Minor amendments to the capital gains tax law

Proposals Paper
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Consultation Process

Request for feedback and comments

We invite interested parties to lodge written submissions on the design of these measures.

We also encourage the identification of any other issues, including interaction issues with other parts of the tax law that may be relevant to the design of these measures. While submissions may be lodged electronically, by post or by facsimile, electronic lodgement is preferred.

Submissions will be made available on the Treasury website unless you clearly indicate that you would like all or part of your submission to remain confidential. Automatically generated confidentiality statements in emails do not suffice for this purpose. A request made under the *Freedom of Information Act 1982* for access to a submission marked confidential will be determined in accordance with that Act.

Closing date for submissions: 25 July 2012

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SUMMARY

The Government announced amendments to the capital gains tax (CGT) provisions in the 2011-12 Budget in order to provide greater certainty for taxpayers by fixing technical deficiencies, removing anomalies, and addressing unintended outcomes in the law.

Later that year, the Government also announced that it would provide CGT relief to assist taxpayers affected by natural disasters that participate in Australian government agency replacement asset programs.

During the policy design of these measures, a number of technical and minor policy issues were identified. To address these issues, the Government announced as part of the 2012-13 Budget that it would:

- disregard any CGT consequences where taxpayers receive compensation, damages and certain insurance proceeds indirectly through a trust, and ensure that insurance policies owned by superannuation funds that were treated as being CGT exempt prior to the 2011-12 Budget changes continue to be CGT exempt;
- make refinements to the 2011-12 Budget measure that provides income tax changes for deceased estates, including broadening the scope of the integrity provisions where an asset passes to a concessionally taxed entity on the death of an individual, reducing compliance costs in relation to the integrity provisions so the deceased's tax return does not need to be amended, and modifying two application dates for minor policy changes to ensure that taxpayers are not disadvantaged;
- resolve minor policy issues relating to the measure that provides CGT relief for taxpayers affected by natural disasters, by ensuring that taxpayers eligible for an automatic CGT exemption are not prevented from choosing the same CGT treatment available to other taxpayers under the measure and ensuring that taxpayers participating in this type of program in relation to their main residence continue to access the CGT main residence exemption; and
- broaden the scope of revenue asset and trading stock roll-overs that apply where a company is interposed in certain circumstances.

1. PURPOSE

This proposals paper forms the basis for consultation on these measures and broadly sets out the way they may be implemented. The purpose of this proposals paper is to provide interested parties with an opportunity to comment on the policy design of these measures.

All legislative references in this paper refer to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise stated.

2. BROADENING THE MEASURE THAT PROVIDES CAPITAL GAINS TAX EXEMPTIONS FOR CERTAIN COMPENSATION PAYMENTS AND INSURANCE POLICIES

This proposal amends the income tax law to broaden the 2011-12 Budget measure that provides CGT exemptions for certain compensation payments and insurance policies. The 2011-12 Budget measure changes take effect for CGT events happening in the 2005-06 income year and later income years.

2.1 CGT EXEMPTION FOR TAXPAYERS THAT RECEIVE COMPENSATION, DAMAGES OR CERTAIN INSURANCE PROCEEDS VIA A TRUST

Background

In the 2011-12 Budget, the Government announced that the CGT exemption available under section 118-37 for certain individuals that receive compensation or damages would be extended to cover trustees (that are not trustees of complying superannuation entities). This change provides greater certainty in these circumstances by legislating an existing Australian Taxation Office (ATO) practice (Tax Determination 14) which disregards capital gains and losses relating to such payments, where the payment relates to compensation or damages for any wrong, injury or illness an individual or their relative suffers.

- It was proposed in the 2011-12 Budget that trustees of complying superannuation entities would be able to access a broader CGT exemption under item 5 of subsection 118-300(1) for policies relating to the wrong, injury or illness of an individual.

The Government also announced that it would amend item 3 of subsection 118-300(1) to ensure that a trustee that owns a policy of insurance on the life of an individual, or an annuity instrument, is also able to access a CGT exemption.

