Chapter 29

TOWARDS A SYSTEMIC SOLUTION TO CGT VALUE SHIFTING

outside consolidation

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A case for reform

Definition of CGT value shifting?

29.1 Capital gains tax (CGT) value shifting arrangements cause shifts in the value of assets, often to other assets. Assets include tangible and intangible assets held by entities as well as interests in entities themselves (for example, shares in companies or interests in trusts).

29.2 Value shifting is a problem if it distorts the calculation of capital gains and capital losses when assets are sold, scrapped or otherwise come to an end. Without specific rules, tax liability may be inappropriately deferred or avoided on 'decreased value' assets. Correspondingly, tax liability may be inappropriately imposed on 'increased value' assets.

What are the types of CGT value shifting?

29.3 There are two generic types of CGT value shifting: at a direct (asset) level and at an indirect (interest in entity) level.

Direct (asset) level

29.4 Value shifting at an asset level is where the value of an asset — which can include an interest in an entity — is directly altered otherwise than by a change in entity value. Examples include share value shifting caused by a change in share rights, or an alteration in the rights attaching to trust interests.

29.5 Without special rules, value shifted from post-CGT to pre-CGT assets may lead to an unwarranted reduction in tax because the sale of the increased value pre-CGT assets would not normally produce a taxable gain.

29.6 If value is shifted between post-CGT assets, without special rules, artificial capital losses or reduced capital gains may result from the sale of the decreased value assets. Artificial capital gains or reduced capital losses may unfairly result from the sale of the increased value assets. Even if these gains and losses even-out in amount, there may be timing advantages or disadvantages under the realisation-based CGT rules.

29.7 Value shifting at the direct (asset) level may occur even if the parties involved deal at market value — for example, on arm's-length terms.
An example of such direct (asset) value shifting is where the rights attaching to particular assets (for example, shares) are varied, thus shifting value between them.

29.8 Another example is where rights are created at market value over an asset which cause that asset to decrease in value. For example, a licence may be granted over property which causes the property to fall in value. If the original property is then sold, an artificial capital loss or reduced capital gain may result. The current law does not accommodate well the changing values of assets and associated rights over them (see Chapter 10).

Indirect (interest in entity) level

29.9 Value shifting out of, or between, entities can impact on the value of interests held directly (or indirectly) in those entities. 'Interests' for these purposes include equity interests (shares and other equity interests in companies, and units and other interests in trusts) and debt interests. 'Interests' include direct and indirect interests in entities.

29.10 Value can be shifted out of or into an entity because the value of individual CGT assets held by the entity is directly altered (as discussed above) or because there is an unequal exchange of assets between entities. An example of the latter case is the transfer of an asset between entities in return for more or less than the market value of the asset.

29.11 Value shifting at the interest in entity level will not arise where parties have dealt at market value. Where that occurs, entity values are unchanged by the shifting of assets.

Deficiencies and limitations with the current law?

29.12 Existing responses to CGT value shifting have focused on the tax avoidance effect of particular value shifting transactions rather than on value shifting as a structural CGT problem requiring a systemic solution.

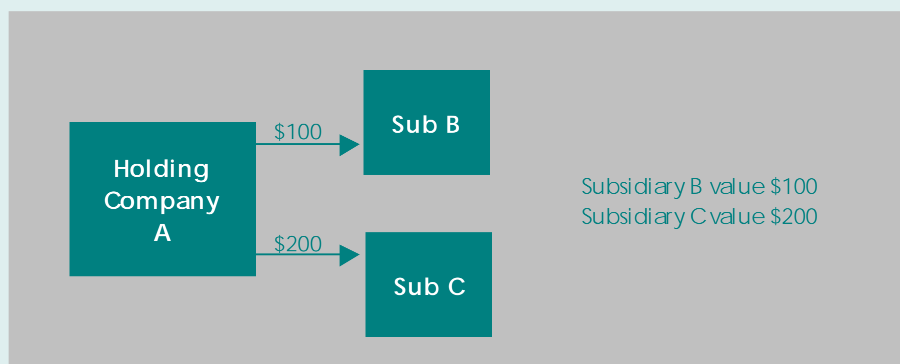
29.13 Thus, there are measures for 'share value shifting' (see Appendix A to this chapter, Example A.1) and 'asset stripping' involving 100 per cent owned companies (see Appendix A to this chapter, Example A.2). Asset stripping deals with the value shifting impact on interests (for example, shares) in such companies if assets are transferred between, or created in, them for less than specified amounts, one of which is market value. The measures have been developed in an ad hoc fashion.

