Chapter 18

DEFINING 'DISTRIBUTION' IN AN ENTITY REGIME

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A case for reform

There is no adequate, generally applicable definition of 'distribution'

18.1 Currently shareholders in companies are taxed on the basis of dividends that are distributed. In contrast trust beneficiaries, not under a legal disability, are taxed on their current actual *entitlement* to the income of the trust. This includes situations in which there has been no actual distribution. A right to demand a distribution will suffice.

18.2 The operation of the current definition of dividend is unclear in a number of respects, particularly as to whether it covers transfers of value to shareholders other than in cash or property, such as the release of liabilities.

18.3 The relationship between closely held entities and their members can provide conditions conducive to disguising distributions of profit as non-commercial loans or other types of payments in order to convert a taxable distribution into an amount which is not taxed in the hands of the member. The law currently does not address these issues comprehensively.

18.4 The provision by entities to members of additional ownership interests in the entity (for example, through selective share issues) has the potential to substitute for entity distributions. Such distributions are often dealt with using anti-avoidance provisions, rather than a consistent definition of distribution.

A strategy for reform

Develop a unified approach to the taxation of distributions with broad application

18.5 Moving to tax trusts and other entities under the same regime as companies will require alteration to the definition of 'dividend' so that it is appropriate to the broader range of entities covered. With the operation of a profits first rule discussed in Chapter 19, the definition required is for distributions generally.

18.6 Integral to the question of definition are three options for taxing distributions canvassed in the chapter.

- Under the first, a broad general definition of distribution would cover all, or most, issues concerning whether a payment is a taxable distribution.
- Under the second, the definition of distribution would be similar to the present situation and special rules would be provided for closely held entities. This approach is closest to the present law but possible reforms of the current approach are canvassed.
- The third option would apply the fringe benefits tax (FBT) to some distribution situations. Under this heading also discussed is the interaction of the FBT and rules on distributions more generally.

18.7 Chapter 38 discusses options for reform of the FBT which include the possibility of repeal of the FBT and taxation of fringe benefits in the hands of recipients. Such a change would rule out the third option.

18.8 An equivalent outcome to a distribution can arise where an entity creates and provides new interests in itself to its members. The current law does not handle this equivalence consistently and reform is needed. Options are canvassed to treat such transactions as involving a distribution in whole or in part and in other cases to deal with such changes solely through cost base adjustments, subject to value shifting rules.

Reform options based on the definition of distribution

Option 1: Apply a broad definition of distribution covering all benefits provided by an entity to its members

Accounting principles

Under accounting principles, a distribution is a transfer in which the entity disposes of assets, provides a service or has a liability established to another party or parties without receiving approximately equal value in exchange for the transfer.

18.9 The accounting principle could be applied so that a distribution occurs when value has been passed from the entity to the member (in that capacity) — that is despite the fact that for many members the value

transferred would have been represented in the value of the membership interest in the entity.

18.10 Generally a distribution will only be assessable in the hands of the recipient if it is out of profits. Chapter 19 discusses a definition of profits and the application of a profits first rule. Consequently, the following discussion concentrates on options for a common definition of distribution. The combination of the rules in these two chapters would determine, first, whether the passing of something of value to members is a distribution and, secondly, whether it is from profits or capital.

Possible definition that covers all benefits

18.11 Distributions to members could include the following elements:

- the passing of value from the entity to a member in any form, including a reduction in a liability and the provision of goods or services at other than fair value;
- the value being provided to the member in that capacity including value given in satisfaction of a right to receive income or capital from the entity (for example, share buy-backs);
- the amount of the distribution decreasing by any value provided to the entity in exchange for the value received; and
- the distribution occurring when the value is paid, credited or otherwise transferred.

