A GENERIC TAX FRAMEWORK FOR DEMUTUALISATIONS OF NON-INSURANCE ORGANISATIONS - AN ISSUES PAPER

Introduction

In the 1997-98 Commonwealth Budget the Government announced its intention to develop - in consultation with the public - a generic framework for determining the tax consequences of transactions associated with the demutualisation of non-insurance organisations. A copy of the Treasurer's press release of 13 May 1997 announcing the Government's decision is provided at Attachment A.

In the past three years major demutualisations in Australia have occurred primarily in the financial sector. Examples of organisations that have recently demutualised, or have announced their intention to demutualise, include National Mutual Life, Colonial Mutual Life, and the Australian Mutual Provident Society (AMP). The taxation treatment for demutualisations of insurance organisations are covered by specific provisions contained in Division 9AA of Part III of the *Income Tax Assessment Act 1936* (ITAA).

It is expected that as other sectors of the Australian economy are opened up to increased competition some non-insurance mutual organisations may also choose to demutualise. The policy intention of the proposed generic tax framework is to facilitate demutualisations of non-insurance organisations by providing greater certainty about the tax consequences of demutualisation and removing potential anomalies in the operation of the existing tax law.

To facilitate public consultation on the development of the generic tax framework the Commonwealth Treasury and the Australian Taxation Office (ATO) are releasing this Issues Paper. The purpose of the Issues Paper is to outline the broad policy principles on which it is proposed to base the generic tax framework. Interested parties are invited to comment on these broad policy principles or identify other issues which may be relevant to the development of this framework. Full details of the consultation process are provided at the end of this paper.

What is a mutual non-insurance organisation for the purposes of this policy?

For taxation purposes, 'mutuality' involves the operation of an organisation in some respect for its participants where any surplus amounts to contribution by them to a common fund created and controlled by them for a common purpose. Such a 'mutual' surplus is simply an increase in a common fund of the mutual participants and as such is not considered income (and is therefore not taxable). The objective of mutual transactions that increase a common fund is not profit, but merely to cover expenditure with any surplus to be used for the benefit of the mutual participants or contributors ("members"). It is possible for 'mutual' organisations also to have trading operations with members or non-members; however gains from those operations would be income and would be taxable.

Mutuality is not a form of organisation. It can apply to some of the activities of unincorporated associations, or to some activities of corporations or other organisations. Although mutual participation is often called 'membership' of the common activity, there need be no connection to the governance of an organisation. For example, a company may be the vehicle for mutual participation in an activity, yet the mutual participants need not be shareholders in the company. (Perhaps only a current committee of participants are shareholders; perhaps none of the mutual participants take part in control of the company.) Similarly, the organisation through which mutual participants are associated may also have other activities, and some people may participate in the control of the organisation without being mutual participants.

A common feature of mutual participation is that it gives no property rights that are easily traded. Members of - mutual participants in - mutual organisations generally do not have the right to sell or otherwise deal in their interests in the common fund, the collectively owned assets and businesses accrued on a mutual basis. In the event membership is terminated, (former) members usually receive no financial benefit from the surrender of their membership interests. New members do not usually contribute to the organisation the value of the share they take in its accumulated value.

Examples of non-insurance organisations which may include 'mutual participation' for tax purposes include friendly societies, credit unions, and some associations (such as social clubs, and some organisations set up in co-operative form).

How to define a non-insurance organisation including mutual participation for the purposes of this policy initiative is an important threshold issue. Those making a submission on the development of the generic tax framework may care to consider whether:

- the definition of mutual participation, outlined above, adequately covers all the different types of non-insurance organisation that may include mutual participation; and

- there are other characteristics of mutuality that should be included in the definition.

What constitutes a demutualisation for the purposes of this policy?

The term 'demutualisation' is often used in the broader community and in the media to describe changes in corporate form. For example, a change from a company limited by guarantee to a company limited by shares is often referred to as a demutualisation.

From a tax perspective, however, the corporate form of an organisation has no necessary bearing on the mutual or non-mutual character of activities in an organisation. Converting from a company limited by guarantee to a company limited by shares would not necessarily involve a demutualisation for taxation purposes. A company limited by shares can be a mutual organisation for members (who need not necessarily be shareholders), as readily as a company limited by guarantee (whose members need not necessarily be guarantors). Moreover, a company limited by guarantee (or shares) that is presently a mutual for taxation purposes can demutualise while still being such a company.

