IN THE HIGH COURT OF AUSTRALIA
SYDNEY REGISTRY

No. S 225 of 2012

ON APPEAL FROM THE FULL COURT OF THE FEDERAL COURT

BETWEEN:

ANDREW VINCENT MILLS
Appellant

and

COMMISSIONER OF TAXATION
Respondent

RESPONDENT'S SUBMISSIONS

Part I: Internet publication

1. These submissions are in a form suitable for publication on the internet.

Part II: Issues

2. The issue in the proceedings is whether the Federal Court erred in holding that, having regard to the whole of the relevant circumstances of the scheme, it would be concluded that the Commonwealth Bank of Australia (the **Bank**) had a purpose (whether or not a dominant purpose but not including an incidental purpose) of enabling the appellant to obtain an imputation benefit within the meaning of s 177EA(3)(e) of the *Income Tax Assessment Act 1936* (Cth)(the **1936 Act**).

3. In relation to the appellant's suggested issues:

   (a) The concept of purpose in s 177EA(3)(e) is contained in a composite phrase within a wider criterion and falls to be construed and applied within the context of the criterion as a whole and does not form a discrete issue of law of the kind suggested.

   (b) Provisions within a single statutory scheme are to be read together, and having regard to scope, object and purpose, and any conflicts resolved by reference to the hierarchy of provisions that here include s 177EA(5)(b) and (11). The suggested issue 2(b) does not arise.

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(c) Issue 2(c), in purporting to generalise from specific criteria within s 177EA(17), does not accurately capture any issue that arises under those criteria.

4. In relation to the questions set out in the notice of contention, the issues are whether the approach of the primary judge is to be preferred to that of the Full Court in respect of ss 177EA(17)(ga) and (h) and whether the Full Court should have had regard to the financial consequences to the Bank of entering into the scheme: s 177D(b)(vi).

Part III: *Judiciary Act 1903*

5. The respondent has considered whether notices should be given pursuant to s 78B of the *Judiciary Act 1903* (Cth) and submits that no such notices are required.

Part IV: Facts

6. The appellant's factual narrative is largely uncontested but is incomplete. The relevant facts are as follows. The appellant invested in "Perpetual Exchangeable Resaleable Listed Securities" (**PERLS V**) issued by the Bank. PERLS V consist of a preference share in the Bank "stapled" to a promissory note (a **Note**) issued by the New Zealand branch of the Bank. To date, the returns on the appellant's investment in PERLS V have been payments of interest on the Note.

7. Returns on PERLS V are calculated in accordance with a formula described by Jessup J at FC[154]-[155], AB648-649, by Edmonds J at FC[82], AB624, and by the trial judge, Emmett J, at TJ[117]-[118], AB571. The formula specifies a market rate of return, namely a margin of 3.4% per annum above the bank bill swap rate. However, that rate of return is then reduced by an amount which represents the value of franking credits. In that way, a portion of each investor's return is received as an interest payment (that is, as a cash distribution) and the balance is made up of the value of the franking credit on the assumption that the distribution will be fully franked. If for any reason the distribution is not fully franked, the Bank must "gross up" the return to each investor for the value of lost franking credits.

8. The trial judge noted that the funds raised by the issue of PERLS V were received by the New Zealand branch of the Bank and then lent to ASB Bank Limited, a New Zealand resident subsidiary of the Bank. The remaining proceeds were used to fund operations of the New Zealand branch: TJ[72], AB557, Edmonds J at FC[11], AB604. The trial judge also found that the funds used by the New Zealand branch to pay distributions on PERLS V "will be earned from the various business activities of the New Zealand branch, including the loan to ASB Bank Limited": TJ[72], AB557.

9. Income of the New Zealand branch of the Bank is exempt from Australian tax: s 23AH of the 1936 Act. The Bank also applied for and received a ruling from the New Zealand revenue authorities confirming that the payments of interest on the

Notes will be an allowable deduction for the purposes of New Zealand tax: FC[156], AB649.[1]

10. By reason of Division 974 of the *Income Tax Assessment Act 1997* (Cth) (the **1997 Act**), PERLS V are treated as equity in the Bank for Australian tax purposes and so the returns to investors (namely interest payments on the Notes) are frankable. But for the determination made by the respondent under s 177EA of the 1936 Act, each interest payment therefore entitled the appellant to an "imputation benefit" [2], giving rise to an offset against his Australian tax: ss 204-30(6), 207-20(2). It is that determination that is now in issue.

11. At paragraph 8 of the appellant's submissions filed 31 August 2012 (**AS**), the appellant submits that it was not at issue in the court below that "the Bank's dominant reason for issuing the PERLS V securities was to raise additional Tier 1 capital." However, the Bank's actual reason for issuing PERLS V in the form which it did was not at issue below because, for reasons given by the trial judge at TJ[75]-[76], AB558, which were not challenged on appeal to the Full Federal Court, it is irrelevant. Also not at issue and equally irrelevant was the characterisation of that reason as "dominant": AS8.

12. The submission at AS9 that, for reasons of "prudent capital management", the Bank preferred not to issue ordinary shares in order to raise further capital but instead chose to issue hybrid securities consisting of a preference share stapled to a note issued by an overseas branch "to comply with APRA standards" conceals several subtleties.

13. The Bank was not required to choose between an issue of ordinary shares, on the one hand, and a hybrid security like PERLS V, on the other, in order to raise further Tier 1 capital. As the trial judge explained at TJ[51]-[52], AB550-551, the relevant prudential statement (APS111) permitted non-innovative residual Tier 1 capital to be raised by the issue of perpetual non-cumulative preference shares issued by the Bank.

14. The requirement to issue a note through a foreign branch arose only where the Bank chose to issue perpetual non-cumulative preference shares through a stapled structure, as happened here: TJ[52], AB550-551. As the appellant implicitly acknowledges at AS10, the adoption of a stapled structure was a "criterion of choice" (cf AS14) in relation to the capital raising.

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[1] See also the affidavit of Lynette Elizabeth Cobley affirmed on 5 July 2010, paras 2-3, AB112, ruling application at AB492-520 and ruling at AB114-127.

[2] Reference may be made to both "imputation benefits", which is defined in s 204-30(6), and "franking credits". Technically, it was an "imputation benefit" that was cancelled in this case. However the expressions are commonly used interchangeably.

15. Nor is correct to say that returns on Tier 1 capital are necessarily frankable, regardless of the chosen structure. That the returns on PERLS V were frankable was not a result mandated by the Act, nor was it a necessary concomitant of any Tier 1 capital raising: cf AS12-14. Where s 215-10 applies, returns on Tier 1 capital raised through a note issued by a foreign branch of a bank are unfrankable.[3] PERLS V, however, is not within that section.

16. In the result, the Bank's chosen means of capital raising had the consequence that the returns on the Notes were sourced in the earnings of a branch that were not subject to Australian tax. Because the Notes were issued by the New Zealand branch, it also had the consequence that the returns were deductible.

17. The Bank's cost of raising capital in that way was thus defrayed in two ways. For Australian tax purposes the returns on the Notes were treated as "non-share distributions" under Division 974 of the 1997 Act (that is, as equivalent to returns on equity) and were therefore frankable. Franking reduced the rate of return payable by the Bank on the Notes in the manner described in paragraph 7 above. And since for New Zealand tax purposes, returns on the Notes were treated as interest payments and were therefore deductible, the economic cost was reduced by the amount of the deduction.

18. In making the decision to issue PERLS V, the "prudent capital management" to which the appellant refers involved consideration of the cost of the securities, as the appellant concedes at AS9 footnote 4. The trial judge explained the matters taken into account by the board in determining the Bank's capital management strategy at TJ[56], AB552. He also described the specific matters taken into account in deciding to issue this particular security at TJ[57]-[68], AB552-556. The ability to frank distributions on PERLS V had a direct impact on the cost to the Bank of raising Tier 1 capital. The 'economic cost' with and without franking benefits was separately quantified and specifically taken into account by the board in deciding to issue PERLS V: TJ[65], AB555. Although not separately quantified, the deduction available to the New Zealand branch of the Bank also impacted on the economic cost of the capital raising, which was noted to be 'the after tax cost': board paper dated 11 August 2009, paragraph 6.1, AB255. Thus, as noted in paragraph 5.1 of board papers dated 9 September 2008 (AB217) and 10 February 2009 (AB231), PERLS V was "expected to achieve franked and deductible economics."

19. In light of those cost considerations the decision to issue PERLS V was undoubtedly prudent insofar as the Bank's capital management strategy was concerned. However, it cannot be inferred that it was the only prudent decision open to the Bank at that time. The trial judge pointed out at TJ[55], AB551-552, that the Bank

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[3] The Bank has raised Tier 1 capital in precisely this way, returns on which are accepted to be unfrankable: see footnote 9 of the appellant's submissions.

had raised Tier 1 capital by the issue of ordinary shares on three separate occasions between 30 June 2008 and 30 June 2009. The proposed issue of PERLS V was considered at various points between 9 September 2008 and 7 September 2009, during which time the issue had been deferred for reasons that had nothing to do with capital management: TJ[59], AB553.

Part V: Legislation

20. The respondent agrees that the legislation set out in Annexure A to the appellant's submissions filed 31 August 2012 is applicable. In addition, it is relevant to have regard to s 215-10 and Division 974 of the 1997 Act, which are set out in Annexure A to these submissions.

Part VI: Argument

21. The suggested statutory construction question concerns the meaning not of the word "incidental" but of the expression "...a purpose (whether or not a dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain an imputation benefit" in s 177EA(3)(e). That composite phrase must itself be read in the context in which it appears and in light of the purpose for which it was enacted.

22. Section 177EA is an anti-avoidance provision contained within Part IVA of the 1936 Act. Its clear purpose is to protect the integrity of the imputation system contained in Part 3-6 of the 1997 Act. It is therefore relevant to have regard both to the direct context (s 177EA and Part IVA) and the wider context (Part 3-6 of the 1997 Act) in construing the provision. When s 177EA was inserted into Part IVA, the legislature expressly adopted a lower threshold for purpose than the dominant purpose test found in s 177D. Having regard to the text of the whole provision and to its statutory context and purpose, the construction for which the appellant contends cannot be sustained.

23. Section 177EA(3)(e) is concerned to identify, by reference to delineated criteria, the purpose for which a person entered into a scheme that enabled a person to obtain imputation benefits. It does so by testing the degree to which a purpose of enabling a taxpayer to obtain imputation benefits influenced the entry into the scheme. The general anti-avoidance provision (s 177D) applies only where the purpose of enabling a person to obtain a benefit is dominant, in the sense of being the ruling, prevailing or most influential purpose.[4] Section 177EA, however, applies even where the purpose of enabling a person to obtain a benefit did not have that level of influence, provided that the purpose was not so lacking in influence (having regard to the prescribed circumstances) as to be merely an "incidental purpose."

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[4] *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404 at 416

24. So construed, the section does not apply to ordinary capital raisings, despite the actual significance of franking to both companies and investors. That is because the anti-avoidance provision operates by reference to what "would be concluded" in relation to "the relevant circumstances of the scheme," identified in subs (17), not by reference to the actual purposes or motivations of either companies or investors. Measured by reference to the relevant circumstances and without more, the fact that there was an actual purpose of raising capital by an instrument that would give rise to franked distributions would not cause the provision to apply, even where the prospect of franking was in fact important and had been taken into account in deciding the manner in which returns on the instrument were to be calculated.

25. Here, however, there was more, as both the primary judge and the majority in the Full Court held. PERLS V deliver a fixed return, a portion of which is the guaranteed value of an imputation benefit. The imputation benefit is "integral to the return" on the Note and is "the very thing that makes an investment in [PERLS V] commercially acceptable" to the investor: J[118], AB571. That benefit is of corresponding value to the Bank, whose cost of raising capital is reduced accordingly. At the same time, the funds raised by PERLS V are employed in a business that is not subject to Australian tax. Returns on the Notes are sourced in the tax exempt New Zealand earnings of the Bank and are deductible in New Zealand. They are not distributions of Australian taxed profits in any sense.

