

# ***TD 2009/1EC - Compendium***

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## **Ruling Compendium – TD 2009/1**

This is a compendium of responses to the issues raised by external parties to TD 2008/D14 – Does subsection 974-135(1) of the *Income Tax Assessment Act 1997* only apply to a legally enforceable obligation?

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft determination.

### **Summary of issues raised and responses**

<b>Issue No.</b>	<b>Issue raised</b>	<b>Tax Office Response/Action taken</b>
1.	<b>Meaning of ‘obligation’</b> Confirm in the draft Determination that all references to an obligation throughout section 974-135 are references to an in substance or effect obligation, not just to a legally enforceable obligation.	This Determination is only intended to confirm that the word ‘obligation’ in the definition of the term ‘effectively non-contingent obligation’ (ENCO) in subsection 974-135(1) extends beyond a legally enforceable obligation. Interactions with other parts of section 974-135 are outside the scope of this Determination but may be addressed separately by the Tax Office.
2	<b>Pricing terms and conditions</b> The draft Determination should consider whether the reference to ‘pricing, terms and conditions’ in subsection 974-135(1) should be confined to those set out in the legal agreement given that obligations are not confined to legally enforceable obligations.	The matters raised under this heading are outside the scope of this Determination but may be addressed separately.

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Issue No.	Issue raised	Tax Office Response/Action taken
3	<p><b>'In substance or effect'</b></p> <p>At paragraph 110 of its draft discussion paper on ENCO, the ATO provide the following comments on the phrase 'in substance or effect':</p> <p><i>These words are evidently intended to direct the enquiry beyond the mere legal form of the scheme, to determine whether, regardless of the legal form of the arrangement, a relevant obligation is 'in substance' non-contingent. (An obligation might be non-contingent in effect or in substance when it is not so in form for two reasons. First, an obligation might be expressed to exist unless some contingency occurred, but that contingency might be such as not to make the obligation contingent in effect because the likelihood of the contingency occurring is immaterially remote; that is to say, so unlikely to occur that no rational person would regard it as a real contingency for any commercial purpose. Second, an obligation might be expressed to exist only if some contingency occurs that is certain to occur, or if one of two contingencies occurs one of which must occur.)</i></p> <p>The ATO to confirm its views on when an obligation will be 'in substance or effect' non-contingent. The above paragraph appears to be predicated on the ATO view that an obligation must be expressed in the legal terms of the agreement. However, given the starting position is that an obligation does not have to be legally enforceable (as is contemplated by the Draft Determination), the ATO is requested to confirm whether the above paragraph needs to be revised.</p>	<p>The discussion paper on ENCO was prepared for the purposes of discussion and to invite comments about a range of possible views on ENCO. The discussion paper explicitly did not purport to represent the Tax Office's view (see paragraphs 2 and 10 of the discussion paper).</p> <p>This Determination sets out the Tax Office's view.</p>

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4	<p><b>Economic compulsion</b>  <i>Accelerating returns</i>            Paragraph 2.175 of the explanatory memorandum to the New Business Tax System (Debt and Equity) Bill 2001 states:  <i>The debt test therefore uses the concept of an effectively non-contingent obligation as opposed to a legally (or formally) non-contingent obligation. Thus a scheme under which an entity has a right but not a legal obligation to provide a financial benefit could nevertheless be debt if, having regard to the pricing, terms and conditions of the scheme, the entity is in substance or effect inevitably bound, to exercise that right. This would occur where not to exercise the right would result in the entity having to sustain a greater loss (in present value terms) from the scheme than if it exercised the right. <b>A simple example of this would be where the issuer of a financing instrument has a right to redeem it after a certain period but is compelled to provide accelerating returns on the instrument if it does not exercise that right: the accelerating returns would make it uneconomic for the issuer not to redeem the instrument so that it is under an effectively non-contingent obligation to do so.</b> [our emphasis added]</i></p> <p>The above paragraph refers to an entity having the right but not having the legal obligation to provide a financial benefit but nonetheless being, in substance or effect, inevitably bound to exercise that right. We consider that the accelerating returns that would make it uneconomic for the issuer not to redeem the instrument mean that the issuer has an ENCO to redeem the instrument. This paragraph was not specifically considered by the ATO in its draft discussion paper on ENCO. We request that the ATO address the above example in the Draft Determination and, more broadly, confirm when economic compulsion may result in an ENCO.</p>	<p>Paragraph 2.175 of the EM is discussed at paragraph 13 of this Determination. A detailed discussion of specific matters that would lead to the conclusion that a party is inevitably bound to exercise a right is not within the scope of this Determination.</p> <p>The comments raised under this heading may be addressed separately.</p>

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<b>Issue No.</b>	<b>Issue raised</b>	<b>Tax Office Response/Action taken</b>
	<p>This may depend on the particular facts so we recommend that the ATO provide examples in the Draft Determination of different scenarios, eg. with different interest rates levels, that illustrate when accelerating returns would and would not result in an ENCO. Furthermore, the above paragraph from the explanatory memorandum appears to be based on section 974-135(1). The ATO is requested to comment on why section 974 135(7) would not apply to the example. That provision states that an obligation is not ENCO merely because you will suffer some detrimental, practical or commercial consequences if you do not fulfil the obligation.</p> <p><i>Dividend stoppers</i></p> <p>Guidance is sought on the existence of an ENCO where an instrument has a dividend (or return) stopper. A dividend stopper is generally included in the terms of instruments that provide for 'discretionary' returns, for example, a preference share that requires a directors' declaration. The effect of the dividend stopper is that it effectively counteracts the discretion and places pressure on the entity to pay the required return on the discretionary instrument.</p>	

