


CR 2018/23 - Income tax: Members Equity Bank - ME Capital Notes

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Class Ruling

Income tax: Members Equity Bank – ME Capital Notes

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📌 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.

Summary – what this Ruling is about

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

Relevant provisions

2. The relevant provisions dealt with in this Ruling are:

- subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936)
- section 26BB of the ITAA 1936
- subsection 43B(1) of the ITAA 1936
- subsection 44(1) of the ITAA 1936
- section 45A of the ITAA 1936
- section 45B of the ITAA 1936
- section 45C of the ITAA 1936
- section 70B of the ITAA 1936
- section 159GP of the ITAA 1936
- section 177EA of the ITAA 1936
- Division 1A of former Part IIIA of the ITAA 1936

- Division 67 of the *Income Tax Assessment Act 1997* (ITAA 1997)
- subsection 110-25(2) of the ITAA 1997
- subsection 110-55(2) of the ITAA 1997
- section 204-30 of the ITAA 1997
- section 207-20 of the ITAA 1997
- section 207-90 of the ITAA 1997
- Subdivision 207-D of the ITAA 1997
- Subdivision 207-F of the ITAA 1997
- section 207-145 of the ITAA 1997
- section 207-155 of the ITAA 1997
- section 207-157 of the ITAA 1997
- Division 974 of the ITAA 1997
- section 974-120 of the ITAA 1997
- subsection 995-1(1) of the ITAA 1997.

All subsequent legislative references in this Ruling are to the ITAA 1997 unless otherwise indicated.

Class of entities

3. The capital notes that are the subject of this Ruling are perpetual, non-cumulative, subordinated, unsecured, floating rate notes that were issued by Members Equity Bank Limited (ME Bank) on 28 November 2017 and form the first Tranche of the first Series under the Programme (such notes are referred to in this Ruling as ME Capital Notes).

4. The class of entities to which this Ruling applies are Holders of ME Capital Notes who:

- acquired their ME Capital Notes by being issued ME Capital Notes under the Programme on 28 November 2017
- are residents of Australia (as defined in subsection 6(1) of the ITAA 1936) during the period they hold their ME Capital Notes
- do not hold their ME Capital Notes as revenue assets (as defined in section 977-50) or as trading stock (as defined in subsection 995-1(1)) – that is, they hold their ME Capital Notes on capital account, and
- are not subject to the Taxation of Financial Arrangements rules in Division 230 in relation to financial arrangements under the scheme.

(Note: Division 230 will generally not apply to individuals unless they have made an election for it to apply to them.)

5. This Ruling does not consider how the gross-up and tax offset rules in Division 207 apply to:

- a partnership or trustee Holder to whom a franked Distribution is made (except a partnership or trustee that is a corporate tax entity, or a trustee of a trust that is a complying superannuation entity, when the Distribution is made), or
- an entity to whom a franked Distribution flows indirectly (as defined in subsection 995-1(1)).

6. This Ruling does not consider how the taxation law applies to ME Bank in relation to the issue of ME Capital Notes.

Qualifications

7. The Commissioner makes this Ruling based on the precise arrangement identified in this Ruling.

8. 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 11 to 44 of this Ruling.

9. 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.

Date of effect

10. This Ruling applies from 1 July 2017 to 30 June 2018. The Ruling continues to apply after 30 June 2018 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

11. The description of the scheme is set out below and is based on the following information provided by ME Bank. The following

documents, or relevant parts of them, form part of and are to be read with the description:

- request for Class Ruling from ME Bank received on 9 October 2017
- Information Memorandum – Programme for the Issuance of Capital Notes dated 14 November 2017 (IM)
- ME Bank Pricing Supplement for ME Capital Notes dated 27 November 2017 (Pricing Supplement)
- ME Capital Notes Deed Poll dated 14 November 2017 (Deed Poll), including Terms of ME Capital Notes dated 14 November 2017 (Note Terms), and
- correspondence and additional information provided by ME Bank.

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

12. In this Ruling, unless otherwise defined, capitalised terms have the meaning specified in the Note Terms, Pricing Supplement and Deed Poll.

Background

13. ME Bank is an authorised deposit-taking institution (ADI) regulated by the Australian Prudential Regulation Authority (APRA) under the *Banking Act 1959* (Cth).

14. ME Bank is an unlisted public company incorporated in Australia and is wholly owned by a number of Australian Industry Superannuation Funds.

15. ME Bank is an Australian resident as defined in subsection 995-1(1) and operates from offices in all major Australian capital cities and provides a range of banking products and services to retail clients in Australia.

The Offer

16. ME Bank has established a Programme enabling it to issue capital notes to investors.

17. Capital notes will be issued in Series. Each Series may comprise one or more Tranches having one or more issue dates and each Tranche will individually satisfy the relevant Prudential Standards.

18. ME Bank raised A\$200 million in Tier 1 capital through the issuance of the ME Capital Notes in accordance with its Capital Management Plan for 2018–2020 which has objectives including maintaining compliance with the APRA regulatory capital requirements and broader capital management risks.

