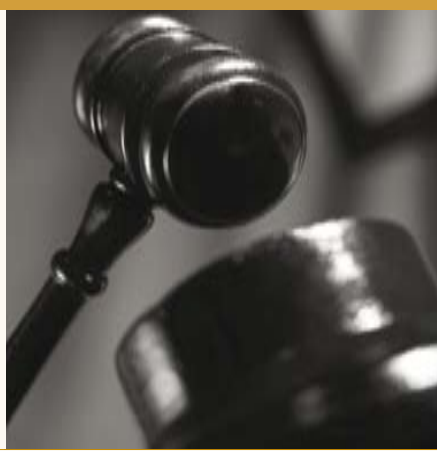
Do sell-back rights form part of a taxpayer's income according to ordinary concepts?



COMMISSIONER OF TAXATION V MCNEIL [2007] HCA 5

On 27 February 2007 the High Court handed down the final decision in the case of *Commissioner of Taxation v McNeil* (**"McNeil"**) which considered the character of sell-back rights in the hands of the taxpayer in relation to her shareholding in St George Bank Limited (**"St George"**). The High Court held, overturning the decisions of both the Federal Court and Full Federal Court, that the sell-back rights that were held for the absolute benefit of the taxpayer constituted income derived by her and, therefore, that amount should be included as part of the taxpayer's assessable income. Although the decision in *McNeil* only resulted in a small tax liability for the taxpayer in question, the decision also affected all of the other shareholders of St George who were offered sell-back rights. More generally, the decision is likely to have an effect on other public companies seeking to issue sell-back rights to their shareholders as a way of capital reduction.

BACKGROUND FACTS

In 1987, Helen McNeil (**"taxpayer"**) acquired shares in St George. On 12 January 2001, St George announced an off-market buy-back[1] of ordinary shares to the approximate value of $375 million with the intention to enhance the future returns to shareholders and to commence a reorganisation of its shareholding. The buy-back was to be funded by St George's existing cash resources, which would then be replenished by the issue of new preference shares. The shares subject to the buy-back were approximately five per cent of St George's issued capital at that time.

At the time of the announcement, the taxpayer held 5,450 ordinary shares in St George and was subsequently offered one sell-back right for every 20 shares (rounded down to the nearest number), giving her 272 sell-back rights. The sell-back rights were issued by St George to St George Custodial Limited (**"Custodial"**) as trustee for the taxpayer. Each of these sell-back rights, if exercised, obliged St George to buy back one ordinary share at a price of $16.50, which was considerably more than the market price of the ordinary shares at that time, being $13.88. On the basis of the recent trends in its share price, St George calculated that each sell-back right was valued at $1.89. The value of the sell-back rights offered to the taxpayer was therefore $514.

To obtain legal title to any (or all) of the sell-back rights, the taxpayer, and other St George shareholders, were required to notify Custodial of their intention by 16 February 2001. Notification would allow those shareholders to either exercise their rights with respect of their current shareholding, or to trade those rights personally, on the Australian Stock Exchange (**"ASX"**) as a secondary market. If the shareholders did not give a direction to Custodial that they were exercising their allocated sell-back rights, then Custodial was to sell the un-exercised rights to Credit Suisse First Boston Australia Equities Limited (**"CSFB"**) who would list the sell-back rights for trading on the ASX and account to Custodial as their trustee. Where the shareholders did not exercise their sell-back rights, they retained all of their existing shares in St George.

In the case of the taxpayer, she chose not to exercise her sell-back rights, which meant that she retained all of her 5,450 ordinary shares in St George and her allocated sell-back rights were traded on the ASX by CSFB from 20 February 2001 until 13 March 2001. At the close of trading on the ASX, St George distributed an amount of $576.64 to the taxpayer which was her portion of the proceeds from the off-market buy-back. Of this amount, $514 was the market value of the taxpayer's sell-back rights at 19 February 2001 and the additional $62.64 represented the increase in realisable value of those rights as a result of trading on the ASX.

