


# ***TR 2009/3EC - Compendium***

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## **Ruling Compendium – TR 2009/3**

This is a compendium of responses to the issues raised by external parties to draft TR 2008/D8 – Income tax: application of section 177EA of the *Income Tax Assessment Act 1936* to non-share distributions on certain ‘dollar value’ convertible notes

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

### **Summary of issues raised and responses**

Issue No.	Issue raised	Tax Office Response/Action taken
1.	<b>The Taxation Ruling focuses on terms of the notes rather than surrounding commercial factors</b>	
1.1	The Ruling is broad and general in nature.	The Taxation Ruling (including Appendix 1 referred to in this compendium as 'the Ruling') deals with a very specific type of convertible note. To this extent, it is not of broad or general application. It does, however, give an indication of our general approach to the application of section 177EA of the <i>Income Tax Assessment Act 1936</i> (ITAA 1936). <sup>1</sup>
1.2	The Ruling: <ul style="list-style-type: none"> <li>• does not seem to have appropriate flexibility when applying section 177EA to specific factual circumstances;</li> </ul>	Paragraph 14 of the Ruling states that consideration of the relevant circumstances set out in the Ruling points to a ‘likely conclusion’ that at least one of the parties to the scheme or part of the scheme described in the Ruling had a more than incidental purpose of enabling the holder of the note to obtain an imputation benefit. Paragraph 134 of the Ruling also states that ‘Consideration of the relevant circumstances ... is likely to lead to...’ that conclusion. We think there is appropriate flexibility in these expressions.

<sup>1</sup> All legislative references are to the ITAA 1936 unless otherwise indicated.

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1.3	<ul style="list-style-type: none"> <li>• focuses predominantly on the terms of the Convertible Notes rather than considering all commercial factors surrounding their issuance; and</li> <li>• should provide more flexibility within the scope of the ruling for the Commissioner to consider additional factors that may be unique to the issuer or acquirer of the convertible notes. This will allow the Commissioner to consider the terms of the Convertible Notes but also take account all of the surrounding circumstances.</li> </ul>	<p>Paragraph 13 of the Ruling points out that the application of section 177EA to a particular scheme requires a careful weighing of all the relevant facts and surrounding circumstances, and that it is not possible to state definitively whether a particular scheme will attract section 177EA in the absence of all relevant information.</p> <p>Paragraphs 123 to 128 of the Ruling expand on this approach under the heading 'Weighing up the circumstances'. In particular, paragraph 128 of the Ruling states that 'Without more, the above consideration of the relevant circumstances of these particular dollar value convertible notes supports a conclusion that a party ...' (had the relevant purpose). This indicates that additional relevant circumstances could lead to a different conclusion.</p> <p>Minor amendments have now been made to paragraphs 13 and 59 of the Ruling to address some of the above points. The comments above relate to the draft Ruling prior to these amendments.</p>
1.4	A number of factors are not considered at all or the implications fully appreciated by the Tax Office. For example:	
1.4.1	<ul style="list-style-type: none"> <li>• The nature of the issuer.</li> </ul>	<p>The Ruling concentrates on the circumstances listed in subsection 177EA(17) but also explains at paragraph 60 of the Ruling that the list of circumstances is not exhaustive. Thus, the nature of the issuer can clearly be considered to the extent that it is a relevant circumstance. Paragraph 3 of the Ruling also notes that there may be additional circumstances to the features listed in paragraph 3 that are peculiar to particular issuers and holders that in some cases may be decisively relevant. However, we doubt that the nature of the issuer would be a circumstance that would easily displace the conclusion that we tend to, where the relevant circumstances that we have addressed are evident.</p>

