


# ***CR 2023/24 - Challenger Limited - Challenger Capital Notes 4***

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## **Class Ruling**

# **Challenger Limited – Challenger Capital Notes 4**

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### **📌 Relying on this Ruling**

This publication (excluding 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 the income tax consequences for Australian-resident entities who subscribed for and acquired non-cumulative, convertible, transferable, redeemable, subordinated, perpetual, unsecured notes issued by Challenger Limited (Challenger) called Challenger Capital Notes 4 (Capital Notes 4).
2. Details of this scheme are set out in paragraphs 38 to 74 of this Ruling.
3. In this Ruling, unless otherwise indicated, capitalised terms have the meaning specified in the Prospectus for the issue of Capital Notes 4 dated 15 March 2023 (the Prospectus), and the Capital Notes 4 Terms (the Terms) as included in Schedule 1 of the Challenger Capital Notes 4 Trust Deed dated 7 March 2023 (the Trust Deed).
4. All legislative references in this Ruling are to 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 your Capital Notes 4 by initial application under the Prospectus
  - are a 'resident of Australia' within the meaning of subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) during the period in which you hold your Capital Notes 4

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- do not hold Capital Notes 4 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 4 on capital account), and
- are not subject to the taxation of financial arrangements rules in Division 230 in relation to gains and losses on your Capital Notes 4.

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

6. The investors described in paragraph 5 of this Ruling are referred to in this Ruling as Capital Notes 4 Holders.

### **What this Ruling does not consider**

7. This Ruling does not deal with:

- how the taxation law applies to Challenger in relation to the issue of the Capital Notes 4
- the tax implications in relation to a ‘non-resident’ (as defined in subsection 6(1) of the ITAA 1936) who holds their Capital Notes 4 through a ‘permanent establishment’ (as defined in subsection 6(1) of the ITAA 1936) in Australia
- the tax implications of Conversion of Capital Notes 4 before the Mandatory Conversion Date on the occurrence of an Acquisition Event or a Non-Viability Trigger Event
- the tax implications of Redemption (other than for the application of sections 26BB, 45A, 45B and 70B of the ITAA 1936) or Resale of the Capital Notes 4
- the tax implications for holders of Challenger Capital Notes 2 (CCN2) reinvesting under the Reinvestment Offer, or of receiving distributions on CCN2, and
- how the gross-up and tax offset rules in Division 207 apply to partnership or trustee investors (other than a partnership or trustee that is a corporate tax entity, or a trustee of a trust that is a complying superannuation entity) 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 2022 to 30 June 2032.

## **Ruling**

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### **Consequences of acquiring Capital Notes 4**

#### ***Acquisition date***

9. You acquired your Capital Notes 4 on 5 April 2023 under table item 2 of section 109-10.

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**Capital Notes 4 are non-share equity interests**

10. Each of your Capital Notes 4 is an 'equity interest' in Challenger pursuant to Division 974 and is a 'non-share equity interest' in Challenger as the term is defined in subsection 995-1(1).

**Cost base and reduced cost base of Capital Notes 4**

11. The first element of the cost base and reduced cost base of each Capital Note 4 is \$100, being the money you paid to acquire your Capital Note 4 (subsections 110-25(2) and 110-55(2)).

**Consequences of holding Capital Notes 4****Distributions on Capital Notes 4 and entitlement to tax offset for franking credits**

12. A Distribution on a Capital Note 4 is a non-share dividend under section 974-120 and is included in your assessable income (subparagraph 44(1)(a)(ii) of the ITAA 1936).

13. In the income year in which the Distribution is made you also:

- include the amount of the franking credit attached to a Distribution in your assessable income, and
- are entitled to a tax offset equal to the franking credit (section 207-20).

14. The franking credit tax offset that you are entitled to under Division 207 is subject to the refundable tax offset rules in Division 67, provided you are not excluded by the operation of section 67-25. Entities excluded by section 67-25 include corporate tax entities (such as companies, corporate limited partnerships and public trading trusts), unless they satisfy the requisite conditions in subsections 67-25(1C) or (1D).

