TD 2008/D6 - Income tax: is a taxpayer entitled to an income tax deduction under subsection 70B(2) of the Income Tax Assessment Act 1936 where a Stapled Security of the kind described in Taxpayer Alert TA 2008/1, is sold at a loss or upon the occurrence of an Assignment Event?

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This document has been finalised by TD 2009/14.

There is a Compendium for this document: **TD 2009/14EC** .

Generated on: 18 July 2026, 04:19:29 AM

Draft Taxation Determination

Income tax: is a taxpayer entitled to an income tax deduction under subsection 70B(2) of the *Income Tax Assessment Act 1936* where a Stapled Security of the kind described in Taxpayer Alert TA 2008/1, is sold at a loss or upon the occurrence of an Assignment Event?

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Ruling

1. No. A taxpayer is not entitled to an income tax deduction under subsection 70B(2) of the *Income Tax Assessment Act 1936* (ITAA 1936)[1] upon the sale of the Stapled Security at a loss, or upon the occurrence of an Assignment Event.

2. Taxpayer Alert TA 2008/1 (the Alert) was issued on 14 January 2008. It described a stapled security arrangement (the Stapled Security arrangement) with some or all of the following features:

- An Australian resident public entity (the Company) issues Notes from one of its overseas branches or subsidiaries to an Initial Purchaser(s) for a fixed amount. This amount is not repayable.
- At the same time, the Initial Purchaser(s) enters into an irrevocable agreement with the Company to offer to assign the Notes back to the Company (or one of its subsidiaries) for nil consideration upon certain events occurring, called 'Assignment Events'. These may occur in a number of specified circumstances, including at the election of the Company.

[1] All subsequent legislative references are to the ITAA 1936 unless otherwise indicated.

- Also at the same time, the Company issues Preference Shares to the Initial Purchaser(s) at a fully paid face value, said to be in consideration of the offer to assign. (It is thought that this extinguishes any indebtedness if a debt was created on issue of the Note.) The Note and the Preference Share have the same face value and no further money is paid for the Preference Share.
- In some cases, the steps listed above may differ in that an overseas resident subsidiary of the Company issues the Notes to the Initial Purchaser(s) for a fixed amount. Immediately after the issue of the Notes to the Initial Purchaser(s), the Initial Purchaser(s) enters into an irrevocable agreement with an Australian resident subsidiary of the Company (Aus Sub) to offer to assign the Notes to Aus Sub for nil consideration upon certain events occurring, the so-called Assignment Events.
- The Preference Shares are stapled to the Notes one-for-one, and will remain stapled until the occurrence of an Assignment Event.
- The Initial Purchaser(s) on-sell the Stapled Securities to resident individuals, companies and superannuation funds (the Investors) for an amount equal to the fixed amount paid for the issue of the Notes. For example, the Stapled Security is purchased by the Investor for $500, even though the Stapled Security consists of a Note and Preference Share, each with a face value of $500.
- The Investors are bound by the same terms as the Initial Purchaser(s). The irrevocable offer of assignment is embedded in the Note Terms.
- While the Notes and the Preference Shares remain stapled, an amount is payable on the Notes on the same terms on which dividends would be payable on the Preference Shares, that is, subject to there being distributable profits and subject to certain requirements regarding solvency, at the discretion of the Company and no dividends are payable on the Preference Shares.
- When an Assignment Event occurs, dividends become payable on the Preference Shares on the same terms as the amounts paid on the Notes. Alternatively, the Preference Shares are converted into Ordinary Shares in the Company.

3. The Alert indicated that the Tax Office was examining the arrangement. The Commissioner has now carefully considered the arrangement, and has concluded that the Stapled Security is a single instrument for the purposes of sections 26BB and 70B. Furthermore, neither the Note nor the Stapled Security, as a whole, is a traditional security for the purposes of section 70B.

4. Accordingly, for taxpayers who do not acquire and sell the Stapled Securities in the ordinary course of business, a profit from the disposal of the Stapled Security by way of a sale is assessable as a capital gain, rather than as statutory income under section 26BB. Likewise, a loss from the sale of the Stapled Security is a capital loss that can be offset against capital gains of the taxpayer, rather than a loss on revenue account under section 70B.

5. However, a taxpayer who acquires and sells Stapled Securities in the ordinary course of business will be entitled to a deduction for a loss incurred on the sale of the Stapled Security under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) if a loss is incurred. Likewise, if a profit is made from the sale of the Stapled Security in the ordinary course of business, it will be assessable under section 6-5 of the ITAA 1997.

6. A taxpayer will not derive any gain or incur a loss upon the occurrence of an Assignment Event as there is no disposal of the Stapled Security at this time.

Part IVA

7. In the Commissioner's view, a taxpayer is not entitled to a deduction under section 70B. Therefore this aspect of the arrangement will not give rise to a tax benefit within the meaning of section 177C.

