

CR 2003/49 - Income tax: Share Buy-Back: Phosphate Resources Limited

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Class Ruling

Income tax: Share Buy-Back: Phosphate Resources Limited

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Preamble

*The number, subject heading, and the **What this Class Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Withdrawal**, **Arrangement** and **Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. CR 2001/1 explains **Class Rulings** and **Taxation Rulings TR 92/1** and **TR 97/16** together explain when a **Ruling** is a 'public ruling' and how it is binding on the Commissioner.*

What this Class Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates.

Tax law(s)

2. The tax laws dealt with in this Class Ruling are:
- Sections 45A, 45B and 45C of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - Paragraph 128B(3)(ga) of the ITAA 1936;
 - Sections 159GZZZP and 159GZZZQ of the ITAA 1936;
 - Section 177EA of the ITAA 1936; and
 - Section 204-30 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Class of persons

3. The class of persons to which this Ruling applies is the shareholders of Phosphate Resources Limited ('PRL') who disposed of shares under the PRL off-market share buy-back ('the Buy-Back') which opened for acceptances at 9.00am (Perth time) on 19 June 2002 and closed for acceptances at 5.00pm (Perth time) on

31 July 2002. The Buy-Back is described in the Arrangement part of this Ruling.

4. The class of persons to which this Ruling applies does not include PRL. The Ruling does not deal with how the taxation law applies to PRL in relation to the Buy-Back. Furthermore, it should be noted that certain information which relates to the affairs of PRL, but is not in the public domain, has been taken into account in determining the application of certain anti-avoidance provisions in this Ruling. This information cannot be disclosed in the Ruling.

Qualifications

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

6. The class of persons defined in this Ruling may rely on its contents provided the arrangement actually carried out is carried out in accordance with the arrangement described below at paragraphs 11 to 22 in this Ruling.

7. If the arrangement actually carried out is materially different from the arrangement that is described in this Ruling:

- (a) this Ruling has no binding effect on the Commissioner because the arrangement entered into is not the arrangement on which the Commissioner has ruled; and
- (b) this Ruling may be withdrawn or modified.

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Date of effect

9. This Class Ruling applies to the year ended 30 June 2003 unless and until it is withdrawn. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Withdrawal

10. This Class Ruling is withdrawn and ceases to have effect after 30 June 2003. However, the Ruling continues to apply after its withdrawal in respect of the tax laws ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling, subject to there being no change in the arrangement or in the person's involvement in the arrangement.

Arrangement

11. The arrangement that is the subject of the Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- the application for Class Ruling from PRL dated 27 March 2003;
- correspondence from Ernst & Young dated 23 August 2002 and 15 November 2002;
- PRL's Explanatory Statement in relation to the general meeting of shareholders held on 1 June 2002;
- PRL's Off Market Buy-Back Offer Document sent to shareholders on 17 June 2002; and
- PRL's Annual Report for the year ended 30 June 2001.

Note: Certain information from PRL has been provided on a commercial-in-confidence basis and will not be disclosed or released under the Freedom of Information Legislation.

12. PRL is an unlisted company which had 4,206,007 shares of only one class on issue as at 30 April 2002. The Buy-Back was approved at a general meeting of PRL's shareholders on 1 June 2002. The Buy-Back offer is open to all shareholders and participation is voluntary.

13. The reasons for undertaking the Buy-Back include:

- to return in a tax effective manner cash reserves and the consideration received by the Company as a result of the relinquishment of part of the Company's mining lease for the Asia Pacific Space Centre project;
- to provide flexibility to shareholders to realise part or all of their investment in the Company at the best market price;
- to facilitate a market for shareholders that wish to sell all or part of their shares at the same price as that paid most recently by a major shareholder;
- to increase the return on equity for shareholders that wish to continue with all or part of their shares;
- to reduce the number of shares on issue and create a more efficient capital structure; and
- to assist certain shareholders living on Christmas Island that may wish to sell all or part of their shares:
 - those who might be considering relocating off-island;
 - employees of the company that have retired or are considering retiring; and
 - those who wish to raise capital in order to participate in the opportunities created by the Asia Pacific Space Centre, the Commonwealth of Australia Detention Centre Projects, and or the privatisation of the company's non-core activities.

14. The Buy-Back offer was open for acceptance during the offer period commencing at 9.00am (Perth time) on 19 June 2002 and ending at 5.00pm (Perth time) on 31 July 2002.

15. PRL offered to buy back up to 1,050,000 (approximately 25% of the total) of its shares for up to a maximum total consideration of \$4,200,000. PRL will fund the payment of the purchase price of the Buy-Back through settlement proceeds it received in consideration for relinquishing part of its mining lease back to the Commonwealth

(for the proposed Asia Pacific Space Centre Project) and existing cash reserves.

