



TD 2008/D17 - Income tax: in accounting for a Dividend Re-investment Plan, can a company taint its share capital account for the purposes of Division 197 of the Income Tax Assessment Act 1997?

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This document has been finalised by TD 2009/4.

 There is a Compendium for this document: **TD 2009/4EC** .



Draft Taxation Determination

Income tax: in accounting for a Dividend Re-investment Plan, can a company taint its share capital account for the purposes of Division 197 of the *Income Tax Assessment Act 1997*?

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This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation 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.

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Ruling

1. No. A Dividend Re-investment Plan (DRP) with the features outlined at paragraph 11 and accounted for in accordance with paragraphs 4 or 8 will not taint the issuing company's share capital account for the purposes of Division 197 of the *Income Tax Assessment Act 1997* (ITAA 1997). However, as noted in paragraph 12, this Determination does not deal with Bonus Share Plans and 'scrip dividends'.

Example 1

2. On 31 July 2008, Alison elects to participate in Corporate Pty Ltd's DRP for the whole amount of her anticipated cash dividend with respect to her holding of 100 shares.

3. On 15 August 2008, Corporate Pty Ltd declares that a dividend of \$1 per share be payable with a record date of 29 August 2008. Alison is a shareholder of Corporate Ltd as of the record date. On 15 September 2008, Corporate Pty Ltd issues 10 shares to Alison by reason of her participation in the DRP.

4. Corporate Ltd accounts for the transaction as follows:

On date of declaration

Dr Retained earnings	\$100
Cr Dividend payable	\$100

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On date of payment

Dr Dividend Payable	\$100	
		Cr Share Capital
		\$100

5. Although the transfer from the Dividend Payable account to the Share Capital account would constitute a transfer for the purposes of subsection 197-5(1) of the ITAA 1997, the share capital account of the company does not become a tainted share capital account as a result of the crediting of the dividend to the share capital account under subsection 6BA(5) of the *Income Tax Assessment Act 1936* (ITAA 1936).

Example 2

6. On 31 July 2008, Luke elects to participate in Company Pty Ltd's DRP for the whole amount of his anticipated cash dividend with respect to his holding of 100 shares.

7. On 15 August 2008, Company Pty Ltd determines that a dividend of \$1 per share be payable with a record date of 29 August 2008. Luke is a shareholder of Company Pty Ltd as of the record date. On 15 September 2008, Company Pty Ltd issues 10 shares to Luke by reason of his participation in the company's DRP.

8. Company Ltd accounts for the transaction by way of short form entries as follows:

On date of payment

Dr Retained Earnings	\$100	
		Cr Share Capital
		\$100

To record payment of dividend to participant in DRP.

9. Although the transfer from the Retained Earnings account to the Share Capital account would constitute a transfer for the purposes of subsection 197-5(1) of the ITAA 1997, the share capital account of the company does not become a tainted share capital account as a result of the crediting of the dividend to the share capital account under subsection 6BA(5) of the ITAA 1936.

Date of effect

10. When the final Determination is issued, it is proposed to apply to years of income commencing both before and after its date of issue from 26 May 2006, the day that Division 197 applies from. However, the Determination 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 Determination (see paragraphs 75 and 76 of Taxation ruling TR 2006/10).

Commissioner of Taxation

10 December 2008

Appendix 1 – Explanation

ⓘ *This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.*

Explanation

11. For the purposes of this draft Determination, a DRP has the following features:
- Participation in the DRP is optional for the shareholder, with the shareholder having the ability to vary participation or withdraw at any time;
 - Shareholders can participate with respect to the whole or part of their shareholding;
 - Shares issued under the plan rank equally with existing fully paid shares; and
 - From the perspective of the issuing company, no cash payment of the dividend is actually made. Rather, the participation of shareholders in the DRP is recorded internally as transfers between accounts which involve a transfer of an amount to the issuing company's share capital account.
12. This draft Determination does not deal with Bonus Share Plans which are not considered to be a DRP for the purposes of this draft Determination. A modern Bonus Share Plan typically involves a company issuing shares in lieu of a dividend to those shareholders who have elected to participate in the Plan with no amount transferred into the company's share capital account. Similarly, 'scrip dividends' as discussed in Taxation Ruling IT 2603 are also not covered by this draft Determination.

