Chapter 11

TOWARDS A MORE COMPETITIVE REGIME FOR TAXING CAPITAL GAINS

Key policy considerations ***285***

How are capital gains taxed at present? 285

Would CGT relief encourage savings and investment? 286

Would CGT relief produce net economic benefits? 286

Would CGT relief encourage long-term investment? 287

Would CGT relief encourage high-risk investments? 287

Would CGT relief help attract mobile international capital? 288

A strategy for reform ***289***

Policy options ***289***

CGT provisions for individuals 289

Scrip-for-scrip rollover relief 294

Targeted concessions for certain types of investment 298

CGT provisions for small business 300

Key policy considerations

How are capital gains taxed at present?

11.1 Prior to 1985 most capital gains were free of any income tax. This had resulted in a situation where taxpayers had a very strong incentive to earn income in the form of capital gains and where a multitude of schemes were devised to convert recurrent income to capital gains in order to avoid taxation.

11.2 In the face of such a marked difference in treatment between the two forms of income it was very difficult to define a boundary line that was based in logic and was practical to administer. The capital gains tax (CGT) was introduced in recognition that capital gains do constitute income and the then current exemption was seriously distorting taxpayer behaviour and damaging the integrity of the tax system.

11.3 Most countries tax capital gains more favourably than ordinary income. They do this because of the view that it will encourage savings and investment, particularly long-term and risky investment, and improve their international competitiveness. The incentive to save rather than consume is obviously strengthened by these measures.

11.4 Australia applies the same tax rate to capital gains as to other income. However, the availability of indexation and the averaging provisions means that the effective tax rate is typically lower than on ordinary income. It is difficult to make international comparisons because of the range of alternative treatments of capital gains. For example, the classification of income as capital gains rather than as ordinary income is much broader in Australia than is typically the case in many other advanced countries. Consequently some income taxed as capital gains in Australia would be taxed as ordinary income in those countries. However, *An International Perspective* noted (page 80, paragraph 4.18) that 'This tends to be an area where other countries provide more generous treatment than does Australia …'

11.5 The fact that other countries have made the judgment that their national interest is best served by taxing capital gains more lightly than other income is not necessarily a conclusive argument that Australia should follow the same path. However, it does mean that it is an issue that requires serious consideration. On a related point, the fact that Australia's taxation of capital gains is relatively harsh compared with many other countries may also have some adverse impact on our international competitiveness.

11.6 Possible reasons for taxing capital gains more lightly than other income are canvassed below.

Would CGT relief encourage savings and investment?

11.7 As a lower tax rate increases the after-tax return to investors, a reduction in capital gains tax would lower the cost of equity capital and increase investment in assets providing returns in the form of capital gains. The issue is whether this extra investment is at the expense of investment in assets which provide returns as ordinary income or is additional to the investment that would have taken place in any case. Clearly there will be some switching of investment and some net addition to investment which, in turn, should be expected to generate additional income tax.

11.8 Assessment of the costs and benefits of such proposals is extremely difficult as it needs to take into account the full range of taxpayer responses. These are frequently hard to identify and often impossible to quantify. For example, it is likely that investment switching from assets providing returns in the form of ordinary income to assets providing returns in the form of capital gains will have some adverse impact on economic efficiency and growth. Whether this is likely to be more than offset by the dynamic gains from the additional investment in capital gain producing assets ultimately comes down to a matter of judgment given the difficulty of measuring such effects.

11.9 It is often argued that there is a greater propensity to save income earned in the form of capital gains than income earned from personal exertion. However, the objective evidence is inconclusive on this point. Nonetheless, it is noteworthy that the USA and the UK have reduced their effective rates of CGT and have experienced increased investment and business development. The actual degree of causation between these factors may be difficult to determine or measure.

Would CGT relief produce net economic benefits?

