

# ***CR 2020/64 - Challenger Limited - Challenger Capital Notes 3***

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## Class Ruling

# Challenger Limited – Challenger Capital Notes 3

### **📌 Relying on this Ruling**

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

If this Ruling applies to you, and you correctly rely on it, we will apply the law to you in the way set out in this Ruling. That is, you will not pay any more tax or penalties or interest in respect of the matters covered by this Ruling.

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### **What this Ruling is about**

1. This Ruling sets out income tax consequences for Australian-resident investors who acquired non-cumulative, convertible, transferable, redeemable, subordinated, perpetual, unsecured notes issued by Challenger Limited (Challenger) called Challenger Capital Notes 3 (Capital Notes 3).
2. Full details of the scheme are set out in paragraphs 39 to 86 of this Ruling.
3. In this Ruling, unless otherwise indicated, capitalised terms take on the same meaning as in the Challenger Capital Notes 3 Prospectus dated 21 October 2020 (the Prospectus), the Capital Notes 3 Terms (as included in the Prospectus) (the Notes Terms) and the Challenger Capital Notes 3 Trust Deed dated 13 October 2020 (the Trust Deed).
4. All legislative references in this Ruling are to provisions of the *Income Tax Assessment Act 1997*, unless otherwise indicated.

### **Who this Ruling applies to**

5. This Ruling applies to you if you:
  - are an investor who acquired Capital Notes 3 by initial application under the Challenger Capital Notes 3 Prospectus dated 13 October 2020, which was subsequently replaced by the Prospectus dated 21 October 2020

- are a 'resident of Australia' within the meaning of that term in subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) during the period in which you hold Capital Notes 3
- do not hold Capital Notes 3 in Challenger as revenue assets (as defined in section 977-50) nor as trading stock (as defined in subsection 995-1(1) – that is, you hold the Capital Notes 3 broadly on capital account), and
- are not subject to the taxation of financial arrangements (TOFA) rules in Division 230 in relation to gains or losses made on your Capital Notes 3.

**Note:** Division 230 will not apply to individuals, unless they have made an election for it to apply.

6. The investors described in the paragraph 5 of this Ruling are referred to in this Ruling as Holders.

## When this Ruling does not apply

7. This Ruling does not deal with:
- how the taxation law applies to Challenger in relation to the issue of the Capital Notes 3
  - how the taxation law applies to Holders who hold their Capital Notes 3 as trading stock or revenue assets
  - the tax implications of the Conversion of Capital Notes 3 on a Non-Viability Trigger Event
  - the tax implications of the Redemption of Capital Notes 3 other than for the application of sections 26BB, 45A, 45B and 70B of the ITAA 1936
  - the tax implications for Challenger Capital Note (CN1) holders of selling their Challenger CCN1 under the Repurchase Invitation or the Reinvestment Offer, and receiving distributions on Challenger CN1
  - the tax implications for Holders for whom gains and losses from Capital Notes 3 are subject to the TOFA rules in Division 230, and
  - how the gross-up and tax offset rules in Division 207 apply to partnership or trustee Holders, or to indirect distributions to partners in a partnership, or beneficiaries or trustees of a trust.

## When this Ruling applies

8. This Ruling applies from 1 July 2020 to 30 June 2030.

## Ruling

### Acquisition time of the Capital Notes 3

9. Holders acquire their Capital Notes 3 on 25 November 2020, being the date the contract for the issue of the Capital Notes 3 is entered into (table item 2 of section 109-10).

**Cost base and reduced cost base of the Capital Notes 3**

10. The first element of the cost base and reduced cost base of each Capital Note 3 is \$100, being the money paid by the Holder to acquire the Capital Note 3 from Challenger (subsections 110-25(2) and 110-55(2)).

**Inclusion of Distributions and franking credits in assessable income**

11. Distributions paid in respect of each Capital Note 3 are non-share dividends under section 974-120 and must be included in the Holder's assessable income (subparagraph 44(1)(a)(ii) of the ITAA 1936).

12. Holders must also include in their assessable income an amount equal to the franking credits attached to the Distribution (subsection 207-20(1)).

**Entitlement to a tax offset**

13. Holders are entitled to a tax offset equal to the franking credit received on Distributions paid in respect of their Capital Notes 3 (subsection 207-20(2)) unless the Distribution is exempt income or non-assessable non-exempt income in the hands of the Holder.

**Franking credit subject to the refundable tax offset rules**

14. Holders who are entitled to a tax offset under subsection 207-20(2) in respect of the franking credits received in relation to the Capital Notes 3 will be subject to the refundable tax offset rules in Division 67, unless they are specifically excluded under section 67-25.

**Imputation benefits – streaming**

15. 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 paid in respect of the Capital Notes 3.

**Section 177EA of the ITAA 1936**

16. 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 Holders in relation to Distributions paid in respect of the Capital Notes 3.

**Gross-up and tax offset**

17. Section 207-145 will not apply to the whole, or any part, of the Distributions paid to Holders. Accordingly, section 207-145 will not adjust the gross-up of the Holder's assessable income to exclude the franking credit, nor will it deny the tax offset to which the Holder would have otherwise been entitled.

18. For the purposes of determining whether a Holder is a 'qualified person' in relation to the Distributions under Division 1A of former Part IIIAA of the ITAA 1936 (which is relevant to paragraph 207-145(1)(a)), the Resale mechanism (of itself) and the Conversion mechanism (of itself) will not affect a Holder's risks of loss or opportunities for gain in respect of the Capital Notes 3. This is because neither the Resale mechanism nor the

Conversion mechanism constitutes a separate position (former sections 160APHJ and 160APHM of the ITAA 1936).

## **Each Capital Note 3 is not a traditional security**

19. Each Capital Note 3 is not a 'traditional security' as defined in subsection 26BB(1) of the ITAA 1936.
20. A gain on the disposal of each Capital Note 3 does not give rise to assessable income under subsection 26BB(2) of the ITAA 1936. A loss on the disposal of each Capital Note 3 does not give rise to an allowable deduction under subsection 70B(2) of the ITAA 1936.

## **Capital Notes 3 are convertible interests**

21. Each Capital Note 3 is a convertible interest under table item 4 of subsection 974-75(1).

## **Conversion of Capital Notes 3 – ordinary income**

22. As Capital Notes 3 are held by Holders on capital account, no amount will be included in the assessable income of a Holder on the Conversion of each Capital Note 3 under section 6-5.
23. Similarly, a Holder will not incur a deductible loss under section 8-1 as a consequence of the Conversion.

## **Conversion of the Capital Notes 3 – capital gains tax (CGT) implications**

24. CGT event C2 will happen for Holders on Conversion of each Capital Note 3 for ordinary shares in Challenger (Ordinary Shares) (section 104-25). Conversion is constituted by the Capital Note 3 (a convertible interest) being converted into Ordinary Shares.
25. Any capital gain or capital loss made by a Holder from CGT event C2 happening on Conversion of each Capital Note 3 will be disregarded (subsection 130-60(3)).

