

# ***CR 2018/16 - Income tax: Commonwealth Bank of Australia - CommBank PERLS X Capital Notes***

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## Class Ruling

# Income tax: Commonwealth Bank of Australia – CommBank PERLS X Capital Notes

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### **1 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

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 provisions

2. The relevant provisions dealt with 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
- Division 67 of the *Income Tax Assessment Act 1997* (ITAA 1997)
- section 104-25 of the ITAA 1997
- section 109-10 of the ITAA 1997
- subsection 110-25(2) of the ITAA 1997
- subsection 110-55(2) 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 207-90 of the ITAA 1997
- Subdivision 207-D of the ITAA 1997
- section 207-145 of the ITAA 1997
- section 207-155 of the ITAA 1997
- section 974-120 of the ITAA 1997
- subsection 995-1(1) of the ITAA 1997.

All subsequent legislative references in this Ruling are to the ITAA 1997 unless otherwise indicated.

### **Class of entities**

3. The class of entities to which this Ruling applies are investors (referred to as Holders) who:

- acquired CommBank PERLS X Capital Notes (PERLS X) by initial application under the CommBank PERLS X Capital Notes Replacement Prospectus dated 15 March 2018 (the Prospectus)
- are residents of Australia (as defined in subsection 6(1) of the ITAA 1936) during the period they hold PERLS X
- do not hold their PERLS X as revenue assets (as defined in section 977-50) or as trading stock (as defined in subsection 995-1(1)) – that is, they hold their PERLS X on capital account
- will not (nor will an associate of an investor) make, be under an obligation to make, or be likely to make, a ‘related payment’ (as defined in former section 160APHN of the ITAA 1936) in relation to a Distribution

- will hold their PERLS X for a continuous period of at least 90 days (excluding the day on which they disposed of their PERLS X, if applicable) during the 'primary qualification period' (as defined in former section 160APHD of the ITAA 1936) in relation to a Distribution
- will not take any 'positions' (as defined in former section 160APHJ of the ITAA 1936) at any time in relation to their PERLS X apart from holding their PERLS X, and
- are not subject to the Taxation of Financial Arrangements rules in Division 230 in relation to gains and losses on their PERLS X.

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

4. This Ruling does not consider the income tax consequences of an Early Exchange or Resale of PERLS X.

5. This Ruling does not consider how the income tax law applies to a Purchaser who acquires PERLS X under a Resale Notice.

6. This Ruling does not consider how the gross-up and tax offset rules in Division 207 apply to:

- a partnership or trustee Holder to whom a franked Distribution is made (except a partnership or trustee that is a corporate tax entity, or a trustee of a trust that is a complying superannuation entity, when the Distribution is made), or
- an entity to whom a franked Distribution flows indirectly (as defined in subsection 995-1(1)).

### **Qualifications**

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 52 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 2017 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 the applicant.

12. In this Ruling, unless otherwise defined, capitalised terms have the meaning specified in the Terms of CommBank PERLS X Capital Notes (the Terms) or the Prospectus.

## Background

13. The Commonwealth Bank of Australia (CBA), together with its subsidiaries (collectively, the Group), is a provider of integrated financial services including retail banking, premium banking, business banking, institutional banking, funds management, superannuation, insurance and investment and share broking products and services.

14. These operations are predominantly conducted in Australia.

15. CBA has branches in London, New Zealand, New York, Singapore, Tokyo, China, Vietnam and Hong Kong, as well as subsidiaries in a number of jurisdictions.

16. CBA is an authorised deposit-taking institution and is regulated by the Australian Prudential Regulation Authority (APRA) and other regulatory bodies.

17. CBA is an Australian resident as defined in subsection 995-1(1), and is not a resident of any other jurisdiction.

18. Under the Prospectus, CBA offered to issue PERLS X to raise A\$1.25 billion with the ability to raise more or less.

19. The PERLS X offer raised Tier 1 capital to primarily satisfy CBA's regulatory capital requirements and otherwise to maintain the diversity of its sources and types of funding.

20. The funds raised from the issue of PERLS X will be used for CBA's general business purposes and as part of CBA's ongoing capital management strategy in meeting its regulatory capital requirements.

**Description of the transaction**

21. PERLS X are Australian Dollar (A\$) denominated perpetual, subordinated unsecured notes issued by CBA.
22. The Offer for subscription for PERLS X was made to the public at large and was not restricted to a particular category of investors.
23. PERLS X are listed on the Australian Securities Exchange (ASX) and trade under the code CBAPG. If an Exchange occurs, PERLS X will be terminated and Exchanged for Ordinary Shares in CBA.
24. The Prospectus invited Applications for PERLS X, along with Application Monies to be submitted for consideration and acceptance.
25. CBA reserved the right to scale back an allocation of PERLS X to an amount lower than the amount specified in an Application.

**Main features of PERLS X*****Issue price***

26. The issue price (Face Value) of each PERLS X was A\$100 (clause 1.2 of the Terms). PERLS X were fully paid on the Issue Date (6 April 2018).

***Distributions***

27. Each PERLS X will accrue quarterly interest (Distributions) on their Face Value equal to the 90 day Bank Bill Swap Rate plus a margin, grossed-down by the corporate tax rate (clause 2 of the Terms). The margin was set under a Bookbuild.
28. Distributions are expected to be fully franked. However, Distributions will be grossed-up to the extent that they are not fully franked (clause 2.4 of the Terms).
29. The payment of a Distribution is subject to CBA's absolute discretion and the payment not breaching certain APRA conditions (clause 2.5 of the Terms).
30. An APRA condition would exist if the payment of a Distribution would result in a breach of CBA's capital requirements under APRA's prudential standards, the payment would result in CBA becoming (or being likely to become) insolvent, or if APRA otherwise objects to the payment of the Distribution.

