# *PCG 2017/10 - Application of paragraphs 215-10(1)(c) and 215-10(1)(d) of the Income Tax Assessment Act 1997*

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**Relying on this Guideline**

*This Practical Compliance Guideline sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow this guideline in good faith, the Commissioner will administer the law in accordance with this approach.*

**Table of Contents** **Paragraph**

## What this Guideline is about

1. Taxation Determination TD 2012/19 *Income tax:  when is a non-share equity interest 'issued at or through a permanent establishment' for the purposes of paragraph 215-10(1)(c) of the Income Tax Assessment Act 1997?* provided guidance on when a non-share equity interest is 'issued at or through a permanent establishment' under paragraph 215-10(1)(c).

2. The view outlined in TD 2012/19 created unintended practical difficulties for banks in legitimately gaining access to the concession provided by section 215-10 of the *Income Tax Assessment Act 1997* (ITAA 1997).[1] As a result, TD 2012/19 was withdrawn on 8 October 2014, with the intention for design of a replacement product, which would also address other areas of uncertainty that had been articulated by banking industry representatives in relation to the permitted purpose test in paragraph 215-10(1)(d).

3. This Guideline provides guidance, from a compliance perspective, on the Commissioner's expectations in relation to the application of paragraphs 215-10(1)(c) and 215-10(1)(d).

4. Taxpayers can use the compliance risk framework in this Guideline to assess the extent to which their facts, circumstances and associated tax treatment are perceived by the Commissioner as presenting a risk of non-compliance. In order to illustrate some of the more common tax issues that can arise, the guidance is provided in a series of scenarios. These scenarios are examples only and do not preclude the application of this Guideline to other arrangements involving the issue of a non-share equity interest in terms of the application of section 215-10.

5. From a compliance perspective, the Commissioner will find as acceptable, those scenarios in the low risk category. As scenarios move from low risk to high risk there is an increasingly higher threshold for taxpayers to justify compliance from both a technical and evidentiary perspective.

6. Any expectations on taxpayers, from a compliance perspective, are not meant to be prescriptive. The Commissioner's decision-making process in relation to risk assessment, and any associated compliance activity, is guided by the facts, complexity and materiality present in any scenario. As such, while this Guideline provides some guidance on the Commissioner's perception of the relative level of risk, and the associated degree of analysis required to justify the tax treatment, taxpayers need to exercise judgment about how the guidance applies to their own facts and circumstances, and the nature and extent of documentation appropriate to justify the tax outcome in their particular circumstances.

## Reliance on this Guideline

7. This Guideline is not a public ruling for the purposes of the *Taxation Administration Act 1953* and therefore cannot offer protection under the law.

8. The Commissioner accepts that taxpayers will rely on the approach set out in this Guideline in assessing the extent to which their practices present any risk of non-compliance.

9. Where a taxpayer follows this Guideline in good faith, and the Commissioner subsequently changes his view and/or these materials are altered or withdrawn, the Commissioner will apply the principles set out under Law Administration Practice Statement PS LA 2011/27 *Matters the Commissioner considers when determining whether the ATO view of the law should only be applied prospectively* and, in appropriate circumstances, will not take action to apply any changed view of the law to prior years or periods.

10. This Guideline will form the basis by which the Commissioner will assess the extent of risk in relation to the issues covered by this Guideline, as part of the Commissioner's banking and finance compliance strategy, which may include follow up review activity at the taxpayer level.

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

11. This Guideline does not preclude the application of Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) or other tax anti-avoidance provisions, including anti-streaming rules. Particular attention should be given to the application of section 177EA of the ITAA 1936 and section 204-30 (refer to paragraphs 156 to 162 of this Guideline).

## Date of effect

12. This Guideline applies from 5 June 2017.

## Review

13. A review of this Guideline will occur no earlier than three years after its date of issue to determine whether it is appropriate to remain on issue. Should the review determine this Guideline is no longer appropriate, it will be withdrawn and cease to have effect from the date of its withdrawal.

## Law change

14. This Guideline may need to be withdrawn if there are any amendments to section 215-10, or other provisions of the ITAA 1936 and/or ITAA 1997 that impact on the application of section 215-10 relevant to this Guideline.

## Compliance risk framework

15. This section details the typical features in relation to the application of paragraphs 215-10(1)(c) and 215-10(1)(d) the Commissioner would perceive to be inherent in capital raising arrangements of a low, medium or high risk of non-compliance. Specific scenarios and further guidance to demonstrate and contextualise the application of this framework is provided in paragraphs 21 to 149 of this Guideline.

### *Low risk scenarios*

16. A low risk scenario would typically present the following features:

(a) *All* necessary branch activities have been carried out by branch personnel.[2]

(b) At the issue date of the non-share equity interest, there is a going concern intention[3] to apply the funds for a permitted purpose.[4] That is, at the issue date, there is no evidence the taxpayer intends to use funds for a purpose other than one or more purposes permitted under subsection 215-10(2) (a non-permitted purpose) at any time in the future.

(c) Funds from the issue of the non-share equity interest are applied entirely, or predominately, for:

(i) a specific permitted purpose, directly referrable to an identifiable transaction(s), as opposed to a general permitted purpose, or

[2] Refer to paragraphs 21 to 52 of this Guideline for necessary branch activities, and definition of ‘branch personnel’.

[3] Refer to paragraphs 63 to 67 of this Guideline for ‘going concern intention’. Note that paragraph 215-10(1)(d) will not be considered satisfied in any circumstance where there is an intention to apply funds for a non-permitted purpose at the issue date of the non-share equity interest (that is, there is no going concern intention at issue date).

[4] The ‘permitted purposes’ under section 215-10 are set out in subsection 215-10(2).

(ii) a general permitted purpose, with the taxpayer able to demonstrate that funds have not been applied for a non-permitted purpose. For example, via a review of journal entries to evidence funds from the issue of the non-share equity interest have not been transferred to head office.[5]

(d) Funds from the issue of a non-share equity interest *continue* to be applied for a permitted purpose for at least six months from the issue date of the non-share equity interest. Where funds have been applied for a general purpose, the taxpayer is able to demonstrate that funds have not been applied for a non-permitted purpose for at least six months from the issue date of the non-share equity interest.

17. Another factor that would not preclude a taxpayer's scenario from being categorised as low risk is where the funds from the issue of a non-share equity interest are transferred to Australia on arm's length terms as part of the bank's risk management approach to hedge risk associated with the purpose for which those funds are applied. For example, under a cross-currency interest rate swap to hedge market risk.

### *Medium risk scenarios*

18. Scenarios that include any of the following evidentiary issues and/or features present a medium risk of non-compliance:

(a) *Most* necessary branch activities have been carried out by branch personnel.

(b) Funds from the issue of a non-share equity interest are applied entirely, or predominately, for a general permitted purpose, that is not directly referrable to an identifiable transaction with *limited evidence* that funds have not been applied for a non-permitted purpose.

(c) Funds from the issue of a non-share equity interest are applied for use with related parties (for example, branch or subsidiary of the authorised deposit-taking institution (ADI)) with *limited tracing* to evidence that funds have not been used for a non-permitted purpose.

(d) Some of the funds from the issue of the non-share equity interest, that have initially been applied for a permitted purpose(s), are subsequently applied (that is, redeployed or 'recycled') for a non-permitted purpose *prior to six months* from the issue date of the non-share equity interest. The legitimacy of a redeployment of funds for a non-permitted purpose will depend on the facts and circumstances of each case.[6]

### *High risk scenarios*

19. Scenarios which include any of the following evidentiary issues and/or features present a high risk of non-compliance:

(a) *Minimal* necessary branch activities have been carried out by branch personnel.

(b) Funds from the issue of a non-share equity interest are applied entirely, or predominately, for a general permitted purpose, that is not directly referrable to an identifiable transaction. The bank is *unable* to demonstrate that funds have not been applied for a non-permitted purpose.

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[5] Refer to paragraphs 68 to 104 of this Guideline for additional guidance on the Commissioner's decision-making process associated with the specificity of purpose for which funds are applied.

