JUNE 2005

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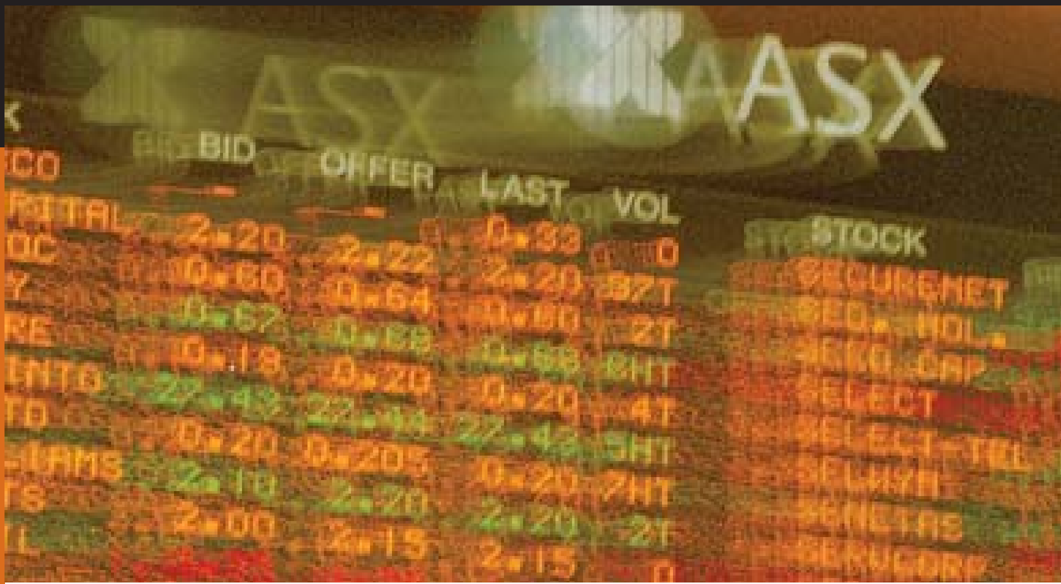


# Takeover/restructure roll-over relief for employee shares and options

The long awaited roll-over of the taxing time for employee shares and options that are 'exchanged' as part of a takeover or restructure is now law, with effect from 1 July 2004. These new provisions were recommended in the Nelson Report on employee share ownership, which was released in October 2000 and on which the Government responded in March 2003. Partner Sarah Bernhardt and Lawyer Suzanne Holstein look at the intricacies of the new arrangements.

## Overview of the new provisions

An employee who has been granted shares or rights to shares in their employer (or holding company of the employer) at less than market value is generally subject to income tax on those shares/rights. However, such an employee may be entitled to defer the income taxing time until a 'cessation time' occurs under Division 13A of the Income Tax Assessment Act 1936 (***Division 13A***). As 'cessation time' for these purposes includes a disposal of the shares or rights, a taxing time could arise under a takeover/restructure (on the 'exchange' of shares/rights) in the absence of appropriate roll-over relief.

Under the new provisions, employees will be able to roll-over the taxing time provided that:

- except for the new roll-over provisions, the restructure or takeover would be a Division 13A 'cessation time' (generally a taxing time);
- in connection with the restructure or takeover, the employee receives ordinary shares or rights to acquire ordinary shares in a new company (***New Shares/Options***) to replace shares or rights in the old company (***Old Shares/Options***);
- the employee ceases to hold the Old Shares/Options as a result of the restructure or takeover;

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- the New Shares/Options can reasonably be regarded as matching shares or options of the Old Shares/Options (ie equivalent value and substantially the same attributes); and
- after the restructure or takeover, the employee works for the company or group of companies in which the New Shares/Options are held.

The roll-over works by treating the New Shares/Options as a continuation of the Old Shares/Options, (and, if relevant, the employee's employment in the new company as a continuation of their employment in the old company).

## Tricks and traps with the new provisions

### '100% takeover' or 'Restructure'

The new roll-over provisions apply to acquisitions of New Shares/Options that occur in connection with a '100% takeover' or 'restructure'. The scope of these terms is not entirely clear and will no doubt result in class rulings being sought in many cases.

The legislation defines '100% takeover' as an arrangement that is **intended** to result in a company becoming a 100 per cent subsidiary of another company, whereas the Explanatory Memorandum (***EM***) notes that the roll-over relief in a takeover scenario will only apply where 100 per cent of the old company's shares are acquired by the new company. Presumably the intent is to only allow the roll-over in the event that the bidder eventually gets to 100 per cent ownership but no doubt there will be practical issues around what is an acceptable period of time between the exchange of the employee shares/options and the obtaining of 100 per cent (eg in the case of a takeover of a foreign company where compulsory acquisition could be a drawn-out and lengthy process).

What is curious is why a '100%' requirement was thought necessary from a policy perspective, given Division 13A generally allows a deferral of the taxing time when the shares/rights are in the 'holding company' (which is a 50 per cent test), and the CGT scrip for scrip roll-over requirement is only 80 per cent. The EM attempts to justify this policy decision by noting that, in a partial takeover, the taxpayer has a choice as to whether or not to dispose of their shares or rights. This of course would not be the case in the event that the relevant plan rules provided for an 'automatic' roll-over of the shares/rights (more likely with options than shares). In any event, even if exchange of the shares/rights is not forced on employees (under the plan rules or otherwise), why should they be denied a roll-over of the taxing time when, if they were granted new shares/rights in the bidder, they would generally be entitled to defer the taxing time on those shares/rights (provided the bidder gets more than 50 per cent of the target)?

