


# ***CR 2005/24 - Income tax: return of share capital: Kemp & Denning Limited***

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 This document has changed over time. This is a consolidated version of the ruling which was published on *1 July 2004*



## Class Ruling

### Income tax: return of share capital: Kemp & Denning 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**

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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. In this Ruling, the arrangement is a proposed return of share capital (the Arrangement) in Kemp & Denning Ltd (K&D).

#### **Tax law(s)**

2. The tax laws dealt with in this Ruling are:

- subsection 6(1) of the *Income Tax Assessment Act 1936* (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 is the shareholders of K&D. In this Ruling these persons are referred to as 'Participating Shareholders'.

4. This Class Ruling does not apply to K&D and does not deal with how taxation laws apply to K&D in relation to the Arrangement. Furthermore, it should be noted that certain in-confidence information relating to the affairs of K&D, but which is not in the public domain, has been taken into account in this Ruling. This information is not 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 carried out in accordance with the Arrangement described in paragraphs 12 to 24 (inclusive).

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

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9. This Class Ruling applies to the income year (as defined in the ITAA 1997) for a Participating Shareholder in which that shareholder receives the proposed return of share capital. The Arrangement will be completed within that income year. For Participating Shareholders that do not have a substituted accounting period, this will be the income year ending 30 June 2005 (the 2004-2005 income year). The Arrangement will be completed by 30 June 2005.

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- it is not taken to be withdrawn by an inconsistent later public ruling; or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

## Withdrawal

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11. 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 entered into the specified Arrangement during the term of the Ruling, subject to there being no change in the Arrangement or in the persons involved in the Arrangement.

## Arrangement

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12. 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:

- Application for Class Ruling on behalf of K&D, dated 7 September 2004, including the Annual Reports for K&D for the years ended 31 May 2003 and 31 May 2004; and
- Correspondence on behalf of K&D dated 29 October 2004, 9 December 2004, 22 December 2004, 7 February 2005 and 10 March 2005.

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

13. K&D is an Australian unlisted public company that was incorporated in 1923 and operates as a provider of hardware and home related products in Tasmania and Victoria. K&D also manufactures fired clay bricks and pavers in Tasmania.

14. K&D is proposing a reduction of its share capital, involving the following steps:

- (a) K&D will obtain debt finance of approximately \$1.34 million to fund the entire proposed return of share capital.
- (b) K&D will use the funds to make a pro-rata share capital reduction to K&D's Participating Shareholders:
  - this proposed capital reduction will be carried out pursuant to section 256B of the *Corporations Act 2001*; and
  - for accounting purposes, the share capital of K&D will be reduced by an amount of \$1,341,818 on a pro-rata basis to each Participating Shareholder as follows:
    - i. currently there are 2,683,635 shares on issue carrying an entitlement to approximately \$1.25 of capital each;
    - ii. upon the reduction of share capital, \$0.50 will be returned to each Participating Shareholder for every share held (the 'Capital Reduction Amount'). This amount will be debited against the share capital account of K&D; and
    - iii. after the proposed capital reduction, each K&D share will carry an entitlement to approximately \$0.75 of capital.

15. The proposed reduction of share capital will occur between April and June 2005. K&D has not as yet entered into any aspect of this transaction.

16. Between 1989 and 2004, K&D has sought to implement a strategy of selling diversified elements of its business to concentrate on its core businesses. The businesses and investments sold included a sawmilling and timber processing business and a joinery manufacturing business that had been part of K&D's operations from the time the enterprise first commenced in 1902. Other businesses and investments sold included a glass and shop fitting business, an automobile retailing business, a fencing business and shares held in another company.

17. These disposals did not result in any significant profits being made in respect of the particular businesses and investments.

18. During this period, K&D established a new hardware warehouse outlet in 1996 and acquired an established hardware business in 2002.

19. The total consideration received on the disposal of the businesses was greater than the cost of establishing or acquiring the new businesses. Thus, K&D's specialisation strategy has resulted in a reduction in the overall size of its operations.

20. In recent years, there have been the following movements in K&D's share capital account:

- A dividend reinvestment plan undertaken in the 1997 financial year resulted in an increase of \$580,380.
- The share premium reserve as at 1 July 1998 was transferred to the share capital account in the 1999 financial year under the Corporations Laws reforms, resulting in an increase of \$666,874.
- A selective share buy back was conducted in the 2000 financial year to facilitate the exit of a specific shareholder, resulting in a decrease of \$230,000.

Apart from this, the number of shares on issue and the total capital contributed by shareholders has remained constant in recent years.

21. No transfer has previously taken place to taint K&D's share capital account.

22. K&D's performance in recent years has resulted in a steady increase in its level of retained profits. As at 31 May 2004, K&D had retained profits equal to \$16,119,127, having been \$13,903,447 as at 31 May 2003.

23. Dividend payments made by K&D have equalled approximately 55% of after tax profits in recent years. However, while the amount of dividends paid to shareholders in the 2004 year increased, this amount represented less than 45% of after tax profits.

24. K&D does not have a publicly disclosed dividend policy but has stated that it has sought to declare interim and final dividends in recent years at an amount at least equal to the corresponding dividend for the previous year. K&D is currently in a position to fully frank any dividends it pays to its shareholders. K&D have indicated that dividend payout levels are not expected to reduce after the proposed capital reduction is completed.

