


CR 2005/93 - Income tax: dividend payment: StateWest Credit Society Limited

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Class Ruling

Income tax: dividend payment: StateWest Credit Society Limited

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Preamble

The number, subject heading, **What this Class Ruling is about** (including **Tax laws, 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:
- subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - section 160APHO of the ITAA 1936;
 - section 177E of the ITAA 1936;
 - section 177EA of the ITAA 1936;
 - section 202-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
 - section 202-40 of the ITAA 1997;
 - section 204-30 of the ITAA 1997; and
 - section 207-145 of the ITAA 1997.

Class of persons

3. The class of persons to which this Ruling applies is the shareholders of StateWest Credit Society Limited (StateWest) who will receive a distribution as described in the Arrangement part of this Ruling. In this Ruling they are referred to as 'participating shareholders'.

4. This Ruling deals with whether the payment to participating shareholders is a dividend. It does not deal with the capital gains tax consequences of the share cancellation. For example it does not deal with the consequences of CGT event C2 in section 104-25 of the ITAA 1997 happening on the share cancellation.

Qualifications

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 11 to 19.

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
- may be withdrawn or modified.

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Date of effect

8. This Class Ruling applies to the income year (as defined in section 995-1 of the ITAA 1997) for a participating shareholder in which that shareholder is issued with Home Building Society (Home) shares in return for the cancellation of their share in StateWest. The arrangement will be completed within that income year. For participating shareholders that do not have a substituted accounting period, this will be the income year ending 30 June 2006.

9. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20). Furthermore, 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

10. This Class Ruling is withdrawn and ceases to have effect after 30 June 2006. 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. This is subject to there being no change in the Arrangement or in the persons' involvement in the arrangement.

Arrangement

11. The arrangement that is the subject of the Ruling is described below. The description is based on the following documents:

- the Application for Class Ruling from KPMG dated 1 September 2005;
- correspondence from KPMG dated 9 September 2005;
- correspondence from KPMG dated 16 September 2005; and
- correspondence from KPMG dated 21 September 2005.

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 StateWest has been provided on a commercial-in-confidence basis and will not be disclosed or released under the Freedom of Information legislation.

12. StateWest is a public company limited by shares. StateWest operates on the 'principles of mutuality' and is a credit society. Each member holds one (1) share in the society and the share confers one (1) vote to the member.

13. Prior to the anticipated amendment of StateWest's constitution, a StateWest share carries no dividend rights and StateWest has never paid any dividends.

14. On 23 August 2005, StateWest announced a proposal to merge with Home. Subject to StateWest shareholder approval, it is proposed that StateWest will 'demutualise'.

15. As part of the 'demutualisation' process, StateWest's constitution will be amended such that StateWest will be able to pay dividends.

16. Subject to shareholder approval, it is proposed that StateWest will pay a fully franked dividend to shareholders. The total amount of the dividend will be approximately \$13.78 million.

17. Subsequent to the dividend payment, the shareholders of StateWest will participate in a scheme of arrangement under which their shares will be cancelled and shares in Home will be issued to them.

18. StateWest has approximately 62,000 members. Each of these members holds (or will hold) a single share paid up to a value of \$10. StateWest's current shareholder register indicates the following:

- 99.6% of shareholders are expected to be Australian residents; and
- 96% of shareholders are listed under individual names.

19. StateWest as head company of a consolidated group has a franking account balance of \$9,489,355.73. The special dividend will utilise approximately \$5.9 million of franking credits.

Ruling

20. The proposed special dividend will constitute a dividend for the purposes of subsection 6(1) of the ITAA 1936.

21. The dividend will be a 'frankable distribution' pursuant to section 202-40 of the ITAA 1997 and therefore will be capable of being franked in accordance with section 202-5 of the ITAA 1997 provided StateWest allocates franking credits to the distribution.

22. The shareholders will be considered to have satisfied the holding period rule under section 160APHO of the ITAA 1936 and be 'qualified persons' for the purposes of Division 1A of Part IIIA of the ITAA 1936 if:

- the StateWest shares were acquired at least 47 days before the date of the merger and held for at least 45 continuous days;
- the shareholder has no other positions (for example, an option) in relation to the shares exchanged in the merger; and
- the shareholder or an associate of the shareholder has not made, is not under an obligation to make, nor is likely to make, any related payments.

