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The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Sir or Madam

Tax Laws Amendments (2008 Measures No.3) Bill 2008 ("Bill")

The Taxation Institute of Australia (Taxation Institute) is pleased to provide its submission to the Senate Standing Committee on Economics in relation to the Committee's inquiry on the measures in response to the *McNeil* decision contained in the Bill.

In addition to the issues raised by the Law Council of Australia and the Institute of Chartered Accountants of Australia in their submissions, the Taxation Institute has the following concerns with the Bill:

Taxpayers holding the original shares on revenue account

The Bill does not clarify the position for those taxpayers who hold their shares on revenue account.

(a) What is the proposed position in respect of non-tradeable rights, whether with or without an institutional book build?

While the facts in *McNeil* concerned a renounceable rights issue, it was not clear in the High Court's reasoning whether their decision would also extend to non-renounceable rights issues or to rights that are not tradeable but with an institutional book-build for lapsed rights.

This uncertainty has not been clarified by the proposed changes. Therefore, it is still unclear whether shareholders who are not holding their shares on capital account and acquire non-renounceable rights in respect of shares they already hold (whether with or without an institutional book-build for lapsed rights) will be subject to tax on the value of their rights at the time of grant under *McNeil*.

It would be preferable that this issue be clarified by legislation rather than relying on an ATO interpretation which may, or may not, reflect the intended policy of Treasury in this area and which may not be expressed for some time.

(b) Potential for double taxation

In light of the above, there still appears to be a risk of effective double taxation where shares are held as trading stock or otherwise on revenue account.

If a taxpayer pays income tax (rather than capital gains tax) on the market value of a right when received, then double tax could arise unless that market value is deducted when calculating the income tax consequences of disposal of the right (or the share acquired on exercise). The taxpayer might be liable to tax on both the value of the right at the time of issue (say 10c. per right) and the gross proceeds of selling the rights (say, 12c. per right) even though the taxpayer has only made 12c. per right in total from the transaction. The problem is that the market value of the right is not explicitly included in the 'cost' of the share for normal income tax purposes.

Section 6-25 of the *Income Tax Assessment Act 1997* prevents 'the same amount' from being included in a taxpayer's assessable income more than once. The Explanatory Memorandum to the Bill states that this provision will prevent the taxpayer being taxed on the value of the rights again 'at any other time' – presumably including when the rights, or when the shares acquired pursuant to the rights, are sold for more than the acquisition price but it is not clear that this is correct as it is not clear that the value of the right on receipt (10c.) is the 'same' amount as the sale proceeds (12c).

In addition, even if that were correct it would not prevent unfair results from arising. For example, even if existing law could allow the taxed value of the right to be set off in calculating income by way of 'profit' on a subsequent sale of the shares acquired on exercise, that would not help a taxpayer who did not end up making a profit. For example, if such a taxpayer ended up selling the shares for an amount equal to the exercise price of the right, then there would be no 'income' from the sale and the provision would not apply. Thus, the taxpayer would have been taxed on the value of the rights (say 10c.), but would not get an offsetting deduction for the loss incurred when the proceeds of the share sale ($1.05) fell short of the exercise price ($1.00) plus the value on which tax had already been levied (10c). In effect, the anti-double counting rule could solve the problem only if the relevant shares were ultimately sold for an amount equal to or greater than the exercise price plus the value on which tax had been levied ($1.10).

Proposed section 59-40(2)

The Taxation Institute has concerns with the following proposed paragraphs under the proposed s 59-40(2):

- *(a) limiting the exemption to shares owned at issue time*: The first condition for the grant of rights to be non-assessable, non-exempt income in proposed section 59-40(2)(a) is that the taxpayer must already own shares in the company at the time he or she is issued with the rights. Given that the second condition (proposed section 59-40(2)(b)) requires that the rights are issued because the taxpayer is a shareholder it is not clear what purpose the first condition serves.

  Of greater concern is the potential unfair outcome which may result from this requirement. Under a tradeable, renounceable rights issue, the grant of the rights will usually occur after the record date. Where a taxpayer, who otherwise satisfies the exemption requirements, has disposed of his or her shares in a company after the record date for the rights, but before the grant of the rights, the first condition will not be satisfied even though the second condition will be. The taxpayer would therefore not be entitled to the exemption and be subject to tax on receipt of the rights.

- *(b) limiting the exemption to rights issued in respect of shares owned*: Strictly speaking, often the rights might be issued because of the acceptance of a renounceable offer. In such circumstances it is not clear why the exemption should not apply.

