

CR 2004/114 - Income tax: capital reduction: SMS Management & Technology Limited

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Class Ruling

Income tax: capital reduction: SMS Management & Technology 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 laws' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates.

Tax laws

2. The tax laws dealt within this Ruling are:
- subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - subsection 6(4) of the ITAA 1936;
 - subsection 44(1) of the ITAA 1936;
 - section 45A of the ITAA 1936;
 - section 45B of the ITAA 1936;
 - section 45C of the ITAA 1936; and
 - section 104-135 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Class of persons

3. The class of persons to which this Ruling applies are the ordinary shareholders in SMS Management & Technology Limited (SMS) who will receive a return of capital as described in the Arrangement part of this Ruling.

Qualifications

4. The Commissioner makes this Ruling based on the precise arrangement identified in this Ruling.
5. The class of persons defined in this Ruling may rely on its contents provided the arrangement actually carried out is carried out in accordance with the arrangement described in paragraphs 10 to 18.
6. If the arrangement actually carried out is materially different from the arrangement that is described in this Ruling, then:
 - (a) 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
 - (b) this Ruling may be withdrawn or modified.
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Date of effect

8. This Class Ruling applies to the year of income ending 30 June 2005. However, this Ruling does not apply to taxpayers to the extent that it conflicts with terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 to 22 of Taxation Ruling TR 92/20). Furthermore this Ruling applies to the extent that the relevant tax laws are not amended.

Withdrawal

9. This Class 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 enter into the specified arrangement during the term of the Ruling. This is subject to there being no change in the Arrangement or in the persons' involvement in the arrangement.

Arrangement

10. The Arrangement that is the subject of the Ruling is described below. This description is based on the following documents:

- (a) the Class Ruling application authored by KPMG and dated 25 August 2004;
- (b) the SMS Annual Reports for the financial years 2000 to 2003 obtained from SMS's website;
- (c) The SMS Preliminary Annual Results for the 2004 financial year obtained from SMS's website; and
- (d) Email dated 10 September 2004 from KPMG with attached information pertaining to the on market share buy backs undertaken by SMS during the 2002 and 2003 financial years.

These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description.

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

11. SMS, a management and consultant service company, is listed on the Australian Stock Exchange (ASX). SMS announced on 23 August 2004, a proposal to return capital to its shareholders conditional upon the shareholders' approval (AGM to be held on 25 October 2004). As at 30 June 2004, the company had on issue 313,972,890 shares and 16,500,700 options to acquire shares. There are no other types of shares on issue.

12. SMS proposes to pay a return of capital of 9 cents per share to all of its shareholders. The total capital to be returned is in the amount of \$28.26 million. The return of capital will be debited entirely to SMS's share capital account.

13. SMS confirms its share capital account, as defined in section 6D of the ITAA 1936, is not tainted as there have been no transfers to the share capital account from other accounts.

14. The return of capital is to be sourced from SMS's cash on hand which at 30 June 2004 held a balance of approximately \$44.58 million, the bulk of which is surplus to requirements. During the 1999 to 2001 financial years, SMS (then known as Sausage Software Limited) obtained capital funds from its shareholders as its costs exceeded earnings in most years. This enabled SMS to retain a net cash surplus in the order of \$40 million.

15. The capital funds were required to continue Sausage Software Limited's website and related software technology operations which have been discontinued or divested. SMS has implemented a consulting based business strategy.

16. SMS has determined that the cash balance is surplus to its operating requirements as:

- its business is profitable and it expects to generate sufficient cash surpluses in the future;
- SMS has paid a fully franked dividend of 1.2 cents per share from its 2004 operating profits on 2 August 2004. SMS does not have retained profits from which it can pay dividends in the future;
- SMS's capital funding requirements are low due to its nature as a consulting business; and
- SMS's future strategy is to expand its business through organic growth. Accordingly, it is not necessary to fund business acquisitions in the short to medium term.

17. As at 30 June 2004, the shareholders equity (on a consolidated basis) totalled \$64.647 million. Approximately \$449.399 million represents share capital, reserves of \$0.129 million, profits of \$5.033 million and retained losses of \$385.855 million. The balance of SMS's franking account amounts to approximately \$6.3 million.

18. SMS's shareholders are a mix of companies, superannuation funds and individuals. As at 30 June 2004, 1.1% of the registered shareholders of SMS were non-residents.

