


CR 2007/97 - Income tax: return of capital: Deep Sea Fisheries Limited

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Class Ruling

Income tax: return of capital: Deep Sea Fisheries Limited

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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);
- subsection 44(1) of the 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; and
- section 855-10 of the ITAA 1997.

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

Class of entities

3. The class of entities to which this Ruling applies is the ordinary shareholders of Deep Sea Fisheries Limited (DSF) who received a return of capital as described in paragraphs 13 to 24 of this Ruling. This Ruling does not apply to DSF 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 24 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.

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. DSF was incorporated on 31 January 1986, and is an Australian resident public company listed on the Australian Securities Exchange (ASX). The company has not returned any capital to shareholders since incorporation.

15. The DSF group owned and operated a fleet of fishing vessels in various Australian fisheries. The Group operated in two main fishing areas – the Northern Prawn Fishery (NPF), access to which is provided by ownership of access rights, known as Statutory Fishing Rights (SFRs) and North West Slope Trawl Fishery (NWSTF).

16. In late 2005 the Government announced a \$220m Structural Adjustment Package (SAP) aimed at reducing excess fishing effort to improve economic and biological sustainability in Australian fisheries. The SAP involved a 'buy back' process whereby willing operators could tender their access rights and retire vessels from given fisheries.

17. In line with industry trends, DSF's fishing operations experienced a reduction in profit in recent years, despite continual strategies to mitigate external factors facing the industry. After careful assessment the Board resolved to tender the Group's NPF SFRs into the SAP.

18. Concurrently the Board negotiated a sale of three of the Group's fishing vessels to a third party, subject to a successful tender of the NPF SFRs.

19. In December 2006 the company was successful in the SAP tender. The sale of the SFRs realised profits. On 12 March 2007 DSF announced that it would pay a special fully franked dividend of \$0.08 per share, totalling \$4,683,173 to the extent of its surplus cash holdings reflected in retained earnings. This dividend was paid on 27 April 2007.

20. The company considered various options for its future but as no suitable new investment opportunities were identified, DSF had significant capital that was surplus to its needs. The Board proposed to make a return of capital of \$0.11 per share, on an equal reduction basis, to ordinary shareholders of the company, totalling \$6,439,363.

21. This return of capital was authorised at a general meeting held on 11 May 2007, which confirmed the Record Date for the return of capital was 18 May 2007 and the Payment Date was 23 May 2007.

22. The return of capital has been debited to the share capital account.

23. DSF has advised that at 9 May 2007 there were 412 ordinary shareholders, made up of 397 resident shareholders and 15 non-resident shareholders.

24. DSF confirms that its share capital account as defined in section 975-300 of the ITAA 1997 is untainted.

Ruling

Distribution is not a dividend

25. The return of the share capital will not be a dividend, as defined in subsection 6(1).

Distribution will not be deemed a dividend under section 45C

26. The Commissioner will not make a determination under subsection 45A(2) or subsection 45B(3) that section 45C applies to the whole, or any part, of the payment of the share capital received by the shareholders.

Capital gains tax

27. CGT event G1 happened when DSF paid the return of capital of \$0.11 per share to a DSF shareholder in respect of a DSF share that they owned at the time of payment (section 104-135 of the ITAA 1997).

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

Foreign resident shareholders

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

Commissioner of Taxation24 October 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

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

31. 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.

32. Relevantly paragraph (d) specifically excludes from the definition of 'dividend':

...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.

33. The return of capital has been debited against DSF's untainted share capital account. Therefore, paragraph (d) of the definition of 'dividend' applies and the return of capital would not be a dividend as defined in subsection 6(1).

Anti-avoidance provisions

Sections 45A and 45B

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.

Streaming of dividends and capital benefits: section 45A

35. Section 45A applies in circumstances where the 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. DSF has provided all its ordinary shareholders with a 'capital benefit' (as defined in paragraph 45A(3)(b)); the capital benefit has been provided to all shareholders in direct proportion to their individual shareholding. As all shareholders benefited equally from the return of capital, there is no indication of '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 DSF.

Schemes to provide capital benefits in substitution for dividends: section 45B

38. Section 45B applies where certain amounts of a capital nature are provided to shareholders in substitution for dividends.

39. Subsection 45B(2) sets out the conditions under which the Commissioner may 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 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 a purpose (whether or not the dominant purposes 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. The return of capital is a 'scheme' within the broad meaning of that term.

41. The phrase 'provided with a capital benefit' is defined at subsection 45B(5). Relevantly, it includes a distribution to a person of share capital. As DSF has debited the return of capital against its share capital account, its shareholders have been provided with a capital benefit.

