

# ***TR 2009/3 - Income tax: application of section 177EA of the Income Tax Assessment Act 1936 to non-share distributions on certain 'dollar value' convertible notes***

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## Taxation Ruling

### Income tax: application of section 177EA of the *Income Tax Assessment Act 1936* to non-share distributions on certain 'dollar value' convertible notes

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This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

## What this Ruling is about

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1. This Ruling considers the application of section 177EA of the *Income Tax Assessment Act 1936* (ITAA 1936)<sup>1</sup> to arrangements involving certain 'dollar value' convertible notes that are non-share equity interests.

### **Class of entity/arrangement**

2. This Ruling is concerned with arrangements where a company issues a certain type of 'dollar value' convertible note. These notes are classified as non-share equity interests by application of Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997), essentially because the issuer may choose to convert the notes into ordinary shares that are equity interests in the issuer rather than to repay the issue price. The notes are expected to yield frankable periodic returns that are non-share dividends in the legal form of interest.

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

3. These 'dollar value' convertible notes exhibit all of the following features:
- (a) The commercial effect of each note is that a holder has negligible exposure to the equity risks and opportunities that are usually associated with holding shares that are equity interests in the issuing company. The holders of these notes are not exposed to the usual equity risks and opportunities because the issuer must either return the issue price at maturity or provide equivalent shares under a 'dollar value' conversion condition. Under this conversion condition, if the issuer decides that it will not return the issue price of a note to the holder at maturity, the issuer must instead convert the note into a number of shares that have a combined value equal to the issue price of the note, plus perhaps a small conversion discount. The number of shares is calculated by dividing the face value of the note by a measure of the market price (possibly less the small discount) at the time of conversion. Subject to the marginal effect of any conversion discount, the value of any shares that the holder would receive instead of the repayment of the issue price of the note will therefore only equal the issue price of the note. The shares into which the notes might convert are expected to be liquid and readily realisable. Under the terms and conditions of issue, the promised return of the issue price or the equivalent value in shares gives the holder no prospect of any substantial gain or loss on the nominal amount of the initial investment. Prior to conversion, the convertible notes can be seen as a source of contingent share capital for the issuer.
  - (b) The issuer is obliged to pay periodic returns and is expected to fully frank the periodic returns on the note.
  - (c) The holder's right to the payment of the periodic returns is not dependent on the issuer having profits available to pay the return. The cash component of the periodic return to be paid on the note is calculated by reference to the value of the expected franking credit that is to be attached. If a return is not fully franked, the issuer must pay an additional cash amount to the holder calculated according to the extent to which the return is unfranked.
  - (d) The periodic return on the note is equivalent to an amount of interest (or an amount in the nature of, or similar to, interest), having regard to the way in which those returns are calculated.

The notes and the circumstances of their issue also exhibit some of these features:

- (e) Until repayment of the face value of the note or conversion of the note into shares of the issuer (or a connected entity), the note ranks ahead of the issuer's ordinary or other shares but equally with other unsecured, unsubordinated debts of the issuer.
- (f) The periodic return is expressed by reference to a recognised market rate (such as a bank bill swap rate) plus a margin.
- (g) The holder may request that the issuer repay the face value of the note, although the issuer is under no obligation to do so.
- (h) The issuer may replace the note with an ordinary debt instrument.
- (i) The arrangement is to remain on foot for a finite period, usually around 5 years.
- (j) The issuer will have franking credits it is unable or unlikely to use in the foreseeable future.
- (k) The note is issued at or through a branch of the issuer in a jurisdiction that considers such notes to be debt instruments, and the issuer receives a deduction on revenue account in that jurisdiction for the periodic payments.
- (l) Non-payment of a periodic amount of interest by the issuer entitles the holder to demand payment from the issuer of the outstanding principal amount and all outstanding interest, and the issuer cannot satisfy this demand by issuing shares.
- (m) The notes are specifically targeted to investors who are able to fully use the franking credits that the parties expect will be attached to the interest payments on the notes, and the notes may be privately placed.

There may also be circumstances peculiar to the position of particular issuers and holders that will be relevant (and in some cases decisively relevant) but which are not included in this general description. The general observations in this Ruling must be understood as subject to the qualification that they are made with respect to incompletely described schemes and are not intended to be conclusive of the way the law will apply to schemes having further relevant features.

4. This Ruling applies to taxpayers that are issuers or holders of the convertible notes described above if the holders would obtain or might reasonably be expected to obtain an imputation benefit from a non-share distribution in respect of those convertible notes.

## Ruling

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5. Section 177EA of the ITAA 1936 could potentially apply to any scheme for the issue of a convertible note if:

- (a) the convertible note is characterised as an equity interest under Division 974 of the ITAA 1997;
- (b) the periodic return on the note is a non-share dividend that is a frankable distribution under section 202-40 of the ITAA 1997; and
- (c) the periodic return on the note is franked, or is expected to be franked.

6. Division 974 of the ITAA 1997 (the debt/equity rules) may classify an interest on which periodic returns are paid as a debt interest or an equity interest. However, the tax treatment of those returns is not determined conclusively by that classification. The treatment of the returns is also determined by the operation of other provisions of the Act, including the anti-avoidance provisions. The franked periodic interest returns that are paid to a holder of the convertible notes that are described in paragraph 3 of this Ruling are not outside the potential operation of section 177EA of the ITAA 1936 merely because the note has been classified by the debt/equity rules as equity (that is, as a non-share equity interest), and the issuer must frank the distributions on that interest.

7. Section 177EA is not limited to countering only those abuses of the imputation system that had been specifically identified when the section was introduced. The provision applies broadly according to its own terms and for its own purposes.

8. Subsection 177EA(3) is the basic application provision of section 177EA. A scheme for issuing the convertible notes described in paragraph 3 of this Ruling is a scheme for a disposition of membership interests in a corporate tax entity (paragraphs 177EA(3)(a) and 177EA(14)(a); subsection 177EA(12)). But for the application of section 177EA, the holder of these notes could reasonably be expected to receive an imputation benefit as a result of a franked distribution (paragraphs 177EA(3)(b), 177EA(3)(c) and 177EA(3)(d)).

9. The question that remains to be considered is whether any person who entered into or carried out the whole or part of a scheme for a disposition of membership interests – in this instance, the issue of these convertible notes – did so for a purpose that was other than an incidental purpose of enabling the holders to obtain imputation benefits (paragraph 177EA(3)(e)). This purpose does not have to be a sole or dominant purpose of any party.

10. The relevant conclusion of purpose in relation to the issue of these convertible notes is an objective conclusion that is to be drawn from the relevant circumstances of the scheme. These circumstances include, but are not limited to, the circumstances set out in subsection 177EA(17), and these include the factors listed in paragraph 177D(b). The relevant circumstances may individually or collectively indicate the requisite purpose. The finding of purpose that is required before section 177EA can apply may be drawn even if some of the listed circumstances do not apply to a particular scheme.

11. In forming the relevant conclusion it is to be emphasised that the question is not answered by asking whether the relevant instrument is 'too debt-like'. Section 177EA may apply to instruments that are highly equity-like. Nor does section 177EA apply to instruments classified as equity interests merely because the instrument is debt or has features associated with debt. Rather, the question is whether the instrument is issued on particular terms, that is, in a particular form or shape, by the particular issuer to particular holders in circumstances from which a reasonable person (having regard to the relevant matters under subsection 177EA(17)) would infer that obtaining an imputation benefit is more than an incidental purpose of at least one of the participants in the scheme. Thus the enquiry requires regard to be had to more than the nature of the instrument. In particular it requires regard to be had to the circumstances of the holders (and other holders of equity interests in the issuer) to determine their appetite for imputation benefits, as well as to the circumstances of the issuer, especially to the state of its franking account. A debt-like instrument, or other arrangement with little or minimal 'equity risk', will be significant because it is a common (but not invariable) indicator that a participant in a scheme is concerned with the obtaining of an imputation benefit for its own sake, and not simply incidentally to the usual purposes attending an equity investment. The circumstance that an instrument is very debt-like but secures an imputation benefit may, *with other matters*, indicate that the instrument has been cast in its particular form and issued by its issuer to its holders substantially to enable imputation benefits to be obtained.

12. The following general observations can be made about the scheme for the issue of these 'dollar value' convertible notes in the absence of consideration of circumstances peculiar to particular issuers and holders. These matters are the most relevant circumstances in the instant arrangements that support the application of section 177EA:

- (a) The convertible note is structured as a frankable equity interest for tax purposes by including the issuer's option to convert (the only element in the instrument that has this result) but limits the holder's exposure to the substantial risks or opportunities usually associated with investing as an equity owner in a company.