23. Having regard to the relevant circumstances of the scheme it could not be concluded that a person or one of the persons that entered into or carried out the scheme or any part of the scheme, did so for a purpose other than an incidental purpose of enabling the relevant taxpayer to obtain an imputation benefit. Therefore, the Commissioner will not seek to make a determination pursuant to paragraph 177EA(5)(b) of the ITAA 1936 in respect of the proposed arrangement. Consequently, section 207-145 of the ITAA 1997 will not apply to deny shareholders a gross-up and tax offset under section 207-20 of the ITAA 1997.

24. The Commissioner will not seek to make a determination pursuant to paragraph 204-30(3)(c) of the ITAA 1997 in respect of the proposed special dividend. Consequently, section 207-145 of the ITAA 1997 will not apply to deny shareholders a gross-up and tax offset under section 207-20 of the ITAA 1997.

25. Section 207-155 of the ITAA 1997 will not apply in respect of the proposed special dividend. Consequently, section 207-145 of the ITAA 1997 will not apply to deny shareholders a gross-up and tax offset under section 207-20 of the ITAA 1997.

26. Section 177E of the ITAA 1936 will have no application in respect of the special dividend.

Explanation

Will the proposed distribution paid by StateWest to its shareholders constitute a dividend for the purposes of subsection 6(1) of the ITAA 1936?

27. A dividend is defined in subsection 6(1) of the ITAA 1936 to include:

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

but does not include moneys paid or credited by a company to a shareholder or any other property distributed by a company to shareholders, where the amount of the moneys paid or credited, or the amount of the value of the property, is debited against an amount standing to the credit of the share capital account of the company.

28. The Constitution of StateWest as it currently stands does not permit the company to pay dividends to shareholders. No dividends have been paid to date. The company has retained all profits generated and has for accounting purposes transferred prior year retained profits to a general reserve account. The proposed special dividend is to be paid in cash and debited to StateWest's current year earnings and general reserve account. Prior to the declaration of the dividend, the Constitution of StateWest is to be amended to permit the payment of dividends. As, following the change of its constitution, StateWest will be making a cash distribution to its shareholders, this distribution will be considered to be a dividend for the purposes of subsection 6(1) of the ITAA 1936.

Will the dividend be a 'frankable distribution' pursuant to section 202-40 of the ITAA 1997 and therefore be capable of being franked in accordance with section 202-5 of the ITAA 1997?

29. Pursuant to section 202-40 of the ITAA 1997, a distribution will be a frankable distribution if it is not unfrankable. A distribution will be unfrankable if it comes within any of the circumstances set out in section 202-45 of the ITAA 1997.

30. In the present circumstances, the only part of section 202-45 of the ITAA 1997 that could potentially apply to the arrangement is paragraph 202-45(e) of the ITAA 1997. This paragraph deems an otherwise frankable distribution to be unfrankable where the distribution is debited wholly or partly against a company's disqualifying account, or where the distribution is debited to a non-disqualifying account but results in a debit to the company's notional disqualifying account (section 46M of the ITAA 1936).

31. In the present instance, the proposed special dividend is to be debited against StateWest's current year earnings and general reserve account. Both these accounts represent retained profits of the company and consequently will not constitute disqualifying accounts. Consequently, the proposed special dividend will represent a frankable distribution.

32. An entity will be taken to have franked a distribution if the following conditions are satisfied;

- (a) the entity is a franking entity that satisfies the residency requirement when the distribution is made;
- (b) the distribution is a frankable distribution; and
- (c) the entity allocates a franking credit to the distribution.

33. As a public company, StateWest will represent a corporate tax entity as defined in section 960-115 of the ITAA 1997. As an Australian resident, StateWest will also satisfy the residency requirements of section 202-20 of the ITAA 1997. Therefore, as the proposed special dividend represents a frankable distribution, it will be franked in accordance with section 202-5 of the ITAA 1997 if StateWest allocates franking credits to the distribution.

Will the shareholders be considered to have satisfied the holding period rule under section 160APHO of the ITAA 1936 and be 'qualified persons' for the purposes of Division 1A of Part IIIAA of the ITAA 1936?

34. For the purposes of this Class Ruling, the following assumptions have been made:

- the StateWest shares were acquired at least 47 days before the date of the merger and held for at least 45 continuous days;
- the shareholder has no other positions (for example, an option) in relation to the shares exchanged in the merger; and
- the shareholder or an associate of the shareholder has not made, is not under an obligation to make, nor is likely to make, any related payments.

