



# ***TR 2012/1 - Income tax: retail premiums paid to shareholders where share entitlements are not taken up or are not available***

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## Taxation Ruling

### Income tax: retail premiums paid to shareholders where share entitlements are not taken up or are not available

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#### **① This publication provides you with the following level of protection:**

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant 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.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

## What this Ruling is about

1. This Ruling is about the taxation of Retail Premiums paid to shareholders in companies in respect of amounts subscribed for shares.

### **Scheme**

2. This Ruling applies to schemes with the following features:
- A company grants rights (Entitlements) to its existing shareholders (subject to their eligibility) that allow them to subscribe for an allotment of new shares in the company at an amount, often called the 'Offer Price';
  - The Entitlements cannot be traded, transferred, assigned or otherwise dealt with by the shareholder or on behalf of the shareholder or anyone else;
  - The Offer Price is, or may be at the time of subscription, less than the current market value of the shares;

- Shareholders can choose not to exercise some or all of their Entitlements to an offered allotment (which Entitlements lapse if not exercised), or may not be eligible to receive an Entitlement or may not be permitted to exercise rights under it. (These shareholders are referred to in this Ruling as 'Non Participating Shareholders');
- Non Participating Shareholders who are not eligible to receive an Entitlement, or are not permitted to exercise rights under it, are most commonly non-resident shareholders who reside in a jurisdiction where an Entitlement they could exercise would require the grant of the Entitlement to comply with rules particular to that jurisdiction;
- Entitlements which Non Participating Shareholders did not exercise or could not exercise or could not receive are collectively referred to in this Ruling as 'Unexercised Entitlements';
- The company issuing the Entitlements also issues shares ('equivalent shares'), equivalent to those which would have been issued under the Unexercised Entitlements, to other subscribers (such as Institutional investors), often to those offering the highest amount for them in what is commonly referred to as a 'Bookbuild process';
- The amount offered by the other subscribers for these equivalent shares is commonly referred to as the 'Clearing Price'. The Clearing Price is offered by the other subscribers as one amount, all as consideration for the issue of the equivalent shares under the Bookbuild process;
- The Clearing Price is paid to the company directly, or indirectly through one or more of its agents or nominees (commonly the 'Lead Managers' or underwriters of the issue of company shares, or the share registry of the company);
- Where the consideration for the issue of the equivalent shares (such as the Clearing Price under a Bookbuild process) is more than a set amount per share, the company makes a payment based on the excess to the shareholders who had Unexercised Entitlements for which the equivalent shares are issued. This is the retail premium (Retail Premium). Commonly the set amount is the Offer Price at which Entitlements could be exercised, and the Retail Premium is the whole excess of a Clearing Price over that Offer Price. The difference between the Offer Price and the Clearing Price commonly arises because the Offer Price of the Entitlements is set at an appreciable discount below the known and expected market value of shares in the company;

- The Retail Premium paid may be all or only part of the excess according to which it is calculated;
  - As a result, the Retail Premium is funded from part of the consideration for the issue of the equivalent shares of the company; and
  - The Retail Premium payment by the issuing company to Non Participating Shareholders is usually recorded on statements by the issuing company prepared by the issuing company's share registry, recording:
    - the issuing company's name;
    - that the amount of the Retail Premium paid is based on the shareholder's Entitlements which in turn are based on their holdings in the issuing company;
    - the amount paid to the shareholder; and, in some cases,
    - that the payment is in relation to new shares issued by the company under the Bookbuild process.
3. This Ruling does not consider arrangements where:
- Entitlements are assignable by, tradeable by, or given to a nominee entity for disposal on behalf of, the Non Participating Shareholders entitled to them; or
  - Entitlement offers are to issue of equity in trusts or to issue of equity in Stapled Groups. Stapled Groups are separate entities including at least one trust that is taxed under Division 6 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) where there is equity in each entity that can be issued or transferred only with a fixed amount of equity in each other entity. Equity in such entities is commonly described as stapled.

## Ruling

### Retail Premium paid to Non Participating Shareholders

#### *Dividends*

4. A Retail Premium paid to a Non Participating Shareholder is a dividend that is included in assessable income under section 44 of the ITAA 1936, unless the Retail Premium is non-assessable non-exempt income.

5. A Retail Premium paid to a non-resident will be non-assessable non-exempt income under section 128D of the ITAA 1936 where it is subject to withholding tax under section 128B of the ITAA 1936.

### **Franking of dividend**

6. A Retail Premium paid to a Non Participating Shareholder is an unfrankable distribution sourced, directly or indirectly, from a company's share capital account pursuant to paragraph 202-45(e) of the *Income Tax Assessment Act 1997* (ITAA 1997).

### **Withholding tax on Retail Premiums to non-resident Non Participating Shareholders**

7. A Retail Premium paid to a non-resident Non Participating Shareholder will be a dividend subject to withholding tax under subsection 128B(1) of the ITAA 1936, unless excluded under another provision of the ITAA 1936, ITAA 1997, or of the *International Tax Agreements Act 1953* which gives the force of law to certain international tax agreements. Withholding tax does not apply to dividends to the extent they are franked (see paragraph 128B(3)(ga) of the ITAA 1936). As a Retail Premium paid to a non-resident is an unfrankable distribution pursuant to paragraph 202-45(e) of the ITAA 1997 withholding tax will apply under subsections 128B(1) and 128B(4) of the ITAA 1936.

### **Ordinary income**

8. In the alternative, a Retail Premium paid to a Non Participating Shareholder is ordinary income that is assessable income under section 6-5 of the ITAA 1997 if the Retail Premium is not a dividend.

### **Capital gains tax**

9. A CGT asset, being a right, comes into existence when a Non Participating Shareholder becomes entitled to a Retail Premium.

10. When the Retail Premium is paid to the Non Participating Shareholder, CGT event C2 under section 104-25 of the ITAA 1997 happens.

11. Any capital gain a Non Participating Shareholder makes from receipt of the Retail Premium is reduced under section 118-20 of the ITAA 1997 to the extent that the amount is otherwise included in the Non Participating Shareholder's assessable income (under section 44 of the ITAA 1936, or alternatively section 6-5 of the ITAA 1997), or is non-assessable non-exempt income (under section 128D of the ITAA 1936).

## **Date of effect**

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12. This Ruling applies to income years commencing both before and after its date of issue. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

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**Commissioner of Taxation**

25 January 2012

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## Appendix 1 – Explanation

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

### **Retail Premiums paid to Non Participating Shareholders are assessable dividends**

#### **Summary**

13. It is the Commissioner's view that the Scheme to which this Ruling applies, includes the:

- grant by a company of rights to shareholders to subscribe for new shares in a company with a facility for payment of Retail Premiums to Non Participating Shareholders;
- issue of new shares in the company to third parties in respect of the unexercised or unavailable Entitlements of Non Participating Shareholders; and
- payment by the company of Retail Premiums to the Non Participating Shareholders,

and is an arrangement for the purposes of subsection 6(4) of the ITAA 1936. Under that arrangement, the subscription money paid by the third parties for the equivalent shares issued in respect of the Unexercised Entitlements of Non Participating Shareholders are paid or credited to the company. The company then pays or credits money (in the form of the Retail Premiums) to the Non Participating Shareholders and debits its share capital account by the amount of the money paid, for the purposes of subsection 6(4).

14. A Retail Premium is paid by a company, to a Non Participating Shareholder, from amounts forming part of the company's share capital and in amounts debited to and sourced from the company's share capital account. As subsection 6(4) of the ITAA 1936 applies to the payment of the Retail Premium it is excluded from the exception in paragraph (d) to the definition of 'dividend' in subsection 6(1) of the ITAA 1936. As a result the Retail Premium falls within the definition of dividend in subsection 6(1), and is deemed to be a dividend paid out of profits under subsection 44(1B) of the ITAA 1936. Consequently, the Retail Premium is assessable income under section 44 of the ITAA 1936 for the reasons stated in paragraphs 13 to 75 of this Explanation.

***Paid by the company***

15. A Retail Premium is paid by the company, whether it is paid directly by the company or by an agent or contractor of the company which is obliged by the company to pay it. The Commissioner considers that the character of a Retail Premium as an amount paid by the company is not changed, whether it is in fact paid by a merchant bank contracted to underwrite the float of shares in the company or as a Lead Manager of that float, or if it is paid by a separate entity that provides the company's share registry, or if it is paid directly by company cheque or by electronic transfer from an account in the company's name.

16. The issuing company usually enters into agreements with any third parties, such as the relevant underwriters, Lead Managers and share registry. The issuing company includes, within the terms of the agreements, its obligation to pay a Retail Premium to Non Participating Shareholders according to the excess subscription monies raised (such as under a Bookbuild process), whether directly or by the underwriters and/or Lead Managers and/or share registry. The relevant third party agreements may provide that the issuing company is itself obliged to pay, or to secure payment, of the Retail Premium from any advance the third parties have to make in relation to the value of the excess to the company before the consideration for the issue of the equivalent shares is paid. However, whether or not there is any advance to the company or any earlier payment of the Retail Premium because of such an advance is not material.

17. A company pays the Retail Premium when it is paid by any third party, such as the relevant underwriters, the Lead Managers and the share registry, acting as agents of the company, or applying the company's funds according to its instructions and directions. If a company elects to have a third party manage money paid as consideration for the issue of shares, the consideration is given to the company, is subscribed to the company's share capital and is the company's money. A Retail Premium payment on account of an amount of consideration subscribed or offered to be subscribed for shares is an application of the company's money by the company.

18. This view is consistent with the practical operation of the dividend provisions in the income tax law and with the practical operation of the *Corporations Act 2001*. The dividend provisions apply in the same way whether a company directly pays, provides or distributes to its shareholders, or acts indirectly through an agent, a contractual counterparty or otherwise.



***Paid to shareholders as shareholders***

19. A Retail Premium is paid by the company to shareholders of the company in their capacity as shareholders. The Non Participating Shareholders are shareholders of the company. A Retail Premium arises for them only because and only according to the extent to which they are shareholders who have not exercised Entitlements or were ineligible to receive or exercise Entitlements. Non Participating Shareholders are entitled to a Retail Premium only if a sufficient amount is offered as consideration for the issue of shares by third party subscribers, and only so far as the new shares are equivalent to those for which the Non Participating Shareholders did not subscribe or could not subscribe by exercising Entitlements.

