


# ***CR 2017/25 - Income tax: Challenger Limited: Challenger Capital Notes 2***

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## Class Ruling

### Income tax: Challenger Limited: Challenger Capital Notes 2

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#### **📌 This publication provides you with the following level of protection:**

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

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

## Summary – what this Ruling is about

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

#### **Relevant provision(s)**

2. The relevant provisions considered in this Ruling are:
- subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936)
  - section 26BB of the ITAA 1936
  - subsection 44(1) of the ITAA 1936
  - section 45 of the ITAA 1936
  - section 45A of the ITAA 1936
  - section 45B of the ITAA 1936
  - section 45C of the ITAA 1936
  - section 70B of the ITAA 1936
  - section 177EA of the ITAA 1936

- Division 1A of former Part IIIAA of the ITAA 1936
- former section 160APHJ of the ITAA 1936
- former section 160APHM of the ITAA 1936
- Division 67 of the *Income Tax Assessment Act 1997* (ITAA 1997)
- section 67-25 of the ITAA 1997
- section 104-10 of the ITAA 1997
- section 104-25 of the ITAA 1997
- section 109-10 of the ITAA 1997
- section 110-25 of the ITAA 1997
- section 110-55 of the ITAA 1997
- section 116-20 of the ITAA 1997
- Subdivision 130-C of the ITAA 1997
- section 130-60 of the ITAA 1997
- section 204-30 of the ITAA 1997
- section 207-20 of the ITAA 1997
- section 207-145 of the ITAA 1997
- section 974-75 of the ITAA 1997
- section 974-120 of the ITAA 1997.

All subsequent references are to the ITAA 1997 unless otherwise indicated.

### **Class of entities**

3. The class of entities to which this Ruling applies are investors who are allotted non-cumulative, convertible, transferable, redeemable, subordinated, perpetual, unsecured notes issued by Challenger Limited (Challenger), called Challenger Capital Notes 2 (Capital Notes 2) and who:

- are residents of Australia (within the meaning of that term in subsection 6(1) of the ITAA 1936)
- hold their Capital Notes 2 on capital account, and
- are not subject to the Taxation of Financial Arrangements (TOFA) rules in Division 230 in relation to financial arrangements under the scheme.

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

4. The investors described in the previous paragraph are referred to in this Ruling as Holders.

5. The class of entities to which this Ruling applies does not extend to Holders of the Capital Notes 2 who acquired their Capital Notes 2 otherwise than by initial application under the Prospectus dated 8 March 2017 issued by Challenger.

### **Qualifications**

6. This Ruling does not deal with:

- how the taxation law applies to Challenger in relation to the issue of the Capital Notes 2
- how the taxation law applies to Holders who hold their Capital Notes 2 as trading stock or revenue assets
- the tax implications of the Conversion of the Capital Notes 2 on a Non-Viability Trigger Event
- the tax implications of the Redemption or Resale of the Capital Notes 2
- the tax implications for Holders for whom gains and losses from the Capital Notes 2 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.

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

8. The class of entities defined in this Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 11 to 60 of this Ruling.

9. If the scheme actually carried out is materially different from the scheme that is described in this Ruling, then:

- this Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled, and
- this Ruling may be withdrawn or modified.

## Date of effect

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10. This Ruling applies from 1 July 2016 to 30 June 2027. The Ruling continues to apply after 30 June 2027 to all entities within the specified class who entered into the specified scheme during the term of the Ruling. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

## Scheme

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11. The following description of the scheme is based on information provided by Greenwoods & Herbert Smith Freehills. The following documents (Transaction Documents), or relevant parts of them, form part of, and are to be read with the description:

- application for Class Ruling from Challenger dated 10 January 2017
- Prospectus dated 8 March 2017 for the issue of the Capital Notes 2 by Challenger (Prospectus)
- Challenger Capital Notes 2 Terms as contained in Appendix A to the Prospectus (Notes Terms)
- Challenger Capital Notes Trust Deed dated 28 February 2017 for the issue of the Capital Notes 2 by Challenger (Trust Deed)
- Challenger Life Company Limited Note Deed Poll dated 28 February 2017 including the terms for the issue of notes by CLC, and
- other correspondence provided by Greenwoods & Herbert Smith Freehills containing further particulars.

