TD 2009/D2 - 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?

Draft Taxation Determination

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*?

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.

You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the following way. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

Ruling

1. A non-share equity interest will be taken to have been 'issued at or through a permanent establishment' for the purposes of paragraph 215-10(1)(c) of the *Income Tax Assessment Act 1997* (ITAA 1997)[1] when:

- the non-share equity interest is offered to investors, by a foreign branch of an authorised deposit-taking institution (ADI) in a listed country; and
- the non-share equity interest is allocated to the investor by the foreign branch; and
- the transaction documents are executed at the foreign branch; and
- the transaction documents provide that the non-share equity interest is transferred to the investor at the permanent establishment; and
- at the time of transfer, the foreign branch relinquishes all control over the non-share equity interest.

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

Example 1

2. ABC Bank is an ADI in Australia with a branch located in New York[2]. ABC Bank's New York Branch needs to raise capital for use in the New York Branch's business in the United States of America (US). The New York Branch requests approval from ABC Bank for the Branch to issue innovative Tier 1 convertible notes. The New York Branch intends to market and sell the notes to US retail investors through a local investment firm. ABC Bank gives its New York Branch the approval. The transaction documents, including the offer document for the notes, are drafted at the New York Branch. Upon acceptance of the offer by the US investors, the notes are allocated to the subscribers. The New York Branch then transfers the notes to the US investors.

3. The convertible notes will be classified as non-share equity interests for the purposes of Division 974 and returns paid in respect of the convertible notes will be taken to be non-share dividends.

4. The convertible notes are taken to be issued at or through the New York Branch because that is the place where the investors acquire control over the notes issued. Furthermore, the New York Branch has taken all the necessary steps for issuing the notes, including the final step whereby the notes are transferred to the investors. Accordingly, paragraph 215-10(1)(c) is satisfied.

5. Assuming that all of the other conditions in section 215-10 are met, the returns paid in respect of the convertible notes will be unfrankable.

Example 2

6. XYZ Bank is an ADI in Australia with a branch in New Zealand[3]. XYZ Bank would like to issue a hybrid instrument to raise Non-innovative Residual Tier 1 Capital under the prudential standards of the Australian Prudential Regulation Authority. It decides it will do this by issuing a stapled security in one of two ways.

7. Under proposal 1, XYZ Bank will issue a stapled security of the type described in paragraph 2 of Taxation Determination TD 2009/14 using LMN Investment Bank, a non-resident, as its intermediary. The stapled security will consist of a fully paid preference share in the ADI and a fully paid note from the New Zealand Branch. The transaction documents which create the note will be executed at the New Zealand Branch and the notes will be acquired by LMN Investment Bank. LMN Investment Bank will also acquire the preference shares from XYZ Bank and will staple each note to a preference share. The stapled securities will then be offered to investors by LMN Investment Bank, on behalf of the XYZ Bank. XYZ Bank has stipulated that the stapled securities be sold to a mix of Australian and New Zealand retail investors. XYZ Bank will allocate the stapled securities once the offer period has closed.

[2] The United States of America is a listed country for the purposes of section 215-10 of the ITAA 1997. '(L)isted country' means a foreign country, or a part of a foreign country, that is declared by the regulations to be a listed country for the purposes of Part X of the *Income Tax Assessment Act 1936* (ITAA 1936): see section 320 of the ITAA 1936 and subsection 995-1(1) of the ITAA 1997. At the time this Determination is published, the Income Tax Regulations 1936 provide that Canada, France, Germany, Japan, New Zealand, United States of America, United Kingdom of Great Britain and Northern Ireland are listed countries for the purposes of Part X of the ITAA 1936.

[3] New Zealand is a listed country for the purposes of section 215-10.

8. The stapled security, as a whole, is classified as a non-share equity interest for the purposes of Division 974 and returns paid on the stapled security will be taken as non-share dividends. Section 215-10 will not apply to treat the non-share dividends as unfrankable because paragraph 215-10(1)(c) will never be satisfied. Although the transaction documents creating the notes are executed at the New Zealand Branch, this is insufficient for a conclusion that the non-share equity interests are issued at or through the New Zealand Branch. It cannot be said that the non-share equity interest, which includes the preference share, was issued at or through the foreign branch.

