Chapter 20

PREVENTING DOUBLE TAXATION OF BUY-BACKS, REDEMPTIONS AND LIQUIDATIONS

A case for reform 453

The potential exists for double taxation 453

A strategy for reform 456

Provide a dividend-consistent treatment 456

Issues associated with share buy-backs and equivalent distributions 458

What tax treatment should apply? 458

How should the untaxed profit component be taxed? 460

In what circumstances should dividend or capital gains treatment apply? 462

How should a market value rule apply? 462

Issues associated with liquidations and equivalent distributions 465

What treatment should apply generally? 465

What treatment should apply to interim liquidation distributions? 466

What should be the tax responsibilities of liquidators and receivers? 467

A case for reform

The potential exists for double taxation

20.1 The treatment of distributions arising from on-market buy-backs, share cancellations and redemptions, and liquidations is inconsistent with the treatment of dividends and may give rise to double taxation. The benchmark to relieve double tax for these arrangements is the capital loss mechanism for relief of double tax with ordinary dividends.

No double tax on dividends over time

20.2 When a shareholder sells shares to another *cum* dividend, 'double' tax may occur to the extent that the company has already paid tax on its retained profits. Those taxed retained profits would be part of the value of the company, and so subject to the capital gains tax applied to the seller on the sale of shares.

20.3 However, that double tax is relieved over time through the capital loss allowed to the buyer when the retained profits are ultimately distributed and the shares sold again. This is illustrated in Example 20.1. Moreover, double taxation does not apply at any stage to any of the taxpayers involved. The availability of the capital loss, in fact, increases the sale value of the shares.

No double tax on off-market buy-backs

20.4 Similar relief from double tax is provided to non-corporate shareholders under the current treatment of off-market share buy-backs. The company buying back the shares determines the source of funds. The amount of the buy-back sourced from profits is treated as a dividend. Only the amount sourced from capital is treated as consideration for the disposal of the shares — so allowing the offsetting capital loss to the shareholder.

20.5 This treatment is effectively the same as provided to Francis in Example 20.1, combining the dividend distribution to Francis and his subsequent disposal of the share ex-dividend into one step. Corporate shareholders, however, are denied the capital loss as an inter-corporate dividend is rebatable (reflecting the lack of integrity in the treatment of distributions through the entity chain arising from the inter-corporate dividend rebate).

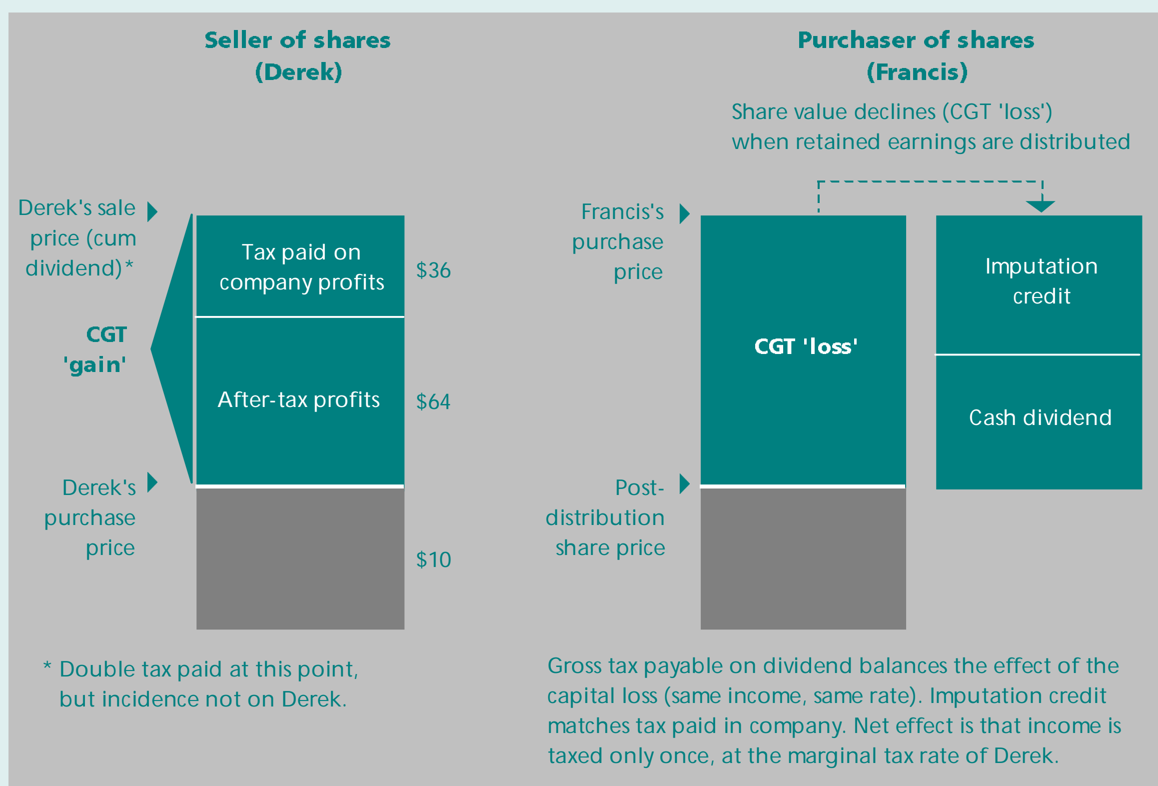
Example 20.1: No double tax on dividends