18.12 A 'member' for these purposes would include a person (or associate of a person) with an interest in either the income or capital of the entity. This definition would cover not only shareholders in a company, but also beneficiaries of a fixed trust, and partners in a limited partnership. The objects of discretionary trusts would be specifically included in the definition of member so as to avoid debate over whether they had an interest in the income or capital of the trust. Life insurance policy holders may, in some cases, also be treated as members (see the discussion in Chapter 35). Additionally, in determining whether a distribution is to a member, the discussion on the distinction between debt and equity and options for the tax treatment of debt equity hybrids in Chapter 7 is relevant.

18.13 'Associate' would have its normal meaning for tax purposes including relatives (such as a spouse, parent, or child), and entities owned or controlled by a member (whether alone or in conjunction with others). The definition would also be subject to generally applicable rules about income such as the doctrine of constructive receipt. This would mean, for example, that the provision of value to a third party at the direction of a member would be covered by the definition.

18.14 As with the existing Division 7A (concerning distributions from private companies) the definition would recognise the negligible economic difference between receiving money or property or having it applied to a member's benefit.

18.15 A definition covering these elements would both clarify certain aspects of the current definition of dividend and extend its operation more broadly.

Main features of a broad definition of distribution

Services

18.16 'Services' would be defined to include the *use* of an entity's property or property that is controlled by the entity. However, one option, consistent with the FBT treatment announced in *A New Tax System*, would be to not treat as a distribution the use of a principal residence held in an entity, provided the entity is not claiming tax deductions for expenses associated with the residence.

Beneficiaries

18.17 Beneficiaries of trusts would no longer be assessed by reference to their present entitlements under the trust. Instead, assessment would depend on whether there has been a distribution, as defined.

18.18 Some specific circumstances in relation to trusts require consideration and consultation — for example, where a beneficiary is presently entitled to part of a trust's profits and that amount is retained by the trust. In this case there is the question whether the profits are distributed and reinvested as trust capital or are simply retained trust profits (paralleling retained company profits). A relevant consideration here is whether there needs to be an implied or express direction by the member to credit the retained profits to the member's 'loan account'.

Reductions in a liability

18.19 The forgiveness by an entity of a debt owed by a member would be a distribution. The offsetting of a liability owed by a member to the entity against a right to receive a distribution would itself be treated as a distribution.

Loans

18.20 The provision of loans, or other forms of financing, under non-commercial terms would result in a distribution under this broad approach. For these purposes there would be a rebuttable presumption that loans provided to members, who are also employees of the entity, are provided

in their capacities as members. This is the same as the current treatment under Division 7A. The practical determination of what is a commercial loan and the amount of the distribution when non-commercial terms are involved are discussed under Option 2 below.

Benefits provided by an associate of the entity

18.21 The provision of a benefit by an associate of an entity, on less than fair terms, to a member of that entity, or their associate, could be treated as a distribution by the entity. This treatment could be extended to cover situations where the benefit is not provided by an associate, but is provided under an 'arrangement' with the entity.

Amount of the distribution

18.22 Excess consideration over the fair value given by an entity, for goods or services provided by a member to the entity would be a distribution. The excess would thus not be an allowable deduction to the entity. On the other hand, members of an entity would be able to contract for the provision of goods or services to the entity on fair terms without the value of the payment for those goods being treated as a distribution.

18.23 The provision of a good or service by an entity to its members, or their associates, in that capacity at less than fair value would result in a distribution. The definition could thus extend to such things as the use by a member or their associate of property owned or controlled by the entity. It would also include goods or services provided at a discount through the use of a shareholder discount card. The amount of the distribution would be the difference between the fair value and the discounted cost.

18.24 Such discounts would be distinguished from volume discounts received by a customer who is also a shareholder. Provided that the discount was 'commercial' having regard to the overall circumstances there would not be a distribution. To the extent that such a volume discount was excessive when compared with a commercial discount the excess would be a distribution.

18.25 The full value of any benefits provided by the entity to either the member or an associate over any value given in return would be treated as a dividend. This is different from the proposed FBT treatment discussed below, which is subject to a $1,000 threshold. The provision of such a threshold is difficult to justify from an equity point of view in circumstances where the benefit is treated as a distribution. Nevertheless for compliance reasons, for example, this type of threshold could be included in the definition of distribution, with only the excess being treated as a distribution.

