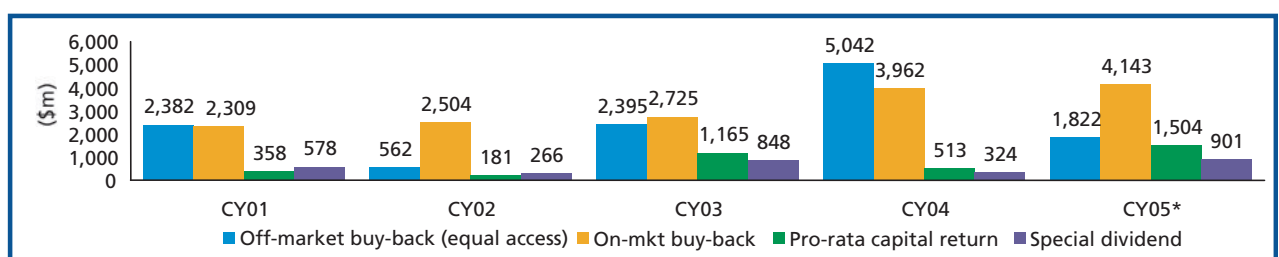


# Capital Management High on CFO's Agenda

With strong operating cash flows and high asset values making acquisitions difficult, CFOs are focussing on capital efficiency. In a recent presentation to CFOs, UBS Investment Bank identified a trend in capital management initiatives totalling \$8.5 billion in the first half of 2005.

## Total value returned to shareholders

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Notes: \*As at 21 June 2005.

- 1 CY05 equal access off-market buy-backs include Rio Tinto Limited (\$1,002m), BlueScope Steel (\$200m), Corporate Express (\$35m) and Coles Myer Limited (\$585m). Note we have classified the Rio Tinto Limited Selective buy-back as an equal access off-market buy-back since it was offered to all shareholders.
- 2 On-market buy-back totals calculated as the announced maximum number of shares applied to the share price the day prior to the buy-back announcements or the announced maximum value (if provided by the company).
- 3 CY05 capital returns include AMP (\$750m); AGL (\$228m); Aristocrat Leisure (\$100m); Promina Group (\$244m) and CSR (\$182m).
- 4 Telstra Corporation's \$750m special dividend has been included in CY05 special dividend total since payment is in CY05 despite being announced in CY04.

A sharp increase in pro rata capital returns in 2005 is evident in the chart with AMP, AGL, Aristocrat Leisure, Promina and CSR announcing capital returns in the first half of 2005.

**Tax outcome is an important issue in all capital initiatives and given the increase in activity, CPA Australia spoke to Wayne Plummer, tax partner with PricewaterhouseCoopers, about the tax considerations for capital returns.**

**Q. If a company has made a commercial decision to return an amount of capital to its shareholders, is it necessary to obtain an ATO Ruling to confirm the tax treatment?**

**A.** The Tax Act gives the Tax Commissioner an incredibly broad discretion in relation to the tax characterisation of any distribution to shareholders. In most circumstances it is therefore virtually impossible for a company to provide shareholders with any level of assurance as to the tax treatment without obtaining an ATO Ruling. Companies will normally obtain a class ruling which may be relied on by all shareholders.

**Q. Isn't the company in the best position to determine the most appropriate form of distribution to shareholders? What power does the Commissioner have to characterise a return differently?**

**A.** The primary rule is contained in section 45B of the Tax Act. It allows the Commissioner to treat all or part of any company distribution as a dividend to the extent he believes the payments the particular distribution is made in substitution for a dividend.

**Q. What implications would this then have for the company and its shareholders?**

**A.** It is open to the Commissioner to either treat the shareholders as having received an unfranked dividend to the extent he believes the distribution should have been a dividend, or to apply a debit to the company's franking account on the same basis. Either way, the result is normally an unacceptable one.

**Q. What information should be included in an application for class ruling?**

**A.** It is best to start off with some background to the company to give the ATO a broad understanding of its business operations and relevant history. Some other key areas to cover include:

- current and historical financials; including a detailed analysis of shareholders equity and reserves;
- dividend policy description; full dividend history; franking position and details of any other shareholder distributions;
- available information on shareholder profiles – such as percentage of non-residents; individuals; companies; superannuation funds and other institutions;
- details of the source of the capital return – ie. sale of assets, excess cash, new borrowings etc;
- an analysis of the law, including details of the relevant factors listed in section 45B.

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It is important to provide as much information as possible up-front. This will limit the number of additional requests for information from the ATO. It is useful to have a look at a few published class rulings and provide the information in the same format.

## **Q. What then are the next steps and within what timeframe can you expect to receive a response?**

**A.** It is normal for the Ruling process to take at least three months. It is best to identify a clear deadline for the ATO to work towards, such as the date of the company board meeting to approve the capital return. However, rulings which involve high complexity or novel concepts might need to be elevated (by the ATO or by the taxpayer) to other levels within the ATO. This could then lead to delays. A number of rulings have taken in excess of six months.

## **Q. Does the ATO have a standard approach or set of internal guidelines for determining these ruling requests?**

**A.** Most capital return class rulings have been based on circumstances specific to the companies involved. The ATO has not issued any general rulings or practice statements in relation to section 45B or the treatment of capital returns.

However, the following principles can be extracted from a review of the published class rulings:

- the first hurdle is to demonstrate to the ATO that the capital return is being undertaken for valid commercial reasons which will provide commercial benefit to shareholders;
- the most important factors the ATO will look at to determine the characterisation of the distribution will be the source of the capital return and the extent to which the capital return is really paid in substitution for a dividend;
- if a company has a good history of paying regular dividends and intends to continue this policy (unaffected by the capital return) this will be a good indication that it is not paid in substitution for a dividend;
- if the source of the distribution is the sale of a capital asset, then the ATO will look to the character of the sale proceeds (ie. profit v. return of capital);
- if the company has had a recent increase in share capital (eg. through a dividend reinvestment scheme or scrip-for-scrip takeover) this might indicate that the company is now merely seeking to return this excess capital to shareholders;
- if the company has significant profit reserves, it will be important to identify any restrictions which may exist as to why these may not be paid out to shareholders. For example, it may be reasonable for a company to maintain a reasonable buffer of retained earnings to protect a constant dividend policy in the future;
- if the company is borrowing to fund the capital return in order to re-gear its balance sheet, the ATO may suggest that a "slice approach" is relevant to determining the tax characterisation (ie. proportion of existing retained earnings over total shareholders equity).

## **Q. Will the ATO give you the opportunity to review the Ruling before it is made public?**

**A.** Yes. The ATO will request that taxpayers review the draft ruling to ensure the correct facts have been disclosed and that no confidential information is included in the ruling to be published.

*CPA Australia thanks Wayne Plummer and PricewaterhouseCoopers for their insights into an area of focus for Chief Financial Officers.*