Tax benefit

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

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

by the taxpayer 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 capital gains tax (CGT) provisions of the income tax law. Unless the amount of the distribution exceeds the cost base of the share 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 share that a capital gain is made. A capital gain may not arise at all for certain foreign shareholders. By contrast, a dividend would generally be included in the assessable income of a resident shareholder or, in the case of a non-resident, subject to dividend withholding tax under section 128B of the ITAA 1936. Therefore, DSF shareholders have obtained 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 in subsection 45B(8) to determine whether any part of the scheme was 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 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 in respect of the capital benefit. The requisite purpose does not have to be the most influential or prevailing purpose but it must be more than an incidental purpose.

46. The purpose which causes section 45B to apply may be the purpose of any party to the scheme. In this case, however, the Commissioner is concerned only with the purpose of DSF. The Commissioner cannot at this stage ascertain the purposes of DSF's numerous shareholders, all of whom were eligible to vote on the return of capital under section 256C of the *Corporations Act 2001* and all of whom would participate in the return of capital that has been paid. Nevertheless, in a case such as this, an objective conclusion as to the purpose of the company should, generally speaking, not be inconsistent with an objective conclusion as to the purpose of the shareholders, in particular those shareholders who voted in favour of the proposal.

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

48. Paragraph 45B(8)(a) refers to the extent to which the capital benefit is attributable to capital or profits (realised and unrealised) of the company or an associate (within the meaning of section 318) of the company. In this case, DSF has returned to its shareholders contributed share capital that was realised on the sale of a significant portion of its business undertaking, the SFRs and fishing vessels. The sale generated gains for DSF which were distributed as a special fully franked dividend prior to the return of capital. Following the divestment, the Board of DSF was of the opinion that its cash holdings were in excess of current and future capital requirements. Therefore, the capital distribution provided to shareholders is wholly attributable to excess share capital arising from the sale of its fishing interests. No part of the return is attributable to specific profits, realised or unrealised, of DSF. (These were distributed as a special fully franked dividend on 27 April 2007.)

49. 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. DSF did not pay dividends in the 2004, 2005 and 2006 income years, though it did pay fully franked dividends in prior years. It has paid a special dividend of \$0.08 a share, fully franked, on 27 April 2007. Accordingly the company's pattern of distributions does not suggest that the return of capital has been made in substitution for a dividend.

50. 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 carried out, the timing of the scheme, its form and substance, and the financial and other implications for the parties involved.

51. DSF has demonstrated that the scheme, being a return of capital to its shareholders, seeks to legitimately return an amount of excess share capital raised. The return will release capital which DSF has stated is excess to its current needs. In this case, the practical implications of the scheme are consistent with it having been, in form and substance, a return of capital.

52. Accordingly, the Commissioner will not make a determination under subsection 45B(3) that section 45C applies to the whole, or any part, of the return of capital.

Application of section 45C

53. As the Commissioner will not make a determination under subsection 45A(2) or subsection 45B(3) in relation to the scheme as described, section 45C will not deem any part of the return of capital to be an unfranked dividend for the purposes of the ITAA 1936 or of the ITAA 1997.

CGT event G1 – section 104-135

54. CGT event G1, in section 104-135 of the ITAA 1997, happened when DSF paid the return of capital in respect of each share that a DSF shareholder owned at the time of the payment as 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 of the ITAA 1936.

55. Where the return of capital of \$0.11 per share is equal to or less than the cost base of the DSF share at the time of the payment, the cost base and reduced cost base of that DSF share will be reduced (but not below nil) by the amount of the return of capital (subsection 104-135(4) of the ITAA 1997).

56. A DSF shareholder will make a capital gain if the return of capital amount is more than the cost base of their DSF share. The amount of the capital gain is equal to this excess (subsection 104-135(3) of the ITAA 1997).

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

58. If the DSF 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).

59. A DSF shareholder cannot make a capital loss when CGT event G1 happens.

CGT event C2 – section 104-25

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

61. 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.

62. A DSF 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 amount of the return of capital (section 116-20 of the ITAA 1997).

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

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

65. Consequently, if the DSF share to which the payment relates was originally acquired by the former DSF shareholder at least 12 months before the 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

66. A foreign resident shareholder can disregard any capital gain made from the return of capital if their DSF 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).

67. A DSF foreign resident shareholder will have an 'indirect Australian real property interest' if it holds a membership interest in DSF, 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).

68. As DSF has confirmed that its foreign resident shareholders, together with their associates, hold less than 10% of the shares in DSF at the time of the return of capital and during the preceding 24 months, their interest will not pass the 'non-portfolio test'. Accordingly, DSF's foreign resident shareholders do not have an 'indirect Australian real property interest'.

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

Appendix 2 – Detailed contents list

70. 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
- share capital

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 1997 116-20
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- ITAA 1997 855-15
- ITAA 1997 855-25
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- ITAA 1997 960-195
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- ITAA 1997 995-1(1)
- TAA 1953
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- Corporations Act 2001 256C
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ATO references

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