Derek has purchased a share for $10. Subsequently, the company earns profits of $100 with respect to that share, paying $36 company tax. Derek then sells the share to Francis for $110. That sale gives rise to a capital gain of $100 for Derek, and therefore tax (if Derek is on the top marginal tax rate) of $48.50.

On this $100 of income, an excessive $84.50 in tax has been paid. Derek, however, has not been double taxed — appropriately paying $48.50.

Francis then receives a fully franked dividend of $64 — so that his assessable income is $100. This gives rise to a personal tax liability of $48.50 less a franking rebate of $36 — for net tax of $12.50. However, Francis has available a capital loss of $100 (as the share is now only worth $10), equal to a tax benefit of $48.50 (assuming the loss can be used in the current year).

Over time, net tax on the $100 of income would have amounted to $36 + $48.50 + $12.50 – $48.50 = $48.50, which appropriately corresponds with Derek's tax rate, the shareholder when the income was earned. Overall therefore, there is no double tax.



Had Derek had a personal tax rate of 30 per cent rather than 48.5 per cent, over time the net tax on the $100 of income would have amounted to $36 + $30 + $12.50 – $48.50 = $30. This outcome again corresponds with Derek's tax rate.

Scope for double tax on on-market buy-backs

20.6 Double taxation can arise, however, when a company buys back shares on-market. The full amount of the buy-back distribution is treated as consideration for the sale of the shares (for example, for capital gains tax (CGT) purposes). However, the company is still treated as having distributed a dividend to the extent the buy-back is sourced from profits. As a result a franking account debit arises, without any benefit to the shareholder.

20.7 Looking at Example 20.1, the company takes the place of Francis. Derek pays tax on the capital gain. Upon its purchase from Derek the share is cancelled. The company, however, is denied the possibility of a capital loss to offset the tax paid on the income by the company, and the franking credits related to the tax paid amount are lost. This is to the detriment of the remaining shareholders, who collectively bear the double tax.

Scope for double tax on share redemptions or cancellations

20.8 For share redemptions, or cancellations arising from a capital reduction (and not as part of a buy-back or liquidation), the amount paid is currently treated as a dividend except to the extent to which it is paid out of capital (as per the existing definition of dividend).

20.9 However, the full amount — including any dividend component — is also treated as consideration on disposal for CGT purposes. This treatment of the dividend component prevents a capital loss arising of the sort that occurs in an off-market buy-back. As a result, there is scope for double tax.

Scope for double tax on liquidations

20.10 Double tax arises on the final distribution of profits on liquidation — forcing companies to ensure that any profits are distributed prior to that. The mechanism providing double taxation is the same as for share cancellations. The full amount of the distribution (including that taxed as a dividend) is treated as consideration for CGT purposes, so denying the offsetting capital loss.