[6] Refer to paragraphs 105 to 125 for 'recycling events'.

(c) Funds from the issue of a non-share equity interest are recycled and applied for a non-permitted purpose *shortly after* the issue date of a non-share equity interest.

(d) Funds from the issue of a non-share equity interest are applied for use with related parties (for example, branch or subsidiary of the ADI) with *no tracing* to evidence that funds have not been used for a non-permitted purpose.

### *Key principles (ceteris paribus)*

20. The compliance risk framework therefore reflects the following key principles in assessing the risk of non-compliance with paragraphs 215-10(1)(c) and 215-10(1)(d):

(a) The fewer the necessary branch activities undertaken in relation to the issuance of a non-share equity interest, the higher the relative risk.

(b) The less specific the permitted purpose (that is, the further along the spectrum from specific to general purpose) the funds have been applied to, the higher the relative risk.

(c) The less evidence able to be produced in demonstrating funds have not been applied for a non-permitted purpose, the higher the relative risk.

(d) The earlier that funds originally applied for a permitted purpose are redeployed for a non-permitted purpose, the higher the relative risk (assuming a going concern intention at issue date).

(e) The less the degree to which the application of funds can be traced with related parties, the higher the relative risk.

### Paragraph 215-10(1)(c): 'issued at or through a permanent establishment'

21. This section provides guidance, from a compliance perspective, on the Commissioner's expectations of the application of paragraph 215-10(1)(c).

22. Paragraph 215-10(1)(c) provides that a non-share dividend paid by an Australian resident ADI is unfrankable if, among other things, the non-share equity interest in respect of which the non-share dividend is paid 'is issued at or through a permanent establishment of the ADI in a listed country'.

23. Some of the more common tax issues which can arise are illustrated in the scenarios below.

### Compliance considerations in relation to 'issued at or through a permanent establishment'

24. In this Guideline, the Commissioner's analysis in relation to the meaning of 'at or through a permanent establishment' in paragraph 215-10(1)(c) has been interpreted primarily in the context of 'issued'. The analysis of the term 'at or through' in this Guideline should not be extrapolated to the analysis of the term in other legislative contexts, unless otherwise indicated.

### *Necessary branch activities under paragraph 215-10(1)(c)*

25. The Commissioner's risk assessment in complying with paragraph 215-10(1)(c), and expectations in relation to the corresponding evidentiary burden on the taxpayer, is influenced by the extent to which necessary branch activities are carried out by branch personnel in relation to the issue of the non-share equity interest. In this regard, the Commissioner acknowledges that whilst the issuance of Tier 1 capital at or through an offshore permanent establishment must be a transaction of the branch, it is an activity that may necessitate involvement from non-branch personnel.

26. For the purposes of this Guideline, 'branch personnel' refers to ADI personnel physically located at the issuing branch, who conduct the business of the issuing branch. 'Non-branch personnel' refers to ADI personnel located outside the issuing branch, for example head office personnel, and/or personnel performing functions for the ADI group as a whole.

27. 'Necessary branch activities' are those the Commissioner views as necessary to be undertaken by branch personnel in order for a non-share equity interest to be assessed as low risk of not complying with the 'issued at or through a permanent establishment' requirement in paragraph 215-10(1)(c).

28. In a compliance context, the necessary branch activities to be categorised as low risk are:

- (a) the non-share equity interests are offered to investors *in the course of the business conducted at the branch*
- (b) transaction documents governing the issue of the non-share equity interest are *executed* by an authorised delegate of the branch. In this regard, some of the transaction documents[7] the ATO would expect to be executed by an authorised delegate of the branch would include (where applicable) those which:
  - (i) govern the underwriting, subscription, and terms and conditions of the non-share equity interest (for example, any relevant Subscription Agreement, Underwriting Agreement, Trust Deed, Deed Poll, and/or Indenture)
  - (ii) outline the steps necessary to give effect to the implementation and completion of the offering and issuance of the non-share equity interest (for example, an Implementation Deed), and
  - (iii) relate to the engagement of joint lead managers, service providers and/or external advisers such as registrar, paying agents, legal counsel and/or trustees to the issuance of the non-share equity interest (for example, any relevant Offer Management Agreement, Agency Agreement, Trust Deed, and/or Indenture).
- (c) the non-share equity interests are *transferred* to investors under authorisation of an authorised delegate of the branch.

29. Where activities or functions in relation to the issuance of a non-share equity interest are performed by personnel located in Australia, the Commissioner expects that a corresponding portion of the remuneration of these Australian 'non-branch personnel' is treated as non-deductible in Australia. For example, if 10 per cent of Group Treasury and Group Legal personnel work in a particular income year is performed solely for the benefit of the branch in the issuance of a non-share equity interest, it would be expected that a corresponding 10 per cent of the remuneration of those personnel would be treated as non-deductible in Australia.

[7] The list of documents is not intended to be prescriptive but rather illustrative of the types of documents that the ATO would expect to be executed by an authorised delegate of the branch.

*Scenario 1: Low risk of non-compliance*

30. ABC Bank is an ADI for the purposes of the *Banking Act 1959* and an Australian resident. ABC New York Branch (the Branch) is a permanent establishment[8] of ABC Bank in New York.[9]

31. The Branch is governed by the New York Management Committee (Management Committee) who is responsible for conducting the business of the permanent establishment. Its responsibilities include monitoring financial performance, identifying and reviewing significant business risks, and approving significant transactions and other matters affecting the Branch. The Management Committee consists of the head of each business group with major operations in the Branch and, as such, Management Committee members are not necessarily based in New York.

32. ABC Bank intends to raise approximately US$750 million by way of the issue of US dollar denominated convertible notes (Hybrid Capital Instruments) through the Branch.

33. The Hybrid Capital Instruments will:

(a) qualify as Tier 1 capital under the Australian Prudential Regulation Authority (APRA) prudential standards, and

(b) be classified as non-share equity interests for the purposes of Division 974, and returns paid in respect of the Hybrid Capital Instruments will be non-share dividends as defined in section 974-120.

34. The funds from the issue of Hybrid Capital Instruments will be applied solely for one or more purposes permitted under subsection 215-10(2) in accordance with paragraph 215-10(1)(d).

35. The decision to raise Tier 1 capital as a whole is driven by the regulatory capital requirements of ABC Bank, in accordance with the bank's prudential obligations and broader capital management strategy, and the need to secure new funding for the operations of the Branch.

36. Group Treasury of ABC Bank (Group Treasury) will prepare the approval memorandums and associated documentation in respect of the issuance, and seek the necessary initial approvals from the Board of ABC Bank. The issue of Hybrid Capital Instruments, and use of funds, will then be subject to final approval from the Management Committee.

37. Following approval by the Management Committee, Group Treasury will project manage the overall documentation process and timeline for the capital raising:

(a) Group Treasury and/or Group Legal of ABC Bank (Group Legal) personnel will:

(i) prepare and negotiate the offer document and legal documents governing the issuance of the Hybrid Capital Instruments, and all other major transaction documents in relation to the capital raising such as settlement documents governing fund flows (the Transaction Documents)

(ii) undertake the formation and management of a syndicate of Joint Lead Managers (JLMs), including the negotiation of the Offer Management Agreement (OMA) between ABC Bank and the JLMs

[8] As defined in subsection 6(1) of the ITAA 1936.

[9] United States of America is a 'listed country'. See section 320 of the ITAA 1936 and regulation 19 of the *Income Tax Assessment (1936 Act) Regulations 2015*.

(iii) be primarily responsible for negotiating the structure and material terms of the capital raising such as pricing, size of issue and final allocations of the Hybrid Capital Instrument to investors

(iv) be primarily responsible for the management of the book-build process

(v) undertake the necessary due diligence on the capital raising; obtain approval from APRA and necessary waivers from the Australian Securities and Investment Commission (ASIC), Australian Securities Exchange (ASX) and foreign regulators as applicable; prepare and issue announcements to the ASX and foreign stock exchanges; and negotiate arrangements with the Note Registrar and clearing house

(vi) undertake marketing, and investor roadshows in relation to the Hybrid Capital Instrument, with assistance from Branch personnel

(b) Branch personnel will:

(i) execute and approve delivery of the Transaction Documents, including the OMA with the JLMs, pursuant to power of attorneys granted in Australia by the Board of ABC Bank

(ii) appoint a Registrar to establish and maintain the Note Register. The Note Register may be located in Sydney, Australia, and

(iii) approve the making of (or delegate final approval to make) the necessary authorisations to the JLMs, clearing houses and Registrar of the Hybrid Capital Instruments to offer and transfer the Hybrid Capital Instruments to investors in accordance with the Transaction Documents.

