



Class Ruling

Income tax: Selective Capital Reduction: Coal and Allied Industries Limited

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ⓘ This publication provides you with the following level of protection:

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.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

What this Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provisions 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 26BB of the ITAA 1936;
 - subsection 44(1) of the ITAA 1936;
 - section 45A of the ITAA 1936;
 - section 45B of the ITAA 1936;
 - section 45C of the ITAA 1936;
 - section 128B of the ITAA 1936;
 - Division 16K of Part III of the ITAA 1936;
 - Division 1A of former Part IIIA of the ITAA 1936;

- section 177EA of the ITAA 1936;
- section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 8-1 of the ITAA 1997;
- Division 67 of the ITAA 1997;
- section 104-25 of the ITAA 1997;
- section 116-20 of the ITAA 1997;
- section 116-30 of the ITAA 1997;
- section 118-20 of the ITAA 1997;
- section 118-25 of the ITAA 1997;
- section 202-5 of the ITAA 1997;
- section 202-40 of the ITAA 1997;
- section 204-30 of the ITAA 1997;
- section 207-20 of the ITAA 1997;
- section 207-145 of the ITAA 1997; and
- Division 855 of the ITAA 1997.

All subsequent legislative references are to the ITAA 1997 unless otherwise indicated.

Class of entities

3. The class of entities to which this Ruling applies consists of the holders of the 7% preference shares of Coal and Allied Industries Limited (CAIL) that have participated in the Selective Capital Reduction announced by CAIL on 1 March 2010 under which the 7% preference shares have been cancelled. In this Ruling, the class of entities is referred to as 'participating shareholders'.

4. However, the class of entities excludes entities that are subject to Division 230 in respect of this scheme.

Qualifications

5. The Commissioner makes this Ruling based on the precise scheme identified in this Ruling.

6. 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 10 to 21 of this Ruling.

7. If the scheme actually carried out was 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

9. 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

10. 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:

- Class Ruling application, dated 14 December 2009; and
- Correspondence received in relation to the Class Ruling application.

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

11. CAIL is an Australian incorporated company, which is listed on the Australian Securities Exchange (ASX).

12. CAIL had two classes of shares on issue. As at 30 June 2009, the classes consisted of:

- 86,584,735 ordinary shares; and
- 1,857,180 7% cumulative non-redeemable preference shares (7% preference shares) which traded under ASX code 'CNAPA'.

13. The 7% preference shares were issued in 1960 and 1961, and have a paid up value of \$0.50 per share. The preference shares carried a cumulative right to a 7% per annum dividend based on the \$0.50 paid up value. The shares were not redeemable, had no conversion rights and had no right to participate in any other distribution.

14. On 1 March 2010, CAIL announced to the ASX that it proposed to cancel all of the 7% preference shares on issue (the Selective Capital Reduction) pursuant to section 256B of the *Corporations Act 2001*. The Selective Capital Reduction was approved by shareholders on 16 April 2010.

15. The purpose of the Selective Capital Reduction was to achieve a more efficient capital structure. There were also cost savings through reduced ASX listing fees, corporate registration fees and associated administration costs. The 7% preference shares represented a small proportion of the equity funding of CAIL.

16. Under the Selective Capital Reduction, CAIL cancelled all the 7% preference shares in return for a payment of \$1.50 per share (the Cancellation Payment). Of the amount, \$0.50 was to be debited to the preference share liability account of CAIL (the Capital component). The balance of \$1.00 was debited to CAIL's retained profits (the Dividend component) and paid as a fully franked distribution. The Cancellation Payment was paid out of CAIL's existing cash reserves.

17. To be eligible for the Selective Capital Reduction, participating shareholders were required to hold their 7% preference shares on the Record Date of 23 April 2010.

18. The Cancellation Payment was paid on 3 May 2010. The Selective Capital Reduction was implemented by the cancellation of the 7% preference shares on the same date, 3 May 2010.