'Restructure' is defined as a change in the ownership, or the structure of the ownership, of the company as a result of which some or all shares or rights held in the company under an employee share scheme immediately before the change are replaced (or could reasonably be regarded as having been replaced) wholly or partly by shares or rights in one or more other companies. On the face of it, this definition appears broad and does not include the '100%' requirement contained in the takeover definition. It would reasonably be expected that this definition would include the insertion of a holding company above a company, where there is no significant change in ultimate ownership. Further, the EM indicates that it could include a demerger where some of the shares/rights in the top entity are cancelled in consideration for shares/rights in the demerged entity. A word of caution with demergers though – the Division 13A tax issues abound and it is unlikely that the limited application of these new roll-over rules will cure all the potential issues.

### Potential extension of tax deferral on shares

Employees who are deferring the Division 13A taxing time on employee shares are generally taxed on those shares on the lifting of the disposal/forfeiture conditions (regardless of whether they continue to hold the shares after that time), subject to a maximum 10-year deferral period.

The new roll-over provisions do not require the new shares to be subject to restrictions on disposal or forfeiture conditions, even if the old shares were subject to such conditions (notwithstanding the 'matching' requirement). The EM states that a replacement of shares or rights with restrictions, with shares or rights without restrictions following a restructure would still be considered 'matching'. Further, any disposal restrictions to which the old shares were subject are disregarded when determining the taxing time on the new shares. Rather, the taxing time for the new shares will generally be the earlier of disposal, cessation of employment and ten years from the date of acquisition of the old shares.

For example, assume that, at the time of a restructure, an employee is holding shares that are subject to restrictions on disposal for six years (of which three years are left to run), which are exchanged for unrestricted new shares as a result of the restructure. If the new roll-over relief applies, the taxing time on those unrestricted new shares will be the earlier of disposal, cessation of employment and 10 years from grant of the old shares. That is, the effect of the roll-over relief is a four-year extension of the potential tax deferral period, with no disposal restrictions being necessary to achieve that deferral.

## Options on which tax has been paid prior to the takeover/restructure

The new roll-over rules only apply to employee shares and rights on which there has not been a Division 13A cessation time at the time of the takeover/restructure. This means that the new rules will not apply, for example, to former employees holding options at the time of the takeover/restructure who were subject to tax on those options on cessation of employment (as cessation of employment is a cessation time). However, it would appear that the new rules will apply to employees holding options on which they elected to pay tax on grant as, by definition, a cessation time would not yet have occurred in relation to such options (notwithstanding tax has been paid by election under Division 13A).

Generally, if an employee has paid tax on options prior to exercise (eg elected to pay tax on grant, or been required to pay tax on cessation of employment), and those options subsequently lapse, the employee is entitled under section 139DD of Division 13A to seek a refund of the tax paid on those options.

If an employee has elected to pay tax on grant of options, it would appear that they should continue to be entitled to claim a refund of that tax in the event that their ‘substituted’ option lapses. This is because the new provisions should treat the new options as a continuation of the old options (given that a cessation time will not yet have occurred on the options at the time of the takeover/restructure, notwithstanding that they elected for up-front tax to apply). However, what is not entirely clear is how this treatment will interact with the CGT treatment for such an employee. The new provisions provide for the capital gain/loss from the exchange of the options to be ignored for CGT purposes, but this provision should not apply to option holders who elected to be taxed on grant of their options.

Depending on how the exchange of the options is structured, it may be possible to put forward a forceful argument that the ‘exchange’ of the options is not a CGT event under s112-25 (split, changed or merged assets), or that the normal CGT scrip for scrip roll-over provisions should apply (assuming the grantor of the options was the company whose shares are the subject of the options). However, in the event that CGT did apply on the exchange of the options, and the new options subsequently lapsed (with a refund sought under s139DD), the capital gain/loss made on exchange of the options would also presumably need to be adjusted (to eliminate the cost base of the old options by reference to the Division 13A market value on grant).

The ability to claim a refund on the subsequent lapse of options is also a very important issue for former employees in the unfortunate position of having retired or been made redundant in circumstances where the option plan rules allow their options to stay on foot for the same term as if retirement/redundancy had not occurred (which is not uncommon, especially with foreign option plans). As the options do not lapse on cessation of employment, Division 13A unfairly provides that tax is payable on those options on cessation of employment **notwithstanding that**, in some cases those options may be unvested at that time, or indeed under water. Logically (and fairly), such employees should continue to be entitled to claim a refund in the event of the lapse of ‘substitute’ options. Unfortunately, however, this issue does not appear to be adequately addressed in the new provisions, given that such option holders will have had a cessation time in relation to their options (ie cessation of employment) prior to the restructure/takeover occurring.

## Tax exempt plans not covered

The new provisions do not address the myriad of issues that can arise in the context of a restructure or takeover for shares acquired under a $1,000 tax exempt scheme. Under such plans, employees generally elect to be taxed on their shares in the year of acquisition, but are then entitled to a tax exemption for up to $1,000 of the value of the shares **provided** the plan is operated to not permit disposal before the earlier of three years and cessation of employment.

The Australian Tax Office have issued a number of class rulings in relation to such plans in the context of takeovers and schemes of arrangements that indicate that the tax exemption claimed by employees on the acquisition of such shares will be retrospectively lost in the event that the participants are allowed to participate in a takeover/scheme of arrangement **other than** by compulsion of law (eg compulsory acquisition). Unfortunately the new provisions contain no relaxation of this requirement.

