


CR 2004/103 - Income tax: share buy-back and redemption of Reset Convertible Preference Shares: Santos Limited

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Class Ruling

Income tax: share buy-back and redemption of Reset Convertible Preference Shares: Santos Limited

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Preamble

*The number, subject heading, **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**. Class Ruling CR 2001/1 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 ruling are:
- Division 16K of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - section 45A of the ITAA 1936;
 - section 45B of the ITAA 1936;
 - section 45C of the ITAA 1936;
 - section 177EA of the ITAA 1936;
 - section 204-30 of the *Income Tax Assessment Act 1997* (ITAA 1997);
 - section 116-20 of the ITAA 1997;
 - section 104-25 of the ITAA 1997;
 - subsection 116-30(2) of the ITAA 1997
 - Subdivision 110-A of the ITAA 1997;
 - section 116-30 of the ITAA 1997;
 - section 116-45 of the ITAA 1997;

- section 109-10 of the ITAA 1997;
- section 112-20 of the ITAA 1997;
- Subdivision 130-B of the ITAA 1997; and
- Division 134 of the ITAA 1997.

Class of persons

3. The class of persons to whom this Ruling applies is the shareholders of Santos Ltd ('Santos') who hold Reset Converting Preference Shares ('RPS') and who under the proposals announced by Santos on 24 August 2004 (as described in the Arrangement part of this Ruling):

- a) disposed of their RPS in the Santos on-market buy-back;
- b) have their RPS redeemed at face value and subscribe for perpetual preference shares ('PPS'); or
- c) do nothing and have their RPS redeemed at face value.

Qualifications

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

5. The class of persons defined in this Ruling may rely on its contents provided the arrangement actually carried out is in accordance with the arrangement described in paragraphs 10 to 14.

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

- 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
- this Ruling may be withdrawn or modified.

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Date of effect

8. This Ruling applies to the year ended 30 June 2005 unless and until it is withdrawn.

Withdrawal

9. This Ruling is withdrawn and ceases to have effect after 30 June 2005. 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 persons' involvement in the arrangement.

Arrangement

10. The arrangement that is subject of the Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, 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 the Class Ruling from Santos Ltd dated 4 August 2004;
- electronic copies of the correspondence from Santos dated 9 August 2004, 10 August 2004, 16 August 2004 and 27 August 2004;
- electronic copy of the Prospectus dated 10 August 2004.

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

11. Santos proposes to issue \$500 million perpetual preference shares ('PPS') to redeem its existing redeemable preference shares ('RPS'), and for general corporate purposes. The new securities will be listed on the Australian Stock Exchange.

12. RPS holders may dispose of their RPS in the following ways:

- Shareholders may sell their RPS into the Santos on-market buy-back ('the Buy-back'), at a price ('the Buy-back price') that reflects the market value of the RPS, during a period prior to redemption.
- Shareholders not participating in the Buy-back will have their RPS redeemed at their face value (\$100) and, if they subscribe for shares in the proposed PPS

issue, will be entitled to a special dividend payment of \$5.

- Shareholders who do not participate in either the Buy-back or the PPS with a special dividend will have their RPS redeemed at face value.

13. The RPS are being redeemed due to a proposed change in accounting standards that will apply from 1 January 2005. Under new accounting standards the RPS will be classified as debt for accounting purposes rather than equity. The PPS will be classified as equity.

14. The Buy-back price will be funded by share capital (in respect of the face value of the RPS) and by retained earnings (in respect of the balance of the Buy-back price).

Ruling

15. The Commissioner will not make a determination under sections 45A or 45B of the ITAA 1936 that section 45C applies to the whole, or any part, of the capital benefit received by a shareholder in respect of the disposal or redemption of the RPS.

16. The Commissioner will not make a determination under subsection 177EA (5) of the ITAA 1936 to deny the whole, or any part, of the imputation benefits received in relation to the special dividend on the PPS.