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1.4.2	<ul style="list-style-type: none"> <li>Whether there is an existing pool of credits should not be a consideration in determining the potential application of section 177EA.</li> </ul>	<p>We think that the franking account balance of an issuing entity is highly relevant in determining purpose. In particular, paragraph 177EA(17)(c) is a listed relevant circumstance and enquires whether, apart from the scheme, the issuing entity would have retained franking credits (or exempting credits) or would have used the credits to pay a franked distribution to another entity (see paragraphs 82 to 86 of the Ruling).</p>
1.4.3	<ul style="list-style-type: none"> <li>If the notes are marketed widely but only Australian investors are attracted to this type of investment, it cannot be said that the notes are designed by the issuer to avoid wastage of franking credits.</li> </ul>	<p>The design of these particular arrangements is such that they are only commercially viable for parties that can use the imputation benefits. If a note holder could not enjoy the franking benefits referable to the franked interest payments on the notes (for example if the holder were a non-resident) the return on the notes would be commercially inadequate. The cash component of a franked distribution is only 70% of the return on the notes – the balance of the interest return is made up by the allocation of franking credits to that distribution. To the extent that an interest payment is not franked, the cash component of interest payments is increased accordingly. The allocation of franking credits to a party that has the ability to use those benefits is central to the arrangement. We agree that this fact is relevant, but think that it is adequately addressed – in particular paragraph 120 of the Ruling. Further, the conversion mechanism under the notes has been considered in great detail in the ruling – see especially paragraphs 65 to 74 of the Ruling.</p>
1.4.4	<ul style="list-style-type: none"> <li>The ability to convert the Convertible Notes into capital at the discretion of the Issuer is only covered very briefly in the Ruling. The option to raise regulatory capital at short notice is invaluable for entities which have strict regulatory requirements to maintain minimum capital levels.</li> </ul>	<p>Paragraphs 103 and 119 of the Ruling explicitly state that the notes that are the subject of this Ruling are debt for regulatory purposes. Further, we think it is clear from the description of the essential features of the notes at paragraph 3 that the Ruling does not deal with notes that are capital for regulatory purposes.</p>

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	<ul style="list-style-type: none"> <li>The Commissioner should also consider the nature of the convertible note for regulatory purposes. If the note is capital for regulatory purposes, then the Taxation Ruling should not apply.</li> </ul>	
<p>1.4.5</p> <p>1.5</p> <p>1.5.1</p>	<ul style="list-style-type: none"> <li>Offshore tax treatment should not be a consideration. Offshore treatment is not expressed as a relevant consideration in section 177EA.</li> </ul> <p>Further improvements suggested:</p> <ul style="list-style-type: none"> <li>The ruling should also make it clear that the existence of one or more of the factors listed in paragraph 11 of the draft Ruling would not necessarily on their own be sufficient to result in the application of section 177EA.</li> </ul>	<p>The offshore tax treatment may be a relevant circumstance. It goes to the manner in which the scheme was carried out; it is discussed briefly at paragraph 115 of the Ruling.</p> <p>We think this is sufficiently clear from the Ruling as drafted. In particular, paragraph 12 of the Ruling sets out general observations about the scheme for the issue of the dollar value convertible notes which are considered the most relevant circumstances supporting the application of section 177EA to the arrangements that are specifically described in paragraphs 2 and 3 of the Ruling. Paragraphs 2 and 3 make it clear that the subject arrangements have a number of essential factors. Paragraph 13 of the Ruling further explains that in the absence of all relevant information, it is not possible to state definitively whether a particular scheme will attract section 177EA. Amended paragraph 14 of the Ruling now indicates that, without more, these features of these arrangements point to a 'likely conclusion' that section 177EA could be applied. Paragraphs 123 to 128 of the Ruling make it clear that the necessary conclusion can only be drawn by having regard to all relevant circumstances.</p>

