory Memorandum[11]

Main provisions

Item 1 amends paragraph 73J(1)(c) of the ITAA 1936 so that the expenditure limit for accessing the current R&D tax offset is raised from $1m to $2m per annum.

Item 2 applies this amendment for the 2009–2010 tax year and later years.

Schedule 2 - Private ancillary funds

Purpose

The proposed amendments in **Schedule 2** to this Bill amend the:

- ITAA 1936
- *Income Tax Assessment Act 1997* (ITAA 1997), and
- *Taxation Administration Act 1953* (TAA 1953)

to improve the administrative integrity of 'prescribed private funds' by:

- concentrating administration and decision making in the Australian Taxation Office, and
- renaming them, for administrative purposes as 'private ancillary funds'.

11. W Swan MP, Treasurer, Explanatory Memorandum, Tax Laws Amendment (2009 Measures No. 4) Bill 2009, 25 June 2009 (hereafter Explanatory Memorandum), p. 3.

Background

What is a prescribed private fund?

As explained by the Australian Taxation Office a 'prescribed private fund' is a trust to which businesses, families and individuals can make tax deductible donations. Such funds may make distributions only to other deductible gift recipients for taxation purposes that have been either endorsed by the Australian Taxation Office or are listed by name in the income tax law.[12] Donations to such funds are tax deductible.

The term 'prescribed private fund' is defined in subsection 995-1(1) of the ITAA 1997 to be a fund that is prescribed by the Income Tax Assessment Regulations 1997 for the purposes of this definition, other than a fund declared by the Treasurer in writing not to be a prescribed private fund.

These vehicles were set up as part of the then Government's response to the report on philanthropy in Australia by the Business and Community Partnerships Working Group on Taxation Reform dated 26 March 1999.[13]

As at 2 December 2008 there were 775 prescribed private funds listed in Schedule 3 of the Income Tax Assessment Regulations 1997. One estimate suggests that there are currently about 800 prescribed private funds with total contributions of $1.2 billion.[14]

A deductible gift recipient (DGR) is defined in section 30-227 of the ITAA 1997 as:

- an entity that is described in section 30-15 of the ITAA 1997
- mentioned by specific name in Subdivisions 30-BA or 30-B of the ITAA 1997 as a DGR
- endorsed as a DGR by the Commissioner for Taxation, or
- a prescribed private fund.

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12. Australian Taxation Office, 'Prescribed Private Funds – An Overview', *webpage*, viewed 14 July 2009 http://www.ato.gov.au/nonprofit/content.asp?doc=/content/8724.htm
13. Australian Taxation Office, *Guidelines for Prescribed Private Funds*, Issued May 2004, Attachment to above webpage.
14. Ernst and Young, Submission - Exposure Draft – improving the integrity of Prescribed Private Funds (PPFs) – Concerns about joint and several penalty liability, Sydney, 27 May 2009, p. 1, viewed 15 July 2009, http://www.treasury.gov.au/documents/1554/PDF/Ernst_and_Young.pdf

Current administrative procedures and problems

Under current arrangements the Governor-General is formally responsible for legally classifying a charitable trust as a prescribed private fund. The Treasurer is responsible for removing a trust or foundation from the list of prescribed private funds. The guidelines used to make these decisions are not binding, but they do form the basis on which most decisions about prescribing a trust are made. The only penalty available is the complete removal of an offending fund from the list of prescribed private funds with the subsequent loss of tax concessional status.[15] This is an 'all or nothing' penalty and may impose a sanction on an innocent donor. These guidelines are not subject to Parliamentary review. Further, the trustees of these vehicles may be either a corporate trustee or an individual and this is not considered desirable for constitutional reasons.[16]

Further, prescribed private funds have minimal reporting requirements and very little is known about their operation. A strong argument can be made that this particular sector's operations should be transparent. Apparently, similar organisations in the United States are required to publicly report on their activities.[17]

By any measure the tax administration of prescribed private funds is fragmented, and for what should be a set of routine decisions, formal responsibility appears to be set at too high a level (i.e. the Governor-General and the Treasurer). The penalties that may be incurred by offending funds are too severe, especially where an unintended breach of the law occurs. The loss of tax exempt status may also impose a tax penalty on a donor who makes a contribution to a fund that loses its tax exempt status at the wrong time.