Although the issuer's option to convert is the only equity element in the instrument, there is no opportunity for any substantial gain or loss by the holder on any conversion of each note because of the terms of the 'dollar value' conversion condition, and returns do not depend on profits. The ranking of the notes in the event of financial distress of the issuer further limits the risk of loss. This is important because tax is imputed to equity holders for the reason that they are conceived to be the owners of the company, and therefore, to bear the cost of the tax paid by the company. The absence of ownership risk and opportunity points to the conclusion that the note holders as such do not share in the economic ownership of the company (paragraph 177EA(17)(a) and subparagraphs 177D(b)(i) and 177D(b)(ii) refer to these circumstances). From the issuer's perspective (the only person who might seek to obtain non-tax advantages by the option) non-tax advantages are obtained only if very unlikely events occur. See further at subparagraph 12(f) of this Ruling.

- (b) The interest payments are non-share dividends. However, unlike periodic dividends that are declared in the ordinary case, the interest returns are not contingent on the issuer having profits. The returns are in the legal form of interest. The amount of the non-share dividend that must be paid is calculated by reference to market rates of return on moneys lent. The expected cash component of the return to be paid by the issuer is less than the market costs of lending money. The value of the expected imputation benefit provides the remaining part of the return that is required to achieve the market rate of return (paragraphs 177EA(17)(f) and 177EA(17)(h); subparagraphs 177D(b)(i), 177D(b)(vi) and 177D(b)(vii)).
- (c) The holders are expected to derive greater benefits from the likely franking credits than some other members of the company (for example, any non-resident shareholders) that are the true economic owners of the company (paragraph 177EA(17)(b)).
- (d) But for the expected franked periodic payments on the convertible notes issued under this scheme, the issuers of these notes would expect to have a surplus of franking credits, having regard to their anticipated franking requirements. But for these payments, it is likely that those franking credits would remain undistributed in the issuer's franking account (paragraph 177EA(17)(c)).

- (e) The effect of franking these returns means that the issuer may be able to use the franking benefits to reduce its cost of capital in a way that is more than incidental to the circumstance that the instrument is an equity interest. For example, additional reductions in the cost of capital might be available where the instrument is to be issued in some foreign jurisdiction where the payments are treated as interest returns on debt for which an income tax deduction is available. In other circumstances, an issuer with distributable profits could have tax losses and a large franking account surplus: paying a lower cash amount as a franked distribution on the convertible notes that are the subject of this Ruling would be of greater benefit to that taxpayer than a tax deduction for a greater cash amount of interest (subparagraphs 177D(b)(i), 177D(b)(vi) and 177D(b)(vii); paragraphs 177EA(17)(c) and 177EA(17)(h)).
- (f) Although the only element in the instrument securing equity classification, and hence the imputation benefit, is the issuer's option to convert, the likelihood of conversion is very low (albeit not unreal) and the non-tax advantages to the issuer of including the option are consequently small, whereas the tax advantages are very significant, suggesting that the explanation for the inclusion of the option is obtaining imputation benefits. Comparable instruments lacking the option may be issued by the issuer to the same market, particularly when the moneys raised by the instrument are not employed in a branch. This in turn implies that the option is included for purposes, including the purpose of securing equity classification, with a view to holders obtaining franking benefits.
- (g) Finally, where the moneys raised by the issue of the instrument are employed as the capital of a foreign branch, the income of which is not assessable income, and the non-share dividends are effectively connected with that branch, the distribution may be seen to be sourced from untaxed profits (paragraph 177EA(17)(ga)). The availability of franking credits to frank such distributions (which might be expected to be used to frank distributions of taxed profits) suggests a surplus of franking credits which might otherwise be 'wasted'.

### **Drawing the conclusion**

13. The application of section 177EA to a particular scheme depends upon a careful weighing of all the relevant facts and surrounding circumstances. In the absence of all relevant information, it is not possible to state definitively whether a particular scheme will attract section 177EA.



14. However, the consideration of the relevant circumstances (at paragraph 12 of this Ruling), without more, points to a likely conclusion that at least one of the persons who entered into or carried out the scheme or part of the scheme, for the issue of the 'dollar value' convertible notes described in paragraph 3 of this Ruling, did so for a more than incidental purpose of enabling the holder to obtain an imputation benefit. The relevant person or persons that participated in the scheme, or part of the scheme, for that purpose are likely to be the issuer and/or the holder. This conclusion of purpose can be drawn even if it is clear that the person or persons also had some other commercial purpose or purposes in entering into the scheme, as long as the purpose of obtaining an imputation benefit was not a merely incidental purpose.

#### **The consequences of a determination made under section 177EA**

15. Where section 177EA applies to the instant arrangements, the Commissioner may make a determination under subsection 177EA(5) that a franking debit is to arise in the franking account of the issuer in respect of each interest payment made under the notes, or alternatively, that the imputation benefits are to be denied to the note holders.

16. The Commissioner would exercise the discretion having regard to the action that would be most effective in countering the mischief of a particular scheme. It would be relevant to consider the number of holders that would receive the imputation benefits under the scheme and whether the issuer has a surplus in its franking account.

17. Where the Commissioner initially makes a determination to post a debit to an issuer's franking account and the issuer persists with the arrangement (perhaps because of a surplus of franking credits), the Commissioner may deny imputation benefits to investors in respect of subsequent non-share distributions.

#### **Date of effect**

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18. This Ruling applies to years of income commencing both before and after its date of issue. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

## Appendix 1 – Explanation

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**❶** *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

### Overview of section 177EA

19. Section 177EA is a general anti-avoidance rule that is intended 'to prevent abuse of the imputation system through schemes which circumvent the basic rules for the franking of dividends'.<sup>2</sup>

20. Imputation benefits represent the tax paid by a company on its profits for the benefit of all its owners. Two of the basic principles of the imputation system are that imputation benefits are only to be available to the true economic owners of the company to the extent that those owners are personally able to use those franking credits, and that those true economic owners of the company are to have the tax paid at the company level imputed to them in proportion to their ownership of the company.<sup>3</sup> A consequence of these principles is that an element of 'wastage' of franking credits is an intended feature of the tax system. 'Wastage' for this purpose includes prolonged deferment of use of franking credits (including cases where distribution of profits to economic owners is deferred because profits are reinvested). Deliberate strategies to prevent wastage by diverting imputation benefits from the true economic owners of a company undermine the principles of the imputation system.

21. Measures to counter practices that would undermine the principles of the imputation system were announced by the Treasurer on 13 May 1997. Broadly, the most obvious abuses involved a party – an owner of the company or the company itself – that could not directly realise the fullest economic advantages of imputation benefits, entering into an arrangement in relation to the benefits with another party that could better enjoy those benefits. There would typically be advantages to both parties under this arrangement. The second party would not have a true interest in the economic ownership of the company, or if it did, would receive imputation benefits by virtue of the arrangement that were disproportionate to its real ownership interests.

22. A suite of specific measures was enacted by *Taxation Laws Amendment Act (No. 3) 1998* to address identified practices. However, it was recognised that the specific measures might be unable to deal with any other arrangements that avoided those rules while similarly undermining the principles of the imputation system.<sup>4</sup>

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<sup>2</sup> Paragraph 2.3 of the Supplementary Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 1998 (the Supplementary EM).

<sup>3</sup> See, for example, paragraph 8.5 of the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 1998 (the EM).

<sup>4</sup> See, for example, paragraphs 8.126 and 8.136 of the EM.

23. Accordingly, section 177EA was 'intended to be a 'catch-all' provision to deal with schemes not otherwise prevented' by the more specific rules.<sup>5</sup> Section 177EA was also introduced by *Taxation Laws Amendment Act (No. 3) 1998* as a general anti-avoidance rule and applies broadly according to its terms.

24. Section 177EA can only apply if, but for its application, a relevant taxpayer would receive or could reasonably be expected to receive an imputation benefit, and other conditions specified in subsection 177EA(3) are satisfied. Where these conditions are satisfied, the Commissioner has a discretion to either cancel the imputation benefits that would otherwise arise for the relevant taxpayer that receives a franked distribution, or (in certain circumstances) to make a franking debit determination for a corporate tax entity that makes a franked distribution.

25. Whether or not section 177EA applies turns largely on whether it would be concluded by reference to relevant circumstances that a party to an identified scheme participated in the scheme or some part of the scheme for a more than incidental purpose of enabling a relevant taxpayer to obtain an imputation benefit.

### **Mere acquisitions**

26. When first enacted, section 177EA applied to a scheme for a disposition of shares or an interest in shares. At that time, franking credits could only be allocated by a company to returns that were distributions on a share in a company. Note that certain interests were deemed to be shares in a company: former subsection 177EA(12). A scheme for a disposition of shares included issuing shares.

