



Class Ruling

Income tax: return of capital: Biota Holdings Limited

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This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

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What this Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified below apply to the defined class of entities, who take part in the scheme to which this Ruling relates.

Relevant provision(s)

2. The relevant provisions dealt with in this Ruling are:
- subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - section 45A of the ITAA 1936;
 - section 45B of the ITAA 1936;
 - section 45C of the ITAA 1936;
 - section 104-25 of the *Income Tax Assessment Act 1997* (ITAA 1997);
 - section 104-135 of the ITAA 1997;
 - section 118-20 of the ITAA 1997; and
 - section 855-10 of the ITAA 1997.

All subsequent legislative references are to the ITAA 1936 unless otherwise indicated.

Class of entities

3. The class of entities to which this Ruling applies are:
- (a) shareholders of Biota Holdings Limited (BHL) who hold ordinary shares on the Record Date; and
 - (b) hold these shares on capital account.

Qualifications

4. The Commissioner makes this Ruling based on the precise scheme identified in this Ruling.
5. The class of entities defined in this Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 9 to 27 of this Ruling.
6. If the scheme actually carried out is materially different from the scheme that is described in this Ruling, then:
- this Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled; and
 - this Ruling may be withdrawn or modified.
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Date of effect

8. This Ruling applies from 1 July 2009 to 30 June 2010. The Ruling continues to apply after 30 June 2010 to all entities within the specified class who entered into the specified scheme during the term of the Ruling. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Scheme

9. The following description of the scheme is based on information provided by the applicant. The following documents, or relevant parts of them, form part of and are to be read with the description:

- application for Class Ruling dated 14 July 2009;
- further correspondence received from 6 August 2009 to 2 December 2009; and
- BHL Annual Reports from 2003 to 2009.

Note: certain information has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

10. BHL is an Australian resident public company that was incorporated on 2 October 1985 and which is listed on the Australian Securities Exchange (ASX).

11. From its date of incorporation, BHL has not paid dividends, or returned capital to its shareholders other than through on-market share buybacks. BHL's stated vision is to reward shareholders principally through asset growth.

12. BHL is in a positive cash position as at 30 June 2009. The cash reserves are attributable to a surplus of litigation fighting funds as a result of concluding a particular litigation (the litigation), contributed capital and profits.

13. BHL is making a return of capital to its shareholders of \$20 million, which equates to a return of capital of 11.18 cents per share.

14. The return of capital is sourced out of BHL's existing cash funds. BHL had current assets made up of cash and cash equivalents of \$86.704 million as at 30 June 2009 and \$60.164 million as at 30 June 2008.

15. The return of capital was approved by BHL shareholders at BHL's annual general meeting on 12 November 2009, and was paid to BHL's shareholders on 3 December 2009.

16. The return of capital is applied equally to each holder of a BHL share on the share register on the Record Date, being 19 November 2009, by way of cash distribution in proportion to the number of shares held on that date.

17. BHL is debiting the entire amount of the return of capital against an amount standing to the credit of the share capital account. This share capital account is not a tainted share capital account for the purposes of Division 197 of the ITAA 1997.

18. The following accounting entry accounts for the payment to shareholders.

	Debit	Credit
Dr Equity – Issued Capital	\$20m	
Cr Bank		\$20m

(To account for the return of capital to shareholders.)

19. In July 2008, BHL entered into a settlement (following formal mediation) in relation to the litigation and received an undissected lump sum cash settlement of \$20 million in full and final satisfaction of its claims and to release the other party from proceedings without admission of liability in relation to the issues litigated.

20. In 2008 and 2009, BHL undertook an on-market buy-back as part of its capital management strategy. The on-market buy-backs resulted in BHL acquiring 9,166,734 shares for a total cost of \$7,952,563 (net of brokerage and transaction costs).

21. There have been no recent disposals of major assets that could be seen to relate to the distribution of share capital.

22. Biota's franking account balance as at 30 June 2009 is \$494,365.

23. BHL does not hold any interest, either directly or indirectly, in any Australian real property.

24. BHL's shareholders are made up of:

- Australian residents – holding approximately 97.73 percent of the interests in BHL; and
- foreign residents – holding approximately 2.27 percent of the interests in BHL.

25. The share price of BHL since listing on the ASX has ranged from \$0.10 to almost \$11.00.

26. BHL's Annual Report for the 2009 year discloses a profit of \$38,181,000 generated for the year.

27. There were 174,563,999 ordinary shares on issue as at 30 June 2009.

Ruling

Dividend

28. The payment of the return of capital from BHL to its shareholders will not be a dividend, as defined in subsection 6(1).

Sections 45A and 45B

29. The Commissioner proposes to make a determination under section 45B that section 45C applies to a part of the return of capital to be received by BHL shareholders. Accordingly, a part of the return of capital (4.92 cents for each BHL share) will be taken to be an unfranked dividend pursuant to section 45C.