Policy development

The Government released a discussion paper on improving the integrity of prescribed private funds in November 2008.[18] One hundred and thirty eight submissions were received in response to this paper.[19]

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15. A prescribed private fund may fail to comply with rules about the limits on the accumulation of trust funds or where the trust is not used for its intended purpose).

16. Explanatory Memorandum, pp. 14-15.

17. E Cham (immediate past National Director of Philanthropy Australia), 'The gift goes into a black hole', *Australian Financial Review*, 20 December 2008, p. 32.

18. C Bowen MP, then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, *Improving the integrity of prescribed private funds – consultation paper released*, media release, no. 101, Canberra, 26 November 2008, viewed 13 July 2009, http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/101.htm&pageID=003&min=ceb&Year=&DocType= and Australian Government, Treasury, 'Improving the Integrity of Prescribed Private Funds', *Discussion Paper*, viewed 13 July 2009 http://www.treasury.gov.au/documents/1444/PDF/Prescribed_Private_Funds.pdf

On 14 May 2009, the Government released an exposure draft of the proposed amendments and received 14 submissions in response.[20] The proposed amendments in this Schedule are based on this exposure draft.

At the same time this Bill was introduced (25 June 2009), the Government released draft guidelines for Private Ancillary Fund Guidelines (as prescribed private funds will be known should these amendments pass through Parliament) and has invited comment on them.[21]

Basis of policy commitment

The proposed amendments were announced in the 2008–2009 Budget by the Treasurer.[22]

Position of significant interest groups/press commentary

Responses to the exposure draft legislation mentioned above generally supported the overhaul of the regulatory arrangements applying to prescribed private funds. Further, these submissions endorsed the move to establish a single regulator of these bodies, though there was less agreement on whether this regulator should be the Commissioner for Taxation.[23] There was, of course, substantial technical comment on the provisions of the exposure draft legislation.

The initial proposals for the enhanced regulation of prescribed private funds caused some concern, particularly a proposal to require such funds to distribute 15 per cent of their assets annually. If this particular proposal had gone ahead most prescribed private funds

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19. Explanatory Memorandum, p. 13.

20. Australian Government, Treasury, 'Exposure Draft – Improving the Integrity of Prescribed Private Funds', *Webpage*, viewed 15 July 2009 http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1541 and Explanatory Memorandum, p. 13.

21. Australian Government, Treasury, 'Draft Private Ancillary Fund Guidelines', *Webpage*, viewed 15 July 2009, http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1568

22. W Swan MP, Treasurer, *Improving the Integrity of Prescribed Private Funds*, media release, No 52, Canberra, 13 May 2008, viewed 14 July 2009, http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/052.htm&pageID=003&min=wms&Year=2008&DocType=0

23. Submissions on the exposure draft legislation released 14 May 2009 by the Taxation Institute of Australia, Trustee Corporations Association of Australia, Philanthropy Australia, Australasia Compliance Institute, Goldman Sachs JBWere, Perpetual Trustees Limited and the Myer Family Office, viewed 15 July 2009, http://www.treasury.gov.au/contentitem.asp?ContentID=1554&NavID=037

would have had to cease operations in the near future through lack of funds.[24] However, this aspect of the proposed changes has been revised in the current proposals, much to the relief of operators of these funds.[25] Though this change is welcome, there are other outstanding technical issues still to be resolved.

Pros and cons

The proposed amendments would resolve many of the administrative difficulties noted above.

While the proposed changes and the draft guidelines require private ancillary funds to provide a greater range of information to the Commissioner for Taxation than presently required, there is no requirement for this information to be publicly available. Thus, the above mentioned transparency issue remains unresolved.

Coalition/Greens/Family First/Independents policy position/commitments

To date, little if any, comment on these proposed amendments has been made by either the Opposition or other political parties.

Financial implications

As the proposed changes are largely administrative in nature there are no financial implications arising from the proposed amendments in this schedule.

