



CR 2005/8 - Income tax: return of capital - Strike Oil NL

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Class Ruling

Income tax: return of capital – Strike Oil NL

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Preamble

*The number, subject heading, **What this Class Ruling is about** (including **Tax laws**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Withdrawal**, **Arrangement** and **Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. CR 2001/1 explains Class Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

What this Class Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax laws' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates.

Tax law(s)

2. The tax laws dealt with in this Ruling are:

- subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) – definition of 'dividend';
- section 44 of the ITAA 1936;
- section 45A of the ITAA 1936;
- section 45B of the ITAA 1936; and
- section 45C of the ITAA 1936.

3. This Ruling does not cover the application of the capital gains and losses provisions of the *Income Tax Assessment Act 1997* (ITAA 1997) to the arrangement.

Class of persons

4. The class of persons to whom this Ruling applies is comprised of the shareholders of Strike Oil NL ('Strike') who held ordinary shares on the 24 March 2004 and who received the return of capital distribution under the arrangement described below.

Qualifications

5. The Commissioner makes this ruling based on the precise arrangement identified in this Ruling.

6. The class of persons defined in this Ruling may rely on its contents provided the arrangement actually carried out was carried out in accordance with the arrangement described in paragraphs 12 to 22.

7. If the arrangement actually carried out was materially different from the arrangement that is described in this Ruling, then:

- this Ruling has no binding effect on the Commissioner because the arrangement entered into was not the arrangement on which the Commissioner has ruled; and
- this Ruling may be withdrawn or modified.

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Date of effect

9. This Ruling applies to the 2003-04 income year.

10. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20). Furthermore, the Ruling only applies to the extent that:

- it is not later withdrawn by notice in the *Gazette*; or
- it is not taken to be withdrawn by an inconsistent later public ruling; or
- the relevant tax laws are not amended.

Withdrawal

11. This Ruling is withdrawn and ceases to have effect after 30 June 2004. However, the Ruling continues to apply despite its withdrawal in respect of the tax laws ruled upon to all persons within the specified class who entered into the specified arrangement.

Arrangement

12. The arrangement that is the subject of the Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- Request for a Class Ruling from TaxCentre Consultants on behalf of Strike dated 7 April 2004;
- The Sale and Purchase Agreement for Strike's interest in a gas permit between Strike and the purchasers dated 11 August 2003;
- Notice of General Meeting and Explanatory Memorandum for Ordinary Shareholders and Preference Shareholders dated 24 March 2004;
- Minutes from the General Meeting of Shareholders and Preference Shareholders dated 19 April 2004; and
- Letters dated 13 July 2004 and 1 November 2004 from TaxCentre Consultants on behalf of Strike.

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

13. At the time of the arrangement Strike was an unlisted company which carried on a business of exploration for oil and gas. Prior to the arrangement its main asset was an interest in a prospective offshore gas permit ('Gas Permit'). It was also engaged in a number of less advanced exploration projects.

14. Prior to the arrangement, Strike was the beneficial owner of certain joint venture interests in the Gas Permit comprising a participating interest of 50% in the permit, certain joint property, the permit area and the associated joint operating agreement. An unrelated company ('A Ltd') held the other 50% interest in the joint venture.

15. In accordance with Australian accounting standards Strike had capitalised exploration expenditure in respect of the Gas Permit of \$14,098,868. The capitalised exploration expenditure included Strike's share of expenditure on drilling an exploration well and an appraisal well. Results from these wells were inconclusive as to whether the field would be commercially viable. Strike and A Ltd agreed that further drilling was required. Rather than risk its own limited funds on further drilling Strike resolved to dispose of its interest in the Gas Permit.

16. Additionally, certain costs had been expensed even though they were attributable to reporting periods during which Strike's primary activity was in developing the Gas Permit assets. These costs were reflected in Accumulated Losses at 31 December 2003 of \$6,043,097. Both capitalised and written-off costs were funded entirely from capital contributed by shareholders.

17. With effect from 1 July 2003, Strike disposed of its interest in the Gas Permit to an unrelated company ('B Pty Ltd'). Under the Sale & Purchase Agreement Strike assigned its interest in the Gas Permit to B Pty Ltd and B Pty Ltd's holding company assumed all of Strike's obligations in respect of the Gas Permit. The proceeds from the disposal of Strike's interest in the Gas Permit totalled \$23.5 million.

18. Strike's board of Directors resolved to distribute approximately 80% of the proceeds from the sale of the Gas Permit to Shareholders by a cash distribution of 42 cents per share to be debited against share capital. This resolution was approved by shareholders in a general meeting and the distribution was made on 22 April 2004.

19. The stated purpose of the distribution was to return surplus funds from the sale of Strike's major asset to shareholders who had participated in funding the development of the Gas Permit. Shareholders could choose to re-invest some or all of the return of capital but were not obliged to do so.

20. As at 31 December 2003, Strike had 42,806,578 ordinary shares on issue with paid up ordinary capital of \$22,209,789. Strike also had 4,888,889 preference shares with paid up capital of \$2.2 million. The preference shareholders were permitted to convert their shares into ordinary shares prior to the return of capital distribution. The distribution resulted in Strike's share capital account being reduced by \$20,032,096.

