

Tax Brief

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New Rules on Taxation of Rights Issues

Introduction

Historically, the issue of rights to acquire shares or units by companies and trusts to their shareholders and unit holders has been treated as not giving rise to any assessable income or capital gain for the shareholders or unit holders. However, last year the High Court handed down its decision in the case of *Commissioner of Taxation v McNeil* [2007] HCA 5 ('**McNeil**') which rather unexpectedly changed this situation and engendered considerable uncertainty in the process.

This Tax Brief examines the new rules proposed by the Government to try to clarify the post-*McNeil* situation, and in particular some of the difficulties these new rules create, as well as the areas they leave untouched.

Background

The *McNeil* decision involved rights issued by St George bank to its shareholders allowing shareholders to 'sell back' some of their shares to St George at a premium to the market price. Shareholders receiving these sell-back rights had three choices. They could:

- exercise the rights and sell the corresponding number of shares;
- sell the rights on market; or
- do nothing, in which case the rights were sold or exercised by a custodian and the proceeds distributed to the shareholder.

The majority decision in *McNeil* was that the value of such rights would be regarded as ordinary income in the hands of the bank's shareholders at the time the rights were issued.

Although *McNeil* related to sell-back rights, the ATO took the position in its ruling program that the same reasoning could apply to the issue of rights to acquire shares or units (at least where the rights were renounceable and tradeable).

Government's response

In response to submissions from industry and the profession, the Government has drafted amendments to the tax law which are designed to:

- 'restore' the treatment of rights issues, where shareholders are given the right to acquire shares at a discount; and

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- ensure that the value of sell-back rights are not subject to double taxation as a result of the decision in *McNeil*.

The proposed amendments differentiate in one case between rights issued by companies and those issued by trusts. The new rules will apply to rights to **acquire** both shares in a company and units in a unit trust but, as noted below, the new treatment of **sell back** rights only applies to rights to sell shares in a company. In this Tax Brief we will refer principally to rights to acquire shares for simplicity.

These amendments are contained in the Tax Laws Amendment (2008 Measures No. 3) Bill 2008 (*'the Bill'*) which is currently being considered by the Senate Economics Committee. The Committee is due to report to the Senate by 18 August 2008.

Proposed changes for call options (rights to buy)

Under the proposed changes, the market value of rights to acquire shares will not be assessable income, provided all of the following six conditions are satisfied:

- the taxpayer must already own shares (the original shares) in the company at the time the taxpayer is issued with the rights;
- the rights must be issued to the taxpayer because of their ownership of the original shares;
- the original shares must be held by the taxpayer on capital account for tax purposes;
- the rights must not have been acquired by the taxpayer under an employee share scheme;
- the original shares must not be convertible interests for tax purposes (which are, broadly, interests that can be 'converted' into a different type of interest – for example, a preference share that is convertible into an ordinary share); and
- the original shares must not be traditional securities. (This is an odd and probably unnecessary requirement. Shares would not normally be considered 'securities' for this purpose and so could not be traditional securities.)

Provided these conditions are met, tax will only be payable by the taxpayer if they (a) dispose of their rights or (b) dispose of the shares acquired on exercise of the rights.

The changes will apply retrospectively to grants of rights made on or after 1 July 2001.

Some issues with the proposed changes

The drafting of the proposed changes raises further issues.

First, the third requirement listed above – that the relevant shares are held on capital account for tax purposes – leaves the existing position unaffected for those taxpayers who hold their shares on revenue account (that is, taxpayers who would pay income tax on their share dealings.) So, it seems to be intended that the *McNeil* treatment will still apply to taxpayers who

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hold their shares on revenue account for tax purposes. While the facts in *McNeil* concerned a renounceable rights issue, it was not clear in the High Court's reasoning whether their decision would also extend to non-renounceable rights issues or to non-tradeable rights but with an institutional book-build for lapsed rights.

This uncertainty has not been clarified by the proposed changes. Therefore, it is still unclear whether shareholders who are not holding their shares on capital account (typically share traders, banks and insurance companies) and acquire non-renounceable rights in respect of shares they already hold (whether with or without an institutional book-build for lapsed rights) will be subject to tax on the value of their rights at the time of grant. The ATO has indicated that it is preparing a decision impact statement on *McNeil*. The general view of commentators is that the grant of a non-renounceable right (ie, the rights are not tradeable and there is no book build for lapsed rights) does not constitute ordinary income, despite *McNeil*.