29.14 The existing CGT value shifting rules are extremely complex and neither comprehensive nor robust in their operation. For example:

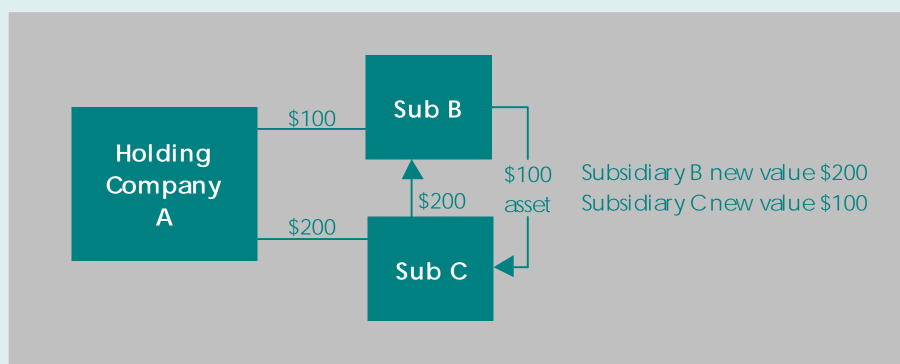
- Specific value shifting measures apply to companies (and interests in companies) but not to trusts (or interests in trusts).

Example 29.1: Example of value shifting between wholly owned group companies (unequal exchange of values)

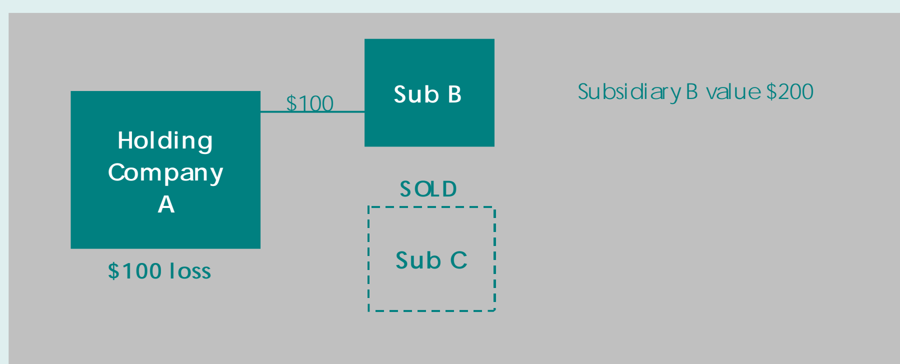
Holding company A subscribes for shares in subsidiary B for $100 and in subsidiary C for $200.



Subsidiary B buys an asset for $100 and immediately transfers this asset to subsidiary C for $200; that is, at overvalue. The transfer is tax free because of the grouping rollover provisions.



Subsidiary C is then sold for $100, leading to a capital loss. Even though subsidiary B now has a $100 unrealised capital gain, the capital loss provides a timing advantage.



Other examples illustrating value shifting at an indirect (interest in entity) level are included in Appendix A to this chapter.

- Asset stripping rules are limited to 100 per cent owned companies and do not apply if assets are transferred or created by companies for *more* than market value. As noted above, transfers or creations at less than market value are addressed. The impact of asset stripping involving controlled but less than 100 per cent owned companies is also not addressed.
- Transactions which effectively strip asset value, but do so otherwise than by asset transfer or creation, are not addressed by the current asset stripping rules (see Appendix A, Example A.1).
- Value shifting out of existing assets by creating valuable rights over those assets is not specifically addressed by existing rules.
- The share value shifting provisions may apply harshly to deem a capital gain for a shareholder even though the value of his or her overall interest in the company is unchanged as a result of a value shifting arrangement.

29.15 The existing rules suffer from the technical, structural and compliance complexity referred to in *A Strong Foundation*.

29.16 If grouping concessions were removed with the introduction of a consolidation regime, it is likely that value shifting rules outside consolidation would have less application, especially at the interest in entity level. For example, because non-consolidated 100 per cent owned entities would trigger a capital gain based on market value if they transfer a gain asset at undervalue, such transfers would be less likely. But other forms of value shifting are likely to occur where the benefit of the value shifted remains under the effective control of the transferor.

