

CR 2005/68 - Income tax: conversion by Ricegrowers' Co-operative Limited to a company registered under the Corporations Act 2001 and subsequent issue of additional shares

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Class Ruling

Income tax: conversion by Ricegrowers' Co-operative Limited to a company registered under the *Corporations Act 2001* and subsequent issue of additional shares

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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

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

- subsection 6(1);
- subsection 6(4);
- section 21A;
- sections 45, 45A and 45B;
- section 103A;
- section 117; and
- Division 13A of Part III.

3. This Ruling also relates to the application of the following provisions of the *Income Tax Assessment Act 1997* (ITAA 1997):

- section 6-5;
- section 102-5;
- section 104-25;
- section 104-135;
- section 104-155;
- section 112-25;
- section 124-15;
- section 124-520;
- Subdivision 130-A;
- section 130-20;
- section 136-25;
- Division 725;
- Division 727;
- subsection 960-130(1);
- section 974-75; and
- section 995-1.

Class of persons

4. The classes of persons to which this Ruling applies are:
- (i) existing members of Ricegrowers' Co-operative Limited (RCL) who will be issued with certain shares when RCL is registered as a company under the *Corporations Act 2001* (Corporations Act), and who may receive further shares ('existing members'); or
 - (ii) ex-members of RCL who will be issued with certain shares on exercise of their rights under subsections 139(2) and 319(3) of the *Co-operatives Act 1992 (NSW)* (Co-op Act) when RCL is registered as a company under the Corporations Act, and who may receive further shares ('ex-members').

Qualifications

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

6. The classes 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 11 to 30.

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

9. This Class Ruling applies to the years of income ended 30 June 2004 to 30 June 2007 unless and until it is withdrawn (see paragraph 10 of this Ruling). However this Class Ruling does not apply to taxpayers to the extent it conflicts with the terms of settlement of a dispute agreed to before the date of issue of this Class Ruling (see paragraphs 21 to 22 of Taxation Ruling TR 92/20). Furthermore this Class Ruling applies to the extent that the relevant tax laws are not amended.

Withdrawal

10. This Class Ruling is withdrawn and ceases to have effect after 30 June 2007. The Class Ruling continues to apply, 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 Class Ruling. Thus, the Class Ruling continues to apply to those persons, even following its withdrawal, for arrangements entered into prior to withdrawal of the Class Ruling. This is subject to there being no change in the arrangement or the persons involved in the arrangement.

Arrangement

11. The arrangement that is the subject of the Class Ruling is described below. This description is based on information supplied by the applicant, RCL, on behalf of existing members and ex-members. The information was provided in the following documents. These documents, or the 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:

- (a) the application letter from RCL dated 30 June 2003 requesting a Class Ruling pursuant to Part IVAAA of the *Tax Administration Act 1953*;
- (b) correspondence dated 8 August 2003 from RCL's tax advisors in response to a request for further information from the Australian Taxation Office;
- (c) the email dated 14 August 2003 from RCL's tax advisors providing additional information;
- (d) the email dated 26 September 2003 from RCL's tax advisors providing additional information;
- (e) the email dated 29 October 2003 from RCL's tax advisors providing additional information;
- (f) the email dated 20 November 2003 from RCL's tax advisors providing additional information by way of a legal opinion dated 19 November 2003;
- (g) the email dated 22 December 2003 from RCL's tax advisors providing additional information including a legal opinion dated 19 December 2003;
- (h) the email dated 16 January 2004 from RCL's tax advisors providing additional information by way of a legal opinion dated 15 January 2004;
- (i) the letter dated 31 May 2004 from RCL providing clarification of the facts of the arrangement; and
- (j) the letter dated 30 June 2004 from RCL's tax advisors providing additional information.

12. RCL, a co-operative registered under the Co-op Act and engaged in the production and marketing of rice and rice products, proposes to change its structure.

13. There are more than one thousand existing members of RCL, and the largest shareholding in the co-operative, determined on an associate inclusive basis, is less than 2%.

14. The change of structure will occur in two stages. The first stage is to convert from a co-operative registered under the Co-op Act, to a company registered under the Corporations Act. A number of steps will be involved in this stage: obtaining the approval of the Registrar of Co-operatives for a disclosure statement to be presented to members, the passage of a special resolution by members approving the conversion, registration of RCL as a 'public company limited by shares' by the Australian Securities and Investment Commission (ASIC), and cessation of RCL's registration as a co-operative, to take effect at the time when registration as a company is obtained. This process will be described in this Ruling as 'the conversion' or 'the conversion of RCL from a co-operative to a company'.

15. The second stage of the restructure proposal is to issue additional class B shares in the company under an arrangement which may be implemented by a court approved scheme of arrangement or otherwise approved by the members of RCL the co-operative or RCL the company. This process will be described in this Ruling as the 'share issue arrangement'. If the issue of additional class B shares is to be approved by the members of RCL the co-operative, the constitution of the company into which RCL is to be converted would authorise (but not compel) the directors to make the issue, after so resolving post-conversion, and the members of RCL the co-operative would approve this constitution as part of their approval of the conversion of RCL into a company.

