



CR 2004/46 - Income tax: Reduction of Share Capital: APPP Holdings Pty Ltd

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Class Ruling

Income tax: Reduction of Share Capital: APPP Holdings Pty Ltd

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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. In this Ruling, the arrangement is a proposed reduction of share capital held (the Arrangement) in APPP Holdings Pty Ltd (APPP).

Tax law(s)

2. The tax law(s) dealt with in this Ruling are:
- subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - subsection 6(4) (ITAA 1936);
 - section 45A (ITAA 1936);
 - section 45B (ITAA 1936);
 - section 45C (ITAA 1936); and
 - Part IVA (ITAA 1936)

Class of persons

3. The class of persons to which this Ruling applies is the shareholders of APPP. In this Ruling these persons are referred to as 'Shareholders'.

4. The Ruling does not deal with how the tax law applies to APPP in relation to the Arrangement to which this Ruling applies.

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 carried out in accordance with the Arrangement, as described in paragraphs 12 to 27 (inclusive) below.

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- this Ruling may be withdrawn or modified.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 for the 2003-2004 income year. The Arrangement will be completed by 30 June 2004.

10. However, the Ruling does 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 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 notice in the *Gazette*; or
- it is not taken to be withdrawn by an inconsistent later public ruling; or
- the relevant tax laws are not amended.

Withdrawal

11. This Class Ruling is withdrawn and ceases to have effect after 30 June 2004. 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

12. The Arrangement that is the subject of the Ruling is described below. This description is based on the application for Class Ruling dated 13 February 2004, incorporating:

- A diagrammatic representation of APPP and its Shareholders;
- The APPP consolidated operating statement for the month of December 2003 together with year to date figures;
- The APPP consolidated balance sheet as at December 2003; and
- Extracts from a Corporate Brochure on Castle Harlan Australian Mezzanine Partners Pty Ltd (CHAMP).

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

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

14. APPP was incorporated on 22 October 2002 and operates as the Australian holding company of a group involved in a business of manufacturing and wholesaling paper products.

15. Prior to 1 November 2002, the business was owned by an unrelated group based in the United States (the Vendor).

16. APPP acquired the business and related assets from the Vendor using equity from private equity funds and management (that is, the acquisition was in part a management buy-out).

17. APPP funded the rest of the acquisition through external borrowings entered into by APPP Finance Pty Ltd, a wholly owned Australian subsidiary of APPP.

18. The following table lists the groups of Shareholders together with the number of shares that each of those groups currently hold:

Shareholder Group	No of \$1 shares held
P.T. Limited (Australian resident)	8,000,000
CHAMP 1D Worldwide SCRL (foreign resident)	12,000,000
Management shareholders (Australian residents – 10 individuals)	3,526,000
Total Shares	23,526,000

Since acquiring the business, the share capital of APPP has been reduced by \$300,000. This reduction was attributable to an original management shareholder leaving the employment of the company and equated to that shareholder's original shareholding in the company.

19. Each share in APPP has a paid-up amount of \$1.00, such that the capital contributed by Shareholders totals \$23,526,000.

20. As at 31 December 2002, the APPP group had retained profits of \$796,685 and exempting credits of \$2,077,310. As at 31 December 2003, the group is forecasting to have retained profits of approximately \$6.9m and gross tax payable in respect of the income year ending December 2003 is expected to be approximately \$2.4m. APPP have stated that the group would be in a position to fully frank any dividends paid to Shareholders.

21. No transfer has previously taken place to 'taint' APPP's share capital account, as that term is defined in subsection 160ARDM(1) of the ITAA 1936.

22. APPP have indicated that the business operations of the APPP group currently generate sufficient 'free cash flows' to enable it to service a higher level of external debt and that the current capital and debt structure of the APPP group is not conducive to achieving the requisite rate of return for the CHAMP's investors.

23. The APPP group's debt to Earnings before Interest, Tax, Depreciation and Amortisation (EBITD) ratio at the time of acquisition of the business was 3.2 times. As at 31 December 2003, it was 1.4 times.

