Law Council
OF AUSTRALIA

Business Law Section

26 May 2020

Board of Taxation Secretariat
The Treasury
Langton Crescent
Parkes
ACT 2600

By email:

Dear Members of the Board,

Review of CGT Rollovers

The Taxation Law Committee (**Taxation Committee**) and SME Business Law Committee (**SME Committee**) of the Business Law Section of the Law Council of Australia thank you for the opportunity to provide comments on matters raised in the Consultation Guide issued by the Board in February 2020 in connection with its review of capital gains tax (**CGT**) roll-overs.

The Committees are two of the fourteen specialist committees established within the Business Law Section to offer technical advice on different areas of law affecting business. Each of these Committees approach issues of law reform and practice from a different perspective, which reflects their respective primary focus.

Response from the Taxation Committee:

The responses to the questions asked in the Consultation Guide are as follows:

1. Do you agree with the policy considerations outlined in this document?

Not entirely. The Taxation Committee has the following comments on the five policy considerations set out in the Consultation Guide:

1. The Taxation Committee does not consider that questions of equity as between the taxation of capital gains and the taxation of income are relevant to a review of CGT rollovers.

   The CGT regime does not establish equity, in the sense of equivalence, in the tax treatment of capital gains and income. Capital gains made by individuals (including trust capital gains allocated to individuals) are generally taxed at a much lower effective rate than income. For companies, capital gains are taxed at the same rate as other income, but franked dividends received by companies are essentially tax free. It can validly be argued, therefore, that for companies the tax system favours the receipt of franked dividends over the realisation of capital gains. The same is true for certain other taxpayers, including complying superannuation funds. Accordingly, the Board's review should not aim to give effect to a principle that, but for the existence of CGT roll-overs, the CGT regime ensures equivalence of tax treatment as between capital gains on the one hand and income on the other.

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More specifically, we disagree with the statement that "In some circumstances, roll-over relief can be counter to fairness in that the deferral of the taxing point is not an available option for taxpayers, particularly lower income taxpayers, earning salary and wages". One of the policy objectives to which roll-overs give effect is that the owner of an asset should not be taxable on an increase in the value of the asset unless and until the increase in value is realised in an economic rather than a legal sense. An unrealised gain is not equivalent to income. Therefore, it is not correct to imply that it may be unfair to relieve a taxpayer of the burden of tax where the roll-over gives effect to a policy objective of ensuring that a taxing point occurs only when capital gains are realised in an economic rather than a legal sense.

2. The Taxation Committee disagrees with the statement that "Proposed roll-over treatment should take proper account of the distortive effects on the efficient allocation of capital of deferring a tax charge further". The premise on which that statement is based is that deferring a tax charge on a capital gain that is unrealised in an economic sense is necessarily distortive. Such a premise runs counter to a clear policy objective of roll-over rules, which is to avoid tax-induced distortion by ensuring that a capital gain is not taxed unless and until it is realised in an economic sense and there is cash with which to pay any ensuing tax liability.

3. The Taxation Committee agrees that a policy objective of roll-overs is to ensure that involuntary disposals of assets do not result in CGT liabilities.

4. The Taxation Committee agrees that a policy objective of roll-overs is to reduce the "lock-in bias" by ensuring that taxpayers are not "trapped in an unsuitable or inefficient structure" and by "removing an impediment to the reallocation of capital to more productive uses", and we agree that "roll-over has been granted for these circumstances only when there is no (or very minimal) change in the underlying ownership of assets, consistent with the equity objectives of CGT". The Taxation Committee considers, though, that the policy principle should be more broadly expressed – i.e., a person who holds a post-CGT asset should be entitled to choose not be taxable on an increase in the value of the asset unless and until the increase in value is realised in an economic rather than a legal sense.

   For this purpose, the concept of "realisation" is to be understood as requiring:

   (i) the reduction of a direct exposure to a CGT asset as a result of the happening of a CGT without a corresponding increase in an indirect exposure to the same CGT asset; or

   (ii) the reduction of an indirect exposure to a CGT asset because of the happening of a CGT event without a corresponding increase in a direct or indirect exposure to the same CGT asset or assets.

   Expressing the principle in that way would encourage the review to consider whether a general roll-over rule could be developed to give effect to the principle that CGT events should, by election, be disregarded (and, for CGT events relating to pre-CGT assets, pre-CGT status should attach to CGT assets acquired as a result of the CGT event) if the CGT event does not constitute a realisation in an economic sense.

5. The Taxation Committee agrees that the circumstances in which roll-over relief is available should be as clear as possible. However, we do not consider that "simplicity" should necessarily be an independent objective. It may well be that simplicity would not achieve an adequate level of clarity. If that is the case, clarity should be preferred

to simplicity. In some cases, preserving the existing roll-over provisions would preserve the validity of valuable precedents and interpretive material. If that means that the roll-over provisions remain lengthy, consideration could be given to providing a clear index to the provisions and clear rules as to the way in which roll-overs can be used in conjunction with one another.