9. Additionally, when the notes are transferred to LMN Investment Bank, XYZ Bank will retain control over the notes. In fact, XYZ Bank will retain control over the stapled securities right up until they are allocated and transferred to the retail investors. Accordingly, it is XYZ Bank that issues the non-share equity interests to the retail investors.

10. Under proposal 2, XYZ Bank will issue a stapled security that is similar to that under proposal 1 but the preference share will remain unpaid until the note is extinguished. The note and the preference share will be classified as two separate equity interests under Division 974, with the note being treated as a non-share equity interest. Returns in respect of the notes will be taken to be non-share dividends.

11. Once again section 215-10 will not apply to treat the non-share dividends as unfrankable because paragraph 215-10(1)(c) will not be satisfied. As with proposal 1, although the transaction documents creating the notes are executed at the New Zealand Branch, this is insufficient for a conclusion that the notes are issued at or through the New Zealand Branch. As with proposal 1, when the notes are transferred to LMN Investment Bank, XYZ Bank will retain control over the notes. In fact, XYZ Bank will retain control over the notes right up until they are allocated and transferred to the retail investors. Accordingly, it is XYZ Bank that issues the non-share equity interests to the retail investors.

Date of effect

12. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination 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 Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
1 July 2009

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

13. Generally, under the imputation system, distributions made by an Australian resident company out of realised profits, regardless of the source of those profits, are frankable. Exceptions to the general rule are expressly provided for in the tax law: section 215-10 is one such exception.

14. Section 215-10 permits certain non-share dividends paid by an ADI to be unfrankable provided certain conditions are satisfied. Subsection 215-10(1) provides:

> A *non-share dividend paid by an ADI (an authorised deposit-taking institution) for the purposes of the *Banking Act 1959* is ***unfrankable*** if:
>
> (a) the ADI is an Australian resident; and
>
> (b) the non-share dividend is paid in respect of a *non-share equity interest that:
>
> (i) by itself; or
>
> (ii) in combination with one or more *schemes that are *related schemes to the scheme under which the interest arises;
>
> forms part of the ADI's Tier 1 capital either on a solo or consolidated basis (within the meaning of the prudential standards); and
>
> (c) the non-share equity interest is issued at or through a permanent establishment of the ADI in a *listed country; and
>
> (d) 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.

15. Section 215-10 was enacted in 2002 (originally inserted as section 160APAAAA of the ITAA 1936), as a consequence of the introduction of the debt/equity rules in Division 974 which would have resulted in certain legal form debt instruments being characterised as equity interests for income tax purposes, and distributions paid in respect of those instruments being frankable.

16. The broad policy intent of section 215-10 was to '*remove a competitive disadvantage that Australian ADIs would otherwise suffer from the introduction of the new debt and equity rules*': see paragraph 2.92 of the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 (the Explanatory Memorandum). Paragraphs 2.93 and 2.94 of the Explanatory Memorandum elaborate on the policy intent.

> 2.93 Australian ADIs are subject to APRA regulations under which there are advantages for the ADI to raise Tier 1 capital through branch structures rather than through foreign subsidiaries. At present, foreign branches and subsidiaries of Australian ADIs compete, broadly, on an equal footing with foreign independent entities which raise capital overseas by the issue of hybrid instruments. These instruments form part of the Tier 1 capital of the Australian ADI under APRA prudential standards. The new debt/equity rules will result in some hybrid instruments which are currently treated as debt interests for income tax purposes being recharacterised as non-share equity interests (eligible hybrids). A consequence is that an Australian ADI (i.e. the entity legally liable in the head office/branch structure) would need to frank the returns on these instruments (i.e. non-share dividends).

> This is an inherent additional cost of raising capital overseas which would not be incurred if the Australian ADI issued eligible hybrids through a foreign subsidiary and is a cost which may not be incurred by a foreign independent entity raising capital in the same way.
>
> 2.94 This measure prevents the disadvantage from arising by treating the returns on the eligible hybrids as unfrankable dividends of the ADI. Aligning the taxation treatment of foreign branches with that of foreign subsidiaries of the ADI and foreign independent entities in relation to the issue of eligible hybrids will assist Australian ADIs to grow their businesses conducted through foreign branches.

