

Current Trends in Mergers and Acquisitions

Minerals Council of Australia
Biennial Tax Conference 2009
18 September 2009

Martin Fry
Partner
Allens Arthur Robinson

Current Trends in Mergers & Acquisitions

Introduction

This paper discusses three important recent trends in the taxation aspects of merger and acquisition transactions, as follows.

1. Top Hat Restructures

First, the new provisions in the tax laws which provide for adjustments to the cost base that would otherwise be obtained by an acquiring company when it acquires the shares in a target company – refer 1. below.

These measures are contained in new sections 124-784A, 124-784B and 124-784C of the Tax Act 1997. They are the enactment of the announcement on 13 May 2008 that the present Government would modify and enact the corresponding measures announced by the previous Government. These new measures are directed at scrip acquisitions under which the acquiring company may otherwise achieve the dual benefits of:

- scrip for scrip rollover relief for the target shareholders; and
- resetting the cost base of assets in the target company to the market value of the shares provided by the acquiring company as consideration for the shares in the target company.

2. Retail Premiums in Renounceable Rights Issues

Second, the taxation of so-called Retail Premiums in a renounceable rights issue – refer 2. below.

A number of company's have funded recent M&A activity at least partly by way of a rights issue. One option for the company is to structure the rights issue so that the rights granted to shareholders are renounceable, ie the rights/shares of the shareholders who choose not to take up their rights are sold or placed with institutional investors via a bookbuild bidding process. In all of the recent renounceable rights issues the bookbuild has resulted in non-participating shareholders receiving an amount of cash representing the excess of the total price paid by the institutional investors over the issue price of the shares. The ATO's view is that this cash should be taxed as an unfranked dividend or ordinary income.

3. Special Dividends paid as part of a takeover bid

Third, the taxation implications of fully franked special dividends paid by a target company as part of a consideration provided to target shareholders under a takeover proposal – refer 3.

A number of recent listed company takeovers have proceeded on the basis of the target company undertaking to pay a fully franked special dividend to the target shareholders – for example the Kirin/Lion Nathan merger in July 2009 and the Viterra/ABB Grain merger in August 2009. In some cases the special dividend has formed an integral part of the 'value proposition' put to shareholders in support of the merger/takeover, while in other cases the special dividend payments have coincided with the takeover/merger but have not been

treated for tax purposes as being part of the total price paid to target shareholders for the takeover/merger.

1. Scrip for Scrip Rollover and Cost Base Push Down

On 13 May 2008 the Assistant Treasurer announced that the Government would modify the changes to the scrip for scrip rollover rules announced by the previous Government in October 2007. The changes announced by the Assistant Treasurer on 13 May 2008 were introduced in *Tax Laws Amendment (2008 Measures No. 6) Bill 2008* (which was enacted as Act No 14 of 2009) and are found in sections 124-784A, 124-784B and 124-784C of the Tax Act 1997. In broad terms the new provisions generally apply from 13 May 2008.

Background

The fundamental concern which led to the introduction of the new provisions was that the scrip for scrip rules in Division 124-M were being used inappropriately to obtain the dual benefit of CGT rollover relief for target shareholders and a resetting of cost bases to market value for the acquirer.

The view of Treasury is that Division 124-M scrip for scrip rollover relief should only be available for takeovers (and the potential benefit of resetting costs bases to market value should also only be available for takeovers) and the concern was that companies were structuring transactions so that the Division 124-M scrip for scrip rollover was available for mere 'restructure' transactions rather than true takeovers.

Interaction between Division 124-G and Division 124-M

Division 124-G of the Tax Act 1997 provides rollover relief for shareholders in a company in circumstances where the shareholders exchange their shares in the 'target company' for shares in the 'acquiring company'. Division 124-G will only apply where all shareholders in the target company exchange their shares in the target company for shares in the acquiring company and, after that exchange, the shareholders of the acquiring company replicate the shareholders of the target company before the exchange (ie they must hold the same proportion of shares in the acquiring company and the relative market values of the shareholdings must not be altered).

As such, Division 124-G might be described as applying to a restructure that is truly a 'top hat' arrangement. Where Division 124-G applies (ie where the transaction is in nature of a 'top hat'), section 124-385 effectively ensures that the transaction will not result in a resetting of cost bases to market value.

Division 124-M also provides rollover relief for shareholders of a target company who exchange their shares in the target for shares in the acquiring company. The CGT cost base rules recognise that where the acquiring company exchanges shares in itself for shares in the target company in an arm's length acquisition, the acquiring company is providing market value consideration and this provides the acquiring company with the potential to reset the cost bases of the assets of the target company in line with the market value consideration provided to acquire that target company.

Division 124-M contains provisions which are designed to prevent a resetting of cost bases to market value (primarily section 124-782) where the resetting to market would be considered inappropriate given that the target shareholders would also be obtaining the benefit of scrip for scrip rollover relief. However these 'anti-reset provisions' will not apply if the target company or bidder company after the exchange of shares have 300 members or more.

Relevantly, Division 124-M will not apply if shareholder can apply the rollover relief in Division 124-G (refer section 124-795). However, the companies involved in a transaction that would otherwise qualify for rollover relief under Division 124-G (ie a transaction that might be described as a top-hat restructure) can make elections which result in the Division 124-G rollover relief **not** applying to the exchange of shares (refer section 124-380(5)).

Therefore, before the introduction of the new provisions, it may have been possible to design a transaction which was in substance a mere top hat restructure, and in respect of which:

- rollover relief under Division 124-G did not apply, and therefore the provisions of Division 124-G which prevent the resetting of cost bases to market value did not operate;
- scrip for scrip rollover relief under Division 124-M did apply, but where the provisions which prevent the resetting of cost bases to market value do not operate because the transaction involves a target company which has more than 300 members.

In other words, before the introduction of the new provisions, it may have been possible to design a transaction which achieved the dual benefits of CGT rollover relief for target shareholders and a resetting of cost bases to market value for the acquirer.

When the new provisions are viewed in this context then, in a very crude sense, it can be said that as a result of the introduction of the new provisions, where the transaction involves an exchange of shares:

- (a) if there is no substantial change in the shareholders of the acquiring company after the exchange when compared to the shareholders of the target company before the exchange (ie the transaction is in the nature of a top hat arrangement), then the transaction is to be characterised as a mere 'restructure' and, as a result, the rollover relief for shareholders in the target under Divisions 124-G or Division 124-M may be available, but in each Division there are provisions which prevent the resetting of cost bases to market value;
- (b) if there is a substantial change in the shareholders of the acquiring company after the exchange when compared to the shareholders of the target company before the exchange (ie there were already material shareholders in the acquiring company before the exchange of shares and, as a result of the exchange, the members of the acquiring company are comprised of both those pre-existing material shareholders and the new ex-target shareholders) then the transaction is to be viewed as a takeover and not a mere restructure and, as such, the rollover relief for shareholders in the target under Division 124-M may be available, and the provisions which prevent the resetting of cost bases to market value should not apply (subject to the 300 member rule in section 124-782).