27. It is important to recognise that by virtue of subsection 177EA(4), the mere acquisition of membership interests by a person would not of itself support a conclusion that would fall within paragraph 177EA(3)(e) about that person's purpose. This would be so even if, for example, the person acquired the interests cum dividend and the declared dividends were to have franking credits attached. Without other relevant circumstances, the *prima facie* conclusion that the person acquired the membership interests for the purpose of taking on the risks and opportunities of the ownership of the company, and that any imputation benefits are a mere incident of that, will not be displaced. However, subsection 177EA(4) is only relevant in considering the purpose of the person that acquired the membership interests. It does not affect the conclusion that can be drawn about any purpose of other parties to the scheme. The requirements of subsection 177EA(3) would be satisfied if the consideration of all the relevant circumstances led to the conclusion that some other party had a sufficient purpose of enabling the acquirer of the interests to obtain an imputation benefit. This could happen if, for example, the issuer of a membership interest constructed the interest in a particular way to ensure the delivery of imputation benefits to the holder.

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<sup>5</sup> Paragraph 2.3 of the Supplementary EM.

**Holding interests at risk in the ordinary way**

28. Paragraph 8.64 of the EM notes as follows:

The mere acquisition of shares or units in a unit trust where the shares or units are to be held at risk in the ordinary way, will not, in the absence of further features, attract the rule, even though the shares or units are expected to pay franked dividends or distributions.

29. The observations at paragraph 20 of this Ruling indicated the significance of economic ownership and are consistent with the above extract from the EM. Shares that are held at risk in the ordinary way will necessarily expose the holder to some risks or opportunities of ownership of an entity. The EM and the Supplementary EM focus attention at various points on shares or interests in shares, which of their nature are interests in the ownership of the company, being held at risk 'in the ordinary way'. Holding shares ordinarily exposes the holder to the risks and rewards that are ordinary incidents of participating in the ownership of a company.<sup>6</sup>

30. Paragraph 2.5 of the Supplementary EM notes that 'it may be possible to predicate a purpose of tax avoidance' if 'the relevant circumstances are attended with artificiality or contrivance, contain uncommercial features or appear to stultify the real purpose of share ownership'.

31. A scheme could be susceptible to the application of section 177EA if a party receives or expects to receive an imputation benefit from holding some interest in a company in circumstances where that party will not thereby have any of the relevant risks or opportunities that would ordinarily attend ownership interests in the company.

32. The principles of the imputation system can also be undermined by a scheme that involves issuing a membership interest on which imputation benefits are to be delivered if that interest is designed to deliver imputation benefits to a party, without that party having any of the risks and opportunities of ownership of the relevant entity from the time of issue. At the time of enactment of section 177EA, examples of both kinds of mischief were to be found: preference shares issued by loss companies with franking credits on debt-like terms, carrying interest-like dividends at less than the prevailing rate (where the imputation benefit supplied the deficiency) was one example; and the legal transfer of ordinary shares on terms that the shares were to be re-transferred without loss or gain apart from the imputation benefit was another.

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<sup>6</sup> See also for example paragraph 8.76 of the EM and paragraph 2.5 of the Supplementary EM.

33. The first condition for the application of section 177EA is that there is a scheme for a disposition of membership interests, or of an interest in membership interests, in a corporate tax entity: paragraph 177EA(3)(a).

34. Because a scheme for a disposition of membership interests specifically includes a scheme that involves issuing the membership interest (paragraph 177EA(14)(a)), the application of section 177EA is not confined to schemes that are entered into after the issue of membership interests. That is, it is not confined to the sort of scheme where, for example, the risks and opportunities of real ownership that attach to a membership interest effectively remain with others while imputation benefits on that interest are delivered to another party that is the 'relevant taxpayer'.

### **Section 177EA and the debt/equity rules**

35. Section 177EA was introduced in 1998 and the debt/equity rules were introduced in 2001. The fundamental role of section 177EA – that is, to protect against any abuses of the imputation system that were not addressed by more specific measures – was not changed on the introduction of the debt/equity rules. 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. Thus, section 177EA will apply in appropriate circumstances to a scheme for a disposition of membership interests that are classified as equity interests under the debt/equity rules. See further at paragraph 46 of this Ruling.

36. The Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 (the debt/equity EM) noted the context in which the debt/equity rules were to operate. The debt/equity EM emphasised the significance in the tax law of the differential tax treatment of returns to shareholders of a company and returns to debt holders:

1.5 Shareholders of a company receive dividends – which may be franked (that is, they may carry imputation credits representing underlying company tax which may be used to reduce the shareholders' tax) but which are not deductible to the company making the dividend. By paying franked dividends a company can ensure that, for the most part, its profits are ultimately taxed at its shareholders' marginal tax rates. Creditors, on the other hand, receive returns which cannot be franked but which are usually deductible to the company.

1.6 This differential tax treatment is fundamental to the tax law. It recognises the fundamental difference between the equity holders of a company, who take on the risks associated with investing in the activities of the entity, and its creditors, who, as far as possible, avoid exposure to that risk.

37. The debt/equity rules were designed in recognition of the significance of these differences. The first object of the debt/equity rules is to establish a test for determining whether a scheme gives rise to a debt or equity interest for certain taxation purposes: subsection 974-10(1) of the ITAA 1997. The note to that subsection explains that one of the uses of the tests is to identify 'distributions that may be frankable'.

38. In very broad terms, the debt/equity rules will characterise a financing arrangement as a debt interest if, after having regard to the pricing, terms and conditions of the arrangement, it is sufficiently certain that the issuer must, as a matter of substance or effect, repay the amount received on issue of the interest. The test for a debt interest is performed from the issuer's perspective at the time that the interest is first issued.<sup>7</sup> The return paid on a debt interest is potentially deductible to the issuer.

39. Equity interests are interests that are not debt interests and (again, in broad terms) have one or more specified features that are matters of form.<sup>8</sup> The classification of an interest as equity by the debt/equity rules does not turn on whether or not the holder of the interest has any of the risks or opportunities that are usually held by a party that has an interest in the economic ownership of the entity.

40. Under the debt/equity rules, a non-share equity interest in a company is an equity interest that is not solely a share.<sup>9</sup> A convertible note issued by a company will be a non-share equity interest in that company if it is not a debt interest and the holder has a right under the note to be issued with an equity interest in the company, or the note will or may convert into an equity interest in the company.<sup>10</sup>

41. An interest can be an equity interest (or a non-share equity interest) under the debt/equity rules if it is designed with specific features that ensure that it fails the debt test and satisfies the equity test. This does not suggest that such an interest would be designed with some mischief in mind. On the contrary, companies are generally free to design their financing arrangements so that they fall on a preferred side of the debt/equity borderline. However, the consequences of the classification that is achieved under the debt/equity rules – such as the availability of deductions or imputation benefits on returns – are subject to the operation of other provisions of the tax law.

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<sup>7</sup> Section 974-20 of the ITAA 1997.

<sup>8</sup> Sections 974-70 and 974-75 of the ITAA 1997.

<sup>9</sup> Subsection 995-1(1) of the ITAA 1997.

<sup>10</sup> Subsection 974-70(1) and item 4 of subsection 974-75(1) of the ITAA 1997.

42. That is, the return paid on a convertible note that is a non-share equity interest will potentially deliver imputation benefits to the holder. Whether or not the holder is entitled to those benefits is subject to the operation of provisions outside the debt/equity rules. Similarly, a return paid on a debt interest (including a convertible note that is a debt interest) will only be deductible to the issuer subject to the operation of relevant provisions (including anti-avoidance rules) that are outside the debt/equity rules.

43. It was noted earlier that section 177EA originally applied to shares and interests in shares. On the introduction of the debt/equity rules, a new subsection (present subsection 177EA(12)) was introduced to ensure that section 177EA could apply to a scheme for a disposition of a non-share equity interest in the same way that it applied to a scheme for a disposition of shares (the term 'membership interests' was subsequently substituted for the term 'shares').

44. The debt/equity EM recognises in various places that a return paid on interests classified as non-share equity interests by the debt/equity rules may be subject to the anti-avoidance rules, including section 177EA, that are intended to protect the imputation system.<sup>11</sup> The return paid on a convertible note that is a non-share equity interest is therefore not outside the potential operation of section 177EA merely because the issuer must frank the distributions on the note as a consequence of the note's classification as an equity interest by the debt/equity rules. Section 177EA applies on its own terms. It requires an enquiry into 'relevant circumstances' for its own purposes. This enquiry allows consideration of a much broader range of matters than the tests in the debt/equity rules and is undertaken for a different purpose.

45. The application of the gross-up rules and the availability of tax offsets referable to the franking credit on the interest payments on these notes are also subject to the rules in Division 207 of the ITAA 1997. In particular, Subdivision 207-F of the ITAA 1997 can apply to cancel the ordinary operation of the gross-up and tax effect rules if the imputation system has been manipulated in an impermissible manner.<sup>12</sup> Section 207-145 of the ITAA 1997 specifically operates to cancel these consequences if the Commissioner has made a determination under paragraph 177EA(5)(b) of the ITAA 1936.

