TAX UPDATE
TAXING SHARE BUYBACKS AND RPS REDEMPTIONS

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When is a share capital account not a share capital account for tax purposes? Why, when it is an equity account, of course! So said the Full Federal Court recently in *Cable & Wireless Australia & Pacific Holding BV (in liquidatie) v FCT* in the context of share buybacks. And on this topic, it is worth revisiting some basics on the buyback of redeemable preference shares (**RPS**).

WHAT IS A SHARE CAPITAL ACCOUNT?

It does not matter what an account is called – you need to look at what the account is used for to determine whether it is a share capital account.

A share capital account is broadly an account which records a transaction in relation to the company's share capital. This can include an account that is a liability account. For example, if RPS are characterised as liabilities for accounting purposes, the liability account that is credited on issue of RPS is nonetheless a share capital account for tax purposes.

The Court in *Cable & Wireless* unanimously ruled that the "buy-back reserve account" created by Optus to effect a buyback of shares was not a share capital account. The buyback occurred in the context of SingTel acquiring Optus, then majority owned by C&W. Shareholders could choose to either receive consideration for the sale of shares to SingTel or consideration for the buyback of shares by Optus (funded by a loan from SingTel to Optus, which was ultimately capitalised through the issue of shares). The tax consequences are quite different between a buy back and a disposal, and best left for another day.

As loathe as we are to refer to accounting entries, they can be summarised as follows in the books of Optus:

Dr Contributed equity	$2.3 billion		
Dr Buy-back reserve	$3.9 billion		
	Cr Debt due to shareholders		$6.2 billion

The Court accepted that the contributed equity account represented share capital actually subscribed by shareholders and which were returned to the Optus shareholders who had shares bought back, while the buy-back reserve account represented the shortfall between the buyback proceeds and the amount debited to the share capital account. It was nothing but a balancing account, the debit coming from money lent by SingTel to effect the buyback, and neither Optus nor C&W treated it as a share capital account (including in a ruling application to the Tax Office).

By contrast, the "share buy-back reserve account" considered by the *High Court in FCT v Consolidated Media Holdings Limited* in 2012 (and which C&W relied on in this case) was the only account debited as part of the buyback. All of the share capital being returned was debited to that account. Hence, the High Court unsurprisingly concluded that the account there was of share capital.

SOME IMPORTANT LESSONS

As much as it pains lawyers, the accounting entries are important!

Don't say one thing to the Tax Office or your shareholders, and expect judges to agree with you when you later say the opposite.

There are more to accounts than their names and their classifications – you have to look to the substance of the transactions they record

HOW DO YOU REDEEM A RPS?

Ask a tax adviser and the answer will be: **DON'T**! As a general rule, tax advisers will avoid redeeming RPS and opt for buying them back despite the corporations law requirements for notice. If you must redeem RPS, care must be taken to avoid unintended and punitive tax consequences.

A precise mechanism involving debits to the share capital account and notices of that amount needs to be followed to ensure that the full redemption proceeds are not treated as a dividend which is taxable in the hands of the recipient. This is particularly important where the RPS are being redeemed out of the proceeds of a fresh issue of shares as well as situations where the RPS are debt for tax purposes. Importantly, the increased share capital from the fresh issue of shares cannot be taken into account in determining the debit to the share capital account!

In addition, where RPS are redeemed out of profits, the accounting entries required for such a redemption will automatically have the effect of "tainting" the share capital account, meaning that any returns of capital thereafter are treated as unfranked dividends that will also reduce the franking account balance of the company. If that was not enough of an incredibly punitive tax outcome for something that is required by the corporations law, when the franking account goes into a deficit balance, the franking deficit tax will be imposed! Or alternatively, tax can be paid to "untaint" the share capital. Neither is appealing!




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