


CR 2008/7 - Income tax: cancellation of shares in Telecom Corporation of New Zealand Limited

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Class Ruling

Income tax: cancellation of shares in Telecom Corporation of New Zealand Limited

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① 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 (unless we are satisfied that the ruling is incorrect and disadvantages you, in which case we may apply the law in a way that is more favourable for you – provided 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);
- subsection 44(1) of the ITAA 1936;
- section 45A of the ITAA 1936;
- section 45B of the ITAA 1936; and
- section 45C of the ITAA 1936.

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

Class of entities

3. The class of entities to which this Ruling applies is Australian resident entities (Australian shareholders) who held ordinary shares in Telecom Corporation of New Zealand Limited (Telecom NZ) and who received a distribution under the Scheme described in paragraphs 14 to 24 of this Ruling.

Qualifications

4. 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 14 to 24 of this Ruling.

5. This Ruling does not address the foreign exchange (forex) consequences that arise under forex realisation event 2 when the shareholders receive the distributions under this scheme. This issue cannot be dealt with in this Ruling as the quantum and tax treatment of any forex realisation gain or loss may differ, depending on the individual circumstances of the shareholder.

6. On 16 October 2007, the Minister for Revenue and Assistant Treasurer announced the Government's intention to introduce changes to the market value substitution rule for widely held entities (Minister for Revenue and Assistant Treasurer's Press Release No. 128). Accordingly, this Ruling does not address the capital gains tax consequences that arise as a result of the scheme.

7. 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

9. This Ruling applies from 1 July 2007 to 30 June 2008. However, the Ruling continues to apply after this date to all entities within the specified class who entered into the specified scheme during the term of the Ruling.

10. 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.

11. If this 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)).

12. If this Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the 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.

13. 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).

Scheme

14. The scheme that is the subject of this Ruling is described below. This description of the scheme is based on information provided by the applicant. The following documents or relevant parts of them form part of and are to be read with the description:

- the application for a Class Ruling dated 24 May 2007 with attachments; and
- correspondence received between 24 May 2007 and 31 January 2008.

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

15. Telecom NZ is a widely held telecommunications company resident in New Zealand and is listed on the New Zealand stock

exchange (NZX), Australian stock exchange (ASX) and the New York Stock Exchange (NYSE).

16. Telecom NZ is the parent company of a group that provides a range of internet, data, voice, mobile and fixed line calling services for customers predominantly in New Zealand and Australia. As at 22 May 2007, Telecom NZ had a market capitalisation of approximately NZ\$9.67 billion, based on the then share price of NZ\$4.82 and 2.008 billion issued shares.

17. Approximately 29.9% of Telecom NZ shareholders are Australian residents, with almost all the remaining shareholders resident in New Zealand, USA and Europe and Asia.

18. Until recently one of Telecom NZ group's business activities was the production and publication of printed Yellow Page and White Page phone directories and their on-line equivalents. These phone directory activities were carried out by two wholly owned subsidiaries of Telecom NZ.

19. The Telecom NZ group launched a competitive sale process for the subsidiaries' shares and on 26 March 2007 announced that it had agreed to sell the business for NZ\$2.24 billion. The sale was completed on 30 April 2007. The sale of this business was undertaken pursuant to various strategic factors and once the cash from the sale was received, Telecom NZ's strategy was to return the excess cash not required for its business to its shareholders. The excess funds were determined after the sale proceeds were used to effect a \$400 million reduction in debt and a \$700 million increase in investments.

20. Telecom NZ's stated commercial objectives in returning excess funds to shareholders include:

- to maintain an 'A' credit rating from Standard and Poor's;
- to maintain long term leverage targets; and
- to maintain sufficient capital to fund known capital commitments and potential future investments.

21. On 3 May 2007, Telecom NZ announced its intention to return excess cash of NZ\$1.1 billion to all its shareholders by way of a court sanctioned share cancellation done on a pro-rata basis. It was proposed that approximately 11.23% of shares issued be cancelled.

22. The share cancellation was approved by Telecom NZ's shareholders at an Extraordinary Meeting on 17 August 2007. Subsequently, an application was made to the High Court of New Zealand to order the share cancellation. This Order was sealed on 3 September 2007.

23. The share cancellation was made on 24 September 2007 in relation to shares held on the Record Date for the cancellation, being 21 September 2007. For each share cancelled, shareholders of Telecom NZ received a certain distribution, based on the volume

weighted average price of Telecom NZ's shares of NZ\$4.88 on the NZX as at 3 May 2007 (date of the announcement). This price is the same as the closing price as at 2 May 2007 (the date immediately prior to the announcement of the share cancellation). Australian shareholders received approximately \$4.17 per share cancelled.

