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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

SENATE

TAXATION LAWS AMENDMENT BILL (NO. 4) 1995

SUPPLEMENTARY EXPLANATORY MEMORANDUM

Amendments, requests for amendments and new item to be moved on behalf of the Government

(Circulated by authority of the Treasurer,
the Hon Ralph Willis, MP)

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General outline and financial impact

Capital gains tax - amendments relating to value shifting

Proposes technical amendments to Schedule 1 of the Bill which introduces amendments to Division 19A of Part IIIA of the Act.

Date of effect: 7.30pm AEST on 9 May 1995.

Amendments announced: Not previously announced.

Financial impact: None overall

Compliance cost impact: The amendments to Division 19A contained in the Bill are intended to reduce compliance costs for taxpayers who undertake company group reorganisations. The amendments to the Bill only effect technical corrections.

Demutualisation of insurance companies

Amends proposed new Division 9AA of Part III of the Act which provides for the taxation consequences of certain transactions undertaken in the course of, or as a consequence of, the demutualisation of a mutual life or general insurance company. The proposed amendments to the Bill will ensure that the demutualisation provisions operate appropriately in all cases.

Date of effect: The amendments apply to mutual insurance companies and mutual affiliate companies which were in existence at 7.30pm AEST on 9 May 1995.

Amendments announced: Not previously announced.

Financial impact: The nature of the demutualisation measures are such that any cost to revenue cannot be reliably estimated.

Compliance cost impact: Most costs incurred in the demutualisation process will be incurred irrespective of the taxation consequences. The proposed amendments to the Bill are compliance cost neutral.

Trust losses

Amends the trust loss provisions set out in Schedule 7 of the Bill. These amendments:

- provide a start-up period for the purposes of testing continuity of ownership for unlisted very widely held trusts;

- alter the pattern of distributions test to provide that where a person who has in the past received distributions from the trust is no longer able to receive distributions because of death or divorce, those past distributions will be ignored in determining whether the pattern of distributions has changed. Any distribution flowing from fixed entitlements to the estate or heirs of a deceased person will also be ignored;

- provide that for the purpose of calculating the fixed entitlements held by the beneficiaries of a complying superannuation fund or complying approved deposit fund in a trust in which the fund holds an interest, each of the beneficiaries will be deemed to have an equal fixed entitlement to the income and capital of the fund;

- provide that for the purpose of calculating the fixed entitlements held by members and life policy holders of a mutual insurance company or a mutual affiliate company in a trust in which the company holds an interest, each of the members or non-member life policy holders will be deemed to have an equal fixed entitlement to the income and capital of the company;

- amend the definition of 'family trust' so that a trust will still be a family trust if, subject to an anti-avoidance rule, the trustee is able to make a distribution to a fund, authority or institution listed under subsection 78(4) or mentioned in paragraph 78(5)(a) of the Act;

- alter the definition of 'excepted trust' to include a unit trust in which all the units are held, directly or indirectly, by a company, trust, society or other body which is exempt from tax under section 23 of the Act;

- amend the definition of 'unlisted very widely held trust' to remove the requirement that units must be redeemable 'at any time';

  alter the transitional provision for family trusts to provide that a trust can become a family trust during a transitional period if

the majority of both income and capital distributions made by the trust in the 6 years prior to the test time were received, directly or indirectly, by family members with a special rule applying where no distributions have been made; and

- provide a transitional provision for a fixed trust, some or all of the fixed entitlements of which are held by a non-fixed trust, so that the fixed trust can carry forward losses incurred in the 1994-95 or earlier years if there are no changes to the trusts, the beneficiaries or their interests;

Date of effect: Subject to transitional arrangements, 7.30 pm AEST on 9 May 1995.

Amendments announced: Not previously announced.

Financial impact: The amendments ensure that the provisions operate as intended. Accordingly, there is no additional financial impact.

Compliance cost impact: No additional compliance cost impact. The amendments are likely to reduce compliance costs.

Chapter 1

Amendments 1 to 5
Requests for amendments 1 to 7

Capital gains tax - amendments relating to value shifting

Purpose of the amendment

1.1 The Bill proposes amendments to Division 19A of Part IIIA of the *Income Tax Assessment Act 1936* which deals with value shifting between commonly owned companies. The proposed amendments and requests for amendments introduce a number of technical corrections to the Bill. Consistent with paragraph 53(3) of the Constitution, amendments and requests for amendments are contained in separate documents, however they are discussed together in this explanatory memorandum. Whether measures are contained in the amendments or the request for amendments document is indicated in the text.