19. CAIL confirmed that its share capital account was not tainted, as defined in subsection 995-1(1).

20. At the time when the Selective Capital Reduction was implemented, CAIL had at least 300 'members' (as defined in section 960-130) and was not a company that was covered by section 116-35.

21. The participating shareholders that are foreign residents did not own 7% preference shares that passed the non-portfolio interest test (section 960-195) on the date that the 7% preference shares were cancelled, or throughout a 12 month period that began no earlier than 24 months before that date and ended no later than that date (section 855-25). Further, items 1, 3, 4 and 5 of the table in section 855-15 did not apply to participating shareholders who were foreign residents.

Ruling

Division 16K

22. The Selective Capital Reduction is not treated as a buy-back for the purposes of Division 16K of Part III of the ITAA 1936.

The Dividend component and the Capital component

23. The amount paid by CAIL to participating shareholders in respect of the cancellation of a 7% preference share (the Cancellation Payment) under the Selective Capital Reduction is a distribution made by the company. The distribution is a dividend to the extent that it is not debited to the company's share capital account (paragraphs (a) and (d) of the definition of 'dividend' in subsection 6(1) of the ITAA 1936). As \$0.50 of the Cancellation Payment will be debited against the company's preference share liability account, which is a share capital account (section 975-300 of the ITAA 1997) [the Capital component], a participating shareholder will receive a dividend of \$1.00 (the Dividend component) for each share cancelled.

24. The treatment of the Cancellation Payment for tax purposes will depend on whether the sale is on capital account (where the shares are held for investment) or on revenue account.

Dividend component

Assessability of the Dividend component for resident participating shareholders

25. The Dividend component is included in the assessable income of resident participating shareholders (subsection 44(1) of the ITAA 1936).

Gross-up and tax offset

26. The Dividend component is a frankable distribution pursuant to section 202-40 and is therefore capable of being franked in accordance with section 202-5.

27. An amount equal to the franking credit on the Dividend component (gross-up) is included in the assessable income of a participating shareholder (subsection 207-20(1)).

28. A participating shareholder will be entitled to a tax offset under subsection 207-20(2) of the ITAA 1997 equal to the amount of the franking credit on the Dividend component, subject to the participating shareholder being a 'qualified person' (paragraph 207-145(1)(a) of the ITAA 1997). A 'qualified person' is defined in the former Part IIIAA of the ITAA 1936.

Qualified persons

29. For the purposes of Division 1A of former Part IIIAA of the ITAA 1936, a participating shareholder is considered to have satisfied the holding period rule under former section 160APHO of the ITAA 1936 and therefore be a 'qualified person' (as long as the related payments rule is also met) in relation to the Dividend component if:

- the 7% preference shares cancelled under the Selective Capital Reduction were acquired on or before 1 February 2010;
- the participating shareholder has no other positions in relation to the shares cancelled under the Selective Capital Reduction; and
- the participating shareholder or an associate of the participating shareholder has not made, is not under an obligation to make, nor is likely to make, any related payments.

30. A participating shareholder who acquired the 7% preference shares after 1 February 2010 that are subsequently cancelled under the Selective Capital Reduction is not a 'qualified person' in relation to the Dividend component of the Cancellation Payment under the Selective Capital Reduction.

Refundable tax offset

31. The tax offset will be subject to the refundable tax offset rules in Division 67. Certain trustees and corporate tax entities will not be entitled to a refundable tax offset because of subsections 67-25(1A) to (1D).

Non-resident participating shareholders

32. As the Dividend component will be fully franked, non-resident participating shareholders will not be subject to Australian withholding tax on the Dividend component (paragraph 128B(3)(ga) of the ITAA 1936).

Capital component***Shares held on revenue account or as trading stock by resident participating shareholders***

33. Where the 7% preference shares are held as revenue assets by resident participating shareholders, the amount by which the Capital component (\$0.50 per share) of the Cancellation Payment exceeds the cost of each share is included in the shareholder's assessable income under section 6-5. Correspondingly, if the cost exceeds the Capital component (\$0.50 per share) of the Cancellation Payment, the difference is an allowable deduction under section 8-1.