19. ME Capital Notes were offered under a syndicated issue via a number of Dealers to investors, including institutional and wholesale investors in Australia.

20. ME Bank issued 20,000 ME Capital Notes on 28 November 2017 for an Issue Price of A\$10,000 per note. The ME Capital Notes were issued by ME Bank within Australia.

21. In a letter dated 10 November 2017, APRA confirmed that the ME Capital Notes will qualify as Additional Tier 1 Capital of ME Bank for the purpose of the regulatory capital requirement.

Main Features of ME Capital Notes

22. The obligations of ME Bank under ME Capital Notes are constituted by, and owing under, the Deed Poll.

23. Each ME Capital Note was issued fully paid for its face value of A\$10,000 (Face Value).

24. ME Capital Notes are perpetual and do not have a maturity date.

25. Some or all of the ME Capital Notes may be written off if a Non–Viability Trigger Event occurs.

26. With the prior written consent of APRA (which is at APRA's discretion and may or may not be given), ME Bank may elect to Redeem all or some of the ME Capital Notes following the occurrence of a Tax Event or a Regulatory Event, or on 28 November 2022 or any subsequent Distribution Payment Date.

27. There is no certainty that ME Capital Notes will be Redeemed as APRA's written approval for Redemption may not be granted, and in any event, ME Bank may be unwilling to Redeem ME Capital Notes.

Distribution calculations

28. Subject to the Note Terms, each Holder of ME Capital Notes on the Record Date is entitled to receive, on the relevant Distribution Payment Date, cash Distributions on their ME Capital Notes.

29. The Pricing Supplement states that ME Capital Notes are Floating Rate Notes. The Distribution payable on each Distribution Payment Date in respect of the preceding Distribution Period in respect of each ME Capital Note is calculated according to the following formula:

$$\text{Distribution} = \frac{\text{Distribution Rate} \times \text{A\$10,000} \times \text{N}}{365}$$

where:

Distribution Rate (expressed as a percentage per annum) means (BBSW Rate + Margin) x (1 – Tax Rate)

where:

BBSW Rate (expressed as a percentage per annum) means, for a Distribution Period, the rate for prime bank eligible securities having a tenor approximately equal to the relevant Distribution Period, which is designated as the 'AVG MID' on the Thomson Reuters Screen BBSW Page (or any designation which replaces that designation on that page, or any page that replaces that page) at approximately 10:15am, Sydney time (or such other time at which such rate customarily appears on that page) on the relevant day ('**Publication Time**'), on the first Business Day of the Distribution Period. However, if such rate does not appear on the Thomson Reuters Screen BBSW Page (or any page that replaces that page) by 10:30am, Sydney time, on that day (or such other time that is 15 minutes after the then prevailing Publication Time), or if it does appear but the Issuer determines that there is an obvious error in that rate, '**BBSW Rate**' means the rate determined by the Issuer having regard to comparable indices then available;

Margin (expressed as a percentage per annum) means the margin specified in the Pricing Supplement; and

N means in respect of:

- (a) the first Distribution Payment Date, the number of days from (and including) the Issue Date until (but not including) the first Distribution Payment Date; and
- (b) each subsequent Distribution Payment Date, the number of days from (and including) the preceding Distribution Payment Date until (but not including) the relevant Distribution Payment Date.

30. If any Distribution is not franked to 100% under Part 3-6 of the ITAA 1997, clause 4.5 of the Note Terms provides that the Distribution will instead be calculated by the following formula:

$$\text{Distribution} = \frac{\text{D}}{(1 - [T \times (1 - F)])}$$

where:

D means the Distribution calculated under paragraph 29 of this Ruling;

F means the Franking Rate; and

T means the applicable Tax Rate.

31. Distributions are expected to be franked to 100% (fully franked).

32. Distribution Payment Dates are stated in the Pricing Supplement as each 28 February, 28 May, 28 August and 28 November, subject to adjustment in accordance with the Business Day Convention.

Distribution conditions

33. The payment of any Distribution is subject to, among other things:

- the absolute discretion of ME Bank, and ME Bank may elect to pay some or none of a Distribution
- the payment of the Distribution not resulting in ME Bank breaching APRA's capital adequacy requirements applicable to it
- the payment of the Distribution not resulting in ME Bank becoming, or being likely to become, insolvent for the purposes of the *Corporations Act 2001* (Cth), and
- APRA not objecting to the payment of the Distribution.

34. Distributions are non-cumulative, and interest does not accrue on any unpaid Distributions. ME Bank has no liability to pay the unpaid amount of the Distribution. Holders have no claim or entitlement in respect of non-payment and non-payment does not constitute an event of default.

35. A restriction applies to ME Bank if ME Bank fails to pay a Distribution in full within 5 Business Days of a Distribution Payment Date. The restriction is that ME Bank must not, without the approval of a Special Resolution of Holders:

- declare, determine to pay or pay any Ordinary Share Dividend, or
- undertake any Buy Back or Capital Reduction.