8. However, if a taxpayer was entitled to a deduction under section 70B, the Commissioner may consider whether Part IVA applies to cancel the deduction. If the Commissioner concluded, based upon the facts of the particular Stapled Security arrangement, that there was a scheme entered into for the sole or dominant purpose of obtaining a tax benefit (being the allowable deduction under section 70B) the Commissioner may determine that Part IVA applies.

Date of effect

9. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraph 75 to 77 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
26 March 2008

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

Explanation

Stapled Security is a single instrument

10. The Commissioner has concluded that the Stapled Security, as a whole, is a single instrument. It is akin to a preference share with some additional rights. In concluding that the Investor has purchased a single instrument, the Commissioner has considered the legal form, purpose, effect, interdependency of rights and obligations, and other key features of both the Stapled Security as a whole and its individual components. The particular features of the arrangement which the Commissioner considers support his conclusion that the Stapled Security is one instrument are as follows:

- Under the Stapled Securities arrangement a Company offers to issue Stapled Securities to Investors. The offer is made in a Prospectus. Investors, in subscribing for the Stapled Securities, accept the offer made by the Company on the terms set out in the Prospectus. Accordingly the Investor purchases the Stapled Securities under a single contract. The terms of the contract are set out in the Deed Poll, the Note Terms and the Preference Share Terms.
- The Note and the Preference Share are stapled prior to being sold to Investors. Once the Note has been stapled to the Preference Share, the Note is no longer capable of existing separately from the Preference Share. It remains part of the Stapled Security until the occurrence of an Assignment Event whereupon the Note is assigned back to the Company and will cease to exist.
- The Note Terms do not permit the holder to receive the face value of the Note after the Note has been stapled to the Preference Share.
- The irrevocable offer by the Investor to assign the Note is a term of the contract as the Investor is bound by the terms of the Irrevocable Assignment Offer.
- Finally, the Investor when acquiring the Stapled Security pays consideration for the Stapled Security equal to the face value of the Preference Share, and the Preference Share is treated as fully paid.

The Stapled Security is not a Traditional Security

11. Section 70B, subject to certain exclusions, allows a taxpayer a deduction for any loss on the disposal or redemption of a traditional security in the income year in which the disposal or redemption takes place.

12. 'Traditional security' is defined in subsection 26BB(1). A traditional security is:

> a security held by a taxpayer that:
>
> (a) is or was acquired by the taxpayer after 10 May 1989;

(b) either:

(i) does not have an eligible return; or

(ii) has an eligible return, where:

(A) the precise amount of the eligible return is able to be ascertained at the time of issue of the security; and

(B) that amount is not greater than 1.5 % of the amount calculated in accordance with the formula:

Payments × Term

where:

Payments is the amount of the payment or of the sum of the payments (excluding any periodic interest) liable to be made under the security when held by any person; and

Term is the number (including any fraction) of years in the term of the security;

(c) is not a prescribed security within the meaning of section 26C; and

(d) is not trading stock of the taxpayer.

13. 'Security' is defined in subsection 159GP(1) to mean:

(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.

14. The Commissioner is of the view that the Stapled Security is not a traditional security for the purposes of section 70B because the Stapled Security does not satisfy the definition of 'security' in subsection 159GP(1).

15. The definition of 'security' in subsection 159GP(1) covers any instrument which would normally be taken to be a security: see paragraph (a) of the definition. It also encompasses some other liabilities which would not normally be characterised as a security: see paragraphs (b), (c) and (d) of the definition.

16. According to its ordinary meaning, a security is a debt or claim the payment of which is in some way secured: see *Singer v. Williams* [1920] All ER Rep Ext 819 per Lord Cave at 822. The Commissioner considers the phrase 'or other security' at the end of paragraph (a) of the definition of 'security' in subsection 159GP(1), when taken in context 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. Again, these types of securities will generally be debt instruments.[2]

[2] The meaning of the term 'traditional security' and 'security' is discussed in Taxation Ruling TR 96/14 and draft TD 2008/D4.

17. The Stapled Security is not covered by paragraph (a) of the definition of 'security' in subsection 159GP(1) because it is not a debt instrument. No debtor/creditor relationship is created between the Company and the Investor by the issue of the Stapled Security. The Investor is only entitled to payments from the Company under the Note Terms or the Preference Share Terms if the Company has sufficient distributable profits. The Investor is not entitled to a return of the face value of the Note. The Stapled Security is more properly characterised as an instrument that is akin to a convertible preference share. What is purchased by the Investor is a Preference Share, that is, issued share capital of the Company, and an additional right to receive payments under the Note Terms, subject to there being sufficient profits.

18. The only other paragraph in the definition of 'security' in subsection 159GP(1) which may cover the Stapled Security is paragraph (d). The Explanatory Memorandum to Clause 11 of the Taxation Laws Amendment Bill (No. 3) 1989 states that the word 'security' is widely defined for the purposes of Division 16E so as to encompass various arrangements that may give rise to a deferral of the payment of income. Paragraph (d) of the definition of 'security' includes a broad range of contracts under which there is a liability to pay an amount (see paragraph 30 of TR 96/14). However, having regard to paragraphs (a), (b) and (c) of the definition of 'security' in subsection 159GP(1), only those contracts that have debt-like obligations will usually fall under paragraph (d) of the definition of 'security'.

