

# TAXATION CONSEQUENCES OF CORPORATE LAW SIMPLIFICATION

By Paul Abbey

*On 13 November 1997, the Treasurer introduced the Company Law Review Bill 1997 (formerly known as the Second Corporate Law Simplification Bill) and issued an accompanying press release which outlined taxation changes to be made in response to this Bill. Subsequently, on 8 April 1998, the Government introduced Taxation Laws Amendment (Company Law Review) Bill 1998 ("Taxation Amendment Bill"). This Bill contained the tax changes to be made as a result of the changes to corporate law in the Company Law Review Bill 1997<sup>1</sup>.*

*The Taxation Laws Amendment (Company Law Review) Act 1998 ("Taxation Amendment Act") was passed by the Senate on 25 June 1998 and both the Taxation Amendment Act and the Company Law Review Act 1998 ("Review Act") received assent on 29 June 1998. The Taxation Amendment Act was proclaimed to commence on 1 July 1998.*

*This article addresses the major taxation changes made by the Taxation Amendment Act in the light of the changes to the Corporations Law made by the Review Act.*

## 1. INTRODUCTION

From a taxation perspective, the Review Act contains two fundamental changes to corporate law, being the elimination of par value for shares and the relaxation of restrictions upon capital reductions. These changes are the fundamental reason for the introduction of the Taxation Amendment Act. In the Second Reading Speech, the Parliamentary Secretary to the Prime Minister stated that:

The changes made in the Taxation Laws Amendment (Company Law Review) Bill 1998 make various consequential amendments to the taxation laws as a result of changes to the Corporations Law made by the Company Law Review Act[1998], which will abolish the concept of par value for shares and the associated concepts of share

premiums as well as make it easier for companies to return capital to shareholders. The amendments will ensure that the provisions in the tax law that are currently dependent on the concept of par value can continue to operate appropriately in the future and introduce an anti-avoidance measure to prevent companies entering into capital streaming and dividend substitution arrangements.

The first response to the Review Act by the Treasury and the Australian Taxation Office ("ATO") was the release of a Tax Discussion Paper on Share Capital Rules on 1 July 1996 ("1996 Discussion Paper").

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<sup>1</sup> On 27 May 1998, a number of amendments were made to the provisions contained in the original Taxation Amendment Bill, particularly in regard to the taxation treatment of bonus shares.

The 1996 Discussion Paper proposed comprehensive changes to the treatment of company distributions through the introduction of a "profits first" rule. Under this rule, any distribution made by a company to its shareholders, when it had retained profits, would be treated as a distribution of those profits. Only if the shareholder was surrendering a substantial portion of its interest in the company would a return of capital be considered to be a genuine capital return. Even then, only that part of the payment which represented the share capital attributable to the relevant shares would be treated as a capital distribution; the remaining amount would be deemed to be a dividend and taxed as such. In addition to these rules, an overriding dividend substitution rule was proposed which could apply even if a genuine capital distribution had been made.

Accompanying these proposals was a further proposal that a company would be obliged to maintain a calculation of the amount of share capital attributable to each issued share. This calculation would need to be updated after each change to the company's share capital account.

These proposals were subject to a range of criticisms including:

- that the proposed attribution of share capital to each issued share was not consistent with the removal of par value;
- that any dividend substitution arrangements could simply be challenged under existing law or addressed by a simple anti-avoidance provision; and
- that the introduction of a "profits first" rule was not warranted by the Review Act - rather the corporate law changes were a "Trojan Horse" for this fundamental change of tax law.

The Taxation Amendment Act reflects these criticisms through abandonment of the "profit first"

rule. As the following discussion indicates, the Treasury and ATO have significantly revised their stance, although the Taxation Amendment Act contains remnants of the ideas originally raised in the 1996 Discussion Paper.

## 2. CORPORATE LAW CHANGES

The Review Act makes a wide range of changes to the Corporations Law with respect to matters such as company procedure, the conduct of meetings, reporting and the filing of returns. The significant aspects from a taxation perspective are the abolition of court confirmation for share capital reductions and the abolition of par value for shares. These changes are contained in Sch 5 to the Review Act. This Schedule became operative immediately after the Taxation Amendment Act commenced on 1 July 1998.<sup>2</sup>

### 2.1 Par Value

The elimination of par value for shares is prescribed in s 254C of the new Corporations Law which states that "shares of a company have no par value". This change will apply to both shares issued after Sch 5 becomes operative (1 July 1998) and shares issued prior to the commencement of the Schedule. Transitional provisions in Sch 5 will maintain a shareholder's liability for unpaid calls and provide that the amount paid on shares issued prior to commencement is the sum of all amounts paid at any time for the share (excluding any share premium) and preserve the effect of existing contracts executed before commencement of the Schedule that refer to par value.

In association with the elimination of par value, the transitional provisions to Sch 5 provide that any amount standing to the credit of a company's share premium account or its capital redemption reserve will become part of its share capital immediately after commencement. Effectively then, all amounts paid to a company for the issue of shares will be credited to its share capital account. However, if a

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<sup>2</sup> 2 Review Act, s 2(5).

company has an amount standing to the credit of its share premium account immediately before commencement of Sch 5, this amount can be used to provide for the premium payable on redemption of debentures or redeemable preference shares issued before commencement, or can be used for the write-off of certain expenses including preliminary expenses.

The elimination of par value will also alter the manner in which a company can capitalise profits. Presently, a company can only capitalise profits by issuing new shares or increasing the par value of existing shares. In the absence of par value, a company will be able to capitalise profits without a share issue (and vice versa). A par value increase will, of course, not be possible.

## 2.2 Capital Reductions

Amendments in the Review Act allow a company to reduce or return its share capital if:

- the reduction is "fair and reasonable to the company's shareholders as a whole";
- it does not prejudice the company's ability to pay its debts; and
- has shareholder approval.

Briefly, where the reduction in capital is to be made on all ordinary shares and for all ordinary shareholders on a pro-rata basis of shares held (that is, an equal reduction), the shareholder approval required is an ordinary resolution passed at a general meeting of the company. If the reduction is not an equal reduction (that is, a selective reduction), it must have the unanimous approval of shareholders at a general meeting, or be passed under a special resolution with no votes being cast in favour of the

resolution by any person who will benefit under the reduction (except when their shares are being cancelled).<sup>3</sup> It should be noted that the Review Act states that these rules seek "to ensure fairness between the company's shareholders".

These rules replace rules which previously required a court order to be obtained before a reduction in share capital would be allowed.

## 3. PROPOSED TAXATION CHANGES

In summary, the taxation changes made by the Taxation Amendment Act are:

- the introduction of three general anti-avoidance provisions in ss 45, 45A and 45B of the *Income Tax Assessment Act 1936* (Cth) ("ITAA36");
- changes in the treatment of bonus shares;
- the introduction of specific rules to deal with the capitalisation of profits and the "tainting" of share capital accounts;
- new rules to deal with the redemption of preference shares; and
- certain definitional changes to address the absence of par value.

This article will consider, in detail, the implications of the anti-avoidance rules, the change in treatment of bonus shares, the consequences of tainting capital accounts and the treatment of redeemable preference shares.

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<sup>3</sup> Corporations Law, s 256C(2).

#### 4. GENERAL ANTI-AVOIDANCE PROVISIONS

The general anti-avoidance provisions deal with two distinct situations, being: dividend substitution - the substitution of a capital return for the payment of a dividend for the purpose of conferring a tax advantage;<sup>4</sup> and dividend streaming - the streaming of capital distributions to some shareholders and dividends to others. The "Treasurer's 1997 Press Release" stated that these situations would be dealt with by a single rule. In fact, three separate provisions have been introduced as discussed below.

These anti-avoidance provisions apply to bonus shares or capital benefits provided on or after 1 July 1998 unless the provision was pursuant to a legally binding commitment entered into before 13 November 1997.<sup>5</sup> The provisions apply to all companies, not merely companies subject to the Review Act.

##### 4.1 Dividend Substitution

The Treasurer's 1997 Press Release stated that the dividend substitution rule would be operative upon:

capital which is returned, or bonus shares which are issued under an arrangement where the company or the shareholder has a purpose, other than an incidental purpose, of conferring or obtaining a tax advantage in connection with the distribution or issue as compared to the payment of dividend, having regard to the factors listed below ...

