2013-2014

EXPOSURE DRAFT

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# TAX AND SUPERANNUATION LAWS AMENDMENT (2014 MEASURES NO. #) BILL 2014

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EXPLANATORY MEMORANDUM

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# Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

| ***Abbreviation*** | ***Definition*** |
|---|---|
| ATO | Australian Taxation Office |
| Commissioner | Commissioner of Taxation |
| CGT | capital gains tax |
| ITAA 1936 | *Income Tax Assessment Act 1936* |
| ITAA 1997 | *Income Tax Assessment Act 1997* |

# Chapter 1
# CGT exemption for compensation and insurance

## Outline of chapter

1.1 Schedule # to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to ensure that a capital gains tax (CGT) exemption is available to certain trustees and beneficiaries who receive compensation or damages.

1.2 Schedule # also amends the CGT exemption available to a trustee of a complying superannuation entity for certain life insurance policies and annuity instruments, to include insurance policies relating to illness or injury.

1.3 All references are to the ITAA 1997 unless otherwise stated.

## Context of amendments

1.4 This measure was one of the 92 announced but unenacted tax and superannuation measures that the Assistant Treasurer announced on 14 December 2013 would proceed.

1.5 It is intended that trustees or beneficiaries who receive compensation or damages in respect of certain events (such as an injury an individual suffers at work) or in respect of certain policies of insurance (such as illness, injury or death) not be subject to CGT. However, the express wording of the relevant provisions in the ITAA 1997 has created uncertainty about this policy. This measure confirms the existing administrative treatment in respect of compensation and insurance policies.

1.6 During consultation on this measure, the need for a further technical amendment was identified. This concerns the CGT treatment of insurance policies and annuity instruments held by complying superannuation entities that are not contingent on the duration of human life but are for injuries or illnesses suffered by an individual. This measure ensures that the CGT exemption applies to these types of policies.

## Summary of new law

1.7 A CGT exemption is available in respect of compensation or damages received by:

- a trustee (other than a trustee of a complying superannuation entity) for a wrong or injury a beneficiary suffers in their occupation, or a wrong, injury or illness a beneficiary or their relative suffers personally; and
  - a beneficiary that subsequently receives a distribution from the trustee;
- a trustee (other than a trustee of a complying superannuation entity) for a policy of insurance on the life of an individual or an annuity instrument if they are the original owner of the policy or instrument; and
- a trustee of a complying superannuation entity for a policy of insurance for an individual's illness or injury.

## Comparison of key features of new law and current law

| ***New law*** | ***Current law*** |
|---|---|
| **CGT exemption for compensation or damages received by trustees** | |
| Disregard a capital gain or capital loss you make from a CGT event relating to compensation or damages you receive as the trustee of a trust (other than a trust that is a complying superannuation entity) for:<br>• any wrong or injury a beneficiary of the trust suffers in their occupation; or<br>• any wrong, injury or illness a beneficiary of the trust or the beneficiary's relative suffers personally. | No equivalent. |

| **CGT exemption for compensation or damages received by beneficiaries** | |
|---|---|
| Disregard a capital gain or capital loss you make as the beneficiary of a trust, from a CGT asset you receive that relates to the compensation or damages the trustee of the trust receives (above), that relates to:<br>• any wrong or injury you suffer in your occupation; or<br>• any wrong, injury or illness you or your relative suffers personally. | No equivalent. |
| **CGT exemption for original owners of insurance policies for life and annuity instruments** | |
| Disregard a capital gain or capital loss you make in relation to a policy of insurance on the life of an individual or an annuity instrument if you are the original owner of the policy or instrument (but not a trustee of a complying superannuation entity, see below). | Disregard a capital gain or capital loss you make in relation to a policy of insurance on the life of an individual or an annuity instrument if you are the original *beneficial* owner of the policy or instrument. |
| **CGT exemption for complying superannuation entities: illnesses or injuries** | |
| Disregard a capital gain or capital loss you make in relation to a policy of insurance for an individual's illness or injury if you are the trustee of a complying superannuation entity for the income year in which the CGT event happened resulting in the capital gain or capital loss.<br>A subsequent capital gain or capital loss that arises when a payment is made to a trust beneficiary is also disregarded. | No equivalent. |