### Employee share trusts

If employee shares are being held by an employee share trust, and the employee is not absolutely entitled to those shares at the time of the takeover/restructure (eg because of disposal restrictions), the trustee would generally have to consider whether there are any capital gains tax implications to it on both the takeover/restructure and also on the employee subsequently becoming absolutely entitled to the new shares.

The new provisions contain CGT relief for the trustee for both the takeover/restructure and also on the subsequent absolute entitlement event. These provisions appear to be limited to shares being held by the trustee on which a cessation time has not yet occurred. As discussed in (c), by definition, a cessation time would not yet have occurred in relation to such shares or rights on which the employee has elected to be taxed on grant (notwithstanding tax has been paid by election under Division 13A). Therefore the new CGT relief for the trustee should apply in these cases. There could, however, be a CGT issue for the trustee in the event that the trustee is holding shares or rights on behalf of former employees who are not absolutely entitled to those shares/rights (eg where shares continue to be subject to vesting requirements after cessation of employment).

## Conclusion

The relief provided by the new roll-over provisions is long overdue and will be welcomed by employers and employees alike. While there are clearly some problems with the limited scope of the rules (which no doubt will lead to lots of class ruling applications), there is a potential unexpected upside for employees holding restricted tax deferred shares.

# New loss recoupment rules

Before a company can recoup its losses or claim deductions for its bad debts, it must first satisfy the continuity of ownership test or, failing that, the same business test contained in Divisions 165 and 166 of the *Income Tax Assessment Act 1997.* Senior Associate Brad Swarz and Lawyer Natasha Tziokas explain.

## Draft policy

On 11 February 2005, the Federal Government released an Exposure Draft of proposed legislation, entitled Loss recoupment rules for companies, that aims to simplify the continuity of ownership test (***COT***) and place a ceiling on the same business test (***SBT***). The Exposure Draft follows a Government press release and Treasury Paper released on 7 April 2004 outlining the proposals.

The measures contained in the Exposure Draft are significant and raise new issues for purchasers of companies and the value they may attribute to a target's losses.

## Overview

Broadly, the effect of these reforms is that the COT will be substantially simplified and improved. However, this will come at the expense of limited access to the SBT.

### New modified Continuity of Ownership test

The Exposure Draft provides that a new modified COT (**Modified COT**) will replace the existing modified COT in Division 166. In particular, the Modified COT will apply more broadly than the current version to companies (including the head company of consolidated groups) that are:

- widely held; or
- majority owned by widely held companies and certain other entities such as superannuation funds.

In addition, new tracing concessions will be introduced that will substantially improve the ability of widely held companies to satisfy the Modified COT. Under these concessions, ownership interests in a loss company can be traced and attributed to:

- direct or indirect interests of less than 10 per cent;
- interests held by deemed beneficial owners (including superannuation funds and managed investment funds);
- interests held by widely held companies;
- indirect interests held by way of bearer shares in foreign-listed companies; and
- indirect interests held by depository entities through foreign-listed companies.

These proposed measures are intended to apply from 1 July 2002.

They are concessionary, but are subject to two 'integrity rules'. One of these rules deems a company to have failed the Modified COT where it knew, or could reasonably be expected to know, that there has been a change in ownership in the company that did not occur in the ordinary course of trading.

The explanatory memorandum to the Exposure Draft outlines situations where a company would generally be expected to know of a change of ownership and transactions that would be considered to be outside the ordinary course of trading. For example, the explanatory memorandum states that a company would generally be expected to know of a change of ownership if:

- notices of substantial shareholdings provided to the company are sufficient to indicate a change of ownership; or
- the transaction giving rise to a change of ownership is widely reported in the media; or
- a change in ownership is widely known by market participants or industry participants.

If a company that is otherwise eligible to apply the Modified COT is of the view that it cannot or does not want to apply the Modified COT, it may choose not to. If this occurs, the original COT contained in Division 165 must be satisfied.

### Same business test ceiling

The Exposure Draft also proposes to introduce a ceiling on the SBT, whereby companies (including consolidated groups) with 'total income' in excess of $100 million in an income year will not be entitled to rely on the SBT as a basis for recouping losses in that income year (the ***SBT Ceiling***). In these circumstances, losses will only be able to be recouped if the COT or the Modified COT is satisfied.

It is proposed that the SBT Ceiling will apply to losses and bad debt deductions arising in an income year commencing on or after 1 July 2005 (other than certain losses originally incurred pre-1 July 2005).

## Issues for purchasers

The proposed Modified COT and SBT Ceiling raise new issues for purchasers in considering whether any value should be placed on a target company's losses.

### Purchasers acquiring 100 per cent of a loss company

Where a purchaser acquires 100 per cent of the shares in a target company, its ability to acquire the company's losses is limited to instances where the company is the head company of a consolidated group or is not a member of a consolidated group. In these circumstances, neither the COT nor the Modified COT will be available and so the target company must satisfy the SBT before the losses can be transferred to the purchaser's consolidated group. (Equally, if the target company is not to form part of a consolidated group with the purchaser, for example where the purchaser is a non-resident, its ability to utilise its losses going forward will be dependent on it satisfying the SBT.)

Accordingly, given the introduction of the SBT Ceiling, this means that purchasers will now have to identify the extent to which the target company's losses constitute pre- and post-1 July 2005 losses. Only pre-1 July losses will be potentially available for transfer or use.

