Law Council
OF AUSTRALIA

Mr John Hawkins
The Secretary
Senate Standing Committee on Economics
PO Box 6100
PARLIAMENT HOUSE
CANBERRA ACT 2600

Dear Mr Hawkins,

Inquiry into: Provisions of Schedules 1 and 2 of the Tax Laws Amendment (2008 Measures No. 3) Bill 2008

I refer to your letter of 27 June 2008 inviting submissions in respect of the above Bill.

The Treasurer in his announcement of 8 April 2008 stated that the Government would amend the income tax law to restore the long-standing taxation treatment of call options issued by companies. It was noted that the bring-forward of a tax liability for call options under *McNeil's* case would impose unnecessary compliance costs on companies and their shareholders.

It is the submission of the Taxation Committee of the Business Law Section of the Law Council of Australia that the Bill does not give full effect to those statements, for the reasons set out below.

Non Tradeable Rights

Although *McNeil's* Case involved tradeable options there remains a question as to whether it affects the position of non-tradeable rights.

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

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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 this decision; those uncertainties impact on the efficient operation of the capital/markets.

Scope of the Amendments

The provisions should be expanded to cover:

(a) rights issued by subsidiaries to shareholders of the parent company or trust; and

(b) non-traditional rights issues.

Subsidiaries

The facts of *FCT v Allinta (1991)* 28 FCR 203 are illustrative. BHP Gold (a wholly-owned subsidiary of BHP) issued renounceable rights to acquire shares in that company to the shareholders of BHP on the basis of one share in BHP Gold for every three shares held in BHP.

This situation would not receive the benefit of proposed s 59-40(1) as sub-section (2)(a) is not satisfied.

(It is noted that the Commissioner expressly declined to argue that the issue of the rights was ordinary income within s 6.5).

Non-Traditional Rights Issues

These structures have developed as an alternative to traditional rights issues to enable issuers to raise funds more quickly and give greater certainty about the funds that will be raised.

However whilst their structures are economically the same as a traditional rights issue they may not fall within proposed s 59-40(1).

For example, a "RAPIDS" (renounceable accelerated pro-rata issue with dual-bookbuild structure) involve the following steps:

(a) Issuer announces an offer to subscribe for shares ("**Offer**") to the market;

(b) The Institutional and Retail Entitlement Offers are intended to be functionally equivalent to pro rata offers in that all holders of ordinary shares on the Record Date are offered pro rata entitlements to new ordinary shares at the same price;

(c) The Institutional Entitlement Offer would be made at a fixed price (Offer Price) to Institutional shareholders on the first 2 days of a 2+1 trading halt;

(d) To the extent that Institutional shareholders do not wish to participate for their full entitlement under the Institutional Entitlement Offer, that entitlement will be made available to other Institutional shareholders (and other institutional investors) during a bookbuild process (First Bookbuild) conducted on day three of the 2+1 trading halt;

(e) Issuer will receive the Offer Price for each share sold but if the clearing price set under the bookbuild exceeds the Offer Price the "renouncing" Institutional shareholders will receive the difference;

(f) Issuer will lodge a prospectus (Prospectus) in respect of the Institutional Entitlement Offer and Retail Entitlement Offer with ASIC and ASX prior to opening of the retail offer;

(g) The Retail Entitlement Offer will then be made under the Prospectus on a pro rata basis to all registered holders of shares as at the Record Date (Retail shareholders) except to the extent that shareholders have received an offer under the Institutional Entitlement Offer (whether or not accepted)

(h) The Retail Entitlement Offer will have a first close. On the same date shares are issued under the Institutional Entitlement Offer, shares would also be issued to those Retail shareholders who have accepted under the Retail Entitlement Offer by that first close date;

(i) The Retail Entitlement Offer will then have a final close. To the extent that Retail shareholders do not wish to participate for their full entitlement that entitlement will be made available to Institutional shareholders (and other institutional investors) during a bookbuild process (Second Bookbuild) conducted after the close of the Retail Entitlement Offer during a 2 day trading halt. Again "renouncing" holders will receive the difference (if any) between the Offer Price and the second bookbuild clearing price; and

(j) Shares are then issued under the Retail Entitlement Offer (if not issued previously under (h) above).

Under this issuing structure at least two issues arise under s 59-40.

First, the above structure is not an issue of rights by the issuing company or trust. It is an offer to shareholders to subscribe for shares at the stated Offer Price. Non-accepting shareholders receive a proportion of any bookbuilt proceeds over that price even though they have not "renounced". Accordingly RAPIDS would not satisfy s 59-40 (1)(a).

Second, s 59-40(1) only applies to the market value at the time of issue. The underlying assumption is that there is a derivation of ordinary income at the time of issue: see *McNeil*. Under RAPIDS, income (if it exists) would only be derived at the time of receipt of the bookbuilt premium. That is different to the time of issue and therefore outside the benefit of s 59-40(1).

Accordingly, the section should confirm that it is only the CGT regime which is applicable to non-traditional rights issues.

