


CR 2012/80 - Income tax: Selective Capital Reduction: Mesbon China Nylon Limited

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Class Ruling

Income tax: Selective Capital Reduction: Mesbon China Nylon Limited

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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, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is 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;
 - section 45C of the ITAA 1936;
 - section 128B of the ITAA 1936;
 - Division 16K of Part III (Division 16K) of the ITAA 1936;
 - section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
 - section 8-1 of the ITAA 1997;

- section 104-25 of the ITAA 1997;
- section 116-20 of the ITAA 1997;
- section 118-20 of the ITAA 1997;
- section 118-25 of the ITAA 1997;
- section 202-5 of the ITAA 1997;
- section 202-40 of the ITAA 1997;
- section 202-45 of the ITAA 1997;
- section 802-15 of the ITAA 1997;
- section 855-10 of the ITAA 1997; and
- section 855-15 of the ITAA 1997.

All legislative references in this Ruling are to the ITAA 1997 unless otherwise stated.

Class of entities

3. The class of entities to which this Ruling applies is the shareholders of Mesbon China Nylon Limited (Mesbon) who:

- participate in the selective capital reduction that is described in the Scheme part of this Ruling;
- hold their ordinary shares in Mesbon (Mesbon shares) on the Record Date of 29 October 2012;
- have their Mesbon shares cancelled on the Implementation Date of 29 October 2012; and
- are not subject to the taxation of financial arrangements rules in Division 230 in relation to gains and losses on their Mesbon shares.

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

Mesbon shareholders who satisfy these requirements are referred to as Participating Shareholders in this Ruling.

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.

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Date of effect

8. This Ruling applies from 1 July 2012 to 30 June 2013. The Ruling continues to apply after 30 June 2013 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. The following documents, or relevant parts of them form part of and are to be read with the description:

- application for Class Ruling dated 3 June 2011;
- correspondence dated 20 July 2011;
- correspondence dated 18 August 2011;
- Mesbon China Nylon Limited annual report for the year ended 31 December 2011;

- Mesbon China Nylon Limited ASX announcement – issue of securities under dividend reinvestment plan dated 4 April 2012; and
- correspondence dated 3 August 2012.

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

Background

10. Mesbon is an Australian incorporated company and has been listed on the Australian Securities Exchange (ASX) since 2007. Mesbon carries on business through its indirect ownership of a Chinese company which engages in the production, sale and development of nylon yarn.

11. As at 31 December 2011, Mesbon had 135,194,554 ordinary shares on issue. On 30 March 2012, an additional 5,054,578 ordinary shares were allotted under the Mesbon Dividend Reinvestment Plan at \$0.189 per share. Consequently, as at 30 June 2012, Mesbon had 140,249,132 ordinary shares on issue of which the key shareholder, MSB International Trading Ltd (MSB International), held 85,683,553 (approximately 61.09%). The remaining 54,565,579 ordinary shares were held by a mix of resident and foreign resident entities (including 100 ordinary shares held by Mr Shen, the Chairman and Managing Director, which will not be included in the capital reduction).

12. Mesbon has been undertaking a multi-phase development aimed at expanding its Chinese production facility. The principal use of the capital raised from listing Mesbon on the ASX in 2007 was the funding of Phase 3 of this development. Phase 3 was completed in August 2009. As at 31 December 2010, Mesbon had commenced Phase 4 of the development. Phase 4 is being funded from internal sources and external debt.

The Selective Capital Reduction

13. On 30 May 2011, Mesbon announced a selective capital reduction under which it proposes to cancel all shares that are held by participating shareholders, delist from the ASX, and make a payment to the participating shareholders of \$0.35 per share (Cancellation Payment). The Cancellation Payment will comprise:

- \$0.2487 which will be debited to Mesbon's share capital account (Capital Component); and
- \$0.1013 which will be debited to Mesbon's retained earnings account (Dividend Component).

14. The Applicant states that the selective capital reduction is being undertaken for these reasons:

- the low liquidity of Mesbon shares;
- Mesbon not being able to access equity capital markets through its listing on the ASX;
- an increase in leveraging to fund Phase 4 of Mesbon's multi-phase development activity not being in the interests of all its shareholders; and
- the achievement of savings in administration and compliance costs.

