THE TAX INSTITUTE

7 July 2020

Board of Taxation Secretariat
The Treasury – Melbourne Office
Level 6, 120 Collins Street
Melbourne VIC 3121

By email: CGTRollovers@taxboard.gov.au

Dear sir or madam

Review of CGT Rollovers – Comments on Consultation Guide

The Tax Institute refers to the Board of Taxation (**Board**) review of the capital gains tax (**CGT**) rollover provisions contained in the Board's February 2020 consultation paper (**Paper**). We welcome this opportunity to provide a submission.

Broadly, the Paper has been commissioned by the Assistant Treasurer to consider practical ways to simplify and rationalise Australia's system of CGT rollovers and associated provisions that have a substantially similar practical effect but are easier to use and interpret.

The terms of reference specifically refer to the Board's proposed principles-based rollovers to simplify the process of giving advice on rollovers whilst protecting the revenue and integrity of the tax system generally.

We have set out below:

- An executive summary of our position; and
- Our responses in relation to the consultation questions outlined in the Paper.

Executive Summary

The principle of the CGT rollover relief provisions is to allow certain CGT events to occur without crystallising liabilities to tax in circumstances where it is considered appropriate for the CGT liability to be deferred until a later time (ie the CGT liability is 'rolled over'). This principle has generally served taxpayers well in the past.

The current CGT rollover categories have evolved over time.

The Institute considers that there is an opportunity to further refine, expand and provide further clarity on CGT rollover relief provisions affecting both large and small businesses. In the light of COVID-19 where businesses have been severely affected by a downturn in economic activity and now seek to restructure to create efficiencies during the recovery phase, refining and expanding the CGT rollover provisions may be more important than ever.

The Institute's recommendations are:

- The Tax Institute does not support principles based drafting for the CGT rollover provisions;
- The Tax Institute recommends additional rollovers be included in tax legislation. These are discussed below;
- The policy intent of the demerger provisions should be reviewed and legislation revised to give effect to the policy;
- It would be beneficial for the Board of Taxation to consider the tax regimes that facilitate business restructuring in other jurisdictions, in particular, Canada;
- The Institute does not consider that any rollovers are redundant;
- The position on back to back rollovers should be specifically confirmed through legislative guidance or sensible ATO guidance in relation to Part IVA;
- There are interactions that should be considered – such as the interactions between CGT event L5, the consolidation provisions and others. These are discussed below;
- The Institute does not support any changes in relation to the grandfathering of pre-CGT assets; and
- The Institute recommends the compliance/administrative changes discussed below.

Responses to Specific Consultation Questions

1. Do you agree with the policy considerations outlined in this document? Are there any other policy considerations that should be taken into account? Why?

In general, the Institute agrees with the policy considerations that are outlined in the Paper.

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2. What framing principles would be appropriate for rationalising the three categories of roll-overs into more principles-based roll-overs?

The Institute has some concerns regarding principles-based drafting, and generally prefers prescriptive rules which can provide a more certain result for taxpayers (especially where a concession is to be relied on).

The plain English redraft of the *Income Tax Assessment Act 1936* and the principles associated with the plain English redraft of tax legislation generally should continue to be adhered to. To some extent, amendments such as the Consolidations Rules have departed from plain English drafting and attempted to graft economic principles into legislation. The Institute considers that all the amendments which have been required in relation to the Consolidations Rules illustrates the detrimental effects of this approach.

3. Are there any deficiencies and limitations in the current suite of roll-overs that can be addressed by a more principles-based approach to roll-over relief?

See the response to question 2 above.

4. **Can the system benefit from any additional categories of roll-overs?**

As the Australian economy emerges from a COVID-19 environment, any new tax policy settings should support investment, efficiency, productivity and ultimately economic growth.

Revenue assets

The rollover rules should be expanded to specifically ensure that rollover relief is available for shares and trust interests held on revenue account. An example where this would be warranted is for a private equity investor who merges their investment on a scrip for scrip basis with another investor. No profit is realised from the merger but if the shares are held on revenue account there is arguably no relief (unless you can say the profit has not "come home"). Further, if the merger went in the other direction (ie the private equity fund continued to hold their shares, and holdco offered scrip to the owner of the other entity who holds their shares on capital account, the economics would be the same but the other owner could get rollover relief. #

Trading stock

Trading stock is usually excluded from CGT rollovers. It would help simplify compliance matters for many taxpayers if trading stock were able to be rolled over in the same way as general CGT assets.

