TR 2005/D8 - Income tax: scrip for scrip roll-over arrangements - application of Subdivision 124-M of the Income Tax Assessment Act 1997 - Part IVA of the Income Tax Assessment Act 1936

This document has been finalised by TR 2005/19.

Draft Taxation Ruling

Income tax: scrip for scrip roll-over arrangements – application of Subdivision 124-M of the *Income Tax Assessment Act 1997* – Part IVA of the *Income Tax Assessment Act 1936*

Contents Para

Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office.*

What this Ruling is about

1. This Ruling examines certain tax avoidance schemes connected with scrip for scrip roll-over. Specifically, the Ruling examines an arrangement under which taxpayers utilise the provisions of Subdivision 124-M of Part 3-3 of the *Income Tax Assessment Act 1997* (ITAA 1997) in such a way so as to seek to obtain the benefit of a capital gain without paying capital gains tax (hereinafter referred to as a 'CGT scrip for scrip scheme').

2. This type of arrangement attempts to artificially circumvent the intended operation of Subdivision 124-M of the ITAA 1997 and attracts the application of Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936).

3. Where features of an arrangement vary from those noted in paragraph 12, the consequences for the taxpayer may nevertheless be the same. Whether this is so will depend upon a consideration of the circumstances of the particular case, for example Company B may not be immediately sold or Company C may be the intended acquirer. The relevant CGT event is the disposal of the shares in Company B by Company A to Company D, which creates the circumstance for the potential application of the provisions of Subdivision 124-M of the ITAA 1997.

Background

Scrip for scrip roll-over

4. The Explanatory Memorandum to the New Business Tax System (Capital Gains Tax) Bill 1999 states that Subdivision 124-M of the ITAA 1997 allows CGT roll-over where shareholders in companies, unitholders in unit trusts or beneficiaries of fixed trusts, exchange these membership interests for comparable interests in an acquiring entity, usually as part of a takeover.

5. The scrip for scrip roll-over provisions allow a capital gain made by the original interest holder on the disposal of an original interest to be deferred until the disposal of the replacement interests.

Where the original interest holder is a significant or common stakeholder

6. Where the original interest holder is a significant or common stakeholder, the original interest holder and the replacement entity must jointly choose for the original interest holder to obtain roll-over. In such a case the original interest holder's cost base in the replacement interest is determined by reference to the cost base of the original interest. In addition the acquiring entity's cost base in the original interest is transferred from the cost base of the original interest holder.

Where the original interest holder is not a significant or common stakeholder

7. Where the original interest holder is not a significant or common stakeholder, only the original interest holder has to choose to obtain roll-over. The original interest holder's cost base in the replacement interest is determined by reference to the cost base of the original interest. In addition, the acquiring entity's cost base in the original interest is determined by reference to the ordinary cost base rules in Divisions 110 and 112 of the ITAA 1997, the result generally being that the first element of the cost base of the original interest in the hands of the acquiring entity would be its market value.

8. Where arrangements are structured in a particular way to ensure the significant stakeholder test is not met and the original interest holder has the ability to obtain control of the acquiring entity, the capital gain deferred under the roll-over is reduced or eliminated.

Date of effect

9. It is proposed that when the final Ruling is issued, it will apply both before and after its date of issue. However, the final Ruling will 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 final Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Arrangement

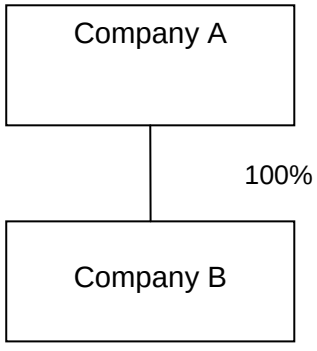
10. This Ruling applies to persons who enter into or carry out the following CGT scrip for scrip scheme, or a similar scheme.

11. A CGT scrip for scrip scheme, to which this Ruling applies, will usually exhibit some or most of the features set out below. A scheme that achieves similar economic and tax effects through the use of broadly similar techniques to those set out below may also be described as a CGT scrip for scrip scheme. The inclusion or exclusion of certain features, aspects or steps in the scheme will not affect the applicability of this Ruling.

12. The features of the scheme are:

a) Company A contemplates a disposal of some of its business assets by selling its 100% owned subsidiary, Company B, (a post CGT asset) which holds the business assets.

Diagram 1

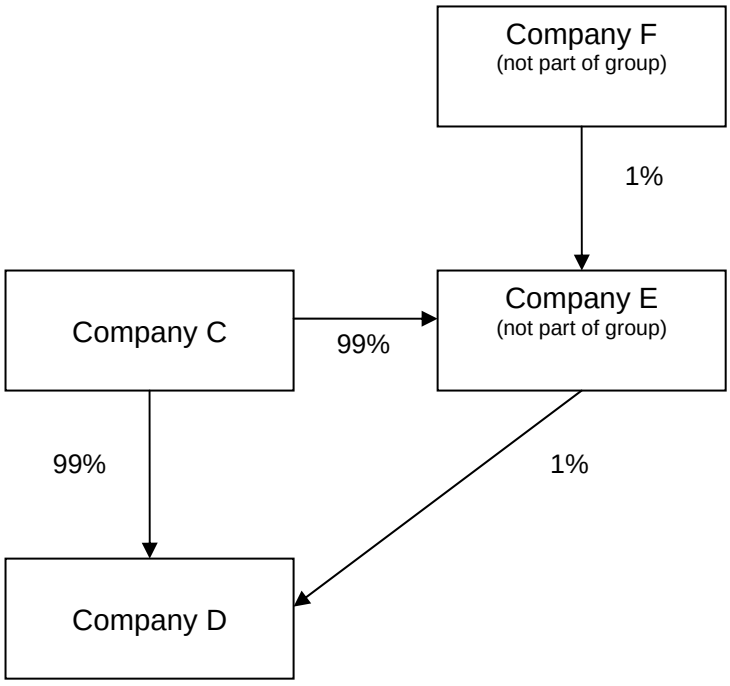


b) Company C, a widely held company (for the purposes of Subdivision 124-M of the ITAA 1997 a widely-held company is one which has at least 300 members), approaches Company A with details of an arrangement that seeks to achieve Company A's commercial aim of disposing of the shares in Company B and also seeks to achieve a disposal of the shares in a way that indefinitely defers Company A's CGT liability.

c) Company C receives a fee for facilitating the arrangement.

d) Company C incorporates two special purpose companies, Company D and Company E. Neither company is wholly-owned by Company C or widely held. Company C owns 99% of Company D and Company E owns the remaining 1%. Company C owns 99% of Company E and Company F (a third party nominee company) owns the remaining 1% of Company E.

Diagram 2



e) Company C makes a bid for Company B which results in Company A disposing of its shares in Company B in exchange for converting shares in Company D, the company nominated for the exchange by Company C, as per the terms of an Exchange Agreement.