34. Where the 7% preference shares are held as trading stock by resident participating shareholders, the Capital component (\$0.50 per share) of the Cancellation Payment will be included in the shareholder's assessable income under section 6-5.

Capital gains tax

35. CGT event C2 will happen to each of the participating shareholders when their 7% preference shares are cancelled under the Selective Capital Reduction (section 104-25).

36. The capital proceeds from the cancellation of the 7% preference shares consists of the money received, or entitled to be received, by the participating shareholders in respect of the cancellation of their shares (subsection 116-20(1)). This is the Cancellation Payment of \$1.50 per share.

37. The market value substitution rule in subsection 116-30(2) will have no application in determining the capital proceeds from the cancellation of the 7% preference shares under the Selective Capital Reduction (subsection 116-30(2B)).

38. A participating shareholder will make a capital gain if the capital proceeds from the cancellation of their 7% preference shares are more than the cost base of the shares. A participating shareholder will make a capital loss if the capital proceeds from the cancellation are less than the reduced cost base of the shares (subsection 104-25(3)).

39. A capital gain made by a participating shareholder when CGT event C2 happens is reduced by the amount that is included in the assessable income of the participating shareholder under section 6-5 of the ITAA 1997 as ordinary income (except where the shares were held as trading stock) or under subsection 44(1) of the ITAA 1936 as a dividend (section 118-20 of the ITAA 1997).

40. A capital gain or capital loss made by a participating shareholder from CGT event C2 is disregarded if, at the time of the cancellation of their 7% preference shares, the shares are held as trading stock (subsection 118-25(1)).

41. A capital gain or capital loss made by a participating shareholder from CGT event C2 is disregarded if they acquired their 7% preference shares before 20 September 1985 (paragraph 104-25(5)(a)).

42. A participating shareholder disregards a capital gain or capital loss from CGT event C2 happening on the cancellation of their 7% preference shares if they are a foreign resident just before the CGT event happens.

Traditional securities

43. Sections 26BB and 70B of the ITAA 1936 will not apply to the cancellation of the 7% preference shares under the Selective Capital Reduction, as the 7% preference shares are not traditional securities.

The anti-avoidance provisions

Sections 45A and 45B

44. The Commissioner will not make a determination under subsection 45A(2) or subsection 45B(3) of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole, or any part, of the Capital component of the Cancellation Payment received under the Selective Capital Reduction by participating shareholders.

Section 177EA

45. The Commissioner will not make a determination under paragraph 177EA(5)(b) of the ITAA 1936 to deny the whole, or any part, of the imputation benefits that arise in respect of the Dividend component of the Cancellation Payment received under the Selective Capital Reduction by participating shareholders.

Section 204-30

46. The Commissioner will not make a determination under subsection 204-30(3) to deny the whole, or any part, of the imputation benefits that arise in respect of the Dividend component of the Cancellation Payment received under the Selective Capital Reduction by participating shareholders.

Appendix 1 – Explanation

❶ *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.*

Division 16K

47. Division 16K of Part III of the ITAA 1936 provides for the taxation treatment of share buy-backs. Section 159GZZZJ of the ITAA 1936 defines 'buy-back' as having the meaning given by paragraph 159GZZZK(a) of the ITAA 1936, which provides that a purchase is a buy-back where a company buys a share in itself from a shareholder in the company.

48. CAIL will not be buying back its 7% Preference Shares from its participating shareholders. Instead the shares will be cancelled in accordance with section 256B of the *Corporations Act 2001*. Therefore, the Selective Capital Reduction will not be treated as a 'buy-back' for the purposes of Division 16K of Part III of the ITAA 1936.