Deductions

18.26 The cost of providing, in the form of money, property or services, a benefit which is treated as a distribution would not be deductible to the entity.

What would not be included

18.27 Creations of property in the form of an interest in the entity would generally not be a distribution under this definition. However, the creation of ownership interests is discussed later.

18.28 The requirement that value be passed to the member in their membership capacity ensures that payments, et cetera, made to a member in some other capacity would not be treated as a distribution.

Interrelationship with FBT provisions

18.29 Some forms of loans and payments could come within the definitions of both a distribution and a fringe benefit (for FBT purposes). Rules are therefore required to determine the interaction between income tax and FBT. *A New Tax System* proposed that income tax would take precedence over FBT. This is consistent with the current treatment of dividends, which are excluded from FBT.

18.30 A primary objective of the new entity system is to apply the new uniform imputation system to profit distributions by entities. This requires that all profit distributions be subject to tax in the hands of the member. As a general principle, there is merit in terms of equity in assessing income to its recipient rather than indirectly by means of FBT (see Chapter 38).

18.31 Under Option 1 there would be no requirement for separate FBT treatment for benefits provided to members or their associates in their capacity as members or associates. The general definition of distribution would cover the field.

18.32 The use of property owned or controlled by the entity by either a member or their associate would also result in a distribution.

18.33 Under this option general valuation rules would need to apply in some circumstances to determine the amount to be treated as a distribution. These valuation rules could be required to determine the fair value of goods and services in some cases.

Application to limited partnerships

18.34 The amount of a limited partnership's profits and the quantum of each partner's share of profits will not be precisely known until the partnership

accounts have been prepared and approved at, or after, the end of the year of income. Usually the partnership agreement will provide for each partner to make drawings from the partnership on account of his or her anticipated share in the partnership profits. The partnership agreement will also usually stipulate that any drawings in excess of the partner's actual share of the profits are to be repaid to the firm within a set period, usually without interest.

18.35 One option for dealing with this would be to treat as a distribution the partner's total drawings for the year, less any repayments of overdrawn amounts made during the year. This calculation would be made as at the limited partnership's annual balance date. If the repayments exceed the drawing for the particular year the excess could be treated as contributed capital.

Option 2: Apply a broad definition of 'distribution', but exclude certain benefits provided by widely held entities

18.36 Under this option there would be a substantial difference between the definition of distribution for members of widely held entities and that for members of closely held entities. The definition of distribution in Option 1 would be modified so that, in respect of widely held entities, it does not apply to the following:

- payments or benefits provided to the associates of members;
- the provision of loans, and other forms of finance, to members or their associates; or
- the forgiveness of a debt owed to the entity by members or their associates.

18.37 Consequently, for widely held entities, the definition of distribution would be similar to the current definition of dividend. For widely held entities, loans and other forms of finance provided by the entity to its members in that capacity, or to their associates, would be subject to the FBT proposals in *A New Tax System*, including the $1,000 threshold.

18.38 However, with the exception of loans and other forms of financing, the elements of a distribution discussed in Option 1 would continue to be relevant for the members of closely held entities under Option 2. In respect of loans the broad principles underlying Division 7A, or the alternative discussed below, would apply to all closely held entities.

18.39 The close relationship between some entities and their members provides conditions conducive to disguising distributions of profit as non-commercial loans or other types of payments in order to convert a taxable distribution into an amount which is not taxed in the hands of the member.

This allows individual members with marginal tax rates higher than the entity's tax rate:

- to effectively limit the total tax paid to that at the entity level for amounts already taxed at that level; or
- to avoid tax being paid at either the individual or entity levels for amounts not previously taxed at the entity level.

This ability has resulted in anti-avoidance legislation, such as Division 7A and section 109 (of the existing law), designed to deal with such practices by private companies.

Interrelationship with FBT provisions

18.40 As with Option 1 above there would be, under this option, no need for FBT treatment of benefits provided by closely held entities to members and their associates in their capacity as members or associates.