17. The purpose of section 215-10 is best understood when considered in the context of the Australian imputation system. Classical company tax systems affect the cost of capital for moneys raised in the form of equity to the extent that they impose an additional layer of taxation on profits earned by that capital. A decrease in the after-tax return on an equity investment attracts demand by investors for a higher pre-tax return, thus increasing the cost of capital. The Australian imputation system is directed at removing double taxation for Australian resident investors in respect of income that is taxed in Australia; and hence puts them in the same position as resident recipients of Australian sourced interest. Franking does not have an equivalent effect for foreign residents, where it will often only relieve an interest withholding tax liability (which may in any event have resulted in a foreign tax credit in the foreign jurisdiction, thus leaving the overall tax burden unaffected). Requiring the franking of returns for non-residents receiving income from non-share equity issued offshore results in wasting franking credits, thus effectively increasing the issuer's cost of capital (compared with issuing non-frankable instruments to the same non-residents).

18. 'Wastage' is usually an intended feature of the system, at any rate for inward foreign equity investment, because it represents the intended Australian source tax on profits attributable to that investment. Dividend streaming rules are enacted to prevent the avoidance of intended wastage by the selective targeting of resident and non-resident equity investors.

19. The purpose of section 215-10 is to prevent unintended wastage for *non-resident investors* making an equity investment *in a foreign jurisdiction*. Outward equity investment is generally outside the imputation system, the result of confining franking accounts to resident companies. A foreign investor in a non-resident company earning profits not sourced in Australia generally has no Australian tax exposure, and the company therefore faces no cost of capital consequences for that equity from the Australian imputation system. However, a resident company with an offshore branch earning foreign source income that has non-resident investors faces the possibility that a distribution to investors will have to be franked, resulting in the wastage of franking credits. This problem arises regardless of the form of the equity[4], but in the case of *non-share* equity competitive neutrality is involved. Non-share equity (that is, legal form debt) will usually be deductible in most foreign jurisdictions. Moreover, most other countries now operate some form of modified classical company taxation, which has the effect of making investors indifferent to whether the company invests on-shore or off-shore.

[4] While it might seem desirable in principle for foreign source income to be distributable from Australian companies to foreign residents without wastage of franking credits, there is a practical problem of identifying the income as foreign source and not inadvertently permitting dividend streaming. Conduit rules attempt to address these problems.

20. When non-share equity capital is raised and used in a foreign jurisdiction it will attract local tax consequences, that is, normally a deduction for the cost of the capital in the foreign jurisdiction, and in the case of branches of foreign companies operating there, usually also exemption or a tax credit in the home jurisdiction for income *net of the deduction*. If, in addition, but only for Australian resident companies, it also attracts an adverse franking consequence in Australia, that consequence will of course increase the cost of capital for Australian companies compared with other companies operating in the same jurisdiction, putting Australian companies at a competitive disadvantage. For ADIs the cost of capital may be crucial for commercial success and this disadvantage correspondingly significant. Section 215-10 is intended to put a foreign branch of a resident ADI in the same position for the issue of the same instrument by other banks operating in that jurisdiction. Therefore, the section 'turns off' the Australian company tax imputation rules so that the advantages and disadvantages of the local company tax rules should apply equally to all.

21. When regard is had to what is said in the Explanatory Memorandum, as well as to how section 215-10 operates as an exception to the general operation of the imputation system, it is clear that section 215-10 is intended to ensure that ADIs do not incur the additional cost of franking returns in respect of capital that is both raised and used offshore: see paragraph 2.93 of the Explanatory Memorandum. The reference to 'raising capital overseas' in the Explanatory Memorandum is consistent with the requirement that the relevant equity interest be 'issued at or through a permanent establishment' of the ADI. Then, paragraph 215-10(1)(d) ensures that the concession only applies when the capital is used offshore. Accordingly, section 215-10 puts a foreign branch in the same position with respect to their cost of capital to that of a foreign resident company.

The meaning of 'issued at or through a permanent establishment'

22. Having regard to the meaning of 'at or through a permanent establishment' in the context of whether a business is being carried on at a permanent establishment, section 215-10 will only apply when the non-share equity interest is issued at the place where the ADI conducts its business in the listed country.

