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Demergers - TD 2019/D1 Submission 10 May 2019

1 Overview

Thank you for the opportunity of making a submission on TD 2019/D1 – what is a 'restructuring' for the purposes of subsection 125-70(1) of the *Income Tax Assessment Act 1997*?

The import of the document is that the demerger provisions will not apply in a variety of innocuous situations which, in our view, are meant to be covered by the regime. The TD reaches that view by reasoning that is strained and sometimes inapt. It is hard to resist the conclusion that the issue of the TD, and approach taken in it, reflects an attempt to justify an administrative decision to reverse previous ATO policy, even if it means taking positions that bear little relationship to the Government policy which the legislation embodies.

And it is surprising that the ATO would want to issue a document which adopts a more restrictive meaning for the term 'demerger' in s. 125-70 since doing so limits the ability of Div 125-B to operate as an anti-abuse rule. The demerger rules are both –

- a concessionary regime which is in part elective seen in s. 125-80 and sometimes automatic in s. 44(3)-(5) and
- an anti-abuse rule which is mandatory (and not conditional on the concession being triggered) seen in ss. 125-85 and 125-90.

Since the defined term 'demerger' is common to both the concessionary and anti-abuse elements, the main practical effect of the TD will be to constrain the ATO's ability to trigger the anti-abuse provisions. The TD will have little practical impact on the concessionary aspect of the regime since taxpayers do not undertake demergers without the benefit of a favourable ATO ruling, and the ATO does not need to issue a TD as a precursor to issuing fewer favourable rulings. Taxpayers will not be able to insist that the ATO issue a favourable ruling because the ATO issued a TD; but taxpayers who do decide to proceed with a transaction will be able to insist that their cost bases remain misaligned because of the TD.

Accordingly, it is clear that the preferable approach is for (1) the TD to be withdrawn; and (2) the ATO to engage with Treasury to initiate a review of the demerger provisions to ensure that the ATO's interpretation of the demerger provisions accords with its policy purpose (and if necessary, consider legislative amendment). Otherwise legitimate commercial transactions cannot be undertaken based on the ATO's now overly restrictive view of the demerger provisions.

2 The policy underpinnings of Div 125

Div 125 ITAA 1997 and ss 44(3)-(5) ITAA 1936 were enacted in the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* in response to the recommendations in chapter 19 of the final report of the Review of Business Taxation, A Tax System Redesigned (1999). The Report had recommended that tax relief be provided where –

> *a widely-held entity splits its operations into one or more new entities and issues membership interests in these entities to the original members in the same nature and proportion as their original membership interests.*

The policy motivating this proposal was simple –

> *… equity holders may face CGT and/or income tax depending on the way in which the business undertakes its reorganisation [and] this acts as an impediment to entities restructuring their operations and may therefore lead to a reduction in the overall efficiency of the economy.*

Consequently no tax should be triggered where –

> *… an entity undertakes a reorganisation of its operations, leaving members in the same economic position as they were immediately before the reorganisation, there should be no taxing event. This includes reorganisations in which the original entity continues to exist.*

In other words, if the shareholders of Head Co simply shift from an interest in Head Co to similar interests in Head Co and Sub Co, no tax should be triggered at that time.

That policy is now reflected in s. 125-5:

> *The object of this Division is to facilitate the demerging of entities by ensuring that capital gains tax considerations are not an impediment to restructuring a *business.*

And it was equally important to ensure that the cost which the shareholder has in its original interest in Head Co was spread over the interest in Head Co and the new interest in Sub Co, and to insist on this outcome even when the shareholder has not enjoyed a tax concession – see s. 125-85 which requires the shareholder to make cost base adjustments if a demerger happens but the shareholder does not choose a rollover. For example, if Sub Co issues 99 new shares to the shareholders of Head Co for every 1 share held by Head Co, this does not need an immunity from tax but it was vital that this transaction be viewed as a 'demerger' so that the shareholders' costs in Head Co and Sub Co could be adjusted accordingly. (There is nothing in s. 6BA, the IVS rules or the DVS rules which would accomplish this.)

