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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAXATION LAWS AMENDMENT BILL (NO.6) 1990

SUPPLEMENTARY EXPLANATORY MEMORANDUM

(Circulated by authority of the Treasurer,
the Hon. P. J. Keating M.P.)

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TAXATION LAWS AMENDMENT BILL (NO.6) 1990

General outline of the amendments

The amendments amend the Taxation Laws Amendment Bill (No.6) 1990 ("the Bill") to overcome some potential technical difficulties with amendments proposed by the Bill to the capital gains tax provisions.

Main features of the amendments

A number of amendments to the Bill are to be moved on behalf of the Government. These further amendments relate to changes proposed by the Bill to the capital gains tax (CGT) provisions contained in Part IIIA of the Income Tax Assessment Act 1936. First, clause 59 of the Bill will be amended to tighten the deemed disposal rules which may apply following the "rollover" of an asset within a company group, where the transferor company is subsequently liquidated. This further amendment is necessary to ensure that tax deferral advantages cannot be obtained in some such cases.

The other significant amendments proposed relate to clause 61, which is intended to ensure that CGT timing advantages do not arise where assets are transferred between companies under common ownership. The further amendments now proposed are necessary to achieve the original anti-avoidance objectives of clause 61, and will extend the application of the new anti-avoidance provisions, particularly in situations where the assets transferred between commonly-owned companies were originally acquired before 20 September 1985.

The amendments to be moved on behalf of the Government have not previously been announced. Therefore, they will apply only from the date of introduction of the amendments.

Financial Impact of the amendments

The further amendments to the Bill that are proposed are necessary to give effect to the original objectives of the Bill. Therefore, they should have no additional revenue impact.

Notes on amendments

Clause 59 - Transfer of Assets Between Group Companies

Clause 59 of the Bill proposes a number of amendments to section 160ZZO, which determines the availability of "rollover relief" on the transfer of assets between companies in a 100% commonly owned company group. As a result of those amendments, a number of existing requirements for transferee companies to issue to the transferor shares or securities as consideration in respect of the transfer of the asset will be removed. However, to ensure that previous tax deferral problems with the rollover provisions do not recur, a new anti-avoidance provision will be inserted to deem a transferred asset to have been disposed of (and reacquired) at market value if the group relationship between transferor and transferee companies subsequently ceases.

Since the introduction of the Bill, a deficiency in this anti-avoidance mechanism, which would potentially make it ineffective, has been identified. This problem has arisen because of a concern (addressed in the Bill) that the subsequent liquidation of the transferor of an asset should not result in the deemed disposal of that asset by the transferee. Accordingly, the proposed "deemed disposal" provision - new paragraph 160ZZO(1)(g) - does not apply where the reason for cessation of the group relationship between transferor and transferee is the dissolution of the transferor.

The reason for this exception is that the purpose of many company group reorganisations is to reduce the number of companies in a group. If a deemed disposal of transferred assets occurred on the liquidation of the transferor, many reorganisations would not achieve their objective - the company group would not benefit from the CGT rollover. On the other hand, if the company group were unable to liquidate surplus companies, the amendments would be open to criticism on the basis that they impose artificial costs on company groups by requiring them to maintain unnecessarily complicated group structures.

However, because of the exception from the deemed disposal rule where the transferor is liquidated, the tax deferral benefits sought to be prevented by the amendments could be obtained by company groups first liquidating the transferor company and subsequently selling shares in the transferee company "outside" the group. The deemed disposal rules as introduced by the Bill would have no application because the group relationship between transferor and transferee companies has ceased because of the liquidation of the transferor.

To overcome that problem, the further amendments now proposed to the Bill will include an additional deemed

disposal rule that would apply following the dissolution of the transferor company. This additional deemed disposal rule is contained in proposed new paragraph 160ZZO(1)(h) and will operate where, at a later time, shares in the transferee company are sold by any other company which, at the time of the transfer of the asset between the transferor and transferee companies, was a group company in relation to the transferee. The deemed disposal rule will also apply if the transferee company issues new shares to a person which was not a group company in relation to it at the time of the asset's original transfer.

