

CR 2016/89 - Income tax: Demerger of Davenport Resources Limited by Arunta Resources Limited



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Class Ruling

Income tax: Demerger of Davenport Resources Limited by Arunta Resources Limited

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① 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

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

Relevant provision(s)

2. The relevant provisions dealt with in this Ruling are:

- subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936)
- section 44 of the ITAA 1936
- section 45 of the ITAA 1936
- section 45A of the ITAA 1936
- section 45B of the ITAA 1936
- section 45BA of the ITAA 1936
- section 45C of the ITAA 1936
- section 104-135 of the *Income Tax Assessment Act 1997* (ITAA 1997)

- section 115-30 of the ITAA 1997
- Division 125 of the ITAA 1997
- Division 230 of the ITAA 1997, and
- Subdivision 855-A of the ITAA 1997.

All subsequent legislative references in this ruling are to the ITAA 1997 unless otherwise indicated.

Class of entities

3. The class of entities to which this Ruling applies is the holders of ordinary shares (AJR shares) in Arunta Resources Limited¹ (AJR) who:

- were listed on the share register of AJR on the Record Date (25 February 2016) for the demerger of ordinary shares in Davenport Resources Limited (DRL)
- on the Demerger Date (26 February 2016) did not hold their AJR shares as revenue assets (as defined in section 977-50) or as trading stock (as defined in subsection 995-1(1)) – that is, they held their shares or options in AJR broadly on capital account
- acquired their AJR shares on or after 20 September 1985, and were not deemed to have acquired them before that date, and
- are not subject to the taxation of financial arrangements rules in Division 230 in relation to gains and losses on their AJR shares.

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

In this Ruling, a person belonging to this class of entities is referred to as an 'AJR shareholder'.

Qualifications

4. The Commissioner makes this Ruling based on the precise scheme identified in this Ruling.

5. 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 8 to 33 of this Ruling.

¹ Arunta Resources Limited was, subsequent to the demerger of DRL, renamed Spirit Telecom Limited (ASX: ST0).

6. 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

7. This Ruling applies from 1 July 2015 to 30 June 2016. The Ruling continues to apply after 30 June 2016 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

8. The following description of the scheme is based on information provided by the applicant. The following documents, or relevant parts of them form part of and are to be read with the description:

- Application for class ruling dated 1 March 2016, including appendices, lodged by Hanson Porter Curzon (the Applicant), and
- All other correspondence from the applicant in relation to this ruling.

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

Background

9. The subject of this ruling is the demerger transaction involving the distribution of shares in DRL (DRL shares) by AJR on 26 February 2016.

AJR

10. AJR is an Australian resident public company incorporated on 24 August 1999.

11. As at 26 February 2015 and immediately prior to the demerger, AJR had:

- \$29,872,184.76 issued share capital
- \$28,608,274.13 accumulated accounting losses
- 1,826,856,250 ordinary shares on issue (AJR shares), and
- 605,586,829 options to acquire ordinary shares in AJR (AJR options) on issue.

12. The AJR shareholders included 10 foreign resident shareholders.

13. Approximately 1.7% of the AJR shares were held by foreign resident shareholders as at the Demerger Date.

14. AJR has not paid any dividends in the 10 years prior to the Demerger Date (and possibly never paid dividends since its incorporation).

15. AJR has carried forward capital losses.

DRL

16. DRL is a company incorporated in Australia.

17. Immediately prior to the demerger its shares were wholly-owned by AJR (AJR and DRL together, are hereafter, referred to as the AJR group).

18. As at 26 February 2016 and immediately prior to the demerger, AJR held 6,000,000 shares in DRL. The paid up share capital in DRL for the 6,000,000 shares held by AJR was \$437,053.80.

19. The market value of AJR's 6,000,000 shares in DRL was \$480,000 immediately before the demerger transaction.

20. DRL accounted for 26.3% of the market value of the AJR group.

The demerger transaction

21. On 19 February 2016, the shareholders of AJR approved the demerger of DRL (the Demerger) involving an *in specie* distribution by AJR to its shareholders of 6,000,000 shares in DRL.

22. That *in specie* distribution was made on the Demerger Date.

23. Holders of AJR options did not participate in the Demerger.

The *in specie* distribution

24. The *in specie* distribution by AJR was conducted as a return of capital with the full amount debited to the share capital account of AJR. The total amount of the capital return was \$513,025.

