


CR 2009/66 - Income tax: amendment of terms of Reset Exchangeable Securities and Preference Shares: Insurance Australia Group Limited

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Class Ruling

Income tax: amendment of terms of Reset Exchangeable Securities and Preference Shares: Insurance Australia Group Limited

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❶ This publication provides you with the following level of protection:

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

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified below apply to the defined class of entities, who take part in the scheme to which this Ruling relates.

Relevant provision(s)

2. The relevant provisions dealt with in this Ruling are:
- section 26BB of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - section 70B of the ITAA 1936; and
 - section 104-155 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Class of entities

3. The class of entities to which this Ruling applies consists of entities which:

- (a) hold Reset Exchangeable Securities (RES) issued by IAG Finance (New Zealand) Ltd (IAG Finance NZ);
- (b) hold RES on capital account immediately before the terms are amended and restated, and hold the amended RES on capital account immediately after the terms are amended and restated; and
- (c) are residents of Australia within the meaning of that expression in subsection 6(1) of the ITAA 1936.

In this Ruling, a person belonging to this class of entities is referred to as a 'RES Holder'.

Qualifications

4. The Commissioner makes this Ruling based on the precise scheme in this Ruling.

5. The class of entities defined in this Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 9 to 33 of this Ruling.

6. If the scheme actually carried out is materially different from the scheme that is described in this Ruling, then:

- this Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled; and
- this Ruling may be withdrawn or modified.

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Date of effect

8. This Ruling applies from 1 July 2009 to 30 June 2010. The Ruling continues to apply after 30 June 2010 to all entities within the specified class who entered into the specified scheme during the term of the Ruling. 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).

Scheme

9. The following description of the scheme is based on information provided by the applicant (Mallesons Stephen Jaques). The following documents, or relevant parts of them, form part of and are to be read with the description:

- Class Ruling application dated 11 August 2009;
- the Amended and Restated Terms of the RES;
- the Amended and Restated Terms of the Preference Shares;
- the Third Amending Deed which contains the Amended and Restated Trust Deed; and
- correspondence from the applicant dated 21 September 2009.

Note: certain information has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

10. Insurance Australia Group Limited (IAG) is an Australian resident company limited by shares. IAG is the head company of an Australian tax consolidated group. It is the non-operating holding company of Insurance Australia Limited (IAL). IAL conducts a business of general insurance under the *Insurance Act 1973*. IAG's capital structure is managed in a manner consistent with the prudential guidelines applied by the Australian Prudential Regulation Authority (APRA) to groups containing an authorised general insurer.

RES

11. In 2005, IAG Finance NZ (which is a member of the IAG tax consolidated group) issued the RES to the public through its New Zealand branch. Each of the RES were issued for \$100. The RES are listed on the Australian Securities Exchange.

12. The RES were issued under a trust deed (the Trust Deed). A public trustee company acts as the Trustee (Note Trustee), holding the right to enforce the obligations of IAG Finance NZ, and other security interests, rights and powers, under the terms of the RES and the Trust Deed.

13. The proceeds of the issue of the RES were used to provide finance for certain New Zealand subsidiaries of IAG. The proceeds were invested, through transactions involving other IAG subsidiaries, in a portfolio of highly rated short-term debt securities (the Portfolio), the income from which is used to fund the payment of interest under the RES. The capital proceeds of the Portfolio can be applied to redeem the RES in the future.

14. Both the financial liability under the RES and the Portfolio are held 'off-balance sheet' to IAG because the financial liability is set off against the Portfolio.

15. As the issuer of the RES, IAG Finance NZ's obligations are secured over the Portfolio for the benefit of the holders of the RES.

16. The RES are perpetual securities. The principal of the RES is only repayable if the RES are redeemed for cash, converted into ordinary shares in IAG or exchanged into preference shares in IAG (Preference Shares), or upon the winding-up of IAG Finance NZ.

17. Periodic interest is payable on the RES, subject to certain conditions being satisfied.

18. If IAG gives the holders of the RES and IAG Finance NZ a notice advising that it will be exercising its right to issue Preference Shares to the holders of the RES, the RES will be redeemed. The redemption amount will be paid to the Note Trustee, who must apply it in paying the issue price of the Preference Shares.

Preference Shares

19. The Preference Shares will qualify as Tier 1 capital.

20. The issue price of each Preference Share will be equal to the RES redemption amount. The Preference Shares will be perpetual securities. The principal of the Preference Shares will only be repayable if the Preference Shares are redeemed for cash or converted into ordinary shares in IAG, or upon the winding-up of IAG.

21. Periodic dividends will be payable on the Preference Shares, subject to certain conditions being satisfied. Payment of a dividend will be conditional upon the profit and regulatory capital tests applicable to Tier 1 instruments.

22. IAG may only change the Preference Share Terms with the consent of the holders.

23. The holders of Preference Shares will not be able to request redemption of their Preference Shares at any time. Subject to certain conditions, IAG will be able to redeem the Preference Shares for cash or convert them into ordinary shares.