The Dividend component and the Capital component

49. The Cancellation Payment received by the participating shareholders for each share cancelled under the Selective Capital Reduction is made up of two elements:

- a Dividend component; and
- a Capital component.

50. The amount of each component is determined in accordance with the definition of 'dividend' in subsection 6(1) of the ITAA 1936, having regard to how CAIL accounts for the Selective Capital Reduction.

51. The Selective Capital Reduction may have different taxation implications for shareholders depending on how the shares were held, for instance:

- a shareholder who held their shares on capital account will be subject to the capital gains tax provisions; and
- a shareholder who held their shares on revenue account or as trading stock will be subject to the ordinary income provisions.

Dividend component

Assessability of the Dividend component for resident participating shareholders

52. Subsection 44(1) of the ITAA 1936 includes in a shareholder's assessable income any dividends, as defined in subsection 6(1) of the ITAA 1936, paid to the shareholder out of profits derived by the company from any source (if the shareholder is a resident of Australia) or from an Australian source (if the shareholder is a non-resident of Australia).

53. The definition of 'dividend' in subsection 6(1) of the ITAA 1936 provides that any distribution made by a company to any of its shareholders, whether in money or other property, is a dividend except where the distribution is debited against an amount standing to the credit of the share capital account of the company (paragraphs (a) and (d) of the definition of 'dividend' in subsection 6(1) of the ITAA 1936).

54. The term 'share capital account' is defined in subsection 975-300(1) as an account that the company keeps of its share capital, or any other account created on or after 1 July 1998 where the first amount credited to the account was an amount of share capital. The preference share liability account that is to be debited with the Capital component of Cancellation Payment is an account that the company keeps of its share capital.

55. Subsection 975-300(3) of the ITAA 1997 states that an account is taken not to be a share capital account (for purposes including the definition of 'dividend' in subsection 6(1) of the ITAA 1936) if it is tainted. Subsection 197-50(1) of the ITAA 1997 states that a company's share capital account becomes tainted if an amount to which Division 197 of the ITAA 1997 applies is transferred to the account and the account is not already tainted.

56. The Cancellation Payment of \$1.50 per share is a distribution made by CAIL to the participating shareholders. \$0.50 of the Cancellation Payment will be debited to the company's share capital account. As the account is not tainted, the amount of \$0.50 will not constitute a dividend because it is excluded by paragraph (d) of the definition of 'dividend' in subsection 6(1) of the ITAA 1936.

57. As the balance of the Cancellation Payment will be debited to CAIL's retained profits, this amount of \$1.00 per share will be treated as a dividend under section 6(1) of the ITAA 1936 (the Dividend component).

58. The Dividend component is included in the assessable income of resident participating shareholders under subsection 44(1) of the ITAA 1936.

Gross-up and tax offset

59. For all participating shareholders, the Dividend component constitutes a frankable distribution pursuant to section 202-40, and is therefore capable of being franked in accordance with section 202-5.

60. An amount equal to the franking credit on the Dividend component (gross-up) is included in the assessable income of a participating shareholder in the income year in which the Dividend component is paid, under subsection 207-20(1).

61. A participating shareholder will be entitled to a tax offset under subsection 207-20(2) of the ITAA 1997 for the income year in which the Dividend component is paid. The tax offset is equal to the amount of the franking credit on the Dividend component, subject to the participating shareholder being a 'qualified person' (see paragraph 207-145(1)(a) of the ITAA 1997). A 'qualified person' is defined in the former Part IIIA of the ITAA 1936.

Qualified persons

62. Paragraph 207-145(1)(a) of the ITAA 1997 provides that an entity that is not a 'qualified person' in relation to a franked distribution for the purposes of Division 1A of former Part IIIA of the ITAA 1936 is denied a gross-up and a tax offset. To be a 'qualified person' in relation to the Dividend component paid under the Selective Capital Reduction, the shareholder must satisfy both the holding period rule and the related payments rule.

