Tax Working Group Information Release

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The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the whole Group or the Government.

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Australian feedback

1. The Group asked Australian CGT experts to review and comment on the Appendix in the Interim Report. These experts included: a senior tax partner from an international law firm, a senior tax partner from an international accounting firm, the tax manager in a large business operating in New Zealand and Australia (and globally), the Australian Tax Office, and an academic. The comments were received over a series of teleconference calls from each of the experts. To preserve what is commercially sensitive information provided by the adviser and/or the organisations they represent, the comments are not attributed. They have been anonymised and grouped broadly into topics.

General

2. Caller 1 thought that, overall, CGT was important because it generates revenue and provides a secure mechanism for taxing some aspects of foreign investment. It is a secure tax for taxing ownership of land (if you're going to tax rent, you should tax terminal value of land for equivalent). CGT is also important for their investment regime and Managed Investment Trusts (MITs). He also thought that CGT was a fundamental aspect of equity and maintaining perception of an equitable tax system. When CGT was introduced, there was a lot of political pushback but now, there is pretty much no pushback (debate is just focused on the discount). Overall he thought the Australian system has been working pretty well since 2010 (with the exception of small business concessions).

3. Caller 2 observed that the original CGT design in Australia was similar to NZ's current proposals in terms of high level principles, but there had been many changes since 1985 (which have added a lot of complexity). Caller 2 focused his comments more on specific issues (particularly integrity) and provided less of a "big picture" assessment.

4. Caller 3 supported starting from general principles, and then carving out exemptions or concessions in specific areas where desired. Caller 3 said that we should bear in mind the interaction with other parts of our law but try not to overengineer it and keep the design simple. For example, instead of 60 different rollovers, just do 1-3 based on general principles and leave detail to the lower level.

Overall design and copying what other countries have done

5. Feedback was mixed. Caller 1 strongly advocated we copy the Australian system as the rules had remained reasonably stable for the last ten years (i.e had been tested and amended significantly during the first 25 years but had remained stable since around 2010), Caller 2 advocated copying in parts (but also noted he may have a familiarity bias), while Caller 3 said we should develop our own system.

6. Caller 1 said the Australian tax system has worked out a lot of issues since enactment and, since 2010, has been relatively stable — in terms of legislation, interpretative material and litigation (legislation enacted 1987, rewritten in 1997, and regularly amended until 2010). He said that they copied the UK's Act in 1985, even when they did not understand some provisions (and that in some cases they still don't understand them). An advantage of copying the UK's model was that it gave them a theoretical and legislative basis to fall back on, and created a lot less work. He observed that the main parts of the legislation that still give rise to concern are the small business concessions.

7. Caller 1 also thought that, given the close economic relationship between NZ and Australia, we should try to copy their laws (not just CGT law, but also shareholder-related relief in other tax law) as much as possible to ensure there are no

impediments to capital markets transactions. Similarly, Caller 2 said NZ's rules should be similar to Australia's to minimise cross-jurisdictional arbitrages, leakages.

8. Caller 2 observed there was a familiarity bias and said that, if there were times where he sounded like he was advocating for the Australian system, it was probably because of familiarity.

What to tax

9. Caller 2 was firmly in favour of comprehensive inclusion with specific exclusions (e.g. personal use assets and excluded home), rather than a specific list of inclusions, as they'd never been able to come close to a comprehensive list of assets. He also pointed out that it's easier to add exclusions to a list through regulations than to add asset classes in legislation. In particular it's uncertain what is meant by "intangibles", and there are issues with proceeds of litigation, etc.

10. Caller 2 thought the original model Australia used, based on property rights, was wrong. In 1989, they expanded the definition.

Pre-CGT assets / grandfathering

11. Feedback was mixed. Overall, Caller 1 thought what Australia did (grandfathering the transition and then legislating close-out) worked very well, Caller 3 thought grandfathering was a very bad idea. Caller 2 was sceptical about the Valuation Day approach given difficulties with valuation, but didn't seem to express a view either way on grandfathering.

12. The callers also disagreed about how common pre-CGT assets were at this point in time and how significant "lock-in" is. Callers 1 and 2 said they rarely saw pre-CGT assets now, and Caller 2 was not concerned about lock-in – he thought people didn't hold onto assets and tended to sell them quickly, especially when assets pass through generations. He also said that often people thought they had a pre-CGT asset which turned out to be a post-CGT asset. In contrast, Caller 3 said that a lot of people with pre-CGT assets are starting to pass away now, and there is ultimate lock-in for those assets (which are regarded as "sacred cows"). They thought grandfathering really distorted decision-making and that people would do whatever they could (including with elaborate structures) to keep pre-CGT status as long as possible, even if it would've made sense to sell the asset long ago.