Issues arose during policy development as to the appropriate CGT treatment of compensation or damages where proceeds that relate to compensation or damages are subsequently distributed from a trustee to a beneficiary. Whilst the ATO has not sought to deny the section 118-37 exemption in these circumstances, there is uncertainty over whether the express terms of the provisions provide this exemption.

Similar issues arose in the context of section 118-300 where a trustee owns a policy of insurance on the life of an individual or an annuity instrument and the trustee subsequently distributes the relevant proceeds to the beneficiary. If a CGT taxing point were to happen in these circumstances, this could effectively claw back the CGT exemption announced in the 2011-12 Budget that applies at the trustee level.

Proposed treatment

The proposal will disregard CGT consequences where taxpayers receive compensation, damages or certain insurance proceeds (including annuity payments) indirectly through a trust, ensuring that these taxpayers receive the same CGT outcome as taxpayers that receive such proceeds directly.

This proposal ensures that any CGT consequences will be disregarded provided the money or property received from the trust is attributable to the capital gain or capital loss that the trustee (that is not a trustee of a complying superannuation entity) has exempted under the changes announced in the 2011-12 Budget to section 118-37 (for compensation or damages) or under item 3, subsection 118-300(1) (for certain insurance payments).

For compensation and damages situations covered under section 118-37, the entity receiving the payment from the trustee must be the individual who is injured, disabled or suffered a wrong (or their relative for paragraph 118-37(1)(b) cases) to be consistent with the current requirement in section 118-37 that these payments must be received directly by an individual (or their relative).

To ensure consistency with the 2011-12 Budget change, the application date for the compensation and damages change will be for CGT events happening in the 2005-06 income year and later income years. The minor policy change to the treatment of insurance policies and annuities will take effect for CGT events happening on or after the day the legislation receives Royal Assent to provide certainty for taxpayers in regards to the tax treatment of these payments.

2.2 CGT EXEMPTION FOR CERTAIN INSURANCE POLICIES OWNED BY A COMPLYING SUPERANNUATION ENTITY

Background

The Government announced in the 2011-12 Budget that the CGT exemptions available to complying superannuation entities for annuity instruments, certain compensation and damages payments, and policies of insurance on the life of an individual would be consolidated into one broad CGT exemption. It was proposed that this would be achieved by expanding item 5 of the table in subsection 118-300(1) to cover life insurance policies more generally (as defined by the *Life Insurance Act 1995*).

- This would replace the current requirement of using both subsection 118-37(1) (in conjunction with TD 14) for compensation and damages cases and subsection 118-300(1) for policies of insurance on the life of an individual and annuity instruments.

Consultation identified that this consolidated exemption would be too narrow, as it would not cover certain insurance policies (such as certain disability policies where the period of cover is less than three years) that complying superannuation entities currently treat as being CGT exempt by relying on ATO administrative practice.

Proposed treatment

This proposal will address this issue by ensuring that insurance policies that were treated as being CGT exempt prior to the 2011-12 Budget changes continue to be CGT exempt for complying superannuation entities.

These changes will take effect for CGT events happening in the 2005-06 income year and later income years, to ensure that taxpayers that could have relied on the ATO administrative practice are not disadvantaged by this change.

3. Refinements to the income tax law in relation to deceased estates

This proposal amends the income tax law to make refinements to the 2011-12 Budget measure in relation to income tax changes for deceased estates.

Under the CGT provisions, any CGT consequences that arise on the death of an individual are typically deferred until a later dealing with that asset by the beneficiary of the estate. The 2011-12 Budget measure ensures that a CGT deferral also operates where the deceased's asset passes through a testamentary trust or a trust established through the operation of law as a result of the ending of the administration of a deceased estate.

As part of these changes, the 2011-12 Budget measure involves making technical amendments relating to the deceased estate provisions. The 2011-12 Budget changes were to take effect for CGT events happening on or after the day the legislation receives Royal Assent.

3.1 Amendments to CGT event K3

CGT event K3 provides an exception to the policy principle of the CGT regime relating to deceased estates, ensuring that if an asset passes to a concessionally taxed entity from a deceased estate, a capital gain or capital loss is still recognised in the deceased's final tax return. The rationale for having this exception is to prevent assets with an embedded capital gain escaping taxation (or being taxed at a reduced rate) when they are later disposed of by the concessionally taxed entity.