25. The *in specie* distribution by AJR to its shareholders was pro rata to their shareholdings in AJR on a 100:0.328415 basis – that is, for every one hundred shares (or part thereof) held in AJR as at the Record Date, the AJR shareholder received 0.328415 DRL shares. Fractional entitlements to DRL shares were rounded up to the nearest whole number.

26. Following the Demerger, AJR shareholders held a total of 1,826,856,250 AJR shares and 6,000,000 DRL shares.

27. AJR's methodology for determining the cost base and reduced cost base of each AJR share and corresponding DRL share is as follows:

- attribute 73.7% of the total of the cost bases of the AJR shares just before the demerger to the AJR shares, and
- attribute 26.3% of the total of the cost bases of the AJR shares just before the demerger to the DRL shares.

Reasons for the Demerger

28. AJR has advised that the key drivers for the Demerger were:

- to increase management focus on the separate companies
- to enable each separate company to pursue its own growth agenda and strategic priorities
- to enable each company to allocate its own capital resources and to attract third party funding, and
- to recognise the different investment profiles of the two companies and hence the provision of investor choice.

Other matters

29. Just after the Demerger, more than 50% of the market value of CGT assets owned by DRL were used directly in the carrying on of DRL's business.

30. Following the Demerger, AJR continued to be an ASX-listed company, while DRL continued to be an Australian incorporated unlisted entity, and AJR did not (and does not) own any shares in DRL (or vice versa).

31. No DRL shares were bought back under the Demerger.

32. AJR's share capital account was not tainted within the meaning of Division 197.

33. AJR has not made an election under subsection 44(2) of the ITAA 1936.

Ruling

CGT Consequences – Australian resident AJR shareholders

CGT event G1

34. CGT event G1 (section 104-135) happened in respect of each AJR share owned by an Australian resident AJR shareholder at the time AJR made the payment of the capital reduction amount (satisfied by the *in specie* distribution of DRL shares).

Capital gain

35. An Australian resident AJR shareholder made a capital gain when CGT event G1 happened if the capital reduction amount for each AJR share (equal to \$0.028 per AJR share) exceeded the cost base of that share. No capital loss can be made from CGT event G1 (subsection 104-135(3)).

Demerger roll-over

36. A demerger, as defined in section 125-70, happened to the AJR demerger group (which included AJR and DRL) under the scheme that is the subject of this Ruling.

37. The resident AJR shareholders are eligible to choose demerger roll-over relief contained in Division 125.

Choosing demerger roll-over relief for AJR shares

38. AJR shareholders who choose demerger roll-over relief for their AJR shares are taken to have acquired the corresponding DRL shares on the date of acquisition of their AJR shares (subsections 125-55(1), 125-80(5) and 125-80(6)).

Consequences of choosing demerger roll-over relief

39. Australian resident AJR shareholders who choose demerger roll-over relief:

- will disregard any capital gain made when CGT event G1 happened under the Demerger in relation to each of their AJR shares (subsection 125-80(1)), and

- must recalculate the first element of the cost base and reduced cost base of their AJR shares, and calculate the first element of the cost base and reduced cost base of the new DRL shares they acquired under the Demerger (subsection 125-80(2)).

40. The first element of the cost base and reduced cost base of each AJR share and corresponding DRL share received under the Demerger is worked out as follows:

- take the total of the cost bases of each AJR share just before the demerger, and
- apportion that total between the AJR shares and the DRL shares acquired under the Demerger.

41. The apportionment of this total is done on a reasonable basis having regards to the market values (just after the Demerger) of the AJR and DRL shares, or a reasonable approximation of those market values (subsections 125-80(2) and 125-80(3)).

Demerger roll-over relief is not chosen for AJR shares

42. An AJR shareholder who owns AJR shares and does not choose demerger roll-over relief:

- cannot disregard a capital gain made when CGT event G1 happened under the Demerger to their AJR shares, and
- must recalculate the first element of the cost base and reduced cost base of their AJR shares, and calculate the first element of the cost base and reduced cost base of the DRL shares they acquired under the Demerger (subsections 125-85(1) and (2)).

Acquisition date of the DRL shares

43. For the purposes of determining eligibility for a discount capital gain, the DRL shares received by an AJR shareholder under the Demerger in relation to AJR shares are taken to have been acquired on the same date as the corresponding AJR shares (item 2 of the table in subsection 115-30(1)). This is the case irrespective of whether demerger roll-over relief is chosen.

CGT consequences – foreign resident AJR shareholders

CGT event G1

44. CGT event G1 in section 104-135 happened in respect of each AJR share owned by a foreign resident AJR shareholder at the time AJR made the payment of the capital reduction amount (satisfied by distributing the DRL shares).

