CR 2005/71 - Income tax: Keycorp Limited - proposed return of capital

Class Ruling

Income tax: Keycorp Limited – proposed return of capital

Contents Para

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 Ruling are:

- subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) – definition of 'dividend';
- section 6D of the ITAA 1936;
- section 44 of the ITAA 1936;
- section 45A of the ITAA 1936;
- section 45B of the ITAA 1936;
- section 45C of the ITAA 1936;
- section 104-25 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 104-135 of the ITAA 1997; and
- section 136-10 of the ITAA 1997.

Class of persons

3. The class of persons to which this Ruling applies is the persons who hold ordinary shares in Keycorp Limited (Keycorp) and who are registered on the Keycorp share register on the Record Date, being the date for determining entitlements to participate in the proposed return of share capital described in paragraphs 9 to 16 of

this Ruling. In this Ruling, this class of persons is referred to as 'Participating Shareholders'.

Qualifications

4. 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 9 to 16.

5. 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- this Ruling may be withdrawn or modified.

Date of effect

7. This Ruling applies to the income year (as defined in subsection 995-1(1) of the ITAA 1997) for a Participating Shareholder in which the return of capital is paid to the Participating Shareholder by Keycorp. The arrangement, as described in paragraphs 9 to 16, will be completed within that income year. For a Participating Shareholder that does not have a substituted accounting period, this will be the income year ending 30 June 2006. However, the Ruling does not apply to a Participating Shareholder 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 *Gazette*;
- it is not taken to be withdrawn by an inconsistent later public ruling; or
- the relevant tax laws are not amended.

Withdrawal

8. This Ruling is withdrawn and ceases to have effect after 30 June 2006. 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

9. The arrangement that is the subject of this Ruling is described below. This description is based on the following documents:

- the application for a class ruling from Ernst & Young dated 12 May 2005 with accompanying submission and financial accounts of Keycorp Limited ('Keycorp') in respect of the year ended 30 June 2004 and 6 months to 31 December 2004; and
- further particulars provided by Ernst & Young and Keycorp dated 28 June, 5 July and 29 July 2005 which included the Notice of Extraordinary General Meeting lodged with ASIC and unaudited draft financial statements of Keycorp for the year ended 30 June 2005.

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

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

11. Keycorp is an Australian resident public company listed on the Australian Stock Exchange (ASX) and is the parent entity of a group of companies whose principal business is the provision of a broad range of secure electronic transaction solutions.

12. On 28 June 2005 Keycorp announced the sale of its Transaction Network Solutions (TNS) business for $55 million, and a related pro-rata return of capital of 41 cents per share ('Capital Return'), subject to shareholder approval. The sale of the TNS business will be effected by the sale of Keycorp Solutions Limited, Keycorp's wholly owned subsidiary that carries on the TNS business.

13. Based on the number of shares on issue at 30 June 2005 (81.8 million), the total capital to be returned is $33 million. The Capital Return is sourced from the equity contributed by Keycorp's shareholders. This equity was originally invested in Keycorp Solutions by way of an intercompany loan to acquire the TNS business. The TNS business will be sold at a loss. The Keycorp board of directors consider it appropriate to return a significant part of the proceeds from the sale to shareholders in the absence of a well advanced and

significant acquisition opportunity, which will require funds in excess of the amount being retained.

14. The Capital Return and the disposal of Keycorp's TNS business was approved by shareholders at an Extraordinary General Meeting ('EGM') held on Monday 29 August 2005.

15. The Capital Return will be applied equally to each holder of fully paid ordinary shares held on the register at 5pm on Monday 5 September 2005 ('the Record Date'), by way of a cash distribution in proportion to the number of shares held on that date. There are no other types of share on issue. Payment of the Capital Return is to be effected on 12 September 2005 ('the Payment Date').

