

CR 2005/47 - Income tax: capital gains: demerger of Novacoat Holdings Limited by Virtualplus Holdings Limited

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Class Ruling

Income tax: capital gains: demerger of Novacoat Holdings Limited by Virtualplus Holdings Limited

Contents	Para
What this Class Ruling is about	1
Date of effect	8
Withdrawal	9
Arrangement	10
Ruling	18
Explanation	27
Detailed contents list	52

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

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 law(s)

2. The tax laws 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 45B of the ITAA 1936;
 - section 45BA of the ITAA 1936;
 - section 45C of the ITAA 1936;
 - section 104-135 of the *Income Tax Assessment Act 1997* (ITAA 1997);
 - Division 115 of the ITAA 1997; and
 - Division 125 of the ITAA 1997.

Class of persons

3. The class of persons to which this Ruling applies comprises the ordinary shareholders of Virtualplus Holdings Limited (VHL) who:
- (a) were 'residents of Australia' (as that term is defined in subsection 6(1) of the ITAA 1936) at the time of the demerger;
 - (b) participated in the arrangement that is the subject of this Ruling; and
 - (c) held their VHL shares on capital account.

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 17.
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 of income ended 30 June 2005 or substituted accounting period. 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 the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Withdrawal

9. This Ruling is withdrawn immediately after 30 June 2005. The Ruling continues to apply, in respect of the tax laws ruled upon, to all persons within the specified class who enter into the arrangement during the term of the Ruling.

Arrangement

10. 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:

- Letter dated 26 October 2004 from KPMG requesting the issue of a Class Ruling under section 14ZAAF of the *Taxation Administration Act 1953*; and
- Letters and emails from KPMG providing further information on the demerger process and participants.

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

11. VHL (previously known as mBox.com Limited) owned 100% of the issued shares in Novacoat Holdings Ltd (NHL).

12. VHL has demerged NHL, resulting in VHL shareholders holding shares in VHL and NHL. The demerger took place on 14 December 2004.

13. Following approval by VHL shareholders at the annual general meeting on 7 December 2004, the demerger was conducted by way of a capital reduction, effected by an in specie distribution of all of VHL's shares in NHL to existing VHL shareholders. VHL debited the capital distribution against the amount standing to the credit of its share capital account. No profits in respect of its shares in NHL were recognised in VHL's accounts. The demerger did not result in a dividend for accounting purposes.

14. VHL shareholders received one NHL share for every ten VHL shares based on their shareholdings at the date of the demerger. A consolidation of VHL shares occurred immediately after the demerger.

15. All of the VHL shares were acquired by VHL shareholders on or after 20 September 1985.

16. VHL had options on issue which represented less than 10% of all ownership interests in VHL measured by either or both of their number and value.

17. Since the demerger, NHL has acquired a blasting and protective coating business and a further strategic acquisition of business assets. NHL, known as Novacoat was admitted to the official list of the Australian Stock Exchange on 19 April 2005 and was listed on the Australian Stock Exchange on 22 April 2005.

Ruling

18. VHL and its subsidiary NHL constituted a demerger group under subsection 125-65(1) of the ITAA 1997.

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

20. CGT event G1 (section 104-135 of the ITAA 1997) happened to each of the shares of the VHL shareholders at the time of the reduction of capital.

21. VHL shareholders are eligible to choose rollover relief under subsection 125-55(1) of the ITAA 1997, in order to defer the capital gains tax (CGT) consequences for CGT event G1 that happened to their VHL shares under the demerger. For VHL shareholders who choose rollover relief, any capital gain made in respect of CGT event G1 that happened to their VHL shares will be disregarded under subsection 125-80(1) of the ITAA 1997.

22. If a shareholder chooses rollover relief the first element of the cost base and reduced cost base of each VHL share acquired before the demerger date, and the corresponding NHL shares acquired under the demerger, will be the sum of the cost bases of the VHL shares, apportioned on a reasonable basis having regard to the market values of the remaining original interests and new interests, or a reasonable approximation of the market values of those interests, just after the demerger (subsections 125-80(2) and (3) of the ITAA 1997).