29.17 Moreover, whether or not consolidation measures are implemented, CGT value shifting measures will be needed to deal with the shifting of value between assets or entities.

A strategy for reform

Pursue a structural solution

29.18 CGT value shifting is a structural problem that requires a structural solution to promote the integrity of capital gains taxation. A comprehensive and generalised CGT value shifting regime replacing existing *ad hoc* share value shifting and asset stripping measures could provide that structural solution.

29.19 A single set of generally applicable principles would allow for more consistent treatment of CGT value shifting. Standardised rules would remove

inconsistencies and anomalies existing under the current law. This would assist in meeting the objectives, set out in *A Strong Foundation*, of growth (fewer distortions and lower compliance costs), equity and simplification.

29.20 Standardised measures could be accompanied by a limited number of specific rules and exceptions. In certain cases, special treatment may also be warranted to minimise compliance costs, but such treatment would have to be consistent with achieving the overall integrity aims of a value shifting regime.

Policy framework

Key objectives

29.21 Arrangements which shift the value of assets, including interests in entities, should not distort the operation of ordinary CGT rules for calculating gains and losses. Adjustments will be designed to neutralise the effect of value shifting.

29.22 As a structural reform, value shifting measures should not be limited to cases where there is a tax avoidance purpose or motive. The measures should address any actual shift in value. This would ensure that the overall integrity of the CGT measures is maintained and that capital gains and capital losses are appropriately calculated following value shifts.

29.23 The conceptual objective for value shifting measures is to treat the transfer of value from one asset to another as if the transfer had not occurred, but without a taxing point.

Design features

29.24 Value shifting measures would address the impact of value shifting at the direct (asset) level (including an entity interest) where the asset is the direct focus of the shifting in value and at the indirect (interest in entity) level where entity values are changed.

29.25 Value shifting provisions would need to be interrelated with other related provisions, such as those dealing with debt forgiveness, bonus plan issues, ordinary realisation rules, generic gain and loss duplication rules and the possible generalised asset regime discussed in the Overview.

Who should be the subject of generalised CGT value shifting rules?

29.26 Generalised value shifting rules would apply broadly across entities, and across holders of interests in entities, where a threshold level of connection was established between parties affected by a value shifting arrangement or transaction. The appropriate level of connection is an issue for consultation. Entities that control (or are controlled by) other entities and their associates (an 'associate inclusive' control test) would provide a consistent and robust basis for the application of generalised value shifting measures. If control does not exist, incentives and opportunities to shift value are likely to be considerably less than where control does exist.

29.27 In relation to a possible associate-inclusive control test and the scope of application of the measures, comments are sought by the Review on all issues including the formulation of a control test and the appropriateness (or otherwise) of excluding non-associated minority interests where value is shifted to or from them but minorities have participated in, and consented to, value shifting arrangements.

International context

29.28 The rules would apply to non-resident entities to the extent that the assets (including entity interests) affected by the value shifting are subject to tax in Australia. Value shifting rules would, appropriately modified, also apply to non-resident entities such as controlled foreign companies (CFCs).

How could value shifting be addressed at the direct (asset) level?

No immediate capital gain

29.29 A movement of value between post-CGT assets held by the same person should not trigger a capital gain or capital loss at that time. As recognised by the current share value shifting rules, the person has not effectively realised value or transferred value to another. It is sufficient to ensure that the movement in value is reflected in any capital gain or capital loss calculated at the time of a later realisation of the assets.

Possible immediate capital gain

29.30 Different considerations arise if value is shifted between persons, or from post-CGT to pre-CGT assets of the same person. In the first case, the value shift has a similar economic effect to a change in ownership (or part realisation) of the asset. In the second case, the shift in post-CGT asset value

to a pre-CGT asset may result in the avoidance of tax. For these reasons, the conceptual objective for value shifting measures — that is, to treat the transfer of value from one asset to another as if the transfer had not occurred, but without a taxing point — is modified.

29.31 In these cases, under the current share value shifting rules, a capital gain is deemed to have been realised by the person whose share has declined in value. The gain is set equal to the value shifted less an appropriate proportion of the cost base of the decreased value share. This methodology could form the basis of measures to address all *direct* (asset) level value shifting.

