06 August 2012

Mr Paul McMahon
Manager – Capital Gains Tax Unit
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600
AUSTRALIA

Dear Paul

Application of Commissioner of Taxation's views in TR 2010/4 on roll-over relief

We wish to raise an issue on the availability of scrip for scrip roll-over relief under Subdivision 124-M of the *Income Tax Assessment Act 1997* (**ITAA 1997**) where a dividend is included in the capital proceeds from a disposal of shares in accordance with the principles set out in Taxation Ruling TR 2010/4. This ruling covers instances when a dividend will be included in the capital proceeds from a disposal of shares that happens under a contract or a scheme of arrangement.

Our view is that the principles set out in TR 2010/4 (which follow on from the decision in *Chief Commissioner of State Revenue (NSW) v. Dick Smith Electronics Holdings Pty Ltd* (2005) 221 CLR 496) result in the unintended dilution of the cost base of replacement interests issued in consideration for a disposal of shares where a dividend is included in the capital proceeds. This issue was previously raised at the NTLG Losses and CGT Subcommittee and the Australian Taxation Office (**ATO**) has indicated that it agrees with our interpretation of the law.

The practical problem for taxpayers from the approach being taken by the ATO is that it will often result in them being taxed on greater amounts than the actual economic gains they have made.

The attachment sets out an example of the issue and suggests amendments to the scrip for scrip roll-over rules to address the issue.

If you have any queries, please contact Paul Drum - Head of Business & Investment Policy, CPA Australia on 03 9606 9701 in the first instance. We would also welcome the opportunity to discuss the issue in more detail with you should that be required.

Yours sincerely

Paul Drum
Head of Business & Investment Policy
CPA Australia

Paul Stacey
Tax Counsel
The Institute of Chartered Accountants in Australia

Tony Greco
Senior Tax Adviser
Institute of Public Accountants

Ken Schurgott
President
The Tax Institute

<u>Attachment</u>

1. Example

The background facts which gave rise to the issue were raised in the NTLG Losses and CGT Subcommittee meeting on 11 November 2009. The facts are summarised as follows:

- Mr X owns 100% of the shares in Target Co.
- The cost base of those shares is $100.
- The market value of those shares is $250, which is represented by the following balance sheet:

	Cost $	Market value $
Cash	100	100
Land	200	350
Borrowings	(200)	(200)
	100	250
Equity	10	
Retained earnings	90	
	100	

- A Co enters into a contract with Mr X for the sale of the shares in Target Co. The contract stipulates the following conditions:
  - Target Co will declare a dividend of $90 prior to completion.
  - The sale price of the shares in Target Co will be $250 less a dividend amount equal to the retained earnings in Target Co of $90 (i.e. $160) to be satisfied by the issue of shares in A Co.
- Mr X has made an economic gain of $150 (i.e. $250 less his $100 cost base) of which $90 has been immediately realised in the form of a dividend and $60 has been deferred in the form of replacement shares.

2. Previous position

Prior to the decision in *Chief Commissioner of State Revenue (NSW) v. Dick Smith Electronics Holdings Pty Ltd* (2005) 221 CLR 496, which resulted in the issue of TR 2010/4, Mr X's income tax position would have been as follows:

- He would have included a dividend of $90 in his assessable income under section 44 of the *Income Tax Assessment Act 1936* (**1936 Act**).
- He would have made a capital gain of $60 on the disposal of his shares in Target Co based on his cost base of $100 and capital proceeds of $160. However, scrip for scrip roll-over would have been available for the entire amount of the gain under Subdivision 124-M.
- The cost base of Mr X's shares in A Co would have been $100 under subsection 124-785(2).
- If Mr X sold his A Co shares for $160 he would make a capital gain of $60 and the total amount that he could be taxed on (i.e. $90 dividend plus $60 capital gain) would be the same as his actual economic gain of $150.

3. Current position

As a result of the view expressed by the Commissioner in TR 2010/4, the consequences for Mr X are:

- A dividend of $90 is included in his assessable income under section 44 of the 1936 Act.
- Any capital gain on the disposal of his shares in Target Co is either rolled over under Subdivision 124-M or reduced under section 118-20.
- He obtains a cost base of only $64 in A Co even though his shares in Target Co had a cost base of $100.
- If Mr X sells his A Co shares for $160 he will have 'crystallised' his economic gain of $150 but will be taxed on $186 - i.e. $90 assessable dividend plus $96 capital gain.

It can be seen that the main difference between the previous and current positions is that Mr X's cost base is lower under the latter. The technical analysis as to why this dilution occurs is set out below, but the important practical point is that the approach being taken by the ATO will result in Mr X being taxed on an amount of $186 whereas his economic gain is only $150 - which is somewhat akin to double taxation.