20.11 In practice, this result can be avoided by distributing profits prior to the final distribution, with the final distribution then sourced only from capital. While double taxation can therefore be avoided, there is little justification for forcing taxpayers to engage in tax planning that potentially falls foul of the general anti-avoidance provision.

20.12 Where the distribution is an interim distribution, the non-dividend component of the distribution gives rise to a cost base reduction only — so

long as it is not within 18 months of the winding-up of the company, in which case it is treated like a final distribution. This treatment does not give rise to potential double tax, unless the distribution falls within the 18 month period.

A strategy for reform

Provide a dividend-consistent treatment

20.13 The scope for 'double taxation' arises in the case of on-market buy-backs; share cancellations and redemptions; and liquidations. In these cases, dual status attaches to a profit distribution, preventing the proper recognition of tax paid at the entity level and of capital losses. Either of the following is involved:

- a profit distribution is expressly treated as both a dividend and part consideration for the disposal of the interest; or
- a profit distribution is treated only as consideration for the disposal of the interest, but a franking account debit still arises.

20.14 A dividend-consistent treatment for distributions arising in connection with share buy-backs, share cancellations and redemptions and liquidations can be achieved by treating profit distributions as either a dividend ('dividend treatment') or as consideration for disposal of the interest with appropriate adjustments at the entity level ('capital gains treatment').

20.15 Both treatments allow for a capital loss on the distribution of retained profits that matches any capital gain that would have arisen in respect of those retained profits on any previous sale of an interest in an entity. Figure 20.1 and Figure 20.2 illustrate that principle for buy-backs (where a partial slice of an entity's assets are distributed), and liquidations (where a 100 per cent slice is distributed). Members initially capitalise an entity by C per share.

Figure 20.1: Dividend-consistent treatment of share buy-backs and equivalent distributions

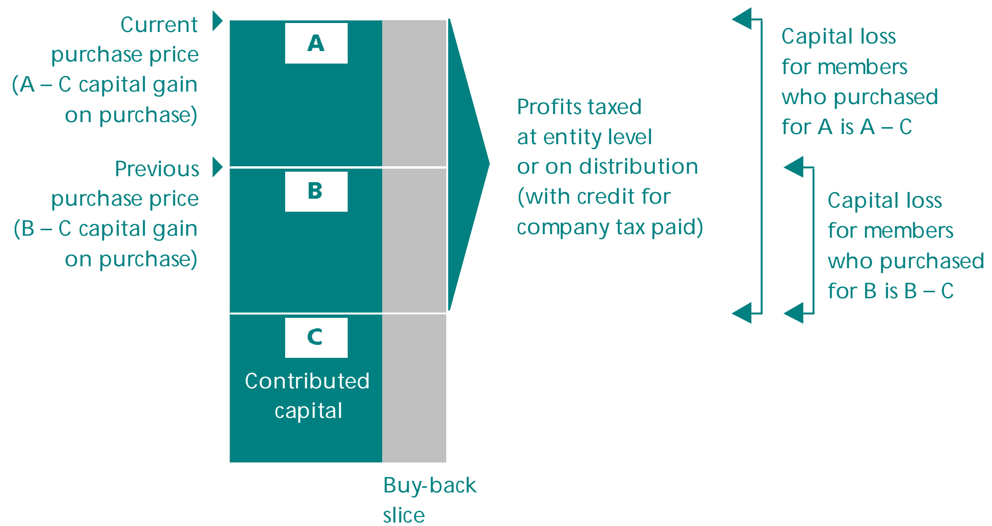
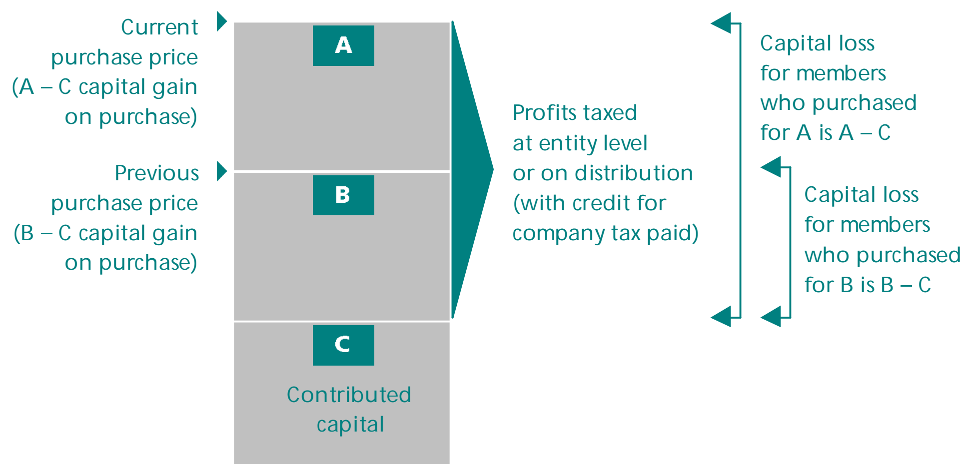