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

12. In this Ruling, unless otherwise indicated, capitalised terms take on the same meaning as in the Prospectus.

13. During the term of the transaction, Challenger will be a resident of Australia under the income tax laws of Australia and of no other jurisdiction.

14. Challenger has applied for the Capital Notes 2 to be quoted on the Australian Securities Exchange (ASX) and the Capital Notes 2 are expected to trade under ASX code 'CGFPB'.

**Challenger**

15. Challenger was established in 1985 and is an investment management firm managing more than \$65 billion in assets.
16. Challenger is the head company of the Challenger tax consolidated group and has been listed on the ASX since 1987.
17. Challenger operates two core investment businesses, a Funds Management division and a Life division.
18. 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 around 60,000 investors through its management of \$14.3 billion in assets.
19. CLC is prudentially regulated by the Australian Prudential Regulation Authority (APRA) as a life insurer.

**The offer of Capital Notes 2**

20. In the Prospectus, Challenger announced its intention to undertake an offer of Capital Notes 2 to raise \$430 million, with the ability to raise more or less (Offer).
21. The classes of Applicants who can apply for the Capital Notes 2 as described in the Prospectus, are:
  - Eligible Shareholders – a person who is:
    - a registered holder of Ordinary Shares or Challenger Capital Notes 1 at 7:00pm (Sydney time) on 23 February 2017
    - shown on the applicable register as having an address in Australia, and
    - not in the United States, or acting as a nominee for a person in the United States.
  - Broker Firm Applicant – a retail or high net worth client of a Syndicate Broker resident in Australia who has received a firm allocation from their Syndicate Broker, and

- Institutional Investor – an investor to whom offers or invitations in respect of the Capital Notes 2 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 2001*, and who has been invited by the Joint Lead Managers to bid for the Capital Notes 2 in the Bookbuild, provided that such investor may not be in the United States.

22. The Prospectus states that no action has been taken to register or qualify the Capital Notes 2 or the Offer, or to otherwise permit a public offering of the Capital Notes 2 outside Australia. However, the Capital Notes 2 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 2**

23. The Offer of the Capital Notes 2 will raise capital to satisfy the Challenger Group's capital (including regulatory / prudential capital) requirements and to maintain the diversity of Challenger's sources and types of funding.

24. The net proceeds of the Offer are intended to be used by Challenger to subscribe for notes to be issued by CLC. Those notes are expected to form part of CLC's Additional Tier 1 Capital for prudential purposes, under the Prudential Standards LPS 110 and LPS 112.

25. The volume of annuities issued by CLC has increased so that CLC requires additional capital to support its corresponding liabilities.

26. APRA has confirmed that the proceeds of the Capital Notes 2 issue may be used to fund a subscription for Additional Tier 1 Capital of CLC.

## **Terms of the Capital Notes 2**

27. The Capital Notes 2 were issued on 7 April 2017 (Issue Date) and are non-cumulative, convertible, transferable, redeemable, subordinated, perpetual, unsecured notes issued by Challenger.

28. The issue price of each Capital Notes 2 is \$100 (Face Value), and on issue is fully paid.

29. A Holder will not have voting rights under the Capital Notes 2, except in the limited circumstances described in the Notes Terms and Trust Deed.

***Distribution calculation***

30. Subject to the conditions outlined in paragraphs 34 and 35 of this Ruling, the Holder of each Capital Notes 2 is entitled to receive on the relevant Distribution Payment Date a cash distribution on the Face Value of the Capital Notes 2 (Distribution) calculated using the formula in clause 3.1 of the Notes Terms:

$$\text{Distribution} = (\text{Distribution Rate} \times \text{A\$100} \times \text{N}) / 365$$

where:

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

where:

**Bank Bill Rate** (expressed as a percentage per annum) means:

for a Distribution Period, the rate for prime bank eligible securities of a term of three months which is designated as 'AVG MID' on the Thomson Reuters Screen BBSW page (or any designation which replaces that designation on that page or any page which replaces that page) at or about 10:15am (Sydney time) (or such other time at which such rate customarily appears on that page (Publication Time)) on the first Business Day of the Distribution Period or, if there is a manifest error in the calculation of that rate or that rate is not displayed by 10:30am (Sydney time) (or such other time that is 15 minutes after the then prevailing Publication Time) on that date, the rate specified in good faith by Challenger at or around 10:30am (Sydney Time) (or such other time that is 15 minutes after the then prevailing Publication Time) on that date having regard, to the extent possible, to:

- (a) the rates otherwise bid and offered for prime bank eligible securities of a term of three months at or around that time on that date; or
- (b) if bid and offer rates for prime bank eligible securities of a term of three months are not otherwise available, the rates otherwise bid and offered for funds of that tenor at or around that time on that date;

**Margin** (expressed as a percentage per annum) means:

the margin determined under the Bookbuild; and

**Tax Rate** (expressed as a decimal) means:

the Australian corporate tax rate applicable to the franking account of Challenger 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.

31. The Distribution Payment Dates are each 22 February, 22 May, 22 August and 22 November, commencing on 22 August 2017 until (but not including) the date on which the Capital Notes 2 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.

32. Challenger expects to fully frank dividends on Ordinary Shares in the period in which the first Distribution is scheduled to be paid. Distributions on the Capital Notes 2 will be franked at the same rate as dividends on Ordinary Shares in each Applicable Franking Period.

33. 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:

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

where:

**D** means:

the Distribution calculated under clause 3.1 of the Notes Terms;

**Tax Rate** (expressed as a decimal) means:

the Australian corporate tax rate as applicable to the franking account of Challenger at the relevant Distribution Payment Date; 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***

34. 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.

35. '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 2 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 2001*, or
- APRA objecting to the payment.

***Distribution terms***

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

37. Distributions are non-cumulative and the Holders of the Capital Notes 2 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 2 have no claim in respect of non-payment.

38. No interest accrues on any unpaid Distributions and the Holders of the Capital Notes 2 have no claim or entitlement in respect of interest on any unpaid Distributions.

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

39. 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***

40. 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 2 on issue at that date into Ordinary Shares.

41. 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:

- (a) 22 May 2025 (the Scheduled Mandatory Conversion Date), and
- (b) a Distribution Payment Date after the Scheduled Mandatory Conversion Date (a Subsequent Mandatory Conversion Date).

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

- the average of the daily volume weighted average sales price of Ordinary Shares sold on ASX (VWAP) 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), and
- no Delisting Event applies to Ordinary Shares in respect of the Relevant Date (the Third Mandatory Conversion Condition).

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

43. Conversion of the Capital Notes 2 may occur at a time before a scheduled Mandatory Conversion Date on the occurrence of a Non-Viability Trigger Event. A Non-Viability Trigger Event occurs when APRA provides a written determination to Challenger that the conversion to Ordinary Shares or write-off of Relevant Perpetual Subordinated Instruments in accordance with their terms or by the operation of law is necessary because:

- without the conversion to Ordinary Shares or write-off, APRA considers that Challenger would become non-viable, or

- without a public sector injection of capital, or equivalent capital support, APRA considers that Challenger would become non-viable.

44. 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.

45. If the Capital Notes 2 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 2 will be written-off and terminated, and those Holders will not have their capital repaid or have any right to any Distributions.

### ***Optional Exchange***

46. Challenger may, with APRA's prior written approval by notice to Holders and the Trustee, elect to Exchange (Holders of the Capital Notes 2 do not have a right to request Exchange):

- (a) all, or some, Capital Notes 2 on an Exchange Date following the occurrence of a Tax Event or a Regulatory Event
- (b) all Capital Notes 2 on an Exchange Date following the occurrence of a Potential Acquisition Event, or
- (c) all, or some, Capital Notes 2 on the Optional Exchange Date being 22 May 2023.

47. If Challenger elects to Exchange the Capital Notes 2, 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 2 (the Exchange Method):

- Convert the Capital Notes 2 into Ordinary Shares in accordance with clause 8 of the Notes Terms
- Redeem the Capital Notes 2 in accordance with clause 9 of the Notes Terms (other than in the case of a Potential Acquisition Event), or
- Resell the Capital Notes 2 in accordance with clause 10 of the Notes Terms (other than in the case of a Potential Acquisition Event).

48. 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***

49. Challenger must give notice to Holders and Convert all (but not some only) of the Capital Notes 2 on the occurrence of an Acquisition Event, subject to the relevant restrictions being met.