## **Capital Notes 3 that are Written-Off – capital gains tax implications**

26. CGT event C2 (section 104-25) will happen on the Write-Off of the Capital Notes 3.
27. The capital proceeds received by Holders on CGT event C2 happening will be nil because the Holders will not receive capital proceeds in respect of a Write-Off and the market value of the Capital Notes 3 at that time will be nil.

## **Cost base and reduced cost base of Ordinary Shares acquired on Conversion**

28. On Conversion of each Capital Note 3, Subdivision 130-C will apply so that the first element of the cost base and reduced cost base of each Ordinary Share acquired from Conversion of a Capital Note 3 will be a pro rata portion of the cost base and reduced cost base of the Capital Note 3 at the time of Conversion (table item 2 of subsection 130-60(1)).

**Acquisition time of Ordinary Shares on Conversion**

29. Ordinary Shares allotted on Conversion of each Capital Note 3 (being a convertible interest) will be taken to be acquired at the time of Conversion (subsection 130-60(2)).

**Share Sale facility**

30. The disposal of a Holder's Ordinary Share allocation by a nominee will give rise to CGT event A1 for the Holder (subsections 104-10(1) and 104-10(2)). The Holder's capital proceeds under section 116-20 will be the cash amount received from the nominee, being the net sale proceeds. The cost base or the reduced cost base of the Holder's Ordinary Shares will be a pro rata portion of the cost base of each Capital Note 3 at the time of Conversion (table item 2 of subsection 130-60(1)).

**Allotment of Ordinary Shares on Conversion not a Distribution**

31. Other than in respect of a Distribution paid on the date on which a Conversion occurs, the Conversion of the Capital Notes 3 will not result in Holders being taken to have received a dividend as defined in subsection 6(1) of the ITAA 1936 or a non-share dividend under section 974-120.

**Resale of Capital Notes 3 – ordinary income**

32. As Capital Notes 3 are held by Holders on capital account, no amount will be included in the assessable income of a Holder on the Resale of each Capital Note 3 under section 6-5.

33. Similarly, a Holder will not incur a deductible loss under section 8-1 as a consequence of the Resale.

**Resale of Capital Notes 3 – capital gains tax implications**

34. CGT event A1 in section 104-10 will happen on the Resale of Capital Notes 3. The capital proceeds under section 116-20 will be the cash amount received from the Nominated Purchaser, being the Resale Price of each Capital Note 3.

35. The Holder will make a capital gain if those capital proceeds are more than the cost base of the Capital Note 3 and a capital loss if those capital proceeds are less than the reduced cost base of the Capital Note 3 (subsection 104-10(4)).

**Section 45 of the ITAA 1936**

36. Section 45 of the ITAA 1936 will not apply to treat the Ordinary Shares issued on Conversion as an unfranked dividend paid by Challenger.

**Section 45A of the ITAA 1936**

37. 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 Conversion of the Capital Notes 3 as an unfranked dividend in the hands of Holders.

## Section 45B of the ITAA 1936

38. 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 Conversion of the Capital Notes 3 as an unfranked dividend in the hands of Holders.

## Scheme

39. The following description of the scheme is based on information provided by the applicant. If the scheme is not carried out as described, this Ruling cannot be relied upon.

## Challenger

40. During the term of the capital-raising under which Challenger issued Capital Notes 3 (Transaction), Challenger will be a resident of Australia under the income tax laws of Australia and of no other jurisdiction.

41. Challenger was established in 1985 and is an investment management firm managing more than \$85 billion in assets (as at 30 June 2020).

42. Challenger is the head company of the Challenger tax consolidated group and has been listed on the Australian Securities Exchange (ASX) since 1987.

43. Challenger operates two core investment businesses, a Funds Management division and a Life division.

44. Challenger Life Company Limited (CLC) is a wholly-owned subsidiary of Challenger. CLC is Australia's largest provider of annuities and a life company registered under the *Life Insurance Act 1995*. CLC guarantees the capital and interest in annuitants' regular payments, providing reliable income to Australian retirees.

45. CLC is prudentially regulated by the Australian Prudential Regulation Authority (APRA) as a life insurer.

## The offer of Capital Notes 3

46. In the Prospectus, which was lodged with the Australian Securities and Investments Commission on 21 October 2020 pursuant to section 718 of the *Corporations Act 2001* (Corporations Act), Challenger announced its intention to undertake an offer of Capital Notes 3 to raise A\$305 million, with the ability to raise more or less (the Offer).

47. This Prospectus expires on the date which is 13 months after 13 October 2020 (Expiry Date) and no Capital Notes 3 will be issued on the basis of this Prospectus after the Expiry Date.

48. The classes of Applicants who can apply for the Capital Notes 3, as described in the Prospectus, are:

- an Eligible Securityholder – a person who is:
  - a registered holder of Ordinary Shares or registered holder of Challenger CN1 or Challenger Capital Notes 2 at 7:00 pm (Sydney time) on 8 October 2020
  - shown on the applicable register as having an address in Australia, and
  - not be in the United States of America (USA), or acting as a nominee for a person in the USA
- a Broker Firm Applicant – a client of a Syndicate Broker, resident in Australia, who has received a firm allocation from their Syndicate Broker
- an Institutional Investor – an investor to whom offers or invitations in respect of the Capital Notes 3 can be made without the need for a lodged prospectus (or other formality, other than a formality which Challenger is willing to comply with), including in Australia persons to whom offers or invitations can be made without the need for a lodged prospectus under section 708 of the Corporations Act, and who has been invited by the Joint Lead Managers to bid for the Capital Notes 3 in the Bookbuild, provided that such investor may not be in the USA, and
- an Eligible Challenger CN1 Holder – a person who is:
  - registered as a holder of Challenger CN1 at 7.00pm (Sydney time) on 8 October 2020 (Challenger CN1 must also be held on the Closing Date)
  - shown on the Challenger CN1 register as having an address in Australia
  - not an individual residing in a member state of the European Union, and
  - not in the USA or acting as a nominee for, or for the account or benefit of, a US Person, and not otherwise prevented from receiving the Reinvestment Offer or Capital Notes 3 under the laws of any jurisdiction.

49. The Prospectus states that no action has been taken to register or qualify the Capital Notes 3 or the Offer, or to otherwise permit a public offering of the Capital Notes 3 outside Australia. However, the Capital Notes 3 may be offered in a jurisdiction outside Australia under the Institutional Offer where such offer is made in accordance with the laws of that jurisdiction.

### **Reasons for issuing the Capital Notes 3**

50. The Offer of the Capital Notes 3 will raise capital to satisfy the Challenger Group's capital (including regulatory/prudential capital) requirements, to replace funding previously provided by Challenger CN1, and to maintain the diversity of Challenger's sources and types of funding.

51. The net proceeds of the Offer are intended to be used by Challenger to subscribe for notes to be issued by CLC (CLC Notes). The CLC Notes are expected to form part of CLC's Additional Tier 1 Capital.

**Terms of the Capital Notes 3**

52. The Capital Notes 3 were issued on 25 November 2020 (Issue Date) and are non-cumulative, convertible, transferable, redeemable, subordinated, perpetual, unsecured notes issued by Challenger.