16. The reasons given for the proposed restructure are:

- to align the shareholding interests of active members to reflect the members support and contribution to the rice industry in recent years;
- to improve the ability of RCL to reward active members through dividends, without the restrictions imposed by the Regulations to the Co-op Act;
- to improve market price signals to rice growers by paying a fair price for rice deliveries and dividends as a fair share in the benefits from the other activities of RCL;
- to increase the flexibility of the share capital structure in a way which would enable the funding of future growth by way of equity injections other than by active members who may be cash constrained;
- to enable ex-members to retain a financial interest in the rice industry;
- to enable RCL to establish a scheme under which employees can acquire shares; and
- to enable the trading of shares.

17. RCL wishes to retain the key features of a co-operative such as one vote per active member, a maximum shareholding percentage, and restrictions on share trading.

The conversion of RCL from a co-operative to a company and additional class B shares issue

18. RCL will obtain its members approval by way of a special resolution to effect the conversion of RCL from a co-operative to a company. In conjunction with the conversion, RCL proposes immediately upon registration under the Corporations Act to issue two classes of shares:

- (a) class A redeemable preference shares ('class A shares'); and
- (b) class B ordinary shares ('class B shares').

The issue of the class A and B shares will replicate the voting and dividend and surplus rights of each member in the former co-operative.

19. The Co-op Act requires, in relation to the conversion of RCL from a co-operative to a company, that the conversion must result in every member of the co-operative at the date of conversion who held shares in the co-operative being the holder of shares in the company equal in number and nominal value to the shares held by the member as a member of the co-operative. The approximate amount standing in credit in the share capital account of the co-operative is \$32.4 million comprising 16.2 million issued shares with a par value of \$2.00.

20. Each existing member of the co-operative upon the conversion will be issued with one class A share which confers a right to vote without any entitlement to dividends or distributions of capital for nil consideration.

21. Each existing member will also be issued with class B shares equal to the number of shares held by the member in RCL (as the co-operative) immediately before the conversion to a company registered under the Corporations Act. Each class B share will confer an entitlement to dividends and distributions of capital but no right to vote. Under the Corporations Act neither share class will have a denominated par value.¹

22. The Co-op Act also stipulates that certain ex-members of the co-operative have a right to become a member of the new company and be issued with shares in the company ('statutory rights').² Ex-members exercising their statutory right to become members of RCL will only be issued with class B shares. The maximum number of class B shares to be issued to ex-members on the exercise of these statutory rights would be approx 1.5 million class B shares.

¹ *Corporations Act 2001* section 254C.

² *Co-operatives Act 1992* (NSW) sections 139 and 319.

23. The total number of shares proposed to be on issue after the conversion of RCL from a co-operative to a company would be approximately:

	Class A shares	Class B shares
Existing members	1,860	16.2 million
Ex-members	Nil	Max 1.5 million
Total	1,860	Max 17.7 million

24. To the extent that ex-members exercise their statutory rights to become members of RCL, the share capital account will be credited with the amounts repaid by ex-members (that is, approx 1.5 million shares of \$2.00). (This amount was paid to ex-members by RCL when their shares were forfeited).

25. The class A share of a member would be redeemed for nil consideration upon that member ceasing to be an active member. The class B shares will be transferable between members of the company at prices determined between the parties.

26. Shortly after the conversion of RCL from a co-operative to a company and issue of class B shares (the 'original class B shares'), RCL will issue further class B shares to members under the share issue arrangement, based on a formula. No payment will be required for the issue of further class B shares. There will be no cancellation of shares under this arrangement. However, the share issue arrangement would have the legal and practical result of an issue of new class B shares (the 'additional class B shares') to members. Thereafter each member will hold a higher number of class B shares.

27. The proposed formula (the 'loyalty formula') for the issue of the additional class B shares to each member will be composed of three components:

- (a) the member's shareholding in the co-operative at a nominated date prior to the conversion of RCL from a co-operative to a company;
- (b) the average annual quantity of rice supplied by the member to the co-operative over a five year period prior to a nominated date; and
- (c) the number of years in which a member has delivered rice to the co-operative up to a maximum of 15 years prior to a nominated date.

28. With respect to components (b) and (c), the loyalty formula would also include a mechanism known as 'tracing' which would enable members to be given credit for rice delivered by certain associated former members. This mechanism is designed to accommodate the fact that many current members have reorganised their farming businesses over the years and changed the entity through which they supply rice, or have had changes in family members who carry on the farming businesses. The formula would therefore align the shareholding interests of members to reflect their support and contribution to the rice industry in recent years, even if they have reorganised their farming businesses or have had family changes.

