


CR 2016/72 - Income tax: Telstra Corporation Limited - off-market share buy-back

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Class Ruling

Income tax: Telstra Corporation Limited – off-market share buy-back

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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 6(4) of the 1936
- subsection 44(1) ITAA 1936
- section 45A of the ITAA 1936
- section 45B of the ITAA 1936
- section 45C of the ITAA 1936
- section 90 of the ITAA 1936
- subsection 95(1) of the ITAA 1936
- paragraph 128B(3)(ga) of the ITAA 1936

- section 159GZZZP of the ITAA 1936
- section 159GZZZQ of the ITAA 1936
- Division 1A of former Part IIIAA of the ITAA 1936
- Former section 160APHM of the ITAA 1936
- Former section 160APHO of the ITAA 1936
- section 177EA of the ITAA 1936
- section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997)
- section 8-1 of the 1997
- Division 67 of the ITAA 1997
- section 100-25 of the 1997
- section 104-10 of the ITAA 1997
- subsection 110-55(9) of the 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 204-30 of the ITAA 1997
- section 207-20 of the ITAA 1997
- section 207-35 of the ITAA 1997
- section 207-145 of the ITAA 1997
- section 855-10 of the ITAA 1997
- section 855-15 of the ITAA 1997, and
- subsection 995-1(1) of the ITAA 1997.

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 the ordinary shareholders of Telstra Corporation Limited (Telstra) who:

- disposed of their ordinary shares in Telstra by participating in the Telstra off-market share buy-back which Telstra announced on 11 August 2016 and which is described in paragraphs 8 to 30 of this Ruling, and

- are not subject to the taxation of financial arrangements rules in Division 230 of the ITAA 1997 in relation to gains and losses on their Telstra 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.)

In this Ruling, these ordinary shareholders of Telstra are referred to as 'Participating Shareholders'.

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 8 to 30 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

7. This Ruling applies from 1 July 2016 to 30 June 2017. The Ruling continues to apply after 30 June 2017 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

8. 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.

9. Telstra is a public company listed on the Australian Securities Exchange (ASX). As at 4 May 2016, Telstra had approximately 1.37 million shareholders.

10. Telstra's ordinary shareholders are a mix of individuals, companies, trusts, partnerships and superannuation funds, some of which are non-residents.

11. The share capital of Telstra is comprised solely of fully paid ordinary shares. The audited Statement of Financial Position of Telstra as at 31 December 2015 discloses that Telstra has share capital of approximately \$5,159 million, reserves of approximately \$529 million and retained profits of approximately \$8,667 million with 12,226 million shares on issue.

12. Telstra has paid fully franked dividends to its shareholders every year since 2000.

13. On 11 August 2016, Telstra announced (First Announcement Date) its intention to undertake an off-market buy-back of its own shares (the 'Telstra Buy-Back'). Telstra proposed to purchase approximately \$1.25 billion of its ordinary shares under the buy-back, representing approximately 2.31% of its issued capital (Buy-Back Limit). Telstra was entitled to purchase a lesser number of shares at the discretion of its Board of Directors.

14. Telstra also announced its intention to conduct an on-market buy-back following completion of the Telstra Buy-Back and which is subject to market conditions. Telstra expects to repurchase approximately \$250 million of its shares under the on-market buy-back. This Ruling is not concerned with the tax implications of the on-market buy-back.

15. The Telstra Buy-Back forms part of Telstra's capital management strategy and aims to return surplus capital and retained profits from recent key disposals.

16. Telstra's most recent significant disposal was 47.4% of the total issued shares in 'Autohome' which was completed on 23 June 2016. Telstra received approximately \$2.086 billion for the disposal.

17. Telstra funded the Telstra Buy-Back from the proceeds of the Autohome disposal.

18. On 11 August 2016 Telstra obtained from ASIC an exemption under subsection 257D(4) of the *Corporations Act 2001* in order to treat the Telstra Buy-Back as an equal access buy-back and therefore shareholder approval was not required for the Telstra Buy-Back .

19. The Telstra Buy-Back was conducted through a tender process which was open to all shareholders who held their Telstra shares on 19 August 2016 (Record Date), unless:

- the shareholders were not residents of either Australia or New Zealand, or
- the shareholders were subject to a Telstra employee share scheme where shares held under the employee share scheme were subject to dealing restrictions.

20. Participation in the Telstra Buy-Back was voluntary. Eligible shareholders who did not want to participate were not required to do anything.

21. Eligible shareholders who did not participate in the Telstra Buy-Back did not receive any property, dividends or distributions as compensation for not participating.