23. The phrase 'issued at or through a permanent establishment' is similar to the phrase 'carrying on business at or through a permanent establishment'. The latter phrase is used in other areas of the income tax law (as well as double tax agreements) and has been the subject of some judicial consideration. It has been held that for a person to be carrying on business at or through a permanent establishment in a country, a person must either have a fixed place where it carries out its business within the country or, alternatively, it must have an agent within the country with the general authority to bind the entity to contracts, and that agent must habitually exercise its general authority to negotiate and conclude contracts on behalf of the person. See *National Commercial Bank v. Wimborne* (1979) 11 NSWLR 156. The mere existence of a general authority to conclude contracts is not sufficient to constitute carrying on business at or through a permanent establishment. There must also be a habitual exercise of that authority. See *Unisys Corporation Inc v. FC of T* [2002] NSWSC 1115 2002 ATC 5146; (2002) 51 ATR 386.

24. While the term 'issued' is not defined for the purposes of paragraph 215-10(1)(c), its meaning in relation to shares and debentures has been considered by the courts on a number of occasions. The High Court considered the meaning of the term 'issue' in relation to when shares could be taken to be issued in *Central Piggery Co Ltd v. McNicoll and Hurst* (1949) 78 CLR 594. Latham CJ observed in his decision that:

> The issue of the shares is the act which ends the transaction and ends in the issue of the shares to a specific person...

25. Rich J came to a similar conclusion. His Honour stated that:

> 'The word 'issue' is one which has not any very definite legal import with reference to shares,' (*Spitzel v. The Chinese Corporation Ltd*). In the instant case the phrase to be construed is 'proceed to the issue,' a phrase which predicates a course of action ending in the issue. Shares are turned from nominal into effective capital upon being issued….It is not the first step which counts but the final step.'

26. Dixon J also made a similar finding when he observed, at pages 599 – 600, that:

> …. Speaking generally the word 'issue' used in relation to shares means, where an allotment has taken place that the shareholder is put in control of the shares allotted. A step amounts to issuing shares if it involves the investing of the shareholder with complete control over the shares. *Re Ambrose Lake Tin and Copper Co* (*Clarke's Case*) makes that quite clear. Cockburn L.C.J. said 'inasmuch as the term 'issue' is used, it must be taken as meaning something distinct from allotment, and as importing that some subsequent act has been done whereby the title of the allottee becomes complete, either by the holder of the shares receiving some certificate, or being placed on the register of shareholders, or by some other step by which the title derived from the allotment may be made entire and complete.

27. These observations when read together support the view that shares are issued when the final step, or final series of steps are taken, which invest the shareholder with complete control over the shares. See also *Re Buckley Earthmoving Pty Ltd (in liq)* (1995) 15 ACSR 732, citing *Central Piggery Co Ltd v. McNicoll and Hurst* (1949) 78 CLR 594 as well as *National Westminster Bank plc v. Inland Revenue Commissioners* [1994] 3 All ER 1.

28. In an earlier case, *Grenfell v. The Commissioners of Inland Revenue* (1875-76) LR 1 Ex D 242, the English Divisional Court had to answer a slightly different question. Rather than determine when a security was issued, the court had to consider where a security had been issued. That is, the court had to decide whether certain bonds had been issued in the United Kingdom and thus taxable in the UK, or issued in New York. The court held that the bonds were issued in New York because that was the place where the issuing company parted with possession and control over the bonds. Kelly J. observed, at page 247, that:

> [T]he company is an American company, having its place of business in New York, and there the shares were offered to the public. Some of the bonds were taken up by the public, and then the company entered into negotiations with Messrs. Morton, Bliss & Co., for the purchase by them of the remainder. Carrying out these negotiations, the company sold the bonds, and parted with their interest in them and control over them.

29. Pollock J. made a similar observation when he said, at page 249, that:

> If I understand the word 'issue', not giving to it any technical meaning, the issue of a bond is its first creation by the company, who give thereby a right of action in favour of some person to whom the bond is given. In the present case that was done, and done completely, in New York; because, although no bond was actually handed over in the first instance, a binding contract took place, whereby Messrs. Morton, Bliss & Co. were entitled, on the one hand, to call upon the company to transfer and issue to them a number of the bonds, and, on the other hand, they incurred the correlative obligation of taking and accepting the whole of the liability upon them.