In our submission the rules, as drafted, give effect to the RBT recommendation. Importantly, the RBT's report did not make this treatment conditional on a requirement that no other events (such as a capital raising or share sale) occur in conjunction with the demerger. Indeed, chapter 19 is labelled is labelled, 'Capital Market Incentives' – its entire focus was directed at solving the problem that, 'the current CGT arrangements are an impediment to corporate acquisition activity in Australia.'

However, it appears that the administration of the rules has recently moved in a way which does not give effect to the policy. This is a recent development: the ATO has apparently decided it no longer approves of the 2013 Texon / Talon transaction (which the ATO blessed at the time) and so the 2018 AMA / Blackstone transaction was effectively prohibited. Just what prompted this change of mind has not been explained in the TD.

This divergence between the policy intent and the administration of the rules is not caused by some defect in the drafting which the ATO has no option but to implement. Rather, in our submission, the ATO could, if it were so minded, administer the rules in a way which gives effect to the policy.

3 Misguided strictness

When the ATO announced the prospective issue of a product in this topic in November 2018, the announcement said it would be issued to explain the ATO's views about the administration of Div 125.

Unhappily, the TD does not explain just why the transactions described ought not be treated as ‘demergers.’ It certainly attempts to argue that the situations do not qualify, but there is no explanation why the transactions are abusive or inimical to the objects of the regime other than a view that “there is a clear theme that CGT consequences are expected where there is both a legal and economic change in the ownership of property resulting from a transaction. However, one clear outcome of the ATO’s view is that transactions that would ultimately trigger CGT consequences (and tax being paid) will no longer be undertaken.

For example, why would the ATO want to prevent a corporate group being divided so that part can be sold [Example 3 and 5]? There are good reasons for the ATO to want to have this transaction in the demerger rules (maybe even, to stretch the interpretation to bring it about!) because the transaction will proceed and some tax will be collected from sales under the subsequent sale and the sale facility. Treating this transaction as outside the scope for demerger relief means the transaction will likely not proceed [as in the AMA / Blackstone transaction] and so no tax will be collected.

4 The term ‘restructuring’ in s. 125-70

The TD makes the word ‘restructuring’ do a great deal of work; in contrast the word ‘demerger’ is largely ignored. In our submission, the word ‘restructuring’ in this section is (and should be regarded as) largely devoid of meaning, the position which applied for the last 15 years. The term ‘restructuring’ has no independent meaning and has played no independent role; it was chosen precisely because it was amorphous that it meant nothing. It is the word the drafters came up with to describe a mechanism: ‘*we don’t care whether the demerger is accomplished by a transfer, a cancellation and issue, or just a fresh issue. However it is done, as long as the transaction results in 80% of the ownership being shifted, that is all that matters*.’

The correct place to start the analysis is s. 125-10(1). It provides that ‘you can choose to obtain a roll-over if … a *demerger happens to the demerger group …’ Section 125-70 says ‘a demerger happens to a *demerger group if there is a restructuring of the demerger group …’ Section 125-70 is not written as a ‘means’ definition; it does not provide an exhaustive statement of the meaning of the word ‘demerger.’ The better way to understand the provision is that the two words are used as synonyms – every demerger involves a restructuring, and every restructuring amounts to a demerger.

We agree with the statement in the TD –

> *2. In subsection 125-70(1), a 'restructuring' of the demerger group has its ordinary business meaning. It refers to the reorganisation of a group of companies or trusts. What constitutes a particular restructuring is essentially a question of fact. However, all the steps which occur under a single plan of reorganisation will usually constitute the restructuring. It is not necessarily confined to the steps or transactions that deliver the ownership interests in an entity to the owners of the head entity of the demerger group, but may include previous or subsequent transactions in a sequence of transactions. Commercial understanding and the objectively inferred plan for reorganisation will determine which steps or transactions form part of the restructuring of the demerger group.*

This passage seems correct to us, but the TD forgets it in subsequent passages. In para 4, the TD says –

> *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, or was the occasion for the restructuring, or because it is enabled by the restructuring of the group or is a consequence of the restructuring of the group*

So even though the 'commercial understanding' might include some steps prior to or after the transfer of shares or units in a 'restructuring,' the TD does not consistently apply this test as the basis for the conclusions in the Examples which follow.

