



**Australian Government**

**The Board of Taxation**

# REVIEW OF THE DEBT AND EQUITY TAX RULES

Discussion Paper

the **board** of taxation  
[www.taxboard.gov.au](http://www.taxboard.gov.au)

**The Board of Taxation**  
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## FOREWORD

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On 14 May 2013, the Board of Taxation was asked to undertake a post-implementation review of the debt and equity rules including whether there can be improved arrangements within the Australian tax system to address any inconsistencies between Australia's and other jurisdictions' debt and equity rules that could give rise to tax arbitrage opportunities.

The debt and equity rules in Division 974 of the *Income Tax Assessment Act 1997* were introduced in 2001 to classify certain financing arrangements as debt or equity for specified tax purposes on the basis of the economic substance of the arrangement rather than merely on the basis of legal form.

The purpose of this discussion paper is to gather views from stakeholders on the issues raised in connection with the terms of reference of this review.

Submissions from industry and other stakeholders will play an important role in shaping the Board's recommendations to the Government.

The Board requests that submissions to this review be made by Friday, 23 May 2014 to enable the Board to finalise its report in the timeframe requested by the Government.



Teresa Dyson  
Chair of the Board of Taxation  
Chair of the Working Group



# NAVIGATING THIS DISCUSSION PAPER AND A FRAMEWORK FOR PREPARING SUBMISSIONS

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## NAVIGATING THIS DISCUSSION PAPER

We present a brief overview to assist readers' navigation of this discussion paper. The broad purpose of the paper is to:

- provide background to this review (**chapters 1-3**);
- identify potential problems in the operation of the current law (**chapter 4**);
- explain a particular practical problem stakeholders have raised to date regarding the integrity provision in section 974-80 (**chapter 5**);
- outline the current law's interactions and non-interactions with other parts of the tax law (**chapters 6-8**);
- identify issues in compliance and administration of the current law (**chapter 9**); and
- identify cross-border tax arbitrage opportunities that exist under the current law (**chapter 10**).

## A FRAMEWORK FOR PREPARING SUBMISSIONS

This paper provides a framework for consideration of the issues that have been brought to the attention of the Board, and poses questions to be addressed as part of the consultation process. It is not expected that all stakeholders will respond to all of the issues and questions identified in the paper. Rather, stakeholders may wish to respond only to those issues of interest to them. Stakeholders are invited to comment on any additional issues within the Board's terms of reference that are not specifically raised in this discussion paper.

A key goal for the Board in issuing this discussion paper, is to identify issues with significant practical implications for businesses and/or administrators, or which involve significant risks to revenue, that warrant further consideration in the review process. The recommendations in the Board's final report will be focused on addressing these significant practical issues.

The Board requests that submissions both highlight priority areas for further consideration, and identify those areas that do not present significant practical challenges and do not warrant further consideration. The Board also requests that submissions substantiate concerns they raise with representative examples of actual practical challenges.

The Board has developed the following criteria for analysing and assessing the operation of Division 974:

- **Economic substance** — the extent to which Division 974 (and its administration) delivers outcomes that are consistent with the economic substance and commercial reality of the legal obligations set out in an arrangement, and achieve neutrality in the tax treatment of economically equivalent financial arrangements.
- **Certainty** — the extent to which Division 974 (and its administration) delivers clear outcomes that enable taxpayers to enter into financial arrangements with certainty about the tax treatment that will apply.
- **Simplicity** — the ease of compliance, administration and understanding of Division 974.
- **Flexibility** — the extent to which the rules in Division 974 appropriately accommodate developments in commercial arrangements and the broader economic environment, and continue to deliver appropriate outcomes in the context of the changing environment.

Often there will be a tension between these objectives. However, they represent a set of factors that need to be balanced, with consideration given to the materiality of each factor, and the impact that they have on businesses, international competitiveness, the integrity of the Australian tax system and the ability to administer the tax system effectively. For example, a balance may be needed between achieving greater substance based characterisation, and imposing greater complexity or compliance costs.



## CHAPTER SUMMARIES

The following table provides a chapter-by-chapter overview.

