



# ***TA 2012/3 - Structured financial products that exploit franking credits and other tax benefits***

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# Taxpayer Alert

TA 2012/3

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## **TITLE: Structured financial products that exploit franking credits and other tax benefits**

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*Taxpayer Alerts are intended to be an 'early warning' of significant new and emerging higher risk tax planning issues or arrangements that the Australian Taxation Office (ATO) has under risk assessment, or where there are recurrences of arrangements that have been previously risk assessed.*

*Taxpayer Alerts provide information that is in the interests of an open tax administration to taxpayers. Taxpayer Alerts are written principally for taxpayers and their advisers and they also serve to inform tax officers of new and emerging higher risk tax planning issues. Not all potential tax planning issues that the ATO has under risk assessment will be the subject of a Taxpayer Alert, and some arrangements that are the subject of a Taxpayer Alert may on further examination be found not to be of concern to the ATO. In these latter cases, the Taxpayer Alert will be withdrawn and a notification published which will be referenced to that Taxpayer Alert.*

*Taxpayer Alerts give the title of the issue (which may be a scheme, arrangement or particular transaction), briefly describe the issue and highlight the features which are of concern to the ATO. These issues will generally require more detailed analysis to provide the ATO view to taxpayers.*

*Taxpayers who have entered into or are contemplating entering into an arrangement similar to that described in this Taxpayer Alert can seek a formal determination of the ATO's position through a private ruling (noting that the Taxation Administration Act 1953 sets out circumstances where the Commissioner may decline to issue such a ruling). Such taxpayers might also contact the tax officer named in the Taxpayer Alert and/or obtain their own advice.*

*This Taxpayer Alert is issued under the authority of the Commissioner.*

### **Overview**

This Taxpayer Alert describes certain complex highly structured investment products that seek, amongst other things, to transfer franking credits. These products claim to offer investors (the taxpayers) exposure to a portfolio of listed securities and the benefit of franking credits whilst using a derivative instrument to effectively transfer the risk of investing in those securities from investors to the derivative counterparty.

### **Context for the arrangement**

Imputation benefits (including franking credits) may attach to distributions paid by a company. An important principle underlying the imputation system is that imputation benefits should only be available to the true economic owners of the company.

The income tax legislation contains specific measures, as well as a general anti-avoidance provision in section 177EA of the *Income Tax Assessment Act 1936* (ITAA 1936), to prevent abuse of the imputation system through schemes which circumvent the basic rules for the franking of distributions. Under section 177EA of the ITAA 1936, the Commissioner may make a determination to deny imputation benefits where it may be concluded that a party to a scheme participated in the scheme or some part of the scheme for a purpose, other than an incidental purpose, of enabling a taxpayer to obtain an imputation benefit.

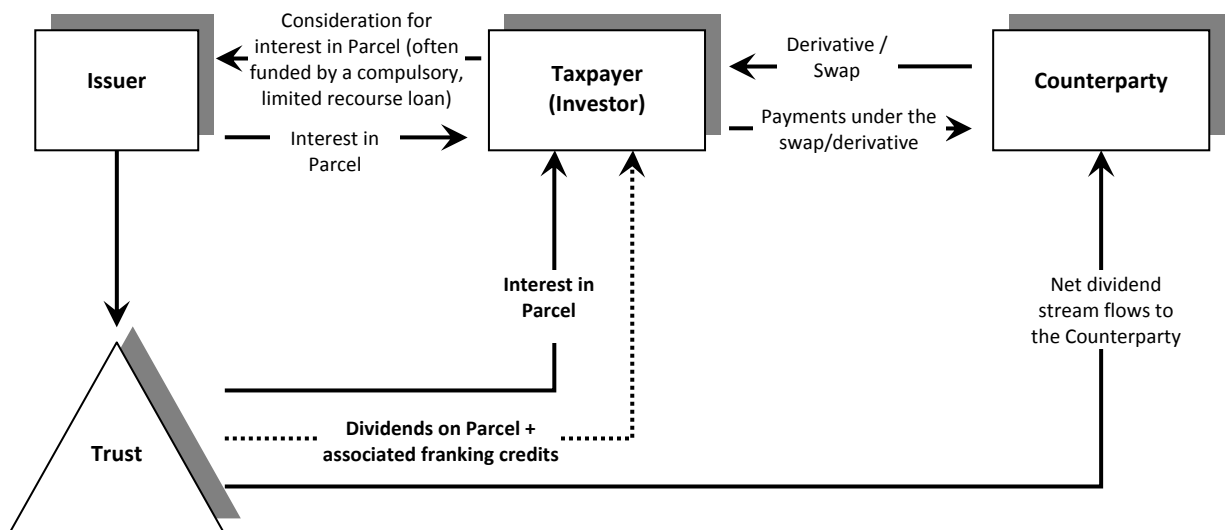
## Description

The alert applies to arrangements with features substantially equivalent to the following:

1. A financial institution or other entity markets an arrangement to taxpayers who are retail or wholesale investors.
2. A taxpayer enters into the arrangement.
3. Once the taxpayer pays the issue price, a parcel of ASX listed securities (the Parcel) is acquired and the legal title to that parcel is held by a custodian or security trustee, or under a similar trust arrangement, on behalf of the taxpayer.
4. The taxpayer also enters into a derivative instrument with the following features:
  - i. The amount of the distributions or other income generated by the Parcel is either diverted by the taxpayer, or the trustee of the trust, to the entity with which the taxpayer, or some other entity acting on their behalf, has entered into the derivative instrument;
  - ii. Under the derivative, the taxpayer may be entitled to a periodic coupon which is calculated by reference to the increase in value of a notional investment in certain reference assets. If the value of those reference assets does not increase during the calculation period, then no coupon will be payable for that period. These reference assets are unrelated to the Parcel.
  - iii. Instead of or in addition to the payment of a periodic coupon, the taxpayer may be entitled to an amount that is payable at the maturity of the investment. This amount may be calculated by reference to the difference between the market value of the Parcel at maturity and the value of a notional investment in a separate portfolio of reference assets. This feature changes the taxpayer's exposure from an exposure to movements in the market price of the securities comprising the Parcel to an exposure to the reference assets.
5. The arrangement may also involve entry into put and call options over the securities comprising the Parcel or other securities that provide the same return as the notional investment. Such options may provide the mechanism to allow the taxpayer or the issuer to exit the arrangement prior to, or at maturity or to protect the invested capital of the taxpayer if they hold their investment to maturity.
6. The taxpayer may be able to exit the investment prior to maturity. However, if this occurs the taxpayer may not receive the benefit of the capital protection mechanism described above in paragraph 5.
7. The taxpayer may also be provided with a loan to fund the investment and, as a result, may incur interest and/or borrowing expenses.

8. In some cases, the entity who marketed the arrangement or an associate who implements the arrangement indicates in marketing documents that certain favourable tax outcomes are available or potentially available to investors, such as:
  - i. franking credits;
  - ii. deductions for payments made by the taxpayer under the derivative; and/or
  - iii. deductions for interest expenses or borrowing costs.
9. The issuer, a custodian or some other entity acting on their behalf issues distribution statements or other documents that reflect favourable tax outcomes for the taxpayer, such as:
  - i. tax offsets in respect of distributions constructively received, but paid to the counterparty under the derivative;
  - ii. revenue deductions for payments made by the taxpayer under the derivative; and
  - iii. deductions for interest or borrowing costs.
10. The taxpayer subsequently claims some or all of the favourable tax outcomes discussed at paragraph 9 in their income tax return.
11. In some cases, there may be differences in implementation of key steps in the arrangement that may affect the potential availability of these favourable tax outcomes, such as failures to transfer the interest in the Parcel or to execute key transactions within the derivative.

### Example of an arrangement form



### Features which concern us

The ATO considers that arrangements of this type give rise to a number of issues relevant to taxation laws, including whether:

- a. the substance of the arrangement provides the investor with exposure to reference assets, even though the form of the arrangement is an investment in the Parcel through a trust;

- b. the deductibility under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) of the amount of any payment made under the derivative reflecting the distributions and other income on the Parcel;
- c. the deductibility under sections 8-1 or 25-25 of the ITAA 1997 of interest or other borrowing expenses incurred by taxpayers under any loan to finance their investment;
- d. for the purposes of former Division 1A Part IIIAA of the ITAA 1936 and Subdivision 207-F of the ITAA 1997, the taxpayer is a qualified person in relation to any distribution paid on the Parcel such that the taxpayer is entitled to tax offsets attaching to those distributions;
- e. paragraph 177EA`ation benefits claimed by the taxpayers in respect of distributions on the Parcel of shares;
- f. other parts of Part IVA of the ITAA 1936 apply;
- g. the assessability of any fee, commission or other amount received by the promoter;
- h. any entity who marketed or otherwise encouraged the growth of the arrangement is a promoter of a tax exploitation scheme for the purposes of Division 290 of Schedule 1 to the *Taxation Administration Act 1953*; and
- i. any taxation statement made by taxpayers in relation to the arrangement may be false or misleading.

