

Extend Scrip for Scrip CGT Rollover relief to Non-Public Entities

Your discussion paper proposes CGT rollover relief in the case of takeovers of public companies and the demerger of public companies. I strongly support this proposal, but would urge you to extend the relief to non-public entities as well.

Speaking from experience in the software sectors in both USA and Australia, the lack of scrip for scrip rollover relief puts Australia at a major competitive disadvantage. That is for both public and non-public entities, but the problem is even more acute for non-public entities because there is no liquid asset to pay the CGT bill with.

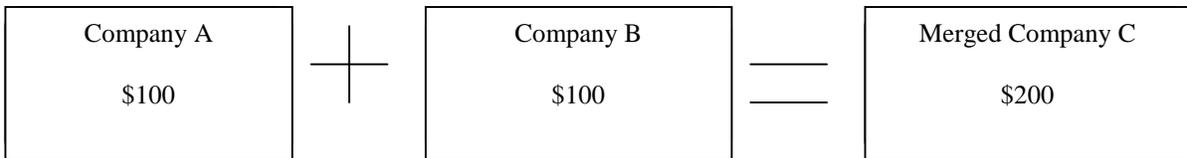
Case Study - Australia Vs USA

Lets compare the situation facing two software companies who are looking to merge their operations. They may be seeking to merge to improve distribution, gain critical mass, gain the synergies of complimentary products, etc.

Like most software companies, these were started by the founders from scratch, the nature of software being what it is there is no CGT cost base. Normally the companies would be short of capital, may have issued equity or options to staff and others who have helped progress the founder's dream, may have issued equity to family, friends, or other business angels for capital injections, etc.

The value of each company is \$100 and that value is almost entirely intangibles. There is very little cash in the companies.

USA Situation



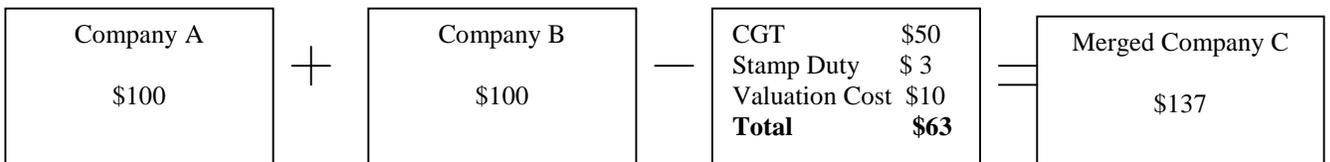
In the USA, if at least 80% of the consideration is in shares of the acquiring company, then it is called a "tax free consolidation". So in this case there would be no CGT payable and the two companies now have a combined \$200 worth of value.

Note: This does not mean that CGT will never be paid, but simply it will not have to be paid until the shares issued as a result of this merger shares are sold.

Plus it encourages investors to maintain their investment in the merged company contributing to the availability of early stage capital.

Further from a practical point of view, through the 80% threshold, the USA recognize to make the merger work you may need to allow some smaller investors to exit. Of course those exiting shareholders that receive cash now pay CGT now.

Australian Situation



Consider the same set of facts in Australia. The situation is very different. One set of shareholders are going to have to pay CGT (\$50) depending on which company acquires which. Plus because the shares are not publicly traded, the shares are going to have to be valued, which will involve expensive valuation fees (say \$10). The smaller the companies the greater the percentage of these transaction costs. Plus Australian States charge Stamp Duty (say \$3), something unheard of in the USA. The two combined companies now have a value of only \$137 (compared to \$200 in the USA)

But wait it gets worse. Remember there is a great shortage of startup capital in Australia and not surprisingly these software companies do not have any liquid assets, the value of their companies lies in intangible assets against which banks will not lend.

So as a result of the merger \$63 cash will have to be paid out of the merged entity or by their shareholders. That is right, a cash starved group in which no shareholder has taken any cash out of the deal is \$63 worse off. If they do the deal before they realize the CGT implications, the tax bill will probably bankrupt the company. If they realize the CGT implications first, they will not do the deal.

In short, instead of waiting for the risk takers (shareholders) to cash out, the government is jumping in and depriving the group of the capital it needs to grow at a crucial stage in their development.

Why is the comparison between the USA and Australia important

Software companies are generally born global. The Australian market will only ever be a very small part of the total market for their product and generally will not be large enough to sustain a viable company in the long term. So right from day one, these software companies design and build products targeted primarily at international markets, right from day one they compete at home and abroad against international companies.

The comparison with the USA is important because the USA is both the largest market for software and the home of most of our software competitors. As a general rule, our software companies are not competing with a company down the street, or in another part of the state, or in another state of Australia. Usually their competitors are based in the USA.