<sup>11</sup> See, for example, paragraphs 2.85 and 2.117 to 2.119 of the debt/equity EM.

<sup>12</sup> Section 207-140 of the ITAA 1997.

46. The enactment of Division 974 of the ITAA 1997 made no change to the policy or legal operation of section 177EA of the ITAA 1936. The section simply operates with respect to any arrangement that confers an imputation benefit, and except in the obvious sense that an interest must be classified as an equity interest before imputation benefits may attach to a distribution in respect of it, the section 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) of the ITAA 1936, which are designed to direct attention to inappropriate use of franking credits. Before the enactment of the Division, section 177EA of the ITAA 1936 would not apply, for example, to an issue of preference shares simply because the shares were issued on terms that carried an interest-like franked dividend,<sup>13</sup> but generally did apply if a loss company issued such shares on terms under which surplus or otherwise unusable imputation benefits supplied a portion of a market rate of interest to persons without any real economic ownership of the company. Likewise, after the enactment of the Division, a debt for accounting purposes or in legal form that is classified as an equity interest under Division 974 of the ITAA 1997 does not attract the operation of section 177EA of the ITAA 1936 simply because the return on it is interest, but may do so in similar circumstances to those in which section 177EA of the ITAA 1936 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.

47. If an interest in a company is designed to be an equity interest under Division 974 of the ITAA 1997, when that interest is to deliver imputation benefits while ensuring that the holder will not be exposed to the risks and opportunities of investing in the activities of the company, a question is raised about the appropriateness of the holder receiving those benefits. Those features ‘appear to stultify the real purpose’ of the ownership of equity.<sup>14</sup> If the enquiry into the respective appetites of issuer and holder for imputation benefits demonstrates avoidance of intended wastage of franking credits, a substantial purpose of obtaining imputation benefits may be inferred. The purposes of the parties to that sort of scheme will be particularly questionable if the parties also agree on a promised cash component of the return on the investment that by itself is less than a market rate of return, and there is no promise of compensatory equity opportunities apart from the expected delivery of imputation benefits. Where a ‘dollar value’ convertible note presents with these features, it should be expected that the purposes of the parties to the scheme would be considered under section 177EA of the ITAA 1936.

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<sup>13</sup> Some so-called debt dividends were not frankable. Section 177EA was nevertheless capable of applying to other debt-like dividends.

<sup>14</sup> See paragraph 30 of this Ruling.



48. It is important to note that a convertible note that is the subject of this Ruling is not effectively reclassified for the purposes of the debt/equity rules if a determination is made under section 177EA of the ITAA 1936 in respect of any returns of interest. The note will remain an equity interest for the purposes of Division 974 of the ITAA 1997, and periodic interest returns on the notes will continue to be frankable, but any determination under subsection 177EA(5) of the ITAA 1936 will have effect according to its tenor.

### **The application of section 177EA to these 'dollar value' convertible notes**

49. The first requirement of subsection 177EA(3) is that there is a scheme for a disposition of membership interests, or an interest in membership interests, in a corporate tax entity: paragraph 177EA(3)(a). It was noted earlier that paragraph 177EA(14)(a) specifically provides that a scheme for a disposition of membership interests includes issuing the membership interests. It follows that issuing a convertible note that is a non-share equity interest is a scheme for a disposition of a relevant interest, and will satisfy paragraph 177EA(3)(a).

50. Under the terms and conditions of the convertible notes that are the subject of this Ruling, it is expected that a frankable distribution will be paid to the note holder as periodic interest, and that the distribution will be a franked distribution, and that the holder could reasonably be expected to receive (but for the application of section 177EA) an imputation benefit as a result of the distribution. In these circumstances, paragraphs 177EA(3)(b), 177EA(3)(c) and 177EA(3)(d) will also be satisfied.

51. Paragraph 177EA(3)(e) remains to be considered. The requirements of that paragraph will be satisfied if:

...having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain an imputation benefit.<sup>15</sup>

### **The element and degree of 'purpose'**

52. The application of section 177EA to these 'dollar value' convertible notes turns on whether, after consideration of the relevant circumstances, it would be concluded that a person who entered into or carried out the scheme or any part of the scheme for the issue of the notes did so for a more than an incidental purpose of enabling the holder to obtain an imputation benefit.

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<sup>15</sup> Paragraph 177EA(3)(e).

53. Section 177EA may apply where only one of the parties to the scheme for the issue of these notes has such a purpose, regardless of whether that person is to receive the imputation benefits under the scheme. While each of the parties to the scheme might have a number of purposes in entering into the scheme, it is sufficient that any of those parties has the relevant purpose.

54. This level of purpose may co-exist with other commercial purposes of those parties, even if one of those other purposes is their dominant purpose. The EM notes as follows:

A purpose is an incidental purpose when it occurs fortuitously or in subordinate conjunction with another purpose, or merely follows another purpose as its natural incident. For example, when a taxpayer holds shares in the ordinary way to obtain the benefit of any increase in their share price and the dividend income flowing from the shares, a franking credit benefit is generally no more than a natural incident of holding the shares, and generally the purpose of obtaining the benefit simply follows incidentally a purpose of obtaining the shares: it is therefore merely an incidental purpose.

On the other hand, if a taxpayer, being a company, entered into a scheme involving the disposition of shares for the immediate purpose of obtaining a tax advantage for itself (for example, one deriving from an allowable deduction and the inter-corporate dividend rebate) and another, substantial, purpose of obtaining franking credits (which will ultimately benefit its shareholders), the fact that the taxpayer may regard the immediate benefit of the first tax advantage as more important than the deferred benefit of obtaining the franking credits does not mean that the second purpose is merely incidental to the first.<sup>16</sup>

55. The Supplementary EM adds as follows:

... while new section 177EA does not require the purpose of obtaining the franking benefit to be the ruling, most influential or prevailing purpose, neither does it include any purpose which is not a significant purpose....<sup>17</sup>

56. The consideration of purpose required by section 177EA is the consideration of the objective purpose of any of the parties to the scheme.<sup>18</sup> This consideration is not concerned with the motives of individuals or their actual subjective intentions. It requires an examination of the scheme itself in light of the relevant circumstances, including in particular, the factors set out in subsection 177EA(17), to determine whether it would be concluded that any of the parties to the scheme had the relevant purpose.<sup>19</sup>

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<sup>16</sup> See paragraphs 8.76 and 8.77 of the EM.

<sup>17</sup> See paragraph 2.6 of the Supplementary EM.

<sup>18</sup> See paragraphs 8.74 and 8.75 of the EM.

<sup>19</sup> See paragraph 2.4 of the Supplementary EM.

57. The proper approach to the finding of purpose has been explained by the Courts in considering the tests in paragraph 177D(b).<sup>20</sup> That approach was also adopted by Cooper J in applying the test in section 177EA in *Electricity Supply Industry Superannuation (Qld) Ltd v. Deputy Commissioner of Taxation (ESI Super)*.<sup>21</sup>

58. In *ESI Super* Cooper J also accepted that the fact that the parties to the scheme may also objectively be found to have other commercial purposes does not mean that the purpose required by paragraph 177EA(3)(e) will not co-exist. His Honour drew on authority dealing with the operation of section 177D to find as follows:

The fact the trustee of the QT and the Trustee on behalf of ESI Super, as parties to the scheme, made investment and trust management decisions on a proper commercial basis, for a proper commercial purpose and to achieve the long term commercial objectives of the QT and ESI Super, does not mean that they, or either of them, did not also have, as a not incidental purpose, a purpose that in carrying into effect the scheme ESI Super would obtain a franking credit benefit: *Spotless Services Ltd* at ATC 5206; CLR 415-416.<sup>22</sup>

### **The relevant circumstances of a scheme**

59. Subsection 177EA(17) affects the meaning of 'relevant circumstances' that are to be considered in drawing any conclusion of purpose.<sup>23</sup> Significantly, the subsection does not attempt to provide an exhaustive list of relevant circumstances, and the Commissioner is also to consider the eight factors listed in paragraph 177D(b).

60. Because there is not an exhaustive definition of the meaning of 'relevant circumstances,' the necessary conclusion of purpose could be supported by some circumstance that is not specifically listed in subsection 177EA(17). Conversely, in a particular scheme there could be a relevant circumstance that is not listed in that subsection that, properly considered, weighs against drawing that conclusion of purpose (see also the discussion at paragraphs 123 to 128 of this Ruling).