22. The Telstra Buy-Back tender process was conducted during the period 5 September 2016 (Opening Date) to 30 September 2016 (Closing Date). Shareholders were able to lodge their tenders during this period.

23. Under the tender process, shareholders could tender to sell up to 100% of their shares at any of the prices within the Tender Range at specified discount percentages (Tender Discount) to the volume weighted average price (VWAP) of Telstra shares over the five trading days up to and including the Closing Date. The Buy-Back Price would be the lowest specified price in the tender Range which enabled Telstra to achieve the Buy-Back Limit or such lesser number of shares as the Board determined.

24. Shareholders could also tender to sell their shares at the Final Price Tender which was the price as finally determined under the tender process. Tenders at prices equal to or less than the Buy-Back Price (or Final Price Tenders) were successful. That is, all Participating Shareholders whose tender was successful were paid the Buy-Back Price even where they tendered at a price that was below the Buy-Back Price. Tenders at prices above the Buy-Back Price were not accepted.

25. However, where more shares were tendered than the Buy-Back Limit allowed, Telstra was entitled to scale back the number of shares purchased from each Participating Shareholder under the Telstra Buy-Back subject to:

- where a Participating Shareholder had a parcel of Telstra shares worth \$5,000 or less (calculated by reference to a Volume Weighted Average Price ('VWAP') of the Telstra shares on the ASX four weeks prior to the Announcement Date), or
- where a Participating Shareholder would be left with a residual parcel worth less than \$2,000, then Telstra would also purchase the balance of the parcel.

26. The Buy-Back Price was subject to two overriding limits:

- Telstra would not purchase shares under the Buy-Back at a price which resulted in a discount greater than

14% to the VWAP of Telstra shares over the five trading days up to and including the Closing Date (30 September 2016) of the Telstra Buy-Back, and

- the Buy-Back Price would not exceed the market value of a Telstra share determined in accordance with Taxation Determination TD 2004/22.

27. On 3 October 2016 Telstra announced that:

- it had successfully completed the buy-back of 282,167,516 Telstra shares, representing 2.31% of the issued capital of Telstra
- the final price for the Telstra Buy-Back was \$4.43 per share (Buy-Back Price), representing a discount of 13.95% to the VWAP of \$5.1482 of Telstra shares over the five days up to and including the Closing Date of the Telstra Buy-Back (30 September 2016)
- tenders at a 14% Tender Discount or as a Final Price Tender were successful
- tenders at a Tender Discount less than the Buy-Back Price achieved (that is, tenders at a higher price) were not accepted, and
- scale back of 84.16% applied subject to priority parcels and residual parcels which were bought back in the manner described at paragraph 26 above.

28. All shares bought back under the Telstra Buy-Back were cancelled.

29. Under the Telstra Buy-Back, \$1.78 per share was debited to Telstra's untainted share capital account, and the balance of the Buy-Back Price was debited to Telstra's retained profits.

30. Telstra shares were not indirect Australian real property interests (as defined in section 855-25 of the ITAA 1997) at the time of the Telstra Buy-Back.

Ruling

Off Market Purchase

31. The Telstra Buy-Back is an off-market purchase within the meaning given by paragraph 159GZZZK(d).

The Dividend Component

32. Participating Shareholders are taken to have been paid a dividend of \$2.65 (the Dividend Component) for each Telstra share disposed of in the Telstra Buy-Back under section 159GZZZP.

33. The Dividend Component is a frankable distribution pursuant to section 202-40 of the ITAA 1997, and is capable of being franked in accordance with section 202-5 of the ITAA 1997.

34. The difference between the Buy-Back Price and the Dividend Component is not a dividend for income tax purposes (subsection 159GZZZP(2)).

Assessability of the Dividend Component and tax offset

Direct distributions

35. The Dividend Component of \$2.65 and an amount equal to the franking credit on the Dividend Component is included in the assessable income of a resident individual, superannuation fund and company Participating Shareholders under subsection 44(1), and under subsection 207-20(1) of the ITAA 1997, respectively in the income year in which the Buy-Back happened.

36. Participating Shareholders will be entitled to a tax offset under subsection 207-20(2) of the ITAA 1997 equal to the amount of the franking credit on the Dividend Component, subject to being a 'qualified person'.

Indirect distributions

Partnerships

37. The Dividend Component of \$2.65 and an amount equal to the franking credit on the Dividend Component is included in the assessable income of a partnership that participates in the Buy-Back for the purposes of working out the net income of the partnership under section 90.

Trusts

38. The Dividend Component of \$2.65 and an amount equal to the franking credit on the Dividend Component is included in the assessable income of a trustee for the purposes of working out the net income of the trust under subsection 95(1).

