

CR 2006/99 - Income tax: return of capital - Talent2 International Ltd

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Class Ruling

Income tax: return of capital – Talent2 International Ltd

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ⓘ This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

What this Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified below apply to the defined class of entities, who take part in the scheme to which this Ruling relates.

Relevant provision(s)

2. The relevant provisions 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;
 - 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.

All subsequent legislative references in this Ruling are to the ITAA 1936 unless otherwise indicated.

Class of entities

3. The class of entities to which this Ruling applies is all ordinary shareholders of Talent2 International Limited (Talent2), who are registered on the Talent2 Share Register on the Record Date and who participate in the arrangement described in this Ruling. This Ruling does not apply to Talent2 shareholders that hold their shares on revenue account.

Qualifications

4. The Commissioner makes this Ruling based on the precise scheme identified in this Ruling.

5. The class of entities defined in this Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 13 to 23 of this Ruling.

6. If the scheme actually carried out is materially different from the scheme that is described in this Ruling, then:

- this Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled; and
- this Ruling may be withdrawn or modified.

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Date of effect

8. This Class Ruling applies to the income year (as defined in subsection 995-1(1) of the ITAA 1997) ending 30 June 2007. 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. Furthermore, the Ruling only applies to the extent that:

- it is not later withdrawn by notice in the *Gazette*; or
- the relevant provisions are not amended.

9. If this Class Ruling is inconsistent with a later public or private ruling, the relevant class of entities may rely on either ruling which applies to them (item 1 of subsection 357-75(1) of Schedule 1 to the *Taxation Administration Act 1953* (TAA)).

10. If this Class Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the Class Ruling is made, the following two conditions are met:

- the income year or other period to which the rulings relate has not begun; and
- the scheme to which the rulings relate has not begun to be carried out.

11. If the above two conditions do not apply, the relevant class of entities may rely on either ruling which applies to them (item 3 of subsection 357-75(1) of Schedule 1 to the TAA).

Withdrawal

12. This Ruling is withdrawn and ceases to have effect after 30 June 2007. However, the Ruling continues to apply after its withdrawal in respect of the taxation provisions ruled upon, to all entities within the specified class who entered into the specified scheme during the term of the Ruling, subject to there being no change in the scheme or in the entities involved in the scheme.

Scheme

13. The scheme that is the subject of the Ruling is described below. This description is based on, and includes reference to, the following documents:

- Application for Class Ruling from Deloitte Growth Solutions Pty Ltd (Deloittes) dated 28 April 2006
- Correspondence from Deloittes dated 23 June 2006 and 24 July 2006.

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

14. Talent2 was established in 1985, known originally as Concept Systems International Ltd (Concept). Its principal activities focus on Human Resource (HR) outsourcing. In 1999, Concept listed on the Australian Stock Exchange. In May 2004, the group changed its name to Talent2 (ASX Code:TWO).

15. Net cash of \$5,758,428 was generated between August 2002 and September 2003 from capital raisings. Acquisitions made by Talent2 after September 2003 until 15 November 2005 were funded by the issue of share capital to the value of \$33,891,355.

16. The net cash of \$5,758,428 was to fund the growth of the HR outsourcing business and geographic expansion into Asia. However, the funds were never used for this purpose as subsequent acquisitions were funded entirely through the issue of additional equity.

17. A review of its capital management strategy identified that \$3,529,255 was excess to its current needs, the excess capital being attributable to the capital raised prior to September 2003 which was never used to fund acquisitions.

18. Talent2 confirms that its share capital account, as defined in section 975-300 of the ITAA 1997, is not tainted as there have been no transfers to the share capital account from other accounts.

19. Large losses were generated in the financial years ended 30 June 2001 and 2002 resulting in a shortfall in retained earnings. Talent2 has only just begun to recoup this shortfall recently as its operations become profitable.

20. A significant proportion of Talent2's top 40 shareholders have been issued shares in lieu of cash payments in respect of the acquisition of their businesses by Talent2.

