CR 2008/58 - Income tax: payment of dividend by MediHerb Holdings Limited

Class Ruling

Income tax: payment of dividend by MediHerb Holdings Limited

Contents Para

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:

- former Division 1A of Part IIIAA of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 177EA of the ITAA 1936;
- section 202-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 204-30 of the ITAA 1997; and
- section 207-145 of the ITAA 1997.

Class of entities

3. The class of entities to which this Ruling applies are the holders of ordinary shares in MediHerb Holdings Limited (MediHerb), an Australian resident company, who will receive the dividend of $10 per share pursuant to the Arrangement described in the Scheme in paragraphs 13 to 21 of this Ruling.

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 21 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.

Date of effect

8. 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.

9. The Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling. Furthermore, the Ruling only applies to the extent that:

- it is not later withdrawn by notice in the *Gazette*; or

- the relevant provisions are not amended.

10. If this Ruling is inconsistent with a later public or private ruling, the relevant class of entities may rely on either ruling which applies to them (item 1 of subsection 357-75(1) of Schedule 1 to the *Taxation Administration Act 1953* (TAA)).

11. If this Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the Ruling is made, the following two conditions are met:

- the income year or other period to which the rulings relate has not begun; and
- the scheme to which the rulings relate has not begun to be carried out.

12. If the above two conditions do not apply, the relevant class of entities may rely on either ruling which applies to them (item 3 of subsection 357-75(1) of Schedule 1 to the TAA).

Scheme

13. The following description of the scheme is based on information provided by the applicant. The following documents, or relevant parts of them form part of and are to be read with the description:

- Class Ruling application received on 7 March 2008 from Allens Arthur Robinson on behalf of MediHerb Holdings Limited;
- copy of the Implementation Agreement signed on 27 February 2008;
- copy of the Bidder's Statement and the Target's Statement lodged with Australian Securities and Investments Commission (ASIC) on 28 February 2008.

Note: certain information received from and on behalf of MediHerb was provided on a commercial-in-confidence basis and will not be disclosed or released under the Freedom of Information legislation.

14. MediHerb is an Australian private company (formerly an Australian public company) that runs a herbal and nutritional product manufacture, distribution and sales business.

15. MediHerb's issued capital comprises 182,583 ordinary shares and 26,158 options to subscribe for MediHerb shares.

16. MediHerb has received a cash takeover offer for all of its shares. The offer is for 100% cash consideration in the total amount of $41,263,758.

17. The cash consideration for each MediHerb share is $226, subject to a dollar for dollar reduction for any dividend declared and paid to MediHerb shareholders, excluding the permitted dividend of $10 per share.

18. The Board of MediHerb supports and recommends the acceptance of this offer in the absence of a superior offer.

19. The permitted dividend of $10 per share was declared by the Board on 7 February 2008. The Board was able to declare the dividend based on MediHerb's balance sheet.

20. The dividend was declared by the Board of MediHerb in the expectation that the takeover offer was to be made. However, it was to be paid irrespective of whether the takeover offer proceeds or not.

21. The ex-dividend date for the dividend was 4 March 2008 and the dividend payment date was 7 April 2008.

Ruling

22. The dividend paid to MediHerb shareholders will be capable of being franked in terms of section 202-5 of the ITAA 1997.

23. MediHerb shareholders are capable of being 'qualified persons' for the purposes of section 207-145 of the ITAA 1997 if they have held their shares 'at risk' for the primary qualification period pursuant to former section 160APHO of the ITAA 1936.

24. The Commissioner will not seek to make a determination pursuant to paragraph 204-30(3)(a) or paragraph 204-30(3)(b) of the ITAA 1997 in respect of the payment of the dividend or any part of it to the MediHerb shareholders.

25. The Commissioner will not seek to make a determination pursuant to paragraph 177EA(5)(a) or (b) of the ITAA 1936 in respect of the dividend of $10 per share.

Commissioner of Taxation
17 September 2008

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.

Franking of dividend

26. The dividend of $10 per share is a distribution made by MediHerb to its shareholders and was debited against MediHerb's Retained Earnings Account. Accordingly, it would constitute a distribution for the purposes of section 960-120 of the ITAA 1997. Section 202-40 of the ITAA provides that a distribution is a frankable distribution unless it is rendered unfrankable pursuant to section 202-45 of the ITAA 1997. As on the facts provided section 202-45 would not render the distribution unfrankable, the dividend would constitute a frankable distribution for the purposes of subsection 202-40(1) of the ITAA 1997, and would be capable of being franked in accordance with section 202-5 of the ITAA 1997.