***Retail Premium not paid as consideration for Entitlements***

20. The Retail Premium is not paid for the rights of the Non Participating Shareholders to subscribe for shares under Entitlements. The Retail Premium has the same character whether the Non Participating Shareholder had Entitlements they could have exercised but did not, had Entitlements they were not permitted to exercise, or had no Entitlements. No Retail Premium will arise if the consideration offered for the equivalent shares does not exceed a threshold. A Non Participating Shareholder has no Entitlements when the equivalent shares are offered for subscription, whether or not a shareholder had Entitlements they could have exercised, or had Entitlements they were not permitted to exercise, or had no Entitlements. At the earliest time when the right to a Retail Premium arises no Entitlements of a Non Participating Shareholder exist. The connection between the shares' consideration that gives rise to the Retail Premium and the shares that would have issued had Entitlements been exercised is only relevant in identifying those particular shareholders who are to receive a Retail Premium. This connection does not alter the character of a Retail Premium as a payment made to shareholders in that capacity. It also does not make the Retail Premium a payment for the loss of Entitlements (see Alternative View 3 at paragraphs 143 to 163 of this Ruling).

***Dividends***

21. The definition of 'dividend' in subsection 6(1) of the ITAA 1936 has the general effect that any distribution made by a company to any of its shareholders, whether in money or property, and any amount credited by a company to any of its shareholders as shareholders, is a dividend.

22. A Retail Premium would fall under paragraphs 6(1)(a) and 6(1)(b) of the ITAA 1936 of the definition of 'dividend', as it is an amount paid or credited by a company to some of its shareholders, the Non Participating Shareholders, as shareholders. When a company secures by contract that an amount be paid or credited to its shareholders, it credits those amounts to them (and does not credit to its shareholders the consideration it gives under the contract which secures the payment or credit to shareholders). A Retail Premium may be paid directly by the company, be paid by the company through an independent share registry acting for the company as its agent, or be paid by the company through a contractor obliged to pay the Retail Premium such as an underwriter of a share issue including subscription for shares on exercise of the Entitlements and for shares issued in substitution for those under Unexercised Entitlements.

23. Paragraph (d) of the definition of 'dividend' in subsection 6(1) of the ITAA 1936 generally excludes a distribution from being a dividend if the distribution is debited against an amount standing to the credit of the company's share capital account. Under the current scheme to which this Ruling applies, the Retail Premium is or might properly be debited against an amount standing to the credit of the share capital account of the company.

24. However, subsection 6(4) of the ITAA 1936 states that the exclusion in paragraph (d) to the definition of 'dividend' in subsection 6(1) of the ITAA 1936 **does not apply** even though the amount is so debited if, under an arrangement:

- (a) a person pays or credits any money or gives property to the company and the company credits its share capital account with the amount of the money or the value of the property; and
- (b) the company pays or credits any money, or distributes property to another person and debits its share capital account with the amount of the money or the value of the property so paid, credited or distributed.

25. As an issuing company under the current scheme has raised share capital from one set of shareholders (here, the third party subscribers who paid for equivalent shares such as under a Bookbuild process) and made a distribution of part of this share capital to another set of shareholders (here, by a Retail Premium paid to the Non Participating Shareholders), subsection 6(4) of the ITAA 1936 applies to exclude the payment of the Retail Premium from the exception in paragraph (d) from the definition of 'dividend' in subsection 6(1) of the ITAA 1936.

26. Accordingly, Retail Premium payments are a dividend as defined in subsection 6(1) of the ITAA 1936 by the application of subsection 6(4) of the ITAA 1936, even if they are debited from amounts standing to the credit of a share capital account.

27. A dividend paid out of profits is included in the assessable income of a shareholder by subsection 44(1) of the ITAA 1936.

28. Subsection 44(1B) of the ITAA 1936 **deems** dividends debited against an amount standing to the credit of a share capital account to have been paid by the company out of profits derived by it. Accordingly, such Retail Premium dividends are deemed to be paid out of the company's profits, and are therefore dividends included in assessable income under subsection 44(1) of the ITAA 1936, unless the dividend is non-assessable non-exempt income (see paragraph 30 of this Explanation).

29. Effective from 28 June 2010, subsection 44(1A) of the ITAA 1936 deems any dividend paid out of an amount other than profits to be paid out of profits. Accordingly, if a Retail Premium is not debited against an amount standing to the credit of a share capital account, and assuming it is possible for the Retail Premium to be paid from amounts other than profits, then it is deemed to be paid out of the company's profits, and is therefore a dividend included in assessable income under subsection 44(1) of the ITAA 1936.

### ***Dividends to resident & non-resident shareholders***

30. Dividends other than non-share dividends (within the meaning given by section 974-120 of the ITAA 1997) are included in assessable income only so far as they are paid out of profits or deemed to be paid out of profits derived by the company (for a resident shareholder, profits derived from any source (subparagraph 44(1)(a)(i) of the ITAA 1936); for a non-resident shareholder, profits derived from sources in Australia (subparagraph 44(1)(b)(i) of the ITAA 1936); for a non-resident shareholder carrying on business in Australia at or through a permanent establishment, and where the company is a resident, profits derived from sources outside Australia so far as the dividends are attributable to the permanent establishment (subparagraph 44(1)(c)(i) of the ITAA 1936). However, a Retail Premium paid to a non-resident and that is subject to withholding tax will be non-assessable non-exempt income under section 128D of the ITAA 1936.

### ***Share capital***

31. The Retail Premium is sourced from share capital of the company.

32. It is the Commissioner's view for the purposes of the income tax law that all amounts paid in consideration for the issue of shares by a company are share capital of the company (which should be credited to the company's share capital account).

33. A Retail Premium is paid according to and sourced from share subscription proceeds, paid by third parties as consideration for the issue to them of shares in the issuing company. The third parties pay the Clearing Price all of which is consideration for the issue of the equivalent shares, whether the third parties pay under a Bookbuild share issue, under a float managed by a Lead Manager or underwriters, or otherwise. Accordingly, the total amount paid by the third parties for the issue of the shares is share capital of the issuing company for income tax purposes and should be properly credited to the share capital account of the issuing company for income tax purposes.

34. The ITAA 1936 and the ITAA 1997 use the concept of share capital without a statutory definition of the term (though share capital account has long been defined for income tax purposes, currently in section 975-300 of the ITAA 1997). The *Corporations Act 2001* includes **Chapter 2H-Shares** and **Chapter 2J-Transactions affecting share capital** but also without a statutory definition of the term. The ordinary meaning of share capital applies. This meaning is supported by case law, which has also been reflected in discussions in legal text books and Explanatory Memoranda.

#### *Case law definition of share capital*

35. The concept of share capital was considered by the High Court in *Archibald Howie Proprietary Ltd & Ors v. Commissioner of Stamp Duties (NSW)* (1948) 77 CLR 143 (*Archibald*) where Williams J stated, at 157:

**A company obtains capital by the issue of its shares....**The amount payable may be satisfied by the payment of money or by some other proper consideration. But all shares must be paid for in full by money or money's worth. When the person to whom the shares are allotted pays or assumes the liability to pay for the shares in money or money's worth, **full consideration in money or money's worth moves from him to the company** for all the rights which he acquires under the memorandum and articles of association [emphasis added].

36. In *Archibald*, Dixon J also supported the above view when he stated at 152-3:

The consideration given is the payment up of the share capital in satisfaction of the liability for the amount of the share incurred on allotment.

From the standpoint of company law the division of the capital of a company into shares and the payment up of shares issued are regarded as respectively significant and real. The shareholder contributes the amount of the share to the capital of the company. This contribution measures his right to any return of capital which the company may make either as a going concern or in a winding up.

37. The principle that it is the total consideration for a share issue that is the capital that is paid to the company was confirmed by Mason J in the High Court in *Ord Forrest Pty Ltd v Federal Commissioner of Taxation* (1974) 130 CLR 124; 1973 2 ALR 403 where his Honour stated at CLR 156:

In the case of the issue of shares for cash the assets of the company are increased only by the total value of the consideration payable in respect of the allotment.

38. The above statements by Williams J and Dixon J in *Archibald* were also referred to and approved by Gillard J in *Re The Swan Brewery Co Ltd* (1976) 3 ACLR 164 (*Swan Brewery*), where his Honour stated at 165:

Those *dicta*, to my mind, indicate the concept of what is 'share capital'.

39. In support of the above principle regarding share capital, Gillard J then said at 166:

But when one talks about share capital, in my view, it means capital raised by the company from the issue of its shares.

40. The meaning of the term 'issued share capital', was also considered by Gillard J in *Swan Brewery* at 166:

...when one uses the words 'issued share capital', then it seems to me that this expression means money or money's worth derived from the issue by directors of shares in order to raise capital.

41. These statements were endorsed and applied by the Full Court of the Federal Court in *St George Bank Ltd v. Federal Commissioner of Taxation* (2009) 176 FCR 424; [2009] FCAFC 62; 2009 ATC 20-103; (2009) 73 ATR 148 (*St George*). As Perram J said at FCAFC paragraph 90:

...If the subscription consideration is money then the company obtains money; if it is land, it obtains land; if the share is not fully paid then the company acquires a right to call upon the unpaid portion. The 'capital' of the company is the money or money's worth derived by the company from the issue of shares: *Re The Swan Brewery Co Ltd* (1976) 3 ACLR 164 at 166 per Gillard J.

#### *Corporate law text book definitions of the term 'share capital'*

42. It should be noted that corporate law text book definitions of share capital quote from, are consistent with and confirm the context of the above case law authority.

43. In Ford's *Principles of Corporations Law*<sup>1</sup>, share capital is described at page 929:

A company's share capital is the total amount of money representing what members, or persons proposing to be members of the company, have provided, or contractually bound themselves to provide, to the company, in cash or other value, for the company to use in its undertaking, they having done so in their character of members or intending members and not as creditors: see [17.020]. Compare *Re Swan Brewery Co Ltd* (1976) 3 ACLR 164.

Capital subscribed by members as such is called 'share capital' rather than just capital.

44. In *Commercial Applications of Company Law*<sup>2</sup> share capital is described at page 355:

**The company's share capital is the amount of money or assets contributed to the company by its members when they subscribe for shares in the company.** In subscribing for a share, a person who wishes to become a member takes some of the person's own money or assets and **contributes that amount to the company.** The money or assets contributed then belong to the company. In return, the member is issued with shares in the company [emphasis added].

45. A similar definition of share capital was used in the corporate law text *Understanding Company Law*<sup>3</sup> where it is described at page 166:

Share capital (sometimes also referred to as 'equity capital') comprises the **total amount of money or other property that investors pay to the company for the shares issued to them** [emphasis added].

#### *Explanatory memorandum discussion of share capital*

46. In a taxation context, a similar definition of share capital was explained in paragraph 4.10 of the Explanatory Memorandum<sup>4</sup> referring to section 975-300 of the ITAA 1997 (which transferred to the ITAA 1997 the long-standing provisions defining the meaning of 'share capital account', originally 'share premium account' in the ITAA 1936). Paragraph 4.10 states:

The concept of share capital is not defined in the ITAA 1997. Under its ordinary meaning, share capital includes amounts received by a company in consideration for the issue of shares.

<sup>1</sup> R P Austin & I M Ramsey (14<sup>th</sup> Ed, Butterworths Aust 2010).