11.10 To some extent this is a rephrasing of the previous question about the effect on savings and investment. However, it has a further dimension in that it may be that assets typically producing capital gains have desirable characteristics in terms of boosting Australia's economic growth. For example, it is sometimes argued that investment in venture capital and high technology start-up industries is particularly important in boosting Australia's growth rates. As returns to these types of investment are predominantly in the form of capital gains, lighter taxation of capital gains income is likely to boost investments of this type.

11.11 Of course, generalised capital gains relief would benefit a much wider range of investments than venture capital and high technology. This suggests there may be a case for some targeting of the relief.

11.12 The realisations basis of the CGT means that there is a lock-in effect for investors. This effect increases with the size of the unrealised capital gains associated with the asset and the rate of tax that would be payable. The lock-in effect can mean that investors are encouraged to hold assets where the rate of return is below what could be obtained elsewhere at some cost to economic efficiency. On these grounds it is argued that CGT rates should be lower to reduce the lock-in effect. However, as discussed in more detail later, others argue that the CGT should be designed to increase the lock-in effect in some respects.

Would CGT relief encourage long-term investment?

11.13 It is often argued that long-term investment is particularly important in boosting Australia's economic growth. In particular, it is argued that patient capital is necessary for companies in the early stage of development. This leads to suggestions that capital gains tax could be lower on longer-held assets. The US and UK have adopted this approach by relating the tax rate to the period that the investment has been held; the longer the period, the lower the rate. A second strand of argument is that many long-term investments provide returns in the form of capital gains and so lower CGT will encourage such investments.

11.14 Long-term investments frequently involve higher risk although many short-term investments can also be high risk. The issue of the impact of the CGT on high-risk investments is discussed below. Lower rates of CGT would result in a lower cost of equity capital for such investments.

Would CGT relief encourage high-risk investments?

11.15 The proposition that CGT relief would be an appropriate way to encourage risky investments presumes that such investments frequently provide returns in the form of capital gains. There is certainly strong anecdotal evidence that this is often the case. For example, venture capital and high technology start-up investments are frequently cited as high-risk investments earning capital gains.

11.16 The quarantining of capital losses raises the possibility that they will only be recognised for tax purposes with a delay or perhaps not at all. This provides a clear bias against risky investments where such losses are more likely. Some taxpayers may be able to offset this bias by investing in a sufficiently diversified portfolio of investments. However, many taxpayers will not be able to do this.

11.17 The quarantining of capital losses is seen as a necessary balance to the realisations basis for taxing capital gains. If investors could offset capital

losses against other income then they would be likely to realise losses earlier to obtain the tax benefit. This would impact adversely on the revenue while tax on capital gains would be deferred through taxpayers not realising capital gains.

11.18 As canvassed in the specialist literature, other features of the CGT arrangements may encourage investment in risky assets:

- The CGT deferral and indexation benefits increase the higher the actual or anticipated capital gain and the longer the period of ownership. In addition:
  - sophisticated investors can, at present, also derive further benefits through the use of synthetic trading and capital loss duplication arrangements; and
  - capital gains and losses can be strategically realised to reduce the tax.
- These strategies will typically only be employed by more sophisticated investors. Even then they might be constrained by considerations other than those relating to tax in manipulating their investment portfolio.

11.19 It is clear that loss quarantining, and indeed the treatment of income losses, provides a bias against risky investments. While this can be offset by some investment strategies and other features of the tax system which may mitigate the bias, it is clear that for some investors it will be an important consideration.

11.20 The Review notes that recent Government initiatives, such as the Innovative Investment Fund Scheme and small business capital gains tax rollover relief target particular activities and particular groups of taxpayers.

Would CGT relief help attract mobile international capital?

11.21 Countries compete for mobile international capital and, as noted earlier, Australia's treatment of capital gains tends to be more harsh than in many other countries.

11.22 Some countries impose lower taxes on capital to counter international tax competition. This has been common in Asian economies and in recent years has become more prevalent in Europe. It is also important to note that foreign portfolio investors in Australian entities do not pay Australian CGT.

