THE TAX INSTITUTE

Law Council
OF AUSTRALIA
Business Law Section

21 May 2019

Japheth Gill
Advice and Guidance
Public Groups & International
Australian Taxation Office
SYDNEY NSW 2000

By email: PGIPAGUnit@ato.gov.au

Dear Mr Gill

Draft Taxation Determination TD 2019/D1: Income tax: what is a "restructuring" for the purposes of subsection 125-70(1) of the *Income Tax Assessment Act 1997*?

The Taxation Law Committee of the Business Law Section of the Law Council of Australia joint with The Tax Institute welcome the opportunity to provide a submission on the Australian Taxation Office's (**ATO**) Draft TD 2019/D1 *"What is a restructuring for the purposes of subsection 125-70(1) of the Income Tax Assessment Act 1997?*" (the **Draft TD**).

Introduction – A change in view

The ATO has taken an expanded view of what can form part of a restructure, which it justifies on the basis of the history to Division 125 and a conclusion that it should be limited to only certain kinds of arrangements.

The ATO makes it clear in the Draft TD that it applies both prospectively and retrospectively.

However, it is clear from the publicly available class rulings, in the form of CR 2013/23 and CR 2008/74 that there has been a shift from a permissive view which was public in 2008-2013, with no public change in view from then, until 2018 where a more restrictive view has been taken (refer CR 2018/7 and CR 2018/31), now explained in the Draft TD.

It is entirely understandable for taxpayers and tax advisors to have had a view on the interpretation of Division 125 that differed to that in the Draft TD.

While the ATO correctly notes that the views expressed in a class ruling are binding only on those the subject of the ruling, it is entirely appropriate for taxpayers to have regard to public views of the ATO in managing their tax affairs. In a system of self-assessment, with no requirement to obtain ATO approval for a demerger, it is possible that taxpayers

adopted a view that a narrower definition of 'restructuring' applied and as a result the “nothing else” and “proportionality tests” were satisfied.

We respectfully request that this be addressed.

Without an understanding of how this can be reconciled, we request at the very least that this Draft TD, once finalised, operates prospectively from the day that the Draft TD was released.

We have set out our substantive concerns with the issues raised in the Draft TD below.

1. Consistency with policy objectives of the demerger regime

The object of Division 125 is “to facilitate demerging of entities by ensuring that capital gains tax considerations are not an impediment to restructuring a business”.

The interpretation of Division 125 must be undertaken having regard to its object.

The approach in the Draft TD results in the ATO attaching significant importance to the requirement that members of the head entity must be in the same economic position after the restructuring as they were immediately prior to the restructuring, not only vis-à-vis each other but also against all entities who have some connection with the scheme under the broad definition of restructuring. This approach is not supported by the legislative framework of Division 125:

(a) Inconsistent with the ordinary meaning of "restructuring"

The central element of the Draft TD is the meaning of "restructuring" and this is stated at paragraph 50 as a word that is "flexible in its ordinary and commercial senses" and "share a common element of a change in the structure of the business". It also references the Ralph Report at paragraph 52 and identifies that the original term used for this type of rollover was "reorganisation".

We submit that the Draft TD has taken a much broader and inconsistent meaning of restructuring to its ordinary meaning when it includes subsequent sale transaction and capital raising besides the demerger. These elements do not reflect the ordinary meaning of "restructuring" and should not be considered a part of the restructuring to which Division 125 applies/is tested. The sale of shares to a third party is not a "restructure" and neither is raising capital via the issue of shares. To give the word "restructuring" such a broad meaning would be inconsistent with the ordinary meaning and not supported by or in line with principles of statutory interpretation (see further comments below).

We consider that the approach taken in the Draft TD does not align with the objects of the regime, the ordinary meaning of "restructure" and respectfully request that this be reconciled.

(b) Inconsistent with the explanatory memorandum

The broad expanded interpretation of "restructuring" put forward by the Draft TD is said to impact the proportionality tests in section 125-70(2). When comparing this outcome with the explanatory memorandum introducing

subsection 125-70(2), it results in the testing of transactions that the proportionality test was not intended to cover. The Explanatory Memorandum introducing subsection 125-70(2) expressed the scope of subsection 125-70(2) to be covering proportionality of interest owners in the head entity only, and not by reference to other transactions not involving the interest owners:

> *Disproportionate demerger*
>
> > *15.53 Roll-over is not available if, under the demerger, certain owners of ownership interests in the head entity are excluded from participating in the demerger. This might occur if certain classes of interests (other than dual listing company voting shares or certain employee benefits) are not allocated ownership interests in the demerged entity.* ***[Schedule 16, Part 1, subsection 125-70(2)] [Emphasis added]***
>
> *Something other than a new interest in the demerged entity is received*
>
> > *15.54 Roll-over is not available for an interest owner who receives something other than a new interest in the demerged entity, for example, cash. This is the case even if the interest owner also receives a new interest in the demerged entity. This exception arises from the combined effect of the proportion test and the market value test. That is, neither of these tests can be satisfied if an original owner receives something other than new interests in the demerged entity.* ***[Schedule 16, Part 1, subsection 125-70(2) and paragraph 125-70(1)(c)]***

It would also assist if further detail on the mischief that the ATO is seeking to guard against could be clarified. It seems that if there are a series of steps taken, each of which is properly open to a group of entities to take, then any corresponding relief should not be denied based on a shift in the ATO's interpretation of the policy considerations from the Ralph Report (1999). It is suggested that the more appropriate approach would be to address denial of relief through the existing anti-avoidance measures.

2. Over reach of the impact of the Draft TD

When the ATO stated it was developing advice and guidance on demergers, it was commonly understood that the advice under development was in relation to "back-to-back CGT rollovers", as reflected in Item 3953 on the "*Advice under development – capital gains tax issues*" ATO webpage.

The ATO announced this new guidance in 2018 as a result of a number of highly publicised transactions (Westfield-One Market and AMA-Blackstone) where the ATO denied demerger relief on the basis the interest owners were to acquire or receive something else under a planned transaction. The change in view was not signalled to the rest of the market more broadly and so the impact of the Draft TD will be significant.

3. Statutory interpretation issues

Having regard to the policy objective of Division 125, as noted above, we consider that the Draft TD needs to be amended to address how the interpretation taken by the ATO is in line with principles of statutory interpretation.

Division 125 is a concessionary provision, granting an exemption from capital gains tax.

The approach of the courts to the interpretation of exemption and exception provisions of Acts which impose taxation was stated by Barton J in *Burt v Federal Commissioner of Taxation* (1912) 15 CLR 482 as follows:

> *The several deductions allowed by s 30 are exceptions to the general rule of taxation prescribed by the Act. Where the construction of such exceptions is seriously in doubt, the interpretation should favour those whose claims are based upon the exceptions.*

In *Diethelm Manufacturing Pty Ltd v Federal Commissioner of Taxation* (1993) 44 FCR 450 French J noted that, while the taxpayer bears the burden of establishing the factual context in which the exception or exemption applies:

> *On the other hand, an exemption which exists for the purpose of encouraging, rewarding or protecting some class of activity is not to be given a narrow application. The liberal construction of provisions of Customs and Excise legislation allowing rebates on duties and excise payable in respect of fuel used in mining operations is one application of that general proposition: Collector of Customs v Cliffs Robe River Iron Associates (1985) 7 FCR 271 at 275.*

Similarly, in Federal Commissioner of *Taxation v Murry* [1998] HCA 42, it was said that a liberal approach should be taken to the exemption of small business from the operation of capital gains tax legislation. In *Distribution Group Ltd v Commissioner of Taxation* [2000] VSC 418, Warren J noted that in interpreting sales tax legislation, the courts have adopted a liberal construction of exemptions unless the text or context requires a narrow construction.

4. Summary of the ATO's position in TD 2019/D1

The ATO's position in TD 2019/D1 now states at paragraph 3 that a restructuring is not necessarily confined to the steps or transactions that specifically deliver the ownership interests in the demerging entity to shareholders, but can include transactions that are legally independent of one another, contingent on different events and transactions that may not even occur (**the expansion**).

The ATO position in TD 2019/D1 can also be more restrictive. The suggestion at paragraph 4 that a transaction "is not necessarily part of the restructuring of the group merely because it is necessary for the restructuring of the group to occur" (**the contraction**) is confusing and contradictory to the reasoning applied in other parts of the TD, not least because it fails to provide a clear practical delineation between permitting or refusing demerger rollover relief.

The true mischief the Draft TD seeks to address and reason for the expansion is perhaps found at the end of paragraph 3 where it states that:

> *thus the planned transfer of interest in the separated entity by all the owners of those interests to a particular acquiring entity would generally be considered to form part of the restructuring where commercially the separation of the interests*

would be understood to be a step in a plan for the owners to transfer their interests in the separated entity to the acquiring entity.

As discussed above, we submit that the expansion should be limited to such cases involving the interest owners and not other entities in associated transactions.

We seek further clarification of the intended ATO approach to assist practitioner understanding, and to remove an unnecessary impediment to transactions.