Partners and Beneficiaries

39. Subsections 207-35(3) to (6) of the ITAA 1997 set out the circumstances in which a partner or beneficiary to whom a franked distribution flows indirectly is required to gross up their assessable income for their share of the franking credit on the franked distribution. Where the franked distribution flows indirectly (within the meaning of Subdivision 207-B of the ITAA 1997) through a trust or partnership to a resident that is an individual, a corporate tax entity (at the time the distribution flows indirectly to it) or a trustee mentioned in paragraphs 207-45(c), (ca) or (d) of the ITAA 1997, the entity will, subject to the qualified person rule, be entitled to a tax offset equal to the entity's share of the franking credit on the franked distribution (section 207-45 of the ITAA 1997).

Refundable tax offset

40. The tax offsets are subject to the refundable tax offset rules in Division 67 of the ITAA 1997. Certain trustees and corporate tax entities are not entitled to the refundable tax offset rules because of subsections 67-25 (1A) to 67-25(1D) of the ITAA 1997.

Non-resident Participating Shareholders

41. As the Dividend Component is fully franked, non-resident Participating Shareholders are not liable for Australian withholding tax on the Dividend Component (paragraph 128B(3)(ga)).

Sale Consideration

42. Participating Shareholders are taken to have received \$2.70 per Telstra share as consideration in respect of each share disposed of under the Telstra Buy-Back (Sale Consideration) on 3 October 2016 in accordance with section 159GZZZQ, unless the Participating Shareholder is a corporate tax entity to which subsections 159GZZZQ(8) and 159GZZZQ(9) apply.

43. Taxation Determination TD 2004/22 outlines how to determine what would have been the market value of the share at the time of an off-market share buy-back if the buy-back did not occur and was never proposed to occur. Where the Buy-Back Price for each share purchased by Telstra under the Telstra Buy-Back was less than what would have been the market value of the share if the Telstra Buy-Back did not occur and was never proposed to occur, then subsection 159GZZZQ(2) applies to the Telstra Buy-Back as outlined in TD 2004/22.

44. The effect of the rule is that the difference between the Buy-Back Price and the market value, determined for the purposes of subsection 159GZZZQ(2) as outlined in TD 2004/22, will be included in the consideration received for the disposal of the share for ordinary income or capital gains tax (CGT) purposes, in addition to the capital amount of \$1.78 per share debited to the share capital account (Capital Component). Accordingly, the Sale Consideration is \$2.70.

Capital gains tax (CGT)

45. The Telstra shares are taken to have been disposed of for CGT purposes on 3 October 2016 pursuant to section 104-10 of the ITAA 1997 (CGT event A1).

46. The Sale Consideration of \$2.70 per Telstra share represents the capital proceeds for CGT purposes pursuant to section 116-20 of the ITAA 1997, unless the Participating Shareholder is a corporate tax entity to which subsections 159GZZZQ(8) and (9) apply.

47. A Participating Shareholder (other than a partnership) will make a capital gain on the Telstra share if the Sale Consideration per share exceeds the cost base of that share. The capital gain is the amount of the excess. Similarly, a Participating Shareholder (other than a partnership) will make a capital loss on a share if the Sale Consideration per share is less than the reduced cost base of the share. The capital loss is the amount of the difference (subsection 104-10(4) of the ITAA 1997).

48. Each partner in a partnership has a separate cost base and reduced cost base for the partner's interest in each Telstra share sold into the Telstra Buy-Back by the partnership (subsection 106-5(2) of the ITAA 1997). Each partner is allocated an appropriate share of the Sale Consideration received by the partnership for the disposal of Telstra shares into the Telstra Buy-Back.

Shares held as trading stock

49. Where shares were held as trading stock (as defined in subsection 995-1(1) of the ITAA 1997), the Sale Consideration of \$2.70 per share is included in assessable income pursuant to section 6-5 of the ITAA 1997, unless the Participating Shareholder is a corporate tax entity to which subsections 159GZZZQ(8) and (9) apply.

50. Any capital gain or capital loss made will be disregarded if at the time of the CGT event the shares were held as trading stock (section 118-25 of the ITAA 1997).

Shares held as revenue assets

51. Where shares were held as revenue assets (as defined in section 977-50 of the ITAA 1997), but were not trading stock, the amount by which the Sale Consideration of \$2.70 per share exceeds the cost of each share is included in the Participating Shareholder's assessable income pursuant to section 6-5 of the ITAA 1997. Similarly, the amount by which the cost of each share exceeds the Sale Consideration of \$2.70 per share is an allowable deduction pursuant to section 8-1 of the ITAA 1997.