26. The fact that those distributions are nevertheless frankable is central to the design of PERLS V. When the relevant circumstances are taken into account, it is clear that a purpose of the Bank in issuing PERLS V was to deliver imputation benefits and that that purpose was more than an incidental purpose. The outcome sought to be achieved, whereby imputation benefits would be obtained by investors, was an essential element of the scheme.

The imputation system

27. The imputation system is contained in Part 3-6 of the 1997 Act. It seeks to avoid double taxation by allowing companies to "pass to their members the benefit of having paid income tax on the profits underlying certain distributions": s 201-1(1). Subdivision 202-C prescribes which distributions are frankable. The object of that subdivision is "to ensure that only distributions equivalent to realised taxed profits can be franked": s 202-35. That object is critical here, having regard to the nature of the scheme under consideration.

28. The defining feature of the system is the ability of a corporate taxpayer to pass on the benefit of tax paid in Australia to its Australian resident owners. It does so by "franking" a "distribution": s 202-5.

29. Part 3.6 does not permit franking credits, once obtained, to be allocated except in conformity with that Part and, in all cases, subject to the possible application of s 177EA. Part 3-6 restricts the benefit of the imputation system so that only the owners[5] of companies may receive imputation benefits; they may receive them only proportionately to their stake in the company; and they may receive them only in respect of distributed taxed profits. The "Benchmark rule" in s 200-30 requires all frankable distributions within a particular period to be franked to the same extent. Credits may only be generated by the payment of Australian tax: s 205-15. Where an Australian resident taxpayer receives a franked distribution, he or she becomes entitled to a tax offset equal to the franking credit on the distribution: Subdivision 207-A.

30. The key architectural feature of this system is the imputation benefit which a shareholder receives when he or she receives a franked distribution. That benefit, the so-called franking credit, is something that is ancillary to the payment of a frankable distribution. The system has no mechanism for providing the benefit of having paid tax except as an adjunct to such a payment. It is of the essence of the imputation system that franking credits (or, more specifically, the tax offsets to which shareholders become entitled upon receipt of franked distributions) are ancillary to such a distribution. In that way, the imputation system ensures that a distribution of Australian taxed profits is not taxed again in the hands of Australian resident shareholders.

Division 974

31. For income tax purposes, whether an investment is to be treated as debt or equity is generally determined by Division 974. The broad effect of Division 974 is as described by the trial judge at TJ[14]-[18], AB539-541. The scheme of the division and of the income tax acts generally is that returns on debt are generally deductible but not frankable and that returns on equity are generally frankable but not deductible.

Section 177EA

32. In addition to the detailed rules contained in Part 3-6[6], s 177EA operates as a flexible general anti-avoidance rule to deal with cases not met by the specific rules in Part 3-6. In every case where s 177EA applies, it denies the benefit of franking

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[5] Sections 201-1(2)(a) and (c) state as objects of Part 3-6 to ensure:

> (a) that the "imputation system is not used to give the benefit of income tax paid by a corporate tax entity to **members who do not have a sufficient economic interest in the entity** and
> (c) that membership is not manipulated to create such an outcome.

[6] Including specific anti-avoidance rules such as contained in Division 204.

notwithstanding that the detailed rules contained in Part 3-6 otherwise permit – and even require – a distribution to be franked.

33. There are two important features of s 177EA which are relevant for the present dispute. The first is that, unlike the general power contained in s 177F, the section does not operate by reference to an alternative postulate. Under s 177F the respondent may cancel a "tax benefit in connection with a scheme" within the meaning of s 177C. Such a benefit exists and can be cancelled only where there is an amount that would have been or might reasonably be expected to have been included in the taxpayer's income or would not have been or might reasonably be expected not to have been allowable as a deduction if the scheme had not been entered into or carried out.

34. Section 177EA, however, does not depend on the existence of an alternative postulate. The power in subs (5)(b), which was exercised in this case, is simply to cancel an imputation benefit that has been received. The result of the application of s 177EA is in every case to bring about a circumstance in which a distribution was permitted and even required to be franked under Part 3-6 but the imputation benefit is cancelled. This is so even if an equivalent benefit might, by some alternative scheme, have been passed to the member. Section 177EA is thus concerned with the nature and quality of distributions that are in fact made; not with whether the franking credit might reasonably be expected to have been obtained by the relevant taxpayer otherwise. Jessup J clearly explained the importance of this distinction at FC[197]-[199], AB667-668.

35. The second feature is that the section has a different threshold for application than the general anti-avoidance provision. Under s 177F the respondent may cancel a tax benefit in connection with a scheme only where it is concluded that a person entered into or carried out the scheme, or part of it, for the dominant purpose of enabling the relevant taxpayer to obtain the tax benefit: s 177D, s 177A(5).

36. By contrast, s 177EA applies where it is concluded that such a person entered into or carried out the scheme, or part of it, "for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain an imputation benefit": subs (3)(e). As will be submitted below, the distinction between this threshold and the dominant purpose threshold is apparent not only from the contrast between the two provisions but from the very terms of the sub-section.

The appellant's argument in relation to construction of subs 3(e)

37. At the heart of the appellant's case is the proposition in AS23-25 that the word "incidental" in subs (3)(e) means "in subordinate conjunction with" or "consequential upon something else," as opposed to "trivial" or "fortuitous." That being so, it is said that so long as the issuer had a "principal purpose of raising

capital" (AS25, AS30), the fact that distributions on that capital are franked must be seen as being merely "incidental" (in that sense) and therefore not within the field of operation of s 177EA.

38. There are several difficulties in the way of that construction. It reads the word "incidental" without having regard to the entire expression in which it appears; it is inconsistent with the wider statutory context of the imputation system; it suggests a false dichotomy between the pursuit of a commercial objective (of raising capital) and the existence of the proscribed purpose (of providing imputation benefits); and it has the practical effect of creating a dominant purpose threshold, contrary to the clear words and apparent intent of the section.

39. The task of statutory construction demands attention to the whole of the statutory language[7], the context of the provision[8] and its statutory purpose "in its widest sense."[9] The starting point, therefore, is to observe that the word "incidental" in s 177EA(3)(e) is used as part of an expression which denotes a particular threshold of purpose. The proscribed purpose may exist notwithstanding that the person's purpose in relation to imputation benefits is not dominant, in the sense of being the ruling, prevailing or most influential purpose in entering into the scheme.[10]

40. It is not the case that a purpose can be described as "incidental" only where it is "subordinate and conducive to another purpose" or if it "follows as a natural incident of pursuit" of some other purpose: cf AS24. In its immediate context, the reference to an "incidental purpose" is used in distinction to the expression "dominant purpose." That same distinction appears from a consideration of its wider context in Part IVA, where it is to be contrasted with the dominant purpose threshold in s 177D. The difference lies in the degree to which the proscribed purpose is seen to have influenced the person in entering into the scheme. The context suggests that the expression is used to denote the extent to which the purpose of providing imputation benefits influenced the entry into the scheme, not whether that purpose was a necessary concomitant to some other prudent commercial activity.

41. Nor can the appellant's construction be reconciled with the wider context of the imputation provisions in Part 3-6. As noted above, a taxpayer only ever obtains an imputation benefit as an incident of ("in subordinate conjunction with") a franked

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[7] *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue* (2009) 239 CLR 27 at 31 [4] per French CJ, at 47 [47] per Hayne, Heydon, Crennan and Kiefel JJ.

[8] *Project Blue Sky Inc v Australian Broadcasting Authority* (1998) 194 CLR 355 at 381 [69] per McHugh, Gummow, Kirby and Hayne JJ; *CIC Insurance Ltd v Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408 per Brennan CJ, Dawson, Toohey and Gummow JJ.

[9] *Travelex Ltd v Commissioner of Taxation* (2010) 241 CLR 510 per Crennan and Bell JJ at 531 [82]; *Commissioner for Railways (NSW) v Agalianos* (1955) 92 CLR 390 at 397 per Dixon CJ.

[10] *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404 at 416.

distribution, being a distribution that was permitted to be and may have been required to be franked. That is how the imputation system works. If "incidental purpose" in s 177EA means "in subordinate conjunction with" some other purpose, it will invariably be the case that the relevant person had an "incidental purpose" in relation to the provision of imputation benefits. If the section is to be given meaningful work to do, it must be able to apply to cancel imputation benefits that were obtained in subordinate conjunction with distributions that were otherwise permitted to be and may have been required to be franked. The appellant's construction would rob the section of its essential field of operation.

10 42. The suggestion in AS24 that "any uncertainty as to the sense in which "incidental purpose" is used in the paragraph is resolved" in favour of the appellant by the explanatory memorandum is wrong. To the contrary, the very same sentence of the explanatory memorandum to which the appellant refers[11] states that the expression is to be understood in the sense of meaning "fortuitously or in subordinate conjunction with....". The appellant elsewhere contrasts "subordinate or attendant" with "fortuitous or trivial": AS29.

43. The appellant's attempt to explain how its construction would operate in the case of franking credit trading or streaming schemes (AS31) exposes the extent to which his construction distorts the operation of the section. At AS31 the appellant
20 suggests that in simple schemes to trade or stream franking credits the purpose of capital raising (ie, in issuing shares) is "incidental" to the provision of franking credits. But the question in those cases, as in this case, is whether the purpose of enabling someone to obtain imputation benefits was an "incidental purpose." In those cases, on the appellant's construction, it could equally be said that the purpose of enabling someone to obtain imputation benefits was merely incidental because imputation benefits were an incident of receiving distributions on the shares in question. In point of principle there is nothing to distinguish those examples from the present case so far as the reference to incidental purpose is concerned.

30 44. The appellant suggests that the section could still operate in those cases, even on his construction, because it could be seen that the issue of shares as part of a trading or streaming scheme was "incidental" to the provision of imputation benefits. However, to express the matter in that way is to say that the purpose of enabling a person to obtain imputation benefits was the dominant purpose. On the appellant's construction this would appear to be the only circumstance in which the subs (3)(e) purpose could be imputed, namely where it can be seen that the purpose of providing imputation benefits is dominant and where the commercial purpose of capital raising can be seen to be "incidental." The appellant's

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[11] Explanatory Memorandum to the *Taxation Laws Amendment Bill (No 7) 1997*, para 8.76. It is assumed that the reference to para 8.6 in footnote 29 of the appellant's submissions should have been to para 8.76.

construction would therefore give the section work to do only where the proscribed purpose was dominant.

45. The real explanation for why the section operates in those cases is, as is impliedly acknowledged in AS31[12], that a person who causes capital to be raised (ie, shares to be issued) to a person as part of a franking credit trading or streaming scheme has a purpose of enabling that person to obtain imputation benefits and that purpose can be seen to be sufficiently influential or persuasive to warrant the application of the section.

46. No support for the appellant's construction is to be gained from any of the authorities cited at AS23. In those cases the question in issue was whether something was "incidental" to some other thing. Leaving aside the widely divergent contexts in which those cases were decided, the question of whether something is "incidental " to something else necessarily concerns the relationship between two identifiable things. Section 177EA(3)(e), however, is not expressed in that way.

47. The appellant's construction assumes a dichotomy (cf *Spotless* at 415) between the existence of a prudent purpose for raising capital, on the one hand, and the existence of the proscribed purpose in relation to imputation benefits, on the other. Such a construction should be rejected. The question is not whether the decision to raise capital was a prudent one. It is whether, having regard to the relevant circumstances, one of the Bank's purposes in entering into that scheme to raise capital was to enable the appellant to obtain imputation benefits and, if so, whether that purpose was sufficiently influential to warrant the application of the section.

48. The appellant's argument ultimately conflates the effect of the scheme with the purpose of the Bank in entering into it. To say that imputation benefits were obtained as an "incident" of receiving distributions on PERLS V in the sense that the benefits were received "in subordinate conjunction with" a return on an investment is only to describe the effect of the scheme. Section 177EA(3)(e), however, is concerned with the Bank's purpose in achieving that effect. Here, the outcome that distributions were frankable was essential and was clearly intended. It was far from an inessential or merely incidental purpose of the Bank in issuing PERLS V that imputation benefits would be received in subordinate conjunction with distributions.

