

TD 2010/D3 - Income tax: where an equity interest is a financial arrangement which satisfies both subsections 230-45(1) and 230-50(1) of the Income Tax Assessment Act 1997, which provision applies?

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This document has been finalised by TD 2011/12.

! There is a Compendium for this document: **TD 2011/12EC** .



Draft Taxation Determination

Income tax: where an equity interest is a financial arrangement which satisfies both subsections 230-45(1) and 230-50(1) of the *Income Tax Assessment Act 1997*, which provision applies?

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This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

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Ruling

1. Subsection 230-50(1) of the *Income Tax Assessment Act 1997* (ITAA 1997)¹ applies if an equity interest satisfies both subsections 230-50(1) and 230-45(1).

Date of effect

2. 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 paragraphs 75 to 77 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

20 October 2010

¹ All legislative references are to the ITAA 1997 unless otherwise indicated.

Appendix 1 – Explanation

❶ *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.*

Background

3. For Division 230 to apply to a gain or loss, it is necessary to identify a financial arrangement. A financial arrangement is the unit of taxation for Division 230. Subsections 230-45(1), 230-50(1) and 230-50(2) provide tests which specify when you have a financial arrangement.
4. Section 230-45 is the general test. Pursuant to subsection 230-45(1), you have a financial arrangement if you have, under an arrangement identified pursuant to subsection 230-55(4), a cash settlable right to receive or obligation to provide a financial benefit, or a combination of such rights and/or obligations, unless, broadly, you have not insignificant other rights to receive or obligations to provide something which is not a financial benefit, or the other rights or obligations are not cash settlable. Subsection 230-45(2) specifies the circumstances in which a right to receive or obligation to provide a financial benefit that you have is cash settlable.
5. Section 230-50 provides two further tests for having a financial arrangement. Subsection 230-50(2), in a similar way to section 230-45, specifies criteria pursuant to which certain rights and/or obligations, under an arrangement identified by subsection 230-55(4), are a financial arrangement that you have.
6. Subsection 230-50(1), on the other hand, provides that an equity interest, as defined, constitutes the financial arrangement. The term ‘equity interest’ is defined in Subdivision 974-C² for an equity interest in a company, and in section 820-930³ for an equity interest for a partnership or trust.
7. Certain arrangements may satisfy both subsections 230-45(1) and 230-50(1). In this event it is necessary to determine which subsection takes precedence as Division 230 has limited operation in relation to section 230-50 financial arrangements.
8. The operation of Division 230 is limited or modified for ‘a financial arrangement under section 230-50’ in the following provisions:⁴
 - paragraph 230-5(2)(b) (guide);
 - paragraph 230-40(4)(e) – accruals/realisation;

² A scheme gives rise to an equity interest in a company under subsection 974-70(1) if the scheme satisfies the equity test in subsection 974-75(1) and the interest is not characterised as and does not form part of a larger interest that is a debt interest in the company.

³ Section 820-930 provides that for certain purposes, an equity interest in an entity that is a trust or partnership has the meaning given by specified provisions in Division 974 as modified in section 820-930. As is made clear by the note to subsection 820-930(1), as for an equity interest in a company, an interest that satisfies the debt test is not treated as an equity interest.

⁴ The operation of Division 230 is also modified for a financial arrangement if the arrangement is an ‘equity interest’ in the provisions: subsection 230-225(1) (fair value method – issued equity interest); subsection 230-415(1) (financial reports method – issued equity interest); paragraph 230-460(3)(b) (a right carried by an interest in a partnership or trust, or an obligation corresponding to such right, if the interest is an equity interest in the partnership or trust)

- subsection 230-270(1) – foreign exchange retranslation;
- subsection 230-300(7) – hedging in relation to a foreign currency hedge you issue;
- subsection 230-330(1) – (when read with subsection 230-330(2)) hedging in relation to a foreign currency hedge you issue;
- paragraph 230-410(1)(d) – financial reports election where you are required to classify or designate, in the financial reports, the asset or liability at fair value through profit and loss;
- paragraph 230-440(1)(a) – balancing adjustment.

9. In summary, a section 230-50 financial arrangement is not subject to the following methods for calculating gains and losses from a financial arrangement:

- accruals and realisation;
- foreign exchange retranslation;
- hedging financial arrangements method (except to the extent it is a foreign currency hedge issued by you);
- fair value method for an equity interest which is issued by you;
- financial reports method for an equity interest which is issued by you.

That is to say, Division 230 applies to an equity interest only where it is:

- subject to the fair value method and is an equity interest you hold;
- subject to the financial reports method and is an equity interest you hold;
- subject to the hedging financial arrangements method and is an equity interest that you issue and is a foreign currency hedge.⁵

Which subsection applies

10. An equity interest that is cash settleable will satisfy subsection 230-50(1) and may also satisfy subsection 230-45(1). In these circumstances, subsection 230-50(1) applies in preference to subsection 230-45(1).

