

TR 2010/D1 - Income tax: the relevance of 'economic compulsion' in deciding whether an issuer of a financing arrangement has an 'effectively non-contingent obligation' for the purposes of section 974-135 of the Income Tax Assessment Act 1997

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This document has been finalised.

 There is a Compendium for this document: **TR 2010/5EC** .



Draft Taxation Ruling

Income tax: the relevance of ‘economic compulsion’ in deciding whether an issuer of a financing arrangement has an ‘effectively non-contingent obligation’ for the purposes of section 974-135 of the *Income Tax Assessment Act 1997*

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ⓘ This publication provides you with the following level of protection:

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

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What this Ruling is about

1. This draft Ruling considers the relevance of economic compulsion in deciding whether the issuer of an interest has an effectively non-contingent obligation (ENCO) to take an action for the purposes of the debt test in Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997).¹
2. In this draft Ruling, ‘economic compulsion’ means that a reasonable person in the position of the issuer of a financing arrangement would conclude at the time of issue that the issuer was inevitably bound to take a future action rather than suffer the adverse economic consequences of not taking that action.
3. In this draft Ruling, an ‘action’ includes an omission to act.

¹ All legislative references are to the *Income Tax Assessment Act 1997* unless otherwise indicated.

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Ruling

4. For the purposes of section 974-135, 'economic compulsion' to take an action may lead to the conclusion that there is an effectively non-contingent obligation to take that action only if the compulsion arises on having regard to the pricing, terms and conditions of the relevant scheme, as subsection 974-135(1) requires. Other matters may only be regarded for the purpose of considering the effect of the pricing, terms, and conditions of the relevant scheme. They are otherwise irrelevant.

Date of effect

5. When the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 77 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

24 March 2010

Appendix 1 – Explanation

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

6. Division 974 was introduced by the *New Business Tax System (Debt and Equity) Act 2001*. One of the objects of Division 974 is to establish a test to determine whether a scheme gives rise to a debt interest or an equity interest for certain taxation purposes (subsection 974-10(1)). Another object is that this test is to operate on the basis of the economic substance of the rights and obligations arising under the scheme rather than the mere legal form of the arrangements (subsection 974-10(2)). The Division does not rely on a specific definition of 'economic substance'.

7. Paragraph 1.10 of the Supplementary Explanatory Memorandum and Correction to the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 (the Supplementary EM) notes as follows:

The emphasis on the economic substance of the rights and obligations is designed to provide a robust approach to determining, for example, whether there is an effective obligation of an issuer to return to an investor an amount at least equal to the amount invested.

8. The test for a debt interest is contained in Subdivision 974-B. An interest arising under a scheme will not be a debt interest if the issuer does not have 'effectively non-contingent obligations' to provide adequate 'financial benefits'.

9. Because the test in Division 974 is to operate on the basis of economic substance, and critically relies on finding 'effectively non-contingent obligations' to take actions under a scheme, it has been suggested that the debt test requires consideration of all the possible consequences (regardless of how they might arise) to an issuer of taking a particular action in deciding whether the issuer is effectively obliged to take the action. On this view, 'economic compulsion' may give rise to an ENCO to take an action, regardless of the nature of the adverse consequences or how they arise. The Commissioner considers that the test for an ENCO does not support this view. The reasons for this are discussed in paragraphs 10 to 45 of this draft Ruling.

The scheme under which effective obligations arise

10. A 'scheme' is broadly defined for the purposes of Division 974. The Division adopts the definition of 'scheme' in subsection 995-1(1) which includes an 'arrangement'. An 'arrangement' in turn is also broadly defined in subsection 995-1(1) to mean 'any arrangement, agreement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable (or intended to be enforceable) by legal proceedings'.

11. In addition, section 974-150 allows the Commissioner to determine that what would ordinarily be a single scheme is to be treated for the purposes of Division 974 as two or more separate schemes that are not related.

12. Therefore, the Division contemplates that the debt test can be applied to an interest that arises under a scheme that is not a legally enforceable contract.

