



CR 2005/7 - Income tax: Telstra Corporation Limited Off-Market Share Buy-back 2004: Telstra Employee Share Scheme Participants

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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: Telstra Corporation Limited Off-Market Share Buy-back 2004: Telstra Employee Share Scheme Participants

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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 laws dealt with in this Class Ruling are:

- section 44 of the *Income Tax Assessment Act 1936* (ITAA 1936);
- sections 45A, 45B and 45C of the ITAA 1936;
- section 97 and 100 of the ITAA 1936;
- section 128B of the ITAA 1936;
- sections 139B, 139CA, 139CC and 139E of the ITAA 1936;
- sections 159GZZZP and 159GZZZQ of the ITAA 1936;
- sections 160APHG, 160APHI, 160APHM, and 160APHO of the ITAA 1936;
- section 177EA of the ITAA 1936;
- Division 67 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 104-10 of the ITAA 1997;
- sections 130-80 and 130-83 of the ITAA 1997;
- sections 202-5 and 202-40 of the ITAA 1997;

- section 204-30 of the ITAA 1997; and
- sections 207-20, 207-45, 207-50, 207-145 and 207-150 of the ITAA 1997

Note: consequential amendments with effect from 1 July 2002 dealing with the simplified imputation system were introduced into Parliament on 18 November 2004 in Tax Laws Amendment (2004 Measures No. 6) Bill 2004. This ruling deals only with the laws as presently enacted and does not extend to the application of the proposed laws.

Class of persons

3. The class of persons to which this Ruling applies is the shareholders of Telstra Corporation Limited ('Telstra') who acquired Telstra shares, as a result of participating in either or both of the Telstra Employee Share Ownership Plan No.1 ('TESOP 97') and the Telstra Employee Share Ownership Plan No.2 ('TESOP 99') as outlined at paragraph 4, and who disposed of those shares under the Telstra off-market share Buy-back ('the Buy-back') the details of which were announced by Telstra on 27 September 2004 and described in the arrangement part of this Ruling. These shareholders are referred to as 'TESOP participants'.

4. The Telstra shares acquired under TESOP 97 and TESOP 99 to which this ruling applies are as follows (see paragraph 29):

- TESOP 97 Loan Shares;
- TESOP 97 Extra Loan Shares;
- TESOP 97 Extra Non-Loan Shares;
- TESOP 99 Loan Shares; and
- TESOP 99 Extra Shares.

Note: Telstra Shares (apart from those listed above) that have been disposed of in the Buy-back are considered by Class Ruling CR 2004/152.

5. The class of persons to which this Ruling applies does not include Telstra. The Ruling does not deal with how the taxation law applies to Telstra in relation to the Buy-back. Furthermore, it should be noted that certain information which relates to the affairs of Telstra, 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

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

7. The class of persons defined in this Ruling may rely on its contents provided the arrangement actually carried out was carried out in accordance with the arrangement described in paragraphs 12 to 25.

8. If the arrangement actually carried out was 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

10. This Class 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

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 person's involvement in the arrangement.

Arrangement

Telstra Off-Market Share Buy-back

12. The arrangement that is the subject of this 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 11 October 2004;
- the Buy-back tender booklet issued by Telstra to shareholders;
- TESOP Participation Letter dated 28 September 2004 issued by Telstra to TESOP participants.

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

13. On Thursday, 12 August 2004 Telstra announced an off-market share buy-back. Under the announced Buy-back Telstra intended to buy back around \$750 million worth of shares (although it could choose to buy back a lesser amount or none at all). As at 8 October 2004 (that is, the Record Date for determination of entitlements to the Buy-back offer) Telstra had approximately 12,628 million ordinary shares on issue (and no other types of shares).

14. In the Tender Buy-back document the Consolidated Balance Sheet, as at 30 June 2004, disclosed total shareholders' equity of \$15.359 billion, consisting of \$6.073 billion contributed share capital, (\$105) million reserves and \$9.391 billion retained profits.

15. The shareholders in Telstra are a mix of individuals, companies, superannuation funds, non-residents and the Commonwealth of Australia. The Commonwealth of Australia did not participate in the Buy-back.

