

CR 2012/1 - Income tax: demerger of Chorus Limited by Telecom Corporation of New Zealand Limited



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Class Ruling

Income tax: demerger of Chorus Limited by Telecom Corporation of New Zealand Limited

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① 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, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is 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);
- section 44 of the ITAA 1936;
- section 45B of the ITAA 1936;
- section 45BA of the ITAA 1936;
- section 45C of the ITAA 1936;
- section 104-135 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 109-10 of the ITAA 1997;
- Division 110 of the ITAA 1997;

- section 115-30 of the ITAA 1997;
- Division 125 of the ITAA 1997; and
- Division 197 of the ITAA 1997.

Class of entities

3. The class of entities to which this Ruling applies is shareholders of Telecom Corporation of New Zealand Limited (TCNZ) who:

- (a) participated in the scheme that is the subject of this Ruling;
- (b) were residents of Australia as defined in subsection 6(1) of the ITAA 1936 on 30 November 2011 (Implementation Date);
- (c) owned ordinary shares in TCNZ (TCNZ shares) and held those shares on capital account at 7:00 PM (New Zealand time) on 25 November 2011 (Record Date); and
- (d) are not subject to the taxation of financial arrangements provisions in Division 230 of the ITAA 1997.

(Note – Division 230 will generally not apply to individuals, unless they have made an election for it to apply to them.)

In this Ruling, a person belonging to this class of entities is referred to as a 'resident TCNZ shareholder'.

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 9 to 35 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 2011 to 30 June 2012. The Ruling continues to apply after 30 June 2012 to all entities within the specified class who entered into the specified scheme during the term of the Ruling. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Scheme

9. The following description of the scheme is based on documents and information provided by the applicant and its advisors.

Background

10. On 24 May 2011 TCNZ announced that it intended to restructure its operations by demerging relevant parts of its network and wholesale business units in order to participate in the New Zealand government's Ultra Fast Broadband initiative (UFB initiative). To facilitate the demerger, TCNZ incorporated a new wholly owned subsidiary company Chorus Limited (Chorus) on 1 July 2011 with the intention that Chorus (and its subsidiaries) would operate the demerged network and wholesale business units.

11. The demerger was approved by the shareholders of TCNZ on 26 October 2011 and implemented on 30 November 2011.

12. The effect of the demerger was to structurally separate, and have separate stock exchange listings for, TCNZ's demerged network and wholesale business units and its other business units, which predominantly involved the provision of retail telecommunications services. The structural separation was a necessary precondition for participation in the UFB initiative.

Relevant Entities

TCNZ

13. TCNZ is a widely held telecommunications company resident in New Zealand. It was established in 1987 as a company wholly owned by the New Zealand government, privatised in 1990 and is listed on the New Zealand Stock Exchange (NZSX), the Australian Securities Exchange (ASX) and (in the form of American Depositary Shares (ADSs)) the New York Stock Exchange (NYSE).

14. Prior to the demerger, TCNZ was the parent company of a group that provided a range of telecommunication services to customers predominantly in New Zealand and Australia including internet, data, voice, mobile and fixed line calling services.

15. Just before the demerger, TCNZ had on issue:

- 1,925,409,580 fully paid ordinary shares that could be publicly traded on the ASX, the NZSX and also the NYSE (in the form of ADSs); and
- 2,806,933 outstanding options (to purchase TCNZ shares) issued under certain incentive schemes.

16. The outstanding options had been issued under certain employee and CEO incentive schemes operated by TCNZ. The incentive schemes included a clause which ensured that, in the event of a reorganisation, option holders would have their interests fairly adjusted to compensate them for the loss in value of their options. The outstanding options issued under the incentive schemes represented less than 10% of the ownership interests in TCNZ (taking into account both their number and value).

17. Each ADS represented 5 TCNZ shares and provided shareholders with full rights of ownership to the corresponding TCNZ shares. Consequently, holders of ADSs participated in the demerger on equivalent terms to other ordinary shareholders of TCNZ.