38. Subsequent to the capital raising:

(a) Branch personnel will be:

(i) signatories to the payment instructions authorising and directing the payment of the net Hybrid Capital Instrument settlement proceeds to the bank account of the Branch. This bank account may not be a separate or isolated bank account from the transaction accounts used by the Branch for general corporate purposes

(ii) be responsible for the subsequent ongoing payments in relation to the Hybrid Capital Instruments, for example, the payments of coupons/principal redemption amounts and payments of ongoing interest/distribution payments and redemptions, and

(b) Group Treasury may manage any foreign currency and interest rate exposures associated with the capital raising and will be responsible for entering into any subsequent swap arrangements.

### Factors considered in forming the Commissioner's assessment of risk

39. In this scenario, the proposed issue of the Hybrid Capital Instruments is initiated, driven, and overall project managed by personnel from ABC Bank (Australian head office). Personnel from ABC Bank also assume primary responsibility for decisions regarding the structure of the capital raising and material terms in relation to the Hybrid Capital Instrument such as pricing, size of the issue and final allocation to investors.

40. The Commissioner considers this scenario to present a low risk of non-compliance.

41. Paragraphs 215-10(1)(b) and 215-10(1)(c) provide that section 215-10 will only be satisfied where a non-share equity interest 'forms part of the ADI's Tier 1 capital', and is 'issued at or through a permanent establishment of the ADI'.

42. Having regard to the above, the Commissioner acknowledges that whilst the issuance of Tier 1 capital at or through an offshore permanent establishment must be a transaction of the branch, it is an activity which may necessitate involvement from non-branch personnel. This is because, in practice, branch personnel will generally be responsible for the front office and client facing activities of the ADI, for example, the borrowing and lending of money. As such, in the context of a Tier 1 capital raising, branch personnel may not have the appropriate level of access to and understanding of the ADI's overall capital management policy, nor the necessary skills and practical experience to independently issue a Tier 1 capital instrument to the market.

43. For example, it is unlikely that branch personnel will have the necessary skills or practical experience to manage group capital and funding requirements, interact with regulators, investors and financial markets, or draft the terms of the eligible hybrid instrument with regard to the overall capital and funding needs of the ADI. In contrast, amongst other things, non-branch personnel such as Group Treasury and Group Legal personnel are directly involved in the overall requirements and capital management strategies of the ADI, understand the risks of the ADI and non-share equity interest to be issued, and maintain relationships with regulators and investment banks that will likely support any capital issuance by the branch.

44. Accordingly for the purposes of section 215-10, the Commissioner considers that provided necessary branch activities have been undertaken by branch personnel, the necessary involvement of non-branch personnel in the issuance of a non-share equity interest will not result in a negative inference being drawn as to whether:

- (a) a non-share equity interest has been 'issued at or through the permanent establishment' of an ADI in paragraph 215-10(1)(c), or
- (b) the funds from the issue of a non-share equity interest have been applied for a permitted purpose for the purposes of paragraph 215-10(1)(d). That is, that the funds have been raised for the ADI as a whole, and not specifically for use in the business of the branch.

45. The nature and extent to which non-branch personnel are involved in the issuance of a non-share equity interest will vary depending on an organisation's unique structure, the location of staff, and where and how transactions are undertaken. Whether involvement by non-branch personnel is practically necessary will be determined on the particular facts and circumstances of each case.

46. In the current scenario, despite the involvement of non-branch personnel, the Hybrid Capital Instruments will be taken to have been 'issued at or through the permanent establishment' for the purposes of paragraph 215-10(1)(c) as the following necessary branch activities will have been conducted by the Branch:

- (a) The Hybrid Capital Instruments will have been offered to investors in the course of the business conducted at the Branch. In this scenario, this will be satisfied via the approval of the Hybrid Capital Instruments by the Management Committee (see paragraph 36 of this Guideline). In practice, this may also occur by way of approval from a head of branch, or some other means. For the purposes of section 215-10, the key risk consideration is whether formal approval is given by the issuing branch in relation to the relevant issuance.
- (b) Transaction documents governing the issue of the Hybrid Capital Instruments will have been executed by an authorised delegate of the Branch. In this scenario, this will be satisfied via settlement of the Transaction Documents by Branch personnel under power of attorneys granted in Australia by the Board of ABC Bank (see paragraph 37 of this Guideline).
- (c) The Hybrid Capital Instruments will have been transferred to investors under the authorisation of Branch personnel. In this scenario, this will be satisfied

via authorisations from Branch personnel to the clearing houses and Registrar of the Hybrid Capital Instruments to transfer the Hybrid Capital Instruments to investors in accordance with the Transaction Documents (see paragraph 37 of this Guideline). Again in practice, it is acknowledged that the process by which non-share equity interests are transferred to investors, and the relevant parties involved in this process, will differ from case to case. For the purposes of section 215-10, the key risk consideration is that relevant authorisations have been given by Branch personnel to transfer the non-share equity interests to investors.

47. As noted at paragraph 29 of this Guideline, the Commissioner would expect a corresponding proportion of the remuneration relating to the Group Treasury and Group Legal personnel involved in the capital raising to be treated as non-deductible by ABC Bank in Australia.

### *Scenario 2: high risk of non-compliance*

48. Same facts as at scenario 1 except that:

(a) Australian head office personnel from ABC Bank will both:

(i) undertake formation and management of JLMs, and

(ii) execute the associated OMA with the JLMs.

### Factors considered in forming the Commissioner's assessment of risk

49. This scenario would be considered by the Commissioner to present a *high risk of non-compliance* due to minimal necessary branch activities being undertaken by branch personnel.

50. With head office personnel from ABC Bank proposing to execute the OMA with the JLMs, all functions and activities undertaken by the JLMs will be done on behalf of, and under the authorisation of, the head office of ABC Bank in Australia, rather than the New York Branch. Consequently:

(a) transaction documents governing the issue of the Hybrid Capital Instruments will not have been executed by an authorised delegate of the Branch, and

(b) the Hybrid Capital Instruments will not be transferred to investors under the authorisations of Branch personnel.

51. There is a high risk that paragraph 215-10(1)(c) will not be satisfied, and section 215-10 may not apply to treat the non-share dividends from the Hybrid Capital Instruments as unfrankable.

52. For the avoidance of doubt, the use and engagement of third parties external to the ADI to provide services/functions in relation to the issuance of a non-share equity interest, such as JLMs, does not of itself present any issues in complying with paragraph 215-10(1)(c). For the purposes of paragraph 215-10(1)(c), the key risk consideration is the formal approval from the issuing branch for the use of the relevant external provider and the services they provide, that is, the external provider must formally be acting for, and on behalf of, the issuing branch.

## Paragraph 215-10(1)(d): permitted purpose

53. This section provides guidance, from a compliance perspective, on the Commissioner's expectations on the application of paragraph 215-10(1)(d). Some of the more common tax issues that can arise are illustrated in the scenarios below.

54. Paragraph 215-10(1)(d) (the funding test) provides that a non-share dividend paid by an Australian resident ADI is unfrankable if, amongst other things, 'the funds from the issue of the non-share equity interest are raised and applied solely for one or more purposes permitted under subsection (2) in relation to the non-share equity interest'.

