TD 2003/D1 - Income tax: Can Part IVA of the Income Tax Assessment Act 1936 (the '1936 Act') apply to a 'Capital Gains Tax reduction arrangement' of the type described in this Taxation Determination?

This document has been finalised by TD 2003/3.

Draft Taxation Determination

Income tax: Can Part IVA of the *Income Tax Assessment Act 1936* (the '1936 Act') apply to a 'Capital Gains Tax reduction arrangement' of the type described in this Taxation Determination?

Preamble

Draft Taxation Determinations (DTDs) present the preliminary, though considered, views of the Australian Taxation Office. DTDs should not be relied on; only final Taxation Determinations represent authoritative statements by the Australian Taxation Office.

Answer

1. Yes.

Capital Gains Tax reduction arrangements

2. While Capital Gains Tax (CGT) reduction arrangements may vary widely in the precise steps used, and the provisions of the income tax law relied upon, they all have similar economic and tax effects, and make use of very similar techniques. The commercial substance of these arrangements is that a corporate group disposes of a CGT asset to an unrelated third party. However, this disposal does not give rise to tax consequences of the same type, or extent, that would normally be expected upon such a disposal.

3. A Capital Gains Tax reduction arrangement will usually exhibit all or most of the features set out below. An arrangement 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 Capital Gains Tax reduction arrangement.

(a) The commercial effect of the disposal of the CGT asset (for example all the shares in a group company that carries on a separately identifiable business) to an unrelated third party is usually achieved by a transaction that takes the form of a sale of all, or a majority, of the shares in a subsidiary that carries on a business or holds the asset, or in the holding company of a sub-group that includes the subsidiary that carries on the business or holds the asset.

(b) Generally, the company, the shares in which are being sold, has large unrealised revenue or capital profits that have not been recognised, or fully recognised, in the company's books of account.

(c) Before the sale of the subsidiary, or the holding company of the sub-group, one or more of the following occurs:

- an internal restructure; or
- revaluation of an asset (or assets) in the books of account of the company that has the unrealised revenue or capital profits. In most cases this revaluation reflects the then market value of the particular assets.

(d) The internal restructure involves the transfer of either shares in the group companies owning income producing assets, or of the income producing assets themselves, to another member of the corporate group. The value of the consideration given for the transfer is generally at least equal to the market value of the shares or assets transferred. In some cases, the value of the consideration given may exceed the market value of the shares or assets transferred.

(e) These internal transfers, or asset revaluations, give rise to accounting profits as the book value of the business or assets is generally lower than their market value. However, no tax is payable on the capital profits arising from the transfer of the assets or shares because:

- both the transferor and the transferee choose to obtain CGT roll-over relief (for example, under Subdivision 126-B of the *Income Tax Assessment Act 1997* (the '1997 Act'));
- the assets or shares do not have the necessary connection with Australia; or
- the profits are otherwise excluded from assessment in Australia.

(f) The company that transferred, or revalued, the assets (or business) declares a dividend to its immediate holding company from the accounting profit arising from the disposal or revaluation. There is no tax payable on the dividend either because:

- the inter-corporate dividend rebate applies (dividends paid from the profits in these situations are said not to attract the operation of section 46E or sections 46G to 46M of the 1936 Act because the relevant account of profits is not an account to which any of those sections applies (however, see the note at paragraph 11));
- the dividend is exempt (for example, by section 23AJ of the 1936 Act); or
- the dividend is otherwise excluded from assessment in Australia.

(g) In many cases the company declaring the dividend is unable to pay a cash dividend for the full amount declared as it has insufficient cash and is unwilling, or unable, to borrow from unrelated third parties. The company declaring the dividend may be unwilling to borrow from an external lender as the intended unrelated third party purchaser is unwilling to purchase the company, or corporate sub-group, if the total debts owed by the company is increased solely as a result of an arm's length borrowing to fund a dividend payment to the vendor just prior to the sale of the company.

(h) In the absence of a contemporaneous agreement with the shareholder(s) for the reinvestment of the dividend, the payment of the dividend would, in some cases, cause the company declaring the dividend to become insolvent.

(i) In some cases the company (the 'vendor company') that will sell the shares to the unrelated third party is not the direct owner of the share in respect of which the dividend referred to in subparagraph (f) is declared. In this situation dividends are paid by a chain of subsidiaries until a dividend representing some or all of the profit referred to in subparagraph (e) is paid to the vendor company.

