



TR 2010/D8 - Income tax: retail premiums paid to shareholders where share entitlements are not taken up or are not available

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Draft Taxation Ruling

Income tax: retail premiums paid to shareholders where share entitlements are not taken up or are not available

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What this Ruling is about

1. This Ruling is about the taxation of Retail Premiums paid to shareholders in companies in respect of amounts subscribed for shares.

Scheme

2. This Ruling applies to schemes with the following features:
- A company grants rights (Entitlements) to its existing shareholders (subject to their eligibility) that allow them to subscribe for an allotment of new shares in the company at an amount, often called the 'Offer Price';
 - The Offer Price is, or may be, less than the current market value of the shares;
 - Shareholders can choose not to exercise some or all of their Entitlements to an offered allotment (which Entitlements lapse if not exercised), or are not eligible to receive an Entitlement or are not permitted to exercise rights under it. (These shareholders are, in these respects, 'Non Participating Shareholders');

- Non Participating Shareholders who are not eligible to receive an Entitlement, or are not permitted to exercise rights under it, are most commonly non-resident shareholders who reside in a jurisdiction where an Entitlement they could exercise would require the grant of the Entitlement to comply with rules particular to that jurisdiction;
- Entitlements which Non Participating Shareholders did not exercise or could not exercise or could not receive are collectively referred to in this Ruling as 'Unexercised Entitlements';
- The company issuing the Entitlements issues a number of shares, equivalent to those which would have been issued under the Unexercised Entitlements, to other subscribers (such as Institutional investors), often to those offering the highest amount for them in what is commonly referred to as a 'Bookbuild process';
- The amount offered by the other subscribers for the equivalent shares is commonly referred to as the 'Clearing Price'. The Clearing Price is offered by the other subscribers as one amount, solely as consideration for the issue of the equivalent shares under the Bookbuild process;
- The Clearing Price is paid to the company directly, or indirectly through one or more of its agents or nominees (normally the 'Lead Managers' or underwriters of the issue of company shares or share registry);
- Where the consideration for the issue of the equivalent shares (such as the Clearing Price under a Bookbuild process) is more than a set amount per share, a company payment based on the excess is paid to the shareholders who had Unexercised Entitlements for which the equivalent shares are issued. This is the retail premium (Retail Premium). Commonly the set amount is the Offer Price at which Entitlements could be exercised, and the Retail Premium is the whole excess of a Clearing Price over that Offer Price. The difference between the Offer Price and the Clearing Price commonly arises because the Offer Price of the Entitlements is set at an appreciable discount below the known and expected market value of shares in the company;
- The Retail Premium paid may be all or only part of the excess according to which it is calculated;
- As a result, the Retail Premium is funded from part of the consideration for the issue of the equivalent shares of the company; and

- The Retail Premium payment by the issuing company to Non Participating shareholders is usually recorded on statements by the issuing company prepared by the issuing company's share registry, recording:
 - the issuing company's name;
 - that the amount of the Retail Premium paid is based on the shareholder's Entitlements based on their holdings in the issuing company;
 - the amount paid to the shareholder; and, in some cases;
 - that the payment is in relation to new shares issued by the company under the Bookbuild process.

Ruling

Retail Premium paid to Non Participating Shareholders

Dividends

3. A Retail Premium paid to a Non Participating Shareholder is assessable income as a dividend under section 44 of the *Income Tax Assessment Act 1936* (ITAA 1936).

4. A Retail Premium paid to a non-resident will be non-assessable non-exempt income under section 128D of the ITAA 1936 where it is subject to withholding tax under section 128B.

Franking of dividend

5. A Retail Premium paid to a Non Participating Shareholder is an unfrankable distribution sourced, directly or indirectly, from a company's share capital account pursuant to paragraph 202-45(e) of the *Income Tax Assessment Act 1997* (ITAA 1997).

Withholding tax on Retail Premiums to non-resident Non Participating Shareholders

6. A Retail Premium paid to a non-resident Non Participating Shareholder will be a dividend subject to withholding tax under subsection 128B(1) of the ITAA 1936, unless excluded under another provision of the ITAA 1936, ITAA 1997, or of the *International Tax Agreements Act 1953* which gives the force of law to certain international tax agreements. Withholding tax does not apply to franked dividends (see paragraph 128B(3)(ga) of the ITAA 1936). As a Retail Premium paid to a non-resident is an unfrankable distribution pursuant to paragraph 202-45(e) of the ITAA 1997 withholding tax will apply under subsections 128B(1) and 128B(4) of the ITAA 1936.

Ordinary income

7. In the alternative, a Retail Premium paid to a Non Participating Shareholder is ordinary income assessable under section 6-5 of the ITAA 1997 if the Retail Premium is not a dividend.

Capital gains tax

8. A CGT asset, being a right, comes into existence when a Non Participating Shareholder becomes entitled to a Retail Premium.

9. When the Retail Premium is paid to the Non Participating Shareholder, CGT event C2 under section 104-25 of the ITAA 1997 happens.

10. Any capital gain a Non Participating Shareholder makes from receipt of the Retail Premium is reduced under section 118-20 of the ITAA 1997 to the extent that the amount is otherwise included in the Non Participating Shareholder's assessable income (under section 44 of the ITAA 1936, or alternatively section 6-5 of the ITAA 1997), or is non-assessable non-exempt income (under section 128D of the ITAA 1936).

Date of effect

11. When the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 77 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

8 December 2010

Appendix 1 – Explanation

ⓘ *This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.*

Retail Premium paid to Non Participating Shareholders are assessable dividends

Summary

12. It is the Commissioner's view that the scheme to which this Ruling applies, including the:

- grant by a company of rights to shareholders to subscribe for new shares in a company with a facility for payment of Retail Premiums to Non Participating Shareholders;
- issue of new shares in the company to third parties in respect of the unexercised or unavailable Entitlements of Non Participating Shareholders; and
- payment by the company of Retail Premiums to the Non Participating Shareholders,

is an arrangement for the purposes of subsection 6(4) of the ITAA 1936. Under that arrangement, the subscription money of the third parties paid for the shares issued in respect of the unexercised Entitlements of Non Participating Shareholders are paid or credited to the company, and the company pays or credits money (in the form of the Retail Premiums) to the Non-Participating Shareholders and debits its share capital account with the money paid, for the purposes of subsection 6(4).

13. A Retail Premium is paid by a company, to a Non Participating Shareholder, from amounts forming part of the company's share capital and in amounts debited to and sourced from the company's share capital account. As subsection 6(4) of the ITAA 1936 applies to the payment of the Retail Premium it is excluded from the exception in paragraph (d) to the definition of 'dividend' in subsection 6(1) of the ITAA 1936. As a result the Retail Premium falls within the definition of dividend in subsection 6(1), and is deemed to be a dividend paid out of profits under subsection 44(1B) of the ITAA 1936, and is assessable income under section 44 for the reasons in paragraphs 14 to 57 of this Explanation.

Paid by the company

14. A Retail Premium is paid by the company, whether it is paid directly by the company or by an agent or contractor of the company which is obliged by the company to pay it. The Commissioner considers that the character of a Retail Premium as an amount paid by the company is not different if it is actually paid by a merchant bank contracted to underwrite the float of shares in the company or as a Lead Manager of that float, if it is actually paid by a separate entity that provides the company's share registry, or if it is paid directly by company cheque or by electronic transfer from an account in the company's name.

15. The issuing company usually enters into agreements with any third parties, such as the relevant underwriters, Lead Managers and share registry. The issuing company includes, within the terms of the agreements, its obligation to pay a Retail Premium to Non Participating Shareholders according to the excess subscription monies raised (such as under a Bookbuild process), whether directly or by the underwriters and/or Lead Managers and/or share registry. The relevant third party agreements may provide that the issuing company is itself obliged to pay, or to secure payment, of the Retail Premium from any advance the third parties have to make in relation to the value of the excess to the company before the consideration for the issue of the equivalent shares is paid, but whether there is any advance to the company or any earlier payment of the Retail Premium because of such an advance is not material.

16. A company pays the Retail Premium when it is paid by any third party, such as the relevant underwriters, the Lead Managers and the share registry, acting as agents of the company, or applying the company's funds according to its instructions and directions. If a company elects to have a third party manage money paid as consideration for the issue of shares, the consideration is given to the company, is subscribed to the company's share capital and is the company's money. A Retail Premium payment on account of the amount of consideration subscribed or offered to be subscribed for shares is an application of the company's money by the company.

17. This view is consistent with the practical operation of the dividend provisions in the income tax law and with the practical operation of the *Corporations Act 2001*. The dividend provisions apply in the same way whether a company directly pays, provides or distributes to its shareholders, or acts indirectly through an agent, contractual counterparty or otherwise.

Paid to shareholders as shareholders

18. A Retail Premium is paid by the company to shareholders of the company in their capacity as shareholders. The Non Participating Shareholders are shareholders of the company. A Retail Premium arises for them only because and only according to the extent to which they are shareholders who have not exercised Entitlements. Non Participating Shareholders are entitled to a Retail Premium only if a sufficient amount is offered as consideration for the issue of shares by third party subscribers, and only so far as the shares are equivalent to those for which the Non Participating Shareholders did not subscribe or could not subscribe by exercising Entitlements.

Retail Premium not paid as consideration for Entitlement rights

19. The Retail Premium is not paid for the rights of the Non Participating Shareholders to subscribe for shares under Entitlements. The Retail Premium has the same character whether the Non Participating Shareholder had Entitlements they could have exercised but did not, had Entitlements they were not permitted to exercise, or had no Entitlements. No Retail Premium will arise if the consideration offered for the equivalent shares does not exceed a threshold, and whether a shareholder had Entitlements they could have exercised or did not, had Entitlements they were not permitted to exercise, or had no Entitlements, they have no Entitlements when the equivalent shares are offered for subscription. At the earliest time when the right to a Retail Premium arises no Entitlements of a Non Participating Shareholder exist. The connection between the shares consideration for which gives rise to the Retail Premium and what shares would have issued had Entitlements been exercised is only relevant in identifying those particular shareholders who receive a Retail Premium. This connection does not alter the character of a Retail Premium as a payment made to shareholders in that capacity. It also does not make the Retail Premium a payment for the loss of Entitlements (see paragraphs 114 to 128 of this Explanation).

Dividends

20. The definition of 'dividend' in subsection 6(1) of the ITAA 1936 has the general effect that any distribution made by a company to any of its shareholders, whether in money or property, and any amount credited by a company to any of its shareholders as shareholders, is a dividend.

21. A Retail Premium would fall under paragraphs 6(1)(a) and 6(1)(b) of the ITAA 1936 of the definition of dividend, as it is an amount paid or credited by a company to some of its shareholders, the Non Participating Shareholders, as shareholders. When a company secures by contract that an amount be paid or credited to its shareholders, it credits those amounts to them (and does not credit to its shareholders the consideration it gives under the contract which secures the payment or credit to shareholders). A Retail Premium may be paid directly by the company, be paid by the company through an independent share registry acting for the company as its agent, or be paid by the company through a contractor obliged to pay the Retail Premium such as an underwriter of a share issue including subscription for shares on exercise of the Entitlements and for shares issued in substitution for those under Unexercised Entitlements.

22. Paragraph (d) concerning the definition of 'dividend' in subsection 6(1) of the ITAA 1936 generally excludes a distribution from being a dividend if the distribution is debited against an amount standing to the credit of the company's share capital account. Under the current scheme to which this Ruling applies, the Retail Premium is or might properly be debited against an amount standing to the credit of the share capital account of the company.

23. However, subsection 6(4) of the ITAA 1936 states that the exclusion in paragraph (d) **does not apply** though the amount is so debited if, under an arrangement:

- (a) a person pays or credits any money or gives property to the company and the company credits its share capital account with the amount of the money or the value of the property; and
- (b) the company pays or credits any money, or distributes property to another person and debits its share capital account with the amount of the money or the value of the property so paid, credited or distributed.