## Detailed explanation of new law

### Compensation or damages payments received by trustees

1.8 A capital gain or capital loss made by a trustee in relation to compensation or damages for any wrong or injury a beneficiary of the trust suffers in their occupation, or any wrong, injury or illness a beneficiary of the trust or their relative suffers personally, is disregarded. ***[Schedule #, item 3, paragraph 118-37(1)(b)]***

## Compensation or damages payments received by beneficiaries

1.9 A capital gain or capital loss made by a beneficiary is also disregarded to the extent that the trustee of a trust then distributes a CGT asset to the beneficiary that it is attributable to compensation or damages received by the trustee to which paragraph 1.8 applies. ***[Schedule #, item 3, paragraph 18-37(1)(ba)]***

## Insurance policies

***Trustees (other than the trustee of a complying superannuation entity)***

1.10 A capital gain or capital loss made from a CGT event happening in relation to a CGT asset that is an interest in a policy of insurance on the life of an individual or an annuity instrument is disregarded by the original *owner* of the policy or instrument (except if they are the trustee of a complying superannuation entity, see item 5 of subsection 118-300(1) in relation to trustees of a complying superannuation entity for these types of interests). ***[Schedule #, item 4, subsection 118-300(1), table item 3]***

1.11 The amendment removes the reference to 'original *beneficial* owner' to ensure that trustees can claim the CGT exemption for compensation or damages received, where they hold the legal interest in the relevant insurance policy for a beneficiary.

*Subsequent payment to a beneficiary*

1.12 Where a trustee then makes a payment to a beneficiary in respect of the policy or instrument, any capital gain or capital loss is also disregarded. This exemption also applies where the payment is made to a legal personal representative, as defined in the ITAA 1997. For example, where the payment is made to the executor of an estate of an individual who has died. ***[Schedule #, item 6, subsection 118-300(1A)]***

1.13 This ensures that the CGT exemption is not clawed back when proceeds are subsequently distributed to a beneficiary or their legal personal representative.

***Trustees of a complying superannuation entity***

1.14 A capital gain or capital loss is disregarded if:

- it is made when a CGT event happens in relation to a CGT asset that is an interest in a policy of insurance for an individual's illness or injury; and
- the capital gain or loss is made by the trustee of a complying superannuation entity for the income year in which the CGT event happened. ***[Schedule #, subsection 118-300(1), table item 7]***

1.15 The table in subsection 118-300(1) has been amended to ensure that the CGT exemption applies to policies of insurance that are not contingent on the duration of human life (item 5 of the table in subsection 118-300(1)) but are for an individual's illness or injury, for example, total and permanent disability, trauma and income protection insurance.

### Adjustment for non-assessable component

1.16 CGT event E4 happens when the trustee of a trust makes a payment in respect of a taxpayer's interest in the trust and some or all of this payment is non-assessable income for taxation purposes (the 'non-assessable component').

1.17 When this occurs, the cost base and reduced cost base of the interest must be reduced by the amount of the non-assessable component. When the cost base reaches zero, any additional non-assessable components result in a capital gain.

1.18 Often, a beneficiary that receives an amount from a trustee that is attributable to an amount for which the trustee received an exemption (under sections 118-37 and 118-300), will have a zero cost base for their interest in the trust because they have not purchased that interest. Therefore, it is more likely that a capital gain equal to the payment received will arise if CGT event E4 happens when they receive the non-assessable payment. This would effectively claw back the CGT exemption provided at the trustee level (see paragraphs 1.8, 1.10-1.11 and 1.14-1.15 above).

