



CR 2004/101 - Income tax: share buy-back: Lemarne Corporation Limited

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Class Ruling

Income tax: share buy-back: Lemarne Corporation Limited

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Preamble

The number, subject heading, **What this Class Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Withdrawal**, **Arrangement** and **Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. CR 2001/1 explains Class Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.

What this Class Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are:

- section 45A of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- section 45B of the ITAA 1936;
- section 45C of the ITAA 1936;
- section 159GZZZK of the ITAA 1936;
- section 159GZZZM of the ITAA 1936;
- section 159GZZZP of the ITAA 1936;
- section 159GZZZQ of the ITAA 1936;
- section 177EA of the ITAA 1936;
- section 202-40 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- section 202-45 of the ITAA 1997;
- section 204-30 of the ITAA 1997; and
- section 960-120 of the ITAA 1997.

Class of persons

3. The class of persons to whom this Ruling applies is the shareholders holding ordinary shares of Lemarne Corporation Limited ('Lemarne') who dispose of shares under the Lemarne off-market share buy-back ('the Buy-Back') announced on 24 February 2004 and conducted on 2 August 2004, and described in the Arrangement part of this Ruling.

4. The class of persons to which this Ruling applies does not include Lemarne. The Ruling does not deal with how the taxation law applies to Lemarne in relation to the Buy-Back. Furthermore, it should be noted that certain information which relates to the affairs of Lemarne, but is not in the public domain, has been taken into account in determining the application of certain anti-avoidance provisions in this Ruling. This information cannot be disclosed in the Ruling.

Qualifications

5. The Commissioner makes this Ruling based on the precise arrangement identified in this Ruling.

6. The class of persons defined in this Ruling may rely on its contents provided the arrangement actually carried out is in accordance with the arrangement described in paragraphs 11 to 19.

7. If the arrangement actually carried out is materially different from the arrangement that is described in this Ruling, then:

- this Ruling has no binding effect on the Commissioner because the arrangement entered into is not the arrangement on which the Commissioner has ruled; and
- this Ruling may be withdrawn or modified.

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Date of effect

9. This Ruling applies to the year ended 30 June 2005. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20). Furthermore, the Ruling only applies to the extent that:

- it is not later withdrawn by Gazette;
- it is not taken to be withdrawn by an inconsistent later public ruling; or
- the relevant tax laws are not amended.

Withdrawal

10. This Ruling is withdrawn and ceases to have effect after 30 June 2005. However, the Ruling continues to apply after its withdrawal in respect of the tax laws ruled upon, to all persons within the specified class who entered into the specified arrangement during the term of the Ruling, subject to there being no change in the arrangement or in the person's involvement in the arrangement.

Arrangement

11. The arrangement that is the subject of the Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- the application for a Class Ruling dated 5 March 2004;
- letters and correspondence from KPMG dated 30 March 2004, 19 April 2004, 26 April 2004 and 7 May 2004; and
- letter from Lemarne dated 1 June 2004.

Note: certain information received from Lemarne and KPMG has been provided on a commercial-in-confidence basis and will not be disclosed or released under the Freedom of Information legislation.

12. Lemarne announced on 24 February 2004 that it proposed to undertake an off-market share buy-back to purchase 35% of each shareholder's holding of Lemarne shares. At the time of the announcement, Lemarne had approximately 17.8 million ordinary shares on issue and had no other shares on issue.

13. The financial statements of Lemarne as at 29 February 2004 (adjusted for the payment of the 2004 interim dividend) show total equity of approximately \$22.9 million, consisting of \$11.43 million contributed equity and \$11.47 million retained profits.

14. Lemarne's shareholders are a mix of individuals, companies, trusts and superannuation funds. Directors of Lemarne and their associates control approximately 38% of Lemarne shares. Approximately 21% of the total number of Lemarne's ordinary shares were acquired prior to 20 September 1985. Non-resident shareholders hold approximately 8.8% of Lemarne shares.

