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AVAILABLE SUBSCRIBED CAPITAL—CONSEQUENCES OF DEEMED REREGISTRATION

Introduction

Under the Income Tax Act 1994, the concept of “available subscribed capital” (ASC) is important in determining whether a distribution by a company to its shareholders is a dividend or a return of capital. The definition of available subscribed capital in section OB 1 is concerned with calculating the amount of available subscribed capital referable to a particular class of share at a point in time. Essentially, it reflects the amounts paid to the company on the issue of shares, less amounts paid out on the repurchase of shares when those amounts are not dividends.

Under the Companies Reregistration Act 1993, any company registered under the Companies Act 1955 is deemed reregistered under the Companies Act 1993 as from the close of 30 June 1997 (or some Court-approved extended time). One effect of reregistration is that the previous memorandum and articles of the company cease to have effect, and the company is then governed by the provisions in the Companies Act 1993.

Under section 28 of the Companies Act 1993, companies without a constitution have rights, powers, duties and obligations as set out in that Act. Further, section 36 sets out shareholder rights and powers for such companies, and in particular provides that a share in a company confers on the holder: the right to vote, dividends, and an equal share in the distribution of surplus company assets. If a company has more than one share class, those share classes merge into the ordinary share class.

We have been asked what effect, if any, the merging of share classes, pursuant to a deemed reregistration under the Companies Reregistration Act 1993, has on ASC.

Legislation

Available subscribed capital is defined in section OB 1 of the Income Tax Act 1994. The relevant parts of the definition are:

Available subscribed capital, ..., means the amount calculated in accordance with the following formula in respect of all shares of the same class (referred to in this definition as the “specified class”) as the share:

$a + b - c$

where -

a is -

- (i) In the case of any company which existed before 1 July 1994, the transitional capital amount; and
- (ii) In any other case, nil; and

b is the aggregate amount of consideration received by the company on or after 1 July 1994 and before the relevant time in respect of the issue of all shares in the company of the specified class, including as consideration -

...

c is the aggregate of amounts distributed-

(i) Upon the acquisition, redemption, or other cancellation by the company of shares in the company of the specified class; and

(ii) On or after 1 July 1994 and before the relevant time; and

...

This definition looks at relevant amounts attributable to shares of the same class (referred to as the “specified class”). The formula calculates the total amount the company received on the issue of a particular class of share, less the total amounts distributed by the company following any acquisition, cancellation, or redemption of the shares.

Generally, shares remain in their specified class and the calculation of ASC is relatively straightforward. But if shares move from a class to become members of another class (“altered shares”) as a result of deemed reregistration, the ASC calculation becomes a little more complex.

Effect of alteration

With an alteration of shareholder rights, a number of issues emerge:

- Does an alteration have the effect of cancelling shares
- To what class do the altered shares belong
- On what basis is ASC calculated for altered shares
- On rectification of altered shares, what is the value of consideration received?

No share cancellation

An alteration of shareholder rights is not a cancellation and reissue of shares. The shareholder still owns the original shares, but certain entitlements attaching to the shares are varied in some way.

The appropriate class

For ASC purposes, a specified class is a reference to “shares of the same class” as defined in section OB 1. This definition generally classifies shares on the basis of any 2 (or more shares) having similar attributes. For example, shares of the same class have identical rights as to voting, decision making, and distribution entitlements. The effect of deemed reregistration is that **all** shares become, at the time of deemed reregistration, members of the ordinary share class.

ASC following deemed reregistration

The ASC definition looks at the balance of the consideration received for all shares in the specified class at the time of calculation, less relevant distributions. For shares originally issued in the specified class, paragraph (b) credits amounts received on issue and paragraph (c) debits amounts distributed.

The definition is concerned with all shares in the specified class at the relevant time - being the time when ASC is calculated. The altered shares simply become members of the new specified class at the time of alteration, and the ASC amount of the altered shares is included in the calculation of ASC of the new specified class.

For “altered” shares, a focus on amounts credited and debited *at issue* is not appropriate because ASC is calculated in terms of the “new” specified class. Accordingly, the altered share component of the ASC of the ordinary share class should reflect *the ASC balance as at the time of alteration*. This approach avoids the ASC of the altered shares being trapped in its original specified class.

The ASC of the altered shares is the balance of the consideration received for all shares in the altered shares class, less relevant distributions. This calculation is made as at the time of the alteration, being the close of 30 June 1997 or such later day if a Court has granted an extended time to reregister.

Rectification of shareholder rights

If a company decides to alter the rights attaching to a share class, the possibility of varying the relative interests of shareholders arises because of the potential dilution of shareholder rights. The Companies Act 1993 minimises the potential impact of this by ensuring that the company does not take any action that affects the rights attached to shares, unless the action has been approved by a special resolution.

With deemed reregistration, the shareholders do not have the option to decide on the variation of their rights. The rights are altered by statute. For ASC purposes the merging of different specified classes, due to deemed reregistration, may dilute the rights and subscribed capital originally received for shares in the original share class and in the altered classes. If the company takes no action to “rectify” the effect of the alteration of shareholder rights (such as creating a new class of share), the amount of ASC for the specified class will include the ASC amounts for the altered shares as at the time of deemed reregistration.

However, if a company proposes to rectify the effect of the variation, the question arises as to the value of the consideration received for the shares.