16. The Buy-back formed part of Telstra's ongoing capital management strategy. It was hoped that this Buy-back would have positive effects on return on equity and earnings per share over the longer term. Telstra funded the Buy-back from surplus capital and accumulated retained profits. Telstra did not undertake specific borrowings to finance the purchase price for the Buy-back.

17. The Buy-back was to be a *pro rata* offer to all Telstra shareholders to buy back up to 100% of their ordinary shares as registered on the record date for the Buy-back of Friday 8 October 2004, subject to the Buy-back Limit, and was to be implemented through a tender process. Participation by shareholders was voluntary. Shareholders not wishing to participate in the Buy-back were not required to do anything.

18. The tender period opened on Monday 25 October 2004 and closed on Friday 12 November 2004. Under the tender process shareholders were invited to tender up to 100% of their shareholding at specified prices within a specified price range of \$4.05 to \$4.65 per share ('the Tender Range'). Shareholders could also submit tenders to sell different parcels of shares at different prices. Alternatively, shareholders could submit a Final Tender Price under which they offered to sell their shares for the price as determined by the tender process.

19. At the end of the tender period, Telstra and its advisers would manage a reverse book build of the tenders to determine the Buy-back price, being the lowest specified price at which Telstra was able to repurchase the amount of capital it chose to buy back. Tenders at prices above the Buy-back Price would not be accepted.

20. Under the Buy-back offer successful tenderers would receive \$1.50 as a capital amount and the balance of the Buy-back price as a fully franked dividend.

21. The Buy-back offer included a scale back mechanism. In the event that more shares were tendered at the Buy-back Price than Telstra wished to repurchase, tenders at the Buy-back Price were to be scaled back *pro rata*. If required, the scale back would be determined on the 14 November 2004.

22. Shares offered into the Buy-back by any participating shareholders who, following the scale back under the Buy-back would be left with an unmarketable parcel (600 shares or less), would have all their shares bought back.

23. TESOP participants whose shares were on the TESOP sub register on 8 October 2004 and who wished to participate in the Buy-back were required to repay their outstanding loans by 5 November 2004.

24. Telstra's stated dividend policy to declare ordinary dividends of around 80% of operating profit after tax will not change as a consequence of the Buy-back. A shareholder who did not participate in the Buy-back did not receive any other dividend or distribution by way of compensation for not participating in the Buy-back.

25. On 15 November 2004 Telstra announced that:

- it had successfully completed its off-market Buy-back of approximately 185.3 million ordinary shares, representing around 1.5 % of issued capital, at a price of \$4.05 per share;
- the total amount of capital repurchased by it under the Buy-back was around \$278 million. The balance, being around \$472 million, would be paid out as a fully franked dividend;

- all shareholders who tendered shares into the Buy-back at \$4.05 or as a final price tender, would receive \$4.05 per share for all of those shares accepted after the scale back;
- shares tendered into the Buy-back above \$4.05 were not successful and would not be bought back;
- as the Buy-back was oversubscribed at the \$4.05 price, there was a scale back of successful tenders by approximately 11.3 %; and
- the Buy-back proceeds would be paid to successful tendering shareholders commencing 23 November 2004.

Shares acquired under TESOP 97 and TESOP 99

26. Under TESOP 97 and TESOP 99, Telstra employees were provided with the opportunity to acquire Telstra shares using either their own funds or an interest free loan (Telstra loan) provided by Telstra or a combination of both. The shares acquired by an employee using a Telstra loan were provided to the employee at a nominal discount to their market value (as determined under Division 13A of the ITAA 1936). Telstra shares acquired by an employee using their own funds are not dealt with in this class ruling.

27. Both TESOP 97 and TESOP 99 also provided extra shares to employees (without additional cost to the employees) where the employees acquired shares in Telstra in accordance with the relevant terms of TESOP 97 and TESOP 99.