It could be said that some of the complexity in the existing roll-over provisions stems from the desire to build in specific integrity provisions to prevent abuse of the roll-over provisions. Given the breadth of the general anti-avoidance provision in Pt IVA, we question whether the continued reliance on a host of specific anti-avoidance measures is necessary. The Taxation Committee comment further on integrity issues below.

In summary, we consider that:

- little, if anything, is to be gained by focusing on items 1 and 2;
- items 3 and 4 set out the policy basis for all existing roll-overs other than the small business replacement asset roll-over;
- ideally, the policy basis underlying item 4 would be expressed more generally, as we have proposed; and
- item 5, modified as we have proposed, is something that all legislative drafting should aim to achieve.

The Taxation Committee therefore submits that the review should take account of four relevant policy objectives: item 3, item 4 (but more generally expressed, as we have proposed), a new item to recognise that in certain circumstances businesses should be able to replace their active assets without incurring a CGT liability (see further below), and item 5 (but with a focus on clarity rather than simplicity).

2. Are there any other policy considerations that should be taken into account? Why?

Yes. The policy objective underlying the roll-over which allows small businesses to replace active assets without incurring a CGT liability should be added to the list of principles upon which any amendments to the roll-over rules should be based. This will allow consideration to be given to the merits of extending that roll-over to all businesses.

3. What framing principles would be appropriate for rationalising the three categories of roll-overs into more principles-based roll-overs?

For example, does the concept of 'involuntariness' adequately capture the unfair circumstances in which roll-over should apply?

The Taxation Committee notes that the roll-overs on pages 6 to 11 of the Consultation Guide are divided into four categories, not three (as implied by the question). The fourth category headed "Replacement asset roll-over", is on page 11 of the Consultation Guide.

If our suggestions in 1 above are adopted, there would be three categories of roll-over, giving effect to the following three principles:

1. the owner of an asset should not be taxable on an increase in the value of the asset unless and until such time as the increase in value is realised (in an economic rather than a narrow legal sense);
2. involuntary disposals of assets should not result in CGT liabilities; and

3. in certain circumstances businesses should be able to replace their active assets without incurring a CGT liability.

   Item 1 in the above list would cover the first and third category of roll-over in the Consultation Guide – i.e., "Business reorganisations with no change in underlying economic ownership" and "Business reorganisations which allow for changes in underlying economic ownership".

4. Are there any deficiencies and limitations in the current suite of roll-overs that can be addressed by a more principles-based approach to roll-over relief?

Our preference is that corrections to any deficiencies and limitations in the current suite of roll-overs be through specific amendments, or additions to, the existing rollovers. Naturally, those amendments must be based on and reflect the principles discussed in points 1 to 3 above but, for reasons set out below, we consider that it would be counterproductive to replace the existing rollover rules with a set of principles.

With a principles-based approach to the drafting of legislation, the "detail" around the provisions typically is contained in a document, or documents, such as the Explanatory Memorandum accompanying the legislation or a Law Companion Ruling and/or Practice Statement from the Australian Taxation Office. The small business restructuring roll-over in Subdivision 328-G of the *Income Tax Assessment Act 1997* (Cth) is an example of this approach.

With the small business restructuring roll-over, a key requirement is that there must be a "*genuine restructure of an ongoing business*" with the key documents on the application of that phrase being the Explanatory Memorandum and *Law Companion Ruling* LCR 2016/3.

The Taxation Committee sees two limitations with this approach:

1. until courts consider the provisions, the Explanatory Memorandum, Law Companion Ruling, and Practice Statement assume greater significance in the interpretation of the legislation with the latter two being the views of the revenue collection authority (in effect, "lore" becomes more important than law);

2. the approach of the courts in interpreting legislation set out by the High Court in FCT v *Consolidated Media Holdings Ltd* (2012) 250 CLR 503 at [39} is that *"… the task of statutory construction must begin with a consideration of the [statutory] text". So must the task of statutory construction end. The statutory text must be considered in its context. That context includes legislative history and extrinsic materials. Understanding context has utility if, and in so far as, it assists in fixing the meaning of the statutory text. Legislative history and extrinsic materials cannot displace the meaning of the statutory text. Nor is their examination an end in itself"*.

In a non-roll-over context, in Victoria, the Victorian State Revenue Office took a "practical approach" to the broadly drafted "principles-based" duty surcharge in relation to whether trustees of discretionary trusts trigger that. The Victorian State Revenue Office withdrew that "practical approach" with effect from 1 March 2020. A legislative clarification, or non-clarification, at the time of the introduction of the surcharge would have been preferable.