Capital gains tax

30. CGT event G1 in section 104-135 of the ITAA 1997 will happen when BHL pays the return of capital in respect of a BHL share that a BHL shareholder owns at the Record Date and continues to own at the time of the payment but only to the extent of that part of the payment (6.26 cents per share) not taken to be an unfranked dividend under section 45C of the ITAA 1936.

31. CGT event C2 in section 104-25 of the ITAA 1997 will happen when BHL pays the return of capital to a BHL shareholder in respect of a BHL share they own at the Record Date but which they cease to own before the time of payment.

32. Any capital gain made as a result of CGT event C2 happening to a former BHL shareholder's right to receive the return of capital is reduced by that part of the payment (4.92 cents per share) included in the former BHL shareholder's assessable income as an unfranked dividend under section 45C of the ITAA 1936 (section 118-20 of the ITAA 1997).

Foreign resident shareholders

33. A foreign resident BHL shareholder who is paid the return of capital disregards any capital gain made when CGT event G1 happens if their shares in BHL are not 'taxable Australian property' (section 855-10 of the ITAA 1997).

34. A foreign resident BHL shareholder who is paid the return of capital disregards any capital gain or capital loss made when CGT event C2 happens if the right to the payment is not 'taxable Australian property' (section 855-10 of the ITAA 1997).

Appendix 1 – Explanation

① *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

Dividend

35. Subsection 44(1) includes in a shareholder's assessable income any dividends, as defined in subsection 6(1), paid to the shareholder out of profits derived by the company from any source (if the shareholder is a resident of Australia).

36. The term 'dividend' in subsection 6(1) includes any distribution made by a company to any of its shareholders. However, later paragraphs in this subsection exclude certain items from being a dividend for tax purposes.

37. Relevantly, paragraph (d) of subsection 6(1) specifically excludes from the definition of 'dividend':

moneys paid or credited by a company to a shareholder or any other property distributed by a company to shareholders (not being moneys or other property to which this paragraph, by reason of subsection (4), does not apply or moneys paid or credited, or property distributed for the redemption or cancellation of a redeemable preference share), where the amount of the moneys paid or credited, or the amount of the value of the property, is debited against an amount standing to the credit of the share capital account of the company

38. The exclusion in paragraph (d) of the definition of dividend is limited by subsection 6(4) which applies in circumstances where, under an arrangement:

- a company raises share capital, receiving either cash or property from a person or group of persons crediting it to its share capital account; and
- returns it to another person or group of persons, giving them either cash or property, debiting it to its share capital account.

39. In the present case, no arrangement exists under which BHL raised share capital from certain shareholders and then distributed the capital raised to other shareholders. Accordingly, subsection 6(4) will have no application in respect of the return of capital.

40. As the return of capital will be wholly debited against an amount standing to the credit of BHL's share capital account, paragraph (d) of the definition of 'dividend' in subsection 6(1) will apply and the return of capital will not constitute a dividend under subsection 6(1).

Anti-avoidance provisions***Sections 45A and 45B***

41. Sections 45A and 45B are two anti-avoidance provisions which, if they apply, allow the Commissioner to make a determination that section 45C applies to treat all or part of the return of capital amount received by the shareholders as an unfranked dividend.

Section 45A – streaming of dividends and capital benefits

42. Section 45A applies in circumstances where capital benefits are streamed to certain shareholders (the advantaged shareholders) who derive a greater benefit from the receipt of capital and it is reasonable to assume that the other shareholders (the disadvantaged shareholders) have received or will receive dividends.

43. Although a 'capital benefit' (as defined in paragraph 45A(3)(b)) will be provided to participating shareholders under the capital return, the circumstances of the capital return indicate that there will be no streaming of capital benefits to some shareholders and dividends to other shareholders.

44. Accordingly, section 45A has no application to the return of capital.

Section 45B – schemes to provide capital benefits

45. Section 45B applies where certain capital payments are made to shareholders in substitution for dividends. Specifically, the provision applies where:

- there is a scheme under which a person is provided with a capital benefit by a company (paragraph 45B(2)(a));
- under the scheme a taxpayer (the 'relevant taxpayer'), who may or may not be the person provided with the capital benefit, obtains a tax benefit (paragraph 45B(2)(b)); and
- having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, entered into the scheme or carried out the scheme or any part of the scheme for a purpose, other than an incidental purpose, of enabling the relevant taxpayer to obtain a tax benefit (paragraph 45B(2)(c)).

Each of these conditions is considered in paragraphs 46 to 53 of this Ruling.

The Scheme

46. A scheme for the purpose of section 45B is defined under subsection 177A(1) to include:

- any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and
- any scheme, plan, proposal, action, course of action or course of conduct.

47. The arrangement involving BHL's return of capital to its ordinary shareholders will constitute a 'scheme' for the purposes of section 45B.