Of course, the rule enacted is wider than the rule announced. This rule is intended to apply to transactions which provide shareholders with a capital return on their shares such as capital reductions, share buy-backs, cancellations or redemptions,

bonus issues and changes in the rights on shares. The rule anticipates that a capital return will have a better tax outcome for the shareholder compared to an assessable dividend. The rule also demonstrates the frustration felt by the ATO and Treasury with the tax deferral allowed by s 104-135 of the *Income Tax Assessment Act 1997* (Cth) ("ITAA97") (formerly s 160ZL of the ITAA36).

##### 4.1.1 Section 45B of the ITAA36

Section 45B(2) provides that the dividend substitution rule will apply if:

- (a) there is a scheme under which a person is provided with a capital benefit by a company; and
- (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; 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 a taxpayer (the relevant taxpayer) to obtain a tax benefit.

In essence, the requirements for this test are satisfied if there is a scheme which:

- provides a "capital benefit" to a person; and
- provides a "tax benefit", but not necessarily the capital benefit, to a taxpayer; and.

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<sup>4</sup> See ITAA36, s 45B(1).

<sup>5</sup> Taxation Amendment Act, Sch 1, s 3

- any person entered into or carried out for a purpose (other than an incidental purpose) of enabling "a taxpayer" to obtain "a tax benefit".<sup>6</sup>

The operation of this test relies upon the concepts of "capital benefit", "tax benefit" and "relevant circumstances", each of which is defined in s 45B.

#### 4.1.2 Capital Benefit

Pursuant to s 45B(4), "a person being provided with a capital benefit" is a reference to the provision of shares (eg, bonus shares) to the person, a distribution of share capital to the person (such as a return of capital or share buyback), or something that is done in relation to a share that has the effect of increasing the value of the share or another share held by the person. Thus, s 45B(2) could apply to a change made to the rights attaching to its shares by a company which has the effect of increasing the value of those shares or other shares held by the person.

As discussed later in this article,<sup>7</sup> one of the changes intended by the Taxation Amendment Act is to limit the circumstances in which bonus shares are treated as dividends. Accordingly, the "provision of shares" under s 45B(4), which encompasses a bonus share issue, is presumed to constitute a capital distribution. A bonus share from retained profits was formerly treated as a dividend which could be franked and was rebateable, which was the deliberate plan of the imputation provisions, not an unintended consequence. In future, it is proposed that such a bonus issue will typically be a capital distribution. As such, a bonus share that was previously treated as a frankable, rebateable dividend will now prima facie be treated as a non-assessable capital amount but bear the risk of being deemed to be an unfrankable, non-rebateable dividend.

#### 4.1.3 Tax Benefit

The definition of "tax benefit" under s 45B(7) differs to the definition found in s177C of Pt IVA of the ITAA36 by providing that a taxpayer obtains a tax benefit if an amount of tax payable, or any other amount payable under the ITAA36, is less than or payable later than the amount that would have been payable if the capital benefit had been a dividend. Hence, the definition focuses on the tax liability of the taxpayer rather than the exclusion of any amount from assessable income.

Section 45B(7) makes no comment about the nature of the dividend received. However, the provision does refer to tax payable "by the relevant taxpayer" and so does imply that the tax payable on the dividend should be determined by reference to circumstances of the relevant taxpayer. This would suggest that a taxpayer would not obtain a tax benefit if the taxpayer obtains a capital benefit in substitution for an otherwise rebateable dividend, for example because the taxpayer is a public company. This would seem a sensible outcome given that, as a matter of fact, the after tax return from a rebateable dividend would not exceed the after tax return from a capital benefit.<sup>8</sup>

It would seem, nevertheless, that such an outcome may be rare. Section 45B(7) appears to propose that the capital benefit actually made would merely fall within the definition of dividend with no other change of circumstance. Accordingly, the capital benefit will normally be distributed from a capital account and be assessable due to s 44(1B) of the ITAA36 but non-rebateable as a dividend under s 46G of the ITAA36. It is unclear how this provision should apply if the "deemed" dividend would have been paid to a private company by a company with franking credits, but the better view would appear to be to consider the "supposed" dividend to be unfranked or unfrankable by virtue of s 46M of the ITAA36.

<sup>6</sup> Notwithstanding the pronouns used in this provision, the relevant taxpayer and tax benefit referred to in s 45B(2)(b) and (c) are apparently the same.

<sup>7</sup> See part 5.1 of this article.

<sup>8</sup> This conclusion may not hold if a non-deductible expense would be deductible if the capital benefit was a dividend.

It should be appreciated that under s 45B(2), the person who is provided with the capital benefit is not necessarily the taxpayer who obtains the tax benefit. Equally, the capital benefit need not be the tax benefit. Accordingly, if the rights are changed on shares held by a person to increase their value with the effect that other shares held by another taxpayer suffer a reduction in value and a capital gain is not realised on the subsequent disposal of the reduced value shares, s 45B could apply to the taxpayer whose share value is reduced.

#### **4.1.4 Relevant Circumstances**

In reaching a conclusion regarding the existence of a purpose under s 45B(2)(c), it is necessary to consider the "relevant circumstances" listed in s 45B(5) as follows:

- (a) the extent to which the capital benefit is attributable to profits of the company or of an associate (within the meaning in s318) of the company;
- (b) the pattern of distributions of dividends, bonus shares and returns of capital by the company;
- (c) whether the relevant taxpayer has capital losses that, apart from the scheme, would be carried forward to a later year of income;
- (d) whether some or all of the shares in the company held by the relevant taxpayer were acquired, or are taken to have been acquired, by the relevant taxpayer before 20 September 1985;
- (e) whether the relevant taxpayer is a non-resident;

(f) whether the cost base (for the purposes of Part IIIA) of the relevant share is not substantially less than the value of the applicable capital benefit;

(g) whether the relevant taxpayer is a private company who would not have been entitled to a rebate under s46F if the taxpayer had been paid an equivalent dividend instead of the capital benefit;

(h) if the scheme involves the distribution of share capital - whether the interest held by the relevant taxpayer after the distribution is the same as the interest would have been if an equivalent dividend had been paid instead of the distribution of share capital;

(i) if the scheme involves the provision of shares and the later disposal of those shares or an interest in those shares - the matters set out in s (6);

(j) if the scheme involves an increase in the value of a share and the later disposal of that share or an interest in that share - the matters set out in (6);

(k) any of the matters referred to Subparagraphs 177D(b)(i) to (viii).

The matters set out in s 45B(6) are:

(a) the period for which the shares, or the interest in the shares, are held by the shareholder or the holder of the interest; and

(b) when the arrangement for the disposal of the shares, or interests in the shares, was entered into; and

(c) whether, and when, any arrangement (for example, an option or other derivative) affecting the incidence of the risks of loss and the opportunities for profit or gain from holding the shares or interests in the shares was entered into; and

(d) if there is such an arrangement, the extent to which the risks or opportunities were borne by or accrued to the shareholder or holder of the interest, and the extent to which they were borne by or accrued to any other person, while the shareholder or holder of the interest held the shares or interest in the shares; and

(e) whether there was any change in those risks and opportunities for the shareholder or holder of the interest or any other person.

Given the similarity between s 45B(2)(c) and s 177D, it would appear the conclusion to be reached for the application of the provision should be of a reasonable man having regard to the matters listed in ss 45B(5) and (6) as objective facts. This would accord with the view of the Full High Court in *FC of T v Spotless Services Limited*<sup>9</sup>. In reaching this objective conclusion, a court would probably consider it necessary to consider, at least, whether each of the relevant circumstances or matters highlighted in ss 45B(5) and (6) are relevant to the particular tax benefit obtained.

These "relevant circumstances" would appear to fit into a number of categories. It is readily apparent that s 45B(5)(c) to (f) raise factors relevant to the capital gains tax treatment of any distribution of capital. For example, whether the relevant taxpayer has capital losses, whether the shares held by the relevant taxpayer are pre-CGT, or whether the relevant taxpayer is a non-resident. In some respects however, these factors are curious:

- Section 45B(5)(c) raises for consideration whether the relevant taxpayer has capital losses that would otherwise be carried forward. Thus, it seems to focus upon whether the capital benefit generates a capital gain under the CGT provisions which recoups capital losses brought forward or incurred in the same year. Presumably, the recoupment of capital losses indicates the existence of the necessary purpose. The factor is not relevant if the taxpayer does not generate a gain which will recoup capital losses.
- The *Explanatory Memorandum* to the Taxation Amendment Bill incorrectly states that s 45B(5)(d) raises whether the capital benefit is provided in respect of pre-CGT shares (see para 1.35). However, to the contrary, s 45B(5)(d) raises whether the shares of the relevant taxpayer, being the taxpayer who obtains the tax benefit, are pre-CGT. As discussed, the relevant taxpayer need not be provided with the capital benefit and the capital benefit need not be provided in respect of the shares of the relevant taxpayer (see s 45B(2)(b)).
- Although s 45B(5)(f) refers to the cost base of the "relevant shares", s 45B does not specify what the "relevant shares" are. In amplification, the *Explanatory Memorandum* states that they are the shares in respect of which the capital benefit is provided. The only implication that can be drawn from the words in s 45B is that the "relevant shares" should be held in the company that provides the capital benefit.<sup>10</sup> It does not follow that they must be held by the relevant taxpayer or be the shares on which the capital benefit is provided.<sup>11</sup>

<sup>9</sup> 96 ATC 5201, 5210 ("*Spotless*").

