


# ***CR 2014/50 - Income tax: proposed return of share capital: IPE Limited***

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## Class Ruling

### Income tax: proposed return of share capital: IPE Limited

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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, 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 provisions

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
  - Division 115 of the ITAA 1997
  - section 855-10 of the ITAA 1997.

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

## Class of entities

3. The class of entities to which this Ruling applies are the holders of ordinary shares in IPE Limited (IPE) who:
- (a) are listed on the IPE share register on the Record Date for the proposed return of share capital
  - (b) will not hold their IPE shares as revenue assets (as defined in section 977-50 of the ITAA 1997) nor as trading stock (as defined in subsection 995-1(1) of the ITAA 1997) - that is, they will hold their IPE shares broadly on capital account, and
  - (c) are not subject to the taxation of financial arrangements rules in Division 230 of the ITAA 1997 in relation to gains and losses on their IPE shares.
- (Note - Division 230 of the ITAA 1997 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 an 'IPE 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 8 to 30 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

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7. This Ruling applies from 1 July 2013 to 30 June 2015. The Ruling continues to apply after 30 June 2015 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).

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## Scheme

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8. 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:

- The Class Ruling application dated 16 April 2014 lodged by Norton Rose Fulbright Australia on behalf of IPE (the Applicant) and documents attached to the Class Ruling application, including the following:
  - Annexure A – IPE Shareholder Update released 22 October 2008
  - Annexure B – IPE Prospectus released 9 June 2009
  - Annexure D – Notice of General Meeting dated 28 March 2014
  - Annexure E – Example of distribution notices received by IPE (5 documents)
  - Annexure F – Investment Transaction Statement of IPE for the half year ended 31 December 2013
  - Annexure G – Interim Report of IPE for the half year ended 31 December 2013, and
  - Additional information from the applicant dated 7 May 2014.

**Note:** certain information has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

## Background

9. IPE is an Australian resident company, which has been listed on the Australian Securities Exchange (ASX) since November 2004.

10. IPE's principal activity is investing in private equity funds.

11. In October 2008 and June 2009 the Board of Directors announced that IPE would cease making new investments and would instead be progressively wound up.

**Investing in private equity funds**

12. Private equity funds operate on a partly paid structure. This means that the funds initially raise capital from investors (including, in this case, IPE) in the form of “commitments” which are able to be called on at any stage of a fund’s life. Thus investors make an initial payment of part only of their total commitment, and have an obligation to pay at any time, up to the limit of their original commitment. Recognising this, IPE has financed its private equity fund commitments through its share capital and through a debt facility used for bridging purposes.

13. Private equity funds usually have an “investment period” of five or six years from the initial commitments date in which to build a portfolio of private investments. Private equity funds are closed to new investors after the initial subscriptions are finalised. No new investment is allowed after the expiry of the investment period though additional capital may be provided to support existing investments. Thus the bulk of an investor’s commitment is called during the investment period and calls after its expiry are usually sporadic and for relatively small amounts.

14. During the holding period of an asset, a private equity fund may receive dividends, interest (if it has provided a loan to a business) or capital returns (if a business has surplus capital from organic growth or when a re-financing changes the capital structure and either loans or equity are returned). The bulk of the cash flows that a private equity fund receives are when it sells an asset.

15. When a private equity fund distributes cash to its investors, it identifies (either at the time of the distribution or by way of an annual “tax statement” provided to investors) which amounts of the cash distributed are attributable to income receipts of the fund and which amounts are attributable to capital receipts of the fund. Because funds are effectively tax transparent, this division between income and capital receipts is reflected in the tax position of the investor.

16. For these reasons, IPE keeps its accounts and portfolio records such that it is able to identify all of its receipts as one of the following:

- a return of capital invested
- a capital gain on capital invested, or
- income generated by capital invested.

**Status of the IPE portfolio – capital now excess to requirements**

17. In recent years, IPE has been able to pay dividends to its shareholders purely out of profits (being income and capital gains arising from its investments in private equity funds). It has used only the capital returns from the private equity funds to satisfy calls from other private equity funds in respect of its commitments.