This deemed disposal rule will operate in some circumstances where the transferee company was the holding company of the transferor. However, this would only be the case if the holding company were part of a wider group i.e., if shares in the holding company were held by other companies which were group companies in relation to it at the time of the asset's transfer. On the other hand, if the transferee were the "ultimate" holding company, no shares in it could be held by other group companies; the sale of any shares in that ultimate holding company would not, therefore, trigger a deemed disposal of the transferred asset. This result would be consistent with the objectives of these anti-avoidance amendments, because the value of shares in the ultimate holding company would continue to reflect the value of the transferred asset both before and after the transfer.

Consequential additional amendments to the record - keeping requirements of section 160ZZU are also proposed, which will require a transferee company to establish a record of the existence of a group relationship with any of its shareholders at the time of transfer of the asset.

Clause 61 - Transfer of Assets Between Companies under Common Ownership

Clause 61 proposes the insertion of new Division 19A, which is intended to prevent artificial CGT timing advantages from arising where assets are transferred between companies under common ownership. A number of further amendments are now proposed to clause 61, to overcome problems with Division 19A in its original form. The first of these amendments relates to a relatively straight forward problem. At present, Division 19A could apply where the transferee of an asset is a subsidiary of the transferor. However, in those cases, no shifting of value would occur - shares held in the transferor would continue to reflect the value of the transferred asset.

It would only be where an asset is transferred to a holding company or between subsidiaries that the value of shares in the transferor would be reduced. To confine the application of the proposed new Division to such

situations, the amendment proposed to the Bill will impose a new condition for the application of the Division i.e., that the transferee is not a subsidiary of the transferor. That additional condition will be contained in new paragraph 160ZZRD(1)(c).

A more complicated problem has arisen because new Division 19A as originally introduced only applies where an asset acquired after 19 September 1985 is transferred. In fact, the opportunity to contrive capital losses (or reduce capital gains otherwise taxable) can also arise in some circumstances where pre 19 September 1985 assets are transferred between two companies under common ownership.

These opportunities are best illustrated by example. Assume that Coy. A. owns 100% of the shares in Coy. X. Assume that pre 19 September 1985, it paid $100 for 100 shares in Coy. X. which in turn purchased an asset for $100. Assume also that after 19 September 1985, Coy. A. subscribed a further $100 for 100 shares in Coy. X., which purchased another asset for $100. Finally, assume that the assets had not increased in value, and Coy. X. transferred its pre 19 September 1985 asset for no consideration to Coy. Z., another 100% subsidiary of Coy. A.

In this situation, Division 19A in its current form would not apply following the asset's transfer, because the asset was not acquired on or after 19 September 1985 (as required by proposed paragraph 160ZZRD(1)(b)). However, following the transfer of the asset, Coy. A. holds 200 $1 shares in Coy. X. The total value of those shares has been reduced to $100, so the value of each share has been reduced to $0.50. Coy. A. would therefore be able to realise a $0.50 capital loss on the disposal of each of its post 19 September 1985 shares in Coy X, each of which has a cost base of $1.00. In these circumstances, no effective change has occurred in the ownership of assets by the group, yet Coy. A. would be able to trigger a capital loss. Therefore, the amendments now proposed will insert new section 160ZZRFA (refer to notes below), to ensure that no such capital loss could arise in these circumstances.

Since the introduction of the Bill, problems have also been identified with the application of proposed section 160ZZRF (which will apply where the transferor acquired assets before the "common ownership time"). The problem is also best illustrated by example. Assume that Coy. A. owns one asset acquired before 19 September 1985 for $100. Assume that Coy. A. is taken over 100 per cent by Coy. X. after 19 September 1985, at which time the asset is worth $1000; accordingly, Coy. X. pays $1000 for its shares in Coy. A. Because a change of more than 50% occurs in the ownership of Coy. A., section 160ZZS would apply to deem the asset to have been acquired after 19 September 1985 for consideration equal to its market value at that time. Prima facie, section 160ZZRF could apply on the

subsequent transfer of the asset from Coy. A. to another company under common ownership, because the asset would then be a post 19 September 1985 asset to Coy. A. (so the requirements in proposed paragraph 160ZZRD(1)(b) for the application of Division 19A are satisfied) and the asset was acquired by Coy. A. before the common ownership time (refer proposed subsection 160ZZRF(1)).