Figure 20.2: Dividend-consistent treatment of liquidations and equivalent distributions



20.16 In Figure 20.1 and Figure 20.2, retention of profits increases the value of the entity above C over time, and some original members sell interests in the entity for B, and then later for A. Sale of those interests gives rise to capital gains (of B–C when the purchase price is at B and of A–C when the purchase price has increased to A reflecting additional profits).

20.17 As those profits are also subject to entity tax or tax on distribution, there is the potential for double tax. That is addressed by allowing a capital loss corresponding to the capital gain (of B–C for interests purchased for price B, and A–C for those purchased at price A). The capital loss is allowed when the retained income is distributed — whether through a dividend or as part of a buy-back or on liquidation.

20.18 Achieving a dividend-consistent treatment would meet the policy design principle of *A Strong Foundation* that business income only be subject to a single layer of Australian taxation. That result needs to extend to distributions that arise in connection with trusts and limited partnerships in analogous circumstances — for example, the cancellation of a unit in a unit trust.

Issues associated with share buy-backs and equivalent distributions

20.19 A buy-back occurs where a company buys a share in itself from a shareholder of the company. For tax purposes, share buy-backs can be either *on-market* or *off-market*. An *on-market* buy-back arises where a share is listed on an official stock exchange and the buy-back is made in the ordinary course of trading on that exchange. All other buy-backs are *off-market*.

20.20 The feature that distinguishes a share buy-back from a general distribution from a company is the associated cancellation of shares (extinguishment of an ownership interest in the entity). Share cancellations can also take place outside a share buy-back (or liquidation) by means of a capital reduction. The treatment of liquidation distributions is considered separately below.

20.21 For trusts, the partial vesting of a trust, or the cancellation or redemption of units in a unit trust, involves an extinguishment of ownership interests in the trust. Distributions arising in these cases are the trust equivalent of share buy-back or share cancellation distributions. For discretionary objects of trusts — including default beneficiaries, who would be treated as not having a fixed entitlement — there do not appear to be any circumstances in which they could be said to receive a distribution related to an extinguishment of their ownership interests in a trust.

20.22 An extinguishment of an ownership interest in a limited partnership could occur in the case of a partner reducing the amount of capital contributed to the partnership or the exit of a partner.

What tax treatment should apply?

20.23 There are two general options for taxing share buy-back or equivalent distributions. The first — referred to here as 'dividend treatment' — corresponds to the current treatment of off-market buy-backs. The second — 'capital gains treatment' — corresponds, though to a lesser extent, with the current treatment of on-market buy-backs.

20.24 Chapter 19 outlined the slice approach that would apply where a distribution arises from the extinguishment of an ownership interest in an entity (for example, a share buy-back). The slice approach treats the distribution as consisting of the slice of contributed capital and taxed and untaxed profits relevant to the member's ownership interest.

20.25 The dividend and capital gains treatments discussed below set out how those slice components could be taxed in a dividend-consistent manner. They are consistent with the option outlined in Chapter 28 for preventing duplication of realised and unrealised gains.

Option 1: Dividend treatment

20.26 A dividend treatment of a share buy-back or equivalent distribution would tax each component of the distribution (as determined under the slice approach) in the same way that distributions of contributed capital, taxed profits and untaxed profits would generally be taxed.

