

Senate Economics Legislation Committee

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

Submission No. 7

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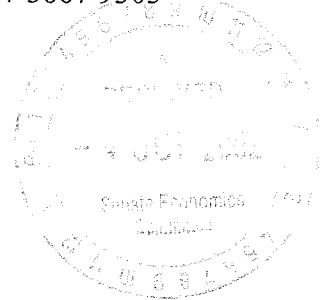
Attachments? No Attachments



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The Secretary
Senate Economics Committee
Suite SG.64
Parliament House
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4 October 2002

Dear Dr Dermody

Demerger Tax Relief

I refer to your letter dated 24 September 2002 inviting Incitec Ltd to make a written submission to the Senate Economics Committee ("the Committee") in relation to the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002* ("the Bill").

Please find our submission enclosed. This submission deals solely with the demerger tax relief aspects of the Bill only.

As explained in our submission, the demerger tax legislation is a key ingredient in Incitec's efforts to rationalise the Australian fertiliser industry. If the Bill, designed to have effect from 1 July 2002, does not receive Royal Assent by 24 October 2002 then Incitec may face further significant delays and costs. In summary, we submit that the Committee should be able to deal with the demergers aspect of the Bill without delay and we encourage the Committee to recommend passage of the Bill, without changes, as soon as possible after the hearing on 14 October 2002.

I would like to take this opportunity to express our willingness to appear as a witness before the Senate Economics Committee to give evidence at the public hearing to be held during the week commencing 14 October 2002. I would propose being accompanied by Peter Collins, a tax partner of PricewaterhouseCoopers. Peter has been providing advice to Incitec in relation to the proposed demerger and has been involved in the consultation process on the demerger measures with Treasury.

Contact details are set out below:

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The demerger tax legislation is a key ingredient in Incitec's efforts to rationalise the Australian fertiliser industry. Achievement of that objective will benefit the shareholders of Orica, Incitec and Pivot. Therefore, we are keen to provide whatever assistance may be necessary. Please do not hesitate to contact Peter Collins or me if you wish to discuss any of these matters.

Yours faithfully

Greg Witcombe
Managing Director
Incitec Ltd

Encl.

INCITEC LTD
**Submission on New Business Tax System (Consolidation, Value Shifting,
Demergers and Other Measures) Bill 2002**
Demerger Tax Relief (proposed sub-division 125 ITAA 1997)

1. Introduction

The following submission relates to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002 ("the Bill"), which was referred to the Economics Committee of the Senate ("the Committee") on 18 September 2002.

We understand that the Committee proposes to conduct a public hearing on the matter during the week commencing 14 October and that the reporting date for the Committee's findings is set as 18 October 2002. The terms of reference are "To explore the detail of the operation, revenue costs and compliance costs of the major measures in the bill."

Incitec would like to take this opportunity to congratulate the ATO and Treasury representatives who have been responsible for formulating the proposed rules. In our view, they have adopted a commercial approach to the provisions and have addressed many of the issues and recommendations raised during the consultation process. We believe that the demerger tax proposals will achieve the objectives stated by the Assistant Treasurer in May 2002 that "Tax relief for demergers will increase business efficiency by allowing greater flexibility in restructuring business, providing an overall benefit to the economy. The Government has implemented this latest measure in business tax reform to enhance competitiveness of Australia's business sector".

2. Executive Summary

The demerger tax relief aspects of the Bill are a key element of Incitec's plans to rationalise the fertiliser industry and is one example of the need for the proposed reform. We would encourage the Committee to recommend passage of the Bill, without changes, as soon as possible. In addition, we seek the Committee's assistance in ensuring that the Bill receives Royal Assent by 24 October 2002.

3. Background

On 29 August 2002, Incitec Ltd, a listed company 76.96% owned by Orica, announced plans to demerge its industrial chemicals and fertiliser businesses. If the demerger is approved by shareholders at a meeting on 22 October 2002, it is proposed that Orica will seek full ownership of the industrial chemicals business and that Incitec will pursue a merger of its fertiliser businesses with a similar business of Pivot Limited. It is expected that these transactions will deliver substantial benefits to Orica, Incitec and Pivot shareholders, principally through the synergies expected to be generated.

The demerger transaction is being pursued by Incitec on the basis of Government announcements in May 2002 that the demerger tax rules would apply from 1 July 2002 and Incitec has devoted considerable management time and has taken corporate finance, legal and accounting advice in relation to this proposal. Incitec has also met with the ATO on a number of occasions¹ to discuss these matters and, on 13 August 2002, sought written confirmation from the ATO regarding the application of the Bill to the Incitec demerger proposal.

The Incitec demerger proposal is one example of the need for the proposed reform. An efficient demerger of the industrial chemicals and fertiliser businesses is an essential pre-condition to the Incitec / Pivot proposals. In the absence of demerger tax rollover relief which provides a tax deferral for shareholders, despite the benefits of the transactions to the respective companies, the proposed transactions simply could not be achieved without material and immediate adverse consequences for the shareholders.

While we understand the need for review of the proposed reforms and the due processes of the Senate, we are obviously disappointed in the delays in the progress of the Bill. In that context, we are prepared to provide whatever assistance may be required to assist in the passage of the Bill through the Senate as soon as possible.

For Incitec, assuming its shareholders approve the demerger proposal at the shareholder meeting on 22 October 2002, the critical date is 25 October 2002, being the date of Incitec's application to the Court for final approval of the scheme of arrangement that will practically implement the demerger.