17. The Commissioner will not make a determination under paragraph 204-30(3)(c) of the ITAA1997 to deny the whole, or any part, of the imputation benefits received in relation to the special dividend on the PPS.

18. The Commissioner is of the view that, for capital gains tax purposes, the capital proceeds from the redemption of the RPS will be the advised amount of \$105 per share, pursuant to Division 116 of the ITAA 1997. If however the market value of the RPS is determined to be different, the capital proceeds will be that different amount.

19. The Commissioner is of the view that the cost base of the PPS, for those shareholders that have an entitlement to the special dividend, will include an amount equal to the value of the RPS that is given up by the shareholder, pursuant to Subdivision 110-A of the ITAA 1997.

Explanation

The taxation treatment of the on-market buy-back

20. The tax effect of a share buy-back is determined under the specific provisions of Division 16K of Part III of the ITAA 1936.

21. With respect to the Buy-back, Division 16K provides that for the purposes of this Act, where a buy-back by a company of a share is an on-market purchase, no part of the purchase price in respect of the buy-back of the share is taken to be dividend. Accordingly, the amount of the purchase price paid by Santos in respect of the buy-back of RPS will not be a dividend for tax purposes and will not be frankable.

The Anti-Avoidance provisions

Sections 45A, 45B and 45C of the ITAA 1936

22. 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 arrangement is treated as an unfranked dividend.

23. 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.

24. Although there is a 'provision of a capital benefit' (within the scope of paragraph 45A(3)(b)) to shareholders, the circumstances of the arrangement indicate that there is no streaming of capital benefits to some shareholders and dividends to other shareholders. In particular, the excess of the Buy-back price over the face value of the RPS is debited to retained earnings and not share capital (it is this excess which reflects the amount of the special dividend). Accordingly, section 45A has no application to the arrangement.

25. Section 45B applies where certain capital payments are paid to shareholders in substitution for dividends. Section 45B 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, 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)).

26. Having regard to the 'relevant circumstances' of the scheme (the arrangement), as set out in subsection 45B(8), it is apparent that there is no requisite purpose, by way of capital distribution, of enabling the shareholder to obtain a tax benefit. The fact that the excess of the Buy-back price over the face value of the RPS is debited to retained earnings and not share capital is also relevant in this regard. Accordingly, section 45B has no application to the arrangement.

Section 177EA of the ITAA 1936

27. 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 shares or an interest in shares, where a franked distribution is paid or payable in respect of the shares or an interest in shares.

28. Specifically, subsection 177EA(3) provides that section 177EA applies if:

- (a) there is a scheme for a disposition of shares, or an interest in shares, in a company; and
- (b) a frankable dividend has been paid, or is payable or expected to be payable, in respect of the shares; or a distribution has been paid, or is payable or expected to be payable, in respect of the interest, as the case may be; and
- (c) the dividend or distribution was, or is expected to be, franked; and
- (d) except for this section, a person (the '**relevant taxpayer**') would receive, or could reasonably be expected to receive, franking credit benefits as a result of the dividend or 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 a franking credit benefit.

29. 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, it would be concluded that, on the part of Santos, its shareholders or any other relevant party, there is a purpose more than merely an incidental purpose of conferring an imputation benefit under the scheme. Under this arrangement the relevant taxpayer is the shareholder who receives a special dividend and the scheme comprises the circumstances surrounding the redemption of the RPS and the issue of the PPS.