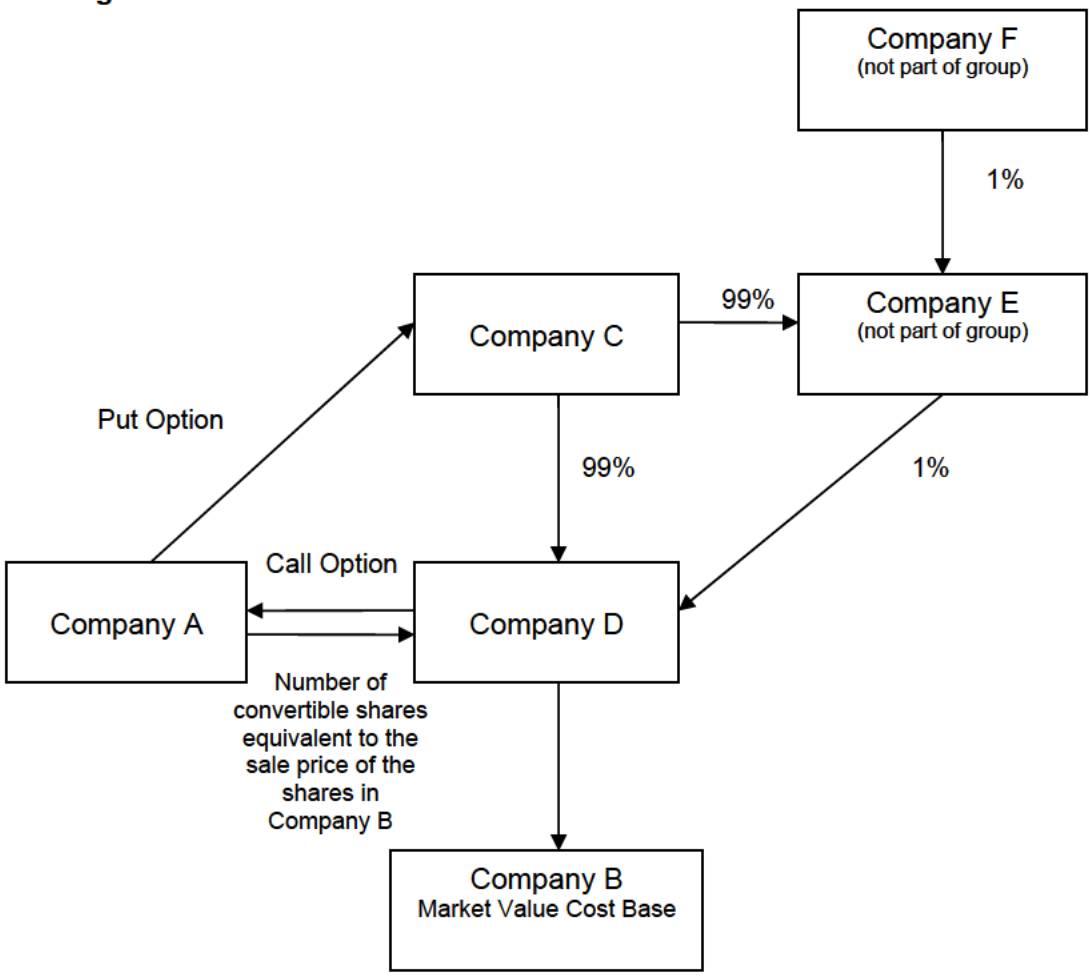
f) Company A receives a number of converting shares equivalent to the sale price of the shares in Company B (under a Converting Share Agreement). The converting shares received by Company A in Company D give an entitlement to less than 30% of the voting, dividend and capital rights in Company D, in contrast with the 100% rights in the original interest held by Company A in Company B.

g) In addition Company A receives put and call options under the terms of an Exchange Agreement.

h) The terms of the put option agreement allow Company A to exercise the put option, within a certain time, to sell its converting shares in Company D to Company C for the sale price of Company B.

i) The terms of a converting share agreement and the call option agreements allow Company A to convert its shares in Company D into shares that have the same rights as the original interest it held in the shares in Company B and to exercise the call options to acquire 100% ownership of Company D.

Diagram 3



j) Company D sells Company B to a third party.

Diagram 4

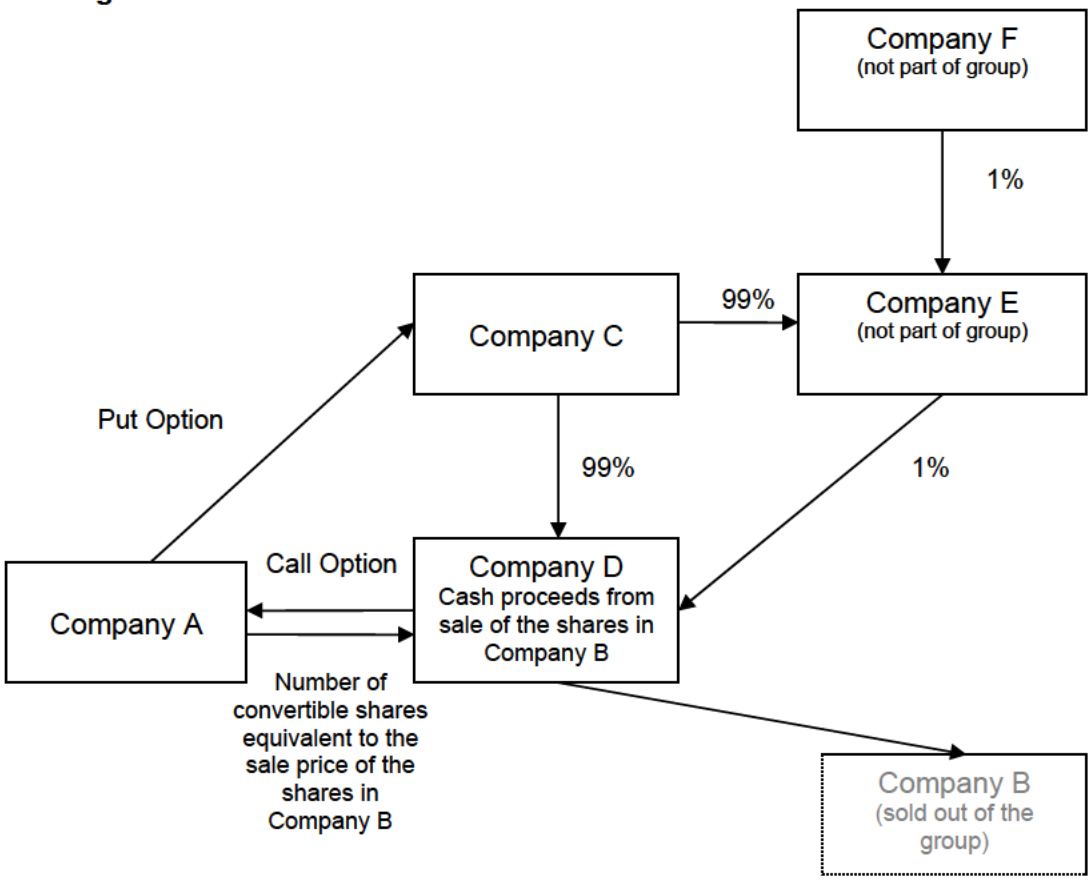
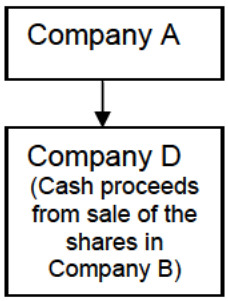


