IT 2603 - Income tax : scrip dividends

This ruling contains references to repealed provisions, some of which may have been rewritten. The ruling still has effect. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten. The legislative references at the end of the ruling indicate the repealed provisions and, where applicable, the rewritten provisions.

TAXATION RULING NO. IT 2603

INCOME TAX : SCRIP DIVIDENDS

F.O.I. EMBARGO: May be released

REF	N.O. REF: 88/8226-6	DATE OF EFFECT: Immediate
	B.O. REF:	DATE ORIG. MEMO ISSUED:

F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1012223	SCRIP DIVIDENDS DIVIDEND COST BASE	6(1), 44(1) 160ZYHC PART IIIAA

PREAMBLE Recently, as a result of the High Court decision in John v. FCT 89 ATC 4101; 20 ATR 1, this Office reconsidered its view of the taxation consequences of scrip dividend arrangements.

2. "Scrip dividend" is a term used to describe the process whereby a company declares a "dividend" and then applies it to pay up the par value and premium attaching to an allotment of shares, without any consent being required from the shareholders.

3. In the particular case considered by this Office the Articles of the public company involved specifically authorised the directors to declare dividends which would be satisfied, either wholly or in part, by the distribution of paid up shares in the company. Such a decision by the directors did not require the ratification of the shareholders. The company proposed to declare a fully franked dividend to be satisfied partly by cash and partly by shares in the company. The company regarded the scrip dividend as a form of mandatory dividend reinvestment scheme, though it is considered that the arrangement is in the nature of a bonus issue.

4. For example, the company would declare, a 50 cent per share dividend to be satisfied by 25 cents in cash and 25 cents in the form of fully paid $1 ordinary shares. The new fully paid shares would be issued for $3.00 which would be slightly below the market value of $3.20. On this basis a shareholder would receive one new share for every 12 shares previously held. The difference between the $1.00 par value of the shares and their discounted market value of $3.00, i.e. $2 in the example, was intended to be credited to a share premium account.

ISSUES

5. This factual situation raises three issues:

(a) the amount to be treated as an assessable dividend;

(b) the cost base of the shares issued by the company for the purposes of Part IIIA of the Income Tax Assessment Act 1936 (the Act); and

(c) whether the difference between the par value and discounted market value of the shares could be credited to a share premium account.

RULING The Amount of the Assessable Dividend

6. The amount of the assessable dividend is determined by applying section 44 and the definitions of "dividend" and "paid" in subsection 6(1) of the Act to the facts of the particular case.

7. In relation to the definition of dividend in subsection 6(1), it might be argued that both paragraph (b) and paragraph (c) of the definition apply to a scrip dividend. Brennan J in John v. FCT 89 ATC 4101 at 4116; 20 ATR 1 at 18 seems to acknowledge this when he says,

> "A succession of Income Tax Assessment Acts have sought to bring within the net of assessable income of a shareholder either the amount credited in payment for bonus shares or the face or paid-up value of bonus shares or both." [Emphasis added]

8. In this regard the view taken is that to the extent that the specific provision of paragraph (c) is in conflict with the more general provision of paragraph (b), paragraph (c) must be preferred.

9. However, for the reasons set out below it is considered that an application of paragraph (b) or paragraph (c) in conjunction with section 44 will result in the amount of dividend included in the shareholder's assessable income being the same. The fact that the same amount is included in assessable income by virtue of more than one provision does not mean that the two provisions are in conflict. Consider, for example, the decisions of the High Court in FCT v. Whitfords Beach Pty Ltd 82 ATC 4031; 12 ATR 692 and FCT v. Myer Emporium Ltd 87 ATC 4363; 18 ATR 693 where sections 25 and 26(a) were both held to apply.

10. The real issue is whether the imposition of a premium which is then fully paid by the company can, to that extent, ever entail a crediting (in the relevant sense) to a shareholder so as to result in the premium being assessable as a dividend under subsection 44(1).