<sup>10</sup> For example, s 45B(2)(a) and (5)(d) support this view.

<sup>11</sup> The cost base of shares held by the relevant taxpayer could be separately raised as an objective fact for consideration by the factors contained in s 177D.

The first two circumstances in s 45B(5) effectively focus on the history of the company prior to the conduct of the relevant scheme.

Section 45B(5)(a) carries notions of the previously proposed "profits first" rule by raising for consideration whether the company (or an associate) has profits at the time of provision of the capital benefit.

The *Explanatory Memorandum* refers to the issue that arises where a company has sold a significant aspect of its business and then makes a capital return to its shareholders. The *Explanatory Memorandum* indicates that a return of capital to shareholders equal to the amount of the profit on the disposal of the business would be considered to be a substituted dividend, whereas a return of the share capital invested in that part of the business would not be seen as a substitute dividend because no amount would be attributable to profits.

There seems no reason to doubt that "profits" in this provision includes revenue and capital profits.<sup>12</sup> What remains unclear however is whether "profits" should always be realised amounts or whether they could be amounts unrealised but reflected in the accounts of the company, or the difference in value between assets and liabilities, that is, profits which may be unrealised and not disclosed in the accounts. It should be remembered that in *Slater Holdings*<sup>13</sup>, the Full High Court held that the starting point in determining the existence of profits is a comparison of assets of a business between two dates. However, the High Court emphasised that each circumstance should be considered separately. Given that this provision is intended to apply where a company distributes capital rather than a dividend, and that the Review Act provides that a dividend must be paid out of profits, it would seem appropriate to apply this factor only where there are distributable profits for Corporations Law purposes.

Section 45B(5)(b) raises the pattern of distributions by the company. The *Explanatory Memorandum* indicates that this factor may be relevant if, ordinarily, dividends of a certain amount are paid, but the company instead makes proportionate returns of capital. Presumably, these proportionate capital returns would be distributions of a similar amount to the prior dividends, distributed at a similar time.

Section 45B(5)(h) raises for consideration whether, if the scheme involves a distribution of capital, the interest held by the relevant taxpayer after the distribution is the same as the interest that would have been held if a dividend had been paid instead. On its own, this factor makes little sense as it fails to indicate that the interest held by the relevant taxpayer is the interest in the company which has provided the capital benefit. Certainly, the *Explanatory Memorandum* indicates that the interest mentioned is the interest held by the taxpayer in this company.

The *Explanatory Memorandum* refers to whether the proportionate voting and other interests held by the taxpayer in the company are less than its pre-reduction interest and so picks up a theme originally established in the 1996 Discussion Paper.<sup>14</sup> This factor would suggest the existence of a capital return rather than a dividend where, in comparison to other shareholders, the rights and interests of the taxpayer in the company are proportionately reduced.

### 4.1.5 Purpose

As already stated, s 45B will apply if any person who entered into or carried out the scheme did so for a purpose (other than an incidental purpose) of enabling a taxpayer to obtain a tax benefit.

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<sup>12</sup> See *FC of T v Slater Holdings Ltd (No2)* 84 ATC 4883, 4886 ("*Slater Holdings*").

<sup>13</sup> *Ibid* 4889.

<sup>14</sup> In that Discussion Paper, it was suggested a distribution would be genuinely capital if there was a substantial reduction in the shareholding interest of the shareholder.

The requirement of s 45B that this outcome merely be a purpose, obviously sets a lesser test than the requirement for a sole or dominant purpose under s 177D. The High Court in *Spotless* said that such a purpose would exist where the purpose was the ruling, most influential or prevailing purpose of the person.<sup>15</sup>

The *Explanatory Memorandum* states that a reference to "a purpose" of a scheme is usually understood to include "any main or substantial purpose" of the scheme. The *Explanatory Memorandum* indicates that the reference to a purpose other than an incidental purpose has been inserted as a matter of caution to clarify the intended meaning. The reference is meant to indicate that a purpose will not be relevant if it is not a "significant purpose" of the scheme.

These remarks would appear to impose a restriction not founded upon the words of the legislation (which is a circumstance reminiscent of the Second Reading Speech to Part IVA). The *Explanatory Memorandum* then explains that a purpose is an incidental purpose when it occurs fortuitously or in subordinate conjunction with one of the main or substantial purposes, or merely follows as its natural incident.<sup>16</sup> This later description accords with dictionary definitions. There is unquestionably though, some space between a purpose that is not a significant purpose and a subordinate conjunction.

Although the discussion of "purpose" in the *Explanatory Memorandum* is the same as the discussion found in the *Supplementary Explanatory Memorandum* to Taxation Laws Amendment Bill (No 3) 1998,<sup>17</sup> the *Supplementary Explanatory Memorandum* makes a number of remarks regarding the purpose test which are not found in the *Explanatory Memorandum*, being:

- it confirms that the test is an objective test which is not concerned with "the motives of individuals nor with their actual subjective, intentions";
- it states that purpose will be imputed to one or more parties to the scheme on the basis of its terms, the effect it actually achieves, and the overt acts by which it is implemented;
- the predication test explained by Lord Denning in *Newton v FC of T*<sup>18</sup> is said to be relevant to the purpose test under s 177EA; and
- it states that actions taken in the ordinary way will not allow an inference of a purpose to avoid tax whereas it may be possible to predicate a purpose of tax avoidance where the relevant circumstances are attended with "artificiality or contrivance" or "contain uncommercial features".<sup>19</sup>

#### 4.1.6 Commissioner's Determination

If s 45B applies, the Commissioner may make a determination that s 45C applies in regard to the whole or part of the capital benefit.<sup>20</sup> If this determination is made, the capital benefit will be taken to be an unfranked, non-rebateable dividend.<sup>21</sup> This dividend will be deemed to be paid out of profits and so will be taxable under s 44(1) of the ITAA36.<sup>22</sup>

The Commissioner also has the power to make a further determination if the capital benefit was wholly or partly paid under a scheme "for which a purpose, other than the incidental purpose, was to avoid franking debits arising in relation to the *distribution from the company*" (emphasis added).<sup>23</sup>

<sup>15</sup> *Spotless* 96 ATC 5201, 5206.

<sup>16</sup> See paras 1.29 - 1.32.

<sup>17</sup> See paras 2.5 and 2.7.

<sup>18</sup> (1958) 98 CLR 1.

<sup>19</sup> See paras 2.4 and 2.5.

<sup>20</sup> ITAA36, s 45B(3).

<sup>21</sup> ITAA36, s 45C(1).

<sup>22</sup> ITAA36, s 45C(2).

<sup>23</sup> ITAA36, s 45C(3).

Pursuant to this further determination, a class 'C' franking debit will arise equal to the amount that would have been the franking debit if a dividend of equal amount to the capital benefit or part of the capital benefit had been paid and fully franked at the same time.

Given the reference made to a "distribution from the company", it would appear that s 45C would only allow this further determination to be made where the capital benefit provided is a distribution of share capital (that is, a return of capital) or possibly a "distribution" of bonus shares. That is, the further determination would not apply where a distribution does not occur, for eg, something done to increase the value of a share held by a person. It could be argued that this was a drafting error given that s 45C(4) specifies the amount of the capital benefit for the purposes of s 45C(3) in regard to all three capital benefits contained in s 45B(4). To the contrary, s 45C(4) also applies for purposes of s 45C(1) which strengthens the argument that s 45C(3) has a limited operation.