Diagram 5



Intended results of entering into the scheme

13. The intended results of entering into the scheme are:

a) Company D obtains a market value cost base for the shares in Company B;

b) when Company D sells the shares in Company B for market value it does not make a capital gain;

c) Company A and Company D do not need to jointly choose for Company A to obtain scrip for scrip roll-over as the significant stakeholder test has not been satisfied. Accordingly Company A does not have to transfer its cost base in Company B to Company D;

d) Company A's cost base in the replacement interest remains the same as the cost base in its original interest;

e) when Company A converts the convertible shares and exercises the call options it obtains control of Company D. Company D's assets consist of the cash proceeds from the subsequent on-sale of Company B. These funds are available to Company A without the need to dispose of the shares in Company D;

f) Company A choses roll-over under Subdivision 124-M of the ITAA 1997; and

g) Company A thereby seeks to indefinitely defer the capital gain on the disposal of its original interest.

Ruling

Subdivision 124-M of the ITAA 1997

14. Company A is not entitled to roll-over under Subdivision 124-M of the ITAA 1997 as the arrangement outlined in paragraph 12 does not satisfy all of the following requirements:

Requirement	Section Reference (ITAA 1997)	Satisfied?
1. There is an exchange of a share in a company for a share in another company.	124-780(1)(a)(i)	Yes
2. The exchange of shares is in consequence of a single arrangement that satisfied subsection 124-780(2).	124-780(1)(b)	Yes
3. The arrangement results in the acquiring entity becoming the owners of 80% or more of the voting shares in the original entity.	124-780(2)(a)(ii)	Yes

4. The arrangement is one in which at least all of the owners of voting shares in the original entity could participate.	124-780(2)(b)	Yes
5. The arrangement is one in which participation was available on substantially the same terms for all of the owners of interests of a particular type in the original entity.	124-780(2)(c)	Yes
6. The conditions in paragraph 124-780(3) are satisfied.	124-780(1)(c)	Yes
7. Shares in the original entity were acquired by the original interest holder on or after 20 September 1985.	124-780(3)(a)	Yes
8. Apart from roll-over, the original interest holder would have made a capital gain from a CGT event happening in relation to its shares in the original entity.	124-780(3)(b)	Yes
9. The replacement interest acquired by the original interest holder is a share in the acquiring entity or the ultimate holding company.	124-780(3)(c)(ii)	Yes
10. The original interest holder has chosen roll-over (where section 124-782 does not apply).	124-780(3)(d)	Yes
11. The original interest holder is not a significant or common stakeholder for the arrangement.	124-782(1)(b)	Yes
12. Does subsection 124-780(4) apply?	124-780(1)(d)	Yes
13. Have the parties dealt with each other at arm's length?	124-780(4)	No
14. Neither the original entity nor the replacement entity had at least 300 members just before the arrangement started.	124-780(4)(a)	Yes
15. Have the conditions in subsection 124-780(5) been satisfied?	124-780(1)(d)	No
16. The market value of the original interest holder's capital proceeds for the exchange is substantially the same as the market value of its original interest.	124-780(5)(a)	Yes
17. The replacement interest carries the same kind of rights and obligations as those attached to the original interest.	124-780(5)(b)	No

18. The capital proceeds received for the original interest do not include ineligible proceeds?	124-790	No
19. None of the exceptions in subsection 124-795 would apply.	124-795	Yes

15. As requirements 13, 15 and 17 are not satisfied, Company A is not entitled to roll-over. The fact that the capital proceeds received by Company A include ineligible proceeds means that partial roll-over would be available if requirements 13, 15 and 17 were satisfied.[1]

16. In particular as the original interest holder and the acquiring entity did not deal with each other at arm's length in relation to the exchange of shares, the arm's length test is not satisfied. Accordingly the requirements of subsection 124-780(5) of the ITAA 1997 must be satisfied. As the replacement interests in Company D do not carry the same kind of rights and obligations as those attached to Company A's original interest in Company B paragraph 124-780(5)(b) is not satisfied.

17. Accordingly roll-over under Subdivision 124-M of the ITAA 1997 is not available to Company A in regards to the disposal of its shares in Company B.

Part IVA of the ITAA 1936

18. On the assumption that Subdivision 124-M of the ITAA 1997 would operate to allow a roll-over Part IVA of the ITAA 1936 will apply to include the capital gain in Company A's assessable income.

Scheme

19. The scheme described in paragraph 12 involves the exchange of shares in Company B for shares in Company D and options in a way that enables Company A to choose scrip for scrip roll-over under Subdivision 124-M of the ITAA 1997 and indefinitely defer the capital gain it makes on the disposal of the shares in Company B.[2]

20. The arrangement is structured in such a way to create the circumstance for Company A to make a choice that scrip for scrip roll-over applies in relation to the disposal of its shares in Company B.

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[1] In the event that scrip for scrip roll-over was available to Company A the receipt of shares and options by Company A as replacement interests in Company D would not qualify for full roll-over under Subdivision 124-M of the ITAA 1997 as the receipt of options constitutes ineligible proceeds. Accordingly, under section 124-790 of the ITAA 1997, scrip for scrip roll-over would be limited to the replacement shares in Company D only.

[2] The scheme could also be posited more narrowly in which case different alternative hypotheses will apply. Depending on the facts, Part IVA of the ITAA 1936 will still apply to disallow the tax benefit.

21. The features of the scheme include the:

- incorporation of the special purpose companies, Company D and Company E, by Company C;
- creation of different rights attached to the replacement interests received by Company A in Company D including Company A's entitlement to less than 30% of the voting, dividend and capital rights;
- entry into a separate call option and put option agreements; and
- conversion of the shares and the exercise of the call options by Company A.

Tax benefit

22. The amount of the tax benefit of the scheme identified in paragraph 12 is the difference between the assessable income returned by Company A from its disposal of Company B under the scheme and the assessable income that would reasonably have been expected to have been included in Company A's assessable income if the scheme had not been entered into and there had been a direct sale of Company B with no roll-over under Subdivision 124-M of the ITAA 1997.

