



# Are recent legislative amendments following McNeil's case right for the job?

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- Recent amendments to tax law may prevent the value of rights in the nature of call options from being included in assessable income
- Not clear why amendments apply to call options but not put options
- McNeil judgment still relevant to some rights issues

In relation to rights issued on or after 1 July 2001 to acquire shares in a company or units in a unit trust, recent amendments to the *Income Tax Assessment Act 1997* (ITAA 1997) following the decision in *Commissioner of Taxation v McNeil* (2007) 229 CLR 656 (*McNeil*) may now prevent the value of such rights from being included in assessable income as ordinary income.

The ITAA 1997 has been amended by *Tax Laws Amendment (2008 Measures No 3) Act 2008*, to ensure that:

- no amount is included in the assessable income of a shareholder in a company or a unitholder in a unit trust as a result of acquiring certain rights issued by the company to acquire further shares or by the trustee of the unit trust to acquire further units<sup>1</sup> and
- an amount that is included in the assessable income of a shareholder as a result of acquiring rights issued by the company to dispose of shares, is appropriately reflected in the cost base of the rights.<sup>2</sup>

This article examines the practical impact of the legislative amendments and their impact on and interaction with *McNeil*.

## Background to the legislative amendments

Any discussion of the recent amendments must begin with an understanding of the High Court's decision in *McNeil*.

St George Bank Ltd ('SGL') used a mechanism of listed 'sellback rights' (a form of put option) (rights) to affect a reduction of its capital. The mechanism adopted to implement the buyback was complicated. Rights were issued by way of deed polls to the trustee of a trust in which the shareholders had an interest.<sup>3</sup> The shareholders had the option of electing to have the rights transferred to them, in which case the rights could have been sold on market or exercised. The rights were listed, which meant that shareholders could have purchase additional rights in addition to their allotted rights. If a shareholder did nothing (as was the case for Mrs McNeil), the trustee would deal with the rights on the shareholders' behalf and distribute an amount (which in Mrs Neil's case was \$576.64) to the shareholder. Of the \$576.64 distributed to Mrs McNeil, \$62.64 represented the increase in the realisable value of the rights since their issue date. The balance of \$514 represented the market value of the rights as at their date of issue. The Commissioner sought to include the \$514 in Mrs McNeil's assessable income, either as ordinary income or as a capital gain.

On 22 February 2007 the High Court allowed the Commissioner's appeal from the Full Federal Court that the value of the rights was assessable as ordinary income.<sup>4</sup> In coming to their decision that the sellback rights were income in Mrs McNeil's hands, the majority (Gummow A-CJ, Hayne, Heydon and Crennan JJ) relied on two key principles that determine the character of income.

The first principle is that whether a particular receipt has the character of income depends upon its quality in the hands of the recipient, not the

character of the expenditure by the other party.<sup>5</sup> In other words, it did not matter in this case that the sellback rights held for Mrs McNeil arose out of the decision by SGL to effect the buyback process and that this involved capital restructuring by SGL.<sup>6</sup>

The second principle is that a gain derived from property has the character of income and this includes a gain to an owner who has waited passively for that return from property.<sup>7</sup> In other words, the sellback rights were characterised as something of independent value which was the product of and severed from Mrs McNeil's shareholding in SGL (which remained untouched)<sup>8</sup> and thus constituted her income according to ordinary concepts, as income from the property constituted by her shares.

As we have set out above, the facts in *McNeil* are often introduced by reference to their commercial descriptors (that is the terms 'sellback rights', 'buyback' and 'put options' are freely used). However, for tax purposes the payment to Mrs McNeil should be more accurately described. That is, what Mrs McNeil received for tax purposes (at least as characterised by the majority) was a right to a payment from a trust, which took its life from deed polls executed by SGL, was not the receipt of a distribution of any form of assets of SGL, did not derive from any rights of shareholders under the constitution of SGL and which left Mrs McNeil's shareholding in SGL 'untouched'.<sup>9</sup> Described in this way, the High Court's reasoning begins to make sense. However, the corollary of describing the payment in this way is that *McNeil* should, arguably, be treated with caution.

To read *McNeil* and conclude that it is authority for the broad proposition that the value of most 'rights' issued by companies to shareholders is ordinary income (which the Commissioner appears to have done,<sup>10</sup> and on which basis Parliament appears to have enacted the recent amendments<sup>11</sup>), is arguably unwarranted.

The remainder of this article examines the impact of the recent amendments and highlights the continuing relevance of *McNeil*.

## Gains from receipt of certain rights to acquire shares are now sheltered

The Commissioner's expressed view is that the

High Court's reasoning in *McNeil* is equally applicable in determining the character of the value of other rights where those rights are not a dividend for income tax purposes. The Commissioner's view is that where such rights are for shareholders in a company to subscribe for shares in the company at less than their market value, the value of those rights ('call' options) will be ordinary income in the same way as in relation to the 'put' options considered in *McNeil* itself.<sup>12</sup> However, by way of distinction, the issue of bonus shares would not appear to give rise to assessable income because, in the words of the majority in *McNeil*, 'bonus shareholders do not receive a gain severed and detached from their existing shareholding. Rather, their proportional interest in the business of the company is re-expressed.'<sup>13</sup>

In relation to 'call' options, that is, rights that a shareholder has to acquire further shares in a company or to a unit holder to acquire additional units in their trust, s 59-40 may now apply to treat the market value of the rights at the time of issue as non-assessable non-exempt income ('NANE income') of the shareholder or unit holder. The section will only apply if all of the following conditions are met.