- *(d) excluding employee share scheme rights*: The effect of this exemption appears to ensure that the more specific provisions dealing with rights acquired under an employee share scheme (Division 13A) will prevail over the more general provisions dealing with the acquisition of rights generally (ie s 6-5 as modified by proposed s 59-40). However, it seems to be superfluous as either the right is an option issued to the shareholder or it is an option issued under an employee share plan.

(e) *excluding shares and rights that are traditional securities*: This restriction also appears superfluous as a share is generally not taken to be a security.

Taxation of gain on sale of rights or compensation paid on lapsed rights

The legislation does not address whether the gain on sale of rights or compensation paid on lapsed rights is on capital or revenue account for a shareholder or unitholder who holds the original shares or units on capital account. Prior to *McNeil* it was assumed that any gain would be on capital account. This was accepted by the ATO in the class ruling on the St George buy back rights, the subject of the *McNeil* decision (ATO Class Ruling CR 2001/75). This position is implied by the statement in paragraph 1.5 of the Explanatory Memorandum.

However, following discussions with the ATO, it is understood that the ATO position is that the taxation of any gain on sale or lapse of the rights would be assessed as ordinary income. This would appear to conflict with Treasury's view implied by the Explanatory Memorandum and is at odds with the purpose of the Bill to restore the previously taxation treatment of rights pre-*McNeil*.

It would be preferable that this issue be clarified by legislation rather than relying on an ATO interpretation which may, or may not, reflect the intended policy of Treasury in this area and may not be expressed for some time.

Put options (rights to sell)

(a) Assessability of put options that have different characteristics to *McNeil*

Unlike call options, the proposed changes will not reverse the decision in *McNeil* for put options. The Bill does not expressly legislate that the value of the put option is assessable, rather relying on the general income provisions to assess a shareholder who receives a put option that has similar features to those in *McNeil*. Accordingly the legislation is silent on the taxation of put options which have different characteristics to those in *McNeil*, such as being non-renounceable or renounceable but non-tradeable. The Bill should clarify whether non-renounceable or renounceable but non-tradeable put options are assessable.

(b) Cost base for put option

The Bill includes changes to the law for put options which will ensure that the taxpayer can include the amount on which tax has been paid (at grant) in the cost base of the put option for CGT purposes, therefore preventing double taxation when the shareholder later disposes of that option.

However, the proposed changes do not include the amount on which tax was paid (at grant) in the cost base of the underlying shares. Contrary to the implication from paragraph 1.24 of the Explanatory Memorandum, we consider that the section 134-1 does not operate to include the amount on which tax has been paid in the cost base of the underlying shares. Therefore, in a situation where the underlying shares are sold by the put option being exercised (rather than the right being disposed of), the shareholder may make a capital gain equal to the amount on which they had previously paid tax, potentially resulting in double taxation to the taxpayer.

Where the rights are held on revenue account, the risk of double taxation remains, as described above.

(c) Put options issued by a trust

The proposed changes concerning 'put options' do not apply to put options over units in a unit trust. The Explanatory Memorandum asserts that most unit trusts would not be able to institute a 'sell back' type arrangement. No supporting evidence is cited for that assertion. It is true that buy-back arrangements are generally more attractive in corporate contexts than for unit trusts, because of the ability to frank the deemed dividend component. However, there seems no reason why the

legislation should not be comprehensive, to deal with occasions where it does matter. For example, if a stapled group wishes to do a share buyback, it will need to do a unit buyback as well.

Amendment to 118-20(4)

The effect of this change is that a call option might still be assessable as a capital gain. This outcome seems inconsistent with the overall policy as s 104-155(5)(e) expressly excludes CGT Event H2. It is not clear now whether there is some other CGT Event that might capture the issue of the option. Further, it is also inconsistent with the scheme of the Act which generally excludes non assessable, non exempt amounts..

Scope of the amendments

It is uncertain whether the proposed changes apply in circumstances where the rights issue has been the subject of ATO assessment or considered by the Courts. Not to reverse the law for these persons would be inequitable.

The Taxation Institute is happy to meet with the Committee to discuss our concerns. If you require further assistance or information about matters raised in this correspondence, please contact the writer, on 03 9286 6135 or our Senior Tax Counsel, Dr Michael Dirkis, on 02 8223 0011.

Yours faithfully

Sue Williamson
President