18. The position has now changed. With the undrawn commitments amount at a low level, IPE wants to continue to deliver cash back to its shareholders. Part of that cash will have the character of capital, in the sense that it flows from returns of share capital invested in private equity funds, arising from the disposal of assets by those funds. In addition, with the debt capital markets being more active over the last 12 months, IPE has received cash from a number of funds, as a result of companies which were the underlying investments of those funds re-financing themselves. In many of those instances the cash-flows to IPE were identified as returns of capital, and according to the fund manager, represented returns of share capital from underlying companies that the private equity funds had invested in.

### **The proposed return of share capital**

19. On 28 March 2014, IPE released a notice and explanatory memorandum announcing that a General Meeting of IPE shareholders was to be held to approve a return of share capital to the shareholders of \$5,462,848 (equating to 4 cents per share), plus further amounts up to an additional \$6.5 million, at possibly several record dates, to holders of ordinary shares by way of equal reductions of the share capital of IPE.

20. IPE shareholders approved the proposed return of share capital at a general meeting held on 2 May 2014. All IPE shareholders were eligible to vote on the proposed return of share capital.

21. The proposed return of share capital (equating to 4 cents per share) will be paid equally to each IPE shareholder listed on IPE's share register on the Record Date.

22. Both the Record Date of the distribution and the Payment Date, when IPE will pay the proposed return of share capital to its shareholders, will occur in July 2014.

23. IPE will debit the entire amount of the proposed return of share capital against the company's share capital account. There will be no change in either the number of IPE shares on issue or the proportionate interest of each IPE shareholder in IPE.

24. The proposed return of share capital will be sourced from IPE's existing net cash reserves.

### **Other matters**

25. The IPE Interim Report for the half year ended 31 December 2013 disclosed:

- a net profit after tax of \$3.14 million
- \$73,004,963 in its share capital account as at 31 December 2013
- Accumulated losses of \$9,446,386, and

- Total equity of \$63,558,577.

26. IPE consistently paid dividends in its early years, but the last dividend paid before the global financial crisis was in September 2008. IPE then retained its receipts to ensure that it would have sufficient cash to satisfy any of its commitments when called on, but was able to start paying dividends again in 2012. The table below shows the dividend history since the resumption in 2012:

<u>Payment date</u>	<u>Cents per share</u>	<u>Franked</u>	<u>Total</u>
28 June 2012	2.50	100%	\$3.41m
9 Nov 2012	2.25	100%	\$3.07m
19 July 2013	3.50	100%	\$4.78m
5 December 2013	3.00	100%	\$4.10m

27. The proposed return of share capital does not reflect any change in the dividend policy of IPE.

28. On the Payment Date of the proposed return of share capital, IPE will have:

- 136,571,202 ordinary shares on issue
- No history of returning share capital to shareholders or undertaking share buy-backs since listing on the ASX.

29. As at the end of February 2014, IPE had 2,086 shareholders on its share register. The top 20 shareholders held 62.23% of the issued shares.

30. IPE has confirmed that its share capital account (as defined in section 975-300 of the ITAA 1997) is not tainted (within the meaning of Division 197 of the ITAA 1997).

## Ruling

### **Distribution debited to the share capital account is not a dividend for income tax purposes**

31. The proposed return of share capital to IPE shareholders, being debited entirely to the share capital account of IPE, will not be a 'dividend' as defined in subsection 6(1).

### **The application of sections 45A, 45B and 45C**

32. The Commissioner will not make a determination under section 45A or section 45B that section 45C applies to the proposed return of share capital. Accordingly, no part of the proposed return of share capital will be taken to be a dividend for income tax purposes.

**CGT consequences**

33. CGT event G1 (section 104-135 of the ITAA 1997) will happen when IPE pays the proposed return of share capital to an IPE shareholder in respect of an IPE share that they owned at the Record Date and continue to own at the Payment Date.