11.23 It has been suggested that certain types of high technology and venture capital investments are very mobile internationally and, as they tend to produce returns in the form of capital gains, the location of such investments may be particularly sensitive to rates of tax on capital gains. The differences in

Australia's taxation of capital gains and those of its competitors for international investment are much greater than is the case for other forms of capital income. Many other countries apply a capital gains rate significantly lower than the rate on other investment income and, in some cases, zero. The argument is that the footloose nature of the investment, the fact that the returns are in the form of capital gains, and the wide disparity in tax rates between Australia and its competitors justifies more concessional treatment of capital gains than for other investment income.

11.24 Objective examples of the importance, or otherwise, of these considerations in the location of investments would be useful in assisting judgments on these issues.

A strategy for reform

11.25 The aim of reform in this area should be to achieve a balance between encouragement of investment and attracting capital in a more vibrant capital market, on the one hand, and collecting an appropriate contribution to revenue, on the other.

Policy options

CGT provisions for individuals

11.26 This section provides some preliminary views on the specific issues relevant to options to cap the CGT rate for individuals at 30 per cent; the adoption of a stepped-rate CGT depending on the time over which the asset is held and the introduction of a $1,000 per annum CGT tax-free threshold. If there were to be a substantial reduction in the rate of CGT, consideration would probably need to be given at the same time to the elimination of indexation and averaging.

11.27 The Review's terms of reference specifically requested that it examine the scope for capping the rate of tax applying to capital gains for individuals at 30 per cent. The $1000 per annum CGT tax-free threshold was also mentioned as a possibility by the Government in *A New Tax System*. The stepped rate CGT is one way of reaching a 30 per cent cap, albeit only for assets held for the qualifying period. It is also an approach to reducing CGT rates which has been adopted in both the UK and the US.

A 30 per cent capped rate

11.28 There are several ways CGT relief could be provided through a capped or stepped rate. Appendix A to Chapter 39 sets out some possible rate structures.

11.29 A 30 per cent capped rate could be designed to continue to apply to ordinary personal income tax rates up to 30 per cent, but rates above 30 per cent (that is, the 40 per cent and the 47 per cent rates) would be reduced to 30 cent for capital gains. Alternatively, all personal income tax rates could be reduced by an equivalent amount with the maximum rate capped at 30 per cent, but this option would be more expensive. Alternatively, all rates could be reduced by the same percentage, say 20 per cent. Effectively, 80 per cent of gains would be taxable at the taxpayer's marginal rate and 80 per cent of losses would be deductible.

11.30 Confining the option to individuals would limit its revenue cost. Many individuals invest through collective investment vehicles such as companies, trusts or superannuation funds. Capital gains income earned via these vehicles would also benefit from the capped rate.

11.31 The fact that capital gains income would be taxed at a lower rate than other income would require the definition of a boundary line between the two categories as taxpayers sought to convert ordinary income to capital gains income. This could lead to some administrative and compliance complexity and could reduce the integrity of the income tax system.

11.32 Such a measure would increase investment in assets likely to provide returns in the form of capital gains. As noted earlier some of this increase would be from switching investments and some would be from net additions to total investment. The difficulty of assessing the costs and benefits of such measures was discussed earlier.

Equity considerations

11.33 A simple cap of the rate at 30 per cent would only benefit taxpayers facing higher marginal tax rates than 30 per cent. The alternative of equivalent reductions in all rates would provide proportionate benefits to lower income earners. Of course, those taxpayers with the highest levels of CGT income will gain the greatest absolute benefit but all taxpayers would benefit proportionately. In a progressive tax system, gains of an equivalent amount are taxed more heavily in the hands of a high marginal rate taxpayer than in the hands of a taxpayer on a lower rate. So, any decreases or increases in rates have higher absolute impacts on different taxpayer groups even when proportionately the same. While some may see this giving rise to some equity concerns it also has to be weighed against the likelihood that it is also the

higher rate taxpayers who have the most capacity to respond to the measure by increasing their savings.