Effectively non-contingent obligations in the debt test

13. Subdivision 974-B contains provisions that refer to ENCOs to take an action to:

- terminate an interest within 10 years of issue, even if the terms of issue of the interest formally allow an obligation to take some other action under the scheme to continue beyond 10 years (subsection 974-35(4));
- exercise a right or option to terminate a scheme early (subsection 974-40(2));

and, in particular:

- provide a financial benefit (paragraph 974-20(1)(c)).

14. 'Effectively non-contingent obligation' is defined in section 974-135. Subsection 974-135(1) provides as follows:

There is an effectively non-contingent obligation to take an action under a scheme if, having regard to the pricing, terms and conditions of the scheme, there is in substance or effect a non-contingent obligation (see subsections (3), (4) and (6)) to take that action.

15. In deciding whether there is a 'non-contingent obligation' as a matter of 'substance or effect' to take an action, the extent of the enquiry that is required is determined by subsection 974-135(1): regard must be had to the 'pricing, terms and conditions' of the relevant scheme. The common expression 'terms and conditions' refers to the terms, including the essential terms, of the relevant scheme. 'Pricing' is a reference to more than the mere elements of price, and encompasses the setting of those elements of price, which in turn requires consideration of commercial context and, therefore, some comparison.

16. It seems clear that a scheme that is to be tested need not be a contractual arrangement.² With this in mind, the pricing, terms and conditions of whatever constitutes the relevant scheme between the parties must be identified and considered for the purposes of subsection 974-135(1) to determine whether in 'substance or effect' there is a non-contingent obligation under that scheme to take an action.

² See the discussion in paragraphs 10 to 12 of this draft Ruling.

17. The following passage from the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 (the EM) – at paragraph 2.181, as amended by paragraph 1.43 of the Supplementary EM – illustrates the importance of considering the terms and conditions of a properly identified scheme in their context:

2.181 Conversely, the *effectively non-contingent* test also identifies formally non-contingent obligations that, having regard to the circumstances of the scheme, are such that there is no non-contingent obligation as a matter of substance or effect. This may be the case, for example, where related parties enter into formally binding obligations which, because of matters such as the relationship between the parties, are in substance or effect not obligations at all because failure to perform the so-called obligation will have no practical consequences. This can be contrasted with ordinary cases involving formally non-contingent obligations, where failure to perform an obligation would expose the non-performer to legal or economic sanctions. This is not, however, intended to indicate that an interest-free loan between associated parties necessarily gives rise to a contingent obligation. Thus, the effectively non-contingent obligation test is not intended to disturb what was decided in *Total Holdings (Aust) Pty Ltd v. Federal Commissioner of Taxation* (1979) 9 ATR 885. As a general statement, the taxpayer's intention and the context of the arrangement are relevant in construing whether an effectively non-contingent obligation is present. In this regard, the substance approach adopted in judicial decisions such as *Ure v. Federal Commissioner of Taxation* (1981) 11 ATR 484 is more consonant with the intent of the debt (and equity) test than that adopted in decisions such as *Federal Commissioner of Taxation v. South Australian Battery Makers Pty Ltd* (1978) 8 ATR 879.

18. That discussion also illustrates the significance of the real understandings between parties entering into a formal contract if, by way of example, those understandings could have the effect that failure to perform legal obligations under the formal contract would have no practical consequences for the defaulting party. In the circumstances of the example, the understandings of the parties could be part of the scheme: the scheme would thus be more than the mere formal agreement between the parties. The terms and conditions would therefore be more than those contained in what is presented as the formal binding agreement. The ostensibly non-contingent obligation under the legal form of that agreement might not be an effectively non-contingent obligation on consideration of all the understandings of the parties to the scheme.

19. 'Having regard' to the pricing, terms and conditions of the scheme requires more than their mere identification. Once identified, the elements must be weighed in an appropriate context to usefully indicate whether the scheme gives rise, in substance or effect, to any non-contingent obligations to take relevant actions.

20. The EM reflects this approach at paragraphs 2.146 and 2.147, as follows:

2.146 For example, a nominally perpetual instrument which may be redeemed by the issuer at any time will have a term of 10 years or less for the purposes of the debt test if the issuer is effectively obliged to redeem the interest within that time because the terms of issue require an economically unsustainable step-up in the return of the interest if the interest is not redeemed after 5 years.