(j) The dividend that is ultimately declared in favour of the vendor company either:

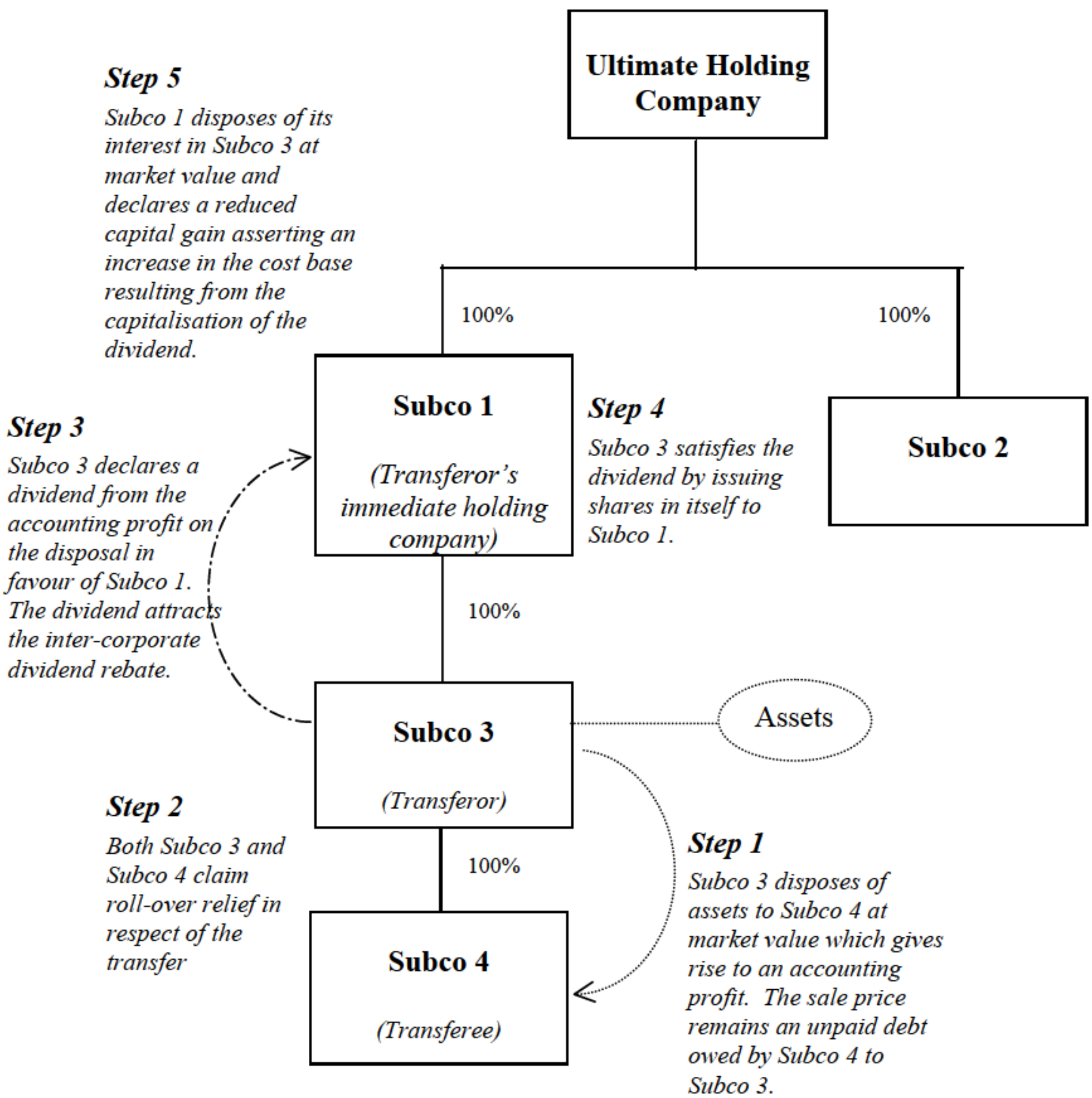
- remains unpaid as a debt owed to the vendor company by the company declaring the dividend;
- is paid and lent back by the vendor company to the company declaring the dividend, again constituting a debt owed to the vendor company by the company declaring the dividend; or
- is paid and used by the vendor company to acquire shares in the company declaring the dividend, that is, the dividend is capitalised.

(k) In the case of either an unpaid dividend, or a dividend that is lent back to the company declaring the dividend, the contract for the sale of the shares to the unrelated third party provides that the consideration to be paid in respect of those shares is to be reduced by the amount of any inter-corporate debts owed to a member of the corporate group of which the vendor company is a member. The contract also provides that the unrelated third party purchaser will repay, on behalf of the subsidiary or sub-group, these inter-corporate debts at the completion of the share sale, or soon thereafter. This is said to reduce, for CGT purposes, the consideration paid to the vendor company for the shares.