31. Distributions are non-cumulative. To the extent that all or part of a Distribution is not paid on a scheduled Distribution Payment Date, Holders of PERLS X will have no claim or entitlement in respect of the non-payment of the Distribution (clause 2.6 of the Terms). A Distribution that is not paid on a Distribution Payment Date for any reason does not accrue interest for the period during which it remains unpaid.

32. Subject to certain exceptions, if any Distribution is not paid in full on the relevant Distribution Payment Date, this will restrict CBA (without Holders approving a Special Resolution) from declaring or determining a dividend, returning capital or undertaking any buy-backs or repurchases in relation to any Ordinary Shares (clause 2.7 of the Terms).

### ***Mandatory Exchange***

33. PERLS X will be Exchanged for Ordinary Shares on the date that is the earlier of (each a Mandatory Exchange Date):

- 15 April 2027 (Scheduled Mandatory Exchange Date) subject to the satisfaction of the Mandatory Exchange Conditions, and
- the first Distribution Payment Date after the Scheduled Mandatory Exchange Date on which the Mandatory Exchange Conditions are satisfied (clause 3.1 of the Terms).

34. Upon Exchange:

- each Holder will be allotted and issued a number (the Exchange Number) of Ordinary Shares for each PERLS X held, and
- each Holder's rights (including to payment of Distributions, other than the Distribution, if any, payable on an Exchange Date where the Exchange is not as a result of a Capital Trigger Event or a Non-Viability Trigger Event) in relation to each PERLS X that is being Exchanged will be immediately and irrevocably terminated for an amount equal to the Face Value and CBA will apply the Face Value of each PERLS X by way of payment for the subscription for the Ordinary Shares to be allotted and issued on Exchange (clause 7.1 of the Terms).

35. The Exchange Number is calculated according to the following formula, but subject to being no greater than the Maximum Exchange Number:

$$\text{Exchange Number for each PERLS X} = \frac{\text{Face Value}}{0.99 \times \text{VWAP}}$$

36. The VWAP is the average of the daily volume weighted average prices of Ordinary Shares traded on the ASX during the VWAP Period, subject to any adjustments under the Terms. The VWAP Period will generally be the period of 20 Business Days on which trading in Ordinary Shares took place immediately preceding (but not including) the Exchange Date.

37. The Maximum Exchange Number is calculated according to the following formula:

$$\text{Maximum Exchange Number} = \frac{\text{Face Value}}{\text{Relevant Percentage} \times \text{Issue Date VWAP}}$$

38. The Mandatory Exchange Conditions are satisfied where, broadly:

- the VWAP of Ordinary Shares on the 25th Business Day prior to the Mandatory Exchange Date is greater than 56.00% of the Issue Date VWAP
- the VWAP of Ordinary Shares during the period of 20 Business Days prior to the Mandatory Exchange Date is greater than 50.51% of the Issue Date VWAP, and
- Ordinary Shares have not been Delisted as at the Mandatory Exchange Date (clause 3.2(a) of the Terms).

39. If the Mandatory Exchange Conditions are not satisfied on the relevant Mandatory Exchange Date, CBA will not proceed with the Exchange on that date. The Exchange will be postponed until the first Distribution Payment Date after the Scheduled Mandatory Exchange Date on which the Mandatory Exchange Conditions are satisfied.

### ***Early Exchange***

40. Under clause 4 of the Terms, PERLS X may be Exchanged for Ordinary Shares before a Mandatory Exchange Date if a Capital Trigger Event, Non-Viability Trigger Event or a Change of Control Event occurs (an 'Early Exchange').

41. A Capital Trigger Event or Non-Viability Trigger Event is triggered by certain circumstances affecting the capital adequacy or viability of CBA (clauses 4.1 and 4.2 of the Terms).

42. A Change of Control Event is triggered by certain takeover bids and schemes of arrangement relating to Ordinary Shares in CBA (clause 4.7 of the Terms).



## ***Early Redemption***

43. CBA may Redeem PERLS X for their Face Value:
- at its option on the Call Date, being 15 April 2025 (clause 5.1 of the Terms)
  - for certain taxation reasons (clauses 5.2 and 5.3 of the Terms), or
  - for certain regulatory reasons (clause 5.4 of the Terms).
44. CBA is not required to Redeem all PERLS X if it chooses to Redeem PERLS X on the Call Date. However, CBA must Redeem all (but not some) PERLS X if it redeems PERLS X for taxation or regulatory reasons. In all cases, the Redemption Date will be a Distribution Payment Date.
45. Redemption is subject to APRA's prior written approval which is at the discretion of APRA and may or may not be given (clause 5.5 of the Terms).