52. Any capital gain made by a Participating Shareholder that held shares on revenue account but not as trading stock will be reduced by the amount otherwise included in assessable income (section 118-20 of the ITAA 1997). The reduced cost base for the corresponding CGT outcome is reduced by the amount of the allowable deduction (subsection 110-55(9) of the ITAA 1997).

Non-resident Participating Shareholders: CGT consequences

53. Any capital gain or capital loss made by Participating Shareholders that are foreign residents is disregarded if the shares disposed of under the Buy-Back were not taxable Australian property (section 855-10 of the ITAA 1997).

Qualified persons

54. For the purposes of paragraph 207-145(1)(a) of the ITAA 1997 which refers to Division 1A of former Part IIIAA, Participating Shareholders will satisfy the holding period rule under former section 160APHO, and therefore be qualified persons (as long as the related payments rule is also met) in relation to the Dividend Component received under the Telstra Buy-Back, if:

- the shares sold into the Telstra Buy-Back were acquired before 18 August 2016, and
- during the period when the Telstra shares were held the Participating Shareholders had sufficient risks of loss or opportunities for gain in respect of the shares (as defined in former section 160APHM) for a continuous period of at least 45 days. Neither the announcement of the Telstra Buy-Back, the making of an invitation to shareholders to offer to sell their Telstra shares nor the making of an offer by a shareholder to Telstra in respect of a Telstra share will affect whether the shares disposed of under the Telstra Buy-Back were held 'at risk' for the purposes of Division 1A of former Part IIIAA.

55. The 'last-in first-out' rule in former subsection 160APHI(4) has no effect for the purposes of the Telstra Buy-Back in respect of Telstra shares acquired on or after 18 August 2016 (the Ex-entitlement Date) which did not confer an entitlement to participate in the Telstra Buy-Back.

The anti-avoidance provisions

56. The Commissioner will not make a determination under subsection 45A(2) or 45B(3) that section 45C applies to the whole, or any part, of the Capital Component of the Buy-Back Price received by Participating Shareholders.

57. The Commissioner will not make a determination under paragraph 177EA(5)(b) to deny the whole, or any part, of the imputation benefits received by Participating Shareholders in relation to the Dividend Component of the Buy-Back Price.

58. The Commissioner will not make a determination under paragraph 204-30(3)(c) of the ITAA 1997 to deny the whole, or any part, of the imputation benefits received by Participating Shareholders in relation to the Dividend Component of the Buy-Back Price.

Commissioner of Taxation

12 October 2016

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.*

Off-market purchase

59. For the purposes of Division 16K, where a company buys a share in itself from a shareholder the purchase is a 'buy-back' (paragraph 159GZZZK(a)).

60. Division 16K categorises a buy-back as either an 'on-market purchase' or an 'off-market purchase'.

61. A buy-back is an on-market purchase if the share bought back is listed for quotation in the official list of a stock exchange in Australia or elsewhere, and the buy-back is made in the ordinary course of trading on that stock exchange (paragraph 159GZZZK(c)). A buy-back that is not an on-market purchase is an off-market purchase (paragraph 159GZZZK(d)).

62. Although Telstra's ordinary shares are listed for quotation in the official list of the ASX, the Telstra Buy-Back was not made in the ordinary course of trading on the ASX. As a result, for the purposes of Division 16K, the Telstra Buy-Back is an off-market purchase within the meaning given by paragraph 159GZZZK(d).

The Dividend and Capital Components

63. The Buy-Back Price received by Participating Shareholders comprises two components:

- a Dividend Component, and
- a Capital Component.

64. The amount of each of these components is determined in accordance with sections 159GZZZP and 159GZZZQ, having regard to how Telstra accounted for the Telstra Buy-Back.

The Dividend Component

65. Section 159GZZZP provides that where the buy-back of a share is an off-market purchase, the difference between the purchase price and the part (if any) of the purchase price which is debited against amounts standing to the credit of the company's share capital account is taken to be a dividend paid by the company to the seller on 3 October 2016 being the day the buy-back occurs.

66. The Buy-Back Price was \$4.43 per share, of which \$1.78 per share was debited against amounts standing to the credit of Telstra's share capital account (Capital Component). As a result, the Dividend Component is taken to be \$2.65 per share.

67. The Dividend Component of \$2.65 per share is frankable, but only to the extent that the Buy-Back Price does not exceed the market value of a Telstra share at the time of the Telstra Buy-Back where the market value is worked out as if the buy-back did not occur and was never proposed to occur (paragraph 202-45(c) of the ITAA 1997).

