


# ***CR 2004/91 - Income tax: distribution to shareholders by Circadian Technologies Limited***

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## Class Ruling

### Income tax: distribution to shareholders by Circadian Technologies 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**. 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**

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

#### **Tax laws**

2. This ruling relates to the application of the following provisions of the *Income Tax Assessment Act 1936* (ITAA 1936):

- subsection 6(1) (definition of 'dividend');
- subsection 6(4) (modification of 'dividend' definition);
- section 6D (meaning of share capital account);
- subsection 44(1) (dividend included in assessable income);
- section 45A (streaming of dividends and capital benefits);
- section 45B (schemes to provide capital benefits);
- section 45C (effect of determination under section 45A or 45B); and
- section 128B (liability for non-resident withholding tax).

This ruling does not cover the application of the capital gains and losses provisions of the *Income Tax Assessment Act 1997* (ITAA 1997).

## Class of persons

3. The class of persons to which this Ruling applies is all the ordinary shareholders of Circadian Technologies Ltd (Circadian), registered as ordinary shareholders on the 'record' date for payment of the distribution described in the Arrangement section of this Ruling.

## 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 carried out in accordance with the arrangement described in paragraphs 10 to 20.

6. The Government has announced its intention to introduce laws with effect from 1 July 2002 dealing with the tainting of share capital accounts [Minister for Revenue and Assistant Treasurer's Press Release C104/02 of 27 September 2002]. Although such laws may be relevant to the provisions of the law relating to dividends, this Ruling does not extend to the application of these proposed laws.

7. 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

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9. This Class Ruling applies to the income year ended 30 June 2005. The Ruling only applies to the extent that:

- it is not later withdrawn by Gazette;
- it is not taken to be withdrawn by an inconsistent later public ruling; or
- the relevant tax laws are not amended.

## Withdrawal

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10. This Class 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 entered 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

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11. The arrangement that is the subject of the Ruling is described below. This description is based on the information provided in:

- letters dated 11 May 2004 and 31 May 2004 in relation to the proposal by Circadian to return capital to all ordinary shareholders; and
- messages from Ernst & Young of 18 June 2004, 12 July 2004, 14 July 2004, 19 July 2004 and 2 August 2004 providing further particulars.

These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description.

**Note:** certain information received from Circadian is considered to be commercial-in-confidence and will not be disclosed or released under the *Freedom of Information Act 1982*.

12. Circadian is an Australian resident company listed on the Australian Stock Exchange (ASX).

13. Circadian was incorporated in April 1984 and was listed on the ASX in March 1985. Circadian has only one class of shares, being ordinary shares and currently it has approximately 6000 shareholders.

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14. Circadian's activities focus on the management and funding of pharmaceutical research. It has a number of joint ventures and wholly owned subsidiaries involved in conducting research and development (R&D) activities.

15. Circadian has historically funded its activities by way of share issues and had incurred accounting losses prior to the 2004 financial year. Circadian raised approximately \$38 million in cash by way of share placements in 2000. As at 30 June 2003, Circadian's cash balance was \$14,680,492. During the 2004 financial year, Circadian received cash proceeds from the sale of investments at a profit of some \$6.2 million.

16. The directors of Circadian have determined that Circadian has excess equity capital having regard to its current operations, proposed R & D projects and the future activities to be undertaken. A significant proportion of this capital is represented by cash and share investments.

17. Circadian undertook an on-market share buy-back during 2003. This buy-back had only limited success in that only \$2.047 million was expended during the buy-back period.

18. Circadian still has excess capital and accordingly is proposing to seek approval, at a general meeting of shareholders, for a distribution of 50c per share to be made to its shareholders. This distribution is to comprise of a special dividend of 12c per share and a return of capital of 38c per share.

19. Circadian's half-year report for the period ended 31 December 2003 discloses 40,114,498 shares on issue representing contributed equity of \$48,396,484. Circadian also had accumulated accounting losses of \$10,018,559 (company) and \$5,260,481 (consolidated group).

20. The return of capital will occur pursuant to Part 2J.1 of the *Corporations Act 2001*, and in particular section 256B. That is, the return of capital will represent a share capital reduction with 76% of the aggregate distribution being debited against the share capital account. No shares will be cancelled. The special dividend component of the distribution will be debited against profits earned in the 2004 financial year.