How do Cost Base Adjustments work?

The new provisions attempt to identify when a transaction is a mere 'restructure' and then impose the new cost base adjustments to that identified restructure.

This means that there must first be a 'restructure' as defined, and then the new cost base adjustments will apply to that restructure.

'First, there must be a 'restructure' as defined

Under section 124-784A there is a 'restructure' if the following conditions are met. For the purposes of this description, assume that an acquiring company acquires all of the shares in a

target entity by way of an exchange (with the target shareholders) of shares in the acquiring company for shares in the target company.

- (a) The first condition is that it must be the case that the acquirer knows or could reasonably be expected to know that a scrip for scrip rollover (under section 124-780) will be obtained in relation to the acquirer's acquisition of the target.

Note that the condition is satisfied if the acquirer knows or could reasonably be expected to know that a scrip for scrip rollover will be obtained, ie there only needs to be one target shareholder who can reasonably be expected to obtain the scrip for scrip rollover.

Comment on 'knowledge'

This is a remarkable condition. It is only satisfied if the acquirer:

- **knows** that scrip for scrip rollover will be obtained; or
- can reasonably be expected to **know** that scrip for scrip rollover will be obtained.

The section uses the word 'know' and therefore must require that the acquirer has that actual knowledge or could reasonably be expected to have that knowledge. The section does not use the words 'reasonably expects' rollover to be obtained, ie it is not satisfied if the acquirer does not **know** (or cannot reasonably be expected to **know**) but the acquirer can reasonably **expect** the scrip for scrip rollover to be obtained. This is an important distinction because scrip for scrip rollover can only ever be obtained if (among other things) the target shareholder would make a capital gain in the absence of rollover relief and the target shareholder **elects** for rollover to apply. How can the acquirer ever have actual knowledge of the cost bases of the target shareholder in their target shares, or of the intention of the target shareholder in relation to electing for rollover to apply. Certainly, if the market value of the target shares has risen over time such that the target shareholder can be expected to realise capital gains from a disposal of their shares and can therefore reasonably be expected to elect for rollover relief to apply, then the acquirer could satisfy the condition if the section had been drafted to use the words 'reasonably expects'. But the acquirer cannot know or reasonably be expected to know whether the target shareholders would make a capital gain from disposal and whether they intend to shelter that gain from tax by electing to apply rollover relief.

For what it is worth, the Explanatory Memorandum states that the 'reasonably be expected to know' test is satisfied if the pre-conditions for scrip for scrip rollover are otherwise met – refer paragraph 1.21 of the Explanatory Memorandum.

- (b) The second condition is that it must be the case that the acquirer knows or could reasonably be expected to know that there is a common stakeholder in relation to the acquisition.

Common Stakeholder

The common stakeholder test will be satisfied where, in relation to the target company just before the acquisition and the acquiring company just after the acquisition:

- a single entity and associates; or
- two or more entities and associates,

between them have

- 80% or more of the voting rights; or
- rights to receive for their own benefit 80% or more of any dividends that may be paid; or
- rights to receive for their own benefit 80% or more of any distribution of capital.

(c) The third condition is that it must be the case that, in broad terms, the sum of:

- the market value of all shares, options and rights over shares in the acquiring company issued to the target shareholders under this acquisition, and
- the market value of all shares, options and rights over shares issued to the target shareholders under earlier acquisitions to which section 124-784A has applied

is more than 80% of the market value of the sum of all shares, options and rights over shares on issue in the acquirer after the acquisition.

Hence, this third condition will be satisfied if, in broad terms:

$$\left(\begin{array}{l} \text{Market value of} \\ \text{shares, options and} \\ \text{rights issued to target} \\ \text{shareholders} \end{array} \right) \div \left(\begin{array}{l} \text{Market value of} \\ \text{shares, options and} \\ \text{rights in the acquirer} \\ \text{after the acquisition} \end{array} \right) \times 100 = \text{more than } 80$$

Second, if there is a Restructure there will be Cost Base Adjustments

Once it has been established that the acquisition is a 'restructure' as defined (ie because (a), (b) and (c) have been satisfied), the acquiring company's cost base for the shares in the target company is as follows under the method statement in section 124-782B:¹

(a) First, add up:

- (i) the market value of the target company's pre-CGT assets;

¹ This method applies only if and to the extent that the cost base transfer rules in section 124-782 do not apply to determine the cost base (refer section 124-784B(1)(b)). The cost base transfer rules can apply if the significant stakeholder (ie a 30% stake) or common stakeholder (ie an 80% stake) tests are met. The significant stakeholder and common stakeholder tests will not be met if the target company or the acquiring company have more than 300 members.

- (ii) in broad terms, the cost base of the target company's post-CGT assets (taking into account CGT assets with no cost base);
 - (iii) in broad terms, the value of trading stock at the time of the acquisition; and
 - (iv) for any assets which are not CGT assets, the cost base if they were CGT assets.
- (b) Then subtract the target company's liabilities in respect of those assets.

Note:

- if a liability of the target company is not specific to an asset then it is taken to be a liability for all assets of the target;
 - this captures all liabilities at law; it is not limited to accounting liabilities.
- (c) Then attribute the resulting amount to the shares in the target company acquired as a result of the exchange (or to the classes of shares if more than one class)

Hence, items (a) and (b) determine a "push up" amount, and this amount attributed as the cost of the shares in the target company acquired by the acquiring company as a result of the exchange of shares.

Cash component

Note that this methodology is only to be applied to the extent that the acquiring company has exchanged its shares (or rights, etc) for shares (or rights, etc) in the target. To the extent that the acquirer acquired the target shares by paying a cash component then the ordinary cost base rules apply to the cash component.

Elect for no Scrip for Scrip Relief

The cost base methodology described above will not apply (and the ordinary cost base rules will apply) if the acquiring company elects for the Division 124-M scrip for scrip rollover relief to **not apply** for the target shareholders – section 124-795(4).

The target shareholders must be advised of this election before the exchange of shares.

Consolidation Interaction

Division 715-W of the Tax Act 1997 provides for the new cost base methodology described above to be integrated into the tax cost setting rules for tax consolidation purposes in the following circumstances:

- (a) where the target company is not the head company of a consolidated group or MEC group and it joins the acquirer's consolidated group or MEC group;
- (b) where the target company is the head company of a consolidated group or MEC group and it does not join a consolidated group as a result of the acquisition;
- (c) where the target company is the head company of a consolidated group or MEC group and it joins the acquiring company's consolidated group or MEC group;
- (d) where the target company leaves a consolidated group or MEC group and does not become a member of another consolidated group as a result of the acquisition.

