The Institute of Chartered Accountants in Australia

26 July 2011

Mr Paul McCullough
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By email: cgt_minoramendments@treasury.gov.au

Dear Paul

Proposals Paper – Minor Amendments to the Capital Gains Tax Law

The Institute of Chartered Accountants in Australia (the **Institute**) welcomes the opportunity to provide a submission on the May 2011 Proposals Paper which sets out, in broad terms, the way in which a number of proposed amendments to the capital gains tax (**CGT**) provisions may be implemented.

Our comments are limited to:

- The proposed amendments to correct technical defects in the CGT provisions relating to CGT roll-overs for:

  a) The disposal of assets by a trust to a company – Subdivision 124-N
  b) The transfer of assets between certain trusts – Subdivision 126-G and
  c) The exchange of shares in one company for shares in another company – Subdivision 124-G.

  The background to and proposed technical amendments to correct the technical issues identified are set out in Chapter 3 of the Proposals Paper.

- The proposed technical amendments to the application of the CGT provisions to deceased estates to be made as part of a rewrite of those provisions.

We welcome the proposed rewrite of the CGT provisions relating to deceased estates and particularly the fact that it will address a number of technical deficiencies in the law.

In the interim however, we would appreciate an assurance that the Australian Taxation Office (**ATO**) will neither withdraw nor 'walk away' (so to speak) from PSLA 2003/12 pending the finalisation of this draft legislation. In order to provide certainty it is important that this PSLA, where the ATO states that it will treat the trustee of a testamentary trust in the same way as a legal personal representative for the purposes of Division 128, continues to be applied by the ATO in the period leading up to the finalisation of the draft legislation.

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Recommendations

Our recommendations in relation to the proposed amendments to the abovementioned Subdivisions dealing with CGT roll-overs are as follows:

Subdivision 126-G – it is proposed that the amendments apply to CGT events that occur after the application date of this Subdivision. In the event that there are taxpayers who may not have chosen roll-over because of the technical deficiency identified, Treasury should ensure that the machinery provisions of the law, particularly the provisions dealing with the time of making of choices and the Commissioner's discretion to extend that time, allow them to now do so.

Subdivision 124-N – on the basis that the proposed amendments will only apply to CGT events which happen after 10 May 2011 either:

- the explanatory memorandum should make clear that the proposed amendments clarify the existing law rather than correct a technical defect with the law or
- the ATO should be encouraged to publicly state that it will not seek to amend assessments to taxpayers' detriment by relying on the technical defect.

Subdivision 124-G – on the basis that the proposed amendments will only apply to CGT events which happen after 10 May 2011, the ATO should be encouraged to publicly state that it will not seek to amend assessments to taxpayers' detriment by relying on the technical defect. We also recommend that consideration be given to extending other forms of replacement asset roll-over relief to revenue assets.

Our observations/recommendations in relation to various issues in relation to deceased assets are set out below.

CGT roll-over for the disposal of assets by a trust to a company and the roll-over for the transfer of assets between certain trusts

In relation to Subdivisions 126-G and 124-N, the Proposals Paper indicates that the proposed amendments are designed to ensure the law operates as intended, by correcting technical defects.

Under both Subdivisions, it is a requirement to qualify for roll-over relief that, just before the transfer of assets, the transferee entity "have no assets other than small amounts of cash or debt". The technical deficiency identified is that the transferee entity may have valuable CGT assets in the form of rights associated with a deed or similar document designed to facilitate the transfer of assets. The proposed amendment will ensure that this does not of itself, mean that a restructure does not qualify for roll-over relief.

Subdivision 126-G

Based on our discussion with Treasury, we understand that this issue has come to light in the context of the transfer of assets between trusts and eligibility for roll-over under Subdivision 126-G. Accordingly, it is intended that the proposed amendment apply to CGT events that happen on or after 1 November 2008, being the application date of Subdivision 126-G.

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This should mean that, in the unlikely event that participants to a Subdivision 126-G restructure treated it as ineligible for roll-over relief because the transferee entity held valuable CGT assets of this kind, they may now be eligible to choose roll-over.

We have not reviewed how the choice provisions in Subdivision 126-G operate (or the effect of the Commissioner's discretion to extend the period in which CGT choices must be made) but note that these and other relevant machinery provisions should be reviewed and amended if necessary to allow amendments to be made.

Subdivision 124-N

Unlike the proposed application date for the amendments to Subdivision 126-G, it is proposed that the corresponding amendment to Subdivision 124-N take effect only in respect of CGT events happening after 10 May 2011 (and not 11 November 1999, being the commencement date of Subdivision 124-N).