Dominant purpose

23. Part IVA of the ITAA 1936 applies to the scheme as it would be concluded, having regard to the eight factors, that Company A entered into or carried out the scheme for the dominant purpose of obtaining a tax benefit as identified in paragraph 22 in connection with the scheme.

24. In particular, the manner, substance, result and change in financial position point to Part IVA of the ITAA 1936 applying.

Explanation

Subdivision 124-M of the ITAA 1997

25. The preconditions for the application of scrip for scrip roll-over under Subdivision 124-M of the ITAA 1997 are as follows:

A. Exchange of shares

26. Roll-over is available if an entity (Company A) exchanges a share in a company (Company B) for a share in another company (Company D); subparagraph 124-780(1)(a)(i) of the ITAA 1997.

27. Paragraph 2.27 in the Explanatory Memorandum to the New Business Tax System (Capital Gains Tax) Bill 1999, states:

> Roll-over will not be available if a share is exchanged for a unit or other interest in a fixed trust or a unit or other interest in a fixed trust is exchanged for a share. Other situations in which roll-over will not be available include the exchange of a convertible note for a share, or a share for a convertible note, an option for a share or a share for an option.

28. The exchange of the shares in Company B from Company A to Company C satisfies this requirement as shares in Company B were exchanged for shares in Company D, which is an interest of the same kind for the purposes of subparagraph 124-780(1)(a)(i) of the ITAA 1997.

29. However, to the extent that Company A exchanged shares for shares and options, Company A is not entitled to claim scrip for scrip roll-over in respect of the capital proceeds relating to the options. Company A, in addition to receiving shares in Company D, received call options and a put option. The call options were in respect of the remaining shares in Company D not already owned by Company A and the put option was in respect of the shares Company A acquired in Company D. Options, like cash, are ineligible proceeds under section 124-790 of the ITAA 1997. Scrip for scrip roll-over cannot be obtained for that part of the proceeds.

B. Exchange is in consequence of a single arrangement

30. Paragraph 124-780(1)(b) and subsection 124-780(2) of the ITAA 1997 require that the shares are exchanged 'in consequence of a single arrangement' that:

- results in the acquiring entity (Company D) becoming the owner of at least 80% of the voting shares in the original entity (Company B);
- is one in which all of the owners of voting shares in Company B are able to participate; and
- is one in which participation is available on substantially the same terms for all interest holders of a particular type.

31. The term 'arrangement' is defined in subsection 995-1(1) of the ITAA 1997 as follows:

> arrangement means any arrangement, agreement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable (or intended to be enforceable) by legal proceedings.

32. While the term 'arrangement' is defined very broadly, there is no definition of the term 'single arrangement'. Paragraph 11.23 of the Explanatory Memorandum to the New Business Tax System (Miscellaneous) Bill (No. 2) 2000 details a number of factors that may assist in determining what constitutes a single arrangement:

> What constitutes a single arrangement is a question of fact. Relevant factors in determining whether what takes place is part of a single arrangement would include, but not be limited to, whether there is more than one offer or transaction, whether aspects of an overall transaction occur contemporaneously, and the intention of the parties in all the circumstances as evidenced by objective facts.

33. The acquiring entity must acquire the shares 'in consequence' of a single arrangement. An exchange of shares occurs in consequence of a single arrangement if it occurs 'as a result of' the single arrangement; *Reseck v. Federal Commissioner of Taxation* 75 ATC 4213; (1975) 5 ATR 538.

34. Under the single arrangement, 100% of the shares held by Company A are, at a point in time and pursuant to a contractual arrangement (comprised of an integrated series of transaction documents), exchanged for a certain number of shares in Company D in satisfaction of the requirement in paragraph 124-780(1)(b) of the ITAA 1997.

C. Acquiring entity becoming the owner of 80% or more of the voting rights in the original entity

35. The requirements under subparagraph 124-780(2)(a)(ii) of the ITAA 1997 are satisfied as Company B has only one class of shares on issue and on completion of the arrangement Company D acquires 100% of the shares in Company B.

D. All of the owners of voting shares in the original entity are eligible to participate in the arrangement

36. The arrangement is one in which at least all of the original owners of voting shares in Company B could participate because Company A is the only 'original' shareholder in Company B and all the shares are disposed of by Company A in satisfaction of paragraph 124-780(2)(b) of the ITAA 1997.

E. Participation available on substantially the same terms

37. As Company A is the only shareholder of Company B participation in the arrangement is available to all of the owners on substantially the same terms as required under paragraph 124-780(2)(c) of the ITAA 1997.

F. Original interest acquired by the original interest holder on or after 20 September 1985

38. Scrip for scrip roll-over is not available for interests in a company that were acquired prior to 20 September 1985 (paragraph 124-780(3)(a) of the ITAA 1997).

39. Company A acquired its shares in Company B after 20 September 1985. Accordingly the requirement in paragraph 124-780(3)(a) of the ITAA 1997 has been satisfied.

G. Apart from roll-over a capital gain would have been made by the original interest holder on a CGT event happening to its original interest

40. Scrip for scrip roll-over is only available for interests that, apart from the roll-over, would have given rise to a capital gain on a CGT event happening in relation to them (paragraph 124-780(3)(b) of the ITAA 1997).

41. Apart from roll-over Company A would have made a capital gain on the sale of its interest in Company B.

H. The replacement interest acquired by the original interest holder is a share in the acquiring entity or an ultimate holding company

42. Paragraph 124-780(3)(c) of the ITAA 1997 requires that shareholders seeking scrip for scrip roll-over must receive replacement interests in the acquiring entity or its ultimate holding company. As Company D is a member of a wholly-owned group as defined in section 975-500 of the ITAA 1997 the replacement interest must be in the ultimate holding company of the wholly-owned group (subparagraph 124-780(3)(c)(ii) of the ITAA 1997).

43. Subsection 124-780(7) of the ITAA 1997 defines ultimate holding company as follows:

> A company is the ***ultimate holding company*** of a wholly-owned group if it is not a 100% subsidiary of another company in the group.

44. This requirement is satisfied because all replacement interests received by Company A are in Company D which is the ultimate holding company of Company B. Company D is not a 100% subsidiary of Company C because 1% of Company D is owned by a company that is currently outside the wholly owned group (special purpose company, Company E).

45. If Company C owned 100% of Company D, the exchange of shares must occur in Company C, a widely held company, in order to satisfy subparagraph 124-780(3)(c)(ii) of the ITAA 1997.