29. The total number of shares on issue after the proposed issue of the additional class B shares would be approximately:

	Class A shares	Class B shares
Existing members	1,860	24.3 million
Ex-members	Nil	Max 2.0 million
Total	1,860	Max 26.3 million

30. No amount will be credited to the share capital account upon the issue of the additional class B shares.

Ruling

31. Holders of shares in the co-operative RCL that are within the class of persons mentioned in subparagraph 4(i) ('existing members') can choose roll-over under section 124-520 of the ITAA 1997 for their shares in the co-operative RCL if, at the time of the conversion:

- they are residents of Australia, under the definition of that term in subsection 6(1) of the ITAA 1936; or
- their shares that end have the necessary connection with Australia, within the meaning of that term in section 136-25 of the ITAA 1997.

32. Holders of statutory rights that are within the class of persons mentioned in subparagraph 4(ii) ('ex-members') can choose roll-over under section 124-520 of the ITAA 1997 for their statutory rights in the co-operative RCL if, at the time of the conversion:

- they are residents of Australia, under the definition of that term in subsection 6(1) of the ITAA 1936; or
- their statutory rights that end have the necessary connection with Australia, within the meaning of that term in section 136-25 of the ITAA 1997.

33. For the classes of persons mentioned in paragraph 4, the issue of additional class B shares to a member of RCL:

- (a) does not give rise to an amount of assessable income to the member as ordinary income under section 6-5 of the ITAA 1997;
- (b) does not satisfy the definition of a 'dividend' in subsection 6(1) of the ITAA 1936;
- (c) does not satisfy the definition of a non-cash business benefit in section 21A of the ITAA 1936;
- (d) is not an amount assessable to a member under Division 13A of Part III of the ITAA 1936;
- (e) does not involve the happening of a CGT event for which a capital gain or capital loss will need to be included in working out a net capital gain for a year of income under section 102-5 of the ITAA 1997;
- (f) does not, in the terms used in section 112-25 of the ITAA 1997, constitute the splitting of the original class B shares into two or more assets; and
- (g) is not an arrangement to which any of the consequences under the direct value shifting rules in Division 725 or the indirect value shifting rules in Division 727 of the ITAA 1997 can apply.

34. Section 45 of the ITAA 1936 does not apply to treat, as a dividend, any amount in consequence of the share issue arrangement.

35. Sections 45A and 45B of the ITAA 1936 do not apply to the issue of the additional class B shares. The Commissioner will not, therefore, make a determination that section 45C of the ITAA 1936 applies to deem the issue of shares to be an unfranked dividend.

36. Additional class B shares issued to a member of RCL will satisfy the definition in subsection 130-20(1) of the ITAA 1997 of bonus equities issued in respect of the original class B shares that member holds.

37. As no part of the additional class B shares is an assessable dividend, the cost base, reduced cost base and acquisition dates of the additional class B shares are modified by subsection 130-20(3) of the ITAA 1997:

- (a) additional class B shares issued in relation to original class B shares that are taken to be acquired before 20 September 1985, are taken to be acquired before 20 September 1985.

- (b) additional class B shares issued in relation to original class B shares that are acquired, or taken to be acquired, on a day on or after 20 September 1985, are taken to be acquired on that day. The first element of the cost base and reduced cost base of the original class B shares is reasonably apportioned across the original class B shares and the additional class B shares.

38. The original class B shares issued to members, following RCL's conversion to a company registered under the Corporations Act, are not 'convertible interests', as defined in section 995-1 of the ITAA 1997.

Explanation

CGT roll-over on conversion of RCL from a co-operative to a company

39. Subdivision 124-I of the ITAA 1997 allows a member of a body that is incorporated under a law other than company law to choose roll-over for a CGT event that happens if the incorporated body converts to a company incorporated under company law. The conditions for roll-over are listed in subsection 124-520(1). The reasons that the conditions will be satisfied for the arrangement are outlined in paragraphs 40 to 60. The consequences of a choice to apply roll-over are set out at paragraph 61.

Conditions for roll-over – existing members

40. Paragraph 124-520(1)(a) of the ITAA 1997 requires that the person choosing roll-over is a member of a body that is incorporated under a law other than company law. 'Company law' is defined in subsection 124-520(2) of the ITAA 1997 to mean the Corporations Act or a similar foreign law.

41. The requirement that the 'body is incorporated under a law other than a company law', is satisfied as RCL is incorporated under the Co-op Act.

42. Paragraph 124-520(1)(b) of the ITAA 1997 requires that the body is converted into a company incorporated under company law (without creating a new legal entity). The Explanatory Memorandum to the Taxation Laws Amendment Bill 1990, that introduced section 160ZZPH of the ITAA 1936, the predecessor to section 124-520, provides that this requirement will usually be satisfied where a law under which the incorporation as a company is to occur specifically provides for the legal succession of the company as successor to the former entity.