Moreover, the TD quickly moves to the idea that that the term 'restructuring' or the phrase 'restructuring of the demerger group' are words of limitation. They narrow the scope of a demerger. Consequently, some 'steps which occur under a single plan of reorganisation [don't] constitute the restructuring …', and that view enlivens the 'and nothing else' test. Adopting a meaning of 'restructuring' which omits some steps all but ensures the rest of the tests in s. 125-70 cannot be met. In the examples, events subsequent to the demerger [raising additional equity; share sales] mean disqualification.

The TD leaves the reader with the impression that the ATO will form a view about whether or not to issue a ruling (based on some underlying policy view held by the ATO which the TD does not explain) and will then justify the conclusion by arguing, as needed:

- on this occasion the term 'restructuring' expands to include some additional steps: 'restructuring … is not necessarily confined to the steps or transactions that deliver the ownership interests in an entity to the owners of the head entity of the demerger group but may include previous or subsequent transactions in a sequence of transactions…' [para 2], but
- on this occasion the term 'restructuring' contracts to exclude some steps: '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 …' [para 4]

5 The U-turn

The idea that the scope of demerger relief and cost base adjustment will now be curtailed where other transactions are contemplated clearly represents a departure from prior ATO practice.

In Example 3, the conditions for demerger relief are not met because, 'the facts indicate that the in specie distribution and listing of Organic Co will be undertaken with the intention of preparing Food Co for acquisition by Giant Co [and] therefore, the sale of Food Co shares to Giant Co objectively forms part of the connected plan to separate Organic Co, meaning it will form part of the restructuring for the purposes of subsection 125-70(1). As a result, the nothing else condition in paragraph 125-70(1)(c) and the proportionality requirements in subsection 125-70(2) (which are relevant because of paragraph 125-70(1)(h)) will not be satisfied.'

The Western Mining Corporation ('WMC') transaction, one of the earliest examples where demerger relief was granted, was exactly this transaction. On 21 November 2001, WMC announced a proposal to divide its two main business into 2 new companies and then undertake a demerger:

- WMC Resources Ltd would hold the copper, nickel and fertilizer assets, and exploration and development projects,
- Alumina Limited would hold WMC's 40% stake in Alcoa World Alumina & Chemicals ('AWAC').

The Scheme Booklet was very clear that the demerger was being done in order to allow WMC to sell its 40% stake in AWAC to Alcoa US. In October 2001, Alcoa had made a tentative offer to buy all the shares in WMC (in order to acquire WMC's 40% stake in AWAC) but at a price which was reduced because Alcoa would have to buy extraneous assets inside WMC. The Scheme Booklet said the demerger was designed as a way of selling the AWAC stake without the deleterious impact on value of the other assets:

> *… the WMC Board believes that Alcoa will remain interested in acquiring WMC's 40% interest in AWAC.*

> *Alcoa made a confidential approach to the WMC Board in October 2001 with a proposal to acquire all the outstanding WMC Shares at a price of A$10.20 per share… The board carefully evaluated this proposal and obtained an independent valuation report from Grant Samuel, which concluded that the value of WMC to a potential acquirer lay in the range of A$11.18 to A$12.91 per WMC Share … Having regard to these valuations and to the considerable interest in the assets of WMC expressed by other major mining companies, the WMC Board determined that, if an offer of A$10.20 per WMC Share were to have been made at that time, it would not have been fair and reasonable… However, Alcoa was free, and remains free, to make an offer directly to WMC Shareholders, but to date has chosen not to do so. The WMC Board actively considered this and various forms of restructuring before announcing the Demerger in November 2001. The WMC Board was of the view, and continues to be of the view, that if WMC continued to operate in its current form, WMC Shareholders would be disadvantaged by the absence of a more transparent valuation of WMC's interest in AWAC …*