15. MSB International is not participating in the selective capital reduction but will acquire 100% ownership of Mesbon as a result of it. The Cancellation Payment to be made to Participating Shareholders will be wholly funded by a loan from MSB International.

16. Mesbon has advised that it will account for the selective capital reduction with the following journal entries:

Dr	Share Capital	13,570,435	
Dr	Retained Earnings	5,527,483	
	Cr	Cash	19,097,918

17. As a selective capital reduction for the purposes of section 256B of the *Corporations Act 2001*, the selective capital reduction is subject to shareholders' approval and will be considered at an Extraordinary General Meeting by Mesbon shareholders that will be held on 5 October 2012.

Other matters

18. As at 31 December 2011, the financial statements of Mesbon on a stand alone basis disclose \$34,074,555 in share capital, a share option reserve of \$870,393 and retained earnings of \$2,088,859. The DRP added an additional amount of share capital of \$955,321 on 30 March 2012. Following these transactions, the company has advised that the balance of share capital at 30 June 2012 for the parent entity was \$34,881,262. On a consolidated basis, Mesbon also has retained earnings of \$18,565,491 as of 31 December 2011. The applicant has advised that it will cause its subsidiary to pay to it a dividend immediately prior to the share capital reduction to ensure that the parent company has sufficient current year profits out of which to pay the dividend component of the cancellation payment.

19. Mesbon reported a profit for the year ended 31 December 2011 of \$1,057,069 and a profit for the year ended 31 December 2010 of \$6,623,743.

20. The applicant has advised that:

- Mesbon's share capital account is not tainted;
- the Dividend Component will not be franked;
- Mesbon paid an unfranked final dividend of \$0.01 cent per share on 30 March 2012 (\$1,351,946) in respect of the 2011 financial year, no dividend in respect of the 2010 financial year and an unfranked final dividend of \$0.005 per share in May 2010 (\$662,791) in respect of the 2009 financial year;
- Mesbon has only paid unfranked dividends since listing on the ASX;
- Mesbon will have at least 300 members on the Implementation Date; and
- there are no pre-CGT Mesbon shares.

Ruling

Division 16K

21. The selective capital reduction will not be treated as a buy-back for the purposes of Division 16K of the ITAA 1936.

The Dividend and Capital Components

22. The amount proposed to be paid by Mesbon to Participating Shareholders in respect of the cancellation of a Mesbon share under the selective capital reduction will be a distribution made by the company. The distribution will be a dividend for tax purposes to the extent that it is not debited to Mesbon's share capital account (paragraphs (a) and (d) of the definition of 'dividend' in subsection 6(1) of the ITAA 1936). As \$0.2487 of the consideration will be debited against Mesbon's share capital account (the Capital Component), the Participating Shareholder will receive a dividend for tax purposes of \$0.1013 (the Dividend Component) for each Mesbon share cancelled.

Franking of the Dividend Component

23. The Dividend Component will be a frankable distribution pursuant to subsection 202-40(1). However, no franking credits will be allocated to the distribution such that it will be an unfranked dividend.

Dividend Component***Assessability of the Dividend Component for resident participating shareholders***

24. The Dividend Component will be included in the assessable income of resident shareholders who participate in the selective capital reduction under subparagraph 44(1)(a) of the ITAA 1936.

Assessability of the Dividend Component for foreign resident participating shareholders

25. Foreign resident participating shareholders will not be subject to Australian withholding tax on the Dividend Component under section 128B of the ITAA 1936 to the extent that the distribution statement associated with the Dividend Component declare it or a part of it to be conduit foreign income pursuant to section 802-15.

Capital Component***Shares held on revenue account***

26. Where the shares are held as revenue assets, the amount by which the Capital Component (\$0.2487 per share) exceeds the cost of each share will be included in the resident Participating Shareholder's assessable income under section 6-5. Correspondingly, if the cost exceeds the Capital Component of \$0.2487 per share the difference will be an allowable deduction under section 8-1.

27. This includes foreign resident Participating Shareholders who will include the Capital Component in their assessable income as it was derived by the shareholder from an Australian source, unless a double tax treaty provides for a different treatment based on the circumstances of the foreign resident Participating Shareholder.

Shares held as trading stock

28. Where the shares are held as trading stock, the Capital Component of \$0.2487 per share will be included in the resident Participating Shareholder's assessable income under section 6-5.