## ***Resale on the Call Date***

46. CBA may elect that Holders of PERLS X Resell some or all of their PERLS X to a Purchaser on the Call Date (being 15 April 2025) by giving a Resale Notice (clause 6(a) of the Terms).
47. The Purchaser will be one or more third parties selected by CBA and cannot be CBA itself, a member of the CBA Group, or a Related Body Corporate of CBA.
48. If CBA issues a Resale Notice:
- each Holder is taken irrevocably to offer to sell the relevant number of their PERLS X to the Purchaser on the Call Date for a cash amount per PERLS X equal to the Face Value (and to have appointed CBA as its agent and attorney to do and execute all things and documents which CBA considers may be necessary or desirable in connection with that offer and any resulting sale)
  - subject to payment by the Purchaser of the Face Value to Holders, all right, title and interest in the relevant number of PERLS X will be transferred from the Holders to the Purchaser on the Call Date, and
  - if the Purchaser does not pay the Face Value to the relevant Holders on the Call Date, the relevant number of PERLS X will not be transferred to the Purchaser and a Holder has no claim on CBA as a result of that non-payment (clause 6(b) of the Terms).
49. CBA will determine shortly before the Call Date whether it will exercise its ability to appoint a Purchaser(s).

50. The terms of any agreement between CBA and a Purchaser have not been determined. The terms of any such agreement will be negotiated approaching the Call Date if CBA wishes to use the Resale mechanism.

51. Prior to issuing PERLS X, CBA did not enter into discussions with any third party in relation to being a Purchaser under the Resale mechanism.

#### **Other matters**

52. This Ruling is made on the basis that:

- (a) The Terms represent a complete and accurate description of the terms of PERLS X.
- (b) PERLS X are non-share equity interests in CBA as defined in subsection 995-1(1).
- (c) Distributions will not be debited to any extent against CBA's non-share capital account or share capital account, or sourced directly or indirectly from CBA's non-share capital account or share capital account.
- (d) Immediately before the payment of a Distribution, CBA expects that the amount of its available frankable profits will be such that no part of a Distribution will be taken to be unfrankable under section 215-15.
- (e) Distributions will be frankable distributions as defined in section 202-40.
- (f) CBA will frank Distributions at the same franking percentage as the benchmark franking percentage for the franking period in which the distributions are made.
- (g) CBA will not differentially frank Distributions to different Holders according to their tax status or on any other basis.
- (h) CBA expects that future tax payments will generate sufficient franking credits for CBA to continue its current policy of fully franking frankable distributions on all equity interests.
- (i) CBA's distribution / dividend payout ratios in relation to its Ordinary Shares and other equity interests are not expected to change as a result of issuing PERLS X.
- (j) CBA's share capital account did not become tainted under Division 197 as a result of issuing PERLS X and will not become tainted as a result of issuing Ordinary Shares on Exchange.
- (k) Ordinary Shares issued on Exchange will be equity interests in CBA as defined in Subdivision 974-C.

- (l) Holders (or their connected entities) will not engage in distribution washing (as outlined in section 207-157) in relation to a Distribution (unless entitled to the exception under subsection 207-157(4)).
- (m) If PERLS X are Redeemed, the Face Value payable to a Holder will be debited in full to CBA's non-share capital account.
- (n) All parties to the transaction are dealing with each other on arm's length terms and fair value consideration was provided by Holders to acquire PERLS X.

## Ruling

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### **Capital gains tax (CGT) implications**

#### ***Acquisition time for each PERLS X***

53. Each Holder is taken to have acquired their PERLS X on 6 April 2018 under Item 2 of the table in section 109-10.

#### ***Cost base and reduced cost base of each PERLS X***

54. The first element of the cost base and reduced cost base of each PERLS X is A\$100, being the money paid by a Holder to acquire PERLS X (subsections 110-25(2) and 110-55(2)).

#### ***Exchange of PERLS X for Ordinary Shares***

55. Each PERLS X is a convertible interest.

56. CGT event C2 will happen for Holders on Exchange (section 104-25).

57. A capital gain or capital loss made by a Holder from CGT event C2 happening on Exchange will be disregarded (subsection 130-60(3)).

58. Ordinary Shares acquired on Exchange will be taken to have been acquired when the conversion happens on the relevant Exchange Date (subsection 130-60(2)).

59. The first element of the cost base and reduced cost base of Ordinary Shares acquired on Exchange will be equal to the cost base and reduced cost base of the relevant PERLS X at the time of Exchange (Item 2 of the table in subsection 130-60(1)).

**Income tax consequences of receiving Distributions*****Inclusion of Distributions and franking credits in assessable income***

60. Distributions are non-share dividends under section 974-120, and Holders are required to include Distributions in their assessable income (subparagraph 44(1)(a)(ii) of the ITAA 1936).

61. Holders are also required to include the amount of the franking credit attached to a Distribution in their assessable income for the income year in which the Distribution is made (subsection 207-20(1)).

***Entitlement to a tax offset for franking credits***

62. Holders will be entitled to a tax offset equal to the amount of the franking credit attached to a Distribution (subsection 207-20(2)).

***Exception for exempt income or non-assessable non-exempt income***

63. If a Distribution is either wholly exempt income or wholly non-assessable non-exempt income in the hands of a Holder, the amount of the franking credit attached to the Distribution is not included in the assessable income of the Holder and the Holder is not entitled to a tax offset under subsection 207-20(2) in respect of the franking credit attached to the Distribution (Subdivision 207-D), unless any of the exceptions in Subdivision 207-E apply.

64. If only part of a Distribution is either exempt income or non-assessable non-exempt income in the hands of a Holder, the amount of the franking credit on the Distribution is worked out under the formula in subsection 207-90(2). This has the effect of reducing the amount of the franking credit attached to the Distribution that is included in the Holder's assessable income and reducing the amount of the tax offset the Holder is entitled to, unless any of the exceptions in Subdivision 207-E apply.