28. Under both TESOP 97 and TESOP 99, an employee was prevented from dealing with or disposing of TESOP shares acquired either using a Telstra loan, or provided to the employee at no further cost, during a particular period (otherwise known as the 'restriction period'). These shares are/were held in trust by the Trustee until the end of the restriction period.

29. The Telstra shares acquired under TESOP 97 and TESOP 99 to which this ruling applies are as follows:

- TESOP 97 Loan Shares – shares purchased by employees as part of TESOP 97 using the interest free loan provided by Telstra;
- TESOP 97 Extra Loan Shares – the extra '1 for 4' shares provided to employees who acquired Loan Shares in TESOP 97;
- TESOP 97 Extra Non-Loan Shares – the extra '1 for 4' shares provided to employees who acquired Non-Loan Shares in TESOP 97;
- TESOP 99 Loan Shares – shares acquired by employees as part of the Telstra component of TESOP 99 using the interest free loan provided by Telstra; and

- TESOP 99 Extra Shares – the extra ‘1 for 4’ shares provided under the Commonwealth component of TESOP 99 to employees who acquired Guaranteed Allocation Shares.

Ruling

Note: consequential amendments with effect from 1 July 2002 dealing with the simplified imputation system were introduced into Parliament on 18 November 2004 in Tax Laws Amendment (2004 Measures No. 6) Bill 2004. This ruling deals only with the laws as presently enacted and does not extend to the application of the proposed laws.

The Dividend Component

30. TESOP participants will be taken to have been paid a dividend component of \$2.55 (‘the Dividend Component’) for each share bought back out of the profits of Telstra on the date the Buy-back occurred under section 159GZZZP of the ITAA 1936.

31. The Dividend Component is a frankable distribution and is therefore capable of being franked in accordance with section 202-5 of the ITAA 1997.

32. Non-resident TESOP participants are not liable for withholding tax on the Dividend Component under paragraph 128B(3)(ga) of the ITAA 1936 because the Dividend Component is a frankable distribution pursuant to section 202-40 of the ITAA 1997, and was fully franked by Telstra.

Qualified Person

33. For the purposes of Division 1A of Part IIIAA of the ITAA 1936 TESOP participants will be considered to satisfy the holding period rule under section 160APHO of the ITAA 1936 and therefore be qualified persons (as long as the related payments rule is also met) in relation to the dividend component under the Buy-back if:

- (a) the shares sold into the Buy-back were acquired on or before 29 September 2004; and
- (b) during the period when the shares or interest in the shares were held the TESOP participant did not have ‘materially diminished risks of loss or opportunities for gain in respect of the shares or interest in the shares’ (as defined in section 160APHM of the ITAA 1936) for at least a continuous 45 day period.

The Capital Component

34. The taxation treatment for a TESOP participant described below is in addition to the taxation treatment described above for the Dividend Component.

35. TESOP participants are taken to have received \$2.25 as consideration in respect of the sale of each of their Telstra shares on 14 November 2004 ('Sale Consideration') for the purposes of section 159GZZZQ of the ITAA 1936.

36. If the Buy-back price for each share bought back under the Buy-back was less than what would have been the market value of the share if the Buy-back did not occur and was never proposed to occur, then the market value rule in subsection 159GZZZQ(2) applies to the Buy-back. The effect of this rule is that the difference between the Buy-back Price and the market value, if the Buy-back did not occur and was never proposed to occur, will be included in the consideration received for the disposal of the share for ordinary income or capital gains tax purposes.

Where an election under section 139E has been made

37. Where a TESOP participant acquired qualifying shares or qualifying rights and made an election under section 139E of the ITAA 1936 for the year of income in which the qualifying shares or qualifying rights were acquired, the discount amount is included in the participant's assessable income in the year of income in which the share was acquired pursuant to subsection 139B(2) of the ITAA 1936.

38. Where a TESOP participant has made an election and a share is disposed of in the Buy-back, by or on behalf of the TESOP participant, the first element of the cost base and reduced cost base of the share is the market value of the share at the time the TESOP participant acquired it, pursuant to section 130-80 of the ITAA 1997.