53. The issue price of each Capital Note 3 is \$100 (Face Value), and on issue is fully paid.

54. A Holder will not have voting rights under the Capital Notes 3, except in the limited circumstances described in the Notes Terms and Trust Deed.

**Distribution calculation**

55. Subject to the conditions outlined in paragraphs 59 and 60 of this Ruling, the Holder of each Capital Note 3 is entitled to receive, in respect of a Distribution Period, on the Distribution Payment Date a cash distribution on the Face Value of the Capital Notes 3 (Distribution) calculated using the formula in clause 3.1 of the Notes Terms:

$$\text{Distribution} = \frac{\text{Distribution Rate} \times \text{A\$}100 \times \text{N}}{365}$$

where:

**Distribution Rate** (expressed as a percentage per annum) in respect of a Capital Note for a Distribution Period is the rate calculated according to the following formula:

$$\text{Distribution Rate} = (\text{Bank Bill Rate} + \text{Margin}) \times (1 - \text{Tax Rate})$$

where:

**Bank Bill Rate** means:

- (a) subject to paragraph (b) immediately below:
  - (i) for a Distribution Period, the rate (expressed as a percentage per annum) designated "BBSW" in respect of prime bank eligible securities having a tenor of three months which ASX (or its successor as administrator of that rate) publishes through information vendors at approximately 10:30am Sydney time (or such other time at which such rate is accustomed to be so published) (the **Publication Time**), on the first Business Day of that Distribution Period; or
  - (ii) if the Issuer determines that such rate as is described in paragraph (i) above:
    - (A) is not published by midday (or such other time that the Issuer considers appropriate on that day); or
    - (B) is published, but is affected by an obvious error, such other rate (expressed as a percentage per annum) that the Issuer determines having regard to comparable indices then available; and
- (b) if the Issuer determines that a Rate Disruption Event has occurred, then, subject to APRA's prior written approval, the Issuer:
  - (i) shall use as the Bank Bill Rate such Replacement Rate as it may determine;

- (ii) shall make such adjustments to these Terms as it determines are reasonably necessary to calculate Distributions in accordance with such Replacement Rate; and
- (iii) in making the determinations under paragraphs (i) and (ii) immediately above:
  - (A) shall act in good faith and in a commercially reasonable manner;
  - (B) may consult with such sources of market practice as it considers appropriate; and
  - (C) may otherwise make such determination in its discretion;

*Holders should note that APRA's approval may not be given for any Replacement Rate it considers to have the effect of increasing the rate of Distributions contrary to applicable prudential standards.*

**Margin** (expressed as a percentage per annum) means the margin determined under the Bookbuild;

**Rate Disruption Event** means that, in the Issuer's opinion, the rate described in paragraph (a) of the definition of 'Bank Bill Rate' above:

- (a) has been discontinued or otherwise ceased to be calculated or administered; or
- (b) is no longer generally accepted in the Australian market as a reference rate appropriate to floating rate debt securities of a tenor and interest period comparable to that of the Capital Notes;

**Replacement Rate** means a rate other than the rate described in paragraph (a) of the definition of 'Bank Bill Rate' that is generally accepted in the Australian market as the successor to the Bank Bill Rate, or if the Issuer is not able, after making reasonable efforts, to ascertain such rate, or there is no such rate;

- (a) a reference rate that is, in the Issuer's opinion, appropriate to floating rate debt securities of a tenor and interest period most comparable to that of the Capital Notes; or
- (b) such other rate as the Issuer determines having regard to available comparable indices; and

**Tax Rate** (expressed as a decimal) means the Australian corporate tax rate applicable to the franking account of the Issuer at the relevant Distribution Payment Date; 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.

56. The Distribution Payment Dates are each 25 February, 25 May, 25 August and 25 November, commencing on 25 February 2021 until (but not including) the date on which the Capital Note 3 is Converted or Redeemed. A Distribution will also be paid on the date on which a Conversion, Redemption or Resale occurs in accordance with clause 3.5 of the Notes Terms.

57. Challenger expects to partially-frank dividends on Ordinary Shares in the period in which the first Distribution is scheduled to be paid. Distributions on the Capital Notes 3 will be franked at the same rate as dividends on Ordinary Shares in each Applicable Franking Period.

58. If any Distribution is not franked or only partially franked the Distribution will be grossed-up to the extent that the franking percentage of the Distribution is less than 100%, as determined by the formula in clause 3.2(b) of the Notes Terms, being:

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

where:

**D** means the Distribution calculated under clause 3.1 of the Notes Terms

**Tax Rate** has the meaning given in clause 3.1 of the Notes Terms, and

**F** (expressed as a decimal) means the franking percentage (within the meaning of Part 3-6 of the *Income Tax Assessment Act 1997* or any provisions that revise or replace that Part) applicable to the franking account of Challenger at the relevant Distribution Payment Date, as determined by Challenger in accordance with clause 3.2 of the Notes Terms.

### ***Distribution payment conditions***

59. The payment of any Distribution on a Distribution Payment Date is subject to:

- Challenger's absolute discretion, and
- no Payment Condition existing in respect of the relevant Distribution Payment Date.

60. 'Payment Condition' is defined in clause 18.2 of the Notes Terms to mean, with respect to the payment of a Distribution on the Capital Notes 3 on a Distribution Payment Date:

- the consolidated retained earnings of the Challenger Group as at the Distribution Payment Date are, or would on payment of the Distribution become, negative
- the payment would result in Challenger becoming, or being likely to become, insolvent for the purposes of the Corporations Act, or
- APRA objecting to the payment.

### ***Distribution terms***

61. A Distribution is only payable to those persons registered as Holders on the Record Date for that Distribution.

62. Distributions are non-cumulative and the Holders of the Capital Notes 3 have no claim or entitlement in the event of non-payment arising because Challenger has determined not to pay a Distribution, a Payment Condition exists at the relevant Distribution Payment Date, or because of any applicable law. Non-payment of all, or part, of a Distribution does not constitute an event of default by Challenger, and the Holders of the Capital Notes 3 have no claim in respect of non-payment.

63. No interest accrues on any unpaid Distributions and the Holders of the Capital Notes 3 have no claim or entitlement in respect of interest on any unpaid Distributions.

***Restrictions in the case of non-payment of Distributions***

64. Subject to clause 3.9 of the Notes Terms, if for any reason a Distribution has not been paid in full on a Distribution Payment Date (the Relevant Distribution Payment Date), Challenger must not without approval of a Special Resolution, until and including the next Distribution Payment Date:

- declare, determine to pay or pay a Dividend, or
- undertake any Buy-Back or Capital Reduction

unless the Distribution is paid in full within three Business Days of the Relevant Distribution Payment Date.

***Mandatory Conversion***

65. Subject to clauses 5, 6 and 7 of the Notes Terms, on the Mandatory Conversion Date, Challenger must Convert all (but not some) of the Capital Notes 3 on issue at that date into Ordinary Shares.