The value that a purchaser may attribute to these losses will be determined by reference to three key factors being:

- the likelihood of the SBT being passed – in this regard it is noted that the Australian Taxation Office has failed to release its public ruling on the application of the SBT to consolidated groups;
- the rate at which the purchaser's consolidated group will be able to utilise the acquired losses having regard to the 'available fraction' attached to the losses; and
- the effect that the losses will have on the tax cost that can be allocated to the underlying assets of

the target company when it joins the purchaser's consolidated group.

For losses that are incurred post-1 July 2005, the effect of the SBT Ceiling means that they will become valueless as neither the target company nor purchaser will be able to use them if the target's total income in the year exceeds $100 million.

### Purchasers acquiring less than 100 per cent of a loss company

In a less than 100 per cent scenario, losses will be trapped in the target company and therefore, will not be able to be transferred to the purchaser.

If the SBT Ceiling is to apply, the target company's ability to utilise post-1 July 2005 losses will be limited to it satisfying the COT or Modified COT. Accordingly, unless a target company has pre-1 July 2005 losses and/or the purchaser acquires an interest of no more than 50 per cent, the target company will lose access to its losses as a result of the sale.

### Impact of the SBT Ceiling for unrealised losses

The SBT Ceiling will also have a significant impact on companies with unrealised losses. Sub-division 165-CC of the 1997 Tax Act provides that if a majority change occurs in the ownership or control of a company that has unrealised losses, the company can only utilise those losses (once realised) if it can satisfy the SBT.

If the SBT Ceiling is to apply, this means that some companies will automatically fail the requirements of Sub-division 165-CC as the SBT will be unavailable to them. For example, if a purchaser acquires a majority interest in a target company that has unrealised losses at the time of the sale, the company will lose its ability to utilise its losses once they are subsequently realised if the sale occurs after 1 July 2005 and the company is subject to the SBT Ceiling. Representations have been made to Treasury to rectify this outcome and to effectively 'grandfather' the unrealised losses as at 30 June 2005 to the SBT.

## Conclusion

The proposed reforms outlined above are a substantial improvement to the current position on an ongoing basis. However, in an acquisition context, the SBT Ceiling will have a major impact on the value purchasers are prepared to attribute to a target company's losses. In many cases, these losses will automatically be taken out of the tax system as a result of the sale.

# Dick Smith Electronics

The recent High Court decision in *Dick Smith Electronics*[1] has significant implications for parties involved in share sales and acquisitions. Briefly, the High Court held that for stamp duty purposes the consideration for an agreement to transfer shares included the purchase price plus the performance by the purchaser of its obligation to fund a dividend declared by the target company in favour of the vendor. Notwithstanding that the case was concerned specifically with stamp duty, it has implications for CGT and GST as Senior Associate Katrina Parkyn explains.

## Summary of facts

The relevant facts of the case (which are not unusual) were as follows:

- InterTAN Inc and InterTAN Canada (the ***vendors***) agreed to sell their shares in InterTAN Australia Pty Limited (the ***target company***) to Dick Smith Electronics Holdings Pty Limited (the ***purchaser***), a wholly owned subsidiary of Woolworths Limited.
- The purchase price for the shares was expressed to be $114,139,649 minus the dividend amount.
- It was agreed that the Vendors would procure the target company to declare, prior to completion, a dividend on the company's ordinary shares equal to the amount of its retained profits.
- The purchaser agreed to 'fund' the target company so that it could discharge the debt owed to the ordinary shareholder in whose favour the dividend had been declared. In order to meet this funding obligation, the purchaser lent $25.5 million to the target company (to enable it to pay the dividend).

The New South Wales Commissioner of State Revenue assessed the share sale agreement to duty

[1] *Commissioner of State Revenue v Dick Smith Electronics* [2005] HCA 3

based on a total consideration of some $114 million. The purchaser objected, and subsequently appealed, on the basis that the dutiable consideration was the purchase price of $89 million; ie $114 million less $25.5 million for the dividend amount.

By a majority of 3:2, the High Court held that the consideration was the full $114 million. The majority focused on the fact that 'what was to be received by the vendors and what was received by them' was $114 million. The fact that part of that amount was received by them in the form of a dividend was immaterial.

## Dutiable value

The dutiable transaction in question was the agreement for the transfer of shares.

Under the *Duties Act 1997* (NSW), the dutiable value of that transaction was the greater of:

- the consideration for the dutiable transaction, being the amount of monetary consideration or the value of a non-monetary consideration; and
- the unencumbered value of the dutiable property that is the subject of the transaction.

No issue was raised by the parties in relation to the value of the shares transferred in the target company. The dispute turned solely upon identifying the 'consideration for' the dutiable transaction. It is significant to note that the Commissioner of State Revenue's case was argued solely on the basis that the amount of the monetary consideration for the dutiable transaction was $114 million. The Commissioner did not seek to identify any non-monetary consideration for the shares (for example, the promise to fund the target company).

## Majority reasoning

A majority consisting of Justices Gummow, Hayne and Kirby placed significant emphasis on what was received by the vendors for their shares and noted that it was only in return for the total sum of $114 million that the vendors were willing to transfer their shares. The fact that part of the $114 million was provided by way of a dividend from the target company, rather than directly from the purchaser, did not alter this conclusion.