A person is provided with a capital benefit by a company

48. The phrase 'provided with a capital benefit' is defined in subsection 45B(5). It states that a person is provided with a capital benefit if:

- (a) an ownership interest in a company is issued to the person;
- (b) there is a distribution to the person of share capital; or
- (c) the company does something in relation to an ownership interest that has the effect of increasing the value of the ownership interest (which may or may not be the same interest) held by that person.

49. As BHL's return of capital was recorded as a debit to the issued capital account, its shareholders will receive a distribution of share capital. Therefore, they will be provided with a capital benefit under paragraph 45B(5)(b).

The relevant taxpayer obtains a tax benefit

50. A shareholder 'obtains a tax benefit' as defined in subsection 45B(9) of the ITAA 1936 if:

- the amount of tax payable; or
- any other amount payable under the ITAA 1936 or the ITAA 1997,

would, apart from the operation of section 45B of the ITAA 1936:

- be less than the amount that would have been payable; or
- be payable at a later time than it would have been payable,

if the capital benefit instead had been a dividend.

51. As discussed in paragraph 49 of this Ruling, the payment of the return of capital to shareholders will be a capital benefit. In the event that the return of capital did represent a dividend rather than a capital benefit, a typical shareholder would pay less tax, or pay tax at a later time as a result of being assessed under the CGT provisions rather than being assessed under subsection 44(1) as a dividend. In the present circumstances, this conclusion would be reinforced by the fact that any dividend payable would largely be an unfranked dividend. Consequently, the receipt of the capital benefit will represent a tax benefit.

52. For the purposes of paragraph 45B(2)(c) the Commissioner is required to consider the 'relevant circumstances' set out in subsection 45B(8) to determine whether any part of the scheme would be entered into for a purpose, other than an incidental purpose, of enabling a relevant taxpayer to obtain a tax benefit.

53. The test for the purpose is an objective one. The question is whether objectively, it would be concluded that a person who entered into or carried out the scheme did so for the purpose of obtaining a tax benefit for the 'relevant taxpayer'. A 'relevant taxpayer' in this instance will be a shareholder of ordinary shares in BHL.

Relevant circumstances of the scheme

54. Each of the relevant circumstances listed in subsection 45B(8) is addressed in paragraphs 55 to 123 of this Ruling.

Paragraph 45B(8)(a)

55. Paragraph 45B(8)(a) refers to the extent to which the capital benefit is attributable to capital or attributable to profits (realised and unrealised) of the company or an associate (within the meaning of section 318) of the company.

56. The term 'profits' takes its ordinary meaning and, as it is generally understood, applies to a gain made by a business and disclosed by a comparison between the state of that business at one point and the state at another. Furthermore, such gain can only be characterised by a comparison of the assets of the business on the basis of valuation not merely enumeration at the two dates and would thus include unrealised gains¹ which, of course, the provision also expressly includes.

57. The ordinary meaning of profit makes the distinction between issued capital of any entity and the accretion or increase on this amount. The latter being the profit within an entity, realised or unrealised.

¹ In *Re Spanish Prospecting Co Ltd* [1911] 1 Ch 92 per Fletcher Moulton LJ at 98-99; *Federal Commissioner of Taxation v. Sun Alliance Investments Pty Ltd (in liq)* (2005) 225 CLR 488 at 504.

58. In this instance, BHL seeks to return capital from BHL's excess cash reserves, which in the main exist from previous capital raisings, the receipt of a settlement of \$20 million following the conclusion of the litigation, and other profits.

59. The following accounting entry accounts for the payment to shareholders:

	<u>Debit</u>	<u>Credit</u>
Dr Issued Share Capital	\$20 million	
Cr Bank		\$20 million

60. Accordingly, the capital distribution is seemingly to be sourced from the shareholder's contributed or issued capital. Typically, with the return of capital there is an event or change in BHL's operations that will allow the release of capital from the operations of BHL. In the present circumstances, BHL seeks to return part of excess cash reserves to the value of \$20 million, with the finalisation of the on-going litigation being related to this event.

61. BHL has received additional equity contributions raised from shareholders. These funds were raised for the conduct of on-going operational activities and the litigation.

62. The overall amount received from shareholders can be seen not to have been utilised in its entirety to fund on-going operational activities and the litigation. The on-going operational activities and the litigation can be considered to have been funded, in part, from revenues received in the year ended 30 June 2007.

63. Importantly, apart from the conclusion of the litigation there has been no major change to the operations of BHL that would cause a release of capital such as the sale of an asset or a change in operations that would warrant the return of capital as it was no longer required by BHL. There has been, however, an increase in profit from the operations of the company, which has helped increase the balance of cash and cash equivalents. This balance has increased from \$60.164 million in the year ended 30 June 2008 to \$86.704 million in the year ended 30 June 2009.

