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Page 1 of 3

Ruling Compendium – TR 2010/5

This is a compendium of responses to the issues raised by external parties to draft TR 2010/D1 – Income tax: the relevance of 'economic compulsion' in deciding whether an issuer of a financing arrangement has an 'effectively non-contingent obligation' for the purposes of section 974-135 of the *Income Tax Assessment Act 1997*

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

Summary of issues raised and responses

Issue No.	Issue raised	ATO Response/Action taken
1.	The Draft Ruling could express a view on what economic compulsion means and why the term is relevant. ...it is relevant to outline that 'in substance or effect' give rise to a broader definition of 'obligation', which may be internal or external to the contractual agreement.	Paragraph 2 of the Ruling provides a broad definition of what is meant by 'economic compulsion'. Paragraph 9 builds on the immediately preceding material (paragraph 6 and the following) to explain the context in which the question about the relevance of economic compulsion has arisen. We think this is sufficient for the purposes of the Ruling. This suggestion refers to 'the contractual agreement': it thus seems to imply that the relevant scheme necessarily involves a contractual agreement. The 'Explanation' section of the Ruling sets out in some detail why this is not the case (see esp. paragraphs 10 to 12, 16, 18 and 22; note also the footnote reference to Taxation Determination TD 2009/1 which addresses this question). The 'Explanation' develops a platform for exploring where 'economic compulsion' is relevant. That is, the 'Explanation' points out the importance of identifying the 'scheme' (and emphasises that it might not be a contractual arrangement) and of considering (in an appropriate context) the 'pricing, terms and conditions' of whatever constitutes that scheme to determine what 'in substance or effect' the issuer's obligations are: economic substance is considered in this context.

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Page status: **not legally binding**

Page 2 of 3

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2.	It would be useful if the Draft Ruling provided some consideration on the terms used in subsection (7), being the words 'practical' and 'commercial'. It is difficult to see how the Commissioner can rule on the operation of that provision without also properly exploring the words used in the provision.	The relevant phrase is 'detrimental practical or commercial consequences'. 'Practical' and 'commercial' are not defined in the legislation. We consider that the individual words and phrase are sufficiently understood and so commonly used that it is unnecessary to attempt a comprehensive definition. Rather, the Explanation contains examples (see especially paragraph 29) of 'practical or commercial detriment'. The Ruling is not directly on subsection 974-135(7). The deliberate emphasis is on subsection 974-135(1). The 'Explanation' sets out why subsection 974-135(7) is relegated to that provision, and intentionally deals with it incidentally.
3.	At paragraph 30, the Draft Ruling states the consequences 'are consequences for the issuer's business that arise outside the operation of the terms of the scheme'. It is requested that the ATO consider changing this to 'are consequences for the issuer's business that arise outside the operation of the <u>terms, pricing or conditions</u> of the scheme'. This terminology is consistent with the wording used in subsection (1).	Broadly agree (however, the words in subsection 974-135(1) are 'pricing, terms and conditions' – if the paragraph is to be amended, we consider that this formulation should be used). We are uncertain whether the reference to 'pricing' adds much in the instant context, but see no harm in including it.
4.	Paragraphs 25 to 32 should be reversed. That is, the Commissioner's view on the operation of subsection (7) should be stated upfront (that is, that subsection (7) is a clarification provision). It could then define the terms 'practical or commercial', and outline examples of what would be practical or commercial consequences [such as those contained in paragraph 29]. It would then be appropriate to address paragraph 22, the interaction with subsection (1) and then the alternative view in that order.	On balance we prefer the present structure. Paragraphs 25 to 27 directly extend the commentary in paragraphs 22 to 24 about an example in paragraph 2.175 of the Explanatory Memorandum. The suggested order of discussion would disjoint the commentary on that item. As drafted, paragraphs 25 to 27 lead in to the broader discussion about the intended operation of subsection 974-135(7). Paragraph 32 introduces and discusses a separate but related point about whether the degree of any detrimental practical or commercial consequence is of significance, and concludes by pointing out the limited function of subsection 974-135(7).

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Page 3 of 3

Issue No.	Issue raised	ATO Response/Action taken
5.	Based on the above, it is recommended that the ATO consider redrafting the conclusions in the Draft Ruling to provide taxpayers with greater certainty as to its operation. Specifically, paragraph 4 should be redrafted to be more consistent with the actual conclusions contained in the Draft Ruling. As currently written, paragraph 4 is non-committal. It states that economic compulsion 'may' be regarded as an ENCO if certain conditions are satisfied. This conclusion provides no degree of certainty for taxpayers. It is requested the final ruling state that 'economic compulsion <u>will</u> result in an ENCO, provided that the compulsion arises having regard to the pricing, terms and conditions'. Paragraph 4 goes on to state: [o]ther matters may only be regarded for the purpose of considering the effect of the pricing, terms, and conditions of the relevant scheme. They are otherwise irrelevant. This sentence is confusing as to the extent that other matters may be regarded. It is recommended that the ruling conclude that if economic compulsion results only from factors external to the pricing, terms and conditions, this will not result in an ENCO under subsection (1). The paragraph should also state that, to avoid doubt, subsection (7) clarifies that this is the case.	Taxpayer representatives have often referred to a broad concept of an 'economic compulsion' to take an action as if that were equivalent to an 'effectively non-contingent obligation' to take an action. The Ruling addresses that proposition. The term 'economic compulsion' does not appear in the legislation; on the other hand, 'effectively non-contingent obligation' is defined in the law, and is a critical element of the debt test. The Ruling attempts to explain these differences, and to emphasise that the test is that which is prescribed in the legislation. At the same time, the Ruling acknowledges that where there is an ENCO to take an action there might also loosely be said to be an 'economic compulsion' to take that action – but this is incidental to whether there is an ENCO. Thus the Ruling explains that things that might be said to amount to economic compulsion to take an action may be relevant in determining whether there is an ENCO to take an action only if that economic compulsion arises on having regard to the pricing, terms and conditions of the scheme. In this sense, 'may' means 'are permissibly', rather than 'are possibly'. The use of 'may' is deliberate – because whether things might be described as 'economic compulsion' might be a mere incident of there being an ENCO (as determined by having regard to the pricing, terms and conditions in context). The corollary noted in the Ruling is that things that are not found by having that regard to the pricing, terms and conditions, but that might in some senses be said to amount to some form of economic compulsion to take an action, are irrelevant to the determination of an ENCO. We do not think that it is appropriate or necessary to say that some forms of economic compulsion will result in an ENCO. We think that this unduly elevates or emphasises 'economic compulsion' at the possible expense of the real test – the ENCO test – that the legislation sets out. We consider that the Ruling as drafted provides adequate certainty about the legal position.