How should loans from closely held entities to members be treated?

Option 1: Retain the current treatment of loans

18.41 The provision of a loan or benefit other than at fair terms represents a shift in value from the entity to the recipient. If the recipient is a member, or the associate of a member, that value shift should be treated as a distribution. Division 7A currently does this by treating various transactions, including loans, between private companies and their shareholders (or associates of a shareholder) as dividends.

18.42 A loan that meets certain criteria is an excluded loan, and is not treated as a dividend. An excluded loan must be documented by written agreement, have regular repayments made at a benchmark interest rate and not exceed a maximum specified term.

18.43 Under this option the policy intention behind the current Division 7A treatment of loans of shareholders and their associates would be extended to cover all other entities that are to be taxed like companies. However, given the proposed greater reach, it is appropriate to consider an option for simplifying the treatment of loans while still maintaining the policy objective of taxing value shifts.

Option 2: Commercial loan exclusion

18.44 An alternative treatment could be based on the fact that there is no transfer of value if:

- the loan is on fully commercial terms, including a fair rate of interest; and
- the forgiveness of the loan includes circumstances where the principal is not fully repaid within a reasonable period.

18.45 In such circumstances the rate of repayment of the principal is not relevant.

18.46 Profits retained in an entity can be either invested or distributed. Where invested, the entity would normally be expected to generate a return at least as great as its opportunity cost of capital. The taxation of that return each year would result in a revenue flow to the Commonwealth. That revenue flow preserves the revenue value of the original income when it is finally distributed, compared with the case if it had been distributed immediately.

18.47 It would still be essential that forgiveness of a loan be treated as a distribution of the amount forgiven. As with non-commercial loan interest rates, such debt forgiveness represents a transfer of value from the entity to the member.

18.48 It would still also be necessary to determine whether there is in fact a genuine loan, rather than a disguised distribution. A disguised distribution would be treated as a distribution. Consequently, a genuine loan would need to satisfy conditions such as the following:

- the loan documented by a written agreement entered into prior to the loan being made;
- the loan period is specified in the agreement and does not exceed a maximum specified term (say 15 years for an unsecured loan, as against seven currently, and 25 years for a secured loan); and
- the fair rate of interest (or a benchmark interest rate) for a loan of this type from a financial institution is to be specified in the agreement.

18.49 Regular repayments need not be required.

18.50 Under this treatment, it would be necessary to determine the interest that should be charged under the loan agreement during the borrower's income year. This would be done by applying the appropriate interest rate to the average maximum daily balance of the loan throughout the year. In contrast, Division 7A does not apply to intra-year loans.

18.51 If the actual interest paid on the loan was equal to or exceeded the notional interest amount, there would be no tax consequences for the borrower. The interest paid would be assessable to the entity under general provisions.

18.52 If the actual interest paid on the loan is less than the amount specified, the difference would be a frankable distribution (on a grossed-up value basis) to the member or their associate. In contrast, under Division 7A, if the interest criterion is not met, the whole loan is treated as a dividend.

18.53 Some aspects of the current Division 7A provisions relating to loans would continue, particularly those relating to debt forgiveness and the use of interposed entities. However, the provisions preventing the rollover of a loan should be able to be removed — these are unnecessary given that the alternative would apply to intra-year loans.

18.54 Division 7A currently uses as the benchmark interest rate for determining whether a loan is commercial the *Indicator lending rates — Bank variable housing loan* published by the Reserve Bank of Australia.

18.55 A requirement to pay a commercial rate of interest, rather than a fixed benchmark rate, would more closely equate these types of loans to commercial loans from arm's length lenders. This would allow the rate applicable to any particular loan to better reflect the circumstances in which it is made (for example, whether secured or unsecured, and the overall credit worthiness of the borrower). While for certain loans this would be relatively straightforward, in many cases it could be difficult to establish the appropriate commercial rate. There is also an issue where a loan is likely to be rolled over, as to what the appropriate period for determining the commercial rate would be.