Background to the legislation

1.2 Division 19A of Part IIIA applies where an asset is transferred between commonly owned companies and, as a consequence of the transfer, a value shift is taken to have occurred. Generally, a value shift will be taken to have occurred where the consideration for the transfer of an asset is less than the indexed cost base or the market value of the asset. The rules are modified in relation to assets acquired prior to the time that the transferor and transferee companies came to be commonly owned.

1.3 Amendments proposed by the Bill are designed to simplify and clarify the operation of Division 19A and thereby reduce taxpayer compliance costs, particularly in relation to transfers of depreciable assets and grouping of assets for the purpose of determining cost base adjustments to shares and loans in transferor and transferee companies.

Explanation of the amendments

Cost base of certain assets

1.4 The Bill proposes new section 160ZZRBA which will deem the cost base of an asset which is deemed to have been created and disposed of by subsection 160M(6) of the Act to be equal to the market value of the

asset. Therefore where the consideration for the transfer of an asset to which subsection 160M(6) applies is less than the market value of the asset a value shift will be taken to have occurred for the purposes of Division 19A.

1.5 Section 160ZZRBA also refers to assets which are deemed to have been created and disposed of by subsection 160M(7). ***Request for amendment 1*** proposes the removal of the reference to subsection 160M(7). Division 19A will therefore apply in relation to assets which are deemed to have been created and disposed of under subsection 160M(6) only.

Grouped assets - 'indexed threshold amount'

1.6 The Bill proposes new Subdivision C of Division 19A which provides that assets may be 'grouped' for the purpose of determining the application of Division 19A. Assets are grouped according to whether they are depreciable assets (section 160ZZRDF) or, in the case of assets other than depreciable assets, whether they were acquired before or after the date on which the transferor and transferee companies came under common ownership (new sections 160ZZRDG and 160ZZRDH). All assets in a group are treated for the purposes of Division 19A as though they were a single asset. Division 19A will apply where the consideration for the transfer of a post CGT, post common ownership asset is less than the lesser of the indexed cost base or market value of the asset. This amount is the 'indexed threshold amount'. A group of post CGT, post common ownership assets is therefore deemed to be a single asset with an indexed threshold amount equal to the sum of the indexed threshold amounts of all of the assets in the group.

1.7 Technical amendments to new subsections 160ZZRDH(2) and 160ZZRDH(3) are proposed so that they refer to the 'indexed threshold amount' and the 'reduced threshold amount' of assets rather than the cost bases, market values and written down values of the assets.
[Amendment 1, requests for amendments 2 and 3]

Depreciable assets

1.8 In relation to transfers of depreciable assets, the cost bases of shares and loans are adjusted by reference to new formulae which are set out at new sections 160ZZRDJ and 160ZZRDM. The formulae are modified where there are shares of different classes in the transferor company (section 160ZZRDK - which applies in substitution of section 160ZZRDJ) or more than one loan in the transferor (section 160ZZRDN). Cost base reductions to loans in a transferor are only undertaken when the cost bases of any post CGT shares have been reduced to nil, or where there are no post CGT shares in the company (new subsection 160ZZRDL(4)). An amendment to paragraph 160ZZRDL(4)(a) is proposed so that it refers to circumstances where the cost bases of shares have been reduced to nil

under both sections 160ZZRDJ and 160ZZRDK. ***[Request for amendment 4]***

1.9 A similar amendment is also proposed to new paragraph 160ZZRDM(4)(a), which provides the formula for cost base reductions to loans. That paragraph presently calculates the reduction only by reference to the excess remaining after cost base adjustments to shares under section 160ZZRDJ have been taken into consideration. Paragraph 160ZZRDM(7)(a), by which the 'total excess share reduction (capital loss) amount' is determined, is also amended correspondingly. ***[Request for amendment 5 and amendment 2]***

1.10 New subsections 160ZZRDM(5) to (7) apply where a capital loss is subsequently realised on the disposal of a loan in a transferor company. Subsection 160ZZRDM(5), which refers to the excess remaining after the indexed cost bases of shares in the company have been reduced to nil, is amended to refer to the excess remaining following reduction of the reduced cost bases of the shares. ***[Request for amendment 6]***

1.11 New paragraph 160ZZRDM(7)(a) is also amended to refer to the reduced, rather than the indexed, cost bases of the shares ***[request for amendment 7]***. The reference to subsection 160ZZRDL(3) is also removed and replaced with a reference to subsection 160ZZRDJ(4) and section 160ZZRDK. The subsection will correctly relate to amounts remaining following reductions to the cost bases of shares in the transferor company ***[amendment 2]***.