We understand that at least part of the reason for this is a reluctance to make amendments retrospective for a lengthy period in circumstances where it is understood that both taxpayers and the ATO have applied Subdivision 124-N as it is intended to apply.

Where prior years are open for amendment, this implies that the ATO will not seek to amend assessments to deny taxpayers (transferor trusts which still exist[1], transferee companies and owners of interests in trusts) access to Subdivision 124-N by relying on this technical deficiency.

Strictly speaking, in our view there is some merit in amending Subdivision 124-N so that it applies to CGT events happening after the date of commencement of Subdivision 124-N.

However, absent this, we recommend that the explanatory memorandum to the bill introducing the amendments make clear that the amendment is being made for the avoidance of doubt, i.e. the amendment is being made to clarify the law and not to correct the law. This should signal to taxpayers that the ATO will not seek to use the technical deficiency to their detriment[2].

In this regard we note that, while we welcome any amendments which provide certainty for taxpayers, we are far from convinced that a court would apply the existing provisions to deny roll-over relief because transferee entities hold, just before the transfer time, rights associated with a deed or similar document designed to facilitate the transfer of assets. To do so would result in a perverse outcome.

The ATO should also be encouraged to indicate to taxpayers that it will not seek to apply the existing law to the detriment of taxpayers.

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[1] We note that the effect of a Subdivision 124-N roll-over may be reversed if the trust does not cease to exist within 6 months.

[2] We have not examined whether Subdivision 124-N in its present form would allow transferee companies, for example, to exploit the shortcomings in the law by arguing a step up in the cost base for assets transferred to it (when the trust no longer exists). If it is possible, appropriate signalling in the explanatory memorandum should lessen the possibility of this occurring.

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CGT roll-over for the exchange of shares in one company for shares in another company – revenue asset treatment

We welcome the proposed amendment to Subdivision 124-G to ensure that the roll-over provisions work appropriately where original shares in a company which are exchanged for shares in another company are held on revenue account.

It is proposed that the amendment apply from 10 May 2011 on the basis that both taxpayers and the ATO have applied the law as it is intended to apply.

Again, in our view, there is some merit in the amendments applying to CGT events occurring after the date of commencement of Subdivision 124-G. However, if this is not the case, the ATO should be encouraged to advise taxpayers that it will not seek to apply the current law strictly.

Although outside the scope of the announced proposal, we also recommend that the availability of other forms of replacement asset roll-over relief be extended to revenue assets. For instance, the failure of Subdivision 124-H to provide rollover relief for revenue assets has recently become more prevalent as many large trusts, which typically have a wide variety of investors, some of which may hold their interests on revenue account, have been or considering corporatizing. In addition, similar concerns exist with Subdivisions 124-E, 124-F, 124-M and 124-Q.

Deceased Estates

We have several comments in relation to the manner in which it is proposed to address the following issues identified in Chapter 5.

Issue 3: Cost base modification deficiency – income producing use

Current law	*Current proposal*
Following on from Issue 2, the market value cost base rule also does not apply where the deceased's dwelling was used for producing assessable income just before their death where that income-producing use would not have affected the deceased's entitlement to a full CGT main residence exemption. *This situation could occur when the deceased was accessing the absence extension in section 118-145.* *Under the main residence exemption, this income-producing use can be disregarded under subsection 118-190(3). However, this only applies for the purpose of calculating a main residence exemption, not for the purposes of Division 128.*	*The cost base modification for a main residence dwelling will take into account where the dwelling was used for producing assessable income but where that use would not have affected the deceased's entitlement to a full CGT main residence exemption.*

Whilst we welcome this proposed change, we would appreciate confirmation that it will apply generally for the purposes of Divisions 118 and 128 of the ITAA 1997. For example, subsection 118-195(1) also requires that the dwelling was not being used for income producing purposes just before the deceased's death.

Issue 6: Joint tenant issues regarding CGT discount

Current law	*Current proposal*
The table in subsection 115-30(1) contains special rules for determining when CGT assets are taken to have been acquired for the purpose of determining eligibility for the CGT discount. Beneficiaries of deceased estates are deemed to have acquired pre-CGT assets of the deceased at the time of the deceased's death. However, there is no equivalent rule for pre-CGT assets for surviving joint tenants. Item 7 in the table in subsection 115-30(1) provides that these assets are acquired by the surviving joint tenant(s) when the deceased acquired his or her interest in the asset.	*When an interest in a pre-CGT asset passes by survivorship, for the purposes of the CGT discount, the interest in the asset will be taken to be acquired by the surviving joint tenant(s) when the deceased died, rather than when the deceased acquired the asset. This ensures consistency between joint tenants and deceased estate cases.*

We query why consistency is required between joint tenants and deceased estates. That is, a joint tenant will clearly have an interest in the relevant asset prior to the death of the deceased which is 'enlarged' (so to speak) on the death of the deceased - i.e. the interest that a surviving joint tenant has in an asset is not (arguably) a new one. A beneficiary of a deceased estate however, is unlikely to have had any interest in the relevant asset prior to the deceased's death and thus, will acquire a new interest.