64. BHL's preference is to have at least two years of expenditure as cash reserves which it estimates to be around \$60 million. The return of capital is seen as a way of returning excess funds to shareholders. The excess funds are represented by an increased cash balance which is attributable to the \$20 million cash settlement from the litigation, other profits of around \$18 million for the year and existing funds.

65. Generally, the money contributed by members of a company is contributed to enable the company to carry out its objects. Generally, the money so contributed is to be retained as a permanent fund while the company pursues its objects. Exceptions to the doctrine of maintenance of capital would not ordinarily include a company generating more money than required for the purposes of the business.

66. A distribution of capital would generally be considered to be a relatively extraordinary company event. Contributed capital is meant to be invested in the objects of the business and, generally, to provide lasting support to the business. Profits which are excess to the requirements of the business are meant to be distributed to the shareholders. A decision to reduce capital would generally be expected to coincide with and be influenced by some other commercial circumstance.

67. The situation of BHL therefore is that it can distribute profits or it can return capital, or it can do a mixture of both. In the context of paragraph 45B(8)(a), the capital benefit, being wholly a return of capital, cannot be said to be wholly attributable to capital. This is because the circumstances to which the paragraph refers, concerning attribution, are concerned with the extent to which the scheme in question is conducted for a purpose of dividend substitution (see paragraph 45B(1)(b)). The attribution referred to concerns what the distribution might be attributable to, having regard to the choices available to BHL. An act to provide only the capital benefit in preference to being able to, but not choosing to, distribute a dividend, points strongly to a purpose of dividend substitution.

68. The capital benefit provided to the shareholders can thus be attributed in the relevant sense, to both profits and to share capital. Accordingly, this circumstance would point strongly towards the requisite purpose in paragraph 45B(2)(c) being present.

Paragraph 45B(8)(b)

69. Paragraph 45B(8)(b) refers to the pattern of distributions made by a company or an associate (within the meaning of section 318) of the company.

70. BHL has not, since its date of incorporation, paid any dividends or returned capital to its shareholders besides the on-market buyback of 2008 and 2009. The objective of BHL is stated to be to reward shareholders principally through asset growth.

71. In the present context, it is considered that this circumstance points neither towards nor against the presence of the requisite purpose in paragraph 45B(2)(c)

Paragraph 45B(8)(c)

72. Paragraph 45B(8)(c) concerns whether the relevant taxpayer has capital losses that, apart from the scheme, would be carried forward to a later year of income. Speaking generally, this circumstance is directed at the extent of the relevant taxpayer's capacity to effectively absorb a capital benefit, or more specifically a capital gain, tax free.

73. In this case the capital benefit is provided to the relevant taxpayer, the shareholders of BHL. It can generally be considered that the relevant taxpayer is unlikely to have any carried forward Australian capital losses at the time of the transaction. In this case, this circumstance tends neither for nor against the requisite purpose in paragraph 45B(2)(c).

Paragraph 45B(8)(d)

74. Paragraph 45B(8)(d) provides for consideration of whether some or all of the ownership interests in the company held by the relevant taxpayer were acquired, or taken to have been acquired, by the relevant taxpayer before 20 September 1985. In general terms, this circumstance looks at whether the relevant taxpayer escapes CGT consequences from the provision of a capital benefit due to the fact that their interests or some of their interests in the company providing the benefit are pre-CGT assets.

75. In this instance, the capital benefit is provided to the relevant taxpayer.

76. BHL was incorporated on 2 October 1985, which is after 20 September 1985.

77. In this case, this circumstance is irrelevant and tends neither for nor against the requisite purpose in paragraph 45B(2)(c).

Paragraph 45B(8)(e)

78. Paragraph 45B(8)(e) of the ITAA 1936 requires consideration of 'whether the relevant taxpayer is a non-resident'. The implication of non-residency is that it would ordinarily point towards a tax preference for a receipt on capital account over a distribution on revenue account, that is, a dividend. Normally, non-residents are liable for dividend withholding tax on dividends paid to them by a resident company, but they are not exposed to the CGT regime in relation to shares unless the shares are 'indirect real property interests' as defined in section 855-25 of the ITAA 1997.

79. In this case, approximately 97.73 percent of the relevant taxpayers are Australian residents.

80. This circumstance would not incline towards the requisite purpose in paragraph 45B(2)(c).

Paragraph 45B(8)(f)

81. Paragraph 45B(8)(f) of the ITAA 1936 requires consideration of whether the cost base (for the purposes of Part 3-1 of the ITAA 1997) of the relevant share is not substantially less than the value of the applicable capital benefit. The 'relevant share' is the share which links the company providing the capital benefit with its shareholder, the 'relevant taxpayer'. This circumstance concerns the CGT outcome in relation to the relevant taxpayer's share in the company in the event of its being provided with a capital benefit, in particular a distribution of share capital. If the cost base of the share is similar or greater in value than the capital benefit provided it will not expose the relevant taxpayer to a capital gain under CGT event G1 or CGT event C2 where the provision of the capital benefit involves the subsequent cancellation of the share.