The majority did not accept that it was necessary (or indeed possible) to identify the 'consideration for' the dutiable transaction in terms of what the purchaser had given, in its various forms. The consideration which moved the transfer was the 'performance by the purchaser of the several promises recorded in the agreement', as a result of which the vendors received 'some $114 million, of which part was received from the [Target] Company because the parties had agreed this should be so'.

The purchaser argued that as the performance of its funding obligation led to the creation of a debt owed by the target company, the funding could not be seen as being part of the consideration for the transfer of shares. Put another way, because the purchaser received two distinct assets for its $114 million, namely, the shares and the debt, it was incorrect to say that the entire $114 million was consideration for the shares. The majority rejected this analysis. They noted that the purchaser had 'satisfied the Vendor's desire for money by a means which gave the Purchaser the asset of a debt as distinct from the indirect interest it would have had in what, but for the dividend, would have been the larger and more valuable assets of the Target Company'.[2]

## Minority reasoning

The minority consisting of Chief Justice Gleeson and Justice Callinan placed significance on the legal form of the various steps involved in the transaction.

They noted that the declaration of the dividend prior to completion involved the vendors exercising their rights as shareholders (as they were at the relevant time) of the target company. The consideration for the payment of the dividend by the target company was the shareholder's original subscription for shares. As the net assets of the target company were inevitably reduced by the declaration of the dividend, the value of the target company, and hence purchase price for the shares, was also reduced. In the end, the vendors received two amounts of money, according to the minority. They received $89 million for their shares and $25 million by way of dividend. The purchase price was received by the vendors in their capacity as vendors whereas the dividend was received by them in their capacity as shareholders of the target company.[3]

The minority also noted that the purchaser's funding obligation could have been satisfied in various forms. Although the obligation ultimately took the form of a loan by the Purchaser to the Target company, it could have equally taken the form of a subscription for further shares or perhaps even a loan from a third party, such as a bank. This supported the legal form of the steps in the transaction and, in the minority's view,

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[2] Paragraph 79.

[3] Paragraph 80.

the fallacy in the majority's assumption that the entire $114 million was consideration for the transfer of the shares.

## Implications for share sales

The decision of the majority represents a very surprising outcome and one that is certainly at odds with the conventional understanding as to the meaning of consideration for stamp duty purposes. Nonetheless, it currently represents the law in Australia and is therefore certainly a decision that warrants careful scrutiny when structuring any share sale agreement in the future.

One of the concerning aspects of the majority judgment is the inevitable, but unstated, conclusion that a payment may be regarded as consideration for more than one transaction. As a matter of law, it cannot be disputed that the purchaser in *Dick Smith* obtained both shares and a debt in return for its $114 million. The provision of the loan that gave rise to a debt, however, was also found to be part of the consideration for the shares.

The impact of the decision is not limited to cases involving a sale of shares 'ex-dividend' but potentially extends to any situation where the vendor can be seen to receive, in any form, something in addition to the purchase price for the shares. At the end of the day, the Purchaser in *Dick Smith* simply lent money to the target company to allow it to discharge the debt created by the declaration of the dividend. One might say that the outcome should be the same where, for example, a purchaser lends money to a company to allow it to repay a loan to the vendor. Again, this is a not uncommon situation.

The outcome, however, might be different if a vendor separately assigns its shares and the debt owed by the company to the purchaser, as opposed to having the purchaser fund the company to allow the debt to be repaid. Economically, the effect should be the same. The vendor receives consideration for the transfer of the shares and separate consideration for the transfer of the debt. Of course, the stamp duty consequences of assigning the debt would need to be considered, as in some states the transfer of a debt is still potentially liable to conveyance duty.

The decision also has potentially significant implications in relation to CGT. The minority made reference to this and noted that the views of the majority may produce some surprising CGT consequences.

The sale of shares in a company gives rise to CGT event A1 for the vendor. The vendor makes a capital gain if the 'capital proceeds' received from the disposal of the shares exceed the 'cost base' of those shares.

For CGT purposes, capital proceeds include money that the vendor receives or is entitled to receive in respect of the event happening. In light of *Dick Smith,* the question that arises is whether there is a distinction between the consideration for the transfer of shares and the amount received in respect of the disposal of shares. Arguably, there is not which, on the facts of the *Dick Smith* case, could mean that the capital proceeds received by the vendors were the full $114 million. This could give rise to double taxation as the dividend component of $25 million would also form part of the vendors' assessable income. It is not entirely clear whether section 118-20 of the *Income Tax Assessment Act 1997* (Cth) would assist to reduce the capital gain.

The other side of this issue is whether the dividend amount could form part of the purchaser's cost base for the shares. The first element of an asset's cost base is 'the money you paid, or are required to pay, in respect of acquiring' the asset. The question is whether the $25 million dividend component could be seen, in light of the majority's reasoning in *Dick Smith,* as money paid 'in respect of' acquiring the shares. On the one hand, the money was paid to acquire (create) the debt owed by the target company to the purchaser. On the other hand, there is an obvious lack of symmetry in treating the $25 million as money received in respect of the shares, if that amount is not also regarded as money paid in respect of acquiring those shares.[4] It is not known what, if any, position the ATO will adopt in relation to the application of the *Dick Smith* case. This is an issue that parties ought to bear in mind when structuring transactions. The case certainly demonstrates that the task of identifying the consideration for a transaction requires a broader analysis than might previously have been contemplated.