16. Keycorp will debit the entire Capital Return against its share capital account. The share capital account, as defined in section 6D of the ITAA 1936, is not tainted for income tax purposes. No shares will be cancelled as a result of the Capital Return and there will be no dilution in the shareholdings in Keycorp.

Ruling

Distribution is not a dividend for income tax purposes

17. As the Capital Return will be debited to Keycorp's share capital account it will not be a dividend, as defined in section 6(1) of the ITAA 1936. The Government has announced its intention to introduce laws with effect from 1 July 2002 dealing with the tainting of share capital accounts (the then Minister for Revenue and Assistant Treasurer's Press Release C104/02 of 27 September 2002). Although such laws may be relevant to the application of section 6D of the ITAA 1936, this Ruling does not extend to the application of these proposed laws.

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

18. The Commissioner will not make a determination under subsections 45A(2) or 45B(3) of the ITAA 1936 that section 45C of the ITAA 1936 applies to the Capital Return. Accordingly, no part of the Capital Return will be taken to be a dividend for income tax purposes.

Capital Gains

19. CGT event G1, in section 104-135 of the ITAA 1997, will happen when Keycorp pays the Capital Return to a Participating Shareholder in respect of a share they own at the Payment Date.

20. Pursuant to subsections 104-135(3) and (4), the cost base and reduced cost base of each ordinary share will be reduced (but not below nil) by the amount of the Capital Return. A Participating Shareholder will make a capital gain from CGT event G1 happening to each share to the extent (if any) that the Capital Return exceeds the share's cost base.

21. CGT Event C2, in section 104-25 of the ITAA 1997, will happen when Keycorp makes the Capital Return to a Participating Shareholder in respect of a share they own at the Record Date but which has been disposed of before the Payment Date.

22. If CGT event C2 happens in respect of a Participating Shareholder's right to the payment, the Participating Shareholder will make a capital gain to the extent the payment exceeds the cost base of the right. A Participating Shareholder will make a capital loss to the extent the payment is less than the right's reduced cost base: see subsection 104-25(3) of the ITAA 1997.

23. A non-resident Participating Shareholder that receives the Capital Return will only make a capital gain if their share has the necessary connection with Australia (section 136-25 of the ITAA 1997). A Keycorp share will have the necessary connection with Australia if, at any time during the 5 years before payment of the Capital Return, the non-resident Participating Shareholder, together with their associates, owned 10% or more by value of the issued shares in Keycorp.

Explanation

Distribution is not a dividend for income tax purposes

24. Subsection 44(1) of the ITAA 1936 includes in a shareholder's assessable income a dividend, as defined by subsection 6(1) of the ITAA 1936, which is paid to the shareholder out of company profits.

25. As the Capital Return will be debited against an amount standing to the credit of Keycorp's untainted share capital account, it does not constitute a dividend because of the exclusion in paragraph (d) in the definition of a 'dividend' in subsection 6(1) of the ITAA 1936. That paragraph excludes a distribution from the meaning of 'dividend' if the amount of a distribution is debited against an amount standing to the credit of the company's 'share capital account'.

26. Share capital account is defined in subsection 6(1) of the ITAA 1936 as having the meaning given by section 6D of the ITAA 1936, which in turn defines the term as an account which the company keeps of its share capital, or any other account created after 1 July 1998 where the first amount credited to the account was an amount of share capital.

27. Subsection 6D(3) states that an account is not a share capital account if it is tainted for the purposes of Division 7B of Part IIIAA of the ITAA 1936. An account, that would otherwise be a share capital account, is tainted for the purposes of Division 7B if an amount is transferred from another account except in the circumstances provided for by section 160ARDM of the ITAA 1936. Keycorp has confirmed that there have been no transfers that have tainted its share capital account under that rule, which applies to transfers before 1 July 2002. The Government has announced its intention to introduce laws dealing with the tainting of share capital accounts (the then Minister for Revenue and Assistant Treasurer's Press Release C104/02 of 27 September 2002). Although such laws may be relevant to the application of section 6D, this Ruling does not extend to the application of these proposed laws.