13. Pre-CGT assets can become post-CGT assets in a number of ways through "creeping asset" provisions:

- **Additions to existing assets**: If a taxpayer does a significant capital improvement on land, the improvement is considered a post-CGT asset.
- **Change in shareholder continuity**: If a company holds pre-CGT assets, but then has a more than 50% change in shareholding, all its assets are then considered to be post-CGT assets.
- **If entity value mostly consists of post-CGT assets**: When at least 75% of the market value of a company's assets are post-CGT assets, the shares in the company become post-CGT assets; this necessitates a valuation of the company's assets at that time.

14. In some places there is no grandfathering. Caller 1 said that in 1998, Australia removed grandfathering assets for listed companies, which he thought was a great idea. Caller 2 said privatised entities used a valuation day approach. Caller 3 mentioned that, shortly after CGT was introduced, superannuation was brought into the base – this was painful at the time but there have been no issues since.

15. Caller 1 said that in the first 15 years of legislation there was a lot of CGT work done on those rules. He also said that there were one or two cases in the early-90s

on timing (because of how it applied to contracts to acquire assets) but that activity fell away quite quickly. However, Caller 1 said he expected that high wealth individuals in particular would still have pre-CGT assets.

16. Caller 3 noted that there were very complicated rules trying to work out how much value is pre-CGT and how much is post-CGT (e.g. if someone is selling an entity with both pre- and post-CGT assets).

17. Caller 3 said Australia should have learnt from the UK, which had grandfathering when the rules were introduced in the 1960s, and then switched to a valuation day approach (in 1988, the cost of assets held at 31 March 1982 were rebased to their market value).

Market value

18. All callers agreed that valuation was difficult, particularly for intangibles.

19. Callers 2 and 3 pointed out valuations are still needed even with grandfathering as pre-CGT assets become post-CGT assets. Valuation is also needed for gifts. Caller 2 mentioned that all gifts are deemed market value disposals.

20. Caller 1 said that jurisprudence on market value is useless because it is unique to the particular factual circumstances, and cases just outline very preliminary principles. If there's a difference of opinion, there's a lot of frustration, uncertainty and cost.

21. Caller 2 said valuation is difficult not just because of the number of valuations required but because of the exercise itself. About 40-50% of the disputes he'd been involved in were valuation disputes. In one case, the difference between the ATO and taxpayer was the size of the Budget deficit in Australia. Valuers are not used to value CGT assets – rather, they value things for takeovers, purchases, etc. For example, when a trademark is registered – is the asset created part of the goodwill or is it from registration of the trademark? He thought there was good reason to value on migration to/from NZ, but not overall. Caller 3 also described issues with valuing intangibles and identifying the asset to be valued – for example was the asset goodwill or something else connected with or making up goodwill.

22. Caller 3 noted that shortly after Australia enacted a CGT, the ATO issued guidance on market value (TD 10). They said the guidance was quite relaxed (at least for transitions into the tax base – not sure if this applied more generally). Basically the guidance allows taxpayers to do whatever's "reasonable" and taxpayers were not expected to pay for professional valuation advice.

23. Caller 3 said that there was some tension, even in related party transactions, that could help prevent excessively high or low valuations. People may want a valuation to be higher (for transferee to get a higher cost base later) or lower (so transferor pays less tax/stamp duty).

Rate of tax – discounted or not

24. The callers seemed to agree that a 50% discount was too generous, and thought that we should tax capital gains at either 28% (Caller 1) or ordinary rates (Caller 3). Caller 2 did not express a view on what the rate should be, but thought that most of the complexity of a CGT came from integrity measures, rather than the rate differential.

25. Caller 1 thought that the economics and academic literature supported lighter taxes on income from capital, and that you shouldn't seek to establish progressivity for capital income. He noted that, in Australia, a significant part of capital income is tax free because of generous (but inconsistent) exemptions/concessions for family home and retirement savings, and it was accepted that there was no coherent

policy position across different pools of savings (retirement savings, housing, and other).

26. However, Caller 1 noted that the discounted marginal rates for CGT created an arbitrage opportunity, whereby people could use negative gearing to arbitrage between the discounted CGT marginal rates on gains and deducting costs against labour full marginal rates. This was exacerbated by the fact that housing stock in Australia is mostly provided by retail investors (over 1.8m individuals in Australia invested in a second property for leasing). He observed that people taking advantage of this were in the top two quintiles of income, and so almost all at the 48% tax rate. (Negative gearing deductions from interest exceeding rental income taken against labour income (a 48% deduction) but gains on sale of the property at the discounted CGT tax rates.)