[12] The appellant seems to use the expression "incidental" in AS31 to mean less influential or prevailing. It is difficult to reconcile that use with construction of the word for which he otherwise contends.

The appellant's argument in relation to the conclusion reached

49. There was no error in the manner in which Jessup J approached the issue of construction at FC[175]-[179], AB658-660, nor was there any error in the ultimate conclusion reached.

50. The appellant's primary argument in the court below, as at trial, was that s 177EA applied only where it could be said that "tax avoidance" of a particular kind could be discerned: FC[180], AB660-661, TJ[83], AB560. Jessup J was right to reject that contention for the reasons given at FC[181], AB661. It would, as his honour noted, be "quite at odds with the express words chosen by the legislature if we were to engraft upon subs (3) an additional requirement as to purpose as proposed by the appellant."

51. This argument still underpins the appellant's case. It is submitted, for example, at AS39 that "no tax was avoided" by the scheme. However, "tax avoidance" for the purposes of s 177EA means enabling a person to obtain imputation benefits in the circumstances referred to in the section. Where the section applies, there is tax avoidance. But for the cancellation of the appellant's imputation benefits, the Bank would fund its cost of capital by recourse to its franking account, notwithstanding the existence of circumstances that take the interest payments on PERLS V outside the broad objects of the imputation system.

52. The competing view is that of Edmonds J, for whom the assertion that PERLS V did not involve "tax avoidance" was the starting point of the analysis, not the conclusion. Before turning to consider the application of s 177EA in any detail, his Honour addressed what he described as three significant matters to emerge from the facts. The first was that the issue of PERLS V "was not part of any scheme of tax avoidance": FC[13(1)], AB605. The second was that deductibility of the distributions was of no relevance whatsoever to the determination of whether the Bank had a non-incidental purpose of enabling the applicant to obtain an imputation benefit within the meaning of s 177EA(3)(e): FC[13(2)], AB605. The third was that the distributions on any issue of Tier 1 capital securities would be required to be franked: FC[13(3)], AB605-606.

53. His Honour also accepted a submission that, although not limited to trading and streaming schemes, the identification of those kinds of schemes "informed or illuminated the mischief or abuse to which the section was directed": FC[25], AB610.

54. The approach of Edmonds J should not be followed. Whether there was "tax avoidance" is the very thing which the application of the section is designed to resolve. To begin the analysis with an *a priori* notion of what constitutes tax avoidance is to fall into error. Nor is it safe to proceed on the basis that the section applies only to schemes of a particular kind for the reasons explained by Jessup J at

FC[181], AB661. The inclusion of subs (17)(ga), which has nothing to do with trading or streaming schemes, is reason enough to reject that approach. Nor is it safe to assert (least of all at the outset) that the New Zealand tax deduction is of no relevance whatsoever to the analysis. The section, properly applied, demands that attention be paid to the manner in which the scheme was entered into, matters of form and substance, and the financial consequences to the Bank of entering into the scheme: s 177D(b)(i)(ii) and (vi). Subs 17(ga) demands that attention be paid to the source of the particular distribution. In these respects, regardless of the ultimate result, it simply cannot be said that the New Zealand deduction is wholly irrelevant to the analysis. Jessup J made this point at FC[183], AB661-662.

55. None of the particular errors for which the appellant contends is made out. The first concerns the extent to which Jessup J had regard to the fact that the returns on PERLS V were calculated by reference to the value of the imputation benefit: e.g. FC[196], AB666-667, [220]-[221], AB676: see AS37-40. This is a reference to the fact, explained at paragraph 7 above, that distributions on PERLS V were calculated on the assumption that the holder would receive a franking credit such that the distribution was reduced by the value of that credit.

56. There was no error in placing emphasis on that circumstance. As his Honour said at FC[196], AB666-667, that circumstance was self-evidently present and contributed to a positive answer to the question posed by the section. It may be true, as the appellant points out, that holders of PERLS V received the very same benefit as holders of like securities issued by the Bank: AS39. That, however, does not meet the point.

57. Nor does it meet this point to say that franking was "required" or "mandated": AS38. As noted above, s 177EA applies notwithstanding that Part 3-6 otherwise requires a distribution to be franked, otherwise it would have no work to do. Furthermore, Part 3-6 contains a specific rule[13] which makes the returns on hybrid Tier 1 capital raisings by banks through foreign branches unfrankable, subject to s 215-10(2). The structure of PERLS V is precisely of the kind contemplated by s 215-10(1). The fact that returns on PERLS V are nevertheless frankable is the result of choices made by the Bank. It is not an outcome dictated by the statute.

58. Nor was there any error in taking into account that the distributions on PERLS V were payments of interest by the New Zealand branch of the Bank, that the funds used to make the payments were sourced from the earnings of that branch, which earnings were exempt from Australian tax, and that the Bank was entitled to a deduction for those payments in New Zealand: FC[183], AB661-662.

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[13] Section 215-10; see paragraph 15 above.

59. The first error attributed to Jessup J in this respect (AS42) is that his Honour disregarded the operation of Division 974 of the 1997 Act. That Division tells whether an interest is debt or equity for the purposes of Australian tax. In the present case, Division 974 treats PERLS V as equity and treats the payments of interest on the notes as "non-share dividends." It is for that reason that the distributions came to be frankable in the first place. However, to observe that distributions on PERLS V are, as a matter of substance, interest payments sourced in untaxed earnings of the New Zealand branch whilst, at the same time, frankable distributions of the Bank by reason of Division 974 is not to disregard Division 974. It is simply to consider the circumstance referred to in s 177D(b)(ii), namely the "form and substance of the scheme." There was a clear divergence between form and substance. As his Honour said at FC[214], AB674, "the situation presented by the design of PERLS V is an exemplar of what the legislature had in mind when it posited a distinction between "form" and "substance" in subpara (ii)."

60. The second error attributed to Jessup J in this respect is that his Honour impermissibly had regard to the fact that the distributions were deductible in New Zealand and thereby "incorrectly assimilate[d] two independent, and quite different, taxing regimes": AS44. The appellant argues that the deductibility of the payments is a matter "wholly foreign" to the entirety of Part IVA: AS43.

61. There are two reasons why that submission should be rejected. The first is that it misapprehends the significance of the New Zealand tax deduction. It is to be remembered that one of the overriding objects of the imputation system is to permit only distributions equivalent to realised taxed profits to be franked. It is therefore relevant, when considering the form and substance of a scheme, to consider the extent to which, in substance, it involves distributions of that kind. The significance of the New Zealand deduction does not lie in the bare fact that New Zealand treats the payment differently to Australia for tax purposes. It lies in the fact that the New Zealand treatment reveals a particular feature of the payment, namely that it is not, in substance, a distribution of Australian taxed profits at all. There was no error in taking the New Zealand deduction into account in that way.

62. Secondly, the submission cannot be accepted as a matter of principle. Part IVA, and in particular s 177D(b), requires a wide variety of circumstances to be taken into account. The nature of those circumstances will vary from case to case. Save for express references to aspects of Australian law in s 177EA(17), those circumstances have no territorial limitation. If, as in this case, the incidents of a particular foreign legal regime are relevant to a person's purpose for entering into a scheme to avoid Australian tax, there is no reason why that circumstance should not be taken into account. In *Spotless*, it was relevant to the conclusion as to purpose that the Cook Islands imposed withholding tax on the interest payments at a particular rate: at 412. Indeed, the scheme itself in that case included a reference to paying "Cook Islands withholding tax": at 414.

63. The appellant's position in relation to the relevance of the New Zealand tax deduction is not advanced by the submission that the deduction did not "enable" the appellant to obtain imputation benefits: AS43. By that submission it is suggested that the existence of the New Zealand deduction made no difference to whether the distributions would be frankable and that the circumstance should therefore be ignored. It may be accepted that the distributions on PERLS V would have been frankable even without the deduction. However, as noted at the outset, s 177EA is not concerned with whether an imputation benefit would still have been obtained if some different scheme had been entered into. It is relevantly concerned with the scheme that was entered into and the legal and financial incidents of that scheme. It is therefore relevant to take the New Zealand deduction into account, as it was an aspect of at least the form and substance of the scheme, and the change in financial position to the Bank as a result of the scheme. As the Board noted at its 12 August 2009 meeting (p11), AB270.10, "this method of capital raising was still well priced", even without the imputation benefits. The economic cost put before the Board was the after tax cost: 11 August 2009 [6.1], AB255. For the reasons explained by Jessup J, the existence of the deduction contributes to the conclusion that the Bank had the proscribed purpose in issuing PERLS V.

64. The respondent submits that there was no error in the judgment appealed from.

Part VII: Notice of Contention

65. The respondent supports the conclusion reached by the Full Federal Court on three additional grounds[14] namely that the conclusion is also supported by the existence of the circumstances to which subs (17)(ga) and (h) refers and also having regard to the financial consequences to the Bank (s 177D(b)(vi)) of entering into the scheme.

Section 177EA(17)(ga)

66. The circumstance to which para (ga) refers is "*whether a distribution that is made or that flows indirectly under the scheme to the relevant taxpayer is sourced, directly or indirectly, from unrealised or untaxed profits.*"

67. The paragraph requires a consideration of the source from which a distribution is made. It is not merely concerned with the identification of the "fund" from which the payment is debited for accounting purposes: cf AS46(b). For the reasons given by the trial judge at TJ[124], AB573, the reference to "profits" is not to profits in the strict company law sense. The term must be construed in the context of the whole provision, which applies equally to all distributions, regardless of their treatment at general law or for accounting purposes. The fact that the distribution in question here was, in legal form, the payment of interest on a Note (and therefore not a

[14] Notice of Contention filed 23 August 2012, AB688.

distribution of profit) does not mean that it is incapable of being a payment "sourced directly or indirectly in unrealised or untaxed profits" for the purposes of para (ga).

68. The construction for which the respondent contends is consistent with the Court's approach in *Federal Commissioner of Taxation v Sun Alliance Investments Pty Ltd* (2005) 225 CLR 488.[15] In that case, the Court considered s 160ZK(5) of the 1936 Act which specified the criteria to be satisfied in order for a "rebateable dividend adjustment" to arise in relation to the calculation of CGT on the disposal of shares. One of those criteria was that:

> *"(b) an amount...., being the whole or a part of the distribution, could reasonably be taken to be attributable to profits that were derived by the company before the holder acquired the RDA share"*

69. The critical question in *Sun Alliance* was the proper construction of s 160ZK(5), including this criterion. Because the "profits" which the Commissioner had identified and which he had taken to satisfy the criterion in s 160ZK(5)(b) did not have the character of "profits" in the context of company law, it was argued that the section did not apply.

70. The Court rejected the taxpayer's argument. At paragraphs [63] to [67] the Court explained that the term "profits" was not intended to have its company law meaning. At [65] the Court expressly approved a passage from *MacFarlane v Commissioner of Taxation* (1986) 13 FCR 356 in which the Full Federal Court had held that the reference to "profits" in s 44 of the 1936 Act did not mean "profits" in the company law sense. Those conclusions have equal force in this context.

71. The contrary argument accepted by Jessup J at FC[204]-[206], AB670-671, treats the reference to "profits" as being to the accountant's conception of that word. Although his Honour rejected the submission that paragraph (ga) was coextensive with the former share tainting rules (FC[202], AB669; cf Edmonds J at FC[88]-[89], AB625-626) his Honour accepted a submission that "profits" in paragraph (ga) has its company law meaning. However, paragraph (ga) does not refer to "profits" in isolation. It refers to "unrealised or untaxed profits." If the paragraph referred only to "unrealised profits" there might be more force in that argument. Certainly the share tainting rules which were repealed at the same time referred only to "unrealised profits." But by referring to "unrealised *or untaxed* profits" paragraph (ga) goes further. It does so in circumstances intended to apply equally to dividends and non-share dividends alike: s 177EA(12). Although, as the appellant points out, it does not make strict sense in Australian tax law to speak of company law profits being "taxed" or "untaxed", it does make sense to ask whether the earnings from

[15] *Sun Alliance* was addressed in argument below but not referred to in the reasons of the Full Federal Court.

which a payment is sourced have borne Australian tax. The discord in the expression "untaxed profits" which the appellant hears is produced by the fact that he assumes, in his favour, that "profits" here has its strict company law meaning.