Capital gain

45. A foreign resident AJR shareholder realised a capital gain when CGT event G1 happened if the capital reduction amount for each AJR share exceeded the cost base of that share. No capital loss can be made from CGT event G1 (subsection 104-135(3)).

46. However, any gain realised by a foreign resident is disregarded if their AJR shares were not taxable Australian property (section 855-10).

47. Based on the facts of the scheme, an AJR share will be taxable Australian property of a foreign resident AJR shareholder if:

- the AJR share has been used at any time by them in carrying on a business through a permanent establishment in Australia (Item 3 of the table in section 855-15), or
- the AJR share is covered by subsection 104-165(3) (Item 5 of the table in section 855-15), regarding an individual's choice to disregard capital gains or losses on assets held at the time the individual ceases to be an Australian resident.

Demerger roll-over relief is not available

48. A foreign resident AJR shareholder cannot choose to obtain demerger roll-over relief under Division 125 unless the DRL shares they acquired under the Demerger were taxable Australian property just after they acquired them (subsection 125-55(2)).

49. A DRL share will be taxable Australian property just after it is acquired by a foreign resident AJR shareholder under the Demerger if:

- the DRL share is used at any time in carrying on a business through a permanent establishment in Australia (Item 3 of the table in section 855-15), or
- the DRL share is covered by subsection 104-165(3) (Item 5 of the table in section 855-15), regarding an individual's choice to disregard capital gains or losses on assets held at the time the individual ceases to be an Australian resident.

Foreign resident AJR shareholders whose ordinary shares were taxable Australian property

50. A foreign resident AJR shareholder cannot disregard a capital gain made from CGT event G1 happening under the Demerger in respect of an AJR share if that AJR share is taxable Australian property (refer paragraph 47 above).

51. A foreign resident AJR shareholder who cannot disregard that capital gain realised on the Demerger of DRL can choose to obtain demerger roll-over relief under Division 125 if the DRL shares they acquired under the Demerger were taxable Australian property (refer paragraph 49 above) just after they acquired them (section 125-55(2)).

Cost base and reduced cost base of AJR and DRL shares

52. A foreign resident AJR shareholder must recalculate the first element of the cost base and reduced cost base of their AJR shares and calculate the first element of the cost base and reduced cost base of new DRL shares they acquired under the Demerger (subsections 125-85(1) and (2)).

Dividend consequences

Distribution of capital is not a dividend

53. The *in specie* distribution to AJR shareholders of DRL shares under the scheme is debited to the share capital account of AJR (that is, \$513,025), and thus is not a 'dividend' as defined in subsection 6(1) of the ITAA 1936.

Demerger dividend

54. AJR shareholders received a distribution consisting of an *in specie* distribution of DRL shares. As this *in specie* distribution was sourced solely from AJR's share capital account (as AJR had no profits available), neither the whole nor any part of the *in specie* distribution would be a dividend or a demerger dividend (subsection 6(1) of the ITAA 1936).

Application of sections 45, 45A and 45B of the ITAA 1936

55. Section 45 of the ITAA 1936 will not apply to the whole or any part of the demerger distribution provided to the AJR shareholders under the demerger.

56. Section 45A of the ITAA 1936 will not apply to the whole or any part of any demerger benefit provided to AJR shareholders and the Commissioner will not make a determination under subsection 45A(2) that section 45C of the ITAA 1936 applies.

57. The Commissioner will not make a determination under paragraph 45B(3)(a) of the ITAA 1936 that section 45BA of the ITAA 1936 applies to the whole or any part of any demerger benefit provided to AJR shareholders under the Demerger.

58. The Commissioner will not make a determination under paragraph 45B(3)(b) of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole or any part of the capital benefit provided to AJR shareholders under the demerger.

Commissioner of Taxation

23 November 2016

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.*

CGT event G1

59. CGT event G1 happened in relation to the AJR shares owned by AJR shareholders at the time that AJR made the payment of the capital reduction amount. The payment is not a dividend as defined in subsection 995-1(1), nor an amount taken to be a dividend under section 47 of the ITAA 1936, consistent with the requirements of section 104-135.

60. An AJR shareholder made a capital gain if the capital reduction amount is more than the cost base of their AJR shares. The amount of the capital gain is equal to this excess (subsection 104-135(3)).

61. An AJR shareholder cannot make a capital loss when CGT event G1 happens (note 1 of subsection 104-135(3)).

62. If the AJR share to which the payment relates was acquired by an AJR shareholder at least 12 months before the payment of the capital reduction amount, a capital gain made from CGT event G1 may qualify as a discount capital gain under subsection 115-25(1) (provided the other conditions in Subdivision 115-A are satisfied).

