

CR 2008/5 - Income tax: Selective Capital Reduction: Orica Limited

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Class Ruling

Income tax: Selective Capital Reduction: Orica Limited

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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);
 - 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 128B of the ITAA 1936;
 - Division 16K of Part III of the ITAA 1936;
 - Division 1A of former Part IIIA of the ITAA 1936 (repealed with savings provisions);
 - section 160APHO of the ITAA 1936;

- section 177EA of the ITAA 1936;
- section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 8-1 of the ITAA 1997;
- Division 67 of the ITAA 1997;
- section 67-25 of the ITAA 1997;
- section 104-25 of the ITAA 1997;
- section 116-20 of the ITAA 1997;
- section 118-20 of the ITAA 1997;
- section 118-25 of the ITAA 1997;
- section 202-5 of the ITAA 1997;
- section 202-40 of the ITAA 1997;
- section 204-30 of the ITAA 1997;
- section 207-20 of the ITAA 1997;
- section 207-145 of the ITAA 1997;
- section 855-10 of the ITAA 1997; and
- section 855-15 of the ITAA 1997.

Class of entities

3. The class of entities to which this Ruling applies is the 5% cumulative non-redeemable preference shareholders of Orica Limited (Orica), a publicly listed company, who participated in the Selective Capital Reduction announced by Orica on 30 October 2007 and described in the Scheme part of this Ruling under which their shares were cancelled. In this Ruling, this class of entities is referred to as 'shareholders' or 'participating shareholders'.

4. The Ruling does not deal with how the taxation laws apply to Orica in relation to the 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 24 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 this date 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 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 dated 12 September 2007; and
- correspondence from PricewaterhouseCoopers dated 14 September 2007, 17 September 2007, 10 October 2007, 17 October 2007, 2 November 2007, 16 November 2007, 23 November 2007, 10 December 2007, 17 January 2008 and 22 January 2008.

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. Orica is an Australian incorporated company listed on the Australian Securities Exchange (ASX). The ordinary and preference shareholders in Orica are a mix of resident and non-resident companies, superannuation funds and individuals. Orica has three classes of shares on issue. As at 10 October 2007, Orica had:

- 307,899,653 ordinary shares on issue;
- 2,000,000 5% cumulative non-redeemable preference shares (5% Preference Shares) on issue; and
- 5,000,000 Step Up Preference Shares on issue.

16. On 30 October 2007 Orica announced that it proposed to undertake a Selective Capital Reduction by way of a share cancellation. The proposal was to cancel all of the 5% Preference Shares in Orica. Orica announced that it would outlay \$9.5 million to implement the proposed Selective Capital Reduction. The proposed Selective Capital Reduction was subject to shareholder approval.

17. The purpose of the Selective Capital Reduction was:

- to implement a more efficient capital structure, with greater flexibility to enable Orica to respond to business opportunities as they arise; and
- to allow for more cost effective corporate governance and secretarial functions.

18. Orica announced that under the proposed Selective Capital Reduction it would cancel all 5% Preference Shares in return for a payment of \$4.75 per share (the Cancellation Payment). Of this amount \$1.00 was to be debited to Orica's share capital account and the balance of the capital reduction amount of \$3.75 was to be debited to Orica's statement of financial performance.
19. To be eligible to participate, a 5% Preference Shareholder would need to hold shares on the Record Date of 14 January 2008.
20. On 21 December 2007, Orica's shareholders approved the Selective Capital Reduction proposal.
21. The last day 5% Preference Shares in Orica were traded on the ASX was 24 December 2007.
22. Orica cancelled all 5% Preference Shares on 14 January 2008.
23. Orica paid \$4.75 per share to participating shareholders on 18 January 2008.
24. Orica has confirmed that its share capital account is not tainted, as defined in section 995-1(1) of the ITAA 1997.

Ruling

Division 16K

25. The Selective Capital Reduction will not be treated as a buy-back for the purposes of Division 16K of Part III of the ITAA 1936.

The Dividend and Capital Component

26. The amount paid by Orica to participating shareholders in respect of the cancellation of a share (the Cancellation Payment) under the Selective Capital Reduction is a distribution made by the company. The distribution is a dividend to the extent that it is not debited to Orica's share capital account (paragraphs (a) and (d) of the definition of 'dividend' in subsection 6(1) of the ITAA 1936). As \$1.00 of the consideration was debited against Orica's share capital account (the Capital Component), the participating shareholder received a dividend of \$3.75 (the Dividend Component) for each share cancelled.
27. The Dividend Component is a frankable distribution pursuant to section 202-40 of the ITAA 1997 and is therefore capable of being franked in accordance with section 202-5 of the ITAA 1997.