55. The Commissioner's assessment of risk in complying with paragraph 215-10(1)(d), and expectations in relation to the corresponding evidentiary burden on the taxpayer, are influenced by:

| | | |
|---|---|---|
| (a) | the extent to which funds from the issue of the non share equity interest are placed into a pool of funds | Paragraphs 57 – 62 |
| (b) | whether there is a going concern intention at the issue date of the non share equity interest for funds to be applied for a permitted purpose | Paragraphs 63 – 67 |
| (c) | the proportion of funds from the issue of a non share equity interest applied for a specific or general permitted purpose | Paragraphs 68 – 104 |
| (d) | the period of time in which funds from the issue of a non share equity interest are applied for a permitted purpose | Paragraphs 105 – 125 |
| (e) | the extent and degree to which funds applied for use with related parties can be traced | Paragraphs 126 – 137 |

56. Circumstances where evidence is unable to be produced to demonstrate that funds have not been applied for a non-permitted purpose, will present a higher risk of non-compliance.

### *Recognition of pool of funds*

57. The Commissioner recognises that in practice, funds from the issue of a non-share equity interest commonly contribute to a pool of funds available to support the business operations of the bank as a whole.[10] The practical problems this creates are analogous to those discussed in paragraph 18 of TR 2005/11 in relation to tracing by a bank of external borrowings that have an associated interest expense.

58. Equally, for the purposes of determining whether paragraph 215-10(1)(d) has been satisfied, it may not ordinarily be possible or practicable to trace or identify the end use of funds transferred out of this pool. As such, the Commissioner considers that where funds from the issue of a non-share equity interest are absorbed into a pool of funds, there will be a higher evidentiary burden on taxpayers to demonstrate the funds have not been used for a non-permitted purpose (for example, a transfer of funds directly or indirectly back to the Australian head office, other than within the exceptions provided in paragraph 215-10(1)(d)).[11] Refer to Scenarios 4 and 8 of this Guideline for examples of the additional factual analysis taxpayers may provide to improve the risk assessment of their facts and circumstances where transfers to the Australian head office occur in the context of pool of funds.

59. However, the Commissioner is mindful that a range of issues can potentially arise that of themselves do not create cause for concern from a compliance perceptive when dealing with the concepts of pool of funds and paragraph 215-10(1)(d).

[10] Taxation Ruling TR 2005/11 *Income tax: branch funding for multinational banks* at paragraph 43.
[11] See subparagraph 215-10(2)(a)(i).

60. Banks may have a policy and practice whereby branch operations transfer, on a temporary basis, excess or surplus funds to the Australian head office. Such a policy may be in place as an efficient or cost effective way for a bank to manage funds that support their global operations. The branch pool of funds in these circumstances may include funds sourced from a section 215-10 compliant capital raising. Transfers that occur in these circumstances do not, of themselves, present a compliance concern where they are truly excess or surplus funds, and where they are short term and not permanent.

61. Based on the ATO's understanding of industry practice, it would not be unusual for a branch to have, a portion of the branch balance sheet on deposit with head office where these funds are excess or surplus funds. In addition, the ATO acknowledges that there may be instances where the excess or surplus funds on deposit with head office are materially higher than usual for a short period. This could, for example, be in a situation where a branch is closing down or exiting a business or investment and has a temporary period of time prior to redeploying those funds to a new use. In these instances, there is no necessary compliance concern with section 215-10. However, it would be likely that such material transfers would be identified as anomalous and thus require the taxpayer to explain the situation to the ATO to demonstrate the funds have not been used for a non-permitted purpose.

62. Banks may also undertake parallel fund raising initiatives through overseas branch operations that, for example, may include scenarios where the issuance of non-share equity instruments (for the purposes of section 215-10) occurs in close proximity to the timing of an external debt issuance. The fact the debt issuance was undertaken in whole or part for head office funding purposes and results in a consequential transfer of funds from the overseas branch to head office in Australia, in close proximity to the timing of the non-share equity issuance, does not of itself cause concern from a compliance perspective.

### *Going concern intention*

63. Paragraph 215-10(1)(d) requires that funds from the issue of non-share equity are 'raised and applied' solely for one or more permitted purposes under subsection 215-10(2).

64. From a compliance perspective, to be assessed as low risk, it is important that there exists a going concern intention at the date of issue for funds to be applied for a permitted purpose. This means that, at the date of issue, the issuing branch does not have an intention to apply funds from the issue of the non-share equity interest for a non-permitted purpose at any time in the future. For example, if the branch initially planned to apply the funds for a particular permitted purpose with a limited life (for example, one year), then at issue date, the branch must have an intention of using the funds for another permitted purpose after the expiry of the initial use.

65. However, the Commissioner's compliance approach is mindful of situations where an issuing branch may have had a going concern intention of applying funds for a permitted purpose at the issue date of the non-share equity interest, but, at some point into the future, commercial or environmental issues have meant that funds have had to be applied for a non-permitted purpose. For example, due to closing part of the business operations in the branch. Refer to paragraphs 105 to 125 of this Guideline.

66. In recognition of this commercial reality, where there is a going concern intention at issue date and funds are subsequently applied for a non-permitted purpose six months or more after the issue date of the relevant capital raising, the Commissioner will regard this as a low risk from a compliance perspective.

67. Note the Commissioner considers that paragraph 215-10(1)(d) will *not* be satisfied in any circumstance where, at the issue date of a non-share equity interest, there is an intention to apply the funds from the relevant capital raising for a non-permitted purpose, that is, there is no going concern intention at issue date. Refer to paragraphs 150 to 153 of this Guideline.

### *Specificity of purpose*

68. In assessing the risk of non-compliance with paragraph 215-10(1)(d), the Commissioner considers a general purpose does not carry as much probative value as a specific purpose in determining whether funds have been applied for a permitted purpose under subsection 215-10(2).

69. A 'specific purpose' refers to an application of funds from the issue of a non-share equity interest that is directly referrable to an identifiable transaction.

70. A 'general purpose' refers to an application of funds from the issue of a non-share equity interest which is not for a specific purpose, that is, it is not directly referrable to an identifiable transaction.

### *Funds applied for a specific permitted purpose(s)*

*Scenario 3: low risk of non-compliance*

71. XYZ Bank is an ADI for the purposes of the *Banking Act 1959* and an Australian resident. XYZ New Zealand Branch (the Branch) is a permanent establishment[12] of XYZ Bank in Auckland, New Zealand.[13]

72. The Branch operates under a pool of funds maintained by XYZ Bank.

73. On 1 January 2014, the Branch raises total net proceeds of approximately NZ$500 million (the Proceeds) by way of NZ dollar denominated convertible notes (Hybrid Capital Instruments).

74. The Hybrid Capital Instruments:

(a) qualify as Tier 1 capital under the APRA prudential standards, and

(b) are classified as non-share equity interests for the purposes of Division 974, and returns paid in respect of the Hybrid Capital Instruments are taken to be non-share dividends as defined in section 974-120.

75. The Hybrid Capital Instruments are issued at or through the permanent establishment of XYZ Bank in New Zealand in accordance with paragraph 215 10(1)(c).

76. An internal document submitted to the Board of XYZ Bank in relation to the Hybrid Capital Instrument issuance states the following under the heading 'Use of Proceeds':

> XYZ New Zealand branch intends to use the net proceeds from the sale of Hybrid Capital Instruments to provide two corporate loans to third parties as part of the wholesale banking business in the New Zealand branch.

77. The Proceeds from the issue of the Hybrid Capital Instruments are placed into a pool of funds and applied in their entirety to provide two corporate loans to third parties.

#### Factors considered in forming the Commissioner's assessment of risk

78. In this scenario, the funds from the issue of Hybrid Capital Instruments have been applied for a specific permitted purpose under paragraph 215-10(2)(a), namely to provide funding for two corporate loans issued to third parties as part of the wholesale banking business of the ADI at or through the branch.

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[12] As defined in subsection 6(1) of the ITAA 1936.

[13] New Zealand is a 'listed country'. See section 320 of the ITAA 1936 and regulation 19 of the *Income Tax Assessment (1936 Act) Regulation 2015*.

79. The Commissioner considers this scenario to present a *low risk of non-compliance* as there is a specific permitted purpose for the application of funds at the issue date of the non-share equity interest. The application of funds from the issue of the non-share equity interest can be directly referenced to an identifiable transaction(s). As such it is more easily verifiable that the funds were used 'solely' for a permitted purpose in accordance with paragraph 215-10(1)(d).