***Refundable tax offset rules***

65. Where a Holder is entitled to a tax offset under subsection 207-20(2) in respect of the franking credit attached to a Distribution, the tax offset will be subject to the refundable tax offset rules in Division 67, unless the tax offset is specifically excluded under section 67-25.

## **Gross-up and tax offset denied in certain circumstances**

66. Section 207-145 will not apply to cancel the effect of the gross-up and tax offset rules in respect of a franked Distribution.

## ***Qualified persons***

67. Based on the description of the scheme and the class of entities to which this Ruling applies (in particular paragraphs 3(d) to (f)), Holders will be qualified persons in relation to a Distribution under former section 160APHO of the ITAA 1936.

68. The Resale and Exchange features of PERLS X will not of themselves affect whether a Holder holds PERLS X 'at risk'.

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

69. 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 a Distribution.

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

70. 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 Holders in relation to a Distribution.

## ***Dividend stripping operation***

71. Distributions will not be made as part of a dividend stripping operation as defined in section 207-155.

## **Other integrity provisions**

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

72. Section 45 of the ITAA 1936 will not apply to treat the value of Ordinary Shares issued on Exchange as an unfrankable dividend paid by CBA to Holders.

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

73. 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 a part of the capital benefit provided to Holders on Exchange or Redemption as an unfranked dividend.

**Section 45B of the ITAA 1936**

74. 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 a part of the capital benefit provided to Holders on Exchange or Redemption as an unfranked dividend.

**PERLS X not traditional securities**

75. Section 26BB of the ITAA 1936 will not apply to include any amount in the assessable income of a Holder for any gain on the disposal or Redemption of PERLS X.

76. Section 70B of the ITAA 1936 will not apply to allow a deduction to a Holder for any loss on the disposal or Redemption of PERLS X.

**Ordinary Shares received on Exchange not a dividend**

77. The Exchange of PERLS X for Ordinary Shares in CBA 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 as defined in section 974-120.

78. However, a Distribution paid on an Exchange Date will be a non-share dividend and subject to the income tax consequences stated at paragraphs 60 to 68 of this Ruling.

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**Commissioner of Taxation**11 April 2018

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## Appendix 1 – Explanation

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① ***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.***

### **CGT implications**

#### ***Acquisition time for each PERLS X***

79. Item 2 of the table in section 109-10 provides that where a company issues or allots equity interests or non-equity shares to you, you acquire the equity interests or non-equity shares when the contract is entered into, or, if there is not a contract, when they are issued or allotted.

80. Each PERLS X is an equity interest in CBA pursuant to Division 974.

81. No contract was entered into between CBA and Holders prior to the issue or allotment of PERLS X.

82. Consequently, for CGT purposes, each Holder will be taken to have acquired each of their PERLS X on 6 April 2018, being the date PERLS X were issued.

#### ***Cost base and reduced cost base of each PERLS X***

83. Under paragraph 110-25(2)(a) and subsection 110-55(2) the first element of the cost base and reduced cost base, respectively, of a CGT asset includes the money paid, or required to be paid, in respect of acquiring the CGT asset.

84. The Face Value of each PERLS X is A\$100, which was paid by Holders to CBA upon subscription for each PERLS X acquired by them.

85. Accordingly, for CGT purposes, the first element of the cost base and reduced cost base of each PERLS X is A\$100.

#### ***Exchange of PERLS X for Ordinary Shares***

##### ***Convertible interests***

86. Subsection 995-1(1) defines a 'convertible interest' in a company to mean an interest of the kind referred to in Item 4 of the table in subsection 974-75(1).

87. Item 4 of the table in subsection 974-75(1) refers to an interest issued by a company that:

- (a) gives its holder (or a connected entity of the holder) a right to be issued with an equity interest in the company or a connected entity of the company, or
- (b) is an interest that will, or may, convert into an equity interest in the company or a connected entity of the company.

88. PERLS X are interests that will or may convert into Ordinary Shares in CBA through the exchange mechanism referred to in paragraphs 33 to 42 of this Ruling (paragraph 974-165(b)).

89. Therefore, PERLS X are convertible interests as defined in subsection 995-1(1).

#### *Acquisition time of Ordinary Shares received upon Exchange*

90. Convertible interests are subject to Subdivision 130-C.

91. Subsection 130-60(2) states:

You are taken to have acquired the shares...when the conversion of the convertible interest happened.

92. Therefore, Holders will be taken to have acquired each Ordinary Share they receive on Exchange on the relevant Exchange Date.

#### *CGT event C2*

93. CGT event C2 will happen as a result of an Exchange. CGT event C2 happens if your ownership of a convertible interest ends by the interest being converted (paragraph 104-25(1)(f)).

94. A capital gain or capital loss made by a Holder as a result of CGT event C2 happening on Exchange will be disregarded (subsection 130-60(3)).

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

95. Under Item 2 of the table in subsection 130-60(1), the first element of the cost base and reduced cost base of the Ordinary Shares acquired on Exchange will be equal to the cost base and reduced cost base of the relevant PERLS X at the time of the Exchange.<sup>1</sup>

### **Income tax consequences of receiving Distributions**

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

96. PERLS X are non-share equity interests and Holders are equity holders as defined in subsection 995-1(1). Distributions will not be debited to any extent against CBA's non-share capital account or share capital account. Accordingly, Distributions are non-share dividends as defined in section 974-120.