Write-off on Non-Viability Trigger Event

36. A Non-Viability Trigger Event occurs when APRA provides a written determination to ME Bank that the conversion or write-off of Relevant Securities is necessary because:

- without the conversion or write-off, APRA considers that ME Bank would become non-viable, or
- without a public sector injection of capital into (or equivalent support with respect to) ME Bank, APRA considers that ME Bank would become non-viable.

37. If a Non-Viability Trigger Event occurs, ME Bank must write-off all or some of the ME Capital Notes (and other Relevant Securities).

Optional Redemption

38. ME Bank may, with APRA's prior written approval, elect to Redeem:

- all or some of the ME Capital Notes on a Distribution Payment Date following the occurrence of a Tax Event or a Regulatory Event, or
- all or some of the ME Capital Notes on 28 November 2022, or any subsequent Distribution Payment Date.

39. In addition to having to obtain APRA's prior written approval to Redeem ME Capital Notes, in certain circumstances ME Bank must replace the ME Capital Notes the subject of the Redemption with certain other capital instruments.

Redemption mechanism

40. ME Capital Notes will be Redeemed by payment on the Redemption Date of the Redemption Price to the relevant Holder.

41. The Redemption Price is defined in the Note Terms as the Face Value of the ME Capital Notes as at the date of redemption and also includes any other amount in the nature of a redemption amount specified in, or determined in accordance with, the Pricing Supplement or the Note Terms.

42. ME Bank has confirmed that ME Bank does not anticipate there will be any additional amounts other than Face Value to be included in the Redemption Price.

43. Upon payment of the Redemption Price, all other rights conferred, or restrictions imposed, by the ME Capital Note will no longer have effect.

Other matters

44. This Ruling is made on the basis that:
- (a) paragraphs 11 to 44 of this Ruling provide a complete and accurate description of the scheme. The Deed Poll, Note Terms, and Pricing Supplement are intended by the parties to have their legal effect and will be implemented according to their terms
 - (b) Distributions will not be debited against ME Bank's share capital account or non-share capital account, and Distributions will not be sourced, directly or indirectly, from ME Bank's share capital account or non-share capital account
 - (c) on a Redemption, ME Bank will make redemption payments out of capital, and not out of profits (that is, the Redemption Price will be debited in full against ME Bank's non-share capital account)
 - (d) Redemption of some (but not all) ME Capital Notes will not depend or vary according to the tax characteristics of Holders
 - (e) ME Bank will not differentially frank Distributions to different Holders according to their tax status or on any other basis
 - (f) if ME Bank declares the unfranked part of a Distribution to be conduit foreign income, Holders who are Australian corporate tax entities will not, after the start of the relevant income year and before the due day for lodging their income tax return for that income year, declare the unfranked part of a frankable distribution made by the Holder to be conduit foreign income (section 802-20)
 - (g) ME Bank will have sufficient available frankable profits such that no part of a Distribution will be taken to be unfrankable under section 215-15
 - (h) neither a Holder, nor an associate of a Holder, will have any 'positions' (as defined in former section 160APHJ of the ITAA 1936) in relation to their ME Capital Notes that would cause the Holder not to be a 'qualified person' for the purposes of Division 1A of former Part IIIAA of the ITAA 1936
 - (i) neither a Holder, nor an associate of a Holder, will make, be under an obligation to make, or be likely to make a 'related payment' (as defined in former section 160APHN of the ITAA 1936) in relation to a Distribution
 - (j) Holders will hold their ME Capital Notes for a continuous period of at least 90 days (excluding the

day on which they disposed of their ME Capital Notes, if applicable) during the 'primary qualification period' in relation to a Distribution (that is, the period beginning on the day after the day on which they acquired their ME Capital Notes and ending on the 90th day after the day on which the ME Capital Notes go ex-distribution)

- (k) Holders (or their connected entities) will not engage in distribution washing (as outlined in section 207-157) in relation to Distributions (unless the exception in subsection 207-157(4) applies)
- (l) the Redemption Price will be equal to the Face Value of the ME Capital Note. The Face Value of an ME Capital Note equals the Issue Price/Purchase Price, being A\$10,000 per ME Capital Note, and
- (m) ME Capital Notes are equity interests in ME Bank pursuant to Division 974 and are non-share equity interests in ME Bank as defined in subsection 995-1(1).

Ruling

ME Capital Notes not traditional securities

45. ME Capital Notes are not securities as defined in subsection 159GP(1) of the ITAA 1936 and are, therefore, not traditional securities for the purposes of sections 26BB and 70B of the ITAA 1936.

ME Capital Notes not qualifying securities

46. ME Capital Notes are not securities as defined in subsection 159GP(1) of the ITAA 1936 and are, therefore, not qualifying securities as defined in subsection 159GP(1) of the ITAA 1936.

Cost base and reduced cost base of ME Capital Notes

47. The first element of the cost base and reduced cost base of each ME Capital Note is A\$10,000, being the money paid by Holders to acquire each ME Capital Note (subsections 110-25(2) and 110-55(2)).