2.147 It is necessary to have regard to all the circumstances when considering whether a step-up in the return on a particular interest is economically unsustainable, thereby rendering a termination of an interest effectively non-contingent. However, as a general rule, the level of permissible step-up provided by the APRA for Tier 1 capital instruments issued by APRA regulated institutions (e.g. Australian banks) would be economically sustainable. Step-ups in excess of that would usually, depending on the circumstances, be unsustainable for those institutions. (emphasis added)

21. In applying the debt test to the example in paragraph 2.146 of the EM, the effect of the terms and conditions had to be considered in the appropriate context, and at the time of issue from the issuer's perspective (see subsections 974-5(1), 974-15(1), and 974-20(1)). A proper consideration of all the relevant circumstances would be required to determine whether the step-up specified in the terms and conditions was economically unsustainable, and economically compelled the issuer to redeem (see also paragraphs 39 and 40 of this draft Ruling).

22. It follows from the discussion in paragraphs 10 to 12, 16 and 18 of this draft Ruling that an effectively non-contingent obligation for the purposes of Division 974 is not invariably an obligation in legal form.³ Paragraph 2.175 of the EM illustrates this proposition as follows:

2.175 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. 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.

³ See also the explanation in Taxation Determination TD 2009/1 Income Tax: does subsection 974-135(1) of the *Income Tax Assessment Act 1997* only apply to a legally enforceable obligation?

23. In the circumstances of this example, the issuer is considered to be under an ENCO to take an action (that is, to exercise what is in legal form a right to redeem the financial instrument) when it does not have a legal obligation to take that action. The substance or effect of the terms and conditions is that the issuer is compelled to take the action by the consequences that would flow from not taking it.

24. In this example, the economic compulsion to redeem – the adverse consequence of sustaining a greater loss if the financing instrument were not to be redeemed – arises directly under the terms and conditions of the scheme under which the interest was issued. Essentially the same example is used at paragraph 2.195, and the economic compulsion also arises in that example under the terms and conditions of issue.

Subsection 974-135(7) – detrimental practical or commercial consequences

25. It has been suggested that the conclusion in the example reproduced in paragraph 22 of this draft Ruling is inconsistent with subsection 974-135(7), which provides as follows:

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.

Note: For example, a contingent obligation to make payments in respect of an income security issued by an approved deposit-taking institution (ADI) is not effectively non-contingent merely because of the detrimental effect non-payment would have on the ADI's business.

26. The example in paragraph 22 of this draft Ruling demonstrated that the issuer had an ENCO to redeem the instrument because not to do so would subject it to an unsustainable greater loss.

27. One reading of subsection 974-135(7) could be taken to mean that a contingent obligation to redeem in circumstances similar to this example should not be considered to be an ENCO to redeem merely because 'the accelerating returns would make it uneconomic for the issuer not to redeem'. It has been suggested that the uneconomic accelerating returns are 'detrimental practical or commercial consequences' for the issuer of not redeeming and, by virtue of subsection 974-135(7), are insufficient to give rise to an ENCO to redeem.

28. The Commissioner does not accept this view. The note to subsection 974-135(7) which is reproduced above indicates the intended operation of the provision. The note refers to an income security that pays a contingent return – returns on income securities are usually contingent upon profits, and are thus contingent on the economic performance of the issuing entity. As such, they are contingent on an 'event, condition or situation' and are not non-contingent obligations (subsection 974-135(3)).

29. A major practical or commercial detriment that an issuer of an income security would be exposed to if it were to miss paying a return – for any reason, including a lack of profits – would be the damage to its general commercial reputation, its credit standing, difficulty in further fund raisings, higher costs of subsequent borrowings and so on. But even though this might suggest that the issuer would pay the amount if it had profits, the obligation to pay is still contingent upon the availability of profits.

30. The adverse practical or commercial consequences of not providing the return in the circumstances of the example in the note to subsection 974-135(7) are consequences for the issuer's business that arise outside the operation of the terms of the scheme. These consequences relate to external factors – the reactions of persons who are not parties to the scheme.

