


# ***CR 2016/87 - Income tax: off-market share buy-back: Insurance Australia Group Limited***

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## Class Ruling

### Income tax: off-market share buy-back: Insurance Australia Group Limited

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#### **📌 This publication provides you with the following level of protection:**

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

## What this Ruling is about

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1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provisions identified below apply to the defined class of entities, who take part in the scheme to which this Ruling relates.

### Relevant provisions

2. The relevant provisions dealt with in this Ruling are:
- subsection 44(1) of the *Income Tax Assessment Act 1936* (ITAA 1936)
  - section 45A of the ITAA 1936
  - section 45B of the ITAA 1936
  - section 45C of the ITAA 1936
  - section 90 of the ITAA 1936
  - subsection 95(1) of the ITAA 1936
  - paragraph 128B(3)(ga) of the ITAA 1936
  - Division 16K of the ITAA 1936
  - section 159GZZZK of the ITAA 1936

- section 159GZZZP of the ITAA 1936
- section 159GZZZQ of the ITAA 1936
- Division 1A of former Part IIIAA of the ITAA 1936
- section 177EA of the ITAA 1936
- section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997)
- section 8-1 of the ITAA 1997
- Division 67 of the ITAA 1997
- section 104-10 of the ITAA 1997
- subsection 104-165(3) of the ITAA 1997
- subsection 106-5(2) of the ITAA 1997
- paragraph 110-55(9) of the ITAA 1997
- section 116-20 of the ITAA 1997
- section 118-20 of the ITAA 1997
- section 118-25 of the ITAA 1997
- section 202-5 of the ITAA 1997
- section 202-40 of the ITAA 1997
- paragraph 202-45(c) of the ITAA 1997
- section 204-30 of the ITAA 1997
- Division 207 of the ITAA 1997
- Subdivision 207-B of the ITAA 1997
- section 207-20 of the ITAA 1997
- section 207-35 of the ITAA 1997
- section 207-45 of the ITAA 1997
- section 207-145 of the ITAA 1997
- Division 230 of the ITAA 1997
- section 855-10 of the ITAA 1997
- section 855-15 of the ITAA 1997, and
- section 977-50 of the ITAA 1997.

All legislative references in this Ruling are to the ITAA 1936, unless otherwise stated.

**Class of entities**

3. The class of entities to which this Ruling applies is the ordinary shareholders of Insurance Australia Group Limited (IAG) who:

- disposed of their ordinary shares in IAG under the off-market share buy-back (the 'IAG Buy-Back') which IAG announced on 19 August 2016 and which is described in paragraphs 7 to 48 of this Ruling, and
- are not subject to the taxation of financial arrangements rules in Division 230 of the ITAA 1997 in relation to gains and losses on their IAG shares.

(**Note:** Division 230 of the ITAA 1997 will generally not apply to individuals, unless they have made an election for it to apply to them.)

In this Ruling, these ordinary shareholders of IAG belonging to this class of entities are referred to as 'Participating Shareholders'.

**Qualifications**

4. The class of entities defined in this Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 7 to 48 of this Ruling.

5. If the scheme actually carried out is materially different from the scheme that is described in this Ruling, then:

- this Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled, and
- this Ruling may be withdrawn or modified.

**Date of effect**

6. This Ruling applies from 1 July 2016 to 30 June 2017. The Ruling continues to apply after 30 June 2017 to all entities within the specified class who entered into the specified scheme during the term of the Ruling. However, this Ruling will 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 this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

## Scheme

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7. The following description of the scheme is based on information provided by the applicant.

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

8. IAG is a public company listed on the Australian Securities Exchange (ASX) and a resident of Australia for the purposes of subsection 6(1). IAG is the parent company of a general insurance group with controlled operations in Australia, New Zealand, Thailand and Vietnam.

9. IAG completed off-market share buy-backs in 2001, 2002 and 2004.

10. In June 2015, IAG entered into an agreement with Berkshire Hathaway Inc., under which (among other things):

- (a) IAG entered into a reinsurance agreement whereby Berkshire Hathaway Inc. agreed to reinsure 20% of IAG's insurance liabilities, resulting in a significant release of capital otherwise required to be held by IAG pursuant to Prudential Standard GPS 110 Capital Adequacy, and
- (b) Berkshire Hathaway Inc. was then issued with 89,766,607 new ordinary shares at \$5.57 per share comprising 3.7% of IAG's total issued ordinary capital.

11. On 15 October 2015, plans to extend IAG's operations into China were reconsidered by the Board and it was decided not to pursue those opportunities. Consequently, the funds reserved for that expansion are now considered surplus to requirements.

12. On 19 August 2016, IAG announced (First Announcement Date) its intention to return around \$300 million to shareholders through an off-market buy-back of its own shares to create and maintain a prudent and efficient capital structure and to increase IAG's earnings per share over time.

13. IAG's purpose for offering the IAG Buy-Back was to distribute the excess funds following the reconsideration of its overseas expansion opportunities, as well as to create a more efficient capital structure, to reduce the cost of capital, to improve shareholder returns, and to make its share registry more efficient to administer by facilitating holders of small parcels of shares to exit the register.

