IT 2656 - Income tax : deductibility of takeover defence costs

There is an Addendum notice for this document.

TAXATION RULING IT 2656

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I 1012895	**ALLOWABLE DEDUCTIONS** **DEFENCE COSTS AGAINST TAKEOVER** **TAKEOVER DEFENCE COSTS**	**51(1)**

OTHER RULINGS ON THIS TOPIC:

TITLE: INCOME TAX: DEDUCTIBILITY OF TAKEOVER DEFENCE COSTS

NOTE:
- Income Tax Rulings do not have the force of law.
- Each decision made by the Australian Taxation Office is made on the merits of each individual case having regard to any relevant Ruling.

PREAMBLE

The purpose of this Ruling is to consider under subsection 51(1) of the Income Tax Assessment Act 1936 ("the Act") the deductibility of takeover defence costs, including costs incurred in preparing and serving Part B and Part D statements required by the Companies (Acquisition of Shares) Act 1980 and Codes (i.e. the takeovers code).

2. In recent years there has been a great deal of takeover activity in the Australian corporate community. Substantial costs have been incurred by target companies in defending themselves against takeover attempts particularly where, in the opinion of their directors, the proposed takeover would be against the interests of the shareholders.

3. Typically, the takeover defence costs include, but are not limited to:

- legal and accounting costs;
- stockbrokers' fees;
- consultancy fees e.g., public relations, merchant bankers and media;
- printing, advertising and mailing of documents produced for shareholders; and

. costs of independent evaluations of the takeover offer.
. the salary or wages of individuals employed specifically to undertake takeover defence activities or the salary or wages of ordinary employees who during the period of the takeover are employed full time on defence activities.

Many of these costs are incurred in issuing a Part B statement or a Part D statement.

4. The takeovers code is concerned with takeovers by way of share acquisitions and not by the purchase of a company's assets. It regulates acquisitions of shares of companies either by persons not previously entitled to more than 20% of the voting shares who would, immediately after the acquisition, become so entitled or by persons who already hold between 20% and 90% of the shares of those companies. In essence, such acquisitions are prohibited under the code unless one of the following permitted methods of acquisition is used :

- a gradual acquisition of shares at the rate of 3% every 6 months;
- a formal takeover offer to all shareholders under a takeover scheme;
- an unconditional offer for 1 month is announced on the floor of a stock exchange.

5. The offeror under a takeover scheme must register and serve on the target company a statement that complies with Part A of the Schedule to the takeovers code. A target company receiving a Part A statement is required by section 22 of the code to give to the offeror a statement that complies with Part B of the Schedule.

6. Similarly, in the case of a takeover announcement, it must be accompanied by a Part C statement that complies with Part C of the Schedule of the takeovers code and the target company is required by section 32 of the code to serve on its home stock exchange a Part D statement that complies with Part D of the Schedule.

7. In addition to costs incurred by a target company in preparing and serving Part B and Part D statements, other takeover defence costs may be incurred by the company. The company might incur costs in adopting other defence tactics such as seeking political intervention, litigating to frustrate an unwelcome takeover bid or seeking to acquire control of the offeror.

8. Subsection 51(1) of the Act provides that:

"All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or

are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income."

RULING

9. The fundamental questions to be decided in considering the deductibility of takeover defence costs under subsection 51(1) of the Act are:

(i) whether the costs are within the scope of the subsection and deductible because they are either :

(a) incurred in gaining or producing the target company's assessable income; or

(b) necessarily incurred in carrying on a business for the purposes of gaining or producing such income; and

(ii) whether the costs are excluded from the scope of the subsection and not deductible because they are losses or outgoings of capital, or of a capital, private or domestic nature.

General Principles

10. The High Court of Australia in Ronpibon Tin N.L. v. F.C. of T. (1949) 78 CLR 47 at 56-57; 8 ATD 431 at 435-436 said that for expenditure to constitute an allowable deduction under subsection 51(1) of the Act as an outgoing incurred in gaining or producing assessable income it must be relevant and incidental to that end. To come within the initial part of subsection 51(1) it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income.

11. This judicial pronouncement emphasises the relationship or connection which must exist between the relevant loss or outgoing and the derivation of assessable income from income producing activities of the taxpayer (F.C. of T. v. Smith (1981) 147 CLR 578 at 586; 81 ATC 4114 at 4117; 11 ATR 538 at 542). It directs attention to the nature or character of the loss or outgoing.

