JOINT SUBMISSION BY

CPA Australia, National Institute of Accountants, The Taxation Institute of Australia, the Institute of Chartered Accountants in Australia and Taxpayers Australia

Draft Taxation Determination TD 2008/D6

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

Date: 21 May 2008

The Professional Bodies welcome the opportunity to comment on Draft Taxation Determination TD 2008/D6 ("the Draft Determination").

GENERAL COMMENTS

The conclusions reached by the Commissioner of Taxation ("Commissioner") in the Draft Determination in applying sections 26BB and 70B of the Income Tax Assessment Act 1936 ("ITAA 1936") appear to be based on the particular facts and circumstances of the arrangement defined in the Draft Determination, and the earlier Taxpayer Alert 2008/1.

It is submitted that:

- the conclusions reached by the Commissioner in the Draft Determination have no regard to precedent for analysing arrangements of this type. In particular, this appears to be the first example of a stapled arrangement being analysed without regard to the features of the individual legal instruments which have been stapled. The Professional Bodies therefore request that the Commissioner discuss in more detail the reasons why the Commissioner adopted the approach he has to analysing the arrangement in the Draft Determination. The Commissioner is also asked to reconcile certain statements in the Draft Determination which appear to be contradictory in relation to the description of the subject facts;

- the conclusions reached by the Commissioner give rise to further questions which need to be addressed (see section 2 below). The Professional Bodies request the Commissioner to make his views clear on these other matters; and

- because the conclusions reached in the Draft Determination are based on particular facts, those conclusions appear to have limited application. For this reason, the Professional Bodies question whether a Tax Determination is an appropriate form for the Commissioner to discuss these matters.

The above general comments are discussed in more detail below.

SPECIFIC COMMENTS

1 Approach to stapled security arrangements

In the Draft Determination, the Commissioner has analysed the "Stapled Security" arrangement by looking at the arrangement as a whole, rather than the individual component instruments comprising the stapled arrangement. This approach does not appear to have been adopted in the past when analysing stapled arrangements. The Professional Bodies request that the Commissioner give detailed reasons as to why this approach has been adopted in these particular circumstances.

Key facts relied upon by the Commissioner in reaching the conclusions in the Draft Determination include (paragraph 10 of the Draft Determination):

- That the Investor purchases the Stapled Securities under a single contract.
- Once the Note has been stapled to the Preference Share, the Note is no longer capable of existing separately from the Preference Share.
- The Note Terms do not permit the holder to receive the face value of the Note after the Note has been stapled to the Preference Share.

It appears that the Commissioner has concluded, as a matter of fact, that the Note and the Preference Share cannot be regarded as separate instruments after the stapling. This approach appears to be unique to the facts in the particular arrangement. The Commissioner is asked to confirm whether this conclusion is limited to the particular facts of the Stapled Security arrangement which is the subject of the Draft Determination, or whether this signals a new approach that the Commissioner will adopt in analysing all stapled security arrangements.

If this does signal a new approach to analysing stapled arrangements, will the Commissioner apply this approach to stapled instruments where the instruments that have been stapled have been issued by different entities? Or will this approach only apply to stapled instruments where the component individual instruments have been issued by the same entity?

In addition, the Commissioner regards the act of the stapling to be a variation to the Note Terms (see paragraph 25). It is not clear how this statement reconciles with the statement above regarding the legal position after stapling. That is, on the one hand the Commissioner is saying that the Note and the Preference Share cannot be regarded as separate instruments after the stapling. However, on the other hand, the Commissioner is saying that the stapling constitutes a variation to the Note Terms. If the Note Terms are varied, rather than terminated, the Note would continue in existence, with varied terms. However, if the Note and the Preference Share are no longer separate legal instruments after stapling, this would seem to assume that the Note no longer exists once stapling has occurred. The Commissioner is asked to explain how these statements reconcile.

