CR 2011/68 - Income tax: proposed return of capital: Wild Child (WA) Pty Ltd

Class Ruling

Income tax: proposed return of capital: Wild Child (WA) Pty Ltd

Contents Para

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); and
- section 104-135 of the ITAA 1997.

All subsequent 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 the ordinary shareholders of Wild Child (WA) Pty Ltd (Wild Child), who:

(a) are registered on the Wild Child share register on the Record Date of each proposed return of capital;

(b) hold their shares on capital account;

(c) are residents of Australia for the purposes of the Australian income tax legislation, including by virtue of the operation of any double tax agreement between Australia and any other country;

(d) are not 'temporary residents' of Australia within the meaning of section 995-1 of the ITAA 1997; and

(e) are not subject to the taxation of financial arrangements (TOFA) rules in Division 230 of the ITAA 1997 in relation to gains and losses on their Wild Child shares.

(Note – Division 230 of the ITAA 1997 will generally not apply to individuals, unless they have made an election for it to apply to them.)

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 9 to 20 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- this Ruling may be withdrawn or modified.

Date of effect

8. This Ruling applies from 1 July 2011 to 30 June 2012. The Ruling continues to apply after 30 June 2012 to all entities within the specified class who entered into the specified scheme during the term of the Ruling. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Scheme

9. The following description of the scheme is based on information provided by the applicant.

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

10. Wild Child is an Australian resident private company.

11. Wild Child develops, manufactures and sells a range of natural products for the safe and effective treatment and prevention of head lice and nits.

12. Historically, Wild Child has been focused on the growth of its business and as such has not distributed profits to its shareholders.

13. In 2006 Wild Child decided to expand its business activities to the United States of America (USA). At the time it was decided that the capital required to fund this business venture would be raised from existing shareholders. During the 2008 and 2009 financial years shares were issued to existing shareholders raising $1,056,473 to fund the expansion.

14. It was decided during the 2009 year to change the USA expansion plan. Subsequently, in September 2009, Wild Child entered into a brand purchase and license agreement with a US corporation.

15. As a result of this change in expansion strategy, the capital raised during the 2008 and 2009 financial years is now surplus to requirements and it is proposed to return it to shareholders by a return of capital.

16. Wild Child plans to make two returns of capital, each by way of a cash payment of $0.30 per share to all shareholders registered at the relevant Record Date. The return of capital payments will be made after each Record Date. The Payment Dates are anticipated to occur in the 2012 financial year. The total amount of capital expected to be returned to shareholders pursuant to the two returns of capital is $986,542.

17. The returns of capital will be funded from the issued capital account.

18. As at 30 June 2010 Wild Child had accumulated losses of $1,641,903.

19. As at 18 February 2011, Wild Child had 1,644,237 ordinary shares on issue. Each share has the same rights in respect of voting, dividends and the right to participate in the returns of capital.

20. Wild Child's share capital account is not tainted within the meaning of Division 197 of Part 3-5 of the ITAA 1997.

Ruling

Distribution is not a dividend for income tax purposes

21. The proposed returns of capital to Wild Child shareholders will not be a dividend, as defined in subsection 6(1).

The application of sections 45A, 45B and 45C to the proposed returns of capital

22. The Commissioner will not make a determination under sections 45A or 45B that section 45C applies to the proposed returns of capital. Accordingly, no part of the proposed returns of capital will be taken to be a dividend for income tax purposes.

Capital gains tax

23. For each return of capital CGT event G1 will happen when Wild Child pays the proposed return of capital to a Wild Child shareholder in respect of a Wild Child share that they own at the Record Date for that return of capital and continue to own at the Payment Date for that return of capital (section 104-135 of the ITAA 1997).

24. For each return of capital CGT event C2 will happen when Wild Child pays the proposed return of capital to a Wild Child shareholder in respect of a Wild Child share that they owned at the Record Date for that return of capital but had ceased to own before the Payment Date for that return of capital (section 104-25 of ITAA 1997).

Commissioner of Taxation
13 July 2011

Appendix 1 – Explanation

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.