Section 45A of the ITAA 1936

48. The Commissioner will not make a determination under subsection 45A(2) of the ITAA 1936 that section 45C of the ITAA 1936 applies to treat the whole, or a part, of a capital benefit that arises on Redemption of ME Capital Notes as an unfranked dividend paid to Holders.

Section 45B of the ITAA 1936

49. The Commissioner will not make a determination under paragraph 45B(3)(b) of the ITAA 1936 that section 45C of the ITAA 1936 applies to treat the whole, or a part, of a capital benefit that arises on Redemption of ME Capital Notes as an unfranked dividend paid to Holders.

Inclusion of Distributions and franking credits in assessable income

50. Distributions are non-share dividends as defined in section 974-120 and Holders must include Distributions in their assessable income (subparagraph 44(1)(a)(ii) of the ITAA 1936).

51. Holders must also include an amount equal to the franking credit attached to a Distribution in their assessable income for the income year in which the Distribution is made (subsection 207-20(1)).

Entitlement to a tax offset

52. Holders will be entitled to a tax offset equal to the franking credit attached to a Distribution (subsection 207-20(2)).

Exception for exempt income or non-assessable non-exempt income

53. If a Distribution is either wholly exempt income or wholly non-assessable non-exempt income in the hands of a Holder, the amount of the franking credit attached to the Distribution is not included in the assessable income of the Holder and the Holder is not entitled to a tax offset under subsection 207-20(2) in respect of the franking credit attached to the Distribution (Subdivision 207-D), unless any of the exceptions in Subdivision 207-E apply.

54. If only part of a Distribution is either exempt income or non-assessable non-exempt income in the hands of a Holder, the amount of the franking credit on the Distribution is worked out under the formula in subsection 207-90(2). This has the effect of reducing the amount of the franking credit attached to the Distribution that is included in the Holder's assessable income and reducing the amount of the tax offset the Holder is entitled to, unless any of the exceptions in Subdivision 207-E apply.

Franking credit subject to the refundable tax offset rules

55. Where a Holder is entitled to a tax offset under subsection 207-20(2) in respect of the franking credit attached to a Distribution, the tax offset will be subject to the refundable tax offset rules in Division 67, unless the tax offset is specifically excluded under section 67-25.

Streaming of imputation benefits

56. The Commissioner will not make a determination under paragraph 204-30(3)(c) to deny the whole, or any part, of the imputation benefits received by a Holder in relation to Distributions.

Determination under paragraph 177EA(5)(b) of the ITAA 1936

57. The Commissioner will not make a determination under paragraph 177EA(5)(b) of the ITAA 1936 to deny the whole, or any part, of the imputation benefits received by a Holder in relation to Distributions.

Gross-up and tax offset denied in certain circumstances

58. Based on the description of the scheme (in particular paragraphs 44(h) to 44(j)), section 207-145 will not apply to cancel the effect of the gross-up and tax offset rules in respect of a franked Distribution paid to Holders.

Commissioner of Taxation

30 May 2018

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.*

ME Capital Notes not traditional securities

59. A 'traditional security' is defined in subsection 26BB(1) of the ITAA 1936 as a security held by the taxpayer that was acquired by the taxpayer after 10 May 1989, is not trading stock of the taxpayer, and either does not have an eligible return, or has an eligible return that satisfies the conditions listed in subparagraph (b)(ii) of the definition of traditional security in subsection 26BB(1) of the ITAA 1936.

60. The term 'security' is defined in subsection 26BB(1) of the ITAA 1936 by reference to subsection 159GP(1) of the ITAA 1936. Pursuant to subsection 159GP(1) of the ITAA 1936, 'security' means:

- (a) stock, a bond, debenture, certificate of entitlement, bill of exchange, promissory note or other security;
- (b) a deposit with a bank or other financial institution;
- (c) a secured or unsecured loan; or
- (d) any other contract, whether or not in writing, under which a person is liable to pay an amount or amounts, whether or not the liability is secured.

61. ME Capital Notes are not stock, a bond, debenture, certificate of entitlement, bill of exchange, or a promissory note.

62. The term 'or other security' in paragraph (a) of the definition of security only encompasses instruments that evidence an obligation on the part of the issuer or drawer to pay an amount to the holder or acceptor, whether during the term of the instrument or at its maturity. The types of securities referred to in paragraph (a) of the definition of security will generally be recognised as debt instruments (Taxation Ruling TR 96/14 *Income tax: traditional securities*).

63. Paragraphs (b) and (c) of the definition of security do not apply because ME Capital Notes are neither a deposit with a bank or other financial institution, nor a secured or unsecured loan.

64. Only those contracts that have debt like obligations will usually fall under paragraph (d) of the definition of security (TR 96/14).

65. The Note Terms do not evidence a liability by ME Bank to pay an amount or amounts to Holders of ME Capital Notes during the term of the instrument or at maturity.

66. ME Capital Notes are perpetual and Holders do not have a right to require Redemption.

67. The payment by ME Bank of Distributions is subject to the Distribution payment conditions in clause 4.6 of the Note Terms. The Distributions are discretionary and non-cumulative. If a Distribution is not paid, ME Bank has no liability to pay the Distribution and Holders have no claim or entitlement in respect of non-payment.