Demerger roll-over relief

63. The demerger roll-over provisions in Division 125 contain a number of conditions for eligibility to choose roll-over. The main conditions that are relevant to the Demerger of DRL shares by AJR are:

- (a) an entity owns a share in a company
- (b) the company is the head entity of a demerger group
- (c) a demerger happens to the demerger group
- (d) under the demerger, a CGT event happens to the original interest and the entity acquires a new or replacement interest in the demerged entity (which must be a company) only because they own the original interest, and acquire nothing else, and
- (e) the entity owning the original interest must acquire, under the demerger, the same proportion of new interests in the demerged entity as they owned in the head entity just before the demerger.

64. AJR option holders did not participate in the Demerger, and accordingly, AJR option holders did not acquire new interests in DRL. However, as the AJR options are 'adjusting instruments' (subsection 125-75(5)), and the market value of the AJR options is less than 10% of the market value of all 'ownership interests' in AJR, those AJR options are disregarded in determining whether participants in the Demerger acquired the same proportion of new interests in DRL as they owned in AJR just before the Demerger. As AJR shareholders obtained new interests in DRL in the same proportion as they owned shares in AJR just before the Demerger, the non-participation of AJR option holders therefore does not prevent AJR shareholders from obtaining demerger roll-over relief under Division 125 (subsections 125-70(2), 125-75(4)).

65. The conditions for choosing demerger roll-over relief under Division 125 were satisfied in respect of the Demerger of DRL shares. Accordingly, the demerger concessions in Division 125 are available to Australian resident AJR shareholders in respect of the Demerger. If an Australian resident AJR shareholder chooses demerger roll-over relief, they must recalculate the cost base and reduced cost base of their AJR shares and calculate the cost base and reduced cost base of their new DRL shares (section 125-80).

66. Any gain realised by a foreign resident on AJR shares that are not taxable Australian property is disregarded for Australian income tax purposes (section 855-10).

67. Based on the facts of this scheme, an AJR share will be taxable Australian property of a foreign resident AJR shareholder at the time of the Demerger if:

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

68. A foreign resident AJR shareholder who cannot disregard any capital gain realised on the Demerger of DRL can choose to obtain demerger roll-over relief under Division 125 if their DRL shares are taxable Australian property immediately after the Demerger.

69. A DRL share will be taxable Australian property of a foreign resident AJR shareholder immediately after it was acquired if:

- the DRL share is used at any time by them in carrying on a business through a permanent establishment in Australia (Item 3 of the table in section 855-15), or
- the DRL share is covered by subsection 104-165(3) (Item 5 of the table in section 855-15).

70. Regardless of whether a foreign resident AJR shareholder can choose demerger roll-over relief, they must recalculate the cost base and reduced cost base of their AJR shares and calculate the cost base and reduced cost base of their new DRL shares (section 125-85(1) and (2)).

Distribution debited to the share capital account is not a dividend

71. Subsection 44(1) of the ITAA 1936 includes in a shareholder's assessable income any dividends, as defined in subsection 6(1) of the ITAA 1936, paid to the shareholder out of profits derived by the company from any source (if the shareholder is an Australian resident) or out of profits derived by the company from sources in Australia (if the shareholder is a non-resident).

72. The term 'dividend' is defined in subsection 6(1) of the ITAA 1936 and includes a distribution made by a company to any of its shareholders, whether in money or other property. However, paragraph (d) of the definition of 'dividend' excludes a distribution that is debited against an amount standing to the credit of the share capital account of the company.

73. The term 'share capital account' is defined in section 975-300 as an account which the company keeps of its share capital, or any other account created on or after 1 July 1998 where the first amount credited to the account was an amount of share capital.

74. Subsection 975-300(3) states that an account is not a share capital account if it is tainted.

75. The *in specie* distribution to AJR shareholders of DRL shares has been recorded as a debit to AJR's share capital account. As the share capital account of AJR is not tainted within the meaning of Division 197, paragraph (d) of the definition of 'dividend' in subsection 6(1) of the ITAA 1936 applies. Accordingly, the *in specie* distribution to AJR shareholders of DRL shares, being debited to the share capital account, is not a 'dividend' as defined in subsection 6(1) of the ITAA 1936. Therefore, it will not be included in the assessable income of AJR shareholders under subsection 44(1) of the ITAA 1936.

