PS LA 2005/21 - Application of section 45B of the Income Tax Assessment Act 1936 to demergers

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PS LA 2005/21

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SUBJECT: **Application of section 45B of the *Income Tax Assessment Act 1936* to demergers**

PURPOSE: **To provide instruction and practical guidance to tax officers on the application of section 45B of the *Income Tax Assessment Act 1936* to a demerger of an entity within the meaning of Division 125 of the *Income Tax Assessment Act 1997***

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STATEMENT

1. This Practice Statement should be followed by tax officers who are considering how section 45B of the *Income Tax Assessment Act 1936* (ITAA 1936) applies to an arrangement or proposed arrangement that is, or includes, a demerger within the meaning of Division 125 of the *Income Tax Assessment Act 1997* (ITAA 1997).
2. All legislative references in this Practice Statement are to the *Income Tax Assessment Act 1936*, unless otherwise indicated.

3. This Practice Statement is only relevant to arrangements that occur on or after 1 July 2002 and applies only to the demerger of a company or those trusts that are treated as a company under the ITAA 1936 (corporate unit trusts and public trading trusts). Although the demerger capital gains tax (CGT) measure (in Division 125 of the ITAA 1997) can apply to beneficiaries of other fixed trusts, section 45B is an integrity provision relating to dividends and therefore only has application to company shareholders and unit holders of corporate unit trusts and public trading trusts.

4. This Practice Statement follows the broad outline of section 45B, covering scheme, demerger benefit or capital benefit, obtaining a tax benefit, purpose, and determinations. It provides administrative and technical guidance on applying these elements of the section and, where appropriate, includes further explanation or interpretations drawn from cited case law, Explanatory Memorandums and other extrinsic material.

5. As a result of the Demergers measure, section 45B now has 2 objects: a demerger specific object and a dividend substitution object. As both of the objects covered by section 45B may be relevant to a demerger, tax officers should have regard to both when considering the application of section 45B to a demerger.

ENGAGING TCN

6. Under Law Administration Practice Statement PS LA 2012/1 *Engaging Tax Counsel Network on technical issues,* the Tax Counsel Network (TCN) must be engaged on certain section 45B issues. This includes when:

   - making a decision to apply section 45B (as TCN engagement is mandatory when determining whether to consult the General Anti-Avoidance Panel)[1]
   - the section 45B issue involves interpretative questions of significant risk or higher (TCN must be engaged on significant risk interpretative matters, regardless of section 45B), or
   - any other circumstance set out in PS LA 2012/1 as relevant to the issue.

BACKGROUND

7. The Demergers measure was enacted in the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* and applies to arrangements that occur on or after 1 July 2002. This Act:

   - inserted Division 125 into the ITAA 1997, which contains the basic demerger tests and the CGT consequences
   - amended subsection 6(1) and sections 44 and 45B relating to defined terms and dividends, and
   - contained a number of other consequential and transitional provisions.

8. The introduction of the Demergers measure was recommended by the Ralph Committee (*A Tax System Redesigned*[2] – recommendation 19.4). This recommendation was given in-principle support by government in the Treasurer's

[1] See Law Administration Practice Statement PS LA 2005/24 *Application of General Anti-Avoidance Rules* for details on the role and operation of this Panel.
[2] See Ralph J (1999) Review of Business Taxation – A Tax System Redesigned Department of Treasury, Canberra.

media release.[3] In the second reading speech[4] introducing the measure into parliament, Mr Slipper, the Parliamentary Secretary to the Minister for Finance and Administration, explained tax relief for demergers in the following terms:

> The tax relief will apply to only genuine demergers and is achieved by requiring underlying ownership to be maintained pre and post a merger and requiring the head entity to demerge at least 80 per cent of its ownership in the demerging entity. Providing tax relief for demergers will increase business efficiency by allowing greater flexibility in restructuring a business and ensuring tax considerations are not an impediment to such restructures. This will provide an overall benefit to the economy and enhance the competitiveness of Australia's business sector through greater opportunities to increase shareholder value by creating more efficient business structures.

9. The object of the demerger tax concession is also explained at paragraph 15.5 of the Revised Explanatory Memorandum to the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002 (Revised EM), which provides:

> The CGT relief and dividend exemption will facilitate the demerging of entities by ensuring that tax considerations are not an impediment to restructuring a business. These amendments are based on Recommendation 19.4 of *A Tax System Redesigned*, and recognise that there should be no taxing event for a restructuring that leaves members in the same economic position as they were just before the restructuring.

10. In other words, tax relief is made available where a corporate group's business is restructured and results in the head entity's shareholders owning a corporation which was previously owned within the group. The effect of the tax relief is to disregard the tax consequences that would otherwise arise from the business restructure.

11. The underlying policy theme of business restructure is reproduced in section 125-5 of the ITAA 1997, which states that the object of Division 125, which is primarily concerned with providing CGT relief, 'is to facilitate the demerging of entities by ensuring that capital gains tax considerations are not an impediment to restructuring a business'.

12. 'Demerger' is defined in subsection 6(1) to have the meaning given by section 125-70 of the ITAA 1997. Under that section, a demerger is something that happens when there is a restructuring of a corporate group (called a demerger group) under which certain things occur and certain requirements are met in relation to the provision of ownership interests (that is, shares or the rights to acquire shares) in another member of the group to the owners of the head entity. Section 125-70 of the ITAA 1997 does not prescribe how a demerger may be implemented, but it identifies various methods of restructure whereby ownership interests in an entity owned by the group are provided to the owners of interests in the head entity of the group. Essentially, for the purposes of Division 125 of the ITAA 1997 and section 45B, a demerger is a group business restructure whereby the underlying owners (usually shareholders of the head entity) acquire direct ownership of a group entity in similar proportion to their original underlying economic interests.

13. Nevertheless, section 125-70 of the ITAA 1997 does prescribe certain conditions regarding the execution of a demerger which must be met in order for demerger tax

[3] Costello, P (Treasurer) 2001, *Business Tax Reform – Implementation Timetable*, media release, Canberra, 22 March.

[4] See Peter Slipper MP, Second Reading Speech, New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, Commonwealth of Australia, Senate, *Official Hansard*, 28 August 2002, page 6018.

relief to be available. The most notable requirements are that the owners of interests in the head entity:

- acquire as new interests at least 80% of the group's ownership interests in the demerged entity
- acquire nothing other than their new interests in the demerged entity, and
- hold the same proportion of interests pre-demerger and post-demerger.

14. Division 125 of the ITAA 1997 contains relief from the possible CGT consequences of a demerger. In particular, it provides for an optional CGT rollover for owners of the head entity, with respect to their original interests in a company or trust (section 125-55 of the ITAA 1997), and that certain capital gains or losses made by members of a demerger group under the demerger be disregarded (section 125-155 of the ITAA 1997).

15. The Demergers measure also provides for dividend relief. In corporate demergers, the provision of property from a head company to a shareholder would usually involve the derivation of dividend income by the shareholder to the extent that the value of the property distributed represents company profit, whether realised or unrealised. This is no less the case where the property distributed is shares in a demerger subsidiary. Thus, subsections 44(3) and (4) provide that a dividend arising as a result of a demerger happening (called a 'demerger dividend') is not assessable or exempt income to the owners of the head entity. For owners who are non-residents, subsection 128B(3D) provides a similar exemption from withholding tax.

16. A demerger dividend is that part of a demerger allocation that, but for the amendments to section 44 in subsections 44(3) and (4), would be assessable to the owners of the head entity under subsection 44(1). A 'demerger allocation' is the value of the ownership interests provided to the head entity's owners under a demerger. The relief from assessment of the profit element of a demerger allocation is subject to the qualification in subsection 44(5) which, in the words of the Revised EM[5], 'ensures that the demerged entity is a viable, independent entity, capable of conducting business in its own right'.

17. By way of a further integrity measure, the dividend tax relief that applies in relation to the provision of ownership interests in the demerged entity from the corporate group to the head entity's shareholders is subject to section 45B, which relies on a purpose test to safeguard the assessment of distributions of corporate profit to shareholders. For present purposes, the test is designed to ensure that only profits distributed under a genuine demerger are subject to tax relief.

THE PURPOSE OF SECTION 45B

18. Subsection 45B(1) provides that the purpose of section 45B is to ensure that relevant amounts are treated as dividends for tax purposes if the capital and profit components of a demerger allocation do not reflect the circumstances of the demerger, or certain payments, allocations or distributions are made in substitution for dividends.

19. Thus, section 45B, which applies in terms of 'benefits', serves 2 objects. One is concerned only with the provision of 'demerger benefits' and the other is concerned with the provision of 'capital benefits' which may be included in a demerger benefit (the part of a demerger benefit that is not a demerger dividend will also be a capital benefit). The first object pertains only to a demerger that happens within the meaning of section 125-70 of the ITAA 1997. However, the second object of section 45B is not

[5] Paragraph 15.72 of the Revised EM.

concerned with demergers exclusively and pertains to any other arrangements that result in a capital benefit being provided to a taxpayer.