Main provisions

Part 1 - Amendments commencing 1 October 2009

Item 2 inserts references to 'private ancillary fund' into the ITAA 1936.

Item 3 amends section 16 of the ITAA 1936 to enable Australian Taxation Office staff to give information to State and Territory Attorneys-General on the non-compliance of private ancillary funds with Commonwealth, State or Territory laws. Similar amendments are made to section 3C of the TAA 1953 by **item 17**.

Item 4 amends subsection 30-15(2) of the ITAA 1997 so that contributions to 'private ancillary funds' (being the new way of referring to 'prescribed private funds') are tax deductible.

24. J Kehoe, 'Tax change plan worries charities', *Australian Financial Review*, 22 January 2009, p. 6. This is one of many articles from different journalists and media organisations expressing these concerns.

25. F Anderson, 'Charity tax rules revised', *Australian Financial Review*, 26 June 2009, p. 15.

Item 7 repeals existing subsection 30-125(1) ITAA 1997 and replaces it with new text so that any fund that meets the definition of a 'private ancillary fund' (see **item 13** below) is entitled to be endorsed as a DGR for taxation purposes.

Item 9 inserts **new subsection 30-229(2A)** into the ITAA 1997 with the effect that a private ancillary fund's entry in the Australian Business Register *may* show that it is a DGR. This requirement extends only up to 1 January 2010 (see **Part 2** following).

Item 13 repeals the current definition of a 'prescribed private fund' in subsection 995-1(1) of the ITAA 1997 while **item 14** defines the term 'private ancillary fund' in this subsection by reference to section 426-105 in Schedule 1 to the TAA 1953 (see **item 22** following).

Item 22 inserts **new subdivision 426-D** into Schedule 1 to the TAA 1953. This new subdivision contains the administrative provisions relating to private ancillary funds.

As noted above **proposed section 426-105** of Schedule 1 to the TAA 1953 defines what a 'private ancillary fund' is. Of particular note is the requirement that the trustee of these funds must be a constitutional corporation. The Explanatory Memorandum suggests this is necessary to impose this requirement to:

- provide the sole regulator of these funds, the Commissioner for Taxation, with the necessary powers to undertake this role, and
- to impose upon the trustees the behavioural standards required of company directors under the *Corporations Act 2001*.[26]

Several comments on the exposure draft legislation noted above disputed that this requirement was necessary and it remains a point of contention between some trustees of such funds and the Government.[27]

Another requirement of this new section is that each trustee of a private ancillary fund must agree to comply with the private ancillary fund guidelines as in force from time to time. This makes these guidelines binding on the trustees of such funds. **New section 426-110** of Schedule 1 to the TAA 1953 requires the relevant Minister to formulate these guidelines by legislative instrument, which means that they would be subject to

26. Explanatory Memorandum, p. 16.

27. For example, see Perpetual Trustees, *Submission: Exposure Draft – Tax Laws Amendment (Prescribed Private Funds) Bill 2009*, 28 May 2009, p. 2, viewed 15 July 2009, http://www.treasury.gov.au/documents/1554/PDF/Perpetual_Trustees.pdf

Parliamentary disallowance procedures in the *Legislative Instruments Act 2003*. As noted above, a draft of these guidelines is currently available.[28]

New section 426-115 of Schedule 1 to the TAA 1953 notes that if a private ancillary fund has an Australian Business Number, it *may* be noted as such a fund in the Australian Business Register. This requirement lasts until 1 January 2010 (see **item 24** below).

Note: the proposed section heading does not match the text of the section ('must' not 'may').

New section 426-120 allows for the imposition of administrative penalties on trustees of private ancillary fund, or the directors of a corporation that is a trustee of the fund. The penalty may apply if a trustee 'holds out' that the fund is endorsed, or entitled to be endorsed as DGR for tax purposes, when is not so endorsed or entitled.

Such persons are jointly and severally liable for a penalty – that is, there are potentially liable even if another trustee was responsible for the incorrect 'holding out' regarding the funds DGR status. Directors can available themselves of a defence of reasonableness – see **new subsection 426-120(5).** A penalty imposed cannot be reimbursed by the fund: **new subsection 426-120(4).**

The Commissioner for Taxation will be able to suspend or remove trustees of private ancillary funds if they breach the abovementioned guidelines or any other Australian law under **new section 426-125** of Schedule 1 to the TAA 1953. Under **new section 426-130** of that Schedule, the Commissioner may appoint an acting trustee in these circumstances.