The process of demutualisation involves a change in organisation that results in members surrendering their rights to participate mutually in any common fund that constitutes the organisation. In effect, this involves giving up the right to benefit in the future from any mutual surplus that has been - or may, in the absence of demutualisation, have been - built.

Upon demutualisation there is effectively a distribution or allocation of any accumulated mutual surplus. Commonly, mutual organisations that demutualise distribute the benefit of any accumulated surplus by issuing shares in the demutualised entity, or an equivalent cash payment from reserves or from the proceeds of the sale of demutualisation shares, to members in exchange for giving up their membership interests. These allocations by non-insurance mutual organisations are made from untaxed surpluses accumulated over time as a result of their activities. In effect, current members benefit from a distribution of an untaxed pool of assets that has been built up over time from the contributions of all members (both past and present). Recent demutualisations of insurance organisations have resulted in these organisations becoming publicly listed companies. That need not necessarily be the case - organisations could demutualise without listing.

Treasury and the ATO consider that the proposed generic tax framework should only apply to those demutualisations where broad continuity of beneficial ownership of any accumulated ‘mutual’ surplus is maintained. This requires that upon demutualisation the benefit of any accumulated ‘mutual’ surplus is distributed among the beneficial owners of that surplus, the (former) mutual participants in the mutual organisation, and that the surplus is distributed in proportions consistent with the mutual participation of the (former) members. Where that is not the case (for example, if a demutualisation were to be structured so as to expropriate from members part or all of the accumulated ‘mutual’ surplus) any transactions arising from this process should be taxed as any other normal business transaction: there is no such continuity overall as to justify special treatment. Similarly, if the surplus were to be distributed in such a way that some (former) members took substantially disproportionate shares of the benefit of any accumulated ‘mutual’ surplus, there would be no such continuity overall as to justify special treatment.

Those making a submission on the development of the generic tax framework may care to consider whether it is appropriate to focus primarily on the pre- and post- demutualisation ownership of any accumulated ‘mutual’ surplus. Are there other property rights (or other rights) associated with mutual membership that should also be considered?

What would be the tax consequences of transactions associated with the demutualisation of non-insurance organisations under the existing tax law?

The process of demutualisation usually involves the realisation of an existing asset (rights of mutual participation) and perhaps the acquisition of a new asset (for example shares or cash). The disposal and acquisition of assets can have capital gains tax (CGT) consequences. The precise tax consequences of transactions associated with the demutualisation of a specific non-insurance organisation would need to be examined by that organisation on a case by case basis

Treasury and the ATO are concerned that the application of the existing tax law to demutualisations of non-insurance organisations can give rise to anomalies. For example, the disposal of membership interests in exchange for an allotment of shares can have the following capital gains tax (CGT) consequences.

(a) At demutualisation (former) members who acquired their membership interests after 19 September 1985 would incur a CGT liability calculated on the difference between the consideration received for the disposal of the rights of mutual participation (which would be equal to the value of the demutualisation shares - at the time of demutualisation) and the joining fee paid (indexed for inflation). The joining fee would only be the cost base to the extent that it had not been allowed or is not allowable as a deduction for income tax purposes.

(b) At the time of any sale of their demutualisation shares (former) members would incur an additional CGT liability calculated on the difference between the market value of the shares (at the time of disposal) and the market value of the surrendered membership rights.

The market value of the demutualisation shares (at the time of demutualisation) and the market value of the surrendered membership interests need not necessarily be the same. The market value of surrendered membership interests would need to be established as a matter of fact on a case by case basis. However, in practice the market value of membership of - mutual participation in - mutual organisations tends to negligible (and may in fact be nil) because members are generally unable to transfer or otherwise deal in their membership rights and generally obtain no financial benefit from terminating their membership of a mutual organisation (other than in the context of demutualisation).

Two possible difficulties therefore arise from the application of the existing tax law to demutualisations of non-insurance organisations. Firstly, (former) members would incur a CGT liability at the conversion of their membership rights into shares. At this point the transaction need not result in any cash flow from which the tax liability can be met (unless cash has been taken instead of, or as well as, shares). Shares themselves may be readily marketable, but need not be so. Secondly, on the disposal of the shares members could incur a CGT liability on part of the value of the shares that has already attracted CGT at the point of demutualisation (ie. there could be an element of double taxation) in some circumstances.

What tax treatment is afforded demutualising insurance organisations?