1.12 Where a value shift has occurred in relation to the transfer of a depreciable asset, the cost bases of shares and loans in the transferor company are reduced by reference to the difference between the consideration for the transfer of the asset and the written down value of the asset (new section 160ZZRDJ). In relation to loans on which a capital loss is subsequently realised, the reference in subsection 160ZZRDM(7) is to the 'reduced cost base' of the transferred asset. To align the two provisions, the reference to 'reduced cost base' is amended to refer to the 'written down value' of the asset. ***[Amendment 3]***

Default provisions

1.13 The Bill contains general 'default' provisions which apply where, in relation to the transfer of a depreciable asset, the application of the formula to reduce the cost bases of shares of different classes, or more than one loan, would be unreasonable (new sections 160ZZRDK and 160ZZRDN). The amendments propose a further default provision so that cost base adjustments to post CGT loans can be made on a reasonable basis where there are both pre CGT shares and post CGT loans in the transferor company. ***[Amendment 4]***

1.14 Items 10 and 11 of the Bill propose amendments to sub-subparagraphs 160ZZRE(6)(b)(ii)(A) and (B) of the Act which relate to post CGT assets, other than depreciable assets, acquired after the transferor and transferee companies came under common ownership. Previously, cost base adjustments to shares and loans could be made on a reasonable basis only where pre and post CGT shares, shares of different classes or more than one loan were held by the same taxpayer. The Bill amends these provisions so that, in relation to shares of different classes and loans, it is no longer a requirement that the shares and loans are held by the same taxpayer. Amendments to subparagraph 160ZZRE(6)(b)(i) of the Act are also proposed so that cost base adjustments can also be made on a reasonable basis where pre and post CGT shares are held by different taxpayers. ***[Amendment 5]***

Chapter 2

Amendments 6 to 24

Requests for amendments 8 and 9

Demutualisation of insurance companies

Purpose of the amendments

2.1 The Bill proposes amendments to the *Income Tax Assessment Act 1936* to provide a framework for the taxation treatment of certain transactions associated with the demutualisation of life and general insurance companies. The amendments to the Bill will ensure that the new provisions apply appropriately in relation to transactions that occur in the course of, or as a consequence of, the demutualisation of a life or general insurance company.

Explanation of the amendments

Definition of 'mutual insurance company'

2.2 Proposed new section 121AB defines a 'mutual insurance company' for demutualisation purposes as either an insurance company, the profits of which are divisible only amongst policyholders in the company (new paragraph 121AB(1)(a)), or a company that satisfies all of the conditions set out in new paragraph 121AB(1)(b). These conditions are discussed further at paragraph 2.4 below. Currently, the term 'policyholder' is not defined. ***Amendment 18*** proposes new section 121AEA which provides that where, pursuant to the exercise of a power under the articles of association of an insurance company, a person is entitled to exercise rights as a policyholder, then that person may be taken to be a policyholder for the purposes of the demutualisation provisions.

2.3 Whether, and the extent to which, a person is taken to be a policyholder under these circumstances is subject to the discretion of the Commissioner of Taxation. An example of the circumstances in which the Commissioner would exercise his discretion to deem a class of persons to be policyholders for the purposes of the demutualisation provisions is where a fiduciary is entitled to receive shares on behalf of the trustee of a superannuation fund.

Division of profits

2.4 Paragraph 121AB(1)(b) currently provides that a company limited by guarantee, the profits of which are not divisible amongst members on winding up, and which has never divided it's profits amongst members, will be a 'mutual insurance company' for the purposes of the demutualisation provisions. By ***amendments 6 and 7*** of the schedule these requirements are modified. In order to be a 'mutual insurance company' or a 'mutual affiliate company' for the purposes of the demutualisation provisions (and provided that the other criteria in new sections 121AB and 121AC are satisfied), a company must not have divided profits amongst members in the 10 years prior to the announcement of the demutualisation taxation arrangements on 9 May 1995.

