Strengthening certain integrity provisions in the scrip for scrip roll-over

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 this measure.

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 this measure. 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: 13 August 2012

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SUMMARY

On 8 May 2012, the Government announced as part of the 2012-13 Budget that it will amend the integrity provisions of the capital gains tax (CGT) scrip for scrip roll-over to remove significant tax minimisation opportunities.

The proposed changes are required to ensure that:

- the stakeholder provisions cannot be avoided by the temporary suppression of ownership rights at the time of a takeover allowing taxpayers to defer paying CGT;
- CGT liability cannot be reduced by the creation of certain types of intra-group debt; and
- the integrity rules for the scrip for scrip roll-over apply appropriately to trusts as well as companies.

The changes will apply to scrip for scrip arrangements entered into after 7.30 pm on 8 May 2012.

1. PURPOSE

This proposals paper forms the basis for consultation on these changes and sets out, in broad terms, 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 changes.

The proposed changes are discussed below. All legislative references in this paper refer to the *Income Tax Assessment Act 1997*.

2. STAKEHOLDER RULES

2.1 BACKGROUND AND CURRENT TREATMENT

The stakeholder provisions in Subdivision 124-M seek to protect the integrity of the scrip for scrip roll-over. There is potential for the stakeholder provisions to be circumvented where shareholders are able to exert some influence over their company (the original company) and, after a takeover is completed, will have some influence over the acquiring company.

For example, this influence can be used by shareholders in the original company when they want to sell the company's assets. They can sell those assets indirectly by entering into a scrip for scrip arrangement with another company (the acquiring company) that acquires their shares in exchange for shares in itself and then on-sells the original company. Because the acquiring company obtains a market value cost base for the shares it acquired in the original company, it could on-sell those shares for no or little capital gain depending on how long it takes for the subsequent sale to take place. This arrangement would allow the former shareholders of the original company to benefit from the reinvestment in the acquiring company of the untaxed capital gains arising from the disposal of the assets of the original company.

While potential tax deferral is inherent to the scrip for scrip roll-over, this deferral is inappropriate where a shareholder or group of shareholders has a threshold level of ownership rights in both the original company and the acquiring company. In this case, the original shareholder's cost base is transferred to the acquiring company by section 124-782. The threshold levels of influence are called a *significant stake* or *common stake*, and are defined by section 124-783:

- a shareholder of a company has a *significant stake* if the shareholder and the shareholder's associates own shares giving 30 per cent or more of voting rights or entitlements to dividends or entitlements to capital distributions; or

- one or more shareholders in a company have a *common stake* if they and their associates own shares giving 80 per cent or more of the voting rights or entitlements to dividends or entitlements to capital distributions.

Section 124-783 also defines a significant stake and common stake in relation to trusts using equivalent tests. The significant stakeholder and common stakeholder tests apply only where the target and takeover entities have less than 300 members, that is they are not widely held.

As demonstrated in *Commissioner of Taxation* v *AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134 ('the AXA case'), the stakeholder tests can be circumvented by using convertible shares, options and similar interests as replacement interests in a scrip for scrip exchange to suppress the holder's ownership rights at the time the tests apply. Afterwards these interests can be converted or exercised to give the holder a level of rights that would have exceeded the threshold level in the tests if they held those rights at the time the test applied.

2.2 Proposed treatment

It is proposed that, for the purpose of the stakeholder tests, any options, rights or similar interests that give an interest holder an entitlement to acquire a share (or, in the case of a trust, a unit or other trust interest) in an entity would be taken into account in determining whether the total interests held by the interest holder exceeded the relevant threshold. In effect, the interest holder will be treated as having acquired the relevant shares (or units or other trust interests) that are the subject of the options, rights or other interests. For example, if an interest holder held convertible instruments or options to acquire interests in the relevant entity, those convertible instruments or options would be treated as having been converted or exercised respectively. Similarly, an entity will be taken to have acquired the right to receive any dividends or distributions of capital of a company, or distributions of income or capital of a trust, if they are entitled to acquire those rights.

