TD 95/37 - Income tax: stripping of company profits: section 177E: does a scheme by way of or in the nature of dividend stripping require the purchaser of the shares in the target company to subsequently dispose of the shares at a deductible loss or to otherwise obtain, for tax purposes, a deduction for the depreciation in value of the stripped shares?

Australian Taxation Office

Taxation Determination **TD 95/37**

This Determination, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the *Taxation Administration Act 1953*, is a public ruling for the purposes of that Part . Taxation Ruling TR 92/1 explains when a Determination is a public ruling and how it is binding on the Commissioner. Unless otherwise stated, this Determination applies to years commencing both before and after its date of issue. However, this Determination does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Taxation Determination

Income tax: stripping of company profits: section 177E: does a scheme by way of or in the nature of dividend stripping require the purchaser of the shares in the target company to subsequently dispose of the shares at a deductible loss or to otherwise obtain, for tax purposes, a deduction for the depreciation in value of the stripped shares?

1. No. While a scheme by way of or in the nature of dividend stripping may exhibit such features, they are not a necessary element of a dividend stripping scheme within the meaning of that term.

2. Taxation Ruling IT 2627 states that in its traditional sense, a dividend stripping scheme would include a scheme 'where a vehicle entity (the stripper) purchases shares in a target company that has accumulated or current year's profits that are represented by cash or other readily-realisable assets. The stripper pays the vendor shareholders a capital sum that reflects these profits and then draws off the profits by having paid to it a dividend (or a liquidation distribution) from the target company.'

3. This description has been criticised as omitting the 'second-half' of a dividend stripping transaction, i.e., the sale or writing down for tax purposes of the stripped shares. In both England and Australia there are cases that have described arrangements involving a two-phase operation as dividend stripping. See, for example, *Griffiths v. J P Harrison (Watford) Ltd* (1962) 40 TC 281 at 297 and *Investment and Merchant Finance Corporation v. FC of T* (1970) 120 CLR 177 at 186; 70 ATC 4001 at 4005; 1 ATR 425 at 430, and (on appeal) (1971) 125 CLR 249 at 258-259 and 265; 71 ATC 4140 at 4144 and 4147; 2 ATR 361 at 365 and 369-370. There are, however, other cases that do not go so far.

4. For example, in *Commissioners of Inland Revenue v. Collco Dealings Ltd* 39 TC 509, a company incorporated in the Republic of Ireland acquired all of the issued share capital in an English company. The next day the English company declared an interim dividend wholly paid out of profits accumulated before the shares were acquired by the Irish company. In the agreed facts set out in the Case Stated there was no suggestion that the Irish company thereafter sold the shares or otherwise wrote them down for tax purposes. Nevertheless, Lord Evershed MR (in the Court of Appeal at 519) said the transaction 'fell within a description known as "dividend-stripping".' In the House of Lords, Viscount Simonds (at 527) described the same transaction as a 'conspicuous example' of the practice 'compendiously, if not felicitously, called "dividend - stripping".'

5. In *Bell v. F C of T* (1953) 87 CLR 548, the taxpayer, along with six others, was a shareholder in a Papuan company with substantial undistributed profits. The shares were sold to certain individuals who had been lent money to fund the acquisition. The vendors received an

amount approximately equal to the undistributed profits within the company. Thereafter the company paid a dividend to the new shareholders thus enabling them to repay the loan. It was not a necessary feature of the arrangement that shares were then on-sold at a loss or otherwise written down for tax purposes. Notwithstanding this, the arrangement was identified by Gibbs J in *Patcorp Investments Ltd & Ors v. FC of T* (1977) 140 CLR 247 at 300; 76 ATC 4225 at 4237; 6 ATR 420 at 434 as one of 'a line of cases in which arrangements, which might be described as dividend stripping operations, were struck down by section 260.'

6. Another in that line of cases was *FC of T v. Ellers Motor Sales Pty Ltd* (1972) 128 CLR 602; 72 ATC 4033; 3 ATR 45. This case also involved a series of transactions whereby undistributed profits of a company were received by former shareholders as the price of shares sold rather than as dividends. The arrangement did not involve a subsequent sale of the stripped shares at a loss or other writing down for tax purposes in order to achieve the intended effect. Notwithstanding the absence of this feature (and the absence of an interposed stranger between the profit company and the vendor shareholders), the transaction was accepted by Walsh J as a dividend stripping operation. Interestingly, while the *Ellers Motor Sales* case was decided after the decision of Windeyer J in *Investment and Merchant Finance Corporation*, Windeyer J specifically agreed with the reasons for decision given by Walsh J in deciding the *Ellers Motor Sales* case.

7. It will depend on the particular circumstances of the new shareholders whether stripped shares need to be on-sold at a loss or otherwise written down in order to obtain the perceived tax effect of a dividend stripping operation. However, while it may be quite appropriate to describe such arrangements that feature on-selling at a loss or otherwise writing shares down for tax purposes as 'dividend stripping', that does not mean that the term is not apt to describe arrangements where the stripper does not sell or otherwise write down the stripped shares for tax purposes.

Example

An Australian company has two non-resident fully owned subsidiaries (Companies A & B). One of the subsidiaries (A) has substantial undistributed prior and current year profits. Rather than repatriate the profits by declaring and paying a dividend, the shares in company A are sold to company B for an amount approximately equal to the undistributed profits in company A. The company is then liquidated and a liquidation distribution is paid to B. Company B does not on-sell the stripped shares or otherwise write them down for tax purposes. Provided the terms of section 177E are otherwise satisfied the scheme shall be taken to be a scheme to which Part IVA applies. The Australian parent company shall be taken to have obtained a tax benefit in connection with the scheme equal to the notional amount referred to in paragraph 177E(1)(c).

Commissioner of Taxation
2 August 1995

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Related Determinations:

Related Rulings: IT 2627

Subject Ref: dividend stripping

Legislative Ref: ITAA 177E; ITAA 177E(1)(c); ITAA 260

Case Ref: Griffiths v. JP Harrison (Watford) Ltd (1962) 40 TC 281; Investment and Merchant Finance Corporation v. FC of T (1970) 120 CLR 177; 70 ATC 4001; 1 ATR 425; (1971) 125 CLR 249; 71 ATC 4140; 2 ATR 361; Commissioners of Inland Revenue v. Collco Dealings Ltd 39 TC 509; Bell v. FC of T (1953) 87 CLR 548; Patcorp Investments Ltd & Ors v. F C of T (1977) 140 CLR 247; 76 ATC 4225; 6 ATR 420; FC of T v. Ellers Motor Sales Pty Ltd (1972) 128 CLR 602; 72 ATC 4033; 3 ATR 45

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