18. There were no other ownership interests in TCNZ just before the demerger.

19. After the demerger, TCNZ continues to be listed on the NZSX, the ASX and the NYSE (in the form of ADSs).

Chorus

20. Chorus was incorporated as a company registered under the *New Zealand Companies Act 1993* (NZ Companies Act) on 1 July 2011. Just before the demerger, Chorus was a wholly owned subsidiary of TCNZ.

21. After the demerger, Chorus (and its subsidiaries) are participating in the UFB initiative and will operate the demerged network and wholesale business units previously operated by TCNZ. Also, all of the ordinary shares in Chorus are listed on both the ASX and NZSX.

Pre-demerger transactions

22. Prior to the demerger, TCNZ undertook certain transactions to facilitate the demerger including:

- entering into an Interim Period Agreement on 24 May 2011 with Crown Fibre Holdings Ltd, a New Zealand government owned investment company which is managing the government's investments to implement the UFB initiative. The Interim Period Agreement sets out the respective obligations agreed between the two entities in relation to the period prior to the structural separation necessary to take part in the UFB initiative;
- incorporating Chorus and Chorus New Zealand Limited (a wholly owned subsidiary of Chorus) on 1 July 2011 to operate the relevant parts of TCNZ's network and wholesale business units after the demerger;
- entering into a Deed on 11 July 2011 to convert a special class TCNZ share held by the New Zealand Minister of Finance into an ordinary TCNZ share prior to 7:00 PM (New Zealand time) on the Record Date; and
- entering into a Separation Deed on 12 September 2011 (subsequently amended and restated on 25 October 2011) with Chorus and Chorus New Zealand Limited recording the agreement between the entities to implement the demerger and to ensure that, just after the demerger, Chorus, either directly or indirectly, owned all the companies and assets relating to the relevant parts of the network and wholesale business units of TCNZ.

The demerger of Chorus

23. The demerger of Chorus was undertaken by a capital reduction and a court approved scheme of arrangement, both of which were approved by the requisite majority of TCNZ shareholders on 26 October 2011.

24. On the Implementation Date, TCNZ reduced its share capital by NZ\$0.1989 per TCNZ share (the capital reduction amount) and made a distribution of NZ\$0.4575 per TCNZ share (the dividend component) which was debited to retained earnings.

25. In accordance with the terms of the scheme of arrangement, the capital reduction amount and the distribution comprising the dividend component were satisfied by all eligible TCNZ shareholders receiving an *in specie* distribution of one Chorus share for every five TCNZ shares owned on the Record Date rounded to the nearest whole Chorus share.

26. After the demerger, TCNZ shareholders held ordinary shares in both TCNZ and Chorus except where the circumstances dealt with in paragraph 28 of this Ruling.

27. Holders of outstanding options in TCNZ issued under the incentive schemes did not receive shares or options in Chorus under the demerger. However, additional options will be issued to these holders to reflect the diminution in value of their options resulting from the implementation of the demerger.

Sale facility

28. For TCNZ shareholders whose registered address on the Record Date was shown as being in any jurisdiction other than New Zealand, Australia, the United States, the United Kingdom, Canada, Germany, Hong Kong, Japan, Luxembourg, Norway, the Netherlands, Singapore, Switzerland or other jurisdictions allowed for in the scheme documentation a sale facility was made available to enable their demerged Chorus shares to be sold on the NZSX and the net proceeds per share remitted to them free of brokerage costs and stamp duty.

Accounting for the demerger distribution

29. The demerger distribution of the Chorus shares to TCNZ shareholders was accounted for by TCNZ making the following entries:

- debiting its share capital account by NZ\$382,879,006 in aggregate (total capital reduction amount); and
- debiting the balance of the demerger distribution NZ\$880,806,489 to its retained earnings account (total dividend amount).

Other matters

30. Chorus commenced trading on the ASX on 21 November 2011 on a deferred settlement basis.

31. The volume weighted average price of the Chorus shares as traded on the NZSX (on a deferred settlement basis) over the last five trading days prior to the Implementation Date was NZ\$3.2816.

32. The volume weighted average price of the TCNZ shares as traded on the NZSX (on a deferred settlement basis) over the last five trading days prior to the Implementation Date was NZ\$1.9870.