21. 8.6% of the top 40 shareholders at 5 September 2006 are non-resident for tax purposes.

22. Shareholders voted on the proposed return of capital at the Extraordinary General Meeting on 27 June 2006 and the resolution was passed unanimously. Therefore:

- the amount of the return of capital will be \$0.03 cents per ordinary share held by shareholders on the register at 5pm on the Record Date (08/11/2006);
- payment of the return of capital to shareholders is to be effected on the Payment Date (15/11/2006); and
- shares will trade ex-entitlement to the return of capital from the close of trading on the Record Date.

23. No shares will be cancelled as a result of the capital return and there will be no dilution in any shareholding in Talent2.

Ruling

Dividends

24. As the proposed return of capital will be debited to Talent2's share capital account, it will not be a dividend as defined in subsection 6(1).

Anti-avoidance provisions

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

Capital gains tax

26. CGT Event G1 will happen when the return of capital is paid to Talent2 shareholders (subsection 104-135(2) of the ITAA 1997).

Commissioner of Taxation11 October 2006

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

Dividends

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

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

29. Relevantly, the specific exclusion in paragraph 6(1)(d) of the definition of 'dividend' provides:

Money paid or credited by a company to a shareholder or any other property distributed by a company to shareholders (not being moneys or other property to which this paragraph, by reason of subsection 6(4), does not apply or moneys paid or credited, or property distributed for the redemption or cancellation of a redeemable preference share), where the amount of the moneys paid or credited, or the amount of the value of the property, is debited against an amount standing to the credit of the share capital account of the company.

30. The return of capital will be debited against Talent2's untainted share capital account. Therefore, paragraph (d) of the definition of 'dividend' applies and the return of capital would not be a dividend as defined in subsection 6(1).

Anti-avoidance provisions

Sections 45A and 45B

31. Sections 45A and 45B are two anti avoidance provisions which, if they apply, allow the Commissioner to determine that all or part of a distribution is treated as an unfranked dividend that is paid by the company out of profits to the shareholder.

Streaming of dividends and capital benefit: section 45A

32. Section 45A applies in circumstances where the capital benefits are streamed to shareholders (the advantaged shareholders) who would, in the year of income in which the capital benefits are provided, derive a greater capital benefit than the other shareholders (the disadvantaged shareholders) who would receive dividends.

33. Talent2 will provide all its ordinary shareholders with a 'capital benefit' (as defined in paragraph 45A(3)(b)), and the capital benefit is to be provided to all shareholders in direct proportion to their individual shareholding. As all shareholders benefit equally from the return of capital, there is no indication of 'streaming' of capital benefits to some shareholders and not to other shareholders. Accordingly, section 45A will not apply to the return of capital, and the Commissioner will not make a determination under subsection 45A(2) that section 45C applies to the return of capital.

Schemes to provide capital benefits in substitution for dividends: section 45B

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

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

- there is a scheme under which a person is provided with a capital benefit by a company (paragraph 45B(2)(a);
- under the scheme a person (the relevant taxpayer), who may or may not be the person provided with the capital benefit, obtains a tax benefit (paragraph 45B(2)(b); and
- having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, entered into or carried out the scheme or any part of the scheme for a purpose (other than an incidental purpose) of enabling a taxpayer to obtain a tax benefit (paragraph 45B(2)(c).

Each of these conditions is considered below.

36. The return of capital is a 'scheme' within the broad meaning of that term.

37. The phrase 'provided with a capital benefit' is defined at subsection 45B(5). Relevantly, it includes a distribution to a person of share capital. As Talent2 proposes to debit the return of capital against its share capital account, its shareholders will be provided with a capital benefit.

38. A shareholder 'obtains' a 'tax benefit', as defined in subsection 45B(9), 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.

39. 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 share 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 share that a capital gain is made. A capital gain may not arise at all for certain foreign shareholders. By contrast, a dividend would generally be included in the assessable income of a resident shareholder or, in the case of a non-resident, subject to dividend withholding tax. Therefore, the shareholder will obtain tax benefits from the return of capital.