18.56 Alternatively, a benchmark rate of interest could be used. One option would be to use an interest rate that better reflects the opportunity cost of capital for closely held entities. This could be, for example, the *Bank's business loans — other loans variable small*, also published by the Reserve Bank. This is usually around one to two percentage points greater than the current benchmark used in Division 7A.

Discussion of the options

18.57 Table 18.1 summarises the two options for dealing with loans — applying the current treatment or the alternative treatment described above.

Table 18.1: Options for treating loans from entities to members

	Current treatment of loans	Alternative treatment of loans
Written agreement required?	yes	yes
Regular repayments required?	yes	no
Maximum term limitation?	yes	yes (longer period allowed)
Commercial interest rate required?	yes (but housing loan rate)	yes (with any shortfall in interest paid treated as a distribution)[(a)]
Applies to intra-year loans?	no	yes
Can loans be rolled over?	no	yes
Applies to loans through interposed entities?	yes	yes

(a) The commercial rate of interest required could be a set benchmark rate or alternatively a general commercial rate requirement.

18.58 The alternative treatment would dispense with the need for regular repayments and should not require provisions aimed at rollovers. By not relying on rollover provisions the alternative treatment would address some potential means of avoiding the current treatment. The allowed maximum term of a loan would also be more generous.

18.59 Failure to pay a commercial rate of interest would not see the entire loan treated as a dividend, only the shortfall in the interest payment — this is consistent with how loans would be treated under Option 1 for a general definition of distribution.

18.60 Against these advantages, there is the potential for increased compliance costs from the application of the arrangements to intra-year loans.

- Many small business owners typically draw from their businesses on an *ad hoc* basis throughout the income year.
- At the time the accounts are drawn up (usually after the end of the year) they decide how much of the aggregate drawings over the year they wish to be treated as wages, dividends, or loans.
- It would be necessary to identify outstanding drawings on a daily basis throughout the year.

Option 3: Adopt Option 1 or Option 2 but tax certain benefits under FBT

18.61 Under this option certain types of benefits provided to members or their associates in their capacity as members/or associates would not be treated as distributions. Instead those benefits would receive FBT treatment. For

example, the use of an entity's property by a member could be a fringe benefit rather than treated as a distribution under either Option 1 or 2.

18.62 In the discussion that follows, reference to a 'member' of an entity includes their associate(s). Likewise, a reference to an employee includes an associate of the employee.

Current arrangements

18.63 Under the current law:

- for loans and debt forgiveness, the income tax provisions of Division 7A take precedence over the loan and debt waiver provisions of the *Fringe Benefits Tax Assessment Act 1986* (FBTAA), where the shareholder is also an employee;
- for payments, the FBTAA takes precedence over Division 7A if the payment was made to the individual in his or her capacity as an employee (rather than as a shareholder); and
- for widely held entities, a benefit that does not fall within the definition of distribution would be taxed under the FBTAA if provided to them in their capacity as employees.

Interaction of income tax and FBT provisions

18.64 Proposed reforms that may affect the interaction of the income tax and FBT provisions include the following:

- the broader definition of distribution and its application to companies, trusts, limited partnerships and co-operatives; and,
- as announced in *A New Tax System*, benefits of more than $1,000 a year provided by companies to shareholders (in respect of a shareholding) or by a trust to beneficiaries (in respect of the trust relationship) are proposed to be subject to FBT provisions unless they are:
  - benefits that are assessed under the provisions of the ITAA; or
  - a principal residence held in an entity, provided the entity is not claiming tax deductions for expenses associated with the residence.

FBT treatment for benefits provided to members or their associates

Where the member is not also an employee

18.65 Where the member is not an employee, the income tax provisions would take precedence over the FBT provisions.

18.66 This would mean that any distribution of money or property or payment on behalf of the member would be taxed under the income tax provisions as either a distribution of profits or contributed capital (depending on the operation of the profits first rule).

18.67 Any non-commercial loans or debt forgiveness that would be assessed under Option 2 would also be treated as a franked distribution when received by a member of a closely held entity.

