IT 2627 - Income tax: application of Part IVA to dividend stripping arrangements

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TAXATION RULING NO. IT 2627

INCOME TAX: APPLICATION OF PART IVA TO DIVIDEND STRIPPING ARRANGEMENTS

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Reference no.:	Subject refs:	Legislative refs:
I 1012530	POST-PART IVA DIVIDEND STRIPPING TAX AVOIDANCE DIVIDEND STRIPPING OPERATION IMPUTATION	PART 1VA SECTIONS 44,46, 160APHA,160APP(6), 160AQT,160AQU, 177A,177E,177F

OTHER RULINGS ON THIS TOPIC:

PREAMBLE As outlined in the Explanatory Memorandum, the enactment in 1981 of Part IVA was intended to overcome the difficulties that had been encountered in the application of the former general anti-avoidance provision, section 260, and to operate as an effective general measure against tax avoidance arrangements.

2. The Explanatory Memorandum went on to say that section 177E was designed to operate as a self-contained code within Part IVA for dealing with so called dividend stripping schemes which might not otherwise have come within the general ambit of sections 177C and 177D, particularly because of perceived difficulties in identifying a "tax benefit".

3. This Ruling provides general guidelines for the application of section 177E to dividend stripping arrangements. In general terms, the Ruling is concerned with the position of the original shareholders of a company that is the subject of a dividend stripping operation. The Ruling does not consider the position of other parties that may be involved in a dividend stripping operation, e.g., a stripper or new shareholders.

RULING GENERAL

4. Where section 177E operates, it deems the scheme to be one to which Part IVA applies (paragraph 177E(1)(e)). This makes it unnecessary to consider the operation of section 177D and whether an entrant into the scheme did so for the purpose of obtaining a tax benefit. Section 177E also deems the taxpayer to have obtained a tax benefit, being the non-inclusion in assessable income of the amount that would have been included if the company had paid the dividend described by paragraph 177E(1)(c) (paragraphs 177E(1)(f) and (g)). This makes it

unnecessary to consider the operation of section 177C.

5. Section 177E operates where four pre-conditions are satisfied. These are set out in paragraphs 177E(1)(a)-(d) of Part IVA and are discussed below.

DIVIDEND STRIPPING

6. Paragraph 177E(1)(a) sets out the initial and key test that there must be a scheme that is, in relation to a company, either one by way of, or in the nature of, dividend stripping or is one having substantially the effect of such a scheme.

7. Scheme is defined in section 177A. That definition is very broad and it may be that in a given case there will be several possible schemes. It is important to identify the point at which a scheme commences and the transactions that are parts of it.
The time of commencement will affect which taxpayer is targeted by Part IVA and the transactions included will determine which disposals of property occurred as a result of the scheme. It is unlikely that an unassociated concurrence of events would amount to a scheme, although questions of proof arise in such instances. It does not matter which of the parties devised the scheme. In some cases it may even be that someone other than a party devised it.

8. The term 'dividend stripping' has no precise legal meaning. Therefore, it is not possible in this Ruling to provide exhaustive definitions of what does and what does not satisfy that expression.

9. However, it can be said that in its traditional sense a dividend stripping scheme would include one where a vehicle entity (the stripper) purchases shares in a target company that has accumulated or current years' profits that are represented by cash or other readily-realisable assets. The stripper pays the vendor shareholders a capital sum that reflects those profits and then draws off the profits by having paid to it a dividend (or a liquidation distribution) from the target company.

10. No exhaustive list of other examples can be given of what might constitute a dividend stripping scheme for the purposes of section 177E. Having regard to the overall scope and purpose of the section, an important element to be looked at will be any release of profits of a company to its shareholders in a non-taxable form, regardless of the different methods that might be used to achieve this result.

11. Where one step in the scheme includes the purchase of shares or an issue of shares, it will usually be the case that the vendor shareholder, the company, or an assignee or associate will receive some consideration for the transfer or issue. It is not necessary that the consideration represents the full market value of the shares. Determining whether such an acquisition forms part of the scheme is very important. If it does, then the effect of applying Part IVA will normally be the

inclusion of an amount in the assessable income of the previous shareholders.

HAVING SUBSTANTIALLY THE SAME EFFECT

12. By its express terms, section 177E can apply not only where there is a scheme by way of, or in the nature of, dividend stripping but also where there is a scheme having substantially the effect of a scheme by way of, or in the nature of, a dividend stripping (subparagraph 177E(1)(a)(ii)). It is considered that the addition of the indefinite article does not affect matters.

13. For a scheme to fall within the subparagraph, it would require at a minimum that company profits are effectively distributed to shareholders.