68. The Redemption of ME Capital Notes is only at the option of ME Bank and requires the prior written approval of APRA. This does not establish a liability on ME Bank to pay an amount.

69. ME Bank will not become liable to pay an amount in respect of ME Capital Notes upon winding up as it would be expected that, before winding up commences, ME Capital Notes would be written off pursuant to a Non-Viability Trigger Event.

70. As ME Capital Notes are not securities as defined in subsection 159GP(1) of the ITAA 1936, they cannot be traditional securities as defined in subsection 26BB(1) of the ITAA 1936.

ME Capital Notes not qualifying securities

71. A 'qualifying security' is defined in subsection 159GP(1) of the ITAA 1936 as a security issued after 16 December 1984, is not part of an exempt series as defined in subsection 159GP(9A) of the ITAA 1936, with a term reasonably likely to exceed one year, and has an eligible return that satisfies the requirement in paragraph (e) of the subsection 159GP(1) definition.

72. ME Capital Notes are not securities as defined in subsection 159GP(1) of the ITAA 1936, as explained at paragraphs 59 to 70 of this Ruling.

73. Accordingly, ME Capital Notes are not qualifying securities as defined in subsection 159GP(1) of the ITAA 1936.

Cost base and reduced cost base of ME Capital Notes

74. Under paragraph 110-25(2)(a) and subsection 110-55(2) the first element of the cost base and reduced cost base, respectively, of a CGT asset includes the money paid, or required to be paid, in respect of acquiring the CGT asset.

75. The Face Value of each ME Capital Note is A\$10,000, which was paid by Holders to ME Bank upon subscription for each ME Capital Note. Holders did not, and were not required to, pay any further amounts or provide any other property to acquire a ME Capital Note.

76. Accordingly, for capital gains tax (CGT) purposes, the first element of the cost base and reduced cost base of each ME Capital Note for each Holder who acquired ME Capital Notes upon subscription is A\$10,000.

Subsection 43B(1) of the ITAA 1936

77. ME Capital Notes are 'non-share equity interests' and Holders are 'equity holders' as defined in subsection 995-1(1). The effect of subsection 43B(1) of the ITAA 1936 is that sections 45A and 45B of the ITAA 1936 (discussed below) apply to non-share equity interests, equity holders and non-share dividends in the same way as they apply to shares, shareholders and dividends, respectively.

Section 45A of the ITAA 1936

78. Section 45A of the ITAA 1936 applies in circumstances where a company selectively directs the provision of capital benefits to certain shareholders who derive a greater benefit from the receipt of capital (the advantaged shareholders) and it is reasonable to assume that the other shareholders have received or will receive dividends (the disadvantaged shareholders).

79. If section 45A of the ITAA 1936 applies, the Commissioner may make a determination under subsection 45A(2) of the ITAA 1936 that section 45C of the ITAA 1936 applies. The effect of such a determination is that the capital benefit, or part of it, is taken to be an unfranked dividend.

80. The Redemption of ME Capital Notes will involve the provision of a capital benefit as defined in subsection 45A(3) of the ITAA 1936 as it will constitute a non-share capital return (subsection 45A(3A) of the ITAA 1936). ME Capital Notes may be Redeemed by payment on the Redemption Date of the Redemption Price. The Redemption Price will be limited to the Face Value of each ME Capital Note. Any Distribution entitlements in respect of ME Capital Notes will be separately paid as Distributions if the Redemption Date is also a Distribution Payment Date under the Note Terms.

81. The Redemption of ME Capital Notes will not involve the streaming of capital benefits and dividends. This is because Redemption will involve termination of ME Capital Notes in consideration for the payment of the Face Value. The Redemption will not involve some Holders receiving the payment of Distributions instead of the Face Value.

82. Accordingly, section 45A of the ITAA 1936 will not apply to the Redemption of ME Capital Notes.

83. Therefore, the Commissioner will not make a determination under subsection 45A(2) of the ITAA 1936 that section 45C of the ITAA 1936 applies to treat the whole, or part, of a capital benefit that arises on the Redemption of ME Capital Notes as an unfranked dividend paid to Holders.

Section 45B of the ITAA 1936

84. Section 45B of the ITAA 1936 applies where certain capital benefits are provided to shareholders in substitution for dividends and the conditions in subsection 45B(2) of the ITAA 1936 are met.

85. If section 45B of the ITAA 1936 applies, the Commissioner may make a determination under paragraph 45B(3)(b) of the ITAA 1936 that section 45C of the ITAA 1936 applies. The effect of such a determination is that all or part of the capital benefit is taken to be an unfranked dividend.

86. The Redemption of ME Capital Notes will constitute a scheme under which Holders are provided with a capital benefit by ME Bank (paragraph 45B(5)(b) of the ITAA 1936 and subsection 45B(7) of the ITAA 1936).