Relevant circumstances

40. For the purposes of paragraph 45B(2)(c), the Commissioner is required to consider the 'relevant circumstances' set out in subsection 45B(8) to determine whether any part of the scheme would be entered into for a purpose, other than an incidental purpose, of enabling a relevant taxpayer to obtain a tax benefit. However, the list of relevant circumstances in subsection 45B(8) is not exhaustive and regard may be had to other circumstances on the basis of their relevance.

41. The test of purpose is an objective one. The question is whether 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 requisite purpose does not have to be the most influential or prevailing purpose but it must be more than an incidental purpose.

42. The purpose which causes section 45B to apply may be the purpose of any party to the scheme. In this case, however, the Commissioner is concerned only with the purpose of Talent2. The Commissioner cannot at this stage ascertain the purposes of Talent2's numerous shareholders, all of whom were eligible to vote on the return of capital under section 256C of the *Corporations Act 2001* and all of whom would participate in the return of capital that was approved at the shareholders meeting of 27 June 2006. Nevertheless, in a case such as this, an objective

conclusion as to the purpose of the company should, generally speaking, not be inconsistent with an objective conclusion as to the purpose of the shareholders, in particular those shareholders who voted in favour of the proposal.

43. The relevant circumstances under subsection 45B(8) cover the circumstances of the company and the tax profile of the shareholders. In this instance, as the return of capital is made to all shareholders of Talent2 regardless of individual shareholder circumstances, paragraphs 45B(8)(c) to (h) do not incline for or against a conclusion as to the purpose. The circumstances covered by paragraphs 45B(8)(i) to (j) pertaining to the provision of ownership interests and demerger respectively are not relevant. In this case, the relevant matters are those covered by the circumstances described in paragraphs 45B(8)(a), (b) and (k).

Paragraph 45B(8)(a) refers to the extent to which the capital benefit is attributable to capital or profits (realised and unrealised) of the company or an associate (within the meaning of section 318) of the company.

44. Having regard to the circumstances of Talent2 and the share capital raised between August 2002 and September 2003, it would tend to a view that the return is attributable to capital rather than profit.

45. Paragraph 45B(8)(b) refers to the pattern of distributions made by a company or an associate (within the meaning of section 318) of the company. Talent2 had never paid a dividend. Talent2 did not pay dividends out of current year profits for the financial years ended 30 June 2001 and 2002 due to overall group consolidated losses after tax. The balance of losses carried forward as at 30 June 2005 was \$20,695,920. Talent2 turnover has increased from \$16 million for the year ended 30 June 2003 to \$100 million for the year ended 30 June 2006.

46. Talent2 announced that it would pay a special dividend of 3 cents a share, partially franked on 1 August 2006. This dividend represents more than 95% of available 2006 estimated profits. Talent2 has advised that it wished to establish a reasonable track record of group consolidated profits after tax before commencing with a dividend policy of returning 60-70% of after tax profits to shareholders in accordance with the Board's recommendation at the appropriate time.

47. Paragraph 45B(8)(k) refers to the matters in subparagraphs 177D(b)(i) to (viii). These matters are by reference to which a scheme is able to be examined from a practical perspective in order to identify and compare its tax and non-tax objectives. The matters include the manner in which the scheme is carried out, the timing of the scheme, its form and substance, and the financial and other implications for the parties involved.

48. Talent2 has demonstrated that the scheme, being a return of capital to its shareholders, seeks to legitimately return an amount of excess share capital raised between August 2002 and September 2003. Talent2's strategy was to use those funds to grow the business by acquisition but the growth was undertaken by issuing share capital. This strategy of issuing capital, holding it in escrow for 2 years and locking in the know how of the principals of the acquired businesses was successful and was reflected in the share price increase over time. The return will release capital which Talent2 has stated is excess to its current needs. In this case, the practical implications of the scheme are consistent with it being, in form and substance, a distribution of share capital.