Definition of 'mutual affiliate company'

2.5 The definition of 'mutual affiliate company' currently proposed by new section 121AC requires that all of the policyholders of a 'mutual insurance company' must be members of the 'mutual affiliate company'.

2.6 An amendment is proposed to the definition of 'mutual affiliate company' so that a company which:

- is limited by guarantee;
- is not an insurance company;
- has not divided its profits amongst members in the 10 years prior to 9 May 1995; and
- has at least 75% of the policyholders of a 'mutual insurance company' as members

will be a 'mutual affiliate company' for the purposes of the demutualisation provisions. ***[Amendment 7]***

Definition of 'policyholder member group'

2.7 The Bill provides a deemed cost for shares in the demutualised entity distributed to members of a 'mutual insurance company' in exchange for the extinguishment of their membership rights (sections 121AS and 121AT which introduce Tables 1 and 2). The deemed cost will only apply to shares issued to members of the 'policyholder member group'. New subsections 121AE(4) and (5) generally define the 'policyholder member group' as consisting of members or policyholders of a 'mutual insurance company, and is extended to include other groups such as employees of the company, charities, and former policyholders.

Amendment consequential to the amendment of the definition of 'mutual affiliate company'

2.8 A technical amendment to new subsection 121AE(5) (which defines the 'policyholder member group' in relation to a demutualisation of a 'mutual insurance company' and 'mutual affiliate company') is proposed as a consequence of the changes to the definition of 'mutual affiliate company' described at paragraph 2.6 above. Subsection 121AE(5) provides that the 'policyholder member group' includes only members of the 'mutual affiliate company' and not policyholders or members of the associated 'mutual insurance company'. Because it will no longer be necessary for all of the policyholders in the 'mutual insurance company' to be members of the 'mutual affiliate company', the 'policyholder member group' in subsection 121AE(5) is expanded to include policyholders in the 'mutual insurance company'. ***[Amendment 7]***

Beneficiaries of single member superannuation funds

2.9 The 'policyholder member group' in relation to both a 'mutual insurance company' and a 'mutual affiliate company' currently includes a beneficiary of a single member superannuation fund where the trustee of the fund is a policyholder or member of the 'mutual insurance company'.

2.10 Amendments are proposed to new subsections 121AE(4) and (5) in relation to single member superannuation funds to ensure that, where a beneficiary of a single member superannuation fund is a policyholder member, the trustee of the superannuation fund will not also be a policyholder member for the purpose of the demutualisation provisions ***[Amendments 8, 9, 11, 12, 13, 14, 16 and 17]***

2.11 A further amendment provides that a member of a superannuation fund of which a wholly owned subsidiary of a 'mutual insurance company' or 'mutual affiliate company' is the trustee will be a policyholder member subject to a number of conditions ***[amendments 12 and 17]***. These conditions are:

- the fund must not be a standard employer sponsored fund. (The term 'standard employer sponsored fund' is defined at section 16 of the *Superannuation Industry (Supervision) Act 1993);* and

- the member's benefits in the fund must consist solely of the proceeds (including the earnings) of a life insurance policy or policies in the mutual insurance company of which the trustee is a subsidiary.

Employees

2.12 The Bill proposes that the 'policyholder member group' will include employees of a 'mutual insurance company' and a 'mutual affiliate company' (new subparagraphs 121AE(4)(c)(i) and 121AE(5)(b)(i)). ***Amendments 10 and 15*** propose that employees of wholly owned subsidiaries of mutual insurance companies and mutual affiliate companies can also be policyholder members for demutualisation purposes.

Technical amendments

Cost base of shares in a mutual insurance company and mutual affiliate company

2.13 Table 1 (proposed by new section 121AS) provides that, prior to listing, shares issued to policyholder members will have a deemed cost for CGT purposes equal to the embedded value of a life insurance company or the net tangible assets of a general insurance company. The applicable amount is spread across all of the shares in the demutualised entity. Where a holding company is interposed between the policyholder members and the insurance company (or a series of companies are interposed) the deemed cost will also apply to shares held by the interposed company in the 'mutual insurance company'. Under demutualisation method 7, set out at new section 121AL, a demutualisation arrangement may relate to a 'mutual insurance company' and a 'mutual affiliate company'. Currently the total embedded value or net tangible assets of both companies is spread equally between all of the shares issued to the interposed entity (section 121AS, table 1 item 6 and note 2).