29.32 A measure will also be needed to address the way a capital gain or loss is calculated on the later realisation of decreased and increased value assets. This measure will be needed in situations where an immediate gain, or no immediate gain, may arise. A cost base adjustment measure is likely to be suitable because of the record keeping and familiarity issues discussed later in this chapter. As is the case with the current share value shifting rules, the type of adjustment required would vary depending on whether a gain can be immediately recognised or not.

Shifts from pre-CGT to post-CGT assets

29.33 The current share value shifting rules also make no adjustment for the impact of value shifted from a pre-CGT to a post-CGT asset. In such a case a capital gain which is too high, or a capital loss which is too low, may inappropriately arise on the realisation of the increased value asset. It can be argued that the new regime should recognise and adjust for this.

Immediate capital loss

29.34 While the current law may deem a capital gain to arise if value is shifted between assets of different taxpayers, or from a post-CGT to pre-CGT asset of the same taxpayer, it does not allow a capital loss to be realised by the holder of the asset whose value has decreased. There is a question whether such treatment should continue.

29.35 Normal adjustments would prevent any capital loss being created by the value shift itself. For example, assume that person A (a controller of a company) held 'A' class shares in the company which cost $100 and had a market value of $100. Person B (an associate of A) held 'B' class shares also with a cost of $100 and market value of $100. If share rights were varied so that the value of the 'A' class shares decreased by $50 and the value of 'B' class shares increased by $50, no gain or loss would be deemed to arise on the 'A' class shares. The $50 of value shifted less $50 (50 percent of $100 cost base) would result in no gain or loss made. The cost base of the 'A' class shares would be reduced to $50 (equal to their post-shift value) and the cost base of the 'B' class shares increased to $150 (also equal to their post-shift value).

29.36 There remains the question of what the treatment should be if the 'A' class shares had a cost of $200 and a market value of $100 before value was shifted. That is, should A be able to realise a capital loss of $50 by arranging to shift $100 of value to B, or should A's loss remain unrealised until A actually disposes of the decreased value shares?

Symmetry for gains and losses

29.37 In favour of allowing the loss at the time of the shift in value is symmetrical treatment that would be achieved with that suggested for value shifts out of 'gain' assets. Against allowing the loss is the opportunity that would be provided for losses to be realised while at the same time retaining both the decreased value asset and effective control over the shifted value. Any gain on the increased value asset would not be taxed until the asset was sold, but the loss on the decreased value asset would be available immediately.

Value shifting by creation of rights

29.38 Special value shifting adjustments may also be needed where rights such as leases, licences and similar rights are created out of existing assets and move value out of those assets. Such adjustments would need to take account of how the creation of the right was dealt with (see Chapter 10). Value shifting adjustments may be necessary even if full value was paid for the created rights, to take account of the impact on the original asset.

How should value shifting be addressed at the indirect (interest in entity) level?

29.39 Ordinary CGT rules will often deal with aspects of a shift in value at the entity level — for example, a transfer of an asset at 'under' or 'over' value may trigger a market value substitution rule. But, as illustrated in Example 29.1, the value shift has flow-on effects at the interest in entity level which are not addressed by such substitution rules. Tax consequences at the entity level may be effectively undone at the interest in entity level if these flow-on effects are not neutralised.

29.40 These flow-on effects could be satisfactorily neutralised at the interest in entity level but without any capital gain or capital loss being deemed to arise at the time of the shift. Options for neutralising the shift are presented below.

Design of interest in entity adjustments

29.41 Three options are presented for implementing entity interest adjustments: one option based on the conceptual value shifting objective, and

two options likely to produce a lower level of integrity benefit than required by the conceptual objective, but with better targeting to offset risk to revenue and/or potentially less compliance cost.

Option 1: Achieve conceptual objective

29.42 The conceptual objective is achieved at the interest in entity level if the overall CGT result on realisation of the interest is as if the value shift had not occurred.

Option 2: Proportional adjustment approach

29.43 A proportional adjustment approach could effectively transfer capital gain amounts in line with the proportion of value shifted and prevent the creation of capital losses.

Option 3: Loss-focused approach

29.44 A narrower loss-focused approach could simply deny losses, attributable to value shifting, on the realisation of decreased value interests, and adjust gains on increased value interests by the amount of losses denied.

