


CR 2008/4 - Income tax: MMC Contrarian Limited - proposed return of capital to shareholders

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Class Ruling

Income tax: MMC Contrarian Limited – proposed 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 provisions 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; and
- section 855-10 of ITAA 1997.

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

Class of entities

3. The class of entities to which this Ruling applies is the ordinary shareholders of MMC Contrarian Limited (MMC) who are registered on the MMC share register on the Record Date, being the date for determining entitlements to the proposed return of capital described in paragraphs 13 to 29 of this Ruling. In this Ruling, those entities are referred to as MMC shareholders. This Ruling only applies to MMC shareholders who hold their shares on capital 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 29 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 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.

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. MMC is an investment company listed on the Australian Securities Exchange (ASX). MMC was incorporated in December 2003 raising \$200 million of capital from the issue of ordinary shares to approximately 8,000 investors.

15. MMC currently has only one class of ordinary shares on issue. As at 31 October 2007 MMC's issued capital was \$249,878,708.

16. MMC has advised that at 31 August 2007 there were 6,732 ordinary shareholders, made up of 6,633 resident shareholders and 99 foreign resident shareholders.

17. MMC primarily invests in ASX listed securities; its investment portfolio mainly comprising shares, cash, hybrid securities and debentures.

18. The investment philosophy of MMC is aimed at exceeding the return of the All Ordinaries Accumulation Index over the medium to long term, within the risk parameters established by the Investment Manager to preserve capital.

19. The recent financial performance of MMC's investment portfolio has been less than its benchmark, the All Ordinaries Accumulation Index. MMC has stated that this has, at least in part, been due to the large cash holdings retained by MMC because suitable low risk equity investments could not be found.

20. On 19 February 2007, MMC announced a pro-rata return of capital of \$0.10 per share to all its shareholders as part of a broader capital management strategy. This return of capital is consistent with MMC's active capital management program, encompassing, at appropriate times, payment of dividends, offering a dividend reinvestment plan and buying back shares on-market when they are trading at a discount to the net tangible assets of the company.

21. The return of capital will be applied equally to each holder of fully paid ordinary shares as at the Record Date in proportion to the number of shares held. No shares will be cancelled as a result of the capital return and there will be no dilution of the shareholdings in MMC.

22. MMC advises that the proposed return of capital represents a return of excess capital arising from the initial capital raising in 2003 since not all of the funds raised were invested by MMC, as suitable low risk equity investments could not be found. MMC has not returned any capital to shareholders since incorporation.

23. The proposed return of capital was authorised at a general meeting held on 25 October 2007.

24. One of the objectives of MMC is to pay regular dividends, franked if possible. Since incorporation in December 2003, MMC has paid fully franked dividends semi-annually.

25. The proposed capital return will be made in addition to the normal annual dividend of 4 cents per share by MMC in respect of the year ending 30 June 2007 paid on 5 October 2007.

26. It is the intention of the Directors of MMC that dividends will continue to be paid semi-annually, at an estimated rate of 50 per cent to 70 per cent of operating profit for the relevant period, in accordance with MMC's dividend policy.

27. The proposed return of capital is to be debited to MMC's untainted share capital account as defined in section 975-300 of the ITAA 1997.

28. As at 30 June 2007, MMC had consolidated paid up capital of \$248.1 million, unrealised reserves of \$9.5 million, and retained profits of \$24.2 million.

29. MMC has confirmed that its foreign resident shareholders, together with associates, will hold less than 10% of the shares in MMC at the time of the proposed return of capital and during the preceding 24 months.

Ruling

Distribution is not a dividend

30. The payment of the proposed return of capital to MMC shareholders will not be a dividend, as defined in subsection 6(1).

Application of section 45C

31. The Commissioner will not make a determination under subsections 45A(2) or 45B(3) that section 45C applies to the whole, or any part, of the payment of the proposed return of capital to be received by MMC shareholders.

Capital gains tax

32. CGT event G1 will happen when MMC pays the proposed return of capital of 10 cents per share to a MMC shareholder in respect of a MMC share that they own at the Record Date and continue to own at the Payment Date (section 104-135 of the ITAA 1997).

33. CGT event C2 will happen when MMC pays the proposed return of capital to a shareholder in respect of a MMC 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

34. Any capital gain or capital loss made by a foreign resident shareholder when the CGT event happens will be disregarded if their MMC shares are not 'taxable Australian property' at that time (section 855-10 of the ITAA 1997).

Commissioner of Taxation

30 January 2008

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

35. 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).

36. 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 excludes certain items from being a dividend for income tax purposes.

37. 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.

38. The proposed return of capital will be wholly debited against MMC's untainted share capital account. Therefore, paragraph (d) of the definition of 'dividend' applies and the proposed return of capital will not be a dividend as defined in subsection 6(1).

Anti-avoidance provisions

Sections 45A and 45B

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

Streaming of dividends and capital benefits: section 45A

40. 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.

41. Although MMC will be providing its shareholders with a 'capital benefit' (as defined in paragraph 45A(3)(b)), the capital benefit is to be provided to all of the shareholders in MMC in direct proportion to their individual shareholding. As all shareholders will benefit equally from the return of capital, there is no indication of 'streaming' of capital benefits to some shareholders and not to others.

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

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

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

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

Each of the conditions is considered below.

Scheme

45. The proposed return of capital will constitute a 'scheme' within the broad meaning of the term.

46. 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 MMC proposes to debit the proposed return of capital against its untainted share capital account, its shareholders will be provided with a capital benefit.

Tax benefit

47. A shareholder '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,

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.

48. 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) where the shareholder still holds the share at payment date. 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 shareholders. 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 of the ITAA 1936. Therefore, MMC shareholders will generally obtain tax benefits from the proposed return of capital.