I. The original interest holder must choose scrip for scrip roll-over

46. Paragraph 124-780(3)(d) of the ITAA 1997 provides that the original interest holder must choose to obtain scrip for scrip roll-over or, if section 124-782 of the ITAA 1997 applies to it for the arrangement, it and the replacement entity must jointly choose to obtain the roll-over.

47. Company A chooses roll-over in respect of this transaction by excluding the amount of the capital gain that would otherwise have been required to be included in its assessable income in respect of the proceeds of the exchange for that year of income.

48. Under subsection 103-25(2) of the ITAA 1997 the way an income tax return is prepared is sufficient evidence of the choice made. Accordingly, when Company A lodges its tax return and excludes the capital gain, paragraph 124-780(3)(a) of the ITAA 1997 has been satisfied.

J. Significant stakeholder or common stakeholder for the arrangement within the meaning of section 124-783 of the ITAA 1997

49. Paragraph 124-780(3)(d) of the ITAA 1997 provides that, if section 124-782 applies to the original interest holder, scrip for scrip roll-over is available only if the original interest holder that is a *significant* or *common stakeholder* and the replacement entity jointly choose to obtain the roll-over.

50. Section 124-782 of the ITAA 1997 provides special rules that apply for the purposes of scrip for scrip roll-over if an original interest holder is a significant stakeholder or a common stakeholder for an arrangement. An original interest holder is a significant stakeholder for an arrangement if it had a significant stake in the original entity before the arrangement started and a significant stake in the replacement entity after the arrangement was completed: subsection 124-783(1) of the ITAA 1997. In addition, if the acquiring entity for an arrangement is an original interest holder in the original entity before the arrangement, its associates may be significant stakeholders: subsection 124-783(2).

51. An entity will have a significant stake in a company if the entity or the entity's associates between them have shares carrying 30% or more of the voting rights, dividend rights or rights to distribution of capital in the company; subsection 124-783(6) of the ITAA 1997.

52. Before the arrangement was entered into, Company A owned 100% of the shares in Company B (original entity). After the sale Company A holds an interest in Company D (the replacement entity) that entitles it to:

- less than 30% of the voting rights;
- less than 30% of the rights to capital; and
- less than 30% entitlement to dividends.

53. Whilst Company A had a significant stake in the original entity it does not have a significant stake in the replacement entity after the arrangement is completed. Therefore, Company A is not a significant stakeholder.

54. An original interest holder is a common stakeholder for an arrangement if it had a common stake in the original entity just before the arrangement started and a common stake in the replacement entity just after the arrangement was completed; subsection 124-783(3) of the ITAA 1997. A common stake is defined in subsection 124-783(9) of the ITAA 1997 as 80% or more of the voting, dividend and capital rights in both the original entity and the replacement entity.

55. The common stakeholder test does not apply to Company A as, whilst it had a common stake in the original entity (Company B) it does not have a common stake in the replacement entity (Company D). Therefore, Company A is not a common stakeholder.

56. The result of Company A not being either a significant or common stakeholder is that Company D is entitled to a cost base equal to the market value for the original interest in Company B, as opposed to a transfer from Company A of the original interest's cost base. In addition there is no requirement for Company A and Company D to jointly choose for Company A to obtain scrip for scrip roll-over. Had Company A been a significant stakeholder, roll-over would only have been available if Company D had agreed to accept a transfer of the original cost base of the interests in Company B.

K. The original interest holder and the acquiring entity must deal with each other at arm's length

57. Subsection 124-780(4) of the ITAA 1997 provides that further conditions need to be satisfied if the original interest holder, Company A, and the acquiring entity, Company D, did not deal with each other at arm's length in relation to the exchange of shares and neither the original entity or the replacement entity had at least 300 members or the original interest holder, original entity and the acquiring entity were all members of the same linked group.

58. The additional requirements are set out in subsection 124-780(5) of the ITAA 1997. As Company B and Company D do not have at least 300 members before the arrangement started, if the parties are not dealing at arm's length subsection 124-780(5) will apply.

59. The question whether the parties are dealing with each other at arm's length is not decided by asking whether the parties were at arm's length to each other. Subsection 995-1(1) of the ITAA 1997 provides:

> ***arm's length***: in determining whether parties deal at ***arm's length***, consider any connection between them and any other relevant circumstance.

60. The fact that there is no ownership connection between the parties is not determinative, on its own, of whether the parties deal with each other at arm's length. The question is whether the parties *dealt* with each other at arm's length; *The Trustee for the Estate of the late AW Furse No. 5 Will Trust v. FC of T* 91 ATC 4007 at 4014-4015; (1990) 21 ATR 1123 at 1132 . This will be determined by considering the terms of the dealing and any other relevant consideration (as outlined in paragraphs 65 to 71).

61. In *Granby Pty Ltd v. FC of T* 95 ATC 4240 at 4243; (1995) 30 ATR 400 at 403 Lee J. stated that the provision 'dealing with each other at arm's length' invited an analysis of the manner in which the parties conduct themselves in forming the transaction. The question is whether the parties behaved in the manner in which parties at arm's length would be expected to behave in conducting their affairs and the expression means, at least, that the parties have acted severally and independently in forming their bargain.

62. Further, Lee J. stated (at ATC 4244; ATR 403-404) that where the parties are unrelated it will usually follow that they deal at arm's length. However this will not be the case where the parties collude to achieve a particular result, or where one of the parties submits the exercise of its will to the discretion of the other.

63. In *Collis v. FC of T* 96 ATC 4831; (1996) 33 ATR 438 ('Collis') the Federal Court found that the parties were not dealing at arm's length because one party was indifferent to the allocation of the sale price for the parcel of land. This indifference was indicative of a submission of one party's will to the other party's wishes which demonstrated a lack of arm's length dealing.

64. The way in which the arrangement was structured and implemented evidences that the parties did not behave in the manner in which arm's length parties would be expected to behave, that is, the original interest holder (Company A) and the acquiring entity (Company D, special purpose company of Company C) did not act severally and independently in conducting and implementing the single arrangement.

65. As Company D was controlled by Company C during the negotiation and implementation of the arrangement it had no bargaining power or ability to act independently from Company C in relation to its discussions with Company A. Therefore, the relevant dealing for determining arm's length concerns Company A and Company C. Specifically, Company A and Company D (through Company C) colluded to achieve a particular result as evidenced by the features of the arrangement set out in paragraph 12. Company C approached Company A with an arrangement which met Company A's commercial intentions, that is, the disposal of the shares in Company B. Company C implemented the structure required, for example, the incorporation of the special purpose companies, Company D and Company E.

66. The integrated nature and terms of the converting shares and the call and put options further support a conclusion that the parties did not act at arm's length. The terms of the converting shares and the disproportionate entitlement to dividend, voting and capital rights attached to the shares received by Company A when measured against the total number of shares received by Company A also evidences non arm's length dealing between the relevant parties.