15. To the extent that a Distribution (or a part of it) is either exempt income or non-assessable non-exempt income in your hands (and none of the exceptions in Subdivision 207-E apply), the amount of any franking credit on the Distribution that is exempt income or non-assessable non-exempt income is not included in your assessable income and you are not entitled to a tax offset under Division 207 (Subdivision 207-D).

**Determination under paragraph 204-30(3)(c)**

16. The Commissioner will not make a determination under paragraph 204-30(3)(c) to deny the whole, or any part, of the imputation benefits you receive in relation to a Distribution.

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

17. 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 you receive in relation to a Distribution.

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**Gross-up and tax offset cancelled in certain circumstances**

18. Paragraph 207-145(1)(a) will not apply to cancel the effect of the gross-up and tax offset in respect of a franked Distribution if you are a qualified person in respect of that Distribution.
19. You will be a qualified person in relation to a Distribution if, during the primary qualification period, you held your Capital Notes 4 for a continuous period of at least 90 days during which you did not have 'materially diminished risks or loss of opportunities for gain' (as defined in former section 160APHM of the ITAA 1936) in respect of your Capital Notes 4.
20. Paragraphs 207-145(1)(b) to (1)(db) will not apply to cancel the effect of the gross-up and tax offset rules in respect of a franked Distribution.
21. In respect of paragraphs 207-145(1)(b) and (c), refer to paragraphs 16 and 17 of this Ruling.
22. In respect of paragraph 207-145(1)(d), there is no evidence that the Distributions will be made as part of a dividend stripping operation.
23. In respect of paragraph 207-145(1)(da), the distribution washing provision does not apply (refer to subparagraph 74(t) of this Ruling).
24. In respect of paragraph 207-145(1)(db), the Distributions do not give rise to a 'foreign income tax deduction' (as defined in section 832-120) (refer to subsection 207-158(1) and subparagraph 74(v) of this Ruling).

**Consequences of disposing of Capital Notes 4****Capital Notes 4 are not traditional securities or qualifying securities**

25. A Capital Note 4 is not a 'traditional security' as defined in subsection 26BB(1) of the ITAA 1936.
26. Section 26BB of the ITAA 1936 will not apply to include any gain on the disposal or Redemption of your Capital Notes 4 in your assessable income. Section 70B of the ITAA 1936 will not apply to allow any loss on the disposal or Redemption of your Capital Notes 4 as a deduction.
27. The Capital Notes 4 are not 'qualifying securities' within the meaning of subsection 159GP(1) of the ITAA 1936.

**Conversion of Capital Notes 4 for Ordinary Shares**

28. Each Capital Note 4 is a convertible interest.
29. CGT event C2 happens on Conversion (section 104-25). A capital gain or capital loss you make from CGT event C2 happening on Conversion will be disregarded (subsection 130-60(3)).
30. Ordinary Shares acquired on Conversion will be taken to have been acquired when the Conversion happens on the relevant date of Conversion (subsection 130-60(2)).
31. The first element of the cost base and reduced cost base of Ordinary Shares acquired on Conversion will be equal to the cost base and reduced cost base of the relevant Capital Notes 4 at the time of Conversion (table item 2 of subsection 130-60(1)).
32. As you hold your Capital Notes 4 on capital account, no amount will be included in your assessable income on Conversion under section 6-5.

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33. In addition, you will not incur a deductible loss under section 8-1 as a consequence of the Conversion.

34. On Conversion, you will not be taken to have received a dividend or a non-share dividend.

#### **Other integrity provisions**

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

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

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

36. 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 for you on Conversion or Redemption of the Capital Notes 4 as an unfranked dividend.

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

37. 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 for you on Conversion or Redemption of the Capital Notes 4 as an unfranked dividend.

## **Scheme**

38. 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.

#### **Background**

39. Challenger is an Australian-resident company for income tax purposes and is the head company of the Challenger tax consolidated group.