20. When a demerger occurs, there is potential for both objects of section 45B to apply as generally the owners of the head entity will be provided with both a demerger benefit and a capital benefit under the demerger. However, officers should appreciate that each of the 2 objects of section 45B is concerned with a different mischief and each has a different scope of application with respect to a demerger.

21. Despite the differences in application between the 2 objects of section 45B, in the context of demergers, the overall purpose of the section is to act as an integrity measure in support of the demergers legislation. The section guards against the use or structuring of a demerger to accommodate a substantial purpose of delivering a tax benefit to a relevant taxpayer (generally the shareholders of the head entity). Broadly, the mischief that mobilises section 45B is the use of a demerger to deliver value from company to shareholder in a tax-preferred form (whether as a demerger dividend or as capital in substitution for a dividend) as an end in itself and not merely as the natural incident of a business restructure of the demerger group.

The first object: the demerger specific rule

22. As discussed in paragraph 21 of this Practice Statement, section 45B was amended as part of delivering demerger tax relief. In this regard, the Revised EM provides:

> 15.69 An assessable dividend arising as a result of a demerger happening is exempt. Integrity rules will limit this exemption where there is a scheme that has a purpose of obtaining that non-assessable dividend. To the extent that a dividend is not a demerger dividend the normal rules relating to dividends apply.
>
> …
>
> 15.74 The demerger dividend exemption is supported by an integrity rule that is aimed at limiting the exemption to genuine demergers, rather than demergers that are directed at obtaining the dividend exemption. The effect of the integrity rule applying to a demerger is to exclude part or all of the demerger dividend from the demerger dividend exemption. So much of that excluded amount would then be considered within section 44 of the ITAA 1936, as an assessable dividend.

23. Thus, the first object of section 45B is concerned with ensuring that the dividend exemption provided for in subsections 44(3) and (4) is available only in genuine demergers and that the components of a demerger allocation provided to head entity shareholders under a demerger – as between capital and profit – reflect the circumstances of the demerger. Section 45B tests whether the demerger is tax driven, and whether an appropriate mix of capital and profit has been adopted by identifying and weighing the relevant circumstances of the demerger proposal, in order to determine whether the object of delivering a tax-free dividend into the hands of the owners is a more than incidental purpose of the demerger.

Genuine demergers

24. As discussed in paragraph 22 of this Practice Statement, paragraph 15.74 of the Revised EM refers to ‘genuine demergers’ in contradistinction to ‘demergers directed at obtaining the dividend exemption’ and Mr Slipper’s second reading speech makes plain that genuine demergers are those directed at restructuring a business in the interests of business efficiency. In such cases, the concessionary tax treatment for the head entity’s shareholders would normally be regarded as merely a natural incident of a business restructure. On the other hand, in the absence of substantive business reasons for a demerger the income tax benefits it provides for shareholders will assume greater significance.

25. In other words, to the extent that a demerger is not undertaken for substantive business reasons or to the extent that the capital and profit elements of the demerger allocation do not reflect the circumstances of the demerger, there is a strong likelihood that pursuant to section 45B, it would be viewed as a scheme whereby the provision of tax benefits to the head entity's shareholders is not a mere incident of the scheme but rather a significant purpose of it.

The second object: capital in substitution for dividends

26. That part of the demerger allocation that is not a demerger dividend is also exposed to the application of the substituted dividend rule in section 45B, if the demerger involves shareholders being 'provided with a capital benefit' for a more than incidental purpose of enabling them to obtain a tax benefit.

27. The original section 45B was enacted in response to company law changes which freed up a company's ability to return capital, subject only to solvency requirements. As a result, the form of any distribution to shareholders became largely a matter of the company's choice. In essence, section 45B is concerned with ensuring that companies do not distribute what are effectively profits to shareholders as preferentially-taxed capital rather than dividends. The substituted dividend rule of section 45B requires that the Commissioner identify and weigh all of the relevant circumstances surrounding the provision of a capital benefit to the relevant taxpayer, in order to determine whether the object of delivering a tax preferred receipt to the shareholders constitutes a more than incidental purpose of the scheme.

THE APPLICATION OF THE DEMERGER SPECIFIC RULE

28. In so far as it relates to the provision of a demerger benefit, subsection 45B(2) provides that the section applies where:

- there is a scheme under which a person is provided with a demerger benefit
- under the scheme, a taxpayer (the 'relevant taxpayer'), who may or may not be the person provided with the demerger benefit, obtains a tax benefit, and
- having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, 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 (the relevant taxpayer) to obtain a tax benefit.

Scheme

29. A 'scheme' for the purposes of section 45B is taken to have the same meaning as provided in subsection 177A(1) of Part IVA, pursuant to the reference to scheme in subsection 995-1 of the ITAA 1997 contained in section 45B(10).[6] That definition is widely drawn and includes any agreement, arrangement, understanding, promise, undertaking, scheme, plan, or proposal. In particular, a scheme is anything that satisfies any of the terms in the statutory definition. It does not have to be a 'wide scheme', nor does it have to reach to include matters covering its overall commercial result or its 'practical meaning' (*Commissioner of Taxation v Hart* [2004] HCA 26

[6] Subsection 45B(10) was amended by Item 126 of Schedule 6 of the *Tax Laws Amendment (2010 Measures No. 1) Act 2010*, with effect from 3 June 2010.

(Hart)).[7] Although, it should be noted that however the scheme is defined, it must be related to the tax benefit obtained.[8]

30. It is expected that a demerger, or part of a demerger, would constitute either a scheme or part of a scheme for the purposes of section 45B. A demerger may be part of a wider scheme which includes a subsequent transaction such as a share buy-back, liquidation or proposed sale of either the demerged entity or the head entity to a third party. Similarly, the scheme may include a transaction precedent to the demerger, such as the transfer of assets or addition of a new company to the group. Alternatively, the demerger itself or part of the demerger may constitute the scheme.

Provided with a demerger benefit

31. The provision of a 'demerger benefit' is defined in subsection 45B(4). It includes the provision of an ownership interest in a company or an increase in value of an ownership interest. The ownership interest must be provided, or the value increased, in relation to a demerger.

32. Under a demerger, it is expected that a person will always be provided with a demerger benefit. The definition of a demerger under section 125-70 of the ITAA 1997 requires there to be a disposal of ownership interests or an issue of ownership interests to the owners of the head entity. This means the owners of the head entity will invariably be provided with a demerger benefit. Nevertheless, at this point it is pertinent to acknowledge that while every demerger will involve the provision of a demerger benefit, it may not involve a demerger dividend.

33. The demerger may, for instance, result from the transfer of shares in the demerged entity to the head entity shareholders in circumstances where the distribution is wholly from contributed capital.

34. Conversely, if the state of the law is that the concept of a dividend is not wide enough to include an indirect distribution of profit, a demerger accomplished by the demerged entity issuing new shares to the head entity's shareholders may not involve those shareholders receiving a demerger dividend. In such a case, however, the demerger benefit would nonetheless constitute the provision of a capital benefit and hence is still examinable under section 45B to ensure that it is an allocation that is made in the context of a genuine demerger and that no part of it is made in substitution for a dividend.

The relevant taxpayer

35. The relevant taxpayer is the taxpayer who obtains a tax benefit within the meaning of subsection 45B(9) under the scheme. Under a demerger, the relevant taxpayers will ordinarily be the owners[9] of the head entity, as it is they who are provided with the demerger benefit. However, there is no requirement that the relevant taxpayer be the person who is provided with the demerger benefit, although it is unlikely to be any other person in the case of a demerger.

36. This Practice Statement proceeds on the basis that the relevant taxpayers are the owners of the head entity in order to provide useful guidance on the application of section 45B. However, officers should recognise that there may be rare cases where the relevant taxpayer is someone other than an owner of the head entity.

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[7] See *Hart*, 217 CLR 216 at [238–239], per Gummow and Hayne JJ.
[8] See *Hart*, 217 CLR 216 at [225], per Gleeson CJ and McHugh J.
[9] The term 'owner' is not defined in the Act: for discussion of the word in another context, see *Bellinz Pty Ltd & Ors v The Commissioner of Taxation* [1998] FCA 615.

Obtaining a tax benefit

37. The meaning of 'obtaining a tax benefit' is contained in subsection 45B(9). Essentially, the relevant taxpayer obtains a tax benefit from a demerger benefit if the amount of tax payable by the relevant taxpayer would, apart from section 45B, be less than the amount that would have been payable or would be payable at a later time than it would have been payable, if the demerger benefit had been an assessable dividend. An assessable dividend is ordinarily a payment to a shareholder out of profits and included in their assessable income under subsection 44(1) or subject to withholding tax, in the case of non-resident shareholders.

38. In most cases, the relevant taxpayer will obtain a tax benefit within the meaning of subsection 45B(9) under a demerger. The dividend and withholding tax exemptions and CGT rollover relief provided for under the Demergers measure ensure that the owner of the head entity is not subject to tax on the demerger benefit at the time of the demerger and thus subject to less tax than if it had been an assessable dividend.