Scenario (c) is likely to be the most relevant case, which is covered by section 715-920. In that scenario, in short, for the purposes of determining the "push up" amount as the cost to the

acquiring company of acquiring the shares in the target company under the method statement in section 124-784B:

- (e) the target consolidated group is taken to remain in tact at the time it joins the acquiring company's consolidated group (eg the assets and liabilities of the subsidiary members of the target consolidated group will continue to be treated as assets and liabilities of the target head company); and
- (f) the core rules are disregarded in relation to the target company becoming a member of the acquiring company's consolidated group. That is, for the purposes only of determining the "push up" amount under the method statement, the single entity rule does not apply, the entry history rule does not apply, and the tax cost setting rules do not apply.

The outcome of section 715-920 is that the method statement in section 124-784A is used to determine the "push up" amount as the cost base for the acquiring company of the shares acquired in the target company, and this cost base is then used as the Step 1 amount for the purposes of pushing down the ACA of the target company and then, in turn, for the purposes of determining the tax cost of the target company's assets. However, the acquiring company can instead choose to retain the existing tax costs of the assets of the target company – refer next.

Stick Election

Where the target company becomes a member of the acquiring company's consolidated group or MEC group the acquiring company can elect to stick with the pre-existing tax costs of the assets held by the target company, ie the tax cost of the assets of the target company will not be reset as described above but will simply be adopted by the acquirer (refer sections 715-910(3) and 715-920(3)).

This option to 'stick' with the targets pre-existing tax costs will be an important consideration in circumstances where the tax cost push down results in an adverse re-allocation of tax cost across the targets assets. For example where the result of the push down is to step-down the tax costs of depreciable plant and to step-up the tax cost of goodwill of the target acquired as a result of acquiring the shares in the target.

2. Retail Premium in a Rights Issue

Over the last year or so Australian corporate groups have raised a very large amount of new capital by way of share rights issues. The following table is a sample of the rights issues undertaken since January 2009 where the capital raising exceeded A\$150 million.

Date announced	Issuer	Size (\$m)
7 Sep 09	Sigma	297
24 Aug 09	ConnectEast	421
18 Aug 09	Amtcor	1,611
17 Aug 09	Boart Longyear	406
10 Aug 09	Bendigo & Adelaide Bank	300
6 Aug 09	Goodman Group	1,300
27 Jul 09	Australand Property Group	475
27 Jul 09	Virgin Blue	210
15 Jul 09	Transpacific Industries	737
1 Jul 09	Hastings Diversified Utilities Fund	192
25 Jun 09	FKP Property Group	324
15 Jun 09	Asciano	769
10 Jun 09	Kagara	150
5 Jun 09	Rio Tinto	15,200
18 May 09	Billabong	290
13 May 09	Stockland	1,780
12 May 09	SP AusNet	413
11 May 09	Santos	3,000
11 May 09	Pacific Brands	226
7 May 09	GPT	1,400
5 May 09	Bluescope Steel	1,413
30 Apr 09	Alumina	1,020
21 Apr 09	DEXUS Property Group	749
16 Apr 09	OneSteel	549
31 mar 09	DUET Group	264
27 Feb 09	Fairfax Media	625

Date announced	Issuer	Size (\$m)
5 Feb 09	Suncorp-Metway	656
22 Jan 09	Wesfarmers	3,700
20 Jan 09	Abacus Property Group	187

A large proportion of recent capital raisings have been undertaken to 'repair the balance sheet' following the onset of the global financial crisis. However, significant recent capital raisings have also been used to fund acquisition activity (usually in combination with funds raised by way of debt). For example:

- (a) In August 2009 Amcor announced a 4 for 9 non-renounceable rights issue at \$4.30 per share which is expected to raise A\$1.6 billion. The proceeds of the rights issue are to be used, along with other committed funding, to finance Amcor's acquisition of the Alcan assets from Rio Tinto plc.
- (b) In May 2008 Wesfarmers completed a 1 for 8 entitlement offer at \$29.00 per share which raised approximately \$2.5 billion. The entitlement offer along with a bond issue and debt facilities enabled Wesfarmers to refinance all of its \$4 billion short term bridge facility and its \$1 billion revolving loan facility associated with its acquisition of the Coles Group.
- (c) In July 2009 Rio Tinto completed a 21 for 40 rights issue at \$28.29 per share (in relation to Rio Tinto Limited shares) which raised approximately US\$15.2 billion (across the entire DLC group). This very substantial capital raising was undertaken to significantly pay down the debt facilities used to fund Rio Tinto's acquisition of the Alcan group.
- (d) In March 2008 Primary Health Care completed an 8 for 5 pro-rata entitlement offer to raise \$1.231 billion. The capital raising was used to assist in funding Primary Health Care's acquisition of Symbion Health Limited.
- (e) In June 2008 Hastie Group completed a 1 for 4.7 pro-rata entitlement offer at an issue price of \$3.10 per share. The funds raised from the offer were used to finance the Hastie Group's \$201 million acquisition of Rotary Limited.

A capital raising by way of a rights issue will generally proceed on the basis that shareholders are offered the right to subscribe for additional shares in the company at a discount to the current trading price of the company's shares.

When a company is considering a capital raising by way of a rights issue one of the threshold issues will be whether it is to proceed on a non-renounceable basis or a renounceable basis.

At present the majority of rights issues proceed on a non-renounceable basis. That is, the rights to subscribe for new shares are not able to be traded on the ASX and shareholders

who choose not to take up their rights will receive no cash from allowing their rights to lapse².

However, significant capital raisings have also occurred by way of renounceable rights issues.

A rights issue may be renounceable but non-tradeable. That is, the rights are not able to be traded on the ASX, but the rights (or shares) attributable to shareholders who allow their rights to lapse or are ineligible to participate are offered to the market by way of a bookbuild bidding process. If the price obtained from the bookbuild exceeds a certain clearing price (this is usually the issue price for the new shares plus costs of undertaking the book build), then that excess will be paid to those shareholders. Recent examples of such structures are the Alumina 5 for 19 rights issue in September 2008, the Wesfarmers 1 for 8 rights issue in April 2008 and the Newcrest rights issue in late 2007.

Alternatively, a rights issue may proceed on a renounceable and tradeable basis. That is, the rights are able to be traded on the ASX during a specified period and, as such, shareholders choosing not to take up their rights can sell them for cash on the ASX. In addition, the rights (or shares) attributable to shareholders who allow their rights to lapse or are ineligible to participate are offered to the market by way of a bookbuild bidding process. Again, where the price achieved from the bookbuild exceeds a certain clearing price then the excess is paid to those shareholders. A recent example of this type of structure is Rio Tinto's 21 for 40 rights issue in July 2009.

McNeil's case and section 59-40

It might be said that there are parallels between the cash received by Mrs McNeil from the sale of her sell-back rights in *McNeil's* case, and the cash received by shareholders who choose not to take up their rights in a renounceable rights issue and who thereby receive cash from the bookbuild process. As such, is possible that our understanding of the correct tax treatment of the cash received by such shareholders from the bookbuild may have been assisted if the High Court in *McNeil* had addressed the tax treatment of the cash received by Mrs McNeil from the sale of her rights. However we did not get any such guidance from the High Court. The High Court's judgement addressed the question of whether Mrs McNeil derived income upon the grant of the sell back rights (finding that she did derive income) but did not address the character of the cash received by Mrs McNeil when her rights were sold. In any event, the arrangement in *McNeil* involved shareholders being granted with rights to sell shares back to the company, whereas a rights issue involves shareholders being granted with rights to subscribe for further shares in the company. As such, the McNeil arrangement was fundamentally different from a renounceable rights issue.