Demutualisations of insurance organisations are covered by specific provisions contained in Division 9AA of Part III of the ITAA. The policy intention of Division 9AA is to facilitate demutualisations of eligible insurance organisations by: providing greater certainty about the tax consequences of demutualisation; removing anomalies in the operation of the tax law; and affording shares (or cash in lieu) allocated to members/policyholders upon demutualisation with concessionary tax treatment. Mutual insurance organisations are a special case, because their mutual surpluses are treated as income for taxation purposes and taxed in the same way as other income or as income of non-mutual insurers.

The key features of the tax treatment currently afforded demutualising life and general insurance organisations are outlined below.

(a) Members do not incur a CGT liability when they dispose of their membership interests in exchange for either an allotment of shares or an equivalent cash payment.

(b) Any shares allotted on demutualisation to (former) members are deemed to be new assets for CGT purposes acquired on demutualisation.

(c) Demutualisation shares are treated as having a cost base equal to their share of the full “embedded value” of a life office (that is, the net assets plus the value of the life business as if it were to continue as a mutual), or the “net tangible asset value” for general insurers, but the cost base cannot exceed the price of shares on listing (taken as the closing price on the first day of trading). The “embedded value” has built up for insurers after the application of tax and without any tax benefit of mutuality.

(d) Demutualising insurance organisations, mutual affiliate organisations and wholly owned subsidiaries are required to extinguish any franking account surpluses upon demutualisation.

Mutual insurance organisations are a special case, because their mutual surpluses are taxed in the same way as their other income or as income of non-mutual insurers. The earnings of mutual insurers are fully taxed (albeit, as with non-mutual insurers, at a concessionary rate) and are required to be distributed to members or accumulated for the future benefit of members. The assets of mutual insurers are therefore generally built up from after-tax income. (Further, much of the contributions and other income from members of mutual insurance organisations would not be deductible for income tax purposes for those members.)

In contrast, the assets of most non-insurance mutual organisations are built up from accumulated untaxed income. Often those gains are made from amounts for which in many cases deductions have also been claimed.

The proposed broad policy principles

The Government intends to develop a generic tax framework specifically covering demutualisations of non-insurance organisations. It is proposed that the generic tax framework will be based on the following broad policy principles. These principles are generally consistent with the tax treatment afforded demutualising insurance organisations. However, Treasury and the ATO consider that the proposed generic tax framework should take into account differences in the tax treatment of mutual insurance organisations and mutual non-insurance organisations. In particular, that the mutual surplus of a demutualising insurance organisation has already been subject to taxation as it has accumulated.

(1) To be treated as a demutualisation for tax purposes there must be broad continuity in the beneficial ownership of any accumulated 'mutual' surplus which is distributed or allocated upon demutualisation.

As noted above, Treasury and the ATO consider that the proposed generic tax framework should only apply to those demutualisations where broad continuity of beneficial ownership of any accumulated 'mutual' surplus is maintained. This requires that upon demutualisation the benefit of any accumulated 'mutual' surplus is distributed among the beneficial owners of that surplus, the (former) mutual participants in the mutual organisation, in proportions broadly consistent with their mutual participation.

Broad continuity of beneficial ownership of any accumulated 'mutual' surplus immediately before and after demutualisation is an important pre-condition for the provision of CGT rollover relief to (former) members (refer policy principle 3).

(2) All interests in the organisation after demutualisation are treated as post-capital gains tax assets, whether or not held by a taxpayer whose membership continued since before 1985.

Upon demutualisation, members dispose of their membership interests in exchange for an allotment of shares in the demutualised entity or an equivalent cash payment (whether the proceeds from the sale of demutualisation shares or a payment from the entity's reserves). For tax purposes members have disposed of one asset (their membership interests) and acquired a <u>new</u> asset (shares in the demutualised entity or the proceeds from the sale of demutualisation shares). All shares in the demutualised entity are therefore post-CGT assets.

Members who acquired their membership interests in the mutual non-insurance organisation before the introduction of CGT in September 1985 are not disadvantaged by this proposed treatment. Under the existing tax law members who acquired their membership interests prior to 20 September 1985 would never incur a CGT liability for gains accumulated up to the disposal of those interests. However the shares members acquire on demutualisation are <u>new</u> assets, and further gains or losses realised on the disposal of these assets should be subject to the CGT provisions.

(3) The conversion of members' interests in non-insurance organisations by demutualisation would be exempt from capital gains tax.