<sup>20</sup> See, for example, *Federal Commissioner of Taxation v. Spotless Services Ltd* (1996) 186 CLR 404 at 421; (1996) 141 ALR 92; 96 ATC 5201; (1996) 34 ATR 183; *Federal Commissioner of Taxation v. Hart* [2004] HCA 26; (2004) 217 CLR 216; 206 ALR 207; 2004 ATC 4599 at 4614; (2004) 55 ATR 712 at 730; *Federal Commissioner of Taxation v. Sleight* [2004] FCAFC 94; (2004) 136 FCR 211; (2004) 206 ALR 511; 2004 ATC 4477 at 4491; (2004) 55 ATR 555 at 571.

<sup>21</sup> [2002] FCA 1274 at [39]; 2002 ATC 4888 at 4900; (2002) 51 ATR 163 at 175.

<sup>22</sup> [2002] FCA 1274 at [75]; 2002 ATC 4888 at 4906; (2002) 51 ATR 163 at 182.

<sup>23</sup> See also subsection 177EA(1).

61. Paragraph 8.79 of the EM addressed what is now subsection 177EA(17), but was previously subsection 177EA(19), as follows:

Circumstances which are relevant in determining whether any person has the requisite purpose include, but are not limited to, the factors listed in new subsection 177EA(19). These factors include the eight factors which are used to determine purpose under the existing section 177D in relation to schemes which omit assessable income or create allowable deductions. To give further guidance to the operation of the new measures, other matters more specifically relevant to schemes to trade or stream franking credits are also included.<sup>24</sup>

62. The eight factors are listed in paragraph 177D(b). In commenting on paragraph 177D(b), Callinan J in the High Court stated as follows:

The Act requires that questions raised by s 177D be answered by reference to the indicia stated in the section. It is not necessary of course that every one of them be relevant to every scheme. Indeed the presence or overwhelming weight of one factor alone may of itself in an appropriate case be of such significance as to expose a relevant dominant purpose.<sup>25</sup>

63. Similarly, not all of the circumstances listed in subsection 177EA(17), including all the factors in paragraph 177D(b), may be relevant in a particular arrangement in considering the question raised by paragraph 177EA(3)(e). Cooper J in the Federal Court noted as follows:

Bearing in mind that the definition of 'the relevant circumstances' in s 177EA(19) is inclusive and deals with numerous circumstances, some of which are not relevant to the present case, I make the following observations as to the relevant circumstances of the scheme without addressing each paragraph of the definition separately, but with them clearly in mind.<sup>26</sup>

64. The relevant circumstances of a scheme for a disposition of these 'dollar value' convertible notes are considered below in the light of the factors listed in subsection 177EA(17). Note that paragraphs 177EA(17)(a), 177EA(17)(f) and 177EA(17)(h) traverse similar matters in the case of these notes and should be read together.

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<sup>24</sup> Section 177EA was re-drafted to reflect the concepts and terminology in the Simplified Imputation System (SIS) which became law with effect from 1 July 2002. Accordingly, the section references in the re-drafted provision do not align with the references in the EM and the Supplementary EM.

<sup>25</sup> *Federal Commissioner of Taxation v. Hart* [2004] HCA 26; (2004) 217 CLR 216; 206 ALR 207; 2004 ATC 4599 at 4626; (2004) 55 ATR 712 at 743.

<sup>26</sup> In *Electricity Supply Industry Superannuation (Qld) Ltd v. Deputy Federal Commissioner of Taxation* [2002] FCA 1274 at [68]; 2002 ATC 4888 at 4904; (2002) 51 ATR 163 at 181.

**Paragraph 177EA(17)(a)**

65. Paragraph 177EA(17)(a) states that the relevant circumstances of a scheme include:

the extent and duration of the risks of loss, and the opportunities for profit or gain, from holding membership interests, or having interests in membership interests, in the corporate tax entity that are respectively borne by or accrue to the parties to the scheme, and whether there has been any change in those risks and opportunities for the relevant taxpayer or any other party to the scheme (for example, a change resulting from the making of any contract, the granting of any option or the entering into of any arrangement with respect to any membership interests, or interests in membership interests, in the corporate tax entity);<sup>27</sup>

66. The note holders' limited exposure to the risks of loss and opportunities for gain that ordinarily attach to equity interests in a company is indicative of a purpose of enabling the holders to obtain an imputation benefit. The notes are designed to insulate the holders from the fortunes of the company. This means that they do not share in the economic ownership of the company in any significant way.

67. Paragraph 177EA(17)(a) requires an examination of the risks and opportunities from holding the particular interests. The EM provides guidance on the relevance of the extent of risks and opportunities to the finding of purpose. Paragraphs 8.80 to 8.82 of the EM explain as follows:

8.80 The extent to which the person receiving a dividend is exposed to the risks and opportunities of owning shares or an interest in shares, or another person is so exposed, is a relevant factor.

8.81 For example, a taxpayer who buys a put option on shares (which provides the right but not the obligation to sell for a stipulated price on or before a specific date) will have diminished risk with respect to the shares because the taxpayer will have guaranteed the sale price of the shares and will be indifferent to falls in the market price of the shares.

8.82 The incidence of risk is a strong pointer to where real ownership of the shares lies. The risks and opportunities of share ownership may be removed or altered, among other ways, by entering into a derivative (for example, a futures contract or an option). For example, where the value of a derivative contract of a shareholder varies inversely with the value of the shareholder's shares, to the extent of the inverse variation, the effect is to pass the risks and opportunities of holding the share to the counterparty under the contract. By using derivatives the risks and opportunities of share ownership can be reduced to nothing, or to any fraction of the ordinary exposure (or even increased). Generally, the greater the risk borne by the taxpayer receiving the franking credit benefit, the less likely it is that the requisite purpose is present.

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<sup>27</sup> The second part of this criterion is generally relevant when the holding of membership interests carries appropriate risks and opportunities which are then negated by some other arrangement. (It may also point against a purpose of obtaining a franking benefit when limited risks and opportunities are enlarged by a collateral arrangement.)

68. While the discussion in the EM refers to shares rather than interests in the economic ownership of the company, a reference to shares should generally be taken as referring to a membership interest that bestows the risks and opportunities of economic ownership of the company. A holder will share in the economic ownership of the company if the membership interest exposes them to the risks and opportunities of the company. This will be the case if the returns on the membership interest bear a relationship to the fortunes of the company. The issue of a membership interest that is designed to limit the ordinary risks and opportunities of ownership of a company is a relevant circumstance that falls for consideration under paragraph 177EA(17)(a).

69. In the instant circumstances, the holder is promised either the return of the issue price of the note, or shares in the issuer of an equivalent value. There is thus no prospect of substantial gain or loss over the issue price by the return of either the money or the shares.

70. Any opportunity for profit on the periodic return on the notes is limited to any profit that might be made by reference to market rates of interest. Payment by the issuer of the scheduled returns (interest) on the notes is not subject to the availability of profits. In some cases, if the issuer does not pay a promised periodic return, the holder is entitled to demand that the issuer pay the outstanding principal amount and all outstanding interest, and the issuer cannot satisfy this demand by issuing shares.

71. These constrained risks and opportunities are under the terms and conditions of issue of the notes, and those terms and conditions do not change over the life of the notes. The rights to the return of the issue price, or of shares in the issuer that are equal in value to the issue price of the note, and to the periodic returns on the note do not depend upon the economic performance of the issuer. From the time of issue, these note holders are not exposed to any of the risks of loss or opportunities for gain that usually attach to an ownership interest in the issuer.

72. In some of these arrangements, the notes rank as senior debt and equally with the issuer's unsecured, unsubordinated debt and ahead of all the issuer's shares.

73. As a practical matter, the extent and duration of risks of loss for the holder over the period that the notes are on issue is effectively limited to the type of risk that a creditor bears in lending money to the issuer. In cases where franking benefits are traded or streamed or otherwise redirected by owners who have no or little appetite for imputation benefit to others who do have such an appetite, that is to say, in a case to which this paragraph would typically apply, the acquirers of the franking benefits would have little interest in assuming any of the risks of ownership, and the true owners would have little interest in parting with any of the opportunities associated with ownership. Consequently the paragraph directs attention to arrangements to sterilise or negate ownership risks and opportunities inherent in a share or membership interest; it also directs attention to instruments which in their own nature confer a return substantially free of such risks and opportunities.

74. The imputation system is intended to deliver imputation benefits to the true economic owners of the entity. Those parties bear exposure to risk and have opportunities for gain that turn on the fortunes of the entity. They are exposed to greater risks and opportunities than a creditor. The payment of any periodic returns to such owners will usually depend on the availability of profits. Thus instruments lacking 'equity risk' will call for close examination. The circumstance that shares or other membership interests are subject to arrangements which limit or negate ownership risks is not, however, decisive: this circumstance may arise through hedging for reasons that, on objective examination, are not substantially directed to obtaining franking advantages. Indeed, such a case is common. Similarly, the issue of an interest on terms that carry an interest-like return (and hence with little exposure to underlying risks and opportunities of ownership) in itself is not decisive. But these cases lie on the margin of appropriate franking and pass the tests of section 177EA because they are attended with no significant purpose of obtaining a franking advantage (as indicated by the other factors). When, however, the other factors point adversely to the existence of a purpose of obtaining an imputation benefit, it will be relatively easy to infer that the purpose is more than incidental.