This means, for example, that a shareholder could be treated as having a significant or common stake in a company even though the shares held by the shareholder are below the relevant threshold if the shareholder also holds other interests that carry an entitlement to acquire shares. The shareholder will be taken to have a significant or common stake at a particular time if the sum of shares actually held by the shareholder together with shares that could be acquired under the other interests held by the shareholder at that time equals or exceeds the relevant threshold.

This test will not be confined to interests acquired by the interest holder directly from the acquiring entity. For example, a call option for a share in an acquiring company acquired from an unrelated third party will be taken into account.

Not all interests relating to shares held by a shareholder will be included in the summation of ownership rights. Interests that would diminish a shareholder's holding, such as put options, will not be counted. As such, where an interest holder holds interests that negate each other, for example, call and put options, those interests will not cancel each other. Similarly, if an interest holder holds interests that yield mutually exclusive outcomes (for example, that permit the holder to exercise call or put options but not both), only the outcome that entitles the holder to acquire interests will be counted in the summation.

Also, a shareholder who holds shares that amount to a significant or common stake would not be able to use put options to reduce their ownership below the relevant threshold.

It is difficult to apply the current stakeholder tests to outstanding conditional transactions such as earnouts as the outcome in terms of ownership rights is uncertain. A standard earnout arrangement allows an entity that sold its original interests to get an initial proportion of interests in the replacement entity, together with further interests depending typically on the yearly performance of the acquired entity. It is proposed that, where the amount of ownership rights delivered is conditional and a maximum payout is set, the taxpayer use that maximum and, where there is no maximum set, the taxpayer use a reasonable estimate of what could be received.

This change will involve amendments to the definitions of significant stake and common stake in section 124-783.

Example 2.1: Treatment of entitlements to acquire interests under stakeholder test

Mr Brown owns all the ordinary shares in Yellow Co, which carry 100 per cent of the voting rights. A takeover offer is made by Green Co for all the shares in Yellow Co, in exchange for convertible preference shares in Green Co. These replacement shares carry 15 per cent of Green Co's voting rights before conversion; after conversion, they carry 40 per cent of the voting rights.

Immediately after the takeover arrangement, Mr Brown owns shares carrying 15 per cent of the voting rights in Green Co. This is not a significant stake.

However, under the proposed changes, Mr Brown's right to convert the shares and acquire further voting rights is taken into account. He is taken to hold shares carrying 40 per cent of Green Co voting rights and therefore has a significant stake in Green Co for the purpose of the stakeholder test.