Where an election under section 139E has not been made

39. Where a TESOP participant acquired qualifying shares and has not made an election under section 139E of the ITAA 1936, for the year of income in which the qualifying shares or any qualifying rights were acquired, the amount of discount on the shares is included in assessable income in the year of income in which the cessation time occurs, pursuant to subsection 139B(3) of the ITAA 1936.

40. Where a TESOP participant disposes of qualifying shares in the Buy-back within 30 days of the cessation time, the discount included in assessable income at cessation time under subsection 139B(3) is calculated in accordance with subsection 139CC(3) of the ITAA 1936. The discount is the amount of any consideration received by the participant (as modified by subsection 159GZZZQ(2), refer to paragraph 36 of this Ruling) for the disposal of the shares reduced by

the amount of any consideration paid or given for the acquisition of the shares.

41. Any capital gain or loss made as a consequence of such a disposal is disregarded pursuant to subsection 130-83(2) of the ITAA 1997.

42. Where a TESOP participant does not dispose of the shares in the Buy-back within 30 days of the cessation time, the discount included in assessable income at the cessation time under subsection 139B(3) is calculated pursuant to subsection 139CC(4). The discount is the market value of the shares at cessation time reduced by the amount of any consideration paid or given by the participant as consideration for the acquisition of the share. The market value is worked out under Subdivision F of Part III of Division 13A of the ITAA 1936.

43. The first element of the cost base and reduced cost base of such shares is the market value of the shares at cessation time pursuant to subsection 130-83(3) of the ITAA 1997. The market value of the share is worked out under Subdivision F of Part III of Division 13A of the ITAA 1936.

The Anti-avoidance Provisions

44. The Commissioner will not make a determination under section 45A or 45B of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole, or any part, of the Capital Component of the Buy-back price received by TESOP participants.

45. 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 received in relation to the Dividend Component under the Buy-back by TESOP participants.

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

Explanation

Note: consequential amendments with effect from 1 July 2002 dealing with the simplified imputation system were introduced into Parliament on 18 November 2004 in Tax Laws Amendment (2004 Measures No. 6) Bill 2004. This ruling deals only with the laws as presently enacted and does not extend to the application of the proposed laws.

The Dividend and Capital Components

47. The purchase price received by TESOP participants comprises two components:

- 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, having regard to how the company accounts for the off-market share Buy-back.

The Dividend Component

48. 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 to the seller on the day the buy-back occurs. In this case the purchase price was \$4.05 per share and \$1.50 of this was debited to the share capital account. Thus the dividend amount is \$2.55 per share.

49. For Australian resident TESOP participants, the amount of the dividend will be included in their assessable income under subsection 44(1) of the ITAA 1936 or where the shares were disposed of on behalf of the TESOP participant by the Trustee, as a trust distribution under section 97 or section 100 of the ITAA 1936 as appropriate. Generally an amount equal to the amount of the franking credit will be included in their assessable income under subsection 207-20(1) or subsection 207-45(1) of the ITAA 1997. They will generally also be entitled to a tax offset under either subsection 207-20(2) or subsection 207-50 of the ITAA 1997 reflecting the imputation benefit attached to the dividend.

50. However, it should be noted that provisions exist which may deny a tax offset in certain circumstances. For instance, paragraphs 207-145(1)(a) and 207-150(1)(a) of the ITAA 1997 require the TESOP participant to be a 'qualified person for the purposes of Division IA of Part IIIAA of the ITAA 1936' to obtain a tax offset. Broadly speaking, to be a qualified person in relation to a dividend a taxpayer must satisfy both the holding period rule (or certain alternative rules) and the related payments rule. These two rules are discussed later in paragraphs 52 to 61.

51. As the dividend component of the consideration received under the Buy-back is fully franked, a TESOP participant who is a non-resident is not liable to Australian withholding tax on the dividend component in accordance with paragraph 128B(3)(ga) of the ITAA 1936.

