



Class Ruling

Income tax: proposed return of capital: eServGlobal 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 provision(s) 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 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; and
- section 855-10 of the ITAA 1997.

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

Class of entities

3. The class of entities to which this Ruling applies consists of the holders of ordinary shares in eServGlobal Limited (eServ) who:

- (a) were registered on the eServ share register on the Record Date;
- (b) held their eServ shares on capital account on that date; and
- (c) are not subject to the taxation of financial arrangements rules in Division 230 of the ITAA 1997 in relation to gains and losses on their eServ shares.

(Note – Division 230 will generally not apply to individuals, unless they have made an election for it to apply to them)

In this Ruling, a person belonging to this class of entities is referred to as an 'eServ 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 23 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 2012. The Ruling continues to apply after 30 June 2012 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 8 October 2010;
- additional information provided by the applicant between 3 December 2010 and 5 April 2011; and
- amendments to the terms of the arrangement dated 1 June 2011.

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. eServ is an Australian resident company which was incorporated in 1991 and is listed on the Australian Securities Exchange (ASX) and the London Stock Exchange AIM market. eServ was listed on the ASX in September 2000 and on the AIM in October 2004.

11. eServ specializes in software development and implementation in Mobile Money Solutions and Value-Added Services which assist Telco Service Providers to increase their revenue, and gain and maintain customer ownership.

12. In August 2010, eServ sold the assets of its Universal Service Platform (USP) to a third party for net cash proceeds of \$103,055,041 by way of a simultaneous asset sale in its numerous subsidiaries.

13. The share capital invested in the USP business was \$59,891,250.

14. eServ proposes to distribute \$57,085,834.74 of the net cash proceeds from the sale of USP, equating to 29 cents per share, to all of its shareholders in the following manner:

- a dividend of \$23,909,951.57, equating to 12.146 cents per share (the proposed dividend); and

- a return of capital of \$33,175,883.17, which equates to 16.854 cents per share (the proposed return of capital).

15. eServ intends to pay the proposed dividend and the proposed return of capital to its shareholders on the same date (the payment date), following shareholder approval of the proposed return of capital.

16. The proposed dividend and the proposed return of capital are sourced out of cash received from the sale of the USP assets, which was completed in August 2010.

17. eServ has confirmed that its share capital account (as defined in section 975-300 of the ITAA 1997) is not tainted (within the meaning of Division 197 of the ITAA 1997).

18. The proposed return of capital will be paid equally to each holder of an eServ ordinary share listed on the share register as at the Record Date, by way of a cash distribution based on the number of shares held on the Record Date.

19. As at 5 April 2011, eServ had only one class of shares on issue, consisting of 196,847,706 ordinary shares.

20. eServ's shareholders are made up of:

- Australian residents – holding approximately 34 percent of the interests in eServ; and
- foreign residents – holding approximately 66 percent of the interests in eServ.

21. From its date of incorporation, eServ has paid dividends in the following financial years:

- 2005 – 1.0 cent per share
- 2006 – 1.2 cents per share
- 2007 – 2.0 cents per share
- 2008 – 3.0 cents per share.

22. eServ reported losses in the 2009 and 2010 financial years respectively and no dividends were paid in these years.

23. Following the sale of the USP assets, eServ has retained, and intends to specialize in, the high growth areas of Mobile Money Solutions and Value-Added Services.

Ruling

Return of capital is not a dividend for income tax purposes

24. The payment of the proposed return of capital to eServ shareholders will not be a dividend, as defined in subsection 6(1).

The application of sections 45A, 45B and 45C to the proposed return of capital

25. The Commissioner will not make a determination under section 45A or 45B that section 45C applies to the proposed return of capital. Accordingly, no part of the proposed return of capital will be taken to be a dividend for income tax purposes.

Capital gains tax

26. CGT event G1 in section 104-135 of the ITAA 1997 will happen when eServ pays the proposed return of capital to an eServ shareholder in respect of an eServ share that they own at the Record Date and continue to own at the payment date.

27. CGT event C2 in section 104-25 of the ITAA 1997 will happen when eServ pays the proposed return of capital to an eServ shareholder in respect of an eServ share that they own at the Record Date but which they cease to own before the payment date.

Foreign resident shareholders

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

29. A foreign resident eServ shareholder who is paid the proposed 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).

Commissioner of Taxation6 July 2011

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.*

Dividend

30. 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) and from an Australian source (if the shareholder is a non-resident of Australia).