23. If a shareholder does not choose rollover relief, the same adjustments as would be made if those shareholders had chosen rollover relief are made to the first element of the cost base and reduced cost base of each VHL share and the corresponding NHL share acquired under the demerger (subsections 125-85(1) and (2) of the ITAA 1997).

24. Under subsection 115-30(1) of the ITAA 1997 (item 2), for CGT discount purposes, the acquisition date of the NHL shares acquired under the demerger is the date that each shareholder acquired their corresponding VHL shares.

25. As the value of the NHL shares was attributed entirely to the share capital of VHL, there is no dividend arising under the demerger for the VHL shareholders (subsection 6(1) of the ITAA 1936).

26. The Commissioner will not make a determination under paragraph 45B(3)(a) of the ITAA 1936 that section 45BA of the ITAA 1936 applies to the whole, or any part, of any demerger benefit provided to VHL shareholders under the demerger. The Commissioner will not make a determination under paragraph 45B(3)(b) of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole, or any part, of the capital benefit provided to VHL shareholders under the demerger.

Explanation

CGT event G1

27. CGT event G1 (section 104-135 of the ITAA 1997) happens if a company makes a payment to a shareholder in respect of their shares in the company and some or all of that payment is not a dividend or an amount that is taken to be a dividend under section 47 of the ITAA 1936 (non-assessable payment). The payment can include the giving of property (section 103-5 of the ITAA 1997).

28. If CGT event G1 happens during an income year, a shareholder will make a capital gain if the total of the non-assessable payments made by the company during the income year in relation to a share exceeds the cost base of the share.

29. CGT event G1 happened when the NHL shares were distributed to the VHL shareholders, as the value of the distribution represented a return of capital which was neither a dividend nor an amount taken to be a dividend under section 47 of the ITAA 1936.

30. VHL shareholders who made a capital gain from the CGT event G1 that happened to their VHL shares may choose demerger rollover relief (section 125-55 of the ITAA 1997) in order to disregard this capital gain (subsection 125-80(1) of the ITAA 1997).

Demerger rollover relief

31. Subsection 125-55(1) of the ITAA 1997 provides that rollover may be chosen if:

- a shareholder owns a share in a company – this requirement is satisfied as VHL shareholders own shares in VHL;
- the company is the head entity of a demerger group – this requirement is satisfied as VHL was the head entity of a demerger group (refer to paragraphs 33 to 35 of this Ruling);
- a demerger happens to the demerger group – this requirement is satisfied as a demerger happened to the VHL/NHL demerger group (refer to paragraph 36 of this Ruling); and

- under the demerger a CGT event happens to the original interest (VHL shares) and a new or replacement interest is acquired in the demerged entity – this requirement is satisfied as CGT event G1 happened to the VHL shares (refer to paragraph 29 of this Ruling) and VHL shareholders received NHL shares under the demerger.

32. Therefore, VHL shareholders can choose rollover relief for the demerger.

Was VHL the head entity of a demerger group?

33. A demerger group comprises one head entity and at least one demerger subsidiary (subsection 125-65(1) of the ITAA 1997). The demerger group in this case comprised VHL as head entity and NHL as a demerger subsidiary (VHL/NHL demerger group).

34. VHL was the head entity because:

- NHL had no ownership interests in VHL (subsection 125-65(3) of the ITAA 1997); and
- there was no other company or trust capable of being a head entity to which NHL could have been a demerger subsidiary (subsection 125-65(4) of the ITAA 1997).

35. NHL was a demerger subsidiary of VHL because VHL owned ownership interests that carried the right to receive more than 20% of any distribution of income or capital by NHL, and the right to exercise more than 20% of the voting power in NHL (subsection 125-65(6) of the ITAA 1997).

Has a demerger happened to the demerger group?