Distribution is not a dividend

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

26. The term 'dividend' is defined in subsection 6(1) and includes any distribution made by a company to any of its shareholders. However, paragraph (d) of the definition of 'dividend' excludes a distribution from the meaning of 'dividend' if the amount of the distribution is debited against an amount standing to the credit of the company's share capital account.

27. The term 'share capital account' is defined in section 975-300 of the ITAA 1997 as an account which the company keeps of its share capital, or any other account created on or after 1 July 1998 where the first amount credited to the account was an amount of share capital.

28. Subsection 975-300(3) of the ITAA 1997 states that an account is not a share capital account, except for certain limited purposes, if it is tainted. Section 197-50 of the ITAA 1997 states that a share capital account is tainted if an amount to which Division 197 of the ITAA 1997 applies is transferred to the account and the account is not already tainted.

29. The proposed returns of capital will be recorded as a debit to Wild Child's share capital account. As the share capital account of Wild Child is not tainted within the meaning of Division 197 of the ITAA 1997, paragraph (d) of the definition of 'dividend' in subsection 6(1) of the ITAA 1936 will apply. Accordingly, the returns of capital will not be a dividend as defined in subsection 6(1) of the ITAA 1936.

Anti-avoidance provisions

Sections 45A and 45B

30. Sections 45A and 45B are two anti-avoidance provisions which, if they apply, allow the Commissioner to make a determination that section 45C applies to treat all or part of the proposed return of capital amount received by the shareholders as an unfranked dividend paid by the company out of profits to the shareholder.

Section 45A – streaming of dividends and capital benefits

31. Section 45A applies where capital benefits are streamed to some shareholders (the Advantaged Shareholders), who would derive a greater benefit from the receipt of capital than other shareholders (the Disadvantaged Shareholders) and these Disadvantaged Shareholders receive, or are likely to receive, dividends.

32. A reference to the 'provision of a capital benefit to a shareholder in a company' is defined in paragraph 45A(3)(b) to include the distribution to the shareholder of share capital. Wild Child will provide its shareholders with a 'capital benefit' as defined in paragraph 45A(3)(b). The capital benefit will be provided to all of its shareholders in the same proportion as their share holdings.

33. Therefore, section 45A will not apply to the proposed returns of capital. Accordingly, the Commissioner will not make a determination under subsection 45A(2) that section 45C applies in relation to the whole, or a part, of the proposed return of capital amounts.

Section 45B – schemes to provide capital benefits

34. Section 45B applies where certain capital payments, including a return of capital, are paid to shareholders in substitution for dividends. It allows the Commissioner to make a determination that section 45C applies to a capital benefit. Specifically, the provision applies where:

- 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 taxpayer (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 the scheme or carried out the scheme or any part of the scheme for a purpose, other than an incidental purpose, of enabling the relevant taxpayer to obtain a tax benefit (paragraph 45B(2)(c)).

Each of these conditions is considered in paragraphs 35 to 51 of this Ruling.

Scheme

35. A 'scheme' for the purposes of section 45B is taken to have the same meaning as provided in subsection 177A(1) of Part IVA. That definition is widely drawn and includes any agreement, arrangement, understanding, promise, undertaking, scheme, plan or proposal.

36. The phrase 'provided with a capital benefit' is defined in subsection 45B(5). It states that a person is provided with a capital benefit if:

- an ownership interest in a company is issued to the person;
- there is a distribution to the person of share capital; or
- the company does something in relation to an ownership interest that has the effect of increasing the value of the ownership interest (which may or may not be the same interest) held by that person.

37. As the proposed returns of capital will be debited to Wild Child's share capital account, Wild Child will provide shareholders with a capital benefit under paragraph 45B(5)(b) in the form of distributions of share capital.

Tax benefit

38. A relevant taxpayer '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 had instead been a dividend.

39. The proposed distributions to Wild Child's ordinary shareholders include return of capital payments and therefore each payment will constitute a capital benefit. In the event that the relevant distributions were dividends rather than a capital benefit, it is likely that the amount of tax payable by Wild Child's shareholders would be greater than is payable in respect of each of the proposed return of capital payments (that payment being the capital benefit). Consequently, the receipt of the capital benefit is a 'tax benefit'.

40. Ordinarily, a return of capital would be subject to the 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. By contrast, a dividend would generally be included in the assessable income of a shareholder. Therefore, Wild Child shareholders will obtain tax benefits from the proposed returns of capital.