40. Challenger was established in 1985 and is the parent company of the Challenger Group, a general investment group with active operations in Australia and overseas managing \$99 billion in assets as at 31 December 2022.

41. Challenger has been listed on the Australian Securities Exchange (ASX) since 1987.

42. Challenger operates 2 core operating segments, being a Funds Management division and a Life division.

43. Challenger Life Company Limited (CLC) is an indirect wholly-owned subsidiary of Challenger and a member of the Challenger tax consolidated group. CLC is registered as a life insurance company under section 21 of the *Life Insurance Act 1995* (Life Insurance Act).

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44. Challenger is authorised as a 'non-operating holding company' of life insurance companies under section 28A of the Life Insurance Act.
45. Challenger and CLC are regulated by the Australian Prudential Regulation Authority (APRA) with respect to prudential matters pursuant to the Life Insurance Act.
46. Under the Prospectus, Challenger announced its intention to undertake a capital raising by the issue of Capital Notes 4 for an issue price of \$100 each to raise \$350 million (with the ability to raise more or less) (the Offer).
47. Investors could apply for the Capital Notes 4 under the Reinvestment Offer or the New Money Offer. The Reinvestment Offer was made to clients of Syndicate Brokers and Institutional Investors who were Eligible CCN2 Holders wishing to reinvest some or all of their CCN2 into Capital Notes 4. The New Money Offer was made to eligible clients of Syndicate Brokers and Institutional Investors wishing to make new investments in Capital Notes 4. Applications under both the Reinvestment Offer and New Money Offer were only accepted from clients of Syndicate Brokers including Retail Investors who satisfied the eligibility requirements in accordance with the Target Market Determination.
48. The Issue Date for the Capital Notes 4 was 5 April 2023.
49. The Capital Notes 4 are listed on the ASX under the ASX code CGFPD.
50. The Capital Notes 4 were issued by Challenger in Australia. The Capital Notes 4 were not issued at or through an offshore permanent establishment or subsidiary of Challenger.
51. The net proceeds of the Offer are intended to be used by Challenger to subscribe for a similar instrument to be issued by CLC (CLC Notes) and refinance CCN2 through the Reinvestment Offer. The CLC Notes are expected to form part of CLC's Additional Tier 1 Capital.

#### **Main features of Capital Notes 4**

52. The Capital Notes 4 are non-cumulative, convertible, transferable, redeemable, subordinated, perpetual, unsecured notes issued by Challenger.
53. A Capital Notes 4 Holder does not have voting rights except in the limited circumstances described in the Terms and the Trust Deed. A Capital Notes 4 Holder does not have voting rights at a general meeting of the shareholders of Challenger.

#### **Issue price**

54. The issue price of each Capital Note 4 is \$100 (Face Value). Capital Notes 4 were fully paid on the Issue Date.

#### **Distributions**

55. Challenger will pay quarterly floating-rate cash Distributions in respect of each Capital Note 4 on a Distribution Payment Date in accordance with the Terms.
56. The Distribution payable is calculated on the Face Value of each Capital Note 4 using a Distribution Rate, which is equal to the BBSW Rate plus a Margin, adjusted by the

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corporate tax rate and based on the number of days in the Distribution Period.<sup>1</sup> The Margin was determined in accordance with the Bookbuild.

57. The Distributions will be franked at the same rate as dividends paid on Ordinary Shares. If the Distribution is not fully franked, then the Distribution will be adjusted to reflect the applicable franking rate.

58. The payment of a Distribution is subject to the absolute discretion of Challenger and will only be paid if a Payment Condition does not exist on the Distribution Payment Date. Broadly, a Payment Condition exists where Challenger is prevented from paying the Distribution by prudential regulatory requirements, applicable law, or insolvency.

59. Distributions are non-cumulative and if all or any part of a Distribution is not paid, Capital Notes 4 Holders have no claim or entitlement in respect of such non-payment, and such non-payment does not constitute an event of default.

60. No interest accrues on any unpaid Distributions and Capital Notes 4 Holders have no claim or entitlement in respect of interest on any unpaid Distributions.