***Paragraph 177EA(17)(b)***

75. Paragraph 177EA(17)(b) states that the relevant circumstances of a scheme include:

whether the relevant taxpayer would, in the year of income in which the distribution is made, or if the distribution flows indirectly to the relevant taxpayer, in the year in which the distribution flows indirectly to the relevant taxpayer, derive a greater benefit from franking credits than other entities who hold membership interests, or have interests in membership interests, in the corporate tax entity;

76. This circumstance is relevant to these convertible note arrangements and is consistent with concluding that a party to this scheme had a relevant purpose.

77. Paragraph 177EA(17)(b) effectively requires a comparison of the relevant taxpayer's circumstances with that of other persons who hold interests in the entity.

78. Subsections 204-30(7), 204-30(8), 204-30(9) and 204-30(10) of the ITAA 1997 set out some circumstances in which a relevant taxpayer will directly receive a greater benefit than other entities. Subsection 177EA(19) of the ITAA 1936 sets out some of the circumstances in which a relevant taxpayer will indirectly receive a greater benefit from franking credits than other entities.

79. For example, it would be relevant to compare the residency status of the relevant taxpayer with that of other holders of membership interests. It may be relevant if other holders are not residents, because resident recipients of franked distributions generally derive a greater benefit from imputation benefits than those that are not.

80. Other significant circumstances include whether the relevant taxpayer would be entitled to a tax offset because of the distribution while other entities would not, and whether a franking credit would arise for other entities if they are corporate tax entities.

81. In the instant matter, the design of the interest and the way in which the return on the interest is to be delivered necessarily means that it is only attractive to parties that can fully enjoy those imputation benefits. Accordingly, the holders of these interests would usually be expected to be able to obtain fuller enjoyment of the imputation benefits than some holders of other membership interests in that entity.

***Paragraph 177EA(17)(c)***

82. Paragraph 177EA(17)(c) states that the relevant circumstances of a scheme include:

whether, apart from the scheme, the corporate tax entity would have retained the franking credits or exempting credits or would have used the franking credits or exempting credits to pay a franked distribution to another entity referred to in paragraph (b);

83. This is to be determined on the facts of each case.

84. Under these instant arrangements, it would be expected that franking credits will ordinarily be used that would otherwise have been retained by the entity (and may be surplus to the entity's requirements) or instead, would have been allocated to other members of the entity that would derive limited or no benefits from franking credits, for example, non-residents as discussed at paragraph 79 of this Ruling. This furnishes the issuer's motive to engage in a scheme under which the imputation benefits may be obtained in return for some other benefit. The avoidance of the 'wastage' which results from a stock of unused franking credits in this way is contrary to the design of the imputation system.

***Paragraph 177EA(17)(d)***

85. Paragraph 177EA(17)(d) states that the relevant circumstances of a scheme include:

whether, apart from the scheme, a franked distribution would have flowed indirectly to another entity referred to in paragraph (b);

86. This factor again falls to be decided on the particular facts. For example, it would be relevant if those facts indicated that, but for the scheme, a franked distribution would have been indirectly received by other members of the entity that derived limited or no benefits from franking credits.



## **Paragraph 177EA(17)(e)**

87. Paragraph 177EA(17)(e) states that the relevant circumstances of a scheme include:

if the scheme involves the issue of a non-share equity interest to which section 215-10 of the *Income Tax Assessment Act 1997* applies – whether the corporate tax entity has issued, or is likely to issue, equity interests in the corporate tax entity:

- (i) that are similar, from a commercial point of view, to the non-share equity interest; and
- (ii) distributions in respect of which are frankable;

88. This paragraph is unlikely to be relevant to the instant arrangements.

89. This factor would be relevant where an authorised deposit-taking institution (ADI) issues interests that are not frankable (by virtue of section 215-10) through a branch to non-residents, and other commercially similar interests to Australian residents which are frankable. In these circumstances a risk of dividend streaming may exist.<sup>28</sup> This paragraph is intended to draw attention to the use of section 215-10 to engage in dividend streaming. However, similar considerations apply where a taxpayer issues debt interests of similar nature to non-share equity interests.

## **Paragraph 177EA(17)(f)**

90. Paragraph 177EA(17)(f) states that the relevant circumstances of a scheme include:

whether any consideration paid or given by or on behalf of, or received by or on behalf of, the relevant taxpayer in connection with the scheme (for example, the amount of any interest on a loan) was calculated by reference to the imputation benefits to be received by the relevant taxpayer;

91. This circumstance is evident in the arrangements under consideration, and supports the conclusion that a party had a purpose of enabling the relevant taxpayer to obtain an imputation benefit.

92. In the instant arrangements, the holder lends money to the issuer. The issuer promises the return of that money or shares of an equivalent value, and interest on the notes. The promised interest comprises a cash sum plus imputation benefits, or (if the imputation benefits cannot be provided by the issuer) a greater cash sum of equivalent value.

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<sup>28</sup> See the debt/equity EM at paragraph 2.117.

93. Because the notes are equity interests for certain tax purposes, franking credits can be allocated to the interest payments. The cash component of the return to the holders is determined with reference to the franking credits to be allocated to the interest payments. The holder's return on the note is provided in part by the allocation of franking credits (that might otherwise not be distributed) to the cash that is paid. The value of imputation benefits directly reduces the cash cost component of the interest to be paid by the issuer. This would be expected to reduce the issuer's servicing costs.

94. The EM states at paragraph 8.88:

It is relevant to note the extent to which consideration paid or provided by the relevant taxpayer represents the value of franking. Where consideration paid by or to, or provided by, the relevant taxpayer is calculated, wholly or in part, by reference to the franking credit benefit, that may indicate the presence of the requisite purpose.

Thus the paragraph operates to identify imputation benefits as having been 'sold'.

#### ***Paragraph 177EA(17)(g)***

95. Paragraph 177EA(17)(g) states that the relevant circumstances of a scheme include:

whether a deduction is allowable or a capital loss is incurred in connection with a distribution that is made or that flows indirectly under the scheme;

96. It is common under arrangements for the trading of imputation benefits for the franked income, which has brought with it imputation benefits, to be paid away (often to the company or real owner of the company, or an associate) in deductible form, leaving the imputation benefit available to frank or shelter other income of the holder. Subparagraphs 177D(b)(i) and 177D(b)(ii) will operate to distinguish an attempt to 'strip' franking credits in this way from interest on non-tax driven borrowings. Paragraph 177EA(17)(g) may not necessarily be a relevant circumstance in the instant schemes but where it is, it is a compelling indicator of a purpose of obtaining an imputation benefit.

#### ***Paragraph 177EA(17)(ga)***

97. Paragraph 177EA(17)(ga) states that the relevant circumstances of a scheme include:

whether a distribution that is made or that flows indirectly under the scheme to the relevant taxpayer is sourced, directly or indirectly, from unrealised or untaxed profits;

98. A relevant circumstance includes whether a distribution that is made or that flows indirectly under the scheme to the relevant taxpayer is sourced directly or indirectly from unrealised or untaxed profits. This factor essentially requires consideration of whether or not the distributions are sourced from business proceeds that have borne Australian company tax. This may not be relevant to the notes in the instant arrangement if they are not issued at or through a permanent establishment and the moneys raised by issuing them are not used as capital of the branch. The connection with a permanent establishment is a question of fact. However, where the non-share dividend is properly seen as a return on moneys invested in the capital of a foreign branch earning income that is not assessable income, the distribution may be seen as directly or indirectly sourced from untaxed profits. This means that the use of the moneys raised by the notes will not be productive of franking credits; that is, the holder will not be receiving taxed income. In cases where moneys received by holders are clearly not sourced in profits capable of being taxed, no double taxation occurs if the holder is taxed on the distribution. Accordingly, a scheme which would result in the holder receiving franked distributions (section 177EA apart) has the effect of misdirecting franking credits resulting from other economic activity. Franking credit wastage may therefore be inappropriately avoided. Where it is seen to be a substantial purpose of a scheme to frank distributions of untaxed income so as, for example, to distribute franking credits which would otherwise not have been distributed at all (paragraph 177EA(17)(c)), this factor will point strongly to the application of section 177EA.