24. As an issuing company under the current scheme has raised share capital from one set of shareholders (here, the third party subscribers who paid for equivalent shares such as under a Bookbuild process) and made a distribution of part of this share capital to another set of shareholders (here, by a Retail Premium paid to the Non Participating Shareholders), subsection 6(4) of the ITAA 1936 applies to exclude the payment of the Retail Premium from the exception in paragraph (d) from the definition of dividend in subsection 6(1).

25. Accordingly, Retail Premium payments are a dividend as defined in subsection 6(1) of the ITAA 1936 by the application of subsection 6(4), even if they are debited from amounts standing to the credit of a share capital account.

26. A dividend is included in the assessable income of a shareholder by subsection 44(1) of the ITAA 1936. Subsection 44(1) applies to include in assessable income dividends paid out of profits.

27. Subsection 44(1B) of the ITAA 1936 **deems** dividends debited against an amount standing to the credit of a share capital account to have been paid by the company out of profits derived by it. Accordingly, such Retail Premium dividends are deemed to be paid out of the company's profits, and are therefore dividends included in assessable income under subsection 44(1).

28. Effective from 28 June 2010, subsection 44(1A) of the ITAA 1936 deems any dividend paid out of an amount other than profits to be paid out of profits. Accordingly, if a retail premium dividend is not debited against an amount standing to the credit of a share capital account, and is not paid out of profits, it is deemed to be paid out of the company's profits, and is therefore a dividend included in assessable income under subsection 44(1).

Dividends to resident & non-resident shareholders

29. For dividends other than a ***non-share dividend***, these are included in assessable income only so far as they are paid out of profits or deemed to be paid out of profits derived by the company (for a resident shareholder, profits derived from any source (subparagraph 44(1)(a)(i) of the ITAA 1936); for a non-resident shareholder, profits derived from sources in Australia (subparagraph 44(1)(b)(i)); for a non-resident shareholder carrying on business in Australia at or through a permanent establishment, and where the company is a resident, profits derived from sources outside Australia so far as the dividends are attributable to the permanent establishment (subparagraph 44(1)(c)(i)). However, a Retail Premium paid to a non-resident and that is subject to withholding tax will be non-assessable non-exempt income under sections 128B and 128D of the ITAA 1936.

Retail Premium a dividend, even if not debited against the company's share capital account

30. There are only two possible sources of a dividend from a company for the purposes of the dividend provisions. These are profits of the company and share capital contributed to the company (which, in certain circumstances, is deemed to be paid out of profits by various sections in the ITAA 1936 and ITAA 1997).

31. A Retail Premium is a dividend paid out of profits, even if it is not debited against the company's share capital account (see paragraphs 150 to 189 of this Ruling).

Share capital

32. The Retail Premium is sourced from share capital of the company.

33. A Retail Premium is paid on the basis of amounts offered by third parties as consideration for the issue to them of shares in the company. Those amounts are share capital of the company and are amounts properly credited to the share capital account of the company. The Clearing Price is undivided and consists entirely and only of such amounts.

34. The meaning of the term 'share capital' was explained in paragraph 4.10 of the Explanatory Memorandum¹ to section 975-300 of the ITAA 1997 (which transferred to the ITAA 1997 the long-standing provisions defining the meaning of 'share capital account', originally 'share premium account'). Paragraph 4.10 states:

The concept of share capital is not defined in the ITAA 1997. Under its ordinary meaning, share capital includes amounts received by a company in consideration for the issue of shares.

35. The concept of share capital was considered in the High Court case of *Archibald Howie Proprietary Ltd & Ors v. Commissioner of Stamp Duties (NSW)* (1948) 77 CLR 143 (*Archibald*) where Williams J stated, at 157:

A company obtains capital by the issue of its shares....The amount payable may be satisfied by the payment of money or by some other proper consideration. But all shares must be paid for in full by money or money's worth. When the person to whom the shares are allotted pays or assumes the liability to pay for the shares in money or money's worth, **full consideration in money or money's worth moves from him to the company** for all the rights which he acquires under the memorandum and articles of association (emphasis added).

36. The above statement was referred to and approved by Gillard J in *Re The Swan Brewery Co Ltd* (1976) 3 ACLR 164 (*Swan Brewery*). His Honour said, at 166:

But when one talks about share capital, in my view, it means capital raised by the company from the issue of its shares.

37. The meaning of the term 'issued share capital', was considered by Gillard J in *Swan Brewery* at ACLR 166:

...when one uses the words 'issued share capital', then it seems to me that this expression means money or money's worth derived from the issue by directors of shares in order to raise capital.

38. These statements were endorsed and applied by the Full Court of the Federal Court in *St George Bank Ltd v. Federal Commissioner of Taxation* (2009) 176 FCR 424; [2009] FCAFC 62; 2009 ATC 20-103; (2009) 73 ATR 148. As Perram J said at FCAFC paragraphs 90 to 93:

90 ...If the subscription consideration is money then the company obtains money; if it is land, it obtains land; if the share is not fully paid then the company acquires a right to call upon the unpaid portion. The 'capital' of the company is the money or money's worth derived by the company from the issue of shares: *Re The Swan Brewery Co Ltd* (1976) 3 ACLR 164 at 166 per Gillard J.

¹ Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No. 3) Bill 2006.

91 ...by that issue of shares the company obtains assets consisting of the subscription consideration proffered for the shares. Those assets may or may not be capital assets. The company may, of course, use the assets obtained by the issue of the shares in any lawful way it chooses. If cash has been obtained, it may choose to acquire another capital asset. If it does so, then the purchase monies constituting that outgoing will clearly be capital in nature. On the other hand, if the money is used to meet ordinary everyday expenses such outgoings will not be ones to which s 8-2(a) applies.

92 ...the assets thus acquired by the company on the issue of its shares are, however, *not* the share capital of the company. Those assets are owned by the company; the share capital is owned by the members. Whilst it is no doubt convenient to refer to a company's capital it is important to understand the limitations inherent in that expression. In particular, it must not be thought that the use of the possessive connotes ownership by the company of the capital. Where every member of a group owns a thing or shares a quality it is common to ascribe ownership of that thing or possession of that quality to the noun describing the entire group. Thus, *the army's hopes* really means *the hopes of the soldiers of the army* for armies, unlike soldiers, do not have hopes, and to speak of *the speed of a team* is but a shorthand way of saying *the speed of the players on a team*. It is in that sense that the expression *the company's capital* is to be understood and in that light it denotes not capital owned by the company but rather, as commonsense suggests, the capital owned by the members of the company.

93 ...as such, both the concept of 'capital' in this context and the concomitant notion of 'profits' are concepts whose purpose is to ensure that creditors of a company are not prejudiced by the surreptitious reduction in the company's wealth. This is achieved by the requirement that dividends be paid only out of profits and that reductions in capital only occur where no prejudice is visited upon creditors. So viewed, this notion of capital – quite unlike the notion of capital referred to in s 8-2(a) [of the ITAA 1997] – is not concerned with a quality possessed by outgoings but, rather, with a concept operating beyond and above the assets of a company and dictating, at that conceptual level, particular outcomes of allocation, distribution and confinement. It is for that reason that no particular asset owned by a company can be identified as being part of the company's capital or of its profits. Both are concepts existing *dehors* the company's assets.

39. Amounts proffered in subscription for the issue of shares are paid, credited or given to the company, whether directly or through its agents. As, where a Retail Premium arises, the shares are issued in consideration of the whole of the amounts being proffered, the whole of the amounts is derived by the company and constitutes share capital of the company.

40. The amounts proffered in subscription for the issue of shares are share capital of the company and are properly credited by the company to its share capital account.

Share Capital Account

41. A share capital account is defined in subsection 975-300(1) of the ITAA 1997 as:

- (a) an account that the company keeps of its share capital; or
- (b) any other account (whether or not called a share capital account) that satisfies the following conditions:
 - (i) the account was created on or after 1 July 1998;
 - (ii) the first amount credited to the account was an amount of share capital.

Subsection 975-300(2) also states that:

If a company has more than one account covered by subsection (1), the accounts are taken, for the purposes of this Act, to be a single account.

42. The consideration offered for the issue of shares by a company is share capital of the company. Where the amount of such consideration is received by others, but is to be applied in a way the company requires, whether by way of Retail Premium or otherwise (such as, for instance, in discharge of company debt or in acquisition of company assets), the entitlement of the company to an account from those others of the application of the amount of consideration constitutes an account under paragraph 975-300(1)(b) of the ITAA 1997. It is an account created when it arises, that is, at the moment amounts offered to subscribe for the company's shares are paid and the application is accepted. At that moment the first (and only) amounts credited to that account are amounts of share capital.

43. Section 975-300 of the ITAA 1997 does not permit a company to choose not to include share capital in the accounts which together constitute its share capital account. The provision is a re-enactment of the cognate provision which accompanied and formed part of the provisions relating to dividends paid out of capital from the introduction of such provisions. The purpose and effect of those provisions clearly adopts and applies the critical concept in relation to companies that they have only profits and share capital; an interpretation of section 975-300 which made inclusion in share capital accounts a nominal rather than a factual matter would be inconsistent with the critical concept on which the provisions depend.

44. The above view is also consistent with the later Parliamentary view in paragraph 1.65 of the Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998 which states:

Under the Corporations Law, amounts received by a company for the issue of shares are credited to the share capital account. The share capital account of the company will thus already include all amounts paid-up on the shares of the company. Therefore a share capital account cannot be tainted by transferring amounts paid-up for shares to that account, but only by other accounts. **(Some accounting standards may require a company to initially treat part of what is legally share capital as a liability for accounting purposes, and then to transfer that amount to share capital. Since, however, for tax purposes the amount will already be credited to the share capital account, this transfer is not affected by the tainting rule)** (emphasis added).

Consideration for issue of shares credited to a company's share capital account even if the company has not reported that it is in its share capital account

45. In instances where a company has not formally recorded or credited some or all of a Clearing Price amount in its identified share capital account (or where the Clearing Price amount may be recorded and credited in a stated 'separate' or 'segregated' account under the name of an entity acting as agent for the company), the Retail Premium amount would still constitute part of the company's share capital account under subsection 975-300(1) of the ITAA 1997.

46. Any account to which the company is entitled of the consideration offered for issue of its shares is an account included as part of the company's share capital account under section 975-300 of the ITAA 1997.

47. Where the entity acts as agent or nominee for the company in keeping the account, the account is that of the company itself. Where the entity may be required to account to the company for the amount of consideration it receives into the 'separate' or 'segregated' account, the entitlement of the company to such accounting is an account. Consequently, what consideration is recorded or credited in a 'separate' or 'segregated' account is part of the share capital account of the company as:

- it is an account the company keeps (via the entity acting as the company's agent or trustee) of its share capital (paragraph 975-300(1)(a) of the ITAA 1997); or
- it is an account (whether or not called a share capital account) that was created to hold and credit, first, amounts received by the company in consideration for the issue of its shares (paragraph 975-300(1)(b)), because the company is entitled to an accounting for those amounts and that entitlement first arises when the first of those amounts begins to be held by the entity as consideration of that kind.

48. If any part of the Clearing Price is recorded in such an account to which the company is entitled, whether an account to the company by another person of the application of that part of the Clearing Price or an account of the company maintained by an agent or nominee of the company, this account would constitute part of the share capital account of the company under section 975-300 of the ITAA 1997. This is because the entity is acting for the company and adhering to the company's instructions, in relation to both holding share capital raised by the company (from its Clearing Price amount) and in applying any of these proceeds to either the company, to the Retail Premium to its Non Participating Shareholders or to any other purpose agreed by the company. Paragraph 975-300(1)(b) also makes clear that an account can be a company's share capital account 'whether or not called a share capital account'.