82. Historically, the market price of the relevant taxpayer's shares has not been less than 10 cents per share and therefore should have a cost base that is at least 10 cents per share. BHL has not previously undertaken any returns of capital that have reduced the cost base of the shares in question.

83. The return of \$20 million equates to a return of capital of approximately 11 cents per share. This will reduce the cost base of a relevant taxpayer's shares to nil where it was purchased at 10 cents a share. Other relevant taxpayers will have purchased BHL shares at a much higher price which would simply result in a lowering of the cost base to an amount that is greater than zero. Historically, BHL shares have traded within the \$0.10 to slightly less than \$11.00 range.

84. Although relevant taxpayers will have a CGT event, and for some, this may mean they will derive a capital gain, it cannot be reasonably inferred that such a gain will be of a significant amount. Accordingly, in comparison with the receipt of a largely unfranked dividend, most relevant taxpayers can be expected to prefer a return of capital with the lesser tax liability. It is this dividend substitution purpose that would incline towards the requisite purpose in paragraph 45B(2)(c).

Paragraph 45B(8)(h)

85. Paragraph 45B(8)(h) is also predicated on the person provided with the capital benefit and the 'relevant taxpayer' being one and the same person. It considers whether the capital benefit affects the substance of their interest in the company; if it did not it would appear, practically speaking, more like a dividend than if it did.

86. The capital distribution does not alter the substance of the shareholder's interest in the taxpayer, and therefore, practically speaking, the distribution is more dividend-like in its outcome. That is, relevant taxpayers can expect to receive a return of capital that would not alter the number of shares they hold nor the rights attached to those shares, as would be the case also if they were to receive a dividend. However, in the absence of section 45B applying, their distribution would receive a more favourable tax treatment than if they were to receive a dividend.

87. This circumstance would incline towards the requisite purpose in paragraph 45B(2)(c).

Paragraph 45B(8)(i)

88. Paragraph 45B(8)(i) applies to a scheme which involves the provision of ownership interest and the later disposal of those interests and requires consideration of the period for which the ownership interests are held by the holder of the interests and when the arrangement for their disposal was entered into. A brief period of holding the shares suggests their acquisition and subsequent sale is the equivalent of a cash dividend in a tax-effective form.

89. In this case, as no provision of any new ownership interest will occur this circumstance is irrelevant and tends neither for nor against the requisite purpose in paragraph 45B(2)(c).

Paragraph 45B(8)(j)

90. The circumstances covered by paragraph 45B(8)(j) are only relevant in the case of a demerger and so are not relevant to this return of capital.

Paragraph 45B(8)(k)

91. Paragraph 45B(8)(k) covers the matters listed in subparagraphs 177D(b)(i) to (viii) in Part IVA which capture more generally most of the circumstances listed above, as well as the wider tax and non-tax implications of the scheme.

Subparagraph 177D(b)(i)

92. This matter refers to the manner in which the scheme was entered into and carried out. It includes consideration of the way in which and method or procedure by which the particular scheme in question was established; in short, the decisions, steps and events that combine to make up the scheme and explain the way it is shaped.

93. Clearly, BHL seeks to return capital from its excess cash reserves, which exist from previous capital raisings, the receipt of settlement of \$20 million following the conclusion of the litigation, and other profits.

94. The decision to make a cash payment of \$20 million was made by the Board of BHL. In reaching the decision to make the cash payment the Board had material before it which addressed the pros and cons of various capital management options. The various options available to the Board included a capital return, an on-market buyback, an off-market buyback and the payment of a dividend.

95. The payment of a capital return has the following advantages listed:

- cash payment likely to be well received by shareholders;
- tax effective for all shareholders;
- shareholder stake remains unchanged; and
- may be perceived as a one-off event.

96. The payment of a dividend has the following advantages listed:

- cash payment likely to be well received by shareholders;
- shareholder stake remains unchanged; and
- no shareholder approval is required.

97. The difference between the payment of a capital return and the payment of a dividend are that a capital return is more tax effective for shareholders, that it may be perceived as a one-off event and that a dividend does not require shareholder approval.

98. The payment of a capital return is listed as having the following disadvantage:

- shareholder approval required.

99. The payment of a dividend is listed as having the following disadvantages:

- not tax effective; and
- may create an expectation of future dividends.

100. Clearly, consideration of whether a dividend or a return of capital was to be paid involved a number of key points, the taxation implications being a major, if not deciding, factor. Besides the taxation implications the issue of the expectation of shareholders to receive further payments of dividends was included as a key disadvantage. This shareholder expectation can be reduced when a dividend is described a 'special dividend' and through explanation of any special circumstances that relate to the dividend. Payments of special dividends are not uncommon.