Secondly, and in light of this, there still appears to be a risk of effective double taxation where shares are held as trading stock or otherwise on revenue account. If a taxpayer pays income tax on the market value of a right when received, then double tax could arise unless that market value is deducted when calculating the income tax consequences of disposal of the right (or the share acquired on exercise) – the taxpayer might be liable to tax on both the value of the right at the time of issue (say 10c. per right) and the gross proceeds of selling the rights (say, 12c. per right) even though the taxpayer has only made 12c. per right in total from the transaction. The problem is that the market value of the right is not explicitly included in the 'cost' of the share for normal income tax purposes. An existing provision in the Income Tax Assessment Act 1997 prevents 'the same amount' from being included in a taxpayer's assessable income more than once and the Explanatory Memorandum to the Bill states that this provision will prevent the taxpayer being taxed on the value of the rights again 'at any other time' – presumably including when the rights, or when the shares acquired pursuant to the rights, are sold for more than the acquisition price but it is not clear that this is correct. It is not clear that the value of the right on receipt (10c.) is the 'same' amount as the sale proceeds (12c.).

However, even if that were correct it would not prevent unfair results from arising. For example, even if existing law could allow the taxed value of the right to be set off in calculating income by way of 'profit' on a subsequent sale of the shares acquired on exercise, that would not help a taxpayer who did not end up making a profit. For example, if such a taxpayer ended up selling the shares for an amount equal to the exercise price of the right, then there would be no 'income' from the sale and the provision would not apply. Thus, the taxpayer would have been taxed on the value of the rights (say 10c.), but would not get an offsetting deduction for the loss incurred when the proceeds of the share sale (\$1.05) fell short of the exercise price (\$1.00) plus the value on which tax had already been levied (10c). In effect, the anti-double counting rule could solve the problem only if the relevant shares were ultimately sold for an amount equal to or greater than the exercise price plus the value on which tax had been levied (\$1.10).

Thirdly, the exemption conditions are themselves rather odd. The first condition for the grant of rights to be exempt from tax is that the taxpayer

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must already own shares in the company at the time he or she is issued with the rights. Given that the second condition requires that the rights are issued because the taxpayer is a shareholder it is not clear what purpose the first condition serves.

Of greater concern is the potentially unfair outcome which may result from this requirement. Under a tradeable, renounceable rights issue, the grant of the rights will usually occur after the record date. Where a taxpayer, who otherwise satisfies the exemption requirements, has disposed of their shares in a company after the record date for the rights, but before the grant of the rights, the first condition will not be satisfied even though the second condition will be. The taxpayer would therefore not be entitled to the exemption and be subject to tax on receipt of their rights.

Finally, the Bill does not clarify whether an amount received for a lapsed right is on capital or revenue account where the shareholder holds the underlying shares on capital account. Prior to *McNeil* the prevailing view was that the receipt would be on capital account. Under a specific deeming provision in the legislation, the date of acquisition of the right for CGT purposes was the date of acquisition of the underlying shares. Accordingly, if the receipt is on capital account and the shareholder has held his or her shares for at least 12 months the shareholder could apply the CGT discount to the gain on lapse. Hopefully, either the legislation or the ATO will provide certainty on this in due course.

Put options (rights to sell)

Unlike call options, the proposed changes will not reverse the decision in *McNeil* for put options. The Bill does not expressly legislate that the value of the put option is assessable, but rather relies on the general income provisions to assess a shareholder who receives a put option that has similar features to those in *McNeil*. Accordingly the legislation is silent on the taxation of put options which have different characteristics to those in *McNeil*, such as being non-renounceable or renounceable but non-tradeable.

The Bill includes changes to the law for put options which will ensure that the taxpayer can include the amount on which they paid tax (at grant) in the cost base of the put option for CGT purposes, preventing double taxation when the shareholder later disposes of that option.

However the proposed changes do not include the amount on which tax was paid (at grant) in the cost base of the underlying shares. Therefore, in a situation where the underlying shares are sold by the put option being exercised (rather than the right being disposed of), the shareholder may make a capital gain equal to the amount on which they had previously paid tax, potentially resulting in double taxation to the taxpayer.

Where the rights are held on revenue account, the risk of double taxation remains, as described above.

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Also, the changes concerning put options do not apply to put options over units in a unit trust. The Explanatory Memorandum asserts that most unit trusts would not be able to institute a 'sell back' type arrangement. No supporting evidence is cited for that assertion. It is true that buyback arrangements are generally more attractive in corporate contexts than for unit trusts (because of dividend franking related issues). However, there seems no reason why the legislation should not be comprehensive, to deal with occasions where it does matter. For example, if a stapled group wishes to do a share buyback, it will need to do a unit buyback as well.

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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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