

CR 2007/75 - Income tax: CDS Technologies Limited - return of capital to shareholders



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Class Ruling

Income tax: CDS Technologies Limited – return of capital to shareholders

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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 (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 45A of the 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;
- section 109-5 of the ITAA 1997;
- section 855-10 of the ITAA 1997;
- section 855-15 of the ITAA 1997; and

- section 975-300 of the ITAA 1997.

All legislative references in this Ruling are to the ITAA 1936 unless otherwise stated.

Class of entities

3. The class of entities to which this Ruling applies is those entities who hold ordinary shares in CDS Technologies Limited (CDST) and who were registered on the CDST share register on the Record Date, being the date for determining entitlement to the return of capital and who received a distribution under the return of capital described in paragraphs 13 to 23 of this Ruling. In this Ruling, those entities are referred to as 'shareholders'. This Ruling does not apply to CDST shareholders that hold their shares on revenue account.

Qualifications

4. The Commissioner makes this Ruling based on the precise scheme 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 23 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 1 July 2006 to 30 June 2007. However, the Ruling continues to apply after 30 June 2007 to all entities within the specified class who entered into the specified scheme during the term of the Ruling.

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 following documents, or relevant parts of them form part of and are to be read with the description:

- application for Class Ruling from KPMG dated 8 March 2007; and
- further correspondence from KPMG dated 14 April 2007 providing further particulars.

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

14. CDST is an Australian resident public company that was incorporated in 1994 and listed on the Australian Stock Exchange in 1997. It is engaged in providing stormwater, wastewater and water re-use technologies.

15. CDST's shareholders are a mix of individuals, companies, pooled development funds, superannuation funds and foreign residents.

16. CDST has advised that, at 7 March 2007, there were 74 non-resident shareholders (approximately 4.95%) holding 2.6% of the issued capital.

17. During the course of the 2007 income year, CDST disposed of its Australian, United Kingdom and United States subsidiaries such that it has only a small wastewater business activity in the United States.

18. The sale of its three subsidiaries realised profits on the sale. On 16 January 2007, CDST announced that it would pay a dividend of \$1.18 per share to the extent of its surplus cash holdings reflected in retained earnings. This dividend was paid on 9 February 2007.

19. The Board of CDST considered its requirements for future capital and has determined that its remaining retained cash is in excess of its immediate and known requirements. Consequently, it determined that it would return the contributed share capital in relation to these assets.

20. This return of capital was authorised at an Extraordinary General Meeting held on 9 March 2007, which confirmed the Record Date for the return of capital was 19 March 2007 and the Payment Date was 26 March 2007.

21. At the Record Date, CDST had 37,991,632 ordinary shares on issue which were held by approximately 1,500 shareholders. The return of capital that was by way of an equal reduction of \$1.0796 per ordinary share, amounting to \$41,015,766, has been debited to the share capital account.

22. As a result of the return of capital there has been no change in the proportionate interest of each shareholder in CDST.

23. All credit entries to the share capital account represented share capital of CDST. There have been no transfers by CDST of any amounts from any of its other accounts to its share capital account (as defined in section 975-300 of the ITAA 1997) prior to the return of capital, which would taint CDST's share capital account.

Ruling

Distribution is not a dividend

24. As the return of capital has been debited to CDST's untainted share capital account, it will not be a dividend as defined in subsection 6(1).

Distribution will not be deemed a dividend under section 45C

25. The Commissioner will not make a determination under either subsection 45A(2) or subsection 45B(3) that section 45C applies to the return of capital. Accordingly, no part of this return of capital will be taken to be a dividend for income tax purposes.

Capital gains tax

26. CGT event G1 in section 104-135 of the ITAA 1997 happened when CDST paid the return of capital of \$1.0796 per ordinary share to a CDST shareholder in respect of a CDST share that they owned at the time of the payment.

27. CGT event C2 in section 104-25 of the ITAA 1997 happened when CDST paid the return of capital to a CDST shareholder in respect of a CDST share they owned at the Record Date but which they ceased to own before the Payment Date.