11. Division 230 has been designed to ensure that not all tax-treatment methods apply to equity financial arrangements. This purpose should be given effect to irrespective of whether the equity financial arrangement also satisfies the requirements of a cash settleable financial arrangement.

⁵ Only an equity interest in a company can be subject to the hedging financial arrangements method where it is an equity interest that you issue which is a foreign currency hedge. An equity interest in a trust or partnership cannot be subject to the hedging financial arrangements election.

12. The structure of the Division is that a broader range of things are included within the provisions, and then there are things excluded from the set of things included, and so on. So, for example, equity interests in partnerships and trusts are included as financial arrangements under subsection 230-50(1), then, broadly, paragraph 230-460(3)(b)⁶ excludes them, then subsection 230-460(4) is an exception to that exclusion in relation to financial arrangements the subject of a fair value or financial reports election which are therefore re-included, and then, of such re-included financial arrangements, subsections 230-225(1) and 230-415(1) exclude issued equity financial arrangements. That leaves held trust and partnership equity interest financial arrangements the subject of a fair value or financial reports election as being subject to Division 230. From this structure, an inference can be drawn that the limited application purpose for section 230-50 financial arrangements ought to take precedence over the purpose that Division 230 ought to apply to all cash settleable financial arrangements. The structure is such that the exclusions and modifications that apply to equity interests are impressed upon the initial general inclusion.⁷

13. The conclusion that section 230-50(1) applies in preference to subsection 230-45(1) (where both are satisfied) is consistent with the statement in section 230-5 that:

(2) This Division does not apply to all financial arrangements. The main exceptions are if:

...

(b) the arrangement is a financial arrangement under section 230-50 (equity interests etc) and neither a fair value election, a hedging financial arrangement election nor an election to rely on financial reports applies to the arrangement.

14. With respect to a convertible note, example 2.17 of the Explanatory Memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 explains that where the convertible note is a cash settleable financial arrangement and an equity financial arrangement the convertible note is only subject to the limited operation of Division 230:

Continuation of Example 2.2 – Convertible note (cash settleable financial arrangement)

Hamish Co's convertible note is a cash settleable financial arrangement. This is because under this arrangement Hamish has the right to receive cash coupon payments, and the ability to redeem the note upon maturity by receiving a payment of money, and Hamish Co did not have the sole or dominant purpose when entering into the arrangement of receiving the shares on conversion instead (subsection 230-45(1) and paragraph 230-45(2)(g)).

If Hamish Co's convertible note is also an *equity interest*, it will satisfy the definition of an 'equity financial arrangement' (see subsection 230-50(1)), and therefore will *only* be subject to a limited operation of Division 230 (refer to discussion on the limited operation of Division 230 to 'equity financial arrangements').

⁶ Paragraph 230-460(3)(b) excludes gains and losses from a financial arrangement from taxation under Division 230 to the extent that a financial arrangement right (or corresponding obligation) is carried by an interest in a partnership or a trust and the interest is an equity interest in the partnership or trust.

⁷ In paragraph 2.106 of the Explanatory Memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 the reasoning for limiting the application of Division 230 in relation to equity interests is evident: 'As a general rule, other areas of the income tax law – such as the capital gains, imputation and general income provisions – largely provide an adequate basis for recognising the capital gains and losses, including dividends, from equity interests.'

Appendix 2 – Alternative views

15. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

16. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the ATO website at www.ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Subject references:

- accruals
- arrangement
- balancing adjustment
- cash settlable
- convertible note
- currency exchange rate effect
- equity interest
- fair value election
- financial arrangement
- financial reports election
- foreign currency hedge
- foreign exchange retranslation election
- hedging financial arrangement election
- realisation
- scheme
- taxation of financial arrangements

- ITAA 1997 230-45
- ITAA 1997 230-45(1)
- ITAA 1997 230-45(2)
- ITAA 1997 230-45(2)(g)
- ITAA 1997 230-50
- ITAA 1997 230-50(1)
- ITAA 1997 230-50(2)
- ITAA 1997 230-55(4)
- ITAA 1997 230-225(1)
- ITAA 1997 230-270(1)
- ITAA 1997 230-300(7)
- ITAA 1997 230-330(1)
- ITAA 1997 230-330(2)
- ITAA 1997 230-410(1)(d)
- ITAA 1997 230-415(1)
- ITAA 1997 230-440(1)(a)
- ITAA 1997 230-460(3)(b)
- ITAA 1997 230-460(4)
- ITAA 1997 820-930
- ITAA 1997 820-930(1)
- ITAA 1997 Div 974
- ITAA 1997 Subdiv 974-C
- ITAA 1997 974-70(1)
- ITAA 1997 974-75(1)

Legislative references:

- ITAA 1997
- ITAA 1997 Div 230
- ITAA 1997 230-5(2)
- ITAA 1997 230-5(2)(b)
- ITAA 1997 230-40(4)(e)

Other references:

- Explanatory Memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008

ATO references

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