14. Just prior to the announcement of the IAG Buy-Back, IAG shares were traded on the ASX at \$5.85.

15. Based on expected fluctuations in the share price and the discount achieved, IAG estimated at the time of the announcement that it would buy-back 59 million shares representing approximately 2.3% of the company's issued shares as at 30 June 2016 (based on a volume weighted average price (VWAP) of \$5.85 and a discount of 8%).
16. IAG does not consider that the buy-back has impacted its capacity to frank dividends in the future. Just before the IAG Buy-Back, IAG's franking account balance was \$347 million.
17. IAG's shareholder base is comprised of approximately 72% residents and 28% non-residents. Over 60% of shareholders (by number of shares held) are institutional investors. Approximately 99% of shareholders (by number of shareholders) are retail investors.
18. The IAG Buy-Back did not qualify as an 'equal access scheme' as defined in subsection 257B(2) of the *Corporation Act 2001*. Relief was obtained from the Australian Securities and Investments Commission in accordance with subsection 257D(4) of the *Corporations Act 2001* so that IAG was not required to obtain shareholder approval for the IAG Buy-Back.
19. The terms of the IAG Buy-Back were approved by IAG's Board of Directors at its meeting on 18 August 2016.
20. IAG funded the IAG Buy-Back from existing cash and investments.
21. The Dividend Component of the IAG Buy-Back was sourced from operating profits.
22. The Dividend Component of the IAG Buy-Back was debited to the retained profits account and was 100% franked.
23. The Capital Component of the IAG Buy-Back was debited against IAG's untainted share capital account.
24. The last day that shares could be acquired to be eligible for franking credit entitlement was 23 August 2016.
25. The ASX ex-entitlement date for the IAG Buy-Back was 24 August 2016. Shares purchased on the ASX on or after the ex-entitlement date did not carry a right to participate in the IAG Buy-Back.
26. The Record Date of the IAG Buy-Back, the date on which shareholders must have been registered in order to participate in the IAG Buy-Back, was 25 August 2016.
27. U.S. and Canadian resident shareholders were not able to participate in the tender process as their inclusion would have resulted in the applicability of US and Canadian tender offer rules that would have reduced the flexibility of IAG in conducting the IAG Buy-Back.

28. Participation in the IAG Buy-Back was voluntary. The IAG Buy-Back documents were made available to shareholders on IAG's website on 26 August 2016.

29. The IAG Buy-Back was conducted through a tender process. The IAG Buy-Back tender period opened to shareholders on 9 September 2016 and closed on 7 October 2016 (Tender Period).

30. Shareholders were invited to offer up to 100% of their shareholding at specified discounts within a range of 4% to 14% inclusive, at 1% intervals (Tender Discount). The maximum available Tender Discount was 14%. Shareholders were not able to sell at a premium above the prevailing market price.

31. Shareholders were able to submit tenders to sell different parcels of shares at different Tender Discounts within the range. Alternatively, shareholder were able to submit a tender under which they could offer to sell their shares for the price as determined by IAG pursuant to the tender process, with such a price being within the specified price range (a Final Price Tender)

32. Shareholders also had the option of making their tender conditional on the IAG Buy-Back Price being no less than one of several specified prices. If the IAG Buy-Back price was below the specified minimum price, the tender was rejected.

33. After the Tender Period closed, IAG's broker managed a reverse book build of the tenders to determine the lowest price at which the targeted amount of capital could be repurchased.

34. Under the terms of the IAG Buy-Back, IAG could choose to buy back a higher or lower number of shares, or none at all.

35. The VWAP Market Price was calculated over the 5 trading days of 3 October 2016 to 7 October 2016 inclusive to be \$5.5127.

36. The Board of IAG announced the outcome of the tender on 10 October 2016, prior to which no shareholder had certainty concerning the sale of their offered shares.

37. On 10 October 2016, IAG announced that:

- it had successfully completed the Buy-Back of 63,860,311 IAG shares representing approximately 2.6% of its issued shares
- the final price for the IAG Buy-Back was of \$4.91 per share (Buy-Back Price), representing a discount of 11.0% to the VWAP of \$5.5127 of IAG's shares over the five days up to and including the Closing Date of the IAG Buy-Back (7 October 2016)
- shares tendered at a Tender Discount greater than or equal to 11% or as a Final Price Tender were bought back in full

- shares tendered at discounts less than or equal to 10% and Tenders conditional upon a Minimum Price above the Buy-Back Price were not bought back, and
- to the extent that the number of shares tendered at and below the final IAG Buy-Back Price exceeded the number of shares IAG had determined it wished to buy back, individual shareholders with tenders at the final IAG Buy-Back Price were scaled back on a pro-rata basis.

38. The total amount of the IAG Buy-Back was \$313,554,127. The amount debited to IAG's share capital account in connection with the IAG Buy-Back was \$190,942,329.89.

39. Notwithstanding the scale-back, shareholders who tendered all of their shares at or below the final IAG Buy-Back Price, or as a Final Price Tender, and had 340 or fewer shares as a result of the scale-back, had all of the shares they tendered bought back in full. Moreover, shareholders with existing holdings of less than 340 shares were only permitted to tender all of their holding, not just a proportion of their holding.

40. Prior to the scale-back, the first 850 shares of each successful tenderer were bought back.

41. The IAG Buy-Back Price of \$4.91 was less than the market value of a share.

42. The IAG Buy-Back Price of \$4.91 was apportioned as follows:

- (a) \$2.99 was debited against IAG's share capital account (Capital Component), and
- (b) The balance of the IAG Buy-Back Price, being \$1.92, was debited against an amount standing to the credit of the retained earnings account of IAG (Dividend Component).

43. The IAG Buy-Back Price (including the ratio of dividend to capital) was the same for each share, regardless of the identity or status of the shareholder.

44. All shares accepted under the IAG Buy-Back, were cancelled on 10 October 2016 with proceeds sent to Participating Shareholders on 17 October 2016.

45. IAG has paid regular dividends to its shareholders out of operating profits over time and it intends to continue to pay dividends to its shareholders in the future.

46. IAG is not aware whether any shareholder has capital losses to be carried forward.

47. None of the shares in IAG subject to the IAG Buy-Back were held as 'pre-CGT' assets as all shareholders acquired their shares in IAG 'post-CGT' as a result of the demutualisation and listing of IAG in August 2000.



