KPMG supplementary submission

Review of CGT Rollovers – second consultation paper

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cgtrollovers@taxboard.gov.au

Contacts: Grant Wardell-Johnson (+61 2 9335 7128)
Jenny Wong (+61 2 9335 8661)

Supplementary comments

We are providing further comments on two questions you have requested that we give further consideration following the consultation meeting with the Board of Taxation on 4 March 2021.

The first is a question of whether the ATO's desire to adopt a fairly restrictive interpretation or specific anti-avoidance mechanisms as against adopting Part IVA was appropriate in the context of demergers.

The second question is to address the extent to which there are any integrity concerns in allowing demerged entities to 'stick' or retain the tax cost base of assets in the demerged entity when they form part of a tax consolidated group.

1. Part IVA vs specific anti-avoidance mechanisms

We have sort feedback from partners in our firm and there are some conflicting views on the question of general vs specific anti avoidance mechanisms. Nevertheless, we provide below some observations.

Demerger transactions are commonly complex transactions undertaken to achieve a commercial objective and will often require additional equity in the demerged entity to enable them to be viable in the market place. We understand that arguably demergers when combined with other transactions (such as capital raisings) are in in effect just asset sales and the only reason a demerger occurs with other transactions is to obtain demerger CGT relief. This view tends to oversimplify the benefits when you have regard to the entity having both assets and liabilities and that whilst assets may be easily transferrable, liabilities within an entity may not be so.

The feedback we have received is that in some cases, the capital raised following a demerger may be due to unrelated (and uncontemplated) circumstances to the demerger such as the impact of COVID. In one case, these concerns were raised with the ATO and in the end we understand the ATO accepted the capital raising was not detrimental to the obtaining of CGT demerger rollover relief. The current position allows taxpayers to achieve certainty by discussing and agreeing their concerns with the ATO via ruling process to achieve a commercially viable outcome. If a 'hard and fast' specific anti-avoidance rule was in place, a commercial outcome would have been more difficult to achieve.

However, a specific anti avoidance rule for certain types of CGT rollover relief are present in the current law and have been effective in providing certainty. Take for example, CGT Event J1 (and prior to that the old Section 160ZZOA) which overall has provided certainty as an anti-avoidance measure relating to effective disposals of rollover over assets outside a company group. The EM to the old Section 160ZZOA recognised that although the general anti-avoidance provisions of Part IVA may apply in cases involving multiple roll-overs, it was decided to include a specific anti-avoidance measure relating to the operation of section 160ZZO to target the mischief. It's also worth mentioning there were earlier deficiencies in the former subgroup break up provisions and subsequently rectified that recognised that transferee companies may wish to issue shares to persons who were not group companies at the time of the roll-over. The amendments recognised the motive for issuing shares may be quite unrelated to the mischief contemplated by the integrity rules. For example, the issue of bonus shares to existing shareholders, the participation of employees in employee share acquisition schemes, or the issue of shares for the purposes of raising new equity would trigger the deemed disposal and re-acquisition.

2 Demerger – stick vs spread

The former government announced in a press release on 7 December 2010 further refinements for tax consolidated and MEC groups undertaking demergers. The press release and discussion paper highlighted that if a consolidated group or MEC group restructures by undertaking a demerger and the demerged entities form a new group, then:

- The tax costs of assets held by subsidiary members of the new group will be retained and
- Any capital gain that would otherwise arise because a demerged entity has net liabilities at the time of a demerger will be disregarded

More generally, the Board of Taxation 2012 discussion paper and report on the Post Implementation Review of Certain Aspects of the Consolidation Tax Cost Setting Process also details the CGT and consolidation interaction issues when CGT rollover is involved. Most of these outcomes occur as the tax consolidation provisions do not provide an appropriate tax cost setting amount in many cases. Specifically. the Board of Tax has identified in 2012:

- Issue 1: owned profits of the joining entity may not be picked up when an entity is rolled into a tax consolidated group following a restructure