***Paragraph 177EA(17)(h)***

99. Paragraph 177EA(17)(h) states that the relevant circumstances of a scheme include:

whether a distribution that is made or that flows indirectly under the scheme to the relevant taxpayer is equivalent to the receipt by the relevant taxpayer of interest or of an amount in the nature of, or similar to, interest;

100. The franked distributions on these convertible notes are equivalent to the receipt by the relevant taxpayer of interest or an amount in the nature of interest. This circumstance is apparent in these arrangements and indicates that a party had the relevant purpose. This is because in such cases, it may be that imputation benefits are effectively being 'traded' to creditors in return for reduced (pre-tax) rates of interest. Creditors who take their returns in this way are generally not willing to bear equity risks, and the issuer is not willing to share equity opportunities, so that the membership interests in respect of which the interest-like distribution is made will generally be of a kind to which attention is drawn by paragraph 177EA(17)(a).

101. The EM notes at paragraph 8.90:

Some dispositions of shares or an interest in shares may cause the character of a dividend or distribution to be equivalent for the relevant taxpayer to interest or a like amount. In these cases, a franking credit benefit is often being provided to allow another party to obtain tax-effective finance.

102. The EM provides an example of such an arrangement at paragraphs 8.96 to 8.100:

8.96 A trust is established with a nominal capital and units are issued to investors. One class of units, A class units, entitles the holder, at the discretion of the trustee, to receive the franked dividend income of the trust up to a specified rate: this rate is calculated by taking the prevailing rate of interest and reducing it to the cash amount of dividends which, grossed up for franking, provide the equivalent after-tax return. (There is also a collateral guarantee of payment.) The A class unitholders may redeem their units at face value after 5 years. Another class of units, B class units, is entitled to any excess over the amounts paid to the A class unitholders. The A class units are acquired by persons who can benefit from franking; B class units are acquired by a single investor associated with the trustee, who cannot benefit from franking, as it has extensive tax losses from interest deductions.

8.97 With the money provided by the A class unitholders, and some additional funds from the B class unitholder, the trustee buys shares on which franked dividends are expected to be paid; it is anticipated that those dividends will suffice to pay the A class holders the agreed rate.

8.98 This arrangement is a scheme involving the disposition of an interest in shares. The units in the trust are issued with a view to the beneficiaries obtaining an interest in shares. For the purposes of new section 177EA the discretionary beneficiaries are taken to have an interest in the shares because they will form part of the trust estate.

8.99 The A class unit holders are not entitled to receive any capital growth from the shares, nor are they exposed to any consequences of a fall in share prices. From their perspective their trust investment behaves like an interest bearing bond, where the lower rate of interest is compensated for by the benefit of franking. They do not have the risks and opportunities associated with share ownership; the B class holder has all those risks. However, it is expected that they will receive a franking credit benefit from distributions from the trust.

8.100 In this case, consideration of the relevant circumstances indicates that there is a purpose (other than an incidental purpose) of obtaining a tax advantage from franking. The incidence of the risks and opportunities of holding the shares points to the B class unitholder as the effective owner of the shares, and to a purpose of the scheme being to confer a tax advantage in relation to franking on the A class unitholders in order to obtain a cheaper cost of funds for the B class unit holder. This is because the subscription of the funds by the A class unitholders is effectively a loan to the B class unitholder, and the disposition of the shares upon the trusts described above is intended to be a means of paying the equivalent of interest in a tax advantaged way through the use of franking credits.<sup>29</sup>

103. The convertible notes that are the subject of this Ruling are debt for accounting and regulatory purposes. The periodic returns are treated as interest, are in the legal form of interest and perform the same relative function as interest. Although the periodic returns are non-share dividends for certain tax purposes, they are calculated in the same manner as interest. The interest is a function of time, principal outstanding and an objectively determined floating interest rate. The interest is paid as cash plus imputation benefits or cash alone (but of a greater amount) if the imputation benefits are not available.

104. Consequently, the value of the interest payment – the cash plus the imputation benefits or an equivalent amount in cash only – will be a return that is a market interest rate.

***Paragraph 177EA(17)(i)***

105. Paragraph 177EA(17)(i) states that the relevant circumstances of a scheme include:

the period for which the relevant taxpayer held membership interests, or had an interest in membership interests, in the corporate tax entity;

106. This circumstance is not expected to be relevant to these convertible notes.

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<sup>29</sup> Section 207-160 of the ITAA 1997 also operates to deny franking benefits where an entity's interest in a distribution could reasonably be regarded as interest on a loan. An arrangement such as this example would be likely to fall within section 207-160.

107. In general, the longer the period for which the ownership interests are held at risk by the person obtaining the franking credit benefit, the less likely it is that the requisite purpose is present. The EM states at paragraph 8.84:

8.84 The length of time in which the shares or the interest in the shares were held, or the length of the period in which the holder was exposed to the risks and opportunities of holding the shares or the interest, is another relevant circumstance. The longer the period for which the shares were held at risk by the person obtaining the franking credit benefit, the less likely it is that the requisite purpose is present.

108. However, these notes are designed to deliver imputation benefits periodically over their life. As the above discussion relevant to paragraph 177EA(17)(a) explains, a holder of these notes does not have the risks and opportunities that usually attend economic ownership of a company (see paragraphs 65 to 74 of this Ruling). These are not arrangements where, for example, the holder assumes legal ownership of a membership interest for a very short period to obtain a single imputation benefit.

***Paragraph 177EA(17)(j)***

109. Paragraph 177EA(17)(j) states that the relevant circumstances of a scheme include:

any of the matters referred to in subparagraphs 177D(b)(i) to (viii).

110. Paragraph 177EA(17)(j) imports the eight factors listed in paragraph 177D(b) to the list of relevant factors to be considered in determining purpose under section 177EA. These factors are:

- the manner in which the scheme was entered into or carried out: subparagraph 177D(b)(i);
- the form and substance of the scheme: subparagraph 177D(b)(ii);
- the time at which the scheme was entered into and the length of the period during which the scheme was carried out: subparagraph 177D(b)(iii);
- the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme: subparagraph 177D(b)(iv);
- any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme: subparagraph 177D(b)(v);

- any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme: subparagraph 177D(b)(vi);
- any other consequence for the relevant taxpayer, or for any person referred to in subparagraph 177D(b)(vi), of the scheme having been entered into or carried out: subparagraph 177D(b)(vii); and
- the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph 177D(b)(vi): subparagraph 177D(b)(viii).

111. Of those factors, the following seem to be the most relevant to these arrangements.

*Manner in which the scheme for the issue of the convertible notes was carried out or entered into (subparagraph 177D(b)(i))*

112. The manner in which any particular scheme is entered into or carried out is likely to be peculiar to that scheme. However, on the basis of the general description of the arrangement it might be concluded that the manner in which the scheme for the issue of convertible notes is carried out will suggest that some party – and the issuer, at least, would be expected to be such a party – had the requisite purpose of providing an imputation benefit to the holder.

113. It might be concluded, particularly if the facts and circumstances indicate that conversion is very unlikely, that the convertible notes are contrived to be frankable equity interests that will deliver surplus franking credits to the investor without exposing that party to the risks and opportunities usually associated with investing as an equity holder in the activities of the entity and hence, this will be a substantial purpose of some person.

114. In some of these arrangements, the convertible notes may be privately placed and not listed. One investor may initially subscribe for the notes with the intention of selling at least some of the notes to other wholesale investors. It would be expected that (because part of the return is to comprise franking credits) the notes would only be attractive to Australian residents or non-residents carrying on business in Australia through a permanent establishment that would be able to take full advantage of the franking benefits attached to the interest payments. The way in which a secondary investor acquires, funds, and disposes of the notes will be relevantly considered as part of the scheme under this matter, and in cases where funding costs are matched to income from the notes so as to leave no profit before income tax, one might conclude that obtaining a franking benefit was a substantial purpose of the investor.

115. In addition to franking the payments for Australian tax purposes, if the notes are issued to Australian investors at or through a foreign branch, the issuer may be able to claim a deduction in that jurisdiction in respect of the interest payments. A purpose of enabling the holder to obtain an imputation benefit will be indicated if arrangements are structured so that promised imputation benefits will be delivered as franked returns to targeted investors or the notes are issued through specifically tailored off-market placements at or through a foreign branch of the issuer. The manner in which moneys are raised under the scheme and used may, in some cases, indicate contrivance, in that it will be seen that under a more straightforward manner of raising and using the money, money would be raised in a way under which no imputation benefit would be obtained. Under this matter, other ways of achieving the same substantial effect must be considered. Generally, raising money as a debt interest will be among them.

116. In other arrangements, an entity could have tax losses: a tax deduction for interest would, therefore, not produce an immediate tax benefit. However, the entity might have accounting profits and a surplus balance in its franking account. If that entity required additional funding, it would be advantageous to issue these convertible notes rather than ordinary debt because the periodic returns with franking credits attached on the notes would require a lower cash outlay. These circumstances would also indicate that some party had the relevant purpose.