18.68 In contrast, as widely held entities would not be subject to provisions aimed at disguised distributions under Option 2, the new FBT provisions applying to members who receive benefits greater than $1,000 in value would apply instead.

18.69 The use of property or the provision of services could be removed from the definition of a distribution. Consequently, non-cash benefits that do not amount to the payment of, application of, or dealing with money or property could also not be treated a distribution. These benefits would be subject to the FBT rules.

Where the member is also an employee

18.70 For many closely held entities, it is common for members to also be employees. Some employees of widely held entities may also be shareholders (for instance, as the result of employee share schemes). This raises the question of which provisions should apply to a member who is also an employee.

18.71 One way of deciding whether the income tax or FBT provisions apply would be to maintain a distinction along the lines that currently operates for Division 7A.

- Payments (other than salaries, wages, bonuses and commissions) made to individuals in their capacity as employees would be subject to FBT, while payments made in their capacity as members would be taxed under the income tax provisions.
  - This would enable employees to continue to have access to various FBT concessions, but would not extend such

concessions to payments that should be treated as profit distributions.

- Loans and debt forgiveness for the benefit of a member would be subject to provisions similar to Division 7A in precedence to the FBT provisions (regardless of whether received in the capacity of an employee or a member). This would affect only closely held entities. For widely held entities, the new FBT provisions where tax benefits received by members over $1,000 in value would apply.

'Use' benefits

18.72 Some benefits are provided in the form of the use of assets owned by an entity, such as a house or car (rather than transferring cash or ownership of property).

18.73 Under this option the income tax provisions would not cover use benefits of this kind. They would be subject only to FBT provisions (which contain the necessary valuation rules).

18.74 Therefore, when benefits arise from the use of entity assets, members of entities receiving the benefit in their capacity as a member would be subject to essentially the same FBT provisions as employees, subject to a yearly threshold of $1,000 and subject to any other exceptions that may be introduced.

18.75 Table 18.2 summarises the possible treatment under this option of the different types of benefits received by members and employees.

Table 18.2: Application of income tax or FBT under Option 3

Type of benefit	Member	Member receiving benefit in capacity as an employee	Employee
Closely held entity			
Loan/debt forgiveness	Income tax	Income tax	FBT
Payment	Income tax	FBT	FBT[b]
'Use' benefit	FBT[a]	FBT	FBT
Widely held entity			
Loan/debt forgiveness	FBT[a]	FBT	FBT
Payment	Income tax	FBT	FBT
'Use' benefit	FBT[a]	FBT	FBT

(a) Refers to the proposal from *A New Tax System* where only fringe benefits of more than $1,000 a year are subject to FBT.
(b) Other than salary and wages, bonuses and commissions.

Summary of the three options for a common definition of distribution for all entities

18.76 Table 18.3 compares the treatment of members under each of the three options for a common definition of distribution.

Table 18.3: Comparison of options for the definition of distribution

Type of benefit	Option 1: Broad definition of distribution applying to all benefits provided[a]	Option 2: Broad definition of distribution does not apply to certain benefits provided by widely held entities	Option 3: Adopt either Option 1 or 2 but tax certain benefits, under FBT[a]
Closely held entity			
Loan/debt forgiveness	Income tax	Income tax[a]	Income tax
Payment	Income tax	Income tax[a]	Income tax or FBT[b]
‘Use’ benefit	Income tax	Income tax[a]	FBT
Widely held entity			
Loan/debt forgiveness	Income tax	FBT[a]	FBT
Payment	Income tax	Income tax	Income tax or FBT[b]
‘Use’ benefit	Income tax	Income Tax	FBT

(a) Includes ‘associates’ of members.
(b) Depending on whether they are a member or a member receiving the benefit in the capacity of employee.

Reform option for created ownership rights

What should be the treatment of created ownership rights?