24. To address this, APPP is proposing a reduction of its share capital, involving the following steps:

- (a) The APPP group will obtain debt finance of \$18,820,800 from Australian financial institutions;
- (b) APPP will use the funds received to make a pro-rata share capital reduction to the Shareholders;
 - This proposed capital reduction will be carried out pursuant to section 256B of the *Corporations Act 2001* (the Corporations Act);

- For accounting purposes, the share capital of APPP will be reduced by an amount of \$18,820,800, on a pro-rata basis to each Shareholder as follows:
 - Currently there are 23,526,000 shares on issue each carrying an entitlement to \$1 of capital;
 - The proposed reduction of share capital will involve \$0.80c being returned to each Shareholder for every share held. Thus, a total of \$18,820,800 will be returned to the Shareholders. This amount will be debited against the share capital account of APPP;
 - After this capital reduction, there will continue to be 23,526,000 shares on issue. However, each share will thereafter carry an entitlement of \$0.20 of capital; and
 - APPP will consider consolidating the share capital after the capital reduction in accordance with section 254H of the Corporations Act.

- (c) This proposed process was considered and agreed upon by the Board of APPP at a meeting on 16 December 2003. No alternative transactions have been considered by APPP.

25. Following this proposed reduction of share capital, the APPP group's debt to EBITDA ratio is expected to be 2.9 times.

26. The proposed reduction of share capital will take place prior to 30 June 2004. The share capital account of APPP will remain the same from the date of effect of this Ruling to the date on which the reduction of share capital takes place. Further, there will be no new or additional classes of shares issued prior to the date on which the reduction of share capital takes place.

27. APPP have indicated that their future dividend policy will involve an equal distribution of dividends to all shareholders in the company.

Ruling

28. The return of capital will not be a dividend, as defined in section 6 of the ITAA 1936.

29. The Commissioner will not make a determination under subsection 45A(2) or subsection 45B(3) of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole, or any part, of the return of capital received by the Shareholders.

30. The anti-avoidance provisions in Part IVA of the ITAA 1936 will not apply to the return of capital received by the Shareholders.

Explanation

Section 6 of the ITAA 1936 – Definition of “Dividend”

31. The capital reduction amount will be debited against an amount standing to the credit of the share capital account of APPP. Therefore, subject to subsection 6(4) of the ITAA 1936, it will not constitute a ‘dividend’ as defined in subsection 6(1) of the ITAA 1936 because of the exclusion in paragraph (d) of that definition.

32. Subsection 6(4) of the ITAA 1936 provides that the exclusion in paragraph (d) of the definition of ‘dividend’ in subsection 6(1) will not apply where, under an arrangement:

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

33. The share capital account of APPP is only made up of the paid up capital initially subscribed in November 2002. Therefore, subsection 6(4) does not apply to negate the effect of paragraph (d) of the definition of ‘dividend’ under subsection 6(1).

34. As a consequence, the money paid by the company to Shareholders does not constitute a ‘dividend’ under section 6 of the ITAA 1936.

Section 45A of the ITAA 1936 – Streaming of Dividends and Capital Benefits

35. In broad terms, for the Commissioner to make a determination under subsection 45A(2) of the ITAA 1936 that section 45C of the ITAA 1936 applies, a company must stream capital benefits to its **advantaged shareholders** and pay dividends to its **disadvantaged shareholders**, whether in the same income year or in different income years.

36. Therefore, for section 45A to apply there must be evidence of ‘streaming’. Streaming requires the company to selectively direct the capital benefits to a specific group of shareholders.

37. Under the Arrangement, the capital reduction is offered to all shareholders equally. Accordingly, under these circumstances, the Commissioner will not make a determination under subsection 45A(2) that section 45C applies to the capital benefits provided under the Arrangement.

Section 45B of the ITAA 1936 – Schemes to Provide Capital Benefits in Substitution for Dividends

38. A purpose of section 45B of the ITAA 1936 is to deem as dividends capital payments that are paid in substitution for dividends.

39. Subsection 45B(2) sets out the conditions under which the Commissioner will make a determination under subsection 45B(3) of the ITAA 1936 that section 45C of the ITAA 1936 applies. These conditions are that:

- there is a **scheme** under which a person is **provided with a capital benefit** by a company;
- under the scheme, a taxpayer (the relevant taxpayer) who may or may not be the person provided with the capital benefit, **obtains a tax benefit**; 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 the relevant taxpayer to obtain a tax benefit**.