50. 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***

51. 'Conversion' means the conversion of the Capital Notes 2 into Ordinary Shares in accordance with and subject to clause 8 of the Notes Terms.

52. On Conversion:

- each Holder of the Capital Notes 2 will be allotted and issued a number (the Conversion Number) of Ordinary shares in respect of each Capital Notes 2 held by the Holder, and
- 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 Notes 2 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 Notes 2 by way of payment for the subscription for the Ordinary Shares to be allotted and issued on Conversion.

53. The Conversion Number (of Ordinary Shares for each Capital Notes 2) 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***

54. 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.

55. 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***

56. The Capital Notes 2 may (subject to APRA's written approval) be Redeemed by payment on the Exchange Date of the Face Value to the Holder (Redemption Price).

57. On the Exchange Date the only right the Holders of the Capital Notes 2 will have in respect of their Capital Notes 2 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 Notes 2 will no longer have effect.

***Resale***

58. Challenger may (subject to APRA's written approval) elect to Resell the Capital Notes 2 in accordance with the Notes Terms.

59. Each Holder on the Exchange Date is taken irrevocably to offer to sell the relevant number of the Capital Notes 2 to a Nominated Purchaser for a cash amount equal to the Face Value (Resale Price). Subject to payment by the Nominated Purchaser of the Resale Price to the Holders, all rights, title and interest in such Capital Notes 2 will be transferred to the Nominated Purchaser on the Exchange Date, free from Encumbrances.

***Other matters***

60. 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 2.
- (c) The Capital Notes 2 are equity interests in Challenger pursuant to Division 974.

- (d) Distributions on the Capital Notes 2 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 2 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 2 or Ordinary Shares of Challenger on Conversion of the Capital Notes 2 within the meaning of Subdivision 197-A.
- (g) The Ordinary Shares issued in the event of Conversion of the Capital Notes 2 will be equity interests in Challenger pursuant to Division 974.
- (h) The majority of the Holders of the Capital Notes 2 are expected to be residents of Australia for tax purposes, although some may be non-residents.
- (i) The Capital Notes 2 are expected to be treated as a liability for Australian International Financial Reporting Standard purposes.
- (j) For the purposes of determining whether a Holder is a 'qualified person' in relation to the Distribution for the purposes of 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 2) in relation to their Capital Notes 2 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) The Holders, or their associates, will not make any related payments (within the meaning of former section 160APHN of the ITAA 1936) in relation to the Distributions on the Capital Notes 2.
- (l) Holders in receipt of Distributions on the Capital Notes 2 will have held their Capital Notes 2 for a period of at least 90 days (excluding the day of disposal), within the period beginning on the day after the day on which the Holder acquired the Capital Notes 2 and ending on the 90th day after the day on which the Capital Notes 2 go ex-distribution.
- (m) Distributions on the Capital Notes 2 will not be sourced, directly or indirectly, from Challenger's share capital or non-share capital.

- (n) Challenger will not differentially frank Distributions to different Holders in respect of the Capital Notes 2 according to the tax status of Holders or on any other basis.
- (o) 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 2.
- (p) Immediately before payment of a Distribution on the Capital Notes 2, Challenger will have sufficient available profits (worked out under section 215-20) to pay the Distribution.
- (q) On Conversion, Challenger will debit the Face Value of the Capital Notes 2 to its non-share capital account.
- (r) On the date of Conversion of the Capital Notes 2 into Ordinary Shares, the rights and obligations attached to the Ordinary Shares are the same as those contained in the Constitution of Challenger.

## **Ruling**

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### **Acquisition time of the Capital Notes 2**

61. Holders acquire their Capital Notes 2 on 7 April 2017, being the date the contract for the issue of the Capital Notes 2 is entered into (item 2 of the table in section 109-10).

### **Cost base and reduced cost base of the Capital Notes 2**

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

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

63. Distributions paid in respect of each Capital Notes 2 are non-share dividends under section 974-120 and must be included in the Holders' assessable income (subparagraph 44(1)(a)(ii) of the ITAA 1936).