Qualified Person

52. Paragraph 207-145(1)(a) of the ITAA 1997 provides that in relation to a franked dividend made by an entity, and paragraph 207-150(1)(a) in relation to a franked distribution that flows indirectly to an entity, only a 'qualified person in relation to the distribution for the purposes of Division 1A of Part IIIAA of the ITAA 1936' is entitled to a franking credit or tax offset. Generally speaking, to be a 'qualified person' in relation to the Telstra dividend ('the Dividend Component') paid under the Buy-back, a TESOP participant must satisfy both the holding period rule and the related payments rule.

53. Broadly a TESOP participant will not satisfy the related payments rule if the TESOP participant or an associate of the TESOP participant is under an obligation to make, or makes, a payment in respect of the dividend which effectively passes the benefit of the dividend to another person.

54. The holding period rule requires TESOP participants to hold the shares or the interest in the shares on which the dividend is paid at risk for a continuous period of at least 45 days. In determining whether a TESOP participant has satisfied the holding period rule, any days during which there is a materially diminished risk in relation to the relevant shares are not counted. The day of acquisition and the day of disposal of the relevant shares are also not counted.

55. For shares sold into the Buy-back, the Trustee will be considered to satisfy the holding period rule under section 160APHO of the ITAA 1936 and therefore be a qualified person (as long as the related payments rule is also met) in relation to the dividend component under the Buy-back if during the period when the shares or interest in the shares were held the Trustee did not have 'materially diminished risks of loss or opportunities for gain in respect of the shares or interest in the shares' (as defined in section 160APHM of the ITAA 1936) for at least a continuous 45 day period.

56. Under subsection 160APHM(2) of the ITAA 1936, a TESOP participant is taken to have materially diminished the risks of loss and opportunities for gain with respect to shares or interests in shares if the 'net position' of the TESOP participant results in the TESOP participant having less than 30% of the risks and opportunities relating to the shares or interest in shares.

57. In this case the Commissioner does not regard the announcement of the Buy-back offer as affecting whether the shares or an interest in the shares was held 'at risk' or not.

58. There are 45 clear days between 29 September 2004 and 14 November 2004 (that is, the date the tender offer was accepted). Therefore, as TESOP participants acquired their shares or had their shares acquired on their behalf by the Trustee before 29 September 2004, they will satisfy the 'holding period rule', (subject to paragraph 59) as long as those shares were held at risk for at least 45 continuous days. A TESOP participant

whose shares were held in trust will be taken to have acquired the shares for the purposes of the 45 day rule at the time the shares were acquired by the Trustee on his or her behalf:
section 160APHG of the ITAA 1936.

59. Generally, under the 'holding period rule' a shareholder will be deemed to have disposed of his or her most recently acquired shares first: subsection 160APHI(4) of the ITAA 1936. The 45 day rule operates on a last-in-first-out basis, so that shareholders will be deemed to have disposed of their most recently acquired shares first for the purpose of applying the 45 day rule. Accordingly, TESOP participants who, on or after 30 September 2004 acquired any additional Telstra shares which conferred an entitlement to participate in the Buy-back, may not qualify for the franking credits attaching to the dividends paid on some or all of their shares sold into the Buy-back.

60. A shareholder is only entitled to tender shares in the Buy-back which are registered in the shareholders name on the Record Date.

61. Telstra shares acquired by participating shareholders which do not confer an entitlement to participate in the Buy-back do not constitute 'related securities' for the purposes of section 160APHI(4) of the ITAA 1936 with Telstra shares which do confer an entitlement to participate in the Buy-back.

Refundable Tax Offsets

62. The excess (if any) of the tax offset attributable to the franking credit on the dividend component will be subject to the refundable tax offset rules of Division 67 of the ITAA 1997.

The Capital Component

63. The taxation treatment for a TESOP participant described below is in addition to the taxation treatment described above for the Dividend Component.

64. TESOP participants are taken to have disposed of those shares accepted under the Buy-back on 14 November 2004. The amount of the Sale Consideration in respect of the disposal of a share under a Buy-back is determined in accordance with section 159GZZZQ of the ITAA 1936.

65. Subsection 159GZZZQ(1) of the ITAA 1936 provides that the TESOP participant is taken to have received an amount equal to the Buy back price (in this case the \$4.05 received for each share bought back) as consideration in respect of the sale of the share bought back. However, this amount is subject to certain adjustments in order to arrive at the Sale Consideration.