43. This condition is satisfied as section 321 of the Co-op Act explains that the entity registered under the Corporations Act is taken to be the same entity as the co-operative.

44. The condition in paragraph 124-520(1)(c) of the ITAA 1997, that the company issues the former member with shares (and nothing else) in substitution for their interest in the body just before the conversion, is satisfied as each existing member will receive only class A shares and class B shares in substitution for their interests in the co-operative.

45. Paragraph 124-520(1)(d) of the ITAA 1997 requires that there is no significant difference between:

- (i) the ownership of the body just before the conversion and the ownership of the company just after the conversion; or
- (ii) the mix of ownership of the body just before the conversion and the mix of the ownership of the company just after the conversion.

46. 'Ownership' is not defined and bears its ordinary meaning in the context in which it appears.

47. In the context of this provision about the conversion of various incorporated entities that have a potentially wide range of ownership type interests, 'ownership' is not used in a narrow legal sense, and refers instead to a member's economic ownership of the assets of the converting entity. This is confirmed in the Explanatory Memorandum to the Bill that introduced section 160ZZPH of the ITAA 1936. Referring to the Commissioner's satisfaction that roll-over should be granted, the Explanatory Memorandum states:

the Commissioner will grant CGT roll-over relief at the request of a converting taxpayer in respect of the disposal of interests formerly held in the original entity and the acquisition of shares in the new company, provided no significant changes occur in the underlying ownership of the assets of each entity. If the former members and new shareholders continue to own assets of similar value, and their rights vis-a-vis each other do not change significantly following the conversion, the CGT roll-over relief will be available.

48. For this reason, the economic ownership of RCL by ex-members who exercise their statutory rights under paragraph 139(2)(b) of the Co-op Act is taken into account in determining if there is a significant difference in the ownership of the body just before conversion and the ownership of the company just after conversion. These ex-members are properly regarded as having ownership of RCL immediately before conversion as they can access the economic ownership of the assets of the body by receiving class B shares.

49. The requirement in subparagraph 124-520(1)(d)(ii) of the ITAA 1997, that there is no significant difference in the mix of ownership just before and just after conversion, will be satisfied. Ex-members will receive only class B (non-voting) shares in the company. This will ensure that there is no difference in the voting power just before and just after conversion. According to section 181 of the Co-op Act, 'a member is not entitled to vote if the member is not an active member of the co-operative'. Ex-members entitled to exercise rights under section 139 of the Co-op Act are by definition

inactive, as their shares have been forfeited for failure of the active membership requirement: paragraph 127(1)(a) and section 128 of the Co-op Act.

50. Paragraph 124-520(1)(e) of the ITAA 1997 requires that, at the time of conversion, either the member is an Australian resident as defined in subsection 6(1) of the ITAA 1936 or the interest in the body for which roll-over is sought has the necessary connection with Australia. The Ruling is limited in paragraphs 31 and 32 in relation to this requirement.

51. The circumstances where an asset will have the necessary connection with Australia are set out in section 136-25 of the ITAA 1997. The necessary connection test cannot be satisfied by any member if RCL is a public company for the year when the conversion happens, as there will be no member that holds, together with their associates, beneficial ownership of at least 10% of the shares in the co-operative at any time within the 5 years before the conversion: category number 5 in the table in section 136-25 of the ITAA 1997. According to the definition of public company in section 103A of the ITAA 1936, RCL will be a public company for the year of income in which the conversion happens if:

- its shares are listed for quotation on the official list of a stock exchange on the final day of the year of income; or
- it satisfies the definition of a co-operative company in section 117 of the ITAA 1936 at all times during the year of income.

52. If RCL is not a public company for the year of income in which the conversion happens, it will be a private company for that year; see the definition of private company in subsection 995-1(1) of the ITAA 1997. If RCL is a private company, then the shares and statutory rights in RCL will meet the necessary connection requirements in category numbers 3 and 7 respectively of the table in section 136-25 of the ITAA 1997.

Conditions for roll-over – ex-members

53. Section 139 of the Co-op Act provides that ex-members who have forfeited their shares for failure of the active membership requirement are to be regarded as ‘the holders of shares in the co-operative (the same in all respects as those that were forfeited)’ for certain purposes.

54. One purpose is determining their entitlement to shares if the co-operative converts to a company registered under the Corporations Act. An ex-member has a statutory right to become a member of the company and be issued with shares, equal in number and nominal value to their former shareholding, if the following conditions are satisfied:

- the resolution under subsection 316(2) of the Co-op Act to convert to a company is passed within 5 years of the time when the shares were forfeited;

- the ex-member has elected to be issued with shares in the company; and
- the ex-member has satisfied the requirement in section 141 of the Co-op Act by repaying any forfeiture proceeds to the co-operative:

(paragraph 139(2)(b), subsections 319(2) and (3) of the Co-op Act).

