

CR 2007/58 - Income tax: conversion by Mackay Sugar Co-operative Association Limited to a company registered under the Corporations Act 2001



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Class Ruling

Income tax: conversion by Mackay Sugar Co-operative Association Limited to a company registered under the *Corporations Act 2001*

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① 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 (unless we are satisfied that the ruling is incorrect and disadvantages you, in which case we may apply the law in a way that is more favourable for you – provided 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:

- subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 45 of the ITAA 1936;
- section 45A of the ITAA 1936;
- section 45B of the ITAA 1936;
- section 45C of the ITAA 1936;
- Division 104 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 124-520 of the ITAA 1997;

- Division 725 of the ITAA 1997; and
- Division 727 of the ITAA 1997.

Class of entities

3. The class of entities to which this Ruling applies are members in the Mackay Sugar Co-Operative Association Limited (the Co-Op) who:

- (a) receive a portion of the 190 million shares in the proposed Mackay Sugar Limited (MSL) under the arrangement; and
- (b) are 'residents of Australia' within the meaning of that expression in subsection 6(1) of the ITAA 1936.

Qualifications

4. The Commissioner makes this Ruling based on the precise scheme identified in the 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 28 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 from 26 June 2007 to 30 June 2008. However, the Ruling continues to apply after this date 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 entities involved in the scheme.

9. 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.

10. If this 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)).

11. If this Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the 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.

12. 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).

Scheme

13. The following description of the scheme is based on information provided by the applicant. The documents or relevant parts of them form part of and are to be read with the description:

- the application for Class Ruling from McCullough Robertson dated 30 March 2007;
- the appendix to the class ruling application;
- the Rules of Mackay Sugar Co-operative Association Limited dated 19 July 1999;
- the Mackay Sugar Limited draft Constitution received 18 April 2007;

- the Mackay Sugar Cooperative Association Limited Information Memorandum for Members, version 13, received 18 April 2007; and
- correspondence received from McCullough Robertson between 18 April 2007 and 8 June 2007.

14. The Co-Op is a co-operative currently registered under the *Cooperatives Act 1997* (Qld) (Co-Op Act) since 1 September 1997.

15. The Co-Op has 1,022 shares, which are held by 1,022 members, of which 61 are former members who are deemed by section 137 of the Co-Op Act to hold a share and to be members. The shares carry rights to dividends; however, dividends have never been paid by the Co-Op.

16. Members made no payment when acquiring these shares. The following rules of the Co-Op are relevant in relation to the shares:

- Rule 12(1) – under which the shares have a ‘nominal value of \$1 each’;
- Rule 12(2) – which deems the shares to be fully paid at the date of adoption of the new rules in 1999; and
- Rules 68(2) and (3), which deal respectively with:
 - assets to be distributed without any right to receive back the \$1 nominal value referred to and deemed to be paid under Rule 12; and
 - the definition of ‘member entitlement on winding up.

17. Currently, membership in the Co-Op derives from having the appropriate level of cane production area. Rights attaching to the membership are:

- voting rights (one vote per member);
- income distribution/bonus rights which have previously been based on 12 month production history of each member; and
- winding up distribution rights which are based on the proportion of the tonnage of international poll scale (IPS) sugar manufactured from sugar cane crushed by the Co-Op’s mill which they have supplied to the Co-Op’s mill (10 year production average).

18. In determining the 10 year production average, regard is had to the most recent 10 complete crushing seasons.

19. The Co-Op wishes to convert from a co-operative structure to a corporate structure to raise capital from its members. Other reasons behind the restructure include:

- the Co-Op currently relies on debt financing for its diversification projection. The ability to continue to rely on debt funding for large projects is limited;
- the existing Rules of the Co-Op hamper the ability to raise equity from current members;
- a new structure would allow the Co-Op to better place itself to take advantage of diversification opportunities that it cannot pursue as a co-operative;
- debt funding requires longer lead times for introduction and opportunities can be lost due to delays in negotiating with financiers; and
- members have asked at previous annual general meetings of the Co-Op that the Co-Op's Board investigate structure options for the members to consider.

20. Under the proposed restructure, it is envisaged that approximately 190 million shares in MSL will be held by members of the Co-Op. The allocation of these will be based on the 10 year production average of the Co-Op members.

21. It is proposed that MSL will be listed on the National Stock Exchange (NSX), with shares being able to be traded amongst existing members and any new grower members who supply sugar cane to MSL. The shares will not be available for purchase by the general public.