Proposed amendments to the RES

24. It is proposed that the RES Terms, the Preference Share Terms and the Trust Deed be amended and restated so that the RES will henceforth be recognised as Innovative Tier 1 capital by APRA under Prudential Standard GPS 112 on a Level 2 group basis. The RES would no longer be considered 'off-balance sheet' contingent capital.

25. As the issuer of the RES, IAG Finance NZ's obligations will not be secured by recourse to any assets and are subordinated to all creditors.

26. The holders of the RES will no longer have a security interest in the Portfolio and payments will no longer be subject to the income and capital proceeds (as applicable) of the Portfolio.

27. The interest payment conditions will be varied, and interest will no longer be subject to the income derived upon the Portfolio.

28. The right of a holder of the RES to request redemption will be varied to a right to request the Conversion of the RES into ordinary shares in IAG upon a Reset Date or following an Acquisition Event only.

29. IAG Finance NZ is able to either Redeem, Convert or cause a Resale of the RES, at its option, if it receives a RES Holder Conversion Notice.

30. The RES will be Exchangeable into Preference Shares mandatorily upon an Exchange Event or at IAG's discretion at any time.

Proposed amendments to the Preference Shares

31. An amended Preference Share Margin will be included and reset will occur at 10 year intervals.

32. Resale mechanics similar to those in the RES will be introduced, in addition to the existing Redemption and Conversion processes.

33. The holders of Preference Shares will be given a right to request Conversion upon a Reset Date or following an Acquisition Event and IAG will be able to either Redeem, Convert or cause a Resale of the Preference Shares, at its option, if it receives such a request.

Ruling

Traditional security gain or loss

34. Section 26BB of the ITAA 1936 will not apply to include any amount in the assessable income of the RES Holders as a result of the amendment of the RES Terms and the Preference Share Terms.

35. Section 70B of the ITAA 1936 will not apply to allow a deduction to the RES Holders as a result of the amendment of the RES Terms and the Preference Share Terms.

Capital gains tax

36. CGT event H2 will happen in respect of the RES under section 104-155 of the ITAA 1997 as a result of the amendment of the RES Terms and the Preference Share Terms. However, the RES Holders will not make a capital gain as a result of CGT event H2 happening. The RES Holders will make a capital loss as a result of CGT event H2 happening if they incur incidental costs that relate to the event.

Commissioner of Taxation

18 November 2009

Appendix 1 – Explanation

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.*

Traditional security gain or loss

37. Subsection 26BB(1) of the ITAA 1936 defines a 'traditional security' as a security held by the taxpayer that:

- (a) was acquired by the taxpayer after 10 May 1989;
- (b) does not have an eligible return or has an eligible return that meets certain conditions;
- (c) is not a prescribed security within the meaning of section 26C of the ITAA 1936; and
- (d) is not trading stock of the taxpayer.

38. The term 'security' is defined by reference to subsection 159GP(1) of the ITAA 1936. The RES held by a RES Holder satisfies the definition of a 'security' within that subsection. All of the RES were acquired by the RES Holders after 10 May 1989. The Debenture Stock, being issued by IAG Finance NZ and not the Commonwealth, is not a prescribed security within the meaning of section 26C of the ITAA 1936.

39. A security will have an eligible return where, at the time of issue of the security, it is reasonably likely that the sum of all payments under the security, other than periodic interest, will exceed the issue price of the security (subsection 159GP(3) of the ITAA 1936). As no payments are liable to be made on the RES other than principal repayments equal to its issue price and periodic interest, the RES do not have an eligible return.

40. Therefore, the RES are a traditional security for those RES Holders who do not hold the RES as trading stock.

41. Under subsection 26BB(2) of the ITAA 1936, where a taxpayer disposes of a traditional security or a traditional security of a taxpayer is redeemed, the amount of any gain on the disposal or redemption shall be included in the assessable income of the taxpayer of the year of income in which the disposal or redemption takes place.

42. Under subsection 70B(2) of the ITAA 1936, where a taxpayer disposes of a traditional security or a traditional security of a taxpayer is redeemed, the amount of any loss on the disposal or redemption is allowable as a deduction from the assessable income of the taxpayer of the year of income in which the disposal or redemption takes place.

43. Subsection 26BB(1) of the ITAA 1936 defines 'dispose', in relation to a security, to mean sell, transfer, assign or dispose of in any way the security or the right to receive payment of the amount or amounts payable under the security.

44. Following the amendment of the RES Terms, the RES continue to exist. Further the issuer continues to be bound by the obligations under the RES Terms, which existed prior to the amendment date.

45. Accordingly, the amendment of the RES Terms will not constitute a sale, transfer, assignment or disposal in any way of the RES or the right to receive payment under the RES. The amendment of the Preference Share Terms will also not constitute a disposal of the RES.