The curious aspect of s 45C is that, while the mischief under s 45B is the provision of the tax benefit to the relevant taxpayer, s 45C penalises the provision of the capital benefit. As previously discussed, it is possible for the taxpayer in receipt of the capital benefit and the taxpayer in receipt of the tax benefit to be separate taxpayers with different benefits. For example, there may be a change of rights on shares so that the value of shares held is increased for one taxpayer (a capital benefit), while another taxpayer may enjoy a lesser capital gain on shares disposed of as compared to a dividend (a tax benefit). Under s 45C(1), the deemed dividend would be the increase in value of the shares held by the taxpayer who obtains the capital benefit.

The nature of this penalty raises, as an issue of concern, the interaction of s 45B with general anti-avoidance provisions such as Pt IVA of the ITAA36

and specific anti-avoidance provisions such as Div 140 of the ITAA97 (share value shifting). Given that s 45C will operate to convert the capital benefit into an unfranked and non-rebateable dividend, there is still the potential that the tax benefit could be denied pursuant to a determination under s 177F. Accordingly, the existence of a single tax benefit could possibly attract more than one assessable amount.

### **4.2 Dividend Streaming**

In the Treasurer's 1997 Press Release, it was stated that the dividend streaming rule will apply where capital is streamed to shareholders:

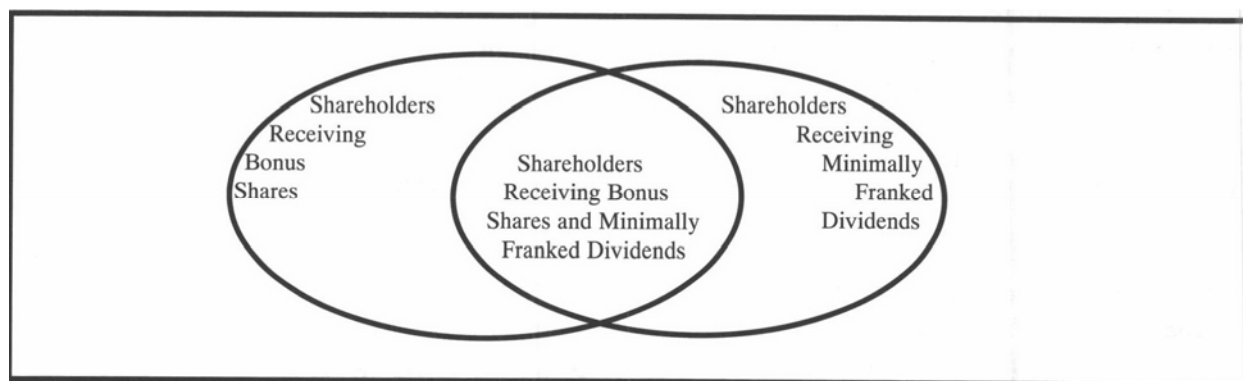
who gain a tax benefit from the receipt of share capital while dividends are paid to those who would not gain such a benefit, or bonus shares are streamed to shareholders in lieu of unfranked dividends.

This announcement has spawned two new anti-avoidance provisions, being s 45 and s 45A of the ITAA36.

#### **4.2.1 Section 45 of the ITAA36**

Section 45 will apply where a company "streams" the distribution of bonus shares and the payment of minimally franked dividends (unfranked dividends or dividends franked to less than 10%) so that bonus shares are received by some shareholders, but not all, and some of the shareholders who do not receive bonus shares receive a minimally franked dividend. Section 45 applies in priority to s 45A.

The conditions necessary for the provision to operate are best illustrated by the following diagram:



Section 45 will not apply where the shareholder has a choice whether to be paid a dividend or issued shares.<sup>24</sup> Consequently, it should not apply to dividend reinvestment plans as conducted by many listed public companies. Due to the exception made in s 6BA(6)(a), it should also not apply to bonus plans, that is, where a shareholder has a choice between an assessable dividend and a bonus share issued from the share capital account.

Where s 45 applies, the value of the bonus share, when provided, will be deemed to be a dividend paid out of profits to the shareholder so that it will be taxed under s 44(1) or subject to dividend withholding tax under s 128B. The dividend will be deemed to be unfranked and non-rebateable.<sup>25</sup> Paragraph 1.15 of the *Explanatory Memorandum* indicates the value of the bonus share will be its "market value" at the time it is provided. It would appear no reference should be made to s 6BA. Section 45 operates automatically; the Commissioner is not required to make a determination for the provision to operate.

#### 4.2.2 Section 45A of the ITAA36

Section 45 applies to relatively simple cases of streaming under which some shareholders get bonus shares and others get a minimally franked or

unfranked dividend. In contrast, s 45A is relevant to more sophisticated streaming such as providing a partially franked dividend to some shareholders and a smaller franked dividend and bonus shares (or a capital return) to other shareholders.

Specifically, s 45A will apply where a company "streams" capital benefits<sup>26</sup> and the payment of dividends to its shareholders in such a way that capital benefits are, or would be absent this provision, received by shareholders who derive "a greater benefit from capital benefits than other shareholders" and it is reasonable to assume that the other shareholders have received or will receive dividends. Where the provision applies, the Commissioner can make a determination that the whole or part of the capital benefit is subject to s 45C.<sup>27</sup>

Where a determination is made under s 45A in regard to the whole or part of the capital benefit, s 45C(1) will deem the relevant portion of the capital benefit to be an unfranked, non-rebateable dividend. Under s 45C(2), this dividend is deemed to be paid out of profits of the company and so will be assessable under s 44(1) or subject to dividend withholding tax under s 128B of the ITAA36. Where s 45A applies, the Commissioner cannot make a further determination to impose a franking debit upon the company under s 45C(3).

<sup>24</sup> ITAA36, s 6BA(5).

<sup>25</sup> ITAA36, s 45(2).

<sup>26</sup> "Capital benefits" have the same definition as adopted under s 45B: see s 45A(3).

<sup>27</sup> ITAA36, s 45A(2).

### 4.2.3 "Derive a Greater Benefit from the Capital Benefits"

Section 45A is substantially similar to s 160AQCBA of the ITAA36 which applies to the streaming of franking credits. The key requirement of the provision is that the streamed capital benefits are received by shareholders who "derive a greater benefit from the capital benefits" in that year compared to other shareholders and the other shareholder receive, or will receive, dividends. Section 45A(4) does not seek to define the phrase "a greater benefit from the capital benefits". Rather, it provides that the circumstances in which a shareholder "would..... derive a greater benefit from capital benefits than another shareholder include" but are not limited to circumstances where the first shareholder:

- has, at least, some pre-CGT shares; or
- is a non-resident; or
- has a high cost base relative to the capital benefit; or
- has available net capital losses or income tax losses; or
- is a private company that would not obtain a dividend rebate if paid the dividend received by the other shareholders.

Section 45A(4) is a clumsy provision. The provision fails to explain what a "greater benefit" is, although it implies it is a better after tax outcome, on a net basis, after the offset of available losses. The provision apparently assumes that this should be determined on the basis of \$1.00 of capital benefit compared to \$1.00 of dividend, rather than by reference to the absolute value of the capital benefits compared to the dividends.

The provision would seem to apply if the shareholder in receipt of capital benefits possesses one of the listed circumstances which the other shareholder does not. However, it is unclear what should be the outcome if the shareholder in receipt of the cap-

ital benefit has a high cost base while the other shareholder receives a dividend on, say, pre-CGT shares and so would possess a circumstance that would establish a "greater benefit" if it had received a capital benefit. Furthermore, what can be the greater benefit for a non-resident who holds shares in a private company compared to a resident unless treaty relief under the business profits article is available and accepted by the Commissioner. And if the shareholder in receipt of the capital benefit has an "unlisted" advantage such as a lower effective tax rate, should the provision automatically apply? All of these matters receive no clarification.

As with s 160AQCBA of the ITAA36, it would appear that s 45A will not apply if distributions are streamed between two shareholders who do not differ as to any of these circumstances, for example, where distributions are streamed between taxable resident corporate shareholders with post-CGT shares with similar cost bases. However, where s 45A does apply and franking credits have been streamed under the same transaction, s 160AQCBA can also apply.

Section 45A(5) provides that s 45A does not apply if it is reasonable to assume that disadvantaged shareholders have received or will receive fully franked dividends. In addition, where the capital benefit is the provision of shares (eg, a bonus issue) and it is reasonable to assume disadvantaged shareholders will receive partly franked dividends, the Commissioner can only make a determination for the amount of the capital benefit as relates to the unfranked part of the dividend. Accordingly, only this portion will be deemed to be a non-rebateable, unfrankable dividend under s 45C. It would appear the operation of s 160AQCBA, which affects the availability of a franking credit benefit, would not deny this relief.