55. An ex-member's statutory right to receive shares in the company (a CGT asset) is acquired at the date when all of these conditions are satisfied. The first element of the cost base of the asset includes the amount of any forfeiture proceeds repaid to the co-operative: paragraph 110-25(2)(a) of the ITAA 1997.

56. CGT event C2 in section 104-25 of the ITAA 1997 happens when the statutory right is satisfied by the issue of class B shares in RCL. Ex-members of RCL can claim roll-over under section 124-520 for the ending of their statutory rights.

57. The requirements in paragraphs 124-520(1)(b) and (d) of the ITAA 1997 are satisfied for the reasons stated in paragraphs 42 to 43 and 45 to 49.

58. Ex-members will satisfy the requirement in paragraph 124-520(1)(a) of the ITAA 1997 that the person claiming roll-over relief is a 'member of the body' that is converting. Member is not defined and takes its meaning according to its context. In this case we consider the term would include any person entitled to benefit in the event that the co-operative were wound-up or converted to a company. This would include those entities that satisfy the conditions referred to in paragraph 53.

59. The condition in paragraph 124-520(1)(c) of the ITAA 1997, that the company issues the ex-member with shares (and nothing else) in substitution for their interest in the body just before the conversion, is satisfied as each ex-member receives only class B shares in substitution for the statutory rights they hold just before conversion.

60. Roll-over will be available for the holders of statutory rights that meet the requirement in paragraph 124-520(1)(e) of the ITAA 1997, that at the time of the conversion they are an Australian resident, or have an interest in the body that has the necessary connection with Australia. For an explanation of the circumstances where these tests are satisfied, refer to paragraphs 50 to 52.

Consequences if Subdivision 124-I roll-over is chosen

61. The consequences of a choice being made to apply Subdivision 124-I of the ITAA 1997 roll-over for shares and statutory rights in RCL that end on conversion are set out in Subdivision 124-A of the ITAA 1997:

- for an existing member that holds shares acquired before 20 September 1985, new class A and class B shares in the company that are issued are taken to be acquired before that day;
- for an existing member that holds shares acquired on or after 20 September 1985, a capital gain or capital loss made on the ending of those shares is disregarded, and the first element of the cost base and reduced cost base of the new class A and class B shares in the company is worked out by apportioning part of the cost base and reduced cost base of the shares that have ended; and
- for an ex-member that holds statutory rights that end on conversion, a capital gain or capital loss made on the ending of those rights is disregarded, and the first element of the cost base and reduced cost base of the new class B shares in the company is worked out by apportioning a part of the cost base and reduced cost base of the rights that have ended.

A share as an amount of income according to ordinary concepts

62. Section 6-5 of the ITAA 1997 includes within the assessable income of a taxpayer any amount which is income according to ordinary concepts ('ordinary income'). The Courts have refrained from attempting to formulate a definition or precise tests for determining what is income according to ordinary concepts (refer, for example, to the comments of Dixon CJ and Williams J in *FC of T v. Dixon* (1952) 86 CLR 540 at 555; (1952) 10 ATD 82 at 84).

63. In *Commissioner of Taxes (SA) v. Executor Trustee and Agency Co. of South Australia Limited* (1938) 63 CLR 108 (*Carden's Case*) Dixon J observed at page 152 that 'income, profits and gains are conceptions of the world of affairs and particularly of business'; in the absence of statutory intervention, it is to those conceptions that one has regard in order to ascertain income. Similarly, the comments of Jordan CJ in *Scott v. Commissioner of Taxes (NSW)* (1953) 3 ATD 142 at 144-145 indicate that income is to be determined according to the ordinary concepts and usages of mankind, including not only legal precedent, but also commercial and business conceptions.

64. The case law establishes that a net amount or net profit may constitute income according to ordinary concepts (refer to *Commercial and General Acceptance Ltd v. FC of T* (1977) 137 CLR 373; 77 ATC 4375; (1977) 7 ATR 716 per Mason J at CLR 382-383; ATC 4380; ATR 721-722, with whom Barwick CJ and Gibbs J agreed). However, a net profit will only be considered income when the gross receipt from which it is calculated itself lacks the character of income.

65. Income is a gain (in some contexts a receipt, in others a profit) from the carrying on of organised activity – an employment, a business or profession, or a business deal – directed to the making of gains. In particular, if a taxpayer's intention or purpose in entering into the transaction was to make a profit or a gain, the profit or a gain will be income, notwithstanding that the transaction was extraordinary, judged by reference to the taxpayer's ordinary business (*FC of T v. Myer Emporium Ltd* (1987) 163 CLR 199; 87 ATC 4363; (1987) 18 ATR 693). Income is also a gain derived from property which leaves the property intact – a fruit of the tree as distinct from the tree itself for example. interest, dividends, royalties (*FC of T v. Montgomery* (1999) 198 CLR 639; 99 ATC 4749; (1999) 42 ATR 475). The gain must be of revenue rather than capital nature in order to constitute income according to ordinary concepts.