61. Subject to certain exceptions, if a Distribution is not paid in full on the Distribution Payment Date, Challenger is restricted from declaring, paying, or determining to pay a Dividend, or undertaking any Buy-Back or Capital Reduction (unless Capital Notes 4 Holders approve by Special Resolution) until the next Distribution Payment Date. If the amount of any unpaid Distribution is paid in full within 3 Business Days of the Distribution Payment Date, this restriction will no longer apply.

### **Conversion**

62. Conversion of the Capital Notes 4 involves:

- each Capital Notes 4 Holder's rights in relation to each Capital Note 4 that is being Converted is immediately and irrevocably terminated for an amount equal to the Face Value and Challenger applies the Face Value of each Capital Note 4 by way of payment for the subscription of the Conversion Number of Ordinary Shares to be issued on Conversion, and
- each Capital Notes 4 Holder being allotted and issued a number of Ordinary Shares for each Capital Note 4 that is being Converted equal to the Conversion Number.

63. Upon Conversion of the Capital Notes 4, all other rights conferred or restrictions imposed on each Capital Note 4 under the Terms no longer have effect (except for rights relating to a Distribution which has been determined to be payable on a date of Conversion).

64. Each Ordinary Share issued upon Conversion ranks equally with all other Ordinary Shares.

### **Mandatory Conversion**

65. All outstanding Capital Notes 4 must Convert into Ordinary Shares on the Mandatory Conversion Date.

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<sup>1</sup> In this Ruling, BBSW Rate takes the definition provided in Clause 3.1 of the Terms (which is not replicated here).

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66. The Mandatory Conversion Date is the first to occur of the following dates on which the Mandatory Conversion Conditions are satisfied:

- 25 February 2032 (the Scheduled Mandatory Conversion Date), or
- the first Distribution Payment Date after the Scheduled Mandatory Conversion Date on which those conditions are satisfied.

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

67. A Non-Viability Trigger Event occurs on:

- the issuance to Challenger of a written determination from APRA that 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 to Challenger in writing, that without a public sector injection of capital, or equivalent support, Challenger would become non-viable.

68. A Conversion following a Non-Viability Trigger Event will occur immediately and is not subject to any conditions. The number of Ordinary Shares that Capital Notes 4 Holders receive on a Conversion will not be greater than the Maximum Conversion Number. If the Capital Notes 4 are not Converted within 5 Business Days after the relevant Non-Viability Conversion Date for any reason they will be Written-Off, which means that all rights in relation to those Capital Notes 4 will be terminated, and those Capital Notes 4 Holders will not have their capital repaid or have any right to any Distributions with effect on and from Non-Viability Conversion Date.

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

69. Broadly, an Acquisition Event occurs where more than 50% of Challenger's Ordinary Shares are acquired by a person as a result of a takeover bid or a scheme of arrangement.

70. If an Acquisition Event occurs, Challenger must convert all (but not some only) Capital Notes 4 on the Acquisition Conversion Date.

#### ***Optional Exchange***

71. Challenger may, with APRA's prior written approval, by notice to Capital Notes 4 Holders and the Trustee, elect to Exchange (Holders of the Capital Notes 4 do not have a right to request Exchange):

- all or some Capital Notes 4 on an Exchange Date following the occurrence of a Tax Event or a Regulatory Event
- all Capital Notes 4 on an Exchange Date following the occurrence of a Potential Acquisition Event, or
- all or some Capital Notes 4 on any Optional Exchange Date (being 25 May 2029, 25 August 2029, 25 November 2029 and 25 February 2030).

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72. If Challenger elects to Exchange the Capital Notes 4, 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 4 (the Exchange Method):

- Convert the Capital Notes 4 into Ordinary Shares in accordance with the Terms
- Redeem the Capital Notes 4 by paying a Capital Notes 4 Holder a cash amount equal to the Face Value of each Capital Note 4 and upon payment by Challenger, all other rights conferred, or restrictions imposed, by the Capital Notes 4 will no longer have effect, or
- Resell the Capital Notes 4 to one or more Nominated Purchaser for the Resale Price, being a cash amount equal to the Face Value of each Capital Note 4.