29.45 Appendix B to this chapter illustrates how these approaches might work in practice for indirect interests.

29.46 All three approaches would be fully effective in preventing the creation of capital losses from value shifting, but only an approach meeting the conceptual objective can prevent the transfer of unrealised gain between entity interests. However, if gain asset rollover were not to be available for entities outside a consolidated group, the prospect of tax at the entity level may discourage such transfers, avoiding flow-on effects at the interest in entity level.

Mechanics of interest in entity adjustments

29.47 The following are some options for making mechanical adjustments where there has been a value shift:

- the capital proceeds at the time of a later realisation can be increased or decreased having regard to the value shifted from or to the interest;
- the amount of capital gain or loss on ultimate realisation can be adjusted to take account of the value shift; and
- the cost base of the interest can be adjusted to take account of the value shift.

29.48 Any of the three methods could be used with the proportional and loss-focused approaches. A cost base adjustment approach cannot achieve the

conceptual objective because cost bases cannot be reduced below zero. If value shifted from an interest exceeds the difference between its pre-shift value and its cost base, a cost base adjustment will not capture the excess.

29.49 Although adjusting capital proceeds or ultimate gains or losses has the advantage that the full effect of the value shift can be captured at the time of ultimate realisation, adjustments cannot be made until that time (although the need for them and the amount required can be separately recorded). These approaches therefore have compliance and administration problems, especially if the final realisation occurs a considerable time after the value shift.

29.50 Cost base adjustments at the time of the value shift may provide a better outcome from a compliance and administration perspective, although, as noted, they cannot neutralise the full impact of 'capital gain' shifting at an interest in entity level. The advantages of cost base adjustments are:

- they can be done contemporaneously with the value shift and are an observable response by the affected parties in a self-assessment environment;
- they remove complications where other things happen (for example, other value shifts) prior to final realisation; and
- people have acquired some familiarity with the approach under the existing law, even though the amount of adjustments required can sometimes raise difficult practical questions.

Other issues for indirect (interest in entity) adjustments

29.51 Following are some additional practical issues, for consideration and consultation, of a generalised value shifting regime for indirect (interest in entity) adjustments:

- Dealing at market value with assets of entities would ensure that the generalised value shifting regime at the interest in entity level is not triggered. An arm's-length deal would be presumed to take place at market value, but all aspects of the particular transaction must occur on an arm's-length basis. Ensuring that the proposed value shifting rules are not triggered, however, is likely to require a greater benchmarking against comparable arm's-length dealings and market valuations than is the case under the existing law.
- Transfers of value down tiers of entities would not require adjustment.
- For minority interests, no downward or upward cost base adjustments would generally be required. Such impacts could be regarded as windfalls arising outside the level of control required by the value shifting regime.

- There would be a list of exceptions to the operation of the rules. For example, a distribution of profits (whether in cash or in-kind) which does not affect the relative values of entity interests would not normally attract cost base adjustments. The provision of intra-group services by entities at full cost, where there is no market benchmark for the service, may also not trigger a value shifting adjustment. The full list of exceptions is for consultation and would be expected to include 'safeharbour rules' (discussed below).

Balancing integrity and compliance costs

29.52 Value shifting rules, whether for direct (asset) level or indirect (interest in entity) level cases, must balance integrity considerations with practical issues in relation to materiality and the need to contain compliance and administration costs.

29.53 Compliance and administration cost concerns will be addressed by providing workable operational guidelines and 'safeharbours'. A safeharbour describes a rule which, if observed by a taxpayer, will not lead to further enquiry being made. For example, the transfer of certain depreciable assets at written down value can be assumed not to involve a shift in value for the purposes of indirect (interest in entity) level value shifting measures. Safeharbour rules should not, however, compromise the integrity aspects of value shifting measures.

29.54 A *de minimis* exception applying to value shifting at the direct (asset) level and indirect (interest in entity) level may also be appropriate to better target the measures where there is likely to be a significant impact on revenue and to minimise compliance and administration costs. A possibility would be a threshold based on an absolute amount and a proportion of value shifted. An anti-avoidance rule would be required to ensure that a series of related value shifts individually below the threshold do not qualify.