14. The examples advanced in the Explanatory Memorandum concerned the removal of profits of the target company by way of irrecoverable loans to the shareholder rather than by way of a dividend or liquidator's distribution. This is because the liberation of profits into shareholders' hands is required for a scheme to have substantially the effect of a dividend stripping scheme but the methods may vary.

15. The Explanatory Memorandum also identified payments, not to the shareholder, but to an associate of the shareholder. Again, the person to whom the profits are released is not vital but the relationship to the shareholder may be. Similarly, it would not matter if the profits were paid to an independent party so long as, in doing so, the payment can be said to be for the benefit of the shareholder or of an associate.

16. Consider, for example, a company with substantial accumulated profits owned by an individual who sells assets to the company for approximately ten times their real market value. This may not strictly be a scheme by way of, or in the nature of, dividend
stripping since there is no dividend or liquidator's distribution. However, it may well be a scheme having substantially the effect of such a scheme since it could involve the removal of profits of a company in a non-taxable form.

17. Another example that is considered to come within section 177E is the case of a cashed up company under a scheme of arrangement under sections 181 and 183 of the former Companies Act or sections 315 and 317 of the new code pursuant to which the assets and liabilities of the company are transferred to a newly incorporated company. The target company is dissolved without being wound up and its shareholders given paid-up shares in the new company to the value of the assets of the target company. The profits stripped from the target company show up in the hands of the vendor shareholders in the form of the paid-up shares in the new company.

PROPERTY IS DISPOSED OF

18. The final part of the first pre-condition is that, as a result of a scheme by way of, or in the nature of, dividend stripping, or one having substantially the effect of such a scheme, any property of the company is disposed of. Although the paragraph apparently lists the disposal of property as a separate requirement, it is difficult to think of a dividend stripping scheme that would not involve a disposal of property. This is particularly so, given the expansive definition of disposal of property in subsection 177E(2).

19. That subsection includes the payment of dividends, the making of loans, the bailment of property and any transactions having the effect directly or indirectly of diminishing the value of company property. The last item covers transactions that, while stripping a company of its profits, might not amount in law to a disposal of property. However, it is not necessary that there be a diminution in the value of company property for there to be a disposal of property. There can be a disposal of property even though it was for full consideration (Rose v. F.C. of T. (1951) 84 CLR 118).
A loan can be a disposal even though it was intended to be, and is likely to be, repaid (paragraph 177E(2)(b)).

20. The disposal of property must be as a result of the scheme. Therefore, as mentioned above, it is important to identify accurately the point at which the scheme commenced and the transactions that formed part of it. Disposals that occurred before the scheme was entered into, and contemporaneous but unrelated disposals, would not be disposals of the kind contemplated by section 177E.

21. What is property for the purposes of section 177E is defined inclusively in subsection 177E(3). The definition adds to, rather than replaces, the ordinary legal meaning. In law, 'property' is the most comprehensive of terms: it is indicative of every possible interest that a party can have (Jones v. Skinner (1836) 5 LJ Ch 90).

DISTRIBUTION OF COMPANY PROFITS

22. Having identified the disposal of property, the second pre-condition to the operation of section 177E is that, in the opinion of the Commissioner, it represents, in whole or in part, a distribution of profits of the company (paragraph 177E(1)(b)). The distribution need not be to a shareholder and may be a distribution of profits of any accounting period, including those before or after the disposal. Accordingly, it is not necessary for the profits to have existed when the property was disposed of. For example, the company's shares might be sold to a stripper who then sells a worthless business to the company for a price including an extravagant amount for goodwill. There is no immediate payment, merely the creation of a debt (secured over company assets) which is repaid in future years as the company derives profits. The creation of the debt is a disposal of property of the company even though it represents a distribution of future profits.

23. What constitutes profits of a company is a matter which depends on the circumstances of each case. However, when Gibbs CJ (with whom the other members of the High Court agreed) examined some of the relevant issues in F.C. of T v. Slater Holdings Ltd (No. 2) (1984) 156 CLR 447, his Honour took as a starting point a definition of 'profits' that involved a comparison of the assets of a business at two specific dates, the 'profit' usually being the gain made between the two dates. His Honour's judgment is also authority for treating profits that are gifts to a company or that are capital profits of a company as profits for the purposes of section 177E. The inclusion of amounts of these types is in accordance with the intention of the section which is to defeat schemes designed to remove profits of a company that would have been assessable if they had been distributed by way of a dividend.