21. Strike's share capital account was not tainted for income tax purposes, as no amount had been transferred to that account from any of Strike's other accounts.

Ruling

22. As the return of capital distribution was debited to Strike's share capital account it is not a dividend, as defined in section 6(1) of the ITAA 1936. The Government has announced its intention to introduce laws with effect from 1 July 2002 dealing with the tainting of share capital accounts [the then Minister for Revenue and Assistant Treasurer's Press Release C104/02 of 27 September 2002]. Although such laws may be relevant to the application of section 6D of the ITAA 1936, this Ruling does not extend to the application of these proposed laws.

23. The Commissioner will not make a determination under subsection 45A(2) or subsection 45B(3) of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole, or any part, of the distribution. The distribution will, therefore, not be taken to be a dividend for income tax purposes.

Explanation

Dividends

24. Subsection 44(1) of the ITAA 1936 includes in a resident shareholder's assessable income a dividend, as defined by subsection 6(1) of the ITAA 1936, that is paid to the shareholder out of company profits.

25. As the distribution was debited against an amount standing to the credit of Strike's untainted share capital account, it does not constitute a dividend because of the exclusion in paragraph (d) in the definition of a 'dividend' in subsection 6(1) of the ITAA 1936. That paragraph excludes a distribution from the meaning of 'dividend' if the amount of a distribution is debited against an amount standing to the credit of the company's 'share capital account'.

26. Share capital account is defined in subsection 6(1) of the ITAA 1936 as having the meaning given by section 6D of the ITAA 1936, which in turn defines the term as an account which the company keeps of its share capital, or any other account created after 1 July 1998 where the first amount credited to the account was an amount of share capital.

27. Subsection 6D(3) states that an account is not a share capital account if it is tainted for the purposes of Division 7B of Part IIIA of the ITAA 1936. An account, that would otherwise be a share capital account, is tainted for the purposes of Division 7B if an amount is transferred from another account except in the circumstances provided for by section 160ARDM of the ITAA 1936. Strike has confirmed that there have been no transfers that have tainted its share capital account under that rule, which applies to transfers before 1 July 2002. The Government has announced its intention to introduce laws dealing with the tainting of share capital accounts [the then Minister for Revenue and Assistant Treasurer's Press Release C104/02 of 27 September 2002]. Although such laws may be relevant to the application of section 6D, this Ruling does not extend to the application of these proposed laws.

28. Sections 45A and 45B of the ITAA 1936 are two anti-avoidance provisions which, if either applies, allow the Commissioner to determine that all or part of a distribution is treated as an unfrankable dividend that is paid by the company out of profits.

Section 45A of the ITAA 1936 – Streaming of dividends and capital benefits

29. In broad terms, for the Commissioner to make a determination under subsection 45A(2) of the ITAA 1936 that section 45C of the ITAA 1936 applies, a company must stream capital benefits to its *advantaged shareholders and pay dividends to its disadvantaged shareholders*, whether in the same income year or in different income years.

30. Under the arrangement, Strike provided a capital benefit to all holders of ordinary shares in proportion to their holdings. In these circumstances, there is no streaming of capital benefits to some shareholders and dividends to other shareholders. Accordingly, section 45A does not apply to the distribution.

Section 45B of the ITAA 1936 – Schemes to provide capital benefits in substitution for dividends

31. Section 45B of the ITAA 1936 applies where certain amounts of a capital nature are provided to shareholders in substitution for dividends. Specifically, the provision applies where:

- there is a **scheme** under which a person is **provided with a capital benefit** by a company (paragraph 45B(2)(a) of the ITAA 1936);
- under the scheme a taxpayer, who may or may not be the person provided with the capital benefit, **obtains a tax benefit** (paragraph 45B(2)(b) of the ITAA 1936); and
- having regard to the **relevant circumstances** of the scheme, it would be concluded that the person, or one of the persons, entered into the scheme or carried out the scheme or any part of the scheme for a **purpose**, other than an incidental purpose, **of enabling a taxpayer to obtain a tax benefit** (paragraph 45B(2)(c) of the ITAA 1936).

Each of these conditions is considered below.

32. The distribution is a 'scheme', or part of a scheme, within the broad meaning of that term.

33. The phrase 'provided with a capital benefit' is defined in subsection 45B(5) of the ITAA 1936. A person is provided with a capital benefit if:

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

34. As Strike debited the amount of the distribution against its share capital account shareholders were provided with a capital benefit.

35. A taxpayer 'obtains a tax benefit', as defined in subsection 45B(9) of the ITAA 1936, where:

- the amount of tax payable; or
- any other amount payable under the ITAA 1936 or the ITAA 1997;

by the taxpayer would, apart from the operation of section 45B:

- be less than the amount that would have been payable; or
- be payable at a later time than it would have been payable;

if the capital benefit had instead been a dividend.

36. Ordinarily, a return of capital distribution is subject to tax under the capital gains and losses provisions of the income tax law. Shareholders would therefore obtain a tax benefit under the arrangement within the meaning of subsection 45B(9).