31. On the other hand, the examples in the EM⁴ suggest that an economically unsustainable consequence that is not an indirect consequence but is one that is provided for under the terms and conditions of the scheme will be relevant. It is not considered significant that in one sense such a consequence might also be considered a practical or commercial detriment.

32. Subsection 974-135(7) refers to 'some detrimental practical or commercial consequences'. The word 'some' is capable of various meanings. One meaning could suggest that the word requires an assessment of the degree of detriment, and therefore any substantial consequence for an issuer in taking or not taking an action could be relevant regardless of the source or nature of that consequence. The Commissioner considers, however, that because subsection 974-135(1) only permits consideration of the pricing, terms and conditions of the scheme in determining whether in substance or effect there is a non-contingent obligation, the better view is that subsection 974-135(7) does not expand on the enquiry required by subsection 974-135(1) but merely clarifies the extent of that enquiry.

⁴ See the EM at paragraphs 2.146-147 (discussed at paragraph 20 of this draft Ruling), and paragraphs 2.175 and 2.195 (discussed at paragraphs 22 and 24 of this draft Ruling.).

'Dividend Stopper' conditions

33. The terms and conditions of issue of an interest under a scheme might sometimes provide for discretionary periodic payments, but a 'dividend stopper' applies if the discretionary payments are not made. The effect of the 'dividend stopper' is that no dividends can be paid to the issuer's ordinary shareholders if the discretionary payments are not made in full to the holders of the other interests. The consequences of not paying dividends to ordinary shareholders might be expected to include adverse consequences for the issuer's standing with those shareholders and a negative effect on its share price, as well as the general adverse consequences noted in paragraph 29 of this draft Ruling that an issuer of income securities might face if it did not make a discretionary payment.

34. As the dividend stopper is part of the terms and conditions of the scheme, there might be a question whether all the consequences that could follow if the dividend stopper were to apply are sufficient to negate the discretion in deciding whether there is an ENCO to make the periodic payments. That is, it could be argued that the dividend stopper economically compels the issuer to make the periodic payments, even though the payments are formally discretionary, and thus the issuer should be considered to have an ENCO to make the periodic payments.

35. The Commissioner does not accept this proposition. An adverse consequence that flows from the dividend stopper and that might be considered to be some form of economic compulsion is again external to the scheme. While the issuer may no doubt experience some practical or commercial detriments if it does not pay a discretionary return and the dividend stopper is activated, those detriments might be expected to follow only because of the reaction of parties that are external to the scheme. The holder of the interest cannot take action to compel the payment of the return under the scheme if the discretionary payment is not made. The practical or commercial detriment that an issuer might experience if a dividend stopper applies is the type of detriment that is contemplated by subsection 974-135(7).

36. In any event, practical or commercial detriments that are similar to those that would be expected if a dividend stopper were to apply might also be expected to accrue to an issuer of ordinary shares if discretionary periodic dividend payments were not made on those shares, particularly if the issuer has a history of sufficient profitability and making dividend payments. The EM makes it clear that '... returns which, for commercial reasons, are contingent on the availability of profits of an entity would generally not be counted in determining whether the debt test is satisfied, even if the possibility of not having profits is slight' (paragraph 2.197).

Interest rate step-ups

37. The terms of some financing arrangements provide that the rate of interest payable by an issuer after a specified future date will increase by a certain amount if the issuer has not redeemed the instrument on or before that date. These are often referred to as interest rate step-up provisions. The EM considers examples of these arrangements in paragraphs 2.146, 2.147, 2.175 and 2.195.⁵

38. The significance of assessing the pricing, terms and conditions of a scheme – at the time of issue and from the issuer's perspective – in their appropriate context was noted in paragraphs 20 and 21 of this draft Ruling.