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<sup>1</sup> Paragraphs (b) and (c) in the third column in Item 2 of the table in subsection 130-60(1) are not relevant to an Exchange.



97. The effect of paragraph 43B(1)(b) of the ITAA 1936 is that section 44 of the ITAA 1936 applies to equity holders in the same way as it applies to shareholders.

98. Subparagraph 44(1)(a)(ii) of the ITAA 1936 provides that the assessable income of an Australian resident shareholder in a company includes all non-share dividends paid to the shareholder by the company.

99. Accordingly, Holders must include Distributions in their assessable income under subparagraph 44(1)(a)(ii) of the ITAA 1936.

100. In accordance with subsection 207-20(1), Holders must also include any franking credit attached to a Distribution in their assessable income for the income year in which the Distribution is made.

### ***Entitlement to a tax offset for franking credits***

101. Holders will be entitled to a tax offset equal to the amount of the franking credit attached to a Distribution in accordance with subsection 207-20(2).

### ***Exception for exempt income or non-assessable non-exempt income***

102. Under Subdivision 207-D, if a Distribution is either wholly exempt income or wholly non-assessable non-exempt income in the hands of a Holder, the amount of the franking credit attached to the Distribution is not included in the assessable income of the Holder and the Holder is not entitled to a tax offset in respect of the franking credit attached to the Distribution.

103. Also under Subdivision 207-D, if only part of a Distribution is either exempt income or non-assessable non-exempt income in the hands of a Holder, the amount of the franking credit on the Distribution is worked out under the formula in subsection 207-90(2). This has the effect of reducing the amount of the franking credit attached to the Distribution that is included in the Holder's assessable income and reducing the amount of the tax offset the Holder is entitled to.

104. However, Subdivision 207-E provides a number of exceptions to the rules in Subdivision 207-D for certain exempt institutions, trusts and life insurance companies.

### ***Refundable tax offset rules***

105. Division 67 contains the refundable tax offset rules, and in particular sets out which tax offsets may be refunded if they exceed basic income tax liability.

106. Subsection 67-25(1) provides that tax offsets available under Division 207 are subject to the refundable tax offset rules, unless otherwise excluded.

107. Where a Holder is entitled to a tax offset under subsection 207-20(2) in respect of the franking credit attached to a Distribution, the tax offset will be subject to the refundable tax offset rules in Division 67, unless the tax offset is specifically excluded under section 67-25.

### **Gross-up and tax offset denied in certain circumstances**

108. Subdivision 207-F creates the appropriate adjustment to cancel the effect of the gross-up and tax offset rules where there has been a manipulation of the imputation system in a manner that is not permitted under the income tax law.

109. One or more of the following circumstances must exist before such an adjustment can occur:

- the entity that receives the franked distribution is not a 'qualified person' in relation to the distribution (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 (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 (paragraph 207-145(1)(c))
- the distribution is made as part of a dividend stripping operation (paragraph 207-145(1)(d)), or
- the distribution is one to which section 207-157 (which is about distribution washing) applies (paragraph 207-145(1)(da)).

***Qualified persons***

110. The effect of former section 160AOA of the ITAA 1936 is that former Part IIIAA of the ITAA 1936 applies to non-share equity interests, equity holders and non-share dividends in the same way as it applies to shares, shareholders and dividends, respectively.

111. An entity will be a qualified person in relation to a dividend for the purposes of Division 1A of former Part IIIAA of the ITAA 1936 if, broadly speaking, they satisfy the holding period rule in former section 160APHO of the ITAA 1936.

112. The holding period rule requires a person to hold shares 'at risk' for a continuous period (excluding the day of acquisition and the day of disposal of the share) of either 45 days (if the shares are not preference shares) or 90 days (if the shares are preference shares) during either the primary qualification period or the secondary qualification period in relation to the dividend. 'Primary qualification period' and 'secondary qualification period' are defined in former section 160APHD of the ITAA 1936.

113. A person would be subject to the secondary qualification period where they (or an associate) have made, are under an obligation to make, or are likely to make, a related payment in respect of a dividend. 'Related payment' is defined in former sections 160APHN and 160APHNA of the ITAA 1936.

114. Subject to certain exceptions, if any Distribution is not paid in full on the relevant Distribution Payment Date, this will restrict CBA (without Holders approving a Special Resolution) from declaring or determining a dividend in relation to any Ordinary Shares. That is, Distributions are in preference to distributions on Ordinary Shares. Accordingly, PERLS X are less risky than Ordinary Shares in CBA and are 'preference shares' for the purposes of former sections 160APHD and 160APHO of the ITAA 1936.

115. In establishing whether a Holder held their PERLS X 'at risk' for the required period, former subsection 160APHO(3) of the ITAA 1936 states:

In calculating the number of days for which the taxpayer continuously held the shares [at risk] ... any days on which the taxpayer has materially diminished risks of loss or opportunities for gain in respect of the shares...are to be excluded, but the exclusion of those days is not taken to break the continuity of the period for which the taxpayer held the shares ...

116. A Holder will be taken to have materially diminished risks of loss or opportunities for gain on a particular day in respect of their PERLS X if their 'net position' on that day in respect of their PERLS X represents less than 30% of those risks and opportunities (former subsection 160APHM(2) of the ITAA 1936).