<sup>2</sup> P Hanrahan, I Ramsay & G Stapleton (8<sup>th</sup> Ed, CCH Aust Ltd 2007).

<sup>3</sup> P Lipton & A Herzberg (12<sup>th</sup> Ed Lawbook Co 2004).

<sup>4</sup> Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No 3) Bill 2006.

47. Although for some accounting purposes a company may treat funds raised from a share issue as a liability until it formally issues shares to its subscribers, paragraph 1.65 of the Explanatory Memorandum to the *Taxation Laws Amendment (Company Law Review) Bill 1998* states:

Under the Corporations Law, amounts received by a company for the issue of shares are credited to the share capital account. The share capital account of the company will thus already include all amounts paid-up on the shares of the company. Therefore a share capital account cannot be tainted by transferring amounts paid-up for shares to that account, but only by other accounts. ( Some accounting standards may require a company to initially treat part of what is legally share capital as a liability for accounting purposes, and then to transfer that amount to share capital. Since, however, for tax purposes the amount will already be credited to the share capital account, this transfer is not affected by the tainting rule.)

48. The above extract confirms the legislative view that, for Corporations Law and for tax purposes, these funds from the time of receipt are part of the share capital of the company and constitute part of the company's share capital account. Even if the funds are not part of the share capital account, once the company is bound to issue shares to the third party subscribers for the consideration making up the Clearing Price, the whole of the consideration received will then constitute part of the share capital and will be included in the share capital account of the company.

49. In the Commissioner's view the above case law, corporate law text book definitions and Explanatory Memoranda provide clear support that **all amounts** proffered in consideration for the issue of shares are paid, credited or given to the company, whether directly or indirectly through its agents. As, where a Retail Premium arises, the shares are issued in consideration of the whole of the amounts being proffered, the whole of the amounts is paid to the company and constitutes share capital of the company.

50. The amounts proffered in subscription for the issue of shares are share capital of the company and are properly credited by the company to its share capital account.

### **Share Capital Account**

51. A share capital account is defined in subsection 975-300(1) of the ITAA 1997 as:

- (a) an account that the company keeps of its share capital; or
- (b) any other account (whether or not called a share capital account) that satisfies the following conditions:
  - (i) the account was created on or after 1 July 1998;
  - (ii) the first amount credited to the account was an amount of share capital.

Subsection 975-300(2) of the ITAA 1997 also states that:

If a company has more than one account covered by subsection (1), the accounts are taken, for the purposes of this Act, to be a single account.

52. The consideration offered for the issue of shares by a company is share capital of the company. Where the amount of such consideration is received by others, but is to be applied in a way the company requires, whether by way of Retail Premium or otherwise (such as, for instance, in discharge of company debt or in acquisition of company assets), the entitlement of the company to an account from those others of the application of the amount of consideration constitutes an account under paragraph 975-300(1)(b) of the ITAA 1997. It is an account created when it arises, that is, at the moment amounts offered to subscribe for the company's shares are paid and the application is accepted. At that moment the first (and only) amounts credited to that account are amounts of share capital.

53. Section 975-300 of the ITAA 1997 does not permit a company to choose not to include share capital in the accounts which together constitute its share capital account. The provision is a re-enactment of the definition which accompanied and formed part of the provisions relating to dividends paid out of capital from the introduction of such provisions. The purpose and effect of those provisions clearly adopts and applies the critical concept that companies have only profits and share capital; an interpretation of section 975-300 which made inclusion in share capital accounts a nominal rather than a factual matter would be inconsistent with the critical concept on which the provisions depend.

54. The above view is also consistent with the later extract in paragraph 1.65 of the Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998 (which is quoted in paragraph 47 in this Explanation).

*Consideration for issue of shares credited to a company's share capital account even if the company has not recorded that it is in its share capital account*

55. In instances where a company has not formally recorded or credited some or all of a Clearing Price amount in its identified share capital account (or where the Clearing Price amount may be recorded and credited in a stated 'separate' or 'segregated' account under the name of an entity acting as agent for the company), the Retail Premium amount would still constitute part of the company's share capital account under subsection 975-300(1) of the ITAA 1997.

56. Any account to which the company is entitled, which comprises consideration offered for the issue of its shares is an account included as part of the company's share capital account under section 975-300 of the ITAA 1997.



57. Where the entity acts as agent or nominee for the company in keeping the account, the account is that of the company itself. Where the entity may be required to account to the company for the amount of consideration it receives into the 'separate' or 'segregated' account, the entitlement of the company to such accounting is an account. Consequently, what consideration is recorded or credited in a 'separate' or 'segregated' account is part of the share capital account of the company as:

- it is an account the company keeps (via the entity acting as the company's agent or trustee) of its share capital (paragraph 975-300(1)(a) of the ITAA 1997); or
- it is an account (whether or not called a share capital account) that was created to hold and credit, first, amounts received by the company in consideration for the issue of its shares (paragraph 975-300(1)(b) of the ITAA 1997), because the company is entitled to an accounting for those amounts and that entitlement first arises when the first of those amounts begins to be held by the entity as consideration of that kind.

58. If any part of the Clearing Price is recorded in such an account to which the company is entitled, whether an account to the company by another person of the application of that part of the Clearing Price or an account of the company maintained by an agent or nominee of the company, this account would constitute part of the share capital account of the company under section 975-300 of the ITAA 1997. This is because the entity is acting for the company and adhering to the company's instructions, in relation to both holding share capital raised by the company (from its Clearing Price amount) and in applying any of these proceeds to either the company, to the Retail Premium to its Non Participating Shareholders or to any other purpose agreed by the company. Paragraph 975-300(1)(b) of the ITAA 1997 also makes clear that an account can be a company's share capital account 'whether or not called a share capital account'.

#### *Consolidated Media Holdings Ltd case*

59. The view that a company cannot assert that accounts that contain its share capital are not part of its share capital account, is supported by the (first instance) Federal Court case of *Consolidated Media Holdings Ltd v Commissioner of Taxation* [2011] FCA 367 (*Consolidated Media*). This case is subject to appeal, and its reasoning is referred to here by way of illustration.

60. As reported in *Consolidated Media*, the taxpayer (Consolidated Media Holdings Ltd) owned all of the issued shares in Crown Melbourne Ltd (Crown). In June 2002, Crown paid the taxpayer \$1 billion as part of an off market share buy-back.

61. To facilitate the off market share buy-back, Crown established a Shareholders Equity Account, Inter-company Loan (Payable) Account, Inter-company Receivables Account and a Share Buy-back Reserve account in its general ledger.

62. At the time of the off market share buy-back, Crown debited its Share Buy-back Reserve account by \$1 billion. No entry was made in the Shareholders Equity Account in relation to the buy-back.

63. The taxpayer argued that the \$1 billion consideration it received under the buy-back was a dividend which attracted a rebate of tax, on the basis that it was paid from Crown's Share Buy-back Reserve account, which it alleged was not a share capital account of Crown.

64. However, the Commissioner argued that the \$1 billion consideration paid to the taxpayer was not a dividend, but a capital payment sourced from Crown's share capital account of which the Share Buy-back Reserve account was part.

65. The key issue in *Consolidated Media* was described by Emmett J in paragraph 67:

The critical question for present purposes is whether the purchase price of \$1,000,000,000 paid by Crown to the Taxpayer was debited against amounts standing to the credit of Crown's share capital account. That is to say, the question is whether any part of that sum was debited against amounts standing to the credit of an account that Crown keeps of its share capital. The taxpayer contends that the Share Buy-Back Reserve Account, number 310250, is the only account of Crown's in which the sum of \$1,000,000,000 was debited and that that account was not a share capital account of Crown.

66. In determining the above issue, Emmett J had to examine the definition of share capital account in the former section 6D of the ITAA 1936 which stated:

A share capital account is:

- (a) an account which the company keeps of its share capital; or
- (b) any other account (whether or not called a share capital account), created on or after 1 July 1998, where the first amount credited to the account was an amount of share capital.

6D(2) [More than one account] If a company has more than one account covered by subsection (1), the accounts are taken, for the purposes of this Act, to be a single account.

67. In *Consolidated Media*, Emmett J rejected the taxpayer's contention that Crown's Share Buy-back Reserve account was not part of its share capital account at paragraphs 68 to 72 of that case.

68. The definition of 'share capital account' in the former section 6D of the ITAA 1936 is materially identical to the current definition of share capital account in section 975-300 in the ITAA 1997. Emmett J's judgment sets out reasoning relevant to determining what amounts constitute part of a company's share capital account for the purposes of section 975-300 of the ITAA 1997.

69. The Commissioner's view in this Ruling is consistent with the reasoning of Emmett J in *Consolidated Media*, that a company cannot assert that accounts (even if these are not called a share capital account) that contain its share capital are not part of its share capital account for the purposes of both common law and section 975-300 of the ITAA 1997.

### ***Share capital applied by the company***

70. The nature of the share capital of a company is that it can be applied to the purposes of the company, including by way of the acquisition of capital assets, by way of meeting revenue outgoings, or by way of dividends to shareholders.

71. The dividend provisions of the income tax law observe and apply the company law distinction between capital and profits, not the general tax law distinction between capital and revenue. A Retail Premium, being calculated according to a component of share capital, may properly be debited to the share capital account of the company. If debited to share capital, it nevertheless will be a dividend paid out of profits under section 44 of the ITAA 1936, by reason of subsection 44(1B) of the ITAA 1936, because all of the requirements of subsection 6(4) of the ITAA 1936 are satisfied. This does not depend on the Retail Premium being paid only after the share capital is paid. For instance, if shares are issued for consideration that has not yet been paid, the consideration will be part of the share capital of the company no later than when it is paid, and, if the consideration is the Clearing Price on the basis of which the Retail Premium is worked out and paid, the Retail Premium might properly be debited against the share capital account when the consideration is paid even if the Retail Premium has already been outlaid.

### ***Retail Premium applies part of the share capital of an issuing company***

72. Under the Scheme to which this Ruling applies, Retail Premiums are an application of part of the share capital of an issuing company.

73. The total consideration given by the successful third party subscribers for the shares they receive (such as in a Bookbuild process) is 'capital raised by the company from the issue of its shares' and is 'amounts received by a company in consideration for the issue of shares' (as per *Archibald's* case and paragraph 4.10 of the Explanatory Memorandum<sup>5</sup> to section 975-300 of the ITAA 1997). Accordingly, the whole amount of the consideration by third party subscribers for shares issued by a company (such as under a Bookbuild process) is share capital of the company. All of the Clearing Price is included in the share capital account of the company.

74. The Retail Premium is paid according to and as an application of part of the amount subscribed. It is worked out by reference to the amount subscribed. It arises so far as the amount subscribed exceeds a set amount, commonly the Offer Price. It is paid by the company, either because it is paid by the company directly, or by the usual agent of the company for such payments (such as the company's registry) or by others contractually bound by and to the company to apply part of the amount subscribed to it in that way. Accordingly the amount of the Retail Premium is properly to be debited against the share capital account of the company.