66. Subsection 159GZZZQ(2) of the ITAA 1936 is one of the adjusting provisions. It provides that if the purchase price is less than the market value of the share at the time of the buy-back if the buy-back did not occur and was never proposed to occur, the TESOP participant is taken to have received an amount equal to the market value as consideration in respect of the sale of the share bought back.

67. For the purposes of determining the application of subsection 159GZZZQ(2) of the ITAA 1936 to the market value of each Telstra share, the following methodology has been proposed by Telstra and accepted by the Commissioner in accordance with TD 2004/22: the volume weighted average price over the five trading days before announcement of the Buy-back, adjusted for the movement in the S&P/ASX 200 Telecoms Index (excluding Telstra) from the commencement of trading on the announcement date to the close of trading on the day the Buy-back closed, and further adjusted on an ex-dividend basis.

68. The Commissioner considers the use of the S&P/ASX 200 Telecoms Index (excluding Telstra) to be an appropriate index for the purposes of calculating market value in the 2004 Telstra Buy-back. Under this methodology, the market value of a share bought back under the Buy-back was calculated to be \$4.80. Thus, the vendor shareholders are taken to have received \$2.25 for the sale of each share rather than \$1.50.

Market Value of a share bought back under the Buy-back	\$4.80
less Reduction Amount	\$2.55
Sale Consideration	\$2.25

Employee Share Schemes

69. Division 13A of Part III of the ITAA 1936 provides for the taxation treatment of shares acquired under employee share schemes. Under Subdivision B of Division 13A if a taxpayer has *acquired* a share or right under an *employee share scheme*, the assessable income of the taxpayer includes the discount given in relation to the share.

70. Section 139G provides that a person acquires a share in several circumstances, including by acquiring a beneficial interest in the share, or having a share allotted to them by another person. For the purposes of section 139G, a TESOP participant will have acquired a share when the Trustee sets aside and holds shares for his or her benefit or a share is allotted or issued to the TESOP participant.

Where an election under section 139E has been made

71. Where a TESOP participant acquired qualifying shares and made an election under section 139E of the ITAA 1936 for the year of income in which the qualifying shares were acquired, the discount amount is included in the participant's assessable income in the year in which the share was acquired under subsection 139B(2) of the ITAA 1936.

72. The first element of the cost base and reduced cost base of the shares for the purposes of the capital gains tax provisions is determined in accordance with section 130-80 of the ITAA 1997.

73. Subsection 130-80(2) of the ITAA 1997 provides that the first element of the cost base and reduced cost base is the market value of the share when the TESOP participant acquired it for capital gains tax purposes.

74. For shares to which this ruling applies that were acquired under an employee share scheme and were held in trust, a TESOP participant acquires the shares for capital gains tax purposes when he or she became absolutely entitled to the shares (section 109-5 of the ITAA 1997). The time when a TESOP participant became absolutely entitled to the shares as against the Trustee is described in detail in Class Ruling CR 2001/28.

75. Subsection 130-80(3) of the ITAA 1997 provides that if a share is acquired from an employee share trust, the first element of the cost base and reduced cost base of the share is its market value when the taxpayer first acquired a beneficial interest in the share. Subsection 130-80(3) applies to shares where the beneficial interest in the share was acquired (within the meaning of section 139G of Division 13A of Part III of the ITAA 1936) by the taxpayer after 5pm (by legal time in the Australian Capital Territory) on 27 February 2001 and to shares acquired at or before that time if a taxpayer chooses that it applies.

76. Where the shares to which this ruling applies that were held in trust, are disposed of, the TESOP participant may adopt as the first element of the cost base or reduced cost base of the shares, either:

- the market value of the shares at the time when the TESOP participant first became absolutely entitled to the shares (as discussed above); or
- the market value of the shares when he or she first acquired a beneficial interest in the shares in accordance with section 130-80 of the ITAA 1997.

Market value is determined in accordance with sections 139FA to 139FF of the ITAA 1936.