Qualified persons

27. Former Division 1A of Part IIIAA of the ITAA 1936 (Division 1A) contains the measures known as the holding period rule and the related payment rule. In broad terms, former Division 1A of the ITAA 1936 provides the statutory tests that must be satisfied for a taxpayer to be a 'qualified person' with respect to a franked distribution they have received and therefore be entitled to a tax offset for the franking credit attached to the distribution.

28. The test of what constitutes a 'qualified person' is provided in former section 160APHO of the ITAA 1936. Broadly speaking, to be a qualified person in relation to a dividend, a taxpayer must satisfy either the holding period rule or the related payment rule.

29. Former subsection 160APHO(1) of the ITAA 1936 states:

> A taxpayer who has held shares or an interest in shares on which a dividend has been paid is a 'qualified person' in relation to the dividend if:
>
> (a) where neither the taxpayer nor an associate of the taxpayer has made, is under an obligation to make, or is likely to make, a related payment in respect of the dividend – the taxpayer has satisfied subsection (2) in relation to the primary qualification period in relation to the dividend; or
>
> (b) where the taxpayer or an associate of a taxpayer has made, is under an obligation to make, or is likely to make, a related payment in respect of the dividend – the taxpayer has satisfied subsection (2) in relation to the secondary qualification period in relation to the dividend.

30. If a taxpayer is not under an obligation to make a related payment in relation to a dividend or distribution, the taxpayer will have to satisfy the holding period requirement within the primary qualification period. If a taxpayer is under an obligation to make a related payment in relation to a dividend or distribution, the taxpayer will have to satisfy the holding period requirement within the secondary qualification period.

31. In order to determine which is the relevant qualification period, it is necessary to determine whether, under the present arrangement, the current shareholders of MediHerb are considered to be under an obligation to make a related payment. Former section 160APHN of the ITAA 1936 provides non-definitive examples of what constitutes the making of a related payment for the purposes of former Division 1A of the ITAA 1936. Former subsection 160APHN(2) of the ITAA 1936 provides as follows:

> The taxpayer or associate is taken, for the purposes of this Division, to have made, to be under an obligation to make, or to be likely to make, a related payment in respect of the dividend or distribution if, under an arrangement, the taxpayer or associate has done, is under an obligation to do, or may reasonably be expected to do so, as the case may be, anything having the effect of passing the benefit of the dividend or distribution to one or more other persons.

32. Former subsection 160APHN(3) of the ITAA 1936 states:

> Without limiting subsection (2), the doing of any of the following by the taxpayer or an associate of the taxpayer in the circumstances mentioned in subsection (4) may have the effect of passing the benefit of the dividend or distribution to one or more other persons:
>
> (a) causing a payment or payments to be made to, or in accordance with the directions of, the other person or other persons; or
>
> (b) causing an amount or amounts to be credited to, or applied for the benefit of, the other person or the other persons; or
>
> (c) causing services to be provided to, or in accordance with the directions of, the other person or other persons, or
>
> (d) causing property to be transferred to, or in accordance with directions of, the other person or other persons; or
>
> (e) allowing any property or money to be used by the other person or other persons or by someone nominated by the other person or other persons; or
>
> (f) causing an amount or amounts to be set off against, or to be otherwise applied in reduction of, a debt or debts owed by the other person or other persons; or
>
> (g) agreeing to treat an amount or amounts owed to the other person or other persons by the taxpayer or associates as having been increased.

33. Former subsection 160APHN(4) of the ITAA 1936 states:

> The circumstances referred to in subsection (3), are where:
>
> (a) the amount or the sum of the amounts paid, credited or applied; or

(b) the value or the sum of the values of the services provided, of the property transferred or of the use of the property or money; or

(c) the amount or the sum of the amounts of the set-offs, reductions or increases;

as the case may be:

(d) is, or may reasonably be expected to be, equal to; or

(e) approximates or may reasonably be expected to approximate; or

(f) is calculated by reference to;

the amount of dividends or distribution.