AMIT rollover

The rollover rules should be expanded to allow rollovers between AMITs, which are currently not available under Subdivision 126-G as CGT event E4 is not capable of applying to an AMIT.

Earn outs

It would be helpful for there to be Australian Taxation Office (**ATO**) guidance that confirms that a qualifying earnout can benefit from scrip for scrip rollover relief.

Amalgamation

The Institute submits that it would be beneficial for the Board of Taxation to consider the tax regimes that facilitate business restructuring in other jurisdictions. The Canadian restructuring provisions provide a good example of the restructuring provisions which are used in many jurisdictions around the world. One component of Canada's tax restructuring provisions is the 'amalgamation' provisions which is the most common form of merger transaction in Canada. This is a statutory procedure that is available under corporate law. Each amalgamating corporation is generally considered to continue to exist as the amalgamated corporation (there is no concept of one surviving corporation and one more corporations that cease to exist).

The governing corporate statute deals with the mechanics of the amalgamation procedure and the Canadian income tax law describes the tax implications of the amalgamation. The amalgamation will be a tax deferred event for both the corporations and their shareholders provided that:

- All property of amalgamating corporations become property of the new corporation;
- The liabilities of the amalgamating corporations become liabilities of the new corporation; and
- All shareholders of the amalgamating corporations receive shares of the new corporation.

There are also limitations to carrying over unused deductions into amalgamated entities.

On a preliminary review of the Canadian amalgamation rules, the advantage of leveraging from some of the rules and principles under the Canadian framework is that it would assist with a more seamless restructuring that is not limited to circumstances where there is no change in underlying ownership.

The disadvantage is the complexity in the design of the 'successor corporation rules' that limits the amount of deductions successor companies can claim.

Interest Realignment Provisions & Joint Venture Rollovers

The Interest Realignment Provisions were introduced with effect from 14 May 2013. The Institute advocates exploring the possibility of extending the existing interest realignment rules, and also allowing further rollovers to assist in the restructure of joint ventures.

Demerger Rules

The ATO released TD 2019/D1 on 20 March 2019 to address their view on what is a 'restructuring' for the purposes of the demerger relief provisions in section 125-70(1) of the ITAA 97. 'Restructuring' is not defined in the tax law.

The issue seems to have come to light after some recent transactions were set out in ATO class rulings in 2018 which consistently denied demerger relief. The ATO's current interpretation of what is a 'restructuring' seems broader than how taxpayers interpreted the phrase in the past, resulting in less restructures satisfying the conditions in s125-70(1) for demerger relief.

By way of background, if the conditions are satisfied the demerger provisions generally allow CGT roll-over when a disposal occurs to original interests in a company or trust under a demerger and new or replacement interests are received in the demerged entity. The roll-over allows a capital gain or loss made from a CGT event happening to original interests to be deferred. These amendments were originally based on Recommendation 19.4 of *A Tax System Redesigned*, and recognise that there should be no taxing event for a restructuring "that leaves members in the same economic position as they were just before the restructuring."

The ATO's current view as set out in TD 2019/D1 on what is a 'restructuring' under the demerger provisions is as follows:

- What is a 'restructuring' is a question of fact. However, all the steps which occur under a single plan of reorganisation will usually constitute the restructuring. It is not necessarily confined to the steps of the transactions that delivers the ownership interests in an entity to the owners of the head entity of the demerger group, but may include previous or subsequent transactions in a sequence of transactions. Commercial understanding and the objectively inferred plan for reorganisation will determine which steps or transactions form part of the restructuring of the demerger group.
- Transactions which are to occur under a plan for the reorganisation of the demerger group may constitute parts of the restructuring of the demerger group even though those transactions are legally independent of each other, contingent on different events, or may not all occur. For example, if a transaction or step is subject to a separate decision making process from steps taken from the entity, it may still be part of a restructuring (separate votes by shareholders of the company that is the head entity of the demerger group).
- Conversely, a transaction is not necessarily part of the restructure of the group merely because it is necessary for the restructuring of the group to occur or because it was enabled

by the restructure or a consequence of the restructuring of the group. For example, independent decisions by some particular owners to dispose of new interests in a separate entity listed on a securities exchange immediately after the new interests have been acquired would generally not be considered part of the restructuring.