27. Caller 1 noted that the CGT discount is a political challenge. The Australian Labor Party has recently said they would reduce the discount from 50% to 25%. He noted that when it was introduced the discount rate based on indexation for inflation made sense – it was based on a 10 year holding period and inflation of 2.5%. But if you look at underlying inflation over past 10 years, the current discount is too generous. He also noted that there had been enormous asset growth in land (which has tapered off significantly now for residential land).

28. Caller 2 thought it was fair to say most gains were not taxed at 24% (half of 48%). There was a lot of income splitting in trusts, which might get effective corporate tax rate down to 13 or 14%. He also noted non-residents don't get the discount, which was a macroeconomic decision.

29. Caller 3 agreed that as much as possible, we should tax capital gains like ordinary income and not have a discount.

Loss ring-fencing

30. Feedback was mixed. Caller 2 was very concerned about loss integrity measures while Caller 3 doubted whether the complexity of ring-fencing was worth it (particularly if capital gains are taxed as ordinary income in other respects).

31. Caller 1 said that in the corporate community, carried forward capital losses are regarded as having virtually nil value and he's never seen them recognised in the financial accounts as a deferred tax asset. This is because companies don't often pay CGT. Listed companies that sell businesses tend to keep or de-merge successful ones and sell off unsuccessful ones (and make losses) (de-mergers are discussed further below).

32. Caller 2 said loss integrity measures were one of his top 3 concerns for revenue leakage (e.g. ability to take losses against revenue assets and the loss quarantine provisions). Caller 2 said the original rule was that something sold within 12 months would be "revenue" and outside 12 months would be "capital". This changed after the stockmarket crash in 1987 – people made massive revenue gains for shares sold in the first half of the year, but when they sold their shares for losses in the second half of the year (e.g. to pay their tax bill) they couldn't offset their losses against the gains. So now, if an asset is sold within 12 months it's treated as a capital gain but can be offset against a capital loss sold outside 12 months (and converse is true).

33. Caller 3 did not think the benefit from ring-fencing outweighed trying to explain to people why their gains are taxed but their losses cannot be deducted (until later, anyway). They did accept that the cost of not having ring-fencing could be high.

Compliance costs and administration

34. Callers thought compliance costs were caused by the rate differential (according to Caller 3; Caller 2 disagreed), integrity measures (Caller 2), exceptions (Caller 3), prescribing how to calculate gains (Caller 3), and choices (Caller 3).

35. Caller 1 said that consolidation and CGT work is an enormous part of their practice. Transactions revolve around class rulings (similar to New Zealand's Public Rulings) and there are a significant number of these rulings each year.

36. Caller 2 thought most of the complexity in the Australian rules came from ensuring integrity (rather than through the discounted rate).

37. Caller 3 said that two big aspects of compliance costs came from rate differentials and exceptions, and that they expected compliance costs would be lower if Australia did not have those. The third big aspect of compliance costs came from trying to prescribe calculation of the amount of gain – e.g. if a person's profit from a sale looks different from their taxable "capital gain". This could be caused by attempts to recapture deductions that occurred at different times but haven't been accounted for properly in the past.

38. Caller 3 also said that a lot of the Australian rules allow choice, which adds to complexity and compliance costs. For example, people may need to keep parallel records because they don't know which choice they will take until later. They suggested that choices be avoided where possible.

Withholding and returns

39. Callers 2 and 3 seemed to agree that withholding was important for collecting from non-residents. However, Caller 2 did not think it was useful for managing compliance costs for residents. Caller 3 was more (cautiously) optimistic.

40. Caller 2 said it was very important to have effective withholding mechanisms – Australia did not use withholding for CGT until about 2 years ago. The withholding tax is not a final tax but can be credited to your final tax. Withholding was more about collecting from non-residents rather than simplifying the system for residents and Australia would probably regard it as a success on that front, even though there are compliance and administrative issues. Caller 2 thought that compliance costs could be better managed through information reporting and prepopulated returns by custodians, etc rather than withholding.

41. Caller 3 noted that the difficulty with withholding was that the withholding party may not know the cost. But if there's an amount being withheld – e.g. 2-5% - that helps people acknowledge they will have a tax liability and file a return to get the right amount of tax sorted. They also pointed out that, particularly for individuals and small businesses, withholding could be a good way to help them manage their debt – i.e. it can be more convenient to get the cash at the time of the disposal, than 1-2 years later when they may have spent the proceeds.

Provisional tax

42. Caller 2 said capital gains are excluded in working out provisional tax because they are lumpy, contract and payment may be in different periods, may not be known in time (e.g. if being assigned gains through a managed fund), etc.