- At the time of issue, the taxpayer must already own an interest in the issuing entity (known as original interests).
- The rights must be issued to the taxpayer because of their ownership of the original interests.
- The original interests and the rights must not be revenue assets or trading stock at the time the rights are issued.
- The rights must not have been acquired under an employee share scheme.
- The original interests and rights must not be traditional securities.
- The original interests must not be convertible interests.

Accepting for the moment that *McNeil* is authority for the broad proposition that the value of most 'rights' issued by companies to shareholders is ordinary income, the question must be asked why Parliament chose to shelter only call options and leave the grant of put options exposed to taxation as ordinary income under the authority of *McNeil*.

Following *McNeil* and Class Ruling CR 2007/42, the then Assistant Treasurer announced on 26 June 2007 that the government would amend the tax legislation to ensure that the value of rights issues was not subject to tax at

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grant. The announcement stated that:

Shareholders issued with rights by companies seeking to raise capital will not have an income tax liability at the time of issue. Instead, the long-standing position to treat rights issues on capital account will be maintained.

...

These amendments will provide certainty for taxpayers by restoring the taxation treatment of rights issues that existed before the decision.

[emphasis added]

It is apparent that the policy behind the amendments is that companies should not be restricted in their capacity to raise capital.<sup>14</sup> It is unclear to the authors why rights issues in the nature of put options to achieve capital reductions should not also be sheltered in the same way as call options. Further, Parliament's decision to exclude 'convertible interests' from the class of rights protected under s 59-40 is unfortunate. Given the Commissioner's expansive interpretation of *McNeil*, the Commissioner may well seek to apply *McNeil* in circumstances where a holder of a convertible interest is granted rights in the nature of call options. If that is the case, there would not appear to be any reason why a holder of a convertible interest should not get the same protection under s 59-40 as that which is afforded to a holder of an ordinary interest.

### New cost base rules for put options

One of the biggest points of contention arising from the recent amendments is that a grant of rights in the nature of put options is still taxed up-front as ordinary income in accordance with the *McNeil* approach. However, new s 112-37 allows taxpayers to include that assessable amount (and any amount paid to acquire the right) in the first element of the cost base or reduced cost base of such options for the purpose of calculating a capital gain or loss on any subsequent CGT event. The legislation also provides (in s 104-155(5)(ea)) that a shareholder has no CGT event H2 from such a right, and by item 7 of the table to s 112-20(3) that the market value substitution rule does not apply to a shareholder getting such a right.

The authors note that in every case, the particular way in which a company goes about achieving a capital reduction must be considered on its own merit. An assumption that *McNeil* applies ab initio is, arguably, unwarranted. For example, in determining whether a grant of rights is ordinary income, one of the key factors is whether the rights are capable of being sold or traded in some type of market (these are referred to as 'renounceable' rights). In *McNeil*, the fact

that the sellback rights were renounceable, which meant that they were 'more readily seen to have been separate and detached from the shares in respect of which they had been granted',<sup>15</sup> appeared to weigh heavily in the reasoning of the majority decision that those rights were ordinary income.<sup>16</sup> In circumstances where a company grants non-renounceable put options directly to shareholders, it is arguable that *McNeil* would not apply.<sup>17</sup>

Given that the grant of put options is not sheltered from *McNeil*, it may be prudent for commercial advisers to consider alternatives to sidestep *McNeil*, such as a straight return of capital, on-market share buybacks, or non-renounceable off-market share buybacks discussed above.

Advising in this area has taken on a new layer of complexity. Advisers must first consider whether 'rights' fall within the class of sheltered rights prescribed by the legislation outlined above, and if not, must then apply *McNeil* and form a view as to whether the value of the rights will nonetheless be included in assessable income. The scope of the *McNeil* decision is therefore still a live issue following the recent amendments.

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### Notes

- 1 s 59-40
- 2 s 112-37
- 3 229 CLR 656 at 661, paras [5] and [8]
- 4 229 CLR 656 at 663, para [18]
- 5 229 CLR 656 at 663, para [20] and at p 667, para [36]
- 6 229 CLR 656 at 663, para [20]
- 7 229 CLR 656 at 663, para [21]
- 8 229 CLR 656 at 664, para [22]
- 9 229 CLR 656 at 662, para [13] and at p 664, para [22]
- 10 See Class Ruling CR 2007/42 and the Decision Impact Statement
- 11 See the Explanatory Memorandum to the *Tax Laws Amendment (2008 Measures No 3) Bill 2008*, para 1.4
- 12 In Class Ruling CR 2007/42, the Tax Office applied the principles outlined in *McNeil* to options issued to shareholders of Hutchison Telecommunications (Australia) Limited (HTAL) to acquire further shares in HTAL under an arrangement relating to the raising of additional equity funding
- 13 229 CLR 656 at 668, para [38]
- 14 Also see the Second Reading Speech to the *Tax Laws Amendment (2008 Measures No 3) Bill 2008* and para 1.4 of the explanatory memorandum
- 15 229 CLR 656 at 661, para [12]
- 16 229 CLR 656 at 661, para [12]
- 17 See the minutes to the National Tax Liaison Group meeting of 28 June 2007 ●