TR 2003/D3 - Income tax: distributions of property by companies to shareholders - amount to be included as an assessable dividend

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This document has been finalised by TR 2003/8.

Draft Taxation Ruling
Income tax: distributions of property by companies to shareholders – amount to be included as an assessable dividend

Contents Para

What this Ruling is about 1
Date of Effect 3
Ruling 4
Explanation 9
Definitions 21
Alternative Views 22
Example 23
Your comments 26
Detailed contents list 27

Preamble

Draft Taxation Rulings (DTRs) represent the preliminary, though considered views of the Australian Taxation Office. DTRs may not be relied on by, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

Class of person/arrangement

1. This Ruling applies to shareholders who receive, in their capacity as shareholders, a distribution of property from a company.

2. This Ruling explains what part of a distribution of property by a company to its shareholders constitutes a dividend to be included in the assessable income of the shareholder, including where the company debits its share capital account in respect of some or all of that distribution. The Ruling does not apply to non-share equity holders, and non-share dividends.

Date of effect

3. It is proposed that when the final Ruling is issued, it will 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 21 and 22 of Taxation Ruling TR 92/20).

Ruling

4. The amount of a dividend in respect of a distribution of property (including shares held by the 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.

5. There are two exceptions to this position:

(a) the special case described in subsection 6(4) of the *Income Tax Assessment Act 1936* ('ITAA 1936'), which deals with certain share capital injection arrangements; and

(b) dividend substitution cases to which section 45B of the ITAA 1936 applies.

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.

Explanations

9. The newly enacted demerger legislation has recently given rise to the issue of how much of any distribution of shares by a company to its shareholders should be treated as an assessable dividend. The views expressed in this Ruling are not limited to the demergers context, and apply generally to all distributions of property by a company to its shareholders.

10. The definition of a dividend in subsection 6(1) of the ITAA 1936 provides that any distribution made by a company to any of its shareholders, whether in money or property, is a dividend unless one of the exceptions in the definition applies. In the present context the relevant exception is that contained in paragraph (d) of the definition. That exception provides that if the amount of the value of the property is debited to the share capital account then that amount is not a dividend. The value of property at any given time is a question of fact, but 'value' ordinarily means fair market value: see Taxation Ruling IT 2668.

Dividends paid out of profits derived by a company

11. Section 44 of the ITAA 1936 includes dividends paid by a company in a taxpayer's assessable income depending on whether they are, or are taken to be, paid out of profits derived by the company. The term 'profits derived' is not defined in the income tax law, nor has it been comprehensively defined by the courts – although there has been judicial consideration of when a dividend is paid out of profits derived by a company. For a discussion of the meaning of profits in the context of section 108 of the ITAA 1936 see paragraphs 24 to 35 of Taxation Ruling IT 2637. This discussion is considered to be equally relevant to subsection 44(1).

12. The following relevant points can be distilled from the case law:

- 'profits' has a wide scope and is not limited to the Corporations Law's conception of the term: MacFarlane v. FCT 86 ATC 4477;
- 'profits' implies a comparison between the states 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. See Fletcher Moulton LJ in Re Spanish Prospecting Company [1911] 1 Ch 92 at 98. A similar formulation was provided by Enderby J of the Supreme Court of NSW

in Masterman v. FCT 85 ATC 4015, at 4029; where it was said that profits constitute 'an increase in the wealth of the business resulting from the conduct of the business'. See also QBE Insurance Group v. ASC (1992) 10 ACLC 1490;

- the question whether there are profits available for distribution 'is to be answered according to the circumstances of each particular case, the nature of the company, and the evidence of competent witnesses': Bond v Barrow Haematite Steel Company [1902] 1 Ch 353 at 365 to 367 (cited by Gibbs CJ in FCT v. Slater Holdings Ltd 84 ATC 4883 at 4889). See also QBE Insurance Group v. ASC (1992) 10 ACLC 1490;
- a dividend does not have to be paid out of a profit fund or a dividend fund before it can be said to be paid out of profits for the purpose of subsection 44(1): MacFarlane v. FCT 86 ATC 4477;
- profits will exist for subsection 44(1) purposes notwithstanding that they might not be considered by accountants as being all available for payment of dividends because of the necessity to make certain provisions: MacFarlane v. FCT 86 ATC 4477; and
- there is no need for accounts, formal or informal, to be drawn up in respect of an accounting period before a dividend can be paid out of profits: MacFarlane v. FCT 86 ATC 4477.