48. The cost base of the shares bought back was not substantially less than the value of the capital component of the IAG Buy-Back Price.

## Ruling

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### Off-market purchase

49. For the purposes of Division 16K, the IAG Buy-Back is an off-market purchase within the meaning given by paragraph 159GZZZK(d).

### The Dividend Component

50. Participating Shareholders are taken to have been paid a dividend of \$1.92 (the Dividend Component) for each share bought back under section 159GZZZP.

51. The Dividend Component is a frankable distribution pursuant to section 202-40 of the ITAA 1997, and is therefore capable of being franked in accordance with section 202-5 of the ITAA 1997.

52. The difference between the IAG Buy-Back price and the Dividend Component (that is, the Capital Component of \$2.99) is not a dividend for income tax purposes (subsection 159GZZZP(2)).

### Assessability of the Dividend Component and tax offset

#### *Direct distributions*

53. The Dividend Component of \$1.92 per share and, subject to being a 'qualified person', the amount of the franking credit on the Dividend Component, is included in the assessable income of Australian resident individual and corporate shareholders, and trustees of resident complying superannuation funds who participated in the IAG Buy-Back in the income year in which the IAG Buy-Back occurred (subsection 44(1) and subsection 207-20(1) of the ITAA 1997). For Participating Shareholders who have not been granted leave to adopt a substituted accounting period, the IAG Buy-Back occurred in the income year ending 30 June 2017.

54. Australian resident individual and corporate shareholders and trustees of resident complying superannuation funds who participated in the IAG Buy-Back will be entitled to a tax offset under subsection 207-20(2) of the ITAA 1997 equal to the amount of the franking credit on the Dividend Component, subject to being a 'qualified person'.

***Indirect distributions******Partnerships***

55. The Dividend Component of \$1.92 per share and, subject to being a qualified person, the amount of the franking credit on the Dividend Component is included in the assessable income of a Participating Shareholder that is a partnership for the purposes of computing the net income of the partnership under section 90.

***Trusts***

56. The Dividend Component of \$1.92 per share and, subject to being a qualified person, the amount of the franking credit on the Dividend Component is included in the assessable income of a Participating Shareholder that is a trustee of a trust for the purposes of calculating the net income of the trust under subsection 95(1).

***Partners and Beneficiaries***

57. Subsections 207-35(3) to 207-35(6) of the ITAA 1997 set out the circumstances in which a partner or beneficiary to whom a franked distribution flows indirectly is required to gross up their assessable income for their share of the franking credit on the franked distribution. Where the franked distribution flows indirectly (within the meaning of Subdivision 207-B of the ITAA 1997) through a trust or partnership to a resident that is an individual, a corporate tax entity (at the time the distribution flows indirectly to it) or a trustee mentioned in paragraphs 207-45(c) or 207-45(d) of the ITAA 1997, the entity will, subject to the qualified person rule, be entitled to a tax offset equal to the entity's share of the franking credit on the franked distribution (section 207-45 of the ITAA 1997).

***Refundable tax offset***

58. The tax offsets are subject to the refundable tax offset rules in Division 67 of the ITAA 1997. Certain trustees and corporate tax entities are not entitled to the refundable tax offset rules because of subsections 67-25(1A) to 67-25(1DA) of the ITAA 1997.

***Non-resident Participating Shareholders***

59. As the Dividend Component is fully franked, non-resident Participating Shareholders are not liable to Australian withholding tax in respect of the Dividend Component (paragraph 128B(3)(ga)).

**Sale Consideration**

60. A Participating Shareholder is taken to have received \$3.89 per share as consideration in respect of each share bought back under the IAG Buy-Back (Sale Consideration) on 10 October 2016 in accordance with section 159GZZZQ, unless the Participating Shareholder is a corporate tax entity to which subsections 159GZZZQ(8) and 159GZZZQ(9) apply.

61. If the IAG Buy-Back Price for each share bought back under the IAG Buy-Back was less than what would have been the market value of the share if the IAG Buy-Back did not occur and was never proposed to occur then the market value rule in subsection 159GZZZQ(2) applies to the IAG Buy-Back. Taxation Determination TD 2004/22 *Income tax: for Off-Market Share Buy-Backs of listed shares, whether the buy-back price is set by tender process or not, what is the market value of the share for the purposes of subsection 159GZZZQ(2) of the Income Tax Assessment Act 1936?* outlines the Commissioner's approach for determining what would have been the market value of the share at the time of the IAG Buy-Back if the IAG Buy-Back did not occur and was never proposed to occur for the purposes of subsection 159GZZZQ(2).

62. The effect of the rule is that if the IAG Buy-Back Price of \$4.91 is less than the market value of \$5.81, which is determined in accordance with TD 2004/22, the difference is included in the consideration received for the disposal of the share, in addition to the amount of \$2.99 debited to IAG's share capital account. Accordingly, the Sale Consideration is \$3.89 per share.

63. The treatment of the Sale Consideration will depend on whether the sale is on capital account or on revenue account.

**Shares held on capital account**

64. The IAG shares are taken to have been disposed of for CGT purposes on 10 October 2016 pursuant to section 104-10 of the ITAA 1997 (CGT event A1).

65. The Sale Consideration of \$3.89 per share represents the capital proceeds for CGT purposes pursuant to section 116-20 of the ITAA 1997.

66. A Participating Shareholder (other than a partnership) will make a capital gain on a share if the Sale Consideration per share exceeds the cost base of that share. The capital gain is the amount of the excess. Similarly, a Participating Shareholder (other than a partnership) will make a capital loss on a share if the Sale Consideration per share is less than the reduced cost base of the share (subsection 104-10(4) of the ITAA 1997).