72. The appellant's alternative objection to this construction of (ga) is that it impermissibly introduces a requirement that the particular distribution be traced to a particular fund of profits on which tax has been paid: AS46(c).

73. However, s 177EA is an anti-avoidance provision which applies according to its own terms and in circumstances where Part 3-6 otherwise permits a distribution to be franked. The fact that Part 3-6 does not otherwise require a distribution to be traced to a particular fund of taxed earnings is nothing to the point. Section 177EA(17) looks to a host of circumstances that are not required to be considered in the operation of the primary provisions in Part 3-6. Paragraph (ga) is one such circumstance. According to its terms it requires the decision-maker to consider the direct and indirect source of a distribution.

74. In the present case, the circumstance is present because the earnings of the Bank against which the distributions were made were exempt from Australian tax by reason of s 23AH of the 1936 Act. The distributions which the appellant received were in no sense distributions of Australian taxed profits.

Section 177EA(17)(h)

75. The circumstance to which paragraph (h) refers is *"whether a distribution that is made or that flows indirectly under the scheme to the relevant taxpayer is equivalent to the receipt by the relevant taxpayer of interest or of an amount in the nature of, or similar to, interest."*

76. Distributions on PERLS V are, in legal form, payments of interest on a promissory note. They also have other characteristics, as the trial judge noted at TJ[128], AB574, including that they are treated as returns on equity for tax purposes. However that may be, s 177EA nevertheless requires a conclusion to be reached as to the character of the payments for the purposes of paragraph (h). Their character must be judged from the point of view of the recipient, not the payer. It is also irrelevant whether the underlying interest (here, the investment in PERLS V) is a loan or something like a loan. The difficulties associated with a test such as contained in s 46D of the 1936 Act, namely whether a dividend on a convertible preference shares was "equivalent to the payment of interest on a loan" therefore do not arise here: cf *Federal Commissioner of Taxation v Radilo Enterprises Pty Ltd* (1997) 72 FCR 300 per Lee J at 308C-E and Sackville and Lehane JJ at 313C-314D.

77. Whilst interest is most commonly associated with a loan arrangement, it may have a wider meaning in commerce, such as where the principal is expected to be repaid in kind. The reference to amounts which are "similar to" interest makes it clear that

there is no requirement in para (h), as there was in s 46D, that the payment be made on an instrument which has the legal characteristics of a "loan."[16]

78. The conclusion reached by Jessup J on this issue at FC[212], AB673, misapprehends the relevance of this circumstance to the application of the section. Jessup J appears to have taken this circumstance to be directed to whether the capital raising was a form of tax effective debt finance for the issuer (FC[212], AB673). His Honour reached this conclusion having regard to the reference to "tax effective finance" in the explanatory memorandum: FC[211], AB672-673). It was for that reason that his Honour observed at FC[212], AB673 that "the Bank was never going to the market for debt finance."

79. However, the circumstance is not concerned with the nature of the return from the issuer's point of view, nor with the nature of the funds raised. Rather, it is concerned with the nature of the return from the point of view of the investor. The fact that an investor receives a return which is "equivalent to the receipt by [him or her] of interest or of an amount in the nature of, or similar to, interest" is a circumstance which is to be taken into account in determining the existence of the proscribed purpose.

80. Jessup J was wrong to dismiss the relevance of this circumstance on the basis that, taken alone, it could not be seen to support the ultimate conclusion reached: FC[211], AB672-3. Rather, where it exists (as it undoubtedly does here) this circumstance, like other relevant circumstances, is to be weighed together with the other relevant circumstances that have found to exist in order to reach an overall conclusion for the purpose of s 177EA(3)(e).

81. The nature of the payment received by the appellant here was similar to interest in numerous respects. The payments are regular and in a fixed amount, paid in respect of an outlay which, as a matter of commerce, holders expect to be returned to them either in cash or in kind.

82. From the point of view of an investor in PERLS V, the return is in substance a fixed income return on a debt instrument, a portion of which is the guaranteed value of the imputation benefit. From the investor's point of view the return is like a payment of interest; it is not like a distribution of Australian taxed profits. Jessup J was therefore correct to acknowledge that the paragraph (h) circumstance was present, however for the reasons stated above it should also have supported the ultimate conclusion reached.

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[16] As to which see *Steele v Deputy Commissioner of Taxation* (1999) 197 CLR 459; *Australian National Hotels Limited v Commissioner of Taxation* (1988) 19 FCR 234 at 239-241.

Section 177D(b)(vi)

83. It was always the respondent's case that the Court should have regard to the financial consequences to the Bank of entering into the scheme. Paragraph 21 of the respondent's submissions at trial made this clear. The circumstance was also addressed in oral argument.[17] The point was again taken in the Full Federal Court in paragraph 106 of his submissions to that court and in oral submissions.[18] In each case, the particular change in financial circumstances was that referred to elsewhere in relation to other circumstances, namely that the scheme raised capital, returns on which were sourced in tax exempt earnings of the Bank and which were both frankable in Australia and deductible in New Zealand.

84. The fact that the matters relevant to the Bank's change in financial position are also relied on in relation to other circumstances does not deprive this aspect of the case of its force. A consideration of the financial impact on the Bank of entering into the scheme is clearly relevant to the application of s 177EA. The fact that PERLS V raised a form of frankable and deductible capital was of significant financial consequence to the Bank and informs the question of whether the relevant purpose should be imputed to it.

85. There is a clear logical connection between this circumstance and the conclusion that the Bank had the relevant purpose: cf AS49. The scheme as a whole achieved a favourable financial outcome that was a product of two distinct features, namely that the returns on the capital would be both frankable and deductible. To say that there is no logical connection between the financial outcome of entering into the scheme and the purpose of enabling investors to obtain franking credits is to accept (without acknowledgement) the appellant's submission that any alternative scheme would have involved frankable distributions in any event. Or, to put this same point in one of the other ways propounded by the appellant, it is to accept that the New Zealand deduction is irrelevant because any alternative structure would have involved frankable distributions.

86. For reasons sought to be explained above, s 177EA is not concerned with a comparison between the tax position of the appellant under the impugned scheme and the position under some alternative. The section operates by reference to the characteristics of the scheme actually entered into and by reference to the nature and quality of distributions under that scheme. What matters is whether the requisite purpose existed in entering into the scheme.

87. That the Bank had the relevant non-incidental purpose here is to be imputed from, amongst other things, the fact that the scheme – and only this scheme – achieved a

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[17] Transcript 14/12/10 T103.29-31.

[18] Transcript 23/8/11, T11, Transcript 24/8/11 T90.20-21, T101.26-102.28 and T140.30-38.

uniquely favourable financial outcome for the Bank. That fact should have been taken into account by reason of s 177D(b)(vi).

88. The respondent submits that the appeal should be dismissed with costs.

Part VIII: Time

89. The respondent estimates that 2 hours will be required for presentation of oral argument.

DATED: 14 September 2012

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IN THE HIGH COURT OF AUSTRALIA
SYDNEY REGISTRY

No. S 225 of 2012

ON APPEAL FROM THE FULL COURT OF THE FEDERAL COURT

BETWEEN:

ANDREW VINCENT MILLS
Appellant

and

COMMISSIONER OF TAXATION
Respondent

ANNEXURE TO RESPONDENT'S SUBMISSIONS: ADDITIONAL LEGISLATIVE PROVISIONS

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(A) PROVISIONS IN FORCE AT RELEVANT TIME

The following provisions were in force as at December 2010.

Income Tax Assessment Act 1997

Act No. 38 of 1997 as amended

This compilation was prepared on 17 December 2010
taking into account amendments up to Act No. 145 of 2010

...

Chapter 3—Specialist liability rules

...

Part 3-6—The imputation system

...

Division 215—Consequences of the debt/equity rules

...

Subdivision 215-B—Non-share dividends that are unfrankable to some extent

...

215-10 Certain non-share dividends by ADIs unfrankable

(1) 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.

(2) The permitted purposes in relation to the *non-share equity interest (the ***relevant interest***) are the following:

(a) the purpose of the business of the ADI carried on at or through the permanent establishment other than the transfer of funds directly or indirectly to:

(i) the Australian head office of the permanent establishment; or

(ii) any *connected entity of the ADI that is an Australian resident; or

(iii) a permanent establishment of the ADI, or of a connected entity of the ADI, located in Australia;

(b) the purpose of redeeming:

(i) a *debt interest; or

(ii) a non-share equity interest;

that is issued, before the relevant interest is issued, at or through the permanent establishment and is held by a connected entity of the ADI that is an Australian resident;

(c) the purpose of returning funds to:

(i) the Australian head office of the permanent establishment; or

(ii) a permanent establishment of the ADI or of a connected entity of the ADI, located in Australia;

if the funds are contributed, before the relevant interest is issued, for use in the business of the ADI carried on at or through the permanent establishment.

...

Chapter 6—The Dictionary

Part 6-1—Concepts and topics

...

Division 974—Debt and equity interests

Table of Subdivisions

Subdivision 974-A—General

Guide to Division 974

974-1 What this Division is about

This Division tells you whether an interest is a debt interest, or an equity interest, for tax purposes. An interest that could be characterised as both a debt interest and an equity interest will be treated as a debt interest for tax purposes (except for certain interests that fund returns on equity interests).

Whether an interest is a debt interest or an equity interest matters because returns on debt interests are not frankable but may be deductible while returns on equity interests are not deductible but may be frankable.

This Division extends beyond shares the range of interests that are recognised as equity in a company. An interest that is an equity interest in a company but is not a share will be treated in the same way as a share for some tax purposes (particularly in relation to the determination of the tax treatment of returns on the interest).

This Division also tells you how to work out which distributions made in respect of a non-share equity interest in a company will be non-share dividends and which will be non-share capital returns. Those that are non-share dividends will be treated, for most tax purposes, in the same way as dividends.

Table of sections

974-5 Overview of Division

Test for distinguishing debt and equity interests

(1) The test for distinguishing between debt interests and equity interests focuses on economic substance rather than mere legal form (see subsection 974-10(2)). The test is designed to assess the economic substance of an interest in terms of its impact on the issuer's position.

Debt interests

(2) Subdivision 974-B tells you when an interest is a debt interest in an entity. The basic test is in section 974-20.

Equity interests

(3) Subdivision 974-C tells you when an interest is an equity interest in a company. The basic test is in section 974-75.

Tie breaker between debt and equity

(4) If an interest satisfies both the debt test and the equity test, it is treated as a debt interest and not an equity interest.

Distributions in relation to equity interests that are not shares

(5) If you have an equity interest in a company that is not a share, Subdivision 974-E tells you what will count as a non-share distribution, a non-share dividend and a non-share capital return in relation to the interest.

Concepts used in the debt and equity tests

(6) Subdivision 974-F defines a number of concepts that are used in the debt and equity tests (financing arrangement, effectively non-contingent obligation, benchmark rate of return and converting interest).

Operative provisions

974-10 Object

(1) An object of this Division is to establish a test for determining for particular tax purposes whether a *scheme, or the combined operation of a number of schemes:

(a) gives rise to a *debt interest; or

(b) gives rise to an *equity interest.

Note: The test is used, for example, for:

(a) identifying distributions that may be frankable and which may be subject to dividend withholding tax; and

(b) identifying returns that may be deductible to the company making the return; and

(c) resolving uncertainty as to the proper tax treatment for debt/equity hybrid interests (interests that have some debt qualities and some equity qualities); and

(d) identifying debt capital for the purposes of Division 820 (thin capitalisation rules).

(2) Another object of this Division is that the test referred to in subsection (1) is to operate on the basis of the economic substance of the rights and obligations arising under the *scheme or schemes rather than merely on the basis of the legal form of the scheme or schemes.