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1.5.2	<ul style="list-style-type: none"> <li>To assist in the practical application of the draft ruling we also recommend that the Tax Office consider including examples which differentiate between convertible notes which are acceptable and those which are not.</li> </ul>	<p>The features of the dollar value convertible note arrangements that are the subject of the Ruling are ostensibly designed to deliver imputation benefits on equity instruments that are also designed so that the holders do not have ownership exposure. The Ruling is intended to explain how these arrangements are likely to be considered under section 177EA. While the Ruling notes that in the absence of all relevant information, it is not possible to state definitively whether a particular scheme or a particular type of convertible note will attract section 177EA, we doubt that we could usefully provide an example of a commercially realistic arrangement with all these features that would necessarily be found acceptable.</p> <p>Subparagraph 12(f) of the Ruling notes the relevance of the conversion option in considering the relative tax and non-tax advantages for the issuer. Paragraph 122 of the Ruling also considers the non-tax considerations regarding the needs of an issuer for a source of 'contingent capital'.</p>
2.  2.1	<p><b>The interaction of the Debt/Equity rules with section 177EA</b></p> <p>The debt/equity rules in Division 974 of the <i>Income Tax Assessment Act 1997</i> (ITAA 1997) determine what is considered debt or equity. It is not appropriate to apply section 177EA of the ITAA 1936, where the character of the return is dictated by the operation of Division 974 of the ITAA 1997; and, there is no discretion under the law to consider whether the return is frankable.</p>	<p>It is clear that section 177EA is intended to apply in appropriate circumstances to schemes involving interests which are classified as equity interests on which frankable returns are paid. Paragraphs 35 to 48 of the Ruling explain in some detail the Commissioner's view of the interaction of the debt/equity rules and section 177EA – see especially paragraph 46 of the Ruling.</p>

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2.2	<ul style="list-style-type: none"> <li data-bbox="322 328 1016 667">• Distributions on Convertible Notes in the form contemplated by the Ruling would be deductible under general principles but Division 974 of the ITAA 1997 re-classifies the notes as equity. Where the debt equity provisions apply to treat the Convertible Notes as equity, it would be unreasonable to apply section 177EA of the ITAA 1936 to undo the tax (franking) consequences of the equity classification.</li> <li data-bbox="322 751 1016 1090">• If the Office has a concern over the frankability (or otherwise) of a Convertible Note due to the operation of the debt/equity provisions, then the Commissioner should be able to make a determination under section 974-65 of the ITAA 1997 to treat such instrument as a 'debt' interest. The distribution would be un-frankable (and deductible) and therefore the concern section 177EA of the ITAA 1936 attempts to address would not be relevant.</li> </ul>	<p data-bbox="1039 328 2029 699">Paragraph 47 of the Ruling explains that section 177EA is not concerned with the question of whether an instrument should be classified as a debt or equity interest as such. It concerns itself with substantial purposes of obtaining imputation benefits, identified by consideration of the criteria in subsection 177EA(17), which are designed to direct attention to inappropriate use of franking credits. Further, it notes that a debt classified as an equity interest does not attract the operation of section 177EA simply because the return on it is interest, but may do so in similar circumstances to those in which section 177EA would have applied to dividends paid on preference shares—that is, where unusable or surplus imputation benefits are directed to persons lacking real ownership of the company.</p> <p data-bbox="1039 751 2029 954">Prior to the introduction of Division 974 of the ITAA 1997, the cash component of distributions on these notes would be subject to Division 3A of Part III of the ITAA 1936 and therefore it would be expected that they would not be deductible. Where the notes are now treated as equity and returns are frankable, section 177EA of the ITAA 1936 may still apply for the reasons set out in paragraphs 36 to 48 of the Ruling.</p> <p data-bbox="1039 959 2029 1297">There is no legislative provision that indicates that deductions should be available for frankable returns on equity interests that are subject to section 177EA of the ITAA 1936. In particular, the discretion in section 974-65 of the ITAA 1997 is not exercisable in the circumstances set out in the Ruling. In brief, that discretion may be exercised where there is an effectively non-contingent obligation to provide the substantial part of the financial benefits that are necessary to satisfy the debt test, and it is substantially more likely than not that the balance of financial benefits required to satisfy that test will be provided. These circumstances are not present in the arrangements that are the subject of this Ruling.</p>

