Senate Economics Legislation Committee

New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002

Submission No. 4

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Attachments? Attachment Included

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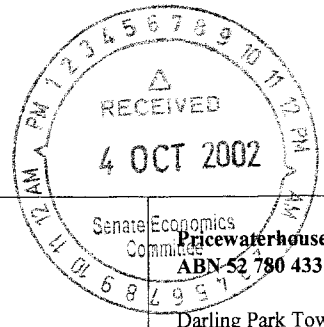

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Dr Dermody
The Secretary
Senate Economics Committee
Suite SG.64
Parliament House
Canberra ACT 2600

2 October 2002

Dear Dr Dermody

Demerger Tax Relief - Submission

I refer to the proposed Tax-Free Demerger provisions contained in New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002 which has been referred to the Senate Economics Committee.

I am a tax partner with PricewaterhouseCoopers, Sydney. I was a member of the Consultation Group which assisted the ATO and Treasury in relation to the demerger provisions. I am currently advising a number of companies at various stages in the planning for and implementation of demergers. I have also been quoted in the Financial Review on a number of occasions in relation to these measures.

I wanted to take this opportunity to place some of the media comments into context.

1. Urgency for the Passage of this Bill

There are a number of companies currently in the process of planning for demerger. The provisions are effective from 1 July 2002. However, as you would expect, many companies are not prepared to proceed with implementation until the legislation is passed. It is therefore critical that these provisions are passed as soon as possible.

2. *Strong Support for the Tax-Free Demerger Provisions*

Dr Dermody
2 October 2002

I strongly support the tax-free demerger provisions. They present a very commercial and practical solution to the need identified by the Ralph Review of Business Taxation. They will allow companies to escape the shackles of inefficient corporate structures and release trapped value for their shareholders. They will provide benefits to the Australian economy in allowing our companies to achieve efficient corporate structures which are conducive to more focused management and shareholder investment decisions.

3. *Possible Improvements/Suggested Recommendations*

I believe that the Tax-Free Demerger provisions could be improved by addressing the issues set out below. However, any such amendments should not further delay the passage of the current Bill. It is submitted that the Committee should make recommendations in relation to the Tax-Free Demerger provisions as follows:

(i) That the Bill be passed in its current form as quickly as possible;

(ii) That the Government should introduce subsequent amendments to the employee share acquisition rules (Division 13A of Pt III of the Income Tax Assessment Act 1936) to ensure that a demerger which otherwise qualifies for tax-free treatment should not give rise to the crystallization of a tax liability under Division 13A. This amendment should apply from 1 July 2002;

(iii) That the Government introduce a subsequent amendment to ensure that a CGT event K6 cannot apply to a pre-CGT share in a listed demerged company provided the demerging company has been a listed public company for at least 5 years (ie. irrespective of how long the demerged entity has been listed before a shareholder sells his or her shares). This amendment should apply from 1 July 2002;

(iv) That the Government introduce subsequent amendments to the demerger provisions (proposed Division 125 of the Income Tax Assessment Act 1997) to allow non-listed entities the same flexibility to qualify for tax-free demerger treatment as publicly listed companies. This amendment should apply from 1 July 2002.

4. Recommended improvement for employees

Dr Dermody
2 October 2002

It is the case that the demerger provisions do not deal with tax liabilities which may arise to employees under Division 13A. Employees represent a significant class of shareholders for many Australian companies. A demerger may result in a tax liability for many employees (because the demerger results in a "cessation time" under Division 13A). This is a particularly onerous result in circumstances where the employee has not received any cash, has not sold his or her shares and has not ceased employment with their employer.

It is submitted that this should be addressed by subsequent amendment with effect from 1 July 2002. Whilst I would encourage this amendment to take place as soon as possible, I believe that it should not be a reason for delaying the passage of the current Bill.

5. Recommended improvement for pre-CGT shareholders

Proposed Section 125-80 provides that shareholders who acquired their interests in the original entity before 20 September 1985 will be taken to have acquired their interests in the demerged entity before that date (ie. maintaining the pre-CGT status).

It is noted that questions have been raised into the appropriateness of maintaining pre-CGT status given that the Ralph Review recommended otherwise. It is submitted that a true "tax-free" demerger regime should remove all the taxation impediments to demergers. On this basis this outcome for pre-CGT shareholders is important and appropriate.