68. Taxation Determination TD 2004/22 sets out the Commissioner's view as to how to determine what would have been the market value of a share at the time of an off-market buy-back if it did not occur and was never proposed to occur. For the Telstra Buy-Back, the Buy-Back Price per share did not exceed the market value determined in accordance with TD 2004/22. As a result, all of the Dividend Component which formed part of the Buy-Back Price is frankable.

Assessability of the Dividend Component and tax offset

Direct distributions

69. For Participating Shareholders who are Australian residents (other than a partnership or a trust) and who directly received the Dividend Component:

- the Dividend Component is included in the assessable income of each Participating Shareholder under subsection 44(1), and
- subject to the 'qualified person' rule, the amount of the franking credit on the Dividend Component is included in the assessable income of each Participating Shareholder under subsection 207-20(1) of the ITAA 1997.

70. Subject to the 'qualified person' rule, Participating Shareholders are entitled to a tax offset under subsection 207-20(2) of the ITAA 1997 equal to the amount of the franking credit on the Dividend Component.

Indirect distributions

Partnerships

71. Pursuant to subsection 44(1), the Dividend Component is included in the assessable income of the partnership for the purposes of working out the net income of the partnership under section 90.

72. Subject to the 'qualified person' rule, pursuant to subsection 207-35(1) of the ITAA 1997, the amount of the franking credit on the Dividend Component is included in the assessable income of the partnership for the purposes of working out the net income of the partnership under section 90.

Trusts

73. Pursuant to subsection 44(1), the Dividend Component is included in the assessable income of the trustee for the purposes of working out the net income of the trust under subsection 95(1).

74. Subject to the 'qualified person' rule, pursuant to subsection 207-35(1) of the ITAA 1997, the amount of the franking credit on the Dividend Component is included in the assessable income of the trustee for the purposes of working out the net income of the trust under subsection 95(1).

Partners and Beneficiaries

75. Subsections 207-35(3) to (6) of the ITAA 1997 set out the circumstances in which a partner or beneficiary to whom a franked distribution flows indirectly is required to gross up their assessable income for their share of the franking credit on the franked distribution.

76. Where the franked distribution flows indirectly (within the meaning of Subdivision 207-B of the ITAA 1997) through a trust or partnership to a resident that is an individual, a corporate tax entity (at the time the distribution flows indirectly to it) or a trustee mentioned in paragraphs 207-45(c), (ca) or (d) of the ITAA 1997, the resident entity will, subject to the qualified person rule, be entitled to a tax offset equal to the entity's share of the franking credit on the franked distribution (section 207-45 of the ITAA 1997).

Refundable tax offset

77. The tax offsets (franking credits) are subject to the refundable tax offset rules in Division 67 of the ITAA 1997, provided the Participating Shareholders are not excluded by subsections 67-25(1A) to 67-25(1DA) of the ITAA 1997.

Non-resident Participating Shareholders

78. As the Dividend Component of the Buy-Back Price is fully franked, and no determination will be made in respect of the Dividend Component under either paragraph 204-30(3)(c) of the ITAA 1997 or paragraph 177EA(5)(b), a non-resident Participating Shareholder is not liable to Australian withholding tax on the Dividend Component (paragraph 128B(3)(ga)).

The Capital Component***Calculation of Sale Consideration***

79. For the purposes of determining the amount of a gain or loss for Telstra shares held on capital account or revenue account (whether or not the shares were held as trading stock), the consideration received by a Participating Shareholder in respect of the disposal of a Telstra share (the Sale Consideration) under the Telstra Buy-Back is determined in accordance with section 159GZZZQ. The effect of section 159GZZZQ is to adjust the Capital Component in order to determine the Sale Consideration for CGT or revenue account treatment.

80. Subsection 159GZZZQ(1) provides that a Participating Shareholder is taken to have received an amount equal to the purchase price (in this case the Buy-Back Price of \$4.43 received for each Telstra share bought back) as consideration in respect of the sale of the share bought back. However, this amount is subject to certain adjustments in order to arrive at the Sale Consideration.

81. Subsection 159GZZZQ(2) is one of the adjusting provisions. It provides that if the purchase price is less than the market value of the share at the time of the buy-back (calculated as if the buy-back did not occur and was never proposed to occur) the Participating Shareholder is taken to have received an amount equal to the market value of the share as consideration in respect of the sale of the share disposed of in the buy-back.

82. For the purposes of determining the application of subsection 159GZZZQ(2) the following methodology was proposed by Telstra and accepted by the Commissioner in accordance with TD 2004/22: The market value of a Telstra share is the VWAP of a Telstra Share over the last five trading days before the first announcement date of the Telstra Buy-Back, adjusted for the movement in the S&P/ASX 200 Index from the commencement of trading on the First Announcement Date (11 August 2016) to when trading ceased on the date the buy-back closed (30 September 2016).