33. TCNZ confirmed that no amounts have been credited to its share capital account other than amounts received for the subscription for shares and its share capital account was not 'tainted' within the meaning of Division 197 of the ITAA 1997.

34. TCNZ did not make an election under subsection 44(2) of the ITAA 1936 that subsections 44(3) and 44(4) of the ITAA 1936 will not apply to the dividend component of the demerger distribution.

35. After the demerger, at least 50% of the market value of capital gains tax (CGT) assets owned by Chorus or its subsidiaries were used directly or indirectly in one or more businesses carried on by Chorus.

Ruling

CGT consequences

CGT event G1

36. CGT event G1 happened in relation to each of the TCNZ shares owned by a resident TCNZ shareholder at the time TCNZ made the payment of the capital reduction amount (section 104-135 of the ITAA 1997).

Capital gain

37. Resident TCNZ shareholders made a capital gain when CGT event G1 happened if the capital reduction amount received for each TCNZ share exceeded the cost base of that TCNZ share. No capital loss can be made from CGT event G1 (subsection 104-135(3) of the ITAA 1997).

Demerger roll-over relief

38. TCNZ and its subsidiary Chorus were part of a demerger group under subsection 125-65(1) of the ITAA 1997.

39. A demerger, as described under section 125-70 of the ITAA 1997, happened under the scheme.

40. Resident TCNZ shareholders can choose demerger roll-over relief under subsection 125-55(1) of the ITAA 1997 for their TCNZ shares.

Demerger roll-over relief is chosen for TCNZ shares

41. Resident TCNZ shareholders who choose demerger roll-over relief disregard any capital gain made when CGT event G1 happened in relation to each of their TCNZ shares under the demerger (subsections 125-55(1) and 125-80(1) of the ITAA 1997).

42. If a resident TCNZ shareholder chooses demerger roll-over relief for their TCNZ shares, they must recalculate the cost base and reduced cost base of their TCNZ and Chorus shares.

43. The first element of the cost base and reduced cost base of their TCNZ shares and corresponding Chorus shares received under the demerger is worked out as follows:

- take the sum of the cost bases of the post-CGT TCNZ shares (just before the demerger); and
- apportion that sum over the post-CGT TCNZ shares and corresponding new Chorus shares received under the demerger.

44. The apportionment of this sum is done on a reasonable basis having regard to the market values (just after the demerger) of the TCNZ shares and Chorus shares, or a reasonable approximation of those market values (subsections 125-80(2) and 125-80(3) of the ITAA 1997).

45. For the purposes of the cost base and reduced cost base apportionment under subsections 125-80(2) and 125-80(3) of the ITAA 1997, the Commissioner accepts the volume weighted average price of the Chorus shares, NZ\$3.2816, and the TCNZ shares, NZ\$1.9870, as indicated at paragraphs 31 and 32 of this Ruling, to be a reasonable approximation of the relative market value of those shares.

Demerger roll-over relief is not chosen for TCNZ shares

46. For resident TCNZ shareholders who do not choose demerger roll-over relief:

- they are not entitled to disregard any capital gain made in respect of CGT event G1 that happened to their TCNZ shares under the demerger; and
- the first element of the cost base and reduced cost base of their TCNZ shares and the corresponding Chorus shares is calculated in the manner described in paragraphs 42 to 44 of this Ruling (subsection 125-85(1) and 125-85(2) of the ITAA 1997).

Acquisition date of the Chorus shares for the purposes of the CGT discount

47. For the purposes of determining eligibility for a discount capital gain, the Chorus shares received by a resident TCNZ shareholder are taken to have been acquired on the same date as the corresponding TCNZ shares (item 2 in the table in subsection 115-30(1) of the ITAA 1997). This is the case irrespective of whether or not demerger roll-over relief is chosen.

Demerger dividend

48. Any dividend arising under the demerger is a demerger dividend (subsection 6(1) of the ITAA 1936).

49. Any demerger dividend is neither assessable income nor exempt income of the participating resident TCNZ shareholders (subsections 44(3) and (4) of the ITAA 1936).

50. As the capital reduction amount was debited to TCNZ's share capital account it is not a dividend, as defined in subsection 6(1) of the ITAA 1936.