24. Telecom NZ accounted for the share cancellation by wholly debiting its share capital account. There have been no transfers into Telecom NZ's share capital account as defined in section 975-300 of the *Income Tax Assessment Act 1997* (ITAA 1997) from any of Telecom NZ's other accounts.

Ruling

Is the distribution a dividend as defined in subsection 6(1)?

25. The distribution of share capital by Telecom NZ upon cancellation of a share is not a 'dividend' as defined in subsection 6(1).

Is the distribution of share capital a dividend assessable under subsection 44(1)?

26. That part of the distribution by Telecom NZ, being an amount of NZ\$3.71 per distribution, that is taken to be an unfranked dividend paid out of profits of Telecom NZ pursuant to section 45C will be assessable to the Australian resident shareholders under subsection 44(1).

The application of sections 45A, 45B and 45C to the Telecom NZ cancellation of share capital

27. The Commissioner will not make a determination (under section 45A) that section 45C applies to the distribution of share capital.

28. The Commissioner has made a determination (under section 45B) that section 45C will apply to the distribution of share capital. Accordingly, part of the distribution of share capital to be paid to a shareholder will be taken to be an unfranked dividend paid out of Telecom NZ's profits for Australian income tax purposes under section 45C.

Appendix 1 – Explanation

① *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

29. Subsection 6(1) defines a 'dividend' to include any distribution made by a company to its shareholder. Paragraph (d) of the definition of 'dividend' in subsection 6(1) however excludes from the definition of 'dividend' any:

moneys 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 (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 share cancellation will be recorded as a debit wholly against the share capital account of Telecom NZ. There have been no transfers into Telecom NZ's share capital account as defined in section 975-300 of the ITAA 1997 from any of Telecom NZ's other accounts. Therefore, paragraph (d) of the definition of 'dividend' in section 6(1) of the ITAA 1936 will exclude the return of share capital pursuant to the share cancellation as a 'dividend' under subsection 6(1) of the ITAA 1936.

31. However, as subsection 44(1) includes in a shareholder's assessable income any 'dividend' paid out of profits derived by the company from any source, a return of share capital that has been deemed to be an unfranked dividend pursuant to section 45C will be assessable pursuant to this section.

Anti-avoidance provisions

32. 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.

Section 45A – streaming of dividends and capital benefit

33. Section 45A applies in circumstances where 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.

34. Telecom NZ has provided all of its ordinary shareholders with a 'capital benefit' (as defined in paragraph 45A(3)(b)), and the capital benefit will be provided to all shareholders in direct proportion to their individual shareholding. As all shareholders benefited equally from the share cancellation and the distribution of share capital, there is no indication of 'streaming' of capital benefits to some shareholders and not to other shareholders.

35. Accordingly, section 45A will not apply to the distribution of share capital, and the Commissioner will not make a determination under subsection 45A(2) that section 45C applies to the distribution.

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

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

37. 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;
- 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; 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 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.

Each of these conditions is considered below.

Scheme

38. The sale by Telecom NZ of its subsidiaries, the equal cancellation of the ordinary shares and the distribution of Telecom NZ's share capital is a 'scheme' within the broad meaning of that term.

Capital benefit

39. The phrase 'provided with a capital benefit' is defined in subsection 45B(5). Relevantly, it includes a distribution to a person of share capital. As Telecom NZ debited the distribution in respect of the share cancellation wholly against its share capital account, its shareholders were provided with a capital benefit.

Tax benefit

40. A shareholder 'obtains a tax benefit' as defined in subsection 45B(9) if:

- the amount of tax payable; or
- any other amount payable under the ITAA 1936 or the ITAA 1997,

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 instead had been a dividend.

41. As discussed in paragraph 39 of this Ruling, the distribution to the ordinary shareholders constitutes a capital benefit. In the event that the relevant distribution did represent a dividend rather than a capital benefit, it is likely that Australian shareholders would have incurred a greater tax liability. Consequently, the receipt of the capital benefit will represent a tax benefit.

Relevant circumstances

42. 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.

43. 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 requisite purpose does not have to be the most influential or prevailing purpose but it must be more than an incidental purpose.

44. The circumstances covered by paragraphs 45B(8) includes the circumstances of the company and the tax profile of the shareholders. In this instance, as the distribution was made to all Telecom NZ shareholders regardless of individual shareholder circumstances, paragraphs 45B(8)(c) to (g) do not incline for or against a conclusion as to 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), (h) and (k).