Of course the other area of tax law where the identification of consideration is relevant is GST. GST on taxable supplies is imposed by reference to the 'consideration for' the supply. A sale of shares is input taxed and therefore not subject to GST in any event. However, the extended meaning of consideration in light of *Dick Smith* still needs to be kept in mind in a

[4] In other circumstances the Commissioner has not been concerned by the lack of symmetry between the vendor's capital proceeds and the purchaser's cost base: see TR 95/15.

GST context, particularly where you are seeking to identify the consideration for a supply that is part of a wider, interconnected series of transactions.

# Tax rulings on scrip for scrip rollover relief

The scrip for scrip capital gains rollover provisions have greatly facilitated scrip-based acquisitions of target companies and unit trusts since they came into effect in 1999.[5] The rules generally operate in a fairly straightforward manner: if the acquiring company or trust acquires at least 80 per cent of the shares or units in the target company, then CGT rollover relief is generally available for target shareholders or unitholders. However, a number of class rulings and determinations highlight some interesting issues that can arise in relation to the scrip for scrip rules. While class rulings are binding on the ATO only in respect of the class of persons to which they apply, they can be helpful in indicating ATO thinking on particular issues. Partner Michael Rigby looks at what the rulings tell us about the issue.

## Taxation Determination TD 2004/50

TD 2004/50 addresses the interface between the scrip for scrip rollover provisions and the tax consolidation regime. The scrip for scrip rollover rules contemplate that the target company may be acquired by a subsidiary member of a 'wholly owned group' of companies, and that consideration for the shares in the target may be provided by an issuance of shares in the ultimate holding company of the group.[6] However, under the 'single entity' rule in the tax consolidation regime, subsidiary members of a group of companies are treated as parts of the group's head company for the purposes of calculating the group's income tax liability.[7] Therefore, if the single entity rule applied for the purposes of determining whether scrip for scrip rollover relief was available, it would not be necessary to establish that the subsidiary company that acquires the target shares is a member of the same 'wholly owned group' of companies as the ultimate parent company; the subsidiary would be treated as part of the holding company and there would simply be an acquisition of target shares by the head company in consideration for an issuance of head company shares.[8]

In many cases, the result will be no different whether or not the single entity rule applies in determining the availability of scrip for scrip rollover relief because the subsidiary company that acquires the target shares will be a member of both the same 'wholly owned group' of companies and the same group for consolidation purposes as the holding company that issues the share consideration. However, the tests for determining whether companies are members of the same wholly owned group of companies and whether they are members of a consolidated group are different in one critical respect. A company is a member of the same wholly owned group as another company if all of its shares are held by the other company or by other group members.[9] In contrast, under consolidation shares that are treated as debt for tax purposes are disregarded in determining whether a company may be a member of a consolidated group.[10] Therefore, a company that has issued to third parties shares that are debt for tax purposes may still qualify as a member of a consolidated group but may not be a member of the same 'wholly owned group' as other companies.

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[5] The scrip for scrip rollover rules are in Subdivision 124-M of the *Income Tax Assessment Act 1997* (***1997 Act***).

[6] Section 124-780(2)(a)(ii) of the 1997 Act.

[7] Section 701-1 of the 1997 Act.

[8] An issuance of shares by the company that acquires the target shares can qualify for scrip for scrip rollover relief under section 124-780(2)(a)(i) of the 1997 Act.

[9] Sections 975-500 and 975-505 of the 1997 Act.

[10] A company may be a member of a consolidated group if all of the 'membership interests' in the company are held by other group members. Under section 960-130(3) of the 1997 Act, shares that are debt for tax purposes are not treated as membership interests and, consequently, are disregarded in determining whether the issuer of the shares is a member of a consolidated group.

This can be illustrated by an example:

> Holdco owns all of the ordinary shares in Sub1, which owns all of the ordinary shares in Sub2. Sub1 has issued redeemable preference shares to third parties the terms of which result in them being treated as debt under Division 974 of the 1997 Act. Sub1 and Sub2 could be members of the Holdco tax consolidated group. However, as Sub1 has issued shares to third parties neither it nor Sub2 would be members of the same wholly owned group as Holdco.

TD 2004/50 states that the consolidation single entity rule does not apply in determining whether CGT rollover relief is available to shareholders in the target company. Therefore, in the above example if Sub2 acquired 80 per cent or more of the voting shares in a target company in exchange for Holdco shares, CGT rollover relief would not be available to target shareholders because the acquiring company would not be in the same wholly owned group as the company issuing the share consideration. We are in agreement with TD 2004/05 in this respect. However, it is anomalous that the issuance of debt in the form of shares can have an impact on scrip for scrip rollover relief when no such problem arises where debt is issued in the form of debt or for that matter equity is issued in the form of debt.[11]

## Class Ruling 2005/10: Fonterra bid for National Foods

Class Ruling 2005/10 is concerned with the availability of scrip for scrip rollover relief in relation to the revised cash and scrip based bid made by Fonterra for all of the shares in National Foods Limited.[12] Under its revised offer, Fonterra offered A$6.00 or 0.6 A$10 redeemable preference shares for each National Foods share. The Class Ruling concludes that scrip for scrip rollover relief would be available for National Foods shareholders to the extent that they accepted Fonterra preference shares rather than cash for their National Foods shares if Fonterra acquired at least 80 per cent of the voting shares in National Foods.