Application of sections 45B, 45BA and 45C of the ITAA 1936

51. The Commissioner will not make a determination under paragraph 45B(3)(a) of the ITAA 1936 that section 45BA of the ITAA 1936 applies to the whole or any part of any demerger benefit provided to resident TCNZ shareholders under the demerger.

52. The Commissioner will not make a determination under paragraph 45B(3)(b) of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole or any part of the capital benefit provided to resident TCNZ shareholders under the demerger.

Commissioner of Taxation

11 January 2012

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.*

CGT consequences

53. The CGT consequences and relevant legislative provisions that arise concerning the scheme that is the subject of this Ruling are outlined in the Ruling part of this document.

54. A significant tax consequence of the scheme is the availability of demerger roll-over under Division 125 of the ITAA 1997. Broadly, resident TCNZ shareholders can choose roll-over to disregard a capital gain made under the demerger.

55. There are special rules for calculating the cost base and reduced cost base of the TCNZ and Chorus shares for resident TCNZ shareholders regardless of whether or not they choose roll-over.

The demerger roll-over relief conditions

56. Demerger roll-over enables a shareholder to choose to disregard a capital gain made as a result of CGT event G1 happening when a non-assessable payment is made in relation to a share under a demerger.

57. The demerger roll-over provisions in Division 125 of the ITAA 1997 contain a number of conditions for eligibility to choose demerger roll-over relief. The main conditions that are relevant to the Scheme are that:

- a shareholder owns a share in a company;
- the company is the head entity of a demerger group;
- a demerger happens to the demerger group; and
- under the demerger, a CGT event happens to the original interest and a new or replacement interest is acquired in the demerged entity and nothing else.

58. Under the scheme to which this Ruling relates the conditions for demerger roll-over relief under Division 125 of the ITAA 1997 are satisfied. As the scheme to which this Ruling relates raises no novel issues of tax law interpretation, the Commissioner does not consider that any further explanation beyond that contained in the Ruling section of the document is warranted, except for one aspect of the conditions for roll-over. The relevant issue concerns the treatment of 'adjusting instruments' under the proportion test in determining whether a demerger happens to a demerger group.

Adjusting Instruments

59. One of the conditions for a demerger happening to a demerger group is the 'proportion' test in subsection 125-70(2) of the ITAA 1997. It requires that each owner of original interests in the head entity must:

- acquire, under the demerger, the same proportion, or as nearly as practicable the same proportion, of new interests in the demerged entity as the original owner owned in the head entity just before the demerger; and
- just after the demerger, have the same proportionate total market value of ownership interests in the head entity and demerged entity as the original owner owned in the head entity just before the demerger.

60. The outstanding options issued under the incentive schemes are ownership interests for the purposes of the proportion test. However, section 125-75 of the ITAA 1997 provides for various exceptions to the proportion test including an exception for certain 'adjusting instruments' that represent not more than 10% of the ownership interests of a listed public company (subsections 125-75(4) and 125-75(5) of the ITAA 1997).

61. The outstanding options issued under the incentive schemes are 'adjusting instruments' and they represent less than 10% of the ownership interests in the company (taking into account both their number and value). Further, the holders of these options will receive additional options to compensate them for the diminution in value of the held options resulting from the demerger. For these reasons, it is considered that the outstanding options can be disregarded for the purposes of the proportion test.

Demerger dividend

62. Subsection 44(1) of the ITAA 1936 operates to include in a shareholder's assessable income any dividends, within the meaning of that term in subsection 6(1) of the ITAA 1936, paid to a shareholder out of company profits.

63. Paragraph 6(1)(d) of the definition of excludes amounts debited against an amount standing to the credit of the share capital account of the company.

64. 'Share capital account' is defined in section 975-300 of the ITAA 1997 as an account that 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.

65. However, subsection 975-300(3) of the ITAA 1997 provides that an account is not a share capital account if it is tainted. A share capital account is tainted if an amount to which Division 197 of the ITAA 1997 applies is transferred to the share capital account where the account is not already tainted.