However, it appears that a drafting oversight could present a material tax impediment for pre-CGT shareholders. CGT Event K6 applies to tax pre-CGT shareholders on the disposal of their shares if the following general conditions are satisfied:

(a) there has been a greater than 75% "churn" of the underlying assets of the company since 20 September 1985, and
(b) the company has not been a listed public company for the 5 year period prior to the shareholder selling their shares.

Where these conditions are satisfied, the shareholder is theoretically subject to tax on their share of the inherent capital gains on all the underlying assets of the company.

Even if the original entity is a long established listed public company and the demerged entity becomes a listed public company from the date of demerger, a pre-CGT shareholder

will be potentially subject to this harsh taxing provision if they sell their shares in the demerged company within 5 years after the demerger.

It is submitted that this should be addressed by subsequent amendment with effect from 1 July 2002. Whilst I would encourage this amendment to take place as soon as possible, I believe that it should not be a reason for delaying the passage of the current Bill.

6. Recommended improvement for small business

The Bill includes two key exemptions which are essential for the practical operation of the demerger rules. The flexibility to exclude a "head entity" from a demerger group (proposed subsection 125-65(5)) and the ability to exclude certain instruments from the ownership tests (proposed subsections 125-75(4)-(7)) will ensure that the demerger rules will operate smoothly for publicly listed companies and trusts.

However, small business (in fact, all non-publicly listed groups) will not benefit from these exemptions. As a result, a large number of businesses, including many family owned companies and trusts, will not be able to satisfy the conditions for demerger. An example of the operation of these restrictions is set out in appendix A.

Of course, this practical limitation extends to large business as well. Any unlisted company or trust will fail to qualify for tax-free demerger if it has a substantial shareholder (ie holding more than a 20% interest) or if it has issued some form of ownership interest (such as options, rights, preference shares or convertible notes) which are not entitled to participate in the demerger. Another entity which will not qualify for demerger relief is an incorporated joint venture (even one owned by listed company shareholders).

When the Government first announced the introduction of the demerger rules (refer Senator Coonan's media release of 6 May 2002), it was hoped that we would see a flexible and commercial demerger regime for all Australian businesses. Senator Coonan specifically noted that the tax-free demerger rules would apply for both widely-held and non-widely held entities. However, what is now before the Parliament may be flexible and commercial, but it is a regime which will not be available to a large portion of Australian businesses.

It is submitted that these restrictions are not necessary as integrity or revenue protection

measures. The strict conditions which must be satisfied for a demerger to qualify for tax-free treatment, together with the broad ATO discretion in relation to the dividend exemption mechanism will mean that only genuine demergers will qualify. There is no economic or policy reason for imposing these restrictions. On the contrary, the economic and policy reasons for the introduction of tax-free demerger rules would suggest that these rules should be made available to the broadest possible range of companies and trusts.

Once again, it is submitted that this improvement should be addressed by subsequent amendment with effect from 1 July 2002. Whilst I would encourage this amendment to take place as soon as possible, I believe that it should not be a reason for delaying the passage of the current Bill.

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I would be more than happy to discuss these matters if you would like further detail or clarification. Please do not hesitate to contact me on 02 8266 7939.

Yours sincerely

Wayne Plummer
Partner
Tax Services

Dr Dermody
2 October 2002

Appendix A – "The problem for small business"

This can be illustrated in the following example.

The Jones Family own two car dealerships, a Holden Dealership and a Mercedes Dealership. The Dealerships are operated through a company ("Jones Motors Pty Ltd"), which is owned as follows:

Mr Jones	20%
Mrs Jones	20%
Jones Family Trust (25 children and grandchildren as beneficiaries)	30%
Jones Family Company (10 children as beneficiaries)	30%

In addition, Uncle Jones has helped out in the past and lent money to the company. Uncle Jones has the option to convert the loan receivable into shares in Jones Motors Pty Ltd.

The Jones Family would like to demerge the Holden Dealership and the Mercedes Dealership. They have been advised that this would make it easier to attract new investors. It also provides them with greater flexibility to consider a future sale or joint venture arrangement in relation to either of the Dealerships.

Unfortunately, they will not be able to qualify for tax-free demerger treatment. They will fail to satisfy the conditions for the following reasons:

(i) Jones Motors Pty Ltd cannot be the "head entity" of a "demerger group" because Jones Family Company owns more than 20% of that company. On this basis, Jones Motors Pty Ltd cannot demerge a subsidiary company to its shareholders.

(ii) Uncle Jones holds an ownership interest in Jones Motors Pty Ltd (ie the option to convert the loan into shares), but will not be entitled to receive shares in the demerged entity. Accordingly, the ownership test will not be satisfied.