101. For the years 2006 to 2009, the financial history of BHL is not atypical for a biotech company which has high costs in its research and development phase with the aspiration for high return on investments when the marketing phase is entered in the event of the development of a successful product. The litigation dispute was essentially one that alleged that under contract the other party did not market BHL's product with the vigour and effort expected under the arrangement with the result that loss of profit and damage to product reputation occurred.

102. At the conclusion of this litigation, which saw a \$20 million mediated settlement in favour of BHL, the return of some of the excess cash held by BHL is intended. This is not unexpected given the shareholders contributed in excess of \$60 million for ongoing operating costs as well as the conduct of the litigation.

103. There has been no alteration in BHL's operations. The timing of the return of capital coincides with the receipt of the mediated sum of the litigation. BHL has advised it holds in its cash reserves the sum of \$20 million being the mediated settlement sum.

104. The dividend history of BHL is that since its inception in 1985 there has been no dividend paid to its shareholders. The receipt of the mediated settlement sum has provided the opportunity for a return to shareholders particularly after the shareholder's funded a substantial part of the litigation. Without sufficient franking credits in BHL's franking account such a distribution as a dividend would be made to the relevant shareholders without the benefit of a franking credit grossing up the dividend yield. Clearly the preference in such circumstances would be for a capital distribution.

105. These circumstances of the scheme would incline towards the requisite purpose in paragraph 45B(2)(c).

Subparagraph 177D(b)(ii)

106. This matter looks to the form and substance of the scheme.

107. The legal form of the scheme will be that of only a return of capital. From the ordinary shareholder's perspective this will also be the substance of what they will receive. This circumstance points neither towards nor away from the purpose in paragraph 45B(2)(c). It can be noted though that the form and substance of the scheme being the same in a case like this does not address the critical point about why BHL is choosing to wholly distribute capital in preference to distributing a dividend, or doing a mixture of both.

Subparagraph 177D(b)(iii)

108. This matter directs attention to the time at which the scheme was entered into and the period during which it was carried out. The matter requires reference not only to time measurement but also to the timing of the scheme in terms of its coincidence with events or circumstances beyond the scheme itself.

109. The scheme coincides with BHL being in a situation where its operating performance has led to the generation of significant cash flows that has resulted in cash and cash equivalents amounts which BHL believes are excess to its current needs and are available for distribution, including the receipt of the mediated settlement sum from the litigation. However, BHL only intends to release those amounts that it considers to be attributable to capital rather than having regard to all of the elements of its operating performance.

110. This matter points towards the requisite purpose in paragraph 45B(2)(c).

Subparagraph 177D(b)(iv)

111. This matter requires that consideration be given to the result the scheme would achieve under the ITAA 1936 and the ITAA 1997 but for the application of section 45B.

112. But for section 45B, the scheme would succeed in providing a capital benefit to the shareholders of BHL when the benefit is dividend-like and has its source in the profit of BHL. The payment if it was a dividend would be unfranked, or mostly unfranked given the amount of franking credits available to BHL. A shareholder in receipt of a capital benefit is in a more advantageous position (if an Australian resident, which the vast majority are) when compared to the receipt of an unfranked dividend when it comes to the assessment of income tax in the year of receipt.

113. But for section 45B, the shareholders of BHL would be incurring less tax liability from income derived from profit than would normally be the case. This is the very tax mischief that section 45B addresses.

114. This matter would point towards the requisite purpose in paragraph 45B(2)(c).

Subparagraph 177D(b)(v)

115. This matter requires consideration be given to any change in the financial position of the relevant taxpayer.

116. The shareholders of BHL as Australian residents would, as noted in paragraphs 112 and 113 of this Ruling, incur a greater tax liability on the receipt of an unfranked dividend than if the receipt is capital in nature. This would be a financial disadvantage as more income would be derived for the purposes of the ITAA 1936 and the ITAA 1997. By way of contrast, the receipt of the capital return would generally reduce the cost base of the relevant shareholder's share pursuant to CGT Event G1, leading to the deferment of any taxing point on the distribution.

117. All of this points to the requisite purpose in paragraph 45B(2)(c).

Subparagraph 177D(b)(vi)

118. This matter looks to any change in the financial position of any person connected with the relevant taxpayer. This has no application on the known facts.

119. In this case, this matter is irrelevant and points neither for nor against the requisite purpose in paragraph 45B(2)(c).

Subparagraph 177D(b)(vii)

120. This matter requires consideration of any other consequence of the scheme for the relevant taxpayer. This has no application on the known facts.

121. In this case, this matter is irrelevant and points neither for nor against the requisite purpose in paragraph 45B(2)(c).

Subparagraph 177D(b)(viii)

122. This matter looks to the nature of any connection between the relevant taxpayer, the shareholders, and any other person referred to in subparagraph 177D(b)(vi).