Cost base

43. Caller 2 noted that cost base analysis was in itself a high compliance cost – for example, to work out the cost base for a share portfolio held for some time, you'd have to work out the original cost, bonus issues, which shares were disposed of, etc. However, he did say that shareholders usually have good records through

custodians and share portals, and managed funds can manage compliance costs for investors. In contrast, he thought records for holiday homes were probably poor.

44. Caller 2 added that corporate accounting systems were not set up to work out the historical cost base. Australia is not prescriptive on lot management (FIFO, LIFO, etc).

Rollover

45. Feedback was mixed. The callers all agreed that the rules had grown over time. Caller 1 thought there was a general unifying principle but Caller 3 did not. Caller 3 saw the rollovers as significantly increasing complexity and creating distortions and avoidance opportunities.

46. Caller 1 admitted that rollover was a bit of a patchwork but thought that overall it formed a coherent body. Generally, he thought, there was rollover if a transaction did not involve the release of cash. Practitioners would work to ensure that their clients got whatever rollover relief they were entitled to. Any significant corporate transaction occurs in the context of an ATO class/public ruling on de-mergers, buybacks, or return of capital of some sort. For example, if there were 3 parts to a transaction, and one part involved cash, they would work to make sure that the cash part does not cause the cashless parts to become ineligible for rollover. He said the system was not perfect and that the revenue authority has changed its position in applying those rules over time.

47. Caller 3 said that rollovers complicate the rules and create distortions. They suggested it was better if CGT was comprehensive at the high level, so that significant accretions of wealth could be brought to account, and then carve out specific exemptions/concessions where it is considered desirable (rather than letting the exemptions/concessions drive the design of your overall rules).

48. Caller 3 said the other issue with rollover was that there are too many and that they don't know exactly how many because they're not contained solely in CGT provisions (and some are even in non-tax law). Recently, they were surprised to find out there was one for common law superannuation plans. Moreover, the rollovers are all different and don't follow the same model. Some are by choice, some aren't; some are available to non-residents, some aren't, etc. Caller 3 recommended any rollover be based on higher level basic principles, with conditions left to lower level. They described two basic types of rollover:

- Involuntary (e.g. compulsory acquisition, divorce); or
- Voluntary but don't want to tax for some reason (e.g. like-kind reinvestment).

49. Caller 3 said that conceptually, rollover is meant to be a deferral. However, if there are multiple rollovers, that could wipe out tax in effect. For example:

- Taxpayer buys Asset A for $100
- Taxpayer sells Asset A and buys similar replacement Asset B for $200 and qualifies for rollover.
- If taxpayer then sells Asset B for $400, they should be taxed on a $300 gain ($400 less rolled over $100 cost base). But if they sell it for, say, $150, they just get taxed on a gain of $50 ($150 less $100), instead of having a $100 gain and a $50 loss.

This seemed to be an issue because of the asymmetrical treatment of gains and losses in other parts of the tax system. Caller 3 said that some other countries have a "tagging" process where the disregarded gain is "tagged" to the new asset. But record keeping, etc would be complicated. Also, from a practical level, the revenue authority may not be able to tell where assets had been rolled over in the past (e.g.

in example above, the revenue authority may not know Asset B's cost base should be $100).

Death and gifting

50. Australia has rollover for testamentary gifts but not *inter vivos* gifts. The callers agreed that estate and succession planning was significant and complex. They agreed it was not an issue to deem gifts to be made at market value and taxed (Caller 2 in particular was very concerned that our proposal to allow rollover for gifts or settlements into trusts would create avoidance opportunities).

51. Caller 1 thought *inter vivos* gifts were relatively rare. Overall he did not see gifts as a significant issue (likely to be because of the deemed market value disposition). Australia also has relief in context of charitable donations.

52. Caller 2 said estate planning and wills was a difficult area. Rollover for transferring assets into a discretionary trust, and for *inter vivos* gifts were 2 of his top 3 concerns for revenue leakage from our proposals (the other one being loss integrity measures). He was a lot more comfortable with rollover for a transfer into a company (as the company or shareholder will get taxed when they sell their shares) instead of for transfer out of a company (e.g. into a trust). He said Australia had very few rollovers for things that are not going into a company.

53. Caller 2 said that family trusts are common so there's little value sitting in estates. Estate planning is huge as there can be very different tax outcomes depending on the structure – e.g. transferring assets to 3 different trusts is taxable but not if it's to one "family trust" with interests by 3 children. To get the tax benefit you need to make a "family trust election" and only distribute to that trust. There's a penalty if distribute to someone outside the family network. He suggested that we should either (1) make sure vesting on death operates in the same way as in a discretionary trust; or (2) make the tax effects more widely known (for people who aren't aware of it enough to plan properly). He did not see a lot of avoidance through discretionary trusts but thought this was due to other integrity measures.