75. If the Retail Premium is so debited to the share capital account, it is nevertheless not excluded from being a dividend because subsection 6(4) of the ITAA 1936 is satisfied, and operates so that the exclusion under paragraph (d) of the definition of 'dividend' in subsection 6(1) of the ITAA 1936 does not apply.

### **Franking of dividend**

76. Section 202-40 of the ITAA 1997 provides that a distribution is a frankable distribution unless it is rendered unfrankable pursuant to section 202-45 of the ITAA 1997. As Retail Premium payments are dividends sourced from a company's share capital account, these dividends are unfrankable pursuant to paragraph 202-45(e) of the ITAA 1997. That paragraph applies so that 'a distribution that is sourced, directly or indirectly, from a company's share capital account' is unfrankable. It does not refer to the distribution as being debited against that account, as a distribution sourced indirectly from the account might not itself be so debited.

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<sup>5</sup> Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998.

## **Withholding tax on Retail Premiums to non-Resident Non Participating Shareholders**

77. A non-resident Non Participating Shareholder who receives a Retail Premium will be subject to withholding tax under subsections 128B(1) and 128B(4) of the ITAA 1936, unless excluded under another provision of the ITAA 1936, ITAA 1997 or of a Double Taxation Agreement.

78. Subsection 128B(1) of the ITAA 1936 states that section 128B of the ITAA 1936 applies to income derived by a non-resident that consists of a dividend paid by a company that is a resident.

Subsection 128B(4) of the ITAA 1936 then states:

A person who derives income to which this section applies that consists of a dividend is liable to pay income tax upon that income at the rate declared by the Parliament in respect of income to which this subsection applies.

79. To the extent that dividends are franked, including being franked in certain circumstances with an exempting credit, they are not included in the income to which withholding tax applies, by reason of paragraph 128B(3)(ga) of the ITAA 1936. A Retail Premium is unfrankable as discussed above, and so is included in the income to which withholding tax applies. A Retail Premium paid to a non-resident and that is subject to withholding tax will be non-assessable non-exempt income under section 128D of the ITAA 1936. (This makes the withholding tax effectively a final tax for Australian taxation purposes.)

80. Resident companies that pay a Retail Premium to non-resident Non Participating Shareholders have a withholding obligation under section 12-210 of Schedule 1 to the *Taxation Administration Act 1953*. Section 12-210 states:

A company that is an Australian resident must withhold an amount from a \*dividend it pays if:

- (a) according to the register of the company's members, the entity, or any of the entities, holding the shares on which the dividend is paid has an address outside Australia; or
- (b) that entity, or any of those entities, has authorised or directed the company to pay the dividend to an entity or entities at a place outside Australia.

81. Non-resident Non Participating Shareholders who receive a Retail Premium should obtain independent legal or accounting advice if they are uncertain as to the withholding tax consequences of any Retail Premiums they receive.

***Dividends not sourced from share capital may be frankable, but Retail Premiums are necessarily sourced from share capital***

82. There are only two possible sources of a distribution from a company under an application of the dividend provisions. These are profits of the company and share capital contributed to the company (which, in certain circumstances, is deemed to be paid out of profits by various sections in the ITAA 1936 and ITAA 1997). Retail Premiums are dividends sourced from share capital, for the reasons stated in paragraphs 13 to 75 of this Explanation.

83. Distributions (which are not Retail Premiums) from the company to its shareholders not debited from its share capital account, are dividends paid out of profits. Such dividends may be frankable.

84. If distributions are not paid from an issuing company's share capital, or if they are paid out of share capital which has not been debited against an amount standing to the credit of a company's share capital account, these payments would still be dividends under the definition in subsection 6(1) of the ITAA 1936 as these are:

- distributions made by the company to any of its shareholders, whether in money or other property (subparagraph 6(1)(a) of the ITAA 1936); and
- any amounts credited by a company to any of its shareholders as shareholders (subparagraph 6(1)(b) of the ITAA 1936).

85. Distributions paid to shareholders out of share capital, but not from the company's share capital account, could **not** fall under the exemption in subparagraph 6(1)(d) of the definition of dividend in the ITAA 1936, as the share capital distributed would not be debited against the credit of the company's share capital account, a precondition of that exception from being a dividend.

86. Company distributions to shareholders not paid out of share capital or if paid out of share capital which has not been debited against a company's share capital account, are paid from profits derived by the company and therefore are assessable dividends under subsection 44(1) of the ITAA 1936. Taxation Ruling TR 2003/8 Income tax: distributions of property by companies to shareholders – amount to be included as an assessable dividend (TR 2003/8) and relevant case law explain why such distributions are dividends paid from the profits of the relevant company.

87. Paragraph 4 of TR 2003/8 states:

The amount of a dividend in respect of a distribution of property (including shares held by a company in another company) to a shareholder in their capacity as a shareholder will be the money value of the property at the time it is distributed, reduced by the amount debited to a share capital account of the distributing company in respect of the distribution.

88. Paragraphs 6 to 8 of TR 2003/8 then state:

6. In the case of a resident shareholder the amount by which the money value of the property exceeds the amount debited to the share capital account will be included in the shareholder's assessable income to the extent that the dividend is paid (or taken to be paid) out of profits derived by the company.

7. In the case of a non-resident shareholder the amount by which the money value of the property exceeds the amount debited to the share capital account will be included in the shareholder's assessable income to the extent that the dividend is paid (or taken to be paid) out of profits derived by the company from an Australian source, unless a double tax treaty provides for a different result in the circumstances of the taxpayer. (Usually such treaties substitute a different test based on effective connection with a permanent establishment in Australia.)

8. For the purposes of paragraphs 6 and 7, the dividend is paid out of profits derived by the company if, immediately after the distribution of property, **the market value of the assets of the company exceeds the total amount (as shown in the company's books of account) of its liabilities and share capital. In addition, if the dividend described in paragraphs 6 and 7 is a repayment by a company of an amount paid-up on the share, the dividend is taken to be paid out of profits derived by the company** [emphasis added].

89. TR 2003/8 is consistent with the view that company distributions to shareholders that are not paid out of share capital, or that are paid out of share capital which has not been debited from a company's share capital account, are dividends paid out of profits derived by the company for the purposes of subsections 6(1) and 44(1) of the ITAA 1936. If a dividend is not debited against a company's share capital account it is, or is taken to be, paid out of profits for these purposes.

90. If a company makes a distribution to its shareholders from its net value, the distribution can only be from share capital or from profits. As paragraph 13 of TR 2003/8 states:

In most cases a company which distributes property to its shareholders and debits part of the value of that property to its share capital account would debit the remaining part to another account or reserve. Where that account or reserve does not represent share capital, it would, for subsection 44(1) purposes, represent profits derived by the company so that the amount debited to it would be included in the shareholder's assessable income under that subsection.

**Ordinary Income**

91. Alternatively, the Retail Premiums are ordinary income included in assessable income under section 6-5 of the ITAA 1997, if the payments are not dividends. This is in accordance with the principles stated and applied by the High Court in *Federal Commissioner of Taxation v. McNeil* (2007) 229 CLR 656; [2007] HCA 5; 2007 ATC 4223; (2007) ATR 431 (*McNeil*) and *Federal Commissioner of Taxation v. Montgomery* (1999) 198 CLR 639; [1999] HCA 34; 99 ATC 4749; (1999) 42 ATR 475 (*Montgomery*).

***McNeil's case***

92. *McNeil* concerned the issue of sell back (put option) rights by St George Bank Ltd (SGL) to one of its shareholders. The key issue was whether the sell back rights issued by SGL were assessable income of the shareholder at the time the rights were received. The majority of the High Court ruled that although the sell back rights were not dividends, the rights were ordinary income and assessable under section 6-5 of the ITAA 1997.

93. The majority stated at [20]:

...whether a particular receipt has the character of the derivation of income depends upon its quality in the hands of the recipient, not the character of the expenditure by the other party. .... The Commissioner correctly submits that, while the share buy-back scheme explains the involvement of SGL and the genesis of the conferral of the entitlement upon the taxpayer, for revenue purposes it does not explain the character of her sell back rights.

94. In determining the character of the sell back rights granted at the time they were received, the High Court stated at [21]:

Secondly, as a general proposition, a gain derived from property has the character of income and this includes a gain to an owner who has waited passively for that return from property.

95. The High Court therefore had to determine whether the sell back rights were a gain from the shareholder's property. In other words, the Court had to decide whether the sell back rights were severed from and were a product of the shares in SGL which the shareholder retained on being issued the sell back rights. If, on the other hand, the grant of the sell back rights did not leave the shareholding intact and untouched, but in some way were a re-expression of the rights which previously constituted the shares of the shareholder, the sell back rights would not constitute a gain from property in the hands of the taxpayer but rather a receipt of capital. (Essentially they would represent a division of the shareholder's existing capital.)



96. The majority of the High Court in *McNeil*'s case did not consider the receipt of the sell back rights as altering the capital structure that was the taxpayer's shareholding in SGL. Their Honours dismissed the taxpayer's submission that SGL issued the sell back rights 'in partial satisfaction of the shareholders' right to participate in reductions of capital' being 'within the congeries of rights comprising the shares'.<sup>6</sup> Rather, the majority pointed out, at [36], that:

...it is the character of the grant of rights to the shareholder that...is decisive. It is not the reduction of capital effected by SGL [so far as rights to sell back shares were exercised] pursuant to the new statutory process provided by the Corporations Law.

97. Accordingly, when the sell back rights were constructively received<sup>7</sup> by the taxpayer, they were characterised by the High Court as something of value which was the product of, but severed from, the taxpayer's shareholding in SGL and that constituted income from property (that is, her shares in SGL). The High Court therefore held that the sell back rights received were ordinary income at the time the rights were issued and were assessable under section 6-5 of the ITAA 1997.

98. The Retail Premium is paid to shareholders in their capacity as such and is the product of their shareholding. That shareholding remains unaffected by the payment of the Retail Premium. So far as the shareholding may be affected by the issue of other shares, including those giving rise to the Clearing Price, this is irrelevant to the character of the Retail Premium itself, in the same way that the reduction of capital in *McNeil*'s case was irrelevant to the character of the sell-back rights in that case. No Retail Premium was payable under the arrangement in *McNeil*'s case. In that case, where the shareholder did not make use of the sell-back rights by a certain time, the terms of the arrangement provided that the rights were to be sold on behalf of the shareholder, who was entitled to the proceeds. This Ruling has no application to cases where, because of such arrangements, no Retail Premium entitlement can arise.

### ***Montgomery's case***

99. The High Court decision in *Montgomery* also supports the view that Retail Premiums are ordinary income under section 6-5 of the ITAA 1997. *Montgomery*'s case was referred to by the High Court in *McNeil* at [21] as:

...identifying the core meaning of 'income' where the character of a gain associated with property is at stake.