Ruling

19. All references are to the ITAA 1936 unless otherwise specified.

Dividends

20. The return of capital of 9 cents per share under the Arrangement is not a 'dividend' as defined by subsection 6(1) and therefore it would not be included in shareholders' assessable income under section 44.

Anti-avoidance Provisions

21. The Commissioner will not make a determination under either subsections 45A(3) or 45B(2) that section 45C applies to the whole, or any part, of the return of capital received by the shareholders.

Capital Gains

22. An Australian resident shareholder who receives the return of capital will derive a capital gain in accordance with section 104-135 of the ITAA 1997, if the return of capital exceeds the cost base of the shares.

Explanations

Dividends

23. Subsection 44(1) includes in a shareholder's assessable income any dividends, as defined in subsection 6(1), paid to a shareholder out of profits derived by the company from any source (if resident in Australia) and from an Australian source (if non-resident).

24. The term 'dividend' defined in subsection 6(1) includes any distribution made by a company to any of its shareholders. However, the ambit of this is confined by later paragraphs in the definition which exclude certain items from being a dividend for income tax purposes.

25. Relevantly, the specific exclusion in paragraph (d) of the definition of dividend provides:

"moneys paid or credited by a company to a shareholder or any other property distributed by a company to shareholders (not being moneys or other property to which this paragraph, by reason of subsection (4), does not apply or moneys paid or credited, or property distributed for the redemption or cancellation of a redeemable preference share), where the amount of the moneys paid or credited, or the amount of the value of the property, is debited against an amount standing to the credit of the share capital account of the company."

26. SMS confirms the return of capital will be debited against its untainted share capital account. Therefore, paragraph (d) of the definition of 'dividend' applies and the return of capital would not constitute a dividend unless some other more specific provision of the Income Tax Assessment Acts (ITAA 1936 or ITAA 1997) operate to make it a dividend.

Anti-avoidance Provisions

Section 45A and 45B

27. Section 45A and 45B are anti-avoidance provisions which, if they apply, allow the Commissioner to make a determination under section 45C that all or part of the return of capital is treated as an unfranked dividend.

Section 45A

28. Section 45A 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.

29. Although SMS will be providing its shareholders with a “capital benefit” (as defined in paragraph 45A(3)(b)), the capital benefit is to be provided to all of the shareholders in SMS. The circumstances of the Arrangement do not indicate that there is a ‘streaming’ of capital benefits to advantaged shareholders and dividends to disadvantaged shareholders. Accordingly, section 45A has no application to the proposed payment of the return of capital.

Section 45B

30. Section 45B applies where certain capital payments are made to shareholders in substitution for dividends. Specifically, the provision applies where:

- (a) there is a scheme under which a person is provided with a capital benefit by a company (paragraph 45B(2)(a));
- (b) 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
- (c) having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into the scheme 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)).

31. In the circumstances of the Arrangement, the conditions of paragraphs 45B(2)(a) and (b) are satisfied, as the proposed payment of the return of capital will provide shareholders with a capital benefit (as defined in subsection 45B(5)) and the shareholders will generally pay less tax on the return of capital than they would on an equivalent amount of dividend (a ‘tax benefit’ as defined in subsection 45B(9)).

32. For the purposes of paragraph 45B(2)(c), the Commissioner is required to consider the circumstances set out under subsection 45B(8) to determine whether any part of the Arrangement would be entered into for a purpose, other than an incidental purpose, of enabling a relevant taxpayer to obtain a tax benefit.

33. The test of purpose is an objective one. The question is whether, objectively, it would be concluded that a person who entered into or carried out the scheme, did so for the purpose of obtaining a tax benefit for the relevant taxpayer in respect of the capital benefit. The purpose does not have to be the most influential or prevailing purpose but it must be more than an incidental purpose.

34. In this regard, the relevant taxpayers are the shareholders of SMS. The relevant circumstances of this Arrangement are:

- SMS intends to fund the return of capital from its cash on hand which is attributable to share capital raised for the purposes of funding its previous business operations. SMS has now effectively discontinued or divested these operations;
- Further, SMS does not have any residual profits either realised or unrealised. Therefore, no part of the return of capital will be attributable to specific profits, realised or unrealised, of SMS or any of its associates (paragraph 45B(8)(a));
- SMS has not previously paid dividends to its shareholders since 1996, the year in which it became a web-based software design company. However, due to improved profitability, on 2 August 2004 SMS paid a fully franked dividend of 1.2 cents per share which was attributable to profits earned in the 2004 financial year. The payment of the dividend was consistent with SMS's dividend policy of distributing the maximum practical amount of profits to its shareholders as dividend payments. (Paragraph 45B(8)(b));
- SMS is a listed public company with a wide range of shareholders. SMS is not aware of whether its shareholders have capital losses;
- Additionally, as SMS was incorporated in 1986, no shares were acquired prior to 20 September 1985 (paragraph 45B(8)(c) and (d));
- SMS does have non-resident shareholders who hold approximately 1.1% of the shares in SMS (paragraph 45B(8)(e));
- the cost base of the shares will vary depending on when each shareholder acquired the shares, however, it is unlikely the cost base of the shares prior to the capital reduction will be less than the value of the benefit provided by the capital reduction (paragraph 45B(8)(f));
- paragraphs 45B(8)(g), (i) and (j) are not relevant to SMS's proposed capital reduction;
- the comparative rights and interests held by the shareholders after the distribution will be the same as those that would have been held had an equivalent dividend been paid instead of the capital benefit (paragraph 45B(8)(h)); and

- the matters referred to in paragraph 45B(8)(k) are the relevant circumstances listed in subparagraph 177D(b)(i) to (viii) in relation to the Arrangement for the purposes of determining whether a scheme was entered into to obtain a tax benefit under Part IVA. In the present circumstances, the capital reduction will apply to all shareholders of SMS equally. The profiles of the wide class of shareholders are not known to SMS and as such, the purpose of ensuring that particular shareholders obtain a tax benefit cannot exist.

35. Having regard to the circumstances outlined in paragraph 34, it is considered that the Arrangement as described will not be entered into for the purpose, not being an incidental purpose, of enabling a shareholder of SMS to obtain a tax benefit. Although a tax benefit would be provided to the shareholders of SMS, any benefit is merely incidental. It is accepted the purpose of the proposed capital reduction is to return capital surplus to its present requirements to its shareholders.

36. Accordingly, the Commissioner will not make a determination pursuant to subsection 45B(3) that section 45C applies to the return of capital.

37. As the Commissioner will not make a determination pursuant to subsection 45B(3) in relation to the Arrangement as described, section 45C will not deem the return of capital provided to be an unfranked dividend for the purposes of ITAA 1936 or ITAA 1997.

Capital Gains

38. The return of capital will give rise to CGT event G1 (section 104-135 of the ITAA 1997). A capital gain will only arise under CGT event G1 if the payment of the return of capital exceeds the shareholder's cost base for each share.

Detailed contents list

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Commissioner of Taxation
20 October 2004

<i>Previous draft:</i>	- ITAA 1936 45B(2)(c)
Not previously released in draft form.	- ITAA 1936 45B(3)
	- ITAA 1936 45B(5)
	- ITAA 1936 45B(8)
<i>Related Rulings/Determinations:</i>	- ITAA 1936 45B(8)(a)
CR 2001/1; TR 92/1; TR 92/20;	- ITAA 1936 45B(8)(b)
TR 97/16	- ITAA 1936 45B(8)(c)
	- ITAA 1936 45B(8)(d)
	- ITAA 1936 45B(8)(e)
<i>Subject references:</i>	- ITAA 1936 45B(8)(f)
- Capital Benefit	- ITAA 1936 45B(8)(g)
- Dividend	- ITAA 1936 45B(8)(h)
- Dividend Substitution	- ITAA 1936 45B(8)(i)
- Return of Capital	- ITAA 1936 45B(8)(j)
	- ITAA 1936 45B(8)(k)
<i>Legislative references:</i>	- ITAA 1936 45B(9)
- ITAA 1936 6(1)	- ITAA 1936 45C
- ITAA 1936 6(4)	- ITAA 1936 177D(b)
- ITAA 1936 6D	- ITAA 1936 177D(b)(i)
- ITAA 1936 44	- ITAA 1936 177D(b)(ii)
- ITAA 1936 44(1)	- ITAA 1936 177D(b)(iii)
- ITAA 1936 45A	- ITAA 1936 177D(b)(iv)
- ITAA 1936 45A(3)	- ITAA 1936 177D(b)(v)
- ITAA 1936 45A(3)(b)	- ITAA 1936 177D(b)(vi)
- ITAA 1936 45B	- ITAA 1936 177D(b)(vii)
- ITAA 1936 45B(2)	- ITAA 1936 177D(b)(viii)
- ITAA 1936 45B(2)(a)	- ITAA 1997 104-135
- ITAA 1936 45B(2)(b)	- TAA 1953 Part IVA
	- Copyright Act 1968

Class Ruling

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ATO references

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