54. Caller 3 agreed that there was lots of succession planning to avoid realising capital gains on death. They noted that Australia has a lot of rules on profit stripping and wealth extraction, so that profits extracted from a business are taxed as dividends. There is a lot of restructuring to avoid those extraction points. There is also planning to ensure realisation or extraction happens while someone is on a lower tax bracket.

55. Caller 3 said there wasn't full rollover on death as it was time-bound. On introduction, a lot of people compared realisation on death to gift duty. The rules are complicated, but generally the transfer to the executor is exempted, and the executor then transfers the assets to beneficiaries. The beneficiary may include a discretionary trust, and the rollover deferral may survive a discretionary trust. There is also an issue in that some people inherit the cost base of an asset but do not get the information they need to evidentially support that cost or to determine what the cost actually is.

56. On *inter vivos* gifts, Caller 3 explained that a general feature of Australia's rules is to deem non-arm's length transactions to be at market value. They accepted this could be complicated. There are also particular rules for determining proceeds and the cost base, and Caller 3 suggested the rules could be less prescriptive. However, they still thought there was a need to deem a transfer to be at market value if an asset is transferred for no consideration or for below market value consideration. They accepted this could cause lock in until death.

57. Caller 3 observed there were some difficulties with jointly held pre-CGT assets – technically when a joint owner dies some part of the asset should be realised at

market value. However, people don't comply and will just say the whole asset is pre-CGT.

General business rollover (scrip for scrip and de-merger)

58. From 1997-99 there was a review of demerger relief, among other things (provisions enacted in 2002).[1] Chapter 19 of the report discusses scrip-for-scrip rollover and de-merger relief. Callers 1 and 2 thought the general business rollover provisions were important to capital markets. Caller 3 commented on rollover more generally, and not specifically on the general business rollovers

59. Caller 2 said that there are three types of rollover that facilitate top-end business: scrip for scrip rollover; demerger provisions; and top-hatting (ability to create single company above group). He thought we need to make sure these work well and facilitate business as CGT should not block sensible corporate transactions. He said it was important to follow and apply corporation law rules rather than tax rules.

60. Caller 1 said that if a company has a successful business it wishes to sell, it tends to de-merge it into the hands of shareholders and shareholders can each, individually, sell off their shares and access the CGT discount. This is much more tax efficient than having the company sell the business and distribute the proceeds to shareholders (taxable as dividends). The only things that companies sell for cash are foreign businesses (because they're tax-free).

61. Caller 3 said there were many cases of people manipulating rollover and doing back-to-back rollovers in a way that wasn't intended by the original provisions. For example, a taxpayer may try to sell a business, but will do it in 3 transactions that qualify for rollover instead of a single transaction that doesn't – e.g. there may be a rollover to restructure a business a certain way; then they do a rollover to interpose an entity, then try to claim rollover or exemption on the final step.

Small business concessions

62. All callers expressed concern with the small business concessions (including, but not limited to rollover). Callers 1 and 2 thought that the main parts of the legislation that are still unstable are the small business concessions; Caller 2 thought this was the area with the largest growth in concessions. Caller 3 also said the rules were complicated and incoherent, and they did not think the rules achieved the objectives they were aimed at (in some cases causing the opposite outcome to what was intended – e.g. inhibiting growth).

63. Caller 1 said any small business concessions need to be watertight, and that manipulation of these concessions by small businesses is rampant — because of the boundary issues, you need enormous care to ensure people who shouldn't qualify don't get it. Australia has a series of these concessions which he thought were essentially political. It is the one part of the CGT law he thought was not stable, as different governments always change them, and because the ATO is always discovering new ways they are being manipulated.

64. Caller 3 said the rules were complicated (both in the drafting and in the law itself), which has led to low practical compliance overall as it's not often worth getting legal advice on this. People tend to self-assess themselves as being "small business" and assume they get a concession, rather than actually applying the laws.

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[1] New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002. The review appears to be the *Ralph Review of Business Taxation,* http://rbt.treasury.gov.au/.

65. Caller 3 suggested getting the rationale for the small business concessions clear:

- One rationale was to ensure tax did not inhibit small business growth (Caller 2 also suggested this was one of the aims), but Caller 3 said the concessions had the opposite effect as taxpayers don't want to grow above the thresholds.

- Another rationale was that the business may represent some people's retirement savings. However, the small business concessions had not been integrated with the retirement exemption of up to $1.6 million (the exemption for assets held for 15 years is still uncapped). Caller 3 suggested it would be better to design the CGT rules as they would ordinarily operate, and then have a separate retirement concession. If there is no general retirement concession, Caller 3 queried why specific concessions were needed for small businesses.