18.77 Even the broadest definition of distribution would generally not apply to the creation of property by an entity which is provided to a member, where that property is an ownership interest in the entity. Examples of where created ownership interests are provided to members include the following:

- a general bonus share issue;
  - for example, a company provides all ordinary shareholders with a bonus share for every two shares that they hold;
- share splits;
- issues of rights or of options; and
- bonus units.

18.78 Such transactions do not shift value from the entity to the member, but rather between a member's own interests (from their old interest to their new interest) and also between different members' interests if the issue of new interests is not on a pro-rata basis for all members. As such they do not fall within the general concept of distribution.

18.79 Generally, cost base adjustments and value shifting rules are the most direct way of dealing with such cases. Cost base adjustments alone would deal effectively with pro-rata issues or splits where value only shifts between a member's own interests. Where value shifts between members, value shifting rules would be relevant. However, for practical reasons discussed in Chapter 29, value shifting rules may need to be confined to control situations. As value shifts between members have the potential to easily substitute for distributions (as exemplified by selective share issues), a dividend consistent tax treatment may be the most practical way to deal with such value shifts.

18.80 Some transactions have combined elements of selective transfers of value from the entity to the member (distributions) and value shifting between members, particularly the following:

- 'dividend reinvestment plans' — which offer shareholders a choice between taking a dividend in cash or having the amount of the dividend applied towards acquiring new shares; and
- 'bonus share plans' — under which shareholders can choose to forgo entitlement to a dividend in advance and are allotted shares instead.

18.81 In both cases some shareholders receive cash from the company while other shareholders receive new shares. The cash component is a transfer of value from the company to shareholders, while shareholders receiving new shares obtain benefits by value shifts from other shareholders. A consistent treatment of shareholders would treat the new shares, as well as the cash payments, as distributions.

Problems with the existing treatment of bonus share plans and selective bonus issues

18.82 The existing law refers collectively to bonus shares and shares provided under dividend reinvestment and bonus share plans as 'bonus shares'. The general treatment of bonus shares is for no amount to be taxed as a dividend and for the cost base of the original shares to be spread over the original and bonus shares. (For pre-CGT shares the bonus shares attain the same status.) If these bonus share issues are accompanied by capitalisation of profits, specific anti-avoidance rules may apply.

18.83 As an exception to the general treatment, where shareholders have effectively a choice between dividends and shares (for example, through the

operation of dividend reinvestment or bonus share plans), and they choose the shares, the shareholders are treated as receiving dividends that are then reinvested in the entity. Those dividends are treated as the consideration (and hence cost base) for the acquisition of the new shares, leaving the cost base of the original shares intact. However, as an exception to this exception, for bonus share plans the general treatment applies even where there is a choice if:

- a public listed company is involved;
- the choice is between shares or dividends franked to greater than 10 per cent; and
- the share capital account is not credited with profits.

18.84 Problems with this latter exception for bonus share plans include the complexity of the law, and the uncertainty created by the reliance placed in this area on general anti-avoidance provisions to deal with the potential use of bonus share plans for dividend substitution and capital streaming purposes. That potential arises because bonus share plans allow for franked dividends to be provided to shareholders with a relative preference for such income and new shares to shareholders with a relative preference for capital returns. Bonus share plans, for example, allow public companies to stream new shares to pre-CGT shareholders in lieu of franked dividends. As these new shares would be treated as pre-CGT shares, the benefit obtained (of an increase in the value of the shareholding) is effectively tax-free.

A reformed treatment of bonus share plans and selective bonus issues

18.85 A reformed treatment of bonus share plans, where shareholders have a choice between a share and a dividend, would tax them as distributions as for dividend reinvestment plans. Although dividend reinvestment and bonus share plans are technically different, the economic substance is the same and the same tax treatment should apply. The same treatment could extend to cases where, even though there is no choice, there is a selective issue of shares that shifts value between members — though in these cases the interaction with value shifting rules would be important.

18.86 Under a distribution treatment, valuation of the ownership interests provided could be based on their fair value at the time they are provided. Consistent with the treatment of normal distributions (and the current treatment of dividend reinvestment plans), any change in value of the original ownership interests would be irrelevant. As an alternative to fair value, if the members of a widely held entity have a choice between receiving additional ownership interests or a profit distribution, it would be logical for the value of the profit distribution to be used.