Once we have a better understanding of the precise integrity concerns that the Draft TD is addressing, then it may be appropriate to engage in a discussion as to whether some form of safe harbour can be developed that might offer some relief for taxpayers who are inadvertently captured by the expanded meaning being attributed to "restructuring".

5. Practical issues

TD 2019/D1 creates a number of practical issues for entities undertaking a demerger and for their advisors. The following represent a number of the practical issues raised in the examples set out in TD 2019/D1. We seek further clarity on those practical issues set out in the following questions:

(a) Examples 1 and 2

1. What is the time period at which a transaction that occurs either before or after the restructure will be disregarded / not be deemed to be part of the restructure?

2. What is the threshold percentage for the quantum of capital raised and pre-separation return of capital or dividend by Sub Co compared to the value of the demerger subsidiary that will not impact the granting of demerger rollover relief?

3. What is deemed to be 'sufficient operating profits' or 'adequate cash flow to fund a business prior to a demerger?

4. Does it matter that not all assets are in Sub Co prior to the demerger and transfers of assets and changes in share capital structure of Sub Co are required prior to the demerger?

5. What does a minor capital raising undertaken following ASX listing "independently" mean?

6. Does it matter that there was a plan or intention to raise additional capital before the formal recommendation of Sub Co management? It is an unrealistic view of business that the decision of the ongoing capital structure will be made by the Sub Co management – it is likely to have been considered by the group demerging Sub Co (with regard to the viability of Sub Co as an independent group).

7. Does it matter that the capital raising is conducted at a discount to trading? Does it matter that the underwriting is not provided by an independent

party? Both situations are often the case.

8. What is the threshold percentage for the stake that an unrelated third party may take in the capital raising in Example 2 that would cause demerger relief not to be available?

9. What is the relevance of an escrow arrangement for majority shareholders in Example 1? If not relevant, should this fact be excluded?

(b) Examples 3 and 4

1. What is the nexus requirement between a third-party acquisition of a demerger subsidiary and demerger relief under Division 125?

2. Are you able to distinguish between demerger related third party activity and unrelated third-party activity more than "unlikely to occur except in preparation for"? Is this test objectively applied? What is the legislative basis for this test?

3. In example 4, what if it is Giant Co (and not Mid Co) that launched a takeover bid for Food Co (and not a scheme of arrangement put forward by Food Co and does not require involvement of Food Co to facilitate the acquisition by Giant Co)?

(c) TD 2019/D1 – Example 5

1. What are the reasons for the sale facility forming part of the restructure in this example?

2. Confirm that, if the sale facility did not trade at a premium, demerger relief would be available.

(d) TD 2019/D1 – Example 6

1. What is the policy rationale for not permitting demerger rollover relief in this example?

6. Concluding comments

The Draft TD is a significant departure from the scope of the expected advice around back-to-back roll overs and addresses the intended scope of the proportionality test (which focuses on transactions of interest owners).

The Draft TD will adversely impact a much greater number of potential demerger transactions with no explanation of the reason for the expanded scope or the mischief that it now seeks to cover (beyond the stated scope above).

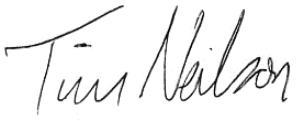
We request that the ATO gives further consideration of the true mischief it seeks to address through the TD, provide a proper explanation of the mischief and, if necessary, limit the impact of the TD accordingly so that it does not create uncertainty in the market. For example, rights issues, capital raising and sale facilities (and other associated transactions under which the interest owners do not acquire or receive something else under a planned transaction) are regularly implemented in conjunction with a demerger

and are done for a genuine business need. It is not clear the nature of the mischief concerning the ATO in relation to such transactions and yet the framing of the Draft TD to apply the proportionality test to those aspects would cause demerger relief to be denied.

This expansion goes beyond the intended scope of the proportionality tests and is a significant change in the administrative practice as it is to be applied to demerger relief and the application of Division 125. The scope and integrity issues that the change in position is trying to address should properly be referred to Treasury (and as appropriate Board of Tax) to consider and effect through legislative change if deemed necessary.

Should you wish to discuss further any aspects of the submission please do not hesitate to contact Clint Harding, Chair of the Taxation Committee (charding@abl.com.au or 02 9226 7236) or Stephanie Caredes, Tax Counsel at the Tax Institute (StephanieCaredes@taxinstitute.com.au or 02 8223 0059).

Yours sincerely,



Rebecca Maslen-Stannage
Chair, Business Law Section
Law Council of Australia

Tim Neilson
President
The Tax Institute