Possible generalised value shifting model

29.55 Table 29.1 summarises a possible generalised value shifting model. The table compares the operation of the current law dealing with value shifting (that is, share value shifting and asset stripping) with the possible generalised model. The model is a matter for consultation.

Table 29.1: Possible generalised value shifting model — summary

Current regime		New regime
Share value shifting	**Asset stripping**	**Possible generalised model**
Entities impacted		
All shareholders	Companies	All entities and their associates (including individuals) within a control framework.
Threshold		
Control	100% owned (group and common-ownership)	Control
Transactions or events impacted		
Share value shifts	Transfers and creations of CGT assets at undervalue.	Arrangements which shift the market value of assets and entities.
CGT Event (possible capital gain)		
Capital gain may be deemed for value shifts between different person shareholders and from post-CGT to pre-CGT shares. No capital loss is deemed. There is proportionate cost base allocation.	No	Could be developed for direct (asset) level value shifting (including direct share or trust interest value shifting). Would not be developed for indirect (interest in entity) level value shifting attributable to the change in value of entities.
Cost base realignment?		
Yes. Generally, between decreased and increased value shares. If gain is assessed, cost bases are uplifted to prevent double taxation.	Yes. In relation to share and debt interests (direct and indirect) in the transferor or creator and the transferee or recipient.	Direct (asset) level value shifting. Yes. Indirect (interest in entity) level value shifting. Cost base realignment is one option.
Mechanics of adjustment		
Based on proportion of value shifted.	Generally, reductions and uplifts based on differential between consideration received and asset cost base. Variations where asset cost base not broadly equivalent to cost base of interest.	Direct (asset) level value shifting. Cost base adjustment having regard to proportion of value shifted. Indirect (interest in entity) level value shifting. Cost base adjustment is an option.
Market value benchmark (that is, dealings not at market value attract measure)		
Yes	No, for transfers of post-common ownership assets. Yes, for most created assets (except for leases and options) and transfers of pre-common-ownership assets.	Yes, but operational issues are to be determined, that is, making the benchmark work with due regard to minimising compliance costs.

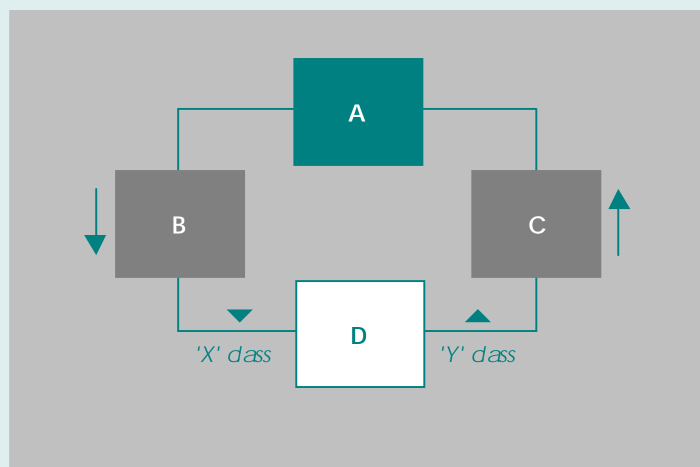
Table 29.1: Possible generalised value shifting model — summary (cont)

Current regime		New regime
Share value shifting	**Asset stripping**	**Possible generalised model**
Exceptions		
To extent other provisions apply (for example, bonus share, share buy-back provisions). Cost base realignment (that is, no deemed gain) for neutral shifts across all shareholders (for example, a fresh equity issue at undervalue to all shareholders).	Transfers/creations of assets down the chain. Special rules for depreciable and grouped assets. Most liquidation distributions	Value shifting out of shares or interests in trusts. Cost base realignment only for neutral shifts across all or some share or interest holders. Indirect (interest in entity) level value shifting. Some possibilities are: ▪ capital distributions; ▪ profit distributions, unless they shift relative value between entity interests; ▪ value transfers down a chain of entities; and ▪ where 'safeharbour' criteria are satisfied.
De minimis?		
Yes	No	Yes