² The Virgin Blue rights issue in August 2009 might be described as something of a hybrid. In that case, the shareholders who were eligible to participate in the issue but who chose not to take up their rights did not receive any cash as a result of allowing their rights to expire. However, the rights of shareholders who were not entitled to participate (being shareholders residing outside Australia or New Zealand) were sold on their behalf by a nominee and those shareholders received the net sale proceeds.

Further, it would have been preferable for new section 59-40 of the Tax Act 1997 to have been drafted so that it clearly extends to the proceeds that a shareholder might receive on the disposal of rights to acquire additional shares in a company. The ATO's view seems to be that the protection offered by section 59-40 is limited to the granting of rights to acquire additional shares in a company and does not extend to the proceeds received from selling such rights.

The taxation of Retail Premiums under TA 2009/11

On 19 May 2009 the ATO released the controversial Taxpayer Alert TA 2009/11, which deals with the taxation of so-called 'retail premiums' received by shareholders who choose not to participate in renounceable rights issue.

In order to understand the significance of TA 2009/11 it is useful to focus on the relevant details of the Wesfarmers and Rio Tinto rights issues.

Wesfarmers 1 for 8 Rights Issue April 2008

The relevant features of the Wesfarmers rights issue were as follows:

- (f) 1 for 8 pro rate offer, at an offer price of \$29.00 per share.
- (g) Rights were **not tradeable**, whether on market or off market.
- (h) To the extent that shareholders chose not to take up their rights or shareholders were ineligible to take up their rights:
 - (i) a number of shares equal to the shares that could have been taken up by such shareholders would be offered for subscription to institutional shareholders via a 'retail bookbuild';
 - (ii) If the amount paid per new Wesfarmers share under the retail bookbuild exceeded the \$29.00 per share issue price, the excess (ie the **Retail Premium**) would be paid to those shareholders.

In fact, a Retail Premium of \$9.75 per share was paid to those shareholders.

Rio Tinto 21 for 40 Rights Issue July 2009

The relevant features of the rights issue by Rio Tinto Limited were as follows.

- (a) 21 for 40 offer, at an offer price of \$28.29 per share.
- (b) Rights were **tradeable** on the ASX in the period 17 to 24 June 2009.
- (c) To the extent that shareholders chose not to take up their rights, or were ineligible to take up their rights:
 - (i) a financial institution would attempt to place the new Rio Tinto Ltd shares attributable to the rights of such shareholders with investors at a price at least equal to the issue price plus the costs of placement;
 - (ii) if the placing price exceeded the \$28.29 issue price plus expenses of the placement, the excess (ie the **Retail Premium**) would be paid to such shareholders.

In fact, a Retail Premium of \$20.10 per share was paid to those shareholders.

Taxpayer Alert TA 2009/11

The so-called Retail Premium of \$9.75 per share for Wesfarmers and \$20.10 per share for Rio Tinto are addressed in Taxpayer Alert TA 2009/11 and in the related Facts Sheet dated 19 May 2009.

In TA 2009/11 the ATO states that it is reviewing the tax treatment of Retail Premiums to determine whether:

- (a) the Retail Premiums are unfranked dividends;
- (b) if not unfranked dividends, the Retail Premiums are ordinary income (in the nature of income from property) under the principles established in *McNeil's* case; and
- (c) in view of (a) and (b), Retail Premiums should not be treated as capital gains (and, by extension, should not be eligible for the CGT discount available for shareholders who are individuals, complying superannuation funds and trustees).

The ATO's Fact Sheet dated 19 May 2009 then seems to direct taxpayers to the conclusion that the Retail Premiums are to be treated as unfranked dividends.

Unfranked dividends

The ATO's view that Retail Premiums are unfranked dividends is based on its view of the operation of section 6(4) of the Tax Act 1936. The analysis is as follows.

- (a) Broadly, the definition of 'dividend' in section 6(1) provides a carve out for distributions paid from a company's share capital account. That is, as a result of the carve-out, distributions to shareholders which are paid from the share capital account are not dividends.
- (b) Section 6(4) 'turns off' this carve out. In broad terms, Section 6(4) provides that the carve out does not apply where, under an 'arrangement':
 - (i) a person pays money to a company and the company credits its share capital account with the money; and
 - (ii) the company pays money to another person and debits its share capital account with the money so credited.

This means that a distribution to a shareholder which is paid from the share capital account of the company will be a dividend (ie because the share capital carve out does not apply) where the amount paid from the share capital account is an amount that was first credited to the share capital account under an 'arrangement' within the meaning of section 6(4).

- (c) Section 975-300 of the Tax Act 1997 contains the definition of 'share capital account' for tax purposes. The definition has two limbs, being:
 - (i) First limb – an account that the company keeps of its share capital; or
 - (ii) second limb – any other account (whether or not called a share capital account) that was created after 1 July 1998 and in which the first amount credited was an amount of share capital.

- (d) Recall that in the Wesfarmers rights issue the number of shares attributable to non-participating shares were offered for subscription to institutional investors via the bookbuild, and in the Rio Tinto Ltd rights issue the shares attributable to the non-participating shareholders were placed with investors via a bookbuild. In each case:
- (i) the price obtained via the bookbuild exceeded the issue price for the shares;
 - (ii) the excess over the issue price (ie the Retail Premium) was paid to the non-participating shareholders; and
 - (iii) the issue price was paid to the issuing company to subscribe for new shares.

The ATO view is that the **total** price paid by the institutional investors under the bookbuild is share capital of the issuing company under the second limb of the definition of 'share capital' in section 975-300. That is, the **total** price paid by the institutional investors represents funds subscribe for the issue of new shares, despite the fact that the issue price for the shares is the lower amount specified by the issuing company under the rights issue. The ATO seems to cite the decision of the Full Federal Court in *St George Bank v FCT* 2009 ATC 9614 as authority for this view.

As the Retail Premium paid to the non-participating shareholders is a sub-part of the total price paid by the institutional investors under the bookbuild, the ATO contends that the payment of the Retail Premium is a payment made under an 'arrangement' to which section 6(4) applies. It follows, in the ATO's view, that the Retail Premium is a dividend.

- (e) Section 202-45 of the Tax Act 1997 contains the list of unfrankable dividends, and paragraph (e) of section 202-45 provides that a distribution is unfrankable if it is sourced directly or indirectly from the share capital account of the company. As a result, if one adopts the ATO analysis in arriving at the conclusion that the Retail Premium is a dividend (ie if one accepts that the Retail Premium is paid from an account which satisfies the second limb of the definition of 'share capital account'), then the Retail premium is an unfrankable dividend as a result of the application of section 202-45.

