Chapter 2

Schedule 1 – Shareholder and unitholder rights

Background

2.1 Schedule 1 of the bill amends the Income Tax Assessment Act 1997 to address concerns over the tax treatment of call options and put options arising from the High Court's decision on share sell back rights in *Commissioner of Taxation v McNeil* 2007 (McNeil case).

2.2 An option is a derivative security that confers a right to buy or sell securities at an agreed price. Call options are a right to acquire shares at a pre-determined price. Put options are a right to sell shares at a pre-determined price. Where these rights are renounceable, shareholders are entitled to take up the offer, sell the right on the market or allow the offer to lapse. Non-renounceable rights cannot be traded.

2.3 The McNeil case involved St George Bank's issue of renounceable sell back rights to its shareholders, including Mrs McNeil. In this instance shareholders could exercise their right and sell back the shares for an amount in excess of their market value, sell the right itself on the market, or do nothing and have the right sold on their behalf for a designated price. Mrs McNeil did not exercise her right and was subsequently paid for their realised value. The central question in McNeil was whether this constituted assessable income subject to income tax or a receipt of capital subject to capital gains tax (CGT). The High Court decided that the market value of tradeable put options issued to shareholders was assessable as ordinary income at the time of issue and subject to income tax. [1]

2.4 Although the decision related directly to the acquisition of put options through the issue of sell back rights, there has been concern that it could also be applied to call options issued by companies attempting to raise capital.[2] The EM indicates that:

> This would require a shareholder or unitholder issued with call options in some circumstances to include the value of the option in their assessable income at the time of receiving the option. Such an outcome would seriously affect the capital markets and have significant implications for companies and trustees of unit trusts wanting to use call options to raise capital.[3]

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1 Treasury, *Answer to question on notice BET 97*, Budget Estimates, 29 May 2007, p. 1; Parliamentary Library, *Bills Digest*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, pp 3-4

2 *Explanatory Memorandum*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, p. 6

3 *Explanatory Memorandum*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, p. 6

2.5 Prior to the court's decision in McNeil, rights issues were treated as issues on capital account and subject to CGT provisions when the gain was realised.[4] On 26 June 2007 the then Minister for Revenue and Assistant Treasurer Peter Dutton MP issued a press release foreshadowing a legislative amendment to restore the tax treatment of rights that existed before McNeil. It said:

> Shareholders issued with rights by companies seeking to raise capital will not have an income liability at the time of issue. Instead, the long-standing position to treat rights issues on capital account will be maintained.[5]

2.6 The bill seeks to implement this intent. The EM states that:

> These amendments restore the original tax treatment of rights issued by issuing entities to existing shareholders or unitholders to acquire additional relevant interests in those entities. As a result, a taxing point will not arise for the shareholders or unitholders in relation to the rights until a subsequent capital gains tax (CGT) event happens to the rights or to relevant interests as a result of exercising the rights.[6]

Proposed amendments

2.7 Item 2 inserts new section 59-40 into the *Income Tax Assessment Act 1997*. This stipulates that the issue of a right to acquire an interest in the relevant entity is non-assessable and non-exempt income at the issue time for tax purposes. Section 59-40(2) lists a number of conditions upon which this will apply. These are:

- at the time of issue, the taxpayer must already own an interest in the issuing entity (known as original interests);
- the rights must be issued to the taxpayer because of their ownership of the original interests;
- the original interests and the rights must not be revenue assets or trading stock at the time the rights are issued;
- the rights must not have been acquired under an employee share scheme;
- the original interests and rights must not be traditional securities; and
- the original interests must not be convertible interests.[7]

4 Parliamentary Library, *Bills Digest*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, p. 4

5 Mr Peter Dutton MP, *Press release*, 'Taxation of Rights Issues', 26 June 2007

6 *Explanatory Memorandum*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, p. 6

7 *Explanatory Memorandum*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, p. 9

2.8 These conditions ensure that the amendments only apply to those with acquired rights because of their original interest and who would ordinarily be taxed on capital account.

2.9 Income derived from the acquisition of call options is subject to capital gains tax (CGT) when a CGT event occurs, such as the shareholder disposing of their rights on the market.

2.10 Item 7 inserts new section 112-37 into the *Income Tax Assessment Act 1997*. This provision applies to ensure that double taxation does not occur where put options have been issued. The market value of the put option is included as assessable income at the time it is issued. To prevent this amount from being taxed again when a CGT event occurs, it is included in the cost base of the put option for CGT purposes. The difference between this and the eventual selling price is subject to CGT.

2.11 Item 9 stipulates that the amendments apply to rights issued on or after 1 July 2001.[8]

Issues

2.12 The Institute of Chartered Accountants in Australia ('the Institute') supported the passage of the bill to provide certainty in the circumstances described above. However, both they and the Law Council of Australia raised a number of concerns about the bill, particularly the exclusions at proposed section 59-40(2).

The pre-McNeil position is not restored

2.13 The Institute of Chartered Accountants notes that although double taxing issues relating to the issuing of put options have been addressed, the amendments do not in fact restore the treatment of put options that was thought to apply prior to McNeil. The Institute indicated that 'no policy reason has been provided for retaining the treatment of put options which arises as a consequence of McNeil's case'.[9]

Non-renounceable rights

2.14 The Law Council of Australia raised uncertainty about whether the McNeil case, which applied directly to renounceable (tradable) rights, also applied to non-renounceable rights. They said that the bill should clarify their status:

> Prior to McNeil the issue of these rights were considered not to create either an income gain or a capital gain to the shareholder.