<sup>6</sup> Commissioner of Taxation v. McNeil [2007] HCA 5 at [36].

<sup>7</sup> The sell back rights were received by an intermediary, whose obligation was to account as trustee for rights sold on the shareholder's behalf should the taxpayer not take up legal title to those rights beforehand: *McNeil* [2007] HCA 5 at [10].

100. The issue in *Montgomery* was whether lease inducement payments were income according to ordinary concepts. In holding that the lease inducement payments were income and not capital, the majority of the High Court stated at [117]:

The inducement amounts received by the firm did not augment the profit-yielding structure of the firm. The lease was acquired as part of that structure; the inducement amounts were not. There was, in the words of Pitney J in *Eisner v. Macomber* ‘*not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being ‘derived’, that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal.*’

101. A Retail Premium is severed from the capital of the shareholder (which the shareholder retains) and comes in, or is derived, when it becomes available to the Non Participating Shareholder.

### ***Principles in McNeil & Montgomery applied to Retail Premiums***

102. *McNeil*’s case makes clear that the nature of a receipt by a shareholder has to be determined from its character in the hands of the recipient, rather than its character to the company paying it (or having it paid). This principle also applies to the receipt of a Retail Premium by a shareholder.

103. Based on the reasoning in both *McNeil* and *Montgomery*, a Retail Premium is ordinary income. The Retail Premium is included in assessable income under section 6-5 of the ITAA 1997, unless it is a dividend included in assessable income under section 44 of the ITAA 1936 or is non-assessable non-exempt income under section 128D of the ITAA 1936.

104. A Retail Premium itself constitutes a gain derived from property (the property being the shares in the issuing company held by the Non Participating Shareholder). This is not because the Retail Premium is an application of or an exercise of Entitlements that are themselves gains derived from property being the shares. Non Participating Shareholders do not get a Retail Premium either as consideration for or by exercising Entitlements, whether they are shareholders who did not exercise Entitlements that were exercisable by them, shareholders whose Entitlements were precluded from being exercised by them, or shareholders who got no Entitlements. (The Entitlements themselves are such gains, under *McNeil*, though they relate to call option rights rather than the put option rights which were considered in *McNeil*’s case. On conditions including that the Entitlements and the shares for which they are issued are not revenue assets or trading stock, the Entitlements will not be assessable income at the time they are issued by reason of section 59-40 of the ITAA 1997.) A Retail Premium arises only so far as Entitlements expired unexercised or never arose for the shareholder. A Retail Premium is available only to a shareholder and only by reason of their being a shareholder who is a Non Participating Shareholder. It is not consideration for or in relation to an Entitlement.

105. The Retail Premium itself, although a product of the Non Participating Shareholder's underlying shares in the company, is severed from those shares. Under the Scheme to which this Ruling applies, the underlying shares of the Non Participating Shareholder are not altered, affected, diminished or disposed of in any way due to the payment of the Retail Premium. It is therefore the Commissioner's view that a Retail Premium is ordinary income within the principles enunciated in both *McNeil* and *Montgomery*.

### **Capital gains tax consequences on receipt of a Retail Premium**

106. Under the Scheme to which this Ruling applies, Non Participating Shareholders are entitled to a Retail Premium only when, upon completion of the issue of equivalent shares (such as under a Retail Bookbuild), it is determined that the Clearing Price is greater than the Offer Price (or other applicable measure) and a Retail Premium is payable. This right to a Retail Premium is an intangible CGT asset under section 108-5 of the ITAA 1997. The right to receive the Retail Premium is satisfied upon payment.

107. Under section 104-25 of the ITAA 1997, CGT event C2 happens when the ownership of an intangible CGT asset ends by the asset being released, discharged or satisfied. Accordingly, when a Non Participating Shareholder receives a Retail Premium (thus satisfying their right to this payment), CGT event C2 happens.

108. A Non Participating Shareholder will make a capital gain if the capital proceeds from CGT event C2 are more than the cost base of the right. A Non Participating Shareholder will make a capital loss if the capital proceeds from the event are less than the reduced cost base of the right (subsection 104-25(3) of the ITAA 1997). Where the Retail Premium right has no cost, the cost base and reduced cost base are zero.

109. The capital proceeds from CGT event C2 is the Retail Premium payment that the Non Participating Shareholder receives.

110. However, subsection 118-20(1) of the ITAA 1997 provides that a capital gain you make from a CGT event is reduced if, because of the event, an amount is included in your assessable income under a provision of the income tax law other than Part 3-1 of the ITAA 1997 (the capital gains tax provisions). The capital gain is reduced by that amount, but not below zero (subsection 118-20(2) of the ITAA 1997). Similarly subsection 118-20(4) of the ITAA 1997 reduces the capital gain you make from a CGT event to the extent that an amount from the CGT event is treated as non-assessable non-exempt income. A Retail Premium that is paid to a non-resident which is subject to withholding tax will be non-assessable non-exempt income under section 128D of the ITAA 1936.

111. To the extent that a Retail Premium is, because of CGT event C2, included in the assessable income of a Non Participating Shareholder either as a dividend under subsection 44(1) of the ITAA 1936 or as ordinary income under section 6-5 of the ITAA 1997, or is non-assessable non-exempt income because it is subject to withholding tax under subsections 128B(1) and 128B(4) of the ITAA 1936, any capital gain made by a Non Participating Shareholder from receipt of a Retail Premium is reduced under section 118-20 of the ITAA 1997.

112. Where a Non Participating Shareholder's capital gain is reduced to zero, the CGT discount provisions of Division 115 of the ITAA 1997 will not apply.

## Appendix 2 – Alternative views

**❶** *This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the binding public ruling.*

### Summary

113. There are alternative views relevant to several points in the Explanation section at paragraphs 13 to 112 of this Ruling. They are discussed in this Appendix where additional description of the alternative view and of the reasons for which it is not accepted by the Commissioner, beyond the Explanation, is warranted. In summary, the alternative views are as follows.

114. If any Retail Premiums paid to Non Participating Shareholders were not a dividend, it is contended that these receipts would not be assessable as ordinary income under section 6-5 of the ITAA 1997.

115. CGT event C2 under section 104-25 of the ITAA 1997 happens when a Non Participating Shareholder receives a Retail Premium, and it is contended that the CGT discount may apply to the Retail Premium so far as the shareholder's shares have been held for more than 12 months.

116. A Retail Premium is contended not to be a dividend because it is not paid by the company (Alternative View 1 - see paragraphs 123 to 139 of this Ruling).

117. A Retail Premium is contended not to be a dividend because it is not paid by the company to shareholders of the company in their capacity as shareholders (Alternative View 2 - see paragraphs 140 to 142 of this Ruling).

118. The Retail Premium is contended not to be a dividend because it is paid for, or for the lapsing or ending of, rights to subscribe for shares (Alternative View 3 - see paragraphs 143 to 163 of this Ruling).

119. The Retail Premium is contended not to be a dividend deemed to be paid out of profits, because subsection 6(4) of the ITAA 1936 only applies to arrangements entered into for the purpose of exploiting distributions from a share capital account. (Alternative View 4 – see paragraphs 164 to 170 of this Ruling).

120. The Retail Premium is contended not to be a dividend under the principles enunciated in the *McNeil* case (Alternative View 5 - see paragraphs 171 to 181 of this Ruling).

121. The Retail Premium is contended not to be ordinary income under the principles enunciated in the *Montgomery* case (Alternative View 6 - see paragraphs 182 to 189 of this Ruling).

122. It is contended that the consideration for the issue of shares so far as it is to be applied as Retail Premiums does not form part of share capital under AASB 132 '*Financial Instruments: Presentation*' (AASB 132) and therefore is not share capital (Alternative View 7 - see paragraphs 190 to 206 of this Ruling).

**Alternative View 1 – A Retail Premium is not paid by the company and does not form part of its share capital**

123. An alternative view contends that:

- No amount representing the Retail Premium amount is ever paid or credited to the company;
- Therefore, the Retail Premium is never credited or forms part of the company's share capital or share capital account; and
- Therefore the company does not pay the Retail Premium to its Non Participating Shareholders.

124. The key to this view is that under the particular arrangements entered into as part of the capital raising and under the instructions given to the underwriter/Lead Manager, the issuing company may be only entitled to the Offer Price and not the Clearing Price under the Bookbuild. The underwriter/Lead Manager (or another entity) may be the party to the arrangements that is required to pay some or all of the balance of the Bookbuild proceeds to the Non Participating Shareholders as a Retail Premium.

125. Where the company does not directly pay the Retail Premium, this view contends that the issuing company never owns, controls or receives the Retail Premium amount and therefore this amount is not share capital of the company and cannot be credited to or debited from its share capital account.

126. It is also contended that in such arrangements the issuing company would never be entitled to demand that the underwriter/Lead Manager or other entity pay the Retail Premium amount over to the company.

127. Where arrangements do not involve the company paying the Retail Premium directly, this view asserts that the Non Participating Shareholders receive the Retail Premium *ab initio*, so that what happens is not the application of moneys belonging to the company by its agent after the company has received or derived those amounts.

128. It is also contended that cases like *Swan Brewery*, *Archibald Howie* and *St George* are not relevant as:

- none of these cases has a bearing on capital raising arrangements; and
- there were no arguments in these cases about whether all of the money paid for the subscription of shares was properly part of the company's share capital.

129. It is also asserted that the analysis regarding section 975-300 of the ITAA 1997 has no relevance, as what became Retail Premium amounts never belonged to the issuing company to begin with.

### **Commissioner's View – A Retail Premium is paid by the company**

130. The Commissioner considers that the Retail Premium component of the amounts is clearly paid to the issuing company as share capital of the company, even where the Retail Premium is not paid directly by the company. This is because **all amounts** paid in consideration for the issue of shares are consideration to the issuing company and as share capital of the company (which should be credited to the company's share capital account). This is so even if the company has made an arrangement about the application of part of the consideration, whether as a Retail Premium, as discharge of an existing debt, or otherwise.

131. The Commissioner's reasons as to why the whole consideration making up the Clearing Price (including the Retail Premium component) is share capital of the issuing company is explained in paragraphs 31 to 50 of the Explanation section of this Ruling. The analysis in these paragraphs also explains the clear relevance of the case law quoted to support the Commissioner's position that all amounts paid for the subscription of shares is share capital.

132. The analysis in paragraphs 51 to 69 of the Explanation section of this Ruling also supports the Commissioner's position that Retail Premium amounts constitute part of the share capital account of an issuing company for the purposes of section 975-300 of the ITAA 1997.

133. It is also evident that the Non Participating Shareholders do not receive and are not entitled to the Retail Premium funds *ab initio*. The whole of the consideration making up the Clearing Price is consideration offered to the company for the issue of shares. Arrangements by which the Clearing Price is received by another entity are arrangements for the handling and application of the Clearing Price offered to the company and which is paid in law to the company. They are not arrangements which alter the character of the Clearing Price.