40. Therefore, the following elements need be satisfied before section 45B will apply to the Arrangement:

- The Arrangement is a 'scheme';
- The Shareholders will be 'provided with a capital benefit' by APPP under the proposed Arrangement;
- The Shareholders or other taxpayers will 'obtain a tax benefit' under the Arrangement; and
- Considering specified circumstances of the Arrangement, it can be concluded that the Arrangement will be entered into for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the Shareholders or other taxpayers to obtain a tax benefit.

41. Each of these elements is considered below.

Scheme

42. The term 'scheme' is taken to have the same meaning as provided in Part IVA of the ITAA 1936. The definition in subsection 177A(1) of the ITAA 1936 provides that a 'scheme' is:

- any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable by legal proceedings; and
- any scheme, plan, proposal, action, course of action or course of conduct.

43. This definition of 'scheme' encompasses a wide range of undertakings. The Arrangement is clearly a scheme for these purposes.

Providing a Capital Benefit

44. The phrase 'provided with a capital benefit' is defined in subsection 45B(5) of the ITAA 1936. A person is provided with a capital benefit if:

- ownership interests in a company are issued to the person;
- there is a distribution to the person of share capital; or
- the company does something in relation to an ownership interest that has the effect of increasing the value of the ownership interest (which may or may not be the same interest) held by that person.

45. In the present situation, APPP proposes to debit the capital reduction distribution against its share capital account. Therefore, the resulting distribution of share capital to Shareholders will amount to the provision of a capital benefit.

Obtaining a Tax Benefit

46. A taxpayer 'obtains a tax benefit', as defined in subsection 45B(9) of the ITAA 1936, where:

- the amount of tax payable; or
- any other amount payable under the ITAA 1936 or the *Income Tax Assessment Act 1997* (ITAA 1997);

by the taxpayer would, apart from the operation of section 45B:

- be less than the amount *that* would have been payable; or
- be payable at a later *time* than it would have been payable;

if the capital benefit had instead been a dividend.

47. Under the Arrangement, the distribution to Shareholders is, *prima facie*, capital in nature and is therefore not assessable in the hands of Shareholders. As previously explained, the distribution is not a dividend under section 6 of the ITAA 1936 and therefore, subject to the operation of section 45B, would not be assessable under section 44 of the ITAA 1936. Thus, the Shareholders would obtain a tax benefit as defined in subsection 45B(9) under the Arrangement.

Purpose

48. The Commissioner is required to consider the circumstances set out under subsection 45B(8) of the ITAA 1936 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.

49. This 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. It is enough that the purpose of the scheme is any main or substantial purpose.

50. In this case, the relevant taxpayers are the Shareholders. The relevant circumstances of this Arrangement are:

- APPP plans to fund the capital distribution through external debt. Therefore, no part of the capital reduction will be attributable to specific profits, realised or unrealised, of APPP or any of its subsidiaries (paragraph 45B(8)(a));
- APPP has not previously paid dividends or undertaken any capital reductions under section 256B of the Corporations Act. The only return of capital made by APPP since acquiring the business was to a management shareholder who left the employment of the company. This reduction in share capital equated to the shareholder's original holding in the company. APPP have indicated their intention to pay future dividends so that frankable profits are distributed equally to the same Shareholders that are to receive the return of capital (paragraph 45B(8)(b));

- The capital reduction distribution 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 made exceeds the Shareholder's cost base for each share. Under the Arrangement as described, the cost base of each share will be reduced by the amount of the capital reduction under subsection 104-135(4) of the ITAA 1997 and a capital gain will not arise. Therefore, if Shareholders have capital losses in the income year in which the capital reduction takes place, these will still be carried forward to a later income year (paragraph 45B(8)(c));
- The majority Shareholder in APPP is a non-resident. Factors that are relevant in determining whether non-residents gain a greater tax benefit from receiving capital benefits rather than dividends include the amount of profits available for distribution, the inefficient use of franking credits on entering into the arrangement and the extent to which dividend distributions are capable of being franked and will therefore be free from withholding tax. Under this Arrangement, it is intended that the non-resident Shareholder will participate equally in APPP's future dividend program. APPP also has the capacity to fully frank dividends out of anticipated retained earnings (paragraph 45B(8)(e));
- The cost base of the shares prior to the capital reduction will not be less than the value of the benefit provided by the capital reduction (paragraph 45B(8)(f));
- Section 46F of the ITAA 1936 will not deny a private company Shareholder an entitlement to a rebate under sections 46 or 46A of the ITAA 1936, assuming that an equivalent dividend was paid instead of the capital benefit, as no Shareholders would be entitled to such a rebate in the first place (paragraph 45B(8)(g)); and
- The proportional interests held by the Shareholders after the distribution of capital will be the same as that that would have been held had an equivalent dividend been paid instead of the capital benefit (paragraph 45B(8)(h)).