34. Paragraph 4.99 of the Explanatory Memorandum accompanying the Taxation Laws Amendment Bill (No. 2) 1999 (the EM) provides some guidance on these provisions and states:

> Because a person does not need to receive an actual payment to receive the economic benefit of a dividend, a related payment includes a notional crediting of an amount which is calculated by reference to the amount of the dividend or distribution. A notional crediting of an amount usually involves having the extent of a person's obligation under an arrangement (e.g. a futures contract or warrant arrangement) determined by a formula which is calculated by reference to the amount of the dividend. A notional crediting differs from an actual crediting in that dividend amounts are not actually attributed to the relevant person, that is, the relevant person has no actual rights in relation to a dividend.

Paragraph 4.103 of the same EM states:

> Likewise, where the price paid for a security includes an estimated dividend component, the offset of the interest component by the estimated dividend compound will be a related payment.

35. In essence, there would be a notional crediting within the terms of section 160APHN of the ITAA 1936 if the circumstances indicate that the amount of the dividend was taken into account in setting the offer price for the shares, such that the offer price was reduced by the amount of the dividend and the benefit of the dividend passed on to the purchasers.

36. In the current case, MediHerb has received an offer of $226 cash for each MediHerb share. MediHerb has declared a dividend of $10 per share knowing at the time of the declaration that a takeover offer was likely to be made. The dividend of $10 per share is to be paid irrespective of whether the takeover offer is made or proceeds. The offer price represents a premium on the limited trades in MediHerb shares that have occurred since 1 July 2007. There is nothing in the offer documents that indicate that the amount of the offer price has been determined by reference to the dividend of $10 per share.

37. Furthermore, under the Bidder's Statement, the offer price will not be reduced by the proposed payment of the dividend of $10 per share. This is in contrast to any other dividends that might be declared by MediHerb; in any other case the amount of consideration MediHerb shareholders receive may be reduced by the amount of any dividend declared to them by MediHerb. In these circumstances, the payment of any other dividends would most likely constitute a related payment. However the payment of the dividend of $10 per share would not constitute a related payment for the purposes of former section 160APHN of the ITAA 1936.

38. As the MediHerb shareholders are not taken, for the purposes of former Division 1A of the ITAA 1936, to be under an obligation to make a related payment in respect of the proposed dividend, the relevant holding period is therefore the primary qualification period pursuant to former paragraph 160APHO(1)(a) of the ITAA 1936.

39. The primary qualification period is defined in former section 160APHD of the ITAA 1936 as follows:

> In relation to a taxpayer in relation to shares or an interest in shares, means the period beginning on the day after the day on which the taxpayer acquired the shares or interest and ending:
>
> (a) if the shares are not preference shares – on the 45^{th} day after the day on which the shares or interest become ex dividend …

40. The concept of 'ex dividend' is defined by former subsection 160APHE(1) of the ITAA 1936 as follows:

> A share in respect of which a dividend is to be paid, or an interest (other than an interest as a beneficiary of a widely held trust) in such a share, becomes ex dividend on the day after the last day on which the acquisition by a person of the share will entitle the person to receive the dividend.

41. Therefore, the primary qualification period is defined by reference to the first dividend that is paid to the holder of the share after they became the owner of the share. Some MediHerb shareholders who have previously received dividends from MediHerb will have the primary qualification period defined by the date of payment of those earlier dividends. For those MediHerb shareholders for whom the current dividend will be the first dividend, as the ex dividend date is 4 March 2008, the primary qualification period will run from the period commencing the day after the shareholder acquired the share to the 45^{th} day after 4 March 2008. If a MediHerb shareholder holds their Mediherb shares 'at risk' for 45 days during the primary qualification period outlined above, they would satisfy the holding period requirement of former section 160APHO of the ITAA 1936 and therefore be capable of being regarded as a 'qualified person' for the purposes of section 207-145 of the ITAA 1997.

Streaming

42. Section 204-30 of the ITAA 1997 is a general anti-streaming measure. It is designed to curb the unintended use of franking credits through streaming arrangements. It permits the Commissioner to make determinations where an entity streams one or more distributions, whether in single franking period or in a number of franking periods, in such a manner whereby:

- an imputation benefit is, or apart from this section would be, received by the member of the entity as a result of a distribution or distributions; and
- that member derives a greater benefit from franking credits than another member of the entity; and
- the other member of the entity receives a lesser imputation benefit, or receives no imputation benefits, whether or not the other member receives other benefits.

