TD 2007/D16 - Income tax: can section 177EA of the Income Tax Assessment Act 1936 apply to the issue of 'dollar value' convertible notes of the type described in this Taxation Determination?

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Draft Taxation Determination

Income tax: can section 177EA of the *Income Tax Assessment Act 1936* apply to the issue of 'dollar value' convertible notes of the type described in this Taxation Determination?

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Ruling

1. Yes.

2. This draft Determination deals with an issue of convertible notes that exhibits some of these features:

(a) until repayment of the face value of a note or upon conversion of a note into shares of the issuer (or a connected entity), the notes rank ahead of the issuer's ordinary or other shares but equally with other non-secured, unsubordinated debt of the issuer;

(b) the periodic return on a note is equivalent to an amount of interest (or an amount in the nature of, or similar to, interest), having regard to the way in which those returns are calculated;

(c) the periodic return is expressed as a recognised market rate (such as a bank bill swap rate) plus a margin;

(d) the holder may request that the issuer repay the face value of a note, although the issuer is under no obligation to do so;

(e) the issuer may substitute a note for ordinary debt;

(f) the arrangement remains on foot for a finite period, usually around 5 years;

(g) the notes are issued at or through a branch of the issuer in a jurisdiction that considers the notes to be debt instruments with the periodic payments deductible to the issuer on revenue account;

(h) non-payment of a coupon by the issuer entitles the holder to demand payment from the issuer of the outstanding principal amount and all outstanding interest and the issuer cannot satisfy this demand by issuing shares; and

(i) the notes are specifically targeted to investors who are able to fully utilise the franking credits that are attached to the interest payments on the notes, and the notes may be privately placed.

The notes will also exhibit all of the following features:

(j) the commercial effect of the note is that a holder has negligible exposure to the equity risk that is usually associated with holding shares. This is achieved through the inclusion of a type of 'dollar value' conversion term under which the issuer may exercise its right to convert the face value of a note into an unrestricted number of shares at a measure of the prevailing market price, rather than at a fixed price determined at the time of issuing the note;

(k) the issuer is expected to fully frank the periodic returns on the note; and

(l) the periodic return on the note is calculated by reference to the franking credit that is expected to be attached. If a return is not fully franked, the issuer must pay an additional cash amount to the holder calculated according to the extent to which the return is unfranked.

3. Section 177EA of the *Income Tax Assessment Act 1936* (ITAA 1936)[1] will only have potential application to a scheme for the issue of such a convertible note if:

(a) the convertible note is characterised as an equity interest under Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997);

(b) the periodic return on the note is a non-share dividend that is a frankable distribution under section 202-40 of the ITAA 1997; and

(c) the periodic return on the note is franked, or expected to be franked.

Date of effect

4. When the final Determination is issued, it is proposed to apply to income years commencing both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination.

Commissioner of Taxation
7 November 2007

[1] All subsequent legislative references are to the ITAA 1936 unless otherwise indicated.

Appendix 1 – Explanation

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.

Explanation

5. Section 177EA is a general anti-avoidance provision that applies to a wide range of schemes designed to obtain a tax advantage in relation to imputation benefits. It is designed to support the underlying principles of the imputation system, namely, that franking credits are available only to the true economic owners of the company and only to the extent that those owners are able to use those franking credits themselves.

6. The application of section 177EA depends upon a careful weighing of all the relevant facts and surrounding circumstances of each case. Therefore, in the absence of all relevant information it is not possible to state definitively whether a particular arrangement or transaction will attract section 177EA. However, dispositions of membership interests having similar economic and tax effects as those notes described in paragraph 2 of this draft Determination, are considered likely to attract the operation of section 177EA.

7. A scheme for the disposition of membership interests is defined broadly in subsection 177EA(14) and specifically includes issuing membership interests in a corporate tax entity. Section 177EA also applies to the issue of non-share equity interests in the same way as it applies to membership interests – refer to subsection 177EA(12).

8. While the convertible notes described in paragraph 2 of this draft Determination may serve the commercial purpose of raising funds for the use in the issuer's business at a low after-tax cost, the relevant question under section 177EA is whether any person who entered into or carried out the whole or part of the issue of the convertible notes did so for a purpose that was other than an incidental purpose of enabling the holders to obtain imputation benefits.