87. For section 45B of the ITAA 1936 to apply, among other things, paragraph 45B(2)(c) of the ITAA 1936 requires that, 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 it) did so for a purpose, other than an incidental purpose, of enabling a relevant taxpayer (a Holder) to obtain a tax benefit. A non-exhaustive list of relevant circumstances of the scheme are provided in subsection 45B(8) of the ITAA 1936.

88. The Commissioner does not consider that the facts and circumstances point towards the relevant parties having the prohibited purpose of enabling Holders to obtain a tax benefit, in particular:

- the redemption payments will be made out of capital, not out of profits
- ME Capital Notes were offered under a syndicated issue via a number of Dealers to a range of investors
- Redemption will occur at the Face Value of the ME Capital Notes which is also equal to the first element of the cost base of the ME Capital Notes, and
- Holders' rights in respect of their ME Capital Notes will be terminated upon receipt of the Redemption Price.

89. Accordingly, the Commissioner will not make a determination under paragraph 45B(3)(b) of the ITAA 1936 that section 45C of the ITAA 1936 applies to treat the whole, or part, of a capital benefit that arises on Redemption of ME Capital Notes as an unfranked dividend paid to Holders.

Inclusion of Distributions and franking credits in assessable income

90. Subparagraph 44(1)(a)(ii) of the ITAA 1936 provides that the assessable income of a resident shareholder in a company includes all non-share dividends paid to the shareholder by the company.

91. ME Capital Notes are 'non-share equity interests' and Holders are 'equity holders' as defined in subsection 995-1(1). The effect of paragraph 43B(1)(b) of the ITAA 1936 is that section 44 of the ITAA 1936 applies to equity holders in the same way as it applies to shareholders.

92. Distributions paid in respect of ME Capital Notes are non-share dividends as defined in section 974-120. Accordingly, Holders must include Distributions in their assessable income under subparagraph 44(1)(a)(ii) of the ITAA 1936.

93. ME Bank expects that Distributions paid in respect of the ME Capital Notes will be franked. This means Distributions on ME Capital Notes are expected to be franked distributions as defined in subsection 995-1(1).

94. In accordance with subsection 207-20(1), Holders must also include any franking credit attached to a Distribution in their assessable income for the income year in which the Distribution is made.

Entitlement to a tax offset

95. Subsection 207-20(2) provides that an entity who receives a franked distribution is entitled to a tax offset for the income year in which the distribution is made. The tax offset is equal to the franking credit on the distribution.

96. Holders will be entitled to a tax offset equal to the amount of the franking credit attached to a Distribution (subsection 207-20(2)).

Exception for exempt income or non-assessable non-exempt income

97. Under Subdivision 207-D, if a Distribution is either wholly exempt income or wholly non-assessable non-exempt income in the hands of a Holder, the amount of the franking credit attached to the Distribution is not included in the assessable income of the Holder and the Holder is not entitled to a tax offset in respect of the franking credit attached to the Distribution.

98. Also under Subdivision 207-D, if only part of a Distribution is either exempt income or non-assessable non-exempt income in the hands of a Holder, the amount of the franking credit on the Distribution is worked out under the formula in subsection 207-90(2). This has the effect of reducing the amount of the franking credit attached to the Distribution that is included in the Holder's assessable income and reducing the amount of the tax offset the Holder is entitled to.

99. However, Subdivision 207-E provides a number of exceptions to the rules in Subdivision 207-D for certain exempt institutions, trusts and life insurance companies.

Franking credit subject to the refundable tax offset rules

100. Division 67 contains the refundable tax offset rules, and in particular sets out which tax offsets may be refunded if they exceed basic income tax liability.

101. Subsection 67-25(1) provides that tax offsets available under Division 207 are subject to the refundable tax offset rules, unless otherwise excluded.

102. Where a Holder is entitled to a tax offset under subsection 207-20(2) in respect of the franking credit attached to a Distribution, the tax offset will be subject to the refundable tax offset rules in Division 67, unless the tax offset is specifically excluded under section 67-25.

Streaming of imputation benefits

103. Subdivision 204-D enables the Commissioner to make a determination where distributions with attached imputation benefits are streamed to a member of a corporate tax entity in preference to another member.

104. The term 'streaming' is not defined in the ITAA 1997.

105. However, paragraphs 3.28 and 3.29 of the Explanatory Memorandum to the New Business Tax System (Imputation) Bill 2002 (Cth), which introduced Subdivision 204-D into the ITAA 1997, explains that:

3.28 Streaming is selectively directing the flow of franked distributions to those members who can most benefit from imputation credits.

3.29 The law uses an essentially objective test for streaming, although purpose may be relevant where future conduct is a relevant consideration. It will normally be apparent on the face of an arrangement that a strategy for streaming is being implemented. The distinguishing of members on the basis of their ability to use franking benefits is a key element of streaming.

106. As such, 'streaming' involves the distribution of franking credits in a way which provides an enhanced benefit to a certain category of members based upon their respective tax attributes.

107. ME Capital Notes were marketed and available to a range of different institutional and wholesale investors, regardless of their tax attributes or their individual tax positions. Moreover, all Holders will receive Distributions which are franked to the same percentage regardless of their tax attributes or their individual tax positions.