80. Of relevance to the risk rating in this scenario is whether the Branch has a going concern intention to apply the funds in the business of the Branch. At the issue date of the non-share equity interest, the Branch must not have an intention to transfer funds to Australia after the funds have finished being applied to the two corporate loans. If at issue date the Branch does intend to subsequently transfer funds to head office after their initial application (the corporate loans), the Commissioner will not consider paragraph 215-10(1)(d) to be satisfied as there was no going concern intention to apply the funds in the business of the Branch. Also refer to paragraphs 150 to 153 of this Guideline.

### ***Funds applied for a general permitted purpose(s) with limited evidence that funds have not been applied for a non-permitted purpose***

*Scenario 4: medium risk of non-compliance*

81. Same as paragraphs 71 to 75 of scenario 3.

82. The 'Prospectus' for the Hybrid Capital Instruments states the following under the heading 'Use of Proceeds':

> XYZ Bank's New Zealand branch intends to use the net proceeds from the sale of the Hybrid Capital Instruments for general corporate purposes of the New Zealand branch.

83. The total net Proceeds from the issue of the Hybrid Capital Instruments are placed into the pool of funds and applied in their entirety for the Branch's general business operations in New Zealand.

84. The Branch has limited evidence to demonstrate the funds have not been applied for a non-permitted purpose. There are some material unexplained transfers to the Australian head office of XYZ Bank reflected in the inter-branch accounts of the Branch a week after the issue date of the capital raising (that is, within six months of the capital raising).

#### Factors considered in forming the Commissioner's assessment of risk

85. The Commissioner considers this scenario to present a *higher risk of non-compliance* than scenario 3, as a general purpose does not carry as much probative value as a specific purpose in determining whether funds have been applied for a permitted purpose under subsection 215-10(2).

86. Unlike scenario 3, where funds are applied for a specific purpose, funds from the issue of a non-share equity interest which are applied for a general purpose and absorbed into a pool of funds (a general purpose scenario), cannot always be directly referenced or traced to an identifiable transaction. The Commissioner has increasing difficulty in easily verifying the identified application of funds from the capital raising to determine they have been used solely for a permitted purpose under subsection 215-10(2).

87. General purpose scenarios will require additional factual analysis, and there will be a higher evidentiary burden on taxpayers to demonstrate that funds have not been applied for a purpose other than 'solely for one or more purposes permitted under subsection 215-10(2)' (for example, a transfer of funds directly or indirectly to head office).[14] General purpose scenarios where taxpayers are only able to provide limited evidence that funds have not been applied for a non-permitted purpose, will present a higher risk of non-compliance, and like the current scenario, would be categorised as medium risk.

88. Alternatively, in general purpose scenarios where a taxpayer is able to evidence that funds have not been applied for a non-permitted purpose, the risk categorisation will be low risk.

89. In the current scenario, the risk assessment may be improved with additional factual analysis including the provision of positive evidence in relation to specific use of the funds for a permitted purpose, for a period up to six months from the issue date.

90. However, in the context of a funding model utilising a pool of funds approach, the Commissioner recognises that demonstration of specific use of funds can be problematic. Therefore the following points can assist taxpayers in providing assurance that there is a low risk of non-compliance in relation to permitted purpose:

(a) For a period up to six months from the issue date, demonstration that funds have not been applied for a non-permitted purpose. This may involve for example, explanation of anomalous transfers of funds as evidenced in journal entries between XYZ Bank head office and the Branch, and/or by movements in the position of relevant balance sheet categories of the Branch (for example, cash on deposit with head office). In this regard, the Commissioner acknowledges that an offshore branch may, for a variety of commercial reasons, have a policy whereby branch operations regularly transfer funds to the Australian head office. Such 'business as usual' transactions may be material in nature and occur in close proximity to, or within six months of, the timing of the non-share equity issuance. From a compliance perspective, transfers which occur in these circumstances do not of themselves present a cause for concern, provided they arise as part of the regular or 'business as usual' operations of the branch. Rather, for the purposes of this Guideline, 'anomalous' transfers of funds would generally be those which fall within the initial six months of the non-share equity issuance, and are material and/or unusual in nature, having regard to all relevant facts and circumstances (for example, the ordinary business of the branch, the size of the relevant issuance, and current economic and business conditions). As mentioned above, the ATO would look to journal entries and the branch balance sheet to identify whether such anomalous transfers have occurred.

    As an example to illustrate this bullet point, journal entries that evidence transfers to head office might usually show transfers of between NZ$20 million and NZ$50 million between the Branch and Australian head office in any given week. However, in one of the weeks within the first six months after issuance there is a week where journal entries indicate that transfers of NZ$400 million have occurred. The ATO would require the bank to explain the commercial reasons justifying these transfers.

(b) For a period up to six months from the issue date, demonstration that the absolute funding position of the Branch has not decreased in a material way relative to its position immediately following issuance of the non-share equity instruments.

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[14] See subparagraph 215-10(2)(a)(i).

> As an example to illustrate this bullet point, assume the total amount of debt and equity funding of the Branch balance sheet, immediately following issuance (that is, including the funds raised from the non-share equity issuance), was NZ$5 billion. However, five months from issuance, a review of the branch balance sheet indicates that the absolute funding position has decreased to NZ$4 billion. Considering the funding needs of the branch have reduced by NZ$1 billion in the six months following the non-share equity issuance, the taxpayer would need to provide additional factual analysis to justify the commercial reasons behind the reduction.

91. As highlighted in the compliance risk framework, the more evidence that is able to be produced in demonstrating funds have not been applied for a non-permitted purpose, the lower the relative risk.

92. The proportion and quantum of funds unable to be evidenced as applied for one or more permitted purposes will be relevant to any ultimate assessment of risk.

93. In support of the above risk assessment position, the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 (the Explanatory Memorandum) states at paragraph 2.111:

> 2.111 The purpose for which funds are raised is normally stated in the relevant prospectus. This may have been cleared by a regulatory authority. The stated purpose for the raising of funds is, accordingly, relevant in determining whether the funding test is satisfied. However, their probative value depends on the facts of the case. For instance, a clear statement of purpose for the raising and the application of funds (e.g. to finance a named project as part of the business of the branch) and a separate announcement of a commitment to the project requiring the capital to be raised carries greater weight than a statement which is unclear. For example, a general statement of purpose (e.g. to fund the business of the branch) and evidence that funds raised were immediately transferred to the ADI in Australia to be part of its working capital suggest that the raising and application of funds were for a purpose other than for use in the business of the foreign branch.

### *Funds applied for several permitted purposes*

*Scenario 5: low to medium risk of non-compliance*

94. Same as paragraphs 71 to 75 of scenario 3.

95. The 'Prospectus' for the Hybrid Capital Instruments states the following under the heading 'Use of Proceeds':

> XYZ Bank's New Zealand branch intends to use the net proceeds from the sale of the Hybrid Capital Instruments for new investment opportunities, as well as continuing to support the general operations of the branch by refinancing existing funding of the New Zealand branch.

96. The Hybrid Capital Instruments are issued on 1 January 2014 and raise total net proceeds of approximately NZ$500 million (the Proceeds).

97. Part of the Proceeds is applied to a new business venture worth NZ$100 million.

98. The balance of the Proceeds (NZ$400 million) is applied to effectively refinance, via a return, NZ$400 million worth of internal funding provided by head office prior to the capital raising, the funds of which, were, and will continue to be, placed in the pool of funds, and used in the business of the Branch for general purposes.

### Factors considered in forming the Commissioner's assessment of risk

99. In this scenario, the funds from the issue of Hybrid Capital Instruments satisfy one or more permitted purposes under subsection 215-10(2) as they have been applied:

- (a) for the business of XYZ Bank carried on at or through the Branch by way of a new business venture (paragraph 215-10(2)(a)), and
- (b) to satisfy a refinancing initiative, by returning pre-existing internal funding that was used in the business of the ADI and contributed to the Branch before the capital raising was issued (subparagraph 215-10(2)(c)(i)).