21. The total distribution will be approximately \$20.057 million. The distribution is to be funded from cash on hand and from third party borrowings of approximately \$2.6 million.

## Ruling

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22. The special dividend component of the proposed distribution will be a 'dividend' for income tax purposes.

23. Subject to the qualifications in paragraphs 4 to 7 of this ruling it is confirmed that 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 return of capital component of the proposed distribution. Accordingly, the return of capital component of the distribution will not be a 'dividend' for income tax purposes.

## **Explanation**

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24. Subsection 44(1) of the ITAA 1936 includes in a resident shareholder's assessable income a dividend, as defined by subsection 6(1) of the ITAA 1936, paid to a shareholder out of company profits.

25. Subject to certain exceptions, the definition of dividend in subsection 6(1) includes:

any distribution made by a company to any of its shareholders, whether in money or other property.

26. One of those exceptions, in paragraph (d) of the definition, excludes from the meaning of 'dividend' a distribution if the amount distributed is debited against an amount standing to the credit of the company's share capital account.

27. Section 6D of the ITAA 1936 defines a share capital account for these purposes as an account which the company keeps of its share capital, provided it is not tainted for the purposes of Division 7B of Part IIIAA of the ITAA 1936. Circadian confirms that there have been no transfers to the share capital account from other accounts, other than the transfer of share premiums into share capital permitted by Corporations Law reforms enacted in 1998.

28. Although Division 7B does not apply to events that occur on or after 1 July 2002, by virtue of section 160AOAA of the ITAA 1936, the Government has announced its intention to introduce laws with effect from 1 July 2002 dealing with the tainting of share capital accounts [Minister for Revenue and Assistant Treasurer's Press Release C104/02 of 27 September 2002]. Although such laws may be relevant to the provisions of the law relating to dividends, this Ruling does not extend to the application of these proposed laws.

29. Under the law as presently enacted, the return of capital component of the distribution – 38c per share – that is debited against the share capital account will not be a dividend for income tax purposes. The exception in subsection 6(4) to paragraph (d) of the 'dividend' definition does not apply to the proposed distribution as it is concerned with certain arrangements where distributions are made to persons other than the contributors of capital.

30. The capital gains and losses provisions of the ITAA 1997 will apply to the return of capital component of the distribution.

31. As the 12c per share special dividend component of the distribution is to be debited against a profit account it will be a dividend for income tax purposes.

32. Under subsection 44(1) of the ITAA 1936 the dividend is included in the assessable income of a shareholder who is a resident of Australia for income tax purposes. Under section 128B of the ITAA 1936 the dividend is subject to withholding tax if it is derived by a person who is not a resident of Australia for income tax purposes.

33. Sections 45A and 45B of the ITAA 1936 are two anti-avoidance provisions which, if they apply, allow the Commissioner to determine that all or part of a distribution is treated as an unfrankable dividend that is paid by the company out of profits to the shareholder.

### **Section 45A – streaming of dividends and capital benefits**

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

35. By making the proposed distribution Circadian will provide a 'capital benefit' to all its shareholders as all shareholders will receive the same amount of return of capital per share. In the circumstances of this return of capital there is no streaming of capital benefits to some shareholders and dividends to other shareholders. Accordingly section 45A of the ITAA 1936 does not apply to the proposed return of capital.

### **Section 45B – schemes to provide capital benefits in substitution for dividends**

36. Section 45B of the ITAA 1936 applies where certain amounts of a capital nature are provided to shareholders in substitution for dividends.

37. Subsection 45B(2) sets out the conditions under which the Commissioner will make a determination under subsection 45B(3) of the ITAA 1936 that section 45C of the ITAA 1936 applies. These conditions are that:

- there is a **scheme** under which a person is **provided with a capital benefit** by a company;
- 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**; and
- 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 tax benefit**.

Each of these conditions is considered below.

38. The proposed return of capital is a 'scheme' within the broad meaning of that term.

39. The phrase 'provided with a capital benefit' is defined in subsection 45B(5) of the ITAA 1936. A person is provided with a capital benefit if:

- ownership interests in a company are issued to the person;
- there is a distribution to the person of share capital; or
- 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.

40. As Circadian proposes to debit part of the distribution against its share capital account, its shareholders will be provided with a capital benefit.