67. Each partner in a partnership has a separate cost base and reduced cost base for the partner's interest in each IAG share sold into the IAG Buy-Back by the partnership (subsection 106-5(2) of the ITAA 1997). Each partner is allocated their appropriate share of the Sale Consideration received by the partnership for the disposal of IAG shares into the IAG Buy-Back.

### ***Shares held as trading stock***

68. Where shares were held as trading stock, the Sale Consideration of \$3.89 per share is included in assessable income pursuant to section 6-5 of the ITAA 1997. Participating Shareholders (other than partnerships) that held shares as trading stock also made a capital gain or capital loss calculated as discussed at paragraph 66 of this Ruling. However, under section 118-25 of the ITAA 1997 any capital gain or capital loss the Participating Shareholders made will be disregarded if, at the time of the CGT event, the shares were held as trading stock. There is a similar exemption for partners in partnerships (paragraph 118-25(1)(b) of the ITAA 1997).

### ***Shares held as revenue assets***

69. Where shares were held as revenue assets (as defined in section 977-50 of the ITAA 1997), but were not trading stock, the amount by which the Sale Consideration of \$3.89 per share exceeds the cost of each share is included in the Participating Shareholder's assessable income. Correspondingly, if the cost of each share exceeds the Sale Consideration of \$3.89 per share the difference is an allowable deduction. Where the Sale Consideration per share exceeds the cost base of that share, the Participating Shareholders (other than partnerships) will also make a capital gain. However, under section 118-20 of the ITAA 1997, any capital gain the Participating Shareholders make will be reduced if, because of the event, an amount is otherwise included in assessable income. The capital gain will be reduced to zero if the capital gain does not exceed the amount otherwise included in assessable income (subsection 118-20(2) of the ITAA 1997). If the capital gain exceeds the amount otherwise included in assessable income, the gain is reduced by the amount of the assessable income (subsection 118-20(3) of the ITAA 1997). There is a similar reduction for partners in partnerships (paragraphs 118-20(1)(b) and 118-20(2)(b), and subsection 118-20(3) of the ITAA 1997).

***Non-resident Participating Shareholders: CGT consequences***

70. A Participating Shareholder who was a non-resident, or the trustee of a foreign trust for CGT purposes, just before CGT event A1 happened in respect of an IAG share as a result of the IAG Buy-Back will disregard a capital gain or capital loss made from CGT event A1, unless the IAG share:

- has been used at any time by the Participating Shareholder in carrying on a business through a permanent establishment in Australia (item 3 of the table in section 855-15 of the ITAA 1997), or
- is covered by subsection 104-165(3) of the ITAA 1997 (item 5 of the table in section 855-15 of the ITAA 1997).

**Qualified persons**

71. For the purposes of paragraph 207-145(1)(a) of the ITAA 1997 which refers to Division 1A of former Part IIIAA, Participating Shareholders will be considered to satisfy the holding period rule under former section 160APHO, and be qualified persons (as long as the related payments rule is also met) in relation to the Dividend Component received under the IAG Buy-Back if:

- the shares sold into the IAG Buy-Back were acquired on or before 25 August 2016, and
- during the period when the shares were held the Participating Shareholders had sufficient risks of loss or opportunities for gain in respect of the shares (as defined in former section 160APHM) for a continuous period of at least 45 days. Neither the announcement of the IAG Buy-Back, the making of an invitation to shareholders to offer to sell their IAG shares nor the making of an offer by a shareholder to IAG in respect of an IAG share will affect whether the shares bought back under the IAG Buy-Back are held 'at risk' for the purposes of Division 1A of former Part IIIAA.

72. The 'last-in first-out' rule in former subsection 160APHI(4) has no effect for the purposes of the IAG Buy-Back in respect of IAG shares acquired on or after 24 August 2016 (the Ex-Entitlement Date) which did not confer an entitlement to participate in the IAG Buy-Back.

**The anti-avoidance provisions**

73. The Commissioner will not make a determination under subsection 45A(2) that section 45C applies to the whole, or any part, of the Capital Component of the IAG Buy-Back price received by Participating Shareholders.

74. The Commissioner will not make a determination under subsection 45B(3) that section 45C applies to the whole, or any part, of the Capital Component of the IAG Buy-Back Price received by Participating Shareholders.

75. The Commissioner will not make a determination under paragraph 177EA(5)(b) to deny the whole, or any part, of the imputation benefits received in relation to the Dividend Component of the IAG Buy-Back Price by Participating Shareholders.

76. The Commissioner will not make a determination under paragraph 204-30(3)(c) of the ITAA 1997 to deny the whole, or any part, of the imputation benefits received in relation to the Dividend Component of the IAG Buy-Back Price by Participating Shareholders.

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**Commissioner of Taxation**

16 November 2016

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## Appendix 1 – Explanation

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

### Off-market purchase

77. For the purposes of Division 16K, where a company buys a share in itself from a shareholder the purchase is a 'buy-back' (paragraph 159GZZZK(a)).

78. Division 16K categorises a buy-back as either an 'on-market purchase' or an 'off-market purchase'.

79. A buy-back is an on-market purchase if the share bought back is listed for quotation in the official list of a stock exchange in Australia or elsewhere, and the buy-back is made in the ordinary course of trading on that stock exchange (paragraph 159GZZZK(c)). A buy-back that is not an on-market purchase is an off-market purchase (paragraph 159GZZZK(d)).

80. Although IAG's ordinary shares are listed for quotation in the official list of the ASX, the IAG Buy-Back was not made in the ordinary course of trading on the ASX. As a result, for the purposes of Division 16K, the IAG Buy-Back is an off-market purchase within the meaning given by paragraph 159GZZZK(d).