Note 1: The basic indicator of the economic character of a debt interest is the non-contingent nature of the returns. The basic indicator of the economic character of an equity interest, on the other hand, is the contingent nature of the returns (or convertibility into an interest of that nature).

Note 2: The test is intended to operate, for example, to:

(a) deny deductibility (but allow franking) for "interest" in relation to a scheme that has the legal form of a loan if the economic substance of the rights and obligations arising under the relevant scheme gives the interest characteristics that are the same as or similar to those of a dividend on an ordinary share (and thereby prevent deductible returns on equity); and

(b) allow a deduction (but not franking) for a "dividend" in relation to a scheme that has the legal form of an ordinary share if the economic substance of the rights and obligations arising under the relevant scheme gives the dividend characteristics that are the same as or similar to those of deductible interest on an ordinary loan (and thereby prevent frankable returns on debt).

This will not happen if a provision in this Act specifically provides for a different treatment for the interest or dividend.

(3) Another object of this Division is that the combined effect of *related schemes be taken into account in appropriate cases:

(a) to ensure that the test operates effectively on the basis of the economic substance of the rights and obligations arising under the schemes rather than merely on the basis of the legal form of the schemes; and

(b) to prevent the test being circumvented by entities merely entering into a number of separate schemes instead of a single scheme.

(4) Another object of this Division is to identify the distributions and credits made in respect of *non-share equity interests in a company that are to be treated as *dividends (***non-share dividends***) and those that are to be treated as returns of capital (***non-share capital returns***).

Note: Non-share dividends will generally be included in the recipient's assessable income and may be frankable.

(5) The Commissioner must have regard to the objects stated in subsections (1) to (3) in exercising the power to make a determination under any of the following provisions:

(a) subsection 974-15(4);

(b) subsection 974-60(3), (4) or (5);

(c) section 974-65;

(d) subsection 974-70(4);

(e) subsection 974-150(1).

Note: An entity can apply to the Commissioner to have a determination made and can object under Part IVC of the *Taxation Administration Act 1953* if it is dissatisfied with a determination (see section 974-112).

(6) Regulations may also be made under the provisions of this Division:

(a) to clarify the meaning of certain words and phrases in the light of emerging commercial practices, conditions and products; and

(b) to give guidance on the detailed operation of particular provisions.

The regulations must be consistent with the objects stated in subsections (1) to (3).

(7) Without limiting subsection 13(3) of the *Legislative Instruments Act 2003*, the regulations made for the purposes of this Division may specify different rules for different classes of circumstances.

Subdivision 974-B—Debt interests

Table of sections

974-15 Meaning of *debt interest*

Single scheme giving rise to debt interest

(1) A *scheme gives rise to a ***debt interest*** in an entity if the scheme, when it comes into existence, satisfies the debt test in subsection 974-20(1) in relation to the entity.

Note 1: A debt interest can also arise under subsection (2) (related schemes) or section 974-65 (Commissioner's discretion).

Note 2: Section 974-55 defines various aspects of the debt interest that arises.

Related schemes giving rise to debt interest

(2) Two or more *related schemes (the ***constituent schemes***) together give rise to a ***debt interest*** in an entity if:

(a) the entity enters into, participates in or causes another entity to enter into or participate in the constituent schemes; and

(b) a scheme with the combined effect or operation of the constituent schemes (the ***notional scheme***) would satisfy the debt test in subsection 974-20(1) in relation to the entity if the notional scheme came into existence when the last of the constituent schemes came into existence; and

(c) it is reasonable to conclude that the entity intended, or knew that a party to the scheme or one of the schemes intended, the combined economic effects of the constituent schemes to be the same as, or similar to, the economic effects of a debt interest.

This is so whether or not the constituent schemes come into existence at the same time and even if none of the constituent schemes would individually give rise to that or any other *debt interest.

Note: Section 974-105 explains the effect, for tax purposes, of actions taken under the schemes.

(3) Subsection (2) does not apply if each of the *schemes individually gives rise to a *debt interest in the entity.

(4) Two or more *related schemes do not give rise to a ***debt interest*** in an entity under subsection (2) if the Commissioner determines that it would be unreasonable to apply that subsection to those schemes.

(5) Without limiting subsection 974-10(5), the Commissioner must, in exercising the power to make a determination under subsection (4), have regard to the following:

(a) the purpose of the *schemes (considered both individually and in combination);

(b) the effects of the schemes (considered both individually and in combination);

(c) the rights and obligations of the parties to the schemes (considered both individually and in combination);

(d) whether the schemes (when considered either individually or in combination) provide the basis for, or underpin, an interest issued to investors with the expectation that the interest can be assigned to other investors;

(e) whether the schemes (when considered either individually or in combination) comprise a set of rights and obligations issued to investors with the expectation that it can be assigned to other investors;

(f) any other relevant circumstances.

(6) If:

(a) 2 or more *related schemes give rise to a *debt interest in an entity; and

(b) one or more of those schemes (the ***hedging scheme or schemes***) are schemes for hedging or managing financial risk; and

(c) the other scheme or schemes give rise to a debt interest in the entity even if the hedging scheme or schemes are disregarded;

the debt interest that arises from the schemes is taken, for the purposes of Division 820 (the thin capitalisation rules), not to include the hedging scheme or schemes.

Note: This means that in these circumstances the losses associated with the hedging scheme or schemes are not debt deductions under section 820-40.

974-20 The test for a debt interest

Satisfying the debt test

(1) A *scheme satisfies the debt test in this subsection in relation to an entity if:

(a) the scheme is a *financing arrangement for the entity; and

(b) the entity, or a *connected entity of the entity, receives, or will receive, a *financial benefit or benefits under the scheme; and

(c) the entity has, or the entity and a connected entity of the entity each has, an *effectively non-contingent obligation under the scheme to provide a financial benefit or benefits to one or more entities after the time when:

(i) the financial benefit referred to in paragraph (b) is received if there is only one; or

(ii) the first of the financial benefits referred to in paragraph (b) is received if there are more than one; and

(d) it is substantially more likely than not that the value provided (worked out under subsection (2)) will be at least equal to the value received (worked out under subsection (3)); and

(e) the value provided (worked out under subsection (2)) and the value received (worked out under subsection (3)) are not both nil.

The scheme does not need to satisfy paragraph (a) if the entity is a company and the interest arising from the scheme is an interest covered by item 1 of the table in subsection 974-75(1) (interest as a member or stockholder of the company).

Note: Section 974-30 tells you when a financial benefit is taken to be provided to an entity.

(2) The ***value provided*** is:

(a) the value of the *financial benefit to be provided under the *scheme by the entity or a *connected entity if there is only one; or

(b) the sum of the values of all the financial benefits provided or to be provided under the scheme by the entity or a connected entity of the entity if there are 2 or more.

Note: Section 974-35 tells you how to value financial benefits.

(3) The ***value received*** is:

(a) the value of the *financial benefit received, or to be received, under the *scheme by the entity or a *connected entity of the entity if there is only one; or

(b) the sum of the values of all the financial benefits received, or to be received, under the scheme by the entity or a connected entity if there are 2 or more.

(4) For the purposes of paragraph (1)(b) and subsections (2) and (3):

(a) a *financial benefit to be provided under the *scheme by the entity or a *connected entity is taken into account only if it is one that the entity or connected entity has an *effectively non-contingent obligation to provide; and

(b) a financial benefit to be received under the scheme by the entity or a connected entity is taken into account only if it is one that another entity has an effectively non-contingent obligation to provide.

Multiple financial benefits

(5) Paragraphs (1)(b) and (c) apply to 2 or more *financial benefits whether they are provided at the same time or over a period of time.

Regulations

(6) The regulations:

(a) may specify circumstances in which paragraph (1)(d) is satisfied or not satisfied; and

(b) may otherwise specify rules to be applied in determining whether or not paragraph (1)(d) is satisfied.

974-25 Exceptions to the debt test

Short term schemes

(1) A *scheme does not satisfy the debt test in subsection 974-20(1) in relation to an entity if:

(a) at least a substantial part of a *financial benefit mentioned in that subsection does not consist of either of the following or a combination of either of the following:

(i) a liquid or monetary asset;

(ii) an amount of money; and

(b) the scheme requires the financial benefit mentioned in paragraph 974-20(1)(c) to be provided within a period of no more than 100 days of the receipt of the first financial benefit mentioned in paragraph 974-20(1)(b); and

(c) the financial benefit mentioned in paragraph 974-20(1)(c):

(i) is in fact provided within that period; or

(ii) is not provided within that period because the entity required to provide the benefit neglects to provide the benefit within that period (although willing to do so); or

(iii) is not provided within that period because the entity required to provide the benefit is unable to provide the benefit within that period (although willing to do so); and

(d) the scheme is not one of a number of *related schemes that together are taken to give rise to a *debt interest under subsection 974-15(2).

Regulations

(2) The regulations may make provision in relation to the application or operation of subsection (1). Without limiting this, the regulations may:

(a) specify what constitutes a substantial part of a *financial benefit for the purposes of paragraph (1)(a); or

(b) specify a period to be substituted for the period referred to in paragraph (1)(b).

974-30 Providing a financial benefit

Issue of equity interest

(1) The following do not constitute the provision of a *financial benefit by an entity or a *connected entity of the entity:

(a) the issue of an *equity interest in the entity or a connected entity of the entity; or

(b) an amount that is to be applied in respect of the issue of an equity interest in the entity or a connected entity of the entity.

Providing a financial benefit to an entity

(2) A *financial benefit is taken to be provided to an entity if it is provided:

(a) to the entity; or

(b) on the entity's behalf; or

(c) for the entity's benefit.

Obligation to provide future financial benefit

(3) For the avoidance of doubt, if you have a present obligation to provide a *financial benefit to an entity at some time in the future:

(a) the financial benefit is taken to be a financial benefit to be provided in the future; and

(b) the obligation to provide the financial benefit is taken not to be a financial benefit being provided at the present.

974-35 Valuation of financial benefits—general rules

Value in nominal terms or present value terms

(1) For the purposes of this Subdivision:

(a) the value of a *financial benefit received or provided under a *scheme is its value calculated:

(i) in nominal terms if the performance period (see subsection (3)) must end no later than 10 years after the interest arising from the scheme is issued; or

(ii) in present value terms (see section 974-50) if the performance period must or may end more than 10 years after the interest arising from the scheme is issued; and

(b) the regulations may make provisions relating to the valuation of a financial benefit.

Assume scheme runs its full term

(2) The value of a *financial benefit received or provided under a *scheme is calculated assuming that the interest arising from the scheme will continue to be held for the rest of its life.

Note 1: Section 974-40 makes specific provision for cases in which there is a right or option to terminate the interest early.

Note 2: Section 974-45 makes specific provision for cases involving convertible interests.

Performance period

(3) The ***performance period*** is the period within which, under the terms on which the interest is issued, the *effectively non-contingent obligations of the issuer, and any *connected entity of the issuer, to provide a *financial benefit in relation to the interest have to be met.

(4) An obligation is treated as having to be met within 10 years after the interest is issued if:

(a) the issuer; or

(b) the *connected entity of the issuer;

has an *effectively non-contingent obligation to terminate the interest within that 10 year period even if the terms on which the interest is issued formally allow the obligation to continue after the end of that 10 year period.

Benefit dependent on variable factor

(5) If:

(a) a *financial benefit received or provided in respect of an interest depends on a factor that may vary over time (such as a variable interest rate); and

(b) that factor is one commonly used in commercial arrangements; and

(c) it would be unreasonable to expect any of the parties to the *scheme to know, or to anticipate accurately, the future value of that factor; and

(d) that factor has a particular value (the ***starting value***) when the scheme is entered into;

the value of the financial benefit is calculated assuming that the factor's value will retain the starting value for the whole of the life of the scheme.

Note: For example, the value of a return based on a floating interest rate is calculated on the basis that the interest rate remains the interest rate that is applicable when the scheme is entered into.

Scheme wholly in foreign currency etc.

(6) If all the *financial benefits provided and received under a *scheme are denominated in a particular foreign currency or in terms of quantities of a particular commodity or other unit of account, they are not to be converted into Australian currency for the purpose of comparing their relative values for the purposes of this Subdivision.