Share capital applied by the company

49. The nature of the share capital of a company is that it can be applied to the purposes of the company, whether by way of the acquisition of capital assets, by way of meeting revenue outgoings, or by way of dividends to shareholders. The analysis of the Full Court of the Federal Court in *St George Bank Ltd v. Federal Commissioner of Taxation* (2009) 176 FCR 424; [2009] FCAFC 62; 2009 ATC 20-103; (2009) 73 ATR 148 gives an account of this, per Perram J at paragraphs 85 to 88:

85 *First*, a company has a separate legal identity from that of its members and, having that separate existence, has all the powers and capacities of a natural person: s 124.

86 *Secondly*, the relationship between a company and its members is unlike relationships that natural persons may have for reasons which include the inability of natural persons to issue interests in themselves. It is because of that that the powers to raise and return shareholders' capital and to pay dividends thereon are expressly granted by statute: see s 124(1). Such powers are not included beneath the broad canopy of powers possessed by natural persons. A necessary consequence is that the payment of dividends and the raising and return of capital are sui generis activities neither sourced in, nor analogous with, the activities of natural persons.

87 *Thirdly*, s 8-2(a) [of the ITAA 1997] is directed to all persons both natural and otherwise. It operates on notions of capital which are applicable to every kind of transaction regardless of the legal personality of the actors concerned. Further, the questions it raises are questions concerned with the characterisation of outgoings. Thus although s 8-2(a) refers in terms to outgoings of 'capital' as well as those which are of a 'capital nature' the denotation of those terms must extend beyond the company law meaning of 'capital'.

88 *Fourthly*, by contrast, company law observes a distinction within a company between 'capital', on the one hand, and 'profits' on the other: cf. Pt 2H.5 and Ch 2J of the *Corporations Act 2001* (Cth). Although there are corresponding concepts in the law of partnership and the law of trusts the position of company law is attended by a significant distinguishing feature. Whereas a company has a legal personality separate from its members and its liabilities are not those of its members, the liabilities of a partnership are indistinguishable from the liabilities of the partners comprising it. In the case of a trust, the trust has no separate existence – what exists is the trustee and its liabilities are its alone although it has a right of indemnity out of the trust assets. No question therefore arises in the case of a partnership or of a trust of creditors being prejudiced by the removal of wealth from the undertaking embodied in them. No distribution of capital by a partnership to its partners can erase their liability to creditors and a trustee remains just as exposed to creditors even if it has disposed of all of the trust assets and even though its indemnity out of those assets be insufficient. The existence of a separate legal personality in a company, by contrast, makes necessary that those contributing their capital to the constituted venture do not withdraw it in a way which prejudices creditors. It is because the existence of the corporate veil presents the opportunity for injustice to be visited upon creditors that those standing behind the company are required to maintain their capital in it.

The quid pro quo, therefore, of the granting of separate legal personality to a company is the concomitant obligation to ensure that the capital advanced by its members remains in play.

89 *Fifthly*, to give effect to that fundamental consideration two principles are axiomatic: members may receive dividends only out of the profits and the members' capital may only be returned to them in tightly controlled circumstances which include requirements protecting both creditors and the position of the members inter se. Such requirements are absent from the law of trusts and the law of partnerships.

50. The dividend provisions of the income tax law observe and apply this company law distinction between capital and profits, not the general tax law distinction between capital and revenue. A Retail Premium being calculated according to a component of share capital, may properly be debited to the share capital account of the company. It then will be taxable under section 44 of the ITAA 1936 as a dividend paid out of profits, by reason of subsection 44(1B), because the requirements of subsection 6(4) of the ITAA 1936 are satisfied. This does not depend on the Retail Premium being paid only after the share capital is paid. For instance, if shares are issued for consideration that has not yet been paid, the consideration will be part of the share capital of the company no later than when it is paid, and, if the consideration is the Clearing Price on the basis of which the Retail Premium is worked out and paid, the Retail Premium might properly be debited against the share capital account when the consideration is paid even if the Retail Premium has already been outlaid.

Section 722

51. The above view is supported by subsection 722(1) of the *Corporations Act 2001*, which states that:

If a person offers securities for issue or sale under a disclosure document, **the person must hold:**

- (a) all application money received from people applying for securities under the disclosure document; and
- (b) all other money paid by them on account of the securities before they are issued or transferred;

in trust under this section for the applicants until:

- (c) the securities are issued or transferred; or
- (d) the money is returned to the applicants.

52. Section 722 of the *Corporations Act 2001* requires funds from a share issue has to be held in trust, until the shares are issued. Under some accounting standards, the funds may be treated as follows just after the funds have been received:

Dr – Cash held in trust

Cr - Application (liability)

Under this accounting approach, the funds only become a company's share capital (and are credited to its share capital account) when the company issues the shares to its subscribers as shown below:

Dr – Cash at bank

Cr – Cash held in trust

Dr - Application (liability)

Cr - Share capital account.

53. Although for some accounting purposes a company may treat funds raised from a share issue as a liability until it formally issues shares to its subscribers, paragraph 1.65 of the Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998 confirms the legislative intent that, for tax purposes, these funds from the time of receipt are part of the share capital of the company and constitute part of the company's share capital account for the purposes of section 975-300 of the ITAA 1997. Even if this were not the case, once the company issues shares to the third party subscribers for the consideration making up the Clearing Price, the whole of the consideration received will then constitute part of the share capital and will then be included in the share capital account of the company.

Retail Premium applies part of the share capital of an issuing company

54. Under the Scheme to which this Ruling applies, Retail Premiums apply part of the share capital of an issuing company.

55. The total consideration given by the successful third party subscribers for the shares they receive (such as in a Bookbuild process) is 'capital raised by the company from the issue of its shares' and is 'amounts received by a company in consideration for the issue of shares' (as per *Archibald's* case and paragraph 4.10 of the Explanatory Memorandum² to section 975-300 of the ITAA 1997). Accordingly, the whole amount of the consideration by third party subscribers for shares issued by a company (such as under a Bookbuild process) is share capital of the company. All of the Clearing Price is included in the share capital account of the company.

56. The Retail Premium is paid according to and as an application of part of the amount subscribed. It is worked out by reference to the amount subscribed. It arises so far as the amount subscribed exceeds a set amount, commonly the Offer Price. It is paid by the company, either because it is paid by the company directly, or by the normal agent of the company for such payments (such as the company's registry) or by others contractually bound by and to the company to apply part of the amount subscribed to it in that way. Accordingly the amount of the Retail Premium is properly to be debited against the share capital account of the company.

² Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998.

57. If the Retail Premium is so debited to the share capital account, it is nevertheless not excluded from being a dividend because subsection 6(4) of the ITAA 1936 is satisfied in each of its elements, and operates so that the exclusion under paragraph (d) of the definition of dividend in subsection 6(1) does not apply.

Franking of dividend

58. Section 202-40 of the ITAA 1997 provides that a distribution is a frankable distribution unless it is rendered unfrankable pursuant to section 202-45 of the ITAA 1997. As Retail Premium payments are dividends sourced from a company's share capital account, these dividends are unfrankable pursuant to paragraph 202-45(e) of the ITAA 1997. That paragraph applies so that 'a distribution that is sourced, directly or indirectly, from a company's share capital account' is unfrankable. It does not refer to the distribution as being debited against that account, as a distribution sourced indirectly from the account might not itself be so debited. However, it is unlikely that a distribution would be regarded as sourced even indirectly from a company's share capital account so far as no source amount for the distribution is debited or properly able to be debited against that account. A Retail Premium is so debited or, for the reasons discussed above, is properly able to be so debited.

Withholding tax on Retail Premiums to non-Resident Non Participating Shareholders

59. A non resident Non Participating Shareholder who receives a Retail Premium payment will be subject to withholding tax under subsections 128B(1) and 128B(4) of the ITAA 1936, unless excluded under another provision of the ITAA 1936, ITAA 1997 or of a Double Taxation Agreement.

60. Subsection 128B(1) of the ITAA 1936 states that section 128B applies to income derived by a non-resident that consists of a dividend paid by a company that is a resident. Subsection 128B(4) then states:

A person who derives income to which this section applies that consists of a dividend is liable to pay income tax upon that income at the rate declared by the Parliament in respect of income to which this subsection applies.

61. So far as dividends are franked, including being franked in certain circumstances with an exempting credit, they are not included in the income to which withholding tax applies, by reason of paragraph 128B(3)(ga) of the ITAA 1936. A Retail Premium is unfrankable as discussed above, and so is included in the income to which withholding tax applies. A Retail Premium paid to a non-resident and that is subject to withholding tax will be non-assessable non-exempt income under section 128D of the ITAA 1936. (This makes the withholding tax effectively a final tax for Australian taxation purposes.)

62. Resident companies that issue Retail Premium payments to non resident Non Participating Shareholders have a withholding obligation under section 12-210 of the *Taxation Administration Act 1953*. Section 12-210 states:

A company that is an Australian resident must withhold an amount from a dividend it pays if:

- (a) according to the register of the company's members, the entity, or any of the entities, holding the shares on which the dividend is paid has an address outside Australia; or
- (b) that entity, or any of those entities, has authorised or directed the company to pay the dividend to an entity or entities at a place outside Australia.

63. Non-resident Non Participating Shareholders who receive a Retail Premium payment should obtain independent legal or accounting advice if they are uncertain as to the withholding tax consequences of any Retail Premiums they receive.

Ordinary Income

64. Alternatively, the Retail Premium payments are ordinary income, assessable under section 6-5 of the ITAA 1997, if the payments are not assessable dividends. This is in accordance with the principles stated and applied in the High Court case of *Federal Commissioner of Taxation v. McNeil* (2007) 229 CLR 656; [2007] HCA 5; 2007 ATC 4223; (2007) ATR 431 (*McNeil*).

McNeil's case

65. *McNeil* concerned the issue of sell back (put option) rights by St George Bank Ltd (SGL) to one of its shareholders. The key issue was whether the sell back rights issued by SGL were assessable income of the shareholder at the time the rights were received. The majority of the High Court ruled that although the sell back rights were not dividends, the rights were ordinary income and assessable under section 6-5 of the ITAA 1997.

66. The majority stated at [20]:

...whether a particular receipt has the character of the derivation of income depends upon its quality in the hands of the recipient, not the character of the expenditure by the other party. The Commissioner correctly submits that, while the share buy-back scheme explains the involvement of SGL and the genesis of the conferral of the entitlement upon the taxpayer, for revenue purposes it does not explain the character of her sell back rights.

67. In determining the character of the sell back rights granted at the time they were received, the High Court stated at [21]:

Secondly, as a general proposition, a gain derived from property has the character of income and this includes a gain to an owner who has waited passively for that return from property.

68. The High Court therefore had to determine whether the sell back rights were a gain from the shareholder's property. In other words, the Court had to decide whether the sell back rights were severed from and were a product of the shares in SGL which the shareholder retained on being issued the sell back rights. If, on the other hand, the grant of the sell back rights did not leave the shareholding intact and untouched, but in some way were a re-expression of the rights which previously constituted the shares of the shareholder, the sell back rights would not constitute a gain from property in the hands of the taxpayer but rather a receipt of capital. (Essentially they would represent a division of the shareholder's existing capital.)

69. The majority of the High Court in *McNeil's* case did not consider the receipt of the sell back rights as altering the capital structure that was the taxpayer's shareholding in SGL. Their Honours dismissed the taxpayer's submission that SGL issued the sell back rights 'in partial satisfaction of the shareholders' right to participate in reductions of capital' being 'within the congeries of rights comprising the shares'.³ Rather, the majority pointed out, at [36], that:

...it is the character of the grant of rights to the shareholder that...is decisive. It is not the reduction of capital effected by SGL [so far as rights to sell back shares were exercised] pursuant to the new statutory process provided by the Corporations Law.