43. A member that derives a greater benefit from franking credits is favoured member while a member that derives lesser imputation benefits is a disadvantaged member.

44. Streaming is the act of selectively directing the flow of franked distributions to favoured members to the exclusion of disadvantaged members. The result of such action by a company is the reduction or elimination of the intended wastage of franking credits, inherent in the design of the imputation system.

45. The dividend of $10 per share will be paid to all MediHerb shareholders. The current proposal does not have any regard to the ability of the recipient shareholders to effectively utilise the franking credits in determining which shareholders will receive the franked distribution.

46. Therefore, it cannot be concluded that the dividend of $10 per share involves the payment of franked distributions in a selective manner to favoured members to the exclusion of disadvantaged members. Consequently, section 204-30 of the ITAA 1997 will not apply to the distribution.

Section 177EA

47. Section 177EA of the ITAA 1936 resists schemes which reflect a significant purpose of dealing with franking credits inappropriately and not merely as an incident of a dividend. Subsection 177EA(3) of the ITAA 1936 provides relevantly that the section applies if:

(a) there is a scheme for a disposition of membership interests in a corporate tax entity;

(b) a frankable distribution has been paid, or is payable or expected to be payable, to a person in respect of the membership interests;

(c) the distribution was, or is expected to be, a franked distribution;

(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 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 an imputation benefit.

48. In this instance, the dividend is frankable and is also a part of a scheme which includes the disposition of shares in MediHerb. Therefore, the application of section 177EA of the ITAA 1936 will turn on the section's purpose test; in other words, whether the relevant circumstances of the scheme give rise to an objective conclusion that the company, or any other person who entered into or carried out the scheme, did so for a non-incidental purpose of enabling the shareholders (the relevant taxpayers) to obtain an imputation benefit. Subsection 177EA(17) of the ITAA 1936 provides a non-exclusive list of 'relevant circumstances' to which one must have regard. The list includes a variety of matters (including the eight matters in subparagraphs 177D(b)(i) to (viii) of the ITAA 1936) which individually and collectively will point towards or away from the requisite purpose; however not all of the circumstances listed will be relevant to every case.

49. The key circumstances of the frankable dividend of $10 per share are that it is to be debited against MediHerb's retained earnings and payable indiscriminately to all of its shareholders, most of whom will have held their shares in the company for a considerable period of time. Furthermore the declaration and payment of the dividend are independent of the cash takeover offer of $226 per share. These circumstances, individually and collectively, suggest that the requisite purpose for the application of section 177EA of the ITAA 1936 is not present and therefore the section will not apply in this case. Accordingly, the Commissioner will not seek to make a determination pursuant to paragraph 177EA(5)(a) or (b) of the ITAA 1936.

Appendix 2 – Detailed contents list

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

References

Previous draft:

Not previously issued as a draft

Subject references:

- deemed dividends
- dividend income
- dividend streaming arrangements
- frankable dividends
- imputation system
- qualified persons
- franking credits

Legislative references:

- ITAA 1936 Pt IIIAA Div 1A
- ITAA 1936 160APHD
- ITAA 1936 160APHE(1)
- ITAA 1936 160APHN
- ITAA 1936 160APHN(2)
- ITAA 1936 160APHN(3)
- ITAA 1936 160APHN(4)
- ITAA 1936 160APHO
- ITAA 1936 160APHO(1)
- ITAA 1936 160APHO(1)(a)
- 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 177EA
- ITAA 1936 177EA(3)
- ITAA 1936 177EA(5)(a)
- ITAA 1936 177EA(5)(b)
- ITAA 1936 177EA(17)
- ITAA 1997 202-5
- ITAA 1997 202-40
- ITAA 1997 202-40(1)
- ITAA 1997 202-45
- ITAA 1997 204-30
- ITAA 1997 204-30(3)(a)
- ITAA 1997 204-30(3)(b)
- ITAA 1997 207-145
- ITAA 1997 960-120
- TAA 1953
- TAA 1953 Sch 1 357-75(1)
- Copyright Act 1968

Other references:

- Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 2) 1999

ATO references

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