18.87 Whatever view is adopted on determining the amount of the distribution, a distribution arising from the creation and provision of ownership interests would be a profit distribution to the extent that distributable profits were available (assuming the introduction of a profits first rule and a separate contributed capital account, see Chapter 19).

18.88 For the entity and members, the normal consequences of a profit distribution would apply. In addition, the entity's contributed capital account would be credited by the amount of the profit distribution, while that amount would also constitute consideration for the new ownership interest (which would be a post-CGT asset, even if the original interest was pre-CGT).

18.89 To the extent there were no distributable profits available, there would be no assessable distribution, but the cost base of pre-existing interests would be spread across the new interests. Where distributable profits were sufficient only to allow part of the distribution to be a profit distribution, the cost base of the original interests plus the amount of the profit distribution would be spread across the original and the new interests.

Example 18.1: Distribution treatment of selective share issue — profits available

Company X has two shareholders, A and B. Each shareholder has a single share, each share having a cost base of $1 and fair value of $1.50. Company X issues an additional share for no consideration to shareholder A only.

The fair value of the new share after its issue is $1 (so that the total value of shares stays at $3). Profits are available and the new share is deemed to give rise to a $1 profit distribution.

The company must therefore debit its franking account to frank the profit distribution, but is able to credit its contributed capital account by $1.

Shareholder A includes the franked profit distribution in assessable income, and the new share has a cost base of $1.

18.90 These rules would not apply to traditional pro-rata bonus issues of shares. Where all members of an entity receive ownership interests in equal proportion to their existing interests, there is no shift of value to or between members. In these cases, the cost base of pre-existing holdings would be allocated across the new, increased holdings. Ownership interests received in respect of pre-CGT interests would obtain the same pre-CGT status. In the case of listed entities, and perhaps other widely held entities, it may be appropriate to allow the same treatment if there is a pro-rata bonus issue of ordinary shares even though there are other classes of shares issued.

Example 18.2: Distribution treatment of pro-rata bonus share issue

Company X has two shareholders, A and B. Each shareholder has a single share, each share having a cost base of $1 and fair value of $1.50. Company X issues a bonus share to each shareholder on a one for one basis.

As neither A nor B had a choice between the bonus share and a distribution, and as all shareholders received new shares in proportion to their existing holdings, the bonus shares would not be treated as giving rise to a distribution.

The company is not affected by the transaction.

Shareholders A and B spread the cost base of their original shares across the original shares and the new shares, so that each share has a cost base of 50 cents.

Extension to other entities and other interests

18.91 The discussion above has been couched in terms of companies and shareholders. Consistent with the proposals for the new entities tax regime, the same rules would extend to other entities. Currently, the treatment of bonus units in unit trusts (other than those unit trusts already taxed like companies) resembles the rules applicable to companies but without the complications in relation to dividend reinvestment plans and bonus share plans. The above treatment could apply equally to unit trusts, other fixed trusts and limited partnerships taxed as entities.

18.92 A similar analysis to that set out above can also be extended to other interests that an entity creates for existing members in that capacity such as rights and options over unissued shares. (As rights and options legally are the same kind of instrument, the term option is used generically in what follows to cover both.) Generally options are issued on a pro rata basis or for full value in which cases questions of a distribution would not arise. Even though value shifting between the interests of a member can arise in pro rata cases, it may be appropriate if control is not present to retain the current regime of not spreading cost base from other interests in the entity. In these circumstances the value shift between a member's interests would usually not be significant.

18.93 If a selective option issue is made for less than full value, then a distribution treatment is likely to be appropriate. The cost base of the option would be the amount taken to be a distribution plus any amount paid by the member for the option, based on the kinds of factors outlined above in relation to bonus shares. In the unlikely event that reinvestment or bonus plans are created for options, a similar treatment to that outlined above for shares could be adopted.