The share capital tainting rules

13. The share capital tainting rules are contained in Division 197 of the ITAA 1997. Division 197 was introduced with effect from 26 May 2006.
14. The existing share capital tainting rules replace, with some modifications, the share capital tainting rules formerly contained in Division 7B of Part IIIA of the ITAA 1936.
15. The share capital tainting rules are integrity rules designed to prevent a company from making tax-preferred capital distributions from a share capital account to which the company has transferred profits. The rules operate by treating a company's share capital account as having been tainted if the company has transferred an amount from another account to the share capital account, other than where the amount transferred is an excluded amount (for example an amount of share capital or an amount transferred under a debt for equity swap).
16. If a company taints its share capital account, a franking debit arises in the company's franking account. Once tainted, the company's share capital account remains tainted until it is untainted. Distributions from a tainted share capital account are treated as unfrankable dividends rather than returns of capital.
17. A company which has tainted its share capital account can elect to untaint the account with the result that an additional franking debit may arise and untainting tax may be payable.¹

¹ Refer to sections 197-55, 197-60 and 197-65 of the ITAA 1997.

18. A share capital account of a company will become tainted if:²

- there is a transfer of an amount to the share capital account that is not an excluded amount; and
- the company is an Australian resident immediately before the transfer took place.

19. An amount is transferred from one account to another where the amount is moved from one account to another. This, in turn, requires the balance of the first account to be reduced, while the balance of the second account is increased by the same amount.³

20. In both of the examples outlined in paragraphs 2 to 9 of this Determination, it is considered that a transfer has taken place for the purposes of Division 197 of the ITAA 1997. As such, the company's share capital accounts could become tainted unless the transfer is considered to constitute an excluded transfer for the purposes of Division 197.

21. One situation in which an amount transferred to a share capital account can constitute an excluded transfer is when an amount is transferred to a share capital account in the circumstances outlined in subsection 6BA(5) of the ITAA 1936. Subsection 6BA(5) provides as follows:

Subject to subsection (6), if a shareholder has a choice whether to be paid a dividend or to be issued shares and the shareholder chooses to be issued with shares:

- (a) the dividend is taken to be credited to the shareholder; and
- (b) the dividend is taken to have been paid out of profits; and
- (c) subsections (2) and (3) apply in working out the consideration for the acquisition of the shares for the purposes of this Act.

However, the share capital account of the company does not become a tainted share capital account as a result of the crediting of the dividend to the share capital account.

Section 6BA

22. On its terms, subsection 6BA(5) of the ITAA 1936 covers the situation of a DRP which, in essence, involves a choice on the part of the shareholder whether to be paid a dividend or issued shares. This is confirmed in the Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998 (the Explanatory Memorandum) that made amendments to section 6BA of the ITAA 1936 and introduced former section 160ARDM (the predecessor of Division 197 of the ITAA 1997) into the ITAA 1936. The Explanatory Memorandum states at paragraph 1.99:

Circumstances where a bonus share will be a dividend or taken to be a dividend include where the general anti-avoidance provisions contained in new sections 45, 45A, or 45B apply (described above). A bonus share will also be taken to be a dividend in circumstances where a shareholder has a choice whether to be paid a dividend or to be issued with shares and the shareholder chooses to be issued with shares, i.e., where there is a dividend re-investment plan. (See below.)

² Refer to section 197-5 and subsection 197-50(1) of the ITAA 1997.

³ See paragraph 4.12 of the Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No. 3) Bill 2006.

23. With respect to the operation of section 6BA(5) of the ITAA 1936, the Explanatory Memorandum provides at paragraph 1.101:

In the case where a shareholder has a choice whether to be paid a dividend or to be issued shares, and chooses to be issued with shares (i.e. dividend re-investment plans):

- the bonus share is taken to be a dividend;
- the amount of the bonus share dividend is the amount of the other, forgone, dividend;
- the dividend is taken to be credited to the shareholder and paid out of profits;
- the dividend is a frankable dividend; and
- the share capital account, provided it is not already a tainted share capital account, does not become a tainted share capital account because of the operation this subsection.

24. In this context, it is considered that section 6BA of the ITAA 1936 applies to DRPs. Section 6BA is not restricted in application to bonus shares within a legal technical meaning. Although subsection 6BA(1) states that section 6BA applies if a shareholder holds shares in a company (the original shares) and the company issues other shares (the bonus shares) in respect of the original shares, the words ‘the bonus shares’ are not used in their legal technical sense or as a term of restriction. Rather, those words are used to describe the outcome of a situation where other shares are issued in respect of the original shares.