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Issue No.	Issue raised	Tax Office Response/Action taken
3.	<p><b>Stifling financial innovation and increased cost of capital raisings</b></p>	
3.1	<ul style="list-style-type: none"> <li>the overriding purpose is to raise a contingent source of capital. Because of the Commissioner not ruling favourably on these notes, the Issuer (or an associate entity) has not had the opportunity to convert Convertible Notes into ordinary equity.</li> </ul>	<p>Paragraphs 121 and 127 of the Ruling acknowledge that these notes are a source of contingent capital, and that this is to be weighed as a relevant circumstance. However, it is clearly possible to raise contingent capital by issuing convertible notes that are equity interests without the essential features of the subject notes set out in paragraphs 2 and 3 of the Ruling.</p>
3.2	<ul style="list-style-type: none"> <li>The form of the issuance, by way of Convertible Notes, had particular tax implications but these were as a consequence of the desire to raise cash which could be converted into capital at short notice.</li> <li>The Commissioner should review his position on the treatment of such Convertible Notes, and not seek to make a determination under section 177EA where banks seek to raise contingent capital.</li> </ul>	<p>Nothing in the Ruling could be taken to prevent the conversion of any of these dollar value convertible notes that are presently on issue into ordinary shares. The Ruling only considers the potential application of section 177EA to the convertible notes.</p>

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4.  4.1	<p><b>Denial of imputation benefits to holders of the notes</b></p> <p>The issuer may decide to keep the Convertible Notes on foot, even with a determination under paragraph 177EA(5)(b) [that is posting a debit to issuing entity's franking account], due to the limited sources of funding in the market (particularly in the current market circumstances). Paragraph 16 of the Ruling, which allows the Commissioner to subsequently deny imputation benefits on subsequent distributions, may lead to an unfair result and creates uncertainty for both the investors and the issuer. This is particularly the case when there have been no changes to the terms of the Convertible Notes. It is recommended that if the Commissioner applies a debit under section 177EA, an imputation benefit may be denied on subsequent distributions, only if there are material changes to the issuance of the Convertible Notes.</p>	<p>The Ruling is intended to provide greater certainty about the circumstances in which section 177EA is likely to apply to a particular type of arrangement. The discretion to take alternative actions under subsection 177EA(5) is available so that the Commissioner has the flexibility to take appropriate action to effectively counteract the scheme (see paragraphs 15 to 17 of the Ruling). This is supported by paragraphs 8.40 and 8.41 of the relevant explanatory memorandum, which are referred to in paragraph 130 of the Ruling. The recommendation if adopted would constrain the Commissioner's intended capacity to effectively counteract these schemes.</p>

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<p>5.</p> <p>5.1</p> <p>5.2</p>	<p><b>The Taxation Ruling is technically flawed – misguided approach to equity risk</b></p> <ul style="list-style-type: none"> <li>• The reasoning and analysis in the draft Ruling of the potential application of section 177EA to the distributions on the convertible notes is technically flawed and contains a misguided approach to the concept of ‘equity risk’ in relation to arrangements that are ‘non-share equity interests’.</li> <li>• Non-share equity holders and, in particular, the holders of the convertible notes, will not be exposed to the substantial risks and opportunities usually associated with holding shares in the issuing company.</li> <li>• One of the two principles of the imputation system – that imputation benefits are only to be available to the true economic owners of the company would appear to have changed because non-share equity holders may be persons other than the true economic owners of the company and are able to access franking benefits.</li> </ul>	<p>The Ruling clearly concerns only non-share equity interests that are convertible notes with all the essential features noted in subparagraphs 3(a) to 3(d) of the Ruling. In particular, unlike other non-share equity interests, the specified conversion feature of these notes together with the absence of any profit contingency that could affect an issuer’s obligation to pay periodic interest (subparagraphs 3(a) and 3(c) of the Ruling respectively) ensure that these notes do not give holders any substantial exposure before conversion to concomitants of having an ownership interest in the company (see also paragraphs 131 and 132 of the Ruling).</p> <p>The Ruling does not imply or state that distributions on non-share equity interests will always be subject to section 177EA. The Ruling is only concerned with the very limited category of non-share equity interests described in paragraphs 2 and 3 of the Ruling that do not have any real aspects of economic ownership of the company. Other forms of non-share equity interests can have some features that expose the holder to some aspects of economic ownership of a company – for example, through profit contingencies that affect periodic returns and/or returns of principal, or equity upside or downside on conversion (see also, for example, the distinction recognised at paragraph 131 of the Ruling). The Ruling does not imply that imputation benefits will only be available where non-share equity interests have all the risks and opportunities that accompany ownership of a company.</p>