11. In Brookton Co-op Society Ltd v. FCT 81 ATC 4346 at 4354; 11 ATR 880 at 889 Mason J (as he then was) said,

> "Payment of a dividend may occur in a variety of ways not involving payment in cash or by bill of exchange, as, for example, by an agreed set-off, account stated or an agreement which acknowledges that the amount of the dividend is to be lent by the shareholder to the company and is to be repaid to the shareholder in accordance with the terms of that agreement. It is, however, well settled that the making of a mere entry in the books of a company without the assent of the shareholder does not establish a payment to the shareholder (Manzi & Ors v Smith & Anor (1975) 49 ALJR 376 at 377." [Emphasis added]

12. The statement by Mason J (with whom the other members of the High Court agreed) as to what constitutes a payment of an interim dividend seems equally applicable to final dividends. In fact his Honour specifically refers to final dividends later in his judgment when discussing the meaning of "dividends paid" in subsection 44(1). Moreover, it seems applicable to the amount of any "premium" purportedly attached and fully paid in respect of a bonus issue by the declaration of a purported dividend.

13. In scrip dividend cases the shareholder has no entitlement to the money amount of the dividend. As Brennan J said in John's Case at 89 ATC 4116; 20 ATR 18,

> "It is only upon and by reason of the company's capitalizing of assets therefore available for distribution that a shareholder acquires any entitlement to a benefit from the company and that benefit is not a right in respect of the assets capitalized but a right to the allotment of shares representing the increase in capital. The only dividend to which a shareholder thus becomes entitled is a dividend to be satisfied by the issue of shares." [Emphasis added]

14. The ordinary meaning of a dividend is an entitlement to receive an aliquot portion of the company's profits (Re Chelsea Water Works Co. and Metropolitan Water Board 73 LJKB 532 at 535 per Sir E. Fry). That entitlement becomes, upon the declaration of the dividend, a debt owed by the company for which the shareholder may sue (Norman v. FCT (1962-63) 109 CLR 9 per Windeyer J at p. 40). However, where a dividend is declared and immediately satisfied by the issuing of shares, the profits remain in the company, as capital, and cannot be sued for (Inland Revenue Commissioner v. Blott [1921] 2 AC 171 per Viscount Finlay at p. 194 and Lord Cave at p. 200). The

shareholder never has a right to sue for the money amount of the dividend; at best he could sue for a share with a par value of, say, $1.

15. It follows that, to the extent that shareholders could not sue for the money amount of the dividend, no debt is created.

16. The concept of entitlement is central to the notion of derivation encapsulated in the words "dividends paid to him" in subsection 44(1). To quote Mason J in the Brookton Co-Operative Case 81 ATC at 4355; 11 ATR 889:

> "Section 44(1)(a) includes in the assessable income of the taxpayer "dividends paid" to it by Tunwin "out of profits derived by it from any source". "Paid" is defined by sec. 6(1) in relation to dividends so as to include dividends "credited or distributed". By virtue of sec. 44(1)(a) and the statutory definition, a dividend does not form part of the assessable income of a shareholder unless it is paid or credited, notwithstanding that the declaration of a final dividend by the company in general meeting creates a debt and an enforceable right on the part of the shareholder to the dividend. Consequently, in its application to a final dividend the extended statutory definition does nothing to disturb or qualify, as between company and shareholder, the characteristic of a dividend as a debt which is owing by the company to the shareholder. As this is the effect of the extended definition in its application to a final dividend, it would be irrational and incongruous to give it a more radical application when applied to an interim dividend. The reference to "dividends" in sec. 44(1)(a) must be read as a reference to dividends the payment of which is enforceable by the shareholder because they have been declared so as to create a debt, or to dividends which are no longer revocable because, as between company and shareholder, they have been satisfied by payment. When sec. 44(1)(a) is so read, the purpose of the extended definition becomes clear - it is to guard against the possibility, perhaps remote, that the word "paid" might be so narrowly construed that dividends credited or distributed to shareholders in circumstances where they can no longer be revoked or rescinded by the company would not constitute assessable income in the hands of shareholders." [Emphasis added]

17. There is nothing in the context of the definitions that would lead one to conclude that the word "credited" has a different meaning in paragraph (b) of the definition of "dividend" than it has in the definition of "paid".