(l) In the case of the capitalised dividends, the effect is said to be an increase to the total cost bases of the shares being disposed of by the amount of the dividend.

(m) The shares in the subsidiary, or in the holding company of the sub-group, are sold to the unrelated third party.

The following diagram illustrates an arrangement in which assets in a subsidiary are transferred generating accounting profits. These profits are used to pay a dividend which is satisfied by the company declaring the dividend issuing shares in itself, hence capitalising the dividend.



Does Part IVA of the 1936 Act apply?

4. The application of Part IVA depends on a careful weighing of all the relevant facts and surrounding circumstances of each case. Therefore, in the absence of all relevant information it is not possible to state definitively whether a particular arrangement or transaction will attract Part IVA. However, arrangements of the type described in paragraph 3 above, and arrangements having similar economic and tax effects, are considered likely to attract the operation of Part IVA.

5. The precise definition of the scheme for the purposes of section 177A of the 1936 Act will depend on the facts of the particular case. However, the steps of the scheme will normally include the key elements of the arrangement described in paragraph 3 of this Determination.

6. In this type of scheme it is likely that, but for the scheme, a CGT asset would have been sold to the third party for its market value. This disposal would have resulted in a capital gain for tax purposes, and indirectly in an amount being potentially included in the assessable income of the taxpayer (being the net capital gain after allowing for capital losses). The relevant tax benefit is the amount of net capital gain that has not been included in the assessable income of the relevant taxpayer.

7. In some cases where a capital loss is obtained in connection with the scheme, the disposal of the asset directly results commercially in a capital profit, but does not give rise to assessable income. In these cases there may be:

- a single tax benefit being the incurring of a larger capital loss than would have been incurred in the absence of the scheme; or
- two tax benefits being both an amount of net capital gain that has not been included in the assessable income of the relevant taxpayer, and the incurring of a capital loss.

8. While the types of arrangements described in paragraph 3 may have as their ultimate commercial effect the disposal of a business, or asset, to an unrelated third party, the relevant question, for Part IVA purposes, is whether the identified scheme has been entered into or carried out in this particular way for the dominant purpose of obtaining a tax benefit (*FC of T v Spotless Services Ltd & Anor* 96 ATC 5201; (1996) 34 ATR 183). The relevant purpose is the objective purpose to be predicated of the scheme by reference to the factors set forth in section 177D of the 1936 Act. In this context the following general observations can be made.

a) The form of the scheme is the sale of shares, but the substance of it will be the disposal of a particular business or asset. The corporate group selling the shares receives the full economic value of the company(s) sold. In some situations part of the purchase price is recharacterised as a repayment of a debt.

b) The manner in which the scheme is carried out will in most cases demonstrate that the steps taken to create the profit and to distribute it as a dividend are undertaken only to reduce the amount of an assessable gain that would otherwise arise upon the disposal of the business or asset. In other cases the manner will demonstrate that the steps are undertaken to create a capital loss for capital gains tax purposes.

c) The manner in which the dividend is declared and then paid will demonstrate that those steps are substantially directed to reducing the assessable capital gain (or increasing the capital loss) arising upon the disposal, and not to liberating and distributing profits of the company. The declaration of a dividend that remains unpaid until discharged by the unrelated third party, as part of the overall agreement to sell the shares, is commercially, and in substance, simply the transferring from buyer to seller of a portion of the purchase price of the shares.

d) The time during which the scheme is carried out will indicate that all steps, including the steps directed to the recognition of profit and its distribution, are part and parcel of the dealings by which the shares in the company are sold.

e) The result achieved by the scheme will be a very substantial reduction in income tax in comparison with the result that might reasonably have been expected to flow if the scheme had not been carried out.

f) Other than the amount of any liability to pay income tax, the changes in the financial positions of the relevant persons and the other commercial consequences of the scheme will be substantially the same as the changes that might reasonably be expected to flow if the scheme had not been carried out.

9. It will therefore be apparent from the overt steps by which the scheme is implemented that it was 'shaped' in a particular form solely or dominantly for the purpose of obtaining a tax benefit that would not have been obtained if that particular scheme had not been entered into or carried out. Accordingly, a reasonable person would conclude, having regard to the matters set out in section 177D of the 1936 Act, that one or more of the parties that entered into the scheme did so for the dominant purpose of enabling the company disposing of the shares to the unrelated third party to obtain a tax benefit.

10. If the Commissioner determines that Part IVA applies to a particular arrangement, then consideration will be given to making compensating adjustments under subsection 177F(3) of the 1936 Act where it is fair and reasonable to do so.