- The scope of the restructuring will be critical in establishing whether or not the conditions to qualify for the demerger are satisfied and this includes satisfying the 'nothing else' condition

We believe the ATO's current approach goes too far as it relates to subsequent transactions in the holding company. Both the scrip for scrip changes and the demerger changes were directed at enhancing the efficiency of the economy (refer 19.3 and 19.4 of A Tax System Redesigned). The broad reading of the term "restructure" by the ATO, which will limit further corporate activity, does not achieve the aim of enhancing economic efficiency. Furthermore, any subsequent corporate activity in relation to the holding company will itself be a CGT event which will crystallise tax outcomes for investors.

We recommend the policy intent of the demerger provisions be reviewed and legislation made clear to give effect to the policy.

Stamp duty

It would be extremely beneficial for the tax system if there was uniform stamp duty relief when rollover relief is available.

Scrip for scrip rollover relief – management shareholders

The rules do not easily permit high level management shareholders to be treated differently to other shareholders. This can create undue complexity and create commercial impediments to a transaction occurring where it may not be commercially feasible to offer such management shareholders scrip.

Trusts, Limited Partnerships, Partnership and other non Company based Rollovers

The current suite of rollovers are heavily focussed on moving from a non company structure to a company structure. No consideration or relief is given for moving assets between Trusts. Trusts are the most common form of small business structure. The objective principle underlying rollover is to allow the efficient flow of capital to is maximum productive potential without any loss of that productive capital through taxation.

It should not be a barrier to the movement of that capital where the capital assets are held by trusts. As such, trust based rollovers and movement of assets between trusts should be explored further and encouraged.

5. Are there any redundant roll-overs?

The Institute does not consider that any roll-overs are redundant.

As a more general comment, it might significantly simplify the rollover provisions if references to indexation were removed. These last applied in 1999 and there have been considerable reductions in the small business CGT rates since then. At the personal level, the 50% long term CGT discount will normally yield a better outcome in the current low inflation environment.

6. What do you consider to be the main integrity risks with the current suite of roll-overs? Should specific integrity/purpose rules be built into the CGT roll-overs?

In certain circumstances rollovers can be used to set up an ownership structure that eventually falls outside the Australian CGT net or has seemingly unintended consequences.

- For example, a non-resident rolling taxable Australian property (TAP) (Section 855-15 ITAA 1997) assets into a non-resident company (NRC). This is permitted where both the asset is TAP and the shares in the company are TAP just after the rollover (Subsection 122-25). The NRC subsequently acquires additional non-TAP assets such that the principle asset test in section 855-30 ceases to apply. We note that the outcome may arguably be the result of the way that the principal asset test works for TAP, as opposed to any particular advantage obtained from a rollover.

- Rolling fully written off depreciable assets into a company and getting a market value cost base for the shares in that company – see, for example 122-50(1)(a). Potentially, this turns an assessable depreciation balancing charge into a discount capital gain.

The position on back to back rollovers should be specifically confirmed through legislative guidance or ATO guidance in relation to Part IVA. There are many circumstances in which back to back rollovers are commercially appropriate, however the ATO typically considers such transactions as being risky for the purposes of assessing Part IVA.

The Institute considers that back to back rollovers should not necessarily be subject to Part IVA when the end economic result is consistent with the policy of rollovers. The ATO has expressed the view that putting oneself into a position to obtain a further rollover is a mischief. However, if the result of more than one rollover is consistent with a result that any rollover may produce (eg deferral), the Institute considers that it is questionable whether there is in fact any mischief.

7. How does the interaction of other aspects of the tax system, such as the tax consolidation regime, impact the decision to choose a roll-over? Do these interactions create favourable or unfavourable outcomes?