39. In circumstances where the head entity may have franking credits that would enable the demerger benefit to be fully franked if it was an assessable dividend, the taxpayer's marginal tax rate may be such that the demerger benefit would be subject to no greater tax than if it had been treated as an assessable dividend. However, even if the taxpayer's marginal tax rate is such that no tax would be payable if the demerger benefit had been a fully franked assessable dividend, those franking credits of the head entity are not preserved as an offset against shareholder's income in future years. Thus, the tax payable by the relevant taxpayer at a later time would be more than if the demerger benefit had been subject to the demerger dividend concession. A tax benefit is also obtained by the relevant taxpayer if the amount of refund payable would be less than if the demerger benefit was an assessable dividend.

40. Similarly, a taxpayer may obtain a tax benefit notwithstanding that they have losses to offset against the otherwise assessable dividend. If a taxpayer uses their losses against the otherwise assessable dividend, this will mean the losses are not available to offset against future assessable income.

41. However, a taxpayer who is an exempt entity would not obtain a tax benefit, because regardless of whether the demerger benefit was an assessable dividend or not, no tax would have been payable at the time of the demerger or at a later time.

A more than incidental purpose of enabling a taxpayer to obtain a tax benefit

42. Section 45B only applies if, 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. In the majority of matters this will be the critical issue determining whether the provision applies or not.

43. Section 45B follows the structure of Part IVA, in that the conclusion about requisite purpose is drawn by having regard to a number of objective matters (listed in subsection 45B(8) and paragraphs 177D(2)(a) to (h)). Similar to Part IVA, section 45B does not require any enquiries into the subjective motives of the relevant taxpayer or persons who entered into or carried out the scheme or any part of it (*Hart*). Thus, section 45B is concerned with determining the objective purpose of the persons who entered into or carried out the scheme. In practical terms, the approach to determining objective purpose is that all the relevant circumstances of the scheme,

including the commercial reasons advanced for entry into it, are to be properly considered and weighed against the tax benefits conferred.

Whose purpose?

44. The purpose of any one of the persons who entered into or carried out the scheme is sufficient to attract the operation of section 45B. Relevant persons would include the members of the demerger group and the owners of the head entity. In complex commercial transactions such as demergers, these persons will widely consult and rely upon professional advisers, and the 'actual parties to a scheme subjectively may not have any purpose, independent of that of a professional advisor' (*Commissioner of Taxation v Consolidated Press Holdings Ltd* [2001] HCA 32 (*Consolidated Press*)). Where this is so, it will generally be appropriate to attribute the purpose of a professional adviser to one or more of the parties. Authority for this approach is found in the High Court case of *Consolidated Press,* where the application of Part IVA in a similar context was considered.

More than incidental purpose

45. The concept of a more than incidental purpose is explained in paragraphs 1.31 and 1.32 of the Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998 (the CLR EM)[10] as follows:

> ***New section 45B*** requires a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling a taxpayer to obtain a tax benefit. The words in parentheses are inserted for more abundant caution; a reference to a purpose of a scheme is usually understood to include any main or substantial purpose of the scheme, and the words in parentheses clarify that this is the intended meaning here. Thus while ***new section 45B*** does not require the purpose of obtaining a tax benefit to be the ruling, most influential or prevailing purpose, neither does it include any purpose which is not a significant purpose of the scheme.
>
> A purpose is an incidental purpose when it occurs fortuitously or in subordinate conjunction with one of the main or substantial purposes of the scheme, or merely follows that purpose as its natural incident.

46. It is expected that most, if not all, schemes of demerger will have a purpose of enabling taxpayers (that is, the head entity's shareholders) to obtain a tax benefit. Whether it constitutes a more than incidental purpose of the scheme is a matter to be determined objectively from the relevant circumstances of the scheme. If the business or commercial purpose for the scheme is not sufficiently cogent, it is likely that the tax purpose will be more than incidental. But if the tax purpose merely follows the commercial purpose as its natural incident, the tax purpose will be incidental.

47. However, a person (or persons) could be found objectively to have 2 or more purposes, none of which is merely incidental and one of which is to obtain a tax benefit (either as a demerger benefit or a capital benefit), in which case section 45B would apply. The fact that they have other substantial purposes would not prevent the section from applying. To avoid the application of section 45B, the tax purpose must be objectively subordinate to the other substantial purposes.

The relevant circumstances

48. Subsection 45B(8) lists the relevant circumstances of the scheme to which the Commissioner must have regard when determining whether or not the requisite

[10] This Bill introduced the original section 45B. The amendments made to section 45B to accommodate the Demergers measure have made no change to the meaning of an incidental purpose.

purpose exists. The list of circumstances is not exhaustive and the Commissioner may have regard to other circumstances which they regard as relevant.

49. The relevant circumstances listed in subsection 45B(8) encompass a range of matters which taken individually or collectively will reveal whether the requisite purpose exists or not. Due to the diverse nature of these circumstances, some may be of no consequence in ascertaining whether or not that purpose exists. In all cases, however, officers should have regard to all the circumstances and determine whether they tend toward, against or are neutral as to the conclusion of a purpose of enabling the relevant taxpayer to obtain a tax benefit.

50. The factors which are used to determine purpose under Part IVA are included by virtue of paragraph 45B(8)(k). The Part IVA factors are to be given equal attention in determining purpose under section 45B(8). The CLR EM as originally enacted in 1998 indicated that in addition to the Part IVA matters, 'other matters more specifically relevant to schemes to obtain a tax benefit' were included to give 'further guidance' to the operation of the section.[11]

Appropriate capital and profit allocation

51. The first relevant circumstance (paragraph 45B(8)(a)) concerns the extent to which the demerger benefit is attributable to capital and profits (realised and unrealised) of the company or of an associate (within the meaning in section 318) of the company. Unrealised profits would ordinarily be identified as the accretions to the value of corporate assets from the time of their acquisition. Accretions to value may or may not be recognised in the company's accounts but would normally be measured by reference to the market value of the assets.

52. Paragraph 45B(8)(a) directs attention to the composition, as between share capital and profits (realised and unrealised), of the demerger benefit provided to the head entity's owners. If the composition of the demerger benefit is inconsistent with the substance (that is, the capital and profit it is attributable to) this would tend to a conclusion that the requisite purpose exists.

53. For instance, if the dividend element of a demerger benefit is not attributable to an amount that could reasonably be regarded as the profit made on or applied to the assets being demerged, this would suggest a purpose of obtaining a non-assessable dividend under the demerger relief. Similarly, if the capital element is 'attributable' to profits, this would suggest a purpose of providing a capital benefit in substitution for a dividend, and recourse to the dividend substitution rule of section 45B may be warranted. This point is discussed more fully at paragraphs 103 to 115 of this Practice Statement.

54. As a demerger can be implemented in a number of ways, it may not always involve a distribution of property from the head entity to its owners. Whether this is the case or not is a question of fact and law. It does not depend upon whether the head entity has, or proposes to record, a distribution to shareholders in its accounts. For instance, the provision of shares in the entity to be demerged by the head entity to its owners is a distribution and the full value of this provision may not be recorded in the accounts.

55. There may be no distribution of property from the head entity to its owners in the case where the ownership interests are provided by a demerging entity that is not the head entity. For example, a subsidiary may transfer shares it owns in the entity to be demerged to the head entity's owners. Similarly, a demerger can be implemented by way of a cancellation of the shares held by the head entity or a member of the group in the entity to be demerged and a fresh issue of shares by the entity to be demerged

[11] Paragraphs 1.34 and 1.35 of the CLR EM.

to the head entity's owners. In these cases, it may be that no dividend and thus no demerger dividend is received by the owners of the head entity under the demerger. However, a capital benefit, in the form of the shares, is provided to the owners thus raising the application of the dividend substitution rule of section 45B.

56. The word 'attributable' is used to describe a discernible connection between the demerger benefit and the share capital and profit of the head entity or an associate. Regardless of whether the ownership interests are provided by the head entity or a subsidiary, the distribution will generally be considered attributable to the 'disposal' of the demerged entity to the head entity's owners, and thus it would be attributable to the amount of share capital that could reasonably be regarded as invested by the head entity's owners (indirectly) in the demerged entity and the profits (realised or unrealised) attributable to the demerged entity.

57. However, in determining what the provision of ownership interests is attributable to, regard should be had to other transactions undertaken in relation to the entity to be demerged before the demerger. For example, the transfer of assets, the capitalisation of entities by cash injections or swapping of intra-group indebtedness may be carried out to ultimately deliver profits to the head entity shareholders in a capitalised form. It should therefore be considered whether the demerger benefit provided is attributable to these transactions.

58. In the ordinary case where there are no special circumstances such as those described in paragraph 57 of this Practice Statement, a reasonable approach should be taken in determining the extent to which share capital was invested in the demerged entities. In some cases, the amount of capital contributed by the head entity shareholders that is represented in the investment in the demerged entity can be precisely identified; however, in many cases it cannot. In the cases where it cannot be identified, it is apparent from the CLR EM[12] that the exercise envisaged by paragraph 45B(8)(a) (formerly paragraph 45B(5)(a)) involves an economic notion of share capital (the nominal value of which is immutable) being apportioned across the assets of the business. Thus, the amount of share capital invested in the demerged entity should be determined in accordance with the relative market value of the demerged entity to the corporate group.