70. Accordingly, when the sell back rights were constructively received⁴ by the taxpayer, they were characterised by the High Court as something of value which was the product of, but severed from, the taxpayer's shareholding in SGL and that constituted income from property (that is, her shares in SGL). The High Court therefore held that the sell back rights received were ordinary income at the time the rights were issued and were assessable under section 6-5 of the ITAA 1997.

71. The Retail Premium is paid to shareholders in their capacity as such and is the product of their shareholding. That shareholding remains unaffected by the payment of the Retail Premium. So far as the shareholding may be affected by the issue of other shares, including those giving rise to the Clearing Price, this is irrelevant to the character of the Retail Premium itself, in the same way that the reduction of capital in *McNeil's* case was irrelevant to the character of the sell-back rights in that case.

³ Commissioner of Taxation v. McNeil [2007] HCA 5 at [36].

⁴ The sell back rights were received by an intermediary, whose obligation was to account as trustee for rights sold on the shareholder's behalf should the taxpayer not take up legal title to those rights beforehand: *Commissioner of Taxation v. McNeil* [2007] HCA 5 at [10].

Montgomery's case

72. The High Court case of *Federal Commissioner of Taxation v. Montgomery* (1999) 198 CLR 639; [1999] HCA 34; 99 ATC 4749; (1999) 42 ATR 475 (*Montgomery*); also supports the view that Retail Premium payments are ordinary income under section 6-5 of the ITAA 1997. *Montgomery's* case was referred to by the High Court in *McNeil* at [21] as:

...identifying the core meaning of 'income' where the character of a gain associated with property is at stake.

73. The issue in *Montgomery* was whether lease inducement payments were income according to ordinary concepts. In holding in that case that lease inducement payments were income and not capital, the majority of the High Court stated at [117]:

The inducement amounts received by the firm did not augment the profit-yielding structure of the firm. The lease was acquired as part of that structure; the inducement amounts were not. There was, in the words of Pitney J in *Eisner v. Macomber* 'not a gain *accruing to* capital, not a *growth or increment of value in* the investment; **but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being 'derived', that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal** (emphasis added).

74. Any Retail Premium is severed from the capital of the shareholder and comes in, or is derived, when it becomes available to the Non Participating Shareholder.

Principles in *McNeil* & *Montgomery* applied to Retail Premiums

75. *McNeil's* case makes clear that the nature of a Retail Premium payment has to be determined from its character in the hands of the recipient, rather than its character to the company paying it (or having it paid).

76. Based on the reasoning in both *McNeil* and *Montgomery*, Retail Premium amounts are ordinary income, assessable under section 6-5 of the ITAA 1997 if the payments were not assessable dividends.

77. A Retail Premium itself constitutes a gain derived from property (the property being the shares in the issuing company held by the Non Participating shareholder). This is not because the Retail Premium is an application of or an exercise of Entitlements that are gains derived from property being the shares. Non Participating Shareholders do not get a Retail Premium either as consideration for or by exercising Entitlements, whether they are shareholders who did not exercise Entitlements that were exercisable to them, shareholders whose Entitlements were precluded from being exercised by them, or shareholders who got no Entitlements. (The Entitlements themselves are such gains, under *McNeil*, from the sell back rights in which case they differ only by being rights to subscribe for, rather than rights to put to the company, shares.

On conditions including that the Entitlements and the shares for which they are issued are not revenue assets or trading stock, the Entitlements will not be assessable income at the time they are issued by reason of section 59-40 of the ITAA 1997.) A Retail Premium arises only so far as Entitlements expired unexercised or never arose for the shareholder. A Retail Premium is available only to a shareholder and only by reason of their being a shareholder who is a Non Participating Shareholder. It is not consideration for or in relation to an Entitlement.

78. However the Retail Premium, although a product of the Non Participating Shareholder's underlying shares in the company, is severed from those shares. Under the Scheme to which this Ruling applies, the underlying shares of the Non Participating Shareholder are not altered, affected, diminished or disposed of in any way due to the payment of the Retail Premium. It is therefore the Commissioner's view that a Retail Premium is ordinary income within the principles enunciated in both *McNeil* and *Montgomery*.

79. Accordingly, a Retail Premium is ordinary income to a Non Participating Shareholder and would be assessable under section 6-5 of the ITAA 1997 were it not assessable as a dividend under section 44 of the ITAA 1936.

Capital gains tax consequences on receipt of a Retail Premium payment

80. Under the Scheme to which this Ruling applies, Non Participating Shareholders are entitled to a Retail Premium only when, upon completion of the issue of equivalent shares (such as under a Retail Bookbuild), it is determined that the Clearing Price is greater than the Offer Price (or other applicable measure) and a Retail Premium is payable. This right to a Retail Premium is an intangible CGT asset under section 108-5 of the ITAA 1997. The right to receive the Retail Premium is satisfied upon payment.

81. Under section 104-25 of the ITAA 1997, CGT event C2 happens when the ownership of an intangible CGT asset ends by the asset being released, discharged or satisfied. Accordingly, when a Non Participating shareholder receives a Retail Premium payment (thus satisfying their right to this payment), CGT event C2 will happen.

82. A Non Participating shareholder will make a capital gain if the capital proceeds from CGT event C2 are more than the cost base of the right. A Non Participating shareholder will make a capital loss if the capital proceeds from the event are less than the reduced cost base of the right (subsection 104-25(3) of the ITAA 1997). Where the Retail Premium right has no cost, the cost base and reduced cost base are zero.

83. The capital proceeds from CGT event C2 is the Retail Premium payment that the Non Participating shareholder receives.

84. However, subsection 118-20(1) of the ITAA 1997 provides that a capital gain you make from a CGT event is reduced if, because of the event, an amount is included in your assessable income under a provision of the income tax law other than Part 3-1 (the capital gains tax provisions). The capital gain is reduced by that amount, but not below zero (subsection 118-20(2) of the ITAA 1997). Similarly subsection 118-20(4) of the ITAA 1997 reduces the capital gain you make from a CGT event to the extent that an amount from the CGT event is treated as non-assessable non-exempt income. A Retail Premium that is paid to a non-resident which is subject to withholding tax will be non-assessable non-exempt income under section 128D of the ITAA 1936.

85. To the extent that a Retail Premium payment is required to be included in the assessable income of a Non Participating shareholder either as a dividend under subsection 44(1) of the ITAA 1936, as ordinary income under section 6-5 of the ITAA 1997, or as non-assessable non-exempt income where it is subject to withholding tax under subsections 128B(1) and 128B(4) of the ITAA 1936, any capital gain a Non Participating shareholder makes from receipt of a Retail Premium is reduced to zero under section 118-20 of the ITAA 1997.

86. Where a Non Participating shareholder's capital gain is reduced to zero, the Discount CGT provisions of Division 115 of the ITAA 1997 will not apply.

Appendix 2 – Alternative views

ⓘ *This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.*

Summary

87. There are alternative views relevant to several points in the Explanation. They are discussed in this Appendix where additional description of the alternative view and of the reasons for which it is not accepted by the Commissioner, beyond the Explanation, is warranted.

88. If any Retail Premium payments paid to Non Participating Shareholders were not a dividend, it is contended that these payments would not be assessable as ordinary income under section 6-5 of the ITAA 1997.

89. CGT event C2 under section 104-25 of the ITAA 1997 happens when a Non Participating Shareholder receives a Retail Premium, and it is contended that the 50% CGT discount may apply to the Retail Premium so far as the shareholder's shares have been held for more than 12 months.

90. A Retail Premium is contended not to be a dividend because it is contended not to be paid by the company.

91. A Retail Premium is contended not to be a dividend because it is contended not to be paid by the company to shareholders of the company in their capacity as shareholders.

92. The Retail Premium is contended not to be a dividend because it is paid for, or for the lapsing or ending of, rights to subscribe for shares. The Retail Premium is contended not to be a dividend, because it is not paid out of profits.

93. The Retail Premium is contended not to be a dividend deemed to be paid out of profits, because elements of subsection 6(4) of the ITAA 1936 are not satisfied:

- The amount subscribed for the issue of shares is contended not to be share capital of the company;
- That amount is contended not to be credited to the share capital account of the company, because the company does not describe the amount as being so credited, or because the account to which it is credited is not part of the share capital account of the company;
- The Retail Premium itself is contended not to be debited against the share capital account of the company; and
- The Retail Premium and the credit to the company's share capital account are contended not to be under the same arrangement.

94. If a Retail Premium is not a dividend, it cannot be a dividend which is unfrankable pursuant to paragraph 202-45(e) of the ITAA 1997.

95. If a Retail Premium is not a dividend, it cannot be a dividend subject to withholding tax if paid to non-resident Non Participating Shareholders.

Alternative View – A Retail Premium is not paid by the company

96. An alternative view is that a Retail Premium is not paid by the company, if it is paid by another entity (such as an underwriter, lead manager of overall share float arrangements, or the company's share registry) out of funds that have not first been paid to the company itself.

97. Under a particular arrangement including a Retail Premium, there may be a legal or contractual obligation agreed with an issuing company that the Clearing Price will be received by another entity and that the issuing company is limited to receiving only the net part of the Clearing Price per share after the Retail Premium and other amounts agreed to be borne from the Clearing Price. The amounts agreed to be borne are debited to the Clearing Price. Therefore, it is argued that the issuing company never has possession or control over the part of the Clearing Price which bears the Retail Premium and so it is argued it does not pay the Retail Premium to Non Participating Shareholders.

Commissioner's View – A Retail Premium is paid by the company

98. The whole of the consideration making up the Clearing Price is consideration offered to the company for the issue of shares. Arrangements by which the Clearing Price is received by another entity are arrangements for the application of the Clearing Price offered to the company and which is paid in law to the company.

99. Consider a third party subscriber who has offered consideration for the issue of shares and has had its offer accepted. The subscriber has given the consideration to the entity which has been specified to receive the Clearing Price. The company would not be able to assert, against the subscriber, that the Clearing Price had been misapplied by the entity and so that the subscriber was not entitled to the issue of shares.

100. Consider the ways in which part of the Clearing Price could be agreed to be applied. One common case in share floats is the repayment from the float proceeds of particular existing loans or drawings owed by the company. An entity which is to receive the Clearing Price may be selected to provide assurance to the lenders that the repayment will have priority in application of the Clearing Price, and so it is likely that the company will agree to that application being made before a balance payable on is worked out. If one of these loans or drawings is a limited recourse debt to which Division 243 of the ITAA 1997 applies, that Division is triggered when a debt has not been paid in full by the debtor. Discharging such a debt from the Clearing Price must be payment by the company. If the contrary was the case, the Commissioner would be able to assert, against the company, that the company did not pay the debt where the Clearing Price was received by another entity and only the net amount after discharging the debt was paid on to the company.

101. Arrangements for another entity to receive the consideration making up the Clearing Price and to apply it are arrangements for payment at the direction of the company of amounts to which it is entitled. Making those arrangements before the consideration is offered does not change the character of the arrangements, or the character of the application of agreed parts of the Clearing Price, from being an application of the company's money.

102. This view is supported by the Federal Court in *Commissioner of Taxation v. White* [2010] FCA 730 (*White*). In *White*, the taxpayer (who was an employee of a company) arranged and directed that certain amounts arising from his employment be paid only to an associated trust. The taxpayer argued that these amounts were derived by the trust rather than himself. Gordon J rejected the taxpayer's argument, stating that although the amounts were paid to a different entity, the amounts were derived by the taxpayer and merely applied at his direction. This was evident at paragraph [25] in *White*, where Gordon J said:

However, it is not necessary that an item of income be paid over to the taxpayer; it is sufficient, according to ordinary concepts and usages, that the item is applied or dealt with on behalf of or at the direction of the taxpayer: see s6-5(4) of the 1997 Act and Cooke 29 ALR 202at 211.