Other new provisions of this **Schedule 2** to the Bill allow the Commissioner for Taxation to:

- determine the terms and conditions of the appointment of an acting trustee
- terminate the appointment of an acting trustee at any time
- vest the property of the fund in the acting trustee, and
- give directions to the acting trustee.[29]

These may be seen as conferring extremely wide powers over the property of a private ancillary fund on an acting trustee.

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28. Australian Government, Treasury, 'Draft Private Ancillary Fund Guidelines', *Webpage,* viewed 15 July 2009, http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1568

29. Proposed sections **426-125**, **426-135**, **426-140**, **426-150** and **426-160** ITAA 1997.

Part 2 - Amendments commencing on 1 January 2010

Item 23 amends **new subsection 30-229(2A)** (see **item 9** above) so that, from 1 January 2010, an entry for a private ancillary fund in the Australian Business Register must show that it is a DGR. Until that date, it is not mandatory for the register to show this information.

Item 24 amends **new subsection 426-115(1)** of Schedule 1 to the TAA 1953 from 1 January 2010 so that an entry for an entity that has an Australian Business Number in the Australian Business Register must show whether the entity is a private ancillary fund (see **item 22** above).

No doubt the provisions in **items 9**, **22**, **23** and **24** allow time for the Australian Business Register to be amended as required.

Schedule 3 - Demutualisation of friendly society health insurers, or friendly society life insurers

Purpose

Schedule 3 amends the ITAA 1936, the ITAA 1997 and the *Income Tax (Transitional Provisions) Act 1997* (Transitional Act 1997) to provide relief from Capital Gains Tax (CGT) where friendly society health, or friendly society life, insurance entities (that is mutual or cooperative associations) demutualise to become a 'for-profit' entity (i.e. a public company).

Background

What is demutualisation?

Demutualisation is the process of changing a mutual or cooperative association into a public company by converting the interests of members into shareholdings, which can then be traded through a stock exchange. Examples of mutuals in Australia are building societies, credit unions, friendly societies and some large insurance institutions. A prominent example of demutualisation in Australia was the conversion of the Australian Mutual Provident Society into AMP Limited in January 1998.[30]

It is normally argued that a mutual or cooperative structure limits their activities to servicing their members and inhibits their ability to pursue profits and diversification as

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30. For further background on demutualisation see Reserve Bank of Australia, 'Demutalisation in Australia', Reserve Bank of Australia Bulletin, January 1999, viewed 28 July 2009, http://www.rba.gov.au/PublicationsAndResearch/Bulletin/bu_jan99/bu_0199_1.pdf

freely as companies.[31] In effect this process involves the participants in the mutual association giving up the right to benefit in the future from any accumulated mutual surplus in exchange for tradable share of the capital of the new entity.[32]

How many mutuals are there?

There are currently about 70 friendly societies operating in Australia with about 1.6 million members. About 24 friendly societies conduct life insurance business (either solely or in conjunction with other businesses), but only one of these societies was proposing to demutualise as at December 2008. There are about 5 friendly societies that conduct health insurance business (either solely or in conjunction with other businesses), only one of which was proposing to demutualise as at December 2008.[33]

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.[34] The large friendly society, Manchester Unity, was undergoing demutualisation as at December 2008.[35] It is not clear whether this particular demutualisation is currently proceeding, particularly in the light of Manchester Unity's recent merger with health insurer, HCF.[36]

What is a 'friendly society'?