974-40 Valuation of financial benefits—rights and options to terminate early

(1) This section deals with the situation in which a party to a *scheme has a right or option to terminate the scheme early (whether by discharging an obligation early, converting the interest arising from the scheme into another interest or otherwise).

Note 1: An example of terminating a scheme early by discharging an obligation early is terminating a loan by discharging the obligation to repay the principal (and any outstanding interest) early.

Note 2: In certain circumstances, conversion of an interest into another interest can terminate its life (see section 974-45).

(2) The existence of the right or option is to be disregarded in working out the length of the life of the interest arising from the *scheme for the purposes of this Subdivision if the party does not have an *effectively non-contingent obligation to exercise the right or option.

(3) If the party does have an *effectively non-contingent obligation to exercise the right or option, the life of the interest ends at the earliest time at which the party will have to exercise the right or option.

(4) This section does not limit subsection 974-35(2).

974-45 Valuation of financial benefits—convertible interests

(1) This section deals with the situation in which a *scheme gives rise to an *interest that will or may convert into an *equity interest in a company.

(2) The life of the interest ends no later than the time when it converts into that *equity interest.

(3) The possibility of the conversion is to be disregarded in working out the length of the life of the interest arising from the *scheme for the purposes of section 974-35 if it is uncertain:

(a) whether the interest will ever convert; or

(b) when the interest will convert.

Note: Section 974-40 deals with the situation in which a party to the scheme may exercise a right or option to convert the interest.

(4) This section does not limit subsection 974-35(2).

974-50 Valuation of financial benefits—value in present value terms

(1) Subject to the regulations made for the purposes of subsection (5), the value in present value terms of a *financial benefit to be provided or received in respect of an interest (the ***test interest***) is calculated under subsection (4).

(2) If you need to calculate the values in present value terms of a number of *financial benefits, the value of each financial benefit is to be calculated separately.

(3) The value of a *financial benefit is to be calculated assuming that all amounts to be paid by an entity in respect of the test interest are paid at the earliest time when the entity becomes liable to pay them.

(4) The value of a *financial benefit in present value terms is:

$$\frac{\text{Amount or value of *financial benefit in nominal terms}}{\left[1 + \text{Adjusted benchmark rate of return}\right]^{n}}$$

where:

adjusted benchmark rate of return is 75% of the *benchmark rate of return on the test interest.

n is the number of years in the period starting on the day on which the test interest is issued and ending on the day on which the *financial benefit is to be provided. If the period includes a part of a year, that part is to be expressed as the fraction:

$$\frac{\text{Number of days in that period}}{\text{Number of days in the year}}$$

year means a period of 12 calendar months.

(5) The regulations may provide for the method of calculating the value in present value terms of a *financial benefit.

(6) Without limiting subsection (5), the regulations may:

(a) provide for an entirely different method of calculating the present value of the *financial benefit; or

(b) specify the adjusted *benchmark rate of return; or

(c) provide for a different method of determining the adjusted benchmark rate of return; or

(d) specify rules for determining whether a *debt interest is an *ordinary debt interest.

974-55 The debt interest and its issue

(1) If a *scheme, or 2 or more *related schemes, give rise to a *debt interest in an entity, the debt interest:

(a) consists of the interest that carries the right to receive a *financial benefit that the entity or a *connected entity has an *effectively non-contingent obligation to provide under the scheme or any of the schemes; and

(b) is taken, subject to section 974-60, to be a debt interest in the entity; and

(c) is taken to be issued by the entity; and

(d) is ***issued*** when the entity (or a connected entity of the entity) first receives a *financial benefit under the scheme or any of the schemes; and

(e) is ***on issue*** while an effectively non-contingent obligation of the entity (or a connected entity of the entity) to provide a financial benefit under the scheme or any of the schemes remains unfulfilled.

(2) The interest referred to in paragraph (1)(a) may take the form of a proprietary right, a chose in action or any other form.

974-60 Debt interest arising out of obligations owed by a number of entities

(1) This section deals with the situation in which a *scheme, or a number of *related schemes together, would, apart from this section, give rise to the same *debt interest in 2 or more entities.

Note: A scheme may give rise to the same debt interest in 2 or more entities if each of those entities has non-contingent obligations to provide financial benefits under the scheme.

(2) The *debt interest:

(a) is a debt interest in the entity identified under subsection (3) or (4); and

(b) is not a debt interest in the other entity or entities.

(3) The *debt interest is a debt interest in the entity identified using the following method statement:

Method statement

Step 1. Work out, for each of the entities, the total value of the *financial benefits that the entity is under an *effectively non-contingent obligation to provide under the *scheme or schemes: this is the entity's ***obligation value***.

Step 2. The *debt interest is taken to be a debt interest in the entity with the greatest obligation value.

Step 3. If it is not possible to determine which entity has the greatest obligation value (whether because of an equality of, or uncertainty as to, obligation values or otherwise), the *debt interest is taken to be a debt interest in the entity agreed on by all the entities.

Step 4. If the entities do not agree, the interest is taken to be a *debt interest in the entity determined by the Commissioner.

(4) Despite subsection (3), the Commissioner may determine that the *debt interest is a debt interest in the entity specified in the determination.

(5) The Commissioner may make the determination only if satisfied, having regard to the economic substance of the relevant transactions, that the *debt interest is properly considered from a commercial point of view to be an interest in the entity specified in the determination.

974-65 Commissioner's power

(1) Despite subsection 974-20(1) (the debt test), the Commissioner may determine that a *scheme gives rise to a ***debt interest*** in an entity if the Commissioner considers that:

(a) the scheme would satisfy paragraphs 974-20(1)(a), (b), (c) and (e); but

(b) instead of satisfying paragraph 974-20(1)(d), the scheme would satisfy all the following subparagraphs:

(i) it is substantially more likely than not that the value of the *financial benefit to be provided by the entity (or a *connected entity of the entity) under the *effectively non-contingent obligation will be at least equal to the substantial part of the value of the financial benefit received or to be received by the entity (or its connected entity) under the scheme;

(ii) it is substantially more likely than not that other financial benefits will be provided by the entity (or its connected entity) to one or more entities under the scheme;

(iii) it is substantially more likely than not that the sum of the values of the financial benefits mentioned in subparagraphs (i) and (ii) will be at least equal to the value of the financial benefit received by the entity (or its connected entity) under the scheme.

(2) In making the determination, the Commissioner must have regard to the following:

(a) the difference between the value of the *financial benefit received and the value of the financial benefit to be provided under the *effectively non-contingent obligation;

(b) the degree of likelihood of other financial benefits being provided under the *scheme;

(c) the degree of likelihood of the sum of the value of the financial benefits mentioned in subparagraphs (1)(b)(i) and (ii) being equal to or greater than the value of the financial benefit received under the scheme;

(d) the particular circumstances surrounding the scheme (including circumstances of the parties to the scheme and their purposes for entering into the scheme).

(3) If the Commissioner determines under this section that a *scheme gives rise to a *debt interest, the scheme has that effect for all purposes of this Division.

Subdivision 974-C—Equity interests in companies

Table of sections

974-70 Meaning of *equity interest* in a company

Scheme giving rise to equity interest

(1) A *scheme gives rise to an ***equity interest*** in a company if, when the scheme comes into existence:

(a) the scheme satisfies the equity test in subsection 974-75(1) in relation to the company because of the existence of an interest; and

(b) the interest is not characterised as, and does not form part of a larger interest that is characterised as, a *debt interest in the company, or a *connected entity of the company, under Subdivision 974-B.

Note 1: An equity interest can also arise under subsection (2) if a notional scheme with the combined effect of a number of related schemes would give rise to an equity interest under this subsection. To do this, the notional scheme would need to satisfy paragraph (b). This means that the related schemes will not give rise to an equity interest if the notional scheme would be characterised as (or form part of a larger interest that would be characterised as) a debt interest in the company or a connected entity.

Note 2: An equity interest can also arise under section 974-80 (arrangements for funding return through connected entities).

Note 3: Section 974-95 defines various aspects of the equity interest that arises.

Related schemes giving rise to equity interest

(2) Two or more *related schemes (the ***constituent schemes***) are taken together to give rise to an ***equity interest*** in a company if:

(a) the company enters into, participates in or causes another entity to enter into or participate in the constituent schemes; and

(b) a scheme with the combined effect or operation of the constituent schemes (the ***notional scheme***) would give rise to an *equity interest in the company under

subsection (1) if the notional scheme came into existence when the last of the constituent schemes came into existence; and

(c) it is reasonable to conclude that the company intended, or knew that a party to the scheme or one of the schemes intended, the combined economic effects of the constituent schemes to be the same as, or similar to, the economic effects of an equity interest.

This is so whether or not the constituent schemes come into existence at the same time and even if none of the constituent schemes would individually give rise to that or any other equity interest.

Note: Section 974-105 explains the effect, for tax purposes, of actions taken under the schemes.

(3) Subsection (2) does not apply if each of the constituent *schemes individually gives rise to an *equity interest in the company.

(4) Two or more related *schemes do not give rise to an *equity interest in a company under subsection (2) if the Commissioner determines that it would be unreasonable to apply that subsection to those schemes.

(5) Without limiting subsection 974-10(5), the Commissioner must, in exercising the power to make a determination under subsection (4), have regard to the following:

(a) the purpose of the *schemes (considered both individually and in combination);

(b) the effects of the schemes (considered both individually and in combination);

(c) the rights and obligations of the parties to the schemes (considered both individually and in combination);

(d) whether the schemes (when considered either individually or in combination) provide the basis for, or underpin, an interest issued to investors with the expectation that the interest can be assigned to other investors;

(e) whether the schemes (when considered either individually or in combination) comprise a set of rights and obligations issued to investors with the expectation that it can be assigned to other investors;

(f) any other relevant circumstances.

974-75 The test for an equity interest

Basic test for equity interest

(1) A *scheme satisfies the equity test in this subsection in relation to a company if it gives rise to an interest set out in the following table:

Equity interests

Item	Interest
1	An interest in the company as a member or stockholder of the company.
2	An interest that carries a right to a variable or fixed return from the company if either the right itself, or the amount of the return, is in substance or effect *contingent on the economic performance (whether past, current or future) of: (a) the company; or (b) a part of the company's activities; or (c) a *connected entity of the company or a part of the activities of a connected entity of the company. The return may be a return of an amount invested in the interest.
3	An interest that carries a right to a variable or fixed return from the company if either the right itself, or the amount of the return, is at the discretion of: (a) the company; or (b) a *connected entity of the company. The return may be a return of an amount invested in the interest.
4	An interest issued by the company that: (a) gives its holder (or a *connected entity of the holder) a right to be issued with an *equity interest in the company or a *connected entity of the company; or (b) is an *interest that will, or may, convert into an equity interest in the company or a connected entity of the company.

This subsection has effect subject to subsection (2) (requirement for financing arrangement).

Note: Section 974-90 allows regulations to be made clarifying when a right or return is taken to be at discretion of a company or connected entity.

Financing arrangement

(2) A *scheme that would otherwise give rise to an *equity interest in a company because of an item in the table in subsection (1) (other than item 1) does not give rise to an equity interest in the company unless the scheme is a *financing arrangement for the company.

Form interest may take

(3) The interest referred to in item 2, 3 or 4 in the table in subsection (1) may take the form of a proprietary right, a chose in action or any other form.

Exception for certain at call loans—until 30 June 2005

(4) If:

(a) a *financing arrangement takes the form of a loan to a company by a *connected entity; and

(b) the loan does not have a fixed term; and

(c) either:

(i) the loan is repayable on demand made by the connected entity, and repayment is required immediately on the making of the demand, or is required at the end of a particular period after the demand is made (being a period that is not longer than is reasonably necessary to arrange repayment); or

(ii) the loan is repayable on the death of the connected entity (if the connected entity is an individual); and

(d) the arrangement was entered into on or before 30 June 2005;

the arrangement does not give rise to an ***equity interest*** in the company. Instead, the arrangement is taken, despite anything in Subdivision 974-B, to give rise to a ***debt interest*** in the company. This subsection ceases to have effect on 1 July 2005.