103. Gordon J expanded the above point at paragraphs [28] & [29] in *White* where she stated:

Put another way, in the 2000 year the purchase of units in the ESTIP was a step taken after Mr White's management fee for his services (\$399,000) was derived by him. As noted earlier (see [25] above), it is not necessary that a taxpayer must personally gain some benefit from a payment for it to be income.

That analysis is also a complete answer to Mr White's second submission that he did not 'derive' the sum of \$399,000 in the 2000 year. Mr White's submission was that because \$399,000 was contributed to the ESTIP and was subject to a vesting period (cl 5.1 of the Trust Deed), that amount was not available to him in the 2000 year and therefore was not 'derived' by him in that year. As explained in para [28] above, the factual findings by the AAT establish that the sum of \$399,000 was 'derived' as income when it was paid by Kalix into the ESTIP at the direction of and on behalf of Mr White. What the ESTIP then decides, or is bound, to do with that sum is not relevant to the issue of whether Mr White derived that amount as income: *McNeil* 229 CLR 656 at [15], [18] and [20].

104. *White's* case applies similarly to Retail Premium amounts. Arrangements for another entity to receive the consideration for the issue of the equivalent shares and to apply it to paying the Retail Premium are arrangements for payment at the direction of the company of amounts to which it is entitled. Making those arrangements even before the consideration is offered (like the arrangements for contribution into the ESTIP, in *White's* case) does not change the character of the arrangements, or the character of the application of agreed parts of the Clearing Price, from being an application of the company's money.

Alternative View – A Retail Premium is not paid to shareholders as shareholders

105. An alternative view is that a Retail Premium is not paid to shareholders as shareholders (and so cannot be a 'dividend' under paragraph (b) of the definition, subsection 6(1) of the ITAA 1936). Because ordinarily a Retail Premium is paid only to some shareholders (as most shareholders are not ordinarily Non Participating Shareholders) it is argued that they do not get the Retail Premium as shareholders, but on some other basis.

Commissioner's View – A Retail Premium is paid to shareholders as shareholders

106. Only shareholders get a Retail Premium. Where only some shareholders get a Retail Premium, there will be qualifying reasons in addition to their shareholding. However those reasons do not mean that the shareholders get the Retail Premium other than as shareholders. So paragraph (b) of the definition of dividend in subsection 6(1) of the ITAA 1936 will be satisfied.

107. The contention that if amounts are credited only to a subset of shareholders they must therefore not be to the shareholders as shareholders is inconsistent with the purpose and history of the relevant provisions of the law. In particular, the exclusion under subsection 6(4) of the ITAA 1936 was originally expressed as applying to a range of arrangements in which amounts were subscribed by some shareholders and credited to others. These provisions clearly apply when amounts or value are credited to another person, whether to all shareholders or not.

Alternative View – A Retail Premium is paid for, or for the lapsing or ending of, rights to subscribe for shares

108. An alternative view is that a Retail Premium is paid for, or for the lapsing or ending of, rights to subscribe for shares. This view is only applied to those Non Participating Shareholders who had rights to subscribe for shares. So different kinds of Non Participating Shareholders are treated differently under this view.

109. These alternative views distinguish between Non Participating Shareholders who:

- receive Entitlements and choose not to exercise some or all of their Entitlements (Entitled shareholders), or
- are not eligible to receive Entitlements ('Ineligible shareholders'), or
- are not permitted to exercise rights under an Entitlement ('Incapable shareholders').

The Commissioner does not accept that Incapable shareholders can be distinguished from Ineligible shareholders. A shareholder who is not permitted to exercise rights is a shareholder without rights, in these circumstances.

110. All alternative views accept that a Retail Premium to Ineligible shareholders is not paid for, or for the lapsing or ending of, rights to subscribe for shares. Ineligible shareholders never had Entitlements and so had no rights to subscribe for shares that could lapse or end. Some views suggest that a Retail Premium to Incapable shareholders is paid for, or for the lapsing or ending of, rights to subscribe for shares although the shareholders themselves were not permitted to exercise those rights; this may be suggested to be on the basis that Incapable shareholders could sell their shares, and that should they do so the acquirer might be able to exercise the rights.

111. In consequence, the alternative view asserts that for Entitled shareholders and perhaps for Incapable shareholders either generally, or where section 59-40 of the ITAA 1997 applies to the issue of the rights, all subsequent matters including payment of a Retail Premium are deemed to be solely taxable under the CGT provisions and in those cases the CGT 50% discount may apply (if the underlying shares were held for at least 12 months).

112. Section 59-40 of the ITAA 1997 provides that if an entity issues rights to a taxpayer to acquire an interest in that entity, the market value of those rights, as at the time of issue, will be non-assessable non-exempt income providing the following conditions are satisfied:

- (a) at the issue time, you must already own shares in the company or units in the unit trust (the original interests);
- (b) the rights, must be issued to you because of your ownership of the original interests;
- (c) the original interests and the rights must not be revenue assets or trading stock at the issue time;
- (d) the rights must not have been acquired (within the meaning of section 139G of the ITAA 1936) under an employee share scheme;
- (e) the original interests and the rights must not be traditional securities;
- (f) the original interests must not be convertible interests.

113. Support for the view that where section 59-40 of the ITAA 1997 applied to the grant of Entitlements then any subsequent matter is taxable solely under the CGT provisions is claimed from paragraph 1.5 of the Explanatory Memorandum⁵ to section 59-40 which states:

These amendments restore the original tax treatment of rights issued by issuing entities to existing shareholders or unitholders to acquire additional relevant interests in those entities. As a result, a taxing point will not arise for the shareholders or unitholders in relation to the rights until a subsequent capital gains tax (CGT) event happens to the rights or to relevant interests as a result of exercising the rights.

Commissioner's View – A Retail Premium is not paid for, or for the lapsing or ending of, rights to subscribe for shares; and if it were it would still be a dividend and, if not a dividend, ordinary income

114. A Retail Premium is paid to any Non Participating Shareholder for the same thing: that is, it is paid on account of amounts subscribed by third party shareholders. That some Non Participating Shareholders had rights to subscribe for shares which they did not exercise and which expired does not give the Retail Premium paid to them the character of consideration for, or for the lapsing or ending of, those rights.

⁵ Explanatory Memorandum to the Tax Laws Amendment (2008 Measures No. 3) Bill 2008.

115. A right to receive a Retail Premium payment is a different and separate right to Entitlements. An Entitled shareholder's Entitlements provide the shareholder with the right to acquire shares from the issuing company. A Retail Premium right, however, is a potential right to cash granted by the issuing company to Non Participating Shareholders and is contingent on the Clearing Price consideration for the issue of shares in the company being higher than the Offer Price (or other applicable measure).

116. Incapable shareholders are not able to exercise the right to subscribe for shares in the company. Accordingly the Commissioner considers that either no rights are issued to them or that which is issued to them is not a right to acquire shares in the company. So section 59-40 of the ITAA 1997 is not applicable to Incapable shareholders.

117. Whilst Retail Premium payments may be connected to Entitlements (so far as they are paid to shareholders who had Entitlements they did not or could not exercise), they are not paid for, or for the lapsing or ending of, those Entitlements. When the Entitlements of Entitled shareholders lapse, they do not receive any consideration for the lapsing of the Entitlements. The character of Retail Premium payments is therefore the same, whether they are to shareholders who had Entitlements they did not or could not exercise, or to shareholders who never had Entitlements at all. The Commissioner's view does not require intricate analysis of the difference between having and not having Entitlements and of the difference between having Entitlements which are not permitted to be exercised and not having Entitlements. These differences are not relevant to the operation of the dividend provisions.

118. The payments making up the Clearing Price are paid by the third party subscribers for shares, on account of whose offered consideration the Retail Premiums arise. Those subscribers offer consideration for the issue of shares by the company to them. They do not offer anything to the Non Participating Shareholders and the Non Participating Shareholders have no rights or entitlements against those subscribers. There is no difference in the character of the consideration offered by the third party subscribers regardless whether some proportion of Non Participating Shareholders had Entitlements they did not or could not exercise.

119. What the subscribers offer is not consideration for, or for the lapsing or ending of, Entitlements of Entitled shareholders (if the shares for which they subscribe are equivalent to those that would have issued had Entitled shareholders exercised their rights). Nor can it be consideration for rights of Ineligible shareholders who never had any Entitlements and of Incapable shareholders who were never able to subscribe for shares. Nothing is offered by the third party subscribers, such as those under a Bookbuild process (for example Institutional investors), for any Non Participating Shareholders to give up their Entitlement rights.

120. The consideration offered by the third party subscribers is solely for the issue of shares to them, regardless of whether the shares for which they subscribe are offered because Entitlements were not exercised, could not be exercised to subscribe for shares, or were not given at all.

121. As the right to Retail Premium payments are different and separate rights to Entitlements, section 59-40 of the ITAA 1997 has no application to Retail Premium payments. The Retail Premium payments are not paid for, or for the lapsing or ending of, any Entitlements whether the Entitlements are rights to which section 59-40 applies or not.

122. If a Retail Premium were paid for, or for the lapsing or ending of, any Entitlements this would not require the Retail Premium to be dealt with only as capital proceeds of a CGT event and would not give access to the CGT 50% discount.

123. The law, and that Explanatory Memorandum⁶ for it, did not provide that any later dealing with a right subject to section 59-40 of the ITAA 1997 will be subject to the CGT rules if the underlying shares were held on capital account. That result is not necessarily true, though it may be correct for most usual or common factual situations.

124. In the table in paragraph 6 of the Explanatory Memorandum⁷, what is said is that 'a capital gain or loss will generally arise when a CGT event subsequently happens to the rights or to the relevant interests acquired as a result of the exercise of the rights' (provided that the original interests are held on capital account). Later, at paragraph 1.15 of the Explanatory Memorandum⁸, it is said that 'If a company or trustee issues rights to a taxpayer to acquire shares in the company or units in the trust and the conditions in subsection 59-40(2) of the ITAA 1997 are satisfied, then a capital gain or capital loss will arise only when a CGT event happens to the rights or to the shares acquired as a result of the exercise of the rights. For example, if the taxpayer disposes of the rights, the taxpayer may make a capital gain or capital loss because CGT event A1 happens'. This is a statement about when a CGT event happens, and is not asserting that only a CGT event can happen. It is discussing generally what happens when a right is disposed of, or equity acquired by exercising a right is realised, as the most likely practical situations, though 'a CGT event happens in relation to the rights or to the shares' in a much wider range of circumstances. It reflects the catch-all character of the CGT event provisions: that is, they happen for revenue assets too (and are ignored because income assessment is also applicable).

⁶ Explanatory Memorandum to the Tax Laws Amendment (2008 Measures No. 3) Bill 2008

⁷ Ibid.

⁸ Ibid.

125. However, the 'generally' is important and reflects the express advice at paragraph 1.12 of the Explanatory Memorandum⁹: 'The conditions in paragraphs 59-40(2)(c) to (e) of the ITAA 1997 ensure that subsection 59-40(1) only applies to shareholders or unit holders that would ordinarily be taxed on capital account in relation to the original interests and the rights'. (Note, again, 'ordinarily'.)

126. There will be situations in which rights, or equity acquired by exercising the rights, may be on revenue account.

Subsection 118-20(1) of the ITAA 1997 provides that a capital gain you make from a CGT event is reduced if, because of the event, an amount is included in your assessable income under a provision of the income tax law other than Part 3-1 (the capital gains tax provisions). The capital gain is reduced by that amount, but not below zero (subsection 118-20(2)).

127. As a Retail Premium payment is required to be included in the assessable income of a Non Participating shareholder either as a dividend under subsection 44(1) of the ITAA 1936, or as ordinary income under section 6-5 of the ITAA 1997, any capital gain a Non Participating shareholder makes from receipt of a Retail Premium is reduced under section 118-20 of the ITAA 1997 to zero.