51. Paragraph 45B(8)(k) also requires the Commissioner to consider the relevant circumstances listed in subparagraph 177D(b)(i) to (viii) of the ITAA 1936 in relation to the Arrangement. These are the circumstances that are to be considered in determining whether a scheme was entered into for the purpose of obtaining a tax benefit under Part IVA of the ITAA 1936. Here, the capital reduction will apply to all Shareholders equally and the current Corporation Law allows the company to reduce its share capital with the approval of the Shareholders.

52. Therefore, having regard to the circumstances outlined in paragraphs 50 and 51, it can be concluded that the Arrangement as described will not be entered into for the purpose, not being an incidental purpose, of obtaining a tax benefit for Shareholders. Although tax benefits would be obtained by Shareholders, the obtaining of these benefits would, at most, be a merely incidental purpose of the Arrangement. It is accepted that the Arrangement is a commercial revision of the gearing levels in the APPP group such that APPP's group debt to EBITDA ratio is returned to a level closely approximating to that in place at the time the business was acquired.

53. Accordingly, under these circumstances, the Commissioner will not make a determination under subsection 45B(3) that section 45C applies to the capital benefits provided under the Arrangement.

Section 45C of the ITAA 1936 – Deeming Dividends to be Paid where Section 45A or 45B Determinations Have Been Made

54. As the Commissioner will not make a determination under subsection 45A(2) of the ITAA 1936 or subsection 45B(3) of the ITAA 1936 in relation to the Arrangement as described, section 45C will not deem any part of the capital benefit provided under the Arrangement to be an unfranked dividend for the purposes of the ITAA 1936 or ITAA 1997.

Part IVA of the ITAA 1936

55. For the reasons outlined at paragraph 51 above, Part IVA of the ITAA 1936 will not apply to the Arrangement as described.

Detailed contents list

56. Below is a detailed contents list for this Class Ruling:

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Commissioner of Taxation

12 May 2004

Previous Rulings/Determinations:
This ruling has not been previously released

Related Rulings/Determinations:
CR 2001/1; TR 92/1; TR 92/20;
TR 97/16

Subject references:

- share capital
- reduction of share capital
- return of share capital

Legislative references:

- Copyright Act 1968
- TAA 1953 Part IVA
- ITAA 1936 6
- ITAA 1936 6(1)

- ITAA 1936 6(4)
- ITAA 1936 44
- ITAA 1936 45A
- ITAA 1936 45A(2)
- ITAA 1936 45B
- ITAA 1936 45B(2)
- ITAA 1936 45B(3)
- ITAA 1936 45B(5)
- ITAA 1936 45B(8)
- ITAA 1936 45B(8)a
- ITAA 1936 45B(8)b
- ITAA 1936 45B(8)c
- ITAA 1936 45B(8)e
- ITAA 1936 45B(8)f
- ITAA 1936 45B(8)g
- ITAA 1936 45B(8)h
- ITAA 1936 45B(8)k
- ITAA 1936 45B(9)

- ITAA 1936 45C
- ITAA 1936 46
- ITAA 1936 46A
- ITAA 1936 46F
- ITAA 1936 160 ARDM(1)
- ITAA 1936 Part IVA
- ITAA 1936 177D(b)i
- ITAA 1936 177D(b)ii
- ITAA 1936 177D(b)iii
- ITAA 1936 177D(b)iv
- ITAA 1936 177D(b)v
- ITAA 1936 177D(b)vi
- ITAA 1936 177D(b)vii
- ITAA 1936 177D(b)viii
- ITAA 1997 104-135
- ITAA 1997 104-135(4)
- Corporations Act 2001 256B
- Corporations Act 2001 254H

ATO references

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