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Secretary-General

Via email: cgt_scripforscrip@treasury.gov.au

Dear Sir/Madam

Strengthening Certain Integrity Provisions in the Scrip for Scrip Roll-Over

The Tax Committee of the Business Law Section of the Law Council of Australia (the Committee) appreciates the opportunity to participate in the Government's consultation process to provide greater consistency in the CGT scrip for scrip roll-over provisions.

Set out below is the Committee's submission on the Proposals Paper.

All references to legislative provisions are to provisions of the *Income Tax Assessment Act 1936* and to the *Income Tax Assessment Act 1997* (together, the Tax Act) unless otherwise specified.

1. Executive Summary

- 1.1 The Proposals Paper proposes changes to improve the operation of sections 124-782 and 124-783 of the scrip for scrip rollover provisions. In particular, the proposed measures aim to ensure that certain look-through entities such as trusts (and their beneficiaries) are treated as the appropriate taxpayer in determining whether the significant stake and common stake tests are satisfied. In this regard the Committee agrees that the proposed measures support the underlying policy principles in respect of the operation of the significant stake and common stake tests. In particular the Committee supports the proposed look-through approach outlined in the Proposals Paper, namely, that the provisions should be based on 'the right to receive', ownership and/or the right to acquire ownership. In this regard, the Committee submits (for the reasons outlined in its submissions below) that the look-through approach should be based on economic ownership or entitlement to the financial benefits of the asset. In the Committee's view, the existence of these factors (in certain situations) would point to a conclusion that a certain entity has the requisite interest in the original or replacement entity so as to satisfy the significant stake and common stake tests, irrespective of whether a different entity has legal ownership of the interest.
- 1.2 The Committee therefore submits that the interaction issues with the CGT provisions should be corrected to ensure that these 'look through' provisions

operate in a manner that reflects the taxpayer that has 'economic ownership' or is 'economically entitled to receive the benefits of ownership' as the relevant taxpayer for the purposes of applying these provisions.

- 1.3 In particular, the Committee submits that section 106-50 should be amended so that it applies consistently with all CGT provisions (and not only in circumstances where there is an 'act done by the trustee in relation to the asset'). In addition, in circumstances where a beneficiary is absolutely entitled or economically entitled, the Committee also supports a look through approach being adopted for the purposes of the broader taxation law.
- 1.4 In the context of the recent issues raised by taxpayers in respect of the uncertainty surrounding the interpretation of the term 'absolute entitlement' and the lack of appropriate guidance from the Australian Taxation Office, the Committee also recommends that Treasury considers clarifying the meaning of absolute entitlement as part of these measures. In particular, in the context of our discussions above, the Committee submits that Treasury should clarify the meaning of that term by providing a more practical, safe harbour style inclusive definition. The Committee has provided its suggested wording below (para 2.18) to illustrate the approach it has in mind.
- 1.5 The Committee also submits that any position adopted should not interfere with the full and complete review of the trust rules rewrite project.

2. The Committee's submissions

Method of amendment

- 2.1 The Committee's comments in respect of amendment to the provisions should be considered having regard to the further comments below in relation to the interaction of these proposals with the broader trust rules rewrite.
- 2.2 The Committee considers that an alternative approach to the suggested amendments may be adopted to achieve the intended policy outcome.
- 2.3 In this regard, the Committee submits that the interaction issues with the CGT provisions should be corrected to ensure that these 'look through' provisions operate in a manner that recognises the taxpayer that has 'economic ownership' or is 'economically entitled to receive the benefits of ownership' as the relevant taxpayer for the purposes of applying these provisions. In particular, this should be supported by an appropriate inclusive 'safe harbour style' definition, which addresses at a minimum each of the specific relationships identified in Subdivisions 106-B, 106-C and 106-D.

Extension of specific application of Subdivisions 106-C and 106-D and section 106-35

- 2.4 As outlined above, the Committee encourages the proposal to amend Subdivisions 106-C and 106-D and section 106-35 to ensure that the significant and common stakeholder tests in the scrip for scrip rollover provisions and the connected entity test apply as intended.

- 2.5 That said, subject to the Committee's comments below regarding having to be mindful of the interaction with the broader trust rules rewrite project, the Committee submits that amendments to these provisions go further than proposed.
- 2.6 The Committee considers that these provisions have application beyond Parts 3-1 and 3-3, to which they are specifically stated to apply. The principles in these look through provisions apply beyond Parts 3-1 and 3-3, whether or not specifically stated in Subdivisions 106-C and 106-D and section 106-35.
- 2.7 In this regard the Committee recommends that the provisions be amended to apply to the Act, as proposed in the drafting recommended at paragraph 2.17.