128. For this reason, also, the alternative view is considered to be clearly incorrect.

Alternative View – A Retail Premium debited to the share capital account is not included in assessable income because subsection 6(4) is not satisfied and so it is not a dividend and not taken to be paid out of profits

129. An alternative view is that a Retail Premium debited to the share capital account does not satisfy the requirements of subsection 6(4) of the ITAA 1936 in some respect. If it does not satisfy those requirements it will not be a 'dividend' as defined in subsection 6(1) of the ITAA 1936; then it will not be included in assessable income under subsection 44(1) of the ITAA 1936, regardless of the effect of subsection 44(1B).

130. Each of the possible elements of subsection 6(4) of the ITAA 1936 is discussed in the Explanation section, and each alternate contention is described there.

⁹ Ibid.

Commissioner’s View – A Retail Premium is a dividend even if debited to the share capital account because in that case subsection 6(4) is satisfied

131. In addition to the matters covered in the Explanation section, it may be noted that this alternative view depends on the Retail Premium having been debited to the share capital account of the company. If a Retail Premium is not so debited, the requirements of subsection 6(4) of the ITAA 1936 need not be met for it to be a ‘dividend’ as defined in subsection 6(1) of the ITAA 1936. The Retail Premium will then be a dividend in any event, as set out in the Explanation.

Alternative View – Subsection 6(4) only applies to arrangements entered into for the purpose of exploiting distributions from a share capital account

132. An alternative view is that subsection 6(4) of the ITAA 1936 can only apply to arrangements where there was a purpose by the company to exploit the tax concessions on distributions made from a share capital account. This view of requiring a ‘purpose requirement’ by the company, is based on the Explanatory Memorandum¹⁰ to the original provision of subsection 6(4) [which dealt with share premiums, when there was a concept of nominal capital for shares] at p9 which stated:

Subsections (4) and (5) are designed as a safeguard against special arrangements that may be entered into for the purpose of exploiting the proposed exemption of distributions out of share premium accounts. Very broadly, the provision will apply where a share premium account is created as part of a scheme for making a tax free distribution of money or other property to shareholders.

Commissioner’s view – ‘purpose requirement’ under subsection 6(4)

133. There is no ‘purpose requirement’ necessary under subsection 6(4) of the ITAA 1936 beyond the terms of the subsection. What the subsection requires is that in addition to an amount being paid to the company and credited to its share capital account, the amount is later paid or distributed by the company (being a debit to its share capital account) such as to another set of shareholders, with the payment to and by the company being common elements ‘under an arrangement’. This is sufficient for subsection 6(4) to apply.

134. There is no additional requirement, such as a requirement that the arrangement be ‘for a purpose of exploiting the proposed exemption of distributions out of share premium accounts.’ This reference in the Explanatory Memorandum¹¹ merely states instances of what is within the ambit of subsection 6(4) of the ITAA 1936. It is not a limitation on the scope of subsection 6(4).

¹⁰ Explanatory Memorandum to the Income Tax Assessment Bill (No. 4) 1967.

¹¹ Ibid.

135. The suggestion that there is an additional ‘purpose requirement’ is also not supported by later Parliamentary consideration, such as shown in the Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998 (which introduced adjustment to subsection 6(4) when share premiums were abolished). The application and ambit of subsection 6(4) was then described in paragraph 1.99 of the Explanatory Memorandum¹², not in the restrictive manner suggested by the Alternative view, but simply as:

The rule will prevent companies entering into arrangements where a company raises share capital from certain shareholders and then makes a tax-preferred capital distribution to other shareholders.

Alternative View – the *McNeil* decision prevents a Retail Premium being a dividend

136. It has been submitted that Retail Premium payments cannot be dividends, due to the reasoning stated in *McNeil*'s case.

137. In *McNeil*, the sell back rights granted to shareholders were considered property separate from the shareholders original shares. However, the rights represented a return generated due to the holding of those original shares. The High Court in *McNeil* also held at paragraphs [37] and [38] that:

The gain made by the taxpayer upon grant of the sell-back rights and the subsequent receipt of the proceeds of sale on her behalf was not the receipt of a distribution of any form of the assets of SGL. Nor, as explained earlier in these reasons, was the sell-back scheme provided in ‘satisfaction’ of the rights of shareholders under the constitution of SGL. The scheme took its life from the deeds poll executed on the record date.

Thus, there is no sound analogy between this case and the liquidation and informal distribution cases beginning with *Stevenson*, and the cases dealing with the dividend provisions of the 1936 Act.

138. Based on the above reasons, the High Court held that the taxpayer’s sell back rights were not dividends in the statutory sense.

139. As Retail Premiums are a product of, but severed from, the shares held by Non Participating shareholders, these payments cannot be dividends as they were not distributions from the issuing company based on the same reasoning mentioned in *McNeil* (discussed at paragraphs 65 to 79 of this Ruling). *McNeil* made clear that the basis of the rights provided and paid to the taxpayer in that case was the deeds poll executed on the record date. The alternative view is that Retail Premium payments are based on the legal documentation concerning these payments and the process by which consideration is offered for the issue of the equivalent shares.

¹² Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998.

140. Accordingly, the alternative view is that it would be contrary to the *McNeil* decision if Retail Premium payments are dividends.

Commissioner's View – the *McNeil* decision does not prevent Retail Premium payments being dividends

141. *McNeil's* case does not prevent Retail Premium payments being dividends.

142. The sell back rights in *McNeil* were not dividends due to the particular nature of these rights. Although the sell back rights in *McNeil* were created by the company, these rights were never the assets of the company. Once the company created the sell back rights, these rights were the assets of the Eligible shareholders who obtained them and never of the issuing company. It was for this reason that the High Court ruled that there was no distribution of assets from the company to the taxpayer in *McNeil*. Accordingly, as there was no distribution by the company to the taxpayer or credit of any amount by the company to the taxpayer, the sell back rights in *McNeil* did not constitute a dividend under section 6(1) of the ITAA 1936.

143. The payment received by the taxpayer in *McNeil* was due to her sell back rights being tradeable on the open market and later being sold on her behalf.

144. The Alternative view's submission that Retail Premium payments are not dividends based on the reasoning in *McNeil* is unsound. While Retail Premium payments are a product of, but severed from, the shares held by Non Participating Shareholders, so is any dividend. The nature of Retail Premium payments is different to the sell back rights ruled on in *McNeil*.

145. The key difference between Retail Premium payments and the sell back rights in *McNeil* is that Retail Premium payments are a distribution from the company to its Non Participating Shareholders. The funds used to pay the Retail Premium payment are the company's money whether debited against its share capital account or not (these funds being raised by the company as consideration for the issue of its shares). Accordingly, as the company has distributed the amount of a Retail Premium to its shareholders, the Retail Premium payment constitutes an assessable dividend by application of subsections 6(1), 6(4), 44(1B) and 44(1) of the ITAA 1936.

146. The fact that there may be documentation (arranged by the issuing company), entitling the company to 'receive' only part of the Clearing Price does not alter the nature of a Retail Premium payment being a distribution and dividend from the company to its Non Participating Shareholders. The effect of the documentation is merely to arrange for the issuing company to pay part of the share capital it has raised as a dividend to Non Participating Shareholders.

Alternative View – If a Retail Premium payment is a dividend, it is not paid out of profits

147. This view asserts that the retained earnings of an issuing company are not affected in any way by the payment of the Retail Premium to the Non Participating Shareholders and therefore that no amount is debited to or against the profits of the company.

148. Accordingly based on the above analysis, Retail Premiums cannot be assessable dividends under section 44 of the ITAA 1936.

Commissioner's View – Retail Premiums are assessable dividends paid, or deemed to be paid, out of profits

149. For the reasons stated in paragraphs 12 to 57 of this Ruling, it is the Commissioner's view that Retail Premium payments are dividends debited against an amount standing to the credit of an issuing company's share capital account.

150. Even if Retail Premium payments are not paid from an issuing company's share capital, or if it is paid out of share capital which has not been debited against an amount standing to the credit of a company's share capital account, these payments would still be dividends under subsection 6(1) of the ITAA 1936 as these are:

- distributions made by the company to any of its shareholders, whether in money or other property (subparagraph 6(1)(a) of the ITAA 1936); and
- any amounts credited by a company to any of its shareholders as shareholders (subparagraph 6(1)(b) of the ITAA 1936).

151. Retail Premiums paid to shareholders out of share capital, but not from the company's share capital account, could **not** fall under the exemption in subparagraph 6(1)(d) of the definition of dividend in the ITAA 1936, as the share capital distributed would not be debited against the credit of the company's share capital account, a precondition of that exemption from being a dividend.

Retail Premiums are paid out of profits

152. Retail Premium dividends, even if not paid out of share capital or if paid out of share capital which has not been debited against a company's share capital account, are paid from profits derived by the company and therefore are assessable dividends under subsection 44(1) of the ITAA 1936. Taxation Ruling TR 2003/8 Income tax: distributions of property by companies to shareholders - amount to be included as an assessable dividend (TR 2003/8) and relevant case law explain the principles why such Retail Premiums are dividends from the profits of the relevant company.

153. Paragraph 4 of TR 2003/8 states:

The amount of a dividend in respect of a distribution of property (including shares held by a company in another company) to a shareholder in their capacity as a shareholder will be the money value of the property at the time it is distributed, reduced by the amount debited to a share capital account of the distributing company in respect of the distribution.

154. Paragraphs 6 to 8 of TR 2003/8 then state:

6. In the case of a resident shareholder the amount by which the money value of the property exceeds the amount debited to the share capital account will be included in the shareholder's assessable income to the extent that the dividend is paid (or taken to be paid) out of profits derived by the company.

7. In the case of a non-resident shareholder the amount by which the money value of the property exceeds the amount debited to the share capital account will be included in the shareholder's assessable income to the extent that the dividend is paid (or taken to be paid) out of profits derived by the company from an Australian source, unless a double tax treaty provides for a different result in the circumstances of the taxpayer. (Usually such treaties substitute a different test based on effective connection with a permanent establishment in Australia.)

8. For the purposes of paragraphs 6 and 7, the dividend is paid out of profits derived by the company if, immediately after the distribution of property, **the market value of the assets of the company exceeds the total amount (as shown in the company's books of account) of its liabilities and share capital. In addition, if the dividend described in paragraphs 6 and 7 is a repayment by a company of an amount paid-up on the share, the dividend is taken to be paid out of profits derived by the company** (emphasis added).

The above principles stated in TR 2003/8 support the view that Retail Premiums that are not paid out of share capital, or that are paid out of share capital but which are not debited from a company's share capital account, are assessable dividends paid out of profits derived by the company under subsections 6(1) and 44(1) of the ITAA 1936. If a dividend is not debited against a company's share capital account it can only derive from net assets of the company other than the share capital.

155. If a company makes a distribution to its shareholders from its net value, the distribution can only be from share capital or profits. As paragraph 13 of TR 2003/8 states:

In most cases a company which distributes property to its shareholders and debits part of the value of that property to its share capital account would debit the remaining part to another account or reserve. Where that account or reserve does not represent share capital, it would, for subsection 44(1) purposes, represent profits derived by the company so that the amount debited to it would be included in the shareholder's assessable income under that subsection.

156. The term 'profits' has a wide meaning and scope, based on the definition provided by Fletcher Moulton LJ in *Re Spanish Prospecting Company* [1911] 1 Ch 92 (*Spanish Prospecting*) at 98:

'Profits' implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates.

157. The above definition of the term 'profits' from *Spanish Prospecting* was applied in the Full Federal Court case of *MacFarlane v. Federal Commissioner of Taxation* (1986) 13 FCR 356; 86 ATC 4477; (1986) 17 ATR 808 (*MacFarlane*). *MacFarlane* also affirmed that the term 'profits' was not limited to the accounting or Corporations Law's concept of that term. To quote Fisher J in *MacFarlane* at ATC 4483:

There are in my opinion a number of indications in the Act which confirm my view that there is no justification for attributing a narrow or accounting meaning to the word 'profits'.