The reorganisation of WMC also involved new equity issues and rationalising intra-group debt:

WMC injects approximately $1.7bn equity into finance companies and approximately $0.648bn equity into WMCR for the balance of the net intercompany receivable [CR 2002/81]

So the demerger was undertaken in anticipation of the sale of AWAC to Alcoa, and involved substantial reorganisation of the share and debt capital of the group, and yet it was approved by the ATO in CR 2002/81. (While Alcoa did not then make a bid for Alumina, the demerger created the conditions for the sale of WMC to BHP Billiton in 2005.)

The disparity between the ATO's treatment of the Texon / Talon transaction in 2013 and the treatment of the AMA / Blackstone transaction in 2018 has already been noted.

That the TD amounts to a u-turn is evident from PSLA 2005/21 where in the context of considering the application of s.45B to a demerger (which itself can only be relevant where the demerger otherwise satisfies the requirements in Division 125:

> *75. As subsection 44(5) of the ITAA 1936 indicates, demerger tax relief is concerned with facilitating restructures that are essentially business driven. That is, their object is to increase business efficiency and thus shareholder value. It is not concerned with facilitating the delivery of assets or profits from the company to the head entity's owners for the purposes of allowing them to realise that value in a tax effective way. In other words, the premise is that a prearranged disposal of the demerged interest or the interest in the head entity by the head entity's owners, may suggest the demerger was undertaken to transfer corporate assets to the shareholder, rather than restructure the business.*

> *<u>76. It is recognised that there are exceptions to this general premise. A prearranged disposal of the head entity or demerged entity shares could have as its only substantial object increased business performance. There may be circumstances where the business performance of one or both of the head entity or demerged entity is enhanced by merging one of those entities with another like business structure. Such a merger could for example involve the disposal of the head entity or demerged entity under a scrip for scrip transaction. Alternatively, it may be that the efficiency of a business is enhanced by the introduction of a new group of owners, such as under a management buy-out</u>.* (our emphasis)

6 The examples in the TD

In our submission, none of the Examples in the TD contradicts the policy set out by the Review of Business Taxation; all should qualify for tax relief; all do qualify on the text of the legislation as it is currently drafted:

- **Example 1 and Example 2**. The problematic aspect of both Examples is apparently the issue of fresh equity [but not debt] by Sub Co to a person which was not an original owner. So this is not simply a situation where, 'an entity undertakes a reorganisation of its operations, leaving [the original] members in the same economic position as they were immediately before the reorganisation …' and at first glance it might seem plausible to take the position that the planned introduction of new owners means demerger relief is not available.

  However, it is not actually evident from the facts given in the TD that there is a problem. The purpose of s. 125-70(2) is to ensure that there is no value-shift between the original owners: after the transaction they should hold stakes in 2 companies that match the number and value of their stakes in the original company. If that is so, the conditions in s. 125-70 are met and demerger relief should be available. The fact that a new shareholder comes in subsequently, presumably for full value, does not mean s. 125-70 is failed: it is still the case that 'each owner … of original interests in the head entity …' holds the same proportions inter se, and that is all that test requires.

  The TD uses a circumstance which does not challenge either the policy and the legislation [an entity which was not an original owner injects equity after the demerger and is issued shares], and then relies on that consideration as the basis for the conclusions that demerger relief should be denied.

- **Example 3 and Example 4**. It is not clear from a policy perspective why Examples 3 and 4 lead to such radically different outcomes for the shareholders, given the transactions that occur are identical.

  Prior to the demerger, the shareholders in Food owned the supermarket business and the organic food business via their shareholding in Food. After the demerger, the shareholders owned the supermarket business via shareholdings in Giant, and the organic food business via their shareholding in Food. So again this is a situation where, 'an entity undertakes a reorganisation of its operations, leaving [the original] members in the same economic position as they were immediately before the reorganisation …' and Div 125 is satisfied.