63. The holding period rule requires the holders of preference shares to hold the shares, or the interest in the shares, on which a dividend has been paid for a continuous period of at least 90 days. In determining whether a shareholder has satisfied the holding period rule, any days on which the shareholder has materially diminished risks of loss or opportunities for gain in respect of the shares or interest are not counted. The day of acquisition and the day of disposal of the relevant shares or interest are also not counted.

64. Under the former subsection 160APHM(2) of the ITAA 1936, a shareholder is taken to have materially diminished risks of loss or opportunities for gain on a particular day in respect of shares, or interests in shares, if the 'net position' of the shareholder on that day in relation to the shares or interest has less than 30% of those risks and opportunities.

65. In this case, the Commissioner does not regard the announcement of the Selective Capital Reduction by way of cancellation of the 7% preference shares as affecting whether the shares, or an interest in the shares, have materially diminished risks of loss or opportunities for gain.

66. There are 90 clear days between 1 February 2010 and 3 May 2010 (that is, the date on which the 7% preference shares were cancelled). Therefore, a participating shareholder who acquired the shares after 1 February 2010 will not satisfy the holding period rule. Only participating shareholders who purchased shares on or before 1 February 2010 will satisfy the holding period rule as long as those shares have been held without materially diminished risks of loss or opportunities for gain for at least 90 continuous days.

67. A participating shareholder who acquired the shares after 1 February 2010 that are subsequently cancelled under the Selective Capital Reduction is not a 'qualified person' under the former section 160APHO of the ITAA 1936 in relation to the Dividend component of the Cancellation Payment under the Selective Capital Reduction for the purposes of Division 1A of former Part IIIAA of the ITAA 1936

68. Further, a shareholder will be subject to the related payments rule if the shareholder, or an associate of the shareholder, is under an obligation to make, or makes, a payment in respect of the dividend which effectively passes the benefit of the dividend to another person.

Refundable tax offset

69. The tax offset will be subject to the refundable tax offset rules in Division 67. Certain trustees and corporate tax entities will not be entitled to a refundable tax offset because of subsections 67-25(1A) to (1D).

Non-resident participating shareholders

70. Under subsection 128B(1) of the ITAA 1936, dividends derived by a non-resident and paid by a resident company are subject to withholding tax under subsection 128B(4) of the ITAA 1936.

71. As the Dividend component of the Cancellation Payment will be fully franked, non-resident participating shareholders will not be subject to Australian withholding tax on the Dividend component under paragraph 128B(3)(ga) of the ITAA 1936.

Capital component

Shares held on revenue account or as trading stock by resident participating shareholders

72. Where the 7% preference shares are held as revenue assets by resident participating shareholders, the amount by which the Capital component (\$0.50 per share) of the Cancellation Payment exceeds the cost of each share is included in the shareholder's assessable income under section 6-5. Correspondingly, if the cost exceeds the Capital component (\$0.50 per share) of the Cancellation Payment, the difference is an allowable deduction under section 8-1.

73. Where the 7% preference shares are held as trading stock by resident participating shareholders, the Capital component (\$0.50 per share) of the Cancellation Payment will be included in the shareholder's assessable income under section 6-5.

Capital gains tax

CGT event C2 – section 104-25

74. Under paragraph 104-25(1)(a), CGT event C2 happens when an entity's ownership of an intangible CGT asset (such as a 7% preference share) ends by the asset being redeemed or cancelled.

75. Therefore, CGT event C2 will happen to each of the participating shareholders when their 7% preference shares are cancelled under the Selective Capital Reduction.

Time of CGT event C2

76. The time of CGT event C2 is when an entity enters into the contract that results in the asset ending, or, if there is no contract, when the asset ends (subsection 104-25(2)).

77. The cancellation of the 7% preference shares under the Selective Capital Reduction will not happen under a contract. Accordingly, CGT event C2 happened on 3 May 2010, the date that the 7% preference shares were cancelled.