117. A Holder's 'net position' is worked out based on all 'positions' in respect of their PERLS X and using the financial concept known as 'delta' (former section 160APHJ of the ITAA 1936). The term 'delta' is not defined, but paragraph 4.56 of the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 2) 1999 (Cth) states:

*Delta* is a well-recognised financial concept that measures the relative change in the price of an option or other derivative for a given small change in the price of an underlying asset. An option with a positive delta indicates that its price is expected to rise and fall with the underlying asset, while a negative delta indicates an inverse price relationship.

118. Former subsection 160APHJ(4) of the ITAA 1936 provides:

To avoid doubt, shares ... are to be treated as a long position (with a delta of +1) in relation to themselves.

119. It is relevant to consider the effect, if any, that the Resale and Exchange mechanisms of PERLS X may have on a Holder's risks of loss or opportunities for gain in respect of their PERLS X.

120. In doing so, it is not necessary to disaggregate the rights and obligations attaching to PERLS X into a number of separate positions held by CBA and Holders (see paragraph 13 of Taxation Determination TD 2007/29 *Income tax: holding period rule: is an embedded share option a position in relation to the share if it is exercisable by or against a party other than the issuer of the share?*).

121. However, embedded share options, such as the Resale and Exchange mechanisms, are separate positions in relation to a share if the options are exercisable by or against a party other than the issuer of the shares (see TD 2007/29 at paragraph 1).

122. Under the Resale mechanism, CBA can elect that Holders sell all or some of their PERLS X to the Purchaser on the Call Date. However, the Purchaser has no right or ability to trigger Resale of PERLS X until selected by CBA and CBA is not required to exercise the Resale mechanism. As CBA, being the issuer of PERLS X, is the only party entitled to make the election to exercise the Resale option, that mechanism will not be considered to be a separate position in relation to PERLS X for the purposes of Division 1A of former Part IIIAA of the ITAA 1936.

123. Similarly, the Exchange mechanism will not represent a separate position in relation to PERLS X because Holders do not have the right to elect Exchange, nor does CBA have an obligation to Exchange.

124. As the Resale and Exchange mechanisms do not constitute separate positions in respect of PERLS X, they will not, of themselves, affect the 'net position' of a Holder and consequently will not affect a Holder's risks of loss or opportunities for gain in respect of their PERLS X.

125. Accordingly, Holders will be 'qualified persons' in relation to a Distribution under former section 160APHO of the ITAA 1936 because:

- the Resale and Exchange mechanisms will not, of themselves, affect the 'net position' of a Holder
- Holders will not take any 'positions' (as defined in former section 160APHJ of the ITAA 1936) at any time

in relation to their PERLS X apart from holding their PERLS X

- neither a Holder, nor an associate of a Holder, will make, be under an obligation to make, or will be likely to make, a 'related payment' (as defined in former section 160APHN of the ITAA 1936) in relation to a Distribution, and
- Holders will hold their PERLS X for a continuous period of at least 90 days (excluding the day on which they disposed of their PERLS X, if applicable) during the 'primary qualification period' (as defined in former section 160APHD of the ITAA 1936) in relation to a Distribution.

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

126. Section 177EA of the ITAA 1936 is a general anti-avoidance provision that applies where one of the purposes (other than an incidental purpose) of a particular scheme is to enable a taxpayer to obtain an imputation benefit.

127. Where section 177EA of the ITAA 1936 applies, the Commissioner may make a determination under paragraph 177EA(5)(b) of the ITAA 1936 to deny the whole, or any part, of the imputation benefit received by a taxpayer in relation to a distribution.

128. Pursuant to subsection 177EA(3) of the ITAA 1936, section 177EA of the ITAA 1936 will apply where:

- (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 [section 177EA], 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.

129. Subsection 177EA(12) of the ITAA 1936 states that section 177EA applies to non-share equity interests, equity holders and non-share dividends in the same way as it applies to membership interests, members and distributions, respectively.

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

- (a) the issue of PERLS X and the issue of Ordinary Shares on Exchange will constitute a scheme for a disposition of membership interests (paragraph 177EA(3)(a) of the ITAA 1936)
- (b) frankable distributions are expected to be payable in respect of PERLS X (paragraph 177EA(3)(b) of the ITAA 1936)
- (c) Distributions are expected to be franked (paragraph 177EA(3)(c) of the ITAA 1936), and
- (d) except for section 177EA of the ITAA 1936, at least some Holders will, or could reasonably be expected to, receive imputation benefits<sup>2</sup> as a result of a Distribution (paragraph 177EA(3)(d) of the ITAA 1936).

131. Consequently, the relevant circumstances of the scheme must be considered to establish whether any person who entered into or carried out the scheme or any part it did so for a more than incidental purpose of enabling a relevant taxpayer (a Holder) to obtain an imputation benefit (paragraph 177EA(3)(e) of the ITAA 1936).

132. The relevant circumstances of a scheme include the circumstances listed in subsection 177EA(17) of the ITAA 1936. This is a non-exhaustive list and the weight accorded to any one of the relevant circumstances will vary according to the extent to which it evidences a purpose of the kind referred to in paragraph 177EA(3)(e) of the ITAA 1936.

133. In considering whether paragraph 177EA(3)(e) of the ITAA 1936 will be satisfied, we had regard to, amongst other things:

- PERLS X raised additional Tier 1 Capital primarily for CBA's regulatory capital requirements and otherwise to maintain the diversity of its sources and types of funding
- PERLS X were offered to the public at large and were not restricted to a particular category of investors
- imputation benefits will be received by Holders by reason of their proportionate holding of PERLS X or Ordinary Shares following an Exchange, and not by

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<sup>2</sup> As defined under subsection 204-30(6).

reference to their tax profiles or individual tax positions, and

- the adjustment to the calculation of Distributions under clause 2.4 of the Terms if they are not fully franked.