83. Under this methodology, the market value of a Telstra share was calculated as \$5.35. As a result, Participating Shareholders are taken to have received \$5.35 for the sale of each Telstra share rather than \$4.43.

84. Pursuant to subsection 159GZZZQ(3), the deemed consideration of \$5.35 is reduced by a 'Reduction Amount'. The Reduction Amount is an amount calculated under subsection 159GZZZQ(4). In the circumstances of the Telstra Buy-Back, the Reduction Amount is equivalent to the Dividend Component (\$2.65), unless a Participating Shareholder is a corporate tax entity to which subsection 159GZZZQ(8) applies (see paragraph 86). As a result, the Sale Consideration for each Telstra share disposed of under the Telstra Buy-Back is \$2.70 (being \$5.35 less \$2.65).

85. However, where a Participating Shareholder is a corporate tax entity which is entitled to a tax offset under Division 207 of the ITAA 1997 in respect of the Dividend Component, an adjustment may be made to the Sale Consideration. Under subsection 159GZZZQ(8), if such a Participating Shareholder would also make either a capital loss or a deductible loss (or would increase such a loss) in respect of the disposal of a Telstra Share in the Telstra Buy-Back, the Reduction Amount (that is the Dividend Component) is itself reduced by so much of the off-settable amount, which is determined under subsection 159GZZZQ(9), that does not exceed the capital loss or the deductible loss.

86. The effect for a Participating Shareholder that is a corporate tax entity is a capital loss or a deductible loss is reduced to the extent of the Dividend Component.

Capital gains tax (CGT)

87. Participating Shareholders are taken to have disposed of their Telstra shares under the Telstra Buy-Back on 3 October 2016 (CGT event A1).

88. The Sale Consideration of \$2.70 per share represents the capital proceeds for CGT purposes see note 3 following subsection 116-20(1) of the ITAA 1997. The Sale Consideration may be adjusted where the Participating Shareholder is a corporate entity (see paragraph 86 above).

89. A Participating Shareholder (other than a partnership) will make a capital gain in respect of the disposal of a share if the Sale Consideration per Telstra Share exceeds the cost base of the share. The capital gain is the amount of the excess. Similarly, a Participating Shareholder (other than a partnership) will make a capital loss in respect of the disposal of a share if the Sale Consideration per share is less than the reduced cost base of the share (subsection 104-10(4) of the ITAA 1997).

90. Each partner in a partnership has a separate cost base and reduced cost base for the partner's interest in each Telstra share sold into the Telstra Buy-Back by the partnership (subsection 106-5(2) of the ITAA 1997). Each partner is allocated an appropriate share of the Sale Consideration received by the partnership for the disposal of Telstra shares into the Telstra Buy-Back.

91. While all Participating Shareholders are subject to CGT, any capital gain or capital loss made will be adjusted if they held their Telstra shares as trading stock, or as revenue assets that are not trading stock, as discussed in paragraphs 92 to 95 of this Explanation.

Shares held as trading stock

92. Where Telstra shares were held as trading stock (as defined in subsection 995-1(1) of the ITAA 1997), Participating Shareholders include the Sale Consideration of \$2.70 per share in assessable income under section 6-5 of the ITAA 1997. The Sale Consideration may be adjusted where the Participating Shareholder is a corporate tax entity (see paragraph 86 above). Any capital gain or capital loss is disregarded at the time of the CGT event where the Telstra shares were held as Trading Stock (section 118-25 of the ITAA 1997). This CGT exemption extends to partners in a partnership (paragraph 118-25(1)(b) of the ITAA 1997) and beneficiaries of a trust (paragraph 118-25(1)(c) of the ITAA 1997).

Shares held as revenue assets

93. Where Telstra shares were held as revenue assets (as defined in section 977-50 of the ITAA 1997), but were not trading stock, the amount by which the Sale Consideration of \$2.70 per share exceeds the cost of each share is included in the Participating Shareholder's assessable income pursuant to section 6-5 of the ITAA 1997.

94. Similarly the amount by which the cost of each share exceeds the Sale Consideration of \$2.70 per share is an allowable deduction pursuant to section 8-1 of the ITAA 1997. The Sale Consideration may be adjusted where the Participating Shareholder is a corporate tax entity see paragraph 86 above).

