



Class Ruling

Income tax: demerger of Dart Energy Limited by Arrow Energy Limited

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① 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 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 44 of the ITAA 1936;
- section 45 of the ITAA 1936;
- section 45A of the ITAA 1936;
- section 45B of the ITAA 1936;
- section 45BA of the ITAA 1936;
- section 45C of the ITAA 1936;
- section 104-135 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 109-5 of the ITAA 1997;

- subsection 115-30(1) of the ITAA 1997; and
- Division 125 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 is the shareholders of Arrow Energy Limited (Arrow) who:

- (a) are listed on the share register of Arrow as at the Demerger Record Date (Record Date);
- (b) are residents of Australia as defined in subsection 6(1) on that date; and
- (c) owned ordinary shares in Arrow at the Record Date and held those on capital account at the time of the scheme.

In this Ruling, an entity belonging to this class of entities is referred to as an 'Arrow shareholder'.

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 37 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 2010 to 30 June 2011. The Ruling continues to apply after 30 June 2011 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 documents and information provided by Arrow's advisers (the applicant for this ruling).

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

Background

10. The demerger of 100% of the ordinary shares in Dart Energy Limited (Dart) to Arrow shareholders was recommended by Arrow to its shareholders through an Australian Securities Exchange (ASX) announcement on 22 March 2010. The announcement also recommended the acquisition, following the demerger, of 100% of the ordinary shares in Arrow by a third party.

Relevant entities

Arrow

11. Arrow was, immediately before the demerger, an Australian resident company listed on the ASX. Arrow was the head company of a consolidated tax group for the purposes of Part 3-90 of the ITAA 1997.

12. Arrow is a resource company. Before the demerger, it had invested in coal seam gas developments, pipeline assets, electricity generation and investments in liquefied-natural gas projects. From late 2006, Arrow had sought to replicate the success and scale of Arrow's Australian coal seam gas business in multiple countries throughout Asia, including India, China, Indonesia and Vietnam.

13. As at the date of the Scheme Booklet, Arrow had 733,503,047 fully paid ordinary shares on issue. The number of shares on issue could increase prior to the demerger if, and to the extent that, Arrow options are exercised before they are cancelled. Arrow expects that most options will be cancelled rather than exercised.

14. Arrow's shareholder spread was estimated to comprise broadly 70% Australian resident shareholders and 30% non-resident shareholders. The largest shareholder, with approximately 17% of the Arrow shares, was a wholly owned subsidiary of an Australian resident company.

15. There were no other ownership interests in Arrow just before the demerger.

16. All outstanding options on issue by Arrow were cancelled or exercised prior to the Effective Date for the demerger (Effective Date).

Dart

17. At the time of the demerger, Dart was an Australian resident company and a wholly owned subsidiary of Arrow. Dart held international coal seam gas assets and a limited number of Australian assets and liabilities.

The demerger of Dart

18. The demerger of Dart from the Arrow consolidated group was effected by a reduction in the share capital of Arrow and by payment of a demerger dividend that was satisfied by an *in specie* distribution of all of the shares in Dart to Arrow shareholders. The ordinary shares in Dart were listed on the ASX on 20 July 2010 which is before the Implementation Date for the demerger (Implementation Date).

Reasons for the demerger

19. Arrow expected that a number of advantages would accrue to its shareholders as a result of the demerger of Dart. These advantages include:

- Arrow and Dart being able to focus more clearly on their strategies, growth objectives and core competencies as a result of separating the domestic and international businesses;
- providing Arrow's domestic exploration and development, including a liquefied natural gas project, with access to capital to meet its own funding needs as it would not have the resources to internally fund the international business;
- providing the international business with separate access to capital so as to meet its funding needs; and
- improving the investment choice for Arrow shareholders who will have the choice of holding investments in companies with markedly different profiles, that is, Arrow (which holds relatively mature Australian coal seam gas assets) and Dart (which holds the international business including assets that are early-stage, higher-risk, cash-absorbing, longer-to-return opportunities).

Transfer of assets and liabilities to Dart

20. Prior to the demerger, Dart held the following assets:
- (i) certain assets and liabilities acquired from Arrow at book value;
 - (ii) cash of approximately \$45 million (less net cash outflows from 4 March 2010 until the Implementation Date);
21. At the time of the demerger, Dart also held a 90% interest in a Singaporean company which holds the portfolio of international coal seam gas assets in China, India, Indonesia and Vietnam).