100. In a compliance context, this scenario presents a:

- (a) lower risk of non-compliance than scenario 4, where funds have been applied solely for a general purpose with limited evidence funds have not been applied for a non-permitted purpose, and
- (b) higher risk of non-compliance than scenario 3, where funds have been applied solely for a specific purpose.

This is because there is, in part, a specific purpose for the application of funds from the issue of the non-share equity interest.

101. As noted in scenario 3, the application of funds for a specific purpose is easily verifiable as it can be directly referenced to an identifiable transaction. In comparison, where funds from the issue of a non-share equity interest are applied for a general purpose, such as the general business operations of the issuing branch, and no identifiable transaction(s) for the application of funds is capable of being traced, then the question of verification remains an issue. As noted in scenario 4, where this occurs, there will be a higher evidentiary burden on taxpayers to demonstrate that funds have not been used for a purpose other than for use in the business of the branch.

102. In light of this, the Commissioner's assessment of risk, and the corresponding evidentiary burden on taxpayers, will depend on the proportion of funds applied for a general purpose. For this reason, funds which are applied primarily for a general purpose, will pose a higher risk of non-compliance, and attract a higher evidentiary burden, than funds which are applied primarily for a specific purpose.

103. In the current scenario, one-fifth (NZ$100 million) of the funds have been applied for a specific purpose with the remainder (NZ$400 million) applied to refinance pre-existing general purpose funding.

104. Verification in relation to the application of funds from the issue of Hybrid Capital Instruments in this scenario is more problematic as four-fifths of the funds have been applied for a general purpose. There is, therefore, a higher evidentiary burden on XYZ Bank to demonstrate that funds have not been applied for a non-permitted purpose.

### *Recycling events*

105. Recycling events are scenarios where funds are applied for an initial purpose and, at a subsequent point in time, are redeployed or 'recycled' to be used for a different purpose. The problematic scenario in the context of paragraph 215-10(1)(d) is where funds originally applied for a permitted purpose are subsequently applied for a non-permitted purpose.

106. The Commissioner will regard as low risk, from a compliance perspective, circumstances where funds, having initially been raised with a going concern intention of being used for a permitted purpose(s), are recycled for a non-permitted purpose six months or more after the issue date of a non-share equity interest. This risk assessment mindset accommodates situations including where an offshore branch legitimately raises funds to be used in the business of the branch, but environmental factors or business conditions have meant that the funds were transferred back to head office, for example, the closure of part of the business in the branch.

### ***A non-permitted application of funds within six months***

*Scenario 6: medium risk of non-compliance*

107. Same as paragraphs 71 to 75 of scenario 3.

108. The 'Prospectus' for the Hybrid Capital Instruments states the following under the heading 'Use of Proceeds':

> XYZ Bank's New Zealand branch intends to use the net proceeds from the sale of the Hybrid Capital Instruments for general corporate purposes of the New Zealand branch.

109. The Hybrid Capital Instruments are issued on 1 January 2014, and raise total net proceeds of approximately NZ$500 million (the Proceeds).

110. The total net Proceeds are placed into the pool of funds, and used for the Branch's general business operations in New Zealand.

111. On 1 April 2014, NZ$200 million of the Proceeds are transferred by the Branch to XYZ Bank. The transfer is not in respect of funds contributed before 1 January 2014.

112. The remainder of the Proceeds continue to be used by the Branch for its general business operations in New Zealand.


Factors considered in forming the Commissioner's assessment of risk

113. In this scenario, proceeds from the capital raising have been transferred to the Australian head office of the Branch (XYZ Bank) three months *after* the issue of the Hybrid Capital Instruments. As the transfer is not in respect of funds contributed to the Branch before the issue of non-share equity interests, the transfer of funds does not meet the requirements of subparagraph 215-10(2)(c)(i).

114. The Commissioner would consider this scenario to present a *medium risk of non-compliance*, as the funds from the issue of the non-share equity interest have been applied for a non-permitted purpose *prior to six months* from the issue date of the relevant capital raising. The fact that funds have also been used for a permitted purpose, that is, for general business operations in the Branch per paragraph 215-10(2)(a) does not change this assessment of risk. However, it should be noted that the proportion and quantum of funds which continue to be used for a permitted purpose(s) will be relevant to any ultimate assessment of risk.

115. As noted in the Explanatory Memorandum, the funding test in paragraph 215-10(1)(d), is primarily an integrity measure to prevent avoidance of franking debits if the non-share equity interest were issued in Australia:[15]

> 2.101 Paragraph 160APAAAA(1)(d) contains a test relating to the raising and application of funds raised from the issue of eligible hybrids (the funding test) [Schedule 1, item 98, paragraph 160APAAAA(1)(d)]. This test is linked, but is not exclusively related, to item 101 of Schedule 1 which deals with anti streaming rules relating to this concession. Those rules are explained in paragraphs 2.117 to 2.119.
>
> 2.102 The funding test is primarily an integrity measure to prevent avoidance of franking debits if the eligible hybrids were issued in Australia. This would occur, for example, if the Australian ADI needs to raise capital for its Australian operations and thereby incur franking debits on the returns but instead raises the capital through its foreign branch and immediately, or sometime later, the funds are transferred to the Australian head office.

116. In practice, non-share equity interests are often long dated or perpetual instruments where the use of funds may vary over time. This can result in a significant compliance burden on taxpayers to demonstrate that funds from the issue of a non-share equity interest have not been directly or indirectly returned to Australia per paragraph 215-10(2)(a).

117. In recognition of what may otherwise be a high compliance burden on the taxpayer, the Commissioner will assess the risk of non-compliance with paragraph 215-10(1)(d) to be low where funds from the issue of a non-share equity interest *continue to be applied* for a permitted purpose for at least six months from the issue date of the relevant capital raising.

118. Conversely, where funds from the issue of a non-share equity interest are subsequently applied for a non-permitted purpose *prior to six months* from the issue date of the relevant capital raising, the Commissioner will generally assess the risk of non-compliance with paragraph 215-10(1)(d) to be medium. This type of scenario raises questions in relation to whether the initial application of funds is for a bona fide permitted purpose, and the legitimacy of the recycling event. The Commissioner will regard recycling events, that are not for a permitted purpose, which occur closer to the issue date of the non-share equity interest as relatively higher risk.

119. The application of funds for a bona fide permitted purpose, and legitimacy of any redeployment of funds for a non-permitted purpose, will be determined on the particular facts and circumstances of each case. Refer to scenarios 4 and 8 of this Guideline for examples of the additional factual analysis taxpayers may provide to improve the risk assessment of their facts and circumstances where transfers to Australian head office occur in the context of pool of funds.

### *Scenario 7: high risk of non-compliance*

120. Same as paragraphs 71 to 75 of scenario 3.

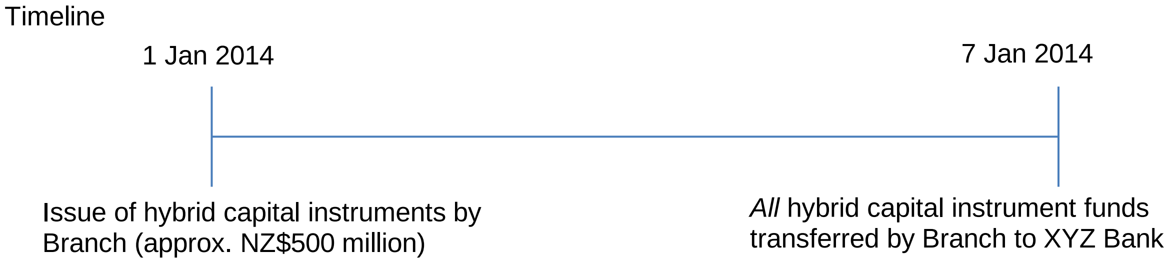
121. The 'Prospectus' for the hybrid capital instruments states, under the heading 'Use of Proceeds':

> XYZ Bank's New Zealand branch intends to use the net proceeds from the sale of the Hybrid Capital Instruments for general corporate purposes of the New Zealand branch.