A stepped rate

11.34 A stepped rate option would allow lower CGT rates on gains from assets the longer the asset was held. The rationale for such an option is to encourage investors to hold assets for a longer period. It is argued that a higher proportion of 'patient' capital would assist business.

11.35 The important design issues are:

- the intervals at which the rate would be reduced; and
- the extent of the reduction including whether the rate finally declines to zero.

11.36 The two issues are inter-related. If the ultimate reduction in rates is to be quite large then initial reductions could start at a modest level after one or two years. Alternatively the first step down could be after a period as long as, say, five years and then be quite significant in order to maximise the incentive to retain the asset for at least that period.

11.37 If the end point was a zero rate this would allow taxpayers to cease record keeping in respect of long-held assets but may raise administrative complexities in that assets would move in and out of the tax system.

11.38 The US and the UK have introduced stepped rates into their capital gains tax arrangements. The USA does not have CGT indexation and averaging. Table 11.1 below provides a summary of the US personal income and company income and CGT rates.

11.39 Effective from 6 April 1998 the UK has introduced CGT taper relief where, based on the complete number of years that a CGT asset is held, a proportion of the gross capital gain is not included as assessable income (net capital gain). Net capital gains (after taper) are taxed at the individual's marginal tax rate. The taper was introduced at the same time as the removal of CGT indexation. The taper is equivalent to a rate reduction on capital gains and varies if the underlying asset is a 'business' or 'non-business' asset. Table 11.2 below provides a summary of the UK income and CGT regime. The UK regime is accompanied by complex anti-avoidance rules (to try to stop value shifting and to preserve the integrity of the income tax system).

Table 11.1: United States individuals and companies — income and CGT rates

Taxable income $US	Marginal tax rate Federal[(a)] %	CGT rate short-term gains (asset held less than 12 months)[(b)] %	Mid-term CGT gains (>18 months) after May 1997 %	Long-term CGT gains (>5 years) after December 2000 %
0-25,350	15.0	15.0	10	8
25,351-61,400	28.0	28.0	20	18
61,401-128,100	31.0	31.0	20	18
128,101-278,450	36.0	36.0	20	18
$278,451 +	39.6	39.6	20	18
Company tax[(c)] (average)	35.0	35.0	35	35

(a) These marginal tax rates do not include social security and State income taxes.
(b) If the asset is held for more than 12 months but not more than 18 months the gain is taxed at a maximum rate of 28 per cent.
(c) For companies dividend income is taxed at the company tax rate which, depending on taxable income, varies between 15 per cent and 35 per cent — the average company tax rate is approximately 35 per cent. Dividend income does not receive imputation credits.

Table 11.2: United Kingdom individuals and companies — income and CGT rates[(a) (b) (c)]

Gains on 'business' assets			Gains on 'non-business' assets		
Number of complete years after 5.4.98 for which asset held	Percentage of chargeable capital gain	Equivalent CGT tax rates for higher rate/ basic rate taxpayers %	Number of complete years after 5.4.98 for which asset held	Percentage of chargeable capital gain	Equivalent CGT statutory tax rates for higher rate/ basic rate taxpayers %
0	100.0	40/23	0	100	40/23
1	92.5	37/21.27	1	100	40/23
2	85.0	34/19.55	2	100	40/23
3	77.5	31/17.82	3	95	38/21.85
4	70.0	28/16.10	4	90	36/20.70
5	62.5	25/14.37	5	85	34/19.55
6	55.0	22/12.65	6	80	32/18.40
7	47.5	19/10.92	7	75	30/17.25
8	40.0	16/9.20	8	70	28/16.10
9	32.5	13/7.47	9	65	26/14.95
10 or more	25.0	10/5.75	10 or more	60	24/13.80

(a) These marginal tax rates do not include social security taxes.
(b) Trusts are taxed at either the basic rate of 23 per cent, while accumulation and discretionary trusts are taxed at 34 per cent. Companies are taxed at the company tax rate of 31 per cent (this falls to 30 per cent after April 1999) — the company tax rate is 10 per cent lower for small companies (taxable income less than 300,000 pounds).
(c) For new assets the point where the taper relief will compensate for the loss of indexation will be after the asset has been held for approximately four years (business assets) and seven years (non-business assets) — where the cpi is assumed to be 2.5 per cent and the real asset growth rate is 6 per cent. This increases to approximately six years and ten years respectively if the real growth rate was instead assumed to be 3 per cent per annum.

