Rollover relief for company demergers

Tax reforms are a continuous process and the government has acted on advice from the Institute to provide rollover relief for companies dismantling corporate structures.

The Institute welcomes the introduction of capital gains tax (CGT) rollover relief for company demergers, which was introduced into the House of Representatives on 27 June 2002 and will have retrospective application from 1 July 2002.

The introduction of rollover relief removes a major impediment to company demergers (spin-offs and reconstructions) and is expected to lead to a significant increase in demerger activity in Australia.

Introduction of this important reform follows strong advocacy by the Institute and other key industry bodies and comes at a critical time for corporate spin-off activity.

A company demerger occurs when a corporate or trust group splits itself into two or more parts by distributing to shareholders a direct interest in one or more parts of the group.

The Institute has always argued that the imposition of CGT on unrealised gains is a powerful disincentive to company demergers and results in the continuation of organisational structures that are no longer suited to the efficient operation of a business.

We believe that if a company undertakes a demerger, leaving its members in the same economic position as they were in immediately before the demerger, there should be no taxing event.

Australia has had very limited demerger activity over recent years because of the potential for CGT to crystallise, even where the transaction only involves an exchange of scrip.

The recent spin-offs of Amcor/PaperLinx, Boral/Origin Energy and BHP/OneSteel were an exception rather than the rule because the fair market value of the businesses being spun off were similar to the cost base of those assets. Companies were able to use the capital reduction provisions to spin off a small part of their businesses without giving rise to significant CGT consequences.

This has not been the experience in many other jurisdictions, particularly the United Kingdom and the United States, where demerger activity has always been more prevalent because their tax regimes encourage structural reorganisation to enable business to concentrate on its core competencies. In those jurisdictions, spun-off businesses have also been shown to outperform the average share market performance.

New legislation

Under the New Business Tax System (consolidations, value shifting, demergers and other measures) Bill 2002, CGT rollover relief will be available where the demerging entity divests itself of at least 80% of its ownership interests in the demerged entity and the underlying ownership of the demerger group as a whole is maintained.

Relief will be available to corporates and trusts, other than discretionary trusts, which have been excluded because of the difficulty of establishing, with any certainty, the real economic ownership of the assets and the difficulty of testing whether that ownership has been maintained.

The new interests must be of a similar kind as the original interest: if the original interests were shares the new interests must be shares, if the original interests were units in a trust the new interests must be units in a trust. It will not be possible to switch between companies and trusts.

Relief will be available for widely held entities and non-widely held entities with additional integrity rules applicable to non-widely held entities. Relief will be available for the demerger of a single entity or multiple entities.

Specific provisions will make relief available to dual-listed companies.

Importantly, rollover relief will apply at both shareholder and corporate levels. From a shareholder perspective this means that CGT will be deferred until the ultimate disposal of the share and from a corporate perspective CGT relief will be available on disposal of the demerged entity.

Relief will be available for Australian residents and non-residents, provided 50% of the demerging entity is owned by either Australian residents or foreign residents who have the necessary connection with Australia

Rollover relief will not be available for shares held on revenue account or employee share schemes.

Impact of relief

Under the new regime, Australia is expected to show similar trends to overseas jurisdictions with the introduction of CGT rollover relief leading to a significant increase in demerger activity.

An Access Economics study into the revenue impact of introducing rollover relief for company demergers indicated that an increased activity, together with the likelihood that shareholders will more readily sell shares in either the parent company or the demerged entity, would lead to a net gain to revenue over time that will more than offset any initial losses. J