### The Dividend and Capital Components

81. The IAG Buy-Back Price received by Participating Shareholders comprises two components:

- a Dividend Component, and
- a Capital Component.

82. The amount of each of these components is determined in accordance with sections 159GZZZP and 159GZZZQ, and has regard to how IAG accounted for the IAG Buy-Back.

### The Dividend Component

83. Section 159GZZZP provides that where the buy-back of a share is an off-market purchase, the difference between the purchase price and the part (if any) of the purchase price which is debited against amounts standing to the credit of the company's share capital account is taken to be a dividend paid by the company to the seller on 10 October 2016 being the day the IAG Buy-Back occurred.

84. The IAG Buy-Back Price was \$4.91 per share, of which \$2.99 (the Capital Component) was debited against amounts standing to the credit of IAG's share capital account. As a result, the Dividend Component is taken to be \$1.92.

85. The Dividend Component is frankable, but only to the extent that the IAG Buy-Back Price does not exceed the market value of a IAG share at the time of the IAG Buy-Back if the IAG Buy-Back did not occur and was never proposed to occur (paragraph 202-45(c) of the ITAA 1997).

86. TD 2004/22 sets out the Commissioner's view as to how to determine what would have been the market value of an IAG share at the time of the IAG Buy-Back if the IAG Buy-Back did not occur and was never proposed to occur. In respect of the IAG Buy-Back, the IAG Buy-Back Price per share did not exceed the market value determined in accordance with TD 2004/22. As a result, the entire Dividend Component is frankable.

### **Assessability of the Dividend Component and tax offset**

#### ***Direct distributions***

87. For Participating Shareholders who are Australian residents (other than a partnership or a trust) and who directly received the Dividend Component:

- the Dividend Component is included in the assessable income of each Participating Shareholder under subsection 44(1), and
- subject to the 'qualified person' rule, the amount of the franking credit on the Dividend Component is included in the assessable income of each Participating Shareholder under subsection 207-20(1) of the ITAA 1997.

88. Subject to the 'qualified person' rule, these Participating Shareholders are entitled to a tax offset under subsection 207-20(2) of the ITAA 1997 equal to the amount of the franking credit on the Dividend Component.

#### ***Indirect distributions***

##### ***Partnerships***

89. Pursuant to subsection 44(1), the Dividend Component is included in the assessable income of the partnership for the purposes of calculating the net income of the partnership under section 90.

90. Subject to the 'qualified person' rule, pursuant to subsection 207-35(1) of the ITAA 1997, the amount of the franking credit on the Dividend Component is included in the assessable income of the partnership for the purposes of calculating the net income of the partnership under section 90.



## *Trusts*

91. Pursuant to subsection 44(1), the Dividend Component is included in the assessable income of the trustee for the purposes of calculating the net income of the trust under subsection 95(1).

92. Subject to the 'qualified person' rule, pursuant to subsection 207-35(1) of the ITAA 1997, the amount of the franking credit on the Dividend Component is included in the assessable income of the trustee for the purposes of calculating the net income of the trust under subsection 95(1).

## *Partners and Beneficiaries*

93. Subsections 207-35(3) to 207-35(6) of the ITAA 1997 set out the circumstances in which a partner or beneficiary to whom a franked distribution flows indirectly is required to gross up their assessable income for their share of the franking credit on the franked distribution. Where the franked distribution flows indirectly (within the meaning of Subdivision 207-B of the ITAA 1997) through a trust or partnership to a resident that is an individual, a corporate tax entity (at the time the distribution flows indirectly to it) or a trustee mentioned in paragraphs 207-45(c) or 207-45(d) of the ITAA 1997, the entity will, subject to the qualified person rule, be entitled to a tax offset equal to the entity's share of the franking credit on the franked distribution (section 207-45 of the ITAA 1997).

## ***Refundable tax offset***

94. The tax offsets are subject to the refundable tax offset rules in Division 67 of the ITAA 1997, provided the offsets are not excluded from the refundable tax offset rules pursuant to subsection 67-25(1A) to 67-25(1DA) of the ITAA 1997.

## ***Non-resident Participating Shareholders***

95. As the Dividend Component of the IAG Buy-Back Price is fully franked, and no determination will be made in respect of the Dividend Component under either paragraph 204-30(3)(c) of the ITAA 1997 or paragraph 177EA(5)(b), a non-resident Participating Shareholder is not liable to Australian withholding tax on the Dividend Component (paragraph 128B(3)(ga)).

**The Capital Component*****Calculation of Sale Consideration***

96. For the purposes of determining the amount of a gain or loss (for IAG shares held on capital or revenue account), the consideration received by a Participating Shareholder in respect of the disposal of a share (the Sale Consideration) under the IAG Buy-Back is determined in accordance with section 159GZZZQ. The effect of section 159GZZZQ is to adjust the Capital Component in order to determine the Sale Consideration for CGT or revenue account treatment.

97. Subsection 159GZZZQ(1) provides that a shareholder is taken to have received an amount equal to the purchase price (in this case the IAG Buy-Back Price of \$4.91 received for each IAG share bought back) as consideration in respect of the sale of the share bought back. However, this amount is subject to certain adjustments in order to arrive at the Sale Consideration.

98. Subsection 159GZZZQ(2) is one of the adjusting provisions. It provides that if the purchase price is less than the market value of the share at the time of the buy-back (calculated as if the buy-back did not occur and was never proposed to occur) the shareholder is taken to have received an amount equal to the market value of the share as consideration in respect of the sale of the share bought back.

