


CR 2008/12 - Income tax: Selective Capital Reduction: Avatar Industries Limited

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Class Ruling

Income tax: Selective Capital Reduction: Avatar Industries Limited

Contents	Para
LEGALLY BINDING SECTION:	
What this Ruling is about	1
Date of effect	9
Scheme	14
Ruling	24
NOT LEGALLY BINDING SECTION:	
Appendix 1:	
<i>Explanation</i>	37
Appendix 2:	
<i>Detailed contents list</i>	55

ⓘ 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 177E of the ITAA 1936;
- section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 104-25 of the ITAA 1997;
- section 116-20 of the ITAA 1997;

- section 116-30 of the ITAA 1997;
- section 118-20 of the ITAA 1997;
- section 118-25 of the ITAA 1997; and
- section 855-10 of the ITAA 1997.

Class of entities

3. The class of entities to which this Ruling applies is the shareholders of Avatar Industries Limited (Avatar), formerly a publicly listed company which was removed from the official list of the Australian Securities Exchange (ASX) on 26 November 2007, who had their shares cancelled under the Selective Capital Reduction described in the Scheme part of this Ruling. In this Ruling, this class of entities is referred to as 'eligible shareholders'.

4. The class of entities to which this Ruling applies does not include Avatar. The Ruling does not deal with how the taxation law applies to Avatar in relation to the Selective Capital Reduction.

Qualifications

5. The Commissioner makes this Ruling based on the precise scheme identified in this Ruling.

6. 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 14 to 23 of this Ruling.

7. 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

9. This Ruling applies from 1 July 2007 to 30 June 2008. However, the Ruling continues to apply after 30 June 2008 to all entities within the specified class who entered into the specified scheme during the term of the Ruling.

10. 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.

11. 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)).

12. 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.

13. 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

14. The scheme that is the subject of this Ruling is described below. This description is based on the following documents listed below. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the scheme are:

- the amended application for a Class Ruling dated 28 May 2007;
- correspondence dated 28 May 2007, 21 June 2007 and 1 February 2008; and
- announcements published on the ASX and Avatar's websites on 29 June 2007, 31 October 2007, 6 November 2007 and 26 November 2007.

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.

15. Avatar was an Australian resident public company listed on the ASX. The shareholders in Avatar were a mix of resident and non-resident individuals, companies, and institutional investors. As at 30 June 2007, Avatar had 79,038,464 fully paid ordinary shares on issue.

16. During the 2007 financial year Avatar sold its shares in Drillcorp Limited for approximately \$134 million. This resulted in a profit on sale of approximately \$103.6 million.

17. On 29 June 2007, Avatar announced that it proposed to undertake a Selective Capital Reduction by way of a share cancellation. The proposal was to cancel all shares in Avatar not held by the majority shareholders, being the Chairman and Managing Director of Avatar and their associated entities. Avatar outlaid approximately \$60 million to implement the proposed capital reduction of approximately 39.6% of the shares. The proposed Selective Capital Reduction by way of a share cancellation was subject to shareholder approval.

18. The purpose of the Selective Capital Reduction, as stated in the application for the Class Ruling, was to return to eligible shareholders their investment in Avatar, given that current market conditions are restricting new value adding opportunities. A selective capital reduction was considered by Avatar to be the most effective means by which to return such investment.

19. On 31 October 2007, Avatar shareholders approved the Selective Capital Reduction proposal.

20. Avatar cancelled the shares that were not held by the two majority shareholders or their associated entities for \$1.91 per share on 26 November 2007. Under the Selective Capital Reduction, a distribution of cash and property, in the form of shares in Avatar's wholly-owned subsidiary, Lednium Pty Limited (Lednium), was made to eligible shareholders. Approximately \$1.25 of the distribution per share was debited to Avatar's share capital account and the balance of the distribution was debited to Avatar's retained profits.

21. Avatar did not have any franking credits available at the time of paying the distribution pursuant to which any part of the distribution that is a dividend could be franked.