64. 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**

65. Holders are entitled to a tax offset equal to the franking credit received on Distributions paid in respect of their Capital Notes 2 (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**

66. 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 2, will be subject to the refundable tax offset rules in Division 67, unless they are specifically excluded under section 67-25.

## **Imputation benefits – streaming**

67. 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 2.

## **Section 177EA of the ITAA 1936**

68. 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 2.

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

69. 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 Holders' assessable income to exclude the franking credit, nor will it deny the tax offset to which the Holders would have otherwise been entitled.

70. 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 Exchange mechanism (of itself) will not affect a Holder's risks of loss or opportunities for gain in respect of the Capital Notes 2. This is because neither the Resale mechanism nor the Exchange mechanism constitutes a separate position (former sections 160APHJ and 160APHM of the ITAA 1936).

**Each Capital Notes 2 is not a traditional security**

71. A Capital Notes 2 is not a 'traditional security' as defined in subsection 26BB(1) of the ITAA 1936.

72. A gain on the disposal of a Capital Notes 2 does not give rise to assessable income under subsection 26BB(2) of the ITAA 1936. A loss on the disposal of a Capital Notes 2 does not give rise to an allowable deduction under subsection 70B(2) of the ITAA 1936.

**Capital Notes 2 are convertible interests**

73. Each Capital Notes 2 is a convertible interest under item 4 of the table in subsection 974-75(1).

**Conversion of the Capital Notes 2 – CGT implications**

74. CGT event C2 will happen for Holders on Conversion of the Capital Notes 2 for Ordinary Shares (section 104-25). Conversion is constituted by the Capital Notes 2 (a convertible interest) being converted into Ordinary Shares.

75. Any capital gain or capital loss made by a Holder from CGT event C2 happening on Conversion of the Capital Notes 2 will be disregarded (subsection 130-60(3)).

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

76. On Conversion of the Capital Notes 2, 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 Notes 2 will be a pro-rata portion of the cost base and reduced cost base of the Capital Notes 2 at the time of Conversion (item 2 of the table in subsection 130-60(1)).

**Acquisition time of Ordinary Shares on Conversion**

77. Ordinary Shares allotted on Conversion of the Capital Notes 2 (being convertible interests) will be taken to be acquired at the time of Conversion (subsection 130-60(2)).

## **Share sale facility**

78. 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 the Capital Notes 2 at the time of Conversion (item 2 of the table in subsection 130-60(1)).

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

79. Other than in respect of a Distribution paid on the date on which a Conversion occurs, the Conversion of the Capital Notes 2 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.

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

80. 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**

81. 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 2 as an unfranked dividend in the hands of Holders.

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

82. 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 2 as an unfranked dividend in the hands of Holders.

## **Appendix 1 – Explanation**

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

### **Acquisition time of the Capital Notes 2**

83. 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 (item 2 of the table in section 109-10).

84. The Capital Notes 2 are equity interests in Challenger. When an investor's application for the Capital Notes 2 is accepted by Challenger, this leads to the formation of a contract for the issue of the Capital Notes 2 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 2 are issued. Under item 2 of the table in section 109-10, a Holder will acquire their Capital Notes 2 on the date on which the contract for the issue of the Capital Notes 2 is entered into.

### **Cost base and reduced cost base of the Capital Notes 2**

85. The first element of the cost base and reduced cost base of a CGT asset includes the money paid in respect of acquiring the CGT asset (paragraph 110-25(2)(a) and subsection 110-55(2)).

86. The issue price of each Capital Notes 2 is \$100. Accordingly, the first element of the cost base and reduced cost base of each Capital Notes 2 is \$100.

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

87. 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.

88. The Capital Notes 2 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.

89. Distributions paid in respect of the Capital Notes 2 are non-share dividends under section 974-120. Accordingly, Holders must include in their assessable income Distributions paid in respect of the Capital Notes 2 under subparagraph 44(1)(a)(ii) of the ITAA 1936.

90. 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.

91. Distributions on the Capital Notes 2 are expected to be fully 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.

### **Entitlement to a tax offset**

92. Holders are entitled to receive a tax offset equal to the franking credit which has been included in their assessable income in respect of Distributions they receive (subsection 207-20(2)) unless the Distribution is exempt income or non-assessable non-exempt income in the hands of the Holder.