31. The term 'dividend' in subsection 6(1) includes any distribution made by a company to any of its shareholders. However paragraph (d) of the definition of dividend specifically excludes a distribution from the meaning of 'dividend' if the amount of the distribution is debited against an amount standing to the credit of the company's share capital account.

32. 'Share capital account' is defined in section 975-300 of the ITAA 1997 as an account which the company keeps of its share capital, or any other account created after 1 July 1998 where the first amount credited to the account was an amount of share capital.

33. Subsection 975-300(3) of the ITAA 1997 states that an account is not a share capital account if it is tainted.

34. The proposed return of capital will be debited against an amount standing to the credit of eServ's share capital account. As the share capital account of eServ is not tainted within the meaning of Division 197 of the ITAA 1997, paragraph (d) of the definition of 'dividend' in subsection 6(1) will apply and the proposed return of capital will not constitute a dividend under subsection 6(1).

Anti-avoidance provisions

Sections 45A and 45B

35. 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 proposed return of capital to be received by eServ shareholders as an unfranked dividend.

Section 45A – streaming of dividends and capital benefits

36. 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.

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

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

Section 45B – schemes to provide capital benefits

39. 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 40 to 58 of this Ruling.

The Scheme

40. 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.

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

Capital benefit

42. 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.

43. As eServ's proposed return of capital will be recorded as a debit to the share 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).

Tax benefit

44. A shareholder 'obtains a tax benefit' as defined in subsection 45B(9) 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:

- 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.

45. As discussed in paragraph 43 of this Ruling, the payment of the proposed return of capital to eServ shareholders will be a capital benefit. In the event that the return of capital did represent a dividend rather than a capital benefit, it is likely that a typical Australian resident shareholder would incur a greater tax liability. Consequently, receipt of the capital benefit by the eServ shareholders will be a tax benefit.

Relevant circumstances

46. 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. However, the list of relevant circumstances in subsection 45B(8) is not exhaustive and regard may be had to other circumstances on the basis of their relevance.

47. The test of purpose is an objective one. The question is whether 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 in respect of the capital benefit. The requisite purpose does not have to be the most influential or prevailing purpose but it must be more than an incidental purpose.

48. The purpose which causes section 45B to apply may be the purpose of any party to the scheme.

49. In this instance, as the proposed return of capital is to be made to all eServ shareholders, regardless of their individual circumstances, paragraphs 45B(8)(c) to (h) do not incline for, or against, a conclusion as to purpose. The circumstances covered by paragraphs 45B(8)(i) to (j), pertaining to the provision of ownership interests and demerger, are not relevant here. In this case, the relevant matters are those covered by the circumstances described in paragraphs 45B(8)(a), (b) and (k).

50. Paragraph 45B(8)(a) refers to the extent to which the capital benefit is attributable to capital or profits (realised and unrealised) of the company or an associate (within the meaning of section 318) of the company. In this case, eServ has decided to return to its shareholders contributed share capital that was released upon the sale of USP.

51. The sale of USP also generated profits for eServ which are to be distributed as dividends at the same time as the proposed return of capital. eServ is of the opinion that the cash holdings generated from the disposal of USP assets are in excess of current and future capital requirements and intends to distribute this surplus back to its shareholders.

52. The amount of the proposed return of capital is reasonably regarded as share capital invested in the assets disposed of by the sale of USP. In view of the proposed dividend, the proposed return of capital is wholly attributable to the share capital released from the sale of USP.

53. Paragraph 45B(8)(b) refers to the pattern of distributions made by a company or an associate of the company. eServ has paid four consecutive dividends between 2004 and 2008. No dividends were paid in the 2009 and 2010 income years because eServ reported losses in those years of income.

54. eServ has not previously issued bonus shares or made a return of share premium.
55. The proposed return of capital is in addition to the payment of the proposed dividend out of the profits realised from the sale of USP.
56. This circumstance neither inclines for or against a conclusion as to purpose.
57. Paragraph 45B(8)(k) refers to the matters in subparagraphs 177D(b)(i) to (viii). These are matters by reference to which a scheme is able to be examined from a practical perspective in order to identify and compare its tax and non-tax objectives. The matters include the manner in which the scheme is carried out, its form and substance, and its financial and other implications for the parties involved. In the present circumstances the practical implications of the scheme for eServ and its shareholders are consistent with its being, in form and substance, a return of capital.
58. Accordingly, the Commissioner will not make a determination under subsection 45B(3) that section 45C applies to the proposed return of capital.