66. Under clause 4.2 of the Notes Terms, the Mandatory Conversion Date is the first to occur of the following Relevant Dates on which the Mandatory Conversion Conditions are satisfied:

- 25 May 2028 (the Scheduled Mandatory Conversion Date), or
- a Distribution Payment Date after the Scheduled Mandatory Conversion Date (a Subsequent Mandatory Conversion Date).

67. The Mandatory Conversion Conditions for each Relevant Date are:

- The average of the daily volume-weighted average sales price (VWAP) of Ordinary Shares sold on the ASX on the 25th Business Day immediately preceding (but not including) the Relevant Date (the First Test Date) is greater than 55.00% of the Issue Date VWAP (the First Mandatory Conversion Condition).
- The VWAP during the period of 20 Business Days on which trading in Ordinary Shares took place immediately preceding (but not including) the Relevant Date (the Second Test Period) is greater than 50.51% of the Issue Date VWAP (the Second Mandatory Conversion Condition).
- No Delisting Event applies to Ordinary Shares in respect of the Relevant Date (the Third Mandatory Conversion Condition).

***Conversion on Non-Viability Trigger Event***

68. Conversion of the Capital Notes 3 may occur at a time before a scheduled Mandatory Conversion Date on the occurrence of a Non-Viability Trigger Event.

69. A Non-Viability Trigger Event occurs upon:

- the issuance of a notice, in writing, by APRA to Challenger that the conversion to Ordinary Shares or write-off of Relevant Perpetual Subordinated Instruments is necessary because, without it, APRA considers that Challenger would become non-viable, or
- a determination by APRA, notified in writing to Challenger, that without a public sector injection of capital, or equivalent support, Challenger would become non-viable.

70. Conversion on account of the occurrence of a Non-Viability Trigger Event will occur immediately and is not subject to any conditions. The number of Ordinary Shares that Holders receive on a Conversion will not be greater than the Maximum Conversion Number. APRA has stated that it will not approve partial conversion or partial write-off in those exceptional circumstances where a public sector injection of funds is deemed necessary.

71. If the Capital Notes 3 cannot be converted at that time due to an Inability Event, they will be Written-Off. This means that all rights in relation to those Capital Notes 3 will be written-off and terminated, and those Holders will not have their capital repaid or have any right to any Distributions with effect on and from Non-Viability Conversion Date.

### ***Optional Exchange***

72. Challenger may, with APRA's prior written approval, by notice to Holders and the Trustee, elect to Exchange (Holders of the Capital Notes 3 do not have a right to request Exchange):

- all or some Capital Notes 3 on an Exchange Date following the occurrence of a Tax Event or a Regulatory Event
- all Capital Notes 3 on an Exchange Date following the occurrence of a Potential Acquisition Event, or
- all or some Capital Notes 3 on the Optional Exchange Date being 25 May 2026.

73. If Challenger elects to Exchange the Capital Notes 3, it must, subject to APRA's prior written approval, elect which of the following (or which combination of the following) it intends to do in respect of the Capital Notes 3 (the Exchange Method):

- Convert the Capital Notes 3 into Ordinary Shares in accordance with clause 8 of the Notes Terms
- Redeem the Capital Notes 3 in accordance with clause 9 of the Notes Terms, or
- Resell the Capital Notes 3 in accordance with clause 10 of the Notes Terms.

74. Challenger may not elect Conversion as the method of Exchange if:

- two Business Days prior to the date on which an Exchange Notice is to be sent by Challenger (or, if trading in Ordinary Shares did not occur on that date, the last Business Day prior to that date on which trading in Ordinary Shares occurred) (the Non-Conversion Test Date) the VWAP of Ordinary Shares is less than or equal to 22.00% of the Issue Date VWAP, or
- a Delisting Event applies on the Non-Conversion Test Date (the Optional Conversion Restrictions).

### ***Mandatory Conversion on an Acquisition Event***

75. Challenger must give notice to Holders and Convert all (but not some only) of the Capital Notes 3 on the occurrence of an Acquisition Event, subject to the relevant restrictions being met.

76. The restrictions on the giving of an Acquisition Conversion Notice are the same as the Optional Conversion Restrictions that would apply if that notice were an Exchange Notice.

**Conversion**

77. 'Conversion' means the conversion of the Capital Notes 3 into Ordinary Shares in accordance with and subject to clause 8 of the Notes Terms.

78. On Conversion:

- each Holder's rights (except in relation to Distributions that have been determined to be payable but have not yet been paid) in relation to each Capital Note 3 that is being Converted will be immediately and irrevocably terminated for an amount equal to the Face Value and Challenger will apply the Face Value of each Capital Note 3 by way of payment for the subscription for the Ordinary Shares to be allotted and issued on Conversion, and
- each Holder of the Capital Note 3 will be allotted and issued a number (the Conversion Number) of Ordinary shares in respect of each Capital Note 3 held by the Holder.

79. The Conversion Number (of Ordinary Shares for each Capital Note 3) is calculated according to the formula set out in the Notes Terms and is always subject to the Conversion Number not being greater than the Maximum Conversion Number.

**Share sale facility**

80. A Holder can notify Challenger that it does not wish to receive Ordinary Shares on Conversion, in which case the number of Ordinary Shares the Holder is obliged to accept will instead be issued to a nominee appointed by Challenger.

81. That nominee will sell that number of Ordinary Shares and pay a cash amount equal to the net sale proceeds to the Holder (after deducting brokerage and certain other applicable costs of the nominee).

**Redemption**

82. The Capital Notes 3 may (subject to APRA's written approval) be Redeemed by payment on the Exchange Date of the Face Value of each Capital Note to the Holder (Redemption Price).

83. On the Exchange Date, the only right the Holders of each Capital Note 3 will have in respect of their Capital Note 3 will be to obtain the Redemption Price payable in accordance with the Notes Terms and, upon the payment of the Redemption Price, all other rights conferred or restrictions imposed by the Capital Note 3 will no longer have effect.

**Resale**

84. Challenger may (subject to APRA's written approval) elect to Resell the Capital Notes 3 in accordance with the Notes Terms.

85. Each Holder on the Exchange Date is taken irrevocably to offer to sell the relevant number of the Capital Notes 3 to a Nominated Purchaser for a cash amount equal to the Face Value (Resale Price) of each Capital Note 3. Subject to payment by the Nominated Purchaser of the Resale Price to the Holders, all rights, title and interest in such Capital Notes 3 will be transferred to the Nominated Purchaser on the Exchange Date, free from Encumbrances.