5. Can the system benefit from any additional categories of roll-overs? To what extent would any additional roll-over category encourage the active use of assets in the economy and maintain the integrity of the system generally?

Despite commenting on a limitation of the small business restructure roll-over above, we submit that consideration should be given to extending the small business restructure roll-over and the small business active asset roll-over under *Subdivision 152-E of the Income Tax Assessment Act 1997* (**SME Roll-over Relief**) to all businesses. The principles upon which those roll-overs are based apply to all businesses. That is:

1. if a business wishes to restructure (a "genuine restructure") and there is no change to the ultimate economic ownership of that business, taxation laws should facilitate, rather than hinder, that restructure ("328-G"); or
2. if an active asset is sold, tax on an amount up to the capital gain is deferred to the extent the seller buys (or creates) another active asset ("152-E").

   Both of those roll-overs encourage the use of active business assets rather than the investment in "passive" assets.

6. Are there any redundant roll-overs?

The Taxation Committee has no comment on this question at this stage of the review.

7. What do you consider to be the main integrity risks with the current suite of roll-overs? Should specific integrity/purpose rules be built into the CGT roll-overs?

The Taxation Committee considers that specific integrity or purpose rules should not be built into the current suite of roll-overs. Part IVA of the *Income Tax Assessment Act 1936* (Cth) applies to all "schemes" including those involving roll-overs. The Government passed legislation to strengthen Part IVA in 2012.

If the Government considers that taxpayers are accessing roll-overs inappropriately then it can pass legislation to amend that roll-over. Similarly, if the Commissioner considers that the dominant reason a taxpayer is undertaking a transaction in a way to access a roll-over that may not otherwise be available, the Commissioner can make a determination under Part IVA.

The Taxation Committee considers that the questions that cause debate between taxpayers and the Commissioner regarding the current suite of roll-overs relate to terms for which there has not been judicial consideration – for example, "restructuring" in the context of demergers and "genuine restructure of an on-going business" in the context of Subdivision 328-G – and "double" or sequential rollovers.

On the first point, we consider that any redrafted roll-over legislation should abolish the use of vague concepts such as "restructuring" and "genuine restructure of an on-going business" so that it is clear that rollovers are available even if the actions giving rise to the CGT events to which the rollover applies take place in the context of a wider set of actions.

On the second point, sequential or back-to-back CGT roll-overs are common in rearranging groups. Several CGT roll-overs include a condition that the selling entity receive, for example, shares and 'nothing else'. The Australian Taxation Office has been concerned that when there is a back-to-back roll-over and the first roll-over includes a 'nothing else' condition the selling entity receives both (say) a share and a right to receive consideration under the second roll-over.

CGT roll-overs with a 'nothing else' condition include:

- Subdivision 124E – exchange of shares;
- Subdivision 124F – exchange of rights or options;
- Subdivision 124I – change of incorporation;
- Subdivision 124Q – exchange of stapled ownership interests for ownership interests in a unit trust;
- Division 125 – demerger relief; and
- Division 615 – rollovers applying to assets generally.

There are other CGT roll-overs where the taxpayer must only include a specific form of consideration. For example, under Subdivision 122-A where an individual or trustee transfers an asset to a company, CGT roll-over relief is only available if the seller "only" receives shares in the buyer. While drafted differently to the 'nothing else' requirement the concepts are similar.

The Australian Taxation Office is developing guidance on back-to-back roll-overs. However, we consider that if the Commissioner "dislikes" a transaction with sequential roll-overs, the Commissioner should look to Part IVA and whether the dominant purpose of the scheme was to obtain a tax benefit rather applying an overly restrictive application of the specific roll-overs.

8. How does the interaction of other aspects of the tax system, such as the tax consolidation regime, impact the decision to choose a roll-over? Do these interactions create favourable or unfavourable outcomes?

The Taxation Committee has no comment on this question at this stage of the review.

9. Given grandfathering of pre-CGT assets is a noted source of complexity in the CGT regime, should the pre-CGT status of assets continue to be preserved in connection with roll-overs?

If the general policy of relieving pre-CGT assets from CGT is maintained, then that policy should apply equally to rolled-over pre-CGT assets and assets acquired in substitution for rolled-over pre-CGT assets, otherwise the roll-over would not achieve its objective of preserving the existing CGT position to the extent possible.

In our view, the review should not be regarded as an opportunity to consider whether an established policy about the treatment of pre-CGT assets should be departed from in particular circumstances.

10. Can any changes be made to simplify the administrative and compliance obligations for taxpayers (particularly 'mum and dad shareholders') where a roll-over occurs?

The Taxation Committee understands the reference to "mum and dad shareholders" to be a reference to holders of listed shares in public companies whose shareholdings change because of reorganisations undertaken by those companies.

The Taxation Committee submits that the review should consider whether it would be appropriate to require Australian public companies whose shares are listed to provide via their websites relevant tax information and a calculator to enable shareholders to determine the tax implications of roll-overs that affect their shares.

