

Senate Economics Legislation Committee

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

Submission No. 6

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Attachments? Attachments Included

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From: Jeffery, Ann
Sent: Friday, 4 October 2002 2:30 PM
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4 October, 2002.

Dr. K. Dermody
Secretary
The Senate Economics Legislation Committee
Parliament House
CANBERRA ACT 2600

Dear Dr. Dermody

I would like to submit for the consideration of the Senate Economics Legislation Committee the attached paper supporting the passage of the proposed demerger relief legislation. WMC is prepared and keen to implement a demerger subject to the passage of the legislation in the October 2002 sitting.

Yours sincerely

HUGH M. MORGAN
CHIEF EXECUTIVE OFFICER

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04/10/2002

PROPOSED DEMERGER RELIEF LEGISLATION

WMC Limited ("WMC") believes that the proposed demerger relief provisions are necessary to improve efficiency and equity in the operation of Australian capital markets.

Improving Capital Market Efficiencies

The Ralph Report reviewed the operation of the Australian capital markets and made recommendations for improvements which would benefit economic activity in Australia and facilitate implementation of good international practice. The proposals made in the Ralph Report follow precedents in the UK and USA.

One such recommendation was the scrip for scrip rollover provisions introduced in 1997, which have improved the workings of the capital markets and brought Australian taxation laws in this respect into line with major overseas economies.

The demerger relief proposals were also recommended in the Ralph Report and will enable Australian businesses to structure their activities and make decisions in a manner which drives the most efficient outcome without being inhibited by adverse tax outcomes. The proposed demerger relief provisions are a logical extension to the scrip for scrip rollover provisions.

The legislation will ensure that the economic interests and liabilities of Australian companies and their shareholders are the same before and after a demerger.

Parity with Scrip for Scrip Rollover Relief

If the demerger relief provisions are not enacted, a capital market inefficiency and inequity will be maintained whereby the taxation treatment of takeovers is favoured (following the introduction of scrip for scrip rollover relief) at the expense of demergers which may deliver greater value to existing shareholders.

WMC believes that the introduction of the scrip for scrip rollover provisions without complementary demerger relief has created a situation where takeovers of Australian companies can be more efficiently structured from a tax perspective than the company could restructure itself. This may leave Australian companies vulnerable to takeover when a demerger would otherwise be in the best interests of shareholders if given equitable tax treatment under Australian law.

The inequity of the current situation (pre-enactment of the proposed demerger relief provisions) is illustrated by the simple example contained in Schedule A.

Demerger tax relief will level the playing field by enabling Australian companies to restructure with similar outcomes and costs as are available to a takeover predator.

Consistency with Ralph Report and Impact on Revenue

WMC understands that concerns were raised in Parliament as to whether some aspects of the proposed demerger relief legislation go further than what was recommended in the Ralph Report. We believe the extensions are appropriate and/or necessary, and incorporate stringent integrity measures to ensure that they apply in the manner intended.

The scrip for scrip rollover provisions enacted by Parliament also included some improvements to the original Ralph Report recommendations. The provisions of the proposed demerger relief legislation are consistent with the Ralph Report and with the improvements to the scrip for scrip rollover provisions now in force.

WMC does not believe that the introduction of this legislation will result in revenue losses to the Commonwealth. Without the legislation, potential demergers generally will not proceed, so the notional tax revenue arising from potential demergers under existing legislation will not in fact materialise. In fact, because demergers enable shareholders to adjust their portfolios taking into account the different risk/return profiles of the demerged entities, this should lead to increased capital gains tax revenue to the Commonwealth due to the resultant increased share trading activities.

Application to WMC's Situation

WMC is keen to demerge its 40% ownership of Alcoa World Alumina and Chemicals ("AWAC") from its other businesses to preserve value to its shareholders. WMC's particular circumstances are unusual, but nevertheless serve as an example of the desirability and equity of introducing demerger relief legislation to improve the operation of Australia's capital markets. The background to WMC's circumstances is described in Schedule B.

WMC wishes to proceed with its demerger before the end of 2002, as it remains vulnerable to takeover and, having announced its intention to demerge almost 12 months ago, its shareholders are anxious to restore certainty to WMC's future by voting on the proposal without further delay.

In order that WMC's demerger can be implemented this calendar year, it is essential that the proposed demerger relief legislation complete its passage through Parliament during the October session.