**Other matters**

86. The Ruling is made on the basis that:
- (a) The Transaction Documents represent a complete and accurate description of the scheme, are intended by parties to have their legal effect, and will be implemented according to their terms.
  - (b) All parties to the scheme are dealing with each other on arm's length terms and fair value consideration will be provided by the Holders to acquire the Capital Notes 3.
  - (c) The Capital Notes 3 are equity interests in Challenger pursuant to Division 974.
  - (d) Distributions on the Capital Notes 3 will be frankable distributions pursuant to section 202-40 and are not unfrankable under section 202-45.
  - (e) Challenger will frank the Distributions on the Capital Notes 3 at the same franking percentage as the benchmark rate for the franking period in which the payments are made.
  - (f) The share capital of Challenger will not become tainted by an issue of the Capital Notes 3 or Ordinary Shares on Conversion of the Capital Notes 3 within the meaning of Subdivision 197-A.
  - (g) The Ordinary Shares issued in the event of Conversion of the Capital Notes 3 will be equity interests in Challenger pursuant to Division 974.
  - (h) The majority of the Holders of the Capital Notes 3 are expected to be residents of Australia for tax purposes, although some may be non-residents.
  - (i) The Capital Notes 3 are expected to be treated as a liability for Australian International Financial Reporting Standards purposes.
  - (j) For the purposes of determining whether a Holder is a 'qualified person' in relation to the Distribution under Division 1A of former Part IIIAA of the ITAA 1936, neither a Holder nor an associate of a Holder will take any positions (apart from the holding of the Capital Notes 3) in relation to their Capital Notes 3 and will neither be under an obligation, nor be likely, to make a related payment (within the meaning of former section 160APHN of the ITAA 1936) in relation to the Distributions.
  - (k) Holders in receipt of Distributions on the Capital Notes 3 will have held their Capital Notes 3 for a period of at least 90 days (excluding the day of acquisition and day of disposal), within the period beginning on the day after the day on which the Holder acquired the Capital Notes 3 and ending on the 90th day after the day on which the Capital Notes 3 go ex-distribution.
  - (l) The Holders (or their connected entities) will not engage in distribution washing (within the meaning of section 207-157) in relation to Distributions on Capital Notes 3 (unless entitled to the exception under section 207-157(4)).
  - (m) Challenger does not have any foreign branches through which it carries on its business, although a member of the Challenger tax consolidated group (other than Challenger) may have one or more foreign branches.
  - (n) Distributions on the Capital Notes 3 will not give rise to any 'foreign income tax deduction' (as defined in section 832-120) for Challenger.

- (o) Distributions on the Capital Notes 3 will not be sourced, directly or indirectly, from Challenger's share capital or non-share capital.
- (p) Challenger will not differentially frank Distributions to different Holders in respect of the Capital Notes 3 according to the tax status of Holders or on any other basis.
- (q) The dividend payout ratios and Challenger's policies in relation to the franking of its dividends on its Ordinary Shares are not expected to change materially as a result of the issue of the Capital Notes 3.
- (r) Immediately before payment of a Distribution on the Capital Notes 3, Challenger will have sufficient available profits (worked out under section 215-20) to pay the Distribution.
- (s) On Conversion, Challenger will debit the Face Value of the Capital Notes 3 to its non-share capital account.
- (t) On the date of Conversion of the Capital Notes 3 into Ordinary Shares, the rights and obligations attached to the Ordinary Shares are the same as those contained in the Constitution of Challenger.
- (u) Holders of Capital Notes 3 will not receive capital proceeds in respect of a Write-Off happening and the market value of Capital Notes 3 at that time will be nil.

**Appendix – Explanation**

**ⓘ** *This Explanation 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.*

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**Acquisition time of the Capital Notes 3**

87. An equity interest that is issued or allotted by a company is acquired when the contract is entered into or, if there is no contract, when the equity interests are issued or allotted (table item 2 of section 109-10).

88. The Capital Notes 3 are equity interests in Challenger. When an investor's application for the Capital Notes 3 is accepted by Challenger, this leads to the formation of a contract for the issue of the Capital Notes 3 to the investor (who will become a Holder). The contract is not formed prior to the Issue Date as Challenger has the option to withdraw the Offer at any time before the Capital Notes 3 are issued. Under table item 2 of section 109-10, a Holder will acquire their Capital Notes 3 on the date on which the contract for the issue of the Capital Notes 3 is entered into.

**Inclusion of Distributions and franking credits in assessable income**

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

90. The Capital Notes 3 are 'non-share equity interests' as defined in subsection 995-1(1) and the Holders are 'equity holders' as defined in subsection 995-1(1). Paragraph 43B(1)(b) of the ITAA 1936 provides that Subdivision D of Division 2 of Part III

of the ITAA 1936 (which governs dividends) applies to an equity holder in the same way as it applies to a shareholder.

91. Distributions paid in respect of the Capital Notes 3 are non-share dividends under section 974-120. Accordingly, Holders must include in their assessable income Distributions paid in respect of the Capital Notes 3 under subparagraph 44(1)(a)(ii) of the ITAA 1936.

92. Under the Australian imputation system, where an Australian-resident company makes a franked distribution directly to a shareholder, the assessable income of the shareholder must also include the amount of the franking credit on the distribution pursuant to subsection 207-20(1). The inclusion of both the dividend and the attached franking credit in a shareholder's assessable income is known as 'grossing-up' the dividend.

93. Distributions on the Capital Notes 3 are initially expected to be partially franked. Holders must include in their assessable income the amount of any franking credit attached to a Distribution, in the income year in which the Distribution is made.

### **Imputation benefits – streaming**

94. 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.

95. Section 204-30 prescribes the circumstances that are required to exist before the Commissioner may make such a determination. Section 204-30 applies where an entity 'streams' the payment of distributions in such a way that:

- an 'imputation benefit' is, or apart from section 204-30 would be, received by a member of the entity as a result of the distribution or distributions (paragraph 204-30(1)(a))
- the member (favoured member) would derive a greater benefit from franking credits than another member of the entity (paragraph 204-30(1)(b)), and
- the other member (disadvantaged member) of the entity will receive lesser imputation benefits, or will not receive any imputation benefits, whether or not the other member receives other benefits (paragraph 204-30(1)(c)).

96. 'Streaming' is not defined for the purposes of Subdivision 204-D. However, the Commissioner understands it to refer to a company 'selectively directing the flow of franked distributions to those members who can most benefit from the imputation credits' (paragraph 3.28 of the Explanatory Memorandum to the New Business Tax System (Imputation) Bill 2002).

97. The Capital Notes 3 will be listed on the ASX and hence will be available for investment by different types of investors. The extent to which a Holder receives franked Distributions will be determined solely by each Holder's proportionate ownership of the Capital Notes 3, irrespective of the Holder's tax profile and regardless of the extent to which any particular Holder will actually benefit from the franking credits attached to the Distribution. The dividend payout ratios and the franking credits arising in relation to the Ordinary Shares of Challenger will not be affected by the issue of the Capital Notes 3.

98. Based on the information provided, the Commissioner has concluded that the requisite element of streaming does not exist in relation to the franked Distributions to be paid by Challenger to Holders. Accordingly, 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 paid in respect of the Capital Notes 3.

### Section 177EA of the ITAA 1936

99. Section 177EA of the ITAA 1936 is a general anti-avoidance provision that applies to a wide range of schemes designed to obtain imputation benefits. In essence, it applies to schemes for the disposition of membership interests or an interest in membership interests, where a franked distribution is paid or payable in respect of the membership interests or an interest in membership interests.