Foreign resident shareholders

28. For a foreign resident shareholder, the payment of the return of capital will only have capital gains tax (CGT) consequences if their CDST shares are 'taxable Australian property' (section 855-10 of the ITAA 1997).

Commissioner of Taxation

8 August 2007

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.*

Distribution is not a dividend

29. Subsection 44(1) includes in a shareholder's assessable income any dividends, as defined by subsection 6(1), paid to a shareholder out of profits derived by the company from any source (if a resident of Australia for tax purposes) and from an Australian source (if non-resident).

30. The term 'dividend' in subsection 6(1) includes any distribution made by a company to any of its shareholders. However, this broad definition is confined by later paragraphs in the definition which expressly exclude certain items from being a dividend for income tax purposes.

31. A specific exclusion is paragraph (d) of the definition of dividend in subsection 6(1), which provides:

... moneys paid or credited by a company to a shareholder or any other property distributed by a company to shareholders (not being moneys or other property to which this paragraph, by reason of subsection (4), does not apply or moneys paid or credited, or property distributed for the redemption or cancellation of a redeemable preference share), 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: ...

32. 'Share capital account' is defined in section 975-300 of the ITAA 1997 as an account which the company keeps of its share capital, or any other account created on or after 1 July 1998 where the first amount credited to the account was an amount of share capital.

33. As the return of capital has been debited against an amount standing to the credit of CDST's untainted share capital account, the return of capital will not constitute a dividend because of the exclusion in paragraph (d) in the definition of 'dividend' in subsection 6(1).

Anti-avoidance provisions

34. Sections 45A and 45B are two anti-avoidance provisions which, if they apply, allow the Commissioner to make a determination that section 45C applies to treat all or part of the return of capital amount received by the shareholders as an unfranked dividend.

Section 45A – streaming of dividends and capital benefits

35. Section 45A 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.

36. CDST has provided its shareholders with a 'capital benefit' (as defined in paragraph 45(A)(3)(b)); the capital benefit has been provided to all shareholders in direct proportion to their individual shareholding. As all shareholders benefit equally from the proposed return of capital, there is no 'streaming' of capital benefits to some shareholders and not to others.

37. Accordingly, section 45A does not apply to the return of capital and the Commissioner will not make a determination under subsection 45A(2) that section 45C applies to the return of capital to the shareholders of CDST.

Section 45B – schemes to provide capital benefits in substitution for dividends

38. Section 45B applies where certain payments are made to shareholders in substitution for dividends.

39. Subsection 45B(2) sets out the conditions under which the Commissioner will make a determination under subsection 45B(3) that section 45C applies. These conditions are that:

- 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 (the relevant 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 could 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 a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain a tax benefit (paragraph 45B(2)(c)).

Each of these conditions is considered below.

Scheme

40. A 'scheme' for the purposes of section 45B is taken to have the same meaning as provided in subsection 177A(1) of Part IVA. That definition is widely drawn and includes any agreement, arrangement, understanding, promise, undertaking, scheme plan or proposal.

41. A return of share capital would constitute a scheme for the purposes of paragraph 45B(2)(a), because the proposed return of capital will provide shareholders with a capital benefit.

Tax benefit

42. A taxpayer 'obtains a tax benefit', as defined in subsection 45B(9), if:

- the amount of tax payable; or
- any other amount payable under the ITAA 1936 or the ITAA 1997,

would, apart from the operation of section 45B:

- be less than the amount that would have been payable; or
- be payable at a later time than it would have been payable,

if the capital benefit had instead been a dividend.

43. Ordinarily, a return of capital would be subject to the CGT provisions of the income tax law. Unless the amount of the distribution exceeds the cost base of the shares, there will only be a cost base reduction under CGT event G1 (section 104-135 of the ITAA 1997). It is only to the extent (if any) that the distribution exceeds the cost base of the shares that a capital gain arises. A capital gain may not arise at all for certain foreign resident shareholders: see paragraphs 63 to 66 of this Ruling. By contrast, a dividend would generally be included in the assessable income of a resident shareholder or in the case of a foreign resident, be subject to dividend withholding tax under section 128B. Therefore, CDST shareholders will obtain tax benefits from the return of capital.