Capital gains tax consequences

29. CGT event C2 happens when a Participating Shareholder's Mesbon share is cancelled under the selective capital reduction (paragraph 104-25(1)(a) and subsection 104-25(2)).

30. The capital proceeds received by a Participating Shareholder in respect of the cancellation of their Mesbon share are the Cancellation Payment of \$0.35 per share (subsection 116-20(1)).

31. A Participating Shareholder makes a capital gain if the capital proceeds for the cancellation of their Mesbon share is more than the cost base of that share. The capital gain is equal to the amount of the excess (subsection 104-25(3)).

32. A Participating Shareholder makes a capital loss if the capital proceeds from the cancellation of their Mesbon share are less than the reduced cost base of that share. The capital loss is equal to the amount of the difference (subsection 104-25(3)).

33. Any capital gain made by a Participating Shareholder when CGT event C2 happens is reduced (but not below zero) by the amount of the gain that is included in the assessable income of the shareholder under section 6-5 of the ITAA 1997 or as a dividend under subsection 44(1) of the ITAA 1936 (subsections 118-20(2) and 118-20(3) of the ITAA 1997).

34. A Participating Shareholder disregards a capital gain or capital loss made from the cancellation of their Mesbon share if, at the time of the cancellation, the share is trading stock (subsection 118-25(1)).

35. A foreign resident Participating Shareholder disregards a capital gain or a capital loss from CGT event C2 happening on the cancellation of their Mesbon share if the share is not 'taxable Australian property' as defined in section 855-15 (section 855-10).

The anti-avoidance provisions – sections 45A and 45B

36. The Commissioner will not make a determination under subsection 45A(2) or subsection 45B(3) of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole, or any part, of the Capital Component of the Cancellation Payment received by Participating Shareholders.

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.*

Division 16K

37. Division 16K of the ITAA 1936 provides for the taxation treatment of share buy-backs. A share buy-back is defined as having the meaning given by paragraph 159GZZZK(a) of the ITAA 1936, which provides that a purchase is a buy-back where a company buys a share in itself from a shareholder in the company.

38. Mesbon will not be buying back its shares from its shareholders. Instead they will be cancelled in accordance with section 256 of the *Corporations Act 2001*. Therefore, the selective capital reduction will not be treated as a buy-back for the purposes of Division 16K of the ITAA 1936.

The Dividend and Capital Components

39. The Cancellation Payment received by participating shareholders for each share cancelled under the selective capital reduction comprises two elements:

- a Dividend Component; and
- a Capital Component.

40. The amount of these components is determined in accordance with the definition of 'dividend' in subsection 6(1) of the ITAA 1936, having regard to how the company accounts for the selective capital reduction.

Franking of the Dividend Component

41. Subsection 202-40(1) provides that a distribution is a frankable distribution to the extent that it is not unfrankable under section 202-45.

42. A distribution for a company (Mesbon) is a dividend or something that is taken to be a dividend under the ITAA 1936 and ITAA 1997 (Item 1 of the table in section 960-120). In this respect, the Dividend Component will be a frankable distribution to the extent that it is not unfrankable under section 202-45.

43. Paragraph 202-45(e) states that a distribution will be unfrankable to the extent that it is sourced, directly or indirectly, from a company's share capital account.

44. In the current circumstances, as the dividend component is sourced from Mesbon's retained earnings or current year profit, it will not be directly or indirectly sourced from Mesbon's share capital account for the purposes of paragraph 202-45(e). Accordingly, the Dividend Component will be a frankable distribution for the purposes of subsection 202-40(1).

Dividend Component

Assessability of the Dividend Component for resident participating shareholders

45. Subsection 44(1) of the ITAA 1936 includes in a shareholder's assessable income any dividends, as defined in subsection 6(1) of the ITAA 1936, paid to the shareholder out of profits derived by the company from any source (if the shareholder is a resident of Australia) or from an Australian source (if the shareholder is a foreign resident of Australia).

46. The definition of 'dividend' in subsection 6(1) of the ITAA 1936 has the effect that any distribution made by the company to any of its shareholders, whether in money or property, is a dividend except where the distribution is debited against an amount standing to the credit of the share capital account of the company (paragraphs (a) and (d) of the definition).

47. 'Share capital account' is defined in subsection 975-300(1) 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.