Deductions under the First Limb of Subsection 51(1)

12. In the view of this Office, there is no sufficient connection between takeover defence costs incurred by a target

company and the derivation of assessable income from its income producing activities to be deductible under the first limb of subsection 51(1). The costs are not incidental or relevant to the operations or activities regularly carried on by the target company for the production of its assessable income. Nor could it be said that the occasion of these costs may be found in the activities of the target company which produce its assessable income. Examples of this type of expenditure would include costs incurred to solicit an alternative, more favourable, takeover bid and costs incurred to maintain an appropriate capital structure or to revalue assets to reduce vulnerability to takeover. These costs are not deductible under the first limb of subsection 51(1). Costs which may otherwise appear to be normal incidents of business would not be deductible if expended for the purpose of defending against a takeover. This would include advertising costs to renew market confidence and defend reputations.

13. Expenses on such things as Part B and D statements are incurred by companies in order to discharge the duties imposed by the Companies Code. It cannot be said that this expenditure is relevant or incidental to the gaining or producing of assessable income. The expenditure is directed to duly informing the shareholders of the true worth of their shares and the adequacy of the offer to acquire their capital interest in the company (F.C. of T. v. The Swan Brewery Co. Ltd.91 ATC 4637 at 4644; (1991) 22 ATR 295 at 303).

Deductions under the Second Limb of Subsection 51(1)

14. To constitute an allowable deduction under the second limb of subsection 51(1)of the Act an outgoing must be necessarily incurred in carrying on a business for the purposes of gaining or producing assessable income. The High Court in John Fairfax & Sons Pty Ltd v. F.C. of T. (1959) 101 CLR 30 at 48; 11 ATD 510 at 519 said that an outlay must be part of the cost of trading operations to produce income i.e., it must have the character of a working expense.

15. As recognised by Professor R.W. Parsons, Income Taxation in Australia, at p 313, para. 5.33, whether the applicability of the first limb or the second limb of subsection 51(1) of the Act is in question, the inquiry must be concerned with the connection between the expense and the particular process of derivation of income.

16. If a company incurs expenditure in defending an unwelcome takeover attempt to ensure that the rights of the company and its shareholders are not compromised (e.g. by ensuring that the shareholders are fully informed and obtain a fair and reasonable price for their shares), it does not incur an outgoing in carrying

on the company's business. The expenditure may relate to the company's business and its assets and to the interests of its shareholders in the share capital of the company, but it owes nothing to the conduct of the company's business (compare Swan Brewery 91 ATC at 4644; 22 ATR at 303). Similarly, costs incurred in preparing Part B and Part D statements which recommend acceptance of takeovers are not deductible. Such costs are not incurred in the carrying on of the company's business. They are again concerned with the ownership of the shares in the company. Insufficient connection exists between the expenditure and the carrying on of the company's business to accept that the costs have the character of a working expense of the business or form part of the cost of the company's trading operations to produce income (Swan Brewery 91 ATC at 4644; 22 ATR at 303).

17. The Full Court of the Federal Court of Australia, in the course of their decision in Swan Brewery (91 ATC at 4644; 22 ATR at 303-4) made an observation to the effect that there may be some situations in which takeover defence costs would be deductible. They gave as an example the situation where the directors of a trading company may perceive a takeover as carrying an inherent threat to the continuation of the company's business and impairment of its income-earning activities, e.g. where the takeover can only lead to a reduction of circulating capital applied in the business and curtailment of the ability of the company's business to gain or produce assessable income. The court said that, in such a case, it may be argued that the costs in defending against a takeover are deductible (although they never finally determined the question) because the expenses would be aimed at maintaining the business activities of the company in the best interests of the shareholders and of the company and not simply directed at discharging the statutory duty of the directors to the shareholders. The Court cited the House of Lords decision in Morgan (Inspector of Taxes) v. Tate & Lyle Ltd [1955] AC 21 as supporting this view.