11.40 If a stepped rate CGT were to be introduced in Australia, an important design issue would be the treatment of capital losses. One option would be to quarantine capital losses to be offset only against capital gains subject to tax at the same rate. That is, losses from an asset sold after a certain period would only be able to be offset against gains assessable at the rate applicable to that period. Such quarantining would be extremely complex. However, without adequate quarantining taxpayers will always offset capital losses against the most highly taxed capital gains to the detriment of the revenue. This may be an acceptable outcome given the complexity of the alternative.

11.41 Whenever the tax system creates a boundary, taxpayers respond by attempting to explore it in order to minimise tax. This would almost certainly be the case with a measure of this type. However, it is difficult to predict the means that taxpayers might use and the likely severity of any problems. Other countries face the same dilemma and, presumably, judge that the benefits outweigh the disadvantages.

Alternatives for lowering CGT rates

11.42 A number of approaches could be used to achieve lower CGT rates, either just for individuals or for both individuals and entities. Proposals already mentioned to the Review involve clawback, at the taxpayer's marginal rate, of deductions relating to those elements of the gain which reflect costs associated with holding the asset. In examining their merits, or designing such options, important considerations will be the following:

- The purpose of the particular measure. A measure designed to encourage savings generally in order to increase funds available for investment will clearly have different characteristics to one targeted at encouraging particular forms of investment.
- The cost to revenue is an important constraint. Removing indexation and averaging might be seen as an acceptable trade-off for other reductions in the burden of CGT. If alternative proposals cost more than the revenue available from abolition of indexation and averaging, covering that extra expense will be at the cost of reductions in the company tax rate, or removal of other tax benefits. Alternatively other sources of revenue clawback could be examined in order to fund the deficit.
- Measures need to be designed to minimise the scope for abuse and to ensure low administration and compliance costs. As mentioned above, if capital gains are subject to a lower tax rate than ordinary income, taxpayers have an incentive to maximise their deductions against ordinary income and minimise them against capital gains income. Significant practical difficulties are involved in attempting to allocate some

deductions, such as interest on borrowings, between capital gains and other income.

A $1,000 CGT threshold

11.43 This option would exempt the first $1,000 of capital gain realised each year from CGT. Its motivation is presumably to increase saving and investment, while reducing compliance costs for small investors.

11.44 Such an option would obviously encourage investors to switch savings from assets returning recurrent income such as interest and dividends to assets producing capital gains. Assets with low transaction costs, such as shares, would be particularly favoured as a gain of $1,000 can be realised each year in order to maximise the benefit of the concession.

11.45 One possible form of abuse includes arrangements where taxpayers engage in 'bed and breakfast' transactions. These involve selling say shares just before the end of the financial year to generate $1,000 of capital gains subject to an agreement to buy them back immediately after the end of the year for the same price. Preventing this type of transaction can be difficult. It is a matter of judgment how serious an 'abuse' this would be.

Scrip-for-scrip rollover relief

11.46 For the purposes of consultation, it is taken that a scrip-for-scrip takeover refers to a transaction where one company acquires another for an exchange of shares rather than cash or a mixture of shares and cash.