77. For shares sold into the Buy-back, to the extent that each share's reduced cost base exceeds \$2.25, the difference will be a capital loss.

Where an election under section 139E has not been made

78. Where a TESOP participant acquired qualifying shares and has not made an election under section 139E, the amount of discount in relation to the shares is included in assessable income, pursuant to subsection 139B(3), in the year of income in which the cessation time occurs.

79. Where the shares are subject to restrictions preventing the taxpayer from disposing of the shares, the cessation time is determined pursuant to subsection 139CA(2) which provides that the cessation time will be the earliest of:

- (a) the time when the taxpayer disposes of the share;
- (b) the later of:
 - (i) the time when any restrictions preventing the taxpayer from disposing of the share cease to have effect; and
 - (ii) the time when any condition that could result in the taxpayer forfeiting ownership of shares ceases to have effect;
- (c) the time when the taxpayer is no longer employed by the employer, in whom the taxpayer was originally employed when the share was acquired, or a holding company or a subsidiary of that employer in accordance with subsection 139CA(3);
- (d) the end of the 10 year period starting when the taxpayer acquired the share.

80. Where the shares are disposed of by the TESOP participant in the Buy-back within 30 days of the cessation time, the discount included in assessable income is calculated pursuant to subsection 139CC(3). The discount is the amount of the Sale Consideration received by the TESOP participant for the disposal of the shares reduced by the amount of any consideration paid or given by the TESOP participant for the acquisition of the shares.

81. Where TESOP 97 Loan Shares, TESOP 97 Extra Loan Shares and TESOP 99 Loan shares are disposed of in the Buy-back by the TESOP participant within 30 days of cessation time:

- (i) the discount amount calculated in accordance with subsection 139CC(3) is nil for the TESOP 97 and TESOP 99 Loan Shares. This is because the Sale Consideration on the disposal of a share in the Buy-back is \$2.25 and this amount is less than the amount paid to acquire the shares under TESOP 97 and TESOP 99; and

- (ii) the discount amount of \$2.25 per share calculated in accordance with subsection 139CC(3) will be assessable to participants under subsection 139B(3) of the ITAA 1936 in respect of TESOP 97 Extra Loan Shares. The Sale Consideration on the disposal of a share into the Buy-back is \$2.25 and no further amount was paid to acquire the shares.

82. Where shares are disposed of into the Buy-back, this will result in CGT event A1 happening under section 104-10 of the ITAA 1997. Any capital gain or loss made as a consequence of such a disposal within 30 days of the cessation time is, however, disregarded pursuant to subsection 130-83(2) of the ITAA 1997. As the time at which CGT Event A1 occurs is 14 November 2004, this means that if the cessation time occurs on or after 15 October 2004, any capital gain or loss from the disposal will be disregarded.

83. Where a TESOP participant does not dispose of the shares in the Buy-back within 30 days of the cessation time, the discount included in assessable income is calculated in accordance with subsection 139CC(4). The discount is the market value of the shares at cessation time reduced by the amount of any consideration paid or given by the participant to acquire the shares.

84. The first element of the cost base and reduced cost base of the shares for the purposes of the capital gains tax provisions is determined in accordance with subsection 130-83(3) of the ITAA 1997, being the market value of the shares worked out under section 139FA to 139FF of the ITAA 1936 at cessation time.

85. For shares sold into the Buy-back, to the extent that each share's reduced cost base exceeds \$2.25, the difference will be a capital loss.

The Anti-Avoidance Provisions

Sections 45A and 45B of the ITAA 1936

86. Sections 45A and 45B of the ITAA 1936 are two 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 the 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.

87. Section 45A of the ITAA 1936 is an anti-avoidance provision that 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.

88. 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.

89. Section 45B applies where certain capital payments are paid to shareholders in substitution for dividends. Broadly, section 45B of the ITAA 1936 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 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)).