Distribution of Dart shares

22. Arrow shareholders voted at a general meeting on 14 July 2010 to approve an ordinary resolution (the capital reduction resolution) to reduce the share capital of Arrow by an amount calculated by reference to the proportion of the relative market values of Arrow and Dart at the time of the demerger (the capital reduction amount).
23. The capital reduction amount was satisfied by an *in specie* distribution to Arrow shareholders of all its Dart shares in accordance with a Demerger Scheme of Arrangement which was subject to Arrow shareholders and Court approval.
24. Arrow shareholders received one Dart share for every two Arrow shares they held on the Record Date.
25. As a result of the demerger, Arrow shareholders owned shares in both Arrow and Dart.

Accounting for the distribution to effect the demerger

26. Arrow accounted for the distributions that effected the demerger by debiting its share capital by the capital reduction amount determined by reference to the proportion of the relative market values of Arrow and Dart at the time of the demerger.
27. The dividend amount was an amount equal to the difference between the market value of Dart on the Implementation Date and the capital reduction amount. This amount was debited to its retained earnings.

Ineligible overseas shareholders

28. Shareholders of Arrow whose address, as shown on Arrow's shareholder register, was outside Australia or New Zealand (and their respective external territories), or who were residents of a jurisdiction other than those places, and in respect of whom Dart was not satisfied that the laws of that shareholder's country of residence permit the issue of Dart shares, either unconditionally or after compliance with acceptable and practical terms, were Ineligible Overseas Shareholders.

29. The shares in Dart that the Ineligible Overseas Shareholders would otherwise have been entitled to receive were transferred or issued to a nominee, who will sell them on the ASX and pay to each Ineligible Overseas Shareholder their share of the net proceeds of sale of those Dart shares, in accordance with the procedures outlined in the Scheme Booklet.

Capital raising proposal

30. Dart will seek to raise new equity capital as soon as practicable following its listing on the ASX. Dart will seek to raise an amount of equity in the order of approximately \$75 million partly by way of a placement at the time Dart is listed on the ASX and partly by way of an additional capital raising at some point not earlier than three months after the date that Dart is listed.

31. If the ASX grants approval, Dart intends to proceed with the placement provided market conditions at the time are considered appropriate by the Dart Board. It is expected that any placement will be to Australian institutional investors, wholesale investors and, to the extent permitted by applicable law, international institutional investors. If the Demerger Scheme is not approved by Arrow Shareholders (or is approved by Arrow Shareholders but not approved by the Court) then a placement will not proceed.

32. Proceeds from the capital raisings will be used to fund Dart's incremental expenditure and new business expenditure including funding on-going exploration, tenement acquisition costs and joint venture and farm-in costs.

Other matters

33. None of the Arrow shareholders acquired their shares in Arrow before 20 September 1985.

34. Arrow confirmed that Capital Gains Tax (CGT) assets representing more than 50% of the market value of all the CGT assets of Dart and its subsidiaries would be used directly or indirectly in a business carried on by Dart or its subsidiaries just after the demerger.

35. Arrow confirmed that no amounts have been transferred to its share capital account (as defined in section 975-300 of the ITAA 1997) from any of its other accounts, and accordingly its share capital account was not tainted within the meaning of Division 197 of the ITAA 1997.

36. Arrow has never paid a dividend to its shareholders and its franking account balance was \$8 million as at the date of the demerger.

37. Arrow confirmed it did not make an election under subsection 44(2) of the ITAA 1936.

Ruling

CGT event G1

38. CGT event G1 happened in relation to each Arrow share owned by an Arrow shareholder at the time Arrow made the payment of the capital reduction amount (section 104-135 of the ITAA 1997).

39. An Arrow shareholder made a capital gain under CGT event G1 if the proportion of the capital reduction amount received for one Arrow share exceeded the cost base of that share. The capital gain is equal to the amount of the excess (subsection 104-135(3) of the ITAA 1997).

(A) CGT consequences for Australian residents

40. The following CGT consequences apply to an Arrow shareholder who was a resident of Australia (as that term is defined in subsection 6(1) of the ITAA 1936) at the time of the demerger.

Demerger roll-over relief

41. Arrow and its subsidiary, Dart, were part of a demerger group under subsection 125-65(1) of the ITAA 1997.

42. A demerger, as described under section 125-70 of the ITAA 1997, happened to this demerger group under the scheme.

43. Arrow shareholders are eligible to choose demerger roll-over relief under subsection 125-55(1) of the ITAA 1997.

CGT consequences of choosing roll-over

44. Arrow shareholders who choose demerger roll-over relief can disregard a capital gain made in respect of CGT event G1 happening to their Arrow shares under the demerger (subsection 125-80(1) of the ITAA 1997).

Other CGT consequences of choosing roll-over

45. If Arrow shareholders choose roll-over relief, they must also recalculate the cost bases and reduced cost bases of their Arrow and Dart shares.

46. The first element of the cost base and reduced cost base of each Arrow share and corresponding Dart share received under the demerger is worked out as follows:

- sum the cost bases of the Arrow shares (just before the demerger); and
- apportion that sum over the Arrow shares and corresponding new Dart shares received under the demerger.