15. Lemarne has advised that the Buy-Back was undertaken to return excess funds generated by the sale of a former subsidiary at a profit by a current subsidiary, and improve earnings per share and return on equity.

16. Under the Buy-Back, Lemarne proposed to purchase 35% of each shareholder's holding, as registered on the record date for the Buy-Back of 25 June 2004. The Buy-Back was available to all shareholders, but participation was voluntary. Furthermore, no partial acceptances were allowed.

17. The price for the Buy-Back ('the Buy-Back Price') was set at \$2.34 adjusted for movements in the S&P/ASX 200 Industrials Index between 24 February 2004 and 30 July 2004 (that is, the day the Buy-Back closes).

18. On 2 August 2004, Lemarne announced that:

- the Buy-Back had been completed, and Lemarne would buy back 3,614,606 shares at a total cost of \$9.11 million;
- the Buy-Back Price was \$2.52; and
- the Buy-Back Price included a fully franked dividend of \$1.01 per share bought back.

19. Lemarne accounted for the Buy-Back Price for each share bought back as follows:

- Lemarne debited \$1.51 per share against an amount standing to the credit of its untainted share capital account; and
- Lemarne debited \$1.01 per share against an amount standing to the credit of its retained earnings account.

Ruling

Buy-Back is an off-market purchase

20. The Buy-Back is an off market purchase as defined by paragraph 159GZZZK(d) of the ITAA 1936.

The Dividend Component

21. Participating shareholders are taken to have been paid a dividend of \$1.01 ('the Dividend Component') for each share bought back on the date the Buy-Back occurred pursuant to section 159GZZZP of the ITAA 1936.

22. The Buy-Back Price does not exceed the market value of Lemarne's shares at the time of the Buy-Back if the Buy-Back did not occur and was never proposed to occur, for the purposes of paragraph 202-45(c) of the ITAA 1997.

23. The whole amount of the Dividend Component constitutes a frankable distribution for the purposes of subsection 202-40(1) of the ITAA 1997.

Anti-avoidance provisions***Sections 45A, 45B and 45C of the ITAA 1936***

24. The Commissioner will not make a determination under section 45A or section 45B of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole, or any part, of the distribution of share capital under the Buy-Back received by participating shareholders.

Section 204-30 of the ITAA 1997

25. The Commissioner will not make a determination under paragraph 204-30(3)(c) of the ITAA 1997 to deny the whole, or any part, of the imputation benefits in relation to the Dividend Component received by participating shareholders.

Section 177EA of the ITAA 1936

26. The Commissioner will not make a determination under paragraph 177EA(5)(b) of the ITAA 1936 to deny the whole, or any part, of the imputation benefits in relation to the Dividend Component received by participating shareholders.

Explanation**Buy-Back is an off-market purchase**

27. Paragraph 159GZZZK(c) of the ITAA 1936 provides that if a share bought back is listed on a stock exchange in Australia or elsewhere, and the buy-back is made in the ordinary course of trading on that stock exchange, the buy-back is an on-market purchase. According to paragraph 159GZZZK(d), any other buy-back is an

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off-market purchase. As Lemarne bought its shares back directly from shareholders, the Buy-Back is an off-market share buy-back.

The Dividend Component

28. The purchase price received by participating shareholders under the Lemarne Buy-Back comprises the following elements:

- a dividend component; and
- a capital component.

The amount of each of these components is determined in accordance with sections 159GZZZP and 159GZZZQ of the ITAA 1936.

29. This Ruling does not deal with the tax consequences of receiving the capital component.

30. Section 159GZZZP provides that where the buy-back of a share is an off-market purchase, the difference between the purchase price and the part (if any) of the purchase price in respect of the buy-back of the share which is debited against amounts standing to the credit of the company's share capital account is taken to be a dividend paid by the company out of profits to the seller on the day the buy-back occurs. 'Purchase price' is defined by section 159GZZZM of the ITAA 1936 to be the amount of money or other property received or receivable by the shareholder as a result of or in respect of the buy-back. The Buy-Back Price is the purchase price pursuant to section 159GZZZM.