18. Nelson J, who heard the matter of Niemann v. Smedley [1973] VR 769 at first instance, and is quoted by the Full Court of the Victorian Supreme Court at [1973] VR 775, stated:

"His [a shareholder's] entitlement to a share in the capital of the company, is determined by the nominal value of the shares he holds. He obtains no larger share in the capital by the payment of the premium which is merely something additional which he has to pay to the company for the privilege of obtaining shares of a certain nominal value".

One can therefore say, in relation to the paid-up value of bonus shares, that there has been, in a real sense, a crediting to a shareholder.

19. The crediting in such cases is inextricably bound up with the issue of bonus shares. The company's purpose is not to give shareholders a claim for the amount of the dividend in money but to issue fully paid shares. The two steps are preordained, integrated and sequential. In fact, there is no need to formally declare a dividend and go through a formal crediting as courts will treat the amount required to pay up the shares as having been credited.

20. In these circumstances it is considered that an amount is credited for the purposes of paragraph (b) of the definition of "dividend" not when the dividend is credited in the physical sense of making an accounting entry (F.C. of T. v. W.E. Fuller Pty Ltd (1959) 101 CLR 403, per Fullagar J at p. 419), but rather when the share is issued to the shareholder (Commissioner of Taxes (Victoria) v. Nicholas (1938) 59 CLR 230 per Rich J at p. 244).

21. When the shares are issued, the only amount really credited to the shareholder is the "paid-up value" of the share. It follows that paragraph (b) and paragraph (c) of the definition treat the same amount as a dividend. This necessary harmony between the two provisions is reflected in Dixon CJ's judgment in W.E. Fuller (1959) 101 CLR at pp. 407-414. Although this was a minority judgment it was adopted by the majority of the High Court in Gibb v FCT(1966) 118 CLR 628.

22. The ordinary meaning of paid-up value is the par or face value of the shares (Bloomenthal v. Ford [1897] AC 156). There is nothing in the context in which "paid-up value" is used in subsection 6(1) that indicates that the draftsman did not intend this ordinary meaning. Consequently, the view is taken that the paid-up value cannot exceed the par value of the share.

23. This accords with the concept of a capitalization of profits which is in essence what a bonus issue is. Such a

capitalization refers to the situation where profits of the company are converted into paid-up capital. In the present situation only the par value of shares is capitalized in the sense of being converted to paid up capital; the excess is credited to a "share premium account" which is strictly speaking a capital profit account.

24. In Drown v. Gaumont British Picture Corporation Ltd (1937) CH 402 it was said that,

> "The premium from its nature is not part of the capital paid up on shares; it is the surplus of the sum received in respect of the share over the amount required to pay up the share to the extent to which it is treated by the company as fully paid up."

The Victorian Supreme Court adopted this statement in its judgment in Niemann v. Smedley.

25. There is a further point. When the cases talk of crediting in the context of a bonus issue it is in relation to "the paying up of bonus shares" (cf. Stephen J in FCT v. Curran at 74 ATC 4308; 5 ATR 87). The accounting from the company's viewpoint requires the money to come from somewhere so that the amount credited to paid up capital can be increased. However, as explained above, it is considered that bonus shares (or any shares) can be paid up only to their par value. The appropriate accounting entries for shares issued at a premium are to credit an Issued and Paid Up Capital Account with the par value, credit a Share Premium Account with the premium and debit a Bank or Cash Account.

26. The separate accounting for the share premium is consistent with the legal analysis that premiums are not moneys paid up on a share. The true nature of a share premium is that of a capital profit made via an allotment contract. In the case of scrip dividends there is no allotment contract and there is no additional capital profit made by the company in issuing the shares. All that happens is that existing retained profits are renamed.