134. The calculation of Distributions by reference to the corporate tax rate and the adjustment to the calculation of Distributions if they are not fully franked points towards a non-incidental purpose of enabling Holders to obtain imputation benefits (paragraph 177EA(17)(f) of the ITAA 1936).

135. However, the Commissioner considers that all of the relevant circumstances of the scheme do not, on balance, lead to a conclusion that the purpose of enabling Holders to obtain imputation benefits is more than incidental to CBA's primary purpose of raising additional Tier 1 Capital for regulatory capital requirements and otherwise to maintain the diversity of its sources and types of funding.

136. 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 a Distribution.

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

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

138. The terms 'streams' or 'streaming' are not defined in the ITAA 1997.

139. Paragraphs 3.28 and 3.29 of the Explanatory Memorandum to the New Business Tax System (Imputation) Bill 2002 (Cth) explain that:

3.28 Streaming is selectively directing the flow of franked distributions to those members who can most benefit from imputation credits.

3.29 The law uses an essentially objective test for streaming, although purpose may be relevant where future conduct is a relevant consideration. It will normally be apparent on the face of an arrangement that a strategy for streaming is being implemented. The distinguishing of members on the basis of their ability to use franking benefits is a key element of streaming.

140. CBA will not stream Distributions. This is because Distributions (and imputation benefits) will be received by all Holders solely by reason of their proportionate holding of PERLS X and not by reference to their tax profiles or individual tax positions. There is nothing in the Terms that allows CBA to treat Holders differently in respect of their entitlement to a franked Distribution.

141. Further, CBA's distribution / dividend payout ratios in relation to its Ordinary Shares and other equity interests (and CBA's current policy of fully franking all frankable distributions) are not expected to change as a result of issuing PERLS X.

142. 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 Holders in relation to a Distribution.

### ***Dividend stripping operation***

143. Section 207-155 provides that a distribution will be taken to be made as part of a dividend stripping operation if, and only if, the making of the distribution arose out of or was made in the course of a scheme that was in the nature of dividend stripping or had substantially the same effect of a dividend stripping scheme.

144. The term 'dividend stripping' has no precise legal meaning. However it has been the subject of judicial discussion, including by the Full Federal Court in *Lawrence v. Commissioner of Taxation* [2009] FCAFC 29; 2009 ATC 20-096 (*Lawrence*) and the High Court in *Federal Commissioner of Taxation v. Consolidated Press Holdings and Ors*; *CPH Property Pty Ltd v. Federal Commissioner of Taxation* (2001) 207 CLR 235; [2001] HCA 32; 2001 ATC 4343 (*Consolidated Press*).

145. In *Consolidated Press*, the High Court outlined the 'common characteristics' of earlier dividend stripping cases. Those characteristics, subsequently adopted in *Lawrence*, include:

- a target company with substantial undistributed profits creating a potential tax liability, either for the company or its shareholders
- the sale or allotment of shares in the target company to another party
- the payment of a dividend to the purchaser or allottee of the shares out of the target company's profits
- the purchaser or allottee escaping Australian income tax on the dividend so declared
- the vendor shareholders receiving a capital sum for the shares in an amount the same as or very close to the dividends paid to the purchasers (there being no capital gains tax at the relevant times), and
- the scheme being carefully planned, with all the parties acting in concert, for the predominant if not the sole purpose of the vendor shareholders, in particular, avoiding tax on a distribution of dividends by the target company.

146. The above characteristics are not present in relation to PERLS X. Accordingly, Distributions will not be made as part of a dividend stripping operation.



## **Other integrity provisions**

147. The effect of subsection 43B(1) of the ITAA 1936 is that sections 45, 45A and 45B of the ITAA 1936 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.

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

148. Section 45 of the ITAA 1936 applies where a company streams the provision of shares and the payment of minimally franked dividends to its shareholders in such a way that:

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

149. Minimally franked dividends are dividends that are not franked, or franked to less than 10% (subsection 45(3) of the ITAA 1936).

150. If section 45 of the ITAA 1936 applies, the value of the share at the time the shareholder is provided with the share is taken to be an unfrankable dividend that is paid by the company out of its profits to the shareholder.

151. Section 45 of the ITAA 1936 will not apply to treat the value of the Ordinary Shares issued to Holders on Exchange as an unfrankable dividend.

152. CBA's distribution / dividend payout ratios in relation to its Ordinary Shares and other equity interests are not expected to change as a result of issuing PERLS X. Further, CBA has a history of fully franking its frankable distributions, which is not expected to change.

153. The issue of Ordinary Shares to Holders on Exchange reflects a change in the type of equity interests held by Holders in CBA. It does not satisfy a Holder's entitlement to Distributions.

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

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

155. Where section 45A of the ITAA 1936 applies, the Commissioner may make a determination that has the effect that the capital benefit (or part of it) is taken to be an unfranked dividend (subsection 45A(2) and section 45C of the ITAA 1936).

156. Both the issue of Ordinary Shares on Exchange and the Redemption of PERLS X will constitute the provision of a capital benefit to Holders (paragraph 45A(3)(a) of the ITAA 1936 for an Exchange, and paragraph 45A(3)(b) of the ITAA 1936 as affected by subsection 45A(3A) of the ITAA 1936 for a Redemption).