39. The process of evaluating a 'step-up' condition (that is, to determine whether the amount of the step-up is so significant that it would be objectively concluded that the issuer has an ENCO to redeem to avoid the step-up) would be expected to include consideration of the following contemporaneous matters:

- The market rate of interest for the issuer at the time of issue for that financing arrangement, determined with reference to the issuer's credit rating at that time;
- The initial rate of interest specified in the terms and conditions of the financing arrangement and whether the initial rate approximates the market rate;
- The amount of the increase under the step-up provision relative to the issuer's expected circumstances at the time that the step-up could be activated;
- The expected credit rating of the issuer at the time the step-up would apply, and expected movements in market rates of interest for that credit rating between the time of issue and the time of the step-up and whether the step-up rate approximates any expected increase in market rates;
- The relevance of any regulatory benchmarks or standards that apply to the industry that the issuer participates in (see for example the discussion of APRA regulatory guidelines in paragraph 2.147 of the EM that is reproduced at paragraph 20 of this draft Ruling);
- The cost of the step-up compared to the expected costs of redeeming and any necessary refinancing.

40. The different circumstances of individual issuers might mean that an interest rate step-up of a particular amount would constitute relevant economic compulsion for one issuer, but not for another issuer in other circumstances.

⁵ See the discussion of these examples in paragraphs 20, 22 and 24 of this draft Ruling.

Conclusion

41. In considering whether adverse consequences which constitute 'economic compulsion' may give rise to an ENCO to take an action, regardless of the nature of the adverse consequences or how they arise, it is important to note that the objects of Division 974 do not require a broad or comprehensive weighing of all the economic consequences that might be borne if the issuer takes an action. Subsection 974-10(2) provides that the debt test is to operate on the basis of the economic substance of the rights and obligations arising under the scheme.

42. Consistent with this object, the debt test largely turns on whether, from the issuer's perspective, objectively determined as at the time of issue, the issuer has ENCOs to provide adequate financial benefits. By virtue of the definition of ENCO, it is necessary to find whether the issuer has in substance or effect a non-contingent obligation to take relevant actions: the non-contingent obligation is to be found by having regard to the pricing, terms and conditions of that scheme.

43. This enquiry is therefore not at large and is constrained by the provisions of the legislation. While the essential enquiry is a broader enquiry than the mere recognition of rights and obligations that appear as a matter of legal form under the terms and conditions of the arrangement (because their substance or effect is to be considered), the enquiry is not so broad as to permit the identification and weighting of all possible consequences that arise from taking an action.

44. An issuer may be economically compelled to take an action, and under an ENCO to take that action, where an effective obligation to take that action arises as a matter of substance or effect on having regard to the pricing, terms and conditions of the scheme.

45. Other matters which might be said to constitute some economic compulsion, but which are external to the scheme or are apparent on making some enquiry other than the required enquiry, will not be sufficient to give rise to effectively non-contingent obligations under the scheme.

Appendix 2 – Your comments

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

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

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

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

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Appendix 3 – Detailed contents list

48. The following is a detailed contents list for this Ruling:

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10; TD 2009/1

Subject references:

- debt equity borderline
- debt interest
- economic compulsion
- effectively non-contingent obligation

Legislative references:

- ITAA 1997
- ITAA 1997 Div 974
- ITAA 1997 974-5(1)
- ITAA 1997 974-15(1)
- ITAA 1997 974-10(1)
- ITAA 1997 974-10(2)
- ITAA 1997 Subdiv 974-B
- ITAA 1997 974-20(1)
- ITAA 1997 974-20(1)(c)
- ITAA 1997 974-35(4)
- ITAA 1997 974-40(2)
- ITAA 1997 974-135
- ITAA 1997 974-135(1)
- ITAA 1997 974-135(3)
- ITAA 1997 974-135(4)
- ITAA 1997 974-135(6)
- ITAA 1997 974-135(7)
- ITAA 1997 974-150

- ITAA 1997 995-1(1)
- New Business Tax System (Debt and Equity) Act 2001

Case references:

- Commissioner of Taxation v. South Australian Battery Makers Pty Ltd (1978) 140 CLR 645; 78 ATC 4412; (1978) 8 ATR 879
- Total Holdings (Aust) Pty Ltd v. Federal Commissioner of Taxation (1979) 43 FLR 217; 79 ATC 4279; (1979) 9 ATR 885
- Ure v. Federal Commissioner of Taxation (1981) 50 FLR 219; 81 ATC 4100; (1981) 11 ATR 484

Other references:

- Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001
- Supplementary Explanatory Memorandum and Correction to the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001

ATO references

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