100. Where section 177EA of the ITAA 1936 applies, the Commissioner has a discretion pursuant to subsection 177EA(5) of the ITAA 1936 to make a determination to either debit the company's franking account or deny the imputation benefit on the distribution that flowed directly or indirectly to each shareholder.

101. The Commissioner can make a determination if the following conditions in subsection 177EA(3) of the ITAA 1936 are satisfied:

- (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 this section, 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.

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

- the issue of the Capital Notes 3 constitutes a scheme for the disposition of membership interests in a corporate tax entity. Paragraph 177EA(12)(a) of the ITAA 1936 applies to treat non-share equity interests in the same way as membership interests for the purposes of section 177EA of the ITAA 1936
- Distributions are frankable distributions and are expected to be payable to Holders in respect of their Capital Notes 3
- Distributions are expected to be franked distributions, and

- the Holders could reasonably be expected to receive an imputation benefit as a result of the Distributions, as Challenger intends to partially or fully frank the Distributions on the Capital Notes 3.

103. Accordingly, the issue is whether having regard to the relevant circumstances of the scheme, it would be concluded that a person, or one of the persons, who entered into or carried out 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.

104. In arriving at a conclusion, the Commissioner must have regard to the relevant circumstances of the scheme which include, but are not limited to, the factors listed in subsection 177EA(17) of the ITAA 1936.

105. The relevant circumstances listed encompass a range of circumstances, which taken individually or collectively, could indicate the requisite purpose. Due to the diverse nature of these circumstances, some may or may not be present at any one time in relation to a particular scheme.

106. Based on the information provided and the qualifications set out in this Ruling, and having regard to all of the relevant circumstances of the scheme, the Commissioner has concluded that the purpose of enabling the Holders to obtain imputation benefits is no more than incidental to Challenger's purpose of raising capital for the Challenger Group to meet the capital adequacy/prudential requirements of members of the Challenger Group and to maintain the diversity of Challenger's sources and types of funding.

107. Accordingly, 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 Holders in relation to Distributions paid in respect of the Capital Notes 3.

### **Gross-up and tax offset**

108. 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.

109. 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))
- the distribution is one to which section 207-157 (which is about distribution washing) applies (paragraph 207-145(1)(da), or

- the distribution is one to which section 207-158 (distributions entitled to a foreign income tax deduction) applies (paragraph 207-145(1)(db)).

110. This Ruling is made on the assumption that the distribution washing provision does not apply. The remaining circumstances are discussed at paragraphs 111 to 131 in this Ruling.

111. Generally, a person is a qualified person for the purposes of Division 1A of former Part IIIAA of the ITAA 1936 if they satisfy the holding period rule in former paragraph 160APHO(1)(a) of the ITAA 1936 or the related payments rule in former paragraph 160APHO(1)(b) of the ITAA 1936.

112. By virtue of former section 160AOA of the ITAA 1936, the holding period rule and the related payments rule 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.

113. The holding period rule applies where neither the holder nor an associate of the holder has made, is under an obligation to make, or is likely to make, a related payment in respect of the dividend (or non-share dividend), and requires the shares (or non-share equity interests) to have been continuously held at risk throughout the primary qualification period (former paragraph 160APHO(1)(a) of the ITAA 1936).

114. The related payments rule applies where the holder or an associate of the holder has made, is under an obligation to make, or is likely to make, a related payment in respect of the dividend (or non-share dividend) and requires the shares (or non-share equity interests) to have been continuously held at risk throughout the secondary qualification period (former paragraph 160APHO(1)(b) and former section 160APHN of the ITAA 1936).

115. This Ruling is made on the basis that neither a Holder, nor associates of the Holder, will make, is under an obligation to make, or is likely to make, a related payment in relation to the Distributions within the meaning of former section 160APHN of the ITAA 1936 (see paragraph 86(j) of this Ruling).

116. A Holder will be a qualified person in relation to Distributions received in respect of their Capital Notes 3 if the Holder continuously held their Capital Notes 3 at risk for a period of at least 90 days (excluding the day of acquisition and the day of disposal, and any days on which the Holder has materially-diminished risks of loss or opportunities for gain in respect of the shares or interest) throughout the primary qualification period.

117. The primary qualification period begins on the day after the day on which the Holder acquired their Capital Notes 3 and ends on the 90th day after the day on which the Capital Notes 3 became ex-dividend (former subsections 160APHO(2) and 160APHO(3) of the ITAA 1936 and former sections 160APHM and 160APHJ of the ITAA 1936).

118. In determining whether a shareholder is a qualified person in relation to a distribution paid on their shares, every 'position' (defined in former subsection 160APHJ(2) of the ITAA 1936) in relation to the shares is taken into account in calculating the 'net position' (defined in former subsection 160APHJ(5) of the ITAA 1936) in relation to the shares. The 'net position' determines whether a shareholder has materially diminished risks of loss or opportunities for gain on a particular day in respect of shares held by the shareholder (former section 160APHM of the ITAA 1936). Under former subsection 160APHJ(2) of the ITAA 1936, a 'position' in relation to shares is anything that has a delta in relation to the shares.

119. An embedded share option is a position in relation to a share if it is exercisable by or against a party other than the issuer of the share (refer to Taxation Determination TD 2007/29 *Income tax: holding period rule: is an embedded share option a position in relation to the share if it is exercisable by or against a party other than the issuer of the share?*).

120. Under the Notes Terms, Challenger may (subject to certain conditions) elect to require the Holders to sell all or some of their Capital Notes 3 to one or more Nominated Purchasers. Until Challenger appoints an entity as a Nominated Purchaser, that entity has no right or ability to call for the Capital Notes 3 from the Holders. Holders have no right to elect Resale of the Capital Notes 3.

121. Challenger is not required to elect to Resell the Capital Notes 3. It follows that the Resale facility is an option that is held by Challenger, the issuer of the Capital Notes 3, and not by a third party. Therefore, the Resale facility does not constitute a separate position in relation to the Capital Notes 3 under former subsection 160APHJ(2) of the ITAA 1936.

122. Similarly, although the Conversion mechanism results in the exchange of Capital Notes 3 for Ordinary Shares, the Conversion mechanism does not constitute a position for the purposes of former Division 1A of Part IIIAA of the ITAA 1936 as the Holders have no right to elect for Conversion.

123. Therefore, for the purposes of determining whether a Holder is a qualified person in relation to the Distributions under Division 1A of former Part IIIAA of the ITAA 1936, neither the Resale facility nor the Conversion mechanism, of themselves, affects a Holder's risks of loss or opportunities for gain in respect of the Capital Notes 3.

124. 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 benefit that arises in respect of a Distribution that is made (see paragraphs 94 to 107 of this Ruling).

125. A distribution will be taken to be made as part of a dividend stripping operation, pursuant to section 207-145, 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.

126. Section 207-155 defines a dividend stripping operation as by way of or in the nature of dividend stripping or has substantially the effect of a scheme by way of or in the nature of dividend stripping.