Purpose

9. The relevant purpose is the objective purpose to be predicated from the relevant circumstances of the scheme which include, but are not limited to, the circumstances set out in subsection 177EA(17). Those circumstances may individually or collectively indicate the requisite purpose. Due to the diverse nature of these circumstances some may not be present.

10. The relevant purpose of enabling the holder to obtain an imputation benefit need not be the dominant purpose – that is, it need not be the 'ruling, prevailing or most influential' purpose (see *Commissioner of Taxation (Cth) v. Spotless Services Ltd* (1996) 186 CLR 404 at 416; 96 ATC 5201 at 5206; (1996) 34 ATR 183 at 188) – but it must be more than an incidental purpose.

11. In this context, the following general observations can be made:

(a) the particular dollar value conversion term limits the opportunities for profit or gain, and the risks of loss. The ranking of the notes in the event of financial distress of the issuer is a further feature limiting the risk of loss. These combined features operate in such a way that the holders are exposed to negligible equity risk in relation to the notes. This absence of equity risk leads to the conclusion that the note holders *per se* are not the economic owners of the company;

(b) the non-share dividends (the 'interest' payments) are equivalent to the receipt of interest by the holder. The amount of the non-share dividend that must be paid is calculated by reference to the available imputation benefits;

(c) the investors targeted by the issuer in promoting the issue can be said to derive greater benefits from franking credits than other members of the company (where, for example, there are non-resident members);

(d) issuers of these convertible notes usually have a surplus of franking credits, having regard to their current franking requirements, and but for the issue of the notes and the payments of franked interest, it is likely that the franking credits would remain undistributed in the issuer's franking account; and

(e) the effect of franking such returns means that the issuer may be able to further reduce its cost of capital, over and above any reduction in the cost of capital that might, for example, arise from the availability of an income tax deduction in some foreign jurisdiction for the payments being classified as interest in that jurisdiction.

Risks of loss and opportunities for profit or gain (paragraph 177EA(17)(a))

12. Exposure to equity risk is a feature which accompanies the true economic ownership of an entity and hence, for the purposes of the integrity of the imputation system, is relevant in determining a taxpayer's entitlement to imputation benefits. Under the terms of the notes in these particular arrangements, holders are extremely limited in their exposure to equity risk.

Dollar value conversion

13. If the notes are converted, the issuer will issue shares (or facilitate the issue of shares in a connected entity) in accordance with a conversion formula which effectively applies the aggregate outstanding principal amount of the notes towards payment of the issuer's (or connected entity's) shares at a measure of their market value on the date of conversion, rather than at a fixed conversion ratio stated at the outset, and there is no limit on the maximum or minimum number of shares that can be provided. This conversion term is a form of a 'dollar value conversion'. However, the absence of any maximum and/or minimum number of shares that can be provided on conversion emphasises the lack of equity exposure that attends this particular type of 'dollar value' convertible note.

14. Accordingly, the holders of these convertible notes are not subject to any of the risks of loss, or opportunities for gain, that are usually associated with holding shares unless the notes are converted into shares.

15. The dollar value conversion term results in a negligible (at best) opportunity for a holder of the note to make any gain on the note that is attributable to share price movements. The holder of the note is thus largely indifferent to movements in the underlying ordinary share price of the issuer – whether or not the share price is performing well does not materially affect the value of the note. The extent of equity participation is very limited or non-existent.

16. This can be contrasted with convertible notes that exhibit equity characteristics through a fixed conversion ratio – that is, where each note may convert into a fixed number of shares – and other types of dollar value convertible notes where there are limits on the number of shares that can be issued on conversion.

Ranking

17. A further feature in some arrangements is that the notes rank ahead of the issuer's ordinary or other shares but equally with its other non-secured, unsubordinated debt. Further, payment by the issuer of the scheduled returns (interest) on the notes is not subject to the availability of profits as would generally be the case for equity instruments. In some cases, non-payment of a coupon by the issuer entitles the holder to demand payment from the issuer of the outstanding principal amount and all outstanding interest and the issuer cannot satisfy this demand by issuing shares.

18. The absence of risks of loss or opportunities for gain (equity risk) by the holders of such notes is highly indicative of a purpose of enabling the relevant taxpayers to obtain an imputation benefit.