35. Division 1A of the ITAA 1936 sets out the circumstances in which a taxpayer can qualify for franking credits in respect of dividends paid on shares. In order to qualify for franking credits in respect of dividends paid on shares a taxpayer must be a qualified person in relation to the dividend. Under section 160APHO of the ITAA 1936 a taxpayer will be a qualified person if the relevant shares are held 'at risk' during the relevant 'qualification period' for a continuous period (not counting the day on which the taxpayer acquired the shares or, if the taxpayer has disposed of the shares, the day on which the disposal occurred) of not less than 45 days where the shares are ordinary shares.

36. *Qualification period:* The qualification period represents the relevant period during which the shares are required to be held at risk for the requisite period of 45 days. Where neither the taxpayer nor an associate of the taxpayer has made, is under an obligation to make, or is likely to make, a related payment in respect of the dividend, the relevant qualification period will be the primary qualification period. As the taxpayers are not expected to make any related payments, (broadly a payment that seeks to pass the economic benefit of the dividend to another party), the relevant qualification period in the present case would be the primary qualification period. The primary qualification period commences on the day after the day on which the shares were acquired and ends on the 45th day after the shares became ex dividend.

37. *At Risk*: Shares will be taken to have been held at risk by a taxpayer if the taxpayer is exposed to at least 30% of the risk of loss or opportunities for gain associated with the shares. Delta is a concept used to measure the relevant risk. If a taxpayer's net position in respect of a given day is less than 0.3, the taxpayer will be taken to have materially diminished their risk of loss or opportunity for gain and those days would be excluded when determining if the shares have been held at risk for the requisite number of days during the primary qualification period. Shares held by a taxpayer will carry a delta of +1 in respect of themselves. However, in determining a taxpayer's net delta, all other long and short positions in respect of the underlying share are also required to be taken into consideration. Based upon the information provided the taxpayers are not expected to have any other positions (for example, an option) in relation to the shares on which the special dividend is paid prior to their exchange in the merger. Therefore, in the absence of any other long or short positions, the shareholders of StateWest will have a net position with a delta of +1 and will be taken to have held their shares at risk.

38. The StateWest shares were acquired by the shareholders at least 47 days before the date of the merger and held for at least 45 continuous days. Given that during this period the shares were held at risk as discussed above, the shareholders will be taken to be qualified persons as they would have held their shares at risk for the requisite period of 45 days during the primary qualification period extending from the date of acquisition of the shares to the date of their disposal in the merger.

Will the Commissioner seek to make a determination pursuant to paragraph 177EA(5)(b) of the ITAA 1936 in respect of the proposed arrangement?

39. Section 177EA of the ITAA 1936 is primarily directed at schemes involving franking credit trading. Its introduction was designed to secure the integrity of one of the underlying principles of the dividend imputation system. Namely, to ensure that the benefits of imputation are restricted to the true economic owners of the shares and only to the extent that those shareholders are able to use those franking credits themselves.

40. As a secondary objective it is designed to back up the specific anti-streaming rules in section 204-30 of the ITAA 1997 and associated provisions.

41. The conditions that must be satisfied for section 177EA of the ITAA 1936 to operate are set out in subsection 177EA(3) of the ITAA 1936. Briefly they are as follows:

- (a) there must be a Scheme for the disposition of membership interests, or an interest in membership interests, in a corporate tax entity;
- (b) either:
 - i. a frankable distribution has been paid, or is payable, or is expected to be payable to a person in respect of the membership interests; or
 - ii. a frankable distribution has flowed indirectly, or flows indirectly, or is expected to flow indirectly to a person in respect of the interest in membership interests as the case may be;
- (c) the distribution was, or is expected to be, a franked distribution or a distribution franked with an exempting credit;
- (d) except for this section, the person (referred to as the 'relevant taxpayer') would receive, or could reasonably be expected to receive, imputation benefits as a result of the distribution; and
- (e) having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain an imputation benefit.

Is there a scheme for the disposition of membership interests?

42. Under the terms of the proposal, Home will acquire the shares in StateWest through the issue of 15.17 million shares in Home.

43. A scheme for the disposition of membership interests is defined widely in paragraph 177EA(14)(a) of the ITAA 1936 and includes the issuing of a membership interest. Consequently, the issue of Home shares to the current StateWest shareholders in consideration for the cancellation of their StateWest shares would constitute a disposition of a membership interest in accordance with paragraph 177EA(14)(a) of the ITAA 1936.

Is a frankable distribution payable or expected to be paid?