Relevant circumstances

41. Paragraph 45B(2)(c) requires the Commissioner to consider the 'relevant circumstances' of the scheme as set out in subsection 45B(8). A consideration of these circumstances determines whether any part of the scheme will be entered into for a purpose, other than an incidental purpose, of enabling the relevant taxpayer (an ordinary shareholder in Wild Child) to obtain a tax benefit.

42. The test of purpose is an objective one. The question is whether it would be concluded that a person who enters into or carries out the scheme does so for the purpose of obtaining a tax benefit for the relevant taxpayer. This requisite purpose does not have to be the most influential or prevailing purpose but it must be more than an incidental purpose.

43. The purpose which causes section 45B of the ITAA 1936 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 Wild Child. The Commissioner cannot ascertain the purposes of Wild Child's numerous shareholders, all of whom will be eligible to vote on the proposed returns of capital under section 256C of the *Corporations Act 2001*, and all of whom may participate in the proposed returns of capital. Nevertheless, in a case such as this, an objective conclusion as to the purpose of the company should not be inconsistent with an objective conclusion as to the purpose of the shareholders, in particular those shareholders who voted in favour of the payment.

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

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

46. The proposed returns of capital are not considered attributable to the profits of Wild Child. The proposed returns of capital are considered attributable to capital only and not to any realised or unrealised profits of Wild Child.

47. 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.

48. Wild Child has not paid dividends. This is consistent with their growth strategy of expansion into overseas markets and research and development. The absence of payment of dividends does not suggest that the proposed returns of capital will be made in substitution for dividends.

49. Paragraph 45B(8)(k) refers to the matters in subparagraphs 177D(b)(i) to 177D(b)(viii). These are matters 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.

50. In this case, the form and substance of Wild Child's proposed returns of capital do not lead to a conclusion that the requisite purpose exists that the scheme was carried out for the purpose of enabling the relevant taxpayer to obtain a tax benefit.

51. Accordingly, it cannot be concluded that Wild Child or participating Wild Child shareholders entered into or carried out the scheme for the purpose of enabling the shareholders to obtain a tax benefit. As such, the Commissioner will not make a determination under subsection 45B(3) that section 45C applies to the whole or any part of the proposed returns of capital.

Section 45C

52. As the Commissioner will not make a determination under subsection 45A(2) or subsection 45B(3) in relation to the scheme as described, section 45C will not deem any part of the proposed returns of capital to be unfranked dividends for the purposes of the ITAA 1936 or the ITAA 1997.

Capital gains tax

CGT event G1 – section 104-135

53. CGT event G1 will happen each time Wild Child pays one of the proposed returns of capital to a Wild Child shareholder in respect of a share that they own in Wild Child at the Record Date for that return of capital and continue to own at the time of that payment (section 104-135 of the ITAA 1997).

54. If the return of capital is equal to or less than the cost base of the Wild Child share at the time of payment, the cost base and reduced cost base of the share will be reduced (but not below nil) by the amount of the payment (subsection 104-135(4) of the ITAA 1997).

55. A Wild Child shareholder will make a capital gain if the return of capital is more than the cost base of the Wild Child share (subsection 104-135(3) of the ITAA 1997). The amount of the capital gain is equal to the excess.

56. If a Wild Child shareholder makes a capital gain when CGT event G1 happens, the cost base and reduced cost base of the Wild Child share is reduced to nil. A Wild Child shareholder cannot make a capital loss when CGT event G1 happens (subsection 104-135(3) of the ITAA 1997).

57. A capital gain made when CGT event G1 happens will be eligible to be treated as a discount capital gain under Division 115 of the ITAA 1997 provided that the Wild Child share was acquired at least 12 months before the payment of the proposed return of capital (subsection 115-25(1) of the ITAA 1997) and the other conditions of that Division are satisfied.

CGT event C2 – section 104-25

58. Each right to receive a return of capital is one of the rights inherent in a Wild Child share at the Record Date for that return of capital. If, after the Record Date but before the Payment Date, a Wild Child shareholder ceases to own a Wild Child share, the right to receive the proposed return of capital in respect of that share will be retained by the shareholder and is a separate CGT asset.