Revenue Assets

Shares or units held on revenue account are excluded from the exemption contained in the proposed s59-40(1).

The Explanatory Memorandum (**EM**), at paragraph 1.12, states that "if the original interests and the rights are revenue assets, then the shareholder will generally be taxed on the profit that is made on the disposal of the rights at the time of disposal". This statement bears no relationship to the problem created by *McNeil* which needs to be rectified. The excluded shareholders are potentially exposed to taxation on the value of the rights when they are issued even if:

- the rights are not tradeable;
- the rights lapse; or
- the rights are exercised.

In the case of rights that are not tradeable the shareholders will be taxed on an illusory benefit which cannot be turned to account other than by exercise. They are put at risk in respect of a paper transaction over which they have no control.

If the rights lapse the shareholders are put to the unnecessary compliance cost of including in their accounts the market value of the rights on issue and then deducting the market value of the rights when they lapse. Again, they are put at risk in respect of a paper transaction over which they have no control.

Where the rights are exercised the shareholders may have made an immediate paper profit for tax purposes, being the value of the rights, but may in reality have realised no actual profit due to the effect of the rights issue on the underlying share value. The shareholders effectively have not realised a true profit in respect of their investment.

Trading Stock

The EM states in respect of trading stock that "if the original interests and rights are trading stock, then the trading stock provisions (Division 70) will apply to the rights". Again Division 70 focuses more on the consequences of disposal of trading stock rather than the taxation position on any relevant acquisition of the item.

Further, for an item to be trading stock it must be held for the purposes of manufacture, sale or exchange.[1]

Where a right is either:

- not tradeable; or
- exercised or allowed to lapse,

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[1] Section 70-10

it cannot be said that it is held for the purpose of sale or exchange.[2]

Therefore, even if the underlying original interests were trading stock, there is a degree of complexity in determining whether both the original interests and the rights are trading stock as required by the sub-section.

Employee Share Scheme Rights

For rights to be acquired under an employee share scheme within Division 13A, they must have been acquired in relation directly or indirectly to the employment or services provided by the taxpayer.[3]

The requirement in section 59-40(2)(b) is that the rights are issued because of the ownership of the original interests.

These two requirements are mutually exclusive[4]. The exclusion in 2(d) is therefore superfluous.

Traditional Securities

It is accepted by the Australian Taxation Office that shares and units are not traditional securities[5]. Again therefore it is difficult to see why this exclusion is also not superfluous.

Convertible Interests

The exclusion in paragraph (f) fails to recognise that shares in a company, such as preference shares, can be convertible interests[6]. Preference shares can be debt interests within Division 974 and convert into equity interests.

The comment in the EM at paragraph 1.13 that the principles annunciated in *McNeil's* case are not easily applied to convertible interests is therefore again misconceived.

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 to those issued to other ordinary shareholders.

Conclusion

If, contrary to the announcement of 8 April, the policy intention of the Government is to only give the benefit of the provision shareholders/unitholders that have their interests on capital account, then it is suggested that this is better achieved by deleting the current subparagraphs 2(c) to 2(f) and replacing them with:

> (c) a disposal of the original interests at the issue date would have attracted tax under a provision other than Part 3-1 of the Act.

This is simple and clear and does not raise the interpretation or application issues of raised above in respect of the current provisions.

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[2] See ATO ID 2004/526
[3] Section 139C(1) and (2)
[4] FCT v McArdle 89 ATC 4051.
[5] TR 96/14 at paras 28, 34-39.
[6] See para 2.40 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001

If the Government considers paragraphs 2(c) to (f), or any other 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:
>
> (k) the rights are not tradeable; or
>
> (l) (i) the rights lapse without being exercised; and
>
> (ii) the shareholder receives no other consideration in respect of the transaction.

A further suggestion, to avoid the cost and complexity of taxing on values which are in fact not realised, is to include a provision similar to that contained s139CC. The provision fixes the taxable amount to the actual disposal consideration if the right is disposed of under an arm's length transaction within 30 days of the issue date.

Cost base consideration

A deficiency in the CGT cost base provisions is that they do not specifically deal with the situation where an asset is acquired in circumstances which give rise to a taxation liability but there is no outlay of property or money by the taxpayer. It has been a matter of practice to include the taxed value as part of the cost base. However, if the taxpayer has not clearly given property or money to acquire the asset[7], this practice is not technically correct. This situation occurs for example where employees acquire assets on which fringe benefits tax has been paid or an entity acquires an asset in exchange for services and the value of the asset is taxed in their hands.

It is suggested that this would be an opportune time to include an amendment similar to proposed section 112-37 in respect of all such costs.

Please note that this submission has been endorsed by the Business Law Section of the Law Council of Australia. Owing to time constraints, the submission has not been reviewed by the Directors of the Law Council of Australia.

If you have any questions in relation to this submission, in the first instance please contact either Committee Chair, Grant Cathro, on 03-9613 8644.

Yours sincerely,

W Grant

Bill Grant
Secretary-General
9 July 2008

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[7] As required by s110-25(2)