48. Subsection 975-300(3) states that an account is taken not to be a share capital account if it is tainted. Subsection 197-50(1) states that a share capital account is tainted if an amount to which Division 197 applies, is transferred to the account and the account is not already tainted.

49. The Cancellation Payment of \$0.35 per share is a distribution made by Mesbon to its participating shareholders. \$0.2487 of the Cancellation Payment will be debited to Mesbon's untainted 'share capital account' (Capital Component). As such it will not constitute a dividend as defined in subsection 6(1) of the ITAA 1936.

50. As the remainder of the Cancellation Payment will be debited to Mesbon's retained earnings, participating shareholders will receive a dividend of \$0.1013 per share (Dividend Component) for tax purposes.

Assessability of the Dividend Component for foreign resident participating shareholders

51. Under subsection 128B(1) of the ITAA 1936, dividends derived by a foreign resident and paid by a resident company are subject to withholding tax.

52. As the Dividend Component is a frankable distribution that will be unfranked, foreign resident participating shareholders will not be subject to Australian withholding tax on the Dividend Component under section 128B of the ITAA 1936 to the extent that the distribution statement associated with the Dividend Component declares it or a part of it to be conduit foreign income pursuant to section 802-15.

Capital Component

Shares held on revenue account

53. Where the Mesbon shares are held as revenue assets by resident participating shareholders, the amount by which the Capital Component (\$0.2487 per share) exceeds the cost of each share is included in the shareholder's assessable income under section 6-5. Correspondingly, if the cost exceeds the Capital Component (\$0.2487 per share), the difference is an allowable deduction under section 8-1.

54. For Mesbon shares held by foreign resident participating shareholders, the amount of the Capital Component is included in their assessable income as it was derived by the company from an Australian source, unless a double tax treaty provides for a different treatment considering the circumstances of the foreign resident participating shareholder. (Usually such treaties substitute a different test based on whether the amount is a profit attributable to the foreign resident carrying on a business through a permanent establishment in Australia).

Shares held as trading stock

55. Where the Mesbon shares are held as trading stock by participating shareholders, the Capital Component (\$0.2487 per share) will be included in the shareholder's assessable income under section 6-5.

Capital gains tax consequences

CGT event C2 – section 104-25

56. Under paragraph 104-25(1)(a), CGT event C2 happens when an entity's ownership of an intangible CGT asset, such as a Mesbon share, ends by the asset being redeemed or cancelled.

Time of the CGT event

57. The time of CGT event C2 is when the entity enters into the contract that results in the asset ending or, if there is no contract, when the asset ends (subsection 104-25(2)).

58. The cancellation of the shares under the selective capital reduction does not happen under a contract. Accordingly, CGT event C2 happens when a Mesbon share ends by being cancelled under the selective capital reduction.

Capital proceeds

59. The capital proceeds from a CGT event are determined under Division 116.

60. Subsection 116-20(1) provides that the capital proceeds from a CGT event are the total of the money received, or entitled to be received, and the market value of any property received, or entitled to be received, in respect of the CGT event happening.

61. The capital proceeds for the cancellation of a Mesbon share are the Cancellation Payment, being \$0.35, that a participating shareholder receives or will be entitled to receive in respect of the cancellation of their Mesbon share.

62. The market value substitution rule in section 116-30 does not apply because the CGT event relates to a share in a company that has at least 300 members and is not an entity that is covered by section 116-35 (paragraph 116-30(2B)(a)).

Capital gain or loss

63. A participating shareholder makes a capital gain if the capital proceeds from the cancellation of their Mesbon share are more than the share's cost base. A participating shareholder makes a capital loss if the capital proceeds from the cancellation are less than the reduced cost base of the share (subsection 104-25(3)).

Section 118-20

64. Under subsection 118-20(1), a capital gain made from a CGT event is reduced if, because of the event, a provision of the income tax legislation outside Part 3-1 includes an amount (for any income year) in an entity's assessable income. The capital gain is reduced by the amount included, but not below zero (subsections 118-20(2) and (3)).

65. Accordingly, a capital gain made by a participating shareholder from CGT event C2 is reduced by the amount that is included in their assessable income under section 6-5 of the ITAA 1997, as ordinary income (except where the shares were held as trading stock), or under subsection 44(1) of the ITAA 1936, as a dividend.

