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Taxation Determination

Income tax: is a taxpayer entitled to an income tax deduction under subsection 70B(2) of the *Income Tax Assessment Act 1936* where a Stapled Security of the kind described in Taxpayer Alert TA 2008/1 is sold at a loss or upon the occurrence of an Assignment Event?

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Ruling

1. No. A taxpayer is not entitled to an income tax deduction under subsection 70B(2) of the *Income Tax Assessment Act 1936* (ITAA 1936)¹ upon the sale of the Stapled Security at a loss, or upon the occurrence of an Assignment Event.

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

2. Taxpayer Alert TA 2008/1 (the Alert) was issued on 14 January 2008. It described a stapled security arrangement (the Stapled Security arrangement) with some or all of the following features:

- An Australian resident public entity (the Company) issues Notes² from one of its overseas branches or subsidiaries to an Initial Purchaser(s) for a fixed amount. This amount is generally not repayable once the Note is stapled (see below) to the Preference Share.³
- At the same time, the Initial Purchaser(s) makes an irrevocable offer to assign the Notes back to the Company (or one of its subsidiaries) for nil consideration upon certain events occurring, called 'Assignment Events'. These may occur in a number of specified circumstances, including at the election of the Company.
- Also at the same time, the Company issues Preference Shares to the Initial Purchaser(s) at a fully paid face value, said to be in consideration for the offer to assign the Notes. (It is thought that this extinguishes any indebtedness if a debt was created on issue of the Note.) The Note and the Preference Share have the same face value and no further money is paid for the Preference Share.
- In some cases, the steps listed above may differ. An overseas resident subsidiary of the Company issues the Notes to the Initial Purchaser(s) for a fixed amount. Immediately after the issue of the Notes to the Initial Purchaser(s), the Initial Purchaser(s) makes an irrevocable offer to assign the Notes to an Australian resident subsidiary of the Company (Aus Sub) for nil consideration upon certain events occurring, the so-called Assignment Events. Alternatively, in some cases, the Company pays money to the Initial Purchaser(s) for making the irrevocable offer in relation to the Notes; the Initial Purchaser(s) uses the money to subscribe for the Preference Shares.
- The Preference Shares are stapled to the Notes one-for-one, and the Stapled Securities will remain stapled until the occurrence of an Assignment Event.
- The Initial Purchaser(s) on-sells the Stapled Securities to individuals, companies and superannuation funds (the Investors) who only pay a single amount for the Preference Share and the corresponding Note, yet both the Preference Share and the corresponding Note are treated as fully paid. For example, the Stapled Security is purchased by the Investor for \$500, even though the Stapled Security consists of a Note and a Preference Share, each with a face value of \$500.
- The Investors are bound by the same terms as the Initial Purchaser(s). The irrevocable offer of assignment is embedded in the Note Terms.

² Any reference to Notes in this Determination includes a reference to any other type of instrument that has the same features of the Note that is described in this Determination.

³ Any reference to Preference Shares in this Determination includes a reference to any other type of instrument that has the same features of the Preference Share that is described in this Determination.

- While the Notes and the Preference Shares remain stapled, a distribution is payable on the Notes, and the Preference Shares carry no dividend entitlement. The amount of the distribution on the Notes and the Preference Shares will be determined on the same basis. That is, the distribution payable on the Note is equivalent to the amount of the dividend that would have been payable on the Preference Share had the Preference Share not formed part of the Stapled Security. Furthermore, the distribution payable on the Note is at the discretion of the Company, subject to there being distributable profits and subject to certain solvency requirements.
- When an Assignment Event occurs, dividends become payable on the Preference Shares on the same terms as the amounts of income paid on the Notes. Alternatively, the Preference Shares are converted into Ordinary Shares in the Company.

3. The Alert indicated that the Tax Office was examining arrangements that may have some or all of these features. The Commissioner has now carefully considered the arrangements, and has concluded that the Stapled Security in these type of arrangements is a single instrument for the purposes of sections 26BB and 70B. Furthermore, neither the Note, nor the Stapled Security as a whole, is a traditional security for the purposes of section 70B.

4. Accordingly, for taxpayers who do not acquire and sell the Stapled Securities in the ordinary course of business, a profit from the disposal of the Stapled Security by way of a sale gives rise to a capital gain, rather than being assessable as statutory income under section 26BB of the ITAA 1936. Likewise, a loss from the sale of the Stapled Security is a capital loss that can reduce capital gains of the taxpayer, rather than a loss on revenue account under section 70B of the ITAA 1936. However, a taxpayer who acquires and sells Stapled Securities in the ordinary course of business will be entitled to a deduction for a loss incurred on the sale of the Stapled Security under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997). Likewise, if a profit is made from the sale of the Stapled Security in the ordinary course of business, it will be assessable income under section 6-5 of the ITAA 1997.