2.14 An amendment to the Bill is proposed so that the deemed cost of shares in a 'mutual insurance company' and a 'mutual affiliate company' respectively will reflect the actual value of each company as measured by the embedded value or net tangible assets of that company. This proposed amendment is introduced as a request for amendment. ***[Requests for amendments 8 and 9]***

Discount rate assumption for the purposes of calculating the embedded value of a mutual life insurance company

2.15 As discussed at paragraph 2.13 above, the embedded value of a life insurance company is relevant in determining the deemed cost of shares issued in the course of the demutualisation of the company. The Bill sets out a number of assumptions that are relevant in calculating the embedded value of a 'mutual life insurance company' (section 121AM). The definition of the 'capital reserve adequacy shortfall percentage' (relevant to the discount rate assumption) at new subsection 121AM(6) refers to amounts which are 'predicted'. An amendment is proposed that will substitute a reference to a 'projection' rather than a prediction. This is

consistent with actuarial practice and Actuarial Guidance Note GN 252, to which the provisions relate. ***[Amendments 19, 20 and 21]***

2.16 Subsection 121AM(8), which deals with expenditure assumptions for the purpose of calculating the embedded value of a 'mutual life insurance company', does not provide for any expenditure assumption to be made for the period between the commencement of the demutualisation (on the 'demutualisation resolution day' - new subsection 121AD(3)) and the 'applicable accounting day' (which is the end of the accounting period prior to the demutualisation resolution day - new subsections 121AM(3) and 121AM(4)). An amendment to the Bill is proposed so that expenditure up until the demutualisation resolution day can be considered in determining expenditure assumptions. ***[Amendment 22]***

Typographical error

2.17 Table 1 describes the taxation consequences of certain transactions undertaken in the course of a demutualisation. Amendments to items 5 and 6 of table 1 to refer to amounts actually paid *or given* for a demutualisation share or interest are proposed (currently the provision refers to an amount paid *or gained*). ***[Amendments 23 and 24]***

Chapter 3

Amendments 25 to 38

Trust losses

Explanation of the amendments

3.1 A number of amendments are being made to the trust loss measures set out in Schedule 7 of the Bill.

Amendments 25, 26 and 34 - unlisted very widely held unit trusts - start-up period

3.2 Under the Bill an unlisted very widely held unit trust cannot deduct prior year or current year losses if it fails the 50% stake test. The 50% stake test is used in determining whether there has been a change in ownership of a fixed trust. It looks at fixed entitlements to income and capital of the trust held directly or indirectly by individuals.

3.3 An unlisted very widely held trust is an unlisted widely held unit trust with at least 1,000 unit holders. There are also a number of other conditions that have to be satisfied such as the units must carry the same rights and the trust must engage only in investment or business activities that are set out in the trust instrument or deed and prospectus of the trust. Because the trust is a widely held unit trust some of the units in the trust must be prescribed interests which have been offered for subscription or purchase to the public within the meaning of Part 7.12 of the Corporations Law.

3.4 A special rule applies to test the change of ownership of unlisted very widely held unit trusts. This rule is that continuity of ownership (ie the 50% stake test) only has to be met when there is abnormal trading in the trust's units. Subdivision 269-B sets out when abnormal trading is taken to have occurred and takes into account general factors such as the timing of trading and the number of units traded, or more specific factors such as the number of units traded in a single transaction or whether the trustee knows or reasonably suspects that an acquisition or merger is taking place.

3.5 In the period commencing when the first units are issued and ending at the time when the trust first reaches 1,000 unit holders, an unlisted very widely held unit trust may fail the 50% stake test because the number of unit holders have increased rapidly due to issue to new

investors. It is often the case that trusts in which units are offered to the public take a while to grow.

3.6 Accordingly, the definition of 'unlisted very widely held trust' in section 271-70 is being amended so that a trust will be taken to be an unlisted very widely held trust at all times from the formation of the trust until the end of a start-up period if certain conditions are met. These are:

- the trust became an unlisted very widely held trust at a time within 2 years of first issuing units;
- there was no abnormal trading in the trust's units, within the meaning of subsections 269-15(1) or section 269-30, in the start-up period; and
- at all times in the start-up period, other than the first 90 days of that period, the trust was a widely held unit trust.

