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Board of Tax Secretariat

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Dear Sir/Madam

**Review of CGT Rollovers - Consultation Paper**

The CTA welcomes the opportunity to provide some high level comments on the Review of CGT Rollovers - Consultation Paper (the Paper). The CTA is the key representative body representing 130 major companies in Australia on corporate tax issues and is a united voice for the collective view of the large corporates we represent in advocating for a better corporate tax system in Australia. Further information about the CTA and its membership can be found on our website at [www.corptax.com.au](http://www.corptax.com.au).

We have had the opportunity to read the Greenwood & Herbert Smith Freehill’s submission dated 12 February 2021 on the Paper and support the observations made therein. In particular we support the observations that scrip for scrip rollovers should retain the market value uplift for publicly held groups.

In what follows we have focussed on the policy reasons for retention of the market value uplift.

**Rollovers in Context - Comprehensive income should not be double taxed.**

We note in Section 1.1 "Roll-overs in context" of the Paper that a key plank of the base broadening CGT reforms in the 1980s was a movement towards a comprehensive income tax base. We note in particular the comment that "Its adoption reflects the economic notion of income, which includes the change in value of assets in addition to the regular cash flow they generate" (our emphasis).[[1]](#footnote-1) This is of course tempered by the reality that a realisation basis of tax is used as a departure from the comprehensive income model as outlined in section 1.2 of the Paper.

In our view, it is important to note the comprehensive notion of income does not mean or should lead to a view that tax should be levied on the regular cash flow and the change in value of an asset where in effect taxing the change in value of the asset amounts to double tax on the same economic gain as was derived from the cash flow. It is where the change in value of the asset is in addition to, or incremental to the cash flows that are generated from the asset that should be taxed. This is crucial to understanding why the taxing of companies and their shareholders can be very different[[2]](#footnote-2), as the cash flows in companies are taxed, but in some cases to tax the increase in value via a tax on realised gains when disposing of shares is taxing the same economic gain again (see discussion later).

**Initial observations on the six guiding principles for coherence on rollovers.**

Whilst we agree with the first 5 principles listed in section 2.1 of the Paper, we do not agree with Principle 6. We would suggest that a substitute principle should be used to underpin any design of CGT rules (or any tax rules for that matter).

Principle 6 should be that rules should be designed as far as practicable to:

* not result in (or should be designed minimise) double tax (or a double loss) for one economic gain (or loss) and
* not introduce further economic distortions.

This principle is important and goes to very heart of the question of whether there are policy justifications for retaining market value uplift for public group scrip for scrip rollovers (whilst retaining the current integrity rules) and the question posited by the Paper at page 33 as to whether there is policy rationale for market value uplift in scrip for scrip rollovers.

**Scrip for Scrip Rollovers Should Retain Market Value Uplift**

Whilst we acknowledge the then Treasurer in 1999 noted in a media release that the scrip for scrip rollover was a compliance saving (page 32), we think this is an over-simplification to say this is the reason for permitting the uplift in this circumstance and that the problem of double tax was also not seen as rationale for its introduction (page 33). In our view, it is clear from the evolving history of scrip for scrip rollovers and the various subsequent amendments made to the initial rules, that double tax was a serious concern impacting the potential to impede real economic activity that may not otherwise occur. In fact, the EM that accompanied the Bill introducing the scrip for scrip rules notes the then Government had not decided on options to deal with cost bases of interposed entities where it is noted at paragraph 2.49 that:

"The Government is examining options for dealing with the cost base of assets acquired by an interposed entity as part of a takeover or merger process where the scrip for scrip roll-over applies to the exchanging shareholders or unitholders, and will be consulting on this issue."[[3]](#footnote-3)

After consultation, changes to the rules were then introduced which retained market value uplift for widely held groups. In our view, the full history as to why there is the market value uplift in scrip for scrip rollovers subject to integrity rules (and not merely the initial view expressed in a 1999 media release, that did not see the light of day) supports the detailed thinking behind its development. In our view, the full history and thinking behind the existence (and retention) of market value uplift are powerful and should not be seen as an anomaly or its removal and replacement with cost base push up as a reasonable trade-off for the other benefits of a general rollover[[4]](#footnote-4).

We believe there are in fact two important policy reasons for retention of market value uplift for scrip deals for widely held groups:

* double tax should be avoided on the same economic gain; and
* rules should not shift the tax burden to those that have not realised a gain.

There should be no double tax for the same gain.

It is almost axiomatic that CGT can tax the same economic gain twice for shareholders in companies. Companies are taxed on earnings as they accrue, and shareholders can also be taxed on the gain from disposal of their shares.

A share’s market value is generally determined by the expected present value of future after-tax cash flows (or free cash flows) in the long run. Thus, taxing current cash flows (profits) through time, and also taxing the change in value when a share is sold (either before or after the cash flows are generated), can amount to double taxation of the same economic gain, increasing the "lock-in" effect.