- The contributed capital component would be treated as consideration for the disposal of the share or interest.
- The taxed profit component would be treated in the same way as a normal franked profit distribution.
- The untaxed profit component would be treated consistently with the treatment under any of the options in Chapter 15 for taxing otherwise unfranked profit distributions (see below).

20.27 The dividend treatment corresponds to the current treatment of off-market buy-backs, and allows for a capital loss. The major difference from the current treatment would be the application of the slice approach to determine the source of funds for the buy-back.

20.28 The treatment would also apply equally to members who are entities taxed like companies. In contrast, the existing off-market provisions deny a capital loss to corporate shareholders. This equal treatment would depend on the adoption of one of the options in Chapter 15 for taxing unfranked profit distributions. Such distributions between companies currently benefit from the inter-corporate dividend rebate. Without the untaxed profit component being taxed on distribution, allowing a capital loss to an entity (by offsetting any previous capital gain) would not just avoid a double layer of taxation but result in no layer of domestic taxation at all. It would allow for the tax-free distribution of an entity's untaxed profits along an entity chain, and provide a basis for dividend stripping and like activities.

Option 2: Capital gains treatment

20.29 A capital gains treatment of a share buy-back or equivalent distribution would treat the member selling their interest to the entity as having made an ordinary sale. The entity that is buying back the interest is then itself in effect given the equivalent of the dividend treatment described above.

- The entire distribution — contributed capital, taxed profit and untaxed profit components — is treated as consideration received by the member for the disposal of the interest.
- A capital loss would be allowed to the entity equal to the taxed profit component. There would be no franking account debit for the entity in respect of the taxed profit component.
- The untaxed profit component would be treated consistently with the treatment under any of the options in Chapter 15 for taxing otherwise unfranked profit distributions (see below).

20.30 The capital gains treatment corresponds, to some extent, to the current treatment of members in *on-market* buy-backs. The major difference in treatment is in respect of the entity as follows:

- A capital loss would be allowed to the entity. This would give the entity the capital loss allowed to members under the dividend treatment.
- There is no franking account debit in respect of distributed profits as would otherwise be the case. This would effectively give the entity the benefit of the franking credits allowed to members under the dividend treatment.
  - Without the retention of the franking credits, the capital loss allowed would only be a temporary benefit.

How should the untaxed profit component be taxed?

Option 1: As for unfranked profit distributions generally

20.31 Under either of the dividend or capital gains treatments, the untaxed profit component should prima facie be treated in line with the treatment of untaxed profit under any of the options considered in Chapter 15 for taxing otherwise unfranked profit distributions.

20.32 Those options would involve the application of deferred company tax or resident dividend withholding tax (except when a member is a non-resident, and the dividend treatment applies) to the untaxed profit

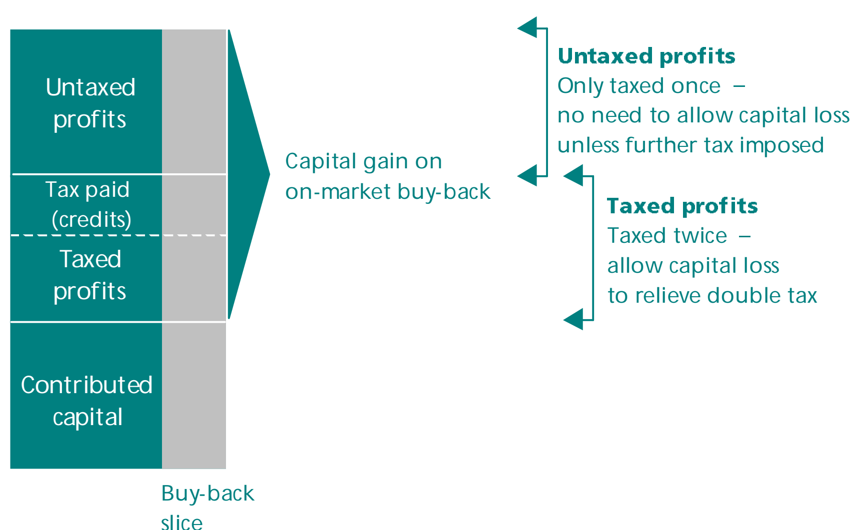
component, or its assessment to the member or entity under the unfranked inter-entity distribution option.