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	<p>Assume that a note pays discretionary returns of 8% subject to a dividend stopper. The returns are contingent returns, but we query whether, based on the views in the Draft Determination, the dividend stopper results in an in substance or effect obligation to pay the returns on the note. In the Private Ruling with the authorisation number 64594, the ATO took the view that a dividend stopper did not change the conclusion that the company's obligation to pay a distribution was contingent on the discretion of the directors:</p> <p><i>The transaction provides that the distribution under each note is at the absolute discretion of the company's directors. Accordingly, the company's obligation to pay the distribution under the notes is contingent on the director's discretion. The presence of a dividend stopper does not change this conclusion as subsection 974-135(7) of the ITAA 1997 provides that:</i></p> <p><i>An obligation of yours is not effectively non-contingent merely because you will suffer some detrimental practical or commercial consequences if you do not fulfil the obligation.</i></p> <p><i>Accordingly, the company does not have an effectively non-contingent obligation to pay any distribution under the bonus security.</i></p> <p>We note that the PBR only considered section 974-135(7) but did not address whether there was in substance or effect an obligation to pay returns under section 974-135(1). We request the ATO to consider the interaction between sections 974-135(1) or 974-135(7) and which of those provisions apply to dividend stoppers. If section 974-135(1) applies, we request the ATO to provide guidance on whether the presence of a dividend stopper may result an obligation to pay distributions being an ENCO.</p>	

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5	<p><b>Subject to profits</b></p> <p>Example 2.27 of the explanatory memorandum to the New Business Tax System (Debt and Equity) Bill 2001 considers whether convertible preference shares with a term of 15 years that are mandatorily convertible at maturity (but with an option to buy back 5 years after issue) and paying an annual dividend of 7.5% are debt interests. The examples states that the company does not have an ENCO to provide a future financial benefit because the payment of a dividend is contingent on profits, and the issue of ordinary shares is specifically excluded as being the provision of a financial benefit.</p> <p>There are several ATO IDs that also take the view that an obligation to pay dividends subject to the availability of profits is not an ENCO because the ability to pay dividends depends on the existence of profits (ATO IDs 2003/200 and 2003/900).</p> <p>If, however, a company is certain that it will generate profits, eg. a company may invest in an instrument that provides it with a fixed interest stream for 10 years with no (or minimal) expenses, it is arguable that the company has an ENCO to pay dividends on preference shares that it has issued (where the terms of those shares require dividends to be paid). Although the payment of dividends is subject to profits, the fact that profits are certain means that the company has an in substance or effect obligation to pay dividends. The ATO's views on this scenario are requested and we request that an example be included in the Draft Determination.</p>	<p>This Determination is intended to confirm the Tax Office's view that the use of the word 'obligation' in the definition of the term 'effectively non-contingent obligation' under subsection 974 135(1) is intended to extend beyond a legally enforceable obligation. The consideration of circumstances in which an effective obligation to take an action may be found for the purposes of the subsection in the absence of a legal obligation is beyond the scope of this Determination but may be addressed separately.</p>

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6	<p><b>Other examples</b></p> <p>The ATO to provide other examples that illustrate the interpretation of the word 'obligation' that is taken in the Draft Determination. Suggested examples include:</p> <ul style="list-style-type: none"> <li>• the effect of a contingency on sales, where sales levels are guaranteed under a separate agreement (that is, something similar to example 2.31 of the explanatory memorandum).</li> <li>• the effect of an immaterially remote contingency (an example where it is unlikely the contingency will occur).</li> </ul>	<p>For the reasons set out in answer to Issue 5, these issues are beyond the scope of this Determination but may be addressed separately.</p>
7	<p><b>ATO draft discussion paper on ENCO</b></p> <p>The views taken by the ATO in the Draft Determination are inconsistent with those expressed in the ATO's draft discussion paper on ENCO. Paragraph 76 of the discussion paper states that the word 'obligation' is used in section 974-135(1) 'in the sense of a legal requirement'. We recommend that the ATO consider this inconsistency and if there are any other inconsistencies between the draft discussion paper and the Draft Determination. The ATO should then consider whether the draft discussion paper needs to be updated upon finalisation of the Draft Determination or whether any inconsistencies should be raised with the NTLG Finance and Investment subcommittee for broader consideration.</p>	<p>The discussion paper on ENCO was prepared for the purposes of discussion and to invite comments about a range of possible views on ENCO. The discussion paper explicitly did not purport to represent the Tax Office's view (see paragraphs 2 and 10 of the discussion paper).</p> <p>The Tax Office does not believe that any revision of the ENCO paper is necessary.</p> <p>Note also that the language in paragraph 76 of the ENCO paper is equivocal. The comments are given as a 'first observation' that 'might' be made.</p>