Relevant circumstances

44. For the purposes of paragraph 45B(2)(c) the Commissioner is required to consider the 'relevant circumstances' set out under subsection 45B(8) to determine whether any part of the scheme would be entered into for a purpose, other than an incidental purpose, of enabling a relevant taxpayer to obtain a tax benefit. However, the list of relevant circumstances in subsection 45B(8) is not exhaustive and regard may be had to other circumstances on the basis of their relevance.

45. The test of purpose is an objective one. The question is whether, objectively, it would be concluded that a person who entered into or carried out the scheme did so for the purpose of obtaining a tax benefit for the relevant taxpayer. The purpose does not have to be the most influential or prevailing purpose but it must be more than an incidental purpose.

46. The relevant circumstances under subsection 45B(8) cover both the circumstances of the company and the shareholders. In this instance, as the return of capital was made to all CDST shareholders, regardless of their individual circumstances, paragraphs 45B(8)(c) to (h) do not incline for, or against, a conclusion as to purpose. The circumstances covered by paragraphs 45B(8)(i) and (j), pertaining to the provision of ownership interests and demerger, are not relevant. In this case, the relevant matters are those covered by the circumstances described in paragraphs 45B(8)(a), (b) and (k).

47. Paragraph 45B(8)(a) refers to the extent to which the capital benefit is attributable to capital and profits (realised and unrealised) of the company or an associate (within the meaning of section 318) of the company. In this case, CDST has returned to its shareholders contributed share capital that was realised upon the sale of its three trading subsidiaries in Australia, the United States and the United Kingdom. The sale of the interest in those subsidiaries generated gains for CDST which were distributed as unfranked dividends prior to the return of capital. CDST is now left only with a minor operation in the United States and it was of the opinion that the cash holdings generated from the disposal of the interests in the subsidiaries were in excess of current and future capital requirements and distributed this surplus back to its shareholders on 26 March 2007. Therefore, the capital distribution provided to shareholders is wholly attributable to excess share capital arising from the sale of CDST's interests in the three subsidiaries. No part of the return is attributable to specific profits, realised or unrealised, of CDST. (These were distributed as an unfranked dividend on 9 February 2007.)

48. Paragraph 45B(8)(b) refers to the pattern of distributions made by a company or an associate (within the meaning of section 318) of the company. CDST has regularly paid unfranked dividends in the past. The return of capital is in addition to the payment of the unfranked interim dividend on 9 February 2007 out of the profits realised from the sale of the interests in the subsidiaries. Accordingly, the company's pattern of distributions does not suggest that the return of capital has been made in substitution for a dividend.

49. Paragraph 45B(8)(k) refers to the matters in subparagraphs 177D(b)(i) to (viii). These are matters by reference to which a scheme is able to be examined from a practical perspective, in order to identify and compare its tax and non-tax objectives. The matters include the manner in which the scheme is entered into or carried out, its form and substance and its financial and other implications for the persons involved. In this case the practical implications of the scheme for CDST and its shareholders are consistent with it having been, in form and substance, a return of capital.

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

CGT event G1 – section 104-135

51. CGT event G1, in section 104-35 of the ITAA 1997, happened when CDST paid the return of capital in respect of each share that a CDST shareholder owned at the time of the payment as all of the payment is not a dividend as defined in subsection 995-1(1) of the ITAA 1997, nor an amount that is taken to be a dividend under section 47.

52. Where the return of capital of \$1.0796 per share is less than the cost base of the CDST share at the time of the payment, the cost base and the reduced cost base of the CDST share are reduced (but not below nil) by the amount of the return of capital (subsection 104-135(4) of the ITAA 1997).