95. Any capital gain made because of the CGT event will be reduced by the amount otherwise included in assessable income (section 118-20 of the ITAA 1997). The reduced cost base for the corresponding CGT outcome is reduced by the amount of the allowable deduction (subsection 110-55(9) of the ITAA 1997). There are similar CGT adjustments for partners in partnerships (paragraph 118-20(1)(b), paragraph 118-20(2)(b) and subsection 118-20(3) of the ITAA 1997).

Non-resident Participating Shareholders: CGT consequences

96. As set out in the scheme, the Telstra Shares were not indirect Australian real property interests at the time of the Telstra Buy-Back (as defined in section 855-25 of the ITAA 1997).

97. A non-resident shareholder that participates in the Telstra Buy-Back disregards any capital gain or capital loss made in respect of a Telstra Share disposed of in the Telstra Buy-Back if the Share is not 'taxable Australian property' under the tests in section 855-10 of the ITAA 1997. Noting the shares were not indirect Australian real property interests, a non-resident Participating Shareholder in the Telstra Buy-Back is subject to Australian CGT if the share:

- was used by the non-resident in carrying on a business through a permanent establishment in Australia (item 3 of the table in section 855-15 of the ITAA 1997), or
- is a CGT asset that is covered by subsection 104-165(3) of the ITAA 1997 (choosing to disregard a gain or loss on ceasing to be an Australian resident – item 5 of the table in section 855-15 of the ITAA 1997).

Qualified persons

98. Paragraph 207-145(1)(a) of the ITAA 1997 provides that for a franked dividend made by an entity, only a 'qualified person' in relation to the distribution for the purposes of former Division 1A of Part IIIAA is required to include the franking credit in its assessable income or is entitled to a franking credit or a tax offset. Broadly speaking, to be a qualified person in relation to the Dividend Component paid under the Telstra Buy-Back, the Participating Shareholder must satisfy both the 'holding period rule' and the 'related payments rule'.

99. Broadly, a Participating Shareholder will not satisfy the related payments rule if the Participating Shareholder, or an associate of the Participating Shareholder, makes, or is under an obligation to make, a payment in respect of the dividend which effectively passes on the benefit of the dividend to another person.

100. The holding period rule requires a Participating Shareholder to hold the Telstra shares, or an interest in the shares, on which the dividend is paid 'at risk' for a continuous period of at least 45 days. In determining whether a Participating Shareholder has satisfied the holding period rule, any days during which there are materially diminished risks in relation to the Telstra shares are not counted. The day of acquisition and the day of disposal of the relevant shares are also not counted.

101. Under former subsection 160APHM(2), a Participating Shareholder is taken to have materially diminished the risks of loss and opportunities for gain with respect to the Telstra shares if the 'net position' of the Participating Shareholder results in the Participating Shareholder having less than 30% of the risks and opportunities relating to the shares or interest in the shares.

102. The Commissioner does not regard the announcement of the Telstra Buy-Back as affecting whether Telstra shares, or an interest in the Telstra Shares, were held at risk or not.

103. A Participating Shareholder who acquired Telstra shares before 18 August 2016 satisfies the holding period rule as long as those shares were held at risk for at least 45 continuous days.

104. A Participating Shareholder who acquired Telstra shares on or after 18 August 2016 was not entitled to tender those shares in the Telstra Buy-Back. That is, a Participating Shareholder was entitled to tender only Telstra shares they acquired before 18 August 2016.

105. Generally, under the holding period rule a Participating Shareholder will be deemed to have disposed of his or her most recently acquired shares first (former subsection 160APHI(4)). The 45 day rule operates on a 'last-in first-out' basis. The 'last-in first-out' rule in former subsection 160APHI(4) has no effect for the purposes of the Buy-Back for Telstra shares acquired on or after 18 August 2016 which did not confer an entitlement to participate in the Buy-Back.

The anti-avoidance provisions

Sections 45A and 45B

106. Sections 45A and 45B are two anti-avoidance provisions, which if they apply, allow the Commissioner to make a determination that section 45C applies. The effect of such a determination is that all or part of the distribution of capital received by a Participating Shareholder under the Telstra Buy-Back is treated as an unfranked dividend.

107. Section 45A 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.

108. Although a 'capital benefit' (as defined in paragraph 45A(3)(b)) is provided to Participating Shareholders under the Telstra Buy-Back, the circumstances of the Telstra Buy-Back indicate that there is no streaming of capital benefits to some shareholders and dividends to other shareholders. The Buy-Back is also open to all eligible Telstra Shareholders. Accordingly, section 45A will not apply to the Telstra Buy-Back.

109. Section 45B applies where certain capital payments are paid to shareholders in substitution for dividends. In broad terms, there needs to be a scheme in which, having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into the scheme or carried out the scheme or any part of the scheme for the provision of capital benefits did so for a purpose, other than an incidental purpose, of enabling the relevant taxpayer to obtain a tax benefit.