18. However, it is questionable whether any reliance may be placed in Australia on the decision in Tate & Lyle. In F.C. of T. v. Snowden & Willson Pty. Ltd. (1958) 99 CLR 431, Taylor and Webb JJ (although in the minority, they were the only judges to directly consider Tate & Lyle) cast considerable doubt on applicability of Tate & Lyle in Australia. Taylor J (see 99 CLR at 451) put the case of Tate & Lyle aside, saying that it "is of no assistance in applying the provisions of s 51(1)". While Webb J. pointed out the considerable difference between the relevant Australian and United Kingdom legislation (see 99 CLR at 440). A similar conclusion was reached by Menzies J in John Fairfax & Sons Pty. Ltd. v. F. C. of T. (1958-1959) 101 CLR 30 at 51, where his Honour stated that due to the differences in the legislation the fact that the decision in Tate & Lyle would allow a deduction does not mean that a deduction is allowable in Australia (see also the Privy Council's comments in Inland Revenue Commissioners v.

Appuhamy [1963] 2 AC 127 at 134 that English authorities are not necessarily applicable to non-United Kingdom legislative rules).

19. Even if the reasoning in Tate & Lyle was to be applied in Australia, it is more than likely that it would be concluded that a deduction is not allowable. For, as Lord Reid observed([1955] AC at 55) "...the company's position is unchanged; it retains its assets and continues to carry on its business. All that happens is that the new shareholders can alter its policy; but a change of shareholders does not interest the company as a trader, and expenditure to prevent a change of shareholders can hardly be expenditure for the purposes of the trade" (see also Lord Morton of Henryton's comments at [1955] AC at 38).

20. Additionally, the Full Federal Court's observations are considered to be inconsistent with the trading operations test in John Fairfax and it is considered more appropriate to apply the test in John Fairfax. It is therefore considered that a deduction would not be allowable in the circumstances referred to in the Full Federal Court's decision in Swan Brewery.

21. The fact that the takeover defence costs are likely to take the form of legal or accountancy expenses or consultancy fees is not of itself significant in determining whether the costs are deductible under subsection 51(1).

22. With the exception of interest incurred on money borrowed in a reverse takeover to buy shares in the offeror company, takeover expenses of the type referred to in paragraph 3 are not deductible even when incurred in a reverse takeover situation. Such expenses can be distinguished from the reasoning used in Taxation Ruling IT 2606 which deals with "Deduction for Interest on Borrowings to fund Share Acquisitions". As was pointed out in that Ruling the taxpayer's purpose in incurring the expense may be relevant in determining the characterisation of the expenditure (see paragraphs 15 and 16 of IT 2606 and the cases referred to in those paragraphs). Interest expenses of the types referred to in IT 2606 are considered to be incurred for the purpose of carrying on the taxpayer's income producing business (paragraphs 18 and 19 of IT 2606). However, in the case of a reverse takeover the non-interest expenses are considered to be incurred not for the purpose of carrying on a business but rather for the purpose of preserving the capital structure of the company or its ownership. The expenditure cannot be characterised as an allowable deduction.

23. No valid distinction can be drawn between interest costs in a reverse takeover and the interest which was the subject of IT 2606. These interest costs are therefore deductible, in accordance with IT 2606, if the requirements of that Taxation Ruling are satisfied.

The Capital Exclusion within Subsection 51(1)

24. An outgoing is, in any event, not deductible under subsection 51(1) of the Act if it is an outgoing of capital, or of a capital, private or domestic nature.

25. The High Court in Sun Newspapers Ltd v. F.C. of T. (1939) 61 CLR 337; 5 ATD 87 regarded expenditure on the business entity, structure or organisation set up or established for the earning of profit as being on capital account and expenditure on the process by means of regular outlay as being on revenue account

26. Expenses incurred in defending one's business against acquisition by another is considered to go either to the structure of the business (see, for example, Broken Hill Theatres Pty Ltd (1952) 85 CLR 423; and Pye v. F.C. of T. (1959) 33 ALJR 337) or to the ownership of the business structure.

27. Takeover defence costs incurred to protect or preserve the capital structure of a company or the ownership of the company are considered to be outgoings on the business entity, structure or organisation or its ownership and not deductible under subsection 51(1) of the Act. They are outgoings of capital or of a capital nature (see Swan Brewery 91 ATC at 4644; 22 ATR at 303 and F.C. of T. v. Consolidated Fertilizers Ltd. 91 ATC 4677 at 4688; (1991) 22 ATR 281 at 293).

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