31. Lemarne debited \$1.51 of the purchase price in respect of the buy-back of each share against an amount standing to the credit of Lemarne's untainted share capital account.

32. The Dividend Component determined under section 159GZZZP(1) is therefore \$1.01, calculated as follows:

The Buy-Back Price	\$2.52
less amount debited to share capital account	\$1.51
Dividend Component	\$1.01

33. The Buy-Back Price does not exceed the market value of Lemarne's shares at the time of the Buy-Back, as worked out in accordance with Taxation Determination TD 2004/22. Accordingly, for the purposes of paragraph 202-45(c) of the ITAA 1997 the market value of the share, at the time of the buy-back if the buy-back did not take place and was never proposed to take place, is \$2.52.

Calculation of the market value

34. The Commissioner's view on the appropriate methodology for arriving at a market value pursuant to subsection 159GZZZQ(2) and

paragraph 202-45(c) of the ITAA 1997 is set out in Taxation Determination TD 2004/22.

35. The market value of the share is to be determined as the volume weighted average price (VWAP) of the company's share on the ASX over the last five trading days before the first announcement of the buy-back adjusted for the percentage change in an appropriate Index from the commencement of trading on the first announcement date to the close of trading on the day the buy-back closes.

36. Lemarne have adopted the following methodology for setting the market value pursuant to Taxation Determination TD 2004/22:

$$\text{\$2.34} \times \frac{\text{Closing S\&P/ASX 200 Industrials Index on 30 July 2004}}{\text{Opening S\&P/ASX 200 Industrials Index on 24 February 2004}}$$

37. The Commissioner agrees that the use of the S&P/ASX 200 Industrials Index forms part of an appropriate methodology for setting the market value for the purposes of Taxation Determination TD 2004/22 since Lemarne does not form part of the S&P/ASX 200 Index.

38. The S&P/ASX 200 Industrials Index opened at 3714.50 on 24 February 2004 and closed at 3992.30 on 30 July 2004. Therefore, the market value of each share calculated under the above formula is \$2.52.

39. Accordingly, there is no difference between the Buy-Back Price and the market value of Lemarne's shares at the time of the Buy-Back if the Buy-Back did not take place and was never proposed to take place. Therefore, there is no part of the Dividend Component that is unfrankable under paragraph 202-45(c) of the ITAA 1997.

Dividend Component is a frankable distribution.

40. The Dividend Component of \$1.01 will be a distribution by Lemarne under Item 1 of the table in subsection 960-120(1) of the ITAA 1997. Pursuant to subsection 202-40(1) of the ITAA 1997, a distribution is a frankable distribution to the extent that it is not made unfrankable under section 202-45 of the ITAA 1997.

41. None of the paragraphs in section 202-45 of the ITAA 1997 apply, and accordingly the distribution is a frankable distribution.

Anti-avoidance provisions

Sections 45A, 45B and 45C of the ITAA 1936

42. It was noted at paragraph 19 that Lemarne will debit \$1.51 of the Buy-Back Price to its share capital account. This amount is a distribution of capital to participating shareholders.

43. Sections 45A and 45B of the ITAA 1936 are anti-avoidance provisions which, if they apply, allow the Commissioner to make a determination under section 45C that all or part of the distribution of

capital received by a participating shareholder under the Buy-Back is treated as an unfranked dividend. Accordingly, the application of these two provisions to the Buy-Back must be considered.

44. Section 45A of the ITAA 1936 applies in circumstances where capital benefits are streamed to certain shareholders (the advantaged shareholders) who derive a greater benefit from the receipt of capital and it is reasonable to assume that the other shareholders (the disadvantaged shareholders) have received or will receive dividends.

45. Although a 'capital benefit' (as defined in paragraph 45A(3)(b) of the ITAA 1936) is provided to participating shareholders under the Buy-Back, the circumstances of the Buy-Back indicate that there is no streaming of capital benefits to some shareholders and dividends to other shareholders. Accordingly, section 45A has no application to the Buy-Back.