In the year ending 30 June 2001, the taxpayer included $62.64 in her assessable income as a capital gain. The taxpayer did not include the market value of her sell-back rights, being $514.

LITIGATION HISTORY

The Commissioner of Taxation (**"Commissioner"**) issued a class ruling with regard to St George's off-market buy-back, stating that taxpayers who received sell-back rights would be liable for income tax[2]. St George funded litigation on behalf of its shareholders objecting to the class ruling, of which this case was the result. In the first instance, the Federal Court allowed the taxpayer's objection to the inclusion of $576.64 in her assessable income. An appeal to the Full Federal Court by the Commissioner was disallowed by the majority who considered that there was no derivation of income or capital gain over $62.64, which the taxpayer had already conceded was income in her 2001 tax return. The Commissioner again appealed

the decision, which has resulted in the present case. As a condition of granting leave to appeal to the High Court, the costs of the appeal were to be borne by the Commissioner.

RELEVANT LEGISLATION

Pursuant to Div 6 of the *Income Tax Assessment Act 1997* (Cth) (**"ITAA 1997"**), the assessable income of the taxpayer, as an Australian resident, includes income according to ordinary concepts derived directly or indirectly from all sources. The taxpayer is taken to have received income as soon as it is applied or dealt with in any way on her behalf or as she directs.

6-5 Income according to ordinary concepts

(1) Your assessable income includes income according to ordinary concepts, which is called ordinary income.

(2) If you are an Australian resident, your assessable income includes the ordinary income you derive directly or indirectly from all sources, whether in or out of Australia, during the income year.

…

(4) In working out whether you have derived an amount of ordinary income, and (if so) when you derived it, you are taken to have received the amount as soon as it is applied or dealt with in any ay on your behalf or as you direct.

As a holder of ordinary shares in St George, the taxpayer's assessable income also includes dividends paid to her by St George, in her capacity as a shareholder pursuant to s 44 of the *Income Tax Assessment Act 1936* (Cth) (**"ITAA 1936"**), which states that:

(1) The assessable income of a shareholder in a company (whether the company is a resident or non-resident) includes:

(a) if the shareholder is a resident:

(i) dividends (other than non-share dividends) that are paid to the shareholder by the company out of profits derived by it from any source; and

(ii) all non-share dividends paid to the shareholder by the company.

Section 6(1) of the ITAA 1936 defines "dividend" to include[3]:

(a) any distribution made by a company to any of its shareholders, whether in money or other property; and

(b) any amount credited by a company to any of its shareholders as shareholders.

…

ISSUES BEFORE THE COURT

The key issue before the High Court was whether the money received by the taxpayer as a consequence of being issued sell-back rights by St George, could be characterised as income according to ordinary concepts and therefore included in her assessable income.

The Commissioner submitted that:

1. the grant of 272 sell-back rights on 19 February 2001, in respect of the taxpayer's shareholding and held by Custodial for her absolute benefit was the derivation of income by her in the amount of $514; and alternatively

2. in any event, the receipt of the proceeds of $576.64 on 2 April 2001 was income in the hands of the taxpayer.

The grant of sell-back rights was a derivation of income

In addressing the Commissioner's first submission, the High Court made some general observations regarding the characterisation of receipts and the nature of returns derived from property.

Firstly, the court upheld the view that whether a particular receipt has the character of the derivation of income depends on its quality in the hands of the recipient and not the character of the expenditure by the other party. As a result, the character of the sell-back rights should not be determined by considerations that the taxpayer's entitlement arose out of the decision of St George to effect the buy-back process and that this involved capital restructuring by St George[4]. Although the share buy-back scheme explains the involvement of St George and the reason for the benefit provided to the taxpayer, it does not explain the character of the sell-back rights in the taxpayer's hands.