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

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

94. Holders who are entitled to a tax offset under subsection 207-20(2) in respect of a franking credit received on a Distribution, will also be subject to the refundable tax offset rules in Division 67, unless they are specifically excluded under section 67-25.

95. The refundable tax offset rules ensure that certain taxpayers are entitled to a refund once their available tax offsets have been utilised to reduce any income tax liability to nil.

96. Entities excluded under section 67-25 include corporate tax entities (such as companies, corporate limited partnerships, corporate unit trusts and public trading trusts), unless they satisfy the requisite conditions as set out in subsections 67-25(1C) or 67-25(1D).

### **Imputation benefits – streaming**

97. 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.

98. 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:

- (a) 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))
- (b) the member (favoured member) would derive a greater benefit from franking credits than another member of the entity (paragraph 204-30(1)(b)), and
- (c) 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)).

99. '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).

100. The Capital Notes 2 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 2 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 2.

101. 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 2.

### **Section 177EA of the ITAA 1936**

102. 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.

103. 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.

104. 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.

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

- (a) the issue of the Capital Notes 2 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
- (b) Distributions are frankable distributions and are expected to be payable to Holders in respect of their Capital Notes 2
- (c) Distributions are expected to be franked distributions, and
- (d) the Holders could reasonably be expected to receive an imputation benefit as a result of the Distributions, as

Challenger intends to fully frank the Distributions on the Capital Notes 2.

106. 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.

107. 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.

108. 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.

109. 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.

110. 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 2.

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

111. 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.

112. 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 IIIA 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)), or
- the distribution is made as part of a dividend stripping operation (paragraph 207-145(1)(d)).

113. Generally, a person is a 'qualified person' for the purposes of Division 1A of former Part IIIA 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.

114. 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.

115. 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).

116. 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).

117. As 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 paragraphs 60(j) and 60(k) above), a Holder will be a 'qualified person' in relation to Distributions received in respect of their Capital Notes 2 if the Holder continuously held their Capital Notes 2 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. The primary qualification period begins on the day after the day on which the Holder acquired their Capital Notes 2 and ends on the 90th day after the day on which the Capital Notes 2 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 (Taxation Determination TD 2007/29).

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 2 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 2 from the Holders. Holders have no right to elect Resale of the Capital Notes 2.

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

122. Similarly, although the Conversion mechanism results in the exchange of Capital Notes 2 for Ordinary Shares, the Conversion mechanism does not constitute a 'position' for the purposes of former Division 1A of Part IIIA 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 IIIA of the ITAA 1936, neither the Resale facility nor the Conversion mechanism, of themselves, affect a Holder's risks of loss or opportunities for gain in respect of the Capital Notes 2.

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 97 to 110 above).

125. Finally, 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 Income Tax Ruling IT 2627 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 2 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. Accordingly, section 207-145 will not apply to adjust the Holders' assessable income to exclude the franking credit, nor will it deny the tax offset to which the Holders would otherwise be entitled.

## **Each Capital Notes 2 is not a traditional security**

131. 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.

132. 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.

133. The Capital Notes 2 are not stock, a bond, debenture, certificate of entitlement, bill of exchange, or a promissory note.

134. The term 'or other security' in paragraph (a) of the definition of security in subsection 26BB(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 (Taxation Ruling TR 96/14).

135. Paragraphs (b) and (c) of the definition of security in subsection 26BB(1) of the ITAA 1936 do not apply because the Capital Notes 2 are neither a deposit with a bank or other financial institution, nor a secured or unsecured loan.

136. 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 (Taxation Ruling TR 96/14).

137. The Notes Terms do not evidence a liability by Challenger to pay an amount or amounts to Holders of the Capital Notes 2 during the term of the instrument or at maturity. The Capital Notes 2 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.

138. 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 Notes 2 held by the Holder. Each Holder's rights in relation to each Capital Notes 2 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 Notes 2 pursuant to the Conversion.

139. Early Redemption of the Capital Notes 2 is possible. However it is at the option of Challenger and will only occur upon the happening of certain events, at Challenger's option, and requires the prior written approval of APRA. This does not establish a liability on Challenger to pay an amount.