The starting point is subsection 124-790(1) in Subdivision 124-M, which states:

> *The original interest holder can obtain only a partial roll-over if its *capital proceeds for its original interest include something (**the ineligible proceeds**) other than its replacement interest. There is no roll-over for that part (**the ineligible part**) of its original interest for which it received ineligible proceeds.*

Furthermore, subsection 124-790(2) states:

> *The *cost base of the ineligible part is that part of the cost base of your original interest as is reasonably attributable to it.*

The Explanatory Memorandum (**EM**) to the *New Business Tax System (Capital Gains Tax) Act 1999* states that "ineligible proceeds" are "something other than a replacement interest in the acquiring entity, for example, cash". In this regard, the Commissioner, in TR 2010/4, takes the view that, in certain circumstances, a dividend declared or paid by an Australian resident company to a resident shareholder who has disposed of shares in the target company under a contract of sale or a scheme of arrangement, will constitute capital proceeds under section 116-20 from the disposal of the shares for the purposes of CGT event A1.

In the context of the example, this would mean that the capital proceeds are $250 instead of $160. Furthermore, $90 of those capital proceeds, as they are a dividend rather than replacement interests in A Co, would constitute ineligible proceeds.

Applying the above principles to the example, the tax consequences to Mr X would be as follows:

- The dividend component of the capital proceeds ($90) would be ineligible proceeds under subsection 124-790(1). Therefore, there would be no roll-over relief for Mr X for those shares for which he received the dividend component of the capital proceeds under subsection 124-790(1).
- The cost base of those shares would be determined on a reasonable attribution basis pursuant to subsection 124-790(2), i.e. the cost base of the shares ineligible for the roll-over relief would equal to $36 ($90/$250*$100).
- If the above calculation is accepted as a reasonable attribution of the cost base of the shares in Target Co to those shares that are ineligible for roll-over relief, the total capital gain of $150 would be split into two parts:
    a) The part that is eligible for roll-over relief of $96 ($160-$64); and
    b) The part that is ineligible for that relief of $54 ($90-$36).
- The capital gain that is ineligible for relief ($54) would be reduced to nil under section 118-20 by the dividend of $90 that is also assessable to Mr X under section 44.
- Furthermore, the cost base of Mr X's shares in A Co would be reduced to $64 pursuant to subsection 124-785(3) which requires the cost base of the original interest to be reduced by so much of that cost base as is attributable to an ineligible part.

It is also useful to compare the position should A Co simply acquire Mr X's shares in Target Co for consideration of $250, i.e. the cash is not paid out as a dividend beforehand. In this case, scrip for scrip roll-over would be available to Mr X for the entire capital gain of $150 that would otherwise arise on the disposal. Furthermore, under subsection 124-785(2), Mr X would obtain a cost base of $100 in A Co.

As illustrated above, the decision in *Dick Smith* and the Commissioner's views in TR 2010/4 based on that decision have significant implications for the application of the scrip for scrip roll-over rules in Subdivision 124-M. Our view is that these implications are inconsistent with the policy behind the scrip-for-scrip provisions.

The EM to the *New Business Tax System (Capital Gains Tax) Act 1999,* which inserted the scrip for scrip roll-over rules, states the policy of the rules as follows:

> *2.3 The existing CGT provisions are an impediment to corporate acquisition activity in Australia. Acquiring an interest in an entity may crystallise a capital gain in the hands of the existing equity holder. Entities seeking to acquire interests often find it necessary to pay a premium to compensate the equity holder for the potential CGT liability. Also, the offer may have to include cash so that the equity holder has funds to pay its tax.*
>
> *2.4 New Subdivision 124-M will enable an equity holder in a scrip for scrip exchange to choose to obtain a CGT roll-over to defer any CGT liability.*
>
> *2.5 The roll-over will enhance the functioning of, and value creation by, the corporate sector in Australia.*

If dividends constitute ineligible proceeds for the purposes of section 124-790, then the policy of the scrip for scrip roll-over rules is arguably compromised as such an outcome would be an impediment to the corporate acquisition activity in Australia, particularly given that pre-acquisition dividends are not uncommon in many mergers and acquisitions transactions. Although the rules are designed to ensure that a capital gain or loss may arise if the proceeds received for the original interests include (non-assessable) cash or something other than an interest in the acquiring entity, treating assessable dividends as ineligible proceeds clearly results in an inequitable outcome which does not mirror economic reality as the above example illustrates.

4. Possible solution

The problem outlined above could be resolved by inserting a provision after subsection 124-790(1), with retrospective effect, as follows:

> **124-790(1A)** Dividends which form part of capital proceeds from the disposal of shares for the purposes of section 104-10 will not constitute ineligible proceeds.

If such a provision were enacted, the consequences for Mr X under the example would be as follows:

- A dividend of $90 would be included in his assessable income.
- The capital proceeds would be $250 but there would be no ineligible proceeds. Accordingly, the capital gain of $150 would be rolled over.
- The cost base of Mr X's shares in A Co would be $100.