67. When Company A exchanges shares in Company B with full rights to voting, dividend and capital for shares with limited voting, dividend and capital rights (below 30%) the result is that Company A fails the significant stakeholder test. Accordingly, Company A entered into an arrangement whereby it received a different replacement interest with a lesser value than its original interest. The exchange of shares did not occur at arm's length because the value of the shares exchanged is disparate to the value of the original interest. Company A agreed to accept the lesser value for its interest in the shares because the call and put options provided another benefit which does not form part of the exchange.

68. Further, the practical outcome of the arrangement is that Company A has the ability to acquire 100% ownership and control of Company D, a factor which meant it would have passed the significant stakeholder test if the replacement interest converting shares had contained their full rights immediately after the exchange. The manipulation and creation of different replacement interests in Company D to deliberately ensure Company A fails the significant stakeholder test evidences collusion between Company A, Company C and Company D and taints the nature and integrity of this part of the dealing.

69. The converting shares, call and put options ensure that both parties never carry a commercial risk that would be expected of an arm's length vendor and purchaser. The effect of the converting shares when combined with either the call or put options is to effectively give Company A the choice of converting its shares and exercising the call options to acquire 100% of Company D (and effectively re-acquire their original interest); or to exercise the put option to sell its shares in Company D for the purchase price.

70. As the original interest holder and the acquiring entity did not deal at arm's length the requirement in subsection 124-780(4) has not been satisfied.

L. Further roll-over conditions must be met if not dealing at arm's length

71. Further as neither the original entity nor the replacement entity had at least 300 members just before the arrangement (paragraph 124-780(4)(a) of the ITAA 1997) the conditions specified in subsection 124-780(5) of the ITAA 1997 must be met. The conditions are:

(a) the market value of the original interest holder's capital proceeds for the exchange is at least substantially the same as the market value of its original interest; and

(b) its replacement interest carries the same kind of rights and obligations as those attached to its original interest.

72. The options received by Company A as part of the capital proceeds for the original interest in Company B do not constitute replacement interests under subparagraph 124-780(1)(a)(i) of the ITAA 1997 and are accordingly additional to the replacement interests referred to in paragraph 124-780(5)(b) of the ITAA 1997. These replacement interests cannot be considered when evaluating whether the replacement interests carry the same kind of rights and obligations.

73. It is a question of fact whether the market value of the original interest holder's capital proceeds are substantially the same as the market value of its original interest. In the facts of the arrangement outlined in paragraph 12, Company A received market value capital proceeds for the exchange which are at least substantially the same as the market value of its original interests. Accordingly, the requirement in paragraph 124-780(5)(a) has been satisfied in this case.

74. Company A does not meet the requirement in paragraph 124-780(5)(b) of the ITAA 1997 as the replacement share in Company D does not carry the same kinds of rights and obligations as those attached to each original share in Company B. Company A received convertible shares in Company D with limited rights to voting, dividends and capital in exchange for its ordinary shares in Company B. Specifically the shares held by Company A in Company B before the sale had a full entitlement to the right to vote, the right to dividends and the right to receive capital on winding up. The focus of the test in paragraph 124-780(5)(b) is on the rights attaching to the shares.

75. As the original and replacement shares did not carry the same kinds of rights and obligations as required, paragraph 124-780(5)(b) of the ITAA 1997 has not been satisfied and roll-over under Subdivision 124-M of the ITAA 1997 is not available to Company A.

M. Partial roll-over where ineligible proceeds received

76. Subsection 124-790(1) of the ITAA 1997 states that:

> The original interest holder can obtain only partial roll-over if its *capital proceeds for its original interest includes something (the ***ineligible proceeds***) other than its replacement interest. There is no roll-over for that part (the ***ineligible part***) of its original interest for which it received ineligible proceeds.

77. Ineligible proceeds include, but are not limited to, cash. Where shares are exchanged for shares, options and cash the capital proceeds received in respect of cash and options constitute ineligible proceeds. As Company A received shares and options upon the exchange of its shares in Company B, Company A will only be entitled to partial roll-over (subject to the satisfaction of the conditions in Subdivision 124-M of the ITAA 1997) in relation to the shares. There is no roll-over for the part of the capital proceeds for its original interest for which Company A received ineligible proceeds.

N. Exceptions

78. None of the exceptions in section 124-795 of the ITAA 1997 are applicable.

Part IVA of the ITAA 1936

79. Part IVA of the ITAA 1936 applies to an arrangement where the following elements exist:

(a) there is a scheme as defined in subsection 177A(1) of the ITAA 1936;

(b) there is a tax benefit as defined in subsection 177C(1) of the ITAA 1936 obtained by a taxpayer in connection with a scheme;

(c) it would be concluded having regard to the eight matters listed in paragraph 177D(b) of the ITAA 1936 that a person who entered into or carried out the scheme did so for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme; and

(d) the Commissioner makes a determination under section 177F of the ITAA 1936 to cancel the relevant tax benefit.

80. Subsection 177F(1) of the ITAA 1936 provides that where a tax benefit has been obtained by a taxpayer in connection with a scheme to which this Part applies, the Commissioner may determine that the whole or part of that amount shall be included in the assessable income of the taxpayer and take such action as he considers necessary to give effect to that determination.

Scheme

81. The identified scheme must be a 'scheme' as defined in subsection 177A(1) of the ITAA 1936 to mean: '(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and (b) any scheme, plan, proposal, course of action or course of conduct.' The definition includes a reference to a unilateral scheme, plan, proposal, action, course of action or course of conduct (*Federal Commissioner of Taxation v. Hart* [2004] HCA 26 at paragraph [43]; (2004) ATC 4599 at 4610; 55 ATR 712 at 724; ('Hart')).

82. The High Court in *Hart* confirmed that the definition of scheme is very broad. Gleeson CJ. and McHugh J. stated at paragraph [43] (at ATC 4610; ATR 724)) that:

> It encompasses not only a series of steps which together can be said to constitute a 'scheme' or a 'plan' but also (by its reference to 'action' in the singular) the taking of but one step. The very breadth of the definition of 'scheme' is consistent with the objective nature of the inquiries that are to be made under Part IVA…

83. However as Gleeson CJ and McHugh J point out at paragraph [9] (at ATC 4603; ATR 717):

> …In a given case, a wider or narrower approach may be taken to the identification of a scheme, but it cannot be an approach which divorces the scheme from the tax benefit.

84. The arrangement whereby Company A exchanged the shares in Company B for shares in Company D and put and call options including the transactions outlined in paragraph 12 are a series of steps which taken together can be said to constitute a scheme. The scheme created the circumstances to allow Company A to make a choice to obtain scrip for scrip roll-over.[3]

[3] Whilst the arrangement identified at paragraph 12 is a broad scheme, an alternative scheme can be argued to be the structuring of the specific rights attached to the replacement interests such that Company A received less than 30% of the rights attaching to those shares in a manner which allowed Company A to make a choice for roll-over, that is, a narrow scheme. Whilst the commercial purpose of the arrangement was to dispose of Company A's interest in Company B the structuring of the rights attached to the replacement interest produced the tax benefit.