The apportionment of this sum is done on a reasonable basis having regard to the market values (just after the demerger) of the Arrow and Dart shares, or a reasonable approximation of those market values (subsections 125-80(2) and (3) of the ITAA 1997).

Arrow shareholders who do not choose demerger roll-over

47. Arrow shareholders who do not choose demerger roll-over relief:

- are not entitled to disregard any capital gain made in respect of CGT event G1 that happened to their Arrow shares under the demerger; and
- the first element of the cost base and reduced cost base of each Arrow share and the corresponding Dart share is calculated in the same manner as if they had chosen demerger roll-over (see paragraphs 45 and 46 of this Ruling (subsections 125-85(1) and (2) of the ITAA 1997)).

Acquisition date of the Dart shares

48. For the purposes of determining eligibility to a discount capital gain, the Dart shares received by an Arrow shareholder will be taken to have been acquired on the date the shareholder acquired, for CGT purposes, the corresponding Arrow shares (item 2 in the table in subsection 115-30(1) of the ITAA 1997). This is the case whether demerger roll-over relief is chosen or not.

49. For all other CGT purposes, Arrow shareholders acquired their Dart shares on the date that the Dart shares are transferred to them by Arrow, being the Demerger Implementation Date (subsection 109-5(2) of the ITAA 1997).

(B) Dividend consequences

50. Any dividend arising under the demerger is a demerger dividend (subsection 6(1) of the ITAA 1936).

51. The demerger dividend is neither assessable income nor exempt income of the Arrow shareholders (subsections 44(3) and (4)).

52. As the capital reduction amount was debited to Arrow's share capital account it is not a dividend, as defined in subsection 6(1).

Application of sections 45, 45A, 45B, 45BA and 45C

53. Section 45 and section 45A will not apply to the whole or any part of any demerger benefit provided to Arrow shareholders under the demerger.

54. The Commissioner will not make a determination under paragraph 45B(3)(a) that section 45BA applies to the whole or any part of any demerger benefit provided to Arrow shareholders under the demerger.

55. The Commissioner will not make a determination under paragraph 45B(3)(b) that section 45C applies to the whole or any part of the capital benefit provided to participating Arrow shareholders under the demerger.

Commissioner of Taxation

4 August 2010

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.*

56. A significant tax consequence of the scheme is the availability of demerger roll-over under Division 125 of the ITAA 1997. Broadly, Arrow shareholders can choose roll-over to disregard a capital gain made under the demerger. There are special rules for calculating the cost base and reduced cost base of the Arrow and Dart shares for Arrow shareholders whether or not they choose roll-over.

Conditions for demerger roll-over relief

57. Subsection 125-55(1) of the ITAA 1997 provides that roll-over may be chosen if, at the time of the scheme:

- a shareholder owns a share in a company – this requirement was satisfied as participating shareholders owned shares in Arrow;
- the company is the head entity of a demerger group – this requirement was satisfied as Arrow was the head company of a demerger group (see paragraphs 11 to 15 of this Ruling);
- a demerger happens to the demerger group – this requirement was satisfied as a demerger happened to the Arrow demerger group (see paragraph 17 of this Ruling); and
- under the demerger a CGT event happens to the original interest and a new or replacement interest is acquired in the demerged entity – this requirement was satisfied because CGT event G1 happened to the Arrow shares (see paragraphs 38 and 39 of this Ruling) and participating shareholders received Dart shares under the demerger.

58. Since the Arrow shareholders to whom this Ruling applies are Australian residents, the condition in subsection 125-55(2) of the ITAA 1997 is not relevant.

59. Under the scheme, the conditions for choosing demerger roll-over relief under Division 125 of the ITAA 1997 were satisfied. Therefore, Arrow shareholders can choose roll-over relief for the demerger.

Dividend

60. Subsection 44(1) of the ITAA 1936 operates to include in a shareholder's assessable income any dividends, within the meaning of that term in subsection 6(1), paid to a shareholder out of company profits.

61. Paragraph (d) of the definition of dividend in subsection 6(1) of the ITAA 1936 provides that a dividend excludes amounts debited against an amount standing to the credit of the share capital account of the company.

62. 'Share capital account' is defined in section 975-300 of the ITAA 1997 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.

63. However, subsection 975-300(3) of the ITAA 1997 provides that an account is not a share capital account if it is tainted. A share capital account is tainted if an amount to which Division 197 of the ITAA 1997 applies is transferred to the share capital account where the account is not already tainted.