20.33 Such a treatment could conceivably make on-market buy-backs unattractive to entities. In an on-market buy-back, a company would pay for a share the market price *plus* an additional amount of tax. Though in return it would receive franking credits and obtain the benefit of a capital loss, this would be unlikely to offset the negatives associated with an outlay above market value.

Option 2: A different, but parallel, capital gains treatment

20.34 It is possible to vary the capital gains treatment — which is the treatment that would apply to on-market buy-backs (see below) — to remove the need to apply deferred company tax, resident dividend withholding tax or include an amount in the entity's assessable income, while still achieving the goal of a dividend-consistent treatment. Figure 20.3 illustrates the point.

Figure 20.3: The capital gains taxation of the untaxed component



20.35 In Figure 20.3, capital has been contributed to a company. Profits are generated, only a part of which are subject to company tax, with the remainder tax-preferred income. The on-market buy-back sale of the shares gives rise to capital gains tax on the retained profits of the entity as the value of those profits are reflected in the market price. This represents a second tier of taxation on the taxed profits, but the first tier of taxation on the untaxed profits.

20.36 When an on-market buy-back takes place (or the equivalent for listed trusts) the double tax issue would be addressed by allowing a capital loss

for the taxed profit component and maintaining the franking credit for prior entity tax.

20.37 However, for the untaxed profit component, there is no need to allow a capital loss — as only a single level of taxation has applied so far — unless the untaxed profit component is subject to further taxation (for example, via deferred company tax or resident dividend withholding tax). Under the capital gains treatment, not allowing a capital loss on the untaxed component would balance not applying additional tax. This would address the possible concerns outlined above.

In what circumstances should dividend or capital gains treatment apply?

20.38 It is necessary to decide in what circumstances the dividend and capital gains treatments would apply. Those circumstances could correspond to current off- and on-market buy-backs, with capital gains treatment only applying where the entity purchases on-market in the ordinary course of trading on an official stock exchange. The capital gains treatment would therefore only be available for listed entities. The current on- and off-market distinction does not appear to have caused significant difficulties.

20.39 It would not be feasible for the dividend treatment to apply to on-market buy-backs. With on-market buy-backs members do not know the identity of the buyer. While the entity is buying on the market there are other buyers so sellers do not know who actually purchases their shares. If the dividend treatment were to apply, members would face unexpected — and possibly unwelcome — tax consequences after they have completed the transaction.

20.40 Applying a capital gains treatment in all cases would have the advantage of providing a uniform treatment of all buy-backs and equivalent events, that for a member would be indistinguishable from a normal sale of their interest. However, it would have less in common with the treatment of profit distributions (dividends) generally and liquidations and similar events, and would provide considerable scope for capital streaming, especially for closely held entities.

How should a market value rule apply?

20.41 The existing legislation currently includes for off-market buy-backs (equivalent to the dividend treatment) a market value rule that in effect requires an off-market buy-back to be at no less than the share's on-market price. Such a rule does not take account of the different tax treatment of a payment

received in the case of an off-market buy-back as against an on-market sale or buy-back. In an off-market buy-back the shareholder benefits from franking credits and a capital loss which are not available for an on-market sale.

20.42 The application of a market value rule (whether specific or general) would be essential, but would need to accommodate the fact that a payment for an interest which is subjected to dividend treatment need not be the same as the interest's market price for it to be of equal value to the member.

Example 20.2: An off-market buy-back subject to dividend treatment

BBack is a company with one million fully-paid ordinary shares on issue. LynCo, a resident company, recently purchased a share in BBack for $16, reflecting:

- the contributed capital of BBack of $1 million ($1 per share);
- the taxed profit of BBack (reflecting a $3.6 million tax-paid franking credit balance, or $3.60 a share) of $6.4 million ($6.40 per share);
- the untaxed profits of BBack of $5 million ($5 per share); and
- the value of the capital loss that would arise on the distribution of BBack's profits.

If deferred company tax applied

BBack offers to purchase shares off-market from its shareholders for $10.60, consisting (under the slice approach) of the $1 of contributed capital, $6.40 of taxed profit and $5 of untaxed profit less $1.80 of deferred company tax payable.