30. In arriving at a conclusion as to purpose, it is necessary to 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.

31. The Commissioner has come to the conclusion that section 177EA does not apply to the arrangement. In coming to this conclusion the Commissioner had regard to all the relevant circumstances of the arrangement, (as outlined in subsection 177EA(17)), in particular:

- the scheme was entered into as a result of proposed changes to the accounting standards;
- the PPS are substitutes for the RPS (whose issue did not attract section 177EA);
- the Buy-back is funded using retained earnings and share capital so that a franking debit arises to the company equal to the debit that would have arisen if the excess of the Buy-back price over the face value of the RPS had been paid to the shareholders participating in the Buy-back as a franked dividend;
- there is no relevant 'other party' to the scheme with whom the risks/opportunities of holding the shares can meaningfully be compared;
- but for the scheme, it is reasonable to suppose that the relevant franking credits would have been distributed to the RPS-holders (who have the same use for franking credits as the anticipated PPS-holders would have);
- Santos anticipates that all dividends paid on ordinary shares and PPS will continue to be fully franked and the level of franked dividends to be paid to ordinary shareholders is not expected to be affected by the issue of PPS (a reasonable expectation given that there has been no change to the level of dividends on ordinary shares, or the extent to which they are franked, since issue of the RPS);
- the amount of the special dividend equals the excess of the Buy-back price over the face value of the RPS bought back (in cash terms); and
- none of the section 177D(b) factors indicates any substantive purpose other than a commercial purpose stemming from the proposed change to accounting standards.

Section 204-30 of the ITAA 1997

32. Section 204-30 applies where an 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 franking credits 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)).

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

- (a) that 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
- (b) that 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)).

34. For section 204-30 to apply, members to whom distributions are streamed must derive a greater benefit from franking credits than the members who do not participate in the Buy-back. 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 franking credits.

35. In this case it is reasonable to conclude that all but an insignificant number of members able to choose to receive the special dividend are able to fully use franking credits. There are, however, a minority of other members of the company (namely non-resident ordinary shareholders) who do not benefit to the same degree and who do not receive the franking credits (because ordinary shareholders are not eligible to receive the special dividend).

36. However, Santos anticipates that all dividends on ordinary shares will continue to be fully franked and that the rate of dividend paid on those shares will not be affected by the issue of the PPS. Dividends payable on the PPS will be franked to the same percentage as dividends paid on ordinary shares.

37. Accordingly, section 204-30 will not apply to deny imputation benefits that arise in respect of the special dividend paid on the PPS. Furthermore, as long as all future dividends, whether paid on the PPS, ordinary shares or any other class of shares issued by Santos,

are fully franked and payout ratios remain unaffected the section should not apply.

The Capital Gains Tax provisions

Capital Proceeds in relation to the redemption of Reset Convertible Preference Shares

38. Under section 104-25 of the ITAA 1997, CGT event C2 happens when the RPS is redeemed by Santos.

39. The general rules in section 116-20 of the ITAA 1997 will ordinarily determine the capital proceeds to be the total of the money and the market value of any property received. Under the terms of the prospectus, it describes two choices that are available to RPS shareholders that involve the redemption of their shares, they can choose to receive PPS shares in exchange for their RPS or they can choose to do nothing and have their RPS redeemed for \$100, being their face value.

40. If a shareholder chooses to do nothing and have their RPS redeemed for their face value, paragraph 116-20(1)(a) would ordinarily apply and capital proceeds would equal the money received (\$100). However, the market value substitution rule in subsection 116-30(2) will apply in this case. Under that section, the capital proceeds from a CGT event C2 are replaced with the market value of the CGT asset that is subject to the event. As advised, the market value of the RPS at the date redeemed will be \$105, therefore the capital proceeds per share will be \$105.

41. If a shareholder chooses to receive PPS shares in exchange for their RPS, paragraph 116-20(1)(b) will apply and the capital proceeds will equal the market value of the property received in respect of the CGT event. In this case, the market value, as advised, will be \$105, reflecting the face value of the PPS (\$100) and the entitlement to the special dividend (\$5). The capital proceeds will therefore be \$105. As the proceeds are equal to the market value of the RPS, the market value substitution rule in section 116-30 is not applicable.

42. The holders of the RPS will make a capital gain if the capital proceeds from the redemption of the RPS are more than the cost base of those shares. Alternatively, if the capital proceeds are less than the reduced cost base of the RPS, the holders of the RPS will make a capital loss.

