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Australian Taxation Office

DRAFT TAXATION DETERMINATION TD2013/D5

We write to provide our comments on the draft determination.

1. The draft determination is drafted with certain assumptions (both express and implied) as to the purpose of the arrangements described in it and the Taxpayer Alert that preceded it:

   1.1 A "non-resident associate" or "entities with carry forward losses" (paragraph 2(g), first bullet point) are included somewhere in the arrangement.

   1.2 Arrangements using chains of trusts have facilitated interest-free loans being made available to shareholders or their associates (presumably prior to the enactment of Subdivision EB on 1 July 2009 (paragraph 2(g), second bullet point)).

   1.3 The absence of evidence being able to show that there is a non-tax related purpose for the arrangement, noting that:

      1.3.1 Such evidence needs to be consistent with the objective facts of the case, having regard to all the evidence; and

      1.3.2 In any case, there having to be a good reason why the alleged purpose could not have been achieved in a simpler and more commercially usual manner, such as simply declaring and paying a dividend on the ordinary shares held by the original shareholder (paragraph 4 of the draft determination).

2. For the purposes of this submission, let us accept that value shifting, debt equity, dividend streaming and the general provisions of Part IVA are not in dispute so that the only issue is whether the arrangements described amount to a scheme that is "by way of dividend stripping" or "in the nature of dividend stripping" within the meaning of Section 177E of Part IVA of the *Income Tax Assessment Act 1936*.

3. In order for either one of the two limbs of Section 177E to apply, it is first necessary that the transaction be part of a scheme by way of, or in the nature of, dividend

stripping or, alternatively, a scheme having substantially the effect of a scheme by way of, or in the nature of, dividend stripping.

4. Given that the term "dividend stripping" is not defined in the income tax legislation, reference to case law must be made. *CPH Property Pty Ltd v FCT* [1998] FCA 1276 provides the indicia for taxpayers to determine whether they have engaged in a scheme that amounts to a dividend strip:

   4.1 There is a company with substantial undistributed profits, creating a potential tax liability for either the company or its shareholders;

   4.2 The distribution of those profits;

   4.3 The shareholders or associates of the shareholders receiving a capital payment or benefit funded by the profits of the target company with the Commissioner forming an opinion that the disposal of the property represents in whole or in part a distribution of profits of the target company; and

   4.4 The scheme having the predominant, if not the sole, purpose of the shareholders in the target company avoiding tax on a distribution of dividends by the target company.

5. *FCT v Consolidated Press Holdings Limited* [2001] ATC 4343 was a first limb case.

   5.1 Sufficient for the purposes of this submission, the scheme entered into met all the criteria save for the question of whether the dominant purpose of the scheme was one of tax avoidance.

   5.2 On the facts of the case, that purpose was found to be lacking. The purpose of the scheme was a restructure to avoid potential double tax as a result of changes in tax legislation in the United Kingdom.

   5.3 Australian companies disposed of their shares in British companies in consideration of receiving shares in a company incorporated in Bermuda. The British companies were subsequently liquidated and the assets transferred to the Bermuda company.

   5.4 Whilst the Court took the view that the motivation for the arrangement was not one of tax avoidance and, on that basis, Section 177E was held not to apply, mention was made that the Australian companies, in disposing of their shares to the company incorporated in Bermuda returned a sizeable, taxable capital gain in Australia. It is not known whether that of itself would have been a sufficient distinguishing feature to take it out of being a dividend strip in the absence of purpose.

6. *Lawrence's Case* [2009] FCAFC 29 significantly widened the ambit of Section 177E and is a second limb case.

   6.1 The reasoning widened the ambit of Section 177E as the second limb was enlivened notwithstanding the absence of the shareholders in the target company making any disposition of the shares.

7. If we leave aside for one moment the mechanics of the particular scheme and, secondly, note that we are required to adduce evidence as to the purpose of the

scheme, you can reconcile the outcome of *Lawrence's Case* with *Consolidated Press* on the basis of what is required to amount to a dividend strip is an outcome of finality in the sense of never having to deal with tax paid reserves again. Further, that a capital tax free sum that is made available must be representative of what was previously tax paid reserves.

8. This is the critical aspect and reference ought to be made to paragraphs 9 and 10 of IT2627.

9. On the basis that this is the key element, then the decision in *Lawrence* can be explained on the basis that the loans advanced to the individual taxpayers were subsequently forgiven as a result of the trust that made the advance being vested within a short period of time of the loan being made. On that basis, the undistributed profits of the target company made their way to shareholders and their associates in a capital non-taxable sum so as to never having to deal with them again.

10. It is worth making reference to comments of Jessup J in *Lawrence's Case* when making a finding that whilst the scheme was not a first limb case, as it lacked many of the characteristics identified by the Full Federal Court in *Consolidated Press*, it was a scheme that had substantially the same effect:

> "in both cases, the profits of the target company would have effectively been disposed of, and no longer have been a potential source of income tax obligation, either for the taxpayer or for anyone else. Both for the taxpayer and for the revenue, the effects of the schemes in the present case are substantially the same as the effect of a scheme by way of or in the nature of dividend stripping".[1]

11. The draft determination can be read as almost suggesting that:

    11.1 Any liberation of corporate value in a closely held environment that does not result immediately in top up tax being payable, or is not on Division 7A terms, amounts to a dividend strip notwithstanding that there is no capital tax free benefit being made available and having no regard to purpose; and

    11.2 The continued deferral of top up tax on retained earnings is unpalatable.

12. Where discretionary dividend shares are being issued to another company, an individual or a discretionary trust so that tax paid reserves of one company are being moved to another company or dividends are being declared within the same family group who are on a better marginal rate of tax, it is incomprehensible that that course of action, of itself, would amount to a dividend strip.

13. There is simply no conversion of tax paid reserves to a capital tax free sum that is made available to shareholders or associates of the target company.

14. Where that result is achieved in circumstances where a taxpayer group has non-resident associate or entities with carried forward losses then, just as the case was in *Consolidated Press*, the purpose of the arrangement would be of utmost importance and evidence of that purpose will need to be adduced.

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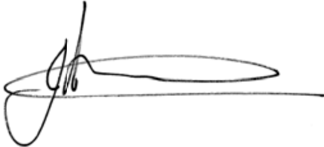
[1] At paragraph 44, Lawrence v FCT [2008]FCA1497

15. It is submitted that the draft determination ought be revised so as to narrow its ambit to arrangements that actually result in:

    15.1 Tax paid reserves of a target company via the scheme, being made available to shareholders or their associates in a capital tax free form that have the character of finality with the former tax paid reserves never having to be dealt with again; and

    15.2 There is an absence of evidence to negate a finding that the dominant, if not sole, purpose of the arrangement was to allow the shareholders to avoid tax on distributions of dividends by the target company.

Yours faithfully



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