108. Therefore, the Commissioner will not make a determination under paragraph 204-30(3)(c) to deny the whole, or any part, of the imputation benefits received by Holders in relation to Distributions paid in respect of ME Capital Notes.

Determination under paragraph 177EA(5)(b) of the ITAA 1936

109. Section 177EA of the ITAA 1936 is a general anti-avoidance provision that applies where one of the purposes (other than an incidental purpose) of a scheme is to enable a taxpayer to obtain an imputation benefit.

110. Subsection 177EA(3) of the ITAA 1936 provides the conditions under which section 177EA of the ITAA 1936 will apply:

- (a) there is a scheme for a disposition of membership interests, or an interest in membership interests, in a corporate tax entity; and
- (b) either:
 - (i) a frankable distribution has been paid, or is payable or expected to be payable, to a person in respect of the membership interests; or
 - (ii) a frankable distribution has flowed indirectly, or flows indirectly or is expected to flow indirectly, to a person in respect of the interest in membership interests, as the case may be; and
- (c) the distribution was, or is expected to be, a franked distribution or a distribution franked with an exempting credit; and
- (d) except for [section 177EA], the person (the **relevant taxpayer**) would receive, or could reasonably be expected to receive, imputation benefits as a result of the distribution; and
- (e) 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.

111. Subsection 177EA(12) of the ITAA 1936 states that section 177EA applies to non-share equity interests, equity holders and non-share dividends in the same way as it applies to membership interests, members and distributions, respectively.

112. The Commissioner considers that the conditions in paragraphs 177EA(3)(a) to 177EA(3)(d) of the ITAA 1936 will be satisfied because:

- (a) the issue of ME Capital Notes is a scheme for the disposition of membership interests in a corporate tax entity (paragraph 177EA(3)(a) of the ITAA 1936)
- (b) frankable distributions are expected to be payable in respect of ME Capital Notes (paragraph 177EA(3)(b) of the ITAA 1936)
- (c) ME Bank expects to frank the Distributions on ME Capital Notes (paragraph 177EA(3)(c) of the ITAA 1936), and
- (d) it is reasonable to expect that, but for the operation of section 177EA of the ITAA 1936, at least some Holders will receive imputation benefits as a result of receiving Distributions (paragraph 177EA(3)(d) of the ITAA 1936).

113. Paragraph 177EA(3)(e) of the ITAA 1936 provides that the relevant circumstances of the scheme must be considered to establish whether any person who entered into or carried out the scheme or any part of the scheme did so for a more than incidental purpose of enabling a relevant taxpayer (a Holder) to obtain an imputation benefit.

114. The relevant circumstances of a scheme include the circumstances listed in subsection 177EA(17) of the ITAA 1936. This is a non-exhaustive list of mandatory relevant considerations. Regard must be had to all relevant circumstances, both collectively and individually, to identify any purpose of the kind referred to in paragraph 177EA(3)(e) of the ITAA 1936.

115. The Commissioner considers that collectively the relevant circumstances of the scheme do not, on balance, lead to a conclusion that the purpose of enabling Holders to obtain imputation benefits is more than incidental to ME Bank's purpose of raising Tier 1 Capital in accordance with its Capital Management Plan and for regulatory capital requirements.

116. Accordingly, the Commissioner will not make a determination under paragraph 177EA(5)(b) of the ITAA 1936 that would deny imputation benefits to Holders.

Gross-up and tax offset denied in certain circumstances

117. Subdivision 207-F creates the appropriate adjustment to cancel the effect of the gross-up and tax offset rules where the entity concerned has manipulated the imputation system in a manner that is not permitted under the income tax law.

118. Pursuant to subsection 207-145(1), this adjustment will occur where a franked distribution is made to an entity in one or more of the following circumstances:

- the entity is not a 'qualified person' in relation to the distribution for the purposes of Division 1A of former Part IIIAA of the ITAA 1936 (paragraph 207-145(1)(a))
- the Commissioner has made a determination under paragraph 177EA(5)(b) of the ITAA 1936 that no imputation benefit is to arise in respect of the distribution for the entity (paragraph 207-145(1)(b))
- the Commissioner has made a determination under paragraph 204-30(3)(c) that no imputation benefit is to arise in respect of the distribution for the entity (paragraph 207-145(1)(c))
- the distribution is made as part of a dividend stripping operation (paragraph 207-145(1)(d)), or
- the distribution is one to which section 207-157 (which is about distribution washing) applies (paragraph 207-145(1)(da)).

Qualified person – paragraph 207-145(1)(a)

119. The effect of former section 160AOA of the ITAA 1936 is that former Part IIIAA of the ITAA 1936 applies to non-share equity interests, equity holders and non-share dividends in the same way as it applies to shares, shareholders and dividends, respectively.

120. A person will be a 'qualified person' in relation to a dividend for the purposes of Division 1A of former Part IIIAA of the ITAA 1936 if, generally speaking, they satisfy the holding period rule in former section 160APHO of the ITAA 1936.