22. The last day shares in Avatar were traded on the ASX was 14 November 2008.

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

Ruling

Dividend

Part of the Distribution is a Dividend for income tax purposes

24. The distribution paid by Avatar to an eligible shareholder in respect of the cancellation of a share consists of cash and property. The distribution will be a dividend to the extent that it is not debited to Avatar's untainted share capital account (paragraphs (a) and (d) of the definition of 'dividend' in subsection 6(1) of the ITAA 1936). As \$1.25 of the distribution was debited against Avatar's untainted share capital account (the capital component), the eligible shareholder received a dividend of \$0.66 (the Dividend) for each share cancelled.

25. No part of the capital component will be a dividend as defined in subsection 6(1) and therefore will not be included in the assessable income of the eligible shareholders pursuant to subsection 44(1) of the ITAA 1936.

26. The Dividend of \$0.66 paid by Avatar to eligible shareholders was unfranked.

Capital gains tax

27. CGT event C2 happens in relation to each eligible shareholder when their Avatar shares are cancelled under the scheme (section 104-25 of the ITAA 1997).

28. The time at which CGT event C2 happens is on the date when the shares were cancelled under the Selective Capital Reduction (subsection 104-25(2) of the ITAA 1997).

29. The capital proceeds received by eligible shareholders from the cancellation of their Avatar shares will be the sum of the cash received and the market value of the Lednium shares worked out as at the time of CGT event C2 (paragraphs 116-20(1)(a) and (b) of the ITAA 1997). The capital proceeds will be replaced with the market value of the Avatar shares if the capital proceeds are more or less than the market value of the shares on the date of cancellation (subparagraph 116-30(2)(b)(ii) of the ITAA 1997).

30. An eligible shareholder will make a capital gain if the capital proceeds from the cancellation of their Avatar shares are more than the cost base of the Avatar shares. If the capital proceeds are less than the reduced cost base of the Avatar shares, the eligible shareholder will make a capital loss (subsection 104-25(3) of the ITAA 1997).

31. Any capital gain made by the eligible shareholder when CGT event C2 happens can be reduced by the amount of the dividend that is included in the assessable income of the eligible shareholder under subsection 44(1) of the ITAA 1936 (subsection 118-20(1) of the ITAA 1997).

32. For a foreign resident eligible shareholder, the payment of the Selective Capital Reduction will only have CGT consequences if their Avatar shares are 'taxable Australian property' (section 855-10 of the ITAA 1997).

Shares held as trading stock

33. Where the shares are held as trading stock, the cancellation consideration of \$1.91 is included in assessable income under section 6-5 of the ITAA 1997.

34. A capital gain or capital loss made from a CGT asset held as trading stock is disregarded (paragraph 118-25(1)(a) of the ITAA 1997).

The anti-avoidance provisions

35. The Commissioner will not make a determination under subsection 45A(2) or subsection 45B(3) of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole, or any part, of the capital component of the distribution received under the Selective Capital Reduction by eligible shareholders.

36. The scheme will not be regarded as a scheme by way of or in the nature of dividend stripping, or a scheme having substantially the effect of a scheme by way of or in the nature of a dividend stripping to which section 177E of the ITAA 1936 is applicable.

Appendix 1 – Explanation

ⓘ *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.*

The dividend and capital component

37. The distribution received by an eligible shareholder for each share cancelled under the Selective Capital Reduction comprises two elements:

- a dividend; and
- a capital component.

The amount of these components is determined in accordance with the definition of 'dividend' in subsection 6(1) of the ITAA 1936, having regard to how the company accounts for the Selective Capital Reduction.

Dividend

38. The definition of 'dividend' in subsection 6(1) of the ITAA 1936 has the effect that any distribution made by the company to any of its shareholders, whether in money or property, is a dividend except where the distribution is debited against an amount standing to the credit of the untainted share capital account of the company (paragraphs (a) and (d) of the definition). The payment of \$1.91 per share was a distribution made by Avatar to its eligible shareholders and \$1.25 was debited to the untainted share capital account (capital component). As the remainder of the distribution was debited against retained earnings, the eligible shareholders received a Dividend, unfranked in the present circumstances, of \$0.66 per share.