1.19 To avoid this result, payments to which paragraph 118-37(1)(ba) (compensation or damages paid through a trust to a beneficiary) and subsection 118-300(1A) (insurance and annuity payments paid through a complying superannuation entity to a beneficiary) are excluded from the calculation in working out the non-assessable component. ***[Schedule #, items 1 and 2, paragraphs 104-71(1)(da) and (db)]***

## Consequential amendments

1.20 Section 295-85 operates to ensure that all gains and losses of superannuation entities are generally taxed under the CGT provisions (the CGT 'primary code rule'). The exceptions to this rule listed in subsection 295-85(4) enable certain capital gains and capital losses that are otherwise disregarded for the purposes of CGT, to be accounted for on revenue account.

1.21 Currently, one of the exceptions to this rule is disregarded capital gains or capital losses in relation to insurance policies under section 118-300. That is, prior to the amendments, a capital gain or capital loss that is disregarded because it relates to a policy of insurance on the life of an individual or an annuity instrument was taxed on revenue account in certain circumstances (subsection 118-300(1), table item 5).

1.22 Schedule # amends the table in subsection 118-300(1) to include a policy of insurance for an individual's illness or injury as an additional policy type to which the CGT exemption applies. ***[Schedule #, subsection 118-300(1), table item 7]***

1.23 As a result, a consequential amendment is made to subsection 295-85(4) to ensure that these types of policies are not subject to treatment on revenue account. This reflects that taxpayers have accounted for such capital gains and capital losses from these policies on the basis that all gains and losses from these policies are taxed under the CGT primary code rule. ***[Schedule #, item 7, subsection 295-85(4), table item 10]***

1.24 Schedule # also restructures paragraph 118-37(1)(a), without changing the operation of the provision, which provides that capital gains or capital losses arising from CGT events are disregarded if they relate directly to compensation or damages a person receives for:

- any wrong or injury the person suffers in their occupation; or
- any wrong, injury or illness they or their relative suffers personally.

***[Schedule #, item 3, paragraph 118-37(1)(a)]***

## Application and transitional provisions

### Application

1.25 Generally, the amendments made by this Schedule apply in relation to CGT events happening in the 2005-06 and later income years. ***[Schedule #, subitem 8(1)]***

1.26 This is to ensure that taxpayers that could have relied on the Commissioner's administrative practices are not disadvantaged by this change. This reflects that the amendments do not adversely affect the rights of taxpayers or impose liabilities or obligations but rather are beneficial to taxpayers.

1.27 The amendments relating to insurance policies concerning payments made by trustees (other than trustees of a complying superannuation entity) to beneficiaries apply in relation to CGT events happening after the day of Royal Assent. This reflects that there is no existing administrative practice to which these amendments need to give retrospective effect. ***[Schedule #, subitem 8(2)]***

### Amendment of assessments

1.28 Section 170 of the ITAA 1936 provides the circumstances in which the amendment of an assessment may be made. Depending on the type of taxpayer, amendments may be made within either two or four years after the day on which the Commissioner gives notice of the assessment.

1.29 However, due to the retrospective application of some of the amendments made by Schedule #, it is important that taxpayers are not denied the opportunity to give effect to the changes because of the operation of section 170. Accordingly, section 170 does not prevent the amendment of an assessment if:

- the assessment was made before Royal Assent of the Bill;
- the amendment is made for the purpose of giving effect to Schedule #; and
- the amendment is made within two years after the day the Bill receives Royal Assent.

***[Schedule #, section 4]***

1.30 Section 170 also does not prevent the Commissioner amending an assessment if a taxpayer applies within two years after the day the Bill receives Royal Assent (see subsection 170A of the *Income Tax Assessment Act 1936*). This ensures that the rights of a taxpayer to give effect to the amendments are not denied if the Commissioner does not make an amendment within the two year period.

1.31 As some of the amendments apply to CGT events that occurred in the 2005-06 income year and later income years, the amendment period available to taxpayers will have expired in some cases. Accordingly this provision ensures that taxpayers are given sufficient time to seek an amendment to previous assessments, if required, following the commencement of Schedule #.

1.32 The amendment period applicable for the purpose of giving effect to Schedule # does not apply to assessments made on or after Royal Assent of the Bill because in these cases taxpayers will be aware of the amendments and are able to take them into account in lodging returns.