44. Based upon the information provided Home has paid dividends of approximately 70% of after tax profits to its shareholders over the past three years. These dividends have been fully franked. It is expected that frankable distributions will continue to be paid in respect of the Home shares issued to the current StateWest shareholders.

Is the distribution franked, or expected to be, franked?

45. As with distributions made by Home over the past three years, it is expected that future distributions to shareholders of Home will continue to be fully franked.

Does the relevant taxpayer receive imputation benefits as a result of the distribution?

46. The payment of franked distributions will provide the new Home shareholders (the former StateWest shareholders) with imputation benefits in the form of a tax offset (paragraph 204-30(6)(a) of the ITAA 1997).

Having regard to the relevant circumstances, would it be reasonable to conclude that one or more parties to the scheme entered into or carried out the scheme to enable the relevant taxpayer to secure imputation benefits?

- (a) *Extent and duration of risk of loss and opportunity for gain, from holding the membership interests in the corporate tax entity that are borne by or accrue to the parties to the scheme.*

The issue of shares to the StateWest shareholders will result in them sharing proportionately in the risk of loss and opportunity for gain associated with the relevant membership interests, with the existing members of Home. The exposure of StateWest shareholders to this risk of loss or opportunity for gain will commence upon the issue of the Home shares. However, a component of that risk of loss and opportunity for gain will be attributable to the business of StateWest which is being acquired by Home as part of the scheme and in which they have held shares since they became members in StateWest for the purposes of depositing or lending funds.

- (b) *Does the relevant taxpayer derive greater benefits from franking credits than other entities that hold membership interests in the corporate tax entity?*

Currently, 99.6% of StateWest shareholders that are being issued with shares in Home are expected to be Australian residents for tax purposes. The existing Home shareholders are also predominantly Australian residents for tax purposes (estimated at 99.5%).

In the absence of the scheme, the relevant taxpayers (StateWest shareholders) could expect a franking percentage of approximately 14.9% in respect of future distributions by StateWest. Following the scheme Home will be able to frank future distributions to its shareholders at a franking percentage of approximately 23.6%. The scheme also results in a reduction in the franking percentage of distributions by Home to its shareholder from 39.6% to 23.6%. However, as a significantly high component of the current shareholders of StateWest and Home are expected to be residents (99.6% and 99.5% respectively), it cannot be concluded that the scheme results in the delivery of a greater share of franking credits to a group of members that are able to derive a greater benefit from those franking credits at the expense of those that are not.

- (c) *Apart from the scheme would the corporate tax entity have retained the franking credits to pay franked distributions to another entity in (b)?*

In the absence of the scheme comprising the issue of Home shares to the StateWest shareholders in return for the acquisition of StateWest by Home, the franking credits that are expected to be attached to future distribution to Home shareholders comprising the current StateWest and Home shareholders, would be used by Home for the purposes of franking future distributions to the existing Home shareholders.

- (d) *Apart from the scheme would the franked distribution flow indirectly to another entity in (b)?*

In the absence of the scheme franked distributions would not have flowed indirectly to any other entity.

- (e) *Does the scheme involve the issue of Non-share equity interests to which section 215-10 of the ITAA 1997 applies?*

This is not a relevant consideration as the scheme does not involve the issue of non-share equity interests to which section 215-10 of the ITAA 1997 applies.

- (f) *Was any consideration paid or given by or on behalf of or received by or on behalf of the relevant taxpayer determined based on imputation benefits to be received by the relevant taxpayer?*

No part of the consideration paid by the shareholders of StateWest through the cancellation of their shares in StateWest, for the shares issued to them in Home was determined on the basis of any imputation benefits likely to be received by them.

The relevant consideration was determined based upon an agreed valuation of StateWest, Home's share price and the number of StateWest shareholders.

- (g) *Was a deduction allowable or a capital loss incurred in connection with the distribution?*

No deduction will be allowable or capital loss incurred as a result of the special dividend.

- (h) *Is the distribution to the relevant taxpayer equivalent to the receipt by the relevant taxpayer of interest or an amount in the nature of or similar to interest?*

It is expected that future distributions to Home shareholders will be sourced in retained profits of the group and profits to be generated by the group and will not represent interest or an amount in the nature of or similar to interest.

- (i) *The period for which the relevant taxpayer held the membership interest or had an interest in the membership interest in the corporate tax entity.*

The scheme facilitates the acquisition of the relevant membership interest by the relevant taxpayers.