Capital proceeds

78. Subsection 116-20(1) provides that the capital proceeds from a CGT event are the total of the money received or entitled to be received, and the market value (worked out as at the time of the event) of any other property received or entitled to be received, in respect of the CGT event happening. The capital proceeds from the cancellation of the 7% preference shares are the Cancellation Payment of \$1.50 per share.

79. Section 116-30 provides that in certain circumstances, the capital proceeds from a CGT event are to be replaced with the market value (worked out as at the time of the event) of the CGT asset that is the subject of the event. Under subparagraph 116-30(2)(b)(ii), the market value substitution rule applies if the capital proceeds from the CGT event are more or less than the market value of the asset and the CGT event is CGT event C2. As it is the subject of CGT event C2, the market value would be worked out as if the CGT event had not occurred and was never proposed to occur (subsection 116-30(3A)).

80. The market value substitution rule in subparagraph 116-30(2)(b)(ii) will have no possible application to the Selective Capital Reduction because of subsection 116-30(2B). This is because:

- the CGT event is CGT event C2; and
- the CGT asset that is the subject of the event is a share in a company (CAIL) that has at least 300 members and is not a company that is covered by section 116-35.

81. Accordingly, the capital proceeds from the cancellation of the 7% preference shares will be the money received or entitled to be received by the participating shareholders – \$1.50 per share.

Capital gain or capital loss

82. A participating shareholder will make a capital gain if the capital proceeds from the cancellation of their 7% preference shares are more than the cost base of the shares. A participating shareholder will make a capital loss if the capital proceeds from the cancellation are less than the reduced cost base of the shares (subsection 104-25(3)).

Section 118-20

83. Under subsection 118-20(1), a capital gain made by an entity from a CGT event is reduced if, because of the event, a provision of the income tax legislation outside of the capital gains tax provisions in Part 3-1 includes an amount (for any income year) in an entity's assessable income. The capital gain is reduced by the amount included, but not below zero (subsections 118-20(2) and (3)).

84. Accordingly, a capital gain made by a participating shareholder from CGT event C2 is reduced by the amount that is included in the assessable income of the participating shareholder under section 6-5 of the ITAA 1997 as ordinary income (except where the shares were held as trading stock) or under subsection 44(1) of the ITAA 1936 as a dividend.

Shares held as trading stock

85. A capital gain or capital loss made by an entity from a CGT asset is disregarded if, at the time of the CGT event, the asset is held as the entity's trading stock (subsection 118-25(1)).

86. Accordingly, a capital gain or capital loss made by a participating shareholder from CGT event C2 is disregarded if, at the time of the cancellation of their 7% preference shares, the shares are held as their trading stock.

Pre-CGT shares

87. A capital gain or capital loss made by a participating shareholder from CGT event C2 is disregarded if they acquired their 7% preference shares before 20 September 1985 (paragraph 104-25(5)(a)).

Foreign resident participating shareholders

88. Under section 855-10, an entity disregards a capital gain or capital loss 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'.

89. The term 'taxable Australian property' is defined in the table in section 855-15. It covers five categories of CGT assets:

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

90. Accordingly, a participating shareholder disregards a capital gain or capital loss from CGT event C2 happening on the cancellation of their 7% preference shares if they are a foreign resident just before the CGT event happens, and the shares are not 'taxable Australian property'.

91. Specifically, the 7% preference shares of a participating shareholder who is a foreign resident will not be an 'indirect Australian real property interest' at the time of CGT event C2 as, in accordance with the facts of this scheme, the shares do not pass the non-portfolio interest test (section 960-195) at that time, or throughout a 12 month period that began no earlier than 24 months before that time and ended no later than that time (section 855-25). As no other item in the table in section 855-15 will apply, the shares will not be 'taxable Australian property' and accordingly, a participating shareholder disregards a capital gain or capital loss from CGT event C2 happening on the cancellation of their shares if they are a foreign resident just before the CGT event happens.