**The ATO is currently reviewing these arrangements.**

***The ATO view on the operation of the imputation system and section 177EA is discussed in Taxation Ruling TR 2009/3.***

**Note 1:** *You may have already sought advice from the ATO in respect of your arrangement by way of a private ruling or class ruling. If you have received a private ruling or class ruling in respect of your arrangement, you can rely on that ruling.*

*A private or class ruling is legally binding against the Commissioner who will be bound to act in the way set out in the ruling, even if the ruling is later found to be incorrect. However, a private ruling only applies to a particular entity identified and the particular scheme described in the ruling, for the period the ruling specifies or if no period is specified for the period from when it is made to the end of the accounting period in which it is made. Similarly, a class ruling only applies to a specified class of entities and the particular scheme described in the ruling.*

*If there is a material difference between the scheme described in the ruling, and the scheme that was actually implemented, the ruling will not be legally binding on the Commissioner. Also, other entities cannot rely on a private ruling issued in respect of a different entity or on a class ruling in respect of a class of entities in which they are not included.*

**Note 2:** *If you have received a private ruling in respect of your arrangement, please check that the application of Part IVA of the *Income Tax Assessment Act 1936* is considered in that ruling. The applicant may not have asked for us to rule on the application of Part IVA to the arrangement ruled upon, or to an associated or wider arrangement of which that arrangement is part. If you want us to rule on whether Part IVA applies to your arrangement, we will first need to obtain and consider all the relevant facts about the arrangement, including (if relevant) the manner in which it has actually been implemented.*

- Note 3:** *Base penalties of up to 50% of the tax avoided can apply where Part IVA is applied. Base penalties of up to 75% of the tax avoided can apply where you make a false or misleading statement to the Commissioner. Reductions in base penalty will be available if the taxpayer makes a voluntary disclosure to the ATO. If you have any information about the current arrangement, phone us on **1800 177 006**. Tax agents wanting to provide information about people or companies who may be promoting arrangements covered by this alert should also call **1800 177 006**.*
- Note 4:** *Penalties of up to 5,000 penalty units for individuals, 25,000 penalty units for bodies corporate or up to twice the amount of consideration received or receivable may apply to promoters of tax exploitation schemes under Division 290 of Schedule 1 to the Taxation Administration Act 1953. The current value of a penalty unit is \$110. The Commissioner can also apply to the Federal Court of Australia for restraining and performance injunctions against promoters where prohibited conduct has occurred, is occurring or is proposed.*
- Note 5:** *In appropriate cases possible sanctions under criminal law may also apply. Where a taxpayer makes a voluntary disclosure and that disclosure indicates possible criminal offences, the Commonwealth Director of Public Prosecutions has indicated that favourable consideration will be given to granting an indemnity from criminal prosecution in relation to the taxpayer's involvement in the scheme where:*
- *the case does not exhibit a significant degree of criminality by the taxpayer*
  - *the taxpayer provides information about how the arrangements worked, including the role and identity of the promoter, and*
  - *the taxpayer co-operates with the investigation and consequential proceedings.*
- Note 6:** *Where appropriate, section 167 of the ITAA 1936 may be used to determine the amount of taxable income upon which the taxpayer should be assessed, see Law Administration Practice Statements, PS LA 2007/7 and PS LA 2007/24.*
- Note 7:** *The Commissioner may amend an assessment at any time where he is of the opinion there has been fraud or evasion. See Law Administration Practice Statement PSLA 2008/6.*
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## References

### *Subject references:*

- capital protected borrowing
- financial products
- interest expense
- interest income
- prepaid expenses
- product rulings
- public rulings
- taxation administration

### *Legislative references:*

#### *Income Tax Assessment Act 1936*

- [Section 51AAA](#)
- [Section 51\(1\)](#)
- [Division 6 Part III](#)

- [Former Division 1A Part IIIA](#)
- [Part IVA](#)
- [Section 177EA](#)

*Income Tax Assessment Act 1997*

- [Section 8-1](#)
- [Section 25-25](#)
- [Division 110](#)
- [Division 207](#)
- [Subdivision 207-B](#)
- [Subdivision 207-F](#)
- [Division 247](#)

*Taxation Administration Act 1953*

- [Division 290](#)

*Related Practice Statements:*

- [PS LA 2005/24](#)
- [PS LA 2008/15](#)

*Related Rulings & Determinations:*

- [IT 2050](#)
- [IT 2682](#)
- [TR 95/33](#)
- [TR 2009/3](#)

*Case references*

- *Mills v Commissioner of Taxation* [2011] FCAFC 158; 2011 ATC 20-295

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Authorised by:	<b>Tim Dyce</b> Deputy Commissioner Aggressive Tax Planning (ATP)
Contact Officer:	<b>Bruce Collins</b> Assistant Deputy Commissioner Financial Products Taskforce Leader Aggressive Tax Planning (ATP)
Business Line:	Financial Products Taskforce
Section:	Financial Products Taskforce
Phone:	(02) 6216 2710

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