3.1.1 Amending the deceased's final tax return

Background

CGT event K3 can be circumvented where an asset does not pass to a concessionally taxed entity until after the deceased's standard amendment period has expired. Where the deceased's assessment cannot be amended (usually four years after the assessment), effectively no capital gain or capital loss can be recognised. The technical amendments announced as part of the 2011-12 Budget measure ensure that where CGT event K3 happens outside of the deceased's standard amendment period, a CGT liability still arises in the deceased's tax return. It was proposed this could be achieved by excluding CGT event K3 from the standard amendment period.

Industry raised concerns that, in some cases, the 2011-12 Budget measure would require the deceased's tax return to be amended potentially decades after the deceased's death. This would add more compliance costs as the deceased's tax return (and the administration of the estate) would have been resolved a long time before CGT event K3 happens. This issue of increased compliance costs arises more generally for CGT event K3 and may arise even where the asset passes to a concessionally taxed entity within the standard amendment period, as the deceased's tax return might have already been finalised.

Proposed treatment

This proposal will modify CGT event K3 for deceased estate cases so that the CGT event will happen to the relevant entity that passes the asset to the concessionally taxed entity, ensuring that no CGT liability escapes taxation outside of the deceased's amendment period while minimising compliance costs by avoiding the need to amend the deceased's tax return in all cases involving CGT event K3.

- This is consistent with how Division 128 operates where a testamentary trustee (using an ATO practice statement) or a legal personal representative (LPR) sells an asset to a third party, rather than passing the asset to the intended beneficiary of the estate. Essentially, no CGT roll-over is provided and the entity selling the asset is required to pay the CGT liability.

Under this proposal, the tax liability will lie with the relevant entity (such as the LPR or testamentary trustee) that passes the asset to the concessionally taxed entity, rather than resting with the beneficiary. This entity will now be able to utilise their realised capital losses against CGT event K3, instead of the current practice of the deceased utilising their capital losses against their capital gain from CGT event K3.

This proposal will ensure that the tax liability is still calculated on the same basis as the current operation of CGT event K3 (that is, based on the difference between the cost base and the market value of the asset at the time of the deceased's death). However, the time at which the event happens is now aligned to when the asset passes to the concessionally taxed entity.

To prevent any retrospective impacts, this change will apply to CGT events that are triggered following the death of an individual, provided the death occurs on or after the day the amending Bill receives Royal Assent.

3.2 CGT event K3 happening in joint tenant situations

Background

In developing the more detailed design of the 2011-12 Budget measure, it was identified that CGT event K3 does not happen in situations where an asset passes via survivorship on the deceased's death to a surviving joint tenant (or joint tenants) that is a concessionally taxed entity (for example, a foreign resident). Rather, CGT event K3 is currently limited to cases where an asset passes through a deceased estate.

Proposed treatment

This proposal will remedy this technical deficiency, providing consistent CGT treatment for assets that pass to concessionally taxed entities regardless of whether an asset passes through a deceased estate or via survivorship. In joint tenant cases, this will ensure the deceased will recognise any CGT consequences in their final tax return.

To ensure consistency with the main changes to CGT event K3, this change will apply to CGT events that are triggered following the death of an individual, provided the death occurs on or after the day the amending Bill receives Royal Assent.

3.3 Endorsement from the Commissioner

Background

The requirement in CGT event K3 that the deceased's asset must pass to a concessionally taxed entity for the event to happen means that the event may be circumvented where an entity (such as a charity) has not been endorsed by the Commissioner as tax exempt at that time, but would otherwise be entitled to tax exempt status at the time the asset passes to it. This could happen where an entity delays applying for endorsement from the Commissioner until after the asset passes to the entity.

The technical amendments in the 2011-12 Budget included a change to CGT event K3 to ensure that this CGT event could not be circumvented in these circumstances.