36. A demerger (subsections 125-70(1), (2) and (3) of the ITAA 1997) happened to the VHL/NHL demerger group because:

- there was a restructuring (paragraph 125-70(1)(a)), and VHL disposed of at least 80% of its existing NHL shares to owners of original shares in VHL (subparagraph 125-70(1)(b)(i));
- CGT event G1 happened to VHL shares and VHL shareholders acquired new shares in NHL and nothing else (subparagraph 125-70(1)(c)(i));
- under the restructure, NHL shares were acquired by VHL shareholders on the basis of their ownership of their shares in VHL (paragraph 125-70(1)(d) and subparagraph 125-70(1)(e)(i));
- paragraphs 125-70(1)(f) and 125-70(1)(g) were satisfied;

- VHL shareholders acquired NHL shares in the same proportion as they owned VHL shares just before the demerger (paragraph 125-70(2)(a));
- the total market value of the shares in each of VHL and NHL after the demerger was reasonably proportionate to the total market value of the VHL shares before the demerger (paragraph 125-70(2)(b));
- options issued in regard to VHL shares were disregarded in determining whether the requirements of subsection 125-70(2) were met (subsections 125-75(4) and (5)); and
- subsections 125-70(4) and (5) are not applicable.

Cost base adjustments

37. The method of calculating the first element of the cost base and reduced cost base for a shareholder's original VHL shares and new NHL shares is the same whether or not rollover is chosen (subsections 125-80(2) and (3), subsection 125-85(2) and Note 1 to subsection 125-80(2) of the ITAA 1997).

38. VHL shareholders must apportion the total original cost bases for their VHL shares over their VHL shares and the corresponding new NHL shares, on the basis of the relative market values of those shares (subsections 125-80(2) and (3) of the ITAA 1997). VHL intends to provide VHL shareholders with information to calculate the cost base adjustments.

Time of acquisition of NHL shares – CGT discount

39. Before a capital gain can be reduced by the CGT discount, one of the conditions that must be satisfied is that the capital gain relates to an asset that was owned for at least 12 months (subsection 115-25(1) of the ITAA 1997). For CGT purposes, shareholders acquired their NHL shares when those shares were received under the demerger (section 109-10 of the ITAA 1997). However, for the purposes of accessing the CGT discount, NHL shareholders are taken to have acquired their NHL shares on the date they acquired their corresponding VHL shares (item 2 in the table in subsection 115-30(1) of the ITAA 1997).

Dividend

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

41. The definition of a dividend includes any distribution made by a company to any of its shareholders. However, paragraph (d) of that definition excludes amounts debited against an amount standing to the credit of the share capital account of the company.

42. In the circumstances of this demerger, VHL debited the entire capital distribution against the amount standing to the credit of the 'share capital account' as defined in section 6D of the ITAA 1936. That amount therefore does not constitute a dividend for the purposes of subsection 6(1) of the ITAA 1936 and is not assessable as a subsection 6(1) dividend under subsection 44(1) of the ITAA 1936.

43. In addition, as the value of the NHL shares distributed under the demerger was exactly equal to the amount debited against the share capital account, a dividend did not arise (see Taxation Ruling TR 2003/8).

Section 45B – schemes to provide certain benefits

44. Section 45B of the ITAA 1936 applies to ensure that relevant amounts are treated as dividends for taxation purposes if:

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

45. Specifically, the provision applies where:

- there is a scheme under which a person is provided with a demerger benefit or a capital benefit by a company (paragraph 45B(2)(a) of the ITAA 1936);
- under the scheme a taxpayer, who may or may not be the person provided with the demerger benefit or the capital benefit, obtains a tax benefit (paragraph 45B(2)(b) of the ITAA 1936); 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 a taxpayer to obtain a tax benefit (paragraph 45B(2)(c) of the ITAA 1936).

46. Where the requirements of subsection 45B(2) of the ITAA 1936 are met, subsection 45B(3) empowers the Commissioner to make a determination under either section 45BA in relation to a demerger benefit, or section 45C in relation to a capital benefit.

Determination under paragraph 45B(3)(a)

47. The effect of a determination made under paragraph 45B(3)(a) of the ITAA 1936 is that some or all of a demerger benefit will be treated as not being a demerger dividend (subsection 45BA(1)). In this case, no part of the distribution paid to VHL shareholders is taken to be a dividend, meaning such a determination would have no effect. Therefore the Commissioner will not make a determination under paragraph 45B(3)(a) that section 45BA will apply.

Determination under paragraph 45B(3)(b)

48. The provision of ownership interests in a company, a distribution or the doing of a thing in relation to an ownership interest that has the effect of increasing the value of an ownership interest owned by the person which occurs under a demerger may be considered to be a capital benefit for the purposes of section 45B of the ITAA 1936 (subsection 45B(5)).