5. A taxpayer will not derive any gain or incur any loss upon the occurrence of an Assignment Event as there is no disposal of the Stapled Security at that time.

Part IVA

6. In the Commissioner's view, a taxpayer is not entitled to a deduction under section 70B. Therefore this aspect of the arrangement will not give rise to a tax benefit within the meaning of section 177C. However, if a taxpayer was entitled to a deduction under section 70B, the Commissioner may consider whether Part IVA applies to cancel the deduction. If the Commissioner concluded, based upon the facts of the particular Stapled Security arrangement, that there was a scheme entered into for the sole or dominant purpose of obtaining a tax benefit (being the allowable deduction under section 70B), the Commissioner may determine that Part IVA applies.

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Date of effect

7. This Determination applies to years of income commencing both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

1 July 2009

Appendix 1 – Explanation

① *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

Explanation

Stapled Security is a single instrument

8. The Commissioner has concluded that the Stapled Security, as a whole, is a single instrument. It is akin to a preference share with some additional rights. In reaching the conclusion that the Investors acquired a single instrument, the Commissioner has had regard to the legal form, purpose, effect, interdependency of rights and obligations, and other key features of both the Stapled Security as a whole and its individual components. The particular features of the arrangement which in the Commissioner's view support the conclusion that the Stapled Security is one instrument are as follows:

- Under the Stapled Security arrangement, a Company offers to issue Stapled Securities to Investors. The offer is made in a Prospectus. Investors, in subscribing for the Stapled Securities, accept the offer made by the Company on the terms set out in the Prospectus. Accordingly, the Investor purchases the Stapled Securities under a single contract (the Stapled Security Contract). The terms of the Stapled Security Contract are set out in the Prospectus which in turn refers to terms in the Deed Poll, the Note Terms, the Preference Share Terms and other document(s) containing the rights and obligations of the Investors in respect of the Stapled Securities.
- The Note and the Preference Share are stapled prior to being sold to Investors. Once the Note has been stapled to the Preference Share, the Note will not exist separately from the Preference Share. It remains part of the Stapled Security until the occurrence of an Assignment Event, whereupon the Note is assigned back to the Company⁴ and will cease to exist.
- The terms of the Note do not permit the Investors to receive the face value of the Note after the Note has been stapled to the Preference Share.
- The irrevocable offer by the Initial Purchaser(s) to assign the Note is a term of the Stapled Security Contract, as the Investors are bound by the same terms as the Initial Purchaser(s).
- The Initial Purchaser(s) on-sells the Stapled Securities to individuals, companies and superannuation funds (the Investors) who only pay a single amount for the Preference Share and the corresponding Note, yet both the Preference Share and the corresponding Note are treated as fully paid. For example, the Stapled Security is purchased by the Investor for \$500, even though the Stapled Security consists of a Note and a Preference Share, each with a face value of \$500. This is contrasted with other types of stapled securities where the Investor pays the face value of the Note and the Preference Share is treated as unpaid until an Assignment Event occurs and the Note is extinguished.

⁴ Or a subsidiary.

- Distributions paid on the Note are payable on the same basis as dividends payable on the Preference Share. Only one income stream is payable at a time, and the distribution payable when the Note is stapled to the Preference Share is equivalent to the dividend payable when the Note is no longer stapled to the Preference Share. The income streams succeed each other precisely.

The Stapled Security is not a Traditional Security

9. Section 70B, subject to certain exclusions, allows a taxpayer a deduction for any loss on the disposal or redemption of a traditional security in the income year in which the disposal or redemption takes place.

10. 'Traditional security' is defined in subsection 26BB(1). A traditional security is:

a security held by a taxpayer that:

- (a) is or was acquired by the taxpayer after 10 May 1989;
- (b) either:
 - (i) does not have an eligible return; or
 - (ii) has an eligible return, where:
 - (A) the precise amount of the eligible return is able to be ascertained at the time of issue of the security; and
 - (B) that amount is not greater than 1.5 % of the amount calculated in accordance with the formula:

$$\text{Payments} \times \text{Term}$$
 where:

Payments is the amount of the payment or of the sum of the payments (excluding any periodic interest) liable to be made under the security when held by any person; and

Term is the number (including any fraction) of years in the term of the security;
- (c) is not a prescribed security within the meaning of section 26C; and
- (d) is not trading stock of the taxpayer.