22. It is intended to issue a Foundation Share by MSL so that growers will have some form of guarantee that key milling assets and activities of MSL will not be sold off or significantly altered under a corporate structure. This Foundation Share is to be held by a new Co-operative (MS Co-Op) which will be comprised of grower members.

23. The rights attaching to this Foundation Share will be limited to the right to approve certain decisions with respect to the sugar milling assets and ongoing activities of MSL. Resolutions in respect of these issues can only be passed with the consent of the Foundation Shareholder.

24. It is proposed that the 190 million shares in MSL will have voting rights and rights to receive dividends and capital.

25. It is proposed that the Co-Op members will exchange their membership interests in the Co-Op for shares in MSL. The proposed conversion from a co-operative structure to a corporate structure (the conversion) is scheduled to be put forward for approval by members at a Member's information meeting to be held on 26 June 2007.

26. It is proposed that the conversion will be carried out in a 4 step process to avoid contravention of the Co-Op Act, and to provide easier implementation regarding the *Corporations Act 2001*:

- (a) Step 1 – to obtain roll-over relief under Subdivision 124-I for the issuing of 1,022 shares in MSL with the following rights:
 - (i) 1 vote per share;
 - (ii) dividend rights;
 - (iii) income distribution/bonus rights (based on the 12 month production history of each member); and
 - (iv) capital rights (based on the 10 year production average of each member).
- (b) Step 2 – to adjust the rights attaching to shares in MSL so that each share has the following rights attached to it:
 - (i) voting rights based on the 10 year production average of each member;
 - (ii) dividend rights to be based on the 10 year production average of each member;
 - (iii) income distribution/bonus rights to be cancelled; and
 - (iv) capital rights to remain based on the 10 year production average of each member.
- (c) Step 3 – to increase the number of shares in MSL from 1,022 to 190 million shares by effecting a division of shares. This will result in the share numbers held by each member being based on their 10 year production average.
- (d) Step 4 – once steps 1 to 3 are completed, to issue a Foundation Share to the MS Co-Op (the members of which will be the members of the existing Co-Op who continue to meet the active membership test) giving MS Co-Op the right to approve certain limited decisions relating to the milling assets held by MSL and its ongoing activities.

27. The introduction of a corporate structure limited by shares will not change the bundle of rights held by each member of the Co-Op, although the number of shares through which these rights are held will change.

28. It is proposed that the steps in paragraph 26 of this Ruling will be incorporated into MSL's constitution.

Ruling

Choosing Subdivision 124-I roll-over

29. Entities within the class of persons in paragraph 3 of this Ruling ('existing members') holding shares in the Co-Op can choose roll-over under section 124-520 of the ITAA 1997 for their shares in the Co-Op at the time of the conversion.

Value shifting provisions

30. For the class of persons mentioned in paragraph 3 of this Ruling, the issue of shares in MSL and the subsequent adjustment of the rights attached to those shares are not an arrangement to which Division 725 or Division 727 of the ITAA 1997 will apply.

31. The issue to MS Co-Op of the Foundation Share in MSL is not an arrangement to which Division 725 or Division 727 of the ITAA 1997 will apply.

Division of shares

32. No CGT event in Division 104 of the ITAA 1997 will happen as a result of the share split whereby 1,022 shares in MSL are increased to 190 million shares.

Assessable dividend

33. None of the steps in the conversion will cause an assessable dividend, as defined in subsection 6(1) of the ITAA 1936, to arise.

Anti-avoidance provisions

34. Section 45 of the ITAA 1936 does not apply to treat any amount as a dividend as a consequence of the conversion.

35. Sections 45A and 45B of the ITAA 1936 do not apply to the issue of shares in MSL. 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.

Commissioner of Taxation

20 June 2007

Appendix 1 – Explanation

① *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.*

Choosing Subdivision 124-I roll-over

36. 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 if the conditions for the roll-over are satisfied. The conditions for roll-over are listed in subsection 124-520(1). In the conversion, the Co-Op is a co-operative registered under the Co-Op Act.

Conditions for roll-over (Step 1)

37. 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 the *Corporations Act 2001* or a similar foreign law ('company law').

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

39. 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, which 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 MSL as successor to the former entity.

40. This condition is satisfied as section 305 of the Co-Op Act explains that the entity registered under the *Corporations Act 2001* is taken to be the same entity as the co-operative.

41. The condition in paragraph 124-520(1)(c) of the ITAA 1997, that MSL 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 of the Co-Op will receive only ordinary shares in MSL in substitution for their membership interests in the Co-Op.