13. 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. This is so irrespective of whether or not the account or reserve is termed a 'profit and loss' account. It could, for example, be an asset revaluation reserve, a reserve to provide for the replacement of wasting assets or, in the context of a demerger, a 'demerger reserve': see QBE Insurance Group 10 ACLC 1490 at 1505. Where a company's assets exceed its liabilities, the excess must represent profits to the extent that it does not represent share capital. This approach is supported by the High Court's approach in Evans v. Deputy Federal Commissioner of Taxation (SA) (1936) 55 CLR 80 at 101. Therefore any account representing the whole or part of such excess, other than the share capital account, is an account of profits. This approach is also generally in accordance with the approach

adopted by the Federal Court in the recent case of Sun Alliance Investments Pty Ltd (in liq) v. FC of T 2003 ATC 4171 (2003) FCA 75.

14. When determining a shareholder's liability to income tax it is not necessary that the company has met all of the relevant accounting formalities. In some cases a company will fail to debit the excess of the property's value to a particular account or reserve, usually because the property is recorded in the books of the company as an asset at less than its true value. In such a case, the excess of the true value over book value will not be recognised in the accounts of the company as a profit, and therefore, as a matter of accounting, it may not be necessary to debit an account of profits when the property is distributed to shareholders. For accounting purposes the increase in the asset's value has never been recognised in the accounts and therefore does not need to be taken out of those accounts. 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. See also the compelling arguments of Kitto J in FCT v. Uther (1965) 112 CLR 630 at 636 to 640. In view of the remarks of the High Court in Slater Holdings (1984) 59 ALJR 89; (1984) 56 ALR 306; 84 ATC 4883; (1984) 15 ATR 1299; (1984) 156 CLR 447 - High Court, the views of the majority in Uther and of Fullager J in FCT v. Blakely (1951) 82 CLR 388 cannot be considered to be determinative of this issue.

15. In deciding whether, as a question of fact, a distribution has been made out of profits derived by the company in cases where the distribution is not formally acknowledged as such, a substantive approach should be adopted. 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.

16. Such an approach was adopted by the NSW Supreme Court in Masterman v. FCT 85 ATC 4015. In reaching its decision that the payment to shareholders in that case was a payment out of profits derived by the company, the court noted (at page 4030) that the company was solvent and that there was no evidence that the relevant payment was out of non-profit sources, and that 'commonsense would require that the company be kept solvent and that only surplus amounts not putting that requirement at risk be paid out'. In making this finding the court took into account the following statement by Lord Russell in Hill v. Permanent Trustee Company of NSW [1930] AC 720 at 731:

> 'A limited company not in liquidation, can make no payment by way of return of capital to its shareholder except as a step in an authorised reduction of capital. Any other payment made by it by means of which it parts with money to the shareholder can only be made by way of dividing profit.'

Note that this quote is still relevant despite subsequent changes to the Corporations Law regarding returns of capital. Although the restrictions on returning capital have been relaxed, they have not been abolished. See, for example, sections 254T and 256B of the *Corporations Act 2001*.

17. On the appeal of the decision in Masterman (known as MacFarlane when appealed to the Full Federal Court), the Full Court in MacFarlane v. FCT 86 ATC 4477 said, at 4484:

> 'so long as in the year in which a payment deemed to be a dividend is made, the company is making profits as defined by *Fletcher Moulton LJ* [i.e. a gain made by the business during a particular period as measured by the company's assets] then that dividend is assessable under subsection 44(1) because it will not here be paid out of capital.'

18. 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). This approach is also supported by Davis Investments v. Commissioner of Stamp Duties (NSW) (1958) 100 CLR 392 at 406 to 407, where a transfer of property at an undervalue involved a liberation or realisation of the gain inherent in the property. More specifically, if the value of the distributed asset has appreciated since it was acquired by the company, that appreciation in value is itself a profit, and the distribution will therefore necessarily be out of profits.

Dividends deemed to be out of profits

19. Finally, it should be noted that the majority of the High Court in Uther's case considered that the whole of the amount distributed in that case was properly described as a return of paid-up capital, including that part of its value in excess of the amount debited to the share capital account. In light of this reasoning, where a company debits its share capital in respect of part of a distribution (thereby indicating a return of capital to its shareholders), the remaining part of

the distribution can be said to constitute a repayment of an amount paid-up on a share (assuming the share has a paid-up amount). Therefore in these cases, in addition to the arguments raised above indicating that the excess must be out of profits, paragraph 44(1B)(b) will apply to deem the resulting dividend to be paid out of profits.

Dividend substitution arrangements

20. The general rule is that so much of the money value of property distributed to a shareholder that is debited against a share capital account of the company is not a dividend. However, that part may be treated as a dividend by the operation of section 45B, which deals with dividend substitution arrangements.

Definitions

21. For the purposes of this Ruling 'debited' has the same meaning as it has under either the Corporations law, and/or generally accepted accounting principles and practice.