16. Under the Buy-Back offer participating shareholders will receive \$2.68 as a fully franked dividend and the balance of the Buy-Back price as a capital amount. PRL stated that the division of the Buy-Back price into its capital and dividend components reflects the ratio of paid up capital to the number of shares on issue at the time.

17. The Buy-Back offer includes a scale back mechanism which will apply in the event that the total number of shares for which acceptances are received pursuant to the Buy-Back exceed the 25% limit. If this occurs, the number of shares bought back by PRL from each participating shareholder will be scaled back on a pro-rata basis so as to result in no more than 25% of the total shares being bought back.

18. The Buy-Back price is \$4.00 per share, which has been calculated based on the highest most recent price paid by a professional investor at the time of the offer, and also on the net asset backing per share (that is, the net assets of the company divided by the total number of issued shares). The most recent recorded sale price is \$4.45 per share. This sale occurred after the Buy-Back date.

19. The Buy-Back will involve a distribution of share capital and fully franked dividends to accepting shareholders. In relation to each share bought back, PRL will debit \$1.32 to its share capital account and \$2.68 to its retained profits. The dividend will be fully franked at 30%.

20. The financial statements as at 31 December 2001 for PRL show share capital of \$5,560,000 and retained profits of \$9,837,000. The franking account balance as at 30 April 2002 was \$25,496,366.

21. PRL has ascertained that most of its shares are held by Australian residents. In particular, 96.1% of its shareholders are residents of Australia, who held 91.2% of the total shares at the time of the Buy-Back.

22. For each of the years ended 30 June 2000 and 2001 PRL paid fully franked dividends of 40 cents per share. The directors of PRL intend to maintain this dividend policy. A once only special dividend of 10 cents was also paid in the year ended 30 June 2001 in recognition of the shareholders' agreement for the relinquishment of part of PRL's mining lease back to the Commonwealth for the proposed Asia Pacific Space Centre project.

Ruling

The Dividend Component

23. Participating shareholders will be taken to have been paid a dividend out of the profits of PRL on the date the Buy-Back occurred ('the dividend component') of \$2.68 for each share bought back.

24. The dividend component will be a frankable distribution pursuant to section 202-40 of the ITAA 1997, and therefore be capable of being franked in accordance with section 202-5 of the ITAA 1997. However, this is only to the extent that the Buy-Back price does not exceed the market value (as normally understood) of PRL shares at the time of the Buy-Back, that market value being determined on the assumption that the Buy-Back did not take place and was never proposed to take place.

25. The dividend component received by non-resident shareholders participating in the Buy-Back will be exempt from withholding tax pursuant to paragraph 128B(3)(ga) of the ITAA 1936.

The Capital Component

26. Participating shareholders are taken to have received \$1.32 as consideration in respect of the disposal of each of their PRL shares on 1 August 2002 for the purposes of section 159GZZZQ of the ITAA 1936. The treatment of this consideration amount for tax purposes will depend on whether the sale is on capital account (where the shares are held for investment) or on revenue account (where the shares are turned over in the course of business). In general, the relevant treatment should be as follows:

(a) Shares held on capital account

- The amount by which the capital proceeds of \$1.32 exceed the cost of each share will be a capital gain to the shareholder in the shareholder's assessable income. If the share's reduced cost base exceeds \$1.32, the difference will be a capital loss.

(b) Shares held on revenue account

- The amount by which the consideration on disposal of \$1.32 exceeds the cost of each share will be included in the shareholder's assessable income. Correspondingly, if the cost exceeds \$1.32, the difference will be an allowable deduction.

The Anti-avoidance Provisions

27. The Commissioner will not make a determination under section 45A or 45B of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole, or any part, of the capital component of the Buy-Back price received by participating shareholders.

28. 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 received in relation to the dividend component of the Buy-Back by participating shareholders.

29. The Commissioner will not make a determination under paragraph 204-30(3)(c) of the ITAA 1997 to deny the whole, or any part, of the imputation benefits received in relation to the dividend component of the Buy-Back by participating shareholders.

Explanation

The Dividend and Capital Components

30. The purchase price received by participating shareholders comprises two components:

- a dividend component; and
- a capital component.

The amount of each of these components is determined in accordance with sections 159GZZZP and 159GZZZQ of the ITAA 1936, having regard to how the company accounts for the off-market share buy-back as detailed below.

The Dividend Component

31. Section 159GZZZP provides that where the buy-back of a share is an off-market purchase, the difference between the purchase price and the part (if any) of the purchase price which is debited to the share capital account of the company is taken to be a dividend paid by the company on the day the buy-back occurs. In this case the purchase price is \$4.00 per share and \$1.32 is to be debited to the share capital account. Thus the dividend amount is \$2.68 per share.