25. Such an interpretation of subsection 6BA(1) of the ITAA 1936 is consistent with the purpose of section 6BA of the ITAA 1936. Section 6BA provides rules for the taxation treatment of the issue of the ‘bonus shares’ depending on whether consideration has or has not been provided for their issue. Consideration will have been provided if the ‘bonus shares’ are a dividend or taken to be a dividend (subsection 6BA(2)). That treatment depends very much on how the company accounts for the issue of the ‘bonus shares’. To interpret subsection 6BA(1) as not covering DRPs would frustrate the intention of Parliament that DRPs are excluded from the share capital tainting rules under subsection 6BA(5). This interpretation is supported by the use of the expressions ‘bonus share’ and ‘dividend re-investment plan’ interchangeably in the Explanatory Memorandum.

26. Therefore, whether section 6BA of the ITAA 1936 applies to issued shares depends on whether it can be said that the company issued those shares in respect of shares the shareholder already holds in that company. The expression ‘in respect of’ is capable of having ‘the widest possible meaning of any expression intended to convey some connection or relation between the two subject matters to which the words refer’.⁴ However, the words do not automatically embrace any connection between the two subject matters to which they refer and take on a meaning shaped by the context in which they appear.⁵ The context in which the words appear will determine the matters to which it extends.⁶ For instance, in the context of *Commissioner of Taxation v. Scully*⁷ the words did not include merely a causal connection: it was character and purpose of the payment which were relevant, rather than cause.

⁴ Taylor J in *State Government Insurance Office (Qld) v. Crittenden* (1966) 117 CLR 412 at 416 quoting with approval from Mann CJ in *Trustees Executors & Agency Co. Ltd. v. Reilly* [1941] VLR 110 at 111.

⁵ *Commissioner of Taxation v. Scully* (2000) 201 CLR 148 at 171.

⁶ *Workers' Compensation Board of Queensland v. Technical Products Pty Ltd* (1988) 165 CLR 642 at 653-654.

⁷ 201 CLR 148

27. As regards subsection 6BA(1) of the ITAA 1936, and the relationship required between the other shares and the original shares, the words ‘in respect of’ require that the relationship must be based upon more than mere coincidence or association. The context of section 6BA of the ITAA 1936 indicates that the relationship between the original shares and the other shares is causal, in the sense that the other shares must be seen as originating in, or arising out of, or as having been received in consequence of, the original shares. It does not have to be a direct causal connection, merely a substantive one. Under a DRP the shareholder can choose whether to be paid dividends or to be issued other shares; the fact of that choice does not alter the characterisation of the other shares having been issued in respect of the original shares. The other shares issued under the DRP arise out of, or are received in consequence of, the original shares. The ability of the shareholder to participate in the DRP, and therefore to be issued the other shares, arises from their shareholding in the company and the terms on which that shareholding is held.

28. Accordingly, it is considered that for the purposes of subsection 6BA(1) of the ITAA 1936, a company may issue shares to a shareholder in respect of existing shares on issue regardless of whether or not the shareholder has the choice to receive the shares. If, under a DRP, the shareholder chooses to be issued shares, then subsection 6BA(5) of the ITAA 1936 would have application due to the availability of that choice. As previously noted, subsection 6BA(5) of the ITAA 1936 constitutes an exception to the share capital tainting rules in Division 197 of the ITAA 1997. As such, it is considered that the operation of a DRP would not taint the issuing company’s share capital account for the purposes of Division 197 of the ITAA 1997.

Appendix 2 – Your comments

29. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

30. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the Tax Office website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date:	23 January 2008
Contact officer:	Chris Magee
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

IT 2603; TR 2006/10

Subject references:

- bonus shares
- dividend income
- dividend reinvestment
- shares
- tainted share capital account

Legislative references:

- ITAA 1997 Div 197
- ITAA 1997 197-5
- ITAA 1997 197-5(1)
- ITAA 1997 197-50(1)
- ITAA 1997 197-55
- ITAA 1997 197-60
- ITAA 1997 197-65
- ITAA 1936 6BA
- ITAA 1936 6BA(1)
- ITAA 1936 6BA(2)
- ITAA 1936 6BA(5)

- ITAA 1936 45
- ITAA 1936 45A
- ITAA 1936 45B
- ITAA 1936 Pt IIIAA Div 7B
- ITAA 1936 160ARDM

Case references:

- Commissioner of Taxation v. Scully (2000) 201 CLR 148; 2000 ATC 4111; (2000) 43 ATR 718
- State Government Insurance Office (Qld) v. Crittenden (1966) 117 CLR 412
- Trustees Executors & Agency Co. Ltd. v. Reilly [1941] VLR 110
- Workers' Compensation Board of Queensland v. Technical Products Pty Ltd (1988) 165 CLR 642

Other references:

- Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998
- Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No. 3) Bill 2006

ATO references

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