11. 'Security' is defined in subsection 159GP(1) to mean:

- (a) stock, a bond, debenture, certificate of entitlement, bill of exchange, promissory note or other security;
- (b) a deposit with a bank or other financial institution;
- (c) a secured or unsecured loan; or
- (d) any other contract, whether or not in writing, under which a person is liable to pay an amount or amounts, whether or not the liability is secured.

12. The Commissioner is of the view that the Stapled Security is not a traditional security for the purposes of section 70B because the Stapled Security does not satisfy the definition of 'security' in subsection 159GP(1).

13. The definition of 'security' in subsection 159GP(1) covers any instrument which would normally be taken to be a security: see paragraph (a) of the definition. It also encompasses some other liabilities which would not normally be characterised as a security: see paragraphs (b), (c) and (d) of the definition.

14. According to its ordinary meaning, a security is a debt or claim the payment of which is in some way secured: see *Singer v. Williams* [1920] All ER Rep Ext 819 per Lord Cave at 822. The Commissioner considers the phrase 'or other security' at the end of paragraph (a) of the definition of 'security' in subsection 159GP(1), when taken in context, only encompasses instruments that evidence an obligation on the part of the issuer or drawer to pay an amount to the holder or acceptor, whether during the term of the instrument or at its maturity. Again, these types of securities will generally be debt instruments.⁵

15. The Stapled Security is not covered by paragraph (a) of the definition of 'security' in subsection 159GP(1) because it is not a debt instrument. No debtor/creditor relationship is created between the Company and an Investor by the issue of the Stapled Security. The Investor is only entitled to payments from the Company under the Note Terms or the Preference Share Terms if the Company has sufficient distributable profits. The Investor is not entitled to a return of the face value of the Note. The Stapled Security is more properly characterised as an instrument that is akin to a convertible preference share. What is acquired by an Investor is a Preference Share, that is, issued share capital of the Company, and an additional right to receive payments under the Note Terms, subject to there being sufficient profits.

16. The only other paragraph in the definition of 'security' in subsection 159GP(1) which may cover the Stapled Security is paragraph (d). Clause 11 of the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 1989 states that the word 'security' is widely defined for the purposes of Division 16E of Part III so as to encompass various arrangements that may give rise to a deferral of the payment of income. Paragraph (d) of the definition of 'security' includes a broad range of contracts under which there is a liability to pay an amount (see paragraph 30 of Taxation Ruling TR 96/14). However, having regard to paragraphs (a), (b) and (c) of the definition of 'security' in subsection 159GP(1), only those contracts that have debt-like obligations will usually fall under paragraph (d) of the definition of 'security'.

17. The obligations to make payments under the Note Terms and the Preference Share Terms are not debt-like obligations. The payments are contingent upon there being sufficient distributable profits out of which the amounts can be paid. Accordingly, the Company has not made an absolute promise to pay the amounts: see *Emu Bay Railway Co Ltd v. Federal Commissioner of Taxation* (1944) 71 CLR 596; (1944) 7 ATD 455.

18. Upon an Assignment Event, when the Note 'de-staples' from the Preference Share, there is no disposal of a Note that meets the definition of 'security' in subsection 159GP(1). Rather, the contingent right of an Investor to receive payments under the Note Terms is terminated. After an Assignment Event occurs, the Stapled Security consists solely of the remaining Preference Share.

⁵ The meaning of the term 'traditional security' and 'security' is discussed in Taxation Ruling TR 96/14 and Taxation Determination TD 2008/21.

Appendix 2 – Alternative views

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

Alternative views

Stapled Security is not made under a single contract

19. There is a contention that the terms of the instruments that comprise a Stapled Security provide that a person who purchases a Stapled Security under such an arrangement acquires two separate instruments (that is, a Note and a Preference Share) that are simply required to be traded together. It is also contended that there is not a single contract because the documents which create the Note and the Preference Share (the Deed Poll, the Note Terms and the Preference Share Terms) are three separate documents which cannot be read together to comprise a single contract. To do so would offend the privity of contract doctrine.

20. The Commissioner does not agree with the contention that when a person acquires a Stapled Security of the kind described in this Determination, the person is acquiring two separate instruments. The Stapled Security is offered to subscribers on the terms set out in the Prospectus and that is as a single instrument. The Stapled Security is not offered as two separate, distinct and transferable instruments that simply must be traded together. The Note is inextricably bound with the Preference Share when it is stapled; it does not exist separately, nor can it be traded separately from the Preference Share.