*Form and substance of the scheme (subparagraph 177D(b)(ii))*

117. Where it is appropriate to infer that the substance of the arrangement is debt, but that it is raised in the form of an equity interest (conferring as little real ability to participate in the risks and opportunities of ownership as possible) in order to enable the holder to obtain imputation benefits from franking credits of little value to the issuer, it would be concluded that obtaining an imputation benefit is a substantial purpose of some person. While it may be expected that the issuer's option is in itself not without substance, the substance of the scheme as a whole must be considered.

118. In commenting on the consideration of subparagraph 177D(b)(ii), Callinan J stated:

The reference in s 177D(b)(ii) to the 'substance of the scheme' invites attention to what in fact the taxpayer may achieve by carrying it out, that is to matters whether forming part of, or not to be found within the four corners of an agreement or an arrangement. They also require that substance rather than form be the focus.<sup>30</sup>

<sup>30</sup> *Federal Commissioner of Taxation v. Hart* [2004] HCA 26; (2004) 217 CLR 216; 206 ALR 207; 2004 ATC 4599 at 4625; (2004) 55 ATR 712 at 741.



119. In the instant arrangements, the notes are in the legal form of debt, but the elements of form in the design ensure that the tax legal classification is equity for certain purposes. As noted in the earlier discussion about the relevance of the circumstances described in paragraph 177EA(17)(h), the notes are treated as debt for accounting and regulatory purposes (paragraphs 99 to 104 of this Ruling). They are valued and treated as debt by the parties to the scheme. Despite the tax form that has been achieved, the holders have invested in an instrument with a debt-like profile and exposure without any substantial characteristics of equity. The substantial effect of the 'equity' elements of the transaction may be expected to be minor in most cases, pointing to the conclusion that it is a purpose of some person to obtain an imputation benefit by the form of the instrument while achieving the effect of holding an instrument under which imputation benefits cannot be obtained. Steps taken by the holder are also capable of affecting the substance of the holder's position. In some cases, the discord between the form of the investment as one in a foreign branch but substantially in Australia may point adversely to a conclusion that the purpose of some person is to obtain an imputation benefit.

*Any scheme-related changes in the financial position of any person who has any connection with the relevant taxpayer; and other consequences for the relevant taxpayer or any person connected with that taxpayer (subparagraphs 177D(b)(vi) and 177D(b)(vii))*

120. Any prospect of reducing the costs of borrowing by delivering franking credits indicates that the issuer had, as one of its purposes, the delivery of imputation benefits to the holder. From the issuer's perspective, the ability to allocate franking credits to interest payments facilitates borrowing funds at a net rate that is much lower than it would be if franking was not available. The franking credits reduce the issuer's direct financing costs. If those funds are used overseas, franking credits that represent Australian tax paid effectively subsidise the cost of operations in a foreign jurisdiction, and the profits of those operations may not be subject to Australian tax.

121. On the other hand, another consequence is that the issuer will have a source of contingent share capital that it can raise by converting the notes. This suggests that a purpose of the issuer could be to establish that source of contingent capital. Assessment of the financial position of an issuer requires attention to the position of particular issuers, and more generally, to the state or anticipated state of the market at the relevant time. More weight is to be given to the consideration that contingent share capital is obtainable when the financial position of an issuer is weak and is strengthened by issuing the notes, and when economic conditions are depressed. Generally, this consideration will be the strongest countervailing consideration. However, for a well-capitalised issuer, it is not thought that this consequence would generally negate an adverse conclusion.

122. As noted above, consideration of any change in the financial position of the holder or associates of the holder must take into account steps to short or hedge the notes (even when the short positions or hedges do not themselves disqualify the holder from imputation benefits).

### **Weighing up the circumstances**

123. It is of course necessary to have regard to all the circumstances of a scheme to discern the purposes and degrees of purpose of relevant parties to the scheme. Some matters may point in one direction, and others may point in another. It is the evaluation of these matters – some for, some against – that is required in order to reach the conclusion to which paragraph 177EA(3)(e) refers.<sup>31</sup>

124. In *Federal Commissioner of Taxation v. Hart*, Callinan J observed that in relation to the consideration of the factors listed in paragraph 177D(b):

It is not necessary of course that every one of them be relevant to every scheme. Indeed, the presence or overwhelming weight of one factor alone may of itself in an appropriate case be of such significance as to expose a relevant dominant purpose.<sup>32</sup>

125. As noted earlier, paragraph 177EA(3)(e) does not require a conclusion of dominant purpose – a more than incidental purpose is sufficient – and circumstances other than the circumstances listed in subsection 177EA(17) may be considered.

126. Matters that would support a conclusion that the requisite purpose exists in the arrangements under consideration have been identified in the previous discussion of the relevant circumstances of the scheme (paragraphs 59 to 122 of this Ruling).

127. It was also noted that the issuer will have a source of contingent share capital that it can raise by converting the notes. This factor weighs against the conclusion of purpose required by paragraph 177EA(3)(e). Whether this consequence is objectively of such demonstrable significance that the purpose of delivery of imputation benefits to the holder is merely incidental to that overriding purpose must be determined in the particular circumstances of each case. However, even if it were to be concluded that this is a purpose of the issuer, it does not necessarily follow that the delivery of imputation benefits to the holder is not also a more than incidental purpose of either or both the issuer or the holder. As discussed earlier, a number of purposes can co-exist as more than incidental purposes (paragraphs 52 to 58 of this Ruling).

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<sup>31</sup> See the comments by Hill J in relation to the operation of section 177D in *Peabody v. Federal Commissioner of Taxation* (1993) 40 FCR 531 at 543; (1993) 112 ALR 247 at 258; 93 ATC 4104 at 4113-4114; (1993) 25 ATR 32 at 42.

<sup>32</sup> At [2004] HCA 26; 217 CLR 216; 206 ALR 207; 2004 ATC 4599 at 4626; (2004) 55 ATR 712 at 743.

128. Without more, the above consideration of the relevant circumstances of these particular 'dollar value' convertible notes supports a conclusion that a party that entered into or carried out the scheme for the issue of the notes, did so for a purpose that was more than an incidental purpose of enabling the holder to obtain imputation benefits.

### **The Commissioner's ability to determine a franking debit or deny imputation benefits**

129. Where the conditions of section 177EA are satisfied, the Commissioner may make a written determination that either a franking debit is to arise for the entity making a franked distribution or that imputation benefits are to be denied to recipients of franked distributions.<sup>33</sup>

130. If the issuer and the recipient of the franked distribution are both parties to the scheme, the Commissioner may decide which of the actions is more appropriate. For example, where there are numerous recipients of the imputation benefits, it will generally be appropriate to debit the company's franking account if this action sufficiently counteracts the disadvantage to the revenue produced by the scheme. In some cases, (for example, where the issuer has very substantial surplus credits), posting debits to the company's franking account will not effectively counteract the scheme. In those cases (particularly where there are few investors) it would be more appropriate to deny the investors the franking credit benefit directly.<sup>34</sup> It will clearly be appropriate to deny an investor the imputation benefit directly when the investor has taken further steps in order to obtain a tax arbitrage.

### **Conclusion**

131. The 'dollar value' convertible notes that are the subject of this Ruling are quite different from other types of 'dollar value' convertible notes where the terms and conditions of issue impose some restrictions on the number of shares that might be provided on conversion. In those cases, any limitation on the number of shares could provide some substantial exposure to the economic performance of the company that is reflected in the share price at the time of conversion.

132. In the instant matter, the note is designed with terms and conditions that have the effect of ensuring that the note holder does not have any of the substantial risks or opportunities that usually accompany an interest in the economic ownership of the company, even though the notes are classified as equity interests under the debt/equity rules.

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<sup>33</sup> Subsection 177EA(5).

<sup>34</sup> See paragraphs 8.40 and 8.41 of the EM.

133. Further, these notes are issued under terms and conditions whereby the provision of imputation benefits is the preferred means of providing a substantial part of the promised periodic returns to the holder. The returns on the notes are calculated by reference to market rates of interest on moneys lent. The imputation benefits are expected to be available on non-share dividends that are in the form of interest.

134. Consideration of the relevant circumstances of these particular 'dollar value' convertible notes is likely to lead to the conclusion that some person that entered into or carried out the scheme for the issue of these notes did so for a more than incidental purpose of enabling the holder to obtain imputation benefits.

## Appendix 2 – Detailed contents list

135. The following is a detailed contents list for this Ruling:

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*Previous drafts:*

TD 2007/D16; TR 2008/D8

*Related Rulings/Determinations:*

TR 2006/10

*Subject references:*

- convertible notes
- corporate tax entity
- debt
- determination
- disposition
- distribution
- dividend
- equity
- equity interest
- frankable distribution
- franked distribution
- franking account
- franking credit
- gross-up
- imputation
- interest
- membership interest
- non-share dividend
- non-share equity interest
- relevant taxpayer
- scheme
- simplified imputation system

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- ITAA 1936 177EA(4)
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