127. The term dividend stripping has no precise legal meaning. Paragraph 9 of Taxation Ruling IT 2627 *Income tax: application of Part IVA to dividend stripping arrangements* states that dividend stripping:

... would include one where a vehicle entity (the stripper) purchases shares in a target company that has accumulated or current years' profits that are represented by cash or other readily-realizable assets. The stripper pays the vendor shareholders a capital sum that reflects those profits and then draws off the profits by having paid to it a dividend (or a liquidation distribution) from the target company.

128. Paragraph 10 of IT 2627 further states that:

...an important element to be looked at will be any release of profits of a company to its shareholders in a non-taxable form, regardless of the different methods that might be used to achieve this result.

129. The Prospectus and Notes Terms provide no indication that the offering of the Capital Notes 3 and the associated payment of franked Distributions to Holders in any way constitutes a dividend stripping arrangement. As such, the dividend stripping provisions do not apply.

130. Distributions on the Capital Notes 3 do not give rise to any 'foreign income tax deductions' (as defined in section 832-120) for Challenger. Accordingly, subsection 207-158(1) does not apply to the Distributions on the Capital Notes 3.

131. Based on this, section 207-145 will not apply to adjust the Holder's assessable income to exclude the franking credit, nor will it deny the tax offset to which the Holders would otherwise be entitled.

### **Each Capital Note 3 is not a traditional security**

132. 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 a prescribed security within the meaning of section 26C of the ITAA 1936, 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.

133. 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), 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.

134. Each Capital Note 3 is not a stock, bond, debenture, certificate of entitlement, bill of exchange, or a promissory note.

135. The term 'or other security' in paragraph (a) of the definition of security in subsection 159(1) of the ITAA 1936 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 will generally be recognised as debt instruments (refer to Taxation Ruling TR 96/14 *Income tax: traditional securities*).

136. Paragraphs (b) and (c) of the definition of security in subsection 159GP(1) of the ITAA 1936 do not apply because each Capital Note 3 is neither a deposit with a bank or other financial institution, nor a secured or unsecured loan.

137. Only those contracts that have debt like obligations will usually fall under paragraph (d) of the definition of security in subsection 26BB(1) of the ITAA 1936 (paragraph 30 of TR 96/14).

138. The Notes Terms do not evidence a liability by Challenger to pay an amount or amounts to Holders of the Capital Notes 3 during the term of the instrument or at maturity. The Capital Notes 3 are perpetual and Holders do not have a right to require Redemption. The payment by Challenger of Distributions is subject to the Distribution Payment Conditions. Distributions are discretionary and non-cumulative and if a Distribution is not paid, Challenger has no liability to pay the Distribution and Holders have no claim in respect of non-payment.

139. Upon Conversion, Challenger will allot and issue a number of Ordinary Shares based on a formula set out in the Notes Terms for each Capital Note 3 held by the Holder. Each Holder's rights in relation to each Capital Note 3 that is being converted are

immediately and irrevocably terminated for an amount equal to the Face Value and Challenger will apply that amount by way of payment for the subscription for Ordinary Shares issued to Holders. Challenger cannot be said to have a liability to pay an amount under the Terms of the Capital Note 3 pursuant to the Conversion.

140. Early Redemption of the Capital Notes 3 is possible. However, it is at the option of Challenger and will only occur upon the happening of certain events and requires the prior written approval of APRA. This does not establish a liability on Challenger to pay an amount.

141. Challenger will not become liable to pay an amount under the Capital Notes 3 upon a wind up as it would be expected that, before a wind up commences, the Capital Notes 3 would either be converted into Ordinary Shares pursuant to a Non-Viability Trigger Event (in which case any distribution would be made to the Holders as Ordinary Shareholders as opposed to under the terms of the Capital Notes 3), or Holders' rights would be terminated where Challenger is not able to issue Ordinary Shares within the time stated in the Notes Terms.

142. As each Capital Note 3 is not a security within the meaning of subsection 159GP(1) of the ITAA 1936, it cannot be a traditional security under subsection 26BB(1) of the ITAA 1936.

143. As the Capital Notes 3 are not traditional securities within the meaning of that term in subsection 26BB(1) of the ITAA 1936:

- subsection 26BB(2) of the ITAA 1936 will not apply to include the amount of any gain in the assessable income of the Holder upon disposal of their Capital Notes 3, and
- subsection 70B(2) of the ITAA 1936 will not apply to allow a deduction for any loss to Holders upon disposal of their Capital Notes 3.

### **Capital Notes 3 are convertible interests**

144. Subsection 995-1(1) defines a 'convertible interest' in a company as an interest of the kind referred to in table item 4 of subsection 974-75(1). Paragraph (b) of table item 4 of subsection 974-75(1) provides that an interest is an equity interest if it is an interest issued by the company and the interest will, or may, convert into an equity interest in the company.

145. Under section 974-165, an interest is an interest that will or may convert into another interest if:

- the interest must be or may be converted into another interest (paragraph 974-165(a)), or
- the interest must be or may be redeemed, repaid or satisfied by the issue or transfer of the other interest (subparagraph 974-165(b)(i)).

146. Each Capital Note 3 is a convertible interest because it will or may be redeemed, repaid or satisfied by the issue of Ordinary Shares upon Conversion.

### **Capital Notes 3 that are Written-Off – capital gains tax implications**

147. If the Capital Notes 3 are Written-Off, the Capital Notes 3 do not Convert, and the rights attached to the Capital Notes 3 are immediately and irrevocably terminated.

148. CGT event C2 happens if a taxpayer's intangible CGT asset ends by the asset being redeemed, cancelled, released, discharged or satisfied (paragraphs 104-25(1)(a) and (b)). Therefore, CGT event C2 happens when the Capital Notes 3 are Written-Off, because they are immediately and irrevocably terminated at that time.

149. For the purposes of determining whether the Holders make a capital gain or a capital loss from CGT event C2 happening in respect of their Capital Notes 3, the Holders are taken to have nil capital proceeds from CGT event C2 happening.

150. The capital proceeds from a CGT event is the total of the money and the market value of any property that the taxpayer has received or is entitled to receive (section 116-20). The Holders do not receive any money or other property when their Capital Notes 3 are Written-Off.

151. Where a taxpayer receives no capital proceeds from a CGT event, they are taken to have received the market value of the CGT asset that is the subject of the event (subsection 116-30(1)). However, when each Capital Note 3 is Written-Off because of a Non-Viability Event, its market value at that time will be nil.

152. Therefore, CGT event C2 happens for the Holders on their Capital Notes 3 being Written-Off, and the Holders are taken to have received nil capital proceeds in respect of CGT event C2 happening.

### **Cost base and reduced cost base of Ordinary Shares acquired on Conversion**

153. The first element of the cost base or reduced cost base for shares acquired by converting a convertible interest that is not a traditional security is worked out under table item 2 of subsection 130-60(1). Table item 2 states that the first element is the sum of:

- (a) the cost of the convertible interest at the time of conversion
- (b) any amount paid to convert the convertible interest, except to the extent that the amount is represented in the paragraph (a) amount, and
- (c) all the amounts that are to be added under subsection 130-60(1A) (concerning amounts to be added back under certain circumstances).