34. CGT event C2 (section 104-25 of the ITAA 1997) will happen when IPE pays the proposed return of share capital to an IPE shareholder in respect of an IPE share that they owned at the Record Date, but ceased to own before the Payment Date.

**Foreign resident shareholders**

35. A foreign resident IPE shareholder who is paid the proposed return of share capital may disregard any capital gain made when CGT event G1 happens if their IPE share does not constitute 'taxable Australian property' (section 855-10 of the ITAA 1997).

36. A foreign resident IPE shareholder who is paid the proposed return of share capital may disregard any capital gain or capital loss made when CGT event C2 happens if their right to receive the proposed return of share capital is not 'taxable Australian property' (section 855-10 of the ITAA 1997).

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**Commissioner of Taxation**25 June 2014

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## 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 debited to the share capital account is not a dividend for income tax purposes**

37. The term 'dividend' is defined in subsection 6(1) and includes any distribution made by a company to any of its shareholders. However, paragraph (d) of the definition of 'dividend' excludes a distribution from the meaning of 'dividend' if the amount of the distribution is debited against an amount standing to the credit of the company's share capital account.

38. The term 'share capital account' is defined in section 975-300 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.

39. Subsection 975-300(3) of the ITAA 1997 provides that an account is generally taken not to be a share capital account if it is tainted. IPE has confirmed that its share capital account is not tainted within the meaning of Division 197 of the ITAA 1997.

40. The proposed return of share capital will be recorded as a debit to IPE's share capital account. As the share capital account of IPE is not tainted within the meaning of Division 197 of the ITAA 1997, paragraph (d) of the definition of 'dividend' in subsection 6(1) of the ITAA 1936 applies. Accordingly, the proposed return of share capital will not be a 'dividend' as defined in subsection 6(1) of the ITAA 1936.

### **Anti-avoidance provisions**

41. Sections 45A and 45B are two anti-avoidance provisions which, if they apply, allow the Commissioner to make a determination that section 45C applies to treat all or part of the proposed return of share capital received by IPE shareholders as an unfranked dividend paid by the company out of profits.

### **Section 45A – streaming of dividends and capital benefits**

42. Section 45A applies where capital benefits are streamed to some shareholders (the Advantaged Shareholders), who would derive a greater benefit from the receipt of capital than other shareholders (the Disadvantaged Shareholders) and the Disadvantaged Shareholders receive, or are likely to receive, dividends.

43. A reference to the 'provision of a capital benefit to a shareholder in a company' is defined in paragraph 45A(3)(b) to include the distribution to the shareholder of share capital. IPE will provide its shareholders with a 'capital benefit' as defined in paragraph 45A(3)(b) when IPE pays the proposed return of share capital to its shareholders.

44. The capital benefit will be provided to all IPE shareholders in the same proportion as their share holdings.

45. Accordingly, section 45A does not apply to the proposed return of share capital and the Commissioner will not make a determination under subsection 45A(2) that section 45C applies in relation to the whole, or a part, of the capital benefit.

### **Section 45B – scheme to provide capital benefits**

46. Section 45B applies where certain capital payments are made to shareholders in substitution for dividends. In broad terms, subsection 45B(2) applies where:

- (a) there is a scheme under which a person is provided with a capital benefit by a company (paragraph 45B(2)(a)); and
- (b) 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
- (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 (the **relevant taxpayer**) to obtain a tax benefit (paragraph 45B(2)(c)).

47. While the proposed return of share capital will satisfy the conditions in paragraphs 45B(2)(a) and 45B(2)(b), paragraph 45B(2)(c) will not be satisfied. Having regard to the relevant circumstances of the scheme, set out in subsection 45B(8), it cannot be concluded that the scheme is to be entered into or carried out for a more than incidental purpose of enabling IPE shareholders to obtain a tax benefit.