Facilitating Passage of Legislation

WMC notes that the relevant provisions are included in a Bill which also contains various elements of the proposed consolidations tax provisions. If the demerger relief provisions are supported by the Senate but other provisions of the Bill require further consideration, WMC recommends that the demerger relief provisions be decoupled from those other provisions and included in a separate Bill to expedite implementation.

SCHEDULE A

Company A is listed on the Australian Stock Exchange. It has two unrelated businesses held in separate subsidiaries. For a variety of reasons the share market undervalues one of them. Consequently, equity capital raisings are difficult and the company's share price trades below fair value. Further, senior management finds it difficult to focus on both businesses. For these reasons, it makes sense for the two businesses to be separately listed. However, a demerger under existing Australian tax legislation would involve a significant capital gains tax cost to the company (due to the historically low cost base of its businesses) and taxation issues to its shareholders. Hence, it would be difficult to proceed as the benefits of the demerger may not be sufficient to compensate for the cash tax cost to the Company and possibly its shareholders. As a result, its shares will continue to trade at less than fair value.

However, benefits similar to a demerger of Company A can be available to another company (Company B) in a takeover. Company B can make a scrip for scrip takeover offer to shareholders of Company A in accordance with the scrip for scrip rollover provisions. Company A shareholders will not pay any capital gains tax upon exchanging their shares in Company A for shares in Company B. Company B will have a higher market value cost base in respect of Company A's businesses as a result of the takeover.

Company B can now deal as it wishes with the acquired businesses. For example, it can retain one and sell the other, realising the benefits of a demerger. And because it has a higher market value cost base, it can do so without incurring the tax liabilities which would apply if Company A sought to demerge.

Because of the impediments Company A had to restructuring, it is probable that Company B will have been able to acquire these businesses at less than fair value, ie. at a loss to Company A's original shareholders. If Company B were a foreign company, this will result in a transfer of value from Australian to foreign shareholders.

SCHEDULE B

WMC's Circumstances

WMC received a proposal from the US company Alcoa Inc in late 2001 whereby, conditional on a WMC Board recommendation supporting the bid, Alcoa would make a takeover offer for all WMC shares. Alcoa was particularly anxious to acquire WMC's 40% interest in Alcoa World Alumina and Chemicals ("AWAC"). It intended to break up the company and sell WMC's other assets and (as in the example in Schedule A) would have been able to do so without incurring a capital gains tax liability because of the higher cost base following a takeover.

Based on an independent expert valuation report commissioned by WMC, WMC's Directors judged Alcoa's indicated offer price to be less than the price at which they could recommend the offer to shareholders.

However, the Directors believed Alcoa's particular interest in WMC's 40% ownership of AWAC would continue and that Alcoa was likely to again seek to acquire WMC at an even less propitious time in the future.

Consequently, after considering a number of alternatives, WMC's Directors proposed a demerger into 2 entities – one to hold AWAC and the other to hold the rest of WMC's resource businesses.

Because WMC had considered the possibility of such an Alcoa approach for some time, WMC had developed a demerger proposal under current applicable Australian tax legislation and had received a draft class ruling from the Australian Tax Office.

This proposal was complex, it had some commercial and regulatory disadvantages and had some adverse tax consequences for WMC shareholders. However, Directors considered it a necessary response to the Alcoa proposal to ensure fair value for shareholders.

Earlier this year, following Government announcements on the proposed demerger tax relief provisions, WMC decided to abandon that original plan and develop a simplified proposal under the proposed new legislation.

This involved an immense amount of work, including comprehensive discussions with relevant Australian and US regulatory authorities, and the only precondition to now proceeding with the demerger is the passage of the demerger relief legislation.

The demerger will enable WMC's shareholders to hold one share in a company owning the 40% owned AWAC business and one share in a second company owning WMC's other resources business. Shareholders will then be free to separately trade their shares in those two companies as they see fit.

WMC believes that the demerger:

- a) will facilitate more transparent valuation of WMC's businesses, particularly AWAC, by the market;
- b) will improve management focus within each demerged company on its respective businesses; and
- c) in the event that Alcoa or any other company subsequently seeks to acquire either of the demerged companies, will ensure that the outcome for shareholders is optimised by promoting free competition for those assets within the market.

Until the demerger is implemented, WMC believes that it remains vulnerable to takeover by Alcoa, acting either alone or in concert with other foreign controlled major resource companies, at a price which will represent less than fair value to WMC's shareholders. WMC shareholders are also anxious to have the demerger proposal put before shareholders without further delay.