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

- 2 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.

#### **Other matters**

74. The Ruling is made on the basis that:

- (a) During the term of the scheme, Challenger is a resident of Australia under the income taxation laws of Australia and of no other jurisdiction.
- (b) The majority of the Capital Notes 4 Holders who acquire the Capital Notes 4 under the Offer are expected to be residents of Australia for tax purposes, although some may be non-residents.
- (c) The Distributions are frankable distributions under section 202-40 and not unfrankable under section 202-45.
- (d) In accordance with Division 203, Challenger will frank Distributions in respect of the Capital Notes 4 at the same franking percentage as the Challenger benchmark for the franking period in which the frankable distribution is made.
- (e) Distributions on the Capital Notes 4 are not sourced, directly or indirectly, from Challenger's share capital account or its non-share capital account.
- (f) Distributions paid on the Capital Notes 4 will not be debited to Challenger's share capital account or its non-share capital account.
- (g) Immediately before the payment of a Distribution on the Capital Notes 4, Challenger has sufficient frankable profits (worked out under section 215-20) exceeding the amount of a Distribution that is proposed to be franked.
- (h) Challenger expects to continue with its policy of fully franking all frankable distributions (to the extent that franking credits are available in its franking account).

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- (i) Challenger does not differentially frank Distributions to different Capital Notes 4 Holders according to their tax status or on any other basis.
- (j) The dividend payout ratios and Challenger's policies in relation to the franking of its distributions on its Ordinary Shares and other equity instruments of Challenger (to the extent such dividends/distributions are frankable) are not expected to change as a result of the issue of the Capital Notes 4.
- (k) The share capital account of Challenger does not become tainted (within the meaning of Division 197) by the issue of the Capital Notes 4 or the allotment of Ordinary Shares on Conversion of the Capital Notes 4.
- (l) On Conversion or Redemption of the Capital Notes 4, Challenger debits the Face Value of the Capital Notes 4 to its non-share capital account.
- (m) On a Redemption, Challenger will make redemption payments out of capital, and not out of profits.
- (n) Ordinary Shares issued to the Capital Notes 4 Holders on Conversion of the Capital Notes 4 are equity interests under Division 974.
- (o) The accounts of the Challenger group are prepared in accordance with the applicable accounting standards.
- (p) All parties to the scheme are dealing with each other at arm's length.
- (q) You will not take any 'positions' (as defined in former section 160APHJ of the ITAA 1936) at any time in relation to your Capital Notes 4 apart from holding your Capital Notes 4.
- (r) You (or an associate) will not make, be under an obligation to make, or be likely to make, a 'related payment' (as defined under former section 160APHN of the ITAA 1936) in relation to a Distribution.
- (s) You will hold your Capital Notes 4 for a continuous period of at least 90 days (excluding the day of acquisition and disposal (if relevant)), during the 'primary qualification period' (as defined in former section 160APHD of the ITAA 1936) in relation to a Distribution.
- (t) You (or your connected entities) will not engage in distribution washing (as outlined in section 207-157) in relation to a Distribution (unless entitled to the exception under subsection 207-157(4)).
- (u) 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.
- (v) Distributions on Capital Notes 4 do not give rise to any 'foreign income tax deduction', as the term is defined in section 832-120, for Challenger.

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- (w) If Challenger declares the unfranked part of a Distribution to be conduit foreign income, Capital Notes 4 Holders who are Australian corporate tax entities will not, after the start of the relevant income year and before the due date for lodging their tax returns for that income year, declare the unfranked part of a frankable distribution made by the Capital Notes 4 Holder to be conduit foreign income.

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**Commissioner of Taxation**

10 May 2023

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## Appendix – Explanation

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**ⓘ** *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.*

<b>Table of Contents</b>	<b>Paragraph</b>
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### **Determination under paragraph 204-30(3)(c)**

75. Subsection 204-30(1) empowers the Commissioner to make a determination under paragraph 204-30(3)(c) if an entity streams distributions in a certain way.