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32. Under the new imputation rules effective from 1 July 2002, resident corporate tax entities that receive a franked distribution such as a franked dividend apply the franking credit (imputation benefit) on the distribution in the same way as resident individuals and superannuation entities (using the gross-up and credit approach that applies).

33. For Australian resident individual and corporate tax entity shareholders, the amount of the dividend (grossed-up for any imputation benefits attached to the dividend under section 207-20 of the ITAA 1997) will be included in their assessable income under subsection 44(1) of the ITAA 1936. Resident individual and corporate tax entity shareholders will also be entitled to a tax offset under section 207-20 reflecting the imputation benefit attached to the dividend.

34. As the dividend component of the consideration received under the Buy-Back is fully franked, a non-resident shareholder is not liable to Australian withholding tax on the dividend component (paragraph 128B(3)(ga) of the ITAA 1936).

35. It should be noted that there are provisions which may deny a franking credit in certain circumstances. For instance, section 160APHO of the ITAA 1936 requires that a taxpayer receiving a franked dividend be a 'qualified person' in order to be entitled to an imputation benefit. Broadly speaking, to be a qualified person in relation to a dividend a taxpayer must satisfy both the holding period rule (or certain alternative rules) and the related payments rule.

36. The holding period rule requires shareholders to hold the shares or the interest in the shares on which the dividend is paid at risk for a continuous period of at least 45 days. In determining whether a shareholder has satisfied the holding period rule, any days during which there is a materially diminished risk in relation to the relevant shares are not counted. The day of acquisition and day of disposal of the relevant shares are also not counted.

37. Section 204-30 of the ITAA 1997 and section 177EA of the ITAA 1936 are anti-avoidance provisions concerned with striking down arrangements which inappropriately provide imputation benefits to a relevant taxpayer. These provisions allow the Commissioner to make determinations denying all or a part of a shareholder's entitlement to imputation benefits. In this case, no determinations will be made to deny imputation benefits received by participating shareholders under the Buy-Back. A discussion of these provisions appears later in this Class Ruling.

The Capital Component

38. The participating shareholders are taken to have disposed of those shares accepted under the Buy-Back on 1 August 2002. The disposal may have different taxation implications for shareholders depending on how the shares were held; for instance:

- an investor holding their shares on capital account will be subject to the capital gains tax provisions; and
- a share trader holding their shares on revenue account will be subject to the ordinary income provisions.

It should be noted that share traders who have both an income tax and a capital gains tax liability will generally have the amount of the capital gain reduced under the anti-overlap provisions in section 118-20 of the ITAA 1997.

39. For the purposes of computing the amount of the gain or loss (on capital or revenue account) in these cases, the consideration in respect of the disposal of a share under a buy-back is determined in accordance with section 159GZZZQ of the ITAA 1936.

40. The consideration determined under section 159GZZZQ is:

- the buy-back price; less
- the reduction amount (within the meaning of subsection 159GZZZQ(4)).

Accordingly, for the purposes of calculating the profit or loss on disposal of the shares, under either the income or capital gains tax provisions, in most cases participating shareholders are taken to have received \$1.32 per share as the consideration on disposal ('the Disposal Consideration').

The Anti-avoidance Provisions

Sections 45A and 45B of the ITAA 1936

41. As discussed earlier, part of the proceeds received by a shareholder in return for participating in a buy-back will be taken not to be a dividend for the purposes of the Act. This part is treated instead as a distribution of share capital by the company to the shareholder.

42. Sections 45A and 45B are two anti-avoidance provisions which, if they apply, allow the Commissioner to make a determination under section 45C that all or part of the distribution of capital received by the shareholder under the Buy-Back is treated as an unfranked distribution. Accordingly, the application of these two provisions to the Buy-Back must be considered.

43. Section 45A is an anti-avoidance provision that 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.

44. Although a 'capital benefit' (as defined in paragraph 45A(3)(b)) is provided to the participating shareholders, the circumstances of the Buy-Back indicate that there is no streaming of capital benefits to some shareholders and dividends to other shareholders. Accordingly, section 45A has no application to the Buy-Back.

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

- (a) there is a scheme under which a person is provided with a capital benefit by a company (paragraph 45B(2)(a));
- (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)); and
- (c) 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 a taxpayer to obtain a tax benefit (paragraph 45B(2)(c)).

46. In this case, whilst the conditions of paragraphs 45B(2)(a) and (b) are met, the requisite purpose of enabling the shareholder to obtain a tax benefit - by way of a capital distribution - is not present.

47. Having regard to the relevant circumstances of the scheme - set out in subsection 45B(8) - it is apparent that the inclusion of a capital element in the Buy-Back price was not inappropriate. Further, the capital component of the Buy-Back cannot be said to be attributable to the profits of the company, nor do the pattern of distributions indicate that it is being paid in substitution for a dividend.