157. However, the issue of Ordinary Shares on Exchange and the Redemption of PERLS X will not constitute the streaming of capital benefits because under an Exchange or Redemption CBA will not selectively direct the flow of capital benefits to Holders who could most benefit from capital. Accordingly, section 45A of the ITAA 1936 will not apply to the Exchange or Redemption of PERLS X, and the Commissioner will not make a determination to treat the whole or a part of the capital benefit received by Holders as an unfranked dividend.

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

158. Subsection 45B(2) of the ITAA 1936 states that section 45B of the ITAA 1936 applies if:

- (a) there is a scheme under which a person is provided with...a capital benefit by a company; and
- (b) under the scheme, a taxpayer (the **relevant taxpayer**), who may or may not be the person provided with... the capital benefit, obtains a tax benefit; and
- (c) having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling a taxpayer (the **relevant taxpayer**) to obtain a tax benefit.

159. Where section 45B of the ITAA 1936 applies, the Commissioner may make a determination under paragraph 45B(3)(b) of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole or a part of the capital benefit. Such a determination would have the effect of treating all or a part of the capital benefit as an unfranked dividend.

160. The issue of Ordinary Shares to Holders on Exchange and the Redemption of PERLS X (a Redemption being a non-share capital return) will each constitute a scheme under which Holders are provided with a capital benefit by CBA (paragraphs 45B(5)(a), 45B(5)(b) and subsection 45B(7) of the ITAA 1936). As a result, paragraph 45B(2)(a) of the ITAA 1936 will be satisfied.

161. At least some Holders will obtain a tax benefit as defined in subsection 45B(9) of the ITAA 1936 as a result of an Exchange or Redemption. As a result, paragraph 45B(2)(b) of the ITAA 1936 will be satisfied.

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

163. Having regard to the relevant circumstances, it could not be concluded that the Exchange or Redemption of PERLS X will be entered into for a more than incidental purpose of enabling Holders to obtain a tax benefit. Accordingly, paragraph 45B(2)(c) of the ITAA 1936 would not be satisfied and the Commissioner will not make a determination under paragraph 45B(3)(b) of the ITAA 1936 that section 45C of the ITAA 1936 applies to the whole or a part of the capital benefit provided to Holders on Exchange or Redemption.

### **PERLS X not traditional securities**

164. Subsection 26BB(1) of the ITAA 1936 defines a 'traditional security' to be a 'security' held by a taxpayer that, relevantly:

- is not trading stock of the taxpayer, and
- either does not have an eligible return or has an eligible return that satisfies the conditions in the definition of traditional security in subparagraph 26BB(1)(b)(ii) of the ITAA 1936.

165. The term 'security' is defined in subsection 26BB(1) of the ITAA 1936 by reference to Division 16E of the ITAA 1936, which at subsection 159GP(1) of the ITAA 1936 defines 'security' as:

- (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.

166. PERLS X are not a deposit with CBA, nor are they a loan. As such, they will not be a 'security' under the definitions in paragraphs 159GP(1)(b) or (c) of the ITAA 1936.

167. PERLS X will not meet the definition in paragraph 159GP(1)(a) of the ITAA 1936 as they are not stock, a bond, debenture, certificate of entitlement, bill of exchange, promissory note or other security. Subsection 6(1) of the ITAA 1936 defines a 'debenture' to include 'notes'. However, PERLS X are not considered to be notes, as they are not an acknowledgement of a debt and a promise to pay a sum at some future time.<sup>3</sup> For this reason, PERLS X will also not fall into the category of 'other security', in paragraph 159GP(1)(a) of the ITAA 1936.<sup>4</sup>

168. This conclusion is also determinative in establishing that PERLS X will not satisfy paragraph 159GP(1)(d) of the ITAA 1936.<sup>5</sup>

169. Accordingly, PERLS X will not meet the definition of 'security' under subsection 159GP(1) of the ITAA 1936 and will, therefore, not be traditional securities for the purposes of section 26BB of the ITAA 1936.

170. As a result, section 26BB of the ITAA 1936 will not apply to include any amount in the assessable income of a Holder for any gain on the disposal or Redemption of PERLS X, and section 70B of the ITAA 1936 will not apply to allow a deduction to a Holder for any loss on the disposal or Redemption of PERLS X.

### **Ordinary Shares received on Exchange not a dividend**

171. The Exchange of PERLS X for Ordinary Shares in CBA will not result in Holders being taken to have received a dividend or a non-share dividend.

172. Holders are not shareholders of CBA in respect of their PERLS X holdings and as such will not receive a 'dividend' as defined in subsection 6(1) of the ITAA 1936.

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

174. The issue of Ordinary Shares to Holders on Exchange of PERLS X will not be a non-share dividend as defined in section 974-120, as the Face Value of the PERLS X will be debited against CBA's non-share capital account.

175. However, a Distribution paid on an Exchange Date will be a non-share dividend and subject to the income tax consequences outlined at paragraphs 60 to 68 of this Ruling.

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<sup>3</sup> See paragraphs 23 and 24 of Taxation Determination TD 2009/14 *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?*

<sup>4</sup> See paragraph 29 of Taxation Ruling TR 96/14 *Income tax: traditional securities.*

<sup>5</sup> See paragraph 30 of Taxation Ruling TR 96/14.

**Appendix 2 – Detailed contents list**

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