Tax benefit

85. Part IVA of the ITAA 1936 cannot apply unless the taxpayer has obtained, or would, but for the operation of section 177F of the ITAA 1936 obtain, a tax benefit in connection with a scheme. The conclusion as to dominant purpose must be made by reference to the particular scheme and the tax benefit that relates to that scheme. Subsection 177C(1) of the ITAA 1936 defines a 'tax benefit' as an amount not included in income in that year which would have been or might reasonably be expected to have been included but for the scheme.

86. In determining whether there was a tax benefit to Company A obtained from entering into the scheme it is necessary to consider what might reasonably have been expected to have happened had the scheme not been entered into or carried out. That requires the making on reasonable grounds of what may be termed 'the alternative postulate'; *Hart* per Gummow and Hayne JJ. at paragraph [66] (at ATC 4614; ATR 730).

87. The reasonable alternative hypotheses are that, 'but for' the scheme, the following could have taken place:

a) Company A could have sold the shares in Company B for cash. In this scenario Company A would have made a capital gain that it would have been required to return in its assessable income in the relevant year;

b) Company A could have exchanged its shares in Company B for shares in a widely held company in which it was not a significant stakeholder. In this scenario the acquiring entity would have received a market value cost base for the original interest it acquired. Company A would have received a cost base for its replacement interest equal to the cost base of its original interest. Company A would then make a capital gain when it sells its replacement interest; or

c) Company A could have exchanged its shares in Company B for shares in a company in which it was a significant stakeholder. In this scenario the acquiring entity and the original interest holder would have had to jointly agree for Company A to obtain roll-over. In addition the acquiring entity would have to accept a cost base transfer from the original interest as the cost base for its acquired interest. Company A would receive a cost base for its replacement interest equal to the cost base of its original interest. Company A would make a capital gain when it sells its replacement interests that it would be required to return in its assessable income in the year of disposal.

88. Subsection 177C(2) of the ITAA 1936 states that a reference to a taxpayer obtaining a tax benefit in connection with a scheme shall be read as not including a reference to:

(a) the assessable income of the taxpayer of a year of income not including an amount that would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer if the scheme had not been entered into or carried out where:

(i) the non-inclusion of the amount in the assessable income of the taxpayer is attributable to the making of an agreement, choice, declaration, election or selection, the giving of notice or the exercise of an option (expressly provided for by this Act)…; and

(ii) the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or affairs the existence of which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised as the case may be.

89. Prima facie, the tax benefit appears to be excluded by subparagraph 177C(2)(a)(i) of the ITAA 1936 in that the non-inclusion of an amount in assessable income cannot be a tax benefit where its non-inclusion is attributable to the making of a choice by the taxpayer which is available to it under the ITAA 1997 and/or the ITAA 1936.

90. However subparagraph 177C(2)(a)(ii) of the ITAA 1936 also applies. The scheme was structured in this way for the dominant purpose (subjective or objective) of creating the circumstances for Company A to be able to choose to obtain roll-over under Subdivision 124-M of the ITAA 1997 in regards to the disposal of its shares in Company B, within the meaning contemplated in subparagraph 177C(2)(a)(ii). Accordingly, whilst the tax benefit arises out of the making of a choice by Company A within the meaning of subparagraph 177C(2)(a)(i) of the ITAA 1997, the circumstances leading up to the availability of that choice were created by the entry of Company A into the scheme.

91. Accordingly, the tax benefit is the difference between the assessable income returned by Company A from its disposal of the shares in Company B under the scheme and the assessable income that would have had to have been returned by Company A under any of the alternative hypotheses listed above, that is, if the scheme had not been entered into. By entering into the scheme Company A has sought to indefinitely defer any gain on the disposal of its asset, the shares in Company B.

Dominant purpose

92. Paragraph 177D(b) of the ITAA 1936 lists eight criteria by which the 'purpose' of a transaction can be determined. Part IVA of the ITAA 1936 applies to a scheme where, having regard to the eight factors, it would be concluded that the taxpayer entered into or carried out the scheme for the purpose of enabling the taxpayer to obtain a tax benefit in connection with the scheme. Section 177D of the ITAA 1936 is not concerned with the subjective intention of the taxpayer in entering the scheme; rather it is focused on whether the evidence elicited in respect of the eight criteria leads to the objective conclusion that the taxpayer entered the scheme with the requisite purpose; *Hart* per Gummow and Hayne JJ. at paragraph [37] (at ATC 4607-4608; ATR 722-723).

93. In *Hart*, per Gummow and Hayne JJ. at paragraph [70] (at ATC 4614; ATR 731) stated:

> …it would be wrong to treat any conclusion drawn from the first of the eight matters mentioned in s.177D(b) as determinative. All eight factors must be considered.

94. Ultimately, what needs to be considered is whether, having regard to the eight factors in paragraph 177D(b) of the ITAA 1936 it would be concluded that the dominant purpose of some person who entered into or carried out the scheme with its particular features was the obtaining of a tax benefit or whether it would be concluded that the dominant purpose of all persons who entered into or carried out the scheme with those particular features was something else.

95. The arrangement in paragraph 12 depends for its efficacy on the structuring of the rights attached to the replacement interest so that Company A fails the significant stakeholder test. Having regard to the factors above features a reasonable person, would draw the conclusion that the sole or dominant purpose in entering into the scheme was to obtain a tax benefit.

Factors in paragraph 177D(b)

(i) The manner in which the scheme was entered into or carried out

96. The way in which the scheme was entered into was:

a) Company C made a formal bid for Company B.

b) Prior to entering into the agreement to purchase Company B, two special purpose companies are incorporated by Company C.

c) Company A and Company C enter into an Exchange Agreement and a Converting Share Agreement. All of the issued shares in Company B are transferred from Company A to Company D.

d) Company C and Company E grant call options to Company A in respect of the converting shares issued in Company D. The call option agreements (together with the converting shares) entitle Company A to convert its converting shares in Company D and exercise the call options to acquire 100% ownership of Company D.

e) Company A also enters into a Put Option agreement with Company C which grants to Company A the right to put a Put Exercise Notice to Company C (or an associate of Company C) to require Company C (or an associate of Company C) to purchase the converting shares.

f) Company A receives converting shares issued to the sale price of Company B under the arrangement. The terms of the converting shares entitle Company A to less than 30% of the rights in Company D.

g) The combination of the converting shares and the call options means that Company A could acquire 100% control of Company D, which held the shares in Company B. In this scenario Company A is able to effectively take back control of the asset it has purportedly disposed of.