For taxation purposes a 'friendly society' is defined in subsection 955-1(1) of the ITAA 1997 as:

(a) a body that is a friendly society for the purposes of the *Life Insurance Act 1995*; or

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31. E Carew, *The Language of Money 3*, Sydney, 1996, viewed 16 July 2009, http://www.anz.com/edna/dictionary.asp?action=content&content=demutualisation

32. Explanatory Memorandum, p. 27.

33. Friendly Societies of Australia, *Submissions on discussion paper demutualisation of friendly societies and capital gains tax*, 4 December 2008, pp. 2-3, viewed 16 July 2009, http://www.treasury.gov.au/documents/1455/PDF/Friendly_Societies_of_Australia.pdf

34. Australian Tax Office, 'Demutualisation of Health Insurers', *Fact Sheet*, Viewed 16 July 2009, http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/00109665.htm

35. PriceWaterhouse Coopers, *Demutualisation of friendly societies and capital gains tax* (submission to Treasury), 5 December 2008, p.1, viewed 16 July 2009, http://www.treasury.gov.au/documents/1455/PDF/PriceWaterhouseCoopers.pdf

36. HCF and Manchester Unity, *Manchester Unity members vote to approve merger with HCF*, joint media release, 15 December 2008, viewed 21 July 2009, http://www.manchesterunity.com.au/Site/uploadedfiles/MEDIA%20RELEASE_MU%20members%20approve%20merger_15Dec08.pdf

(b) a body that is registered or incorporated as a friendly society under a State law or a Territory law; or

(c) a body that is permitted, by a State law or a Territory law, to assume or use the expression *friendly society*; or

(d) a body that, immediately before the date that is the transfer date for the purposes of the *Financial Sector Reform (Amendments and Transitional Provisions) Act (No. 1) 1999* (see section 3 of this Act for the various transfer dates), was registered or incorporated as a friendly society under a State law or a Territory law.

How are the proceeds of a demutualisation currently taxed?

The Explanatory Memorandum notes that Division 9AA of the ITAA 1936 allows for capital gains or losses that arise from this transaction to be disregarded for members and policy holders of both life and general insurance entities. Division 315 of the ITAA 1997 has a similar impact in respect of members and policy holders of private health insurers.[37]

Technically, the capital gains tax relief in Division 9AA of the ITAA 1936 may not apply to friendly societies that have a life insurance business held in a wholly owned subsidiary. Further, the capital gains tax relief is only available under this Division in limited circumstances. The proposed amendments seek to supply relief from CGT in a broader range of circumstances than allowed by current tax law.[38]

Policy development

In November 2008 Treasury released a discussion paper on the proposed changes.[39] Four submissions were received in response to this paper.[40] On 17 April 2009 the Government released an exposure draft of the proposed legislation. It has received 3 submissions on the proposed legislation.[41]

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37. Explanatory Memorandum, pp. 27 to 28.

38. Explanatory Memorandum, p. 28.

39. Australian Government, Treasury, 'Demutualisation of friendly societies and capital gains tax', *webpage*, viewed 15 July 2009, http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1437

40. Australian Government, Treasury, 'Submissions: Demutualisation of friendly societies and capital gains tax', *webpage,* viewed 16 July 2009. http://www.treasury.gov.au/contentitem.asp?ContentID=1455&NavID=037

41. Australian Government, Treasury, 'Exposure draft: Demutualisation of friendly societies and capital gains tax', webpage, viewed 16 July 2009, http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=1520

Basis of policy commitment

The proposed amendments were announced by the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs on 24 October 2008.[42]

Position of significant interest groups/press commentary

Press or any other general comment on this particular proposal is scarce. Submissions to Treasury on both the discussion paper and the exposure draft legislation noted particular technical issues to be addressed.

Pros and cons

Should a friendly society choose to demutualise, its members should be taxed in the same manner as members of former life, health and general insurance entities that have gone through the same process. The proposed amendments seek to achieve this end.

Financial implications

The proposed amendments are expected to have a 'small but unquantifiable' impact on revenue.[43]

Main provisions

Part 1 – Main amendments

Item 1 amends the ITAA 1997 by inserting **new Division 316** into this Act. This new Division deals with the demutualisation of friendly society health or life insurers.