3.7 The start-up period is essentially the period from when the trust first issued units until the earlier of the end of 2 years after that first issue or when the trust becomes an unlisted very widely held trust. If the trust does not become an unlisted very widely held trust within 2 years, it will not benefit from the start-up rules.

3.8 As noted above, a condition that must be satisfied is that there has been no abnormal trading in the trust during this period within the meaning of subsection 269-15(1) or section 269-30. Subsection 269-15(1) sets out factors that have to be considered in determining whether there has been abnormal trading and section 269-30 provides that abnormal trading will have occurred if a trustee knows or reasonably suspects that an acquisition or merger is taking place.

3.9 Sections 266-115 and 266-120, which set out the rules for the deductibility of current and prior year losses for unlisted very widely held trusts, will also be amended so that the start-up period will be excluded from the test period where the conditions set out in amended section 271-70 are satisfied.

Amendment 27 - pattern of distributions test

3.10 Under the Bill the pattern of distributions test for non-fixed trusts examines the pattern of distributions of income and capital of the trust over a period to determine whether there has been an effective change in those who benefit under the trust. It compares the distributions made by a trust in the year of recoupment and the relevant years in the 6 years prior to this year. The pattern of distributions test does not apply to family trusts as defined in the Bill.

3.11 The pattern of distributions test may be failed by non-fixed trusts that are not family trusts as defined where the potential beneficiaries of the trust have included natural persons who have died or who no longer benefit under the trust because of a divorce. If a person who received a distribution in an earlier year which is tested under the pattern of distributions test has died before another distribution is made it may mean that the test cannot be passed.

3.12 Subsections 267-25(3A)-(3C) will be inserted into the Bill to apply where distributions have been made from the trust in the past to a person who is no longer able to receive distributions because that person has died or has been a party to a divorce (subsection 3A). The amendment will apply so that the distributions which had been received by the deceased or divorced person will be ignored in applying the pattern of distributions test to the trust (subsection 3B). Also, where a deceased person had a direct or indirect fixed entitlement in the trust and that entitlement is passed on to the person's estate or an heir, the distributions flowing from the fixed entitlements will also be ignored in appyling the pattern of distributions test (subsection 3C).

Amendments 28, 31 and 35 - tracing through certain superannuation funds and approved deposit funds

3.13 A complying superannuation fund or a complying approved deposit fund ('ADF') may invest in another trust. It may be necessary to trace through to the ultimate beneficial owners of these funds to determine whether a trust in which one of those funds has invested and which has incurred losses ('loss trust') has satisfied the 50% stake test. For example, if a complying superannuation fund has an interest in a loss trust it would be necessary to trace through to the fixed entitlements held by each individual member in the fund to determine the individuals who hold a stake in the income or capital of the loss trust when applying the 50% stake test to the loss trust.

3.14 However, it may be difficult and costly for a superannuation fund or an ADF to determine the exact quantum of the fixed entitlements to income and capital held by each of its members in the fund. This is because the quantum of an individual members interest in the fund will depend upon a range of facts and matters, for example, the superannuation contributions made by and on behalf of the member and the benefit scheme which operates in relation to the member.

3.15 To overcome this problem the Bill will insert new subsection 271-5(3) which provides that each of the members of the complying superannuation fund or an ADF will be deemed to have an equal fixed entitlement to the income and capital of the fund.

3.16 The Bill will also provide a definition for 'complying superannuation or deposit fund' in section 271-75 of the Bill. The

inclusion of this definition has required a further amendment to the definition of 'excepted trust' contained in section 271-50 which includes the terms complying superannuation or deposit fund. This change to section 271-50 in no way alters the effect of that section.

Amendments 29 and 36 - holdings of mutual companies in fix d trusts - 50% stake test

3.17 Under the Bill, a fixed trust cannot deduct a prior year loss if there has not been sufficient continuity of ownership of the trust. As outlined in paragraph 3.2 above, the 50% stake test applies to fixed trusts to test whether there has been a change of ownership.