46. Section 45B of the ITAA 1936 applies where certain capital payments are paid to shareholders in substitution for dividends. Specifically, section 45B applies where:

- there is a scheme under which a person is provided with a capital benefit by a company (paragraph 45B(2)(a));
- under the scheme, a taxpayer, who may or may not be the person provided with the capital benefit, obtains a tax benefit (paragraph 45B(2)(b)); and
- having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling a taxpayer to obtain a tax benefit (paragraph 45B(2)(c)).

In this case, whilst the conditions of paragraphs 45B(2)(a) and 45B(2)(b) of the ITAA 1936 have been met, the requisite purpose of enabling the shareholder to obtain a tax benefit – by way of capital distribution – was not present.

47. Having regard to the 'relevant circumstances' of the scheme (the Buy-Back) as set out in subsection 45B(8) of the ITAA 1936, it would be concluded that the inclusion of a capital element in the Buy-Back Price is appropriate. In particular, the occasion for the capital distribution under the Buy-Back is the sale of the former subsidiary and the capital component (\$1.51 per share) can be reasonably regarded as being a return of the capital invested in that business. Further, the pattern of distributions that have been made by Lemarne in the past indicate that the capital component was not paid in substitution for a dividend.

Section 204-30 of the ITAA 1997

48. Section 204-30 of the ITAA 1997 applies where a company streams the payment of franked distributions to its shareholders in such a way that the imputation benefits attaching to the distributions are received by those shareholders who derive a greater benefit from them and other shareholders receive lesser imputation benefits, or no imputation benefits.

49. If section 204-30 applies the Commissioner is vested with a discretion, pursuant to subsection 204-30(3), whether or not to make a determination to debit the company's franking account pursuant to paragraph 204-30(3)(a), or that no imputation benefit is to arise in respect of the dividend to those shareholders who derive a greater benefit pursuant to paragraph 204-30(3)(c).

50. For section 204-30 to apply, members to whom distributions are streamed must derive a greater benefit from imputation benefits than the members who do not participate in the Buy-Back. The words 'derives a greater benefit from franking credits' (imputation benefits) are defined in subsection 204-30(8) by reference to the ability of the members to fully utilise imputation benefits.

51. Having regard to the information provided, it cannot be said that there exists, in relation to the shareholders of Lemarne, a group of shareholders that have a greater ability to use the franking credits than other shareholders within the meaning of the words in subsection 204-30(8). There are no identifiable characteristics attaching to the shareholding of Lemarne that would suggest one part of that shareholding would benefit more or less from franking credits. Non-resident shareholders (for the purposes of the ITAA 1936 and ITAA 1997) hold only a small proportion of Lemarne's shares. Further, Lemarne has a strong history of paying fully franked dividends and expects to continue to pay fully franked dividends in the foreseeable future. Accordingly, section 204-30 does not apply to the Dividend Component of the Buy-Back.

Section 177EA of the ITAA 1936

52. Section 177EA of the ITAA 1936 is a general anti-avoidance provision that applies to a wide range of schemes to obtain a tax advantage in relation to imputation benefits. In essence, it applies to schemes for the disposition of membership interests, or an interest in membership interests, where a franked distribution is paid or payable in respect of the membership interest or an interest in membership interests. This includes a buy-back with a franked dividend component.

53. Specifically, subsection 177EA(3) provides that section 177EA of the ITAA 1936 applies if:

- (a) there is a scheme for a disposition of membership interests, or an interest in membership interests, in a corporate tax entity; and

- (b) either:
 - (i) a frankable distribution has been paid, or is payable or expected to be payable, to a person in respect of the membership interests; or
 - (ii) a frankable distribution has flowed indirectly, or flows indirectly or is expected to flow indirectly, to a person in respect of membership interests, as the case may be; and
- (c) the distribution was, or is expected to be, a franked distribution or a distribution with an exempting credit; and
- (d) except for section 177EA, a person (the 'relevant taxpayer') would receive, or could reasonably be expected to receive, imputation benefits as a result of the distribution; and
- (e) having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain an imputation benefit.