Form and substance of the scheme (paragraph 177EA(17)(j) and subparagraph 177D(b)(ii))

19. Division 974 of the ITAA 1997 sets out a test for debt and equity interests that is intended to 'operate on the basis of the economic substance of the rights and obligations … rather than merely on the basis of the legal form …': refer to subsection 974-10(2) of the ITAA 1997. Division 974 has regard to specified matters to determine whether a scheme gives rise to an interest that is a debt interest or an equity interest. The Division thus approaches economic substance according to its own terms for particular purposes. An interest that is not a debt interest will be an equity interest if certain criteria are met. To be an equity interest, it will be sufficient that such an interest is in a form that might convert into an equity interest in the issuer (or connected entity of the issuer). The prevention of deductible returns on equity and frankable returns on debt are objectives of Division 974 – see the notes to subsection 974-10(2) of the ITAA 1997.

20. Where the legal form of the dollar value conversion term confers this equity characterisation on the convertible note under Division 974 of the ITAA 1997, it does not follow that the conversion term confers an equity risk. The interest held by holders of these notes does not represent true economic ownership in the issuer, an important touchstone for entitlement to franking credits under the imputation system. Section 177EA of the ITAA 1936 has a role to play in preventing the incidence of frankable debt.

21. From the note holder's perspective the convertibility feature does not provide any opportunities for gains in respect of the increase in the share price of the company as other types of convertible notes would. Objectively (imputation benefits aside), the convertibility feature is an insubstantial element of the note from the holder's perspective.

22. The notes are valued and treated as debt by the parties to the scheme. The holders have invested in an instrument with a debt-like profile and exposure. The features of the convertible notes that are inconsistent with an equity profile include:

- the return is calculated by reference to prevailing interest rates;
- the returns are not subject to profits and are cumulative;
- the holders rank *pari passu* with all other unsecured unsubordinated debt of the issuer (other than claims mandatorily preferred by law);
- the absence of equity-like exposures and risks. For example, upon redemption or conversion of the notes, holders will receive money or shares to the value of the amount subscribed (other than, perhaps, additional value that is attributable to a small conversion discount); and
- the holders may protect their investment upon an event of default by declaring principal and interest to be due and payable immediately. In some cases, the issuer may not be able to satisfy this obligation to 'pay' by converting the notes into ordinary shares.

23. Where the notes achieve equity characterisation under Division 974 of the ITAA 1997 notwithstanding an absence of equity risk, there is a discord between substance and form and this is indicative of a purpose of enabling the relevant taxpayer to obtain an imputation benefit.

Amount received by the holder is calculated by reference to the imputation benefit and is equivalent to the receipt of interest (paragraphs 177EA(17)(f) and (h))

24. These particular factors require examination of the arrangement to determine whether imputation benefits have been priced into any distribution on a share that is an equity interest, or non-share dividend on a non-share equity interest, and whether by its nature that distribution is equivalent to a payment of interest.

25. The convertible notes issued in these particular arrangements are debt for accounting and regulatory purposes, and the periodic returns are treated as interest, and perform the same relative function as interest. Although they are non-share dividends for certain tax purposes, they are calculated in the same manner as interest, being a function of time, principal outstanding and an objectively determined floating interest rate. The label 'interest' is often used by the parties in the terms of the notes to describe the return.

26. As the notes are equity interests for certain tax purposes this enables franking credits to be allocated to interest payments. As a consequence, the holder's return is funded in part by the allocation of franking credits to the coupon thereby reducing the issuer's servicing costs.

27. The return to be paid to holders is determined by reference to franking credits allocated to the interest payments. The amount of interest that accrues for a particular period is a function of the interest rate, the outstanding principal and the Australian company tax rate. Further, interest payments must be grossed up to the extent they are not fully franked. The grossed up amount of the interest payment will reflect a return based on a market interest rate. This circumstance indicates that the relevant purpose is present: see paragraph 177EA(17)(f).

Manner in which the convertible notes are issued (paragraph 177EA(17)(j) and subparagraph 177D(b)(i))

28. The manner in which the schemes are entered into or carried out depends on the facts of each particular case and the circumstances surrounding the issue of the notes.

29. In some of these arrangements the convertible notes may be privately placed and not listed. One investor may initially subscribe for the notes with the expectation to sell at least some, if not all, the notes to other wholesale investors. Although available to different kinds of potential investors, it is expected that most of the investors in the notes will be either Australian residents or non-residents carrying on business in Australia through a permanent establishment in Australia and therefore able to fully utilise the franking credits attached to the interest payments.

30. In addition to franking the payments for Australian tax purposes, where the notes are issued to Australian investors at or through a foreign branch, the issuer may be able to claim a deduction in that jurisdiction in respect of the interest payments.