- (j) *Any of the matters referred to in subparagraphs 177D(b)(i)-(viii) of the ITAA 1936*

The proposed arrangement is based upon a desire of StateWest and Home to provide the West Australian community with a strong, vibrant home-grown viable alternative to the big banks. It is expected that the merged organisation will have in excess of 110,000 customers and total customer funds under management of over \$3.5 billion.

The arrangement is to be implemented firstly through an amendment to the StateWest constitution to permit the payment of dividends to its members. This is to be followed by the payment of a special dividend of \$13.78 million thereby reducing its retained profits from \$69.79 million to \$56.01 million. Home will then issue 15.17 million Home shares to the current shareholders of StateWest in exchange for the cancellation of their

StateWest shares and the issue of a single StateWest member share to Home.

As a result of the merger the financial position of the StateWest shareholders is not likely to be affected. Having received a fully franked dividend out of profits accrued during their membership, the StateWest shareholders are issued Home shares in exchange for their StateWest share. The number of shares issued to them is determined based upon an agreed valuation of StateWest, Home's share price and the number of StateWest shareholders.

47. Section 177EA of the ITAA 1936 could also have application in the context of a scheme for the disposition of a membership interest where a frankable distribution has been paid prior to the relevant disposition. The cancellation of the shares held by StateWest shareholders in StateWest, in exchange for Home shares will constitute a scheme for the disposition of a membership interest under paragraph 177EA(14)(d) of the ITAA 1936.

48. Therefore, the potential does exist for section 177EA of the ITAA 1936 to apply in respect of the fully franked special dividend of \$13.78 million paid to the StateWest shareholders prior to the disposition of their membership interest in StateWest. The relevant frankable distribution is being paid to persons (the relevant taxpayers) in respect of a membership interest being disposed of by them. Consequently, they will receive imputation benefits in the form of tax offsets and requirements paragraphs (a) to (d) of subsection 177EA(3) of the ITAA 1936 will have been satisfied.

49. The relevant circumstances of the scheme considered in determining the potential application of section 177EA of the ITAA 1936 include the following:

- The relevant taxpayers have carried all associated risks of loss and opportunities for gain in respect of the membership interest being disposed of ever since acquiring those membership interests as clients of StateWest.
- The membership of StateWest comprises approximately 99.6% resident members. The taxpayers deriving the benefit of franking credits associated with the special dividend represent the entire membership of StateWest. Consequently, it cannot be suggested that as a result of the disposition greater benefits from franking credits are received by some members at the expense of other entities that hold membership interests.

- In the absence of the scheme representing the cancellation of the membership interests of the StateWest members in return for the issue of Home shares, the relevant franking credits would have been retained by StateWest and utilised in franking future distributions to those StateWest members, provided its constitution is amended to permit the payment of dividends. In the absence of the amendment to the constitution the relevant profits would be retained by StateWest and the associated franking credits would accumulate in its franking account.
- The consideration received by StateWest members for the cancellation of their StateWest shares was determined based upon an agreed valuation of StateWest, Home's share price and the number of StateWest shareholders. It was not in any way based upon the availability of imputation benefits.
- No deductions will be allowable or capital losses incurred as a result of the special dividend.
- The relevant membership interests have been held by the relevant taxpayers since they became clients of StateWest for the purpose of depositing or lending funds.
- The structure of the transaction reflects a genuine commercial objective on the part of StateWest and Home to achieve a merger with a view to providing the community with a viable alternative to the larger banks. Furthermore, the proposed special dividend represents a release of profits and associated franking credits accrued by StateWest over many years when its constitution prevented the payment of dividends. The relevant imputation benefits flow to those shareholders that carried the relevant risk of loss and opportunity for gain associated with ownership of the StateWest shares.

Will the Commissioner seek to make a determination pursuant to paragraph 204-30(3)(c) of the ITAA 1997 in respect of the proposed special dividend?

50. Section 204-30 of the ITAA 1997 is a general anti-streaming measure. It is designed to curb the unintended use of franking credits through streaming arrangements. It permits the Commissioner to make determinations where an entity streams one or more distribution whether in a single franking period or in a number of franking periods, in such a manner whereby:

- an imputation benefit is, or apart from this section would be, received by a member of the entity as a result of a distribution or distributions;

- that member derives a 'greater benefit from franking credits' than another member of the entity; and
- the other member of the entity receives a lesser imputation benefit, or receives no imputation benefits, whether or not the other member receives other benefits.