49. Therefore, having regard to the relevant circumstances of the scheme to return capital to Talent2's shareholders, it would be concluded that Talent2 will enter into or carry out the scheme for an incidental purpose of enabling the shareholders to obtain a tax benefit. Accordingly, the Commissioner will not make a determination under subsection 45B(3) that section 45C applies to the whole, or any part, of the return of capital.

Deeming dividends to be paid where a determination is made: section 45C

50. As the Commissioner will not make a determination under subsection 45B(3) in relation to the scheme as described, section 45C will not apply.

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

51. CGT event G1 (section 104-135 of the ITAA 1997) will happen 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 as defined in subsection 995-1(1) of the ITAA 1997, or an amount that is taken to be a dividend under section 47 of the ITAA 1936.

52. A shareholder will make a capital gain if the return of capital by the company in relation to a share exceeds the cost base of the share (subsection 104-135(3) of the ITAA 1997).

53. The cost base and reduced cost base of each Talent2 share will be reduced (but not below nil) by the amount of the return of capital (subsections 104-135(3) and (4) of the ITAA 1997). If the share was acquired by the shareholder at least 12 months before the date of payment, a capital gain from the share may qualify as a discount capital gain (subsection 115-25(1) of the ITAA 1997) if the other conditions in Subdivision 115-A of the ITAA 1997 are satisfied. As the return of capital is expected to be \$0.03 per share, it is not likely to result in any capital gains for Talent2 shareholders.

Appendix 2 – Detailed contents list

54. The following is a detailed contents list for this Ruling:

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References

<i>Previous draft:</i>	- ITAA 1936 45B(8)(h)
Not previously issued as a draft	- ITAA 1936 45B(8)(i)
	- ITAA 1936 45B(8)(j)
<i>Subject references:</i>	- ITAA 1936 45B(8)(k)
- capital gains tax	- ITAA 1936 45B(9)
- return of capital on shares	- ITAA 1936 45C
- share capital	- ITAA 1936 47
	- ITAA 1936 177D(b)(i)
<i>Legislative references:</i>	- ITAA 1936 177D(b)(ii)
- ITAA 1936 6(1)	- ITAA 1936 177D(b)(iii)
- ITAA 1936 6(1)(d)	- ITAA 1936 177D(b)(iv)
- ITAA 1936 6(4)	- ITAA 1936 177D(b)(v)
- ITAA 1936 44(1)	- ITAA 1936 177D(b)(vi)
- ITAA 1936 45A	- ITAA 1936 177D(b)(vii)
- ITAA 1936 45A(2)	- ITAA 1936 177D(b)(viii)
- ITAA 1936 45A(3)(b)	- ITAA 1936 318
- ITAA 1936 45B	- ITAA 1997 104-25
- ITAA 1936 45B(2)	- ITAA 1997 104-35
- ITAA 1936 45B(2)(a)	- ITAA 1997 104-135
- ITAA 1936 45B(2)(b)	- ITAA 1997 104-135(2)
- ITAA 1936 45B(2)(c)	- ITAA 1997 104-135(3)
- ITAA 1936 45B(3)	- ITAA 1997 104-135(4)
- ITAA 1936 45B(5)	- ITAA 1997 Subdiv 115-A
- ITAA 1936 45B(8)	- ITAA 1997 115-125(1)
- ITAA 1936 45B(8)(a)	- ITAA 1997 136-10
- ITAA 1936 45B(8)(b)	- ITAA 1997 975-300
- ITAA 1936 45B(8)(c)	- ITAA 1997 995-1(1)
- ITAA 1936 45B(8)(d)	- TAA 1953
- ITAA 1936 45B(8)(e)	- TAA 1953 Sch 1 357-75(1)
- ITAA 1936 45B(8)(f)	- Corporations Act 2001 256C
- ITAA 1936 45B(8)(g)	- Copyright Act 1968

ATO references

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