## **Ruling**

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25. The payment of the Capital Reduction Amount will not be a dividend, as defined in subsection 6(1) of the ITAA 1936.

26. The Commissioner will not make a determination under subsection 45A(2) or subsection 45B(3) of the ITAA 1936 that section 45C applies to the whole, or any part, of the payment of the Capital Reduction Amount received by the Participating Shareholders.

27. CGT event G1 in section 104-135 of the ITAA 1997 will happen when K&D pays the Capital Reduction Amount in respect of a share that a Participating Shareholder owns at the time of the payment. If the Capital Reduction Amount of \$0.50 per share is not more than the cost base of the K&D share at the time of the payment, the cost base and reduced cost base of the share are reduced by the Capital Reduction Amount under subsection 104-135(4) of the ITAA 1997.

28. A Participating Shareholder will make a capital gain if the Capital Reduction Amount is more than the cost base of their K&D share under subsection 104-135(3) of the ITAA 1997. The amount of the capital gain is equal to this excess. However, a capital gain is disregarded pursuant to subsection 104-135(5) of the ITAA 1997 if the Participating Shareholder acquired the share before 20 September 1985.

## Explanation

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### **Subsection 6(1) of the ITAA 1936 – definition of ‘dividend’**

29. The Capital Reduction Amount will be debited against an amount standing to the credit of the share capital account of K&D. Therefore, the payment of the Capital Reduction Amount 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.

### **Specific anti-avoidance provisions**

#### ***Sections 45A and 45B of the ITAA 1936***

30. Sections 45A and 45B of the ITAA 1936 are two anti-avoidance provisions which, if they apply, allow the Commissioner to determine that all or part of the payment of the Capital Reduction Amount is treated as an unfrankable dividend that is paid by the company out of profits. Accordingly, the application of these two provisions to the payment of the Capital Reduction Amount must be considered.

31. 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.

32. Although K&D 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 K&D. 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 Capital Reduction Amount.

33. 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)).

34. In the case of the Arrangement, 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 shareholders to obtain a tax benefit (by way of capital distribution) is not present.

35. For the purposes of paragraph 45B(2)(c) of the ITAA 1936, 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.

36. Having regard to the 'relevant circumstances' of the scheme as set out in subsection 45B(8) of the ITAA 1936, it is apparent that the Arrangement cannot be said to be attributable to the profits of the company (paragraph 45B(8)(a)). In this case, K&D has disposed of a substantial part of its business over a period of time as part of its specialisation strategy. During that period, K&D also made significant investments in businesses in line with its core capabilities. The proposed payment of the Capital Reduction Amount can be reasonably regarded as the share capital invested in that part of the business that has been disposed of once the impact of the intervening investments (in particular its impact on the excessiveness of K&D's equity accounts, including the share capital account) has been appropriately factored into the analysis.

37. Accordingly, the Commissioner will not make a determination pursuant to subsection 45B(3) that section 45C applies to the Arrangement.

**Capital gains tax*****CGT event G1 – section 104-135 of the ITAA 1997***

38. CGT event G1 in section 104-135 of the ITAA 1997 happens if a company makes a payment to a shareholder in respect of a share they own in the company and some or all of the payment is not a dividend, nor an amount taken to be a dividend under section 47 of the ITAA 1936.

39. Therefore, CGT event G1 will happen when K&D pays the Capital Reduction Amount in respect of a share that a Participating Shareholder owns at the time of the payment.

40. If the Capital Reduction Amount of \$0.50 per share is not more than the cost base of the K&D share at the time of the payment, the cost base and reduced cost base of the share are reduced by the amount of the Capital Reduction Amount (subsection 104-135(4) of the ITAA 1997).

41. A Participating Shareholder will make a capital gain if the Capital Reduction Amount is more than the cost base of their K&D share of subsection 104-135(3) of the ITAA 1997. The amount of the capital gain is equal to this excess. However, a capital gain is disregarded pursuant to subsection 104-135(5) of the ITAA 1997 if the Participating Shareholder acquired the share before 20 September 1985.

42. If a shareholder makes a capital gain, the cost base and reduced cost base of the K&D share are reduced to nil (subsection 104-135(3) of the ITAA 1997).

43. A Participating Shareholder cannot make a capital loss under CGT event G1.

**Detailed contents list**

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

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**Commissioner of Taxation**

 20 April 2005
 

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<i>Previous draft:</i>	- ITAA 1936 45A(2)
Not previously issued as a draft	- ITAA 1936 45A(3)(b)
	- ITAA 1936 45B
<i>Related Rulings/Determinations:</i>	- ITAA 1936 45B(2)(a)
CR 2001/1; TR 92/1; TR 92/20;	- ITAA 1936 45B(2)(b)
TR 97/16	- ITAA 1936 45B(2)(c)
	- ITAA 1936 45B(3)
<i>Subject references:</i>	- ITAA 1936 45B(8)
- return of capital on shares	- ITAA 1936 45B(8)(a)
- share capital	- ITAA 1936 45C
	- ITAA 1936 47
	- ITAA 1997 104-135
<i>Legislative references:</i>	- ITAA 1997 104-135(3)
- TAA 1953 Pt IVA	- ITAA 1997 104-135(4)
- Copyright Act 1968	- ITAA 1997 104-135(5)
- Corporations Act 2001 256B	
- ITAA 1936 6(1)	
- ITAA 1936 45A	

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 ATO references

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