66. In the circumstances of the Chorus demerger, TCNZ debited an aggregate amount of NZ\$382,879,006 to its 'share capital account' (as that term is defined in subsection 6(1) of the ITAA 1936 and section 975-300 of the ITAA 1997). This amount is therefore not a dividend for the purposes of subsection 6(1) of the ITAA 1936 and is not assessable under subsection 44(1) of the ITAA 1936.

67. Also, resident TCNZ shareholders did receive a dividend to the extent that the market value of the Chorus shares distributed under the demerger exceeded the amount debited against the share capital account (see Taxation Ruling TR 2003/8).

68. However, this dividend is neither assessable income nor exempt income (subsections 44(3) and 44(4) of the ITAA 1936) if:

- the dividend is a demerger dividend (as defined in subsection 6(1) of the ITAA 1936);
- the head entity does not elect that subsections 44(3) and 44(4) of the ITAA 1936 do not apply to the demerger dividend (subsections 44(2) of the ITAA 1936); and
- subsection 44(5) of the ITAA 1936 is satisfied.

69. In the present circumstances, as each of the conditions outlined in paragraph 68 of this Ruling are satisfied, the dividend component received by resident TCNZ shareholders under the demerger is neither assessable income nor exempt income pursuant to the operation of subsections 44(3) and 44(4) of the ITAA 1936.

Application of section 45B of the ITAA 1936

70. The purpose of section 45B of the ITAA 1936 is to ensure that relevant amounts distributed to shareholders of a company are treated as dividends for tax purposes if:

- (a) components of a demerger allocation as between capital and profit do not reflect the circumstances of the demerger; or
- (b) certain payments, allocations and distributions are made in substitution for dividends (subsection 45B(1) of the ITAA 1936).

71. Subsection 45B(2) of the ITAA 1936 provides (relevantly) that the section applies if:

- (a) there is a scheme under which a person is provided with a demerger benefit or a capital benefit by a company;
- (b) under the scheme the taxpayer obtains a tax benefit as defined in subsection 45B(9) of the ITAA 1936; and
- (c) having regard to the relevant circumstances of the scheme, it would be concluded that the scheme was

entered into or carried out for a more than incidental purpose of enabling the taxpayer to obtain the tax benefit.

72. In this case, while the conditions of paragraphs 45B(2)(a) and 45B(2)(b) of the ITAA 1936 are met, the requisite purpose of enabling resident TCNZ shareholders to obtain a tax benefit (by way of a demerger benefit or a capital benefit) is not present.

73. Accordingly, the Commissioner will not make a determination under paragraph 45B(3)(a) or 45B(3)(b) of the ITAA 1936 that either section 45BA or 45C of the ITAA 1936 applies to the scheme to which this Ruling relates.

Appendix 2 – Detailed contents list

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

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Reference

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2003/8; TR 2006/10

Subject references:

- capital gains
- CGT events
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- CGT capital proceeds
- cost base adjustments
- demerger
- demerger allocation
- demerger benefit
- demerger dividend
- demerger group
- demerger subsidiary
- return of capital on shares

Legislative references:

- ITAA 1936 44(1)
- ITAA 1936 44(2)
- ITAA 1936 44(3)
- ITAA 1936 44(4)
- ITAA 1936 44(5)
- ITAA 1936 45B
- ITAA 1936 45B(1)
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- ITAA 1936 45B(2)(a)
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 - ITAA 1936 45B(3)(a)
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 - ITAA 1936 45B(9)
 - ITAA 1936 45BA
 - ITAA 1936 45C
 - ITAA 1997 104-135
 - ITAA 1997 104-135(3)
 - ITAA 1997 115-30
 - ITAA 1997 115-30(1)
 - ITAA 1997 Div 125
 - ITAA 1997 125-55(1)
 - ITAA 1997 125-65(1)
 - ITAA 1997 125-70
 - ITAA 1997 125-70(2)
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 - ITAA 1997 125-75(4)
 - ITAA 1997 125-75(5)
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 - ITAA 1997 125-80(3)
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 - ITAA 1997 Div 197
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ATO references

NO: 1-39VKM0W

ISSN: 1445-2014

ATOlaw topic: Income Tax ~~ Capital Gains Tax ~~ demerger relief