Assessability of the Dividend Component for shareholders who hold their shares on capital account

28. The Dividend Component is included in the assessable income of resident individual, superannuation fund and company shareholders who held their 5% Preference Shares on capital account and who participate in the Selective Capital Reduction, under subsection 44(1) of the ITAA 1936.

Shares held on revenue account

29. Where the shares are held as revenue assets, the amount by which the Cancellation Payment (\$4.75 per share) exceeds the cost of each share is included in the shareholder's assessable income under section 6-5 of the ITAA 1997. Correspondingly, if the cost exceeds the Cancellation Payment of \$4.75 per share the difference is an allowable deduction under section 8-1 of the ITAA 1997.

30. Where the shares are held as trading stock, the Cancellation Payment of \$4.75 per share is included in assessable income under section 6-5 of the ITAA 1997.

Gross-up and tax offset

31. An amount equal to the franking credit on the Dividend Component (gross-up) is included in the assessable income of participating shareholders under subsection 207-20(1) of the ITAA 1997.

32. Participating shareholders will be entitled to a tax offset under subsection 207-20(2) of the ITAA 1997 equal to the amount of the franking credit on the Dividend Component (tax offset), subject to being a 'qualified person': see paragraph 207-145(1)(a) of the ITAA 1997.

Qualified persons

33. For the purposes of Division 1A of former Part IIIAA of the ITAA 1936 participating shareholders are considered to have satisfied the holding period rule under former section 160APHO of the ITAA 1936 and therefore be qualified persons (as long as the related payments rule is also met) in relation to the Dividend Component under the Selective Capital Reduction if:

- the shares cancelled under the Selective Capital Reduction were acquired on or before 15 October 2007;
- the participating shareholder has no other positions (for example, an option) in relation to the shares cancelled under the Selective Capital Reduction; and

- the participating shareholder or an associate of the participating shareholder has not made, is not under an obligation to make, nor is likely to make, any related payments.

34. A participating shareholder who acquired shares after 15 October 2007 that were subsequently cancelled under the Selective Capital Reduction is not a qualified person in relation to a dividend paid in respect of those shares.

Refundable tax offset

35. The tax offsets will be subject to the refundable tax offset rules in Division 67 of the ITAA 1997. Certain trustees and corporate tax entities are not entitled to a refundable tax offset because of subsections 67-25(1A) to (1D) of the ITAA 1997.

Non-resident shareholders

36. As the Dividend Component is partially franked, participating non-resident shareholders will be subject to Australian withholding tax on the unfranked part of the Dividend Component (subsection 128B(1) of the ITAA 1936).

37. Participating non-resident shareholders are not liable for Australian withholding tax on the franked part of the Dividend Component under paragraph 128B(3)(ga) of the ITAA 1936.

Capital gains tax

38. CGT event C2 happened on 14 January 2008 in relation to each participating shareholder when the 5% Preference Shares were cancelled under the Selective Capital Reduction (section 104-25 of the ITAA 1997).

39. The capital proceeds from the cancellation of the 5% Preference Shares is the amount received by shareholders in respect of the cancellation of their shares (subsection 116-20(1) of the ITAA 1997).

40. A shareholder will make a capital gain if the capital proceeds for the cancellation of their 5% Preference Shares are more than the cost base of the shares. If the capital proceeds are less than the reduced cost base of the 5% Preference Shares, the shareholder will make a capital loss (subsection 104-25(3) of the ITAA 1997).

41. Any capital gain made by a shareholder when CGT event C2 happens can be reduced by the amount of the gain that was included in the assessable income of the shareholder under section 6-5 of the ITAA 1997 or as a dividend under subsection 44(1) of the ITAA 1936 (section 118-20 of the ITAA 1997).

42. A capital gain or capital loss made from the cancellation of the 5% Preference Shares is disregarded if, at the time of the cancellation, the shares were trading stock (subsection 118-25(1) of the ITAA 1997).

43. Any capital gain or capital loss made from the cancellation of 5% Preference Shares acquired before 20 September 1985 (pre-CGT 5% Preference Shares) is disregarded (subsection 104-25(5) of the ITAA 1997).