122. The Hybrid Capital Instruments are issued on 1 January 2014 and raise total net proceeds of approximately NZ$500 million (the Proceeds).

[15] Paragraphs 2.101 and 2.102 of the Explanatory Memorandum. Paragraph 160APAAAA of the ITAA 1936 was repealed from 30 June 2002 with the introduction of the new simplification imputation system, and replicated by section 215-10 of the ITAA 1997.

123. The Proceeds from the issue of the Hybrid Capital Instruments are directly transferred to XYZ Bank on 7 January 2014, that is, one week later. The transfer is not in respect of funds contributed before 1 January 2014.




<u>Factors considered in forming the Commissioner’s assessment of risk</u>

124. As in scenario 6 of this Guideline, the funds in this scenario have also been redeployed for a non-permitted purpose. However, the Commissioner would consider the facts at scenario 7 of this Guideline to present a *relatively higher risk of non-compliance* than scenario 6.

125. This is attributed to the fact that the timing, quantum and proportion of funds redeployed for a non-permitted purpose cast doubt on the legitimacy of the recycling event, and suggest that the initial application of funds from the issue of Hybrid Capital Instruments was not for a bona fide permitted purpose.

## Indirect transfers of funds to Australia

### *On-lending to related parties with limited tracing*

*Scenario 8: medium risk of non-compliance*

126. Same as paragraphs 71 to 75 of scenario 3.

127. The Hybrid Capital Instruments are issued on 1 January 2014 and raise total net proceeds of approximately NZ$500 million (the Proceeds). The total net Proceeds from the issue of Hybrid Capital Instruments are applied for the Branch’s general business operations in New Zealand.

128. On 3 February 2014, the Branch on-lends NZ$400 million of the Proceeds to XYZ London Branch (Branch 2), a permanent establishment of XYZ Bank located in the United Kingdom.

129. The loan has a maturity date of 30 December 2014 and an applicable arm’s length interest rate.

130. Branch 2:

(a) also operates under a pool of funds maintained by XYZ Bank, and

(b) intends to use the loaned funds for general business purposes in the London branch.

131. XYZ Bank has limited evidence that the loaned funds have not been on-lent or transferred by Branch 2 (or another branch or related party of XYZ Bank) to head office, or otherwise not applied for a non-permitted purpose under subsection 215-10(2).

<u>Factors considered in forming the Commissioner’s assessment of risk</u>

132. In this scenario, funds from the issue of Hybrid Capital Instruments have been applied for a general permitted purpose, and subsequently internally on-lent to another branch of the ADI (Branch 2) for general business use in that branch.

133. As Branch 2 operates under a pool of funds maintained by XYZ Bank, it may not be ordinarily possible or practicable to trace or identify the end use of the loaned funds.

134. The Commissioner would consider this scenario to present a *medium risk of non-compliance.* Branch 2 has limited evidence of its application of funds and, accordingly, cannot demonstrate the end use of funds is not for a non-permitted purpose.

135. Analogous to general purpose scenarios, where funds are subsequently internally on-lent to another branch of the ADI (Branch 2) and there is limited evidence that the end use of funds is not for a non-permitted purpose, the Commissioner has increasing difficulty in easily verifying the identified application of funds from the capital raising to determine they have been used solely for a permitted purpose. Such scenarios present a higher risk of non-compliance, and like the current scenario, would be categorised as medium risk.

136. Alternatively, the Commissioner will assess the risk of non-compliance with paragraph 215-10(1)(d) to be low where taxpayers are able to demonstrate that the end use of funds is not for a non-permitted purpose. For example, it can be demonstrated that funds from the issue of non-share equity interest have not been ultimately on-lent, for example, through the ADI's offshore branch or related party network, to head office.

137. In the current scenario, the risk assessment may be improved by providing additional factual analysis including the following:

(a) a narrative describing the use of the Proceeds by Branch 2

(b) for a period up to six months from the issue date, positive evidence of specific use of the Proceeds for a permitted purpose. Alternatively, demonstrating that the Proceeds have not been applied for a non-permitted purpose, for example by explanation of anomalous transfers (which would be evidenced in journal entries between Australian head office and Branch 2, and supported by corresponding movements in the position of relevant balance sheet categories/intergroup account positions of the Branch, Branch 2 and Australian head office. (Refer to paragraph 90 of this Guideline for guidance on the nature of anomalous transfers that would be of interest to the ATO for section 215-10 compliance purposes), and

(c) demonstrating the absolute funding position of Branch 2 has not decreased in a material way relative to its position immediately following its receipt of NZ$400 million in issuance proceeds from the Branch. Where a material decrease has occurred, the ATO would require the bank to justify the commercial reasons behind the reduction (see paragraph 90 of this Guideline).

## Related party hedging

### *Cross-currency swaps with Australian head office*

138. The Commissioner will assess the risk of non-compliance with paragraph 215-10(2)(a) to be low where derivative transactions have been entered into with head office at market rates as part of the bank's risk management approach in managing risk that the branch operation is exposed to as a result of the issuance of a non-share equity interest, for example, in managing interest rate and foreign exchange risk.

*Scenario 9: low risk of non-compliance*

139. Same as paragraphs 71 to 75 of scenario 3.

140. The ‘Prospectus’ for the Hybrid Capital Instruments states the following under the heading ‘Use of Proceeds’:

> XYZ Bank’s New Zealand Branch intends to use the net proceeds from the issuance of Hybrid Capital Instruments for general corporate purposes of the New Zealand branch.

141. The total net Proceeds from the issue of the Hybrid Capital Instruments are placed into the pool of funds, and used for the Branch’s general business operations in New Zealand.

142. The Branch enters into a cross-currency swap with XYZ Bank to swap the funds raised from the issue of Hybrid Capital Instruments. The swap is executed in order to manage the foreign exchange and interest rate exposure arising from the capital raising.

143. Under the terms of the swap agreement, the pricing of the swap will be determined by reference to market rates on the date the swap is entered into.

Factors considered in forming the Commissioner’s assessment of risk

144. In this scenario, the funds from the issue of Hybrid Capital Instruments have been applied for a permitted purpose, being general corporate purposes in the Branch’s operations. From a risk assessment perspective, the key consideration is whether the swap transaction presents a risk of non-compliance with paragraph 215-10(2)(a). That is, whether there is a risk that cash flows and/or book entries under the swap could be considered a ‘transfer’ for the purposes of paragraph 215-10(2)(a).

145. The Commissioner considers this scenario to present a *low risk of non-compliance*.

146. The Commissioner acknowledges that in practice, separate hedging arrangements need to be executed in order to manage certain on-going risks that may arise from the issue of non-share equity interests. In certain instances, for example, where the counterparty to the hedging arrangement is the head office of the issuing branch, this may result in the transfer of funds from the issue of a non-share equity interest to Australia.

147. In recognition of this commercial reality, the Commissioner will consider the risk of non-compliance with paragraph 215-10(2)(a) to be low where such hedging transactions are conducted in accordance with the arm’s length separate enterprise principle[16] under Australia’s transfer pricing rules, and as part of the ordinary course of the risk management of the issuing branch.

148. In a compliance context, the Commissioner’s analysis of these transactions will be more akin to the dealing being a separate stand-alone transaction, rather than a ‘transfer of funds directly or indirectly’ to Australia for the purposes of section 215-10.

149. This analysis accords with the economic reality of a foreign currency hedge transaction. While the foreign currency hedge may result in income or losses in the issuing branch, depending on changes in foreign exchange rates, economically, there has been no transfer of capital out of the branch.

## Other considerations

### *No going concern intention*

150. The Commissioner considers paragraph 215-10(1)(d) will *not* be satisfied in any circumstance where, at the issue date of a non-share equity interest, there is an intention to apply the funds from the relevant capital raising for a non-permitted purpose. That is, there is no going concern intention at issue date.