134. Consider a third party subscriber which has offered consideration for the issue of shares and has had its offer accepted. The subscriber has given the consideration to the entity which has been specified by the company to receive the Clearing Price. The company would not be able to assert, against the subscriber, that the Clearing Price had been misapplied by the entity and so that the subscriber was not entitled to the issue of shares. Any action to secure issue of the shares would be against the company.

135. Consider other ways in which part of the Clearing Price could be agreed to be applied. One common case in share floats is the repayment from the float proceeds of particular existing loans or drawings owed by the company. An entity which is to receive the Clearing Price may be selected to provide assurance to the lenders that the repayment will have priority in application of the Clearing Price, and so it is likely that the company will agree to that application being made before a balance payable on is worked out. If one of these loans or drawings is a limited recourse debt to which Division 243 of the ITAA 1997 applies, that Division is triggered when a debt has not been paid in full by the debtor. Discharging such a debt from the Clearing Price must be payment by the company. If the contrary was the case, the Commissioner would be able to assert, against the company, that the company did not pay the debt where the Clearing Price was received by another entity and only the net amount after discharging the debt was paid on to the company.

136. Arrangements for another entity to receive the consideration making up the Clearing Price and to apply it are arrangements for payment at the direction of the company of amounts to which it is entitled. Making those arrangements before the consideration is offered does not change the character of the arrangements, or the character of the application of agreed parts of the Clearing Price, from being an application of the company's money.

137. This view is supported by the Federal Court in *Commissioner of Taxation v. White* [2010] FCA 730 (*White*). In *White*, the taxpayer (who was an employee of a company) arranged and directed that certain amounts arising from his employment be paid only to an associated trust. The taxpayer argued that these amounts were derived by the trust rather than himself. Gordon J rejected the taxpayer's argument, stating that although the amounts were paid to a different entity, the amounts were derived by the taxpayer and merely applied at his direction. This was evident at paragraph [25] in *White*, where Gordon J said:

However, it is not necessary that an item of income be paid over to the taxpayer; it is sufficient, according to ordinary concepts and usages, that the item is applied or dealt with on behalf of or at the direction of the taxpayer: see s6-5(4) of the 1997 Act and Cooke 29 ALR 202 at 211.



138. Gordon J expanded the above point at paragraphs [28] & [29] in *White* where she stated:

Put another way, in the 2000 year the purchase of units in the ESTIP was a step taken after Mr White's management fee for his services (\$399,000) was derived by him. As noted earlier (see [25] above), it is not necessary that a taxpayer must personally gain some benefit from a payment for it to be income.

That analysis is also a complete answer to Mr White's second submission that he did not 'derive' the sum of \$399,000 in the 2000 year. Mr White's submission was that because \$399,000 was contributed to the ESTIP and was subject to a vesting period (cl 5.1 of the Trust Deed), that amount was not available to him in the 2000 year and therefore was not 'derived' by him in that year. As explained in para [28] above, the factual findings by the AAT establish that the sum of \$399,000 was 'derived' as income when it was paid by Kalix into the ESTIP at the direction of and on behalf of Mr White. What the ESTIP then decides, or is bound, to do with that sum is not relevant to the issue of whether Mr White derived that amount as income: *McNeil* 229 CLR 656 at [15], [18] and [20].

139. *White's* case applies similarly to Retail Premium amounts. Arrangements for another entity to receive the consideration for the issue of the equivalent shares and to apply it to paying the Retail Premium are arrangements for payment at the direction of the company of amounts to which it is entitled. Making those arrangements even before the consideration is offered (like the arrangements for contribution into the ESTIP, in *White's* case) does not change the character of the arrangements, or the character of the application of agreed parts of the Clearing Price, from being an application of the company's money.

### **Alternative View 2 – A Retail Premium is not paid to shareholders as shareholders**

140. An alternative view is that a Retail Premium is not paid to shareholders as shareholders (and so cannot be a 'dividend' under paragraph (b) of the definition, subsection 6(1) of the ITAA 1936). Because ordinarily a Retail Premium is paid only to some shareholders (as most shareholders are not ordinarily Non Participating Shareholders) it is argued that they do not get the Retail Premium as shareholders, but on some other basis.

### **Commissioner's View – A Retail Premium is paid to shareholders as shareholders**

141. Only shareholders may receive a Retail Premium. Where only some shareholders get a Retail Premium, there will be qualifying criteria in addition to their shareholding. However those criteria do not mean that the shareholders receive the Retail Premium other than as shareholders. So paragraph (b) of the definition of dividend in subsection 6(1) of the ITAA 1936 will be satisfied.

142. The contention that if amounts are credited only to a subset of shareholders they must therefore not be to the shareholders as shareholders, is inconsistent with the purpose and history of the relevant provisions of the law. In particular, the exclusion under subsection 6(4) of the ITAA 1936 was originally expressed as applying to a range of arrangements in which amounts were subscribed by some shareholders and credited to others. These provisions clearly apply when amounts or value are credited to another person, whether to all shareholders or not.

**Alternative View 3 – A Retail Premium is paid for, or for the lapsing or ending of, rights to subscribe for shares**

143. An alternative view is that a Retail Premium is paid for, or for the lapsing or ending of, rights to subscribe for shares. This view is only applied to those Non Participating Shareholders who had rights to subscribe for shares. So different kinds of Non Participating Shareholders are treated differently under this view.

144. These alternative views distinguish between Non Participating Shareholders who:

- receive Entitlements and choose not to exercise some or all of their Entitlements (Entitled shareholders);
- are not eligible to receive Entitlements ('Ineligible shareholders'); or
- are not permitted to exercise rights under an Entitlement ('Incapable shareholders').

The Commissioner does not accept that Incapable shareholders can be distinguished from Ineligible shareholders. A shareholder who is not permitted to exercise rights is a shareholder without rights, where the rights lapse and are not exercised or disposed of on behalf of the shareholder.

145. It is the Commissioner's view that a Retail Premium to Ineligible shareholders is not paid for, or for the lapsing or ending of, rights to subscribe for shares. Ineligible shareholders never had Entitlements and so did not have any rights to subscribe for shares that could lapse or end. Some views suggest that a Retail Premium to Incapable shareholders is paid for, or for the lapsing or ending of, rights to subscribe for shares although the shareholders themselves were not permitted to exercise those rights.

146. In consequence, the alternative view asserts that for Entitled shareholders and perhaps for Incapable shareholders either generally, or where section 59-40 of the ITAA 1997 applies to the issue of the rights, all subsequent matters including payment of a Retail Premium are deemed to be solely taxable under the CGT provisions and in those cases the CGT discount may apply (if the underlying shares were held for at least 12 months).

147. Section 59-40 of the ITAA 1997 provides that if an entity issues rights to a taxpayer to acquire an interest in that entity, the market value of those rights, as at the time of issue, will be non-assessable non-exempt income providing the following conditions are satisfied:

- (a) at the issue time, you must already own shares in the company or units in the unit trust (the original interests);
- (b) the rights, must be issued to you because of your ownership of the original interests;
- (c) the original interests and the rights must not be revenue assets or trading stock at the issue time;
- (d) the rights must not have been acquired (within the meaning of section 139G of the ITAA 1936) under an employee share scheme;
- (e) the original interests and the rights must not be traditional securities;
- (f) the original interests must not be convertible interests.

148. Support for the view that where section 59-40 of the ITAA 1997 applied to the grant of Entitlements then any subsequent matter is taxable solely under the CGT provisions is claimed from paragraph 1.5 of the Explanatory Memorandum<sup>8</sup> referring to section 59-40 which states:

These amendments restore the original tax treatment of rights issued by issuing entities to existing shareholders or unitholders to acquire additional relevant interests in those entities. As a result, a taxing point will not arise for the shareholders or unitholders in relation to the rights until a subsequent capital gains tax (CGT) event happens to the rights or to relevant interests as a result of exercising the rights.

**Commissioner's View – A Retail Premium is not paid for, or for the lapsing or ending of, rights to subscribe for shares; and if it were it would still be a dividend and, if not a dividend, ordinary income**

149. A Retail Premium is paid to any Non Participating Shareholder for the same thing: that is, it is paid on account of amounts subscribed by third party shareholders. That some Non Participating Shareholders had rights to subscribe for shares which they did not exercise and which expired does not give the Retail Premium paid to them the character of consideration for, or for the lapsing or ending of, those rights.

150. A right to receive a Retail Premium payment is a different and separate right to Entitlements. An Entitled shareholder's Entitlements provide the shareholder with the right to acquire shares from the issuing company. A Retail Premium right, however, is a potential right to cash granted by the issuing company to Non Participating Shareholders and is contingent on the Clearing Price consideration for the issue of shares in the company being higher than the Offer Price (or other applicable measure).

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<sup>8</sup> Explanatory Memorandum to the Tax Laws Amendment (2008 Measures No. 3) Bill 2008.

151. Incapable shareholders are not able to exercise the right to subscribe for shares in the company. The right is neither exercised nor disposed of on behalf of Incapable shareholders, but lapses unexercised. Accordingly the Commissioner considers that either no rights are issued to them or that which is issued to them is not a right to acquire shares in the company. So section 59-40 of the ITAA 1997 is not applicable to Incapable shareholders.

152. Whilst Retail Premium payments may be connected to Entitlements (so far as they are paid to shareholders who had Entitlements they did not or could not exercise), they are not paid for, or for the lapsing or ending of, those Entitlements. When the Entitlements of Entitled shareholders lapse, they do not receive any consideration for the lapsing of the Entitlements. The character of the Retail Premium is therefore the same, whether received by shareholders who had Entitlements they did not or could not exercise, or to shareholders who never had Entitlements at all. The Commissioner's view does not require intricate analysis of the difference between having and not having Entitlements and of the difference between having Entitlements which are not permitted to be exercised and not having Entitlements. These differences are not relevant to the operation of the dividend provisions.

153. The payments making up the Clearing Price are paid by the third party subscribers for shares, on account of whose offered consideration the Retail Premiums arise. Those subscribers offer consideration for the issue of shares by the company to them. They do not offer anything to the Non Participating Shareholders and the Non Participating Shareholders have no rights or entitlements against those subscribers, even though the subscribers may be aware that a Retail Premium may arise depending on the total of the Clearing Prices accepted by or for the company. There is no difference in the character of the consideration offered by the third party subscribers regardless whether some proportion of Non Participating Shareholders had Entitlements they did not or could not exercise.

154. What the subscribers offer is not consideration for, or for the lapsing or ending of, Entitlements of Entitled shareholders (if the shares for which they subscribe are equivalent to those that would have issued had Entitled shareholders exercised their rights). Nor can it be consideration for rights of Ineligible shareholders who never had any Entitlements and of Incapable shareholders who were never able to subscribe for shares. Nothing is offered by the third party subscribers, such as those under a Bookbuild process (for example Institutional investors), for any Non Participating Shareholders to give up their Entitlements.