44. A foreign resident shareholder disregards a capital gain or a capital loss from CGT event C2 happening on the cancellation of their 5% Preference Shares if the shares are not taxable Australian property as defined in section 855-15 of the ITAA 1997 (section 855-10 of the ITAA 1997).

The anti-avoidance provisions

Sections 45A and 45B

45. 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 Cancellation Payment received under the Selective Capital Reduction by participating shareholders.

Section 177EA

46. The Commissioner will not make a determination under paragraph 177EA(5)(b) of the ITAA 1936 to deny the whole, or any part, of the imputation benefits received in relation to the Dividend Component received under the Selective Capital Reduction by participating shareholders.

Section 204-30

47. The Commissioner will not make a determination under subsection 204-30(3) of the ITAA 1997 to deny the whole, or any part, of the imputation benefits received in relation to the Dividend Component received under the Selective Capital Reduction by participating shareholders.

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.*

Division 16K

48. Division 16K of Part III of the ITAA 1936 provides for the taxation treatment of share buy-backs. Buy-back is defined as having the meaning given by paragraph 159GZZZK(a) of the ITAA 1936 which provides that a purchase is a buy-back where a company buys a share in itself from a shareholder in the company.

49. Orica will not be buying back its 5% Preference Shares from its shareholders. Instead they will be cancelled in accordance with section 256 of the *Corporations Act 2001*. Therefore, the Selective Capital Reduction will not be treated as a buy-back for the purposes of Division 16K of the ITAA 1936.

The Dividend and Capital Component

50. The Cancellation Payment received by participating shareholders for each share cancelled under the Selective Capital Reduction comprises two elements:

- a Dividend Component; and
- a Capital Component.

51. 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.

Assessability of the Dividend Component for shareholders who hold their shares on capital account

52. Subsection 44(1) of the ITAA 1936 includes in a shareholder's assessable income any dividends, as defined in subsection 6(1) of the ITAA 1936, paid to the shareholder out of profits derived by the company from any source (if the shareholder is a resident of Australia) or from an Australian source (if the shareholder is a non-resident of Australia).

53. 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 share capital account of the company (paragraphs (a) and (d) of the definition).

54. 'Share capital account' is defined in subsection 975-300(1) 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.

55. Subsection 975-300(3) of the ITAA 1997 states that an account is taken not to be a share capital account if it is tainted. Subsection 197-50(1) of the ITAA 1997 states that a share capital account is tainted if an amount to which Division 197 of the ITAA 1997 applies, is transferred to the account and the account is not already tainted.

56. The Cancellation Payment of \$4.75 per share is a distribution made by Orica to its participating shareholders. \$1.00 of the Cancellation Payment was debited to Orica's non-current interest bearing liability account which is a share capital account for the purposes of section 975-300 of the ITAA 1997 because the first amount credited to this account was an amount of share capital. As this amount of \$1.00 (Capital Component) per share has been debited to Orica's untainted 'share capital account' it will not constitute a dividend because of the exclusion in paragraph (d) in the definition of 'dividend' in subsection 6(1) of the ITAA 1936.

57. As the remainder of the Cancellation Payment was debited to the statement of financial performance, the shareholders have received a dividend of \$3.75 per share (Dividend Component).

Shares held on revenue account

58. Where the shares are held as revenue assets, the amount by which the Cancellation Payment (\$4.75 per share) exceeds the cost of each share is included in the shareholder's assessable income under section 6-5 of the ITAA 1997. Correspondingly, if the cost exceeds the Cancellation Payment of \$4.75 per share the difference is an allowable deduction.

59. Where the shares are held as trading stock, the Cancellation Payment of \$4.75 per share is included in assessable income under section 6-5 of the ITAA 1997.

Gross-up and tax offset

60. For all participating shareholders, the Dividend Component constitutes a frankable distribution for the purposes of subsection 202-40(1) of the ITAA 1997, and is capable of being franked in accordance with section 202-5 of the ITAA 1997. Further, the Dividend Component was not rendered an unfrankable distribution pursuant to the operation of section 202-45 of the ITAA 1997.

61. An amount equal to the franking credit on the Dividend Component (gross-up) is included in the assessable income of participating shareholders in the year in which the distribution is made under subsection 207-20(1) of the ITAA 1997.

62. Participating shareholders will be entitled to a tax offset under subsection 207-20(2) of the ITAA 1997 for the income year in which the distribution is made. The tax offset is equal to the franking credit on the Dividend Component, subject to the shareholder being a 'qualified person': see paragraph 207-145(1)(a) of the ITAA 1997.