11.47 Where a scrip-for-scrip merger or takeover occurs, the CGT provisions are currently triggered because the taxpayer has disposed of one asset for another, even though there has been no realisation of cash. Countries that allow rollover do so on the basis that the cost base has not changed and the shareholder has a continuing interest in the same assets together with those combined through the merger. If the transaction is wealth generating the tax ultimately collected is greater since the original cost base is retained. It is not unusual for annual turnover of shares of a company on the Australian Stock Exchange to exceed 50 per cent of the number of shares on issue so some of the gains to the revenue accrue relatively early. Of course it is likely that taxpayers with large accrued gains before the takeover would remain reluctant to sell and trigger a significant CGT liability.

11.48 It has been suggested that the CGT provisions are a significant barrier to takeovers based wholly on scrip-for-scrip and the allowance of rollover relief in such circumstances may facilitate the development of a more

efficient business sector in Australia through having a more efficiently functioning domestic capital market.

11.49 Scrip-for-scrip rollover relief is a feature of the tax law in many other taxation jurisdictions, including the United States, Canada and the United Kingdom.

11.50 The Review will consult on the following:

- where scrip-for-scrip is offered in the case of a merger of two separate entities; and
- where scrip-for-scrip is offered in the case of a deconsolidation. (A deconsolidation arises where a corporate group is split into separate entities and the shareholders in the original group receive shares in the entities such that their newly combined interests are identical to their previous interests.)

Why is CGT an impediment to mergers?

11.51 Under Australia's CGT regime tax is deferred until shares are disposed of. In the case of a scrip-for-scrip transaction, shareholders in the target company may become liable to pay tax on a realised capital gain but may not have the cash available to pay it. At the time the takeover or merger is announced shareholders may have capital gains that have accrued over a long period and frequently the takeover or merger will result in further capital gains.

11.52 For shareholders with significant unrealised capital gains before the takeover or merger, the CGT liability that would be triggered by accepting the transaction may be quite significant. In order to make the offer attractive to such shareholders the acquiring company has to increase the price of the shares to the point where those shareholders feel that the gains from the takeover make it worth triggering the CGT liability. As a consequence it is argued that takeover premiums could be significantly lower if a rollover were allowed and so more takeovers would take place.

11.53 A similar argument would apply for a cash-based takeover with the important difference that the shareholders would have realised the cash with which to pay the tax.

11.54 The uneven distribution of unrealised capital gains amongst shareholders in the target company means that a premium sufficient to satisfy those shareholders with large unrealised capital gains will provide a windfall to those with little or no unrealised capital gains.

11.55 Shareholders in the target company may be disadvantaged compared with those in the acquiring company, notwithstanding that both sets of shareholders would be likely to benefit from the merged activities. This

is because it is only the shareholders in the target company that will have to give up their shares and so be subject to CGT. A further distortion is created because some shareholders may not wish to sell (and realise a capital gain) but are required to do so either through fear of being locked into a minority situation or because the compulsory acquisition provisions are invoked.

11.56 In addition to the cash flow argument it is sometimes suggested that shareholders should receive rollover relief in all cases where one investment is replaced by another of equivalent value. Some countries such as the United States and Canada do have provisions that enable an asset to be replaced by a similar asset without triggering a CGT liability. This is an argument that applies to all assets, rather than just to scrip-for-scrip transactions and would be a significant concession compared with current CGT arrangements.

11.57 A recent study by Ernst and Young — *Mergers and Acquisitions Index: Looking Out for Opportunities* (1998) — did not identify CGT as an impediment to mergers and acquisitions. Respondents cited competition legislation, lack of suitable targets and potential for industrial unrest as factors inhibiting takeover activity. Nevertheless, it is possible that as CGT is likely to increase the offer price for takeovers, some takeovers would not have proceeded to the bid stage. There is anecdotal evidence that otherwise economically attractive transactions have not proceeded because of the CGT liability that would have arisen for shareholders not receiving cash. Those making these decisions are not aware of the actual tax position of the various shareholders and will tend to take a conservative position militating against going ahead.

Does CGT influence decisions on takeover bids?