Section 177EA of the ITAA 1936

48. Section 177EA 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 disposition of membership interests (such as shares), or an interest in membership interests, where a franked distribution is paid or payable in respect of the membership interests. This would include a buy-back with a franked dividend component.

49. Specifically, subsection 177EA(3) provides that the section applies where:

- (a) there is a scheme for a disposition of membership interests, or an interest in membership interests, in a corporate tax entity;
- (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.
- (c) the distribution was, or is expected to be, a franked distribution or a distribution franked with an exempting credit;
- (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 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 the relevant taxpayer to obtain an imputation benefit.

50. In the present case, the conditions of paragraphs 177EA(3)(a) to (d) are satisfied. Accordingly, the issue is whether, having regard to the relevant circumstances of the scheme (as provided for in subsection 177EA(17)), it would be concluded that, on the part of PRL, its shareholders or any other relevant party, there is a purpose more than merely incidental, of conferring an imputation benefit under the scheme. Under this arrangement the relevant taxpayer is the

participating shareholder and the scheme comprises the circumstances surrounding the Buy-Back.

51. 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). The relevant circumstances listed there encompass a range of circumstances 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.

52. Having regard to the objectives and the relevant circumstances of the scheme, in particular the mix of capital and franked dividend in the buy-back, the shareholder profile and the Buy-Back participation by resident and non-resident shareholders, the Commissioner has come to the view that it cannot be concluded that PRL or the shareholders entered into or carried out the scheme for the purpose of enabling the shareholders to obtain imputation benefits.

53. Accordingly, the Commissioner will not make a determination under paragraph 177EA(5)(b) to deny imputation benefits received by participating shareholders under the Buy-Back.

Section 204-30 of the ITAA 1997

54. 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:

- (a) an imputation benefit is, or apart from this section would be, received by a member of the entity as a result of the distribution or distributions (paragraph 204-30(1)(a));
- (b) the member would derive a greater benefit from imputation benefits than another member of the entity (paragraph 204-30(1)(b)); and
- (c) 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)).

55. If section 204-30 applies the Commissioner is vested with a discretion under subsection 204-30(3) to make a determination that either:

- (a) the streaming entity will incur an additional franking debit in respect of each distribution paid or other benefit given to a disadvantaged member (paragraph 204-30(3)(a)); or
- (b) no imputation benefit is to arise in respect of any streamed distributions paid to a favoured member (paragraph 204-30(3)(c)).

56. For the section to apply, members to whom distributions are streamed must derive a greater benefit from imputation benefits than the members who do not participate in the Buy-Back. The words 'derive 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.

57. Under the PRL Buy-Back there will be no streaming of imputation benefits to particular shareholders. Accordingly section 204-30 does not apply and the Commissioner will not make a determination under paragraph 204-30(3)(c).

Detailed contents list

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Commissioner of Taxation

25 June 2003

<i>Previous draft:</i>	- ITAA 1936 159GZZZQ(4)
Not previously issued as a draft	- ITAA 1936 160APHO
	- ITAA 1936 177EA
	- ITAA 1936 177EA(3)
	- ITAA 1936 177EA(3)(a)
<i>Related Rulings/Determinations:</i>	- ITAA 1936 177EA(3)(b)
TR 92/1; TR 92/20; TR 97/16;	- ITAA 1936 177EA(3)(c)
CR 2001/1	- ITAA 1936 177EA(3)(d)
	- ITAA 1936 177EA(3)(e)
<i>Subject references:</i>	- ITAA 1936 177EA(5)(b)
- dividend streaming arrangements	- ITAA 1936 177EA(17)
- share buy backs	- ITAA 1997 118-20
	- ITAA 1997 202-5
<i>Legislative references</i>	- ITAA 1997 202-40
- TAA 1953 Part IVA	- ITAA 1997 204-30
- ITAA 1936 44(1)	- ITAA 1997 204-30(1)(a)
- ITAA 1936 45A	- ITAA 1997 204-30(1)(b)
- ITAA 1936 45A(3)(b)	- ITAA 1997 204-30(1)(c)
- ITAA 1936 45B	- ITAA 1997 204-30(3)
- ITAA 1936 45B(2)(a)	- ITAA 1997 204-30(3)(a)
- ITAA 1936 45B(2)(b)	- ITAA 1997 204-30(3)(b)
- ITAA 1936 45B(2)(c)	- ITAA 1997 204-30(3)(c)
- ITAA 1936 45B(8)	- ITAA 1997 204-30(8)
- ITAA 1936 45C	- ITAA 1997 207-20
- ITAA 1936 128B(3)(ga)	- Copyright Act 1968
- ITAA 1936 159GZZZP	
- ITAA 1936 159GZZZQ	

ATO references

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