3. Debt and the potential reduction of capital gains in 'downstream acquisitions'

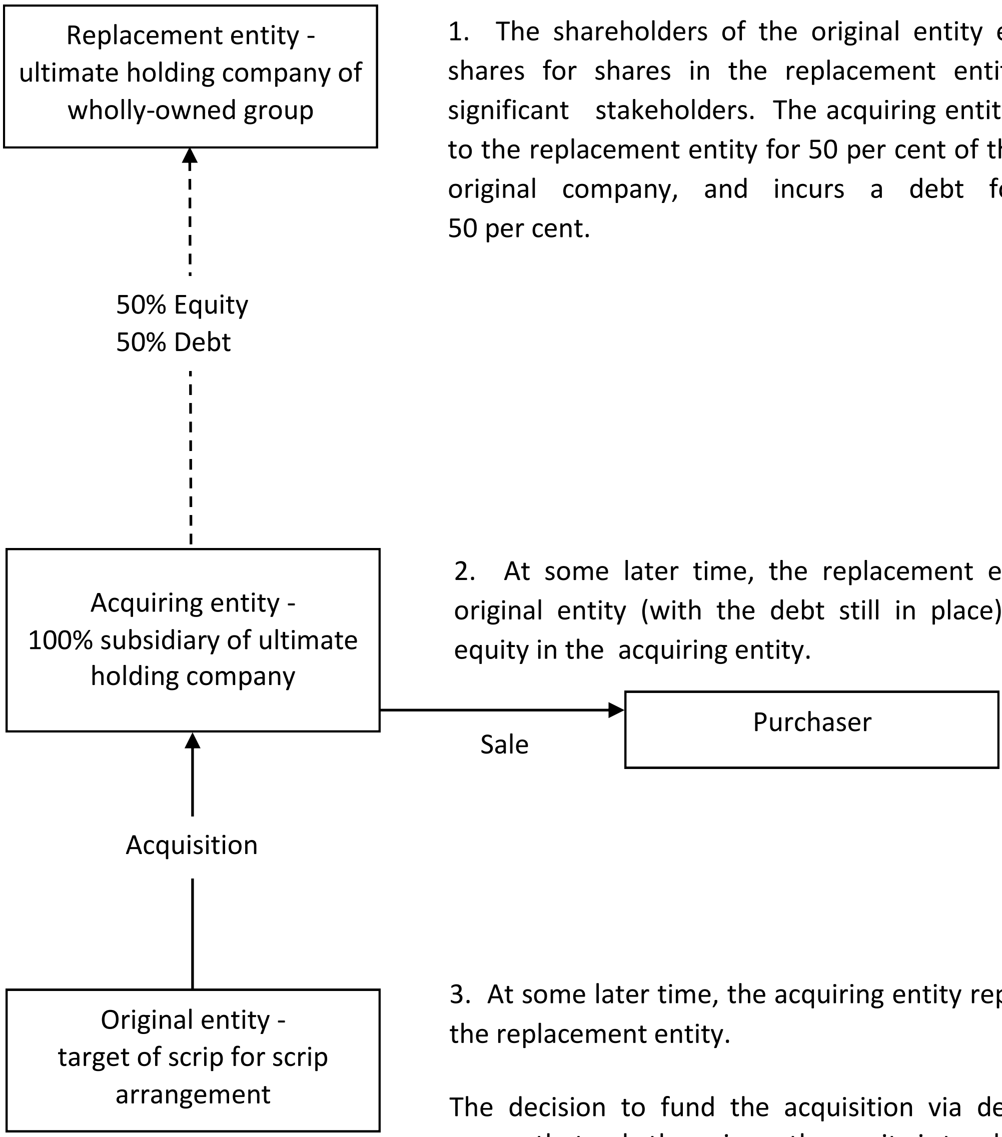
3.1 Background and current treatment

Contemplating changes to the stakeholder provisions to deal with the issues raised in the AXA case also highlighted a weakness in the cost base transfer rules for downstream acquisitions involving significant or common stakeholders. In 'downstream acquisitions', the acquiring company is a member of a wholly owned group and original shareholders receive shares in the parent company (ultimate holding company) in exchange for their shares in the original company. As consideration for the shares issued by the ultimate holding company, the acquiring company may incur a debt to the ultimate holding company in addition to, or instead of, issuing equity.

When an acquiring company repays a loan to its ultimate holding company acquired under a takeover arrangement, the capital gain that would otherwise arise (that is, if the cost base allocated to the debt is less than its market value) is disregarded under subsection 124-784 (3), or 124-784C(3) under the restructure provisions.

If the ultimate holding company sells the acquiring company (and therefore the original company) by selling all of the equity of the acquiring company, the capital gain that arises reflects only a portion of the capital gain that would arise if instead the acquiring entity sold the original company. The use of debt between the acquiring company and the ultimate holding company provides a shelter for a portion of the capital gain that should effectively be transferred with the cost base transfer to the ultimate holding company if it sells the acquiring company.

3.1.1 Diagram 3.1



1. The shareholders of the original entity exchange their shares for shares in the replacement entity. They are significant stakeholders. The acquiring entity issues equity to the replacement entity for 50 per cent of the value of the original company, and incurs a debt for the other 50 per cent.

2. At some later time, the replacement entity sells the original entity (with the debt still in place) by selling its equity in the acquiring entity.

3. At some later time, the acquiring entity repays its debt to the replacement entity.

The decision to fund the acquisition via debt and equity means that only the gain on the equity is taxable.

A separate issue with the cost base allocation rules for downstream acquisitions arises if the acquiring company issues debt or equity to a company in the group other than the ultimate holding company. The rule in the stakeholder and restructure integrity provisions that allocates a transferred or reduced cost base between equity and debt assumes that the equity or debt is issued directly by the acquiring company to the ultimate company.

