

CR 2006/107 - Income tax: proposed return of capital by Hostworks Group Ltd

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Class Ruling

Income tax: proposed return of capital by Hostworks Group Ltd

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ⓘ This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

What this Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified below apply to the defined class of entities, who take part in the scheme to which this Ruling relates.

Relevant provision(s)

2. The relevant provisions dealt with in this Ruling are:

- section 45A of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 45B of the ITAA 1936;
- section 45C of the ITAA 1936;
- section 104-25 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 104-135 of the ITAA 1997; and
- section 136-10 of the ITAA 1997.

All references are to the ITAA 1936 unless otherwise stated.

Class of entities

3. The class of entities to which this Ruling applies is the shareholders of Hostworks Group Ltd (HGL) who hold ordinary shares as at the Record Date for the pro-rata capital return.

Qualifications

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

5. The class of entities defined in this Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 13 to 27 of this Ruling.

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

- this Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme 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 income year ended 30 June 2007 or, where a substituted accounting period is used, the substituted accounting period in which the capital return occurs. 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 issue of the Ruling. Furthermore, the Ruling only applies to the extent that:

- it is not later withdrawn by notice in the *Gazette*; or
- the relevant provisions are not amended.

9. If this Class Ruling is inconsistent with a later public or private ruling, the relevant class of entities may rely on either ruling which applies to them (item 1 of subsection 357-75(1) of Schedule 1 to the *Taxation Administration Act 1953* (TAA)).

10. If this Class Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the Class Ruling is made, the following two conditions are met:

- the income year or other period to which the rulings relate has not begun; and
- the scheme to which the rulings relate has not begun to be carried out.

11. If the above two conditions do not apply, the relevant class of entities may rely on either ruling which applies to them (item 3 of subsection 357-75(1) of Schedule 1 to the TAA).

Withdrawal

12. This Ruling is withdrawn and ceases to have effect after 30 June 2007. However, the Ruling continues to apply after its withdrawal, in respect of the relevant provisions rules upon, to all entities within the specified class who entered into the specified scheme during the term of the Ruling, subject to there being no change in the scheme or in the entity's involvement in the scheme.

Scheme

13. The scheme that is the subject of the Ruling is described below. The description is based on the following documents.

- Request for a Class Ruling from Ernst & Young on behalf of HGL dated 4 September 2006 and 12 September 2006;
- HGL's Income Statement for the year ended 30 June 2006;
- HGL's Balance Sheet as at 30 June 2006;
- HGL's Cash Flow Statement for the year ended 30 June 2006; and
- Correspondence from HGL providing further particulars dated 17 October 2006.

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

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

15. At the time of the scheme HGL is an Australian owned and managed company listed on the Australian Stock Exchange. HGL is the head company of a consolidated group, which also consists of Hostworks Ltd, Hostworks Internet Services Pty Ltd, ISEC Management Ltd and Hostworks Central Pty Ltd.
16. HGL's capital management strategy up to 2006 has been to distribute excess cash to shareholders. Previous share buy-backs were undertaken on-market (with the relevant shares subsequently cancelled) and funded out of cash reserves. The source of these cash reserves has been capital that was raised through previous share issues not otherwise required or utilised for expansion.
17. As at 31 August 2006 81.4% of HGL's shares were held by Australian residents and 18.6% by overseas holders. Total shareholding as of 31 August 2006 is 164,869,683 ordinary shares. The proposed transaction would result in a return of capital of approximately \$1.648 million.
18. GL intends to make a 1 cent per share pro-rata return of capital to shareholders. All shareholders of HGL are eligible to vote on the proposed return of capital at HGL's Annual General Meeting scheduled to be held on 25 October 2006.
19. The return of capital will be applied equally to each holder of fully paid ordinary shares as at the Record Date in proportion to the number of shares held.
20. No shares will be cancelled as a result of the return of capital and there will be no dilution of the shareholdings in HGL.
21. It is expected that the return of capital will be funded entirely from HGL's existing cash reserves. These cash reserves were generated as a result of previous capital raisings, including the original share capital raising, which have yet to be utilised. HGL's Management considers that the best use of this cash is to return it to shareholders as it is not required by HGL for other purposes.
22. The \$1.648 million return of capital will be debited against HGL's contributed equity account, which is untainted.
23. HGL has a cash balance in excess of \$2 million. It has no retained earnings and no current year profits from which to pay a dividend. HGL board believes that the cash is in excess of its needs and as such it is better off in the hands of the shareholders, as the shareholders can earn a return on these funds pursuant to their own personal investment choices and decisions.
24. The HGL board considered other options for the return to shareholders of the excess cash raised but considered that a capital return was best suited to the company's situation.
25. Under HGL's Ongoing Capital Management Programme the strategy to date has been to return all profits to shareholders as dividends, finance expansion through capital raisings and to return surplus capital to shareholders when it is not required in the business.