155. The consideration offered by the third party subscribers is solely for the issue of shares to them, regardless of whether the shares for which they subscribe are offered because Entitlements were not exercised, could not be exercised to subscribe for shares, or were not given at all.

156. As the rights to Retail Premium payments are different and separate to the rights that are the Entitlements, section 59-40 of the ITAA 1997 has no application to Retail Premium payments. The Retail Premium payments are not paid for, or for the lapsing or ending of, any Entitlements whether the Entitlements are rights to which section 59-40 applies or not.

157. If a Retail Premium were paid for, or for the lapsing or ending of, any Entitlements this would not require the Retail Premium to be dealt with only as capital proceeds of a CGT event and would not give access to the CGT discount.

158. The law, confirmed by the Explanatory Memorandum<sup>9</sup>, did not provide that any later dealing with a right subject to section 59-40 of the ITAA 1997 will be subject to the CGT rules if the underlying shares were held on capital account. That result is not necessarily true, though it may be correct for most usual or common factual situations.

159. In the table in paragraph 6 of the Explanatory Memorandum<sup>10</sup>, what is said is that 'a capital gain or loss will generally arise when a CGT event subsequently happens to the rights or to the relevant interests acquired as a result of the exercise of the rights' (provided that the original interests are held on capital account). Later, at paragraph 1.15 of the Explanatory Memorandum<sup>11</sup>, it is said that 'If a company or trustee issues rights to a taxpayer to acquire shares in the company or units in the trust and the conditions in subsection 59-40(2) of the ITAA 1997 are satisfied, then a capital gain or capital loss will arise only when a CGT event happens to the rights or to the shares acquired as a result of the exercise of the rights. For example, if the taxpayer disposes of the rights, the taxpayer may make a capital gain or capital loss because CGT event A1 happens'. This is a statement about when a CGT event happens, and is not asserting that only a CGT event can happen. It is discussing generally what happens when a right is disposed of, or equity acquired by exercising a right is realised, as the most likely practical situations, though 'a CGT event happens in relation to the rights or to the shares' in a much wider range of circumstances. It reflects the catch-all character of the CGT event provisions, that is, they happen for revenue assets too (although the consequences of this may be affected by section 118-20 of the ITAA 1997).

160. However, the 'generally' is important and reflects the express advice at paragraph 1.12 of the Explanatory Memorandum<sup>12</sup>: 'The conditions in paragraphs 59-40(2)(c) to (e) of the ITAA 1997 ensure that subsection 59-40(1) only applies to shareholders or unit holders that would ordinarily be taxed on capital account in relation to the original interests and the rights'. (Note, again, 'ordinarily'.)

<sup>9</sup> Explanatory Memorandum to the Tax Laws Amendment (2008 Measures No. 3) Bill 2008.

<sup>10</sup> Ibid.

<sup>11</sup> Ibid.

<sup>12</sup> Ibid.

161. There will be situations in which rights, or equity acquired by exercising the rights, may be on revenue account.

Subsection 118-20(1) of the ITAA 1997 provides that a capital gain you make from a CGT event is reduced if, because of the event, an amount is included in your assessable income under a provision of the income tax law other than Part 3-1 of the ITAA 1997 (the capital gains tax provisions). The capital gain is reduced by that amount, but not below zero (subsection 118-20(2) of the ITAA 1997).

162. As a Retail Premium is required to be included in the assessable income of a Non Participating Shareholder either as a dividend under subsection 44(1) of the ITAA 1936, or as ordinary income under section 6-5 of the ITAA 1997, or is non-assessable non-exempt income under section 128D of the ITAA 1936, any capital gain a Non Participating Shareholder makes from receipt of a Retail Premium is reduced under section 118-20 of the ITAA 1997.

163. For these reasons the alternative view is not accepted.

#### **Alternative View 4 – Subsection 6(4) only applies to arrangements entered into for the purpose of exploiting distributions from a share capital account**

164. An alternative view is that subsection 6(4) of the ITAA 1936 can only apply to arrangements where there was a purpose by the company to exploit the tax concessions on distributions made from a share capital account. This view of requiring a 'purpose requirement' by the company, is based on the Explanatory Memorandum<sup>13</sup> to the provision [which dealt with share premiums, when there was a concept of nominal capital for shares] from which subsection 6(4) has its origins. At page 9 of that Explanatory memorandum it was stated:

Subsections (4) and (5) are designed as a safeguard against special arrangements that may be entered into for the purpose of exploiting the proposed exemption of distributions out of share premium accounts. Very broadly, the provision will apply where a share premium account is created as part of a scheme for making a tax free distribution of money or other property to shareholders.

165. It is contended that the Explanatory Memorandum (Senate version) to the *Taxation Laws Amendment (Company Law Review) Act 1998* (CLR Act) which amended subsection 6(4), also supports a 'purpose requirement' for the application of the provision. In paragraphs 1.105 and 1.106 of the Explanatory Memorandum (Senate version) to the CLR Act it was stated:

1.105 Subsection 6(4) of the Act, an anti-avoidance rule, provides that the exclusion to the definition of a dividend in subsection 6(1) does not apply where, pursuant to an agreement or an arrangement, a company issues shares at a premium and then distributes those premiums to shareholders in the company. The rule prevents companies substituting profit distributions with preferentially-taxed share premiums.

<sup>13</sup> Explanatory Memorandum to the Income Tax Assessment Bill (No. 4) 1967.

1.106 As a result of the Corporations Law changes that abolish the concept of share premiums and associated terms, **the amendments introduce an equivalent rule** to subsection 6(4) that applies to the share capital account. The rule will prevent companies entering into arrangements where a company raises share capital from certain shareholders and then makes a tax-preferred capital distribution to other shareholders. [Item 7 of Schedule 3; amends subsection 6(4)] [emphasis added].

166. Accordingly, the alternative view contends that the history and terminology of subsection 6(4) of the ITAA 1936 as an anti-avoidance provision indicates that it only applies to 'special' arrangements, designed to provide tax benefits in the form of the special treatment of payments out of share capital.

#### **Commissioner's view – 'purpose requirement' under subsection 6(4)**

167. There is no 'purpose requirement' under subsection 6(4) of the ITAA 1936 beyond the terms of the subsection. What the subsection requires is that in addition to an amount being paid to the company and credited to its share capital account, the amount is later paid or distributed by the company (being a debit to its share capital account) such as to another set of shareholders, with the payment to and by the company being common elements 'under an arrangement'. This is sufficient for subsection 6(4) to apply.

168. There is no additional requirement, such as a requirement that the arrangement be 'for a purpose of exploiting the proposed exemption of distributions out of share premium accounts.' The anti-avoidance references in the Explanatory Memorandum<sup>14</sup> merely states instances of what is within the ambit of subsection 6(4) of the ITAA 1936. It is not a limitation on the scope of subsection 6(4).

169. The suggestion that there is an additional 'purpose requirement' is also not supported by later Parliamentary consideration, such as shown in the Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998 (which introduced amendments to subsection 6(4) of the ITAA 1936 when share premiums were abolished). References in paragraph 1.105 of the Explanatory Memorandum (Senate version) to the CLR Act, that the amendments '*introduce an equivalent rule to subsection 6(4)*' merely refers to the abolition of share premium accounts and that the provision now applies to share capital accounts. It provides no basis of support for the 'purpose requirement' alleged in the alternative view.

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<sup>14</sup> Both the Explanatory Memorandum to the Income Tax Assessment Bill (No. 4) 1967 and the Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998.

170. Also, the application and ambit of subsection 6(4) of the ITAA 1936 is described in paragraph 1.106 of the Explanatory Memorandum<sup>15</sup>, not in the restrictive manner suggested by the alternative view, but simply as:

The rule will prevent companies entering into arrangements where a company raises share capital from certain shareholders and then makes a tax-preferred capital distribution to other shareholders.

### **Alternative View 5 – the *McNeil* decision prevents a Retail Premium being a dividend**

171. It has been argued that Retail Premiums cannot be dividends, due to the reasoning in *McNeil*'s case.

172. In *McNeil*, the sell back rights granted to shareholders were considered property separate from the shareholders original shares. However, the rights represented a return generated due to the holding of those original shares. The High Court in *McNeil* also held at paragraphs [37] and [38] that:

The gain made by the taxpayer upon grant of the sell-back rights and the subsequent receipt of the proceeds of sale on her behalf was not the receipt of a distribution of any form of the assets of SGL. Nor, as explained earlier in these reasons, was the sell-back scheme provided in 'satisfaction' of the rights of shareholders under the constitution of SGL. The scheme took its life from the deeds poll executed on the record date.

Thus, there is no sound analogy between this case and the liquidation and informal distribution cases beginning with *Stevenson*, and the cases dealing with the dividend provisions of the 1936 Act.

173. Based on the above reasons, the High Court held that the taxpayer's sell back rights were not dividends in the statutory sense.

174. As Retail Premiums are a product of, but severed from, the shares held by Non Participating Shareholders, these payments cannot be dividends as they were not distributions from the issuing company based on the same reasoning mentioned in *McNeil* (discussed at paragraphs 91 to 105 of this Ruling). *McNeil* made clear that the basis of the rights provided and paid to the taxpayer in that case was the deeds poll executed on the record date. The alternative view is that Retail Premiums are based on the legal documentation concerning these payments and the process by which consideration is offered for the issue of the equivalent shares.

175. Accordingly, the alternative view is that it would be contrary to the *McNeil* decision if Retail Premiums are dividends.

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<sup>15</sup> Senate version-Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998.



**Commissioner's View – the *McNeil* decision does not prevent Retail Premium payments being dividends**

176. *McNeil's* case does not prevent Retail Premium payments being dividends.

177. The sell back rights in *McNeil* were not dividends due to the particular nature of these rights. Although the sell back rights in *McNeil* were created by the company, these rights were never the assets of the company. Once the company created the sell back rights, these rights were the assets of the Eligible shareholders who obtained them and never of the issuing company. It was for this reason that the High Court ruled that there was no distribution of assets from the company to the taxpayer in *McNeil*. Accordingly, as there was no distribution by the company to the taxpayer or credit of any amount by the company to the taxpayer, the sell back rights in *McNeil* did not constitute a dividend under subsection 6(1) of the ITAA 1936.

178. The payment received by the taxpayer in *McNeil* was due to her sell back rights being tradeable on the open market and later being sold on her behalf.

179. The Alternative view that Retail Premiums are not dividends based on the reasoning in *McNeil* is unsound. While Retail Premiums are a product of, but severed from, the shares held by Non Participating Shareholders, so too is any dividend. The nature of Retail Premiums is different to the sell back rights ruled on in *McNeil*.