Qualified person

63. Paragraph 207-145(1)(a) of the ITAA 1997 provides that, an entity that is not a 'qualified person' in relation to a franked distribution for the purposes of Division 1A of former Part IIIA of the ITAA 1936 is denied a gross-up and a tax offset. Broadly speaking, to be a 'qualified person' in relation to the dividend paid under the Selective Capital Reduction, the shareholder must satisfy both the holding period rule and the related payments rule.

64. Broadly, a shareholder will not satisfy the related payments rule if the shareholder, or an associate of the shareholder, is under an obligation to make, or makes, a payment in respect of the dividend which effectively passes the benefit of the dividend to another person.

65. The holding period rule requires preference shareholders to hold the shares, or the interest in the shares, on which the dividend is paid at risk for a continuous period of at least 90 days. In determining whether a shareholder has satisfied the holding period rule, any days during which there is a materially diminished risk in relation to the relevant shares are not counted. The day of acquisition and the day of disposal of the relevant shares are also not counted.

66. Under former subsection 160APHM(2) of the ITAA 1936, a shareholder is taken to have materially diminished the risks of loss and opportunities for gain with respect to shares or interests in shares if the 'net position' of the shareholder results in the shareholder having less than 30% of the risks and opportunities relating to the shares or interest in the shares.

67. In this case, the Commissioner does not regard the announcement of the Selective Capital Reduction by way of share cancellation as affecting whether the shares or an interest in the shares are held at risk or not. The Commissioner is satisfied that, by virtue of the *Corporations Act 2001*, Orica shares are held at risk until the date of cancellation.

68. There are 90 clear days between 15 October 2007 and 14 January 2008. Therefore, a participating shareholder who acquired shares after 15 October 2007 will not satisfy the holding period rule. Only participating shareholders who purchased shares on or before 15 October 2007 will satisfy the holding period rule as long as those shares were held at risk for at least 90 continuous days.

A participating shareholder who acquired shares after 15 October 2007 that were subsequently cancelled under the Selective Capital Reduction is not a qualified person under former section 160APHO of the ITAA 1936 in relation to the dividend paid under the Selective Capital Reduction for the purposes of Division 1A of former Part IIIAA of the ITAA 1936.

Refundable tax offset

69. The tax offsets will be subject to the refundable tax offset rules in Division 67 of the ITAA 1997. Certain trustees and corporate tax entities are not entitled to a refundable tax offset because of subsections 67-25(1A) to (1D) of the ITAA 1997.

Non-resident shareholders

70. Subsection 128B(1) of the ITAA 1936 provides that dividends derived by a non-resident and paid by a resident company are subject to withholding tax.

71. As the Dividend Component of the Cancellation Payment received under the Selective Capital Reduction is partially franked, participating non-resident shareholders are not liable for Australian withholding tax on the franked part of the Dividend Component under paragraph 128B(3)(ga) of the ITAA 1936.

72. Participating shareholders will be subject to tax on the unfranked part of the Dividend Component at the dividend withholding tax rate of 30%. This rate is generally reduced to 15% for countries which have a double tax agreement with Australia.

Capital gains tax

CGT event C2 – section 104-25

73. CGT event C2 happens when a taxpayer's ownership of an intangible CGT asset ends by, for example, being redeemed or cancelled (paragraph 104-25(1)(a) of the ITAA 1997).

74. Accordingly, CGT event C2 happened in relation to each participating shareholder when their 5% Preference Shares were cancelled under the Selective Capital Reduction (paragraph 104-25(1)(a) of the ITAA 1997).

Time of the CGT event

75. The time of CGT event C2 is when you enter into the contract that results in the asset ending or if there is no contract, when the asset ends (section 104-25(4) of the ITAA 1997).

76. The cancellation of the 5% Preference Shares under the Selective Capital Reduction did not happen under a contract.

Accordingly, CGT event C2 happened on 14 January 2008 when the 5% Preference Shares ended by being cancelled under the Selective Capital Reduction (subsection 104-25(2) of the ITAA 1997).

Capital gain or capital loss

77. A shareholder will make a capital gain if the capital proceeds for the cancellation of their 5% Preference Shares is more than the cost base of the shares. If the capital proceeds are less than the reduced cost base of the 5% Preference Shares, the shareholder will make a capital loss (subsection 104-25(3) of the ITAA 1997).