51. Put simply, streaming is the act of selectively directing the flow of franked distributions to those members that are best positioned to utilise imputation benefits, to the exclusion of those members that are not. The result of such action by a company is the reduction or elimination of the intended wastage of franking credits, inherent in the design of the imputation system.

52. Based upon the information provided, 99.6% of StateWest shareholders who will be entitled to the special dividend are expected to be residents of Australia. The special dividend of \$13.78 million to be paid to the shareholders of StateWest is expected to be fully franked carrying franking credits of \$5.9 million.

53. Clearly all shareholders of StateWest will receive imputation benefits, the resident shareholders in the form of a tax-offset (paragraph 204-30(6)(a) of the ITAA 1997) and the non-resident shareholders in the form of an exemption from dividend withholding tax (paragraph 204-30(6)(e) of the ITAA 1997). The resident members will in accordance with subsection 204-30(8) of the ITAA 1997 derive a greater benefit from franking credits than the non-resident members who comprise approximately 0.4% of the shareholding. However, as the entire proposed special dividend is to be fully franked and paid prior to the merger to all shareholders alike, it cannot be argued that StateWest has directed the flow of distributions in such a manner as to ensure that imputation benefits are derived by members who derive a greater benefit from franking credits, while other members receive lesser or no imputation benefits.

Will section 207-155 of the ITAA 1997 apply in respect of the proposed special dividend?

54. Section 207-145 of the ITAA 1997 denies an entity the gross-up and tax offset available under section 207-20 of the ITAA 1997 where a manipulation of the imputation system is taken to have occurred. Such a manipulation of the imputation system will be taken to have occurred if the relevant distribution is made as part of a dividend stripping operation. For the purposes of section 207-145 of the ITAA 1997, section 207-155 of the ITAA 1997 defines the circumstances under which a distribution will be taken to have been made as part of a dividend stripping operation.

55. Under section 207-155 of the ITAA 1997, a distribution made to a member of a corporate tax entity will be taken to have been made as part of a dividend stripping operation if it arose out of or was made in the course of a scheme that:

- was by way of, or in the nature of, dividend stripping; or
- had substantially the effect of a scheme by way of, or in the nature of, dividend stripping.

56. In the discussion of section 177E of the ITAA 1936 below, it has been concluded that the special dividend would not represent a distribution that arose out of or was made in the course of a scheme that was by way of or in the nature of dividend stripping; or had substantially the effect of a scheme by way of or in the nature of dividend stripping.

57. Consequently, for the purposes of section 207-145 of the ITAA 1997 no manipulation of the imputation system would be taken to have occurred and there will be no denial of the gross-up and tax offset available under section 207-20 of the ITAA 1997.

Will section 177E of the ITAA 1936 apply in respect of the special dividend?

58. Section 177E of the ITAA 1936 deals with situations where any property of a company, is disposed of as a result of a scheme entered into after 27 May 1981, whether in Australia or outside Australia:

- by way of or in the nature of dividend stripping; or
- having substantially the effect of a scheme by way of or in the nature of dividend stripping.

59. The term dividend stripping carries no defined meaning. In its traditional form a dividend stripping operation occurs when shares are acquired in a company with substantial retained profits usually by a share trader who pays the existing shareholders a capital sum reflecting the value of the retained profits. The new shareholders then liberate those profits through the payment of a dividend. Generally the new shareholders who derive dividend income from the company would be liable to tax upon those dividends.

60. Section 177E of the ITAA 1936 was introduced prior to the introduction of the capital gains tax measures to address the capital payment to the former shareholders, which effectively repatriated the retained profits in the company to the former shareholders in a non-taxable form.

61. Therefore a scheme by way of or in the nature of dividend stripping; or one that has substantially the effect of a scheme by way of or in the nature of dividend stripping, would be one that has the effect of delivering a shareholder's entitlement to a dividend, in a tax advantaged manner to the shareholder or an associate.

62. Under the present circumstances the proposed special dividend will be included in the assessable income of StateWest's shareholders by subsection 44(1) of the ITAA 1936 and be liable to tax.

63. Consequently, as it cannot be said that there exists a scheme by way of or in the nature of dividend stripping; or having substantially the effect of a scheme by way of or in the nature of dividend stripping, section 177E of the ITAA 1936 will have no application.

Detailed contents list

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Commissioner of Taxation

2 November 2005

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<i>Related Rulings/Determinations:</i>	- ITAA 1936 177EA(3)(d)
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