Capital gains tax

39. CGT event C2 happens in relation to each eligible shareholder when their Avatar shares are cancelled under the scheme (section 104-25 of the ITAA 1997).

40. The time at which CGT event C2 happens is on the date when the shares were cancelled under the Selective Capital Reduction (subsection 104-25(2) of the ITAA 1997).

41. The capital proceeds received by eligible shareholders from the cancellation of their Avatar shares will be the sum of the cash received and the market value of the Lednium shares worked out as at the time of CGT event C2 (paragraphs 116-20(1)(a) and (b) of the ITAA 1997). The capital proceeds will be replaced with the market value of the Avatar shares if the capital proceeds are more or less than the market value of the shares on the date of cancellation (subparagraph 116-30(2)(b)(ii) of the ITAA 1997).

42. An eligible shareholder will make a capital gain if the capital proceeds from the cancellation of their Avatar shares are more than the cost base of the Avatar shares. If the capital proceeds are less than the reduced cost base of the Avatar shares, the eligible shareholder will make a capital loss (subsection 104-25(3) of the ITAA 1997).

43. Any capital gain made by the eligible shareholder when CGT event C2 happens can be reduced by the amount of the dividend that is included in the assessable income of the eligible shareholder under subsection 44(1) of the ITAA 1936 (subsection 118-20(1) of the ITAA 1997).

44. A foreign resident disregards a capital gain or capital loss from a CGT event that happens in relation to a CGT asset that is not 'taxable Australian property' (section 855-10 of the ITAA 1997). The term 'taxable Australian property' as described in the table in section 855-15 of the ITAA 1997 covers five categories of CGT assets. Broadly, these CGT asset categories are:

- (1) taxable Australian real property which is held directly;
- (2) indirect Australian real property interests which are not covered by category 5 of the table;
- (3) CGT assets used in carrying on a business through an Australian permanent establishment which are not covered by categories 1, 2 or 5 of the table;
- (4) options or rights to acquire CGT assets covered by categories 1, 2 or 3 of the table; and
- (5) CGT assets where a capital gain or capital loss is deferred when an individual ceases to be an Australian resident.

45. Accordingly, a foreign resident eligible shareholder disregards the capital gain or capital loss made from the payment of the Selective Capital Reduction if their Avatar shares are not 'taxable Australian property' (section 855-10 of the ITAA 1997).

Shares held as trading stock

46. A capital gain or capital loss made from a CGT asset held as trading stock is disregarded (paragraph 118-25(1)(a) of the ITAA 1997).

The anti-avoidance provisions

Sections 45A and 45B

47. Sections 45A and 45B of the ITAA 1936 are anti-avoidance provisions which, if they apply, allow the Commissioner to make a determination that section 45C of the ITAA 1936 applies. The effect of such a determination is that all or part of the capital component received by the shareholder under the Selective Capital Reduction is treated as an unfranked dividend. Accordingly, the application of these two provisions to the capital reduction must be considered.

48. Section 45A of the ITAA 1936 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 share capital and it is reasonable to assume that the other shareholders (the disadvantaged shareholders) have received or will receive dividends.

49. Although a 'provision of capital benefit' (as defined in subsection 45A(3) of the ITAA 1936) is provided to shareholders under the Selective Capital Reduction, the circumstances of the Selective Capital Reduction indicate that there is no streaming of capital benefits to some shareholders and dividends to other shareholders. Accordingly, section 45A of the ITAA 1936 has no application to the capital reduction.

50. Section 45B of the ITAA 1936 applies where certain capital payments are paid to shareholders in substitution for dividends. In broad terms, section 45B 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, 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 a taxpayer to obtain a tax benefit (paragraph 45B(2)(c)).