Capital proceeds

78. The capital proceeds from a CGT event are determined under Division 116 of the ITAA 1997.

79. Subsection 116-20(1) of the ITAA 1997 provides that the capital proceeds from a CGT event are the total of the money received or entitled to be received and the market value of any property received, or entitled to be received, in respect of the CGT event happening.

80. However, section 116-30 of the ITAA 1997 provides that in certain circumstances the capital proceeds from a CGT event are replaced with the market value of the CGT asset that is the subject of the CGT event. This market value substitution rule applies, with some exceptions specified in subsection 116-30(3) of the ITAA 1997, if the capital proceeds from CGT event C2 happening are more or less than the market value of the asset that is the subject of the event (subparagraph 116-30(2)(b)(ii) of the ITAA 1997).

81. The capital proceeds from the cancellation of the 5% Preference Shares are the money the shareholders received or were entitled to receive in respect of the cancellation, that is, \$4.75 per share. The market value substitution rule will apply if this amount is more or less than the market value of a 5% Preference Share worked out as at the time of the cancellation as if the cancellation had not occurred and was never proposed to occur (subsection 116-30(2) and subsection 116-30(3A) of the ITAA 1997).

82. The Commissioner accepts that the capital proceeds for the cancellation of the 5% Preference Shares (\$4.75) are not more or less than the market value of the shares at the relevant time. Accordingly, the capital proceeds from the cancellation of the 5% Preference Shares are \$4.75 per share.

Section 118-20

83. Under subsection 118-20(1) of the ITAA 1997, a capital gain you make from a CGT event is reduced if, because of the event, an amount is included in your assessable income under a provision of the income tax law other than Part 3-1 of the ITAA 1997 (the capital gains tax provisions). The capital gain is reduced by that amount, but not below zero (subsection 118-20(2) of the ITAA 1997).

84. Accordingly, any capital gain made by the shareholder when CGT event C2 happens can be reduced by the amount of the gain that was included in the assessable income of the shareholder under section 6-5 of the ITAA 1997 or as a dividend under subsection 44(1) of the ITAA 1936 (section 118-20 of the ITAA 1997).

Shares held as trading stock

85. A capital gain or capital loss made from a CGT asset is disregarded if, at the time of the CGT event, the asset is trading stock (subsection 118-25(1) of the ITAA 1997).

86. A capital gain or capital loss made from the cancellation of the 5% Preference Shares is disregarded if, at the time of the cancellation, the shares were trading stock (subsection 118-25(1) of the ITAA 1997).

Pre-CGT 5% preference shares

87. Any capital gain or capital loss made from the cancellation of pre-CGT 5% Preference Shares is disregarded (subsection 104-25(5) of the ITAA 1997).

Foreign resident shareholders

88. 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.

89. A foreign resident shareholder whose 5% Preference Shares are cancelled under the Selective Capital Reduction disregards a capital gain or capital loss from CGT event C2 happening on cancellation of the shares unless the shares are 'taxable Australian property' (section 855-10 of the ITAA 1997).

The anti-avoidance provisions

Sections 45A and 45B

90. 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 distribution of capital 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.

91. 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.

92. Although there has been a 'provision of capital benefit' (as defined in subsection 45A(3) of the ITAA 1936) to shareholders under the Selective Capital Reduction, the circumstances of the Selective Capital Reduction indicate that there was no streaming of capital benefits to some shareholders and of dividends to other shareholders. Accordingly, section 45A of the ITAA 1936 does not apply.

93. Section 45B of the ITAA 1936 applies where certain capital payments are made to shareholders in substitution for dividends. In broad terms, section 45B of the ITAA 1936 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)).

94. 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 participating shareholder to obtain a tax benefit – by way of capital distribution – was not present.

95. Having regard to the relevant circumstances of the scheme, set out in subsection 45B(8) of the ITAA 1936, it is apparent that the inclusion of a capital element in the consideration for the Selective Capital Reduction was appropriate. Further, the Capital Component of the Cancellation Payment cannot be said to be attributable to the profits of the company, nor does the pattern of distributions indicate that it is being paid in substitution for a dividend. Accordingly, section 45B of the ITAA 1936 does not apply.

Section 177EA

96. Section 177EA of the ITAA 1936 is a general anti-avoidance provision that applies to a wide range of schemes to obtain a tax advantage in relation to imputation benefits. In essence, it applies to schemes for the disposition of shares or an interest in shares where a franked distribution is paid or payable in respect of the shares or an interest in shares. This would include a capital reduction with a franked dividend component.