110. While the conditions of paragraphs 45B(2)(a) and (b) were met in respect of the Telstra Buy-Back, the requisite purpose of enabling a Participating Shareholder to obtain a tax benefit - by way of a dividend disguised as a capital distribution - was not present.

111. Having regard to the 'relevant circumstances' of the scheme (the Telstra Buy-Back), as set out in subsection 45B(8):

- the Capital Component of the Buy-Back Price is acceptable in Telstra's circumstances
- the pattern of distributions of Telstra does not indicate that the Capital Component was paid in substitution for a dividend
- the Telstra Buy-Back is not expected to alter Telstra's dividend policy, and
- as a consequence of the Telstra Buy-Back, the distribution of share capital resulted in a reduction in ordinary shares in Telstra held by Participating Shareholders.

112. Accordingly, the Commissioner will not make a determination under subsection 45B(3) that section 45C applies to treat all or part of the Capital Component of the Buy-Back Price as an unfranked dividend paid by Telstra.

Section 177EA

113. Section 177EA is a general anti-avoidance provision that operates to prevent franking credit trading.

114. The conditions of paragraphs 177EA(3)(a) to (d) are satisfied as the Buy-Back is a scheme involving the disposal of Telstra shares in which there is a franked distribution and franking credits were received by eligible Shareholders who participated in the Telstra Buy-Back.

115. For section 177EA to apply, the requirements of paragraph 177EA(3)(e) must also be satisfied. In broad terms, paragraph 177EA(3)(e) requires that, in considering the relevant circumstances of the scheme, it would be concluded that a person, or one of the persons, who entered into or carried out the scheme, did so for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain an imputation benefit.

116. Accordingly, the issue is whether, having regard to the relevant circumstances of the scheme, it would be concluded that, on the part of Telstra, its Shareholders or any other relevant party, there is a more-than-incidental purpose of conferring an imputation benefit under the scheme. Under the Telstra Buy-Back, the relevant taxpayer is the Participating Shareholder and the scheme comprises the circumstances surrounding the Telstra Buy-Back.

117. In arriving at a conclusion the Commissioner must have regard to the relevant circumstances of the scheme which include, but are not limited to, the circumstances set out in subsection 177EA(17). The relevant circumstances listed in the subsection encompass a range of circumstances which, taken individually or collectively, could indicate the requisite purpose. Due to the diverse nature of these circumstances some may not be present at any one time in any one scheme.

118. The Commissioner has come to the view that section 177EA applies to the Telstra Buy-Back having regard to all the relevant circumstances of the Telstra Buy-Back as outlined in subsection 177EA(17). Among the circumstances of the Telstra Buy-Back reflected in the subsection, paragraph 177EA(17)(b) which is concerned with the greater attraction of the Telstra Buy-Back to resident shareholders who could fully use the franking credits rather than to non-resident shareholders is relevant.

119. Where section 177EA applies, the Commissioner has a discretion pursuant to subsection 177EA(5) to make a determination to debit the company's franking account pursuant to paragraph 177EA(5)(a), or deny the imputation benefit to Participating Shareholders pursuant to paragraph 177EA(5)(b).

120. The Commissioner will exercise his discretion in such a way that he will not make a determination that denies the imputation benefits obtained by Participating Shareholders under the Telstra Buy-Back pursuant to paragraph 177EA(5)(b).

Section 204-30

121. Section 204-30 of the ITAA 1997 applies where a corporate tax entity streams the payment of dividends to its members in such a way that certain shareholders, referred to as favoured members, obtain imputation benefits, and other shareholders, referred to as disadvantaged members, obtain lesser or no imputation benefits, whether or not they receive other benefits. The favoured members are those that derive a greater benefit from imputation benefits than disadvantaged members.

122. For section 204-30 of the ITAA 1997 to apply, Participating Shareholders must be those who derive a greater benefit from franking credits than other shareholders who do not participate in the Telstra Buy-Back and are disadvantaged members. Some of the circumstances when a member of an entity 'derives a greater benefit from franking credits' than another member are listed in subsection 204-30(8) of the ITAA 1997 by reference to the ability of a member to fully use franking credits or otherwise.

123. The conditions for the application of section 204-30 set out in subsection 204-30(1) of the ITAA 1997 may be present in the Telstra Buy-Back to the extent any non-resident shareholders do not participate. However, the Commissioner will not make a determination under subsection 204-30(3) of the ITAA 1997.

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Income tax ~~ Capital management ~~ Share buy back
International issues ~~ Non-resident Australian income ~~
Other

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