30. Having regard to these cases, it is concluded that a non-share equity interest will be issued at, or through, a permanent establishment for the purposes of section 215-10 when:

- the non-share equity interest is offered to investors, by the foreign branch of an ADI in a listed country;
- the non-share equity interest is allocated to the investor by the foreign branch;
- the transaction documents are executed at the foreign branch;
- the transaction documents provide that the non-share equity interest is transferred to the investor at the permanent establishment; and
- at the time of transfer, the foreign branch relinquishes all control of the non-share equity interest.

31. It is not enough just for the transaction documents which create the non-share equity interests to be prepared and executed at the place where the foreign branch conducts business. It must also be the case that the steps necessary to complete the process of transferring the non-share equity interests to the investor such that the ADI has 'parted with their interest and control' over the interests are done at the foreign branch.

32. Paragraph 215-10(1)(c) is satisfied when the transaction documents for creating the non-share equity interests are executed at the foreign branch, and the marketing and allocation of the non-share equity interests is undertaken at the foreign branch such that the investor is placed in possession and control of the instrument by the foreign branch.

33. The answer is no different when a non-share equity interest is transferred to an intermediary and stapled to an equity interest. The non-share equity interests are not issued until the point in time when they are transferred to the investors by an intermediary. Where the foreign branch has issued the non-share equity interests and satisfies all of the conditions in paragraph 30 of this draft Determination, the capital has been raised offshore. It will generally be the case that the non-share equity interests will have been acquired predominantly by non-resident investors.

34. When the ADI, or an intermediary on their behalf, has marketed non-share equity interests to Australian residents, it is unlikely that paragraph 215-10(1)(c) will be satisfied as the ADI will not have relinquished all control of the non-share equity interests up until the time of the transfer. When an ADI intends to offer a non-share equity interest to Australian resident investors, it is the usual practice for the documents which create the non-share equity interests to be executed at the place where the foreign branch conducts business, but the ADI retains control over the newly created non-share equity interests of the transfer. Control is generally retained until the non-share equity interests are transferred to the ultimate investors. In retaining control the ADI usually dictates that the interests be transferred to particular intermediaries, who in turn sell the interests to the ultimate investors after the ADI, or the intermediary on their behalf, has marketed the interests and decided to whom the interests should be sold. Where this is the case, the non-share equity interests are not issued at, or through, the permanent establishment. They are not issued until they are transferred to the Australian investors, and they are issued in Australia by the ADI or an intermediary on the ADI's behalf.

Appendix 2 – Your comments

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

36. 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:

(a) provide responses to persons providing comments; and

(b) 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.

Due date: **31 July 2009**

Contact officer: **Usha Narain**

Email address: **usha.narain@ato.gov.au**

Telephone: **(02) 6216 2355**

Facsimile: **(02) 6216 1247**

Address: **PO Box 9977**
Civic Square ACT 2608

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10; TD 2009/14

Subject references:

- debentures
- imputation system
- listed countries
- non-share equity interest
- permanent establishment
- preference shares
- securities

Legislative references:

- ITAA 1936 160APAAAA
- ITAA 1936 320
- ITAA 1936 Pt X
- ITAA 1997
- ITAA 1997 215-10
- ITAA 1997 215-10(1)
- ITAA 1997 215-10(1)(c)
- ITAA 1997 215-10(1)(d)
- ITAA 1997 Div 974
- ITAA 1997 995-1(1)
- Banking Act 1959
- Income Tax Regulations 1936

Case references:

- Central Piggery Co Ltd v. McNicoll and Hurst (1949) 78 CLR 594
- Grenfell v. The Commissioners of Inland Revenue (1875-76) LR 1 Ex D 242
- National Commercial Bank v. Wimborne (1979) 11 NSWLR 156
- National Westminster Bank plc v. Inland Revenue Commissioners [1994] 3 All ER 1
- Re Buckley Earthmoving Pty Ltd (in liq) (1995) 15 ACSR 732
- Unisys Corporation Inc v. FC of T [2002] NSWSC 1115 2002 ATC 5146; (2002) 51 ATR 386

Other references:

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

ATO references

NO:	2009/4996
ISSN:	1038-8982
ATOlaw topic:	Income Tax ~~ Entity specific matters ~~ companies Income Tax ~~ Entity specific matters ~~ franking of dividends - company matters Income Tax ~~ Tax integrity measures ~~ debt and equity interests