The ATO's view that the Retail Premium is an unfranked dividend is obviously controversial. A number of points can be made in response to the ATO's propositions:

- (a) The definition of 'dividend' in section 6(1) provides that a payment to a shareholder can only ever be a dividend if it is **made or credited by a company** to its shareholders. Here, it submitted that the funds represented by the Retail Premium are never the funds or property of the issuing company. The total price paid by the institutional investors in the bookbuild process is received by the appointed nominee/underwriter for the rights issue. The nominee/underwriter determines whether there is an excess over the issue price and, if so, pays that excess (the Retail Premium) to the non-participating shareholders. As such, it can never be

said that the funds represented by the Retail Premium form part of the funds or property of the issuing company and, as such, it cannot be said that the Retail Premium payment is made or credited by the issuing company to the non-participating shareholders.

- (b) As the total price paid by the institutional investors in the bookbuild process is received by the appointed nominee/underwriter for the rights issue and not by the issuing company, it is extraordinary to suggest that this sum is credited to a share capital account of the issuing company.
- (c) The shares issued to the institutional investors are issued on the same terms as the other shares issued under the rights issue. As such, the share capital raised by the issuing company is not the total amount paid by the institutional investors in the bookbuild but is the lower issue price which is payable for the issue of new shares under the terms of the rights issue.

For the issuing company the fact that the ATO considers the Retail Premium to be an unfranked dividend has a number of significant implications.

- (a) Where the non-participating shareholders to whom Retail Premiums are paid are non residents, the issuing company, on the ATO's view, is obliged to withhold and remit dividend WHT. As the Retail Premium dividend is an unfrankable dividend, the issuing company is not able to shelter the payment from WHT by attaching franking credits to the payment.
- (b) The rate at which WHT is to be withheld will depend on whether or not the registered address of the non resident shareholders is in a country with which Australia maintains a Double Tax Agreement. Where the nominee/underwriter which is managing the bookbuild process is not the same as the entity that arranges for the issuing company to pay its ordinary dividends or manage its share register, the nominee/underwriter will not have the information necessary to determine the registered address of the non resident shareholder (and therefore will not have the information necessary to comply with the WHT obligation).

Strictly speaking it would also be necessary to determine whether non resident shareholders hold the shares through an Australian permanent establishment, as there will be no dividend WHT to the extent the dividend is referable to that permanent establishment – refer section 128B(3E). However the *Taxation Administration Act 1953* provides that a company paying a dividend can rely on the registered address of the shareholder – refer section 12-210.

An Australian nominee holding shares on behalf of foreign shareholders will generally have matching WHT obligations – refer section 12-215 of the *Taxation Administration Act 1953*.

- (c) Where the non-participating shareholders to whom Retail Premiums are paid are Australian residents:
 - (i) the issuing company, on the ATO's view, is obliged to withhold and remit TFN withholding tax if such shareholders have not provided the issuing company with their TFNs (again, this outcome cannot be cured by

- attaching franking credits to the Retail Premium as the Retail Premium is considered to be an unfrankable dividend);
- (ii) the shareholder is treated as receiving an unfranked dividend which is taxable at the shareholder's marginal rate of tax.
- (d) On the ATO's view, the issuing company would be required to provide a payment summary setting out the type of details that are set out when ordinary dividends are paid to shareholders – refer section 16-155 of the *Taxation Administration Act* 1953.

Of course, from a commercial perspective the key implication of the ATO's view is that the non-participating shareholders will be receiving an after tax Retail Premium which is less than was anticipated. This will particularly stark in respect of:

- non resident shareholders with registered addresses in non-DTA countries, for whom the rate of WHT will be 30%; and
- resident shareholders on marginal tax rates below 46.5% who have not provided their TFN to the issuing company, for whom the rate of WHT will be 46.5%.

This extraordinary outcome is even more pronounced in a case, such as the Rio Tinto rights issue, where the rights were tradeable on the ASX. In that case, a shareholder who chose not to take up his/her rights and decided to sell the rights on the ASX for cash during the trading period could be forgiven for taking the view that the proceeds from the sale of the rights are to be treated on capital account and, potentially, entitled to the CGT discount (depending on, for example, whether the shareholder holds the underlying shares on capital account). If instead of selling the rights on the ASX, that shareholder allowed the rights to lapse and received the \$20.10 Retail Premium from the bookbuild, the shareholder would suffer the dividend WHT (or TFN WHT) on the Retail Premium.

Ordinary Income

The ATO's view in TA 2009/11 and the related Facts Sheet dated 19 May 2009 is that if the Retail Premiums are not dividends under section 6(4), they are ordinary income (in the nature of income from property) on the basis of the principles established by the High Court in *McNeil*.

The ATO's view seems to be based on the dual propositions that:

- first, the rights issued to the shareholders are benefits which are severed from the property (being the underlying shares) and do not diminish that property and, as such, are income on the basis of the decision in *McNeil*; and
- second, that the bookbuild is a means by which that benefit is turned to account (in the amount of the Retail Premium) and, as such, the receipt of the Retail Premium should take the same character as the benefit, ie the character of income.

The relevant connection between the decision in *McNeil* and the Retail Premium is that Mrs McNeil received cash proceeds from the sale of the rights granted to her and, in the scenarios under consideration, the non-participating shareholders receive cash proceeds from the bookbuild process. Leaving aside the fact that in *McNeil* the company was returning cash shareholders by way of a buyback whereas in a rights issue the company is

raising capital from its shareholders, the obvious response to the ATO's proposition is simply that the High Court in *McNeil* did not decide that the cash received by Mrs McNeil from the sale of her rights was income. The fact that the High Court made no comment on the character of the cash received by Mrs McNeil is indisputable and is acknowledged by the ATO in its (revised) Decision Impact Statement on the *McNeil* decision.

The position adopted by the ATO creates a very difficult distinction in cases where, as in the Rio Tinto rights issue, the rights are tradeable. In such cases, shareholders who were entitled to participate in the rights issue and received the Retail Premium because they allowed their rights to lapse could have instead sold their rights on the ASX in the trading period and received cash proceeds from the sale.

The ATO view is that the shareholder derives income if he/she is passive (ie allows the rights to lapse) and receives the Retail Premium via the bookbuild. Would the ATO also take the view that the shareholder derives income where he/she sells the rights on the ASX and receives cash proceeds from the sale?

Neither TA 2009/11 nor the ATO's Decision Impact Statement on *McNeil* addresses the character of cash received from the sale of rights in such circumstances. The High Court clearly did not say that the cash received by Mrs McNeil from the sale of her rights was income and, in any event, the *McNeil* arrangement involved rights to have shares bought back by the company as distinct from rights to subscribe for additional shares in the company. As such, under current law, the shareholder who chooses to sell his/her rights on the ASX and receive cash proceeds from the sale (as opposed to receiving Retail Premium from allowing the rights to lapse) may well be forgiven for forming the view that (depending on, for example, whether the underlying shares are held as capital assets) the proceeds of the sale are to be treated on capital account and, potentially, entitled to the CGT discount (if the shareholder is an individual, complying superannuation fund or trustee).