53. A CDST shareholder will make a capital gain where the return of capital of \$1.0796 per share is more than the cost base of their CDST share. The amount of the capital gain is equal to this excess (subsection 104-135(3) of the ITAA 1997).

54. Where a CDST shareholder makes a capital gain as a result of the return of capital, the cost base and reduced cost base of the CDST share are reduced to nil (subsection 104-135(3) of the ITAA 1997).

55. If the CDST share was acquired by the shareholder at least 12 months before the time of payment of the return of capital, a capital gain from CGT event G1 happening 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).

56. A CDST shareholder cannot make a capital loss when CGT event G1 happens.

CGT event C2 – section 104-25

57. The right to receive the return of capital is one of the rights inherent in the CDST share at the Record Date. If, after the Record Date but before the Payment Date, a CDST shareholder ceases to own some, or all, of their shares in CDST, the right to receive the return of capital is retained by the shareholder and is considered to be a separate CGT asset.

58. CGT event C2, in section 104-25 of the ITAA 1997 happened when the return of capital was paid and the right to receive that payment ended.

59. The CDST shareholder will make a capital gain if the capital proceeds from the ending of the right are more than the cost base of the right (subsection 104-25(3) of the ITAA 1997). The capital proceeds will be the return of capital amount (section 116-20 of the ITAA 1997).

60. The cost base of the CDST shareholder's right to receive the return of capital is worked out under Division 110 of the ITAA 1997 (modified by Division 112 of the ITAA 1997). As the CDST shareholder will have paid nothing for the right, the cost base of the right is likely to be nil. Therefore, the CDST shareholder will generally make a capital gain equal to the return of capital amount paid under the scheme.

61. As the right to receive the return of capital amount was inherent in the CDST share during the time it was owned, the right is considered to have been acquired at the time the share was acquired (section 109-5 of the ITAA 1997).

62. Consequently, if the CDST share to which the payment relates was originally acquired by the former shareholder at least 12 months before the time of payment of the return of capital, a capital gain from CGT event C2 happening to 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).

Foreign resident shareholders

63. A foreign resident shareholder can disregard any capital gain made from the return of capital if their CDST shares are not 'taxable Australian property' (section 855-10 of the ITAA 1997). The term 'taxable Australian property' includes an 'indirect Australian real property interest' (item 2 in the table in section 855-15 and section 855-25 of the ITAA 1997).

64. A CDST foreign resident shareholder will have an 'indirect Australian real property interest' if it holds a membership interest in CDST, and the interest passes the 'non-portfolio test' (section 960-195 of the ITAA 1997) and the 'principal asset test' (section 855-30 of the ITAA 1997).

65. As CDST's foreign resident shareholders, together with their associates, hold less than 10% of the shares in CDST, their interest will not pass the 'non-portfolio test'. Accordingly, CDST's foreign resident shareholders do not have an 'indirect Australian real property interest'.

66. Therefore, a CDST share will only be 'taxable Australian property' if the foreign resident shareholder has used their CDST share in connection with the carrying on of a business through a permanent establishment in Australia (item 3 in the table in section 855-15 of the ITAA 1997).

Appendix 2 – Detailed contents list

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

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References

Previous draft:

Not previously issued as a draft

Subject references:

- capital gains tax
- capital streaming
- dividend streaming arrangements
- dividends
- foreign residents
- return of capital on shares

Legislative references:

- ITAA 1936
 - ITAA 1936 6(1)
 - ITAA 1936 44(1)
 - ITAA 1936 45A
 - ITAA 1936 45A(2)
 - ITAA 1936 45A(3)(b)
 - ITAA 1936 45B
 - ITAA 1936 45B(2)
 - ITAA 1936 45B(2)(a)
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 - ITAA 1936 45B(2)(c)
 - ITAA 1936 45B(3)
 - ITAA 1936 45B(8)
 - ITAA 1936 45B(8)(a)
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 - ITAA 1997 960-195
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ATO references

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