97. Specifically, subsection 177EA(3) of the ITAA 1936 provides that section 177EA applies if:

- (a) there is a scheme for a disposition of membership interests, or an interest in membership interests, in a corporate tax entity; and
- (b) either:
 - (i) a frankable distribution has been paid, or is payable or expected to be payable, to a person in respect of the membership interests; or
 - (ii) a frankable distribution has flowed indirectly, or flows indirectly or is expected to flow indirectly, to a person in respect of the interest in membership interests, as the case may be; and
- (c) the distribution was, or is expected to be, a franked distribution or a distribution franked with an exempting credit; and
- (d) except for this section, the person (the 'relevant taxpayer') would receive, or could reasonably be expected to receive, imputation benefits as a result of the distribution; and

- (e) 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 of 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 an imputation benefit.

98. In the present case the conditions of paragraphs 177EA(3)(a) to (d) of the ITAA 1936 are satisfied. Accordingly, the issue is whether, having regard to the relevant circumstances of the scheme, it would be concluded that, on the part of Orica, its shareholders or any other person, there is a purpose more than merely an incidental purpose of conferring an imputation benefit under the scheme. Under this scheme the relevant taxpayer is a participating shareholder and the scheme comprises the circumstances surrounding the Selective Capital Reduction.

99. In arriving at a conclusion the Commissioner must have regard to the relevant circumstances of the scheme which include, but are not limited to, the circumstances set out in subsection 177EA(17) of the ITAA 1936. The relevant circumstances encompass a range of circumstances which, taken individually or collectively, could indicate the requisite purpose. Due to the diverse nature of these circumstances, some may not be present at any one time in any one scheme.

100. Having regard to the relevant circumstances of the scheme, the Commissioner has come to the view that the requisite purpose is not present and accordingly will not make a determination under paragraph 177EA(5)(b) of the ITAA 1936.

Section 204-30

101. Section 204-30 of the ITAA 1997 applies where a corporate tax entity streams the payment of dividends, or the payment of dividends and the giving of other benefits, to its members in such a way that:

- an imputation benefit is, or apart from that section would be, received by a member of the entity as a result of the distribution or distributions (paragraph 204-30(1)(a) of the ITAA 1997);
- the member would derive a greater benefit from franking credits than another member of the entity (paragraph 204-30(1)(b) of the ITAA 1997); and
- the other member of the entity will receive lesser imputation benefits, or will not receive any imputation benefits, whether or not the other member receives other benefits (paragraph 204-30(1)(c) of the ITAA 1997).

102. Relevantly, if section 204-30 of the ITAA 1997 applies the Commissioner is vested with a discretion under subsection 204-30(3) to make a determination in writing either:

- that a specified franking debit arises in the franking account of the entity, for a specified distribution or other benefit to a disadvantaged member (paragraph 204-30(3)(a) of the ITAA 1997); or
- that no imputation benefit is to arise in respect of any streamed distributions made to a favoured member and specified in the determination (paragraph 204-30(3)(c) of the ITAA 1997).

103. For section 204-30 of the ITAA 1997 to apply, members to whom distributions are streamed must derive a greater benefit from imputation benefits than other members. The words 'derives a greater benefit from franking credits' (imputation benefits) are defined in subsection 204-30(8) by reference to the ability of the members to fully utilise imputation benefits.

104. Under the Selective Capital Reduction, participating shareholders will receive an imputation benefit as a result of the Dividend Component; the resident shareholder in the form of a tax offset (paragraph 204-30(6)(a) of the ITAA 1997) and the foreign resident shareholders in the form of an exemption from dividend withholding tax (paragraph 204-30(6)(e) of the ITAA 1997). The resident members will derive a greater benefit from franking credits than the foreign resident members. However, as the Dividend Component will be franked to the same extent and paid to all the 5% Preference Share shareholders and having regard to the profile of Orica's members and non-share equity holders, it is concluded that Orica has not directed the flow of distributions in such a manner as to ensure that imputation benefits are derived by members who derive greater benefit from franking credits, while other members receive lesser or no imputation benefits.

105. Having regard to all of the relevant circumstances the Commissioner has formed the view that section 204-30 of the ITAA 1997 does not apply to the Selective Capital Reduction.

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Subject references:

- cancellation of shares
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