3.18 The interests of a member in a mutual company are usually characterised as a right to vote at meetings and, in some cases, to participate in any surplus of the company on winding up. Thus, members of mutual companies do not usually have fixed entitlements to income and capital of the trust. The effect is that if a mutual trust has a fixed entitlement to income or capital of a trust that interest will be excluded in determining whether the trust has satisfied the 50% stake test.

3.19 New subsection 271-10(3) will be inserted into the Bill with the effect that members and life policy holders who are not also members of a mutual company or a mutual affiliate company will be treated as holding an equal fixed entitlement to the capital and income of the company. A mutual insurance company will be as defined in subsection 121AB(1) of the Act and a mutual affiliate company will be as defined in section 121AC. These sections are proposed to be inserted in the Act by Schedule 3 of the Bill.

Amendment 30 - change to definition of 'family trusts'

3.20 A family trust is defined in section 271-45 of the Bill as a trust in which an individual and his or her family are the only persons who are able, directly or indirectly, to receive distributions of income or capital of the trust for their own benefit. Also, special provision is made to ensure a family trust retains its status as such where certain bodies, such as charitable institutions, can benefit under the trust on the death of family members.

3.21 Some non-fixed trusts of a predominantly family nature are able to make distributions during the life of the trust to a fund, authority or institution in Australia which is listed under the gift tax provisions of section 78 of the *Income Tax Assessment Act 1936* (the Act). A trust which includes such a fund, authority or institution as a beneficiary will not currently satisfy the definition of 'family trust'.

3.22 The definition of 'family trust' contained in section 271-45 of the Bill is being amended so that a trust will be a family trust where a

fund, authority or institution in Australia that is mentioned in any of the tables in subsection 78(4) or that is covered by paragraph 78(5)(a) of the Act is able to receive a distribution from the trust. However, the distribution must be, or be capable of being, fully deductible under section 78A of the Act on the assumption that the distribution was a deductible gift within the meaning of section 78.

Amendment 32 - trusts with only tax exempt bodies as beneficiaries

3.23 Some unit trusts only have units held, directly or indirectly, by tax exempt bodies. Before these trusts can deduct prior year losses they will have to satisfy the 50% stake test as described above. This test depends on being able to identify an individual's fixed entitlement in a trust. Where a tax exempt body holds the units, directly or indirectly, in the trust it will generally not be possible to identify an individual's fixed entitlement in the trust.

3.24 The definition of 'excepted trust' contained in section 271-50 is therefore being amended so that it will include a unit trust all of the direct and indirect fixed entitlements to income and capital of which are held by bodies exempt from tax under section 23 of the Act. No advantage from the losses can arise to these trusts because of their tax exempt status. 'Excepted trusts' are trusts which have been exempted from the trust loss measures.

Amendment 33 - unlisted very widely held trusts - conditions that units must be redeemable

3.25 In the Bill, special rules apply in the testing of ownership of unlisted very widely held trusts. One of the conditions that must be satisfied before a trust qualifies as an unlisted very widely held trust is that the units of the trust must be redeemable 'at any time' for a price determined on the basis of its net asset value.

3.26 It may not be possible for these trusts to redeem units <u>at any time</u> because of various requirements in trust deeds or the Corporations Law, ie it may be necessary for a given period of time to elapse before redemptions may be made. For instance, some trust deeds allow the trustee up to 30 days in which to redeem, and Division 5A of Part 7.12 of the Corporations Law allows unlisted property trusts to restrict redemptions in circumstances where, by redeeming on request, the trust will become illiquid.

3.27 Paragraph 271-70(1)(d) is being amended to provide that, whenever a redemption occurs, the redemption price must be determined on the basis of the fund's net asset value. This amendment will remove the need for units to be redeemable at any time.

Am ndm nt 37 - transitional arrang m nts for family trusts

3.28 Under the trust loss measures family trusts receive concessional treatment with the result that they are not required to satisfy any of the tests for deductibility of prior or current year losses other than the income injection test. As outlined in paragraph 3.20 above, a family trust is defined in the Bill as a trust where an individual and his or family are the only persons who are able, directly or indirectly, to receive distributions of income or capital of the trust for their own benefit.