11.65 As noted earlier, the decision by a shareholder on whether to accept a scrip-for-scrip offer will involve a balancing of the immediate and anticipated future gains likely to flow from the takeover or merger against the disadvantage of triggering a CGT liability. The weight to be given to the disadvantage of the CGT liability would depend on the taxpayer's capacity to fund any tax liability and the size of the liability relative to the expected gain from the transaction.

11.58 Where the shareholder's unrealised gains at the time of the takeover or merger are small the CGT liability is not likely to be an important consideration. However, as noted earlier, where the unrealised gains are significant the CGT liability may be a high proportion of, or outweigh, the anticipated benefits from the takeover or merger. For such shareholders the CGT liability could be a significant disincentive.

11.59 The overall weight to be given to the disincentive flowing from the CGT liability will depend on how many shareholders are in each category.

Equity considerations

11.60 The proposal for allowing rollover relief for scrip-for-scrip transactions raises a number of equity issues. Obviously it will address perceived equity issues involved in taxing shareholders on 'unrealised' gains. However, it will provide more favourable treatment to shareholders involved in scrip-for-scrip exchanges compared with those involved in cash transactions. In particular, shareholders who sell in the lead-up to a takeover or merger would not benefit from rollover relief. This can be justified on the grounds that they do not face the same cash flow problems, having realised cash for their shares.

11.61 To the extent that rollover relief would be addressing equity and cash flow concerns associated with taxing 'unrealised' gains there may be scope to confine it to certain classes of shareholders. For example, lower income shareholders would have more difficulty in meeting CGT liabilities on scrip-for-scrip takeovers in the absence of a rollover. On the other hand, major institutions are less likely to be impeded by the bringing forward of CGT liability.

11.62 Targeted relief would imply some compliance and administration costs, but would constrain revenue cost.

What design rules would be relevant?

11.63 The design issues that would need to be considered include the following:

- Any rollover relief could be confined to publicly listed companies. This would avoid tax avoidance and minimisation problems that might arise if the provisions were extended to unlisted companies where the value of shares is less easily determined and because other assets can be shifted into companies for sale in return for shares.
- Whether rollover relief should be given for mergers of non-listed widely held trusts and superannuation funds. In some cases, because the assets are publicly listed shares and the like, and entry and exit prices are determined on a daily basis, valuation issues may not arise. There may be an equity case to provide rollover relief for these funds in strictly defined circumstances.
- A further issue is whether rollover relief would apply to shares in overseas companies. If the rationale is to remove any impediment to more efficient Australian business there may be a case for excluding overseas companies.

Should scrip-for-scrip CGT rollover relief be granted for corporate deconsolidations?

11.64 A corporate deconsolidation does not involve any change in ownership of assets and applying CGT to such transactions would raise the same cash flow concerns as for scrip-for-scrip transactions. There are strong equity grounds for not making a deconsolidation a taxing event and splitting the cost base over the same underlying assets.

Revenue considerations

11.65 The revenue cost of providing scrip-for-scrip rollover relief is contingent upon the assumptions used, including the amount of embedded gains in the shares being exchanged, the levels of future takeover activity and the future realisation patterns of the exchanged shares. Any increase in the efficiency of the Australian business sector would also be reflected in increased revenues.

11.66 As a general proposition, however, implementation of the measure, in whatever form, is likely to impose an up-front cost to the revenue in the first two years or so as tax is deferred. In later years some of that will be clawed back as shares are subsequently sold and will partially offset the costs of allowing rollover for new transactions. The expected efficiency gains from increased takeover and merger activity are also likely to generate extra tax revenue. (The up-front cost may be in the order of $100 million, if the measure were limited to listed public companies.)

11.67 If implementation of the measure did lead to a significant increase in takeover or merger activity and increases in efficiency, the tax revenue from the additional activity could more than offset the cost to revenue. Of course the cost to revenue relates to allowing rollover relief for both those takeovers that would have proceeded anyway plus those that only proceed as a result of rollover relief being allowed.