Relevant circumstances

49. For the purposes of paragraph 45B(2)(c), the Commissioner is required to consider the 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.

50. 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 or any part of the scheme did so for the purpose of obtaining a tax benefit for the relevant taxpayer in respect of the capital benefit. The purpose does not have to be the most influential or prevailing purpose, but it must be more than an incidental purpose.

51. 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 proposed return of capital is made to all MMC shareholders regardless of 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 here. In this case, the relevant matters are those covered by the circumstances described in paragraphs 45B(8)(a), (b) and (k).

52. 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. MMC advises that the proposed return of capital of \$0.10 per share will be funded from excess cash reserves that are sourced from the initial capital raising in 2003. As MMC has not found suitable low risk equity investments to invest in, these funds are excess to MMC's requirements. The proposed return of capital is wholly attributable to excess share capital arising from the initial capital raising. No part of the return of capital is attributable to specific profits, realised or unrealised, of MMC.

53. 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. Since incorporation, MMC has maintained a policy of paying out most of the profits earned by the company. The proposed return of capital will be made in addition to the payment of interim and final dividends anticipated by MMC in respect of the year ended 30 June 2008. The proposed return of capital will not affect the current dividend policy of MMC under which it intends to continue to pay out approximately 70% of annual operating profits to shareholders. Accordingly, the company's pattern of distributions does not suggest that the proposed return of capital will be made in substitution for a dividend.

54. 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, its form and substance, and its financial and other implications for the parties involved. In this case, the practical implications of the scheme for MMC and its shareholders are consistent with its being, in form and substance, a distribution of share capital.

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

Application of section 45C

56. 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 proposed return of capital to be an unfranked dividend for the purposes of the ITAA 1936 or of the ITAA 1997.

Capital gains tax

CGT event G1 – section 104-135

57. CGT event G1 in section 104-135 of the ITAA 1997 will happen when MMC pays the proposed return of capital in respect of a share that a MMC shareholder owns at the Record Date and continues to own at the Payment Date as the payment will not be a dividend as defined in subsection 995-1(1) of the ITAA 1997.

58. If the proposed return of capital amount (10 cents per share) is not more than the cost base of the MMC share at the time of the payment, the cost base (and reduced cost base) of the share will be reduced by the amount of the proposed return of capital (subsection 104-135(4) of the ITAA 1997).

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

60. If a MMC shareholder makes a capital gain, the cost base (and reduced cost base) of the share is reduced to nil (subsection 104-135(3) of the ITAA 1997).

61. A MMC shareholder cannot make a capital loss under CGT event G1.

62. If the MMC share to which the payment relates was originally acquired by an MMC shareholder at least 12 months before the payment of the proposed return of capital, a capital gain from CGT event G1 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).

CGT event C2 – section 104-25

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

64. CGT event C2 happens when the proposed return of capital is paid and the MMC shareholder's right to receive that payment ends (section 104-25 of the ITAA 1997).

65. A MMC 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 proposed return of capital (section 116-20 of the ITAA 1997).

66. The cost base of the MMC shareholder's right to receive the proposed 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 MMC shareholder will have paid nothing for the right, the cost base of the right will likely be nil. Therefore, the MMC shareholder will generally make a capital gain equal to the amount of the proposed return of capital.

67. As the right to receive the proposed return of capital amount was inherent in the MMC 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).

68. Consequently, if the MMC share to which the payment relates was originally acquired by an MMC shareholder at least 12 months before the payment of the proposed return of capital amount, 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

69. A foreign resident shareholder disregards any capital gain made from the proposed return of capital if their MMC 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).

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

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

72. Therefore, a MMC share will only be 'taxable Australian property' if the foreign resident shareholder has used their MMC 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

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References

Previous draft:

Not previously issued as a draft

Subject references:

- capital benefit
- capital reductions
- dividend substitution
- share capital

Legislative references:

- ITAA 1936 45B(9)
- ITAA 1936 45C
- ITAA 1936 128B
- ITAA 1936 177D(b)(i)
- ITAA 1936 177D(b)(ii)
- ITAA 1936 177D(b)(iii)
- ITAA 1936 177D(b)(iv)
- ITAA 1936 177D(b)(v)
- ITAA 1936 177D(b)(vi)
- ITAA 1936 177D(b)(vii)
- ITAA 1936 177D(b)(viii)
- ITAA 1936 318
- ITAA 1997
- ITAA 1997 104-25
- ITAA 1997 104-25(3)
- ITAA 1997 104-135
- ITAA 1997 104-135(3)
- ITAA 1997 104-135(4)
- ITAA 1997 109-5
- ITAA 1997 Div 110
- ITAA 1997 Div 112
- ITAA 1997 Subdiv 115-A
- ITAA 1997 115-25(1)
- ITAA 1997 116-20
- ITAA 1997 855-10
- ITAA 1997 855-15
- ITAA 1997 855-25
- ITAA 1997 855-30
- ITAA 1997 960-195
- ITAA 1997 975-300
- ITAA 1997 995-1(1)
- TAA 1953
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- Copyright Act 1968
- ITAA 1936 45B(1)
- ITAA 1936 6(1)(d)
- ITAA 1936 44(1)
- ITAA 1936 45A
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- ITAA 1936 45A(3)(b)
- ITAA 1936 45B
- ITAA 1936 45B(2)
- ITAA 1936 45B(2)(a)
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- ITAA 1936 45B(3)
- ITAA 1936 45B(5)
- ITAA 1936 45B(8)
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- ITAA 1936 45B(8)(h)
- ITAA 1936 45B(8)(i)
- ITAA 1936 45B(8)(j)
- ITAA 1936 45B(8)(k)

ATO references

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