Avoiding the Dividend Trap?

As noted above, the ATO's view that the Retail Premium is an unfranked dividend is based upon the proposition that the total sum paid by the institutional investors in the bookbuild is the price paid to subscribe for new shares and, as such, the total sum paid is share capital of the issuing company. Recall that the total sum paid by the institutional investors is comprised of two parts – that is, the issue price for the new shares and the excess over the issue price (the latter being the Retail Premium).

It should be possible to structure the bookbuild process so as to separate these two components and thereby ensure that the Retail Premium component is not treated as an unfranked dividend. For example, consider a structure under which:

- (a) shareholders who decide to not take up their rights or who are prevented by foreign laws from taking up their rights (ie non-participating shareholders) are deemed to appoint a nominee to sell their rights to new investors, eg institutional investors;
- (b) the nominee offers the rights for sale at the best available price;

- (c) the institutional investors pay the price to the nominee to purchase those rights, and the nominee remits these sale proceeds (net of any costs of the sale) to the non-participating shareholders;
- (d) separately, the institutional investors exercise the rights which they have purchased from the nominee and pay the issue price to the issuing company to subscribe for new shares. (Of course it is also possible that institutional investors may choose to not exercise their rights if, for example, the issuing company has suffered a calamitous event in the days since purchasing the rights.)

Under this structure, the net sale proceeds remitted to the non-participating shareholders under (c) can, for present purposes, be described as the Retail Premium. However, it is submitted that it would be very clear that the price paid by the institutional investors to purchase the rights is:

- a price paid to purchase an asset from the non-participating shareholders; and
- not share capital of the issuing company.

As such, the Retail Premium would not be an unfranked dividend.

Would the ATO consider that the Retail Premium is ordinary income? It is difficult to see how the so-called Retail Premium in this scenario is any different from the cash that would be received by the shareholder if he/she had sold the rights on the ASX.

3. Special Dividends in Acquisitions

Another recent trend in M&A activity involving listed companies has been the payment of fully franked special dividends to target shareholders. In some cases the special dividends have formed an integral part of the 'value proposition' put to shareholders in support of the merger/takeover, while in other cases the special dividends have been paid at the same time as or shortly after the merger/takeover. For example:

- (a) Kirin's all cash bid for Lion Nathan in August 2009 comprised cash paid under the scheme of arrangement to non-Kirin shareholders of \$11.50 per share plus a fully franked special dividend paid by Lion Nathan to all shareholders of \$0.50 per share. The original bid also priced Lion Nathan's \$0.22 interim dividend, but the interim dividend was excised from the bid when it was paid by Lion Nathan on 23 June 2009.
- (b) Yanzhon's bid for Felix Resources in August 2009 comprises:
 - \$16.95 cash per share;
 - \$0.50 fully franked dividend declared by Felix on announcement of the bid;
 - \$0.50 fully franked dividend, the payment of which by Felix is conditional on shareholder approval for the bid; and
 - in specie distribution by Felix of shares in its subsidiary South Australian Coal Corporation.
- (c) Viterra's bid for ABB Grain in July 2009 comprised (under the standard consideration option):
 - \$4.35 cash per share;
 - \$0.41 fully franked special dividend, the payment of which by ABB Grain is conditional on approval of the scheme of arrangement; and
 - 0.4531 Viterra shares for each ABB Grain share.
- (d) Westpac's offer to acquire all of the shares in St George on a basis of 1.31 Westpac shares for each St George share was enhanced in September 2008 by Westpac agreeing to the payment by St George of a fully franked special dividend of \$0.31 per share on the proviso that the aggregate of the St George final dividend and the special dividend would not exceed \$1.25 per share.
- (e) The scheme booklet for the merger of IOOF and Australian Wealth Management in March 2009 stated the intention for IOOF to pay a post-merger special dividend, and in July 2009 that special dividend was paid fully franked at \$0.13 per share.

Cash Value of Franking Credits

In some cases bidders will highlight the cash value of franking credits attaching to the special dividend as part of the value proposition put to shareholders in support of the bid.

For example, in the Kirin/Lion Nathan bid the media release on 11 May 2009 announcing the signing of the Merger Implementation Agreement stated that the franking credits

attached to the dividends would deliver an additional cash benefit of \$0.15 for certain classes of shareholders.

The equivalent announcement by ABB Grain and Viterra on 19 May 2009 in relation to its merger proposal was more direct when it stated:

'Including the franking benefits attached to the special cash dividend payment from ABB, there will be further value for certain classes of shareholders of up to A\$0.18 per share, taking the proposed transaction value up to A\$9.29-A\$9.59 per share.'

The additional cash benefit attributed to the franking credits attached to a fully franked special dividend generally derives from the following:

- The franking credit attached to the dividend is a tax offset against the tax otherwise payable on receipt of the dividend after the dividend has been grossed up by the amount of the franking credit (refer section 207-20 of the Tax Act 1997, and subject to the shareholder being entitled to the benefits of franking credits including the requirement that the shareholder has satisfied the holding period rule in section 207-145(1)(a)).
- The tax offset equates to tax payable at 30% on the grossed-up dividend (ie the tax offset shelters the grossed-up dividend from tax at a 30% tax rate) – refer section 207-20(2) and section 202-60 of the Tax Act 1997.
- Certain shareholders who pay tax at a rate of less than 30% will be entitled to a cash refund equal to the excess of the 30% tax offset over the tax payable by such shareholders on the dividend – refer subsections 67-25(1) to (1E) of the Tax Act 1997.

Hence, the statement in the ABB Grain/Viterra merger proposal quoted above that the franking credits attached to the \$0.41 special dividend delivers further value for certain classes of shareholders of up to \$0.18 per share is presumably based on the following analysis in relation to tax exempt Australian resident shareholders.

	\$	Reference
franked dividend	0.41	
franking credit	0.18	assumed fully franked; $0.41 \times (0.3/0.7) = 0.18$; refer s 202-60
tax on dividend	nil	
excess tax offset	0.18	refer s 63-10
cash refund	0.18	refer s 67-25

The same principles apply to enhance the after tax outcomes of complying superannuation fund shareholders as they generally pay tax on income at 15% and therefore may potentially receive a 15% cash refund on the fully franked special dividend.

Will section 177EA apply to deny the franking credits?

In circumstances where the pricing of a bid takes into account franking credits attached to a special dividend which is to be paid as part of the overall merger/takeover proposal it is necessary to have regard to section 177EA of the Tax Act 1936.