Targeted concessions for certain types of investment

11.68 As noted earlier it is sometimes argued that certain types of investment, such as venture capital and high technology start-ups tend to be high risk and provide returns predominantly in the form of capital gains. Further they are footloose internationally and so differences in CGT regimes can have a significant influence on their location.

11.69 The Review has been advised that there is an overwhelming consensus among venture capital experts and others involved in high technology start-up companies that Australia's taxation treatment of capital

gains penalises investment and management participation in such companies. This view was recently reinforced by the Wills Review of Health and Medical Research which pointed out that US pension funds are predisposed to invest 'very significant sums' in Australian medical research and industry spin-offs, but will not do so under the current CGT regime.

11.70 Clearly such investments would benefit from generalised CGT relief. However, if it were decided that they did have particular problems there may be a case for implementing a scheme targeted specifically at such investments.

11.71 The advantage of a targeted scheme is that it reduces the direct costs to revenue and does not influence investment decisions across the whole economy. Its impact on investor behaviour is more confined to the targeted area and, if the measure is successful, the impact is positive. Targeting also opens up the possibility of much larger concessions for any given revenue cost.

11.72 The disadvantage is that a targeted scheme sets up boundary lines that need to be complied with and administered by the authorities. The greater the degree of targeting sought the more difficult are these boundary lines.

11.73 Clearly such schemes are not appropriate to address a general deficiency of the CGT regime or a widespread market failure. However, where a particular investment niche can be identified it may be that a targeted scheme delivering a substantial concession to the beneficiaries would be an effective response.

11.74 In considering such proposals the following issues are relevant:

- It is important to be very clear about the objectives of the scheme.
- Mechanisms should be put in place at the time the scheme is adopted to monitor and report back on outcomes compared with the identified objectives.
- The balance between the degree of targeting, the cost to revenue, and the administrative and compliance costs need to be carefully considered. Investors may not be attracted by even quite substantial tax relief if the compliance costs are too onerous.

CGT provisions for small business

Current arrangements

11.75 Several concessions operate under the CGT provisions to assist small business.

- Taxpayers operating a small business with net assets of $5 million or less are eligible for CGT rollover relief where the taxpayer disposes of some or all of their business and reinvests the proceeds.
- There is also a CGT exemption on a capital gain arising from the disposal of an active asset of the business where the proceeds are used for retirement.
- Taxpayers operating a business with net assets of $2.2 million or less are eligible for a 50 per cent exemption for the goodwill component of a capital gain that accrues to a taxpayer on the disposal of a business. CGT payable on the residual can be rolled over.

11.76 The CGT rollover relief, the CGT retirement exemption provisions and the CGT goodwill exemption have the same underlying objectives — that is, to provide small business people with access to funds for retirement or expansion. The provisions were enacted on the basis that they would go towards correcting the following concerns.

- A favourable taxation bias in favour of wage and salary earners who provide for their retirement through tax-preferred superannuation arrangements.
- Unfavourable access to commercial loans. Provision of CGT relief is to facilitate small business expansion and through it job creation.

11.77 The CGT relief and retirement exemption measures have only recently been introduced and sufficient data are unlikely to be available to estimate their impact. It may therefore be too early to determine whether the measures are the most effective means of achieving the objectives of job creation in the small business sector, and retirement income for small business people.

11.78 Nevertheless, these provisions are complicated and there would appear to be scope to merge and simplify them to make them operate more efficiently. For example, rollover provisions are necessarily complex to prevent tax avoidance through taxpayers rolling gains into goodwill and then using the goodwill exemption. Moreover, the goodwill exemption has been

litigious and difficult to administer because the precise meaning and valuation of 'goodwill' are elusive.

Replace the goodwill exemption with a generalised exemption

11.79 A possible reform model would be to substitute the goodwill exemption with a generalised exemption of, say, 20 per cent of all capital gains arising on disposal of active assets of the small business, defined as those with net assets of less than $5 million. Such an approach would not otherwise disturb the existing design rules for the rollover relief and retirement exemption.