37. The Commissioner is required to consider the circumstances set out under subsection 45B(8) of the ITAA 1936 to determine whether any part of the arrangement was entered into for a purpose, other than an incidental purpose, of enabling a relevant taxpayer to obtain a tax benefit. That list of circumstances is not exclusive and not all factors will be relevant to every scheme.

38. The test of purpose is an objective one. Having regard to the relevant circumstances of the scheme, the purpose test will be met if, 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.

39. In this case, the relevant taxpayers are the holders of ordinary shares in Strike. The relevant circumstances of the arrangement are:

- although Strike realised an accounting profit on the disposal of the Gas Permit it is appropriate to have regard, in addition to the capitalised expenditure, to an allocation of the operational costs expensed during reporting periods in which development of the Gas Permit was Strike's primary activity and, the consequent proportion of the sale proceeds that reflect profits. It is also relevant that these costs were funded entirely from capital contributed by shareholders and that not all the proceeds from the disposal of the Gas Permit were distributed. It is, therefore, concluded that the distribution is attributable to capital rather than to profits (paragraph 45B(8)(a));

- strike had previously paid dividends only in respect of preference shares (paragraph 45B(8)(b));
- at the time of the distribution, Strike had a diverse range of shareholders, corporate and individual, who were mainly residents of Australia. There are no tax characteristics common to shareholders that are especially suggestive of there being a more than incidental purpose of enabling the shareholders to obtain tax benefits from a return of capital (paragraphs 45B(8)(c) to 45B(8)(f)); and
- the proportional interests held by the shareholders after the distribution were the same as that that would have been held had an equivalent dividend been paid instead of the capital benefit. This factor tends toward finding that there exists the requisite degree of purpose (paragraph 45B(8)(h)).

40. Paragraph 45B(8)(k) of the ITAA 1936 also requires the Commissioner to consider the matters listed in subparagraph 177D(b)(i) to (viii) of the ITAA 1936 in relation to the arrangement, including the form and substance of the scheme and its financial implications for the parties to it. These matters are not considered to incline for or against a conclusion as to whether the requisite degree of purpose exists.

41. Having regard to the circumstances outlined in paragraphs 39 and 40, it is concluded that the arrangement as described was not entered into for a more than incidental purpose of enabling shareholders to obtain a tax benefit.

42. Although there was a scheme by which shareholders were provided with a capital benefit and obtained tax benefits, these tax benefits are, at most, a merely incidental purpose of the arrangement.

43. Accordingly, the Commissioner will not make a determination under subsection 45B(3) that section 45C applies to the distribution.

Section 45C of the ITAA 1936 – Deeming dividends to be paid where sections 45A or 45B determinations have been made

44. As the Commissioner will not make a determination under subsection 45A(2) of the ITAA 1936 or subsection 45B(3) of the ITAA 1936 in relation to the arrangement as described, section 45C will not deem any part of the return of capital distribution to be an unfranked dividend for the purposes of the ITAA 1936 or ITAA 1997.

Detailed contents list

45. Below is a detailed contents list for this Class Ruling:

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Commissioner of Taxation

23 February 2005

<i>Previous draft:</i>	- ITAA 1936 Pt IIIAA Div 7B
Not previously issued as a draft	- ITAA 1936 44
	- ITAA 1936 44(1)
<i>Related Rulings/Determinations:</i>	- ITAA 1936 45A
CR 2001/1; TR 92/1; TR 92/20;	- ITAA 1936 45A(2)
TR 97/16	- ITAA 1936 45B
	- ITAA 1936 45B(2)
<i>Subject references:</i>	- ITAA 1936 45B(2)(a)
- return of capital on shares	- ITAA 1936 45B(2)(b)
- share capital	- ITAA 1936 45B(2)(c)
	- ITAA 1936 45B(3)
	- ITAA 1936 45B(5)
<i>Legislative references:</i>	- ITAA 1936 45B(8)
- Copyright Act 1968	- ITAA 1936 45B(8)(a)
- TAA 1953 Pt IVA	- ITAA 1936 45B(8)(b)
- ITAA 1936 6(1)	- ITAA 1936 45B(8)(c)
- ITAA 1936 6D	- ITAA 1936 45B(8)(d)
- ITAA 1936 6D(3)	- ITAA 1936 45B(8)(e)

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- ITAA 1936 45B(8)(f)
- ITAA 1936 45B(8)(g)
- ITAA 1936 45B(8)(h)
- ITAA 1936 45B(8)(k)
- ITAA 1936 45B(9)
- ITAA 1936 45C
- ITAA 1936 160ARDM
- ITAA 1936 177D(b)(i)
- ITAA 1936 177D(b)(ii)
- ITAA 1936 177D(b)(iii)
- ITAA 1936 177D(b)(iv)

- ITAA 1936 177D(b)(v)
- ITAA 1936 177D(b)(vi)
- ITAA 1936 177D(b)(vii)
- ITAA 1936 177D(b)(viii)

Other references:

- Minister of Revenue and Assistant
Treasurer's Press Release
C104/02 of 27th September 2002

ATO references:

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