31. Accordingly, where the arrangements are structured so that imputation benefits will be delivered through franked returns to targeted investors, or the notes are issued via specifically tailored off-market placements at or through the foreign branch, the manner of the arrangements indicates a purpose of enabling the relevant taxpayer to obtain an imputation benefit.

Changes in the financial position and other consequences - lowering the cost of capital (paragraph 177EA(17)(j) and subparagraphs 177D(b)(vi) and 177D(b)(vii))

32. From the issuer's perspective, franking credits allocated to interest payments facilitate the borrowing of funds at a net rate that is much lower than would otherwise be the case if franking was not possible. As such, the franking credits effectively subsidise the issuer's financing costs, reducing its cost of capital. Where those funds are used overseas, franking credits that represent Australian tax paid are used to subsidise the cost of operations in a foreign jurisdiction, the profits of which may not be subject to Australian tax.

Conclusion

33. Where section 177EA applies, the Commissioner is authorised to make a determination under subsection 177EA(5) that a franking debit will arise in the franking account of the issuer in respect of each interest payment made under the notes or, alternatively, deny the imputation benefits to the note holders.

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.

Alternative views

34. An alternative view is that section 177EA does not apply to the issue of convertible notes of the type described in this draft Determination because the Commissioner has not taken sufficient account of the following matters:

(a) the issuer is provided with a source of contingent capital. As a result of the issue, debt may be converted into ordinary share capital without the need to make a public offer of shares or prepare a prospectus. The issuer is able to raise funds from investors it might not otherwise attract;

(b) the parties to the arrangements are usually dealing with each other at arm's length and the transaction occurs at fair value; and

(c) holders are indifferent to the degree of franking because interest payable will be grossed up to the extent that those interest payments are not fully franked.

35. The Commissioner does not accept that these matters warrant a different conclusion being reached in respect of purpose. The conclusion about purpose requires a careful weighing of all the relevant circumstances, and it might be expected that not all relevant circumstances will support a finding of the relevant purpose.

36. Another alternative view is that section 177EA of the ITAA 1936 has no role to play in relation to an instrument that is properly classified as an equity interest under Division 974 of the ITAA 1997. The corollary to this argument is that section 177EA of the ITAA 1936 can only apply to franking credit trading schemes and dividend streaming arrangements; it does not apply to questions of characterisation.

37. The Commissioner does not accept that section 177EA of the ITAA 1936 is limited in this way. Section 177EA of the ITAA 1936 applies on its own terms to counter schemes that seek to bring about results that are inconsistent with the principles underlying the imputation system. A particular characterisation under Division 974 of the ITAA 1997 applies only for certain tax purposes and adopts an analysis from the perspective of the impact on the issuer's position: see subsection 974-5(1) of the ITAA 1997. This does not foreclose any further enquiry as to whether the consequences of that characterisation attract the operation of Part IVA of the ITAA 1936. Part IVA of the ITAA 1936 necessarily involves a consideration of a broader range of circumstances and matters.

Appendix 3 – Your comments

38. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date. (Note: the Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel or relevant Tax officers. The Tax Office may use a version (names and identifying information removed) of the compendium in providing responses to persons providing comments. Please advise if you do not want your comments included in the latter version of the compendium.)

Due date:	**7 December 2007**
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References

Previous draft:

Not previously issued as a draft

Subject references:

- convertible interest
- equity interest

Legislative references:

- ITAA 1936 Pt IVA
- ITAA 1936 177D(b)(i)
- ITAA 1936 177D(b)(ii)
- ITAA 1936 177D(b)(vi)
- ITAA 1936 177D(b)(vii)
- ITAA 1936 177EA
- ITAA 1936 177EA(5)
- ITAA 1936 177EA(12)
- ITAA 1936 177EA(14)
- ITAA 1936 177EA(17)
- ITAA 1936 177EA(17)(a)
- ITAA 1936 177EA(17)(f)
- ITAA 1936 177EA(17)(h)
- ITAA 1936 177EA(17)(j)
- ITAA 1997 202-40
- ITAA 1997 Div 974
- ITAA 1997 974-10(2)
- ITAA 1997 974-5(1)

Case references:

- Commissioner of Taxation (Cth) v. Spotless Services Ltd (1996) 186 CLR 404; 96 ATC 5201; (1996) 34 ATR 183

ATO references

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