Note: If this subsection ceases to have effect in relation to an interest that is, according to the other provisions of this Division, an equity interest immediately after the cessation, an adjustment to the company's non-share capital account will occur at that time (see subsection 164-15(2)).

(5) If, while subsection (4) applies to a *financing arrangement, a circumstance occurs that would otherwise have attracted the operation of subsection 974-110(1) or (2) in relation to the arrangement:

(a) that subsection of section 974-110 does not apply to change the result that subsection (4) of this section produces in relation to the arrangement; but

(b) for the purpose of applying this Division in relation to the arrangement after subsection (4) of this section has ceased to have effect, that subsection of section 974-110 is taken to have produced the result that it would have produced if subsection (4) of this section had not applied to the arrangement.

Further exception for certain related party at call loans

(6) In applying this Division in relation to a particular *scheme and a particular income year (which may be the income year in which the scheme is entered into or a later income year), the scheme is taken not to give rise to an ***equity interest*** in a company, and instead to give rise to a ***debt interest*** in the company, if:

(a) the scheme takes the form of a loan to the company that satisfies paragraphs (4)(a), (b) and (c); and

(b) the company's *GST turnover (worked out at the end of the income year) is less than $20,000,000.

Note: If this subsection does not apply in relation to the previous income year or the next income year, and the scheme gives rise to an equity interest according to the other provisions of this Division, an adjustment to the company's non-share capital account will occur at the end of the previous income year or the start of the next income year (see subsections 164-15(2) and 164-20(3)).

(7) For the purpose of paragraph (6)(b), the question whether a company's *GST turnover (worked out at the end of an income year) is less than $20,000,000 is to be determined in accordance with subsection 188-10(2) of the *GST Act, as if that amount of $20,000,000 were a turnover threshold for the purposes of that subsection of the GST Act.

974-80 Equity interest arising from arrangement funding return through connected entities

(1) This section deals with the situation in which:

(a) an interest carries a right to a variable or fixed return from a company; and

(b) the interest is held by a *connected entity of the company; and

(c) apart from this section, the interest would not be an *equity interest in the company; and

(ca) the *scheme that gives rise to the interest is a *financing arrangement for the company; and

(d) there is a scheme, or a series of schemes, designed to operate so that the return to the connected entity is to be used to fund (directly or indirectly) a return to another person (the ***ultimate recipient***).

(2) The interest is an ***equity interest*** in the company if:

(a) the amount of the return to the ultimate recipient is in substance or effect *contingent on the economic performance (whether past, current or future) of:

(i) the company; or

(ii) a part of the company's activities; or

(iii) a *connected entity of the company or a part of the activities of a connected entity of the company; or

(b) either the right itself, or the amount of the return to the ultimate recipient, is at the discretion of:

(i) the company; or

(ii) a connected entity of the company; or

(c) the interest in respect of which the return to the ultimate recipient is made or another interest that arises from the scheme, or any of the schemes, referred to in paragraph (1)(d):

(i) gives the ultimate recipient (or a connected entity of the ultimate recipient) a right to be issued with an *equity interest in the company or a connected entity of the company; or

(ii) is an *interest that will, or may, convert into an equity interest in the company or a connected entity of the company;

and if the interest does not form part of a larger interest that is characterised as a *debt interest in the entity in which it is held, or a *connected entity, under Subdivision 974-B. The return may be a return of an amount invested in the interest.

Note 1: Section 974-90 allows regulations to be made clarifying when a right or return is taken to be at the discretion of a company or connected entity.

Note 2: Paragraphs (a), (b) and (c) parallel items 2, 3 and 4 of the table in subsection 974-75(1).

Example: Company A, Company B1, Company B2 and Company B3 are connected entities.

Company B1 operates Trust Fund C. An interest in Trust Fund C is issued to person H and the return on that interest is contingent on the economic performance of Company A.

Trust Fund C lends the money paid by H for the purchase of the interest to Company B1 which lends the money to Company B2 which lends the money to Company B3 which lends the money to Company A.

Under the arrangements under which the interest is issued and the loans made, payments of interest by Company A on the loan that Company B3 makes to Company A are intended to pass back through Company B2 and Company B1 to fund the return on H's interest in Trust Fund C.

Under subsection (2), Company B3 will have an equity interest in Company A. If the return to Company B3 were itself contingent on Company A's performance, Company B3's interest would be an equity interest in Company A under item 2 of the table in subsection 974-75(1) (and not under subsection (2) of this section).

Company B2 has an equity interest in Company B3 and Company B1 has an equity interest in Company B2. This is because the returns they get are intended to fund the return on H's interest in Trust Fund C and that return is contingent on the economic performance of Company A (which is related to both Company B3 and Company B2).

(3) The interest referred to in paragraph (1)(a) or (2)(c) may take the form of a proprietary right, a chose in action or any other form.

974-85 Right or return contingent on economic performance

(1) A right, or the amount of a return, is not ***contingent on the economic performance*** of an entity, or a part of the entity's activities, merely because the right or return is contingent on:

(a) the ability or willingness of an entity to meet the obligation to satisfy the right to the return; or

(b) the receipts or turnover of the entity or the turnover generated by those activities.

(2) The regulations may specify circumstances in which a right or return is to be taken to be contingent, or not contingent, on the economic performance of an entity or a part of an entity's activities.

(3) The regulations may provide that paragraph (1)(b) does not apply in the circumstances specified in the regulations.

(4) The regulations may provide that an interest that:

(a) is covered by item 2 in the table in subsection 974-75(1) or paragraph 974-80(2)(a); and

(b) arises in the circumstances specified in the regulations;

is not an ***equity interest*** because of:

(c) the limited extent to which the right or return that the interest carries is *contingent on the economic performance of an entity or a part of the entity's activities; or

(d) the practical insignificance of the right or return that the interest carries being contingent on that performance.

974-90 Right or return at discretion of company or connected entity

The regulations may specify circumstances in which a right, or the amount of a return, is to be taken to be ***at the discretion*** of a company or a *connected entity of the company.

974-95 The equity interest

(1) If a *scheme gives rise to an *equity interest in a company because of an item of the table in subsection 974-75(1), the equity interest consists of the interest referred to in that item.

(2) If 2 or more *related schemes give rise to an *equity interest in a company because of an item of the table in subsection 974-75(1), the equity interest consists of the combination of interests under the schemes that satisfy the requirements of that item.

(3) Subsection 974-80(2) also provides that certain interests are *equity interests in a company.

(4) If the returns on a *non-share equity interest in a company are payable to 2 or more entities:

(a) each entity is taken to be the holder of a non-share equity interest in the company; and

(b) each entity's non-share equity interest consists of the interests that:

(i) constitute the non-share equity interest; and

(ii) are held by that entity.

(5) The company in which an *equity interest exists is taken to be the issuer of the interest.

Subdivision 974-D—Common provisions

Table of sections

974-100 Treatment of convertible and converting interests

(1) If a *debt interest is an *interest that will or may convert into an *equity interest, the conversion is taken, for the purposes of this Division to give rise to a new interest (and is not treated merely as a continuation of the debt interest).

(2) If an *equity interest is an *interest that will or may convert into a *debt interest, the conversion is taken, for the purposes of this Division to give rise to a new interest (and is not treated merely as a continuation of the equity interest).

974-105 Effect of action taken in relation to interest arising from related schemes

(1) If:

(a) a *scheme, or schemes, give rise to a *debt interest in an entity or an *equity interest in a company; and

(b) the entity or company pays a return, or undertakes any other transaction, in respect of any of the following (the ***component element***):

(i) the scheme; or

(ii) a part of the scheme; or

(iii) one of those schemes; or

(iv) a part of one of those schemes;

then, for the purposes of the provisions that subsection (2) covers, the return is taken to be paid, or the transaction to have been undertaken, in respect of the debt interest or equity interest and not in respect of the component element.

Example: Company A issues a convertible note to Company B. Company C, a connected entity of Company B, provides a binding collateral undertaking to Company A that Company B will exercise the option to convert the note into shares in Company A. The convertible note and the undertaking are related schemes that may give rise to an equity interest in Company A if their combined effect satisfies section 974-70. If so, the returns on the note are taken to be returns in respect of the equity interest.

(2) This subsection covers:

(a) the provisions of this Division (other than this section); and

(b) any other provision of this Act whose operation depends on an expression whose meaning is given by this Division.

974-110 Effect of material change

Change to existing scheme—general rule

(1) If:

(a) a *scheme or schemes give rise to a *debt interest (or an *equity interest) in a company; and

(b) the scheme, or one or more of the schemes, are subsequently changed, including where one or more (but not all) of the schemes cease to exist; and

(c) the scheme or schemes as they exist immediately after the change would give rise to an equity interest (or a debt interest) in the company if they came into existence when the change occurred; and

(d) subsection (1A) does not apply to the change;

this Division applies after the change as if the scheme or schemes as they exist immediately after the change came into existence when the change occurred.

Note 1: This will mean that the characterisation of the interest will change at that time.

Note 2: This section can apply to an interest a number of times so that, for example, an interest that is equity when issued may change to debt because of one subsequent change and then back to equity because of a later change.

Note 3: There will be an adjustment to the company's non-share capital account when the change occurs (see subsections 164-15(2) and 164-20(3)).

Change to existing scheme—special rule for changing a related party at call etc. loan to a private company from equity to debt

(1A) If:

(a) a *scheme takes the form of a loan that satisfies paragraphs 974-75(4)(a), (b) and (c); and

(b) the scheme gives rise to an *equity interest (disregarding the effect this subsection has on the characterisation of the interest because of the change referred to in paragraph (c) of this subsection); and

(c) the scheme is subsequently changed; and

(d) the change occurs in the period starting immediately after the end of a particular income year (the ***year of effect***) and ending at the end of the earlier of the following days:

(i) the due date for lodgment of the company's *income tax return for the year of effect;

(ii) the date of lodgment of the company's income tax return for the year of effect; and

(e) the scheme, as it exists immediately after the change, would give rise to a *debt interest in the company if the interest came into existence when the change occurred; and

(f) the company is a *private company in relation to the year of effect; and

(g) subsection 974-75(6) does not apply in relation to the loan and the year of effect; and

(h) the company elects that this subsection is to apply to the change;

this Division applies as if the scheme, as it exists immediately after the change, had come into existence at the start of the year of effect, and as if no other change of a kind referred to in subsection (1) had occurred in relation to the interest in the period commencing at the start of the year of effect and ending when the first-mentioned change was made.

Note 1: This will mean that:

(a) the characterisation of the interest will change, with effect back to the start of the year of effect; and

(b) that characterisation will not be affected by other changes that occurred after the start of the year of effect and before the change to which this subsection applies.

Note 2: This section can apply to an interest a number of times so that, for example, an interest that is an equity interest when issued may change to debt because of one subsequent change and then back to equity because of a later change.

Note 3: An adjustment to the company's non-share capital account will be taken to have occurred at the start of the year of effect (see subsection 164-20(3)).

(1B) An election for the purposes of paragraph (1A)(h):

(a) must be in writing; and

(b) can only be made in the period referred to in paragraph (1A)(d); and

(c) cannot be revoked.

Entering into a new related scheme

(2) If:

(a) a *scheme or schemes give rise to a *debt interest (or an *equity interest) in a company; and

(b) the company subsequently enters into, participates in or causes another entity to enter into or participate in a new *related scheme; and

(c) the scheme or schemes, together with:

(i) the new related scheme; and

(ii) any other related scheme that the entity (or company) enters into, participates in or causes another entity to enter into or participate in before the new related scheme is entered into;

would give rise to an equity interest (or a debt interest) in the company if they all came into existence when the new related scheme is entered into;

this Division applies after the new related scheme is entered into as if all the schemes referred to in paragraph (c) had come into existence when the new related scheme is entered into.

Note 1: This will mean that the characterisation of the interest will change at that time.

Note 2: This section can apply to an interest a number of times so that, for example, an interest that is equity when issued may change to debt because of one subsequent change and then back to equity because of a later change.