If the Fonterra bid had succeeded, the Fonterra preference shares were to be issued fully paid at an issue price of A$10 per share. The shares were to be mandatorily redeemed for their face value on 15 March 2010 if they had not been redeemed earlier, and while on issue would have paid dividends quarterly at a rate of 7 per cent of the issue price. If, on redemption Fonterra was unable to pay in full the A$10 per share and any outstanding dividends, the shares would nevertheless have been cancelled and the unpaid balance would have remained payable as an unsecured debt. The interesting aspect of these shares is that it is likely that they would have been classified as debt interests under Division 974 of the 1997 Act. However, debt classification under Division 974 is irrelevant for scrip for scrip rollover purposes. If consideration is provided in the form of a share, rollover relief may be available under section 124-780. On the other hand, if the consideration were to be provided in the form of a note having the same terms as the preference shares offered by Fonterra, rollover relief would not have been available.

## Class Ruling 2005/11: Metcash capital reorganisation

Class Ruling 2005/11 is concerned with the capital reorganisation of Metcash under which a newly incorporated holding company (***Newco***) acquired all of the shares in Metcash. Prior to the reorganisation, around 52 per cent of the shares in Metcash were owned by a wholly owned subsidiary of Metoz Holdings, which was a South African listed company, and the remaining 48 per cent were held directly by the public. The capital reorganisation involved Newco acquiring 100 per cent of Metcash by:

- acquiring all of the shares in Metoz for cash under the Metoz scheme of arrangement, thereby giving Newco indirect ownership of 52 per cent of Metcash; and
- acquiring under the Metcash scheme of arrangement the 48 per cent shareholding in Metcash held by the public in exchange for Newco shares.

The Metcash scheme of arrangement was conditional on the Metoz scheme of arrangement being implemented. Therefore, the two schemes of arrangement were sequenced so that the Metoz scheme completed first, giving Newco indirect ownership of 53 per cent of Metcash's shares, and the Metcash scheme then proceeded giving Newco a direct holding of the remaining 48 per cent shareholding in Metcash.

[11] In the example in the text, if Sub1 issued notes that were equity and not debt under Division 974, Sub1 would be a member of the same wholly owned group as Holdco and the issuance of the notes would therefore have no implications for scrip for scrip rollover purposes.

[12] Fonterra ended its bid for National Foods on 11 April 2005 in the face of a higher competing bid from San Miguel.

For scrip for scrip capital gains rollover relief to be available, the share for share exchange in respect of which relief is sought must be 'in consequence of a single arrangement'.[13] That single arrangement must result in:

- a company that is not a member of a wholly owned group becoming the owner of 80 per cent or more of the voting shares in the target; or
- a company that is a member of a wholly owned group increasing the percentage of voting shares it holds in the target so that the company, or members of the group, become the owner of 80 per cent or more of the voting shares in the target.[14]

Further, the arrangement must be one in which at least all owners of voting shares in the target company, except companies in the acquirer group, can participate.[15]

An issue that arises in relation to transactions like this, where there is an indirect acquisition of a significant stake in a target company as well as a direct acquisition of the remaining target shares, is whether there is a 'single arrangement' under which members of a group acquire 80 per cent or more of the voting shares in the target and under which all members of the target can participate. If the arrangement were the Metoz scheme and the Metcash scheme together, Metoz and its subsidiaries would not be members of the Newco group at the time that the arrangement commenced. This could raise a question of whether the requirement that all owners of voting shares could participate in the arrangement would be satisfied given that the Metoz subsidiary that held the Metcash shares did not participate in the share for share exchange under the Metcash scheme. The class ruling avoided this problem by concluding that the Metcash scheme was the relevant scheme for scrip for scrip rollover purposes. As that scheme was conditional on implementation of the Metoz scheme, Metoz and its subsidiaries would be members of the Newco group at all times during the relevant arrangement. Consequently, it was not necessary for the Metoz subsidiary that held the 52 per cent Metcash shareholding to participate in the share for share exchange offer under the Metcash scheme in order for rollover relief to be available for all other Metcash shareholders.

The Class Ruling suggests that the ATO is prepared to interpret the scrip for scrip rollover rules in a way that is consistent with their objective of removing tax obstacles to takeover activity. This is entirely appropriate given that the rules are facilitative, rather than proscriptive, in nature.

## Scrip for scrip rollover for trusts

CGT rollover relief is also available in respect of exchanges of fixed interests in one trust for fixed interests in another.[16] Relief is not available to the extent that consideration other than fixed interests in the acquiring trust is provided. Therefore, where the acquirer is a trust that is part of a stapled trust/company structure, rollover relief is not available to the extent that holders of interests in the target trust receive shares in the company that is part of the stapled vehicle. The extent to which rollover relief is available in these circumstances involves placing a separate value on the shares and units in the acquiring vehicle. If most of the value is in the trust units in the stapled structure, the taxable component of the consideration provided to target unitholders will be small. This was the case in the acquisition by the Investa Property Group of all of the units in the Principal Office Fund. There, the units in the trust in the Investa Property Group represented 97 per cent of the total value of the stapled securities issued to Principal Office Fund unitholders so that the taxable component of the consideration received would have been 3 per cent of the total value.[17]

Where one stapled group acquires another, there would ordinarily be an exchange of shares in the company in the target group for shares and units in the acquiring group, and an exchange of units in the target trust for shares and units in the acquiring group. Therefore, only partial rollover relief would be available in respect of the exchange of shares and units in the target group. This problem was avoided in the merger of the Centro Properties Group and Prime Retail Group by de-stapling the shares and units in both groups prior to the merger, and having the shares in the target company exchanged for shares in the acquiring company and the units in the target trust exchanged for units in the acquiring trust. The shares and units in the acquiring group were then re-stapled. In Class Ruling CR 2004/118, the Commissioner ruled that share for share and unit for unit CGT rollover relief was

[13] Section 124-780(1)(b), 1997 Act.