To address the difficulties arising from the application of the existing tax law to demutualisations of non-insurance organisations, it is proposed that (former) members should be afforded CGT rollover relief. Under the existing tax law there are a number of situations which attract CGT rollover relief. Examples include the death of the taxpayer, certain compulsory acquisitions and marriage breakdown. The policy underpinning most of the existing rollover provisions is that rollover relief is available where, even though there has been a disposal, there has been no change in the beneficial ownership of the asset. As outlined above, it is proposed that the generic tax framework will only be applied to those demutualisations where there is broad continuity of beneficial ownership of any accumulated 'mutual' surplus immediately before and after demutualisation.

Rollover relief would allow members to defer any CGT liability that would otherwise be incurred upon the surrender of their membership interests until the shares acquired as a result of demutualisation are disposed of.

The operation of the current rollover relief provisions will be examined in light of the proposed generic tax framework. For example section 160ZZPH of the ITAA currently provides rollover relief where incorporated associations convert to companies incorporated under company law. This rollover relief is available to members of the association who become shareholders in the newly incorporated company.

Section 160ZZPH sets out preconditions which must strictly be met if the provision is to apply. Also, the rollover relief is only available if the Commissioner is satisfied that it should apply. The Commissioner may also determine the appropriate cost base or reduced cost base of the newly acquired assets which replace the member's interest in the association.

The provision of CGT rollover relief to (former) members of demutualising non-insurance organisations is consistent with the tax treatment afforded (former) members of demutualising insurance organisations.

(4) The cost base imputed to shares issued to (former) members would be the indexed costs incurred by members in acquiring and maintaining their rights of mutual participation (to the extent that such costs were not and are not allowable as a deduction).

Given the differences between the taxation treatment of insurance and non-insurance mutual organisations, Treasury and the ATO do not consider that it would be appropriate to provide demutualisation shares in non-insurance organisations that same concessionary cost base treatment as that afforded demutualisation shares in insurance organisations.

It is proposed that demutualisation shares issued to those (former) members will be given a cost base equal to the indexed costs incurred by those members in acquiring and maintaining their rights of mutual participation (to the extent that such costs were not and are not allowable as a deduction). The calculation of the cost base will not include contributions made by members to the mutual non-insurance organisation's common fund or any amounts paid by members as a result of the organisation's trading activities.

Allowing the costs incurred by members in acquiring and maintaining their rights of mutual participation to be indexed ensures that longstanding members are not disadvantaged.

(5) Members would not be able to create a capital loss by demutualisation.

It is proposed that if the market price of demutualisation shares on listing is lower than the imputed cost base, then the cost base on demutualisation would be reduced to an amount equal to the lower (sale) price. This will ensure that members are not able to create a capital loss by demutualisation.

(6) Where (former) members receive a cash payment to surrender their rights of mutual participation, rather than the proceeds from the sale of demutualisation shares, only the amount over and above the value of the cost base that would be imputed to their demutualisation shares would constitute assessable income for tax purposes.

There is a need to ensure that the generic tax framework is neutral as to whether a (former) member chooses to take shares in the demutualised entity, the proceeds from the sale of demutualisation shares, or a cash payment in exchange for the surrender of their rights of mutual participation. Neutrality requires that where (former) members receive a cash payment to surrender their rights of mutual participation only the amount over and above the value of the cost base that would be imputed to their demutualisation shares would be included in assessable income.

(7) Demutualising non-insurance organisations, mutual affiliate organisations and wholly owned subsidiaries of these organisations would be required to extinguish any franking account surpluses upon demutualisation.

Members of mutual organisations do not have any right to franking account surpluses that may be held by those organisations. It would therefore be inappropriate to allow any franking account surpluses, that have accumulated while an organisation was a mutual, to be retained and distributed as franked dividends to the shareholders in the demutualised entity.

The Consultation Process

Treasury and the ATO invite interested parties to comment on the broad policy principles outlined in this paper or identify other issues that may be relevant to the development of the generic tax framework. It is not our intention to respond individually to each submission.

Comments should be provided in writing or may be forwarded electronically (in text or Microsoft Word format).

While Treasury and the ATO do not intend to publicly release any submissions received on this issue, those making a submission should clearly identify any information that is commercially or otherwise sensitive.

Submissions should reach Treasury by **14 July 1997** and be addressed to:

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Following the consultation process the Government will consider its position.

CANBERRA ACT
28 May 1997