26. HGL intends to continue this broad strategy into the future and will also evaluate the use of debt funding as a possible method to finance future expansions.

27. The proposed return of capital is consistent with HGL's ongoing capital management program and is being undertaken for the reasons described above and as a result of a commercial analysis that considered such matters as a minimum working capital requirements, gearing/debt levels and the overall funding strategy of the group.

Ruling

Application of sections 45A, 45B and 45C to the proposed return of capital

28. The Commissioner will not make a determination under section 45A or 45B that section 45C applies to the whole or any part of the return of capital received by an HGL shareholder. Accordingly, no part of the pro-rata return of capital will be taken to be a dividend for income tax purposes.

Capital gains consequences

29. CGT event G1 will happen to an HGL shareholder when the return of capital is paid (section 104-135 of the ITAA 1997).

30. CGT event C2 will happen to an HGL shareholder receiving the return of capital who ceases to own their HGL shares after the Record Date but before the Payment Date (section 104-25 of the ITAA 1997).

31. A foreign resident shareholder will only make a capital gain as a result of the return of capital if the relevant asset has the necessary connection with Australia (section 136-10 of the ITAA 1997).

Commissioner of Taxation

25 October 2006

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner’s view has been reached. It does not form part of the binding public ruling.*

Section 45A – streaming of dividends and capital benefits

32. Sections 45A and 45B are two anti-avoidance provisions which, if they apply, allow the Commissioner to make a determination under section 45C that all or part of the distribution of capital received by the shareholder under the capital return is treated as an unfranked distribution. Accordingly, the application of these two provisions to the capital return must be considered.

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

34. Although a ‘capital benefit’ (as defined in paragraph 45A(3)(b)) is provided to participating shareholders under the capital return, the circumstances of the capital return indicate that there is no streaming of capital benefits to some shareholders and dividends to other shareholders.

35. Accordingly, section 45A has no application to the proposed return of capital.

Section 45B – schemes to provide capital benefits

36. Section 45B applies where certain capital payments are paid to shareholders in substitution for dividends. Specifically, the provision applies where:

- (a) there is a scheme under which a person is provided with a capital benefit by a company (paragraph 45B(2)(a));
- (b) under the scheme a taxpayer, who may or may not be the person provided with the capital benefit, obtains a tax benefit (paragraph 45B(2)(b)); and
- (c) having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, 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)).

On the basis of the information surrounding the return of capital as described in the ruling application and the accounts, section 45B does not apply to this return of capital.

37. Accordingly, the Commissioner will not make a determination pursuant to subsection 45B(3) that section 45C applies to the pro-rata return of capital of HGL.

Section 45C – deeming dividends to be paid where determinations under sections 45A or 45B are made

38. As the Commissioner will not make a determination under subsections 45A(2) or 45B(3) in relation to the scheme as described, section 45C will not deem any part of the pro-rata return of capital to be an unfranked dividend for the purposes of the ITAA 1997.

CGT event G1 – section 104-135 of the ITAA 1997

39. CGT event G1 (section 104-135 of the ITAA 1997) will happen if a company makes a payment to a shareholder in respect of a share they own in a company and some or all of the payment is not a dividend as defined in subsection 995-1(1) of the ITAA 1997, or an amount that is taken to be a dividend under section 47 of the ITAA 1936.