Under **new section 316-5** of the ITAA 1997 this new Division applies only to a demutualisation of a friendly society if:

- the society is, or its wholly-owned subsidiary is, either a private health insurer as defined in the *Private Health Insurance Act 2007*, or a company registered under section 21 of the *Life Insurance Act 2007*
- the society's capital is not divided into shares held by its members, and

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42. C Bowen MP, then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, *Capital gains tax relief for the demutualisation of friendly societies*, media release, No. 86, Canberra, 24 October 2008, viewed 15 July 2009, http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/086.htm&pageID=003&min=ceb&Year=2008&DocType=0

43. Explanatory Memorandum, p. 4.

- the objective of the society post-demutualisaiton is to operate to secure a profit or pecuniary gains for the society's members.

New section 316-55 allows capital gains and losses to be disregarded where they arise as a result of a demutualisation event. This only applies where a person does not receive any money as a result of the demutualisation.

However, **new section 316-60** requires that where money is received as a result of a friendly society demutualisation, the associated capital gains and losses are not disregarded for taxation purposes.

New sections 316-65 to **316-115** contain provisions governing the calculation of capital gains and losses arising as a result of a demutualisation to which **item 1** applies and which are otherwise tax assessable.

Item 1 also inserts **new Subdivision 316-D** into the ITAA 1997.[44] This subdivision contains provisions dealing with the tax treatment of capital gains and losses arising from the demutualisation where the shares, rights to acquire shares or money arising from this procedure are held in a trust. This occurs where a member or a person entitled to these benefits cannot be contacted (i.e. is a lost policy holder).

New Subdivision 316-E contains special rules for the assessment of capital gains and losses that pass directly to the beneficiaries of a deceased estate.

The treatment of these gains and losses where the shares etc are transferred to a friendly society member's beneficiary is the same as the treatment where the member has received these benefits directly.

New subdivision 316-F contains provisions dealing with the non CGT consequences of a demutualisation. A system of franking credits and debits is available to ensure the new company does not have a franking credit surplus as an immediate result of the demutualisation. It also ensures the company does not have access to CGT credits and debits for events that happened before demutualisation.

Part 2 – Related amendments

The provisions contained in this part are mostly minor amendments to tax law to ensure that the overall intent of the amendments in **Part 1** above are applied throughout tax law. They are administrative in nature.

Item 2 adds **new section 121AU** to the ITAA 1936 which clarifies that existing Subdivision C of Division 9AA of Part III of that Act does not apply to demutualisations to which **new Division 316** of the ITAA 1997 applies.

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44. See Tax Laws Amendment (2009 Measures No. 4) Bill 2009 p. 33 and following.

Item 4 ensures that amendments to the ITAA 1936 made by **Part 2** of **Schedule 3** apply to demutalisations occurring on or after 1 July 2008.

Item 23 requires that the amendments to the ITAA 1997 by **Part 2** of **Schedule 3** of this Bill apply to demutualisations occurring on or after 1 July 2008.

Item 24 inserts **proposed Part 3-32** into the Transitional Act 1997 dealing with co-operatives and applies the provisions of **new Division 316** of the ITAA 1997 (see **Part 1** above) to demutualisations occurring on or after 1 July 2008.

Schedule 4 - Consolidation: application of losses with nil available fraction

Purpose

The provisions of **Schedule 4** amend the ITAA 1997 so that from 1 July 2002 losses attached to an insolvent corporate entity, that joins a 'consolidated group' or a 'multiple entry consolidated group', can be used by the head company of those groups in certain circumstances.

Background

Consolidation

Consolidation for tax purposes refers to the grouping of wholly owned subsidiaries of a company into one entity for taxation purposes. The Howard Government introduced consolidation to reduce compliance costs for business, remove impediments to the most efficient business structures and improve the integrity of the tax system. Consolidation allows wholly-owned corporate groups to operate as a single entity for income tax purposes from 1 July 2002.[45]

What is a 'multiple entry consolidated group'?

Australian-resident wholly-owned subsidiaries of a common foreign holding company may be able to form a group that would qualify as a consolidated group for Australian tax purposes.[46] These arrangements are known as 'multiple entry consolidated groups' (MEC groups) and generally comprise two or more wholly-owned first tier Australian-resident

45. Australian Tax Office, Consolidation, *Information Sheet*, viewed 16 July 2009, http://www.ato.gov.au/businesses/pathway.asp?pc=001/009/026

46. Requirement for MEC groups are in Division 719 ITAA 1997.

subsidiaries of a foreign resident ultimate parent company, together with their wholly-owned, lower tier, Australian-resident subsidiaries.[47]

What is an 'available fraction'?