Secondly, the court confirmed that a gain derived from property has the character of income and this includes a gain to a passive owner. As a result, the question to be answered by the court was whether the "rights enjoyed by the taxpayer arose and were severed from…her shareholding in [St George]"[5]. The court considered it was

> "Income was derived by the taxpayer because, while the sell—back rights were a product of the taxpayer's shareholding, the gain arose from an arrangement that was separate from her shares."

significant that the taxpayer had not given up any part of her shares in St George in order to receive the gain from the proceeds of the off market buy-back arrangement.

The taxpayer was truly a passive participant in the off-market buy-back. As a result of her shareholding in St George she was offered sell-back rights and as a result of her failure to notify Custodial by the required date that she would be exercising those rights, pursuant to the Deed Poll under which the arrangement occurred, the taxpayer became entitled to the observance and performance of the obligations owed to her under the buy-back arrangement by Custodial and CSFB. This situation meant that, in equity, the taxpayer's rights were accrued and vested in her despite her taking no action with regard to those rights.

The taxpayer submitted the following:

1. The Commissioner erred in speaking of the sell-back rights as severed or detached from the taxpayer's shares and as a result the proceeds could not be a derivation of income.

2. Section 44 of the ITAA 1936 and Part III, SubDiv 2D of the ITAA 1936 constituted a complete code with respect to the taxation of receipts by shareholders from companies, which was unconstitutional as it covered the field.

Could the sell-back rights be detached from the taxpayer's shares?

The taxpayer argued that the sell-back rights were not detached from the ordinary shares

and therefore the proceeds received as a result of those sell-back rights could not be income in nature, but capital as a result of her shares. In this regard, it was submitted that the Commissioner had conflated two separate rights, the "general right" to returns of capital which is part of the "variety of rights making up the share" on the one hand and the grant by St George of sell-back rights to forego that general right to conclude that the rights were detached from the taxpayer's shares.

The taxpayer firstly argued that the amounts received by her from St George were analogous with monies that could be paid to shareholders as capital receipts rather than income. In this regard the taxpayer relied on the reasoning in *Federal Commissioner of Taxation v Blakely*[6] for the proposition that payments relating to the realisation of a share investment were capital in nature as they were not detached from, but instead inherently connected with, that shareholding.

Secondly, the taxpayer submitted that, even if the payment was to be regarded as a dividend, the characterisation of "dividend" did not capture the amounts received by a shareholder in respect of shares cancelled as a consequence of a reduction of capital that was in excess of the amount actually paid up on those shares[7].

Lastly, the taxpayer argued that the issue of sell-back rights could be regarded as an issue of bonus shares and renounceable rights. In this event the proceeds received by her with respect to her sell-back rights did not give rise to the derivation of income according to ordinary concepts because those rights were connected with her existing shareholding.

Did a "code" exist for the taxation of receipts by shareholders from companies?

The taxpayer submitted that s 44 together with Part III, SubDiv 2D of the ITAA 1936 constituted a "code" for taxation of receipts by shareholders from companies and further, that the application of s 6-5 was restricted by a process of construction giving exhaustive operation to s 44 relating to dividends. If such provisions were to be a code, the taxpayer argued that it was unconstitutional because it "covered the field" relating to the taxation of receipts by shareholders from companies.

DECISION OF THE HIGH COURT

The court rejected all of the taxpayer's submissions. In relation to the "detachment" of the sell-back rights from the existing shareholdings it held that:

- it was not sufficient to say that St George issued the sell-back rights to Custodial on behalf of the shareholders in satisfaction of the shareholder's right to participate in the reductions of capital and stated that the character of the grant of rights to the shareholder is decisive; and
- the receipt of proceeds and grant of sell-back rights to the shareholder was not a distribution of St George's assets; and
- nor, could the receipts be seen as analogous to dividends or bonus shares because the scheme to issue sell-back rights "took its life from the deed polls" executed on the 19 February 2001.