Case Study 1

It is proposed that Small Company Limited (Smallco) be demerged from the Multinational Limited (Multinational) group of companies.

Multinational has been in business for approximately 100 years and has evolved from a small credit provider to a large wholly owned group of companies operating mainly in the finance industry. It is now a multi-billion dollar global business. It has been consistently profitable and has had a dividend reinvestment plan in place for the last 22 years, which the shareholders have made good use of. Multinational has also had a number of rights issues over the years, raising various sums of capital. In 1992, Multinational used a combination of cash on hand and existing lines of credit to acquire 100% of Smallco, an online securities dealer, for $100 million. Since then, Smallco has grown substantially using internally generated profits and funds from Multinational (again, a mixture of share capital and debt) and has paid dividends to Multinational annually.

At the time of the demerger proposal, the Smallco shares are recorded in the books of Multinational at $1 billion and have a current market value of $2 billion. The market value of the entire Multinational enterprise is $10 billion.

At the time of the demerger, the accounts of Multinational were as follows:

Assets	
Various Business Assets	*$6 billion*
Shares in Smallco	*$1 billion*

[12] Paragraph 1.35 of the CLR EM.

Total Assets		***$7 billion***
Liabilities		
Loans	*$2 billion*	
Total Liabilities		***$2 billion***
Equity		
Contributed Capital	*$2 billion*	
Accumulated Profits	*$2 billion*	
Asset Revaluation Reserve	*$1 billion*	
Total Equity		***$5 billion***

In the circumstances, it is not feasible to identify an amount of the capital contributed by Multinational shareholders that was directed to the investment in Smallco. Accordingly, there being no contra-indicators, the acceptable approach to identifying the capital element of the demerger allocation is to debit Multinational's capital account by the ratio of the Smallco market value to the total enterprise market value (that is, $2 billion ÷$10 billion = 20% × $2 billion = $400 million). The remaining $600 million required to write the Smallco investment out of the accounts of Multinational would be debited against booked profits (which may be accumulated profits or revaluation reserves).

Note: Multinational shareholders would receive a demerger dividend of $1,600 million – the market value of the property distributed ($2 billion) less the amount debited to contributed capital ($400 million) (see Taxation Ruling TR 2003/8 Income tax: distributions of property by companies to shareholders – amount to be included as an assessable dividend).

Case Study 2

It is proposed that Bread Shops Pty Ltd (Bread Shops) be demerged from Flour Mill Pty Ltd (Flour Mill).

Flour Mill owns all the issued capital in its subsidiary, Bread Shops, which it has decided to demerge by transferring all its shares in Bread Shops to its shareholders.

Flour Mill was incorporated in 1982 and its 2 founding shareholders, Serge and Sylvia, each contributed $50,000 of equity capital. That money was used to acquire and operate a business of milling flour. In January 1997, Serge, Sylvia and a group of investors contributed an additional $1 million of capital under a rights issue for additional Flour Mill shares. This money was used by Flour Mill at the time to subscribe for shares in the newly incorporated Bread Shops, who used the money to acquire a chain of 4 retail outlets. Bread Shops has since expanded considerably and has operated independently of Flour Mill financially. It has not received any further funds from Flour Mill and has retained all profits it has made. Flour Mill re-valued the shares in Bread Shops in 2001 to $5 million; they now have a market value of $10 million.

At the time of the demerger, the accounts of Flour Mill were as follows:

Assets		
Flour Milling Business Assets	*$10 million*	
Shares in Bread Shops (at 2001 valuation)	*$5 million*	
Total Assets		***$15 million***
Liabilities		
Loans	*$1 million*	
Total Liabilities		***$1 million***
Equity		
Contributed Capital	*$1.1 million*	
Accumulated Profits	*$4 million*	

Asset Revaluation Reserve	*$8.9 million*
Total Equity	***$14 million***

There being no other factors relevant to the contributed capital sum of Flour Mill, this demerger is in substance a return of the $1 million capital contributed in 1997. In the circumstances, returning $1 million of contributed capital (satisfied in part by the in specie distribution of the Bread Shops shares) to Flour Mill shareholders would therefore be acceptable. Similarly, it would be accepted that $4 million from the revaluation reserve is distributed (also satisfied in part by the in specie distribution of the Bread Shop shares) to Flour Mill shareholders.

Note: Flour Mill shareholders receive a total dividend of $9 million – the market value of the property distributed ($10 million) less the amount debited to contributed capital ($1 million) (see TR 2003/8).

Pattern of distributions

59. Paragraph 45B(8)(b) directs attention to the pattern of distributions of dividends, bonus shares and returns of capital or share premium by the company or an associate (within the meaning in section 318) of the company. The inference here is that an interruption to the normal pattern of profit distribution and its replacement with a distribution under a demerger would suggest dividend substitution. Regard is had to the general pattern of distributions of the company in order to determine, for example, whether its previously regular dividend distribution policy has been affected by the demerger, or the head entity has a pattern of making capital distributions (with that capital thus performing the function of dividends).

60. In the context of a demerger, the occasion for the distribution is an extraordinary event, being the demerger of part of the group and should be additional to normal distribution policy. Thus, it should be acknowledged that a demerger, an extraordinary corporate event, is unlikely to be used to replace standard profit distributions. Caution should be exercised when a company has a 'no dividend' policy, however. When a company accumulates all its profits, a subsequent distribution of profit, if it occurs, is more likely to occur as a single, extraordinary payment. It may in such cases be tempting to seek to secure a tax-effective mode of distribution. Cases of this type often have a history of expansion, during which profits are reinvested, succeeded by a period of maturity in which profits continue to accumulate, often as cash reserves, until the no dividend policy is changed.

Characteristics of shareholders

61. Paragraphs 45B(8)(c) to (f) require that consideration be given to the tax characteristics of the owners of the head entity and thus to determining the tax effects of the scheme. If the tax characteristics of the owners of the head entity are such as to indicate there is a tax preference for one form of distribution (capital or profit) over another, this may be suggestive of a more than incidental purpose of delivering a tax benefit, particularly if the composition of the distribution does not follow the substance of what was provided.

62. In the case of public companies, the head entity and its subsidiaries would generally be aware of the broad tax characteristics of the owners of the head entity, but not their more detailed tax characteristics. It is also administratively difficult for the Commissioner to obtain this knowledge. Nevertheless, a company may enter into a scheme, without knowing the precise tax profile of each of its shareholders, upon the premise that large numbers of its shareholders will have tax characteristics that will enable them to secure a tax advantage by a particular form of distribution, and for that purpose. In the case of a closely held group, the detailed tax characteristics of

the owners of the head entity are more likely to be known to the group and also discernible by the Commissioner.

63. To the extent that the shareholders' tax characteristics are known, they should be considered thoroughly to discern whether they incline for or against a conclusion as to the requisite purpose.

64. In this regard, however, it should also be borne in mind that the application of section 45B turns upon objective matters and does not require that the head entity, its associated entities or any other person who entered into or carried out the scheme be aware of the tax characteristics of the relevant taxpayers in order for it to apply.

Capital losses

65. Paragraph 45B(8)(c) concerns whether owners of the head entity have capital losses that, apart from the scheme, would be carried forward to a later year of income. This is a circumstance which it is unlikely would be immediately taken advantage of by a demerger which, of itself, would not ordinarily produce a capital gain in the hands of the owners to offset the capital loss. However, the fact that an owner of the head entity is in a position to offset any capital gain from the subsequent disposal of the head entity interests or new ownership interest delivered by the demerger process with the capital loss may be relevant to the demerger scheme.

Pre-CGT ownership interests

66. Paragraph 45B(8)(d) directs attention to whether some or all of the ownership interests held by the head entity's owners in the head entity or an associate (within the meaning of section 318) were acquired or are taken to have been acquired before 20 September 1985. This circumstance makes the distinction between pre and post-CGT assets, a characteristic of the ownership interests in the head entity which by the operation of Division 125 of the ITAA 1997 is normally transmitted to the new ownership interests in the demerged entity. In other words, the decision to deliver ownership interests under a demerger could be influenced by owners of the head entity receiving new pre-CGT interests.

Residency of owners of the head entity

67. Paragraph 45B(8)(e) requires consideration of whether the owners of the head entity are non-residents. The non-residency of the head entity's owners could have a bearing on the preference for capital or profit in the composition of a demerger benefit. While non-residents are normally taxed on unfranked dividends at the rate of 15% under the withholding tax provisions in Division 11A of Part III[13], they are not exposed to capital gains tax where a CGT event (such as disposal) happens to their shares in a resident public company, unless they and their associates (within the meaning of section 318) beneficially owned at least 10% by value of the shares of the demerged entity. There is no similar concession in regard to the disposal of private company shares however and any capital gain from their disposal by non-residents is exposed to the general non-resident rates of tax. Changes enacted in 2006 expanded the CGT exemption for non-residents to most shares in companies (except land-rich companies).[14]

[13] Although a demerger dividend paid to non-resident shareholders is not subject to withholding tax pursuant to subsection 128B(3D) of the ITAA 1936, any subsequent dividend paid to relevant non-resident shareholders ordinarily would be.