42. 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 MSL just after the conversion; or

- (ii) the mix of ownership of the body just before the conversion and the mix of the ownership of MSL just after the conversion.

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

44. In the context of this provision, '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-à-vis each other do not change significantly following the conversion, the CGT roll-over relief will be available.

45. In the first step of the conversion, the company MSL will be formed with the same number of shares as the membership interests that exist in the Co-Op immediately before the conversion (that is, 1022 shares). The rights attaching to the members' shares in MSL are not significantly different to the rights which attached to their membership interests in the Co-Op. The following rights are attached to the members' interests in the Co-Op:

- (a) voting rights (1 vote/share);
- (b) income distribution/bonus rights based on the 12 month production history of each member; and
- (c) winding up distribution rights, which are based on the 10 year production average.

The following rights will attach to the shares in MSL:

- (a) 1 vote per share;
- (b) dividend rights;
- (c) income distribution/bonus rights (based on the 12 month production history of each member); and
- (d) capital rights (based on the 10 year production average of each member).

It is considered that the two sets of rights are sufficiently similar for this condition to be satisfied.

46. 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 as the existing Co-Op members will be the ordinary shareholders of MSL.

47. 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 is taxable Australian property just before the time of conversion and the shares are taxable Australian property. The class of entities is limited in paragraph 3(b) of this Ruling to residents of Australia. This requirement is satisfied.

Consequences if Subdivision 124-I roll-over is chosen

48. The consequences of a choice being made to apply the roll-over in Subdivision 124-I of the ITAA 1997 are set out in Subdivision 124-A of the ITAA 1997:

- for a member that holds shares and membership rights in the Co-Op acquired before 20 September 1985, new shares in MSL are issued and are taken to be acquired before that day; and
- for a member that holds shares and membership rights in the Co-Op 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 shares in MSL is worked out by apportioning part of the cost base and reduced cost base of the shares and rights that have ended.

Value shifting consequences in respect of the adjustment to rights (Step 2)

49. Divisions 725 and 727 of the ITAA 1997 prevent entities from obtaining Capital Gains Tax (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.

50. Divisions 725 and 727 of the ITAA 1997 may trigger CGT liabilities where value is shifted from shares to other shares such as by the change in rights to those shares. However, these provisions do not apply unless there is an entity that controls MSL.

51. Division 725 of the ITAA 1997 has no application to the conversion as there is no entity that controls MSL 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 of the ITAA 1997 also has no application as no entity that provides economic benefits to MSL, or receives such economic benefits in return, would, together with MSL, meet the ultimate controller or common ownership nexus test as required by paragraph 727-100(c).

CGT consequences of division of shares (Step 3)

52. Taxation Determination TD 2000/10 states that if a company converts its shares into a larger or smaller number of shares ('the converted shares') in accordance with section 254H of the Corporations Law in that:

- (a) the original shares are not cancelled or redeemed in terms of the Corporations Law;
- (b) there is no change in the total amount allocated to the share capital account of MSL; and
- (c) the proportion of equity owned by each shareholder in the share capital account is maintained;

no CGT event happens to the shareholder's original shares for CGT purposes. While there is a change in the form of the original shares, there is no change in their beneficial ownership. The issue of roll-over relief under section 124-240 of the ITAA 1997 does not arise because no CGT event happens to the shares.

53. The converted shares have the same date of acquisition as the original shares to which they relate. For example, if the original shares were acquired before 20 September 1985 (pre-CGT shares), the converted shares have the same acquisition date.

54. In the case of original shares acquired on or after 20 September 1985 (post-CGT shares), section 112-25 of the ITAA 1997 applies to attribute a proportionate cost base to the converted shares.

55. In the conversion, the abovementioned requirements will be satisfied as the ordinary shares will not be cancelled and no share capital will be altered. While there is a change from a member holding membership interests in the Co-Op to the member holding shares in MSL, there is no change in beneficial ownership. The proportion of equity and other rights held by each member is maintained. In addition, no CGT event happens upon the increase in the number of shares from 1,022 shares to 190 million shares.

Value shifting consequences from issuing a Foundation Share (Step 4)

56. Once Steps 1 to 3 have been effected, a Foundation Share in MSL will be issued to the new co-operative 'MS Co-Op'. The Foundation Share will be issued so that MS Co-Op has a right to approve only limited decisions **related** to the milling assets held in MSL and the on-going activities of MSL.

57. The rights attaching to the Foundation Share will be limited to a right to approve certain resolutions pertaining to the sale of the Co-Op's milling assets and changes to the activities of MSL.