158. Paragraph 14 of TR 2003/8 states:

When determining a shareholder's liability to income tax it is not necessary that the company has met all of the relevant accounting formalities....However, for taxation purposes the existence of profits does not depend on their recognition in the books of the company: see Latham CJ in *Dickson v. FCT* (1940) 62 CLR 687 at 705 to 706.

159. In determining whether there are profits, paragraph 15 of TR 2003/8 states:

There does not need to be a formal debiting of an account of profit of the company. So long as the market value of the company assets exceeds the total amount (as shown in its books of account) of its liabilities and share capital what remains is profits. **If the distribution is not debited to share capital the distribution is one of profits** (emphasis added).

160. Paragraph 18 of TR 2003/8 reiterates the above point for Retail Premiums not paid out of share capital or paid out of share capital and not debited against a company's share capital account:

This approach, when applied to a company that distributes property whose value is greater than the amount debited to the share capital account, will have the following consequence. The excess (which is a dividend) will be paid out of profits for the purposes of subsection 44(1) provided that immediately after the distribution the market value of the assets of the company exceeds the total amount (as shown in its books of account) of its liabilities and share capital. In such a case the only source of the dividend will be the company's earnings or an increase in its assets (that is, profits).

161. If a company receives consideration such as under a Bookbuild process on the basis of which Retail Premium amounts will be paid, which is not share capital, then these amounts would be profits of the company (as these amounts would increase the market value of the company compared to its liabilities and share capital (that is credited to the company's share capital account). When a company distributes the consideration as Retail Premium amounts, these Retail Premium payments would be assessable dividends under subsections 6(1) and 44(1) of the ITAA 1936 as they would be paid out of those profits.

162. The view that distributions which are not debited from a share capital account are of profits is also supported by the dissenting judgment of Kitto J in the High Court case of *Federal Commissioner of Taxation v. Uther* (1965) 112 CLR 630; (1965) 13 ATD 542 (*Uther*).

163. *Uther's* case involved a company that did a capital reduction by cancelling some of its shares. As part of this capital reduction, the company paid the taxpayer shareholder £32,288 in respect of the cancellation of 2,244 shares (which had a paid up value of £2,244). The Commissioner included the difference between the amount received by the taxpayer for the cancellation of their shares (£32,288) and its paid up value (£2,244), namely £30,044 as an assessable dividend under subsection 44(1) of the ITAA 1936. The issue in *Uther* was whether the excess amount of £30,044, which was not debited from the company's share capital account, was an assessable dividend paid out of the company's profits to its shareholder under subsection 44(1) of the ITAA 1936.

164. In *Uther*, Kitto's J view was that the excess amount clearly was from the company's profits and therefore was an assessable dividend under subsections 6(1) and 44(1) of the then *Income Tax and Social Services Contribution Assessment Act 1936-1962*. In his judgment Kitto J stated at CLR 637:

Indeed it seems obvious that the moneys distributed on the reduction of capital, so far as they exceeded the amount paid up on the cancelled shares, consisted of profits which the company had derived. Whether capital profits or trading profits it is not material to inquire. The fact that the excess was not distributed separately from the share capital returned does not seem to me a ground for saying there was not a distribution of the excess out of profits within the meaning of s44(1).

165. Kitto J also stated that in determining whether an amount received by a shareholder is an assessable dividend, one had to examine whether the relevant amount had a profit character from the company's viewpoint. Kitto J explained this at CLR 639:

The criterion for the inclusion of a shareholder's receipts from the company is no longer the 'dividend' character of the receipts, that is to say their income character when considered from the shareholder's point of view; it is the profit character – from the company's point of view – of the source from which distributions should be made.

166. However, Kitto's J judgment was not accepted by the majority (Taylor J and Menzies J) in *Uther*. Taylor J stated that the facts in *Uther* were essentially 'indistinguishable' from the facts in the earlier High Court case of *Federal Commissioner of Taxation v. Blakely* (1951) 82 CLR 388; (1951) 9 ATD 239 (*Blakely*) and that he supported the views expressed by Fullagar J in that case.

167. *Blakely's* case involved shareholders in a company who, without putting the company in liquidation, had paid off its external liabilities and appropriated the company's remaining assets without any company resolution or any other legal formality. After taking over the company's business under a new partnership structure, the shareholders later had the company dissolved. The issue in *Blakely* was whether the appropriation of the company's assets by the taxpayer shareholder and his wife was a distribution by the company which was an assessable dividend under subsection 44(1) of the ITAA 1936.

168. Fullagar J in *Blakely* stated that even if the taxpayer's appropriation of the company's assets was a dividend under subsection 6(1) of the ITAA 1936, it was not a dividend derived out of the company's profits (and therefore was not an assessable dividend under subsection 44(1) of the ITAA 1936). At CLR 406-407 Fullagar stated:

I would not be prepared to deny that there was a 'distribution' in this case. There was clearly a 'distribution' in *Stevenson's Case*. But the point in this case is, as it was in *Stevenson's Case*, as to the nature of the receipt. There was not a distribution of profits, or a distribution out of profits. There was no detachment or severance from the funds of the company of money or other assets as representing a profit made by the company. There was simply a realization of a share investment (per Starke J in *Thornett's Case*).There is, in my opinion, nothing in the Act which gives the character of income to this receipt, which was according to general principles a capital receipt.

169. In *Uther*, Taylor J based his view largely on Fullagar's J judgment in *Blakely* and argued that even if the distribution in *Uther* was a dividend under subsection 6(1) of the ITAA 1936, it would not be a dividend paid out of profits derived by the company. On this basis the distribution was held not to be an assessable dividend under subsection 44(1) of the ITAA 1936.

170. At CLR 642 Taylor J stated:

On the assumptions which I have made it is true that the respondent received from the company by way of dividend as defined the sum of £30,044 but, in my view, it is impossible to say that this amount was paid out of profits derived by the company. It was, to adopt the language of Dixon CJ in *Parke Davis & Co v. Commissioner of Taxation*, received in partial distribution of a mass of assets which, although in a colloquial sense they contained profits, was a distribution of capital. The point which *Blakely Case* made was that, although, in the case of distribution by a liquidator, s47 carried the matter as far as deeming such distributions to a limited extent to be dividends paid out of profits derived by the company, in the case of distributions of the character now under consideration, no provision of the Act takes this final and essential step.

171. Menzies J in *Uther* held that the entire distribution of £32,288 received by the shareholder (both the amount debited from the share capital account and the excess amount that was not) was a 'return of paid-up capital or payment off of share capital' and therefore was not a dividend, as it fell within the exemption words of the definition of dividend in subsection 6(1) of the ITAA 1936 (as it was then defined). That exemption no longer applies.

172. Although Kitto's J view in *Uther* was a dissenting judgment, his view found support in the later Full High Court case of *Federal Commissioner of Taxation v. Slater Holdings Ltd* (1984) 156 CLR 447; 84 ATC 4883; (1984) 15 ATR 1299 (*Slater*), where Gibbs J (whose judgment was supported by the other justices) stated at CLR 457:

In *Federal Commissioner of Taxation v. Uther*, Kitto J, in his dissenting judgment, advanced a criticism of the judgment of Fullagar J, which, with all respect, I find compelling.

173. Gibbs J in *Slater* later stated at CLR 458:

There were two possible grounds for holding that the distributions in *Federal Commissioner of Taxation v. Blakely* and *Federal Commissioner of Taxation v. Uther* were not assessable income. The first, which appears to have been accepted by Fullagar J, in the earlier case, is that the receipt in the hands of the shareholder was capital in nature, representing as it did, the value of the shareholder's interest in the company. **However, as I have already said, Kitto J pointed out in *Federal Commissioner of Taxation v. Uther* that to take that view would be to disregard the words of the Act. The second possible ground was that the distribution was not made out of profits. The fact that a distribution is itself of a capital nature does not mean that it did not have its source in profits**, that proposition was recognised as correct by Lord Reid in *Staffordshire Coal and Iron Ltd v. Brogan* and is consistent with the language of Dixon CJ in *Park Davis & Co v. Commissioner of Taxation*, but in any case is not novel [emphasis added].

174. While Gibbs J in *Slater* stated at CLR 459 that it was 'unnecessary finally to decide whether the reasons given by the majority in *Federal Commissioner of Taxation v. Blakely* and *Federal Commissioner of Taxation v. Uther* were in all respects correct', his comments (endorsed by the rest of the High Court) casts doubt on whether the views expressed by the majority in *Uther* and Fullagar J in *Blakely* are now determinative of this issue (paragraph 14 of TR 2003/8).

175. Gibbs J and the rest of the High Court also stated that the wide definition of profits by Fletcher Moulton LJ in *Spanish Prospecting* while 'not of universal application, and that each case must depend on its own circumstances' was a 'starting point' and 'guide' in relation to determining whether an amount was profits.

176. Given the High Court's support (in *Slater's* case) for the dissenting judgment of Kitto J in *Uther* and the wide profit test enunciated by Moulton LJ in *Spanish Prospecting*, it is the Commissioner's view that Retail Premiums paid and not debited from a company's share capital account would be sourced from profits of the company and therefore would be assessable dividends paid out of profits under subsection 44(1) of the ITAA 1936.

Retail Premium dividend from share capital is deemed to be paid out of profits by subsection 44(1B)

177. If a Retail Premium dividend from share capital that is not debited against a share capital account is not actually paid out of profits, it is the Commissioner's view that paragraph 44(1B)(b) of the ITAA 1936 would also apply to deem the Retail Premium dividend to be paid out of profits.

178. Paragraph 44(1B)(b) of the ITAA 1936 is a deeming provision which states:

Where:

- (b) a dividend paid by a company is a repayment by the company of an amount paid-up on a share;

the dividend shall, for the purposes of this section, be deemed to have been paid by the company out of profits derived by it.

179. Paragraph 44(1B)(b) was specifically inserted into the ITAA 1936 in 1967, to overcome the decision in *Uther* (before the majority decision in *Uther* was criticised by the later High Court case in *Slater*). This was explained in pages 6-7 of the Explanatory Memorandum to the Income Tax Assessment Bill (No. 4) 1967:

Broadly stated, the present definition provides that a 'dividend' includes any amount paid, credited or distributed by a company to its shareholders but does not include a 'return of paid-up capital'. The definition was recently considered by the High Court in the case of the *Commissioner of Taxation v. Uther*. In that case a company reduced its capital by cancelling part of its paid-up capital and distributed to its shareholders amounts very much in excess of the amount by which the nominal paid-up capital was reduced. The Court decided that no part of the amount distributed to the shareholders was liable to tax.

....The proposed amendments are designed to overcome the anomaly in the law revealed by the Court's interpretation of it [in *Uther*]. Broadly, the effect of the new provisions will be to tax in the hands of shareholders of a company so much of any distribution made in consequence of a reduction of the nominal paid-up capital of the company as exceeds the amount by which that capital is actually reduced. The amount of the nominal paid-up capital returned to shareholders will not be taxed [insertion added].

180. Retail Premiums paid by a company to its shareholders out of share capital which has not been debited against its share capital account would come within paragraph 44(1B)(b) of the ITAA 1936 as these payments:

- would fall under the definition of dividend under subsection 6(1) of the ITAA 1936 – as a distribution or an amount credited by a company to its shareholders; and
- would constitute a repayment by the company of an amount paid-up on a share.

181. *Uther's* case made clear that the term 'repayment' by a company of an amount paid up on a share simply means a return of paid up capital by the company to its shareholders, not only a return to a particular shareholder of an amount actually paid up by that shareholder. This was supported by the judgment of Kitto J in *Uther* where he stated at CLR 635:

The expression 'a return of paid-up capital' has no special technical legal meaning, and as a matter of English it means a **repayment of capital paid up**.The expression in the Companies Act 1958 (Vict), s53(1)(b)(ii), is not 'return' but 'pay off'; but I see no difference between them. Nor, apparently, did Lord Radcliffe in *Ex parte Westburn Sugar Refineries Ltd*.