[14] Refer Division 855 of the ITAA 1997.

Cost base of the ownership interests

68. Paragraph 45B(8)(f) directs attention to whether the cost base (for the purposes of the ITAA 1997) of the relevant ownership interest provided to the head entity's owner is not substantially less than the value of the applicable capital component of demerger benefit or the capital benefit.

69. In the case of a demerger, the relevant ownership interest would be the ownership interest in the head entity. The point here is that the demerger could be influenced by the opportunity to obtain a distribution under a demerger that is subject to the CGT rollover which, but for the concession, would result in a capital gain. That opportunity to defer the CGT taxing point may incline to a conclusion that the purpose of the demerger is to access the tax concessions as a means to an end in itself, rather than to increase business performance.

Nature of interest after demerger

70. Paragraph 45B(8)(h) requires, where the demerger involves a distribution of share capital or share premium, that regard be had to whether the interest held by the owners of the head entity after the distribution is the same as the interest would have been if an equivalent dividend had been paid instead of the distribution of share capital or share premium.

71. This relevant circumstance proceeds from the premise that when a dividend is paid the owner's interest remains unchanged, and that a distribution of capital made in similar circumstances may be performing the same function as a dividend and be made in substitution for it. Thus, if the proportionate voting and other interests held by the owner are less than their pre-reduction interest, this would be more suggestive of a 'genuine return of capital' than if they remained the same post-reduction.

72. In the context of demerger, this circumstance would be limited to demergers where the transfer of ownership interests involves 'distributions' (that is, returns) of share capital or share premium. Ordinarily however, a demerger should not disturb the head entity shareholder's existing ownership interest in the way described, owing to the requirements of the proportion test in subsection 125-70(2) of the ITAA 1997. As a consequence, it is unlikely that this circumstance will have significant relevance for demergers.

Scheme involving the later disposal of ownership interests

73. Paragraph 45B(8)(i) directs attention to those cases where the scheme of demerger involves the provision of ownership interests and the later disposal of those interests, or an increase in the value of ownership interests and the later disposal of those interests, recognising that the proceeds on disposal of such ownership interests provide the equivalent of a cash dividend in a more tax-effective form.

74. It is a question of fact whether or not the scheme of demerger involves the later disposal of the ownership interests. In determining whether the scheme of provision and later disposal of ownership interests is suggestive of obtaining a tax benefit, regard is to be had to the length of time the ownership interests are held, including any arrangements to reduce the risk of holding them. The temporal nexus between the demerger and the arrangement for the disposal of the ownership interests must also be considered.

75. If a demerger is merely a preparatory step for disposal, the moving of the ownership interests to the owners of the head entity in a tax effective way is a key incident of

the scheme and thus may be suggestive of a more than incidental purpose of enabling the head entity's owners to obtain a tax benefit.

76. As subsection 44(5) indicates, demerger tax relief is concerned with facilitating restructures that are essentially business driven. That is, their object is to increase business efficiency and thus shareholder value. It is not concerned with facilitating the delivery of assets or profits from the company to the head entity's owners for the purposes of allowing them to realise that value in a tax effective way. In other words, the premise is that a prearranged disposal of the demerged interest or the interest in the head entity by the head entity's owners, may suggest the demerger was undertaken to transfer corporate assets to the shareholder, rather than restructure the business.

77. It is recognised that there are exceptions to this general premise. A prearranged disposal of the head entity or demerged entity shares could have as its only substantial object increased business performance. There may be circumstances where the business performance of one or both of the head entity or demerged entity is enhanced by merging one of those entities with another like business structure. Such a merger could for example involve the disposal of the head entity or demerged entity under a scrip for scrip transaction. Alternatively, it may be that the efficiency of a business is enhanced by the introduction of a new group of owners, such as under a management buy-out.

78. However, caution should be exercised in considering the purposes for which the pre-arranged disposal of the head entity or the demerged entity is undertaken. As noted in paragraph 46 of this Practice Statement, a person may be found to have more than one substantial purpose. In other words, in light of all of the relevant circumstances, it might be concluded that a substantial business purpose is matched by a substantial tax purpose in regard to the disposal.

79. In a different context, some large public company demergers provide an optional facility for head entity owners to dispose of their demerged entity shares immediately after the demerger. In others, the proposal may include a compulsory sale facility for foreign shareholders, where it is impractical to comply with regulatory requirements in foreign jurisdictions.

80. Although paragraph 45B(8)(i) requires that the Commissioner have regard to these types of arrangements or facilities in determining whether the requisite purpose exists or not, their existence will not necessarily lead to an adverse conclusion in this regard. The reasons for the arrangements or facilities, their structure and terms and the number and nature of the shareholders who participate in the facility may lead to the conclusion that the existence of the arrangement or facility is neutral in terms of the requisite purpose.

Transactions between the entity and an associate

81. Paragraph 45B(8)(j) is stated to apply only to demergers and requires that regard be had to whether the profits and assets of the demerging entity are attributable to or acquired under transactions with associated entities (within the meaning of section 318). The demerging entity is the entity that provides the ownership interests in the demerged entity to the head entity's owners.[15]

82. This relevant circumstance elaborates on paragraph 45B(8)(a) and looks for the concentration of assets or profits of the corporate group in the demerging entity beyond that which would be explicable by a business restructure; the premise being that the demerger is being used to deliver assets or profits tax free to the head entity's owners in the form of an ownership interest. The implication here is that the

[15] Subsection 125-70(7) of the ITAA 1997.

purpose for the demerger must be more than a mere transfer of property from the corporate group to the head entity's shareholders.

83. For example, this relevant circumstance exposes whether the demerger relief is being used as a device for distributing corporate earnings to owners of the head entity. If it is established that part of the profits or assets of the demerging entity are referable to those of an associate and are not explainable by the demerging entity's need to be a viable, stand-alone entity, this is suggestive of a purpose of enabling a taxpayer to obtain a tax benefit by way of non-assessable dividend.

The Part IVA matters

84. Paragraph 45B(8)(k) requires that regard be had to any of the matters referred to in paragraphs 177D(2)(a) to (h). The matters referred to in these paragraphs are matters of reference for the 'dominant purpose' test in the general anti-avoidance provision, Part IVA. However, in the context of section 45B, they facilitate the 'more than incidental purpose test' and do not introduce a different purpose test. Furthermore, they are matters by reference to which one is able to examine a demerger from a broad, practical perspective in order to identify and compare its tax and non-tax objectives.

85. The paragraph 177D(2) matters operate together to direct attention to the means by which the tax benefit has been obtained, including the manner in which the scheme was entered into or carried out, the form and substance of the scheme, the timing of the scheme, the financial, tax and non-tax effects of the scheme and the nature of any connection between the taxpayer and other parties to the scheme. Many of the other relevant circumstances discussed in this Practice Statement amplify or elaborate on the paragraph 177D(2) matters and to this extent there may be some overlap.

86. One of the chief indicators against the application of section 45B will be the non-tax objects or effects of the demerger scheme. The 8 matters in paragraph 177D(2) constitute the essential facts and circumstances of a scheme, including the outcomes for the parties to the scheme, by reference to which the tax and non-tax objects of the scheme can be identified and contrasted from an objective point of view. If, on the one hand, reference to the matters in paragraph 177D(2) reveal that the essential object of a demerger is to produce changes and improvements to the business structures of the corporate group, the tax-free aspect of the transfer of ownership interests to the head entity's owners is more likely to be an incidental object of the demerger. If, on the other hand, reference to those matters reveals that the transfer of ownership interests from the corporate group to the head entity's shareholders is an essential object of the scheme, the tax-free aspect of the transfer would ordinarily be a substantial object of the demerger.

Paragraph 177D(2)(a)

87. Paragraph 177D(2)(a) refers to the manner in which the scheme was entered into or carried out. This is a reference to consideration of the method or procedure by which the particular scheme in question was established. In other words, consideration of the decisions, steps and events that combine to make up the scheme. In effect, an enquiry into the manner of a scheme is an objective enquiry into the reasons a taxpayer had for entering into it. In the context of the policy intent behind the demergers measure, 'manner' is examinable from the perspective of the scheme being a business restructure. In considering section 45B, it will be more likely to apply to a demerger where the decision to execute such a restructure cannot be explained by reasons other than the tax-free distribution to shareholders.

Paragraph 177D(2)(b)

88. Paragraph 177D(2)(b) refers to the form and substance of the scheme. A scheme which takes the form of a demerger scheme is one which accords with the description of a demerger in Division 125 of the ITAA 1997. However, the substance of a scheme is a reference to its essential nature which, in the case of a demerger, would normally be determined from the effects of the scheme on the commercial and economic circumstances of all of the parties involved in the demerger, including the head entity, the head entity's owners, the companies in which the ownership interests are transferred and other members of the corporate group.

Paragraph 177D(2)(c)

89. Paragraph 177D(2)(c) directs attention to the time at which the scheme was entered into and the length of the period during which the scheme was carried out. This is not limited to a reference to time measurement; it also includes a reference to the timing of the scheme from the point of view of the scheme's coincidence with events or circumstances beyond the scheme itself. In particular, whether the scheme was designed to take advantage of events or changes of a tax or non-tax nature that were taking place at the time.