Application of sections 45, 45A and 45B of the ITAA 1936

Section 45

76. Section 45 of the ITAA 1936 applies where a company streams the provision of shares and the payment of minimally franked dividends to its shareholders in such a way that the shares are received by some shareholders and minimally franked dividends are received by other shareholders. Minimally franked dividends are dividends which are not franked or are franked to less than 10% (subsection 45(3) of ITAA 1936).

77. Considering the circumstances of the demerger, the Commissioner is of the view there was no streaming of shares and minimally franked dividend. Therefore section 45 of the ITAA 1936 will not apply to the whole or any part of any demerger allocation received by AJR shareholders.

Section 45A

78. Section 45A of the ITAA 1936 is an anti-avoidance provision that applies where capital benefits are streamed to certain shareholders (the advantaged shareholders) who derive a greater benefit from the receipt of capital, and it is reasonable to assume that the other shareholders (the disadvantaged shareholders) have received or will receive dividends.

79. Although a 'capital benefit', as defined in paragraph 45A(3)(b) of ITAA 1936, is provided to AJR shareholders as part of the demerger distribution, all shareholders will benefit equally and there is no indication of 'streaming' of capital benefits to some shareholders and dividends to others.

80. Therefore, section 45A of ITAA 1936 will not apply to the whole or any part of any capital benefits provided to AJR shareholders and the Commissioner will not make a determination under subsection 45A(2) that section 45C applies.

Section 45B

81. Section 45B of the ITAA 1936 is an anti-avoidance provision which, if applicable, allows the Commissioner to make a determination that all or part of a demerger allocation or return of capital received by shareholders is to be treated as an unfranked dividend.

82. The purpose of section 45B of the ITAA 1936 is to ensure that the relevant amounts distributed to shareholders are treated as dividends for tax purposes if certain payments, allocations, and distributions are made in substitution for dividends. Specifically, the provision applies where:

- (a) there is a scheme under which a person is provided with a demerger benefit or a capital benefit by a company (paragraph 45B(2)(a) of the ITAA 1936), and
- (b) under the scheme, a taxpayer, who may or may not be the person provided with the demerger benefit or the capital benefit, obtains a tax benefit (paragraph 45B(2)(b) of the ITAA 1936), 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 (other than an incidental purpose) of enabling a

taxpayer to obtain a tax benefit (paragraph 45B(2)(c) of the ITAA 1936).

83. The arrangement involving the *in specie* distribution to AJR shareholders of DRL shares constitutes a scheme for the purposes of section 45B of the ITAA 1936.

84. The phrase 'provided with a demerger benefit' is defined in subsection 45B(4) of the ITAA 1936 and includes a company providing a person with ownership interests in that or another company. The phrase 'provided with a capital benefit' is defined in subsection 45B(5) of the ITAA 1936 and includes the provision of ownership interests in a company to a person. The *in specie* distribution of DRL shares means that AJR shareholders will be taken to have been provided with a demerger benefit, and provided with a capital benefit.

85. The Commissioner considers that at least some AJR shareholders obtained a tax benefit (within the meaning given by subsection 45B(9) of the ITAA 1936) under the scheme.

86. For the purposes of paragraph 45B(2)(c) of the ITAA 1936, the Commissioner is required to consider the relevant circumstances of the scheme (as outlined in subsection 45B(8) of the ITAA 1936) to determine whether it could be concluded that entities that entered into or carried out the scheme, or any part of the scheme, did so for a purpose (other than an incidental purpose) of enabling the relevant taxpayer to obtain a tax benefit. Having regard to the relevant circumstances as outlined in subsection 45B(8) of the ITAA 1936, the Commissioner has formed the view that such a purpose did not exist.

87. Accordingly, the Commissioner will not make a determination:

- under paragraph 45B(3)(a) of the ITAA 1936 that section 45BA of the ITAA 1936 applies to the whole, or any part, of the demerger benefit provided to AJR shareholders under the Demerger, and
- under paragraph 45B(3)(b) of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole, or any part, of the capital benefit provided to AJR shareholders under the Demerger.

Appendix 2 – Detailed contents list

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References

<i>Previous draft:</i>	- ITAA 1997 104-165(3)
Not previously issued as a draft	- ITAA 1997 109-5(2)
	- ITAA 1997 115-30
<i>Related Rulings/Determinations:</i>	- ITAA 1997 115-30(1)
TR 2006/10	- ITAA 1997 Div 125
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<i>Legislative references:</i>	- ITAA 1997 125-55(2)
- ITAA 1936	- ITAA 1997 125-70
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