Alternative views

22. Based on a literal reading of paragraph 6(1)(d) of the ITAA 1936, there is an alternative argument that, unless the *whole* value of the property is debited to the share capital account, the entire distribution is a dividend. However, this argument is not compelling in light of the policy underlying the treatment of company distributions as evinced in, for example, the share buy-back provisions of Division 16K of Part III of the ITAA 1936. Further, the use of the words '*the* amount of the value of the property' in paragraph (d) means that a potential third outcome – that if any part of the distribution is debited to the share capital account then paragraph (d) prevents the whole of the distribution being a dividend – cannot be reasonably argued.

Example

23. Company A, which has share capital of $1.5 billion, owns all the shares in Company B, an operating subsidiary. Those shares have a book value of $100 million, and a market value of $150 million.

24. Pursuant to a capital reduction, Company A distributes its shares in Company B directly to its own shareholders. Company A debits its share capital account in respect of the distribution by $100 million (the book value of the shares in Company B). The share capital account is untainted, and there are no features of the capital reduction attracting the anti-avoidance provision in section 45B of the ITAA 1936. Immediately after the distribution, the assets of Company A exceed its liabilities and share capital.

25. The $50 million representing the value of the distributed shares which exceeds the $100 million debited to the share capital account is a dividend paid out of profits. This is so irrespective of whether the company debits the excess to a profit account (for example a demerger reserve) or fails to make any debit in respect of the excess. Given that, immediately after the distribution, the assets of the company exceed its liabilities, the only source of the excess is profits of the company.

Your comments

26. We invite you to comment on this draft Taxation Ruling. We are allowing 6 weeks for comments before we finalise the Ruling. If you want your comments to be considered, please provide them to us within this period.

Comments by Date: 22 May 2003

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Detailed contents list

27. Below is a detailed contents list for this draft Taxation Ruling:

	Paragraph
What this Ruling is about	**1**
Class of Persons/Arrangement	1
Date of effect	**3**

Ruling **4**
Explanations **9**
Dividends paid out of profits derived by a company 11
Dividends deemed to be out of profits 19
Dividend substitution arrangements 20
Definitions **21**
Alternative views **22**
Example **23**
Your comments **26**
Detailed contents list **27**

Commissioner of Taxation
9 April 2003

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
IT 2637; TR 2668; TR 92/20

Subject references:
- assessable Income
- distributions
- dividends
- exempt Income
- profits
- property
- shareholders

Legislative references:
- ITAA 1936 6(1)
- ITAA 1936 6(1)(d)
- ITAA 1936 6(4)
- ITAA 1936 21
- ITAA 1936 44
- ITAA 1936 44(1)
- ITAA 1936 45B
- ITAA 1936 Div 108
- ITAA 1936 Div 16K Pt III
- Corporations Act 2001 254T
- Corporations Act 2001 256B

Case references:
- Bond v. Barrow Haematite Steel Company [1902] 1 Ch 353
- Davis Investments Pty Ltd v. Commissioner of Stamp Duties (NSW) (1958) 100 CLR 392
- Dickson v. FCT (1940) 13 ALJ 508 1940] ALR 49 (1940) 5 ATD 264 (1940) 62 CLR 687
- Evans v. DCT (1936) 55 CLR 80
- FCT v. Blakely 25 ALJ 399 ATD 239 (1951) 82 CLR 388
- FCT v. Slater Holdings Ltd (1984) 59 ALJR 89 (1984) 56 ALR 306 84 ATC 4883(1984) 15 ATR 1299 (1984) 156 CLR 447 - High Court
- FCT v. Uther (1965) 112 CLR 630 (1965) 39 ALJR 184 [1966] ALR 411 (1965) 13 ATD 542
- Hill v. Permanent Trustee Company of NSW Ltd [1930] AC 720 (1930) 4 ALJ 342 [1930] All ER Rep 87 (1930) 99 LJPC 191 (1930) 144 LT 65 (1930) 31 SR (NSW) 32 (1930) 48 WN (NSW) 13 [1930] 3 WWR 433
- MacFarlane v. FCT 86 ATC 4477 (1986) 17 ATR 808 (1986) 67 ALR 624 (1986) 13 FCR 356 – Federal Court
- Masterman v. FCT 85 ATC 4015
- (1984) 16 ATR 77 (1984) 81 FLR 1
- QBE Insurance Group v. ASC (1992) 10 ACLC 1490 (1992) 8 ACSR 631 (1992) ALD 334 (1992) 110 ALR 301 (1992) 38 FCR 270

- Re Spanish Prospecting Company Ltd, [1911] 1 Ch 92
- Sun Alliance Investments Pty Ltd (in liq) v. FCT 2003 ATC 4171 (2003) FCA 75

ATO references

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