27. It is clear from John's Case that the issue of fully paid bonus shares does not involve a set-off; there is no cost to the shareholder (other than the purchase price of the original shares) and this fact tends to suggest a conclusion that there is no crediting of the "premium" to a shareholder. In the light of other statements to the effect that there is a crediting in the process of a bonus issue it is not open to interpret the High Court's decision as saying that there is no crediting at all. Bearing in mind that the word "paid" in its literal

meaning and the word "distributed" are inapt in the context of a bonus issue, if one took the view that there was no crediting at all it would seem to lead to the conclusion that section 44(1) does not apply to bonus issues. However, there is a long line of cases supporting the view that there is a crediting. The only question is: How much is credited? This Office takes view that it is the amount of the paid-up value of the bonus shares.

28. Accordingly, it is the view of this Office that the so called premium purportedly imposed and paid up does not constitute a dividend within the meaning of paragraph (b) of the definition of dividend in subsection 6(1).

29. Additionally, the purported crediting of an amount representing a share premium does not constitute a "dividend paid to a shareholder" within the meaning of subsection 44(1). The increased value that the shareholder gets from the issue of the fully paid bonus share comes from the marketplace which is prepared to pay more to purchase the share than the par value or the paid-up value, as the case may be. It does not come via a distribution of company profits.

30. Consequently the assessable dividend is the par or nominal value of the shares issued. In the present example this would mean that the assessable dividend would be $1 per bonus share issued. This amount will be a "frankable dividend" provided the dividend is not specifically excluded by the definition of that term in section 160APA.

Cost Base of the Shares

31. Section 160ZYHC of the Act specifies that the cost base of shares, where some or all of the paid-up value of bonus shares is a dividend, shall be the consideration paid by the shareholder plus so much of the paid-up value of the shares as is a dividend. Paragraph 160ZH(4)(a) states that "consideration" for the purposes of the capital gains tax provisions includes any amount "paid or payable" in respect of the asset. As to the amount of the consideration (if any) paid by the shareholder, the High Court in John's Case concluded that the declaration of a dividend, to be satisfied by the issue of shares, did not result in the paying of an amount for those shares; nor did it result in the shareholder forgoing anything in respect of those shares. Consequently, it is the view of this Office that no consideration can be taken to have been paid in respect of the scrip dividend shares under either the relevant capital gains provisions or under general law.

32. Some of the professional bodies have asked whether subsection 160ZH(9) of the Act, as amended by section 19 of the Taxation Laws Amendment Act 1990, will deem any consideration to

have been paid in the circumstances of a scrip dividend. These changes apply to all assets acquired on or after 16 August 1989. Paragraph 160ZH(9)(a), as amended, does not apply to situations where the acquisition of an asset does not involve a corresponding disposal by the person from whom the asset was acquired. Under paragraph 160M(5)(a) of the Act the issue or the allotment of shares by a company does not constitute, for capital gains purposes, the disposal of those shares by the company. Consequently, paragraph 160ZH(9)(a) will not deem a consideration to have been paid.

33. Additionally, paragraph 160ZH(9) of the Act, in so far as is relevant, will only deem consideration to have been paid where there is no disposal of the asset by the taxpayer, and the actual consideration paid for the asset is greater than the asset's market value. Applying the reasoning in John's case, no amount has actually been paid as consideration for the issuing of the shares.

34. Consequently, in these circumstances the cost base under section 160ZYHC of the Act is in our opinion limited to "so much of the paid-up value of the bonus shares as is a dividend". As was explained in paragraphs 22 to 26 above this Office takes the view that the paid-up value of shares can never exceed the par value. Therefore both the dividend and the cost base of the shares is limited to the par value of the shares, that is, $1 in the example used.