### 4.2.4 "Streams"

Both ss 45 and 45A fundamentally depend upon the interpretation of the word "streams". The *Macquarie Dictionary* (2nd ed, 1996) 1729, relevantly defines "stream" as meaning "to send forth or dis-

charge in a stream". Unfortunately, the term "streams" is not defined in either provision nor in s 160AQCBA. In addition, there is no discussion in the *Explanatory Memorandum* to the Taxation Amendment Bill as to what constitutes streaming under s 45 or s 45A.

The *Supplementary Explanatory Memorandum* provides a detailed discussion on the meaning of dividend streaming for the purposes of s 160AQCBA.<sup>28</sup> It describes dividend streaming as selectively directing the flow of franked distributions to those shareholders who can most benefit from franking. Later, it describes dividend streaming as any strategy directed to defeating the policy of the law by avoiding wastage of franking benefits through directing the flow of franked dividends to those shareholders who can most benefit from them to the exclusion of disadvantaged shareholders. These interpretations of the term are surprising as they focus on the outcome of the actions taken rather than the actions themselves. In the legislation, the outcomes are dealt with separately.

In contrast, when the term "stream", in combination with the phrase "in such a way that", is used in ss 45 and 45A, it suggests the issue is whether the company providing the capital benefit has consciously directed the benefit to certain shareholders in a particular, deliberate manner.<sup>29</sup> The same meaning for this term can be implied from the definition of "dividend streaming arrangement" in s 160APA of the ITAA36. Whether the outcome of the company's actions is the mischief to which the provision is directed should be irrelevant to determining, as a pre-condition, whether streaming per se has occurred.

#### 4.2.3 Capital Gains Tax Consequences

A bonus share that is deemed to be a dividend under ss 45 or 45A will be non-rebateable and unfrankable and, consequently, assessable income in the hands of all resident taxpayers under s 44(1). In accordance with this treatment, the bonus share will not be subject to the cost base spreading rules introduced by the Taxation Amendment Act (as discussed below).<sup>30</sup> Rather, the bonus share will continue to be subject to the application of s 130-20(2) of the ITAA97.<sup>31</sup> Accordingly, the cost base of the bonus share will be the amount of the dividend assessed. The bonus share will be deemed to be acquired at the time it is distributed. If the bonus share is trading stock or a revenue asset, it will be taken to be acquired for a consideration equal to the amount included in assessable income.<sup>32</sup>

### 5. BONUS SHARES

Section 254A of the Corporations Law provides that a company has the power to issue bonus shares with no consideration being payable to the issuing company for the issue of the shares. Consequently, a company is able to issue bonus shares and no credit entry need be passed to the share capital account as the bonus share issue can effectively constitute a division of that account. However, the Review Act does not prevent a company from debiting its retained profits and crediting its share capital to reflect a dividend satisfied by the issue of shares. This change has led to amendments to ss 6(1) and 6BA of the ITAA36 which seem bizarre and are possibly ineffective. What these amendments were meant to achieve and what they do achieve are discussed below.

<sup>28</sup> Paragraphs 2.8 - 2.17

<sup>29</sup> The reference in s 45 to s 6BA(5) implies that streaming could also occur where a shareholder exercises a choice under a dividend reinvestment plan or bonus plan. It is unclear whether this is the intent of the legislation or whether it was merely intended to stipulate that s 45 is not relevant if the bonus share is an assessable dividend. It should be noted that a share buyback, which involves a choice by the shareholder, would appear to fall within streaming.

<sup>30</sup> See ITAA36, s 6BA(3).

<sup>31</sup> ITAA97, s 130-20(2) is the rewrite of Div 8A of Pt IIIA of the ITAA36 which applied where a bonus share was an assessable dividend.

<sup>32</sup> ITAA36, s 6BA(2).

## 5.1 New Tax Treatment

Under the Taxation Amendment Act, it is intended that all bonus shares issued after 1 July 1998 will be treated in the same manner as bonus shares issued from a share premium account under the ITAA36. In essence, the Taxation Amendment Act proposes that a bonus share will not be a dividend and so will not be included in assessable income, even where profits are credited to the share capital account upon their issue. Accordingly, bonus shares will not carry franking credits and will not achieve any dividend equivalent cost base under s 130-20(2) of the ITAA97. Briefly, s 130-20(2) will only operate if the bonus share is a dividend or is deemed to be a dividend by s 45 or s 45C (as discussed above).

This approach constitutes a complete reversal in the taxation treatment adopted for bonus issues on the introduction of the imputation system. When the former Treasurer, Mr Paul Keating, announced the imputation system on 10 December 1986, he stated that:

Post-30 June 1987 bonus issues, except those paid out of the genuine share premium account, are to be treated as dividends (required to be distributed first from the QDA) and to be assessable in the hands of individual shareholders who also would receive any imputation credits in respect of the bonus issue and gross up the amount of the bonus issue by the imputation credits in determining assessable income. For CGT purposes, the cost base of the bonus shares is to be their paid up value, with indexing applying from the date of bonus issue.

Under the Taxation Amendment Act, for CGT purposes, any bonus share issued will be deemed to be acquired at the time the original shares were

acquired for CGT purposes and will merely effect a spreading of the cost base from existing post-CGT shares over the increased number of shares.<sup>33</sup> If the shareholder is obliged to pay an amount for a bonus share issued on a pre-CGT share, the bonus share will be deemed to have been acquired at the time the liability to pay that amount arises<sup>34</sup> and their cost base will be their market value immediately before acquisition.

If the bonus share is trading stock or a revenue asset, amounts paid or payable for the original shares will be deemed to be paid or payable for the original shares and the bonus shares in proportions the Commissioner considers appropriate.<sup>35</sup>

If the bonus share is a dividend or deemed dividend (under ss 45 or 45C) it will receive the treatment described in part 4.2.5 of this article. However, if any bonus share dividend is rebateable for the shareholder under ss 46 or 46A, the treatment as described above will apply.

## 5.2 Dividend Reinvestment Plans

A number of listed public companies presently provide shareholders with the choice of accepting a dividend either in cash or through the issue of bonus shares. These reinvestment plans typically attract a franking debit penalty under s 160AQCB of the ITAA36.

Under the Taxation Amendment Act, provided the shareholder has a choice whether to be paid a cash dividend or to be issued shares, any bonus share issued through the exercise of this choice will be treated as a dividend for taxation purposes and included in the taxpayer's assessable income.<sup>36</sup> For corporate shareholders, this dividend may still be rebateable pursuant to ss 46 or 46A of the ITAA36. For all shareholders, this dividend will be frankable for dividend imputation purposes.<sup>37</sup> Such a bonus

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<sup>33</sup> ITAA97, s 130-20(3), Items 1 and 3.

<sup>34</sup> ITAA97, s 130-20(3), Item 2.

<sup>35</sup> ITAA36, s 6BA(3).

<sup>36</sup> ITAA36, s 6BA(5).

<sup>37</sup> ITAA36, s 160APA(a). The amendment made to this provision introduces a new para 160APA(a) to the definition of frankable dividend but does not (and does not intend to) repeal the existing paragraph. It would appear the amendment should actually be the insertion of para (aa).

share dividend will not taint the share capital account.<sup>38</sup>

Under s 6BA, as amended, the shareholder will be deemed to pay a consideration for the bonus share equal to the amount of the dividend included in its taxable income. However, to the extent to which the dividend is rebateable, the rebateable portion of the dividend will not be considered as consideration paid for the acquisition of the shares.<sup>39</sup> Rather, the consideration paid for the rebateable portion of the bonus share dividend will be determined by spreading the cost of the original shares across those shares and the bonus shares.<sup>40</sup> For CGT purposes, the cost base of the bonus shares will be equal to the amount of the dividend. This will be the cost base even if the dividend is rebateable. This would appear to create the unfortunate treatment that bonus shares held on capital account will have a cost base equal to the amount of the assessable dividend whereas rebateable bonus shares acquired on revenue account or as trading stock will not acquire any new basis for tax purposes.

This treatment will not apply if a listed public company provides a choice between a dividend franked to 10% or more and a bonus share but does not credit its share capital account on issue of the bonus share. In this circumstance, the bonus share will not be a dividend and will not be rebateable or frankable. Rather, the bonus issue will be treated as merely the division of existing shares and their cost base will be spread across all shares accordingly. This outcome ensures a listed company does not create a frankable, rebateable dividend merely by dividing the shares currently on issue.

### 5.3 Is the Legislation Effective?

Notwithstanding the intent of the Taxation Amendment Act, it is unclear whether the aim of the legislation has been achieved by the amendments made. This concern arises in two respects.