49. Where a capital benefit is provided under a demerger, the Commissioner may make a determination under paragraph 45B(3)(b) of the ITAA 1936 that some or all of the capital benefit will be deemed to be an unfranked dividend. Such a determination is made after having regard to the relevant circumstances of the scheme as set out in subsection 45B(8).

50. In this case, while the conditions of paragraphs 45B(2)(a) and (b) of the ITAA 1936 are met, the requisite purpose of enabling the VHL shareholders to obtain a tax benefit (by way of a capital benefit) is not present. In other words, having regard to the relevant circumstances of the scheme as set out in subsection 45B(8), it would not be concluded that any of the parties to the demerger entered into or carried out the scheme to obtain a tax benefit in the form of a capital benefit.

51. It is apparent that the capital benefit provided to VHL shareholders reflects the circumstances of the demerger. In this regard, the capital benefit provided cannot be said to be attributable to the profits of the company, nor does VHL have a pattern of distributions that indicates it is being paid in substitution for a dividend. Furthermore, although the tax result for participating shareholders is favourable, there is nothing known of the circumstances of the VHL shareholders to indicate that the demerger was structured to provide tax benefits.

Detailed contents list

52. Below is a detailed contents list for this Class Ruling:

	Paragraph
What this Class Ruling is about	1
Tax law(s)	2
Class of persons	3
Qualifications	4
Date of effect	8
Withdrawal	9
Arrangement	10
Ruling	18
Explanation	27
CGT event G1	27
Demerger rollover relief	31
Was VHL the head entity of a demerger group?	33
Has a demerger happened to the demerger group?	36
Cost base adjustment	37
Time of acquisition of NHL shares – CGT discount	39
Dividend	40
Section 45B – schemes to provide certain benefits	44
Determination under paragraph 45B(3)(a)	47
Determination under paragraph 45B(3)(b)	48
Detailed contents list	52

Commissioner of Taxation22 June 2005

<i>Previous draft:</i>	- demerger
Not previously issued as a draft	- demerger allocation
	- demerger benefit
<i>Related Rulings/Determinations:</i>	- demerger dividend
CR 2001/1; TR 92/1; TR 92/20;	- demerger group
TR 97/16; TR 2003/8	- demerger subsidiary
	- return of capital
<i>Subject references:</i>	- rollover
- capital benefit	- schemes to provide certain
- capital gains	benefits
- cost base adjustments	

Legislative references:

- ITAA 1936 6(1)
- ITAA 1936 6D
- ITAA 1936 44
- ITAA 1936 44(1)
- ITAA 1936 45B
- ITAA 1936 45B(2)
- ITAA 1936 45B(2)(a)
- ITAA 1936 45B(2)(b)
- ITAA 1936 45B(2)(c)
- ITAA 1936 45B(3)
- ITAA 1936 45B(3)(a)
- ITAA 1936 45B(3)(b)
- ITAA 1936 45B(5)
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- ITAA 1936 47
- ITAA 1997 103-5
- ITAA 1997 104-135
- ITAA 1997 109-10
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- ITAA 1997 115-25(1)
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- ITAA 1997 Div 125
- ITAA 1997 125-55
- ITAA 1997 125-55(1)
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- ITAA 1997 125-65(3)
- ITAA 1997 125-65(4)
- ITAA 1997 125-65(6)
- ITAA 1997 125-70
- ITAA 1997 125-70(1)
- ITAA 1997 125-70(1)(a)
- ITAA 1997 125-70(1)(b)(i)
- ITAA 1997 125-70(1)(c)(i)
- ITAA 1997 125-70(1)(d)
- ITAA 1997 125-70(1)(e)(i)
- ITAA 1997 125-70(1)(f)
- ITAA 1997 125-70(1)(g)
- ITAA 1997 125-70(2)
- ITAA 1997 125-70(2)(a)
- ITAA 1997 125-70(2)(b)
- ITAA 1997 125-70(3)
- ITAA 1997 125-70(4)
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ATO references

- NO: 2005/8433
 ISSN: 1445-2014
 ATOLaw topic: Income Tax ~~ Capital Gains Tax ~~ CGT events G1 to G3 – shares
 Income Tax ~~ Capital Gains Tax ~~ roll-overs - other