51. In the case of the Selective Capital Reduction, 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 eligible shareholder to obtain a tax benefit – by way of capital distribution – is not present.

52. Having regard to the relevant circumstances of the scheme, as set out in subsection 45B(8) of the ITAA 1936, it is apparent that the inclusion of a capital component in the distribution under the Selective Capital Reduction is not inappropriate. Whilst some of the specific relevant circumstances would point towards a conclusion as to the existence of the requisite purpose, other circumstances would point towards the opposite conclusion. Overall, in weighing all of the relevant circumstances, the Commissioner has come to the conclusion that the requisite purpose is not present. Accordingly, section 45B of the ITAA 1936 has no application to the Selective Capital Reduction.

Dividend stripping

53. Broadly, section 177E of the ITAA 1936 applies where:

- a company's property is disposed of under a scheme in the nature of, or that has a similar effect to, a dividend stripping scheme;
- the Commissioner concludes that the disposal represents in whole or in part a distribution of the company's past, present or future profits; and
- if immediately before the scheme was entered into the company notionally paid a dividend out of the profits represented by the disposal of the property, the amount represented by the dividend would have been, or might reasonably be expected to have been, included in the assessable income of a taxpayer.

54. In this case, there is a disposal of the company's property, being shares in Lednium, to the shareholders. However, the property together with cash comprises compensation to the shareholders of Avatar for the cancellation of their shares based on their value. The compensation is distributed to and received by the shareholders as a mix of dividend and share capital. In these circumstances, the company's property, the shares in Lednium, cannot be characterised as being disposed of under a scheme in the nature of or having a similar effect to a dividend stripping scheme to which section 177E of the ITAA 1936 is applicable.

Appendix 2 – Detailed contents list

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

	Paragraph
What this Ruling is about	1
Relevant provision(s)	2
Class of entities	3
Qualifications	5
Date of effect	9
Scheme	14
Ruling	24
Dividend	24
<i>Part of distribution is a dividend for income tax purposes</i>	24
Capital gains tax	27
Shares held as trading stock	33
The anti-avoidance provisions	35
Appendix 1 – Explanation	37
The dividend and capital component	37
Dividend	38
Capital gains tax	39
Shares held as trading stock	46
The anti-avoidance provisions	47
<i>Sections 45A and 45B</i>	47
Dividend stripping	53
Appendix 2 – Detailed contents list	55

References

Previous draft:

Not previously issued as a draft

Subject references:

- cancellation of shares
- capital reductions
- dividend stripping

Legislative references:

- ITAA 1936 6(1)
 - ITAA 1936 44(1)
 - ITAA 1936 45A
 - ITAA 1936 45A(2)
 - ITAA 1936 45A(3)
 - ITAA 1936 45B
 - ITAA 1936 45B(2)(a)
 - ITAA 1936 45B(2)(b)
 - ITAA 1936 45B(2)(c)
 - ITAA 1936 45B(3)
 - ITAA 1936 45B(8)
 - ITAA 1936 45C
 - ITAA 1936 177E
 - ITAA 1997 6-5
 - ITAA 1997 104-25
 - ITAA 1997 104-25(2)
 - ITAA 1997 104-25(3)
 - ITAA 1997 116-20
 - ITAA 1997 116-20(1)(a)
 - ITAA 1997 116-20(1)(b)
 - ITAA 1997 116-30
 - ITAA 1997 116-30(2)(b)(ii)
 - ITAA 1997 118-20
 - ITAA 1997 118-20(1)
 - ITAA 1997 118-25
 - ITAA 1997 118-25(1)(a)
 - ITAA 1997 855-10
 - ITAA 1997 855-15
 - ITAA 1997 975-300
 - TAA 1953
 - TAA 1953 Sch 1 357-75(1)
 - Copyright Act 1968
-

ATO references

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ATOLaw topic: Income Tax ~~ Assessable income ~~ dividend, interest and royalty income

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