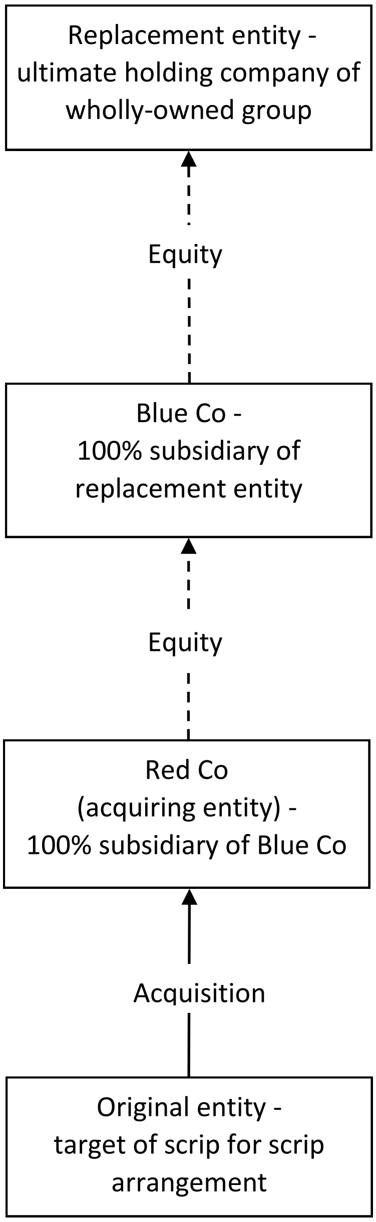
This rule does not apply where a company in the group other than the ultimate holding company makes the acquisition and issues equity or owes a debt as a result of the acquisition to another company in the group other than the ultimate holding company. This means that there will be no cost base transfer or no reduction to the cost base of the debt asset or equity issued by the acquiring company to the other group company as part of the scrip for scrip acquisition. If the other company then on-sells its equity in the acquiring company, the integrity provisions would not recapture any of the tax deferral. This outcome undermines the intent of the integrity provisions.

3.2 PROPOSED TREATMENT

It is proposed that the stakeholder and restructure integrity rules in Subdivision 124-M be amended to ensure they apply effectively to downstream acquisitions. This involves removing the debt sheltering opportunity arising from the current disregarding of a capital gain arising on the settlement of a debt owed, as part of a scrip for scrip acquisition, by an acquiring company to its ultimate holding company. This outcome would be achieved simply by removing subsections 124-784(3) and 124-784C(3).

A further change is proposed to ensure that, where an acquiring company in a wholly owned group issues equity or debt to another company in the group other than the ultimate holding company as part of a takeover arrangement, an appropriate cost base is allocated to the equity or debt. The cost base transfer will be replicated in relation to equity or debt issued by the acquiring company to a company (the first interposed company) other than the ultimate holding company, and in relation to equity or debt issued by the first interposed company or any other company in the group, as part of a takeover arrangement. This change will require amendments to subsections 124-784(1) and 124-784(2), and also parallel amendments to subsections 124-784C(1) and 124-784C(2).

3.2.1 Diagram 3.2



1. As part of a scrip for scrip arrangement, Red Co, the acquiring entity, acquires all the shares in the original entity. The original entity's shareholders, who are significant stakeholders, receive shares of the replacement entity in exchange.

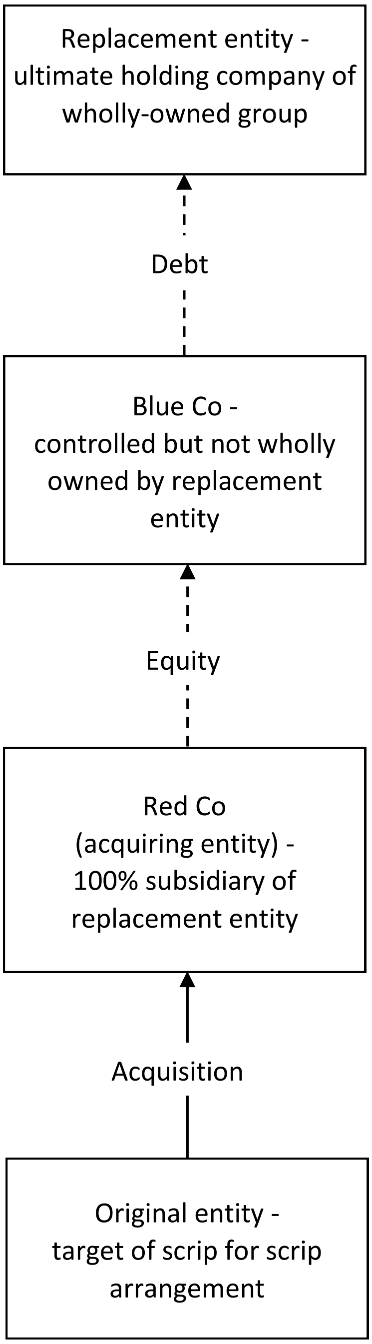
Red Co issues equity to Blue Co, and Blue Co issues equity to the replacement entity for the issue of its shares.