Appendix A

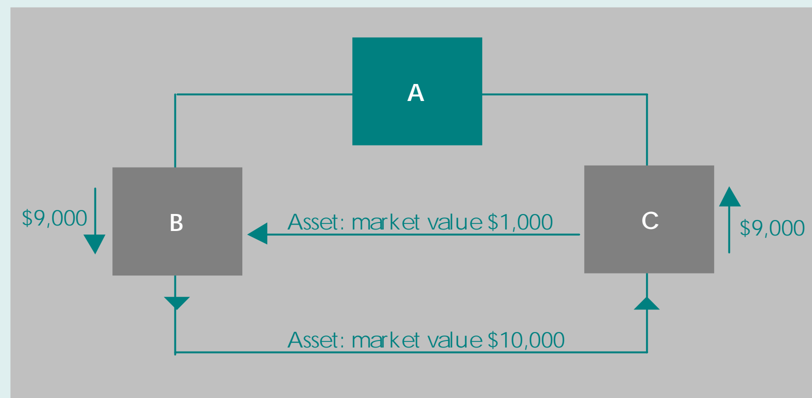
Additional examples illustrating value shifting at the indirect (interest in entity) level

Example A.1: Value shifted out of an entity because the value of assets held by the entity is directly altered



A, B, C and D are a 100 per cent owned group with A the parent. B holds 'X' class shares in D, and C holds 'Y' class shares in D. A's shares in B and in C are of a single class. The share rights between the X class and the Y class are varied with the result that the X class shares fall in value and the Y class shares rise in value by a corresponding amount. This value shift also has an impact on A's shares in B (which fall in value) and A's shares in C (which increase in value). This has arisen because the value of assets held by B and C (that is, their shares in D) have been directly altered. The current law deals with the value shift for B and C, but does not deal with the value shift which occurs for A's shares in B or A's shares in C because a variation in share rights is not a transfer or creation of property or other asset.

Example A.2: Value shifted out of an entity because of an exchange of assets at other than market value



B and C are sister subsidiaries with a common parent A. B and C exchange assets with different market values. In this case the property exchanged retain their individual values (contrast example A.1 above where the value of the shares in D themselves change), but there is nevertheless an impact on the value of A's shares in B and in C.

Appendix **B**

Indirect (interest in entity) adjustments

Example B.1: Three options for indirect (interest in entity) adjustments

Assume a single interest in an entity had a cost of $100, a pre-shift market value of $250, and that $75 value is shifted from the entity to another entity so that $75 value is likewise shifted from the interest in the first entity to a single interest in the second entity. It is assumed below that no further changes in value occur prior to any realisation of the interests and the effect of indexation (if any) is ignored.

The **conceptual objective** would require that on realisation of the decreased value interest any capital gain would be increased by $75 with a similar adjustment (decreasing gain and increasing loss) for the increased value interest.

A **proportional** approach would adjust by $30 — ($75 ÷ $250) x $100 — the results that would otherwise arise on realisation of the interests after the value shift — i.e. $75 + $30 = $105 gain on the decreased value interest and $75 – $30 = $45 gain (or reduced loss) on the increased value interest. In this way the unrealised gain of $150 is shared between the interests based on the proportion of value shifted (30%) from the decreased value interest and its pre-value shift ratio of cost to market value (40%, i.e. $100/$250).

A **loss-focused** approach would not adjust the normal result on realisation because the value shift of $75 does not create a capital loss on the decreased value interest. Half ($75) of the $150 unrealised gain on the decreased value interest would effectively be transferred to the increased value interest.

Assume now that $200 value, rather than $75 value, were shifted:

The **conceptual objective** would make a $200 adjustment, preventing creation of a loss in respect of the decreased value interest and preserve in full its $100 gain. The $200 adjustment in respect of the increased value interest would fully eliminate the effect of the value shift on realisation of this interest.

continued

Example B.1: Three options for indirect (interest in entity) adjustments (cont)

A **proportional** approach would adjust by $80 the outcomes that would otherwise arise on realisation of the interests. This would prevent loss and preserve some gain on the decreased value interest ($100 cost less decreased value $50 plus $80 = $30 gain) and relieve $120 of the $200 gain (or reduced loss) that would otherwise arise, because of the value shift, on realisation of the increased value interest.

A **loss-focused** approach would merely prevent loss on the decreased value interest (i.e. adjust by $50 to eliminate a $50 ($100 cost less $50) post-shift value loss), and adjust only $50 of a $200 gain (or reduced loss) on realisation of the increased value interest. The $150 unrealised gain on the decreased value interest is effectively transferred to the increased value interest.