Proposed treatment

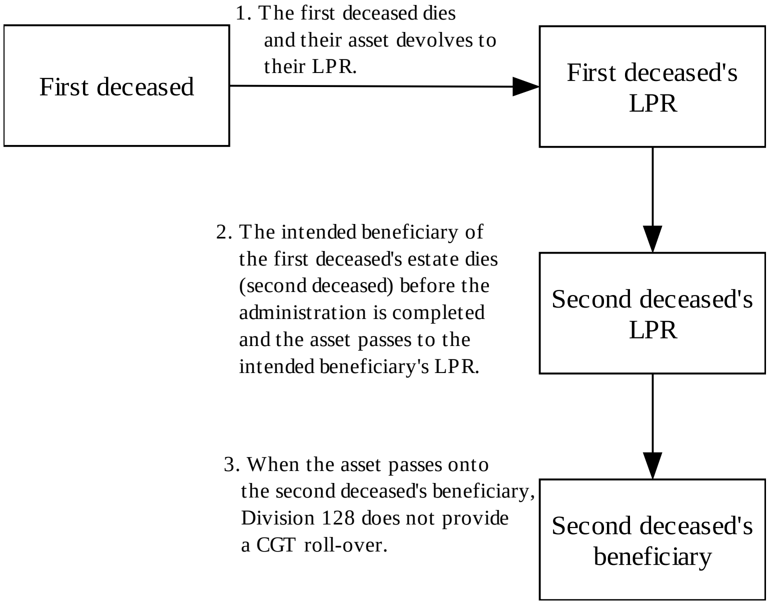
To be consistent with the application date for the above changes to CGT event K3 and to avoid any retrospective impacts, this technical amendment will now also apply to CGT events that are triggered following the death of an individual, provided the death occurs on or after the day the amending Bill receives Royal Assent.

3.4 Backdating the application date for the CGT roll-over that will apply where an intended beneficiary dies before administration is completed

Background

Where the intended beneficiary of a deceased estate dies before administration is completed, a CGT roll-over is provided by section 128-15 where the asset passes from the first deceased’s LPR to the intended beneficiary’s LPR. However, no CGT roll-over is provided where the asset passes from the intended beneficiary’s LPR to the trustee of a testamentary trust or a beneficiary in the intended beneficiary’s estate. This is because the asset was not one which the intended beneficiary owned when they died, a core condition of section 128-15.

Diagram of issue 3.4 — intended beneficiary dies before administration is completed



The 2011-12 Budget measure ensures that a relevant entity (such as the intended beneficiary’s LPR) accesses a CGT roll-over where an individual (the first deceased) dies and the intended beneficiary dies before an asset that the first deceased owned passes to them.

These changes were to apply to CGT events happening on or after the day the legislation receives Royal Assent. However, to cover existing cases, an amendment needs to be made to the existing Division 128 provisions to prevent the CGT taxing point that would otherwise arise in this situation.

Proposed treatment

This change will be backdated to apply to CGT events that happen in the 2006-07 and later income years to ensure that this change covers existing live cases.

4. Broadening the capital gains tax relief for taxpayers affected by natural disasters

On 9 October 2011, the Government announced that it will remove CGT impediments to taxpayers participating in an Australian government agency replacement asset program to assist taxpayers affected by a natural disaster.

As part of this relief, participating taxpayers will be able to choose a CGT exemption if their original asset was lost, destroyed or disposed of to the relevant Australian government agency as a consequence of the natural disaster.

This proposal amends the income tax law to provide two further minor extensions to this measure.

4.1 Ensuring tax relief is available to taxpayers who are eligible for an automatic CGT exemption

Background

Issues arose during policy development indicating that some taxpayers may be excluded from accessing the previously announced relief in circumstances where they are eligible for an automatic CGT exemption (such as the CGT main residence exemption or exemption for pre-CGT assets). This is on the basis that an automatic CGT exemption would potentially override this optional exemption.

Proposed treatment

This proposal ensures that taxpayers that are affected by a natural disaster and are eligible for an automatic CGT exemption will be able to choose to apply the previously announced relief for natural disasters.

This proposal will generally apply to CGT events happening on or after 1 July 2011, in line with the original measure.