[16] See Taxation Ruling TR 2005/11 and Taxation Ruling TR 97/20 *Income tax: arm’s length transfer pricing methodologies for international dealings.*

### *Scenario 10: Non-compliance*

151. Same facts as scenario 6 however the 'Prospectus' details that:

> XYZ Bank's New Zealand branch intends to use the net proceeds from the Hybrid Capital Instruments for general business operations in both New Zealand (the Branch) and Sydney (XYZ Bank).

### Factors considered in forming the Commissioner's assessment

152. Although the application of funds in this scenario mirror those at scenario 6 (that is, funds recycled for a non-permitted purpose within six months of the capital raising), the Commissioner *does not consider subsection 215-10(1)(d) to be satisfied* as the Branch does not have a going concern intention at the issue date of the non-share equity interest to apply the funds for a permitted purpose.

153. At the issue date of the Hybrid Capital Instruments, the Branch's intention is to apply part of the funds for use in XYZ Bank. This is not a permitted purpose under subsection 215-10(2).

## ***Source of funds***

154. There may be instances where subscription for non-share equity interests issued at or through an overseas permanent establishment is taken up by Australian resident investors. There may, or may not, have been a marketing campaign targeting Australian investors.

155. The Commissioner does not believe that non-share equity interests issued at or through an overseas permanent establishment that are partly or wholly subscribed to by Australian resident investors present any issues in complying with section 215-10.

## ***Application of tax anti-avoidance provisions***

156. The concession in section 215-10 can, in certain circumstances, lead to streaming outcomes that may attract the operation of the anti-avoidance rule in section 177EA of the ITAA 1936, or other anti-avoidance rules such as the anti-streaming rule in section 204-30 (collectively the 'anti-streaming provisions'). In support of this, the Explanatory Memorandum states at paragraph 2.117:

> 2.117 There is a risk to the revenue that this ADI concession could be used by an eligible ADI to stream franking credits to certain equity holders. The most obvious type of streaming that could occur would be by issuing non-share equity interests through the ADI's branch to non-residents, while issuing similar equity interests to residents. Because the non-share equity interests issued through the branch would be unfrankable under the ADI concession, the effect of such conduct would be to stream franking credits from non-residents (who are unable to fully benefit from franking) to residents (who benefit most from franking). While this type of streaming is the most obvious type of streaming (to which the modified section 177EA could apply), it does not represent the only type of streaming activity that an ADI could undertake. *[Schedule 1, item 105, paragraph 177EA(19)(da)]*

157. Issuances of Additional Tier 1 qualifying securities to different investor bases may be commercially separate, but largely similar in nature, because of the regulatory requirements relating to Additional Tier 1 capital. These arrangements may prima facie give rise to streaming outcomes where one issuance seeks to take advantage of section 215-10. However, there is no presumption the anti-streaming provisions will apply where the concession in section 215-10 is accessed.

158. From a compliance perspective, scenarios that are likely to present a dividend streaming concern to the ATO will have the following features:

(a) securities are issued to different, or predominately different, investor bases, with different tax profiles

(b) one issuance seeks to take advantage of section 215-10

(c) distributions in respect of one issuance are frankable

(d) the securities are, or will be, issued at similar points in time (that is, the issue dates of the relevant capital raisings occur, or will occur, in close proximity to one another)

(e) the terms of the issuances are largely similar with regard to their legal and/or commercial effect, and

(f) overall, the effect of the relevant issuances is that one investor base gains a greater benefit from franking credits than other persons holding shares or interests in the bank. For example, distributions are made such that franking credits flow to residents, who benefit most from franking, to the exclusion of non-residents who are unable to fully benefit from franking. As a result, maximum value is derived from the franking credits distributed and wastage is avoided.

159. Where these features are present, the ATO will require banks to explain the commercial or regulatory reasons behind such issuances to justify the presence of any perceived 'streaming' outcome.

160. The most obvious example of where a streaming conclusion would be drawn is where the circumstances are consistent with one capital raising being split into two tranches, for example one unfrankable to, for example, non-residents, and one frankable to residents. The more similar the terms of the securities, and the closer together the issuance dates, the more likely it is that a conclusion would be drawn about the existence of streaming.

161. However, in drawing a conclusion as to whether there is streaming, the Commissioner will place weight on the genesis of different capital raisings and the commercial or regulatory factors that might otherwise explain the proximity of two issuances. Mere coincidence in timing will not, of itself, be sufficient to ground a conclusion as to streaming has occurred. Similarly, the ATO would be less likely to reach a streaming conclusion where the circumstances are such that it could not reasonably be concluded there is a purpose, associated with the capital raising, of streaming franking credits to reduce wastage.

162. If there is uncertainty in relation to the potential application of the anti-avoidance provisions, taxpayers are encouraged to approach the ATO to obtain advice.

### *Documentation requirements*

163. The Commissioner expects sufficient documentation be prepared and maintained, as required by section 262A of the ITAA 1936, to enable a taxpayer's liability under the ITAA 1936 and ITAA 1997 to be readily ascertained.

164. The legislation does not require a taxpayer to go beyond what is reasonable in terms of documentation. What is reasonable is determined on the basis of what a reasonable business person in the taxpayer's circumstances would do, having regard to the complexity and materiality of the transaction. This will be applicable whether the case is relatively straightforward or complex, but the greater the complexity and unusualness of the case, the greater the importance placed on the documents to justify the outcome.

165. As highlighted in the compliance risk framework (paragraphs 15 to 19 of this Guideline), a key feature of this Guideline relates to the extent to which taxpayers can demonstrate that funds have not been applied for a non-permitted purpose in general purpose scenarios. This will be critical for taxpayers to have their factual scenarios and associated tax treatment categorised as low risk.

**Commissioner of Taxation**
5 June 2017

## Appendix 1: Summary of risk assessment factors

**Low** **High**

| **Factors affecting risk assessment** | **Paragraphs** | **Risk of non-compliance** | | |
|---|---|---|---|---|
| **Necessary branch activities undertaken** | 21 – 52 | All | Most | Minimal |
| **Evidence funds are applied for a permitted purpose/ not applied for a non-permitted purpose** | 53 – 0 | Able to provide | Limited evidence | Unable to provide evidence |
| **Specificity of permitted purpose** | 68 – 104 | Specific permitted purpose; or<br>General permitted purpose, *with evidence* that funds have not been applied for a non-permitted purpose | A general permitted purpose with *limited evidence* that funds have not been applied for a non-permitted purpose | A general permitted purpose with *no evidence* that funds have not been applied for a non-permitted purpose |
| **Period in which funds are applied for a permitted purpose (assuming going concern intention present)** | 105 – 125 | Continued application for at least six months | Between 0-6 months | Short<br>(that is, funds applied for a non-permitted purpose shortly after capital raising) |
| **Extent to which funds are applied for use with related parties with limited tracing** | 126 – 137 | Minimal | Most | All |

## References

| | |
|---|---|
| ATOlaw topic(s) | Income tax ~~ Capital management ~~ Dividend streaming<br>Income tax ~~ Capital management ~~ Frankability of distribution<br>Income tax ~~ Capital management ~~ Franking credits / tax offsets<br>Income tax ~~ Capital management ~~ Hybrid capital raisings |
| Legislative references | ITAA 1936<br>ITAA 1936 6(1)<br>ITAA 1936 Pt IVA<br>ITAA 1936 177EA<br>ITAA 1936 262A<br>ITAA 1936 320<br>ITAA 1997<br>ITAA 1997 204-30<br>ITAA 1997 215-10<br>ITAA 1997 215-10(1)(c)<br>ITAA 1997 215-10(1)(d)<br>ITAA 1997 215-10(2)<br>ITAA 1997 215-10(2)(a)<br>ITAA 1997 215-10(2)(a)(i)<br>ITAA 1997 215-10(2)(c)(i)<br>ITAA 1997 Div 974<br>ITAA 1997 974-120<br>TAA 1953<br>IT(1936)R 2015 19 |
| Related Rulings/Determinations | TR 2005/11<br>TR 97/20<br>TD 2012/19 (Withdrawal) |
| Other references | PS LA 2011/27<br>Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 |
| ATO references | 1-BHUTTFP |
| BSL | PGI |