The court also rejected the taxpayer's argument that a code existed for the taxation of receipts to shareholders from companies as an "awkward" way to characterise the legislation, holding that:

- the practice for Australia's various taxation laws deal with parts of the overall regime suggested that there was no "code" as submitted by the taxpayer; and
- the legislation did not cover the field as the grant of sell-back rights fell outside the dividend provisions which "marked the boundary" resulting in s 6-5 being a general provision and Part III, Subs 2D providing more specific direction.

The court upheld the Commissioner's submissions that the issue of sell-back rights to the taxpayer was a derivation of income in her hands. Income was derived by the taxpayer because, while the sell-back rights were a product of the taxpayer's shareholding, the gain arose from an arrangement that was separate from her shares. Furthermore, the court held it was relevant that the taxpayer's shareholding remained unaffected, and that this was evidence that the gain was not in respect of a return of company capital and was therefore income in her hands.

CONCLUSION AND COMMENT

On 12 January 2001 St George announced an off-market buy-back under which it issued 272 sell-back rights to the taxpayer based on her shareholding in the company of 5,450 ordinary shares. As the taxpayer chose not to exercise her sell-back rights, the rights were instead traded on the ASX. The taxpayer received $576.64 as proceeds of the off-market buy-back, of which $514 was the market value of her sell-back rights at the date of issue and a further $62.64 was an increase in the realisable value of the rights as a result of trading on the ASX. The taxpayer retained all of her ordinary shares in St George. The Commissioner issued a class ruling stating that the sell-back rights would be subject to income tax.

The majority of the High Court has now held that the Commissioner was correct in characterising the sell-back rights as a derivation of income because the proceeds received by the taxpayer as a result of her allocated sell-back rights were detached from her shareholding in St George. The detachment occurred because the taxpayer did not have to provide any consideration (for example, giving up any of her shares) in return for the allocated sell-back rights.

However, it is clear from the two decisions of the Federal Court and Callinan J's dissenting opinion in the High Court, that the question of whether the charcterisation of sell-back rights is a derivation of income in the hands of the taxpayer may not yet be settled. In his dissenting judgment, Callinan J regarded the key to unlock the problem lay in the fact that the money received by the taxpayer "… was not an entitlement derived from profits earned by the company. It arose out of the decision by the company to reduce its issued capital through a buy-back process"[8] by which the capital of St George and the value of the taxpayer's rights as a shareholder in St George, became less.

Callinan J did not agree that the character of a payment for the purposes of income according to ordinary concepts could always be determined by reference to its quality in the hands of the recipient, because examination of the payment in the hands of that recipient is only part of the quality of the receipt, which is also gained from examining that amount in the hands of the company. In his opinion, the taxpayer's continuing shareholding in St George, which represented a contingent entitlement to the capital of St George, was being reduced through the process of capital reduction. This process was recorded in the deed

polls, although he reasoned that instead of the deeds giving rise to her sell-back rights, it was really the decisions behind the deeds and the excess of capital which result in the capital reduction. As a result, Callinan J held that the proceeds from the sell-back rights was not a derivation of income by the taxpayer.

While the decision in the *McNeil* case results in only a small tax liability for the taxpayer in question, the decision will also impact on the other St George shareholders which were subject to the class ruling, and more generally, on other public companies and their shareholders, where sell-back rights are issued as a method of capital reduction.

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Reference notes

1 *Rights are referred to as "buy-back" from the perspective of St George Bank Limited and as "sell-back" from the perspective of the taxpayer.*

2 *ATO website – see impact statement*

3 *Subject to several exceptions relating to money paid from the share capital account of the company, redeemable preference shares, and life assurance policies.*

4 *At [20].*

5 *At [21], see further Federal Commissioner of Taxation v Montgomery (1999) 198 CLR 639 at 660–660 [62]–[69].*

6 *(1951) 82 CLR 388.*

7 *Federal Commissioner of Taxation v Uther (1965) 112 CLR 630.*

8 *At [54], referring to French J in Commissioner of Taxation v McNeil (2005) 144 FCR 514 at 529 [44].*