123. In this case, this matter is irrelevant and points neither for nor against the requisite purpose in paragraph 45B(2)(c).

Conclusion

124. After having regard to the relevant circumstances of the scheme, in particular those listed in subsection 45B(8), it is concluded that the scheme was entered into for a more than incidental purpose of enabling the relevant taxpayer, the shareholders, to obtain a tax benefit.

125. The Commissioner considers that only a part of the return of capital to shareholders can be attributed, in the relevant sense, to a capital return. Part of the return of capital is considered to be attributable, in the relevant sense, to the profits of the company.

126. There is no formula specified as to how the Commissioner is to determine the extent to which section 45C (and the deeming of an unfranked dividend), is to apply to the capital benefit covered by paragraph 45B(2)(c). However, in keeping with the object of examining the extent to which the scheme in question is carried out for a purpose of dividend substitution, and having regard to general principles of apportionment, the determination should reflect the extent to which BHL is able to distribute profits as compared to returning capital. It should involve an apportionment between the two that is fair and reasonable, and neither a 'profits first', nor any 'capital first' rules should apply.

127. In this matter BHL was able, should it have chosen, to declare a dividend of up to \$38.181 million. Its goal however, was to only distribute \$20 million. Selection of an appropriate comparative figure regarding the maximum amount of capital it might return in a case like this is somewhat problematic, as there is no concept of 'distributable capital' that necessarily applies.

128. However, by looking at the amount the company could readily realise, of up to \$86.704 million, it is possible to see that the profits figure of \$38.181 million is 44.04% of this first mentioned amount. It is considered that such an apportionment of 44.04% of profits to the distribution is a fair and reasonable one in all the circumstances. The Commissioner will therefore determine under subsection 45B(3) that section 45C applies to that part of the return of capital to the shareholders of BHL.

129. Consequently, 44.04% of the 11.18 cents per share payment to BHL shareholders will be deemed to be an unfranked dividend paid by BHL out of its profits to the 'relevant taxpayer', the shareholders of BHL. This would amount to 4.92 cents per share.

Deeming dividends to be paid where a determination is made: section 45C

130. As the Commissioner will make a determination under subsection 45B(3) in relation to the scheme described, section 45C will apply.

131. Under subsection 45C(1) of the ITAA 1936, if the Commissioner makes a determination under subsection 45B(3) of the ITAA 1936, the amount of the capital benefit, or the part of the benefit, is taken, for the purposes of the ITAA 1936 and the ITAA 1997, to be an unfranked dividend that is paid by the company to the shareholder or relevant taxpayer at the time that the shareholder is provided with the capital benefit. This equates to 4.92 cents per share of the 11.18 cents per share that is to be distributed to shareholders as a return of capital.

132. Under subsection 45C(2), the dividend is taken to have been paid out of profits of the company.

133. Accordingly, 4.92 cents per each BHL share is taken to be an unfranked dividend paid by the company, out of profits of the company, to the shareholder on the date the shareholder is to be provided with the payment.

Capital Gains Tax

CGT event G1 – section 104-135

134. CGT event G1 (section 104-135 of the ITAA 1997) happens when a company makes a payment to a shareholder in respect of a share they own and some or all of the payment (the non-assessable part) is not a dividend as defined in subsection 995-1(1) of the ITAA 1997 or an amount that is taken to be a dividend under section 47 of the ITAA 1936.

135. Under subsection 995-1(1) of the ITAA 1997, 'dividend' has the meaning given by subsections 6(1), 6(4), 6BA(5) and section 94L of the ITAA 1936 and section 375-872 of the ITAA 1997.

136. Where a determination is made under subsection 45A(2) or 45B(3) of the ITAA 1936, the amount of the capital benefit is taken, for the purposes of the ITAA 1936 and the ITAA 1997 to be an unfranked dividend that is paid out of the profits of the company (subsections 45C(1) and 45C(2) of the ITAA 1936). This brings the amount within the meaning of a dividend in subsection 6(1) of the ITAA 1936 and therefore within the definition of 'dividend' in subsection 995-1(1) of the ITAA 1997.

137. Accordingly, CGT event G1 will happen when BHL pays the return of capital to a BHL shareholder in respect of a share that they own in BHL at the Record Date and continue to own at the Payment Date, but only to the extent of that part of the payment not taken to be a dividend under section 45C (the non-assessable part).

138. The non-assessable part of the return of capital is 6.26 cents per BHL share.

139. If the non-assessable part of the payment (6.26 cents per share) is equal to or less than the cost base of the BHL share at the Payment Date, the cost base and reduced cost base of the share will be reduced by the amount of the non-assessable part (subsection 104-135(4) of the ITAA 1997).

140. A BHL shareholder will make a capital gain if the non-assessable part of the payment (6.26 cents per share) is more than the cost base of the BHL share (subsection 104-135(3) of the ITAA 1997). The amount of the capital gain is equal to that excess.