99. For the purposes of determining the application of subsection 159GZZZQ(2) the following methodology has been proposed by IAG and accepted by the Commissioner as outlined in TD 2004/22: The relevant market value of an IAG share is the Volume Weighted Average Price (VWAP) of an IAG share over the last five trading days before the first announcement of the IAG Buy-Back, adjusted for the percentage change in the ASX quoted price of IAG shares from the close of trading on the day prior to the First Announcement Date (19 August 2016) to the opening of trading on the Closing Date of the IAG Buy-Back (7 October 2016).

100. Under this methodology, the market value of an IAG share bought back was calculated as \$5.81. As a result, Participating Shareholders are taken to have instead received consideration of \$5.81 for the sale of each IAG share.

101. Pursuant to subsection 159GZZZQ(3), the deemed consideration of \$5.81 is reduced by a 'Reduction Amount'. The Reduction Amount is an amount calculated pursuant to subsection 159GZZZQ(4). In the circumstances of the IAG Buy-Back, the Reduction Amount is equivalent to the Dividend Component of \$1.92, unless a Participating Shareholder is a corporate tax entity to whom subsection 159GZZZQ(8) applies. As a result, the Sale Consideration for each IAG share disposed of under the IAG Buy-Back is \$3.89 (being \$5.81 less \$1.92).

102. However, where a Participating Shareholder is a corporate tax entity which is entitled to a tax offset under Division 207 of the ITAA 1997 in respect of the Dividend Component, a further adjustment may be made to the Sale Consideration. Under subsection 159GZZZQ(8), if such a Participating Shareholder would also make either a capital loss or a deductible loss (or any increase in such a loss) in respect of the sale of an IAG share bought back under the IAG Buy-Back, the Sale Consideration is increased by an offsetable amount determined under subsection 159GZZZQ(9). The Reduction Amount (being the Dividend Component) is itself reduced by so much of the offsetable amount that does not exceed the capital loss or the deductible loss.

103. Participating Shareholders are taken to have disposed of their shares accepted under the IAG Buy-Back on 10 October 2016 (CGT event A1). The disposal may have different taxation implications for Participating Shareholders depending on how the shares were held, for instance:

- an investor who held their shares on capital account will be subject to the CGT provisions, and
- a share trader who held their shares on revenue account will be subject to the ordinary income provisions and the CGT provisions.

### ***Shares held on capital account***

104. The Sale Consideration of \$3.89 per share represents the capital proceeds for CGT purposes pursuant to section 116-20 of the ITAA 1997. A Participating Shareholder (other than a partnership) will make a capital gain in respect of the disposal of a share if the Sale Consideration per share exceeds the cost base of the share. The capital gain is the amount of the excess. Similarly, a Participating Shareholder (other than a partnership) will make a capital loss in respect of the disposal of a share if the Sale Consideration per share is less than the reduced cost base of the share (subsection 104-10(4) of the ITAA 1997).

105. Where the Participating Shareholder is a partnership, any capital gain or loss will be made by the partners individually – subsection 106-5(1) of the ITAA 1997. Each partner in a partnership has a separate cost base and reduced cost base for the partner's interest in each IAG share sold into the IAG Buy-Back by the partnership (subsection 106-5(2) of the ITAA 1997). Each partner is allocated their appropriate share of the Sale Consideration received by the partnership for the disposal of IAG shares into the IAG Buy-Back.

***Shares held as trading stock***

106. Where shares were held as trading stock, the Sale Consideration of \$3.89 per share is included in assessable income under section 6-5 of the ITAA 1997. Participating Shareholders (other than partnerships) who disposed of shares held as trading stock will also make a capital gain or capital loss. However, as the shares were held as trading stock, the capital gain or capital loss is disregarded pursuant to section 118-25 of the ITAA 1997. There is a similar exemption for partners in partnerships (paragraph 118-25(1)(b) of the ITAA 1997).

***Shares held as revenue assets***

107. Where shares were held as revenue assets (as defined in section 977-50 of the ITAA 1997), but were not trading stock, the amount by which the Sale Consideration of \$3.89 per share exceeds the cost of each share is included in assessable income pursuant to section 6-5 of the ITAA 1997. Correspondingly, if the cost exceeds the Sale Consideration of \$3.89 per share, the difference is an allowable deduction pursuant to section 8-1 of the ITAA 1997.

108. Where the Sale Consideration per share exceeds the cost base of the share these Participating Shareholders (other than partnerships) will also make a capital gain. However, Participating Shareholders who held their shares as revenue assets other than as trading stock will have the amount of the capital gain reduced under the CGT anti-overlap provisions contained in section 118-20 of the ITAA 1997. The reduced cost base for the corresponding CGT outcome is reduced by the amount of the allowable deduction (subsection 110-55(9) of the ITAA 1997). There are similar CGT adjustments for partners in partnerships (paragraphs 118-20(1)(b) and 118-20(2)(b), and subsection 118-20(3) of the ITAA 1997).

***Non-resident Participating Shareholders: CGT consequences***

109. A non-resident shareholder who participate in the IAG Buy-Back disregards any capital gain or capital loss made in respect of a share bought back under the IAG Buy-Back if the share is not 'taxable Australian property' under the tests in section 855-10 of the ITAA 1997. An IAG share that is disposed of in the IAG Buy-Back will constitute taxable Australian property if the share:

- was used by the non-resident in carrying on a business through a permanent establishment in Australia (item 3 of the table in section 855-15 of the ITAA 1997), or
- is a CGT asset that is covered by subsection 105-165(3) of the ITAA 1997 (choosing to disregard a gain or loss on ceasing to be an Australian resident – item 5 of the table in section 855-15 of the ITAA 1997).

110. Items 1 and 4 of the table in section 855-15 of the ITAA 1997 do not apply to an IAG share.

111. Item 2 of the table in section 855-15 of the ITAA 1997 also does not apply to an IAG share. This is because at the time CGT event A1 happened to an IAG share as a result of the IAG Buy-Back, an IAG share was not an indirect Australian real property interest (as defined in section 855-25 of the ITAA 1997).