58. Divisions 725 and 727 of the ITAA 1997 will have no application on the issue of the Foundation Share as there is no entity that controls MSL at any time during the conversion as required by paragraph 725-50(b). Division 727 also has no application as no entity that provides economic benefits to MSL, or receives such economic benefits in return, would together with MSL meet the ultimate controller or common ownership nexus test as required by paragraph 727-100(c).

Assessable dividend

59. 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.

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

60. Subsection 6(4) of the ITAA 1936 provides that paragraph (d) of the definition of 'dividend' in subsection 6(1) 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.

61. In this case, the issue by MSL of ordinary shares to grower members, or the Foundation share to MS Co-Op would not constitute a dividend as it will not involve either a distribution of money or property of MSL to the shareholders or an amount being credited by MSL to any of its shareholders as shareholders.

62. As none of the shares is an assessable dividend, shares issued in relation to original member interests in the Co-Op 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 member interest by apportioning the first element of the cost base of the original member interest in a reasonable way: item 1 in the table in subsection 130-20(3) of the ITAA 1997.

63. As no payment is required to be made for their issue, shares issued in relation to original member interests 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 shares will be taken to be acquired before 20 September 1985 are set out at paragraph 53 of this Ruling.

Anti-avoidance provisions**Section 45**

64. Section 45 of the ITAA 1936 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

65. 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 of the ITAA 1936 that all or part of a capital benefit is treated as an unfranked dividend.

66. 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).

67. The 'provision of a capital benefit' is defined in subsection 45A(3) of the ITAA 1936 to include the provision to a shareholder of shares in MSL. The issue by the Co-Op of shares in accordance with the loyalty formula would constitute the provision of a capital benefit.

68. Although a 'capital benefit', as defined in paragraph 45A(3)(a) of the ITAA 1936, will be provided to the Co-Op members, the circumstances of the conversion and 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) of the ITAA 1936 is not satisfied, section 45A of the ITAA 1936 will not apply to the issue of shares.

69. As section 45A of the ITAA 1936 will not apply to the issue of shares, the Commissioner will not make a determination under subsection 45A(2) of the ITAA 1936 that section 45C of the ITAA 1936 applies to deem the provision of shares to be an unfranked dividend.

Section 45B

70. 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)).

71. In this case, whilst the conditions of paragraphs 45B(2)(a) and 45B(2)(b) of the ITAA 1936 have been met, the requisite purpose of enabling the shareholders to obtain a tax benefit is not present.

72. Having regards to the 'relevant circumstances' of the scheme as set out in subsection 45B(8) of the ITAA 1936, it is apparent that there is no requisite purpose, in the conversion, by way of capital distribution, of enabling the members to obtain a tax benefit.

Appendix 2 – Detailed contents list

73. The following is a detailed contents list for this Ruling:

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References

Previous draft:

TD 2000/10

Subject references:

- assessable income
- bonus equities
- capital gain
- CGT event
- CGT roll-over
- control test
- co-operative company
- distribution
- dividends
- incorporation
- ordinary income
- profits
- share capital
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Legislative references:

- TAA 1953
- TAA 1953 Sch 1 357-75(1)
- ITAA 1936 6(1)
- ITAA 1936 6(4)
- ITAA 1936 45
- ITAA 1936 45A
- ITAA 1936 45A(1)
- ITAA 1936 45A(2)
- ITAA 1936 45A(3)
- ITAA 1936 45A(3)(a)
- ITAA 1936 45B
- ITAA 1936 45B(2)(a)
- ITAA 1936 45B(2)(b)

- ITAA 1936 45B(2)(c)
- ITAA 1936 45B(8)
- ITAA 1936 45C
- ITAA 1936 160ZZPH
- ITAA 1997 Div 104
- ITAA 1997 112-25
- ITAA 1997 Subdiv 124-A
- ITAA 1997 124-240
- ITAA 1997 Subdiv 124-I
- ITAA 1997 124-520
- ITAA 1997 124-520(1)
- ITAA 1997 124-520(1)(a)
- ITAA 1997 124-520(1)(b)
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- ITAA 1997 124-520(1)(d)
- ITAA 1997 124-520(1)(d)(ii)
- ITAA 1997 124-520(1)(e)
- ITAA 1997 130-20(3)
- ITAA 1997 Div 725
- ITAA 1997 725-50(b)
- ITAA 1997 Div 727
- ITAA 1997 727-100(c)
- Copyright Act 1968
- Corporations Act 2001
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Other references:

- Explanatory Memorandum to the
Taxation Laws Amendment Bill
1990

ATO references

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