In broad terms, section 177EA applies where the following are satisfied:

- (a) First, there is a scheme for the disposition of membership interests.
This will be satisfied in the context of a merger/takeover proposal.
- (b) Second, a franked distribution has been paid or is payable and shareholders can reasonably be expected to obtain imputation benefits.
This will be satisfied if the special dividend is franked.
- (c) Third, having regard to the **relevant circumstances** it would be concluded that a more than incidental purpose of the scheme was to enable shareholders to obtain imputation benefits.

Where section 177EA applies the Commissioner may determine:

- (a) if the company is considered to be a party to the scheme – that franking debits arise in the franking account of the company; or
- (b) that imputation benefits do not attach to the franked distribution (ie the shareholder in receipt of the franked distribution cannot apply the tax offset).

The **relevant circumstances** which are to be taken into account in assessing whether there is a more than incidental purpose of enabling shareholders to obtain imputation benefits include those set out in subsection 177EA(17). Relevantly, paragraph (f) of subsection 177EA(17) states that the following is a relevant circumstance:

- '(f) whether any consideration paid or given by or on behalf of, or received by or on behalf of, the relevant taxpayer in connection with the scheme (for example, the amount of any interest on a loan) was calculated by reference to the imputation benefits to be received by the relevant taxpayer.'

As such, in circumstances where the 'value proposition' put to shareholders in support of a merger/takeover highlights the value of franking credits attached to a special dividend, the question is whether there is a scheme with the more than incidental purpose of enabling the shareholders to obtain the franking credits.

It will generally be the case that when the 'scheme' for the purpose of section 177EA is appropriately viewed as encompassing the overall merger/takeover arrangement, it will be very difficult to come to any conclusion other than that the overwhelming purpose of the arrangement is for the merger/takeover to occur. In other words, given that the relevant scheme for the purposes of section 177EA is the proposal for the target shareholders to dispose of their shares under the merger/takeover it would generally be very difficult for the Commissioner to form the view that the decision to provide a fully franked special dividend as part of the proposal reflected a more than incidental purpose of enabling shareholders to obtain franking credits. In short, the overwhelming purpose will generally be the takeover/merger transaction itself.

The question of whether section 177EA may apply to a fully franked special dividend paid as part of a merger was addressed in the class ruling for the Lion Nathan/Kirin proposal – refer CR 2009/44. The Commissioner ruled that a determination under section 177EA would not be made to disallow the franking credits attached to the special dividend, as:

- (a) the fully franked dividend is to be paid to **all** Lion Nathan shareholders, including Kirin as a 46% shareholder in Lion Nathan.
As Kirin is ultimately foreign owned, the payment of the fully franked special dividend to Kirin meant that there was a substantial degree of wastage of franking credits arising from the arrangement;
- (b) the fact that the special dividend was fully franked could be viewed as a continuation of Lion Nathan's history of paying ordinary dividends fully franked;
- (c) the special dividend was a pro rata distribution of the current profits of Lion Nathan which would not otherwise be available to Lion Nathan shareholders after the acquisition.

The Commissioner arrived at the same conclusion in the Class Ruling for the ABB Grain/Viterra merger – refer Class Ruling 2009/46.

Having regard to the Class Rulings for the Kirin/Lion Nathan and ABB Grain/Viterra mergers the key factors for the purpose of section 177EA will be as follows (although no single factor will be determinative):

- (a) whether the target company has a history of paying its ordinary dividends fully franked such that the fully franked special dividend can be viewed as a continuation of the target's dividend history. Adverse inferences will be drawn if the target company had paid less than fully franked dividends or no dividends in the years leading up to the merger;
- (b) whether the special dividend is paid pro rata to all target shareholders. Where the target is widely held or listed it will be difficult to justify an application of section 177EA; and
- (c) whether the special dividend can appropriately be viewed as a distribution of the target company's current year profits to its shareholders.

Contrast Share Buy Backs

The fact that the Commissioner does not make a determination to disallow the franking credits attached to a special dividend (being a determination under para (b) of subsection 177EA(5)) does not preclude the Commissioner from making a determination to debit the franking account of the payer company if the payer company is considered to be a party to a scheme to enable shareholders to obtain franking credits (being a determination under para (a) of subsection 177EA(5)).

The Commissioner has a history of making a determination under para (a) of subsection 177EA(5) to debit the franking account of a company where the company has undertaken a tender-style off market share buyback in respect of which the buyback price contains a substantial franked dividend component.

However, in tender-style share buybacks it is usually the case that shareholders who benefit from franking credits (and, in particular, from the cash refund of excess tax offsets in respect of franking credits) offer their shares into the tender at a **discount** to the prevailing market prices for the shares. In these circumstances, such shareholders rely upon the franking credit benefits attaching to the dividend component of the buyback price in order for the buyback to make financial sense for them. That is, the cash refund arising from the excess tax offset attributable to the franked dividend component of the buy back price is relied upon to ensure that, after taking the cash refund into account, the shareholder is selling the shares at a price that is at or above the market price.

However, there is certainly no evidence of such considerations being at play where a fully franked special dividend is paid as part of a merger/takeover proposal involving widely held listed companies.

Is the Special Dividend taxed as if it is part of the Value Proposition?

Where a merger/takeover involving a special dividend is proposed to shareholders on a recommended basis (ie recommended by the directors of the target) the proposal will often be presented on the basis that the special dividend is included in the total 'value proposition' put to shareholders in support of the transaction.

In these circumstances, a key issue, from a tax perspective, is whether the special dividend is considered to form part of the total consideration provided to target shareholders for the sale/exchange of their shares in the target company. In some cases the special dividend cannot appropriately be viewed as forming part of the total value provided to shareholders as consideration for the sale/exchange of their shares – for example, in the Westpac/St George merger the special dividend was payable whether or not the merger was implemented. In other cases it will be less clear.

From a tax perspective this question will be relevant in two key contexts:

- first, whether the special dividend forms part of the capital proceeds for CGT purposes; and
- second, whether the special dividend gives rise to a 'related payment' for the purposes of the holding period rule in respect of the franking credits attached to the special dividend.

Capital Proceeds for CGT purposes

Section 116-20 of the *Tax Act 1997* provides that the capital proceeds from the disposal of shares in the target company is the aggregate of:

- the money; and
- the market value of any other property

received or entitled to be received **in respect of the CGT event happening.**

As such, in order for the special dividend to be included in the capital proceeds there must be some meaningful connection between the receipt of the special dividend and the sale/exchange of the shares in the target company under the merger/takeover bid. This question is complicated by the fact that as a special dividend is at law a dividend, it would

generally be considered to be received by the target shareholders in their capacity as shareholders (rather than as the vendors of their shares).

In *Dick Smith Electronics* the High Court considered a scenario in which vendors agreed to transfer shares to a purchaser for a purchase price defined as \$114m minus a dividend amount. The sale agreement provided that before completion the vendors would cause the target company to declare a dividend of its retained earnings and that the purchaser would provide funding to the target company to enable it to pay the dividend so declared. Accordingly, the purchaser paid \$88.5m to the vendors and provided a loan to the target company which was used to fund the payment of a dividend of \$25.5m. By majority, the High Court held that the 'consideration which moved the transfer by the vendors' was the performance of the promises in the sale agreement which resulted in the vendors receiving the total sum of \$114m. The minority of Gleeson CJ and Callinan disagreed and found that the \$25.5m dividend was, in broad terms, received by the relevant vendor in its capacity as a shareholder in the target company.