- A third rationale may be to reduce compliance costs for small businesses (Caller 2 also suggested this). But Caller 3 thought the concessions had not done anything to reduce compliance costs.

66. Caller 3 also said the concessions were cumulative, quite generous, and not limited to rollover. There are many different rules (something like 28?) but broadly the types of thresholds/ factors involved were:

- **Net wealth** – there are look-through rules to the business owners which involve lots of different tests, depending on how much of the business a taxpayer holds. Caller 3 noted this test can be manipulated (e.g. holiday homes are excluded from the asset test so people may kick tenants out of a rental property and claim it is a holiday home, even if it hasn't been used as such for most of the period of ownership). They said the anti-avoidance rules were very rarely invoked.
- **Turnover ($2 million threshold)** – the taxpayer only has to meet this threshold in the income year of the gain.
- **15 year exemption** – there is a complete exemption for assets that were held for at least 15 years, if it was an active asset for at least half the period of ownership.
- **Percent of ownership –** 20% is needed to get one of the concessions (Caller 3 observed maybe it should be 100%, or at least controlling interest). But if you hold over 40%, all the value of the business is attributed to you (for the net wealth concession?). So there is lots of manipulation in between 20% and 40%.

Caller 3 said taxpayers could choose one or the other (i.e. if they didn't qualify under one threshold they could try the other) – one rule requires you to hold for 1 day, one rule requires to hold for 12 months, one rule requires to hold for 15 years. Overall they thought the rules did not make a lot of sense and it would be better if there was just one small business exemption – i.e. under a certain threshold, you don't have to worry about the rules.

67. Caller 3 also noted that, because concessions exist at certain thresholds, people can become reluctant to expand their business. They suggested applying a consistent definition of "small business" (not necessarily just within tax law) – for example, there's a $2 million turnover threshold for CGT concessions but $10m for some other concessions. They commented that, in a review/consultation of the small business rules, taxpayers have favoured a simple threshold based on number of employees rather than turnover or asset figure, because it is easier to know and control.

68. Caller 3 also queried why qualifying business assets excludes real property leased to third parties. They recommended having consistent definitions of "qualifying business asset" where possible.

69. When asked how much tax was at stake, Caller 3 said the CGT still collects a lot of tax, but noted that some of Australia's wealthiest taxpayers qualify for the turnover test because of the two thresholds, and the fact that the asset test could be manipulated. There was also planning around rates, losses, and succession (in small business context).

Taxation of shares – double deductions and double tax

Double deductions and consolidation

70. All three callers thought the consolidation reforms worked well in dealing with double deductions within corporate groups. Before Australia had tax consolidation (in 2002), they just had lots of CGT provisions dealing with duplication of losses within capital groups. Consolidation can apply to wholly owned groups of companies.

71. Subdivisions 165-CC and CD deal with double deduction of losses (and still exist outside of consolidation). Broadly, they do 3 things:

    - **Selling something with an unrealised loss** – need an adjustment (Caller 2 said these are relatively simple).
    - **Loss carry forward/loss testing for realised and unrealised losses when ownership changes, etc.** – unrealised loss can only be recognised when the sale is eventually undertaken (Caller 2 also thought this was relatively simple).
    - **Multi-tiered losses** – adjust cost bases through chains when there are alteration events (major change in shareholding). Caller 2 said these rules worked to a point, but thought these were some of the most complex rules in the Australian regime.

72. Caller 2 said we should not model these rules as they are defective in numerous ways, but they could be used to understand problem areas. The immense complexity was one of the drivers for moving to consolidation. Caller 2 thought multi-tiered losses caused a lot more issues than subvention payments (Australia allows loss offsetting only if 100% common ownership, not 66% - he thought 66% was good).

73. Caller 1 thought there was lots of activity spent dealing with something done by relatively few people. The tax consolidation system has worked in that, within corporate groups, transfers generate no capital loss at all; and there is only tax if there is an external transaction for cash.

Double tax

74. Australia has issues with inside basis vs outside basis for companies and trusts. Caller 1 did not think any effort should be made to solve double tax for companies as consolidation takes the problem away for groups.

75. There can be a distortion where a company has high basis in an underlying asset but shareholders have low basis in their company shares– Australia provides no relief, and has rules against people trying to manipulate out of that situation. Caller 1 thought that was right.

76. Caller 1 also noted that the way they administer trusts created opportunities to eliminate double tax (e.g. collapsing trusts). Australia has a lot of unit trusts.

Avoidance, integrity and behavioural distortions

77. Caller 2 thought complexity came from integrity measures, and that Australia's original rules in particular dealt poorly with proceeds of litigation; look through

entities; and market value substitution rules (when taxpayers are deemed to have paid/received market value).