Note 3: There will be an adjustment to the company's non-share capital account when the change occurs (see subsections 164-15(2) and 164-20(3)).

All prior changes to be taken into account

(3) In applying paragraphs (1)(c), (1A)(e) and (2)(c) to the *scheme or schemes, take into account:

(a) all changes to the scheme or schemes that occur before the change or before the new related scheme is entered into; and

(b) all *related schemes entered into before the change or before the new related scheme is entered into; and

(c) all changes to related schemes referred to in paragraph (b) that occur before the change or before the new related scheme is entered into.

974-112 Determinations by Commissioner

Determinations covered by this section

(1) This section covers a determination by the Commissioner under any of the following provisions:

(a) subsection 974-15(4);

(b) subsection 974-60(3), (4) or (5);

(c) section 974-65;

(d) subsection 974-70(4);

(e) subsection 974-150(1).

Determination on own initiative or on application

(2) The Commissioner may make a determination covered by this section:

(a) on his or her own initiative; or

(b) on an application made under subsection (3).

Application for determination

(3) An entity may apply to the Commissioner for a determination covered by this section in relation to:

(a) an interest of which the entity is the issuer; or

(b) an interest of which the entity would be the issuer:

(i) if the determination were made; or

(ii) if the determination were not made.

Note: Paragraph (b) may apply, for example, if the effect of the determination applied for would be to allow, or to prevent, a number of related schemes giving rise to a debt interest or an equity interest.

(4) The application:

(a) must be in writing; and

(b) must set out the grounds on which the applicant thinks the determination should be made; and

(c) must set out any information relevant to deciding whether to make the determination.

Review of determinations

(5) A taxpayer who is dissatisfied with a determination covered by this section may object against the determination in the manner set out in Part IVC of the *Taxation Administration Act 1953*.

Subdivision 974-E—Non-share distributions by a company

Table of sections

974-115 Meaning of *non-share distribution*

A company makes a ***non-share distribution*** to you if:

(a) you hold a *non-share equity interest in the company; and

(b) the company:

(i) distributes money to you; or

(ii) distributes other property to you; or

(iii) credits an amount to you;

as the holder of that interest.

974-120 Meaning of *non-share dividend*

(1) Subject to subsection (2), all *non-share distributions are ***non-share dividends***.

(2) A *non-share distribution is not a ***non-share dividend*** to the extent to which the company debits the distribution against:

(a) the company's *non-share capital account; or

(b) the company's *share capital account.

974-125 Meaning of *non-share capital return*

A ***non-share capital return*** is a *non-share distribution to the extent to which it is not a *non-share dividend.

Subdivision 974-F—Related concepts

Table of sections

974-130 Financing arrangement

(1) A *scheme is a ***financing arrangement*** for an entity if it is entered into or undertaken:

(a) to raise finance for the entity (or a *connected entity of the entity); or

(b) to fund another scheme, or a part of another scheme, that is a *financing arrangement under paragraph (a); or

(c) to fund a return, or a part of a return, payable under or provided by or under another scheme, or a part of another scheme, that is a financing arrangement under paragraph (a).

(2) The following are examples of *schemes that are generally entered into or undertaken to raise finance:

(a) a bill of exchange;

(b) income securities;

(c) a *convertible interest that will convert into an *equity interest.

Note: Paragraph (a) is likely to be relevant for debt interests, paragraph (b) for equity interests and paragraph (c) for both.

(3) The following are examples of *schemes that are generally not entered into or undertaken to raise finance:

(a) a derivative that is used solely for managing financial risk;

(b) a contract for personal services entered into in the ordinary course of a business.

Note: These may be relevant for both debt interests and equity interests.

(4) For the purposes of subsection (1), the following *schemes are taken not to be entered into or undertaken to raise finance:

(a) a lease or bailment that satisfies all of the following:

(i) the property leased or bailed is not property to which Division 16D of Part III of the *Income Tax Assessment Act 1936* (arrangements relating to the use of property) applies;

(ii) the lease or bailment is not a relevant agreement for the purposes of section 128AC of that Act (deemed interest in respect of hire-purchase and certain other arrangements);

(iii) the lease or bailment is not an *arrangement to which Division 240 of this Act (about arrangements treated as a sale and loan), or Division 242 of this Act (about luxury car leases), applies;

(v) the lessee or bailee, or a *connected entity of the lessee or bailee, is not to, and does not have an obligation (whether contingent or not) or a right to, acquire the leased or bailed property;

(vi) Division 250 of this Act does not apply to a person and the property leased or bailed;

(b) a securities lending arrangement under section 26BC of the *Income Tax Assessment Act 1936*;

(c) a life insurance or general insurance contract undertaken as part of the issuer's ordinary course of business;

(d) a scheme for the payment of royalties (within the meaning of the *Income Tax Assessment Act 1936*) other than:

(i) a qualifying arrangement for the purposes of Division 16D of Part III of the *Income Tax Assessment Act 1936*; or

(ii) a relevant agreement for the purposes of section 128AC of that Act; or

(iii) a scheme or arrangement for the payment of royalties in relation to an asset if Division 250 of this Act applies to a person and the asset.

(5) The regulations may:

(a) specify that particular *schemes are not ***financing arrangements***; and

(b) specify circumstances in which a scheme will not be a ***financing arrangement***.

974-135 Effectively non-contingent obligation

(1) 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.

(2) Without limiting subsection (1), that subsection applies to:

(a) providing a *financial benefit under the *scheme; or

(b) terminating the scheme.

(3) An obligation is ***non-contingent*** if it is not contingent on any event, condition or situation (including the economic performance of the entity having the obligation or a *connected entity of that entity), other than the ability or willingness of that entity or connected entity to meet the obligation.

(4) The existence of the right of the holder of an *interest that will or may convert into an *equity interest in a company to convert the interest does not of itself make the issuer's obligation to repay the investment not non-contingent.

(5) An obligation to redeem a preference share is not contingent merely because there is a legislative requirement for the redemption amount to be met out of profits or a fresh issue of *equity interests.

(6) In determining whether there is in substance or effect a non-contingent obligation to take the action, have regard to the artificiality, or the contrived nature, of any contingency on which the obligation to take the action depends.

Note: The artificiality, or the contrived nature, of a contingency would tend to indicate that there is, in substance or effect, a non-contingent obligation to take that action.

(7) 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.

(8) The regulations may make further provisions relating to the following:

(a) what constitutes a non-contingent obligation;
(b) what does not constitute a non-contingent obligation;
(c) what constitutes an *effectively non-contingent obligation;
(d) what does not constitute an effectively non-contingent obligation.

974-140 Ordinary debt interest

(1) A *debt interest arising from a scheme is an ***ordinary debt interest*** if none of the obligations under the scheme is in substance or effect *contingent on the economic performance of:
(a) the issuer of the interest; or
(b) a *connected entity; or
(c) a part of the operations of the issuer or a connected entity.

(2) The regulations may specify rules for determining whether a *debt interest is an *ordinary debt interest.

974-145 Benchmark rate of return

(1) The ***benchmark rate of return*** for an interest (the ***test interest)*** in an entity is the annually compounded internal rate of return on an *ordinary debt interest that:
(a) is issued, immediately before the test interest is issued, by the entity, or an equivalent entity, to an entity that is not a *connected entity; and
(b) has a comparable maturity date; and
(c) is in the same currency; and
(d) is issued in the same market; and
(e) has the same credit status; and
(f) has the same degree of subordination to debts owed to the ordinary creditors of the issuer.

(2) If there is no interest that satisfies subsection (1), the ***benchmark rate of return*** for the test interest is the annually compounded internal rate of return on an interest that is closest to the test interest in the respects referred to in that subsection (adjusted appropriately to take account of the differences between that interest and the test interest).

(3) The regulations may:
(a) specify the meaning to be given to an expression used in this section; or
(b) provide for a different method of determining the *benchmark rate of return.

974-150 Schemes

(1) The Commissioner:
(a) may determine that what would otherwise be a single *scheme is to be treated for the purposes of this Division as 2 or more separate schemes; and
(b) may determine that the schemes are to be taken for the purposes of this Division to not be *related schemes.

(2) Without limiting subsection 974-10(5), the Commissioner must, in exercising the power to make a determination under subsection (2), have regard to the following:

(a) the purpose of the *scheme (considered both as a whole and in terms of its individual components);
(b) the effects of the scheme and each of its components (considered both as a whole and in terms of its individual components);
(c) the rights and obligations of the parties to the scheme (considered both as a whole and in relation to its individual components);
(d) whether the scheme (when considered as a whole or in terms of its individual components) provides the basis for, or underpins, an interest issued to investors with the expectation that the interest can be assigned to other investors;
(e) whether the scheme (when considered as a whole or in terms of its individual components) comprises a set of rights and obligations issued to investors with the expectation that it can be assigned to other investors;
(f) any other relevant circumstances.

(3) The regulations:
(a) may provide that, in the circumstances specified in the regulations, what would otherwise be a single *scheme is to be treated for the purposes of this Division as 2 or more separate schemes; and
(b) may provide that the schemes are to be taken for the purposes of this Division to not be *related schemes.

974-155 Related schemes

(1) Subject to subsection (3), 2 *schemes are ***related*** to one another if they are related to one another in any way.

(2) Without limiting subsection (1), 2 *schemes are ***related*** to each other if:
(a) the schemes are based on stapled instruments; or
(b) one of the schemes would, from a commercial point of view, be unlikely to be entered into unless the other scheme was entered into; or
(c) one of the schemes depends for its effect on the operation of the other scheme; or
(d) one scheme complements or supplements the other; or
(e) there is another scheme to which both the schemes are related because of a previous application or applications of this subsection.

(3) Two *schemes are not ***related*** to one another merely because:
(a) one refers to the other; or
(b) they have a common party.

(4) The regulations may specify circumstances in which 2 *schemes:
(a) are taken to be related to one another; or
(b) are taken not to be related to one another.

974-160 Financial benefit

(1) In this Act:

financial benefit:
(a) means anything of economic value; and

(b) includes property and services; and

(c) includes anything that regulations made for the purposes of subsection (3) provide is a financial benefit;

even if the transaction that confers the benefit on an entity also imposes an obligation on the entity.

(2) In applying subsection (1), benefits and obligations are to be looked at separately and not set off against each other.

(3) The regulations may provide that a thing specified in the regulations is a ***financial benefit*** for the purposes of this Act.

974-165 Convertible and converting interests

An interest (the ***first interest***) is an ***interest that will or may convert into another interest*** (the ***second interest***) if:

(a) the first interest, or a part of the first interest, must be or may be converted into the second interest; or

(b) the first interest, or a part of the first interest, must be or may be redeemed, repaid or satisfied by:

(i) the issue or transfer of the second interest (whether to the holder of the first interest or to some other person); or

(ii) the acquisition of the second interest (whether by the holder of the first interest or by some other person); or

(iii) the application in or towards paying-up (in whole or in part) the balance unpaid on the second interest (whether the second interest is to be issued to the holder of the first interest or to some other person); or

(c) the holder of the first interest has, or is to have, a right or option to have allotted or transferred to the holder or to some other person, or for the holder or some other person otherwise to acquire:

(i) the second interest; or

(ii) a right or option to acquire the second interest.

(B) WHETHER PROVISIONS STILL IN FORCE

Section 215-10 of the *Income Tax Assessment Act 1997* remains in force, in the form set out above, as at the date of these submissions.

The provisions of Division 974 of the *Income Tax Assessment Act 1997* have been amended in only minor respects as follows:

The *Acts Interpretation Act 2011* (Act No. 46 of 2011), s 3 and Schedule 2 (Item 695), amended subs 974-50(4) with effect from 27 December 2011 by omitting from the definition of "year" the word "calendar".

The *Tax Laws Amendment (2011 Measures No.2) Act 2011* (Act No. 41 of 2011), s 3 and Schedule 5, Part 31 (Item 418), amended subs 975-150(2) with effect from 27 June 2011 by omitting the words "subsection (2)" and substituting "subsection (1)".