Further, on an Assignment Event, the Note "destaples" from the Preference Share and is assigned to a subsidiary of the Company. This assignment seems to support the separate existence of the Note subsequent to the stapling, in contrast to the Commissioner's assertion at paragraph 10 that:

> *"Once the Note has been stapled to the Preference Share, the Note is no longer capable of existing separately from the Preference Share."*

The Commissioner makes the following statement in the next sentence of paragraph 10:

> *"It [the Note] remains part of the Stapled Security until the occurrence of an Assignment Event whereupon the Note is assigned back to the Company and will cease to exist."*

The Commissioner is asked to explain how these statements reconcile. In particular, how is it the case that the Note *"is no longer capable of existing separately from the Preference Share"* after stapling, yet some time subsequently (at the time of an Assignment Event) regains its separate legal identity?

2 Further questions to be addressed

(a) Is there a CGT event in respect of the Note?

The Commissioner makes the following statement at paragraph 10 of the Draft Determination:

> *"The Note Terms do not permit the holder to receive the face value of the Note after the Note has been stapled to the Preference Share."*

Paragraph 25 expands on this concept:

> *"It should be noted that the Commissioner accepts that before being stapled, the Note exists in legal form as an instrument giving the Initial Purchaser(s) the right to receive the face value on maturity, and therefore would be a 'note' for the purposes of the definition of 'security' under subsection 159GP(1). However, when the Initial Purchaser(s) enters into an agreement with the Company such that the Note Terms are varied resulting in the Initial Purchaser(s) no longer having the right to receive the face value of the Note, it is the Commissioner's view that the Note no longer meets the ordinary definition of the word 'note': there is no longer an entitlement for the holder to receive their investment in the instrument back."*

The footnote (footnote 3) to the above paragraph reads as follows:

> *"The change in the terms of the Note does not amount to a disposal of the Note by the Initial Purchaser(s); all that happens is that there is a waiver by the Initial Purchaser(s) of some of their rights under the Note. Any loss that the Initial Purchaser(s) would suffer from this waiver would not be a deduction to the Initial Purchaser under subsection 70B(2) due to the operation of subsection 70B(5)."*

The discussion below assumes that there is, as a matter of fact, a waiver by the Initial Purchaser(s) of some of their rights under the Note when the Note is stapled to the Preference Share.

The Commissioner's view is that any loss that the Initial Purchaser(s) would suffer from this waiver would not be a deduction to the Initial Purchaser under subsection 70B(2). This is due to the operation of subsection 70B(5). The Commissioner does not then consider whether some other provision of the tax law might give the Initial Purchaser a deduction or a capital loss. For example, if the Initial Purchaser has "released" the Company from having to pay the face value, or if the Initial Purchaser's right to receive that face value has been "abandoned, surrendered or forfeited", has CGT event C2 applied to those rights? Does the Initial Purchaser have a reduced cost base in those rights that would give rise to a capital loss as a result of CGT event C2 happening? The Commissioner is asked to discuss the potential application of CGT event C2 (section 104-25 of the Income Tax Assessment Act 1997) in these circumstances if section 70B does not give rise to a loss for the Initial Purchaser. To disaggregate the rights to be paid the face value of the Note in this way from the remainder of the Note Terms would seem to be consistent with the Commissioner's approach to underlying rights as expressed in Draft Taxation Determination TD 2008/D5.

(b) Is there a forgiveness of a commercial debt?

These findings of fact by the Commissioner lead to a further question which is not addressed in the Draft Determination. If the variation to the Note Terms results in a "release" or "waiver" of the Company's obligation to pay the face value of the Note to the Initial Purchaser, do the commercial debt forgiveness rules in Schedule 2C to the ITAA 1936 apply to the Company? It would seem that the Commissioner's analysis would mean that the stapling of the Note to the Preference Share would give rise to the application of the commercial debt forgiveness rules if the Company has, in effect, been forgiven its obligation to pay the face value on the Note. This would not seem an appropriate circumstance for the application of these rules as the Company has not economically benefited (in the traditional sense) from the "forgiveness" of a debt.

In summary, where as a matter of fact, there has been a waiver by the Initial Purchaser(s) of some of their rights under the Note when the Note is stapled to the Preference Share, the Professional Bodies request that the following two matters be addressed in detail:

- The potential application of CGT event C2 to the Initial Purchaser and whether the Initial Purchase makes a capital loss as a result of the happening of CGT event C2.