40. The cost base and reduced cost base of each HGL share will be reduced (but not below nil) by the amount of the return of capital (subsections 104-135(3) and (4) of the ITAA 1997).

41. An HGL shareholder may make a capital gain if the return of capital by the company in relation to each HGL share exceeds the cost base of the share (subsection 104-135(3) of the ITAA 1997). If the HGL share was acquired by the shareholder at least 12 months before the date of payment, a capital gain from the share may qualify as a discount capital gain (subsection 115-25(1) of the ITAA 1997) if the other conditions in Subdivision 115-A of the ITAA 1997 are satisfied.

CGT event C2 – section 104-25 of the ITAA 1997

42. If, after the Record Date but before the Payment Date, a person who is a registered ordinary shareholder of HGL ceases to own some or all of their HGL shares in respect of which the proposed 2006 return of capital is payable, the right to receive the payment in respect of each of the shares disposed of is considered to be a separate CGT asset. That right is one of the rights inherent in the share on the Record Date and is retained by the shareholder when the share is sold.

43. CGT event C2 (section 104-25 of the ITAA 1997) will happen when the return of capital is paid and the right to payment ends. A capital gain will result if the capital proceeds for the event are more than the cost base of the right. The capital proceeds will be the amount of the proposed return of capital from HGL. The cost base of the HGL shareholder's right to receive a payment under the scheme is worked out in accordance with Division 110 of the ITAA 1997. However, the cost base (or reduced cost base) of the right is likely to be nil because the full cost base (or reduced cost base) of the share previously held by the shareholder has been applied in working out the capital gain or loss when a CGT event happened to the share – for example the shareholder disposed of the share.

44. The right to payment from the company was inherent in the share during the time that it was owned. Therefore, for the purposes of Subdivision 109-A of the ITAA 1997 the right is considered to have been acquired at the time when the share was acquired. Consequently, if the share was originally acquired by the former shareholder at least 12 months before the payment, a capital gain from the right may qualify as a discount capital gain under subsection 115-25(1) of the ITAA 1997 (provided the other conditions in Subdivision 115-A of the ITAA 1997 are satisfied).

Division 136 of the ITAA 1997 – foreign resident shareholders

45. If the HGL shareholder is not an Australian resident for income tax purposes, a CGT event G1 (section 136-10 of the ITAA 1997) capital gain cannot be made unless the shares have the necessary connection with Australia (section 136-25 of the ITAA 1997).

46. As HGL is an Australian resident public company for the 2007 income year, the shares in HGL will not have the necessary connection with Australia, and a capital gain or a capital loss will not be made, where the foreign resident shareholder and their associates beneficially own less than 10% by value of the shares in the company during the five years before the Record Date.

47. Accordingly, where a HGL shareholder is a non-resident for income tax purposes, any capital gain arising from the return of capital will not be taxed in Australia provided that the shareholder and their associates beneficially own less than 10% by value of the shares in HGL.

Appendix 2 – Detailed contents list

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References

- Previous draft:*
- Not previously issued as a draft
- Related Rulings/Determinations:*
- Subject references:*
- capital benefit
 - return of capital
- Legislative References*
- ITAA 1936 45A
 - ITAA 1936 45A(2)
 - ITAA 1936 45A(3)(b)
 - ITAA 1936 45B
 - ITAA 1936 45B(2)(a)
 - ITAA 1936 45B(2)(b)
 - ITAA 1936 45B(2)(c)
 - ITAA 1936 45B(3)
 - ITAA 1936 45C
 - ITAA 1936 47
 - ITAA 1997 104-25
 - ITAA 1997 104-135
 - ITAA 1997 104-135(3)
 - ITAA 1997 104-135(4)
 - ITAA 1997 Subdiv 109-A
 - ITAA 1997 Div 110
 - ITAA 1997 Subdiv 115-A
 - ITAA 1997 115-25(1)
 - ITAA 1937 Div 136
 - ITAA 1937 136-10
 - ITAA 1997 136-25
 - ITAA 1997 995-1(1)
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ATO references

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Income Tax ~~ Capital Gains Tax ~~ CGT events C1 to C3 - end of a CGT asset