112. As a result, under subsection 855-10(1) of the ITAA 1997, a Participating Shareholder that was a non-resident, or the trustee of a foreign trust for CGT purposes, just before CGT event A1 happened to an IAG share as a result of the IAG Buy-Back will disregard a capital gain or capital loss made from CGT event A1 unless:

- the IAG share has been used at any time by the Participating Shareholder in carrying on a business through a permanent establishment in Australia (item 3 of the table in section 855-15 of the ITAA 1997), or
- the IAG share is covered by subsection 104-165(3) of the ITAA 1997 (item 5 of the table in section 855-15 of the ITAA 1997).

### **Qualified persons**

113. Paragraph 207-145(1)(a) of the ITAA 1997 provides that in relation to a franked dividend made by an entity, only a 'qualified person' in relation to the distribution for the purposes of Division 1A of former Part IIIAA is required to include the franking credit in its assessable income or is entitled to claim the franking credit as a tax offset. Broadly speaking, to be a qualified person in relation to the Dividend Component paid under the IAG Buy-Back, a Participating Shareholder must satisfy both the 'holding period rule' and the 'related payments rule'.

114. Broadly, a Participating Shareholder will not satisfy the related payments rule if the Participating Shareholder, or an associate of the Participating Shareholder, is under an obligation to make, or makes, a payment in respect of the dividend, which effectively passes on the economic benefit of the dividend to another person.

115. The holding period rule requires a shareholder to hold the shares on which the dividend is paid 'at risk' for a continuous period of at least 45 days during the relevant qualification period. In the absence of a related payment, the relevant qualification period is the primary qualification period, which commences on the day after the shares are acquired and ends on the 45<sup>th</sup> day after the day on which they became ex-dividend. In determining whether a shareholder has satisfied the holding period rule, any days during which there is a materially diminished risk of loss or opportunity for gain in respect of the relevant shares are not counted. The day of acquisition and the day of disposal of the relevant shares are also not counted.

116. Under former subsection 160APHM(2), a shareholder is taken to have materially diminished the risks of loss and opportunities for gain with respect to shares if the 'net position' in respect of the risks of loss and opportunity for gain of the shareholder results in the shareholder having less than 30% of the risks and opportunities relating to shares.

117. The Commissioner does not regard the announcement of the IAG Buy-Back as affecting whether IAG shares were held at risk or not.

118. There are 45 clear days between 25 August 2016 (the Record Date for the IAG Buy-Back) and 10 October 2016 (the date tender offers were accepted). As a result, a Participating Shareholder who acquired shares on or before 25 August 2016 that were bought back under the IAG Buy-Back satisfies the holding period rule as long as those shares were held at risk for at least 45 continuous days.

119. A Participating Shareholder who acquired shares after 25 August 2016 that were subsequently bought back under the IAG Buy-Back may not be a qualified person in relation to the dividend paid under the IAG Buy-Back for the purposes of Division 1A of former Part IIIAA except in certain circumstances.

120. Generally, under the holding period rule a shareholder will be deemed to have disposed of their most recently acquired shares first (former subsection 160APHI(4)). The 45 day rule operates on a 'last-in first-out' basis, so that shareholders will be deemed to have disposed of their most recently acquired shares first for the purposes of applying the 45 day rule. Accordingly, Participating Shareholders who, after 25 August 2016, acquired any additional IAG shares, which conferred an entitlement to participate in the IAG Buy-Back, may not qualify for the franking credits attached to the dividends paid on some or all of the shares sold into the IAG Buy-Back.

121. Where a Participating Shareholder acquired ex-entitlement IAG shares and participated in the IAG Buy-Back with cum-entitlement shares (which conferred an entitlement to participate in the IAG Buy-Back), the shareholder will not be considered for the purposes of the 45 day rule to be subject to the last-in first-out rule in former subsection 160APHI(4) and so will not be considered to have participated with the 'ex-entitlement' shares. Ex-entitlement shares do not constitute 'related securities' for the purposes of former subsection 160APHI(2) in relation to any cum-entitlement shares. IAG shares commenced trading on an ex-entitlement basis on 24 August 2016. Accordingly, for any additional IAG shares that a Participating Shareholder acquired on or after 24 August 2016 on an ex-entitlement basis, the 'last-in first-out' rule in former subsection 160APHI(4) will not apply in relation to those shares.

## The anti-avoidance provisions

### Section 45A

122. Section 45A is an anti-avoidance provision that applies in circumstances where capital benefits are streamed to certain shareholders (the advantaged shareholders) who derive a greater benefit from the receipt of share capital and it is reasonable to assume that the other shareholders (the disadvantaged shareholders) have received or will receive dividends.

123. Although a 'capital benefit' (as defined in paragraph 45A(3)(b)) is provided to Participating Shareholders under the IAG Buy-Back, the circumstances of the IAG Buy-Back indicate that there is no streaming of capital benefits to some shareholders and dividends to other shareholders. Under the IAG Buy-Back, all Participating Shareholders received both a distribution of share capital as well as a Dividend Component in equal proportion based on the number of shares they sold into the IAG Buy-Back. Accordingly, section 45A has no application to the IAG Buy-Back.

### Section 45B

124. Section 45B applies where certain capital payments are paid to shareholders in substitution for dividends. In broad terms, section 45B applies where:

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

125. While the conditions of paragraphs 45B(2)(a) and 45B(2)(b) were met in respect of the IAG Buy-Back, the requisite purpose of enabling a person to obtain a tax benefit as a result of the capital distribution was not present.