154. On Conversion, Subdivision 130-C will apply so that the first element of the cost base and reduced cost base of each Ordinary Share acquired from Conversion of each Capital Note 3 will be a pro rata portion of the cost base of the Capital Note 3 at the time of Conversion (table item 2 of subsection 130-60(1)).

### **Share Sale facility**

155. Subsection 104-10(1) provides that CGT event A1 happens if you dispose of a CGT asset. A disposal of a CGT asset occurs if there is a change of ownership, whether because of some act or event or by operation of law (subsection 104-10(2)).

156. The disposal of a Holder's Ordinary Share allocation by a nominee will give rise to CGT event A1 happening (subsections 104-10(1) and (2)).

157. The Holder will make a capital gain if the capital proceeds from the disposal are more than the cost base of the Ordinary Shares. The Holder will make a capital loss if those capital proceeds are less than the reduced cost base of the Ordinary Shares (subsection 104-10(4)).

158. The Holder's capital proceeds under section 116-20 will be the cash amount received from the nominee, being the net sale proceeds.

159. The cost base or the reduced cost base of the Holder's Ordinary Shares will be a pro rata portion of the cost base and reduced cost base of the Capital Notes 3 at the time of Conversion (table item 2 of subsection 130-60(1)).

### **Allotment of Ordinary Shares on Conversion not a Distribution**

160. The Conversion of Capital Notes 3 for Ordinary Shares in Challenger will not result in Holders being taken to have received a dividend or a non-share dividend.

161. Holders are not shareholders of Challenger in respect of their Capital Notes 3 holdings. Accordingly, the Holders will not receive a dividend as defined in subsection 6(1) of the ITAA 1936.

162. The application of the Face Value to subscribe for Ordinary Shares on Conversion of the Capital is a crediting of that amount to the Holder and, therefore, a non-share distribution under section 974-115.

163. All non-share distributions are non-share dividends unless they are debited against the distributing company's non-share capital account or its share capital account (section 974-120).

164. The issue of Ordinary Shares to Holders on Conversion of Capital Notes 3 will not be a non-share dividend as defined in section 974-120, as the Face Value of the Capital Notes 3 will be debited against Challenger's non-share capital account.

### **Section 45 of the ITAA 1936**

165. Section 45 of the ITAA 1936 applies where a company streams the provision of shares and the payment of minimally franked dividends to its shareholders in such a way that the shares are received by some shareholders and minimally franked dividends are received by other shareholders. Minimally franked dividends are dividends which are franked to less than 10%.

166. Challenger has stated its intention to continue to frank frankable dividends/distributions to the fullest extent possible to all its shareholders and non-share equity holders into the foreseeable future. Based on the information provided and having regard to the circumstances of the scheme, section 45 of the ITAA 1936 will not apply to treat the issue of Ordinary Shares on Conversion as an unfranked dividend in the hands of Holders.

### **Section 45A of the ITAA 1936**

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

168. If these conditions are satisfied, 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 all or part of the capital benefit is taken to be an unfranked dividend.

169. A provision of capital benefits includes the provision to the shareholder of shares in the company pursuant to paragraph 45A(3)(a) of the ITAA 1936. The issue of Ordinary Shares to Holders on Conversion of the Capital Notes 3 will constitute the provision of capital benefits.

170. The issue of Ordinary Shares on Conversion is in effect a restatement of the Holder's interest in the capital of Challenger. In the absence of any other factors that would contribute to an alternative conclusion, the issue of Ordinary Shares on Conversion is not considered to be streaming of the provision of capital benefits.

171. Redemption of the Capital Notes 3 involves the provision of a capital benefit within the meaning of subsection 45A(3) of the ITAA 1936 as it is a non-share capital return (subsection 45A(3A) of the ITAA 1936). The amount paid to Holders on Redemption is limited to the amount of the Face Value of the Capital and any Distribution entitlements on the Capital Notes 3 will be separately paid as Distributions, given that each date on which Redemption occurs will also be a Distribution Payment Date under the Notes Terms.

172. Accordingly, it cannot be said that Holders would derive a greater benefit from the receipt of the capital benefits than other Challenger shareholders. Therefore, the issue of Ordinary Shares on Conversion or the Redemption of the Capital Notes 3 will not trigger the application of section 45A of the ITAA 1936.

173. As such, 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 Conversion of the Capital Notes 3 as an unfranked dividend in the hands of the Holders.

### **Section 45B of the ITAA 1936**

174. 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. Paragraph 45B(3)(b) of the ITAA 1936 empowers the Commissioner to make a determination that section 45C applies in relation to the whole, or a part, of the capital benefit such that it will be treated as an unfranked dividend, so that it can be included in the assessable income of the relevant taxpayer.

175. Specifically, section 45B of the ITAA 1936 applies where:

- there is a scheme under which a person is provided with a capital benefit by a company (paragraph 45B(2)(a) of the ITAA 1936)
- under the scheme, a taxpayer who may or may not be the person provided with the capital benefit, obtains a tax benefit (paragraph 45B(2)(b) of the ITAA 1936), and
- 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 a taxpayer (the relevant taxpayer) to obtain a tax benefit (paragraph 45B(2)(c)).

176. The issue of Ordinary Shares to Holders on Conversion will constitute a scheme under which the Holders are provided with a capital benefit by Challenger (paragraph 45B(5)(a) of the ITAA 1936). Similarly, Redemption of the Capital Notes 3 will also constitute a scheme under which the Holders are provided with a capital benefit by Challenger (paragraph 45B(5)(b) of the ITAA 1936 and subsection 45B(7) of the ITAA 1936).

177. For the provision 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, entered into the scheme or carried out the scheme or any part of the scheme for a purpose, other than an incidental purpose, of enabling a taxpayer to obtain a tax benefit. A non-exhaustive list of relevant circumstances of the scheme is provided in subsection 45B(8) of the ITAA 1936.

178. Having regard to the relevant circumstances surrounding the issue of Ordinary Shares on Conversion and Redemption of the Capital Notes 3, it cannot be concluded that Challenger, the Holders or any other person entered into or carried out the scheme for the purpose of enabling Holders to obtain a capital benefit.

179. The allotment of Ordinary Shares on Conversion is not in satisfaction of the Holders' entitlement to Distributions, but rather a product of the Conversion of the Capital Notes 3 held by the Holders according to the Notes Terms. Conversion simply involves a change in the type of equity interests that are held by the Holder; an instrument paying franked distributions (the Capital Notes 3) is replaced with another instrument paying franked distributions (Ordinary Shares). Any Distribution entitlements on Conversion will be separately paid as a Distribution given that each date on which a Conversion occurs will also be a Distribution Payment Date under the Notes Terms.

180. Similarly, it cannot be said that Redemption involves any benefit provided to Holders that is in substitution for Distributions. The amount paid to Holders on Redemption is limited to an amount equal to the Face Value of the Capital Note 3 and any Distribution entitlements on the Capital Note 3 are separately paid as a Distribution, given that each date on which a Redemption occurs will also be a Distribution Payment Date under the Notes Terms.

181. 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 Conversion or Redemption of each Capital Note 3 as an unfranked dividend in the hands of Holders.

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