Paragraph 177D(2)(d)

90. Paragraph 177D(2)(d) requires that consideration be given to the result in relation to the operation of this Act that, but for 'this Part', would be achieved by the scheme.

91. The reference to 'this Part' could present an interpretational difficulty when applied in the context of section 45B. In its original context it is a reference to Part IVA. In the context of section 45B, however, 'this Part' could be interpreted as a reference to Part III which includes both sections 44 and 45B; the former relieves a demerger dividend from tax and the latter withdraws the relief.

92. However, paragraph 177D(2)(d) should not be disregarded in relation to section 45B. The reference in paragraph 45B(8)(k) to 'any of the matters referred to in subsection 177D(2)' suggests that the legislature intended that paragraph 177D(2)(d) should apply in the context of section 45B; in which case, the most sensible construction of the words of paragraph 177D(2)(d) is to read 'this Part' to mean 'this section'.

93. The issue then becomes a matter of identifying the tax results of the scheme if section 45B were not to apply. In regard to this matter, it is critical to consider just what constitutes the scheme, as this will have a direct bearing on the breadth and scope of the tax results for the relevant taxpayers that are taken into consideration. Accordingly, officers must have regard to all of the relevant tax outcomes produced by the scheme. From the perspective of the head entity's shareholders, this would include both the capital gains tax and other income tax implications of the transfer of ownership interests from the group. In other words, in the context of the purpose test, regard must be had to the totality of the scheme's relevant tax consequences, to reliably determine the extent to which the scheme did or did not advantage the shareholders tax-wise.

Paragraph 177D(2)(e)

94. Paragraph 177D(2)(e) directs attention to any change in the financial position of the head entity's owners that results, will result, or may reasonably be expected to result, from the scheme. Similar to the preceding paragraph, it is also critical to consider just what constitutes the scheme for the purposes of this paragraph. This will have a

direct bearing on the breadth and scope of the financial implications for the head entity's owners that one takes into consideration.

95. Clearly, however, a demerger of itself provides the head entity's owners with an ownership interest which, prior to the demerger, was owned by the corporate group and in which they had only the economic interest of an 'underlying owner'. In financial terms, the demerger delivers to the head entity's shareholders an asset which they can liquidate, exchange or use as financial security. Furthermore, depending on the strength of the business outcomes of the demerger, the head entity's owners are likely to be in an improved position in regard to an investment return on their equity interests.

Paragraph 177D(2)(f)

96. Paragraph 177D(2)(f) requires that consideration be given to any change in the financial position of any person who has, or has had, any connection with the head entity's owners, being a change that results, will result or may reasonably be expected to result from the demerger scheme. This paragraph provides the opportunity to identify any financial changes that are consistent with a business restructure. It is not likely, however, that parties connected with the head entity's owners that are not members of the group would be affected financially as a result of the restructure. But perhaps the group's creditors, if not considered too remote from the head entity's owners, might also be included in the class of persons covered by this paragraph.

97. A demerger undertaken to restructure business may involve movements of assets and liabilities within the group as part of the restructuring process or, put another way, a reallocation of capital reflecting a movement towards a more effective business allocation. Normally, this would involve financial change for the parties affected by the movement. Also, as a result of the demerger, the net asset position of the head entity would ordinarily be reduced by the value of the ownership interests demerged to the head entity's owners. Depending on the positioning of the demerging entity or entities within the group, the net asset position of other entities in the corporate group may be similarly affected.

98. The demerger may also result in the settlement or reconstitution of loans with group creditors and the severing of financial interdependence between the group and the demerged entity.

Paragraph 177D(2)(g)

99. Paragraph 177D(2)(g) directs attention to any 'other' consequence of the demerger scheme for the head entity's owners or for any person connected with the head entity's owners. Ordinarily, the other consequences at issue here would be consequences of the demerger and not of something that has occurred post-demerger. In which case, the other consequences of the scheme would generally include the sorts of changes of a non-financial nature that might occur in, and be consistent with, a business restructure.

100. It is not feasible to devise an exhaustive list of such changes. But by way of example, the case studies which start at paragraph 101 of this Practice Statement include the sorts of matters that would qualify as 'other' consequences of schemes to demerge a business. Nonetheless, in the context of this paragraph, it is pertinent to point out that, depending on the nature of the demerger group and its existing business, a business restructure could involve any one or more of a wide variety of initiatives of a business nature, the implications of which could also vary significantly. For example, a demerger that divides a public company business into 2 discrete corporate enterprises would be expected to incur changes to infrastructure, personnel and

operations of a kind unlikely to occur in a simple demerger of a private company business aimed at concentrating or rationalising its management and control.

Paragraph 177D(2)(h)

101. Paragraph 177D(2)(h) requires consideration of the nature of any connection (whether of a business, family or other nature) between the head entity's owners and any person referred to in paragraph 177D(2)(g) – ordinarily that would be the members of the demerging group of companies. The connection between the head entity's owners and members of the group is essentially the relationship of shareholder and company, the significance of which for tax purposes is defined by the principle that a distribution of corporate profit is assessable income of the shareholder. Indeed, the requirement for demerger to preserve the economic substance of the relationship between the group and its underlying ownership forecloses its use as a means to make provision for shareholders individually.

Case Study 3

TransNational Ltd (TransNational) is the head company of a demerger group that includes, as one of its demerger subsidiaries, Parts Co. Ltd (PartsCo).

PartsCo operates a business that manufactures components for the motor vehicle industry. It currently operates in the Australian market only. TransNational has been advised by a business consultancy firm that the PartsCo business has the product range and technical expertise to expand internationally. It also advises that there are a number of opportunities to rationalise the motor vehicle components industry in Australia and overseas through mergers and acquisitions. The business consultants have advised that PartsCo would require significant additional capital resources to expand its own business and undertake strategic acquisitions.

At the same time, TransNational's core business of property development has been expanding significantly following the takeover of an overseas competitor. This takeover continues to absorb much of management's time and available capital resources.

The Board of Directors has endorsed the broad thrust of the business consultant's report; however, they are concerned that the current ownership structure of the group will impede the implementation of the expansion plans. In particular, they are concerned that they will not be able to devote the necessary management time to the PartsCo business (only one member of the Board has had any experience in the motor vehicle component industry). Given the capital requirements of the property development arm of the business, they are also concerned that the group will not be in a position to devote the capital necessary for the expansion.

The Board has therefore decided that demerging PartsCo by transferring its shares to the TransNational shareholders is in the best interests of the business carried on by that entity. The Board expects that the advantages of demerging will be reflected in improved profitability for both the property development and motor vehicle component businesses. They believe that the demerger has the following business advantages:

- *A board of directors with specialist knowledge of the motor vehicle industry can be appointed.*
- *Senior management with the same sort of expertise can be appointed. (This will also ensure that the senior management of TransNational is focused on the property development business.)*
- *PartsCo is free to access additional capital to the extent it can service that capital, without competing with the capital requirements of the larger property development arm.*
- *PartsCo will be a standalone specialised business and its performance will become much more transparent to the market.*

For the purposes of section 45B, it is evident that the purpose for undertaking the demerger is to improve the performance of the businesses of both PartsCo and its parent, TransNational. This is reflected in the structural, financial and personnel changes that have been made with a view to improvement in profitability of the discrete operations. In the circumstances, the Commissioner would not make a determination under subsection 45B(3) that sections 45BA or 45C applies to this proposed demerger.

Case Study 4

Doris, Noreen and Bob are siblings, each with a one-third interest in Family Farm Pty Ltd (Family Farm), which in turn owns all of the issued capital in Secure IT Pty Ltd (Secure IT).

There is a proposal in place for Family Farm to demerge Secure IT by transferring all the issued shares in Secure IT to Doris, Noreen and Bob, and for Doris and Noreen to subsequently dispose of their interests in Secure IT to Bob. The demerger will involve each of the siblings receiving a significant demerger dividend which, but for the demerger concession, would be assessed at the top marginal tax rate in their hands. Family Farm has a very small amount of contributed capital and the demerger will involve the return of a nominal capital amount of $1 per share.

Family Farm was incorporated in 1966 by Graham and Marge (the parents of Doris, Noreen and Bob), who were the only shareholders. In that same year, Family Farm acquired a grazing property of 5,000 acres set in what proved to be rather poor country. In 1987, Graham and Marge decided to appoint a manager to run the farm and to move to the city where Graham started up a security business which was owned and run by Secure IT, incorporated as a subsidiary of Family Farm.

While Doris and Noreen went to university and studied medicine, Bob helped his father in the security business.

In 1995, Graham and Marge passed away, leaving Doris, Noreen and Bob a one-third interest each in Family Farm. Doris and Noreen have pursued their medical careers and now practice in partnership. Each is carrying forward a capital loss from their earlier solo ventures into medical practice and neither has ever taken an active interest in the security business. Bob assumed responsibility for running the security business in 1995 and has run it successfully ever since. Doris and Noreen left all the decision-making for both Secure IT and its business to Bob.