Note

11. In this Taxation Determination it is assumed that the scheme is effective to obtain the tax benefit but for the operation of Part IVA. However the particular arrangement may be such that:

a) there is no reduction in the assessable capital gain arising form the disposal;

b) another CGT event occurs giving rise to an assessable net capital gain; or

c) the distribution is fully taxable.

Examples

Example 1

12. *A large multinational corporate group (the '**ABC Group**') intends to dispose of part of its US operations. **Aus Parent Co**. owns all of the shares in **US Holding Co** (a US resident corporation), and **US Holding Co** initially owns all of the shares in **US Operations Co** (a US resident corporation). **US Operations Co** carries on the US operations that the **ABC Group** intends to sell.*

13. *The **ABC Group** has already entered into negotiations with an unrelated third party to sell those operations and is close to reaching a final agreement under which all of the shares in **US Holding Co** will be sold to the unrelated third party.*

14. *Several weeks prior to the sale being finalised,* ***US Holding Co*** *transfers all of the shares in* ***US Operations Co*** *to* ***US Co****, a newly incorporated US resident company.* ***US Holding Co*** *receives all of the shares of* ***US Co*** *as consideration for the transfer of the shares in* ***US Operations Co****.* ***US Holding Co*** *makes an accounting profit in respect of the transfer of shares in* ***US Operations Co*** *as the shares are transferred for their market value.*

15. *The accounting profit made by* ***US Holding Co*** *from the transfer of the shares has been used to fund a dividend that is paid to* ***Aus Parent Co****, the Australian resident parent company of* ***US Holding Co****. The dividend is paid by way of promissory notes, and is exempt from income taxation in Australia as a consequence of section 23AJ of the 1936 Act.*

16. *Prior to the declaration of the dividend,* ***US Holding Co*** *and* ***Aus Parent Co*** *enter into an agreement under which* ***Aus Parent Co*** *agrees to use the dividend to subscribe for shares in* ***US Holding Co****. The promissory notes received from* ***US Holding Co*** *are used for this purpose. The new shares are acquired for their market value. The payment of the dividend and the re-investment of that dividend occur one week before the sale of all of the shares in* ***US Holding Co*** *to the unrelated third party.*

17. *The payment of the dividend and its reinvestment has not altered the underlying economic position of the companies. The market value of* ***US Holding Co*** *immediately after the reinvestment is exactly the same as it was immediately before the declaration of the dividend. The total market value of* ***Aus Parent Co's*** *investment in* ***US Holding Co*** *is exactly the same immediately after the reinvestment as it was immediately before the declaration of the dividend.* ***Aus Parent Co*** *continues to own 100% of the issued shares in* ***US Holding Co****, there are simply more* ***US Holding Co*** *shares owned by* ***Aus Parent Co****. However, from the point of view of the Australian income tax law, it is asserted that the total cost bases of* ***Aus Parent Co's*** *shareholding in* ***US Holding Co*** *has been increased by the amount of the dividend reinvested.*

18. *Just prior to the sale of the shares in* ***US Holding Co*** *to the unrelated third party,* ***Aus Parent Co*** *sells all of the shares in* ***US Holding Co*** *to* ***Aus Co,*** *another Australian resident member of the* ***ABC Group****. Both* ***Aus Parent Co*** *and* ***Aus Co*** *elect for CGT rollover relief under Subdivision 126-B of the Income Tax Assessment Act 1997 to apply. Consequently,* ***Aus Co*** *has the same CGT cost base in respect of the shares in* ***US Holding Co*** *as* ***Aus Parent Co*** *had.*

19. ***Aus Co*** *sells the shares in* ***US Holding Co*** *to the unrelated third party for their market value.*

20. *The Commissioner is of the opinion that having regard to all of these circumstances, Part IVA applies.*

Your comments

21. We invite you to comment on this Draft Taxation Determination. We are allowing 4 weeks for comments before we finalise the Determination. If you want your comments considered, please provide them to us within this period.

Comments by date:	**14 February 2003**
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Commissioner of Taxation
15 January 2003

Previous draft:
Not previously issued in draft form

Subject references:
- tax avoidance
- tax benefits under tax avoidance shemes

Legislative references:
- ITAA 1936 23AJ
- ITAA 1936 46
- ITAA 1936 46E
- ITAA 1936 46G
- ITAA 1936 46M
- ITAA 1936 Part IVA
- ITAA 1936 177A
- ITAA 1936 177D
- ITAA 1936 177F(3)
- ITAA 1997 Subdiv 126-B

Case references:
- FC of T v Spotless Services Ltd & Anor 96 ATC 5201; (1996) 34 ATR 183

ATO References
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