The first concern relates to the definition of dividend. To ensure that a bonus share issue is no longer taxed as a dividend, para (c) of the definition of dividend in s 6(1) of the ITAA36 has been repealed. Briefly, this paragraph provided:

the paid-up value of shares issued by a company to any of its shareholders to the extent to which the paid-up value represents a capitalisation of profits;

It is important to observe though, that s 6(1)(a) and (b) in the definition of dividend have been retained without amendment and no specific amendment has been made to exclude bonus shares from the definition of dividend. Thus s 6(1) continues to provide that a dividend includes:

- (a) any distribution made by a company to any of its shareholders, whether in money or other properties;
- (b) any amount credited by a company to any of its shareholders as shareholder.....

There are a number of reasons for believing the legislation may fail its purpose of not treating a bonus share as a dividend.

In *Law and Taxation of Company Distributions* (CCH looseleaf service), Slater observes that a bonus share paid to a shareholder may fall within the s 6(1)(a) definition of dividend. At para 13.20, he comments:

Paragraph (a), which together with s 44(1) brings into the assessable income of a shareholder any distribution made by a company to any of its shareholders, whether in money or other property, would also comprehend the distribution to a shareholder of bonus shares; and if the bonus shares issued had a value (whether reckoned as the asset backing

<sup>38</sup> ITAA36, s 6BA(5).

<sup>39</sup> ITAA36, s 6BA(2).

<sup>40</sup> ITAA36, s 6BA(3).

value or as the market value of the shares) in excess of the par amount of the bonus shares, the question would arise whether the amount of the excess of the value over the nominal amount of the shares could be taxed to the shareholder.

In *Nicholas v C of T (Vic)*<sup>41</sup>, the dissenting Justice, Gavan Duffy J, held that the bonus shares considered in that case had been:

distributed out of reserve account the whole amount in which consisted of ... undistributed profits. They were therefore distributed or credited from profits made by the company. I do not think there is any reason to read the words in a more restricted sense that their natural one because of their association in the section.<sup>42</sup>

When this case reached the Privy Council,<sup>43</sup> their Lordships held the bonus shares were assessable because a sum was credited from profits and so stated that it was unnecessary to consider the view of Gavan Duffy J. Nevertheless, the elimination of par value would not appear to detract from the observation by Slater that a bonus issue could be a distribution by a company to a shareholder under s 6(1)(a).

Section 6(1)(b) of the definition of dividend includes any amount credited by a company to any of its shareholders as shareholders. There would appear to be strong authority to the effect that where dividend is declared and then credited to the share capital account of the company in paying up a bonus share issued, a dividend will exist under s 6(1)(b) of the definition of dividend.

In *John v FC of T*<sup>44</sup>, Brennan J acknowledged that a bonus share satisfied by a dividend declared from retained profits would fall under s 6(1)(b) in the definition of dividend. Brennan J stated:

However, as bonus shares have to be paid for and as the company can not pay for its own shares out of its own money, the amount applied to payment for bonus shares is treated as credited to shareholders to whom the shares are allotted though the shareholders acquire no right to the credit anterior to or independent of the allotment of the bonus shares.... Statute apart, a company which allots bonus shares to its shareholders distributions not income but capital ..... A succession of Income Tax Assessment Acts have sought to bring within the net of assessable income of a shareholder either the amount credited in payment for bonus shares or the face or paid-up value of bonus shares or both.

After discussion of earlier taxing provisions, Brennan J referred to the definition of dividend in s 6(1) as an example of where either the amount credited or the paid up value has been assessed. In Brennan J's opinion:

The only dividend to which a shareholder thus becomes entitled is a dividend to be satisfied by the issue of shares.

In *Law and Taxation of Company Distributions*, Slater also indicates that a bonus share may fall within the s 6(1)(b) definition of dividend. At para 12.14, he comments:

This limb of the definition would, of itself, be sufficient to bring into the definition the amount of any bonus share or bonus debentures distributed to a shareholder as such, but for reasons associated with the historical development of the definition, bonus shares are separately dealt with in paragraph (c) of the definition.

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<sup>41</sup> (1937) 4 ATD 344.

<sup>42</sup> In this case, the relevant provision sought to assess "any dividend interest profit or bonus credited paid or distributed.....".

<sup>43</sup> *Nicholas v C of T (Vic)* (1940) 5 ATD 369 ("*Nicholas*").

<sup>44</sup> 89 ATC 4101, 4115 - 4116.

In considering the provision relevant to that case, the Privy Council in *Nicholas*<sup>45</sup> stated:

an application by the Company of an appropriate proportion of undistributed profits for the benefit of the shareholder is aptly described as crediting the shareholder with the amount necessary to render the shares fully paid, the source of the credit being profits of the Company.

Briefly, in that case profits were transferred by a company to a reserve account and bonus shares were distributed out of the account.

In *Income Tax Ruling* IT 2603, the Commissioner recognises that a bonus share paid in lieu of a dividend declared from retained profits may be treated as a dividend under either s 6(1)(b) or (c) of the definition of dividend. The Commissioner further observes that under both provisions, the same amount is treated as a dividend.

The view taken by the ATO in the preparation of the Taxation Amendment Act would appear to be that, in the absence of par values, a bonus share paid in lieu of a dividend from retained profits will not be a dividend under s 6(1)(b) of the definition of dividend. However, where a company declares a dividend from retained profits which is not paid to shareholders but rather is applied to satisfy an otherwise binding liability on shareholders to pay an amount for the issue of shares, it is unclear why s 6(1)(b) should not apply. The ability of companies to oblige shareholders to pay an amount on the issue of new share capital is not denied by the elimination of par values.<sup>46</sup>

If bonus shares satisfied by a dividend declared from retained profits are a dividend under s 6(1)(a) or (b) of the definition of dividend, the treatment under the amended s 6BA will change. Briefly, to the extent to which the dividend is paid to a share-

holder that can not obtain a rebate under ss 46 or 46A, the tax basis of the bonus share which constitutes trading stock or a revenue asset will be the amount included in the taxpayer's assessable income. If a rebate is available, there will be a spreading of tax basis from the original shares. For CGT purposes however, the availability of a dividend rebate will be irrelevant and all such bonus issues on post-CGT shares will have a cost base equal to the amount included in the taxpayer's assessable income.

Such bonus issues, of course, will be included in the taxpayer's assessable income and will be frankable for dividend imputation purposes.

The second difficulty created by the new treatment for bonus shares is found in the preconditions which exist under s 6BA(3). Briefly, this provision operates to spread the tax basis for bonus shares which are revenue assets or trading stock. One of the preconditions to the operation of this provision is that the bonus shares are:

(aa) issued for no consideration and are not a dividend or taken to be a dividend; or

Under s 6BA(4), a company issues shares for no consideration if:

(a) it credits its share capital account with the profits in connection with the issue of the shares; or

(b) it credits its share capital account with the amount of any dividend to a shareholder and the shareholder does not have a choice—whether to be paid the dividend or to be issued with the shares.

It is unclear whether this definition is meant to operate inclusively or exclusively. If it is taken that

<sup>45</sup> (1940) 5 ATD 369, 372.

<sup>46</sup> The decisions of the Privy Council and High Court in *Nicholas* suggest that there must be an obligation on the shareholder that would otherwise have to be satisfied if the dividend declared was not credited in payment for the shares.

s 6BA(4) has an exclusive operation in determining whether bonus shares have been issued for no consideration, then s 6BA(3) will have no application where the bonus shares are issued and no accounting entry of any type is made to the company's share capital account.

The reservation made in s 6BA(4) that "[t]he subsection does not limit the generality of subsection (1)" may have been included for the purposes of indicating that the definition is merely meant to be inclusive. It should be noted however that there is no precondition to the operation of s 6BA(1) to the effect that the company must issue shares for no consideration. Indeed, s 6BA(1) would appear to have been drafted widely enough to apply to a circumstance where an amount is paid by a shareholder to a company for the issue of shares made in regard to original shares, eg a rights issue.

## 6. CAPITALISATION OF PROFITS

Section 254S of the Corporations Law provides that the company may capitalise profits but does not need to accompany this capitalisation with an issue of shares. However, this flexibility will be rendered nugatory by the taxation consequences under the new Div 7B in the imputation provisions contained in Pt IIIAA of the ITAA36.<sup>47</sup> These consequences are discussed below.

Division 7B has been introduced to address concerns that retained profits and capital reserves could be transferred to the share capital account and distributed on a tax preferred basis. They apply to transfers to the share capital account from 1 July 1998.