59. CGT event C2 will happen each time one of the returns of capital is paid (section 104-25 of the ITAA 1997). The right to receive the payment (being an intangible CGT asset) will end by the right being discharged or satisfied when the payment is made.

60. A Wild Child shareholder will make a capital gain if the capital proceeds from the ending of the right are more than its cost base. The capital gain is equal to the amount of the excess. A Wild Child shareholder will make a capital loss if the capital proceeds from the ending of the right are less than its reduced cost base (subsection 104-25(3) of the ITAA 1997). The capital loss is equal to the amount of the difference.

61. In working out the capital gain or capital loss made when CGT event C2 happens, the capital proceeds will be the amount of the return of capital at that time (subsection 116-20(1) of the ITAA 1997).

62. The cost base of a Wild Child shareholder's right to receive a return of capital is worked out under Division 110 of the ITAA 1997 (modified by Division 112 of the ITAA 1997). The cost base of the right does not include the cost base or reduced cost base of the share previously owned by the Wild Child shareholder that has been applied in working out a capital gain or capital loss made when a CGT event happened to the share – for example, when the Wild Child shareholder disposed of the share after the Record Date but before the Payment Date for that return of capital.

63. Therefore, if the full cost base or reduced cost base of a Wild Child share has previously been applied in working out a capital gain or capital loss made when a CGT event happened to that share, the right to receive the return of capital is likely to have a nil cost base.

64. As the right to receive a return of capital was inherent in the Wild Child share during the time it was owned, the right is considered to have been acquired at the time when the corresponding share was acquired (section 109-5 of the ITAA 1997). Accordingly, if the Wild Child share was acquired at least 12 months before the return of capital, a capital gain made from the ending of the corresponding right will satisfy the requirements of section 115-25 of the ITAA 1997. Such a capital gain will be eligible to be treated as a discount capital gain under Subdivision 115-A of the ITAA 1997 provided the other conditions of that Subdivision are satisfied.

Appendix 2 – Detailed contents list

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

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Subject references:

- capital gains tax
- capital streaming
- CGT events C1-C3 – end of a CGT asset
- CGT events G1-G3 – shares
- distributions
- dividends
- return of capital on shares
- share capital

Legislative references:

- ITAA 1936
- ITAA 1936 6(1)
- ITAA 1936 6(1)(d)
- ITAA 1936 44(1)
- ITAA 1936 45A
- ITAA 1936 45A(2)
- ITAA 1936 45A(3)
- ITAA 1936 45A(3)(b)
- ITAA 1936 45B
- ITAA 1936 45B(2)(a)
- ITAA 1936 45B(2)(b)
- ITAA 1936 45B(2)(c)
- ITAA 1936 45B(3)
- ITAA 1936 45B(5)
- ITAA 1936 45B(5)(b)
- ITAA 1936 45B(8)
- ITAA 1936 45B(8)(a)
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- ITAA 1936 45B(8)(g)
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- ITAA 1936 45B(8)(i)
- ITAA 1936 45B(8)(j)
- ITAA 1936 45B(8)(k)
- ITAA 1936 45B(9)
- ITAA 1936 45C
- ITAA 1936 177A(1)
- ITAA 1936 177D(b)(i)
- ITAA 1936 177D(b)(ii)
- ITAA 1936 177D(b)(ii)
- 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 1936 318
- ITAA 1997
- ITAA 1997 104-25
- ITAA 1997 104-25(3)
- ITAA 1997 104-135
- ITAA 1997 104-135(3)
- ITAA 1997 104-135(4)
- ITAA 1997 109-5
- ITAA 1997 Div 110
- ITAA 1997 Div 112
- ITAA 1997 Div 115
- ITAA 1997 Subdiv 115-A
- ITAA 1997 115-25
- ITAA 1997 115-25(1)
- ITAA 1997 116-20(1)
- ITAA 1997 Div 197
- ITAA 1997 197-50
- ITAA 1997 Div 230
- ITAA 1997 975-300
- ITAA 1997 975-300(3)
- ITAA 1997 995-1
- TAA 1953
- Copyright Act 1968
- Corporations Act 2001 256C

ATO references

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