180. The key difference between Retail Premiums and the sell back rights in *McNeil* is that Retail Premiums are a distribution from the company to its Non Participating Shareholders. The funds used to pay the Retail Premium are the company's money whether debited against its share capital account or not (these funds being raised by the company as consideration for the issue of its shares).

Accordingly, as the company has distributed the amount of a Retail Premium to its shareholders, the Retail Premium constitutes a dividend paid out of profits by application of subsections 6(1), 6(4), 44(1B) and 44(1) of the ITAA 1936.

181. The fact that there may be documentation (arranged by the issuing company), entitling the company to 'receive' only part of the Clearing Price does not alter the nature of a Retail Premium being a distribution and dividend from the company to its Non Participating Shareholders. The effect of the documentation is merely to arrange for the issuing company to pay part of the share capital it has raised as a dividend to Non Participating Shareholders.

**Alternative View 6 - *FCT v Montgomery* does not support Retail Premiums being ordinary income**

182. This alternative view argues that the Commissioner's reliance on the quote extracted from *Montgomery* [at paragraph 117] is misplaced as it precedes the relevant passage. What made the lease incentive income in *Montgomery* was that the firm was exploiting its commercial position to advantage. *Montgomery* is therefore confined (on this view) to the deliberate exploitation of a business asset:

the firm used or exploited its capital (whether its capital is treated for this purpose as being the agreement to take premises or its goodwill) to obtain the inducement amounts ... and

The firm used or exploited its capital in the course of carrying on its business, albeit in a transaction properly regarded as singular or extraordinary... [*Montgomery* at paragraph 118].

183. The High Court's reasoning was that the firm had an asset – size, reputation, goodwill – which made them a desirable tenant. They were a business; they had a business asset; they put it to its best advantage – they used it to extract a cash payment from the landlord.

184. This is unlike the position of the shareholders who passively collect a Retail Premium. This Ruling states that *Montgomery* involved a gain from an item of property, but the alternative view considers it is irrelevant. The gain that *Montgomery* made was (i) actively pursued and (ii) arose from a business asset. *Montgomery* tells you nothing about (i) a passive receipt from (ii) an asset held as an investment outside the business context.

185. *Montgomery* is all about a business taxpayer who actively pursues an amount of cash by exploiting one of their business assets. It has nothing to say about a passive investor.

**Commissioner's View - *FCT v Montgomery* does support Retail Premiums being ordinary income**

186. The High Court in *Montgomery* did not limit its ratio only to business taxpayers (as opposed to passive investors). The key principle that the High Court stressed in *Montgomery* was that income was normally due to the exploitation of capital (regardless of whether the capital was from a business asset or passive investment). This is evident in *Montgomery*, where the High Court after referring approvingly to *Eisner v Macomber* (1920) 252 US 189 (Eisner) stated at 67:

What can be seen from the passage of *Eisner v Macomber* is that income is often the product of exploitation of capital. But of course, that is not always so.

187. The quote in paragraph 182 of this Ruling shows that the firm in *Montgomery* used or exploited its capital to obtain the inducement amount it received, but this only states what occurred on those facts, and was never expressed to restrict the general principles of either *Eisner* or *Montgomery*.

188. That the ratio in *Montgomery* is not limited to business assets as opposed to passive investors is evident in the High Court's statements in *McNeil*. At paragraph 21 in *McNeil*, the High Court clearly applied the principles of *Montgomery* and *Eisner* to owners of passive assets:

Secondly, as a general proposition, **a gain derived from property has the character of income and this includes a gain to an owner who has waited passively for that return from property.**

*The question then becomes one whether, as the Commissioner contends, the rights enjoyed by the taxpayer arose and were severed from, and were a product of, her shareholding in SGL, which she retained. The metaphor of severance and like expressions were used by Pitney J in *Eisner v Macomber* in a passage accepted in *FCT v Montgomery* as identifying the core meaning of 'income' where the character of a gain associated with property is at stake [emphasis added].*

189. The alternative view is contrary to the High Court judgments in both *Montgomery* and *McNeil*. Accordingly, the Commissioner considers that, if Retail Premiums are not dividends, these amounts are ordinary income for the reasons stated in paragraphs 91 to 105 of the Explanation section of this Ruling.

#### **Alternative View 7 – consideration for the issue of shares so far as it is to be applied as Retail Premiums does not form part of share capital under AASB 132 and therefore is not share capital**

190. An alternative view is that part of Retail Premiums cannot form part of an issuing company's share capital under AASB 132. The alternative view concludes that therefore this part of the consideration for the issue of shares is not credited to the share capital account of the company for income tax purposes.

191. Under this view, an issuing company does not record a Retail Premium amount as an asset in its financial records because so far as the issuing company has a legal and contractual obligation to pay the Retail Premium amount it is not an asset of the company for accounting purposes.

192. If a company does recognise the Retail Premium component from a share issue as an asset, it would also be required to record a corresponding financial liability under paragraph 16 of AASB 132 that is discharged when the Retail Premium is paid to Non Participating Shareholders. Paragraph 16 of AASB 132 states:

16. When an issuer applies the definitions in paragraph 11 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

- (a) The instrument includes no contractual obligation:
  - (i) to deliver cash or another financial asset to another entity; or

- (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.
- (b) If the instrument will or may be settled in the issuer's own equity instruments, it is:
  - (i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
  - (ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments.

193. A Retail Premium amount neither increases or changes the net asset position of an issuing company under a Bookbuild process and therefore cannot constitute part of the company's share capital or share capital account. Paragraph 102 of the AASB Framework for the Preparation & Presentation of Financial Statements (the 'Framework') is quoted as support for the above view:

A financial concept of capital is adopted by most entities in preparing their financial report. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets of the entity.

194. The alternative view also asserts that the receipt of a Retail Premium amount does **not** represent an exchange by Non Participating Shareholders of their shares in the issuing company, as they retain their full existing shareholding in the company (notwithstanding that third party investors pay for new shares of the issuing company under the Bookbuild process).

195. Therefore on the above analysis, the alternative view is that a Retail Premium amount cannot (or need not) be recognised as additional share capital of an issuing company for accounting purposes. The alternative view is that it would be inconsistent to treat an amount which does not meet the definition of share capital for accounting purposes as being credited to the share capital account of an issuing company for tax purposes.

### **Commissioner's view – Retail Premium payments are share capital of an issuing company both for accounting and tax purposes**

196. It is the Commissioner's view that Retail Premiums are paid from consideration which forms part of the share capital of an issuing company for both accounting and tax purposes.

197. While the obligation to pay a Retail Premium may well be or arise under a financial instrument under AASB 132, the terms for subscription and issue of a company's shares provide for consideration offered for what is an equity instrument only (fully satisfying both conditions (a) and (b) of paragraph 16 of AASB 132). The share issue arrangement creates a contractual obligation for the issuing company to issue shares to third party investors who correspondingly are contractually obliged to provide the consideration making up the Clearing Price. However, the share issue does not create any contractual obligation for the issuing company to exchange financial assets or financial liabilities with the third party investors on terms unfavourable or potentially unfavourable to the company. Accordingly the effect of AASB 132 as it applies to the share issue does not reduce the assets acquired by the company below the Clearing Price, for accounting purposes.

198. Under the Scheme to which this Ruling applies, the issue of a company's shares is for the consideration making up the Clearing Price and is a non-derivative, there being no obligation for the company to deliver any variable number of its shares, or is a derivative to be settled only by a fixed amount of cash (the best bids per share) for a fixed number of company shares (the new shares bid to be subscribed for).

199. The alternative view that a Retail Premium is or may be a financial instrument and financial liability for the purposes of AASB 132 has no effect or relevance to characterising the consideration for the issue of shares, being for an equity interest. This is supported under paragraph 15 of AASB 132 which states:

The issuer of a financial instrument shall classify the instrument, **or its component parts**, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument [emphasis added].

200. Paragraph 15 of AASB 132 makes clear that under the AASB Standards, accounting is for 'component parts' of compound arrangements that themselves answer the different requirements of different parts of the AASB Standards. Funds raised in the consideration making up the Clearing Price are wholly for an equity instrument.

201. The alternative view asserts that under paragraph 102 of the Framework, the financial concept of the financial capital of a company is synonymous with the net assets or (shareholders') equity of the issuing company. Accordingly, any share capital raised under a Bookbuild process is reduced by the company's obligation to pay the Retail Premium (this being a financial liability under paragraph 16 of AASB 132). The Framework has no such effect.

202. Consideration raised forming part of the Clearing Price is share capital of the issuing company. The fact that these funds may be used by the issuing company to meet a revenue outlay does not in any way change the nature of the equity instrument involved in the share capital or how it must be accounted for. The full amount received under the Bookbuild process is an accretion, not to the 'financial capital' of the company, but to its share capital. As financial capital is about net assets, it rarely is consistent and is not required to be consistent with share capital. Were it otherwise, every share placement where the proceeds were committed to any particular application, such as paying off particular debt, acquiring a particular asset, or otherwise would raise no assets of the company to that extent – and the company could not be regarded as applying assets to that application either.

203. The corresponding question of how a company is to account for what it pays for in equity (or in equity-denominated consideration), and for the equity by which (or by reference to which) it pays, is dealt with in two AASB Standards: AASB 2 *Share-based Payment* (AASB 2) (the more general standard) and AASB 3 *Business Combinations* (AASB 3) (specific to bringing together separate businesses into a single reporting entity). In these standards, it is clear that where a share-based payment transaction is settled by issuing shares both the value of what is received or acquired by the company must be recorded and a corresponding increase in equity must be recorded in the company's accounts. These AASB Standards show that for accounting purposes the assertion that the Framework discussion of the 'financial capital of a company' precludes including in share capital amounts committed to a payment is false. In situations to which AASB 2 or AASB 3 apply and which are settled by issuing shares the share capital of the company increases by the same amount as is brought to account for what is acquired by the payment, though in such situations it is clear that the shares are payment for what the company has contracted to get.

204. Accordingly, consideration according to which Retail Premiums will be paid forms part of a company's share capital under Australian accounting standards.

## ***Tax provisions take precedence over accounting standards***

205. Even if there were an inconsistency between what constitutes 'share capital' of a company for accounting purposes and for tax purposes, the taxation provisions about share capital in the ITAA 1936 or ITAA 1997 must be interpreted according to their terms in their tax law context and that meaning takes precedence over any accounting meaning that differs from it. Accounting formalities are not necessarily determinative of the characterisation of amounts for tax purposes. This is supported by the case of *Macfarlane v. Federal Commissioner of Taxation* (1986) 13 FCR 356; 86 ATC 4477; (1986) 17 ATR 808, where the Full Federal Court made clear that the term 'profits' was not limited by companies legislation or accounting standard concept of that term.

206. Section 975-300 in the ITAA 1997 is a specific provision in determining what is part of a company's share capital account. Therefore this provision will take precedence over any accounting meaning of share capital, should that differ.

## Appendix 3 – Detailed contents list

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- dividend income
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- unfranked dividends

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