45. 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. In this case, Telecom NZ disposed of a part of its business for the amount of NZ\$2.24 billion. The accounting profit generated was NZ\$2.08 billion. In the absence of Telecom NZ's profit from the disposals, the company's perception or business need to relieve its balance sheet of excess cash would not arise.

46. Paragraph 45B(8)(b) refers to the pattern of distributions made by a company or its associates. Telecom NZ has paid a dividend of 7 to 7.5 NZ cents per share per quarter since 2000 and the company has also paid special dividends in 1998, 2005 and twice in 2006. The special dividends during the 2005-2006 period were made to return excess working capital from the profitable realisation of assets. Overall, Telecom NZ's dividend culture has been to return surplus funds by way of imputed dividends. In this specific instance, the lack of sufficient imputation credits under New Zealand tax law appears to be a significant factor in the decision to return share capital.

47. Paragraph 45B(8)(h) considers whether the shareholder's equity interest in the company is the same before and after the distribution of share capital. In this case, notwithstanding the equal cancellation of ordinary shares by Telecom NZ, the proportionate and voting interests inter se of each shareholder and *vis a vis* the company will remain unchanged. The effect is that the distribution of share capital is not economically dissimilar to an ordinary or special dividend where cash is received by a shareholder.

48. 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.

49. From the perspective of Telecom NZ, the form and substance of the scheme was to return to its shareholders their proportionate share in the net assets of the company including their interest in the underlying assets of the company. In particular the profits realised from the sale of the subsidiaries. That distribution was sourced directly from the cash proceeds from the sale. In that regard, Telecom NZ will be perceived to be rewarding its shareholders for their investment and interests in the company. However, the timing of the distribution following the realisation of profit from the disposal of assets by Telecom NZ, Telecom NZ's pattern of distributions, Telecom NZ's stated intentions of not returning any of the profits generated from the disposal of the subsidiaries as a special dividend and using that profit to fund new capital acquisitions would all lend support to a conclusion that the scheme was carried out to enable Telecom NZ's shareholders in Australia to obtain a tax benefit.

50. Therefore, having regard to the relevant circumstances of the scheme, as discussed in paragraphs 42 to 49 of this Ruling, it would be concluded that Telecom NZ entered into or carried out the scheme for more than an incidental purpose of enabling the Australian shareholders to obtain a tax benefit for the purposes of paragraph 45B(2)(c). Accordingly, the Commissioner has made a determination under subsection 45B(3) that section 45C applies to a part of the distribution paid to the Australian shareholders.

Section 45C – deeming dividends to be paid where a determination is made

51. As the Commissioner has made a determination under subsection 45B(3) in relation to the scheme as described, section 45C will apply.

52. Under subsection 45C(1), if the Commissioner makes a determination under subsection 45B(3), the amount of the capital benefit, or the part of the benefit, is taken, for the purposes of the ITAA 1936 and ITAA 1997, to be an unfranked dividend that is paid by the company to the shareholder or relevant taxpayer at the time that the shareholder is provided with the capital benefit. Under subsection 45C(2), the dividend will be taken to have been paid out of the profits of the company.

53. Accordingly, of the total distribution of NZ\$4.88 for each Telecom NZ ordinary cancelled, NZ\$3.71 will be taken to be an unfranked dividend paid by the company, out of the profits of the company, to the shareholder on 24 September 2007, the date Australian resident shareholders were provided with the distribution of share capital.

Appendix 2 – Detailed contents list

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References

Previous draft:

Not previously issued as a draft

Subject references:

- capital reduction
- CGT event
- dividend
- return of capital on shares
- share cancellation

Legislative references:

- ITAA 1936
- ITAA 1936 6(1)
- 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(2)(c)
- ITAA 1936 45B(3)
- ITAA 1936 45B(5)
- ITAA 1936 45B(8)
- ITAA 1936 45B(8)(a)
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- ITAA 1936 45C(1)
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- ITAA 1936 177D(b)(i)
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- ITAA 1936 177D(b)(iv)
- ITAA 1936 177D(b)(v)
- ITAA 1936 177D(b)(vi)
- ITAA 1936 177D(b)(vii)
- ITAA 1936 177D(b)(viii)
- ITAA 1997 975-300
- TAA 1953
- TAA 1953 Sch 1 357-75(1)
- Copyright Act 1968

Other references:

- Minister for Revenue and Assistant Treasurer's Press Release No. 128

ATO references

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