2. The cost base of the significant stakeholders in the original entity's shares is transferred to Red Co, but is not allocated to Blue Co or the replacement entity under the existing law.

3. Under the proposed change, Red Co's cost base would be allocated to Blue Co for the shares issued by Red Co, and to the replacement entity for the shares issued by Blue Co.

The scrip for scrip roll-over will not be available in downstream acquisitions where equity or debt is issued outside a wholly owned group as part of the takeover arrangement. Otherwise, a downstream acquisition could be structured to circumvent the operation of the proposed amendment to section 124-784 (that is, to cover the situation where an acquiring company in a wholly owned group issues equity or debt to another company in the group other than the ultimate holding company) by interposing a company that is controlled but not wholly owned by the replacement entity between the original entity and the replacement entity.

3.2.2 Diagram 3.3



1. As part of a scrip for scrip arrangement, Red Co, the acquiring entity, acquires all the shares in the original entity in exchange for shares of the replacement entity.

Red Co issues equity to Blue Co, and Blue Co issues a debt to the replacement entity, for the issue of the replacement entity's shares.

2. Under the proposed change, the original entity's shareholders will not be eligible for the scrip for scrip roll-over because Blue Co is not a 100 per cent subsidiary of the replacement entity.

4. Trusts and the restructure and stakeholder provisions

4.1 Background and current treatment

The restructure rules are currently designed to apply to companies, reflecting the additional tax minimisation opportunities that were arising, when the rules were being developed, out of the interaction between the scrip for scrip roll-over and the consolidation provisions. They do not apply to trusts.

The restructure provisions prevent an acquiring entity from obtaining a market value cost base for the ownership interests it acquires in the original entity in a scrip for scrip acquisition that is effectively a company restructure rather than a genuine commercial takeover. A scrip for scrip acquisition is a restructure if, just before the arrangement was completed, the market value of the replacement interests issued by the replacement entity in exchange for interests in the original entity is more than 80 per cent of the market value of all the shares (including options, rights and similar interests to acquire shares) issued by the replacement entity.

If an acquisition that qualifies for the scrip for scrip roll-over is taken to be a restructure and the acquiring entity chooses roll-over, the cost base for the original interests that the acquiring entity acquires reflects the cost bases of the underlying net assets of the original entity, rather than the market value of the original entity.

Trusts are also eligible for the scrip for scrip roll-over and may engage in similar transactions that are more like restructures of an existing trust than a genuine takeover, with no substantial change in ownership. The stakeholder tests do not apply if an original trust or acquiring trust has 300 members or more. Although trusts do not get the additional tax minimisation opportunities that come out of the interaction between the scrip for scrip roll-over and the consolidation provisions, they nevertheless can on-sell an entity and obtain a significant deferral benefit.

4.2 Proposed treatment

It is proposed to extend the operation of the restructure provisions so that they apply to trusts in addition to companies. To achieve this outcome, amendments to Step 3 of the method statement in section 124-784A(2) will be required to ensure that units or other interests in a trust that is an acquiring entity, and options, rights or similar interests to acquire units or other interests in the trust, are taken into account in determining the market value of all the membership interests of a acquiring entity that is a trust.

Minor technical amendments will be made to the stakeholder provisions to ensure that terms are used consistently in relation to the rules dealing with the application of the stakeholder provisions to trusts.