CGT consequences for shares held as trading stock

66. A capital gain or capital loss made by an entity from a CGT asset is disregarded if, at the time of the CGT event, the asset is held as the entity's trading stock (subsection 118-25(1)).

67. Accordingly, a capital gain or capital loss made by a participating shareholder from CGT event C2 is disregarded if, at the time of the cancellation of their Mesbon share, the share is held as their trading stock.

Foreign-resident participating shareholders

68. Under subsection 855-10(1), an entity disregards a capital gain or capital loss made from a CGT event if they are a foreign resident, or the trustee of a foreign trust for CGT purposes, just before the CGT event happens in relation to a CGT asset that is not 'taxable Australian property'.

69. Section 855-15 sets out when a CGT asset is 'taxable Australian property':

Item 1	taxable Australian real property;
Item 2	an indirect Australian real property interest not covered by item 5;
Item 3	a CGT asset used at any time in carrying on a business through a permanent establishment in Australia and which is not covered by item 1, 2 or 5;
Item 4	an option or right to acquire a CGT asset covered by item 1, 2 or 3; and
Item 5	a CGT asset that is covered by subsection 104-165(3) (choosing to disregard a gain or loss on ceasing to be an Australian resident).

70. A Mesbon share is neither 'taxable Australian real property' nor an 'indirect Australian real property interest'. However, a capital gain cannot be disregarded by a foreign resident participating shareholder under subsection 855-10(1) if the Mesbon share:

- has been used at any time by the foreign resident participating shareholder in carrying on a business through a permanent establishment in Australia (item 3 of the table in section 855-15); or
- is covered by subsection 104-165(3) (item 5 of the table in section 855-15).

The anti-avoidance provisions – sections 45A and 45B

71. Sections 45A and 45B of the ITAA 1936 are anti-avoidance provisions which, if they apply, allow the Commissioner to make a determination that section 45C of the ITAA 1936 applies. The effect of such a determination is that all or part of the distribution of capital received by the shareholder under the selective capital reduction is treated as an unfranked dividend. Accordingly, the application of these two provisions to the capital reduction must be considered.

72. 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 share capital and it is reasonable to assume that the other shareholders (the disadvantaged shareholders) have received or will receive dividends.

73. Although there will have been a 'provision of capital benefit' (as defined in subsection 45A(3) of the ITAA 1936) to shareholders under the selective capital reduction, the circumstances of the selective capital reduction indicate that there will be no streaming of capital benefits to some shareholders and of dividends to other shareholders. Accordingly, section 45A of the ITAA 1936 does not apply.

74. Section 45B of the ITAA 1936 applies where certain capital payments are made to shareholders in substitution for dividends. In broad terms, 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) of the ITAA 1936);
- (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) of the ITAA 1936); 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) of the ITAA 1936).

75. In the case of the selective capital reduction, whilst the conditions of paragraphs 45B(2)(a) and 45B(2)(b) of the ITAA 1936 will have been met, the requisite purpose of enabling the participating shareholder to obtain a tax benefit – by way of capital distribution – will not be present.

76. Having regard to the relevant circumstances of the scheme, set out in subsection 45B(8) of the ITAA 1936, it is apparent that the inclusion of a capital element in the consideration for the selective capital reduction will be appropriate. Further, the Capital Component of the Cancellation Payment cannot be said to be attributable to the profits of the company, nor does the pattern of distributions indicate that it will be paid in substitution for a dividend. Accordingly, section 45B of the ITAA 1936 does not apply.

Appendix 2 – Detailed contents list

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Subject references:

- cancellation of shares
- capital reductions
- dividend streaming arrangements
- share capital
- unfranked dividends

Legislative references:

- ITAA 1936 6(1)
- ITAA 1936 44(1)
- ITAA 1936 44(1)(a)
- ITAA 1936 45A
- ITAA 1936 45A(2)
- ITAA 1936 45A(3)
- 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(8)
- ITAA 1936 45C
- ITAA 1936 128B
- ITAA 1936 128B(1)
- ITAA 1936 Pt III Div 16K
- ITAA 1936 159GZZZK(a)
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 104-25
- ITAA 1997 104-25(1)(a)
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- ITAA 1997 Div 116
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- ITAA 1997 995-1(1)
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- Corporations Act 2001

ATO references

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Income Tax ~~ Capital Gains Tax ~~ CGT events C1 to C3 – end of a CGT asset