21. The Commissioner also does not accept the argument that there can be no single contract. The Commissioner's view that the Stapled Security is acquired under a single contract is not predicated on the view that the three documents combine to form the single contract. Rather, a new and distinct contract is created between the Investor and the Company (as well as the subsidiary, if a subsidiary of the Company issues the Note) when the Investor accepts the Company's offer to acquire the Stapled Securities and agrees to be bound by the terms in the Prospectus. The rights and obligations under the contract are described in the Prospectus and the contract specifically includes rights and obligations that were also created under the Note Deed Poll, the Note Terms, the Preference Share Terms and any other relevant document(s).

Note itself is a 'security'

22. It has been argued that the Note itself satisfies the definition of 'security' in subsection 159GP(1) on the basis that the Note and the Preference Share are separate legal instruments. The Note is said to be covered by paragraph (a) of the definition of security in subsection 159GP(1). The Commissioner does not accept this view.

23. The Note on its own while forming part of the Stapled Security does not satisfy the definition of 'security'. Whilst paragraph (a) of the definition includes a 'debenture', and this term is defined in subsection 6(1) to include 'notes', when regard is had to the other instruments specified in the definition of 'debenture', it is the Commissioner's view that 'debenture' for the purposes of the Act encompasses a written instrument whereby one person promises to pay a sum to another person. In other words, the Note would have to be a debt instrument.

24. In order for an instrument to be a 'note', there must be a written acknowledgment of a debt and some promise to pay a sum at some time in the future. The Note in the Stapled Security does not have any acknowledgment of a debt or an absolute promise to pay a sum to the Investors. Payments under the terms of the Note are contingent on the Company having distributable profits, and the face value of the Note is never payable to the Investors. Even on the winding up of the Company, the face value of the Note is payable to the Company (or a subsidiary of the Company) as Assignee rather than the Investors. Therefore, whilst on its face the Note in the Stapled Security is covered by the definition of 'debenture' in subsection 6(1), it is the Commissioner's view that 'Note' is an incorrect label for the instrument.

25. The Note in the Stapled Security can be distinguished from a 'perpetual note'. Under the latter, the Investor usually has an entitlement to receive a sum on the winding up of the issuing company. An Investor in the Stapled Security has no such right under the terms of the Note.

26. It should be noted that the Commissioner accepts that before being stapled, the Note exists in legal form as an instrument giving the Initial Purchaser(s) the right to receive the face value on maturity, and therefore would be a 'note', and hence a 'debenture', for the purposes of the definition of 'security' under subsection 159GP(1). However, when the Initial Purchaser(s) enters into an agreement with the Company such that there is an irrevocable offer to assign the Note, the Initial Purchaser(s) no longer has the right to receive the face value of the Note. It is the Commissioner's view that the Note no longer meets the ordinary meaning of the word 'note'. The Initial Purchaser(s) no longer has an entitlement to receive their investment in the instrument back.⁶

⁶ The agreement with the Initial Purchaser(s) does not amount to a disposal of the Note by the Initial Purchaser(s); all that happens is that there is a waiver by the Initial Purchaser(s) of some of their rights under the Note. Any loss that the Initial Purchaser(s) would suffer from this waiver would not give rise to a deduction to the Initial Purchaser(s) under subsection 70B(2) due to the operation of subsection 70B(5).

References

Previous draft:

TD 2008/D6

Related Rulings/Determinations:

TR 96/14; TR 2006/10; TD 2008/21

Subject references:

- debentures
- disposal
- notes
- preference shares
- securities
- traditional securities

Legislative references:

- ITAA 1936
- ITAA 1936 6(1)
- ITAA 1936 26BB
- ITAA 1936 26BB(1)
- ITAA 1936 26C
- ITAA 1936 70B

- ITAA 1936 70B(2)
- ITAA 1936 70B(5)
- ITAA 1936 Pt III Div 16E
- ITAA 1936 159GP(1)
- ITAA 1936 Pt IVA
- ITAA 1936 177C
- ITAA 1997 6-5
- ITAA 1997 8-1
- TAA 1953

Case references:

- Emu Bay Railway Co Ltd v. Federal Commissioner of Taxation (1944) 71 CLR 596; (1944) 7 ATD 455
- Singer v. Williams [1920] All ER Rep Ext 819

Other references:

- Taxpayer Alert TA 2008/1
 - Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 1989
-

ATO references

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