Issue 7: CGT event K3 - Delay seeking endorsement

Current law	*Current proposal*
CGT event K3 can be circumvented where an entity would be entitled to tax-exempt status but has not been endorsed as such by the Commissioner until after the asset has passed to it. This could happen due to an entity delaying seeking endorsement or if the trust is only created when the asset passes to it.	*CGT event K3 will happen if at the time an asset passes to an entity, the entity satisfies all of the conditions required for exempt entities, despite not yet having been endorsed by the Commissioner.*

We query the practicalities of this proposed change - i.e. how is an executor supposed to work out/ know that an entity has satisfied all of the conditions required for endorsement as an exempt entity?

Issue 8: CGT event K3 - Amendment period

Current law	*Current proposal*
CGT event K3 can also be circumvented where an asset does not pass to an entity listed in that CGT event until after the deceased's standard amendment period has expired. Where the deceased's assessment cannot be amended (usually two or four years after the assessment), effectively no capital gain or capital loss can be recognised.	*An embedded capital gain or loss will still be subject to tax when an asset is transferred to an entity listed in CGT event K3 outside the deceased's standard amendment period. This can be achieved by excluding CGT event K3 from the standard amendment period.*

It is not entirely clear to us whether the proposed amendment is designed to remedy a technical defect or, as suggested, to prevent executors of deceased estates deliberately delaying the transfer of assets until after the deceased's amendment period has expired to avoid the application of CGT Event K3.

We have not revisited why CGT Event K3 is not currently excluded from the standard amendment period under section 170(10AA) of the ITAA 1936. However, to the extent that this was done deliberately to provide finality to the affairs of the deceased, then we would ask that Treasury consider the need for the proposed amendment, other than to prevent the avoidance of tax[3].

We note that there may well be a number of valid non-tax reasons for any delay in transferring an asset to an entity listed in section 104-215.

Issue 9: CGT 'E' Events — Issues with deceased estates

Current law	*Current proposal*
Section 102-20 requires a CGT event to 'happen' for a taxpayer to make a capital gain or capital loss. If more than one CGT event happens in particular circumstances, section 102-25 generally requires the taxpayer to use the CGT event that is most specific to their circumstances. *CGT events E5 to E8 (relating to trusts, sections 104-75 to 104-100) contain an exception so that they do not 'happen' to a 'trust to which Division 128 applies.'* *The exception was intended to ensure that neither the trustee nor the beneficiary made a capital gain or capital loss in the circumstances giving rise to those CGT events. However, if the exception is satisfied, it means that those events do not 'happen' at*	*The relevant CGT E event will 'happen' for 'trusts to which Division 128 applies' but both the trustee and beneficiary of these trusts will not realise a capital gain or capital loss when these events happen, to the extent the gain or loss relates to assets owned by the deceased.*

[3] This assumes that the ATO does not already have an unlimited period in which to amend the deceased's return on the basis of fraud or evasion.

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all and another (less relevant) CGT event which has happened may apply. *Although it is immaterial to an LPR which event happens when an asset passes to a beneficiary (because of the exception in subsection 128-15(3)), the same is not true for a beneficiary.* *The beneficiary's interest in the trust may come to an end (in whole or in part) when an asset owned by the deceased passes from their LPR to the beneficiary or when the beneficiary disposes of their capital interest in the trust to a third party before administration is complete. Because another CGT event would happen to the beneficiary instead of CGT events E5-E8 at this time, the beneficiary generally cannot disregard any capital gain or capital loss on their trust interest. There is nothing in the CGT provisions to disregard that capital gain or loss.*	

We submit that the problem that has been identified here is merely symptomatic of the broader problems that are being encountered due to the current wording of section 102-25 of the ITAA 1997 - which requires taxpayers to use the most specific CGT event that "can happen" in their situations.

We submit that a far better solution would be to amend section 102-25 so that it reads (emphasis added):

> *… If more than one CGT event can* ***apply*** *to your situation, the one you use is the one that is most specific to your situation.*

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Should you have any questions in relation to our submission please call Susan Cantamessa on 02 9290 5625.

Yours sincerely,

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