* A company which has generated cash flows.

Take the simple example of a company that has generated cash flows. Say a shareholder has $100 equity in a company, and it generates $10 profit on which $3 tax is paid. If the company is not expected to increase in value and all the shares are sold before a dividend of $7 is paid, the shareholder would receive $107, and the shareholder would have a gain of $7 on sale of the share upon which tax is payable. Thus there is double tax on the same economic gain. To solve the problem, the answer may be to pay out the $7 dividend to get back to $100 before the share is sold (or to discount the capital gain for the already taxed retained profits). In Australia, not all retained profits in public companies are distributed, nor do we reduce capital gains for taxed retained profits on the sale of shares so as to minimise double tax.[[5]](#footnote-5)

* A company that has not generated cash flows.

The case of a company holding an active asset that has not yet generated positive cash flows can be similar in outcome to a company that has done so. For example, assume a company is capitalised to $100 but has spent $100 in exploring for mineral resources and has yet to derive any positive cash flows. Assume its exploration activities find an economic resource which it will exploit over the next 10 years generating $7 per year after tax and after recouping the initial $100 spent on exploration. The company's market value increases by the expected future post tax NPV of the project, so it is worth $147 (using a 5% discount rate).

If shares are sold for $147 before any income flows, there is a prima facie capital gain of $47 to the shareholder. Thus, although the gain of $47 has been determined post tax (on the basis the company will pay the tax on the income generated in the future), the shareholder pays tax on the gain when the shares are sold, and the company also will pay tax on the future cash flows. If the company is valued at more than $147, because of reasons other than future cash flows, taxing that part of a gain which exceeds $147 may not be subject to double tax.

**Does tax imputation solve double taxation?**

In a classic income tax system, the potential for double tax on active company profits has been used as the rationale for lower tax rates on both capital gains and dividends, as were enacted in 2003 in the US.[[6]](#footnote-6)

It has been argued that double taxation is not a significant problem in Australia because imputation grants tax credits to shareholders against tax paid at the company level reducing the double tax to the extent that company profits are paid out as dividends. It is however important to note that share values generally fall when a share becomes ex-dividend. Even to the extent that a company retains earnings and the share price may not fall, it has been argued the credit partially offsets the tax owed on capital gains as the retained earnings translate into higher asset values (notably cash), and thus more capital gains tax, but to the extent that profits are retained, the corporation also retains a valuable asset - the unused franking credits which will shelter future distributions from tax. The credits should thus be capitalised into the value of the company, increasing the capital gain and partially offsetting the double tax.[[7]](#footnote-7)

Whilst this observation may be true, it is only in the case where the dollar value of a franking credit is worth $1 in market value that there is no double tax on retained profits in an imputation system.[[8]](#footnote-8) It is worth noting that if the company is in receipt of exempt foreign dividends, then imputation will never solve (or mitigate) the problem of double tax.

Having scrip for scrip rollovers at market value uplift mitigates this double tax.

**Value shift in scrip for scrip deals at cost.**

The optional scrip for scrip rollover rules allow the original shareholder to retain the original cost base rather than being taxed on the CGT event. The correct policy outcome is obtained as any gain is deferred by the rollover and it ensures any eventual realised gain on disposal is taxed (or loss allowed).

It is worth noting if the cost base is retained (rather than market value) by the issuing company in a scrip for scrip rollover, there is a value shift created as the rollover dilutes the value of shares in the issuing company equal to the difference between the market value and the historic cost base of the target company multiplied by the tax rate.

For example, assume XCo has one shareholder A. A’s cost base in XCo is $200, and the market value of XCo is $200. YCo has a market value of $200. YCo is wholly owned by shareholder B, who has a cost base in YCo shares of $100.

XCo enters into a scrip for scrip deal issuing $200 worth of XCo shares to B in exchange for YCo shares. After the scrip deal, the XCo group is now worth $400, with shareholders A and B having cost bases of $200 and $100 respectively, with the market value of their XCo shares being $200 each. If XCo then sells YCo for $200 cash, it makes a taxable gain of $100 if it only receives a cost base push up of $100. It then pays tax of $30 on the notional gain of $100. The XCo group is now worth $370 ($200 for the original XCo and $170 cash after paying $30 tax on the sale of YCo) – if tax paid is valued at nil. XCo has no accounting profit on the sale of YCo as the cost of the shares in YCo have an accounting value of $200, not $100. If shareholders A and B were to sell their shares in XCo at this time they will each receive $185, with shareholder A showing a loss of $15 (cost base of $200 less proceeds of $185) and shareholder B a gain of $85 (proceeds of $185 less cost base of $100). Essentially a cost base push up reduces the value of A and B's shares in XCo by their share of the tax paid on the notional gain made by XCo on the sale of YCo. This reduction is “shared” between A and B in proportion to their ownership of XCo.