Where a company becomes part of a consolidated group, its business losses may be used by that group to reduce its tax. However, a consolidated group cannot use these losses at a faster rate than the company originally generating these losses would have been able to use them had it remained outside the consolidated group.[48] The rate at which a bundle of losses can be used by the consolidated group is determined by the 'available fraction'. This determines the amount of the transferred losses that can be used in each year. It is basically the proportion that the joining entity's market value (at the time of joining) bears to the value of the whole group (including the joining entity) at that time.[49] The formula for working out the fraction is set out in section 707-320 of the ITAA 1997 as follows:

$$\frac{\text{modified market value of the real loss-maker at the initial transfer time}}{\text{Transferee's adjusted market value at the initial transfer time}}$$

Nil available fraction

A nil available fraction arises where the liabilities of the company joining the consolidated group exceeds its assets. That is, the joining company has no market value. In these circumstances, under the formula in section 707-320 ITAA 1997 used for working out the available fraction (see above) gives a nil result.

Policy issue

Concerns have been raised that in certain circumstances, these rules give an inequitable result. That is, the consolidated group is unfairly prevented from making use of the tax losses of the joining company. These circumstances are:

- where a debt is forgiven after the joining time, resulting in the head company being subject to the commercial debt forgiveness rules (Division 245, Schedule 2C to the ITAA 1936)
  - briefly, special rules apply to remedy the effective duplication of tax deductions that would otherwise arise from the forgiveness of commercial debt. Duplication could occur because, while a creditor may be entitled to a tax deduction or a capital loss when a debt is forgiven, the debtor, though relieved of the liability to

47. 2009 CCH Australian Master Tax Guide, Topic 14-610 – MEC Groups.
48. Section 707-310 of the ITAA 1997.
49. Section 707-320 of the ITAA 1997.

repay the debt, is not assessed on any gain and could continue to claim deductions for accumulated revenue and capital losses and other un-deducted expenditure

- a debt is terminated after the joining time, resulting in the head company being subject to the limited recourse debt rules (Division 243, Schedule 2C to the ITAA 1936
  - briefly, special provisions operate to prevent taxpayers from obtaining deductions for certain capital expenditure on property in excess of the amounts actually outlaid if the property was acquired under limited recourse finance, or
- a liability that is taken by an entity which leaves the consolidated group, resulting in the head company making a capital gain.[50]

Policy development

An exposure draft of the proposed changes in this Bill was included in general draft legislation applying to the consolidation regime released on 28 April 2009.[51] Public consultation has taken place and only one submission was received on the issue of amending the treatment of tax losses with 'nil available fraction' for consolidated groups.[52]

Basis of policy commitment

These measures were announced jointly by the Treasurer and the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs on 13 May 2008.[53] They had previously been announced by the Howard Government (see footnote 50).

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50. Concerns noted in Explanatory Memorandum, p. 64.

51. C Bowen MP, then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, *Release of draft legislation to improve the consolidation regime*, media release, No. 33, 28 April 2009, viewed 16 July 2009, http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/033.htm&pageID=003&min=ceb&Year=2009&DocType=0 and Australian Government, Treasury, Income tax consolidation regime: Exposure draft legislation and explanatory material, *webpage*, viewed 16 July 2009, http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1522

52. Australian Government, Treasury, *Consolidation: Application of losses with nil available fraction, summary of consultation process*, viewed 16 July 2009, http://www.treasury.gov.au/documents/1522/PDF/Consultation_Summary.pdf

53. W Swan MP, Treasurer and C Bowen MP, then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, *The way forward on tax measures announced, but not enacted, by the previous government*, media release, No. 53, Canberra, 13 May 2008, viewed 15 July 2009, http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/053.htm&pageID=003&min=wms&Year=2008&DocType=0

Position of significant interest groups/press commentary

The Institute of Chartered Accounts in Australia and the Taxation Institute jointly noted in their submission on the exposure draft legislation, in relation to losses with nil available fraction:

> … we are generally content with the form of the legislative amendments to give effect to this measure, and in particular welcome the extension of the sort of losses to which this measure can apply to now include net capital losses in addition to tax losses.[54]

This submission did contain additional technical details on the proposed changes in the Bill. This will be mentioned in the Main Provisions section.