3.29 Under the transitional arrangements for family trusts, a trust that is predominantly, although not technically, a family trust which became a family trust as defined within a transitional period will be treated as though it satisfied the definition of family trust from the time of the 1995 Budget. The transitional period is the time from the 1995 Budget until the earlier of 30 June 1996 or the time the trust becomes a family trust. A trust will be predominantly a family trust where 50% or more of the individuals who are able, directly or indirectly, to receive distributions from the trust are family members.

3.30 A trust that is predominantly a family trust may not be able to satisfy the requirements of this transitional provision. This is because at the Budget time, the beneficiaries of the trust may include any company or trust in which a family member has an interest. Thus, if a family member holds an interest in a large public company or widely held trust, there will be a very large number of non-family members who are able to indirectly benefit from the trust with the result that the existing transitional provision cannot be satisfied. However, the trust may have made distributions only to members of the family.

3.31 To overcome this problem, paragraph (2)(a) of item 7 of Schedule 7 will be replaced with paragraphs (2)(a) and (aa).

3.32 Paragraph (2)(a) will allow the transitional provision to apply where the majority of both the income and capital distributions made by the trust in the six years prior to the test time were received, directly or indirectly, by family members. The test time refers to the time before 1 July 1996 when the trust became a family trust.

3.33 Paragraph (2)(aa) will apply where the trust did not distribute income or capital in the period of six years prior to the test time. In this case, the trust will be able to satisfy the conditions of the transitional provision if the Commissioner considers it reasonable to treat the trust as a family trust. The Commissioner is to have regard to the individuals who during that six year period were capable of receiving, directly or indirectly, and for their own benefit, income or capital of the trust.

Am ndment 38 - transitional provision for fixed trusts wh re fixed entitlements are held by non-fixed trusts where no individuals have more than a 50% stake

3.34 In the Bill, the 50% stake test which applies to test the continuity of ownership of fixed trusts is the only test, other than the income injection test, that needs to be satisfied by fixed trusts. In contrast, in addition to the income injection test, a non-fixed trust has to satisfy a control test. It may also have to satisfy a 50% stake test (if individuals have fixed entitlement to more than 50% of the income or capital of the trust at any time during the relevant test period) and a pattern of distributions test.

3.35 The 50% stake test which applies to fixed trusts operates in the same manner as the continuity of beneficial ownership test that applies to companies under the existing company loss provisions in section 80A of the Act. For the purposes of applying section 80A, where shares in a company are held by a non-fixed trust in which there are no fixed entitlements, no natural person can be treated as beneficially owning those shares.

3.36 Similarly, where a fixed entitlement in a fixed trust is held by a non-fixed trust in which there are no fixed entitlements, no natural person will have any fixed entitlement to the income and capital of the fixed trust. This is because a person who is merely a potential beneficiary under a non-fixed trust does not have an entitlement to receive anything and thus does not own anything which is capable of being taken into account in applying the 50% stake test (and correspondingly, which is capable of economically suffering the loss).

3.37 Thus, for example, where the majority of the fixed entitlements in a fixed trust are held by a non-fixed trust in which there are no fixed entitlements, the 50% stake test cannot be satisfied by the fixed trust.

3.38 The effect of these provisions is that a fixed trust (which is not a family trust) which has losses incurred before the Budget date may lose those losses solely because majority interests in the trust are held by a non-fixed trust with no or insufficient fixed entitlements. The difficulty does not arise if the non-fixed trust is a family trust or could become a family trust. This is because of the special rule in subsection 271-20(2) of the Bill, for calculating fixed entitlements held by a family trust.

3.39 A new transitional provision will be inserted into Part 3 of Schedule 7 which will apply where individuals do not, directly or indirectly, hold more than 50% of the fixed entitlements in a fixed trust because some or all of the fixed entitlements in that trust are held directly or indirectly by a non-fixed trust.

3.40 The transitional provision will only apply if the following conditions are satisfied:

- the trust was a fixed trust at all times during the period from the 1995 Budget to the end of the income year and had incurred a loss for the 1994-95 or an earlier income year;

- there is no change in the persons holding, directly or indirectly, fixed entitlements in the trust or the percentage of their fixed entitlements; and

- every non-fixed trust (that is not a family trust) that holds entitlements in the fixed trust would satisfy the continuity of ownership, control and pattern of distribution tests if they stood in place of the loss trust.

3.41 Where these conditions are satisfied, the relevant loss of the 1994-95 or earlier income years can be carried forward for offset against later income of the trust.