This value shift would not happen if XCo retained a market value cost base for the shares in YCo under a scrip for scrip rollover. In such a case, if XCo sells the shares in YCo for $200, it has no taxable (or accounting gain) and thus no tax to pay. Moreover, if shareholder A sells shares in XCo they would have no gain (or loss) on the sale ($200 market value less a $200 cost base) and shareholder B would have a gain of $100 ($200 market value less a $100 cost base) on which they pay tax. The full economic gain of $100 is taxed and importantly taxed in the hands of the party making the economic gain.

**Scrip for Scrip and Consolidation**

We note that in the context of tax consolidation rules and publicly listed groups that the acquiring company may obtain a market value uplift for certain underlying reset cost base assets, and that this may lead to increased tax deductible expenses that may not otherwise arise. This concern was the reason the then Treasurer Dutton proposed rules to prevent consolidation step-up in 2007.[[9]](#footnote-9)

It is worth noting however that the Dutton proposal was refined in *Tax Laws Amendment (2008 Measures No. 6) Act* (Cth) to ensure the rules were directed to the mischief that was of concern rather than some wider response impacting widely held public groups, even in the context of a potential consolidation benefit. It is important to read the EM accompanying these rules carefully to understand the policy rationale for the market value uplift remaining and the limits placed on the breadth of the integrity rules.[[10]](#footnote-10)

Whilst it is acknowledged it is possible for an acquiring company that is widely held to sell the shares in a newly acquired entity under a scrip for scrip deal, it is important to note the integrity rules were introduced and directed towards closely held groups, where the integrity issue arose. Essentially, widely held public groups do not undertake scrip for scrip deals issuing shares at market value to then “flip” shares or assets to generate a tax-free or tax advantaged gain. It is the synergies and economies of scale in holding the assets in the scrip for scrip deal that make the value proposition work. Public groups are banking on the value of the combined group after the scrip for scrip deal being more valuable over time than before the scrip was issued.

Whilst there may be a benefit for consolidated groups from such a rollover, it should be remembered any uplifted tax benefit to an underlying asset relative to the historic value of the asset only applies to the extent value is allocated to reset cost base assets under the consolidation rules. Of course, not all reset cost base assets result in future tax deductions in any event (e.g. goodwill or land).

Should you have any questions in relation to the above, please contact me.

Regards



Paul Suppree

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1. See page 11 of the Paper. [↑](#footnote-ref-1)
2. Companies are taxed on earnings as they accrue, and shareholders can also be taxed on the gain from disposal of their shares. [↑](#footnote-ref-2)
3. See paragraph 2.49 [New Business Tax System (Capital Gains Tax) Bill 1999 (legislation.gov.au)](https://www.legislation.gov.au/Details/C2004B00576/Download#:~:text=New%20Business%20Tax%20System%20(Capital%20Gains%20Tax)%20Bill,the%20progress%20of%20bills%20and%20on%20amendments%20proposed) [↑](#footnote-ref-3)
4. Per question 11 of the Paper [↑](#footnote-ref-4)
5. Publicly listed groups distribute around 70% of retained profits. See graph 3 at [The Australian Equity Market over the Past Century | Bulletin – June Quarter 2019 | RBA](https://www.rba.gov.au/publications/bulletin/2019/jun/the-australian-equity-market-over-the-past-century.html) [↑](#footnote-ref-5)
6. A great summary of the policy discourse on capital gains can be found at: <http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/411857-Taxing-Capital-Gains-in-Australia-Assessment-and-Recommendations.PDF> [↑](#footnote-ref-6)
7. Supra [↑](#footnote-ref-7)
8. See: [complete\_future\_corp\_tax\_ingles\_july\_2017.pdf (anu.edu.au)](https://taxpolicy.crawford.anu.edu.au/sites/default/files/publication/taxstudies_crawford_anu_edu_au/2017-07/complete_future_corp_tax_ingles_july_2017.pdf) which indicates a value of around 50 cents in the dollar. [↑](#footnote-ref-8)
9. See : [Improving the Integrity of the Tax Consolidation Regime | Treasury Ministers](https://ministers.treasury.gov.au/ministers/peter-dutton-2006/media-releases/improving-integrity-tax-consolidation-regime) [↑](#footnote-ref-9)
10. See [Explanatory Material - Reforms to the Scrip for Scrip Roll-Over (treasury.gov.au)](https://treasury.gov.au/sites/default/files/2019-03/C2015-023_EM_scrip-for-scrip.pdf)

and [Tax Laws Amendment (2008 Measures No. 6) Bill 2008 – Parliament of Australia (aph.gov.au)](https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/bd/bd0809/09bd080) [↑](#footnote-ref-10)