66. A share (the nature of which is discussed at paragraph 106) is the personal property of the member representing their portion of ownership in the net worth or share capital of the company.³ In addition the constitution of a company will generally define the rights attaching to the share. In the hands of a member a share is generally a capital asset (except in the situation of share trading) representing *inter alia* a proprietary right to a 'dividend stream'.⁴ Normally, therefore, an issue of shares will be distributed and received as capital and not income (per Dixon CJ in *Federal Commissioner of Taxation v. W.E. Fuller Pty Ltd* (1959) 101 CLR 403 at 408).

67. In the present case, the issue of additional class B shares will give rise to a dilution of the value of the existing shares and a reconfiguration of the interest of the members *inter se* based on certain criteria. The additional shares would be received as capital and not as income.

A share as a 'dividend' under the ITAA 1936

68. Subsection 6(1) of the ITAA 1936 defines 'dividend' for the purposes of the income tax legislation to include:

- (a) any distribution made by a company to any of its shareholders, whether in money or other property; and
- (b) any amount credited by a company to any of its shareholders as shareholders.

³ *Corporations Act 2001* paragraph 1070A(1)(a).

⁴ *Gambotto v. WCP Ltd* (1995) 13 ACLC 342.

However, paragraph (d) of the definition within subsection 6(1) excludes any distribution which is debited against the share capital account of the company, except where subsection 6(4) applies.

69. Subsection 6(4) of the ITAA 1936 provides that paragraph 6(1)(d) of the ITAA 1936 of the definition of 'dividend' does not apply if, under an arrangement, a company raises share capital from one taxpayer which is credited to its share capital account, and then distributes that amount which has been credited to the share capital to another taxpayer.

70. In this case, the issue of additional class B shares would not constitute a dividend as it will not involve either a distribution of money or property of the company to the shareholders or an amount being credited by the company to any of its shareholders as shareholders.

The additional class B shares issue and non-cash business benefit under the ITAA 1936

71. Section 21A of the ITAA 1936 provides for a non-cash business benefit that is derived by a taxpayer as income in the context of carrying on a business and is not convertible into cash to be treated as if it were convertible into cash and brought into account at an arm's length value. The additional class B shares would not be derived as income by the shareholders in any context and would therefore not constitute a non-cash business benefit for the purposes of section 21A.

The additional class B shares issue and Division 13A of Part III of the ITAA 1936

72. Division 13A of Part III of the ITAA 1936 provides for the taxation treatment of shares and rights under employee share schemes. Section 139B provides that the operation of the Division applies to include within the assessable income of the taxpayer any discount from the market price of the shares or rights provided under the employee share scheme.

73. The key concepts underlying the operation of Division 13A are the existence of an 'employee share scheme' and the acquisition of the share by the taxpayer or an associate being related directly or indirectly to their provision of services to the company: section 139C of the ITAA 1936.

74. In the present case, the membership of RCL includes employees of RCL. However, those shareholders will acquire their additional class B shares in accordance with the criteria applying to all members, which relates to membership history and is independent of any reference to their employment relationship. In these circumstances, Division 13A would not apply.

CGT events on issue of additional class B shares

75. The issue of additional class B shares to members will not cause any CGT event to happen for which a capital gain or capital loss will need to be included in working out a net capital gain for a year of income under section 102-5 of the ITAA 1997.

CGT event G1 – section 104-135

76. CGT event G1 in section 104-135 of the ITAA 1997 happens if a company makes a payment to an entity in respect of a share the entity owns in the company. Payment can also occur in terms of section 104-135 by the giving of property.

77. The words 'paid' and 'payment' are used in several contexts connected with companies in the ITAA 1936, for example section 44. In these contexts the word is used in its sense of discharging an obligation due to the shareholder. When a company distributes money or property, and debits the distribution to profits or capital, it is discharging an obligation to its shareholders, and the money or property so distributed is properly described as a payment.

78. In the Commissioner's view CGT event G1 does not apply to the issue of the additional class B shares under the share issue arrangement. The issue of shares does not discharge or perform any obligation owed by RCL to its shareholders, and is therefore not relevantly a payment.

CGT event H2 – section 104-55

79. CGT event H2 in section 104-155 of the ITAA 1997 happens if an act, transaction or event occurs in relation to a CGT asset owned by an entity, and the act, transaction or event does not result in an adjustment being made to the asset's cost base or reduced cost base.

80. The issue of additional class B shares could constitute an act, transaction or event that happens in relation to the original class B shares, in terms of paragraph 104-155(1)(a) of the ITAA 1997. It is the Commissioner's view, however, that there could be no consequences for CGT event H2 applying to the share issue arrangement.

81. For original class B shares that are acquired, or taken to be acquired, on or after 20 September 1985, CGT event H2 will not apply as in these circumstances the issue of the additional class B shares will result in an adjustment being made to the cost base of the original class B shares (see paragraphs 102 to 103): paragraph 104-155(1)(b) of the ITAA 1997.