The government has previously (in the 2010-11 Mid-Year Economic and Fiscal Outlook) accepted Treasury's recommendation to ensure demerger relief extends to CGT event L5 and to prevent the resetting of tax costs of assets held by subsidiaries of a demerged group, and determined that the changes would have a negligible impact to the revenue. While it was announced that the changes would not proceed on 14 December 2013 as part of 'clearing the backlog' of announced but un-enacted measures, we consider these issues should be revisited.#

The possible application of CGT event L5 affects decisions to do a demerger. It is often complex to perform the required calculations, and they can move significantly during the period in which the demerger is being implemented. Further, the possible application of section 45B also affects decisions to do a demerger and can create undue complexity having regard to the commercial purpose of a demerger.

The requirement to reset the cost base of assets under the consolidation regime in some circumstances – or being prevented from doing so in other circumstances – can impact the decision to undertake the transaction (either positively or negatively, depending on the circumstances).

While not specifically relating to rollovers, the fact that liabilities can still be reset under the anti-churn measures also may prevent a business from restructuring. This is particularly relevant for swaps that can be in or out of the money. The law should be amended to mirror the position on assets (ie so that liabilities are not reset).

8. Given grandfathering of pre-CGT assets is a noted source of complexity in the CGT regime, should the pre-CGT status of assets continue to be preserved in connection with roll-overs?

The Institute considers that, while complex, the treatment of pre-CGT assets is not overly onerous. The Institute does not recommend any changes to the grandfathering of pre-CGT assets.

9. Can any changes be made to simplify the administrative and compliance obligations for taxpayers (particularly 'mum and dad shareholders') where a roll-over occurs?

As a general observation, CGT record keeping becomes more difficult the longer an asset is held. Consider the different CGT outcomes for an asset purchased on 19 September 1985 as against one purchased the next day. Perhaps a "nightmare" scenario for an executor of a deceased estate is where all CGT records are kept on a password protected file on a password protected computer or password protected cloud storage and none of the passwords are available to the executor. In theory, a rollover to a wholly owned company should not significantly increase the compliance burden unless the relevant share registry is unable to provide details of the deceased's previous, personal holdings. To be in strict compliance with section 122-20 the market value of the assets transferred must be the substantially the same as the market value of the shares received in the transferee. If anything, a correctly executed 122-A rollover would seem to offer an opportunity to bring the CGT records up to date.

Perhaps the bigger problem is a possibly widespread perception that CGT records only need to be kept for 5 years being the general retention period for business records. The ATO website is clear that CGT records need to be kept for 5 years after the asset disposal for a capital gain or until a capital loss resulting from the CGT event is fully offset against contemporaneous or subsequent capital gains.

The record keeping issue could be simply addressed by making it a requirement for all rollovers that the transferor provide the transferee with sufficient information to enable the transferee to calculate the cost base of the asset transferred – see, for example, section 122-70(2).

CGT record keeping becomes incrementally more difficult in the context of a hostile Family Law regulated separation where the transferor refuses to provide the transferee with sufficient information to calculate the relevant asset's CGT cost base.

In terms of simplification, we also note the following general comments:

- The various CGT and capital allowance (ie depreciation) balancing charge rollover provisions are scattered throughout the 1997 Act.

- Ideally, they would be centralised in one part of the Act or with clear links to outlying provisions;
- There should be safe harbour rules so that taxpayers can undertake rollovers with confidence of the tax outcomes;
- Movement of capital can be stalled because of uncertainty. The provision of an opinion by the ATO to provide certainty on the application of a rollover in a specific instance must be given at the speed at which business operates. Turnaround times of 28 days are rarely achieved.
- The Institute considers that some thought should be given to the how tax administration should be undertaken where transactions move faster than the ATO can provide any assistance. Consideration should be given to whether the balance between tax advisers and ATO participation in facilitating business restructures achieves the objectives of the legislation.

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If you would like to discuss, please contact either me or Tax Counsel, Angie Ananda, on 02 8223 0000.

Yours faithfully,

Peter Godber
President