However, the problems arise because, by paragraph 160ZZRF(2)(b), a cost base reduction to share or loans in the transferor is only to be made (in cases where the section potentially may apply i.e., where the transferor had acquired assets before it came under common ownership with the transferee) if the market value of the transferor's assets substantially exceeded their indexed cost base at the common ownership time. If assets are taken to have been acquired after 19 September 1985 by the application of section 160ZZS, their market value (which, in the above example, is $1000) will form their indexed cost base; accordingly, section 160ZZRF would not reduce the cost base of shares in the transferor company on the subsequent transfer of the assets to another company under common ownership.

Under the Bill as introduced, problems can also arise in the event of a partial takeover of the transferor after 19 September 1985 i.e., if the transferor and transferee came under common ownership after that date. In some of these cases, section 160ZZS would not apply because more than 50% continuity of beneficial ownership would be maintained. Accordingly, because a particular asset could remain a pre 19 September 1985 asset to the transferor, Division 19A, as originally introduced, would not apply on the subsequent transfer of the asset to another company under common ownership.

In each of these cases, a significant timing advantage could arise. For example, in the 100% takeover situation, because section 160ZZRF would not apply to make any cost base reductions (the market value of the assets being equal to their indexed cost base), the pre 19 September 1985 asset could then be transferred by Coy. A. to another company under common ownership, yet an allowable $1000 capital loss would arise to Coy. X. on disposal of its post 19 September 1985 shares held in Coy. A. (because, following the transfer of the asset, Coy. A. is worthless).

To address these problems a number of further amendments to the Bill are now proposed. First, proposed section 160ZZRD will be amended to ensure that proposed Division 19A will not apply where assets are transferred from a holding company to a subsidiary company. The proposed section will also be amended to remove the current requirement for the application of proposed Division 19A that the transferred asset was acquired by the transferor on or after 20 September 1985.

This further amendment will also insert a new subsection 160ZZRD(2), which will determine the amount of consideration that must be paid by a transferee company to the transferor (in respect of an asset's transfer) to effectively avoid the application of the proposed Division (except in cases where proposed sections 160ZZRF and 160ZZRFA may apply). For assets acquired by the transferor before 20 September 1985, the proposed Division will not apply if consideration is paid by the transferee in respect of the asset's transfer equal to its market value at that time. For assets acquired on or after 20 September 1985, the requisite amount of consideration for avoiding the application of the proposed Division will be the lesser of the transferred asset's indexed cost base or market value at the time of the transfer.

A further amendment to the Bill now proposed will affect the potential application of proposed section 160ZZRE. Proposed section 160ZZRE contains a number of specific rules and formulas which determine the amount of any cost base reductions to be made to shares or loans held directly in the transferor of an asset, where Division 19A applies in respect of the transfer. However, section 160ZZRE does not apply where the transferred assets were acquired by the transferor before it came under common ownership with the transferee (in which case cost base adjustments will be made pursuant to proposed section 160ZZRF), nor does it apply in making cost base adjustments to shares or loans held indirectly in the transferor (which, instead, is dealt with by proposed section 160ZZRG). The effect of the amendment will be to restrict the application of section 160ZZRE to transfers of assets acquired by the transferor on or after 20 September 1985. Where Division 19A applies on the transfer of assets acquired before 20 September 1985, any cost base adjustments to shares or loans in the transferor will be made pursuant to proposed new section 160ZZRFA (refer to notes below).

The key amendments to the Bill now proposed in relation to Division 19A will expand the application of proposed section 160ZZRF and insert a new section 160ZZRFA.