Sections 45A and 45B of the ITAA 1936

28. 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 a distribution is to be treated for tax purposes as an unfranked dividend paid by the company out of profits to the shareholder.

Section 45A – streaming of dividends and capital benefits

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

30. Although Keycorp 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 Keycorp. 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 of the ITAA 1936 will not apply to the Capital Return, and the Commissioner will not make a determination under subsection 45A(2) that section 45C applies to the Capital Return.

Section 45B – schemes to provide capital benefits in substitution for dividends

31. Section 45B of the ITAA 1936 applies where certain amounts of a capital nature are provided to shareholders in substitution for dividends.

32. 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:

(a) there is a scheme under which a person is provided with a capital benefit by a company;

(b) 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

(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 the relevant taxpayer to obtain a tax benefit.

Each of the conditions is considered below.

33. The Capital Return will be a 'scheme' for the purposes of section 45B.

34. The phrase 'provided with a capital benefit' is defined in subsection 45B(5) of the ITAA 1936. Relevantly, it includes a distribution to a person of share capital. As Keycorp proposes to debit the Capital Return against its untainted share capital account, its ordinary shareholders will be provided with a capital benefit.

35. 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 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.

36. Ordinarily, a return of capital would be subject to the capital gains tax ('CGT') provisions of the income tax law. Unless the amount of the distribution exceeds the cost base of the shares, there will only be a cost base reduction under CGT event G1 (section 104-135 of the ITAA 1997). It is only to the extent (if any) that the distribution exceeds the cost base of the shares that a capital gain arises. A capital gain may not arise at all for certain non-resident shareholders: see paragraph 55. By contrast a dividend would generally be included in the assessable income of a resident shareholder or, in the case of a non-resident, be subject to dividend withholding tax. Therefore,

Participating Shareholders will generally obtain a tax benefit by receiving the distribution as a return of capital as compared to a dividend of the same amount.

37. 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.

38. 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.

39. In this case, the relevant taxpayers are the Participating Shareholders. After consideration of the relevant circumstances the requisite purpose for section 45B to apply is considered not to be present in this case.

40. Keycorp intends to fund the Capital Return from its cash on hand, which will be supplemented by the release of capital following the disposal, at a loss, of the TNS business. In these circumstances, it is accepted that the purpose of the proposed Capital Return is to return equity capital surplus to Keycorp's present requirements to the company's shareholders. The proposed distribution is attributable to capital and not to profits and is not in substitution for a dividend.

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

Section 45C – deeming dividends to be paid where determinations under section 45A or section 45B are made

42. As the Commissioner will not make a determination pursuant to subsection 45A(2) or subsection 45B(3) in relation to the arrangement as described, section 45C will not deem the Capital Return to be an unfranked dividend paid out of the profits of the company.

CGT event G1 – section 104-135 of the ITAA 1997

43. CGT event G1 in section 104-135 of the ITAA 1997 will happen when Keycorp pays the Capital Return amount in respect of a share that a Participating Shareholder owned at the Record Date and continues to own at the payment time and some or all of the payment is not a dividend as defined in subsection 995-1(1) of the ITAA 1997.

44. Keycorp proposes to make a payment to its Participating Shareholders out of its untainted share capital account. This payment will not be a dividend as defined in subsection 995-1(1) of the ITAA 1997. If the Capital Return amount (41 cents per share) is not more than the cost base of the Keycorp share at the time of the payment, the cost base and reduced cost base of the share are reduced by the amount (subsection 104-135(4) of the ITAA 1997).

45. A Participating Shareholder will make a capital gain if the Capital Return amount is more than the cost base of their Keycorp share. The amount of the capital gain is equal to this excess. However, the capital gain is disregarded if the share was acquired before 20 September 1985 (subsection 104-135(5) of the ITAA 1997).

46. If a Participating Shareholder makes a capital gain, the cost base and reduced cost base of the share are reduced to nil (subsection 104-135(3) of the ITAA 1997).