19. The obligations to make payments under the Note Terms and the Preference Share Terms are not debt-like obligations. The payments are contingent upon there being sufficient distributable profits out of which the amounts can be paid. Accordingly, the Company has not made an absolute promise to pay the amounts: see *Emu Bay Railway Co Ltd v. Federal Commissioner of Taxation* (1944) 71 CLR 596; (1944) 7 ATD 455.

20. Upon an Assignment Event when the Note 'destaples' from the Stapled Security, there is no disposal of a Note that meets the definition of 'security' in subsection 159GP(1). Rather, the right of the Investor to receive payments under the Note Terms is terminated. On an Assignment Event the Stapled Security consists solely of the remaining Preference Share.

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.

Alternative views

21. It has been argued that the Note itself satisfies the definition of 'security' in subsection 159GP(1) on the basis that the Note and the Preference Share are separate legal instruments. The Note is said to be covered by paragraph (a) of the definition of security in subsection 159GP(1). The Commissioner does not accept this view.

22. The Note on its own while forming part of the Stapled Security does not satisfy the definition of 'security'. Whilst paragraph (a) of the definition includes a 'debenture' and this term is defined in subsection 6(1) to include 'notes'; when regard is had to the other instruments covered by the definition, it is the Commissioner's view that 'debenture' for the purposes of the Act encompasses a written instrument whereby one person promises to pay a sum to another person. In other words, the Note has to be a debt instrument.

23. In order for an instrument to be a 'note', there must be a written acknowledgment of a debt and some promise to pay a sum at some time in the future. The Note in the Stapled Security does not have any acknowledgment of a debt or an absolute promise to pay a sum to the Investors. Payments under the Note Terms are contingent on the Company having distributable profits, and the face value of the Note is never payable to the Investors. Even on the winding up of the Company, the face value of the Note is payable to the Company as Assignee rather than the Investor. Therefore, whilst on its face the Note in the Stapled Security is covered by the definition of 'debenture' in subsection 6(1), it is the Commissioner's view that 'Note' is an incorrect label for the instrument.

24. The Note in the Stapled Security can be distinguished from a 'perpetual note'. Under the latter the Investor usually has an entitlement to receive a sum on the winding up of the issuing company: the Investor in the Stapled Security has no such right under the Note Terms.

25. It should be noted that the Commissioner accepts that before being stapled, the Note exists in legal form as an instrument giving the Initial Purchaser(s) the right to receive the face value on maturity, and therefore would be a 'note' for the purposes of the definition of 'security' under subsection 159GP(1). However, when the Initial Purchaser(s) enters into an agreement with the Company such that the Note Terms are varied resulting in the Initial Purchaser(s) no longer having the right to receive the face value of the Note, it is the Commissioner's view that the Note no longer meets the ordinary meaning of the word 'note': there is no longer an entitlement for the holder to receive their investment in the instrument back.[3]

[3] The change in the terms of the Note does not amount to a disposal of the Note by the Initial Purchaser(s); all that happens is that there is a waiver by the Initial Purchaser(s) of some of their rights under the Note. Any loss that the Initial Purchaser(s) would suffer from this waiver would not be a deduction to the Initial Purchaser under subsection 70B(2) due to the operation of subsection 70B(5).

Appendix 3 – Your comments

26. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date. (Note: the Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel or relevant Tax officers. The Tax Office may use a version (names and identifying information removed) of the compendium in providing responses to persons providing comments. Please advise if you do not want your comments included in the latter version of the compendium.)

Due date: **2 May 2008**
Contact officer: **Usha Narain**
Email address: **Usha.Narain@ato.gov.au**
Telephone: **(02) 6216 2355**
Facsimile: **(02) 6216 1247**
Address: **PO Box 9977**
Civic Square ACT 2608

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 96/14; TR 2006/10

Subject references:

- debenture
- disposal
- notes
- preference shares
- securities
- traditional securities

Legislative references:

- ITAA 1936
- ITAA 1936 6(1)
- ITAA 1936 26BB
- ITAA 1936 26BB(1)
- ITAA 1936 26C
- ITAA 1936 70B
- ITAA 1936 70B(2)
- ITAA 1936 70B(5)
- ITAA 1936 Pt III Div 16E
- ITAA 1936 159GP(1)
- ITAA 1936 Pt IVA
- ITAA 1936 177C
- ITAA 1997 6-5
- ITAA 1997 8-1

Case references:

- Emu Bay Railway Co Ltd v. Federal Commissioner of Taxation (1944) 71 CLR 596; (1944) 7 ATD 455
- Singer v. Williams [1920] All ER Rep Ext 819

Other references:

- Taxpayer Alert TA 2008/1
- Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 1989

ATO references

NO: 2008/3453
ISSN: 1038-8982
ATOlaw topic: Income Tax ~~ Deductions ~~ other investment related expenses