Does section 116-45 reduce the capital proceeds on the RPS to \$100?

43. Where the RPS holders do nothing and their RPS are redeemed, the non-receipt rule in section 116-45 will not apply to reduce the market value capital proceeds to the face value of the RPS (\$100). Section 116-45 does not apply to the market value substitution rules, such as subsection 116-30(2).

Note on market value

44. For the purposes of this ruling we have accepted the market value of the RPS shares at the time they are redeemed will be \$105. If however the market value is determined to be different, under section 116-30 of the ITAA 1997 the capital proceeds received by the RPS shareholder will be the market value as determined at the time of the redemption.

What is the cost base of PPS that carry an entitlement to the special dividend?

45. Under section 109-10 of the ITAA 1997, shareholders will acquire PPS at the time they are allotted to shareholders.

46. In accordance with the prospectus, RPS shareholders are offered the option of receiving PPS in exchange for the redemption of their RPS. A shareholder has no entitlement to cash under this option in respect of the redemption of their RPS. That part of the consideration for redemption of the RPS takes place as an exchange under the terms of issue in respect of RPS. Accordingly, the general rules under paragraph 110-25(2)(b) will apply, so that the cost base of the PPS is to be determined by reference to the value of property given up by the person, being the RPS redeemed. The value of RPS at the date redeemed will be \$105, therefore this amount will be included in the cost base of the PPS.

47. The market value substitution rules in section 112-20 do not apply.

Is there an option or right?

48. It is our view there is no separate option or right created because of the special dividend attaching to PPS. Accordingly, Subdivision 130-B and Division 134 of the ITAA 1997 have no application.

Note on market value

49. For the purposes of this ruling we have accepted the market value of the RPS shares at the time they are redeemed will be \$105. If however the market value is determined to be different, under paragraph 110-25(2)(b) the cost base of the PPS to shareholders will be the market value of the RPS share as determined at the time of the redemption.

Detailed contents list

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Commissioner of Taxation

29 September 2004

CR 2004/103

Previous draft:

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Related Rulings/Determinations:

CR 2001/1; TR 92/1; TR 92/20;
TR 97/16

Subject references:

- dividend streaming arrangements
- redeemable preference shares
- return of capital on shares
- share buy-backs

Legislative references:

- Copyright Act 1968
- TAA 1953 Pt IVAAA
- ITAA 1936 Pt III Div 16K
- ITAA 1936 45A
- ITAA 1936 45A(2)(a)
- ITAA 1936 45A(2)(b)
- ITAA 1936 45A(2)(c)
- ITAA 1936 45A(3)(b)
- ITAA 1936 45B
- ITAA 1936 45B(8)
- ITAA 1936 45C
- ITAA 1936 177D(b)
- ITAA 1936 177EA
- ITAA 1936 177EA(3)

- ITAA 1936 177EA(3)(a)
- ITAA 1936 177EA(3)(b)
- ITAA 1936 177EA(3)(c)
- ITAA 1936 177EA(3)(d)
- ITAA 1936 177EA(5)
- ITAA 1936 177EA(17))
- ITAA 1997 104-25
- ITAA 1997 109-10
- ITAA 1997 Subdiv 110-A
- ITAA 1997 110-25(2)(b)
- ITAA 1997 112-20
- ITAA 1997 116-20(1)(a)
- ITAA 1997 116-20(1)(b)
- ITAA 1997 116-30
- ITAA 1997 116-30(2)
- ITAA 1997 116-45
- ITAA 1997 119-10
- ITAA 1997 Subdiv 130-B
- ITAA 1997 Div 134
- ITAA 1997 204-30
- ITAA 1997 204-30(1)(a)
- ITAA 1997 204-30(1)(b)
- ITAA 1997 204-30(1)(c)
- ITAA 1997 204-30(3)
- ITAA 1997 204-30(3)(a)
- ITAA 1997 204-30(3)(c)
- ITAA 1997 204-30(8)

ATO references

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