90. In the case of the Buy-back, 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.

91. Having regard to the 'relevant circumstances' of the scheme (the Buy-back), as set out in subsection 45B(8) of the ITAA 1936, it is apparent that the inclusion of a capital element in the Buy-back price was not inappropriate. Further, the Capital Component of the Buy-back cannot be said to be attributable to the profits of the company, nor does the pattern of distributions that have been made by Telstra in the past indicate that the Capital Component was being paid in substitution for a dividend.

Section 177EA of the ITAA 1936

92. 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 shares or an interest in shares, where a franked distribution is paid or payable in respect of the shares or an interest in shares. This would include a buy-back with a franked dividend component.

93. 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 franked with an exempting credit; and
- (d) except for this section, 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.

94. 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 Telstra, 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 the participating shareholder and the scheme comprises the circumstances surrounding the Buy-back.

95. 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.

96. The Commissioner has come to the view that section 177EA applies to the Buy-back. In coming to this conclusion the Commissioner had regard to all the relevant circumstances of the arrangement, as outlined in subsection 177EA(17). Among the circumstances of the Buy-back reflected in those paragraphs are:

- the delivery of franking credits in excess of what would have otherwise been distributed in the ordinary course of dividend declaration;
- the greater attraction of the Buy-back to resident shareholders who could fully utilise the franking credits than to non-resident shareholders who could not;
- the greater attraction of the Buy-back to some resident shareholders with a low marginal tax rate than other resident shareholders (for example, whereas superannuation funds are taxed at 15% and corporations at 30% individuals can be taxed at a marginal tax rate up to 47%); and
- that participating shareholders were more likely than not to make an economic gain, but a loss for tax purposes, from their participation.

97. Where section 177EA applies the Commissioner has a discretion, pursuant to subsection 177EA(5) to make a determination to debit the company's franking account pursuant to paragraph 177EA(5)(a), or deny the imputation benefit to each shareholder pursuant to paragraph 177EA(5)(b). The Commissioner will exercise his discretion in such a way that he does not make a determination that the imputation benefit obtained by the participating shareholders be denied under paragraph 177EA(5)(b). It would be inappropriate, given the large and diverse shareholding of the company, to make a determination to deny franking imputation benefits in relation to each participating shareholder.

Section 204-30 of the ITAA 1997

98. Section 204-30 of the ITAA 1997 applies where a corporate tax entity streams the payment of dividends, or the payment of dividends and the giving of other benefits, to its members in such a way that:

- (a) an imputation benefit is, or apart from this section would be, received by a member of the entity as a result of the distribution or distributions (paragraph 204-30(1)(a));
- (b) the member would derive a greater benefit from franking credits than another member of the entity (paragraph 204-30(1)(b)); and

- (c) the other member of the entity will receive lesser imputation benefits, or will not receive any imputation benefits, whether or not the other member receives other benefits (paragraph 204-30(1)(c)).

99. If section 204-30 applies the Commissioner is vested with a discretion under subsection 204-30(3) to make a determination in writing either:

- (a) that a specified franking debit arises in the franking account of the entity, for a specified distribution or other benefit to a disadvantaged member (paragraph 204-30(3)(a)); or
- (b) that no imputation benefit is to arise in respect of any streamed distributions made to a favoured member and specified in the determination (paragraph 204-30(3)(c)).

100. 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.

101. A significant portion of Telstra's ordinary shareholding was held by the Commonwealth and non-residents, shareholders who do not benefit from franking to the same extent as other resident shareholders. Thus, the conditions in subsection 204-30(1) for the provisions to apply are met. However, the Commissioner will not exercise his discretion under subsection 204-30(c) to deny imputation benefits that arise in respect of the Dividend Component of the Buy-back paid to participating shareholders.

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Commissioner of Taxation

16 February 2005

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Not previously issued as a draft	- ITAA 1936 44(1)
	- ITAA 1936 45A
<i>Related Rulings/Determinations:</i>	- ITAA 1936 45A(3)(b)
	- ITAA 1936 45B
CR 2001/1; CR 2001/28;	- ITAA 1936 45B(2)(a)
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<i>Subject references:</i>	- ITAA 1936 45C
- dividend streaming arrangements	- ITAA 1936 97
- share buy backs	- ITAA 1936 100
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