Traditional securities

92. Subsection 26BB(1) of the ITAA 1936 defines a 'traditional security' as a 'security' held by the taxpayer that:

- (a) was acquired by the taxpayer after 10 May 1989;
- (b) does not have an eligible return or has an eligible return that meets certain conditions;
- (c) is not a prescribed security within the meaning of section 26C of the ITAA 1936; and
- (d) is not trading stock of the taxpayer.

93. The term 'security' is defined by reference to subsection 159GP(1) of the ITAA 1936. The 7% preference shares do not satisfy the definition of a 'security' within that subsection. Therefore, the 7% preference shares are not traditional securities for the purposes of sections 26BB and 70B of the ITAA 1936.

94. Therefore, sections 26BB and 70B of the ITAA 1936 will not apply to the cancellation of the 7% preference shares under the Selective Capital Reduction.

The anti-avoidance provisions

95. Sections 45A and 45B of the ITAA 1936 are anti-avoidance provisions, which, if they apply, allow the Commissioner to make a determination that section 45C of the ITAA 1936 applies. The effect of such a determination is that all or part of the Capital component of the Cancellation Payment received by the participating shareholders under the Selective Capital Reduction is treated as an unfranked dividend. Accordingly, the application of these two provisions to the Capital component must be considered.

Section 45A

96. Section 45A of the ITAA 1936 applies in circumstances where capital benefits are streamed to certain shareholders (the advantaged shareholders) who derive a greater benefit from the receipt of share capital and it is reasonable to assume that the other shareholders (the disadvantaged shareholders) have received or will receive dividends.

97. Although there has been a 'provision of capital benefit' (as defined in subsection 45A(3) of the ITAA 1936) to participating shareholders under the Selective Capital Reduction, the circumstances of the Selective Capital Reduction indicate that there will be no streaming of capital benefits to some shareholders and of dividends to other shareholders. Accordingly, section 45A of the ITAA 1936 does not apply to the Selective Capital Reduction.

Section 45B

98. Section 45B of the ITAA 1936 applies where certain capital payments are made to shareholders in substitution for dividends. In broad terms, section 45B of the ITAA 1936 applies where:

- (a) there is a scheme under which a person is provided with a capital benefit by a company (paragraph 45B(2)(a) of the ITAA 1936);
- (b) under the scheme, a taxpayer, who may or may not be the person provided with the capital benefit, obtains a tax benefit (paragraph 45B(2)(b) of the ITAA 1936); and
- (c) having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a purpose (whether or not the dominant purpose but not including an incidental purpose), of enabling a taxpayer to obtain a tax benefit (paragraph 45B(2)(c) of the ITAA 1936).

99. In the case of the Selective Capital Reduction, whilst the conditions of paragraphs 45B(2)(a) and 45B(2)(b) of the ITAA 1936 have been met, the requisite purpose of enabling the participating shareholder to obtain a tax benefit – by way of a capital distribution – is not present.

100. Having regard to the relevant circumstances of the scheme, set out in subsection 45B(8) of the ITAA 1936, it is apparent that the inclusion of a capital element in the consideration for the Selective Capital Reduction is appropriate. Further, the Capital component of the Cancellation Payment cannot be said to be attributable to the profits of the company, nor does the pattern of distributions indicate that it is being paid in substitution for a dividend. Accordingly, section 45B of the ITAA 1936 does not apply to the Selective Capital Reduction.

Section 177EA

101. Section 177EA of the ITAA 1936 is a general anti-avoidance provision that applies to a wide range of schemes to obtain a tax advantage in relation to imputation benefits. In essence, it applies to schemes for the disposal of shares or an interest in shares where a franked distribution is paid or payable in respect of the shares or an interest in shares. This would include a cancellation of shares with a franked dividend paid as part of the consideration for the cancellation.