All the siblings use Family Farm's grazing property for family holidays and, though a manager is still employed to run it, the property barely produces enough income to cover costs and it has not contributed to the distributable fund of profits for many years. Family Farm's distributable profits have traditionally come from an annual dividend paid to it by Secure IT.

All 3 siblings wish to retain their underlying ownership interests in the grazing property. However, since Doris and Noreen have never taken an active interest in Secure IT and have in fact left all the decision-making to Bob, they agree with Bob's suggestion that he buy them out. They have agreed to dispose of their interests in Secure IT to Bob immediately after the demerger at their market value.

The security business is now a mature business with established clientele and stable profit history. Bob is a careful and conservative manager and, after acquiring 100% of the equity in Secure IT, he proposes to continue to run the business exactly as he has and hopes to eventually dispose of it to a larger competitor for a healthy capital gain.

Doris and Noreen will make a capital gain on the disposal of their Secure IT shares to Bob (the cost base of their Secure IT shares is a proportion of the cost base of their Family Farm shares, determined under section 125-80 of the ITAA 1997). However, they will return only a small net capital gain in the income year of disposal as they each have carry forward capital losses to offset part of the capital gain. The remaining capital gain from the disposal of their shares will be eligible for the 50% CGT discount.

There is nothing in the manner or effect of the scheme to suggest that its purpose is to, in any way, improve or restructure either the farm or security businesses. Rather, it is apparent that the overall object of the scheme is for Doris and Noreen to realise their economic interests in Secure IT in the most tax effective way. The demerger concession is simply the means chosen to obtain tax-free access to the Secure IT shares. In this case, the distribution and disposal of the shares results in the permanent tax advantage inherent in the conversion of an income receipt (in the nature of a dividend) into a tax-preferred capital receipt (in the nature of a capital gain). It is illustrative of a scheme with a non-incidental purpose of obtaining a tax benefit, and one which section 45B is designed to counter.

In a case such as this, the Commissioner would make a determination under subsection 45B(3) that section 45BA applies to deny the demerger dividend status to the demerger benefit provided under the scheme.

Case Study 5

Brendan and Ann-Marie are business partners who established a clothing manufacturing business in 1982. In 1984, they transferred the business into a company called SnipnStitch Pty Ltd (SnipnStitch), which they own half of each.

In 1998, Brendan and Ann-Marie acquired a retail health-food shop in a major shopping centre. They acquired this business through a newly incorporated subsidiary of SnipnStitch Pty Ltd, called Healthy Retail Pty Ltd (Healthy Retail).

The clothing business has expanded considerably. It now employs 15 full-time staff, returns substantial profits and generates strong cash flow. The net assets of the business are also significant – the most valuable asset being the unencumbered building occupied by the business.

The health food business has also expanded and is now a chain of 10 leased retail outlets in major shopping centres. Each year, Brendan travels to an international Natural Product Expo to look for new product lines to sell in the health food outlets. At the most recent Expo, he signed a distribution agreement with an overseas manufacturer for an exciting new weight-loss product, SkinnyTabs. The manufacturer claims the product produces outstanding results, although it has not been subject to independent clinical trials. Brendan believes the product has scope to expand the health food retail business enormously. Both Ann-Marie and Brendan are, however, concerned at the potential product liability and other risks associated with borrowing funds required to expand into distributing and retailing SkinnyTabs.

Brendan and Ann-Marie have also come to the view that their interests and managerial strengths are respectively in the health food and clothing businesses. They believe that the combined business structure is impeding each of them in focusing on the respective businesses.

They have therefore decided to undertake a demerger of Healthy Retail from SnipnStitch.

This restructure has, as its essential object, the improved business operations of the 2 companies. The legal separation of those companies will allow Healthy Retail to engage in the risky SkinnyTabs venture. Both companies can independently focus on maximising their return on capital by addressing their individual business needs and pursuing different growth opportunities. Improved management of each company is also reasonably expected to result from the restructure. Albeit that without the demerger dividend concession the restructure would not be financially viable, there is nothing to indicate that the non-incidental purpose of any of the parties to the transaction is to secure this concession. It is unlikely therefore, that the Commissioner would make a determination under paragraph 45B(3)(a) that section 45BA applies to the demerger benefit provided.

Case Study 6

Herb and Ruby began making lemon and sarsaparilla soda drinks from their home in the late 1960s, setting up the business in a wholly owned company called SodaPop Pty Ltd (SodaPop). Over time, they developed a strong following for the product and set up a free home delivery service for surrounding suburbs. In the mid-1990s, a group of venture capitalists approached Herb and Ruby with a proposal to undertake a scrip take-over of SodaPop. The object was to merge the SodaPop distribution network with an existing network the venture capitalists owned. Herb and Ruby accepted. The transaction was undertaken by reverse scrip takeover, with SodaPop acquiring all the issued capital in Statewide Drinks Distributor Pty Ltd (Statewide) in return for issuing new shares to the venture capitalists. Herb and Ruby held 30% of the shares in SodaPop following this transaction. The distribution business was moved out of SodaPop into Statewide.

The Board of SodaPop has now received a proposal whereby that company will be taken over (by way of a scrip for scrip merger) by one of its competitors to form a national drinks distribution company. This is a medium-sized public company called Big Drink Distributions Co Ltd (Big Drink) and is listed on the Australian Securities Exchange.

Most of the Board members believe the sale of SodaPop to their competitor is in the best interests of the distribution business (it is expected that the expanded group will carve out additional market share and that there will be a range of other synergistic improvements). Herb and Ruby have misgivings in regard to the SodaPop business. They think it will be damaged by being taken over by a business which is focused on distribution. In addition, they have always performed the core managerial role in SodaPop and believe their authority and effectiveness in that role will be diminished if SodaPop is answerable to the board of Big Drink Distributions.

SodaPop advisers have proposed a restructure which will effect the merger while ensuring that the management of the SodaPop business remains autonomous. It is proposed that Statewide be demerged from SodaPop, with Statewide then being subject to the scrip takeover by Big Drink Distributions.

On balance, it is considered that this proposed restructure would not attract the application of section 45B. Enhancing the business prospects of the distribution business is the essential and immediate objective of the restructure. The provision of ownership interests to the head entity's shareholders is an incident of the business restructure. It is acknowledged that immediately following the demerger the head entity shareholders cease to own shares in Statewide under the scrip for scrip transaction. However, this aspect of the arrangement is consistent with the business objects of the restructure and simply leaves the shareholders in the position of economic owners of a larger business.

THE APPLICATION OF THE DIVIDEND SUBSTITUTION RULE

102. In so far as it relates to the provision of a capital benefit, subsection 45B(2) provides that section 45B applies where:

- there is a scheme under which a person is provided with a capital benefit by a company
- 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, and
- 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 the relevant taxpayer to obtain a tax benefit.

Capital benefit

103. The concept of being provided with a capital benefit is explained in subsection 45B(5), which states that a person is provided with a capital benefit if they are either provided with an ownership interest in a company, distributed share capital or share premium or something is done that increases the value of their ownership interest.

104. In a demerger, subsection 45B(5) includes in the provision of a capital benefit that part of a demerger benefit that is not a dividend. As the concepts of demerger benefit and capital benefit are both defined by reference to the provision of ownership interests, to some extent their meanings overlap. The overlap of the 2 concepts is confirmed and explained by subsection 45B(6), which stipulates that a person is not provided with a capital benefit to the extent that the provision of interests to them involves their receiving a demerger dividend. Thus, the effect of subsections 45B(5) and (6) is that to the extent that the provision of a demerger benefit is not a demerger dividend, it will also constitute the provision of a capital benefit.

105. Officers should also note that for the provision of ownership interests to be considered a capital benefit under a demerger it is not necessary that they be provided by the head entity. For example, if the entity to be demerged issues ownership interests to the head entity's owners this constitutes the provision of ownership interests in a company and, therefore, the provision of capital benefits.

Tax benefit

106. Under subsection 45B(9), a taxpayer obtains a tax benefit if the amount of tax payable by the taxpayer would, apart from section 45B, be less than the amount that would have been payable, or would be payable at a later time than it would have been payable, if the capital benefit had been a dividend. As discussed in this Practice Statement, with respect to demerger benefits, the tax effect of paying the amount as a notional dividend (under subsection 45B(9)) must be taken into account in determining whether the taxpayer has obtained a tax benefit or not. Thus, the existence of capital losses, income tax losses and franking credits at the time at which the capital benefit was provided does not mean that the same or less tax would have been payable if the capital benefit had been a dividend. In most cases, taxpayers would pay less tax on the provision of a capital benefit than they would pay if it were received as an assessable dividend.

A more than incidental purpose of enabling a taxpayer to obtain a tax benefit

107. A similar approach to that used for concluding whether the requisite purpose exists or not for the demerger object in section 45B should also be followed for the purposes of determining whether there is a more than incidental purpose of enabling a taxpayer to obtain a tax benefit in the form of tax preferred capital. The difference is merely one of emphasis and relevance, due to the different ways in which the tax benefit is provided.