46. The term 'redemption' is not defined in subsection 26BB(1) or section 70B of the ITAA 1936. Even though that term is defined in subsection 159GP(1) of the ITAA 1936, it was held, in *Proudfoot v. Federal Commissioner of Taxation* (2004) 56 ATR 1230; 2004 ATC 2229; [2004] AATA 823 that the definition in subsection 159GP(1) of the ITAA 1936 should not be relied upon to limit the meaning of the term, for the purposes of applying sections 26BB and 70B of the ITAA 1936. The ordinary meaning of 'redemption' should be adopted instead.

47. The Macquarie Dictionary defines 'redemption' to mean repurchase; paying off; recovery by payment. In *Ashton Mining Ltd v. Federal Commissioner of Taxation* (2000) 44 ATR 249; 2000 ATC 4307; [2000] FCA 590, it was held that the term concerns the legal entitlement of the parties and requires that there be no outstanding legal liability on the part of the debtor to pay the amount of the traditional security to the creditor. Under the amended RES Terms and Preference Share Terms, the issuer's obligations which existed prior to the amendment continue to exist – that is, there is no extinguishment of existing liabilities and it cannot be said that there is no longer any outstanding legal liability on the part of the debtor to pay the amount of the traditional security to the creditor (see clauses 1.4 and 3.8 of the Amended and Restated Terms of the RES).

48. Accordingly, the amendments to the RES Terms and Preference Share Terms do not constitute redemption of the RES.

49. Therefore, subsection 26BB(2) of the ITAA 1936 will not apply to include any amount in the assessable income of the RES Holders as a result of the amendment of the RES Terms and the Preference Share Terms. Subsection 70B(2) of the ITAA 1936 will not apply to allow a deduction to the RES Holders as a result of the amendment of the RES Terms and the Preference Share Terms.

Capital gains tax

50. The RES are a CGT asset (section 108-5 of the ITAA 1997). A RES Holder can make a capital gain or capital loss only if a CGT event happens (section 102-20 of the ITAA 1997).

51. CGT event H2 happens if an act, transaction or event occurs in relation to a CGT asset that you own and the act, transaction or event does not result in an adjustment being made to the asset's cost base or reduced cost base (section 104-155 of the ITAA 1997). The amendment of the RES Terms and the Preference Share Terms is an act, transaction or event that occurs in relation to the RES and it does not result in an adjustment being made to the cost base or reduced cost base of the RES. Therefore, CGT event H2 will happen in respect of the RES under section 104-155 of the ITAA 1997 as a result of the amendment of the RES Terms and the Preference Share Terms.

52. A RES Holder will make a capital gain if the capital proceeds from the event are more than the incidental costs incurred in relation to the event. A RES Holder will make a capital loss if those capital proceeds are less than the incidental costs (subsection 104-155(3) of the ITAA 1997).

53. The capital proceeds from CGT event H2 happening are the money or other consideration received, or entitled to be received, because of the act, transaction or event (subsection 116-20(2) of the ITAA 1997). 'Consideration' for these purposes can include the benefit of mutual promises flowing to the parties even if those promises are not in themselves property (refer to paragraph 29 of Taxation Ruling TR 95/3).

54. Incidental costs are defined in section 110-35 of the ITAA 1997 and consist of nine forms of expenditure.

55. The RES Holders will not receive or be entitled to receive money or other consideration, including the benefit of any mutual promises, because of the event happening.

56. Therefore, although CGT event H2 will happen as a result of the amendment of the RES Terms and the Preference Share Terms, the RES Holders will not make a capital gain as a result of CGT event H2 happening.

57. The RES Holders will make a capital loss as a result of CGT event H2 happening if they incur incidental costs that relate to the event.

Appendix 2 – Detailed contents list

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

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10; TR 95/3

Subject references:

- capital gains tax
- CGT events H1-H2 – special capital receipts
- preference shares
- redeemable preference shares
- securities
- traditional securities

Legislative references:

- ITAA 1936 6(1)
- ITAA 1936 26BB
- ITAA 1936 26BB(1)
- ITAA 1936 26BB(2)
- ITAA 1936 26C
- ITAA 1936 70B
- ITAA 1936 70B(2)
- ITAA 1936 159GP(1)
- ITAA 1936 159GP(3)

- ITAA 1997 102-20
- ITAA 1997 104-155
- ITAA 1997 104-155(3)
- ITAA 1997 108-5
- ITAA 1997 110-35
- ITAA 1997 116-20(2)
- Insurance Act 1973
- TAA 1953
- Copyright Act 1968

Case references:

- Ashton Mining Ltd v. Federal Commissioner of Taxation (2000) 44 ATR 249; 2000 ATC 4307; [2000] FCA 590
- Proudfoot v. Federal Commissioner of Taxation (2004) 56 ATR 1230; 2004 ATC 2229; [2004] AATA 823

Case references:

- The Macquarie Dictionary, Macquarie Multimedia, version 5.0.0

ATO references

NO: 1-1PLWX3X

ISSN: 1445-2014

ATOlaw topic: Income Tax ~~ Assessable income ~~ traditional securities

Income Tax ~~ Capital Gains Tax ~~ CGT events H1 and H2 - special capital receipts