If LynCo accepted, it would be taken to have received a dividend of $9.60 and consideration for the disposal of its share of $1. Its assessable income arising from the buy-back would be $15 (the grossed-up value of the dividend), with franking credits of $5.40 ($3.60 from the original franking credit balance plus $1.80 from payment of deferred company tax). It would have a capital loss of $15.

continued

Example 20.2: An off-market buy-back subject to dividend treatment (cont)

As LynCo has a tax rate of 36 per cent, it would pay no additional tax on the $9.60 dividend. The value of the capital loss (assuming available capital gains) would be $5.40 (36 per cent of $15). LynCo's total return would be $1 of contributed capital, $9.60 of dividend, $5.40 of tax benefit, for a total of $16.

If resident dividend withholding tax (RDWT) applied

BBack offers to purchase shares off-market from its shareholders for $12.40 subject to RDWT of $1.80, consisting of the $1 of contributed capital, $6.40 of taxed profit (which is fully franked) and $5 of untaxed profit (which is unfranked).

If LynCo accepted, it would receive $10.60 in cash, reflecting BBack withholding the $1.80 of RDWT. LynCo would then be in the same position as for deferred company tax above.

If unfranked dividends are taxed in the hands of members

BBack offers to purchase shares off-market from its shareholders for $12.40, consisting of the $1 of contributed capital, $6.40 of taxed profit (which is fully franked) and $5 of untaxed profit (which is unfranked).

If LynCo accepted, it would be taken to have received a fully franked dividend of $6.40, an unfranked dividend of $5 and consideration for the disposal of its share of $1. Its assessable income arising from the buy-back would be $15 (the grossed-up value of the dividend), with franking credits of $3.60, for a net tax liability of $1.80. It would have a capital loss of $15. As for the deferred company tax and RDWT cases, the after tax value of the buy-back to LynCo would be $16.

LynCo could choose to accept the buy-back offer even though the buy-back payment is less than the on-market price of the share because of the value of the capital loss. The difference between the share's market price and the buy-back cash offer reflects the value placed by LynCo on that potential capital loss.

Issues associated with liquidations and equivalent distributions

20.43 Liquidations can be either voluntary or by court order (non-voluntary). They involve the distribution of all of a company's assets, and end with the formal dissolution of the company. Equivalent situations arise on the dissolution of a limited partnership, or where all the assets of a trust vest in beneficiaries. However, for some trusts it may be difficult in practice to determine at what point full vesting has occurred.

What treatment should apply generally?

A dividend treatment

20.44 The dividend treatment outlined for share buy-backs and equivalent distributions would also apply in the case of liquidation or equivalent distributions. Application of the dividend treatment would address the scope for double taxation under the current tax treatment of liquidations. There would be no scope for applying the capital gains treatment as that treatment assumes the entity continues in existence.

A modified slice approach

20.45 A liquidation, or equivalent event for a trust or limited partnership, would see the distribution of all contributed capital, and taxed and untaxed profits to members. As the distribution would be related to the extinguishment of ownership interests in an entity, the slice approach to determining the source of funds for tax purposes would logically apply. (The treatment of interim liquidation distributions is discussed below.)

20.46 That a liquidation or equivalent event results in the distribution of all the funds of an entity — a 100 per cent 'slice' of the entity — raises the question whether it is necessary to apply the slice approach with its rules for attributing contributed capital, taxed profits, and untaxed profits to members. While it may not be necessary to distinguish between taxed and untaxed profits, it would be important to use the slice approach to provide attribution rules for contributed capital.

20.47 Under the new entity tax system, entities could be required to maintain a separate contributed capital account (Chapter 19). As a result, the source of funds for tax purposes of a liquidation or equivalent distribution could be independent of a liquidator's distribution from share capital for accounting purposes. A liquidator could for tax purposes easily stream

contributed capital to members with a relative preference for share capital. The slice approach would remove this possibility.