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

## **CGT consequences**

### ***CGT event G1 – section 104-135 of the ITAA 1997***

49. CGT event G1 will happen when IPE pays the proposed return of share capital to an IPE shareholder in respect of a share that the shareholder owned at the Record Date and continues to own at the Payment Date (section 104-135 of the ITAA 1997).

50. An IPE shareholder will make a capital gain if the return of share capital is more than the cost base of the shareholder's IPE share. The amount of the capital gain is equal to the excess (subsection 104-135(3) of the ITAA 1997).

51. If an IPE shareholder makes a capital gain when CGT event G1 happens, the cost base and reduced cost base of the IPE share is reduced to nil. An IPE shareholder cannot make a capital loss when CGT event G1 happens (subsection 104-135(3) of the ITAA 1997).

52. If the proposed return of share capital (i.e., 4 cents per share) is equal to or less than the cost base of the IPE share at the time of payment, the cost base and reduced cost base of the share will be reduced by the amount of the payment (subsection 104-135(4) of the ITAA 1997).

53. A capital gain made when CGT event G1 happens will be eligible to be treated as a discount capital gain under Division 115 of the ITAA 1997 provided that the shareholder acquired the IPE share at least 12 months before the payment of the proposed return of share capital (subsection 115-25(1) of the ITAA 1997) and the other conditions of Division 115 are satisfied.

54. An individual who is a foreign resident or temporary resident must meet further conditions to be eligible to treat the capital gain as a discount capital gain under Division 115 of the ITAA 1997.

### ***CGT event C2 – section 104-25 of the ITAA 1997***

55. CGT event C2 will happen when the proposed return of share capital is paid to a shareholder that held the share at the Record Date but no longer owned the share at the Payment Date (section 104-25 of the ITAA 1997).

56. The right to receive the proposed return of share capital is one of the rights inherent in an IPE share held at the Record Date. If, after the Record Date but before the Payment Date, an IPE shareholder ceased to own an IPE share in respect of which the proposed return of share capital was payable, the right to receive the return of share capital is retained by that shareholder and constitutes a separate CGT asset.

57. The right to receive the proposed return of share capital will end by the right being discharged or satisfied when the payment is made.

58. An IPE 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. The capital gain is equal to the amount of the excess. An IPE shareholder will make a capital loss if the capital proceeds from the ending of the right are less than the reduced cost base of the right. The capital loss is equal to the amount of the difference (subsection 104-25(3) of the ITAA 1997).

59. In working out the capital gain or capital loss made when CGT event C2 happens, the capital proceeds will be the amount of the proposed return of share capital (4 cents per share) (subsection 116-20(1) of the ITAA 1997).

60. The cost base of the IPE shareholder's right to receive the proposed return of share capital is worked out under Division 110 of the ITAA 1997 (modified by Division 112 of the ITAA 1997). The cost base of the right does not include the cost base or reduced cost base of the share previously owned by an IPE shareholder that was applied in working out a capital gain or capital loss made when a CGT event happened to the share, for example when the IPE shareholder disposed of the share after the Record Date.

61. Therefore, if the entire cost base or reduced cost base of the IPE share was applied in working out a capital gain or capital loss when a CGT event happened to that share, then the right to receive the return of share capital is likely to have a cost base of nil. Therefore, the IPE shareholder will generally make a capital gain equal to the amount of the proposed return of share capital of 4 cents per share.

62. As the right to receive the payment of the proposed return of share capital was inherent in the IPE share during the time it was owned, the right is considered to have been acquired at the time when the corresponding share was acquired (section 109-5 of the ITAA 1997).

63. Accordingly, if the IPE share was acquired at least 12 months before the payment of the proposed return of share capital, a capital gain made from the ending of the corresponding right satisfies the requirements of section 115-25 of the ITAA 1997. The capital gain may be eligible to be treated as a discount capital gain under Division 115 of the ITAA 1997 provided the other conditions of Division 115 are satisfied.

64. An individual who is a foreign resident or temporary resident must meet further conditions to be eligible to treat any capital gain as a discount capital gain under Division 115 of the ITAA 1997.