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8 *Explanatory Memorandum*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, pp 8-12; Parliamentary Library, *Bills Digest*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, pp 6-7

9 Institute of Chartered Accountants in Australia, *Submission 1*, p. 4

> The provisions should make it clear that this continues to be the case for both put and call options that are non-tradeable, in order to eliminate the uncertainties caused by the decision; those uncertainties impact on the efficient operation of the capital/markets. [10]

Subsidiaries

2.15 The Law Council commented that acquiring rights as a consequence of owning shares in a wholly owned subsidiary would not satisfy the requirement for the person issued the rights to have an original interest.[11]

Non-traditional rights issues

2.16 They also raised concerns over whether non-traditional rights issues would fall within the scope of new section 59-40. Using the example of a renounceable accelerated pro-rata issue with dual bookend-structure, they suggested that this type of rights issue would not satisfy section 59-40 because the structure is not an issue of rights by the issuing company and there is no market value at the time of issue.[12]

Convertible interests

2.17 Convertible interests are financial instruments that may be converted into shares. The EM explains that they are excluded from the amendments applying to the tax treatment of call options because 'the principles enunciated in McNeil's case are not easily applied to convertible interests'.[13] The Institute of Chartered Accounts warned that this exclusion could result in double taxation by the Australian Tax Office. They stated that 'it is unfortunate that the opportunity was not taken to ensure that the amendments contained in the Bill put the issue beyond doubt'.[14]

2.18 The Law Council of Australia also disagreed with the exclusion, describing it as 'misconceived'. They wrote:

> There appears to be no policy or other basis why rights issued to preference share holders who hold their shares on capital account should be taxed any different [sic] to those issued to other ordinary shareholders.[15]

Revenue assets and trading stock exclusions

2.19 Both the Institute of Chartered Accountants and the Law Council of Australia raised concerns over this exclusion covering shares held as revenue assets or trading

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10 Law Council of Australia, *Submission 2*, pp 1-2

11 Law Council of Australia, *Submission 2*, p. 2

12 Law Council of Australia, *Submission 2*, pp 2-3

13 *Explanatory Memorandum*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, p. 9

14 Institute of Chartered Accountants in Australia, *Submission 1*, pp 5-6

15 Law Council of Australia, *Submission 2*, p. 5

stock. The Institute stated that it was unclear how shareholders subject to the provision will be able to calculate their tax liability. They also questioned the rationale for the exclusion:

> …until the McNeil decision, there was no authority of which we are aware to the effect that the value of rights granted to a shareholder or unitholder in respect of pre-existing shares or units held on revenue account or as trading stock was assessable as income.[16]

2.20 They suggested that in these circumstances shareholders should only be taxed on profits made on the disposal of the rights. They added:

> To assess a shareholder … simply because the shareholder … has a right to invest more capital is in our view an undesirable outcome since such policy will create uncertainty and may adversely impact the capital raising alternatives available to Australian companies and unit trusts.[17]

2.21 The Law Council of Australia also objected to the exclusion. On shares held on revenue account, they indicated that shareholders could be exposed to an immediate tax liability even where no actual profit is subsequently realised.[18] With respect to trading stock, the Law Council commented that there was potential inconsistency between the proposed amendment and the existing provisions relating to trading stock.[19]

Consultation

2.22 The Institute indicated that government consultation was not 'entirely satisfactory'. They asserted that the government's response and feedback to the business sector following the McNeil decision was too slow, while the actual legislative development was too hasty once commenced. They submitted the following comment:

> Unfortunately, the consultation process was very abbreviated and focussed only on the most common scenario impacted by the McNeil decision and has resulted in a number of areas of uncertainty for stakeholders as noted above.[20]

Proposed amendments to the bill

2.23 The Law Council of Australia proposed the following changes to the bill to avoid unintended consequences for those with rights that are non-renounceable or not exercised:

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16 Institute of Chartered Accountants in Australia, *Submission 1*, p. 6

17 Institute of Chartered Accountants in Australia, *Submission 1*, p. 6

18 Law Council of Australia, *Submission 2*, p. 4

19 Law Council of Australia, *Submission 2*, pp 4-5

20 Institute of Chartered Accountants in Australia, *Submission 1*, p. 7

> If the Government considers [the exclusions] should be retained then, at the very least, the section should be amended to provide
>
> (3) Paragraphs 59-40(2)(c) to (f) do not apply if:
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> (k) the rights are not tradeable; or
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> (l) (i) the rights lapse without being exercised; and
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> (ii) the shareholder receives no other consideration in respect of the transaction.[21]

Committee comment

2.24 The committee acknowledges the concerns raised about the bill during the inquiry. However, these should not delay the passage of the bill, which will largely circumvent the uncertainty created by the High Court's decision in McNeil. The Senate should therefore pass the bill. The committee is also of the view that the government should address the concerns of the Institute of Chartered Accountants, the Law Council of Australia and other concerned organisations through continuing consultation.

21 Law Council of Australia, *Submission 2*, p. 6