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	<ul style="list-style-type: none"> <li>• Non-share equity interests will not be shares/membership interests. Thus, to have the same 'equity risk' requirement for non-share equity interests as that associated with shares/membership interests is both absurd as a matter of policy and technically incorrect as a matter of statutory interpretation the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 1998 (the 1998 EM) cannot be relied upon as an interpretive aid once section 177EA was extended to apply to non-share equity interests. To that extent, it is not extrinsic material that can be relied upon to interpret the legislation. The scope of the legislation and the legislative policy has clearly changed, and the alleged 'principle of the imputation system' referred to above will not apply in respect of non-share equity interests.</li> <li>• Most of the 'features' of the convertible notes, as set out in paragraph 3 of the draft Ruling, are present in non-share equity interests, particularly when they are legal form debt.</li> </ul>	<p>We do not agree that the essential principles of the imputation system have changed in the way claimed or that the noted extrinsic material is no longer relevant.</p> <p>Our view of the interaction between section 177EA and the debt equity rules is discussed in paragraphs 35 to 48 of the Ruling. Also, as explained in paragraph 35 of the Ruling, section 177EA is ambulatory, in the sense that it may apply to any scheme which is capable of conferring imputation benefits under the law as it stands from time to time.</p>

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6.	<b>The application of section 177EA will depend on the facts of each case</b>	
6.1	<ul style="list-style-type: none"> <li>Whether a conclusion can be reached that section 177EA can apply to the convertible notes, or to other schemes for the disposition of non-share equity interests, will depend on the facts of each case.</li> </ul>	Agreed – we think the Ruling makes this clear (see especially paragraphs 13, 123 and 128 of the Ruling).
6.2	<ul style="list-style-type: none"> <li>What will not be determinative of the question is the interests' apparent lack of the equity risk usually borne by shareholders. Similarly not determinative are the many 'features' of the convertible notes referred to above – which are common features of many non-share instruments issued by companies.</li> </ul>	The Ruling now provides that the consideration of the relevant circumstances that are noted, without more, points to a likely conclusion that would support a determination under section 177EA (see paragraph 14 as now amended, also paragraph 128 of the Ruling). It leaves open the possibility that in a particular case the absence of any equity risk in the specific cases could conceivably be overtaken by some additional unspecified relevant circumstance (see also paragraph 59, as now amended, of the Ruling). To this extent, the Ruling does not say that the absence of equity features is determinative. That is, it does not hold that having the essential features at paragraph 3 of the Ruling means that section 177EA will necessarily apply.
6.3	<ul style="list-style-type: none"> <li>The draft Ruling incorrectly ascribes a heavy emphasis and weighting to these features [that is, those described in paragraph 3 of the Ruling], concluding that they warrant the application of section 177EA. The reasoning in the draft Ruling is so flawed that it should be withdrawn and reconsidered.</li> </ul>	We agree that the Ruling ascribes a heavy weighting to the features listed at paragraph 3 of the Ruling, but consider that this is appropriate for the reasons set out in the Ruling. Paragraph 14 of the Ruling now states that the consideration of the relevant circumstances, without more, points to a likely conclusion that section 177EA could apply.