- Is it the original issue price
- Is it calculated on the ASC value per share as at the time of deemed reregistration
- Is it found by dividing the ASC for the specified class by the number of shares in the

class immediately prior to rectification?

In the Commissioner's view, when enacting the definition of ASC Parliament did not expressly turn its mind to the potential effect of deemed reregistration. However, it is clear that the definition of ASC is concerned with calculating the balance of consideration received less distributions of shares in a share class. Like deemed reregistration, a rectification is not an issue of shares. Accordingly, the relevant consideration should be calculated as at the time the altered shares join the new specified class, i.e. immediately prior to the rectification.

On this basis, it is appropriate that, if a company alters the shareholder rights to rectify the effect of deemed reregistration, it is the proportionate amount of ASC, calculated by dividing the ASC for the specified class by the number of shares in the class immediately prior to rectification, that becomes the ASC of the rectified class.

Reissue of shares

The result outlined above may be contrasted with one where, instead of a reclassification, the shares of the other class (e.g. preference shares) are redeemed by conversion into ordinary shares. Whereas a reclassification is an *alteration* of the rights attaching to *existing* shares, a conversion involves the issue of new shares. For ASC purposes, the consideration received for the ordinary shares is not based on the price of preference shares at the time of issue, but it is the market value at the point of conversion. This reflects the reality that the conversion triggers a tax event in the form of a cancellation and new issue, while a reclassification, of itself, does not.

Examples

The following examples illustrate the operation of this approach.

Example 1: pre-deemed reregistration

This example illustrates the calculation of ASC as at 29 June 1997 (prior to deemed reregistration).

A company is formed on 1 August 1994, and issues 10,000 ordinary shares at \$1 per share. It issues a further 5,000 ordinary shares at \$1 per share on 1 December 1994; at the same time issuing 4,000 preference shares at \$1.50. A further issue of 3,000 preference shares (at \$1.50 per share) is made on March 1 1996. The company decides to cancel some ordinary shares and redeem some preference shares. On 1 December 1996, 4,000 ordinary shares are cancelled at \$1.50 per share. On the same day, the company redeems 2,000 preference shares at \$2.00 per share.

Calculation of ASC

Ordinary share class

ASC is defined as: $a + b - c$

a = nil

b = all consideration received in respect of the issue of ordinary shares, i.e.
 $\$10,000 + \$5,000 = \$15,000$

c = the aggregate amount distributed upon the cancellation by the company of shares in the company of the specified class = $\$6,000$ (4,000 at $\$1.50$ per share)

ASC for ordinary share class is $\$9,000$ ($\$15,000 - \$6,000$).

Preference share class

a = nil

b = $\$10,500$ (7,000 shares at $\$1.50$ per share)

c = $\$4,000$ (2,000 shares at $\$2.00$ per share)

ASC for preference share class is $\$6,500$.

Example 2: post-deemed reregistration

This example illustrates the ASC calculation following deemed reregistration.

This example uses the same facts as Example 1, except that the ASC is measured as at 1 July 1997.

Calculation of ASC

Due to deemed reregistration, there are no longer any shares in the preference share class and therefore no ASC to calculate for that class.

Ordinary share class

Prior to the alteration of rights, the ASC in the ordinary class was $\$9,000$ and in the preference share class, $\$6,500$ (see Example 1).

The effect of the alteration of rights is that the preference shares become ordinary shares. The “altered” preference shares (and the ASC amount) simply join the ordinary share class. The ASC amount is $\$15,500$. This amount includes the amount of ASC for the ordinary shares as calculated in Example 1 ($\$9,000$) and the ASC balance of the preference shares when they became ordinary shares as calculated in Example 1 ($\$6,500$).

Example 3: rectification

In this example the company wishes to re-establish the preference share class, and to this end, on July 10 1997 it alters the rights of 3,000 ordinary shares.

Calculation of ASC

Preference share class

When shares join another class, the relevant ASC goes with them. In this example 3,000 ordinary shares become preference shares and the ASC for these shares must be calculated as at the time of reclassification. This figure is found by calculating the value of the ASC per ordinary share, multiplied by the number of shares reclassified.

- ASC for the ordinary shares (at the time of reclassification) = \$15,500 (see Example 2).
- Number of ordinary shares on issue = 16,000 (see Example 1).

ASC per ordinary share = $(\$15,500/16,000) = \0.96875 .

Accordingly the value of the ASC for the 3,000 preference shares is \$2,906.

Ordinary share class

The ASC for the ordinary share class following reclassification can be found by calculating the ASC for the class (prior to reclassification), less the ASC for the preference shares (\$2,906).

Prior to reclassification, the consideration received in respect of the issue of the ordinary shares is $[10,000 \times \$1] + [5,000 \times \$1] + [\text{ASC for the "altered" preference shares} = (\$6,500)] = \$21,500$.

b = \$21,500

c = the aggregate amount distributed upon the cancellation by the company of shares in the company of the specified class = \$6,000 (4,000 at \$1.50 per share).

ASC for the ordinary share class is \$15,500 ($\$21,500 - \$6,000$)

After reclassification, 3,000 ordinary shares become preference shares and item 'b' becomes $\$21,500 - \$2,906 = \$18,594$.

Item 'c' = \$6,000

ASC for the ordinary share class is \$12,594 ($\$18,594 - \$6,000$).