### **Foreign resident shareholders**

65. Under subsection 855-10(1) of the ITAA 1997, an entity disregards a capital gain or capital loss made from a CGT event if:

- just before the CGT event happened, the entity is a foreign resident, or the trustee of a foreign trust for CGT purposes; and

- the CGT event happens in relation to a CGT asset that is not 'taxable Australian property'.

66. The term 'taxable Australian property' is defined in the table in section 855-15 of the ITAA 1997. The table sets out five categories of CGT assets:

Item 1	taxable Australian real property;
Item 2	an indirect Australian real property interest not covered by item 5;
Item 3	a CGT asset used at any time in carrying on a business through a permanent establishment in Australia and which is not covered by item 1, 2, or 5;
Item 4	an option or right to acquire a CGT asset covered by item 1, 2 or 3; and
Item 5	a CGT asset that is covered by subsection 104-165(3) (choosing to disregard a gain or loss on ceasing to be an Australian resident).

67. A foreign resident, or the trustee of a foreign resident trust for CGT purposes, cannot disregard a capital gain or capital loss made when CGT event G1 happens to their IPE share under subsection 855-10(1) if:

- their IPE share was an indirect Australian real property interest (item 2 of the table in section 855-15 of the ITAA 1997); or
- their IPE share had been used at any time by them in carrying on a business through a permanent establishment in Australia (item 3 of the table in section 855-15 of the ITAA 1997); or
- their IPE share was covered by subsection 104-165(3) of the ITAA 1997 (item 5 of the table in section 855-15 of the ITAA 1997).

68. A foreign resident, or the trustee of a foreign resident trust for CGT purposes, cannot disregard a capital gain or capital loss made when CGT event C2 happens to their right to receive the proposed return of share capital if:

- the right had been used at any time by them in carrying on a business through a permanent establishment in Australia (item 3 of the table in section 855-15 of the ITAA 1997); or
- the right was covered by subsection 104-165(3) of the ITAA 1997 (item 5 of the table in section 855-15 of the ITAA 1997).

## **Appendix 2 – Detailed contents list**

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

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## References

*Previous draft:*

Not previously issued as a draft

*Related Rulings/Determinations:*

TR 2006/10

*Subject references:*

- capital benefit
- capital gains tax
- capital reductions
- CGT event C1-C3 – end of a CGT asset
- CGT event G1-G3 – shares
- return of capital on shares
- share capital
- shareholder payments

*Legislative references:*

- ITAA 1936
- ITAA 1936 6(1)
- ITAA 1936 45A
- ITAA 1936 45A(2)
- ITAA 1936 45A(3)(b)
- ITAA 1936 45B
- ITAA 1936 45B(2)
- ITAA 1936 45B(2)(a)
- ITAA 1936 45B(2)(b)
- ITAA 1936 45B(2)(c)
- ITAA 1936 45B(3)
- ITAA 1936 45B(8)
- ITAA 1936 45C
- ITAA 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 104-165(3)
- ITAA 1997 Div 110
- ITAA 1997 Div 112
- ITAA 1997 Div 115
- ITAA 1997 115-25
- ITAA 1997 115-25(1)
- ITAA 1997 116-20(1)
- ITAA 1997 Div 197
- ITAA 1997 Div 230
- ITAA 1997 855-10
- ITAA 1997 855-10(1)
- ITAA 1997 855-15
- ITAA 1997 975-300
- ITAA 1997 977-50
- ITAA 1997 995-1
- TAA 1953
- Copyright Act 1968

## ATO references

NO:	1-5DCER2N
ISSN:	1445 2014
ATOLaw topic:	Income Tax ~~ Administration ~~ public rulings Income Tax ~~ Capital Gains Tax ~~ CGT events C1 to C3 - end of a CGT asset Income Tax ~~ Capital Gains Tax ~~ CGT events G1 to G3 – shares Income Tax ~~ Return of capital

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