35. It has been suggested that paragraph 6BA(3)(b) would operate in the circumstances of a scrip dividend to apportion the cost of the original shares between the original and the new shares. This Office takes the view that paragraph 6BA(3)(b) was intended to operate in conjunction with Division 8 of Part IIIA of the Act and that together they were intended to establish a general code for determining the cost base of bonus shares issued in circumstances where no amount is included in the assessable income of the shareholder as a dividend. (See the Explanatory Memorandum to sections 4 and 19 of the Income Tax Assessment Amendment (Capital Gains) Act 1986).

36. Subsequent to the introduction of the these provisions a separate code, Division 8A of Part IIIA, was introduced specifically to deal with the situation where an assessable dividend is used in part or whole, to pay up a share. Division 8A has its own specific formula in section 160ZYHC for the calculation of the cost base of such shares.

37. Given this legislative history this Office takes the view that paragraph 6BA(3)(b) has no operation in respect of shares which are covered by the provisions of Division 8A.

38. Support for this construction can be found in the Explanatory Memorandum to section 32 of Taxation Laws Amendment Act (No.3) 1987 which introduced Division 8A. The Memorandum explains (at page 60) that:

> "In cases where the new Division 8A applies, the cost base, indexed cost base or reduced cost base of the bonus shares is determined solely by reference to the terms of Part IIIA. This contrasts with the determination of the cost base, indexed cost base or reduced cost base to which Division 8 applies, which requires reference to section 6BA of the Principal Act."

Share Premium Account

39. The definition of a "share premium account" in subsection 6(1) of the Income Tax Assessment Act requires that such an account may only contain premiums received by the company on shares issued by it. On the basis of Inland Revenue Commissioners v. Blott [1921] 2 AC 171, per Viscount Finlay at 194 and Lord Cave at 200, and Commissioner of Taxes (Victoria) v. Nicholas (1940) 69 CLR 191 per Lord Thankerton at 197, this Office takes the view that no amount is received by the company in the circumstance of a scrip dividend where the par value and any "premium" are fully satisfied by the transfer of accounting entries in the company's books. Those cases make it clear that in the circumstances of a scrip dividend the company does not divest itself of any amount nor is any amount received by the shareholder. In such a case shareholders do not make any actual disbursement. All that happens is that amounts are transferred between accounts in the books of the company. It logically follows that if a shareholder receives nothing from the company and pays nothing in respect of the shares (John's Case) then the company receives nothing from the shareholder.

40. It is considered that the definition of share premium account in using the word "received" is referring to an actual receipt and not some sort of constructive receipt (Gresham Life Assurance Society v. Bishop [1902] AC 287 per Lord Brampton at 294).

41. In any event, since the shareholders cannot sue for the money amount attributable to the additional shares they receive (cf Blott's Case [1921] 2 AC 171 at 194) and have no choice between money or scrip (John's Case 89 ATC 4101 at 4111 and 4115; 20 ATR 1 at 12 and 17) the arrangement cannot be regarded as involving a set-off of one legally enforceable debt against another so as to give rise to any possible constructive receipt.

42. Paragraph (a) of the definition of "share premium account" in subsection 6(1) of the Act states that if the amount standing to the credit of an account includes an amount which is not in respect of share premiums received by the company

then that account is not a share premium account within the meaning of the definition. It follows that where the difference between the par value and discounted market value of the shares is credited to a pre-existing share premium account that account ceases to be a share premium account for taxation purposes as it no longer solely contains premiums received by the company. However, it is considered that the account will only lose its status as a share premium account during the period in which it contains disqualifying amounts. The removal of all such amounts, e.g. by transfer to another account, would result in the account regaining its status as a share premium account.

Date of Effect

43. In respect of those taxpayers who have received an Advance Opinion explaining the revised approach the date of effect of this Ruling will be the date the Advanced Opinion was received. For all other taxpayers this Ruling will apply to all scrip dividends (as described in paragraph 2) declared on or after 1 July 1990.

44. Nothing in this Ruling should be read as altering Taxation Ruling No. IT 2285 which deals with conventional non-compulsory dividend reinvestment plans.

COMMISSIONER OF TAXATION
29 June 1990