Growth by merger to gain critical mass, or a more complete product, or more effective distribution channel is a key strategy for growing a successful software company. Our USA competitors gain the full value (\$200) from a merger. In Australia, we are barely better off (\$137) then where we started and on a cash flow basis probably a lot worse off.

Do not limit the rollover relief to Australian companies only

As explained above, we are competing in a global marketplace. The company you wish to merge with may not be Australian based, it could well be based in the USA. So it is important that this rollover relief apply to international transactions as well. The Australian shareholders will still have to pay CGT when they sell their shares in the merged entity anyway.

Public & Private company mergers

The merger may not just be between two public companies or two private companies, often it will be between a private company and a public company, so it is important rollover relief is allowed in these situations as well. Let me give you a couple of examples to show why.

In the software business, people are a key asset. So when you acquire a business you want to keep those people focused on the main game, growing the business and increasing shareholder value. You do this by not letting these people cash out. You do not pay cash for their shares, you pay them in shares in your company and do not let them sell their shares for 2 to 5 years.

Just because a company is a public company does not mean there is a highly liquid market for the shares, nor does it mean that the share price is very stable.

Let me give you a very common example.

You run (and own a significant share of) an Australian software company and you decided that the best strategy to grow your company is to merge with a USA public company. This would give you better access to distribution channels in the USA and much better access to capital to grow your business. What is more you have agreement from a public USA company.

Since the USA company is the public company, the logical way to do the deal is for the USA company to acquire the shares in your company. You started your software company from scratch and have no CGT cost base. Your company's main assets are intangible. Your company has never made a profit so there is no cash available and you have not accumulated any substantial wealth outside of your software company which you have spent every waking minute building.

Scenario 1

The USA Company agrees to do the deal by issuing you \$5 million worth of shares based on their current market price. Since they view you a key asset they restrict the shares issued to you so you can only sell them after 2 years. Being a high tech startup, the stock market value of the USA company's shares is volatile to say the least.

Do you do the deal?

You cannot afford to because under Australia's current laws you would have to pay \$2.5million in Capital Gains Tax today and nobody will lend that to you against the shares in a high tech startup even if it is publicly listed. If you could borrow against it, you may decide it is too risky because who knows what the share price will be in two years when you can sell.

Scenario 2

The same as Scenario 1 except you manage to convince them not to restrict when you can sell your shares (highly unlikely that they would agree), but as with many publicly listed high tech startups in the USA, the market for their stock is not very liquid.

Do you do the Deal?

If you do you run a very high risk of being bankrupted by the Australian Taxation Office for being unable to pay your \$2.5million CGT tax liability. Here's why. The share price is highly volatile to start with. Plus you are a forced seller. You must sell enough shares to realize \$2.5 million cash by the time you have to pay your CGT bill.

It becomes a nasty cycle, as you start to sell the price starts to drop. So you have to sell a greater number of shares, which drives the share price down further. You end up selling all your shares for the Grand Sum of \$1million.

Pretty good for a company you started yourself a few years ago.

But in Australia, you are a bankrupt failure. You see you have to pay you CGT tax bill of \$2.5 million. You only realized \$1 million cash in the end which is not enough to pay the CGT bill. You explain that to the tax office who tell you that because the shares were worth \$5 million when they were issued to you and you only realized \$1 million in cash from them, you have a \$4million CGT loss you can carry forward to set off against future gains.

But that doesn't change the fact that you owe \$2.5 million CGT of which you can only pay \$1 million. Sorry your bankrupt.

Another Australian High Tech Failure – bankrupt instead of a millionaire thanks to our CGT system.

Effect on Revenue from changes to rectify these problems

For obvious reasons, on the whole these deals are not happening in Australia at the moment because of the way our CGT works. So there is no revenue to be lost. In the long term, you would hope CGT revenue would grow as these changes allow more valuable software businesses to grow in Australia.

What about other government programs

The amazing thing about this problem is that it runs counter to the objectives of a number of other government programs. For example, for many years the government ran a business networks program encouraging companies to work together – the very thing many Australian software companies need to do. But the current CGT regime ensured that would never happen to the extent it should.

The government has recently launched an “Innovative Investment Fund” scheme to encourage the provision of early stage capital for high tech startups. But the current CGT regime is actively draining those high tech startups of capital.

What needs to change

- Scrip for Scrip rollover relief for mergers/acquisitions between:
 - Two or more public companies
 - Two or more private companies
 - Public & Private companiesEven if one or more of those companies are foreign companies.
- Allow the carry back of CGT losses as well as the carry forward.

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