Royal Assent to the Bill is a condition precedent to the demerger proposal. If the Bill does not receive Royal Assent by 24 October 2002, Incitec may face further significant delay in implementing both the demerger and subsequent proposed merger with Pivot.

4. Issued Raised in Parliament

Based on our review of Hansard, we understand that the Honourable Bob McMullan MP raised several issues in Parliament on 28 August 2002 in relation to the demerger tax relief proposals. In the interests of assisting the Committee's review of the demerger aspects of the Bill, we comment below on each of these concerns:

Timeliness of tax reform. Demerger tax relief was foreshadowed in the Ralph review of business tax in July 1999. Since then, it is our understanding that bipartisan support for demerger tax relief has been consistent. The Government delivered on this issue through the introduction of the Bill on 27 June this year. We were involved in the process of consultation that led to the measures in the Bill and some subsequent technical corrections to the Bill. This is a process that we applaud as it has now produced legislation which we believe is relatively flexible, workable and, above all, will achieve the economic goals discussed above. This has been an extremely long

¹ 2 July, 24 July and 1 August 2002.

period of consultation and therefore we do not understand the need to submit the measures to further review and consultation.

The delay caused by this further review will expose any companies who are in the process of, or seriously considering, undertaking a demerger, to considerable additional costs.

Relief for non-widely held entities. At page 619 of the July 1999 report of the Review of Business Taxation (“RBT Report”) it is stated in relation to demerger relief that “it would be more difficult for valuations to be determined for entities that are not widely held”. This would seem to be the reason that the RBT Report recommends demerger relief for widely held entities only. However, the demerger provisions in the Bill relating to both proportionate holding of membership interests before and after a demerger and the cost base allocation rules are rigorous and have, in our view, more than addressed any concern over non-widely held entities accessing demerger relief. In addition, we note that the rules are restrictive in the sense that shareholders in unlisted companies with a single shareholder holding more than 20% will not qualify for demerger tax rollover relief. In effect, this severely restricts the application of the rules and should address any concerns in relation to non-widely held entities.

Finally, we note, as identified by the Honourable Bob McMullan in Parliament, that certain comments in the RBT Report were premised on an entity regime of taxation – a regime that has not been adopted.

Pre-capital gains interests retaining their nature. This recommendation of the RBT Report, if adopted, may have led to the rejection of some proposed demergers by shareholders who were concerned about converting pre-CGT interests into post-CGT interests. However, if the purpose of the RBT Report recommendation is to be put into effect, shareholders should have no tax consequences from a demerger. Thus, the rules in the Bill more closely align with this purpose than the concept of bringing pre-CGT interests into the CGT net.

We also note that shareholders can be brought to tax, through CGT Event K6, even if their shares are pre-CGT. Accordingly, we submit that CGT Event K6 is the proper mechanism for dealing with pre-CGT interests, not the demerger tax relief provisions.

The Bill does not cover linkages with consolidation or integrity measures for non-widely held entities. As you are aware, the third tranche of tax consolidation legislation was released on Thursday 27 September 2002. It is expected that a fourth tranche be released later this year. In the interest of timeliness it is more appropriate that the consolidation linkages (and the further demerger integrity measures) are dealt with in that legislation. In addition, we note that this issue is partly dealt with by the tax consolidation transitional rules which, in effect, make tax consolidation “optional” for up to two years.

The revenue cost of the measure is “unquantifiable”. The Honourable Senator McMullan identified that without demerger relief some (if not most, in our view)

economically desirable demergers may not proceed. As Senator McMullan noted, it is difficult to predict behaviour and consequent revenue impact. However, we draw your attention to the fact that without demerger tax relief, economic inefficiency will be retained and the possible additional revenue that could be generated by the Australian economy will be foregone. In fact, as you will be aware, a less efficient economy will necessarily lead to a contraction in the Commonwealth's revenue base. In addition, we remind you that the RBT Report recommended the implementation of demerger tax rules.

The proposed measures go beyond the recommendations in the RBT Report by extending relief to the entity (as well as shareholders) and allowing relief for non-widely held entities. With respect, it is our view that this is not the case. The fact that the tax impact of a demerger for a demerging entity is not dealt with by the RBT Report may be explained by two considerations. First, the recommendation in the RBT Report considers the position of the shareholder but is silent on the position of the demerging group. However, it is clear that the RBT Report supports making demergers completely tax neutral as this is the only way to ensure that many possible demergers become viable. This must by inference include making a demerger tax neutral for the demerging group. Second, the RBT Report also recommends tax consolidation and most probably assumed that demerger tax relief and tax consolidation would be in place at the same time. However, the deferral of tax consolidation has necessitated specific relief at the entity level as an interim measure and may continue to be a necessary feature for groups that do not elect tax consolidation for tax purposes.

In addition, the demerger relief proposed in the Bill is more restrictive in certain aspects than that proposed in the RBT Report. For example, the proposed demerger relief will not be available to many non-residents or to shareholders who hold their interest on revenue account. The RBT Report did not recommend such a restriction. Moreover, the demerger relief proposed in the Bill is not available for demergers by listed public companies owned 80% or more by a single member or group, or for other companies owned more than 20%. This restriction was not recommended by the RBT Report.

5. Employee Shareholders

Subsequent to the comments in Parliament referred to above, we understand that issues have been raised with Senator McMullan's office in relation to the treatment of employee shareholders (under Division 13A ITAA 1936). It is clear our preference that any further review or changes in this area do not delay the Bill and we suggest that, if necessary, a separate Bill be introduced to address this issue.

Incitec Ltd
4 October 2002