

Fiscal Watch

Renounceable Rights Issues – Warning to Companies

The High Court in February 2007 decided that sell-back rights issued by St. George Bank Limited (SGL) to a shareholder of SGL, were income according to ordinary concepts overruling the Federal Court. This was quite a startling decision emphasised by the dissenting judgment of Callinan J and the decisions below.

Although the facts only involved sell-back rights the decision can be applied generically to other types of share issues. The general principle stated by the High Court was that the sell-back rights were to be characterised as something of value which were the product of and severed from the shareholding. They were therefore income from property according to ordinary concepts.

The effect is that even though no actual monies may be received by a shareholder and although there is no change in economic substance because the sum of the value of the rights and the existing shares is no more or less than before the rights issue, nevertheless the value of the rights is considered to be ordinary income. Because it is ordinary income the full amount of the gain is taxable (as distinct from the CGT provisions where a discount capital gain may be available to certain types of taxpayers).

The ATO has recently issued a class order which indicates they are going to apply this case generically. CR 2007/42 deals with a proposed offer by Hutchison Telecommunications (Australia) Limited to issue to its shareholders 20 renounceable rights for every ordinary share held entitling the shareholder to subscribe for a convertible preference share. The shareholders could either exercise them, trade them, or allow them to lapse.

The Commissioner, applying his interpretation of the above High Court decision, rules that the rights will be valuable property which will be derived by the shareholders as income from property at the point of receipt, regardless of whether they subsequently exercise the rights, trade them or allow them to lapse.

The rights **will be delivered as income** by the **shareholders when they are granted** and therefore the market value of their rights on that date must be included in the assessable income of each shareholder.

Companies need to consider the taxation effects carefully before undertaking capital restructures.

Small Business CGT Concessions

In 2006, the controlling individual 50 per cent test was replaced with a new significant individual 20 per cent test that can be satisfied either directly or indirectly through one or more interposed entities.

The significant additional benefits that will apply from 1 July 2007 are:

- > an entity that is a small business entity can access the concessions, ie, it satisfies the \$2 million aggregated turnover test; or
- > the maximum net asset test is increased to \$6 million (formerly \$5 million).

Taxation of Boating Activities

The current law has been that unless you can demonstrate that you are carrying on a business of boating activities, deductions are not available. This affected persons who invested in a charter boat and sought to offset losses against their other income.

The law is now proposed to be changed so that taxpayers who cannot demonstrate that they are carrying on a business using a boat to claim deductions for boating expenses up to the level of their boating income. Deductions in excess of the boating income are carried forward to be deducted against assessable income from boating activities in later years. However, the quarantined amount can be offset against a capital gain made with respect to a CGT event which occurs with respect to the boat.



Division 7A Amendments

Division 7A are essentially tax anti-avoidance provisions. They were enacted to prevent private companies providing benefits to shareholders other than by way of dividend eg, by way of loan. The provisions currently have a double punitive effect. First, the benefit is treated as a deemed unfranked dividend so the shareholder is taxed without the benefit of any franking credit and secondly the company is required to make a debit to its franking account.

Problems also arise because taxpayers and their advisers often do not recognise a Division 7A issue with what is not intended as a transaction to avoid tax but is a normal business transaction.

However these rules are being relaxed.

There will no longer be an automatic debiting of a company's franking account when a deemed dividend arises so this will reduce the current punitive impact of Division 7A.

The Commissioner will be given a new general discretion in Division 7A to allow the Commissioner to provide relief for deemed dividends that have arisen because of honest mistakes or inadvertent omissions by taxpayers such as allowing the dividend to be franked.

Taxpayers will be able to convert a Division 7A payment to a permissible loan prior to the date of lodgement of their tax return which will ensure that if a transaction has occurred without consideration of a Division 7A issue it can be rectified prior to lodgement of the company's income tax return.

Trusts and Proportionate Rule Problem

There can be a problem with trusts where there are income and capital beneficiaries and there is a gain that has the character of capital in the hands of the trustee. This is because the net income of the trust for tax purposes will include any net capital gains made by the trustee. However, for trust law purposes the capital gain will not be income of the trust but on capital account. The proportionate method means the beneficiary will be subject to income tax on the net capital gain which they never receive but the capital beneficiary gets the benefit of the gain. This is recognised by the ATO which has issued various practice notes on the issue.

The problem will now be resolved for testamentary trusts only. The position will be that the trustee will now be assessed on capital gains that would otherwise form part of a share of the net income of the trust estate where those gains would be included in the assessable income of a beneficiary who could not benefit from them or the trustee would otherwise be liable to tax on the gains on behalf of such a beneficiary. This appears to be similar to the alternative quantum approach expressed by Merkel J in *Richardson v FC of T* 97 ATC 5098.

Same Business Test – Company Losses – No More Cap

The same business test is an alternative test where the change of ownership test fails. However, the same business test was not available to companies with a size more than \$100 million. This cap will now be removed as part of the 2007 budget measures retrospective to 1 July 2005.

Superannuation Death Benefits

As from 1 July 2007 there are new rules governing superannuation death benefits.

The whole of the taxable component of the superannuation death benefit will now be tax free if paid to a superannuation death dependant. Previously there was a limit equal to the pension RBL.

Forestry and Non-Forestry MIS Scheme Investments

There are new rules for the taxation of agricultural MIS investments. Investments in forestry schemes will have their own separate division and rules. It is anticipated the deductibility of investments in non-forestry MIS will cease from 1 July 2008 unless a test case against the ATO is successful. A more detailed discussion can be found in our F.S.T. e-bulletin.

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