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

Participating Shareholder disposed of shares – CGT event C2

48. If a Participating Shareholder ceases to own some, or all, of their shares in Keycorp in respect of which the Capital Return is payable before the payment is made, the right to the payment is considered to be a separate CGT asset. This is because the right to the payment has been separated from the bundle of rights that once attached to the share.

49. A Participating Shareholder's right to receive the payment will be discharged or satisfied when the payment is made under the arrangement, causing CGT event C2 to happen.

50. In working out the capital gain or capital loss made from CGT event C2 happening, the capital proceeds from the event will be the Capital Return amount.

51. The cost base of the Participating Shareholder's right to receive a payment under the arrangement is worked out in accordance with Division 110 of the ITAA 1997. However, the cost base of the right will be nil if the full cost base (or reduced cost base) of the share previously held by the Participating Shareholder has been applied in working out a capital gain or loss when a CGT event happened to the share – for example, when the Participating Shareholder disposed of the share. In these cases, the Participating Shareholder will generally make a capital gain equal to the amount paid under the arrangement.

52. Because the right to a payment such as the Capital Return was inherent in the share during the time it was owned then, for the purposes of Subdivision 109-A of the ITAA 1997, the right is considered to have been acquired at the time when the share was acquired.

53. Consequently, if the share to which the payment relates was originally acquired by a Participating Shareholder at least 12 months before the payment of the Capital Return amount, a capital gain from CGT event C2 happening to the right may qualify as a discount capital gain under subsection 115-25(1) of the ITAA 1997 (provided the other conditions in Subdivision 115-A of the ITAA 1997 are satisfied).

54. Any capital gain or loss from CGT event C2 will be disregarded if the share in respect of which the payment was made was acquired before 20 September 1985 (paragraph 104-25(5)(a) of the ITAA 1997).

Non-resident shareholders – Division 136

55. Pursuant to section 136-10 of the ITAA 1997, a non-resident Participating Shareholder will make a capital gain from the Capital Return only if their Keycorp share has the necessary connection with Australia. Under category 5 of the table in section 136-25 of the ITAA 1997, a Keycorp share will have the necessary connection with Australia if, at any time during the 5 years before the payment of the Capital Return, the Participating Shareholder together with their associates owned 10% or more by value of the issued shares in Keycorp.

Detailed contents list

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

Commissioner of Taxation
7 September 2005

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

CR 2001/1; TR 92/1; TR 92/20; TR 97/16

Subject references:

- capital benefit
- dividend substitution
- reduction of share capital
- return of capital
- share capital

Legislative references:

- ITAA 1936 6(1)
- ITAA 1936 6D
- ITAA 1936 6D(3)
- ITAA 1936 44
- ITAA 1936 44(1)
- ITAA 1936 45A
- ITAA 1936 45A(2)
- ITAA 1936 45A(3)(b)
- ITAA 1936 45B
- ITAA 1936 45B(2)
- ITAA 1936 45B(3)
- ITAA 1936 45B(5)
- ITAA 1936 45B(8)
- ITAA 1936 45B(9)
- ITAA 1936 45C
- ITAA 1936 Pt IIIAA Div 7B
- ITAA 1936 160ARDM
- ITAA 1997 104-25
- ITAA 1997 104-25(3)
- ITAA 1997 104-25(5)(a)
- ITAA 1997 104-135
- ITAA 1997 104-135(3)
- ITAA 1997 104-135(4)
- ITAA 1997 104-135(5)
- ITAA 1997 Subdiv 109-A
- ITAA 1997 Div 110
- ITAA 1997 Subdiv 115-A
- ITAA 1997 115-25(1)
- ITAA 1997 Div 136
- ITAA 1997 136-10
- ITAA 1997 136-25
- ITAA 1997 995-1(1)
- TAA 1953 Pt IVAAA
- Copyright Act 1968

ATO references

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