[14] Section 124-780(2)(a), 1997 Act.

[15] Section 124-780(2)(b), 1997 Act.

[16] Section 124-781, 1997 Act.

[17] Class Ruling 2004/78.

available in full in this case. This is a sensible outcome that is consistent with the policy underlying the scrip for scrip rollover rules. However, the need to de-staple and then re-staple the acquiring group securities to ensure full rollover relief does highlight a deficiency in the roll-over rules in relation to stapled structures. This option is not available, for example, where, as in the takeover by Investa Property Group of the Principal Office Fund, a stapled group acquires units in a trust that is not part of a stapled structure in exchange for units and shares in the stapled group.

## Taxation Ruling 2005/D8: Scrip for scrip schemes

In TR 2005/D8, the ATO concludes that scrip for scrip rollover relief is not available in relation to certain schemes involving the disposal of shares in a company that have been structured to take advantage of the scrip for scrip rollover provisions. The schemes described in the draft ruling are quite complex, but may be summarised as follows:

- Company A wishes to sell to a third party all of the shares in a wholly owned subsidiary company, Company B.
- Company C, a widely held company, approaches Company A with a proposal that is intended to permit the sale of the shares in Company B utilising the scrip for scrip rollover provisions. Under the proposal, Company C establishes two companies, Company D and Company E, each of which is owned 99 per cent by Company C. The remaining 1 per cent in Company D is held by Company E, and the remaining 1 per cent in Company E is held by a third party.
- Company A exchanges its shares in Company B for converting shares in Company D. The converting shares entitle Company A to less than 30 per cent of the voting, dividend and capital distribution rights in relation to Company D. However, Company A is granted a put option under which it can require Company C to purchase its converting shares for an amount equal to the price at which it could have sold its Company B shares. Also, Company A is able to convert the converting shares into shares having the same rights as the shares that it held in Company B carried, and is granted a call option that entitles it to acquire the shares in Company D that are held by Company C.
- Company D then sells the shares in Company B for cash, and Company A acquires the Company D shares that are held by Company C. Company C receives a fee for facilitating the transaction.

The intended outcome of the transaction is that Company A is entitled to scrip for scrip rollover relief in relation to the exchange of Company B shares for Company D shares, Company D has a cost base in the Company B shares equal to their market value so that no capital gain arises in respect of the disposal of the Company B shares to a third party, and as Company A acquires all of the shares in Company D it has access to the cash received by Company D in respect of the sale of the Company B shares.

There are certain structured elements of the transaction that no doubt attracted the ATO's attention. Company C holds only 99 per cent of the shares in Company D before the arrangement commences so that Company D can be the entity that issues the shares under the scrip for scrip exchange.[18] Also, the significance of the converting shares issued by Company C having less than 30 per cent of the voting, dividend and capital rights in respect of Company D is that Company A therefore does not become a 'significant stakeholder' in Company D. This means that Company D obtains a market value cost base in the Company B shares, rather than a lower cost base inherited from Company A, with the consequence that no capital gain arose for Company D in connection with the on-sale of the Company B shares.[19]

As neither Company A nor Company D had more than 300 members before the scheme started, the legislation provides that if those companies did not deal with each other at arm's length rollover relief is available only if the shares issued by Company D carry the same kinds of rights and obligations as those attached to the shares in Company B.[20] The Draft Ruling asserts that Company A and Company D did not deal at arm's length in relation to the scheme, and that as the shares in Company D carry different rights to those in Company A scrip for scrip rollover relief is not available. In broad terms, it appears that the ATO considers that the parties did not deal at arm's length with each other because of the way in which the transaction is deliberately structured to fall within the scrip for scrip rollover provisions, and to ensure that Company D acquires a market value cost base in

[18] If Company C held all of the shares in Company D, scrip for scrip rollover would only be available to Company A if it exchanged its Company B shares for Company C shares: section 124-780(3)(c)(ii).

[19] If Company A were a significant stakeholder in Company D, section 124-782 would apply to give Company D a cost base in the Company B shares equal to Company A's cost base in those shares.

[20] Section 124-780(4) and (5), 1997 Act.

the Company B shares. In any event, the Draft Ruling concludes that even if scrip for scrip rollover relief were available, the general anti-avoidance provisions of Part IVA would apply to deny the rollover benefit to Company A.

## Conclusion

The scrip for scrip rollover provisions are not integrated with the debt-equity characterisation rules of Division 974 of the 1997 Act. The discussion of TD 2004/50 indicates that this can cause anomalous results where a member of a group that is entering into a scrip for scrip transaction has issued shares that are treated as debt for tax purposes. Class Ruling 2005/10 indicates that this can also create opportunities by permitting rollover relief where the consideration provided is in substance debt but in form shares.

Class Rulings 2005/11 and 2004/118 suggest that the ATO is prepared to interpret the scrip for scrip rollover rules in a way that is consistent with their objective of facilitating takeover activity if they consider that the transaction concerned is of a type in respect of which rollover relief should be available. However, TR 2005/D8 indicates that the ATO may take a more proscriptive approach where it considers that a transaction in respect of which rollover relief would not be available has been deliberately structured to fall within the scope of the rollover provisions. This suggests a distinction in the ATO's mind between acceptable use of the rollover provisions and unacceptable abuse of those provisions.

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