  The only problematic aspect of these Examples is the exchange of the shares in Food for shares in Giant and cash, but that does not happen under the demerger; it happens under a scrip-for-scrip rollover under Div 124-M (which the TD never mentions). The shareholders would be eligible for scrip-for-scrip rollover, except in so far as they receive 'ineligible proceeds' being the cash [s. 124-790] and would likely pay some tax, and have most of their initial cost split between the shares in Organic and in Giant. This is the correct result.

  Instead, the TD wants to deny any deferral benefit to shareholders by insisting that the 'nothing else condition in paragraph 125-70(1)(c) will not be satisfied.' There is no 'and nothing else' requirement in Div 124-M, but there is in Div 125, so the TD insists that a scrip-for-transaction will have to be pass Div 125 as well as 124-M; and to get to that position it has to insist the scrip transaction is part of a 'restructuring.' Again the conclusion seems wrong.

- **Example 5**. Prior to the demerger, the shareholders in Jigsaw owned the toy business and the furniture business via their shareholding in Jigsaw. After the demerger, the shareholders owned the furniture business via shareholdings in Jigsaw, and the toy business via their shareholding in Louis. So again this is a situation where, 'an entity undertakes a reorganisation of its operations, leaving [the original] members in the same economic position as they were immediately before the reorganisation …' and Div 125 is satisfied.

But the TD says because the shareholders are given a means of selling their shares after the demerger is complete, and for a premium, no demerger relief is available to anyone. The subsequent sale will trigger tax and the premium will ensure a higher gain (or smaller loss); the ATO ought to be applauding the existence of the facility. Instead, the ATO's approach ensures that the transaction will not happen, Jigsaw will continue to trade in its inefficient form, and no tax will be collected from selling shareholders.

- **Example 6**. Prior to the demerger, the shareholders in Family Holding Co own one two businesses conducted by the subsidiaries via their shareholding in Family Holding Co. After the demerger, the two shareholders each own half the shares in each subsidiary. So again this is a situation where, 'an entity undertakes a reorganisation of its operations, leaving [the original] members in the same economic position as they were immediately before the reorganisation …' and Div 125 is satisfied.

  But the TD says because the shareholders subsequently execute a sale of their shares – which will trigger tax because no rollover exists for this transaction – no demerger relief is available to anyone. Again the ATO ought to be applauding their decision. Instead, the ATO's approach ensures that the transaction will not happen, Family Holding will continue to trade in its inefficient form, and no tax will be collected from selling shareholders.

As we noted above, the examples all seem to us to defeat Parliament's intent and are not necessary from the text of the legislation. The results are achieved by reading into the anodyne word 'restructuring' very ambitious meanings so that it serves as the means of ensuring that particular transactions are prohibited.

7 Commencement date

The TD represents a U-turn by the ATO and one which will be applied retrospectively: para 41 of the TD says, 'it is proposed to apply both before and after its date of issue.'

Recommendation2 of the Inspector General's inquiry into U-turns, Review into Delayed of Changed ATO Views on Significant Issues (2010) recommended a comprehensive process be undertaken before the ATO, 'seeks to apply its views retrospectively …' which would take into account, 'the extent to which the ATO has facilitated or contributed to the taxpayer perception of the previous industry practice or position …' The ATO agreed to adopt the Inspector General's recommendation (subject to one exception which is not currently relevant). PSLA 2011/27 is meant to direct the circumstances in which ATO views will be applied retrospectively and again the criterion is whether, 'the ATO has facilitated or contributed to taxpayers adopting a different view of the law (which may result from an industry practice or position) … [para 5].'

Given the ATO issued Rulings since 2002 which approved of the kinds of transactions now being criticised, it is not consistent with the ATO's stated acceptance of the Inspector General's report, nor the terms of the PSLA, to insist that this TD applies retrospectively.