## 6.1 Tainting the Share Capital Account

### 6.1.1 How will a Share Capital Account be Tainted?

Under s 160ARDM of the ITAA36, a share capital account will be "tainted" if an amount is transferred to the account from any other account. Effectively then, the share capital account will be tainted in the same manner that a share premium account can presently be tainted by a transfer of profits. However, the share capital account will not be tainted where an amount is transferred under a debt/equity swap pursuant to s 63E<sup>48</sup> of the ITAA36 or where amounts of share premium or capital redemption reserve are amalgamated into the share capital account on commencement of Sch 5 of the Review Act<sup>49</sup> on 1 July 1998.

A difficulty may arise for companies who do not have a genuine share premium account on commencement of Sch 5. For these companies, the amalgamation of the tainted share premium account will be subject to s 160ARDM. This could arise particularly for companies which have made scrip dividend issues at a "premium", subject to IT 2603. It is understood representations have been made to the ATO seeking relief on this point.

### 6.1.2 What is the Consequence of Tainting?

Any distributions from a tainted share capital account will be unfrankable and non-rebatable dividends for tax purposes. This treatment is achieved by amendments which provide that a share capital account does not include an account which has been tainted.<sup>50</sup> Consequently, amounts distributed to

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<sup>47</sup> This article does not address the consequences for life insurance companies.

<sup>48</sup> ITAA36, s 160ARDM(2). This could prove limited relief given the conditions in s 63E.

<sup>49</sup> Taxation Amendment Act, Sch 2, s 10.

<sup>50</sup> Taxation Amendment Act, Sch 5, s 4. This section inserts a definition for "share capital account".

shareholders from a tainted share capital account are not excluded from the definition of dividend (as amended) under s 6(1)(d). Such a distribution will be deemed to be paid from profits for the operation of s 44(1) by s 44(1B), but will remain a distribution from a share capital account under s 46H and, consequently, will be unfrankable and non-rebateable through the operation of s 46G and s 46M of the ITAA36. Such distributions, if paid to non-residents of Australia, will be subject to dividend withholding tax under s 128B of the ITAA36.

### **6.1.3 How Can a Share Capital Account Become Untainted?**

All companies will automatically incur a debit to their franking account at the time an amount is transferred to a share capital account.<sup>51</sup> This debit will equal the class C required franking amount that would arise if a dividend equal in amount to the transfer was paid on the same day. Accordingly, this debit will not exceed the franking surplus of a company at the time the transfer occurs.

Although a class C franking debit arises automatically on the day of the transfer, the share capital account will remain tainted until the company elects for the account to be untainted.<sup>52</sup> The consequence of this election will be determined by the classification of the company.

A company will be classified on the basis of whether or not the company is wholly owned by other companies (this does not mean merely other group companies) or non-residents, or both. The distinction made in Div 7B, is between "a company with higher tax shareholders" and a "company with only lower tax shareholders". A company with only lower tax shareholders<sup>53</sup> is a company whose only shareholders, from the time the share capital account was tainted until it becomes untaint-

ed, were other companies, (apart from life insurance companies or registered organisations) non-residents or a combination of both. A company with higher tax shareholders<sup>54</sup> is any company that does not have only lower tax shareholders.

If the company is a company with only lower tax shareholders and there is a sufficient franking surplus when the transfer occurs to allow for a franking debit for the entire transfer, the company can elect to untaint its share capital account at any time and no further franking debit (nor any other tax consequence) will arise.<sup>55</sup>

If such a company has an insufficient franking surplus at the time the transfer occurs to allow a franking debit for the entire amount of the transfer, the company may elect to untaint its share capital account at any time and will be required to make an additional debit to its franking account at that time. This debit will equal the amount of the transfer for which a debit did not previously arise.<sup>56</sup> To the extent any franking deficit arises at the conclusion of that franking year, the company will pay franking deficit tax. Alternatively, such a company can wait until a later time when a further franking surplus exists and elect to untaint its share capital account and make a further debit to its franking account at that time.

For a company with higher tax shareholders, an election is also required to untaint the share capital account. In addition to any franking debit, untainting tax must also be paid by such a company to untaint its share capital account. Untainting tax will not generate franking credits.<sup>57</sup>

The consequences for a company with higher tax shareholders from tainting its share capital account depend upon the amount of franking debit arising upon transfer, as follows:

<sup>51</sup> ITAA36, s 160ARDQ.

<sup>52</sup> ITAA36, s 160ARDN.

<sup>53</sup> ITAA36, s 160APA.

<sup>54</sup> ITAA36, s 160APA.

<sup>55</sup> ITAA36, s 160ARDS.

<sup>56</sup> If multiple transfers have occurred, the debit will cover the previously unfranked portion of each transfer: ITAA36, s 160ARDS.

<sup>57</sup> ITAA36, s 160ARDO.

- If the franking debit equals the transferred amount, the company will be liable to pay untainting tax effectively equal to 13.5% of the tainting amount<sup>58</sup> when it elects to untaint its franking account.
  
- If the franking debit does not equal the tainting amount, or no franking debit arises, the company will have an option at the time it elects to untaint its franking account to specify the amount of franking debit to arise at that time.<sup>59</sup> In such a circumstance, the portion of the tainting amount for which a franking debit is specified will be subject to untainting tax of, effectively, 13.5%. The remainder of the tainting amount will be subject to untainting tax of, effectively, 49.5%.
  
- If the company specifies no further franking debit, the portion of the transferred amount which does not relate to a franking debit, will be subject to untainting tax at, effectively, 49.5%.

Untainting tax will be calculated according to the following formula:<sup>60</sup>

$$\frac{\{(Tainting\ Amount + Notional\ Franking\ Amount)\}}{Top\ Marginal\ Rate\ plus\ Top\ Medicare\ Levy\ Rate} - Notional\ Franking\ Amount$$

*Notional Franking Amount* is calculated as follows:

$$Total\ Franking\ Debits \times (36/64)$$

Where *Total Franking Debits* is the sum of the franking debits arising at the time of transfer and the franking debits specified by the company when it elects to untaint.

The examples below demonstrate the implications of an untainting election.

**Example One**

A wholly owned subsidiary company earns a profit before tax of \$100 and pays \$36 in company tax. A franking credit of \$64 arises from the tax payment. It subsequently capitalises \$64 of retained profits at a time it has a \$64 franking surplus.

A debit equal to the tainting amount of \$64 will arise to its franking account on the same day.

To untaint its share capital account, the company must elect for the account to be untainted. This can be done at any time in the current franking year or a future franking year. The share capital account is tainted until this election is made. No further debit arises to the franking account upon election.

<sup>58</sup> The tainting amount is the sum of all relevant transfers: ITAA36, s 160APA.

<sup>59</sup> ITAA36, s 160ARDR(2).

<sup>60</sup> ITAA36, s 160ARDT.

**Example Two**

Listed Company earns a profit before tax of 100, pays tax of \$36 and so generates a franking credit of \$64. It later capitalises \$64 of retained profits when it has \$64 of franking surplus.

A debit equal to the tainting amount will arise to its franking account on the same day of \$64. Accordingly, no further franking debit can be made.

As some of its shareholders are resident individuals, to untaint its franking account, Listed Company must make an election and pay untainting tax calculated as follows:

*{( Tainting Amount + Notional Franking Amount)*

*x*

*Top Marginal Rate plus Top Medicare Levy Rate}*

*-*

*Notional Franking Amount*

$\{(64 + (64 \times 36/64) \times 49.5\% \} - (64 \times 36/64)$

$(100 \times 49.5\%) - 36 = \$13.5$

**Example Three**

This example is the same as Example Two except that the franking account is nil when the transfer of \$64 occurs.

Listed Company then has three options to untaint its share capital

account:

- Elect to make a full debit and effectively pay 13.5% untainting tax;
- Elect to make a partial debit and effectively pay 13.5% untainting tax on the franked amount and 49.5% untainting tax on the unfranked amount; or

- Make no debit and effectively pay 49.5% untainting tax on the tainting amount.