Interaction with broader trust rules rewrite

- 2.8 The Committee notes that the concept of 'absolutely entitled' beneficiaries for CGT purposes has been a vexed issue for some years and this concept applies in other areas of the Tax Act. The CGT absolute entitlement test was considered by Justice Lindgren in *Kafataris and Anor v. Deputy Commissioner of Taxation* 2008 ATC 20-048. The impact of this case on ATO policy is discussed in the Kafataris Decision Impact Statement. The ATO has also set out its position on these issues in *TR 2004/D25 - Income tax: capital gains: meaning of the words 'absolutely entitled to a CGT asset as against the trustee of a trust' as used in Parts 3-1 and 3-3 of the Income Tax Assessment Act 1997* – which was raised at the March 2006 meeting of the ATO National Tax Liaison Group (NTLG), and referred to the (then) newly formed Tax Consultation Sub-committee Group (TCSG) for discussion at its meeting in May 2006. It was discussed at later meetings of the TCSG in August 2006 and November 2006.
- 2.9 The TCSG members considered that the ruling should be finalised only on condition that taxpayers would not be disadvantaged in terms of tax on capital gains (CGT) or other tax liabilities if they restructured their affairs to fit within its terms. Members said that if the ruling could not be issued on that condition then it should not be finalised and that Treasury should again be made aware of the consequences to the investment fund industry of the views expressed in the draft ruling.
- 2.10 TR 2004/D25 includes the following pertinent statements:

*10. The core principle underpinning the concept of absolute entitlement in the CGT provisions is the ability of a beneficiary, who has a vested and indefeasible interest in the entire trust asset, to call for the asset to be transferred to them or to be transferred at their direction. This derives from the rule in *Saunders v. Vautier* applied in the context of the CGT provisions (see *Explanation paragraphs 41 to 50*). The relevant test of absolute entitlement is not whether the trust is a bare trust (see *Explanation paragraphs 33 to 40*).*

33. It is considered that the test of absolute entitlement is based on whether the beneficiary can direct the trustee to transfer the trust property to them or at their direction. While the existence of a bare trust may be a good indicator that a beneficiary of the trust is absolutely entitled, it is not necessary to establish that the trust is a bare trust in order to establish

absolute entitlement. Likewise, the existence of a bare trust does not lead automatically to the conclusion that a beneficiary of the trust is absolutely entitled.

73. The interest a beneficiary has in the trust asset or assets must be vested in possession and indefeasible. A trustee would only be obliged to satisfy a demand from a beneficiary with such an interest.

74. A vested interest is one that is bound to take effect in possession at some time and is not contingent upon an event occurring that may or may not take place. A beneficiary's interest in an asset is vested in possession if they have the right to immediate possession or enjoyment of it.

75. Also, the interest must not be able to be defeated by the actions of any person or the occurrence of any subsequent event. For example, if the class of potential beneficiaries has not yet closed then a beneficiary's interest is capable of being defeated, at least in part, by the admission of new beneficiaries to the class. Another example is if assets are held on trust for X should X attain the age of 25, but if X does not attain 25, then the assets are to pass to Y. This is referred to as a 'gift over' and its existence means that X's interest will be defeated if he does not attain 25.

- 2.11 Many commercial arrangements – including custodial arrangements – will not meet the strict notion of 'absolute entitlement' as described in *Saunders v. Vautier*. This may be because although the custodian will generally be required to act upon directions of the beneficiary, there are some exceptions and these qualifications may not meet the strict notion of 'absolute entitlement'. In addition, some nominee arrangements apply where for example a foreign resident is unable to hold the assets directly, which equally may not meet the strict notion of 'absolute entitlement'. However, it is clear that in many of these commercial arrangements, the legal owner or trustee should not be the relevant taxpayer for the purposes of applying the CGT provisions. Accordingly, the Committee submits that in resolving these issues, an appropriate and commercially workable definition or concept of 'absolute entitlement' should be introduced to resolve this ambiguity.
- 2.12 The Committee notes that these or similar issues are also under consideration as part of the trust rules rewrite project. Accordingly, the Committee submits that any position adopted should not interfere with the full and complete review of this trust rules rewrite project.