As described above, the potential application of proposed section 160ZZRF will continue to be restricted to situations where an asset was acquired by the transferor before the "common ownership time". In these cases, potential cost base adjustments to shares or loans held in the transferor may need to be made by reference to an amount greater than the indexed cost base of a transferred asset. This would commonly occur where the transferor has been taken over and the value of its assets has substantially increased, as a result of which the price paid for shares in the transferor attributable to the underlying assets is greater than the indexed cost base of

those assets. However, as originally introduced, section 160ZZRF could in practice apply only on the transfer of assets actually acquired by the transferor on or after 20 September 1985. That limitation meant that a number of further potential tax avoidance opportunities (as also described above) remain open.

To overcome those problems, further amendments to section 160ZZRF are proposed which will insert new subsection 160ZZRF(3). This new subsection will operate either where the transferred asset was actually acquired by the transferor before 20 September 1985, or where the asset was deemed to have been acquired on or after that date by the operation of section 160ZZS (i.e., where a change in majority underlying interests in the transferor had occurred, for example, pursuant to a 100 per cent takeover of the transferor). In these cases, subsection 160ZZRF(3) will effectively enable adjustments to be made to the cost base, indexed cost base or reduced cost base of shares or loans held in the transferor by reference to the amount paid in respect of the acquisition of those shares or loans. Adjustments would effectively be made by reference to the extent to which the amounts paid were attributable to the value of underlying assets subsequently transferred by the transferor company to another company under common ownership. As is the case with section 160ZZRF as introduced, the potential application of the section can continue to be avoided if consideration equal to the market value of the transferred asset is paid in respect of the transfer. However, unlike proposed subsection 160ZZRF(2) (as it will continue to apply to assets actually acquired by the transferer on or after 20 September 1985), it will not be relevant in applying proposed subsection 160ZZRF(3) to consider any difference between the market value of the transferred assets and their indexed cost base. Instead, it will be necessary to consider the extent to which the market value of the particular shares or loans is reduced by the transfer of the asset. Effectively, cost base adjustments will then be made by reference to the difference between the actual consideration paid by the transferee in respect of the asset's transfer and the appropriate proportion of amounts paid for the acquisition of shares or loans in the transferor attributable to the value (at the time of acquisition of these shares or loans) of the transferred asset.

A further amendment to the Bill now proposed will insert a new section 160ZZRFA. This section will effectively operate in cases where both the transferor and transferee companies were under common ownership before 20 September 1985 and the transferred asset was also acquired before that date. However, the section will only operate where shares or loans are held in the transferor which were acquired on or after 20 September 1985, and which are reduced in value as a result of the transfer of

the asset. In these circumstances, to ensure that artificial CGT timing advantages do not arise on the transfer of the asset, adjustments to the cost base, indexed cost base, or reduced cost base of shares or loans can be made by reference to those amounts paid in respect of the acquisition of the shares or loans which, in turn, were attributable to the value at that time of the asset subsequently transferred. However, in cases where the section may potentially apply, it would not be reasonable for any such cost base adjustments to be made where actual consideration is paid equal to the transferred asset's market value at the time of the transfer.

Clause 63 - Keeping of Records

As a consequence of the further amendments proposed to the Bill in relation to section 160ZZO, a further amendment to the record keeping requirements contained in section 160ZZU is also necessary. A deemed disposal of an asset rolled-over pursuant to section 160ZZO will now occur if, after the liquidation of the transferor, shares held by other group companies in the transferee are disposed of outside the group, or new shares are issued to non-group companies by the transferee. Accordingly, the transferee will now be required by new subsection 160ZZU(3A) to establish and maintain records of the existence of a company group relationship with any of its shareholders, at the time when rollover relief pursuant to section 160ZZO was obtained in respect of an asset's transfer to another group company. In turn, these records must be kept for a period of five years following the actual disposal of the transferred asset, or its deemed disposal pursuant to paragraph 160ZZO(1)(h). The penalty for non-compliance with these additional record-keeping requirements will be $3000.

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