Profits from the sale of pre-CGT assets

20.48 *A New Tax System* proposed that all profits distributable at liquidation be treated as dividend distributions (which would be achieved by the slice approach), but without changing the current exclusion of profits from the sale of pre-CGT assets in pre-CGT companies. Trusts would obtain such an exclusion by virtue of the definition of contributed capital for existing trusts set out in Chapter 19.

20.49 For companies, the proposal could be achieved by treating liquidation profit distributions sourced from *realised* gains on pre-CGT assets as consideration for the disposal of shares. The liquidator would have the discretion to source what would otherwise be a profit distribution from such gains. As consideration for the disposal of the shares, there would be no CGT consequences for pre-CGT shares.

What treatment should apply to interim liquidation distributions?

20.50 After the commencement of a liquidation, the liquidator can make interim distributions prior to the final liquidation distribution. Distributions within 18 months of the dissolution of a company, including relevant interim distributions, are currently treated in the same way as final liquidation distributions for CGT purposes.

- This subjects interim distributions made within 18 months of dissolution to the same treatment as final distributions. That prevents a capital loss arising and can cause double taxation.
- It also has the potential to create compliance problems and uncertainty, as interim distributions up to two income tax years prior to the dissolution could be affected.

Option 1: Apply the profits first rule

20.51 Interim distributions could be subjected to the profits first rule, treating them consistently with other pre-liquidation distributions. However, requiring liquidators to distribute profits first could sometimes cause practical difficulties, as there could be uncertainty as to the level of profits available until assets are realised. Applying a slice approach to each interim distribution could also cause difficulties.

Option 2: Apply the modified slice approach

20.52 An option that would provide for a consistent application of the slice approach while still providing liquidators with an appropriate level of discretion would be to apply the slice approach to distributions taken as a whole over the course of a liquidation, rather than to each liquidation distribution individually. Liquidators would have the discretion to source a particular liquidation distribution from contributed capital and/or profit, so long as that when distributions over the course of the liquidation are looked at as one they meet the requirements of the slice approach.

Treatment of contributed capital distributions

20.53 Under the dividend treatment, a contributed capital distribution is treated as consideration for disposal of the interest in the entity. Where an interim distribution consists in whole or part of contributed capital (as determined under either of the options above), there is a question whether it should be treated as consideration (as the 18 month rule currently achieves) or give rise to a cost base reduction (the general treatment of contributed capital distributions where ownership interests are not extinguished — see Chapter 19).

20.54 Both treatments are largely equivalent in their effect, and so ease of compliance is the major issue. An option would be to treat all contributed capital distributions made in the same income tax year as the dissolution of the company as disposal consideration, and contributed capital distributions made in prior income tax years as giving rise to a cost base reduction. This approach would avoid relying on the 18 month rule or an equivalent provision.

What should be the tax responsibilities of liquidators and receivers?

20.55 As part of consideration of the tax treatment of liquidations, there is scope for clarifying the responsibilities of liquidators and receivers.

The responsibilities of liquidators and receivers are uncertain

20.56 Under the current tax law, liquidators and receivers are defined to be 'trustees' and must comply with certain requirements concerning their representative capacity.

20.57 Where a liquidator or receiver is appointed to a company, that person, as trustee, has a legal responsibility for the lodgment of income tax

returns for that company from the date of their appointment. Considerable uncertainty arises under these arrangements concerning lodgment responsibilities (for example, where there is both a liquidator and receiver manager) and the need to lodge a company return or trustee return.

Clarifying the responsibilities of liquidators and receivers

20.58 To rectify this situation, an option would be *not* to treat the appointment of a liquidator or a receiver as creating a trust for tax purposes (this would be consistent with the definition of trustee discussed in Chapter 22). Instead, the following rules could apply:

- The liquidator or receiver would be the person responsible for lodgment of the return for the company in liquidation or receivership. In the income year in which the company was placed in liquidation or receivership, there would be two returns lodged on behalf of the company — one by the directors to the date of the appointment of the liquidator or receiver and one by the liquidator or receiver for the balance of the year.
- The company would continue to be taxed as an entity.
- The liquidator or receiver would be responsible for the payment of tax assessed.

20.59 Other issues concerning the responsibilities and exposure of the liquidators and receivers for tax purposes could also be considered.