76. Based on the scheme, there is no evidence of streaming. Distributions will be received by all Capital Notes 4 Holders by reason of their proportionate holding of Capital Notes 4 and not by reference to their tax profiles or individual tax positions. There is nothing in the Terms that allows Challenger to treat the Capital Notes 4 Holders differently in respect of their entitlement to a franked Distribution.

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

77. 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 particular scheme is to enable a taxpayer to obtain an imputation benefit.

78. The conditions in paragraphs 177EA(3)(a) to (d) of the ITAA 1936 are satisfied, therefore 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 Capital Notes 4 Holder to obtain an imputation benefit (refer paragraph 177EA(3)(e) of the ITAA 1936).

79. The Commissioner considers that the relevant circumstances of the scheme do not, on balance, lead to a conclusion that the purpose of enabling Capital Notes 4 Holders to obtain imputation benefits is more than incidental to Challenger's primary purpose of raising funds to subscribe for Additional Tier 1 capital in CLC for regulatory capital requirements and to refinance CCN2 through the Reinvestment Offer.

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**Gross-up and tax offset cancelled in certain circumstances**

80. If you are not a qualified person in relation to a Distribution, you:
- do not include the franking credit attached to the dividend in your assessable income (paragraph 207-145(1)(e)), and
  - are not entitled to a tax offset equal to the amount of the franking credit attached to the dividend (paragraph 207-145(1)(f)).
81. As this Ruling is made on the basis that you have not made a related payment in respect of a Distribution, the relevant qualification period is the primary qualification period (as defined in former section 160APHD of the ITAA 1936). The primary qualification period begins on the day after you acquire your Capital Notes 4 and ends on the 90th day after the day your Capital Notes 4 becomes ex-distribution.
82. You need to have held your Capital Notes 4 'at risk' for a continuous period of 90 days (excluding the days of acquisition and disposal, if relevant) during the primary qualification period. Any days you had materially diminished risks of loss or opportunities for gain in respect of your holding are also excluded (former subsection 160APHO(3) of the ITAA 1936).
83. Under former subsection 160APHM(2) of the ITAA 1936, you are taken to have materially diminished the risks of loss and opportunities for gain on a particular day with respect to your Capital Notes 4 if your net position on that day does not retain 30% or more of the risks and opportunities associated with holding Capital Notes 4.
84. Embedded options such as Resale and Conversion do not represent separate positions in relation to Capital Notes 4 (see also 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?*). Under a Resale, you will only be taken to have made an offer to sell Capital Notes 4 if Challenger elects to Resell. As Challenger is the only party entitled to make an election to exercise the Resale option, it is not a separate position that you have taken in relation to your Capital Notes 4. Similarly, under Conversion you do not have the right to elect Conversion of your Capital Notes 4 and neither does Challenger have an obligation to Convert.
85. Therefore, Resale and Conversion will not, of themselves, affect your risks of loss or opportunities for gain in respect of your Capital Notes 4.
86. However, if you do enter into any risk management strategies in respect of your Capital Notes 4 that have the effect of reducing your risks of loss and opportunities for gain below 30% (for example, by the use of limited recourse loans, options or other derivatives), then you will not be considered a qualified person in respect of a Distribution.

**Conversion of Capital Notes 4 for Ordinary Shares**

87. The issue of Ordinary Shares to Capital Notes 4 Holders on Conversion is a distribution of property made to holders of non-share equity interests and a non-share distribution under subparagraph 974-115(b)(ii). A non-share distribution is a non-share dividend under subsection 974-120(1), subject to the application of subsection 974-120(2).
88. Subsection 974-120(2) provides that a non-share distribution is not a non-share dividend to the extent to which the company debits the distribution against the company's share capital account or non-share capital account.
89. On Conversion, Challenger will debit the Face Value of each Capital Note 4 to its non-share capital account. Accordingly, the issue of Challenger Ordinary Shares on

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Conversion will not be a non-share dividend and will not be included in your assessable income under subparagraph 44(1)(a)(ii) of the ITAA 1936.