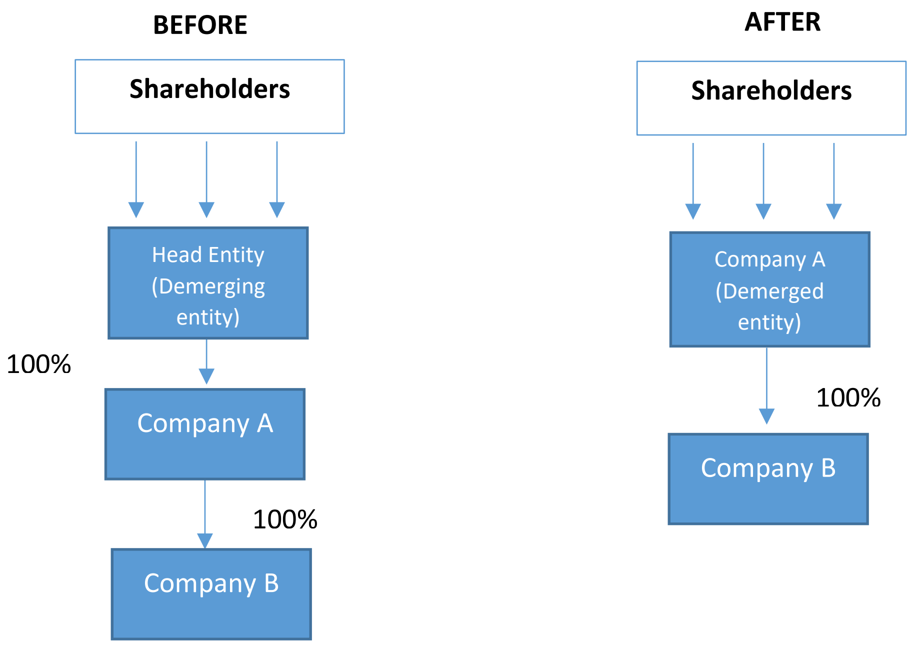
— Issue 2: the tax consolidation provisions rely on the CGT cost base rules contained in each of the rollover provisions, which may not provide an appropriate cost base for step 1 purposes of the tax cost setting process

— Issue 3: where the joining entity has a goodwill asset (or other asset) with value, this can inappropriately skew the tax cost setting process under the restructure

— Issue 4: the interposition of a new holding company under a restructure using certain CGT rollovers can result in the old group ceasing to exist and may require a new group to be formed. This can result in exit calculations, CGT event L3 capital gains and inappropriate entry calculations

In the context of demergers, the issues identified by the Board of Taxation such as tax cost base skewing are also reflected in consolidated groups that obtained demerger relief.

Take for example the following scenario



Company B has the following assets:

Asset 1 Cost base $100 (market value $100)

Goodwill Cost base = Nil (market value $100)

Exit ACA for B on demerger of A = $100

A consolidates with B:

Entry ACA = $100

Assuming market values remain the same, the tax cost of B's assets are now:

Asset 1 = $50

Goodwill = $50

Conclusion:

The demerger has resulted in a skew of tax cost base of Company B's assets. Less cost base is allocated to Asset 1 and more cost base allocated to goodwill.

The existence of assets with market value in excess of their tax cost base value will give rise to skewing of tax cost amounts under tax consolidation

The economic ownership of the group A and B has not changed.

Other observations are:

— The tax cost base skewing outcomes is an inherent feature of tax consolidation tax cost setting process.
— the economic ownership from the restructure and the economic position of the asset have not changed and it would be simpler from a compliance perspective to allow Company B to retain the cost base of its assets. This was accepted in earlier Board of Tax review and the former government in 2010 with the release of the Treasury paper Tax Relief for Consolidated Groups that Undertake Demergers. We believe these previously announced amendments should proceed.

— The skew outcomes is more likely to be one of timing if the assets are subject to tax when disposed of unless the skew is to or away from valuable assets that are not subject to tax.

Distortions from the tax cost setting process as a result of the demerger may arise where Company B has TARP assets.

	Retained cost base	Reset tax cost setting	Market value	Gain under reset	Gain under retain	Economic gain
Asset 1	100	50	100	50	Nil	Nil
Goodwill	nil	50	100	50	100	100