This requirement could be implemented through brief amending legislation permitting regulations to be made specifying the information and other material that must be made available to shareholders via a company's website.

11. Other matters which we consider should be considered during the review

Rollovers in the context of broader reorganisations

Reorganisations often involve steps that include but are not limited to steps for which a CGT rollover is available. A question that commonly arises in such cases is whether the steps that are additional to those for which the particular CGT rollover is available are to be taken into account in determining whether the conditions for the CGT rollover would be satisfied. It is frequently the case that if the additional steps are taken into account, one or more of the conditions for the availability of the CGT rollover would not be satisfied even though the entirety of the reorganisation does not result in the economic realisation of any capital gains.

Draft Taxation Determination TD 2019/D1 illustrates this issue in relation to the application of Division 125 of *Income Tax Assessment Act 1997* (Cth) (demerger relief). The draft determination focuses on the use of the word "restructuring" in s 125-70(1) of *Income Tax Assessment Act 1997* (Cth) and concludes that if steps that would themselves satisfy the conditions for demerger relief are followed by steps that are part of an overall "restructuring", then the additional steps are relevant in considering whether the conditions for demerger relief have been satisfied.

The Taxation Committee is unable to discern any policy-based reason for that view. The Taxation Committee therefore considers that any redrafted rollover legislation should abolish the use of vague concepts such as "restructuring" so that it is clear that rollovers are available even if the actions giving rise to the CGT events to which the rollover applies take place in the context of a wider set of actions.

More generally, we consider that the Board should consider recommending the introduction of an overall rule that each set of steps in a reorganisation (disregarding the right to participate in subsequent steps) is capable of satisfying the conditions for a CGT rollover. In our view, such a rule is necessary to give effect to one of the key purposes of CGT rollovers – i.e. the non-taxation of gains that are not realised in an economic sense.

State and Territory stamp duty reorganisation reliefs

Ideally, a review of CGT roll-overs should result not only in a rationalisation of the CGT roll-overs in the Commonwealth income tax law but also the rationalisation of reorganisation reliefs in State and Territory-based duties law, and the co-ordination of the CGT roll-overs with those State and Territory-based reliefs.

This would seem to be too ambitious an objective for the current review, especially as the review has been commissioned by the Federal Government and not any of the States or Territories. It is nevertheless a fact that the policy objectives underlying the CGT roll-over relief regime and the State and Territory-based reorganisation reliefs will not be fully achieved if there are circumstances in which a reorganisation which would qualify for a CGT roll-over does not qualify for the corresponding State or Territory-based relief, or vice versa. In our view, the Board's Report to the Commonwealth Government should mention that fact and recommend that steps be taken to address the issue.

Response from the SME Committee:

The SME Committee strongly supports the reiteration by the Taxation Committee of the policy position behind the introduction of CGT rollover relief, which was to avoid tax-induced distortions by ensuring that a capital gain is not taxed unless and until it is realised in an economic sense and there is cash with which to pay any ensuing tax liability. This is particularly relevant to SME businesses and individuals.

The SME Committee supports the submission by the Taxation Committee that 'the policy principle should be more broadly expressed – i.e. a person who holds a post-CGT asset should be entitled to choose not be taxable on an increase in the value of the asset unless and until the increase in value is realised in an economic rather than a legal sense' so that 'the principle expressed in that way would encourage the review to consider whether a general roll-over rule could be developed to give effect to the principle that CGT events should, by election, be disregarded (and, for CGT events relating to pre-CGT assets, pre-CGT status should attach to CGT assets acquired as a result of the CGT event) if the CGT event does not constitute a realisation in an economic sense.'

The SME Committee also supports the SME Rollover Relief, and the Taxation Committee's submission that this should be extended to apply to all businesses.

The SME Committee also submits that there is an opportunity to remove the need for unnecessarily complex processes currently undertaken to achieve an outcome, because CGT rollover relief is not available, with the outcome of an economically less favourable result. For example, the SME Committee understands from experience that to be able to transfer an existing superannuation pension entitlement being paid from an SMSF to another SMSF (e.g. when a business relationship is being divested), the existing pension needs to be commuted to cash, paid out to the pensioner/member, contributed to the new SMSF and a new pension (calculated on a lower initial balance and a new start date) paid from the new SMSF. If there was CGT Rollover relief available for superannuation benefits being maintained within the superannuation regime, thereby allowing the transfer in specie of pension investment assets from the first SMSF to the new SMSF without the application of CGT and allowing continuation of the pension in the new SMSF, the outcome achieved would be easier and more appropriate for the economic needs of the pensioner member.

If you have any questions please contact the Chair of the Taxation Committee Clint Harding at charding@abl.com.au.

Yours sincerely,

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Chair, Business Law Section