Value shifting and indirect transfers

78. All callers said we needed to think about value shifting — e.g. shifting value from one asset to another without disposing of either asset; or shifting value from one entity to another without triggering a disposal; restraint of trade payments that emasculate an asset instead of selling it; or other derivative rights over an asset short of full ownership. Australia has quite detailed rules for value shifting and have improved their market value substitution rules.

79. Caller 3 did not think the rules for dealing with derivative rights were robust enough and thought there should perhaps be an attribution rule.

Gifting and trusts

80. Caller 2 was concerned about lack of tax on trusts, and was nervous about allowing the family home exclusion to apply to properties held in trusts. He mentioned an example of people rolling an asset over into a discretionary trust and then passing the trust onto someone in a tax-preferred way.

81. Although Caller 2 had some sympathy for the view that rollover for gifts to spouses is too limited, he said there could be many transactions where people pretend to have 12 unrelated transactions even though, if they had been combined (e.g. a gift plus a capital distribution) it would have been taxable. He agreed that not allowing rollover for gifting created an incentive to hold assets until death, but thought that may just be needed for integrity.

82. Caller 3 said there had been a recent resurgence in the use of life interests (e.g. right to occupy property) as this could be a way of providing value without significant cost, particularly with divorce and providing for children.

Difficulties taxing non-residents

83. Caller 3 said it was a mistake to make the deemed disposal on emigration optional, because as a matter of practicality the ATO had no way to keep track of a person (and what they did with their assets) once they had left the country.

84. Caller 1 said there was a lot of difficulty in the hedge fund and private equity areas. In the past, there was lots of investment into mid-early stage mining companies and oil and gas with underlying land assets. Problems arose with treaty shopping, and interaction of CGT, revenue asset regime and treaty regimes. Some aspects may go away under the multilateral instrument (MLI). He said there has been a lot of reform of in this area. In particular, hedge funds and private equity tend to try and realise investments for cash, and play with many boundary issues to try and avoid tax on that. He described "long-arm" rules – e.g. if a Cayman Co sells Cayman Co 2, and fundamental value of Cayman Co 2 is from Australian land, Australia tries to tax that transaction. He was not sure how effective the rules were, but it has been a focus because there is a lot of foreign investment into the Australian resource base. He thought it may now be under control.

Behavioural distortions

85. Caller 3 thought that there were distortions caused by grandfathering pre-CGT assets, rollover, and the various small business concessions (see above).

86. Caller 1 thought the two biggest distortions were overinvestment in residential property and negative gearing (see above), by a factor of 100. He thought that the generally tax-free nature of housing caused Australians to overinvest in their homes. He noted that the fundamental value of residential property arose from

zoning, but Australia's zoning rules were quite restrictive. Caller 1 also said that when CGT was first introduced there was excessive investment in personal use assets, particularly cars.

87. Caller 1 noted that sometimes corporate restructures don't qualify for rollovers so they don't happen, but there weren't a lot of those in Australia.

Managed funds and PIEs

88. Caller 2 thought PIEs sounded similar to Australia's attribution managed investment trusts (AMITs). Until the last 2-3 years, Australia's system was unsophisticated. In most cases, AMITs distributed passive income and would only allocate capital gains at end of relevant year because they didn't know the quantum until end of year. This led to the "last man standing" problem. However, Caller 2 pointed out that this was the case for 30 years and was not considered a huge concern.

89. Now the Australian rules allow the trustee to attribute gains independent of distribution to unitholders. Caller 2 said the tax rules were never used as a means of prescribing solution to that outcome and he didn't think it was for the CGT rules to solve that problem. Instead, he thought the tax regime should just facilitate allocation of those gains, combined with corporate disclosure of those gains.

Look through entities

90. Caller 2 said that every time a new partner is admitted to a partnership, there'd be a capital gain under the market substitution rules. ATO has said that for "no goodwill partnerships", they ignore acquisition and disposal by admissions and retirements. Caller 2 used this as an example of the need for tax authorities to have support on the introduction of the regime, and for the need to be flexible.

Proceeds of litigation

91. Caller 2 said there's a detailed ruling about this. He says it's not based in law but is practical and works. Again, Caller 2 used this as an example of the need for tax authorities to be flexible.