4.2 Ensuring taxpayers who participate in an Australian government agency land swap program have access to the main residence exemption in particular circumstances

Background

The previously announced measure ensures that taxpayers whose original main residence dwelling is accidentally destroyed will access the CGT main residence exemption on their new dwelling, where a subsequent CGT event happens to the property after the taxpayer has rebuilt a new dwelling on the land but the taxpayer has not yet established the new dwelling (and its adjacent land) as their main residence.

However, under the announced measure, taxpayers that dispose of their main residence under an Australian government agency land swap program for taxpayers affected by natural disasters are not able to claim the CGT main residence exemption on their new land until they have built a new dwelling on that land and established it as their main residence.

Proposed treatment

This proposal removes this impediment by ensuring that these taxpayers will treat the replacement land they receive under an Australian government agency program (with or without a dwelling on it) as their main residence, without the taxpayer having to first establish it as their main residence, subject to the remainder of the main residence rules.

For example, taxpayers will be able to access the absence extension to the CGT main residence exemption, which will give them time to make decisions about what to do with their new land without the requirement to move in.

This proposal will apply to CGT events happening to the replacement land on or after 1 July 2011, to be consistent with the original measure.

5. AMENDMENTS TO THE REVENUE ASSET AND TRADING STOCK ROLL-OVERS FOR INTERPOSING A COMPANY

Subdivision 124-G ensures CGT considerations do not impede company restructures by providing a roll-over where all of the shares in one company are exchanged for shares in another company. The roll-over also defers a profit or loss where the original shares are held as revenue assets or trading stock. However, the current provisions are technically deficient in they do not effectively provide roll-over for revenue assets. As part of the 2011-12 Budget, the Government announced that it would make amendments to Subdivision 124-G to resolve this technical deficiency.

During consultation on the 2011-12 Budget changes, it was identified that Subdivision 124-H, which provides a CGT roll-over where units in a unit trust are exchanged for shares in a company, does not provide roll-over for revenue and trading stock assets. Following this, the Government announced on 17 November 2011 that it would extend the CGT roll-over in Subdivision 124-H to provide roll-over where the original units are held as revenue assets or trading stock. This change, in conjunction with the 2011-12 Budget measure, is currently under development.

In the 2012-13 Budget, the Government announced further changes to broaden the scope of and ensure the efficient operation of the revenue asset and trading stock roll-overs for Subdivisions 124-G and 124-H. These changes are described in detail below.

5.1 BROADENING THE REVENUE ASSET AND TRADING STOCK ROLL-OVERS IN SUBDIVISION 124-G

Background

The Subdivision 124-G roll-overs for shares held as trading stock or as revenue assets are currently limited to cases where shares in a head entity of a consolidated group are exchanged for shares in an interposed company which becomes the head company of the consolidated group.

Proposed treatment

This proposal will remove income tax impediments to certain company and trust restructures by expanding the Subdivision 124-G roll-overs and the proposed Subdivision 124-H roll-overs for revenue assets and trading stock to all shares that qualify for the general conditions of the roll-over — not only shares that are in a consolidated group.

The changes to Subdivision 124-H apply from 7.30pm on 10 May 2011 to align with when the proposed revenue asset and trading stock roll-overs apply from. The changes to Subdivision 124-G apply from 7.30pm on 8 May 2012.

5.2 MAINTAINING THE CHARACTER OF THE ORIGINAL REVENUE OR TRADING STOCK ASSET THAT WAS EXCHANGED

Background

Under the current Subdivision 124-G revenue asset and trading stock roll-overs it is not a requirement that the share in the interposed company that is received as a replacement for a share in the original company must retain the character of that original share. Not ensuring this treatment may allow taxpayers to use the revenue asset or trading stock roll-over to change the character of their assets, so that replacement assets are accounted for under the CGT provisions and benefit from the concessional treatment of CGT assets (such as the CGT discount).

A similar problem may arise when the revenue asset and trading stock roll-overs in Subdivision 124-H are enacted.

Proposed treatment

The existing revenue asset and trading stock roll-overs in Subdivisions 124-G and the proposed revenue asset and trading stock roll-overs in Subdivision 124-H will be amended to ensure that the roll-over will only be available where the replacement shares in the interposed company maintain the character of the original revenue asset or trading stock asset that was exchanged.

This change will apply from 7.30pm on 8 May 2012.