The reasoning in *Dick Smith* makes it interesting to note the different outcomes applied by the ATO in class rulings issued in respect of recent merger/takeovers.

Merger	Special Dividend	Included in capital proceeds?	Comment
Westpac/St George Nov 2008	\$0.31 per share fully franked	No	Dividend payable whether or not merger proceeded. Westpac's agreement conditional on dividend not exceeding specified amount.
Kirin/Lion Nathan	\$0.50 per share fully franked	Yes	The Implementation Agreement required Kirin and Lion Nathan to consult and agree on the form and manner, dividend to be paid in accordance with agreement of Kirin. Dividend was not payable if scheme not approved.
Viterra/ABB Grain	\$0.51 per share fully franked	No	Viterra's agreement not required for payment of dividend. Scheme Booklet listed the dividend as part of scheme consideration. Dividend not payable if scheme not approved.

Who benefits from a special dividend?

In circumstances where it would be appropriate to regard the special dividend as forming part of the total consideration provided for the sale/exchange of the shares (and therefore, where the special dividend would be included in the capital proceeds for CGT purposes), it is necessary to recognise that the after tax outcomes of different categories of target shareholders will differ depending on whether the bid price is constructed to include a special dividend component, or is simply provided by way of cash from the bidder. The different after tax outcomes arise from the following considerations in relation to Australian resident target shareholders:

- (a) Whether or not the special dividend is included in capital proceeds, it will generally be taxable in the hands of the target shareholders under section 44 of the *Tax Act 1936*.
- (b) In general, and subject to satisfying the holding period rule (refer below), the franking credits attached to the special dividend provide the recipient target shareholder with:
 - (i) a tax offset at 30%; and
 - (ii) for non-corporate shareholders paying tax at less than 30% (for example complying super funds), potentially a cash refund for the excess tax offset.
- (c) Where an individual shareholder pays tax at the top marginal rate and is entitled to the CGT discount on disposal of the shares, the rate of tax payable on a discounted capital gain will be very similar to the top-up tax that the shareholder pays when receiving a fully franked dividend of an amount equal to the capital gain.
- (d) Thus, where the cost base of the target shareholder in the target shares is lower than the bid price excluding the special dividend:
 - (i) the capital proceeds are reduced by the amount of the special dividend and shareholders pay tax at their marginal rate on the remaining capital gain (refer section 118-20 of the *Tax Act 1997*). The remaining capital gain may be reduced by the CGT discount;
 - (ii) the franked special dividend carries a 30% tax offset, and non-corporate shareholders paying tax at less than 30% (eg complying super funds) may be entitled to a cash refund.

In these circumstances, complying super funds and other lowly taxed shareholders are advantaged by the inclusion of a franked dividend in the bid price (ie by the amount of the cash refund arising from the franking credits on the special dividend), whereas resident individual shareholders paying tax at the top marginal rate will be largely indifferent as to whether the bid price includes a special dividend where the effect of the CGT discount is to bring the marginal tax rate on capital gains broadly into line with the top-up tax payable on receipt of fully franked dividends.

- (e) Where the cost base of the target shareholder in the target shares is higher than the total bid price (ie including the special dividend):

- (i) the capital proceeds are **not** reduced by the amount of the special dividend even though the special dividend is taxable on receipt and may require the shareholder to pay top up tax. This is because the anti-overlap rule in section 118-20 only operates to reduce capital proceeds where the shareholder would make a capital gain. The economic result is that the tax shelter that would otherwise be available from the making of a capital loss is reduced, or 'burnt up', by the receipt of the special dividend;
- (ii) again, the franked special dividend carries a 30% tax offset, and non-corporate shareholders paying tax at less than 30% (eg complying super funds) may be entitled to a cash refund.

In these circumstances, complying super funds and other lowly taxed shareholders are advantaged by the inclusion of a franked dividend in the bid price, while all shareholders are disadvantaged by the fact that the dividend is assessable but the amount of the capital loss is not adjusted to reflect the receipt of that assessable dividend.

Is the Special Dividend a Related Payment?

Where the special dividend is appropriately viewed as being part of the total consideration provided for the sale/exchange of the target shares the ATO tends to take the view that the special dividend gives rise to a 'related payment' for the purposes of the holding period rule (refer to the class ruling on the Viterra/ABB Grain proposal CR 2009/46 and the class ruling on the Kirin/Lion Nathan proposal CR 2009/44).

- (a) In broad terms the holding period rule requires a shareholder to hold shares for a continuous period of 45 days (or 90 days for preference shares), **excluding** days on which the shareholder's net position results in the shareholder having less than 30% of the risks and opportunities on the shares, in order for the shareholder to be entitled to franking credits attached to the special dividend – refer section 207-145(1)(a) of the *Tax Act 1997* in relation to the 'qualified person' requirement and section 160APHM(2) of the *Tax Act 1936*.
- (b) Under section 160APHN, a 'related payment' obligation includes an amount being applied towards an amount owing where the amount so applied is calculated by reference to the amount of a dividend.

The ATO tends to take the view that there is a related payment obligation where the total bid price offered to target shareholders includes the special dividend on the basis that the dividend is effectively applied to the price owing by the bidder to purchase the shares.

- (c) Where such a related payment obligation exists (ie where it is appropriate the view the bid price as including the special dividend), the holding period rule in (a) above must be satisfied in the secondary qualification period, being the period (section 160APHD):
 - (i) commencing on the 45th day **before** the shares go ex-dividend;
 - (ii) ending on the 45th day **after** the shares go ex-dividend.

In relation to (ii) – where the merger is to occur by Scheme of Arrangement, the ex-dividend date for the special dividend will usually coincide with the Record Date for the Scheme and shareholders will generally be considered to have less than 70% risks/opportunities from the Record Date. This usually means that the requisite 45 days will need to be satisfied in period (i) as the shareholder will be considered to have insufficient risks/opportunities in period (ii).

- (d) The outcome under (c) is to be contrasted with the position if the shareholder is **not** considered to be under a related payment obligation. In that case, the holding period rule can be satisfied on a once-and-for-all basis (as opposed to a dividend-by-dividend basis, as applies under (c)). That is, it is to be satisfied in the period (section 160APHD):
- (i) commencing from the day after the day of acquisition of the shares;
 - (ii) ending on the 45th day after the day on which the shares go ex-dividend.

These timing considerations will obviously be important where the merger/takeover includes the payment of a special dividend and it may reasonably be expected that certain categories of shareholders (ie. those entitled to refunds of excess franking offsets) may be motivated to 'buy in' to the target company shares in time to benefit from the franking credits attached to the special dividend.