Feedback from Business

Caller 4 had the following comments:

- CGT has had one big rewrite, when they dropped indexation, introduced consolidation, in the early 2000s.
- Included assets:
    - When CGT was first introduced, it focussed on assets, following the UK model. This made things like restrictive covenants difficult where people get payments for granting contractual rights. The *Cooling* and *Hepples* cases are examples. So the rewrite happened, which defined the CGT events and how they are taxed. Caller 4 liked the prescriptive approach.
    - The Australian rule for personal use assets is that gains are only taxed if more than $10,000. Losses never deductible.
    - Sale of depreciable property – subject to tax as ordinary income in most cases, no CGT.
- Anti-overlay provisions deal with the possibility that a gain might be subject to both income tax and CGT. Generally income tax takes precedence and there is no double counting. But just because a transaction is taxable under the income tax rules does not mean it is not also subject to CGT, where there might be residual tax due to quantum. So Caller 4 said every transaction is reviewed for CGT.

(This might not be the case under the design the Group is proposing.) Apparently there is no simplification rule for the capital/revenue distinction – whether an asset is on capital or revenue account is determined under the common law rules.

- Consolidation:
    - Caller 4 said that when it came in the Government required corporate groups to adjust all their assets to market for tax purposes. The company Caller 4 was working for at the time wrote up depreciated plant and equipment by a few billion dollars. The Australian Government wore the loss of tax as the inevitable price of introducing a full tax consolidation regime.
    - Caller 4 thought NZ's consolidation regime was hopeless, and we should at least move to having a single economic entity principle, rather than just eliminating certain intra-group transactions.
    - Caller 4 said the earlier version of the rules simply tried to stop loss duplication. Nobody understood the rules – they were famously impenetrable and probably did not work. Consolidation is very complex, but probably worth doing. Caller 4 thought it was probably the only satisfactory way to stop double deductions.
    - We asked about the rules for companies with less than 100% but greater than 50% common ownership. Caller 4 said there are rules to stop value shifting, but he was not familiar with this space.
- Rollover:
    - Rollover is a pervasive feature of the CGT system. Caller 4 mentioned a range of restructuring type rules in addition to demergers and scrip for scrip. There is, of course, incorporation of a business by a sole trader or partnership. But also transfer of assets from one trust to another.
    - Caller 4 said that on death, Australia gives broad roll-over.
    - Australia has scrip for scrip as well as demerger relief. Also an outright exemption for sales of smaller businesses on retirement.
- Cost base and record keeping
    - Every year the tax return asks the question, have you had a CGT event. People have to keep track of basis themselves. Note that individuals at least are allowed specific identification to establish the cost base of shares, so can sell those with the highest cost base first.
    - Caller 4 says CGT record keeping is a huge exercise. May have to keep track of basis for a long time and roll-over complicates this further. For corporates, CGT cost of assets is not the same as accounting cost in most cases. This means record keeping of cost base, even for corporates, is generally very poor. For individuals, records are generally inadequate and there is little/no auditing.
    - Cost base has a number of elements:
        - acquisition cost
        - transaction cost
        - non-deductible taxes eg stamp duty

    - holding costs
    - enhancement/improvement costs.

- Complexity – Australian CGT is around 850 pages. Half (450 pages) is on basic principles. Most of the rest (370pp) is consolidation, then participation exemption.

- Participation exemption – Caller 4 mentioned that the active/passive test is applied on the basis of the kind of income the target's assets produce. Also, it has to be applied even if the company is in a listed country, i.e. one where none of its income is subject to attribution (e.g. the US). The test applies at the time of the CGT event which is contract date. This is annoying if the transaction requires the preparation of completion accounts at another date, e.g. settlement. Should use the settlement date, or other date used for transaction purposes (this was top of mind because Caller 4 was currently involved in sale of a foreign subsidiary).

- Excluded home:

    - Important to define the exclusion by reference to the assets you are trying to exclude from the tax, rather than having a definition which is not tied to those assets

    - Australia allows a person to have two excluded homes for up to six months, where they are buying/selling. If the overlap is longer, the person has to choose one of them to be taxable for the additional period. (Logically you would expect people to would pick the one they are buying, so as to defer the tax.)

    - Caller 4 discussed holding costs where an excluded home ceases to be an excluded home and is later sold. Apparently, the system works by apportioning the gain on sale between the excluded and non-excluded period. Apparently, this also involves splitting holding costs between the two periods. This is done by aggregating those costs and then apportioning them. As most people have no idea of their holding costs while the home is an excluded home this is problematic. We suggested it would be better not to aggregate then split them, rather to only include in cost base those incurred while home is not excluded. In any event should not be a problem for us as the Group does not propose to include them in cost at all.

- Valuation – Caller 4 noted that in order to do the tax return for sale of a manufacturing group worth around $800M, the cost of valuing the assets for tax purposes alone is about $1M (this cost would arise even without a capital gains tax in many cases, if the assets rather than the subsidiaries, were sold, since you would need to allocate the purchase price for depreciation purposes) .