140. Challenger will not become liable to pay an amount under the Capital Notes 2 upon a wind-up as it would be expected that, before a wind-up commences, the Capital Notes 2 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 2), or Holders' rights would be terminated where Challenger is not able to issue Ordinary Shares within the time stated in the Notes Terms.

141. As the Capital Notes 2 are 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.

142. As the Capital Notes 2 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 2, 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 2.

### **Capital Notes 2 are convertible interests**

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

144. 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)).

145. Each Capital Notes 2 is a convertible interest as it may be converted into another interest because of the allotment of Ordinary Shares upon Conversion.

### **Conversion of the Capital Notes 2 – CGT implications**

146. Under paragraph 104-25(1)(f), CGT event C2 happens if an entity's ownership of an intangible CGT asset ends by the asset (if it is a convertible interest) being converted.

147. The Capital Notes 2 are convertible interests. Conversion of the Capital Notes 2 for Ordinary Shares constitutes the conversion of a convertible interest. Therefore, CGT event C2 will happen to Holders on Conversion of the Capital Notes 2.

148. Conversion of the Capital Notes 2 happens as part of a conversion to which Subdivision 130-C applies. Under subsection 130-60(3), a capital gain or capital loss made from converting a convertible interest is disregarded.

149. Therefore, any capital gain or capital loss made by a Holder from CGT event C2 happening on Conversion of the Capital Notes 2 is disregarded.

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

150. 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 item 2 of the table in subsection 130-60(1). 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).

151. 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 a Capital Notes 2 will be a pro-rata portion of the cost base of the Capital Notes 2 at the time of Conversion (item 2 of the table in subsection 130-60(1)).

### **Acquisition time of Ordinary Shares acquired on Conversion**

152. Subsection 130-60(2) states that the shares are acquired when the conversion of the convertible interest happened.

153. Ordinary Shares acquired on Conversion of the Capital Notes 2 (being convertible interests) will be taken to be acquired when the Conversion happens on the relevant date of conversion (subsection 130-60(2)).

### **Share sale facility**

154. 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)).

155. 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 104-10(2)).

156. 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)).

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

158. 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 2 at the time of Conversion (item 2 of the table in subsection 130-60(1)).

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

159. The issue of Ordinary Shares to Holders on Conversion is a distribution of property to holders of a non-share equity interest and a non-share distribution under subparagraph 974-115(b)(ii). Subsection 974-120(1) states that, subject to subsection 974-120(2), all non-share distributions are a non-share dividend.

160. 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.

161. Challenger will debit the Face Value of the Capital Notes 2 to its non-share capital account on Conversion. Accordingly, the issue of Ordinary Shares on Conversion is not a non-share dividend and will not be included in a Holder's assessable income under subparagraph 44(1)(a)(ii) of the ITAA 1936.

162. Furthermore, the Ordinary Shares will not be issued to the Holders of the Capital Notes 2 as shareholders of Challenger. Therefore, it would 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 the assessable income of the Holders under subparagraph 44(1)(a)(i) of the ITAA 1936.

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

163. 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%.

164. 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**

165. 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.

166. 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.

167. 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 2 will constitute the provision of capital benefits.

168. 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 the provision of capital benefits.

169. Redemption of the Capital Notes 2 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 Notes 2 and any Distribution entitlements on the Capital Notes 2 will be separately paid as Distributions given that each date on which a Redemption occurs will also be a Distribution Payment Date under the Notes Terms.

170. 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 2 will not trigger the application of section 45A of the ITAA 1936.

171. 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 2 as an unfranked dividend in the hands of the Holders.

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

172. 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.

173. 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 are provided in subsection 45B(8) of the ITAA 1936 (paragraph 45B(2)(c)).

174. 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 2 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).

175. 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 are provided in subsection 45B(8) of the ITAA 1936.

176. Having regard to the relevant circumstances surrounding the issue of Ordinary Shares on Conversion and Redemption of the Capital Notes 2, 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.

177. 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 2 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 2) 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.

178. 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 Notes 2 and any Distribution entitlements on the Capital Notes 2 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.

179. 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 the Capital Notes 2 as an unfranked dividend in the hands of Holders.

## **Appendix 2 – Detailed contents list**

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NO: 1-AOOHM1P  
ISSN: 2205-5517  
ATOlaw topic: Income tax ~~ Capital management ~~ Hybrid capital raisings

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