These options are illustrated below

	Approach		
	Full Debit	Partial Debit	No Debit
<b>Automatic Debit</b>	-	-	-
<b>Elected Debit</b>	<b>\$64</b>	<b>\$32</b>	-
<b>Untainting Tax @ 48.5%</b>	<b>\$13.5</b>	<b>\$22.59</b>	<b>\$31.68</b>

The Treasurer's 1997 Press Release stated that the potential revenue loss from the tainting of the share capital account was the difference between the tax that would have been paid on the profits distributed as a dividend and the tax that would be paid on profits distributed from share capital. In the determination of this difference, the legislation assumes that a dividend, if paid from capitalised profits, would be taxed at the top marginal tax rate plus Medicare levy and Medicare surcharge less any franking credit available, while the tax on a capital distribution would be nil. This assumption obviously ignores the consequence that a capital distribution could be fully taxable under s 160ZL at the top marginal tax rate and equally ignores the divergent tax treatment of franked dividends in the hands of different shareholder groups.

These provisions, as in the 1996 Discussion Paper, are founded on the belief that s 160ZL is ineffective as a means to tax capital distributions.

The strict nature of these changes is founded upon frustration with the apparent permanent deferral that s 160ZL provides.

#### **6.1.4 Bonus Shares**

These rules will also apply where bonus shares are issued at the time retained profits are capitalised into share capital (apart from dividend reinvestment schemes). This treatment means that a bonus share distributed in lieu of a dividend from retained profits, which will be a capital distribution and not be frankable, will attract a franking debit and possibly untainting tax. This bonus share could also be deemed to be a dividend if one of the anti avoidance rules discussed above apply.

#### **6.1.5 General Anti-Avoidance Rules**

It should be noted that the share capital increase created by the capitalisation of profits could still be subject to one of the general anti-avoidance provisions if distributed to shareholders. This outcome would effectively create a situation of double taxation. No relief is provided under the Taxation Amendment Act.

### **7. SECTION 6(4) OF THE ITAA36 AND REDEEMABLE PREFERENCE SHARES**

Given the new flexibility in the ability of a company to make capital distributions to shareholders, the Taxation Amendment Act demonstrates a renewed concern from the ATO, and apparently the Government, that companies may issue new shares to supplement their share capital account and then use the share capital thereby obtained to make capital distributions (which have a tax advantage) to shareholders.

#### **7.1 Section 6(4)**

This use of share premium accounts was the mischief to which s 6(4) of the ITAA36 previously

applied. To address the renewed concerns, s 6(4) has been amended to operate from 1 July 1998 where new share capital is issued to facilitate capital distributions to shareholders.<sup>61</sup>

The amended s 6(4) provides that the s (6)(1)(d) definition of dividend (as amended by the Taxation Amendment Act) does not apply if:

under an arrangement:

(a) a person pays or credits any money or gives any property to the company and the company credits its share capital account with the amount of the money or the value of the property; and

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

Section 6(1)(d), as amended, provides that distributions of amounts debited to the share capital account fall outside the definition of dividend. If s 6(4) applies, the amount paid, credited or distributed by the company will be a dividend under ss 6(1)(a) or (b) which will be taxable under s 44(1) of the ITAA36 due to the deeming function of s 44(1B) which will be amended so that any dividend that is debited to a share capital account will be deemed to have been paid out of profits derived by the company. Dividends debited against a share capital account will not, of course, be rebateable or frankable due to the operation of ss 46G and 46M of the ITAA36.

It should be remembered that any transaction undertaken by a company that may be subject to the application of the amended s 6(4) will also be subject to the anti-avoidance provision contained in s 45B and the general anti-avoidance provisions

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<sup>61</sup> ITAA36, s 6(5) has been repealed by the Taxation Amendment Act.

contained in Pt IVA of the ITAA36. It is understood that submissions were made to the ATO that, given the introduction of s 45B, there was no longer a requirement to include s 6(4) in the ITAA36. The continued inclusion of this provision would seem to represent an abundance of caution on behalf of the ATO.

## 7.2 Preference Shares

Under s 254J of the Corporations Law, a company can redeem preference shares. However, s 254K of Sch 5 of the Corporations Law provides that this redemption can only be from the proceeds of a new share issue made for that purpose or out of profits. Section 1447 further provides that any premium disclosed in the share premium account at the time the share premium account and share capital account are amalgamated may be used to repay the premium on redeemable preference shares which are subsequently redeemed.

For taxation purposes, the redemption of redeemable preference shares will have the following consequences:

- If redeemable preference shares are redeemed solely from profits, the amount received by the shareholder will be a dividend under s 6(1) and assessable under s 44(1) of the ITAA36. A corporate shareholder may obtain a rebate under ss 46 or 46A of the ITAA36 without any restriction from s 46G. The dividend will be frankable under s 160APA.
- If (as above) the shares are redeemed solely from profits, there will be no relief through s 6(1)(d) or (e). Section 6(1)(e) has no application if a debit is not made to the share capital account. Section 6(1)(d) explicitly provides that it does not apply on the redemption of redeemable preference shares.
- To effect a redemption out of profits, the company will pass the following entries:

Debit: Retained Profits

Credit: Bank (or a liability account)

The Corporations Law effectively prohibits a transfer from retained profits to the share capital account to then make a redemption of preference shares from that account, so that tainting of the share capital account should not occur under s 160ARDM. The use of retained profits should not be considered to effect any "notional" transfer of retained profits to share capital. It should be remembered the amendments to s 254K by Sch 5 of the Review Act eliminate the use of capital redemption reserves.

- If redeemable preference shares are redeemed from premiums contained in the share premium account when it was amalgamated with the share capital account, relief will be available under s 6(1)(e). Under this provision, the amount paid on redemption of a redeemable preference share will not be a dividend if:
  - it is debited to the share capital account;
  - the company gives the shareholder a notice on redemption which specifies the amount paid up on the share (under s 6(1) of the ITAA36 the amount paid up includes any premium paid on the issue of a share); and
  - the amount paid on redemption does not exceed the amount specified in the notice as the amount paid up.

Any excess paid on redemption over the amount paid up will be a dividend under s 6(1).

- However, under the Corporations Law, the former par value of redeemable preference shares cannot be redeemed from amounts of share premium transferred to the share capital account on amalgamation. Consequently, if new shares are not issued to

redeem the redeemable preference shares, the amount paid on redemption of the former par value of the shares must be debited to retained profits and will be a dividend for taxation purposes, that is s 6(1)(e) will not apply as the amount paid will not be debited to the share capital account.

- Apart from the use of amalgamated share premiums, redeemable preference shares cannot be redeemed from share capital under the Review Act.
- If new shares are issued and the redeemable preference shares are redeemed from the amount paid up, there will be no relief under s 6(1)(d). It should be appreciated that s 6(4) does not operate to deny the operation of s 6(1)(d) because the paragraph expressly does not apply. Instead, relief will be available under s 6(1)(e) and the amount repaid should not be a dividend provided it does not exceed the amount paid up on the share. This transaction will not affect any tainting of the share capital account as no amount will be transferred to that account to effect the redemption of the preference shares.

In summary, the redemption of preference shares will not result in a tainting of the share capital account irrespective of the source of the funds. It should also be appreciated that redeemable preference shares can be subject to a share buy-back which may avoid any of detrimental outcome which arises from the redemption consequences set out above.

## 8. OTHER CHANGES

A range of other changes to the ITAA36 have been made to accommodate the elimination of par value. Broadly, these changes will replace refer-

ences to share premium accounts and paid up capital with references to share capital accounts and paid up share capital. The changes made are contained in Sch 5 of the Taxation Amendment Act.

## 9. CONCLUSION

The Taxation Amendment Act highlights many of the fundamental flaws with the development of tax legislation.

Undoubtedly, the Taxation Amendment Act was not understood by the legislators, even those who attempt to take a specialist interest in tax legislation.

The Taxation Amendment Act is an over-reaction to the impact of Corporations Law simplification. Nonetheless, the Taxation Amendment Act is a substantial improvement on the misconceived proposals contained in the 1996 Discussion Paper.

The Taxation Amendment Act fails to make any rigorous effort to ensure unwarranted outcomes do not arise. It allows circumstances of possible double taxation to exist and it entirely reverses the treatment of bonus shares without any rational or logical foundation.

The Taxation Amendment Act fails to make rigid legislative rules. Rather, it adopts the common mischief of granting the Commissioner a discretion. This is the ATO's tool when they know they want to prevent something, but they don't know what it is until they see it. It is a convenient technique to defer any decision on the real scope of the legislation until another (unsupervised) day.

Finally, the Taxation Amendment Act is difficult to comprehend and in a number of situations apparently deficient.

**Paul Abbey** BEc LLB (ANU) ACA is a partner at Shaddick & Spence. Paul has previously published articles in various legal publications as well as given papers and seminars for the the Taxation Institute of Australia and the Institute of Chartered Accountants