Pros and cons

The proposed changes will allow increased flexibility to a head company of a consolidated group in dealing with tax losses arising from an insolvent entity joining that group.

Coalition/Greens/Family First/Independents position/commitments

As at the date of writing, no comments on this particular proposal had been made.

Financial implications

This measure will have an 'unquantifiable (but minimal)' cost to revenue.[55]

Main provisions

Item 4 of **Schedule 4** inserts **new section 707-415** into the ITAA 1997. Briefly, where a joining company has an available fraction of zero then the head company may apply the loss to:

- reduce a total net forgiven amount under the abovementioned commercial debt forgiveness rules
- reduce a capital allowance that is adjusted under the limited recourse debt rules, or

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54. Institute of Chartered Accountants in Australia, *Exposure Draft - Tax Laws Amendment (2009 Measures No 4) Bill 2009: Consolidation* (joint submissions to Treasury), 18 June 2009, p. 42, viewed 16 July 2009, http://www.charteredaccountants.com.au/files/documents/JointSubmission_ConsolidationED-17June09.pdf

55. Explanatory Memorandum, p. 5.

- reduce a capital gain that arises when the joining company subsequently leaves the group.

New subsection 707-415(3) requires that all the loss in relation to an income year must be used in the same income year, and only to the extent that they can be used in that year. If the losses exceed the tax liability of the consolidated group the unused portion of those losses cannot be saved for use in a later year.

Comment

The joint submission by the Institute of Chartered Accountants and the Taxation Institute identified two particular problems with this amendment:[56]

- under current subsection 707-320(4), the nil available fraction can never be exactly zero. It must be rounded up to the number of decimal places that includes the first or only such digit (or rounded up if the next decimal place is 5 or more).
- the proposed amendment calls for the available fraction to be exactly '0' before these provisions can be made use of. This submission suggests that this requirement be changed so that **new paragraph 707-415(1)(c)** reads:

  "(c) that loss is included in a *bundle of losses that but for the operation of subsection 707-320(4)(b) would be 0.000"
- as noted above, **new subsection 707-415(3)** limits the extent to which companies may make use of the transferred loss. This submission suggests that where the consolidate group was unable to make use of the full losses arising from the joining entity that they be allowed to save those losses until such time that they can be used to offset the relevant tax liabilities.

Item 5 applies the amendments made by **Schedule 4** to apply on and after 1 July 2002, which means that they would operate retrospectively from the start of the consolidation regime. It is not clear what effect, if any, this would have on accounting and taxation practices for companies affected by the new provisions, particularly if they have already been assessed by the Australian Taxation Office for the intervening income years. However, it may mean that affected companies will be able to amend past year's tax assessments to take account of the increased losses available. This would be a beneficial outcome.

56. See Institute of Chartered Accountants in Australia submission noted above at footnote 52.

Schedule 5 - Minor amendments

Purpose

This Schedule makes a large number of minor amendments to taxation law. As such, only a brief description of these changes follows.

Part 1 deals exclusively to references to Ministers, Departments and Departmental Secretaries and updates taxation law to reflect contemporary naming practice.

Part 2 repeals Part IV of the TAA 1953. Part IV deals with exchange controls and taxation certificates and is now inoperative because foreign exchange controls no longer apply in Australia. Amongst other things, the necessary consequential amendments flowing from this repeal are also made by **Part 2**.

Part 3 makes consequential amendments arising from the new foreign tax offset rules in Division 770 of the ITAA 1997. These new rules were enacted by the *Tax Laws Amendment (2007 Measures No. 4) Act 2007*.

Parts 4 and **5** make further minor amendments (mainly of a typographical or stylistic nature) to income tax legislation.

Further details of the amendments in **Schedule 5** of this Bill are contained in the Explanatory Memorandum.