

## JOINT SUBMISSION BY

**Institute of Chartered Accountants in Australia, National Institute of Accountants, The Taxation Institute of Australia, the, CPA Australia and Taxpayers Australia**

### ***Draft Taxation Determination TD 2008/D17***

**Income tax: in accounting for a Dividend Re-investment Plan, can a company taint its share capital account for the purposes of Division 197 of the *Income Tax Assessment Act 1997*?**

**Date: 30 January 2009**

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The Professional Bodies welcome the opportunity to comment on Draft Taxation Determination/Ruling TD 2008/D17.

#### **GENERAL COMMENTS**

The objective of the share capital tainting rules in Division 197 of the *Income Tax Assessment Act 1997* (ITAA 97) is outlined in paragraph 4.4 of the Explanatory Memorandum (EM) to *Tax Laws Amendment (2006 Measures No.3) Bill 2006* introducing Division 197 of the ITAA 97:

“Shareholders are taxed preferentially on distributions of share capital. In contrast, shareholders are generally taxed at their marginal tax rate on distributions of profits. The share capital tainting rules are integrity rules designed to prevent a company from disguising a distribution of profits as a tax-preferred capital distribution by transferring profits into its share capital account and subsequently making distributions from that account.” (emphasis added)

Dividend reinvestment plans (DRPs) are generally a popular means of investment for investors as it allows the investment return from dividends to be immediately invested into additional shares of the issuing company, without the brokerage fees being incurred.

Because of its commercial drivers, a company would not typically have the intention of using a DRP to disguise a distribution of profits as a tax-preferred capital distribution by transferring profits into its share capital account and subsequently making distributions from that account.

Thus, we welcome clarification from the ATO that a DRP will generally not taint the issuing company's share capital account, as this provides an outcome that is consistent with the intended purpose of the share capital tainting provisions as set out in EM.

There are, however, specific technical issues and observations with TD 2008/D17 that we would like the ATO to address to further enhance the final determination on this particular issue. These include:

- Articulating in the final TD why the ATO believes a transfer to the share capital account has taken place (as opposed to say a constructive payment) and whether its views are determined solely because of the accounting journal entries.

- In this regard, we have provided alternative journal entries to record a dividend reinvestment by an issuing company in order to compare whether such entries might not result in share capital tainting.
- In addition, whilst we acknowledge that the determination is intended to cover a single issue, we believe that other issues articulated in an earlier submission by the Institute of Chartered Accountants in Australia (ICAA) dated 9 August 2007 (attached) arise as a result of the conclusion that a share capital account is not tainted under a DRP because of Section 6BA(5) of the *Income Tax Assessment Act 1936* (ITAA 36). We are interested in understanding how the ATO will reconcile these issues.

### SPECIFIC COMMENTS

Although the conclusion in TD 2008/D17 that a DRP does not result in a share capital account being tainted for tax purposes is the right outcome, it is unclear as to why the ATO has adopted a different reasoning in TD 2008/D17 from the now withdrawn ATOID 2001/63.

Section 197-5(1) of the ITAA 97 provides:

“(1) Subject to subsection (2), this Division applies to an amount (the *transferred amount*) that is **transferred to a company’s \*share capital account** from another of the company’s accounts, if the company was an Australian resident immediately before the time of the transfer” (emphasis added)

The term “transfer” is not defined in the ITAA 97.

It is unclear whether “a transfer” for the share capital tainting provisions is only determined by accounting principles, the Corporations Act 2001, by the directors or some alternative principle.

Paragraph 4.12 of the EM to *Tax Laws Amendment (2006 Measures No.3) Bill 2006* provides that:

*“amount is transferred from one account to another where that amount is moved from one account to another. This, in turn, requires the balance of the first account to be reduced, while the balance of the second account is increased by the same amount.”*

Paragraph 4.13 of the EM provides:

*“an amount is not transferred from one account to another where the particular accounting entries result in the balances of both accounts increasing in size. Accordingly, an accounting entry of the form ‘debit asset, credit share capital account’ does not represent a transfer in the relevant sense. Furthermore, a transfer to the share capital account will not arise if an expense account is debited at the same time that the share capital account is credited.”*

The comments in this paragraph of the EM were made in the context of transfers between general ledger accounts. These paragraphs of the EM clearly suggest that

the occurrence of a transfer *may* be determined by accounting entries, which are generally governed by accounting standards.

In addition, the ATO's fact sheet on *Share capital tainting* also suggests a transfer is to be determined by accounting principles. Moreover, in Example 5 of the fact sheet dealing with "costs of raising share capital", the ATO fact sheet provides that "*in determining whether the transfer of an amount from one account to another has triggered the operation of the share capital tainting rules it is the entries which a company makes to its general ledger that will be determinative.*"

On the other hand, the commentary in ATP Taxpoint<sup>1</sup> on the new share capital tainting provisions provides a varied interpretation of the meaning of "transfer" for the purposes of the share capital tainting provisions. It provides that:

*"Perhaps the preferred approach is to have regard to the substance of the underlying transaction as supplemented by the factual matrix. The factual matrix would either confirm or negate whether in substance the underlying transaction was a transfer. The factual matrix could include decisions of directors, accounting standards, requirements of the Corporations Act 2001, etc. The substance of the underlying transaction should always prevail and not be tainted by the factual matrix. The factual matrix should only be used where there are ambiguities whether a transfer has in fact occurred."*

This observation is consistent with principles established in case law<sup>2</sup> on interpretation of other provisions of the tax law, for example, Section 8-1 of the ITAA 97, which provides that accounting principles are relevant, but not determinative of the interpretation of such a provision.