82. For original class B shares that are taken to be acquired before 20 September 1985 no cost base adjustments will be made on the issue of the additional class B shares, so the conditions for the application of CGT event H2 in subsection 104-155(1) of the ITAA 1997 may be satisfied. None of the exceptions in subsection 104-155(5) of the ITAA 1997 apply to the issue of additional class B shares. However, the additional class B shares are bonus equities to which the consequences in subsection 130-20(3) of the ITAA 1997 apply, including the consequence for bonus equities issued in relation to original equities acquired before 20 September 1985 that 'any capital gain or capital loss you make from the bonus equities is disregarded': column 3 of item 4 in the table in subsection 130-20(3). This means that any capital gain made on the issue of additional class B shares in these circumstances is disregarded.

The issue of additional class B shares does not involve the splitting of a CGT asset

83. The issue of the additional class B shares will not alter the original class B shares in relation to which the additional class B shares are issued. For this reason, section 112-25 of the ITAA 1997, that determines cost base and other consequences where a CGT asset is split into 2 or more new assets, will not apply.

84. In taking this view, we consider that there is no basis for applying reasoning similar to that in Taxation Determination TD 2000/10, Income tax: capital gains: what are the CGT consequences for a shareholder if a company converts its shares into a larger or smaller number of shares?, to the share issue arrangement considered in this Ruling. That determination considered the application of the power to subdivide shares in section 254H of the Corporations Act. In the Commissioner's view, an arrangement that involves the issue of further shares to members on a differential basis is not within the scope of that Corporations Act power.

85. The authorities support the proposition that, in a single class of share in a company, each shareholder has an interest representing a fixed fraction of the whole share capital of the company.

86. 'Share' is defined in the Australian Oxford dictionary as 'any of the equal parts into which a company's capital is divided entitling its owner to a proportion of the profits'. The classic judicial statement of the nature of a share can be found in the description of Farwell J in *Borland's Trustee v. Steel Bros & Another* [1901] 1 Ch 279 at 288 where he said:

A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all of the shareholders *inter se* in accordance with the Companies Act. The contract contained in the articles of association is one of the original incidents of the share. A share is not a sum of money ...but is an interest measured by a sum of money and made up of the various rights contained in the contract including the right to a sum of money of a more or less amount.

87. This concept of the nature of a share has not been altered by the abolition of par value in the Company Law Review amendments in 1998. In Ford, HA, 2003, *Ford's Principles of Corporations Law*, 11th ed, Butterworths, Sydney, it is stated at paragraph 17.200:

Since the abolition of par value by amendments to the Corporations Law in 1998, a share in the company with only one class of shares is a unit or interest in the company's share capital after all prior claims on the company have been met. There will be no need to relate ordinary shareholders' rights to anything more than a number of shares. It is not enough for a company to say simply that a member is entitled of a certain fraction of the company's total share capital. The member's interest must be expressed in shares in the share capital. Even a sole shareholder must have been issued with a single share or a number of shares.

88. The power to convert shares into a larger or smaller number, contained in section 254H of the Corporations Act, merely allows a shareholder to take one thing, a specified number of shares representing a specific fractional entitlement to the share capital of a company, and convert that thing into something else, a different number of shares. The section does not allow shareholders a greater or lesser interest in the share capital of the company. That would not be a conversion or subdivision as each shareholder would have a greater or lesser entitlement to any distribution of profits, or to a distribution of share capital on winding up.

Application of the value shifting rules to the issue of additional class B shares

89. The rules in Divisions 725 and 727 of the ITAA 1997 prevent entities from obtaining CGT and income tax advantages from schemes involving direct or indirect value shifts. Both Division 725 and Division 727 may apply to a scheme involving the issue of new shares in a company at a discount. Division 725 has no application to the share issue arrangement as there is no entity that controls RCL for value shifting purposes at any time from when the scheme is entered into until when it is carried out, as required by paragraph 725-50(b). Division 727 also has no application as no entity that provides economic benefits to RCL, or receives such economic benefits in return, would, together with RCL, meet the ultimate controller or common ownership nexus test as required by paragraph 727-100(c).

Specific anti-avoidance provisions

Section 45 of the ITAA 1936

90. Section 45 applies where a company streams the provision of bonus shares and the payment of minimally franked dividends to its shareholders in such a way that bonus shares are received by some shareholders and minimally franked dividends are received by other shareholders. As the described share issue arrangement does not contemplate the distribution of dividends, section 45 does not apply.

Section 45A of the ITAA 1936

91. Sections 45A and 45B of the ITAA 1936 are anti-avoidance provisions which, if either applies, allow the Commissioner to make a determination under section 45C that all or part of a capital benefit is treated as an unfranked dividend.