90. Furthermore, the Ordinary Shares will not be issued to the Capital Notes 4 Holders as shareholders of Challenger. Accordingly, the issue of the Challenger Ordinary Shares will not satisfy paragraphs (a) or (b) of the definition of 'dividend' in subsection 6(1) of the ITAA 1936. This means that it will not be included in your assessable income under subparagraph 44(1)(a)(i) of the ITAA 1936.

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

91. 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 but not all shareholders, and
- some or all of the shareholders who do not receive the shares receive or will receive minimally franked dividends.

92. Challenger's payout ratios and Challenger's policies in relation to the franking of its distributions on its Ordinary Shares and other equity interests are not expected to change as a result of issuing Capital Notes 4.

93. Under the Terms, Challenger is unable to issue Ordinary Shares to all or some Capital Notes 4 Holders in satisfaction of their Distribution entitlement under Capital Notes 4. The issue of Ordinary Shares on Conversion merely reflects a change in the type of equity interests held by Capital Notes 4 Holders in Challenger.

94. 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 value of Ordinary Shares issued to you on Conversion as an unfrankable dividend.

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

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

96. Both the issue of Ordinary Shares on Conversion and the Redemption of Capital Notes 4 will constitute the provision of a capital benefit to Holders (paragraph 45A(3)(a) of the ITAA 1936 for a Conversion, and paragraph 45A(3)(b) of the ITAA 1936 as affected by subsection 45A(3A) of the ITAA 1936 for a Redemption).

97. However, the issue of Ordinary Shares on Conversion and the Redemption of Capital Notes 4 will not constitute the streaming of capital benefits because under a Conversion or Redemption, Challenger will not selectively direct the flow of capital benefits to Capital Notes 4 Holders who could most benefit from the receipt of capital. Accordingly, as this requirement does not apply to the Conversion or Redemption of Capital Notes 4, the Commissioner will not make a determination to treat the whole or a part of the capital benefit received by you as an unfranked dividend.

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Status: **not legally binding**

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**Section 45B of the ITAA 1936**

98. Section 45B of the ITAA 1936 applies where certain capital benefits are provided to shareholders in substitution for dividends. Where the conditions are met, the Commissioner may make a determination under paragraph 45B(3)(b) of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole, or a part, of the capital benefit such that it will be treated as an unfranked dividend.

99. The issue of Ordinary Shares to Capital Notes 4 Holders on Conversion and the Redemption of Capital Notes 4 will each constitute a scheme under which Capital Notes 4 Holders are provided with a capital benefit by Challenger (paragraphs 45B(5)(a) and (b) and subsection 45B(7) of the ITAA 1936). As a result, paragraph 45B(2)(a) of the ITAA 1936 will be satisfied.

100. At least some Capital Notes 4 Holders will 'obtain a tax benefit' as defined in subsection 45B(9) of the ITAA 1936 as a result of a Conversion or Redemption. As a result, paragraph 45B(2)(b) of the ITAA 1936 will be satisfied.

101. Therefore, whether section 45B of the ITAA 1936 will apply to a Conversion or Redemption turns on whether paragraph 45B(2)(c) of the ITAA 1936 will be satisfied. This involves considering the relevant circumstances, including but not limited to those listed in subsection 45B(8) of the ITAA 1936, of the Conversion and Redemption schemes to establish whether one of the persons who will enter into or carry out the schemes will do so for a more than incidental purpose of enabling a relevant taxpayer (the Capital Notes 4 Holder) to obtain a tax benefit.

102. Having regard to the relevant circumstances, it could not be concluded that the Conversion or Redemption of Capital Notes 4 will be entered into for a more than incidental purpose of enabling Capital Notes 4 Holders to obtain a tax benefit. Accordingly, paragraph 45B(2)(c) of the ITAA 1936 would not be satisfied and 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 the whole or a part of the capital benefit provided to you on Conversion or Redemption.

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Status: **not legally binding**

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TD 2007/29

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