The ATO's reasoning provided in the withdrawn ATO ID 2001/63 supporting the conclusion that a DRP does not result in the tainting of a share capital account is as follows:

*"Although on face value the condensed accounting entry appears to result in amounts being transferred from 'other accounts' (retained earnings) to the share capital account, this does not result in 'tainted' share capital account. Dividend reinvestment plans involve a constructive payment of dividends by the company to the shareholder to acquire new shares in the company. In this case, however, there is no direct transfer of amounts from retained earnings to share capital account. There is, in fact, a subscription of new capital in the company by shareholders who participate in the dividend reinvestment plan (see CGT Determinations No.55<sup>3</sup>). Therefore, the share capital account will not be 'tainted' as a result of the company's dividend reinvestment plan."*

The view adopted in TD 2008/D17, however, is that the journal entries specified in Example 1 and Example 2 of that ruling results in a transfer to the share capital account for the purposes of Section 197-5(1) of the ITAA 97.

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<sup>1</sup> ATP Taxpoint, Tax Analytical Services, Commentary ITAA 1997, paragraph [197.1320]

<sup>2</sup> *FC of T v James Flood Pty Ltd* (1953) 88 CLR 492

<sup>3</sup> Now replaced by TD 2000/3

It is not clear in TD 2008/D17 why the ATO has changed its view from ATOD 2001/63 that a dividend reinvestment plan results in a transfer to a share capital account for the purposes of Division 197 of the ITAA 97.

The ATO's reasoning for the conclusion reached in TD 2008/D17 appears to focus on the accounting journals in the general ledger reflecting the dividend reinvestment plan.

However, the ATO clarifies it is Section 6BA(5) that prevents a share capital account not being tainted.

Although the outcome that a dividend reinvestment plan does not result in a tainted share capital account, we believe it is important for TD 2008/D17 to clarify whether a "transfer" has occurred to a share capital account in the first place for the purposes of Section 197-5. For example, is it solely the accounting journal entries that dictate whether there is a transfer for the purpose of the share capital tainting provisions?

If the ATO considers that accounting journal entries are given primacy or is seen to be the only factor that should be considered in determining whether a transfer has occurred to a share capital account for the purposes of Section 197-5, there is a question on whether this is an appropriate approach to interpreting the legislation.

Accounting journals are made because of legislative requirements to comply with the accounting standards. The purpose of recording an entry in an accounting standard often has a different purpose to a tax provision. The share capital tainting provisions seek to deter taxpayers from disguising a distribution of profits into a tax preferred capital distribution by transferring profits into its share capital account and subsequently making distributions from that account. It would seem inappropriate to interpret "transfer" in Section 197-5 without having regard to the intention of the provisions, particularly if the literal meaning of the words could give an outcome that may not be what policy drafters had intended.

It may be possible (albeit we would acknowledge these entries would not be common or preferred) for an issuing company to book the alternate entries to reflect a dividend reinvestment plan:

DR. Retained Earnings  
    CR. Dividend Payable  
(to record the declaration of a dividend)

DR. Receivable  
    CR. Share Capital  
(to reflect the allotment of ordinary shares for which their issue price has not yet been settled)

DR. Dividend Payable  
    CR. Receivable  
(to record the application of dividend payable against the amount payable for shares)

If accounting entries in the general ledger are the determinative factor in determining whether there is a transfer to a share capital account, then based on the comments in paragraph 4.12 & 4.13 of the EM and these journal entries to reflect to dividend reinvestment plan, the issuing taxpayer would not have transferred an amount to a

share capital account because this accounting entry will result in the balance of both accounts increasing in size. As a result, this accounting entry will not result in a relevant transfer to the share capital account for the purposes of the share capital tainting rules.

It is also interesting to note that these accounting entries to record a dividend reinvestment plan are similar to accounting entries to record the redemption of certain convertible debentures set out in PBR 81699. The journal entries for this transaction for the issuing company was:

DR Convertible Debentures (equity)  
    CR Payable  
(redemption of convertible debentures)

DR Receivable  
    CR Share Capital  
(subscription for ordinary shares)

DR Payable  
    CR Receivable  
(application of redemption proceeds against amount payable for shares)

In PBR 81699, the ATO concluded that, because the journal entry will credit/increase the share capital account upon conversion of the convertible debentures to ordinary shares and will be associated with an increase in the receivable (asset) account (i.e. the journal entry will result in the balance of both accounts increasing in size) there is not a transfer to the share capital account under the share capital tainting rules.

In summary, the point we are trying to highlight is that solely focussing on the accounting entries seems to give rise to capricious results when attempting to apply an integrity measure.

Finally, an earlier ICAA submission dated 9 August 2007 (attached) set out the issues that need to be addressed if it was argued a DRP would not taint a company's share capital account because of Section 6BA(5) of the ITAA 36. That submission raised two issues as a consequence:

- Are shares issued to a shareholder pursuant to a DRP issues in respect of the shareholder's existing shares? The main point articulated in the ICAA's submission on 9 August 2007 is that by arguing Section 6BA(5) applies in preventing that a DRP gives rise to a tainted share capital accounting, the shares issued to the shareholder under a DRP are in relation to the shareholder's existing shares. However, this is contrary to the view expressed in TD 2000/3, which states that "shares acquired under a dividend reinvestment plan are not issued in relation to the shareholder's original shares".
- Consequences of corporate participants of DRPs if section 6BA applies, particularly in circumstances where the dividend was rebateable.

We are interested in understanding how the ATO will reconcile these issues.