108. Section 45B is concerned not only with capital benefits provided in substitution for a company's ordinary dividend policy, but also the substitution of capital for extraordinary dividends. In other words, section 45B is concerned with striking down the provision of tax preferred capital if, effectively, it distributes profits to owners. In the case of demergers, it is rare for the substitution of capital for ordinary dividends to occur. Rather, a restructure such as a demerger offers the opportunity for extraordinary or accumulated profits, which may not otherwise have been distributed, to be provided in the form of capital.

109. Officers should have regard to all the relevant circumstances in determining whether the requisite purpose of providing a capital benefit in substitution for a dividend for tax advantage is present or not. The starting point of an enquiry into the dividend substitution purpose under section 45B is whether the capital benefit is attributable to profits, as required under paragraph 45B(8)(a). That is whether, in the company's circumstances, a discernible connection can be made between the capital benefit and the profits of the company or its subsidiaries. An enquiry such as this will involve having regard to the essential nature of contributed capital and profit, and the availability for distribution of each.

110. Contributed capital is an immutable nominal sum contributed by the shareholders and by reference to which the growth of the corporate business is measured and identified as profit. Under the corporate paradigm, the contributed capital is meant to provide lasting support to the business and profit excess to the requirements of the business is meant to be distributed to the corporators. A distribution of profits is a relatively ordinary corporate event and a distribution of capital a relatively extraordinary one. A distribution of capital would be expected to coincide with its release from a disposal of part of the corporate business structure or, perhaps, its replacement with debt capital where it is shown to be more profitable for shareholders. However, where profits are available and contributed capital is not demonstrably available or surplus to needs, there is a strong likelihood that the return of capital is in substance attributable to profits.

111. If the provision of capital is attributable to profits, then a consideration of this in conjunction with an examination of the other relevant circumstances indicates whether the substituted dividend was made for the more than incidental purpose of enabling the taxpayer to obtain a tax advantage. As with the demerger specific rule, the chief indicator against a finding as to requisite purpose will be the non-tax effects of the demerger, particularly those consistent with improving the business operations of the group.

112. Where the demerger is a genuine business demerger, the issue for section 45B generally is whether the components of the demerger allocation as between profit and capital reflect the circumstances of the demerger. Paragraphs 52 to 59 of this Practice Statement illustrate the broad approach to be taken in identifying those components.

113. The exercise envisaged involves an economic notion of share capital being apportioned across the assets of the business. Thus, the amount of share capital invested in the demerged entity would commonly be determined in accordance with the relative market value of the demerged entity to the corporate group. An exception might occur where, for example, the demerger allocation is able to be traced historically to specific investments of the head entity's profit or contributed capital.

114. Logically, a bias towards contributed capital in demerger allocations would be rare. However, if the distribution does include an over-allocation of capital, its implications for enabling shareholders to obtain a tax advantage should be explored. For example, after considering all the relevant circumstances of the demerger scheme, it may be concluded objectively that the head entity is preserving profits for later distribution to shareholders on a tax-preferred basis. In this regard, the availability of surplus franking credits as a result of the demerger dividend not being frankable may also play a part.

SPECIFIC ISSUE

Demergers implemented by a voluntary winding up

115. A demerger may be implemented by way of a voluntary winding up. That is, the ownership interests in the demerging entity may be provided to the head entity's owners by way of an in specie distribution of shares from the liquidator.

116. When a company is placed in voluntary liquidation, the liquidator replaces the board of directors, becomes the governing body of the company and assumes all the powers of the board. The liquidator exercises these powers as an agent of the company (see *Re: Crest Realty Pty. Ltd [No 2]*[16]). Thus, when a liquidator makes an in specie distribution of shares to the head entity's owners, the distribution is made by the liquidator in his or her capacity as agent of the company, and thus by the company.

117. Accordingly, an in specie distribution of shares from the liquidator is capable of constituting a demerger benefit or capital benefit within the meaning of subsections 45B(4) and (5) respectively and meets the requirement for the application of section 45B in paragraph 45B(2)(a) that a person is provided with a demerger benefit or a capital benefit by a company. Further, the liquidator's distribution of the shares in the demerged entity will be exposed to the same enquiries as to purpose and appropriate allocation of the benefit to profit (see discussion beginning at paragraph 50 of this Practice Statement and otherwise.

118. As a general observation, it may be noted that the liquidation of a head entity would ordinarily not be expected to result in any changes to the business of the demerged entity. Accordingly, there is a strong likelihood that enabling the shareholders to obtain a tax advantage from the demerger dividend is a substantial purpose of the demerger scheme.

EFFECT OF THE APPLICATION OF SECTION 45B – DETERMINATIONS

119. If the conditions for application in subsection 45B(2) are met, the Commissioner is empowered under subsection 45B(3) to make a determination that:

- section 45BA applies in relation to the whole, or a part, of the demerger benefit, or
- section 45C applies in relation to the whole, or a part, of the capital benefit.

120. A determination under section 45BA will be made where it is considered that there is a more than incidental purpose of obtaining a tax-free dividend under the demerger relieving provisions. A determination under section 45C will be made where it is considered that there is a more than incidental purpose of obtaining a capital benefit in substitution for dividend for tax advantage. If both the requisite purposes exist, it is open to the Commissioner to make a determination under both sections 45BA and 45C. Logically, the Commissioner would turn their mind to section 45BA first.

Determinations under paragraph 45B(3)(a) that section 45BA applies

121. The effect of a section 45BA determination is that the demerger benefit, or part of the benefit, is taken not to be a demerger dividend for the purposes (subsection 45BA(1)). In other words, the whole or a part of the demerger benefit will not be eligible for the demerger dividend exemption provided for in subsections 44(3) and (4) and will be assessable as a dividend in the ordinary way. Similarly, for

[16] [1977] 1 NSWLR 664.

non-residents, the amount will not be a demerger dividend that is excluded from withholding tax under subsection 128B(3D).

122. Although the Commissioner is empowered to make a determination in respect of the whole demerger benefit, if that demerger benefit includes in part a capital component, any such determination in relation to section 45BA would be ineffective against that part. Thus, a determination in relation to section 45BA will only be made in respect of the demerger dividend part of the demerger benefit.

Determinations under paragraph 45B(3)(b) that section 45C applies

123. The effect of a determination that section 45C applies is that the amount of the capital benefit, or part of the capital benefit, is taken to be an unfranked and non-rebatable dividend that is paid by the company out of profits of the company to the shareholder or relevant taxpayer at the time that the shareholder or relevant taxpayer is provided with the capital benefit (subsections 45C(1) and (2)). The result is that the whole or part of the capital benefit in respect of which the determination is made becomes a dividend which is fully assessable, or subject to withholding tax, in the hands of the recipient.

124. In addition, under subsection 45C(3), the Commissioner is empowered to make a further determination that the whole or part of the capital benefit was paid under a scheme for which a purpose, other than an incidental purpose, was to avoid franking debits arising in relation to the distribution from the company if the Commissioner has made a determination in respect of the capital benefit under paragraph 45B(3)(b). Such a further determination would result in an additional franking debit arising in the company's franking account.

125. The ability to make a further determination under subsection 45C(3) recognises that the preservation of franking credits in the company's accounts may be a more than incidental purpose of the parties to a scheme to provide capital benefits in substitution for dividends. The amount of the franking debit is equal to the franking debit that would have arisen if the amount in respect of which the determination is made had been a fully franked dividend and arises on the day on which notice of the determination is served on the company.

Amendment history

18 April 2024

Part	Comment
Throughout	Minor changes to align to current style and citation standards, including updating case citations.
Contact officer	Updated.

10 October 2012

Part	Comment
Generally	Updated to current style guide and updated legislative references.
Paragraph 4A and footnote 1A	Renumbered to Paragraph 5 and footnote 1 and other paragraphs and footnote renumbered appropriately.
Old paragraphs 68, 69 and footnote 13A	Deleted.
Contact officer	Updated.

17 May 2012

Part	Comment
Related practice statements	Inserted PS LA 2005/24 and PS LA 2012/1.

26 April 2012

Part	Comment
Paragraph 4A and footnote 1A	Amended following the issue of PS LA 2012/1 and inserted new footnote 1A.

21 November 2011

Part	Comment
Contact details	Updated.

1 July 2008

Part	Comment
Paragraph 4A	Inserted new heading and paragraph.
Paragraphs 68, 69 & footnote 13A	Minor changes.

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Related public rulings	TR 2003/8
Related practice statements	PS LA 2005/24 PS LA 2012/1
Case references	Bellinz Pty Ltd & Ors v The Commissioner of Taxation [1998] FCA 615; 155 ALR 220; 98 ATC 4634; 39 ATR 198 Commissioner of Taxation v Consolidated Press Holdings Ltd [2001] HCA 32; 207 CLR 235; 75 ALJR 1150; 179 ALR 625; 2001 ATC 4343; 47 ATR 229 Commissioner of Taxation v Hart [2004] HCA 26; 217 CLR 216; 2004 ATC 4599; 55 ATR 712; 78 ALJR 875; 206 ALR 207 Re: Crest Realty Pty. Ltd. (in Liq.) and the Companies Act [1977] 1 NSWLR 664; 2 ACLR 502; [1977] CLC 40-349
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