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Capital raising and franking credits: Where are we now?

Tax and Litigation Update

The Australian Taxation Office recently released a Decision Impact Statement regarding the decision of the High Court in *Mills v Commissioner of Taxation* [2012] HCA 51.

The case concerned stapled securities which consisted of an unsecured subordinated note issued by the New Zealand branch of the Commonwealth Bank of Australia (CBA) and a preference share issued by CBA. The stapled securities were qualified as Tier 1 capital for regulatory purposes.

The total capital raised by the offering was AUD $2,000 million.

Funds raised through the issue of the securities were lent by the New Zealand branch of the CBA to a New Zealand subsidiary or were otherwise employed in the branch business.

The income of the New Zealand branch is exempt from Australian tax under s23AH of the *ITAA 1936*.

The CBA obtained a deduction for the distributions on the note in New Zealand.

The Commissioner made a determination under s177EA(5)(b) of the *ITAA 1936* to deny imputation benefits attached to a distribution expected to be made to a representative taxpayer.

The taxpayer was unsuccessful in challenging the determination before the Federal Court, and on appeal to the Full Federal Court, but was successful in the High Court.

Section 177EA deals with the creation of franking credits and the cancellation of franking credits.

Who does this affect?

- Financiers
- Capital raising advisors
- Investors
- Holders of hybrid stapled securities

Article Highlights

- High Court sets aside Commissioner's determination to deny imputation benefits attached to a distribution expected to be made to a representative taxpayer holding hybrid stapled securities issued by the CBA
- High Court considers application of the purpose test in respect of imputation benefits in s.177EA of the *ITAA 1936*.

In broad terms, the provision applies if:

a. there is a scheme in place for a disposition of membership interests in a corporate tax entity;

b. a frankable distribution has been paid to a taxpayer in respect of the membership interests;

c. the distribution was a franked distribution;

d. the taxpayer would, but for the operation of s.177EA, receive imputation benefits as a result of the distribution; and

e. having regard to the relevant circumstances of the scheme, it could be concluded that one of the persons who entered into or carried out the scheme did so 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.

It was common ground in this case that the securities possessed the first four features.

The question was whether the purpose of the scheme (not including an incidental purpose) was to enable the investors to obtain an imputation benefit.

At first instance, Justice Emmett held that the relevant matters and circumstances pointed towards the purpose of enabling holders of the securities to obtain an imputation benefit. His Honour considered that the characteristics of the securities were more like those of debt than equity. By issuing the securities in New Zealand, the CBA obtained a deduction in New Zealand regarding the distributions on the securities and the advantage of offering Australian residents the imputation benefit.

The Full Court of the Federal Court upheld Emmett J's decision.

In allowing the taxpayer's appeal, the High Court found that the CBA had a demonstrated need to raise Tier 1 capital, this was its main purpose and all means available to do so would have involved the CBA franking distributions to the same extent.

The High Court held that the franking purpose was no more than incidental in the sense that it followed as a natural consequence of the commercial requirement for Tier 1 capital and the other identified relevant circumstances did not alter this conclusion.

Accordingly, s.177EA did not apply and the Commissioner could not disallow the imputation benefits.

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The High Court stated that a purpose will be incidental and outside the scope of s.177EA(3)(e) *"if that purpose does no more than further some other purpose or follow from some other purpose" and that "a purpose can be incidental even where it is central to the design of a scheme if that design is directed to the achievement of another purpose".*

The case creates uncertainty as to how the ATO will view capital raising activities that result in the flow of franking credits. Taxation Ruling 2009/3 may be amended having regard to the decision.

The ATO Decision Impact Statement notes the High Court's decision suggests that in cases where a substantial, albeit not dominant, purpose of franking is evident, there will be a need to carefully scrutinise the extent to which the franking purpose can be said to do no more than further, or follow from, some other purpose.

It further notes that in the absence of a consideration of all of the facts of a case, it is not possible for the ATO to indicate where on the spectrum various types of capital raising will lie.

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