64. In the circumstances of this demerger, Arrow debited a capital reduction amount to its 'share capital account' as that term is defined in subsection 6(1) of the ITAA 1936 and section 975-300 of the ITAA 1997. This amount is therefore not a dividend for the purposes of subsection 6(1) of the ITAA 1936 and is not assessable as a dividend under subsection 44(1) of the ITAA 1936.

65. However, Arrow shareholders did receive a dividend to the extent that the market value of the Dart shares distributed under the demerger exceeded the amount debited against the share capital account (see Taxation Ruling TR 2003/8).

66. This dividend is neither an assessable income nor an exempt income amount (subsections 44(3) and (4) of the ITAA 1936) if:

- the dividend is a demerger dividend (as defined in subsection 6(1));
- the head entity did not elect that subsections 44(3) and (4) do not apply to the demerger dividend (subsection 44(2)); and
- subsection 44(5) is satisfied.

67. In the present circumstances, each of the conditions in paragraph 66 of this Ruling was satisfied. Therefore, the dividend received by Arrow shareholders under the demerger is neither assessable income nor exempt income by operation of subsections 44(3) and (4) of the ITAA 1936.

The application of sections 45, 45A, 45B, 45BA and 45C

Section 45

68. Section 45 applies where a company streams the provision of shares and the payment of minimally franked dividends to its shareholders in such a way that the shares are received by some shareholders and minimally franked dividends are received by other shareholders. Minimally franked dividends are dividends which are not franked or are franked to less than 10%.

69. Based on the information provided and having regard to the circumstances of the scheme, section 45 will not apply to the *in specie* distribution received by Arrow shareholders.

Section 45A

70. Section 45A is an anti-avoidance provision that applies 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.

71. Where the Commissioner makes a written determination under subsection 45A(2) that section 45C applies in relation to the whole or part of the capital benefits, the capital benefits will be treated as unfranked dividends paid out of the company's profits.

72. Based on the information provided and having regard to the circumstances of the scheme, section 45A will not apply to the *in specie* distribution to Arrow shareholders of Dart shares and the Commissioner will not make a determination under subsection 45A(2) that section 45C applies.

Sections 45B, 45BA and 45C

73. Section 45B applies to ensure that relevant amounts are treated as dividends for taxation purposes if:

- (a) components of a demerger allocation as between capital and profit do not reflect the circumstances of the demerger; or
- (b) certain payments, allocations and distributions are made in substitution for dividends (subsection 45B(1)).

74. Where the requirements of subsection 45B(2) are met, subsection 45B(3) empowers the Commissioner to make a determination that either section 45BA applies in relation to a demerger benefit or section 45C applies in relation to a capital benefit.

75. In this case, while the conditions of paragraphs 45B(2)(a) and 45B(2)(b) were met, the requisite purpose of enabling the Arrow shareholders to obtain a tax benefit (by way of a demerger benefit or a capital benefit) was not present.

76. Accordingly, the Commissioner will not make a determination under paragraph 45B(3)(a) or (b) that either sections 45BA or 45C apply to the scheme to which this Ruling relates.

Appendix 2 – Detailed contents list

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2003/8; TR 2006/10

Subject references:

- capital benefit
- capital gains
- capital proceeds
- CGT discount
- CGT event G1-G3 – shares
- CGT roll-over relief
- cost base adjustments
- demerger
- demerger roll-over
- return of capital on shares

Legislative references:

- ITAA 1936
 - ITAA 1936 6(1)
 - ITAA 1936 44
 - ITAA 1936 44(1)
 - ITAA 1936 44(2)
 - ITAA 1936 44(3)
 - ITAA 1936 44(4)
 - ITAA 1936 44(5)
 - ITAA 1936 45
 - ITAA 1936 45A
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 - ITAA 1997
 - ITAA 1997 104-135
 - ITAA 1997 104-135(3)
 - ITAA 1997 109-5
 - ITAA 1997 109-5(2)
 - ITAA 1997 115-30(1)
 - ITAA 1997 Div 125
 - ITAA 1997 125-55(1)
 - ITAA 1997 125-65(1)
 - ITAA 1997 125-70
 - ITAA 1997 125-80(1)
 - ITAA 1997 125-80(2)
 - ITAA 1997 125-80(3)
 - ITAA 1997 125-85(1)
 - ITAA 1997 125-85(2)
 - ITAA 1997 Div 197
 - ITAA 1997 Pt 3-90
 - ITAA 1997 975-300
 - ITAA 1997 975-300(3)
 - TAA 1953
 - Copyright Act 1968
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ATO references

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 Income Tax – Capital Gains Tax – demerger relief
 Income Tax – Capital Gains Tax – discount capital gains
 Income Tax – Capital Gains Tax – CGT events G1 to G3 – shares
 Income Tax – Assessable income – dividend, interest and royalty income
 Income Tax – Tax integrity measures – dividend streaming and demerger benefits