41. A taxpayer 'obtains a tax benefit', as defined in subsection 45B(9) of the ITAA 1936, where:

- the amount of tax payable; or
- any other amount payable under the ITAA 1936 or the ITAA 1997;

by the taxpayer 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 had instead been a dividend.

42. The return of capital component of the proposed distribution is of a capital nature and ordinarily would be subject to tax under the capital gains and losses provisions of the income tax law. Shareholders would therefore obtain a 'tax benefit', as defined in subsection 45B(9), under the arrangement.

43. The Commissioner is required to consider the circumstances set out under subsection 45B(8) of the ITAA 1936 to determine whether any part of the arrangement would be entered into for a purpose, other than an incidental purpose, of enabling a relevant taxpayer to obtain a tax benefit.

44. This test of purpose is an objective one. The question is whether, objectively, 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 purpose does not have to be the most influential or prevailing purpose but it must be more than an incidental purpose.

45. Under the arrangement, the relevant taxpayers are the Circadian shareholders. The relevant circumstances are:

- Circadian intends to fund the distribution from cash on hand sourced substantially from contributed equity and borrowings. To the extent it relates to the return of capital component the distribution is not considered to be attributable to profits (paragraph 45B(8)(a));
- Circadian has not previously paid dividends or undertaken a reduction of capital, however, the proposed distribution includes a special dividend of 12c per share which is attributable to profits earned in the 2004 financial year (paragraph 45B(8)(b));
- Circadian is a listed public company with a wide range of shareholders. The tax profile of the current shareholders is not known by Circadian, but this is not considered to be a material factor (paragraphs 45B(8)(c), (d), (e) and (f));
- paragraphs 45B(8)(g), (i) and (j) are not relevant to Circadian's proposed distribution;
- the proportionate interests held by the shareholders after the distribution will be the same as that that would have been held had an equivalent dividend been paid instead of the capital benefit (paragraph 45B(8)(h)); and
- the matters referred to in paragraph 45B(8)(k) are not considered to incline for or against the forming of the conclusion that a person entered into or carried out the scheme for a 'more than incidental' purpose of enabling a taxpayer to obtain a tax benefit.

46. Having regard to the circumstances outlined in paragraph 45 it is not considered that the a person would enter into or carry out the scheme for the purpose, not being an incidental purpose, of enabling a shareholder to obtain a tax benefit.

47. Accordingly, the Commissioner will not make a determination under subsection 45B(3) that section 45C applies to the return of capital component of the distribution.

### **Section 45C of the ITAA 1936 – deeming dividends to be paid where determinations under section 45A or 45B are made**

48. As the Commissioner will not make a determination under subsection 45B(3) of the ITAA 1936 in relation to the arrangement as described, section 45C will not deem the return of capital component of the distribution to be an unfranked dividend for the purposes of the ITAA 1936 or ITAA 1997.

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## Detailed contents list

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### Commissioner of Taxation

25 August 2004

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<i>Previous draft:</i>	- ITAA 1936 45B(8)(b)
Not previously issued as a draft	- ITAA 1936 45B(8)(c)
	- ITAA 1936 45B(8)(d)
<i>Related Rulings/Determinations:</i>	- ITAA 1936 45B(8)(e)
CR 2001/1; TR 92/1; TR 97/16	- ITAA 1936 45B(8)(f)
	- ITAA 1936 45B(8)(g)
	- ITAA 1936 45B(8)(h)
<i>Legislative references:</i>	- ITAA 1936 45B(8)(i)
- TAA 1953 Pt IVA	- ITAA 1936 45B(8)(j)
- ITAA 1936 6(1)	- ITAA 1936 45B(8)(k)
- ITAA 1936 6(4)	- ITAA 1936 45B(9)
- ITAA 1936 6D	- ITAA 1936 45C
- ITAA 1936 Pt IIIA Div 7B	- ITAA 1936 128B
- ITAA 1936 44(1)	- ITAA 1936 160AOAA
- ITAA 1936 45A	- Copyright Act 1968
- ITAA 1936 45B	- Corporations Act 2001
- ITAA 1936 45B(2)	- Freedom of Information Act 1982
- ITAA 1936 45B(3)	
- ITAA 1936 45B(5)	
- ITAA 1936 45B(8)	
- ITAA 1936 45B(8)(a)	

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*Other references:*

- Minister for Revenue and  
Assistant Treasurer's Press  
Release C104/02 of 27 September  
2002

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ATO references

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