Definition of absolute entitlement

- 2.13 As stated above, the Committee submits that an inclusive definition of 'absolute entitlement' should be adopted so as to specify the specific circumstances in which the 'look through' approach would apply.
- 2.14 For example, in the context of our discussion above, the provision should clarify that an entity will be absolutely entitled to a CGT Asset as against the trustee of a trust if the requirements for absolute entitlement at general law are satisfied, that is, where:

- (a) the entity has an ability against the holder (whether absolute or subject to conditions) to call for the asset to be transferred to it or to be transferred at its direction; and
 - (b) the entity has a vested and indefeasible interest in the trust asset.
- 2.15 However, because certain commercial arrangements could fall outside the general law definition of the term 'absolutely entitled' (as discussed above) the Committee submits that those arrangements where there is sufficient or materially all entitlements to the financial benefits (i.e those available to the owner of the asset) should also be subject to the look through approach.
- 2.16 In this regard, the Committee's view is that an 'inclusion approach' should be implemented as part of section 106-50 which would ensure that relevant commercial arrangements (which may not fall within the general concept of absolute entitlement) are also subject to the look through approach in section 106-50. In this regard, the Committee proposes that the general principle should rely on whether an entity is entitled to the financial benefits of ownership of an asset.
- 2.17 The Committee's suggested wording to achieve this purpose is as follows:

*If an entity is *entitled to the financial benefits of ownership of a *CGT asset, treat the CGT asset as a CGT asset of the entity and not the legal owner for the purposes of this Act.*

An entity is entitled to the financial benefits of ownership of a CGT asset if the entity:

(a) has a right (whether contingent or not) as against the holder of the CGT asset to acquire title to, or direct the disposition of, the CGT asset; and

*(b) has a vested and indefeasible right to receive all of the *financial benefits in relation to the CGT asset, or to have all of the financial benefits in relation to the CGT asset applied at the entity's direction or for the entity's benefit (including to reduce, meet or discharge a liability or obligation of the entity).*

An entity is also entitled to the financial benefits of ownership of a CGT asset if the entity is absolutely entitled to the CGT asset as against a trustee of a trust in relation to the CGT asset.

An entity is not prevented from being entitled to the financial benefits of ownership of a CGT asset merely because:

(a) another entity has title to, or rights in respect of, the CGT asset as part of a security interest in relation to the CGT asset;

*(b) the CGT asset is vested in the trustee under the Bankruptcy Act 1966 or under a similar *foreign law;*

*(c) the CGT asset is vested in the trustee as a result of an arrangement with creditors under the Bankruptcy Act 1966 or under a similar *foreign law;*

*(d) the CGT asset is vested in the liquidator of a company or the holder of a similar office under a *foreign law;*

(e) in relation to a CGT asset that is fungible, the entity holding title to the CGT asset has disposed of, or granted rights in relation to, the CGT asset, provided that entity has rights to recover a substantially identical asset;

*(f) some or all of the *non-monetary incidental rights can be exercised by the holder;*

(g) the person in whose name a CGT asset is registered is entitled to insist on payment of fees and charges for services rendered to the entity entitled to the financial benefits of ownership of the CGT asset before the CGT asset is transferred to that person; or

(h) the entity is subject to a legal disability.

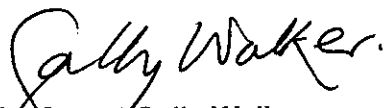
A right in relation to a CGT asset is a non-monetary incidental right if it is not a right to receive money and the right does not of itself substantially affect the value of the CGT asset.

- 2.18 The Committee also considers that the relevant provision should not be defined by reference to "you" (as section 106-50 is currently drafted), as the rules need to be able to be applied to third parties.
- 2.19 The Committee submits that adopting the proposed definition above would provide greater clarity and consistency in the application of section 106-50, and would ensure that the trustee (or other relevant entity) is not treated as the relevant taxpayer in applying the CGT provisions (and in applying the broader taxation law provisions as discussed above). This is particularly so in commercial arrangements such as nominee arrangements and bare trusts which may not otherwise qualify under the general law concept of absolute entitlement.

Please note that due to time constraints this submission has not been considered by the Directors of the Law Council of Australia.

The Committee would be happy to discuss these views. Further enquiries should be directed to the Committee Chair, Teresa Dyson. Ms Dyson may be contacted by phone on 07 3259 7000 or via email: teresa.dyson@ashurst.com.

Yours sincerely



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Secretary-General