121. The holding period rule requires a person to hold shares 'at risk' for a continuous period (excluding the day of acquisition and the day of disposal of the share) of either 45 days (if the shares are not preference shares) or 90 days (if the shares are preference shares) during either the primary qualification period or the secondary qualification period in relation to the dividend. 'Primary qualification period' and 'secondary qualification period' are defined in former section 160APHD of the ITAA 1936.

122. A person would be subject to the secondary qualification period where they (or an associate) have made, are under an obligation to make, or are likely to make, a 'related payment' in respect of a dividend. 'Related payment' is defined in former sections 160APHN and 160APHNA of the ITAA 1936.

123. Subject to certain exceptions, if for any reason a Distribution is not paid in full on a Distribution Payment Date, ME Bank is restricted (without Holders approving a Special Resolution) from declaring, determining to pay or paying any interim, final or special dividend in relation to Ordinary Shares. That is, Distributions are in preference to distributions on Ordinary Shares. Accordingly, ME Capital Notes are less risky than Ordinary Shares in ME Bank and are 'preference shares' for the purposes of former sections 160APHD and 160APHO of the ITAA 1936.

124. In establishing whether a Holder held their ME Capital Notes 'at risk' for the required period, former subsection 160APHO(3) of the ITAA 1936 states:

In calculating the number of days for which the taxpayer continuously held the shares [at risk]...any days on which the taxpayer has materially diminished risks of loss or opportunities for gain in respect of the shares...are to be excluded, but the exclusion of those days is not taken to break the continuity of the period for which the taxpayer held the shares...

125. A Holder will be taken to have materially diminished risks of loss or opportunities for gain on a particular day in respect of their ME Capital Notes if their 'net position' on that day in respect of their ME Capital Notes represents less than 30% of those risks and opportunities (former subsection 160APHM(2) of the ITAA 1936).

126. In accordance with former subsection 160APHJ(2) of the ITAA 1936, a position in relation to a share is anything that has a 'delta' in relation to that share. Although 'delta' is not a defined term, paragraph 4.56 of the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 2) 1999 (Cth) states:

Delta is a well-recognised financial concept that measures the relative change in the price of an option or other derivative for a given small change in the price of an underlying asset. An option with a positive delta indicates that its price is expected to rise and fall with the underlying asset, while a negative delta indicates an inverse price relationship.

127. All 'positions' are taken into account in identifying a 'net position'.

128. Based on the description of the scheme (in particular paragraphs 44(h) to 44(j)), Holders will be 'qualified persons' in relation to Distributions received in respect of their ME Capital Notes because:

- neither a Holder, nor an associate of a Holder, will have any 'positions' (as defined in former section 160APHJ of the ITAA 1936) in relation to their

ME Capital Notes that would cause the Holder not to be a 'qualified person' for the purposes of Division 1A of former Part IIIAA of the ITAA 1936 (that is, they will hold their ME Capital Notes 'at risk')

- neither a Holder, nor an associate of a Holder, will make, be under an obligation to make, or be likely to make a 'related payment' (as defined in former section 160APHN of the ITAA 1936) in relation to a Distribution, and
- Holders will hold their ME Capital Notes for a continuous period of at least 90 days (excluding the day on which they disposed of their ME Capital Notes, if applicable) during the 'primary qualification period' in relation to a Distribution (that is, the period beginning on the day after the day on which they acquired their ME Capital Notes and ending on the 90th day after the day on which the ME Capital Notes go ex-distribution).

Paragraphs 207-145(1)(b) and (c)

129. As explained above, the Commissioner will not make a determination under paragraph 177EA(5)(b) of the ITAA 1936 or paragraph 204-30(3)(c) to deny the imputation benefits attached to Distributions paid to Holders in respect of ME Capital Notes.

Dividend stripping operation – paragraph 207-145(1)(d)

130. A distribution will be taken to be made as part of a dividend stripping operation, pursuant to section 207-155, where the distribution arose out of, or was made in the course of, a scheme or substantially similar arrangement that was in the nature of dividend stripping.

131. The Explanatory Memorandum to New Business Tax System (Imputation) Bill 2002 (Cth) states at paragraph 5.57:

Schemes by way of, or in the nature of, dividend stripping schemes include those where a person purchases for a capital sum the shares in a target company that has accumulated profits, and then draws off the profits by effecting the payment of a dividend by the target company.

132. There is no indication that the offering of ME Capital Notes and the associated payment of franked Distributions to Holders in any way constitutes a dividend stripping arrangement.

Distribution washing – paragraph 207-145(1)(da)

133. Holders (or their connected entities) will not engage in distribution washing (as outlined in section 207-157) in relation to Distributions (unless the exception in subsection 207-157(4) applies).

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134. As paragraphs 207-145(1)(a) to (da) will not apply to franked Distributions paid to Holders, section 207-145 will not apply to cancel the effect of the gross-up and tax offset rules in respect of franked Distributions paid to Holders.

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Previous draft:

Not previously issued as a draft

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TR 96/14: TR 2006/10

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Income tax ~~ Capital management ~~ Anti avoidance rules ~~ Section 177EA

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