141. If a BHL shareholder makes a capital gain when CGT event G1 happens, the cost base and reduced cost base of the BHL share are reduced to nil.

142. A BHL shareholder cannot make a capital loss when CGT event G1 happens (Note 1 to subsection 104-135(3) of the ITAA 1997).

143. A capital gain made when CGT event G1 happens will be a discount capital gain under Subdivision 115-A of the ITAA 1997 provided that the BHL share was acquired at least 12 months before the payment (subsection 115-25(1) of the ITAA 1997) and the other conditions of that Subdivision are satisfied.

CGT event C2 – section 104-25

144. The right to receive the payment of the return of capital is one of the rights inherent in a BHL share at the Record Date. If, after the Record Date but before the Payment Date, a BHL shareholder ceases to own some, or all, of their shares in BHL, the right to receive the payment of the return of capital in respect of each of the shares disposed of will be retained by the shareholder and is considered to be a separate CGT asset.

145. CGT event C2 (section 104-25 of the ITAA 1997) will happen when the return of capital is paid. The right to receive the payment (being an intangible CGT asset) will end by the right being discharged or satisfied when the payment is made.

146. A BHL shareholder will make a capital gain if the capital proceeds from the ending of the right are more than its cost base. The capital gain is equal to the amount of the excess. A BHL shareholder will make a capital loss if the capital proceeds from the ending of the right are less than its reduced cost base. The capital loss is equal to the amount of the difference (subsection 104-25(3) of the ITAA 1997).

147. In working out the capital gain or capital loss made when CGT event C2 happens, the capital proceeds will be the amount of the return of capital (11.18 cents per share) (subsection 116-20(1) of the ITAA 1997).

148. However, the capital gain made when CGT event C2 happens will be reduced under the anti-overlap provisions contained in section 118-20 of the ITAA 1997 by the amount (4.92 cents per share) that is included in the former BHL shareholder's assessable income as an unfranked dividend under section 45C of the ITAA 1936.

149. The cost base of a BHL shareholder's right to receive the return of capital is worked out under Division 110 of the ITAA 1997 (modified by Division 112 of the ITAA 1997). The cost base of the right does not include the cost base or reduced cost base of the share previously owned by the BHL shareholder that has been applied in working out a capital gain or capital loss made when a CGT event happened to the share – for example, when the BHL shareholder disposed of the share after the Record Date.

150. Therefore, if the full cost base or reduced cost base of a BHL share has been previously applied in working out a capital gain or capital loss made when a CGT event happened to that share, the right to receive the return of capital will have a nil cost base.

151. As the right to receive the return of capital was inherent in the BHL share during the time it was owned, the right is considered to have been acquired at the time when the share was acquired (section 109-5 of the ITAA 1997). Accordingly, if the BHL share was acquired at least 12 months before the return of capital, a capital gain made from the ending of the corresponding right will satisfy the requirements of section 115-25 of the ITAA 1997. Such a capital gain will be a discount capital gain under Subdivision 115-A of the ITAA 1997 provided the other conditions of that Subdivision are satisfied.

Foreign resident shareholders

152. Under subsection 855-10(1) of the ITAA 1997, an entity disregards a capital gain or capital loss made from a CGT event if they are a foreign resident, or the trustee of a foreign trust for CGT purposes, just before the CGT event happens and the CGT event happens in relation to a CGT asset that is not 'taxable Australian property'.

153. The term 'taxable Australian property' is defined in the table in section 855-15 of the ITAA 1997. The table sets out these five categories of CGT assets:

Item 1	taxable Australian real property;
Item 2	an indirect Australian real property interests not covered by item 5;
Item 3	a CGT asset used at any time in carrying on a business through a permanent establishment in Australia and which is not covered by item 1, 2 or 5;
Item 4	an option or right to acquire a CGT asset covered by item 1, 2 or 3; and
Item 5	a CGT asset that is covered by subsection 104-165(3) of the ITAA 1997 (choosing to disregard a capital gain or capital loss on ceasing to be an Australian resident).

154. A BHL shareholder that is a foreign resident, just before CGT event G1 happens, cannot disregard under section 855-10 of the ITAA 1997 a capital gain made when CGT event G1 happens if the BHL shares are 'taxable Australian property'.

155. A foreign resident BHL shareholder who has a right to the payment of the return of capital, disregards any capital gain or capital loss made when CGT event C2 happens to that right because the right is not 'taxable Australian property' (section 855-10 of the ITAA 1997).

Appendix 2 – Detailed contents list

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Previous draft:

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Related Rulings/Determinations:

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Subject references:

- capital gains tax
- capital reductions
- CGT events C1-C3 – end of a CGT asset
- CGT events G1-G3 – shares
- dividend income
- return of capital on shares
- share capital

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Income Tax ~~ Capital Gains Tax ~~ CGT events C1 to
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