126. Having regard to the 'relevant circumstances' (as set out in subsection 45B(8)) of the IAG Buy-Back, it is apparent that:

- the distribution of share capital of \$2.99 per share accords with average capital per share and could not be said to be attributable to the profits of IAG

- the pattern of distributions of IAG does not indicate that the distribution of share capital of \$2.99 per share reflects amounts in substitution for a dividend
- the IAG Buy-Back is not expected to alter IAG's dividend policy, and
- as a consequence of the IAG Buy-Back, the distribution of share capital resulted in the cancellation of ordinary shares in IAG held by Participating Shareholders and corresponding loss of dividend, voting and other rights.

127. Accordingly, the Commissioner will not make a determination under subsection 45B(3) that section 45C applies to treat all or part of the distribution of share capital of \$2.99 per share as an unfranked dividend paid by IAG.

### **Section 177EA**

128. Section 177EA is a general anti-avoidance provision that applies to a wide range of schemes designed to obtain imputation benefits. In essence, it applies to schemes for the disposition of shares or an interest in shares, where a franked distribution is paid or payable in respect of the shares or an interest in shares. This would include a buy-back with a franked dividend component.

129. Specifically, subsection 177EA(3) provides that section 177EA applies if:

- (a) there is a scheme for a disposition of membership interests, or an interest in membership interests, in a corporate entity; and
- (b) either
  - (i) a frankable distribution has been paid, or is payable or expected to be payable, to a person in respect of the membership interests; or
  - (ii) a frankable distribution has flowed indirectly, or flows indirectly or is expected to flow indirectly, to a person in respect of the interest in membership interests, as the case may be; and
- (c) the distribution was, or is expected to be, a franked distribution or a distribution franked with an exempting credit; and
- (d) except for this section, the person (the **relevant taxpayer**) would receive, or could reasonably be expected to receive, imputation benefits as a result of the distribution; and
- (e) having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain an imputation benefit.



130. The conditions of paragraphs 177EA(3)(a) to 177EA(3)(d) are satisfied in respect of the IAG Buy-Back. Accordingly, the issue is whether, having regard to the relevant circumstances of the scheme, it would be concluded that, on the part of IAG, its shareholders or any other relevant party, there is a more than incidental purpose of conferring an imputation benefit under the scheme. In respect of the IAG Buy-Back, the relevant taxpayer is the Participating Shareholder and the scheme comprises the circumstances surrounding the IAG Buy-Back.

131. In arriving at a conclusion the Commissioner must have regard to the relevant circumstances of the scheme which include, but are not limited to, the circumstances set out in subsection 177EA(17). The relevant circumstances listed in subsection 177EA(17) encompass a range of circumstances which, taken individually or collectively, could indicate the requisite purpose. Due to the diverse nature of these circumstances some may not be present at any one time in any one scheme.

132. The Commissioner has come to the view that section 177EA applies to the IAG Buy-Back. In coming to this conclusion the Commissioner had regard to all the relevant circumstances of the arrangement, as outlined in subsection 177EA(17). Among the circumstances of the IAG Buy-Back reflected in those paragraphs is the greater attraction of the IAG Buy-Back to the resident shareholders who could fully utilise the franking credits than to non-resident shareholders who could not.

133. Where section 177EA applies the Commissioner has a discretion pursuant to the subsection 177EA(5) to make a determination to debit IAG's franking account pursuant to paragraph 177EA(5)(a), or deny the imputation benefit to each Participating Shareholder pursuant to paragraph 177EA(5)(b). The Commissioner will exercise his discretion in such a way that he will not make a determination that the imputation benefit obtained by Participating Shareholders will be denied under paragraph 177EA(5)(b).

### ***Section 204-30 of the ITAA 1997***

134. Section 204-30 of the ITAA 1997 applies where a corporate tax entity streams the payment of dividends, or the payment of dividends and the giving of other benefits, to its members in such a way that:

- (a) an imputation benefit is, or apart from section 204-30 of the ITAA 1997 would be, received by a member of the entity as a result of the distribution or distributions (paragraph 204-30(1)(a) of the ITAA 1997)
- (b) the member would derive a greater benefit from franking credits than another member of the entity (paragraph 204-30(1)(b) of the ITAA 1997), and

- (c) the other member of the entity will receive lesser imputation benefits, or will not receive any imputation benefits, whether or not the other member receives other benefits (paragraph 204-30(1)(c) of the ITAA 1997).

135. If section 204-30 of the ITAA 1997 applies, the Commissioner is vested with a discretion under subsection 204-30(3) of the ITAA 1997 to make a determination in writing either:

- (a) that a specified franking debit arises in the franking account of the entity, for a specified distribution or other benefit to a disadvantaged member (paragraph 204-30(3)(a) of the ITAA 1997), or
- (b) that no imputation benefit is to arise in respect of any streamed distribution made to a favoured member and specified in the determination (paragraph 204-30(3)(c) of the ITAA 1997).

136. For section 204-30 of the ITAA 1997 to apply, Participating Shareholders to whom distributions are streamed must derive a greater benefit from franking credits than ordinary shareholders of IAG who do not participate in the IAG Buy-Back. Some of the cases in which a member of an entity 'derives a greater benefit from franking credits' are listed in subsection 204-30(8) of the ITAA 1997 by reference to the ability of a member to fully utilise franking credits.

137. A portion of IAG ordinary shares are held by non-resident shareholders who do not benefit from franking credits to the same extent as resident shareholders. As a result, the condition in subsection 204-30(1) of the ITAA 1997 for section 204-30 of the ITAA 1997 to apply are met. However, the Commissioner will not make a determination under subsection 204-30(3) of the ITAA 1997.

## Appendix 2 – Detailed contents list

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 Income tax ~~ Capital management ~~ Share buy back  
 International issues ~~ Non-resident Australian income ~~ Other

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