Capital gains tax

CGT event G1 – section 104-135

59. 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 in the company;
 - some or all of the payment 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; and
 - the payment is not included in the shareholder's assessable income.
60. No part of the proposed return of capital to an eServ shareholder will be a dividend.
61. Accordingly, CGT event G1 will happen when eServ pays the proposed return of capital to an eServ shareholder in respect of an eServ share that they own at the Record Date and continue to own at the payment date.
62. If the proposed return of capital (16.854 cents per eServ share) is not more than the cost base of the eServ share at the payment date, the cost base and reduced cost base of the share will be reduced (but not below nil) by the amount of the proposed return of capital (subsection 104-135(4) of the ITAA 1997).

63. An eServ shareholder will make a capital gain if the amount of the proposed return of capital (16.854 cents per eServ share) is more than the cost base of the eServ share (subsection 104-135(3) of the ITAA 1997). The amount of the capital gain is equal to that excess.

64. If an eServ shareholder makes a capital gain from CGT event G1 happening, the cost base and reduced cost base of the eServ share are reduced to nil. An eServ shareholder cannot make a capital loss from CGT event G1 happening (subsection 104-135(3) of the ITAA 1997).

65. If the eServ share to which the proposed return of capital relates was acquired by an eServ shareholder at least 12 months before the payment, a capital gain from CGT event G1 happening may qualify as a discount capital gain under subsection 115-25(1) of the ITAA 1997, provided the other conditions in Division 115 of the ITAA 1997 are satisfied.

CGT event C2 – section 104-25

66. The right to receive the payment of the proposed return of capital is one of the rights inherent in an eServ share at the Record Date. If, after the Record Date but before the payment date, an eServ shareholder ceases to own some, or all, of their shares in eServ, the right to receive the payment of the proposed 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.

67. CGT event C2 (section 104-25 of the ITAA 1997) will happen when the proposed 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.

68. An eServ 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. An eServ shareholder will make a capital loss if the capital proceeds from the ending of the right are less than the reduced cost base of the right. The capital loss is equal to the amount of the difference (subsection 104-25(3) of the ITAA 1997).

69. In working out the capital gain or capital loss made when CGT event C2 happens, the capital proceeds will be the amount of the proposed return of capital (16.854 cents per eServ share) (subsection 116-20(1) of the ITAA 1997).

70. The cost base of an eServ shareholder's right to receive the proposed 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 eServ 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 eServ shareholder disposed of the share after the Record Date.

71. Therefore, if the full cost base or reduced cost base of an eServ 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 proposed return of capital is likely to have a nil cost base.

72. As the right to receive the proposed return of capital was inherent in the eServ 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).

73. Accordingly, if the eServ share was acquired by the eServ shareholder at least 12 months before the proposed return of capital was paid, a capital gain from CGT event C2 happening on the ending of the corresponding right may qualify as a discount capital gain under subsection 115-25(1) of the ITAA 1997, provided the other conditions in Division 115 of the ITAA 1997 are satisfied.

Foreign resident shareholders

74. Under subsection 855-10(1) of the ITAA 1997, 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'.

75. 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 interest 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).

76. An eServ shareholder that is a foreign resident, just before CGT event G1 happens, disregards any capital gain made when CGT event G1 happens if their eServ shares are not 'taxable Australian property' (section 855-10 of the ITAA 1997).

77. An eServ shareholder that is a foreign resident, just before CGT event C2 happens, who has a right to the payment of the cash distribution, disregards any capital gain or capital loss made when CGT event C2 happens if that right is not 'taxable Australian property' (section 855-10 of the ITAA 1997).

Appendix 2 – Detailed contents list

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

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

Legislative references:

- ITAA 1936
- ITAA 1936 6(1)
- ITAA 1936 44
- ITAA 1936 44(1)
- ITAA 1936 45A
- ITAA 1936 45A(2)
- ITAA 1936 45A(3)(b)
- ITAA 1936 45B
- ITAA 1936 45B(2)(a)
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- ITAA 1936 45B(5)(b)
- ITAA 1936 45B(8)
- ITAA 1936 45B(8)(a)
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- ITAA 1997 Div 112
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- ITAA 1997 Div 230
- ITAA 1997 855-10
- ITAA 1997 855-10(1)
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- ITAA 1997 975-300
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- TAA 1953
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ATO references

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