102. Specifically, subsection 177EA(3) of the ITAA 1936 provides that section 177EA applies if:

- (a) there is a scheme for a disposition of membership interests, or an interest in membership interests, in a corporate tax entity; and

- (b) either:
 - (i) a frankable distribution has been paid, or is payable or expected to be payable, to a person in respect of the membership interests; or
 - (ii) a frankable distribution has flowed indirectly, or flows indirectly or is expected to flow indirectly, to a person in respect of the interest in membership interests, as the case may be; and
- (c) the distribution was, or is expected to be, a franked distribution or a distribution franked with an exempting credit; and
- (d) except for this section, the person (the 'relevant taxpayer') would receive, or could reasonably be expected to receive, imputation benefits as a result of the distribution; and
- (e) having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme of any part of the scheme did so for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain an imputation benefit.

103. In the present case, the conditions of paragraphs 177EA(3)(a) to (d) of the ITAA 1936 are satisfied. Accordingly, the issue is whether, having regard to the relevant circumstances of the scheme, it would be concluded that, on the part of CAIL, its shareholders or any other person, there is a more than incidental purpose of conferring an imputation benefit under the scheme. For the purposes of section 177EA, the 'relevant taxpayer' is a participating shareholder and the scheme comprises the circumstances of the Selective Capital Reduction.

104. In arriving at a conclusion, the Commissioner must have regard to the relevant circumstances of the scheme which include, but are not limited to, the circumstances set out in subsection 177EA(17) of the ITAA 1936. The relevant circumstances encompass a range of factors which, taken individually or collectively, could indicate the requisite purpose. Due to the diverse nature of these circumstances, some may not be present at any one time in any one scheme.

105. Having regard to the relevant circumstances of the scheme, the Commissioner has come to the view that the requisite purpose is not present. Accordingly, section 177EA of the ITAA 1936 will not apply to the Selective Capital Reduction.

Section 204-30

106. Section 204-30 applies where a corporate tax entity streams the payment of dividends, or the payment of dividends and the giving of other benefits, to its members in such a way that:

- an imputation benefit is, or apart from that section would be, received by a member of the entity as a result of the distribution or distributions (paragraph 204-30(1)(a));

- the member would derive a greater benefit from franking credits than another member of the entity (paragraph 204-30(1)(b)); and
- the other member of the entity will receive lesser imputation benefits, or will not receive any imputation benefits, whether or not the other member receives other benefits (paragraph 204-30(1)(c)).

107. Relevantly, if section 204-30 applies the Commissioner may make a determination in writing under subsection 204-30(3), that either:

- a specified franking debit arises in the franking account of the entity, for a specified distribution or other benefit to a disadvantaged member (paragraph 204-30(3)(a)); or
- no imputation benefit is to arise in respect of any streamed distributions made to a favoured member and specified in the determination (paragraph 204-30(3)(c)).

108. For section 204-30 to apply, members to whom distributions are streamed must derive a greater benefit from imputation benefits than other members. The words 'derives a greater benefit from franking credits' (imputation benefits) are defined in subsection 204-30(8) by reference to the ability of the members to fully utilise imputation benefits.

109. Under the Selective Capital Reduction, participating shareholders will receive an imputation benefit as a result of the Dividend component; resident participating shareholders in the form of a tax offset (paragraph 204-30(6)(a)) and non-resident participating shareholders in the form of an exemption from dividend withholding tax (paragraph 204-30(6)(e)). The resident participating shareholders will derive a greater benefit from franking credits than the non-resident participating shareholders.

110. However, as the Dividend component will be franked to the same extent and paid to all the participating shareholders and having regard to the profile of the participating shareholders, it is concluded that the company has not directed the flow of distributions in such a manner as to ensure that imputation benefits are derived by members who derive greater benefit from franking credits, while other members receive lesser or no imputation benefits.

111. Having regard to all of the relevant circumstances, section 204-30 will not apply to the Selective Capital Reduction.

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Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Subject references:

- cancellation of shares
- capital reductions
- dividend streaming arrangements
- franked dividend
- holding period rule
- qualified person
- related payment rule

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