- The potential application of the commercial debt forgiveness rules to the Company that issued the Note.

If, as a matter of fact, there is no waiver by the Initial Purchaser(s) of some of their rights under the Note when the Note is stapled to the Preference Share, but instead the Note and the Preference Share are no longer capable of existing separately, the Commissioner is asked to address further questions.

(c) Is there a CGT event in respect of both the Note and the Preference Share?

As discussed above, the Commissioner has concluded, as a matter of fact, that the Note and the Preference Share cannot be regarded as separate legal instruments after the stapling. On that analysis, those intangible assets must end. Therefore:

- Does CGT event C2 happen to the Initial Purchaser in respect of the ending of the Note and the Preference Share upon the stapling?

- Is the amount of the capital proceeds received by the Initial Purchaser as a result of the CGT event C2 happening to the Note and the Preference Share equal to the market value of the bundle of rights referred to as the Stapled Security?

- Does CGT event C2 only happen in respect of the Note because the Note has ceased to exist (it has expired or it has been cancelled)?

Whichever analysis applies, the Commissioner is at least asked to confirm:

- How many CGT assets exist before stapling? (We assume two – the Note and the Preference Share). What is the cost base and reduced cost base of the asset(s)?

- How many CGT assets exist after stapling? (Is it still two, or is it only one, being the bundle of rights referred to as the Stapled Security, as a whole?). What is the cost base and reduced cost base of the asset(s)?

- If the answer to the above two questions is different, what CGT event applies?

- If a CGT event occurs, what is the amount of the capital proceeds received by the entity to whom the CGT event happens?

- How does this analysis potentially apply to other stapled arrangements where the instruments that have been stapled together have been issued by different legal entities?

3. Meaning of "security"

The approach taken in the Draft Determination is to:

- limit the words "or other security" in paragraph (a) of the definition of "security" in Section 159GP(1) to debt-like instruments by applying the *ejusdem generis* rule of statutory interpretation; and

- limit, similarly, the scope of paragraph (d) of the definition of "security" (that is, "any other contract … under which a person is liable to pay an amount …") to contracts with debt-like obligations.

We support this aspect of the Draft Determination, subject to the following comments on the proposed approach

We recommend that the ATO provide greater guidance regarding the indicia of what it considers to be a "debt like instrument". For example, does this concept link through to the debt / equity rules in Division 974 of the ITAA 1997? Is legal characterisation of the instrument as a "loan" (or similar) required?

On finalisation of the Draft Determination, paragraphs 30 and 31 of Taxation Ruling TR 96/14 (Traditional Securities), which currently states that paragraph (d) of the definition of "security" is *not* limited to debt-like contracts, will need to be consequently amended in order to ensure consistency between the ATO guidance.

4 Form of comments

The Commissioner's analysis appears very focussed on the particular facts and circumstances surrounding the particular arrangement. This means that the Draft Determination does not make clear to what extent the Commissioner's views in the Draft Determination represent a new approach to analysing the consequences of stapled security arrangements.

The Commissioner is therefore asked to make clear to what extent his views in the Draft Determination are meant to have broader application. In this regard, what are the particular circumstances that will give rise to an analysis of a stapled security arrangement as a whole bundle of rights, rather than as individual legal component assets which are to be dealt with together?

If the conclusions in the Draft Determination are unique to the particular facts, is a Taxation Determination the most appropriate form in for the Commissioner to publish his views?

5. Date of Application

In the event that approach set out in the Draft Determination is adopted in the final determination, we recommend that this approach be prospective only, that is, that the final determination only apply from its date of issue (or alternatively from the date of issue of the draft determination on 26 March 2008).

The ATO's proposed approach is unfavorable to taxpayers, as compared with the conventional treatment of separate instruments that are stapled. The Commissioner's proposed approach will potentially adversely impact stapled securities that have already been issued into the market.

Accordingly we submit that the final determination should have prospective application only.