54. In the present case the conditions of paragraphs 177EA(3)(a) to (d) are satisfied. Accordingly, the issue is whether, having regard to the relevant circumstances of the scheme, it would be concluded that, on the part of Lemarne, its shareholders or any other relevant party, there is a purpose more than merely an incidental purpose of conferring an imputation benefit under the scheme. Under this arrangement the relevant taxpayer is a participating shareholder and the scheme comprises the circumstances surrounding the Buy-Back.

55. In arriving at a conclusion the Commissioner must have regard to the relevant circumstances of the scheme which include, but are not limited to, the circumstances set out in subsection 177EA(17). The relevant circumstances listed there encompass a range of circumstances which taken individually or collectively could indicate the requisite purpose. Due to the diverse nature of these circumstances some may not be present at any one time in any one scheme.

56. Where section 177EA applies the Commissioner is vested with a discretion, pursuant to subsection 177EA(5), to make a determination. If the company is a party to the scheme, the Commissioner has a choice as to whether that determination is to debit the company's franking account pursuant to paragraph 177EA(5)(a) or to deny the imputation benefit to each shareholder pursuant to paragraph 177EA(5)(b).

57. The Commissioner has come to the view that section 177EA does not apply to the Buy-Back. In coming to this conclusion, the

Commissioner has had regard to all the relevant circumstances of the arrangement, in particular the allocation of the Buy-Back Price between share capital and retained profits, the shareholder profile of Lemarne, whether the franking credits were being delivered in excess of what would have otherwise been distributed in the ordinary course of dividend declaration, and Lemarne's capital management strategy.

58. Accordingly, the Commissioner will not make a determination under paragraph 177EA(5)(b) to deny imputation benefits received by participating shareholders under the Buy-Back.

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Commissioner of Taxation

22 September 2004

<i>Previous draft:</i>	- ITAA 1936 159GZZZP
Not previously issued as a draft	- ITAA 1936 159GZZZP(1)
	- ITAA 1936 159GZZZQ
<i>Related Rulings/Determinations:</i>	- ITAA 1936 159GZZZQ(2)
CR 2001/1; TR 92/1; TR 92/20;	- ITAA 1936 177EA
TR 97/16; TD 2004/22	- ITAA 1936 177EA(3)
	- ITAA 1936 177EA(3)(a)
<i>Subject references:</i>	- ITAA 1936 177EA(3)(b)
- dividend streaming arrangements	- ITAA 1936 177EA(3)(c)
- return of capital on shares	- ITAA 1936 177EA(3)(d)
- share buy-backs	- ITAA 1936 177EA(5)
	- ITAA 1936 177EA(5)(a)
<i>Legislative references:</i>	- ITAA 1936 177EA(5)(b)
- Copyright Act 1968	- ITAA 1936 177EA(17)
- ITAA 1936 45A	- ITAA 1997 202-40
- ITAA 1936 45A(3)(b)	- ITAA 1997 202-40(1)
- ITAA 1936 45B	- ITAA 1997 202-45
- ITAA 1936 45B(2)(a)	- ITAA 1997 202-45(c)
- ITAA 1936 45B(2)(b)	- ITAA 1997 204-30
- ITAA 1936 45B(2)(c)	- ITAA 1997 204-30(3)
- ITAA 1936 45B(8)	- ITAA 1997 204-30(3)(a)
- ITAA 1936 45C	- ITAA 1997 204-30(3)(c)
- ITAA 1936 159GZZZK	- ITAA 1997 204-30(8)
- ITAA 1936 159GZZZK(c)	- ITAA 1997 960-120
- ITAA 1936 159GZZZK(d)	- ITAA 1997 960-120(1)
- ITAA 1936 159GZZZM	

ATO references

NO: 2004/13189

ISSN: 1445-2014