182. Menzies J in *Uther* also confirmed that any payment of share capital by a company back to its shareholders, which is not debited from its share capital account, would still be considered a repayment or a return of capital by the company to its shareholders. This is evident in his judgment in *Uther* at CLR 643 when he said:

Indeed, it is common enough to refer to **all** that a shareholder receives in a reduction of capital as 'returned capital' **even in a case where what is received exceeds the nominal amount whereby his share are reduced**: *Ex parte Western Sugar Refineries Ltd*. See too *Archibald Howie Pty Ltd v. Commissioner of Stamp Duties (N.S.W.)* [emphasis added].

183. Later at CLR 644, Menzies reiterated his point when he said:

A return of paid-up capital or a payment off of share capital- whichever form of words used- is of course, a distribution by a company to its shareholders but, **whether or not what is distributed exceeds the nominal amount by which capital is reduced, there is always but a single distribution and all that is distributed has the one character, viz. a return of paid-up capital or a payment off of share capital** [emphasis added].

184. Kitto J in *Uther* also stated that the source of the excess payment was:

...so far as they exceeded the amount paid up on the cancelled shares, consisted of profits which the company had derived. Whether capital profits or trading profits it is not material to inquire.

185. The fact that paragraph 44(1B)(b) of the ITAA 1936 is meant to capture returns of capital not debited from a share capital account, even if this capital is from a composite amount containing profits, is made clear in pages 16-17 of the Explanatory Memorandum to the Income Tax Assessment Bill (No. 4) 1967:

The proposed new subsection (1B) is designed to ensure that the new definition of dividend proposed by clause 4 is effective for the purposes of section 44(1) of the Principal Act. If, on a reduction of capital an amount of the distribution to shareholders is a dividend under the new definition, that amount will be deemed by subsection (1B) of section 44 to be paid out of profits of the company. **In the absence of this provision it might be argued that, although the amount was a dividend as defined, section 44(1) was not effective for the purpose of including the amount in the assessable income of the shareholder because, technically, it had been paid as a composite sum including the nominal paid-up capital returned to shareholders.**

186. Accordingly, it is the Commissioner's view that if a company distributes a Retail Premium dividend to its shareholders, from share capital but that has not been debited from its share capital account, the Retail Premium dividend would be considered a repayment of an amount paid-up on a share (assuming the share has a paid-up amount). Such Retail Premium dividends will be deemed to be paid out of profits under subparagraph 44(1B)(b) of the ITAA 1936 and therefore would be assessable dividends under subsection 44(1) (see similar analysis in paragraph 19 of TR 2003/8).

Retail Premium dividend deemed to be paid out of profits under subsection 44(1A)

187. If a Retail Premium dividend that is not debited against a share capital account, is not actually paid out of profits, it is the Commissioner's view that subsection 44(1A) of the ITAA 1936 would also apply to deem the Retail Premium dividend to be paid out of profits (and therefore be an assessable dividend under subsection 44(1)).

188. Subsection 44(1A) of the ITAA 1936 is a deeming provision which states:

For the purposes of this Act, a dividend paid out of an amount other than profits is taken to be a dividend paid out of profits.

189. Subsection 44(1A) was inserted into the ITAA 1936 by the *Corporations Amendment (Corporate Reporting Reform) Act 2010*, as a result of changes to the definition of dividend in the *Corporations Act 2001*. Subsection 44(1A) applies to dividends declared on or after 28 June 2010.

Alternative View – consideration for the issue of shares so far as it is to be applied as Retail Premiums does not form part of share capital under AASB 132 and therefore is not share capital

190. An alternative view is that part of Retail Premiums cannot form part of an issuing company's share capital under AASB 132 *'Financial Instruments: Presentation'* (AASB 132). The alternative view concludes that therefore this part of the consideration for the issue of shares is not credited to the share capital account of the company for income tax purposes.

191. Under this view, an issuing company does not record a Retail Premium amount as an asset in its financial records because so far as the issuing company has a legal and contractual obligation to pay the Retail Premium amount it is not an asset of the company for accounting purposes.

192. If a company does recognise the Retail Premium component from a share issue as an asset, it would also be required to record a corresponding financial liability under paragraph 16 of AASB 132 when the Retail Premium is paid to Non Participating shareholders. Paragraph 16 of AASB 132 states:

16. When an issuer applies the definitions in paragraph 11 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

- (a) The instrument includes no contractual obligation:
 - (i) to deliver cash or another financial asset to another entity; or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.
- (b) If the instrument will or may be settled in the issuer's own equity instruments, it is:
 - (i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
 - (ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments.

193. A Retail Premium amount neither increases or changes the net asset position of an issuing company under a Bookbuild process and therefore cannot constitute part of the company's share capital or share capital account. Paragraph 102 of the AASB Framework for the Preparation & Presentation of Financial Statements (the 'Framework') is quoted as support for the above view:

A financial concept of capital is adopted by most entities in preparing their financial report. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets of the entity.

194. The Alternative view also asserts that the receipt of a Retail Premium amount does **not** represent an exchange by Non Participating Shareholders of their shares in the issuing company, as they retain their full existing shareholding in the company (notwithstanding that third party investors pay for new shares of the issuing company under the Bookbuild process).

195. Therefore on the above analysis, the alternative view is that a Retail Premium amount cannot (or need not) be recognised as additional share capital of an issuing company for accounting purposes. The alternative view is that it would be inconsistent to treat an amount which does not meet the definition of share capital for accounting purposes as being credited to the share capital account of an issuing company for tax purposes.

Commissioner's view – Retail Premium payments are share capital of an issuing company both for accounting and tax purposes

196. It is the Commissioner's view that Retail Premiums are paid from consideration which forms part of the share capital of an issuing company for both accounting and tax purposes.

197. While the obligation to pay a Retail Premium may well be or arise under a financial instrument under AASB 132, the terms for subscription and issue of a company's shares provide for consideration offered for what is an equity instrument only (fully satisfying both conditions (a) and (b) of paragraph 16 of AASB 132). The share issue arrangement creates a contractual obligation for the issuing company to issue shares to third party investors who correspondingly are contractually obliged to provide the consideration making up the Clearing Price. However, the share issue does not create any contractual obligation for the issuing company to exchange financial assets or financial liabilities with the third party investors on terms unfavourable or potentially unfavourable to the company. Accordingly the effect of AASB 132 as it applies to the share issue does not reduce the assets acquired by the company below the Clearing Price, for accounting purposes.

198. Under the scheme arrangement, the issue of a company's shares is for the consideration making up the Clearing Price and is a non-derivative, including no obligation for the company to deliver any variable number of its shares, or is a derivative to be settled only by a fixed amount of cash (the best bids per share) for a fixed number of company shares (the new shares bid to be subscribed for).

199. The Alternative view that a Retail Premium is or may be a financial instrument and financial liability for the purposes of AASB 132 has no effect or relevance to characterising the consideration for the issue of shares, being for an equity interest. This is supported under paragraph 15 of AASB 132 which states:

The issuer of a financial instrument shall classify the instrument, **or its component parts**, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument (emphasis added).

200. Paragraph 15 of AASB 132 makes clear that under the AASB Standards, accounting is for 'component parts' of compound arrangements that themselves answer the different requirements of different parts of the Standards. Funds raised in the consideration making up the Clearing Price are wholly for an equity instrument.

201. The Alternative view asserts that under paragraph 102 of the Framework, the financial concept of the financial capital of a company is synonymous with the net assets or (shareholders') equity of the issuing company. Accordingly, any share capital raised under a Bookbuild process is reduced by the company's obligation to pay the Retail Premium (this being a financial liability under paragraph 16 of AASB 132). The Framework has no such effect.

202. Consideration raised forming part of the Clearing Price is share capital of the issuing company. The fact that these funds may be used by the issuing company to meet a revenue outlay does not in any way change the nature of the equity instrument involved in the share capital or how it must be accounted for. The full amount received under the Bookbuild process is an accretion, not to the 'financial capital' of the company, but to its share capital. As financial capital is about net assets, it rarely is consistent and is not required to be consistent with share capital. Were it otherwise, every share placement where the proceeds were committed to any particular application, such as paying off particular debt, acquiring a particular asset, or otherwise would raise no assets of the company to that extent – and the company could not be regarded as applying assets to that application either.

203. The corresponding question of how a company is to account for what it pays for in equity (or in equity-denominated consideration), and for the equity by which (or by reference to which) it pays, is dealt with in two accounting standards: AASB 2 *Share-based Payment* (AASB 2) (the more general standard) and AASB 3 *Business Combinations* (AASB 3) (specific to bringing together separate businesses into a single reporting entity). In these standards, it is clear that where a share-based payment transaction is settled by issuing shares both the value of what is received or acquired by the company must be included and a corresponding increase in equity must be included in the company's accounts. These standards show that for accounting purposes the assertion that the Framework discussion of the 'financial capital of a company' precludes including in share capital amounts committed to a payment is false. In situations to which AASB 2 or AASB 3 apply and which are settled by issuing shares the share capital of the company increases by the same amount as is brought to account for what is acquired by the payment, though in such situations it is clear that the shares are payment for what the company has contracted to get.

204. Accordingly, consideration according to which Retail Premiums will be paid forms part of a company's share capital according to Australian accounting standards.

Tax provisions take precedence over accounting standards

205. Even if there were an inconsistency between what constitutes 'share capital' of a company for accounting purposes and for tax purposes, the taxation provisions about share capital in the ITAA 1936 or ITAA 1997 must be interpreted according to their terms in their tax law context and that meaning takes precedence over any accounting meaning that differs from it. Accounting formalities are not necessarily determinative of the characterisation of amounts for tax purposes. This is supported by the case of *Macfarlane v. Federal Commissioner of Taxation* (1986) 13 FCR 356; 86 ATC 4477; (1986) 17 ATR 808, where the Full Federal Court made clear that the term 'profits' was not limited by the Corporations Law or accounting standard concept of that term.

206. Section 975-300 in the ITAA 1997 is a specific provision in determining what is part of a company's share capital account. Therefore this provision will take precedence over any accounting meaning of share capital, should that differ.

Alternative View – Share tainting context

207. The Commissioner's view on share tainting under Division 197 of the ITAA 1997 is contended to be that only accounts recognised by a company as its share capital account, or actual accounting entries made by a company to them, are relevant factors in determining a company's share capital account.

208. Taxation Determination TD 2009/4 Income tax: in accounting for a Dividend Re-Investment Plan, can a company taint its share capital account for the purposes of Division 197 of the *Income Tax Assessment Act 1997*? (TD 2009/4) is contended to support the view that a 'transfer' to a share capital account depends solely on the accounting entries of a company.

Commissioner's View – analysis on share tainting does not support the Alternative view

209. The Commissioner's analysis on share capital tainting under Division 197 of the ITAA 1997 does not support the inference suggested in the Alternative view. While the specific facts in the examples mentioned in TD 2009/4 are based on accounting entries, this should not be misinterpreted as support for the broader inference made in the Alternative View that only accounting entries to accounts recognised by the company as its share capital account are relevant.

Published material expressing the Commissioner's view on share tainting is wholly consistent with the views expressed in this Ruling.

Appendix 3 – Your comments

210. You are invited to comment on this draft Ruling. Please forward your comments to the contact officer by the due date.

211. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the Australian Taxation Office website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date:	10 February 2011
Contact officer:	Ramesh Lingam
Email address:	Ramesh.Lingam@ato.gov.au
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2003/8; TR 2006/10,
TD 2009/4;

Subject references:

- capital gains tax
- CGT events C1-C3 – end of a CGT asset
- CGT discount
- dividend income
- deemed dividends
- non resident dividend withholding tax
- share capital
- unfranked dividends

Legislative references:

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