92. Section 45A of the ITAA 1936 applies in circumstances where capital benefits are streamed to certain shareholders who derive a greater benefit than other shareholders 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).

93. The 'provision of a capital benefit' is defined in subsection 45A(3) to include the provision to a shareholder of shares in the company. The issue by RCL of class B shares in accordance with the loyalty formula would constitute the provision of a capital benefit.

94. Although a 'capital benefit', as defined in paragraph 45A(3)(a), will be provided to RCL members, the circumstances of the share issue arrangement indicate that there is no streaming of the provision of shares to some members and the payment of dividends to other members. As the second condition in subsection 45A(1) is not satisfied, section 45A will not apply to the issue of additional class B shares.

95. As section 45A will not apply to the issue of additional class B shares, the Commissioner will not make a determination under subsection 45A(2) that section 45C applies to deem the provision of shares to be an unfranked dividend.

Section 45B of the ITAA 1936

96. Section 45B of the ITAA 1936 applies where certain capital benefits are provided 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, 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 a taxpayer to 'obtain a tax benefit' (paragraph 45B(2)(c)).

97. The share issue arrangement under which RCL will issue additional class B shares to members is a scheme (within the broad meaning of that term). The issue of those shares constitutes the 'provision of a capital benefit' as defined by paragraph 45B(5)(a).

98. As no tax is payable on the receipt of the additional shares, members will 'obtain a tax benefit' within the meaning conveyed by subsection 45B(9).

99. However, having regard to the relevant circumstances specified in subsection 45B(8), it cannot be concluded that a person would enter into, or carry out, the share issue arrangement for a (more than incidental) purpose of enabling RCL members to obtain a tax benefit. In particular, the issue of shares does not represent the capitalisation of profits, and is therefore not attributable to profits. The form and manner of the share issue arrangement, for the issue of additional class B shares, reflects the intended commercial object of aligning the respective ownership interests in accordance with the loyalty formula approved by members. As the third condition in subsection 45B(2) is not satisfied, section 45B will not apply to the issue of additional class B shares.

100. As section 45B will not apply to the issue of additional class B shares, the Commissioner will not make a determination under subsection 45B(3) that section 45C applies to deem the provision of shares to be an unfranked dividend.

Additional class B shares are bonus equities – capital gains tax consequences

101. The additional class B shares will satisfy the definition of bonus equities in subsection 130-20(1) of the ITAA 1997, as they are to be issued in relation to the original class B shares. Accordingly, the cost base, reduced cost base and acquisition date for the additional class B shares and the original class B shares will be determined under Subdivision 130-A of the ITAA 1997.

102. As none of the additional class B shares is an assessable dividend, shares issued in relation to original class B shares that are acquired, or taken to be acquired, on a particular date on or after 20 September 1985, are also taken to be acquired on that date. A shareholder is required to work out the cost base of their original class B shares and additional class B shares by apportioning the first element of the cost base of the original class B shares in a reasonable way: item 1 in the table in subsection 130-20(3) of the ITAA 1997.

103. As no payment is required to be made for their issue, additional class B shares issued in relation to original class B shares that are taken to be acquired before 20 September 1985 are also taken to be acquired before that date: item 4 in the table in subsection 130-20(3) of the ITAA 1997. Note that the circumstances where original class B shares will be taken to be acquired before 20 September 1985 are set out at paragraph 61.

Shares issued upon conversion – not convertible interests

104. Upon RCL's registration as a company under the Corporations Act class A and class B shares ('original class B shares') will be issued to existing members, in the same proportion, and to ex-members under the first stage of the restructure.

105. The issue of additional class B shares in stage 2 will occur in accordance with the loyalty formula. The entitlement of a member to additional shares inheres in the share issue arrangement and not in the shares issued under the first stage of the restructure.

106. For an interest in a company to be a 'convertible interest' as defined by section 995-1 of the ITAA 1997 it must be of the kind referred to in item 4 of the table in subsection 974-75(1) of the ITAA 1997. That item describes the interest as:

An interest issued by the company that:

- (a) gives its holder (or a *connected entity of the holder) a right to be issued with an *equity interest in the company or a *connected entity of the company; or
- (b) is an *interest that will, or may, convert into an equity interest in the company or a connected entity of the company.

Section 974-165 of the ITAA 1997 defines what an 'interest that will, or may, convert into an equity interest' is.

107. The original class B shares do not convey rights on a holder to be issued with an equity interest in RCL or a connected entity. Neither do they constitute an 'interest that will, or may, convert into an equity interest'.

108. The original class B shares are, therefore, not 'convertible interests' as defined in section 995-1 of the ITAA 1997.

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Related Rulings/Determinations:

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Subject references:

- assessable income
- bonus equities
- capital gain
- CGT event
- CGT roll-over
- chose in action
- co-operative company
- distribution
- dividends
- incorporation
- non-cash business benefit
- ordinary income
- profits
- share capital
- shareholders
- shares
- subdivision

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