97. The way in which the scheme was structured and implemented created the circumstances to enable Company A to make a choice to obtain roll-over. The structuring of the terms of the converting shares resulted in the roll-over provisions in Subdivision 124-M of the ITAA 1997 being utilised in a manner that indefinitely deferred the capital gain. This points to Part IVA of the ITAA 1936 applying because the disposal of the shares in Company B would not have been undertaken in this way except for the tax benefit.

(ii) The form and substance of the scheme

98. The form of the scheme was the exchange of the shares in Company B for shares in Company D and options, the exercising by Company A of the call options and the choice by Company A to obtain scrip for scrip roll-over.

99. The substance of the scheme is the sale of shares in Company B for cash to an ultimate purchaser.

100. Further, under the form of the scheme Company A is not a significant stakeholder. However, in substance, Company A is a significant stakeholder due to the existence of the call options.

101. The difference between the form and the substance of the scheme points to Part IVA of the ITAA 1936 applying.

(iii) The time at which the scheme was entered into and the length of the period during which the scheme was carried out

102. The scheme is entered into at a time when Company A decides to dispose of its shares in Company B.

103. This factor on its own, is neutral as to the application of Part IVA of the ITAA 1936.

(iv) The result in relation to the operation of the ITAA 1936 or the ITAA 1997 that, but for Part IVA, would be achieved by the scheme

104. Under the scheme Company D obtains the benefit of a market value cost base for its interest in Company B, rather than a cost base transfer of the original interest holder's cost base in Company B which would have occurred under an alternative hypothesis.

105. The result for Company A is that although Company A has disposed of its shares in Company B, the capital gain on that disposal has been indefinitely deferred.

106. The result achieved points to Part IVA of the ITAA 1936 applying.

(v) Any change in the financial position of the relevant taxpayer that has resulted, or will result, or may reasonably be expected to result, from the scheme

107. Company A disposed of an asset and in exchange received shares in Company D. Company A obtains 100% ownership of Company D through the use of the call options which enable Company A to buy out the remaining 100 shares in Company D. The combination of the converting shares and the call options allows Company A to indefinitely defer the capital gain on the disposal of its original interest.

108. Accordingly Company A's financial position has improved by gaining control of Company D and its assets by the difference between the amount Company A did return in assessable income under the scheme and the amount that Company A would reasonably have been expected to return had the scheme not been entered into.

109. The change in financial position of Company A points to Part IVA of the ITAA 1936 applying.

(vi) Any change in the financial position of any person who has, or has had any connection with the relevant taxpayer, being a change that has resulted, or will result, or may reasonably be expected to result, from the scheme

110. As a result of the scheme Company C receives a fee.

111. As a result of the scheme Company D's financial position improves as it obtains the cash proceeds from the on-sale of Company B.

112. The change in the financial position of the entities which have a connection with Company A points to Part IVA of the ITAA 1936 applying.

(vii) Any other consequence for the relevant taxpayer or for any person referred to in (vi) of the scheme being entered into or carried out

113. The inclusion of the converting shares and the put and call option agreements enables Company A to enter into the transaction for little or no commercial downside risk, whilst obtaining a significant tax benefit. The combination of the converting shares and the exercise of the call options enables Company A to gain control of Company D.

114. This factor supports a conclusion that Part IVA of the ITAA 1936 applies.

(viii) The nature of any connection between the relevant taxpayer and any person referred to in (vi)

115. The only connection between Company A and Company C was that created through the approach by Company C to Company A with details of the proposal and Company A's agreement to pay the fee to facilitate the agreement.

116. This factor is either neutral or points to Part IVA of the ITAA 1936 applying if the fee paid by Company A was based on the tax benefit sought to be obtained.

Your comments

117. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date.

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Detailed contents list

118. Below is a detailed contents list for this draft Taxation Ruling:

Commissioner of Taxation
11 May 2005

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 92/1; TR 92/20; TR 97/16

Subject references:

- CGT roll-over
- scrip for scrip roll-over
- tax avoidance
- tax benefits under tax avoidance schemes

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1936 Pt IVA
- ITAA 1936 177A(1)
- ITAA 1936 177C(1)
- ITAA 1936 177C(2)
- ITAA 1936 177C(2)(a)(i)
- ITAA 1936 177C(2)(a)(ii)
- ITAA 1936 177D
- ITAA 1936 177D(b)
- ITAA 1936 177F
- ITAA 1936 177F(1)
- ITAA 1997 103-25(2)
- ITAA 1997 Div 110
- ITAA 1997 Div 112
- ITAA 1997 Subdiv 124-M
- ITAA 1997 124-780(1)(a)(i)
- ITAA 1997 124-780(1)(b)
- ITAA 1997 124-780(1)(c)
- ITAA 1997 124-780(1)(d)
- ITAA 1997 124-780(2)(a)(ii)
- ITAA 1997 124-780(2)
- ITAA 1997 124-780(2)(b)
- ITAA 1997 124-780(2)(c)
- ITAA 1997 124-780(3)
- ITAA 1997 124-780(3)(a)
- ITAA 1997 124-780(3)(b)
- ITAA 1997 124-780(3)(c)
- ITAA 1997 124-780(3)(c)(ii)
- ITAA 1997 124-780(3)(d)
- ITAA 1997 124-780(4)
- ITAA 1997 124-780(4)(a)
- ITAA 1997 124-780(5)
- ITAA 1997 124-780(5)(a)
- ITAA 1997 124-780(5)(b)
- ITAA 1997 124-780(7)
- ITAA 1997 124-782
- ITAA 1997 124-782(1)(b)
- ITAA 1997 124-783
- ITAA 1997 124-783(1)
- ITAA 1997 124-783(2)
- ITAA 1997 124-783(3)
- ITAA 1997 124-783(6)
- ITAA 1997 124-783(9)
- ITAA 1997 124-790
- ITAA 1997 124-790(1)
- ITAA 1997 124-795
- ITAA 1997 995-1(1)

Case references:

- Collis v. FC of T 96 ATC 4831; (1996) 33 ATR 430
- The Trustee for the Estate of the late AW Furse No. 5 Will Trust v. FC of T 91 ATC 4007; (1990) 21 ATR 1123
- Federal Commissioner of Taxation v. Hart [2004] HCA 26; (2004) ATC 4599; 55 ATR 712
- Granby Pty Ltd v. FC of T 95 ATC 4240; (1995) 30 ATR 400
- Reseck v. Federal Commissioner of Taxation 75 ATC 4213; (1975) 5 ATR 538

Other references:

- Explanatory Memorandum to the New Business Tax System (Capital Gains Tax) Bill 1999
- Explanatory Memorandum to the New Business Tax System (Miscellaneous) Bill 2000

ATO references
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