WHO IS ASSESSED AND ON HOW MUCH

24. The third pre-condition is provided for by paragraph 177E(1)(c) which calls for a consideration of what would have been the position if the profits concerned had been paid as a dividend immediately before the scheme was entered into. It requires the conclusion that in that event an amount would, or might reasonably be expected to, have been included in a taxpayer's assessable income. The wording of the paragraph is sufficiently broad to cover not only the position of shareholders who might have received a dividend on their own account but those whose entitlement is as a beneficial owner of shares held by a trustee.

25. There is no necessity for there actually to be any profits immediately before the moment that the scheme was entered into. Paragraph 177E(1)(c) is concerned with the purely hypothetical question of whether the payment of a dividend out of profits (which might or might not have existed at the time) immediately before the
scheme was entered into would, or might reasonably be expected to, have included an amount in the assessable income of any taxpayer. The purpose of the paragraph is to identify the taxpayers who would have received the notional hypothetical dividend and the amount that would have been included in their assessable income if that dividend had been declared. It does not require that the payment of a dividend was feasible at that time.

TIMING OF SCHEME

26. The final pre-condition can be found in paragraph 177E(1)(d) which requires that the scheme was entered into after
27 May 1981, whether inside or outside Australia. This requirement ensures that the application of section 177E is consistent with the general application of Part IVA.

OPERATION OF PART IVA

27. If all of the pre-conditions are satisfied, the deeming provisions described in paragraph 4 apply.

28. It needs to be borne in mind that even if some company profit stripping schemes fall outside the operation of section 177E, consideration should be given to whether the other provisions of Part IVA apply.

29. If section 177E operates in a particular case, the Commissioner may apply section 177F to determine precisely what adjustments should be made in the assessments of the vendor shareholders and of other taxpayers affected by the scheme. A relevant question here is whether the actual shareholders are also to be assessed on dividends received. A taxpayer may seek a compensating adjustment under subsections 177F(3) to (8).

30. The appropriate determination under subsection 177F(1) in dividend stripping cases is the inclusion in the assessable income of vendor shareholders of the full amount of the tax benefit obtained in connection with the scheme, as calculated for the purposes of section 177E. Regardless of when the scheme was entered into, a reduction should not be made for amounts representing capital profits of the target company since any dividend declared out of those profits would have been assessable under section 44. This is so notwithstanding that the target company may later be wound up.

31. Subsection 177F(1) uses the word "may". This gives the Commissioner a discretion whether or not to make a determination (Fletcher v. FCT 88 ATC 4834). A determination will usually be made where the Commissioner believes the provisions of Part IVA are satisfied. However, the discretion will not be exercised if
cases arise where the view is formed that there is no real avoidance of tax. This may be particularly relevant to the application of section 177E, where there need not be a tax benefit or a tax avoidance purpose before the section applies.

32. Subsection 177F(2) requires the Commissioner to determine the appropriate provision of the Act under which the amount in question is to be included in the assessable income. In the case of dividend stripping schemes, the appropriate provision will normally be section 44, which provides for the assessment of dividends paid out of profits.

33. Some doubt has been expressed whether the effect of including an amount under section 44 is to make that amount a dividend or merely to include it in the assessable income without characterisation. In this regard the Explanatory Memorandum stated:

> 'An example of where a determination of the provision under which an amount is to be included in assessable income would be relevant is where there is a question of whether or not an amount to be included in the assessable income of a company has the character of a dividend on which the rebate of tax on inter-corporate dividends (section 46) is allowable.'

34. It is considered that inclusion of an amount, by the operation of section 177E, in the assessable income of a taxpayer by virtue of section 44 makes that amount a dividend receipt in the hands of the taxpayer. A vendor shareholder that is a company would be entitled to the rebate of tax on inter-corporate dividends if section 46 of the Act is otherwise satisfied and if other disabling provisions do not apply. This result is consistent with the general approach of section 177E to treat the former shareholders as if they had received an assessable dividend paid by the company.

35. With regard to imputation, it is not practicable to attempt to provide definitive rulings in view of the various factual positions that may arise. For example, there need not be any dividends actually declared for section 177E to apply. It is clear that an amount included in assessable income under section 44 by virtue of section 177E and subsection 177F(2) would not come within the definition of "frankable dividend" in section 160APA. Accordingly, these dividends cannot be franked. Where dividends are declared it is probable that the franking credits and franking rebates that would otherwise be available would be denied to the actual shareholders by the operation of section 160APHA, subsection 160APP(6) and sections 160AQT and 160AQU. Should any cases arise to which this paragraph would apply the details should be furnished to National Office.

COMMISSIONER OF TAXATION
10 January 1991