<b>Chapter 1</b>	Outlines the terms of reference and processes for this review, the review team appointed and making submissions.
<b>Chapter 2</b>	Introduces fundamental policy principles of debt/equity characterisation, discusses the law as it was before the enactment of Division 974, and comments on the law, including its key features and application, as it is now embodied in Division 974.
<b>Chapter 3</b>	Describes how Division 974 has operated amidst significant developments since its introduction, including the reaction of financial markets, the experience of taxpayers and advisors in applying it, the Australian Taxation Office's (ATO) experience in administering it, domestic and international developments and developments in the non-tax environment that have changed the context in which Division 974 now operates.
<b>Chapter 4</b>	Introduces general practical problems that have arisen in the operation and administration of Division 974 and explains their mechanics in the context of key provisions and concepts in Division 974.
<b>Chapter 5</b>	Outlines particular problems arising with the integrity provision in section 974-80. This chapter explains the purpose, operation and design features of section 974-80, outlines the main concerns raised by stakeholders as understood by the Board, and illustrates the concerns with the application of section 974-80 to financier trust stapled arrangements.
<b>Chapter 6</b>	Discusses the intended interactions of Division 974 with other areas of the tax system. It comments on the policy intent and basic features of each area of the tax law Division 974 interacts with, before identifying problematic issues, anomalies or inconsistencies in that interaction of a technical or policy nature where they have arisen.
<b>Chapter 7</b>	Discusses those interactions Division 974 has with other areas of the tax system that arose after the introduction of Division 974 (for example, tax consolidation and stages 3 and 4 of TOFA). The chapter focuses on the effectiveness with which Division 974 interacts with those regimes, judged against their policy objectives.
<b>Chapter 8</b>	Discusses numerous areas of current non-interaction between Division 974 and other areas of the tax system which use similar concepts to those in Division 974 to distinguish between debt and equity. It seeks to identify whether there are other areas of the tax law that should incorporate Division 974 concepts.
<b>Chapter 9</b>	Discusses transitional arrangements and the impact of the structure and style of Division 974 on compliance and administration costs, assessed against original objectives to achieve clarity, simplicity, lowered compliance costs and equity in Australia's tax system. It outlines post-enactment legislative developments, and the experience of taxpayers in complying with, and of the ATO in interpreting and administering, the law.
<b>Chapter 10</b>	Addresses mismatches in the debt/equity classification of financial instruments between Australia and other jurisdictions' laws that can give rise to tax arbitrage opportunities. This chapter explains tax arbitrage, in particular tax arbitrage involving hybrid mismatch arrangements, and discusses types of mismatches with illustrative examples; the current work of, and policy options proposed by, the OECD/G20 on base erosion and profit shifting (BEPS); other similar jurisdictions' debt/equity classification rules; and policy directions generally.



## GLOSSARY

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AASB	Australian Accounting Standards Board
ADI	Authorised Deposit-taking Institution
APRA	Australian Prudential Regulation Authority
ATO	Australian Taxation Office
ATOID	Australian Taxation Office Interpretative Decision
BEPS	Base erosion and profit shifting
CFC	Controlled foreign company
CGT	Capital gains tax
Commissioner	Commissioner of Taxation
Division 974	Division 974 of the ITAA 1997 – Debt and Equity Interests
DWT	Dividend withholding tax
DTA	Double Tax Agreement
ENCO	Effectively non-contingent obligation, per s.974-20(1)(c), ITAA 1997
ESS	Employee share scheme
Explanatory Memorandum	Explanatory Memorandum that accompanied the New Business Tax System (Debt and Equity) Bill 2001
FIF	Foreign investment fund
FIS	Finance and Investment Subcommittee
G20	The Group of Twenty
GFC	Global financial crisis
IWT	Interest withholding tax
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
ITAR 1997	Income Tax Assessment Regulations 1997
LLC	Limited liability company
MEC group	Multiple entry consolidated group
MNE	Multinational enterprise
MIT	Managed investment trust
MRPS	Mandatory redeemable preference shares
Non-ADI	Non Authorised Deposit-taking Institution
NTLG	National Tax Liaison Group
OB Activity	Offshore banking activity
OBU	Offshore banking unit
OECD	Organisation for Economic Co-operation and Development
PBR	Private binding ruling

PERLS V	Perpetual exchangeable resaleable listed securities V
R&D	Research & development
Ralph Report	The Review of Business Taxation chaired by Mr John Ralph AO report entitled 'A Tax System Redesigned' – July 1999
RPS	Redeemable preference shares
SPC	Special purpose company
Supplementary Explanatory Memorandum	Supplementary Explanatory Memorandum and correction to the Explanatory Memorandum that accompanied the New Business Tax System (Debt and Equity) Bill 2001
The Bill	New Business Tax System (Debt and Equity) Bill 2001
The Board	Board of Taxation
TLAB 5	<i>Tax Laws Amendment (2005 Measures No. 5) Act 2005</i>
TOFA	Division 230, ITAA 1997 – Taxation of Financial Arrangements
TD	Taxation determination
TR	Taxation ruling

# CHAPTER 1: INTRODUCTION

---

1.1 On 14 May 2013, the Board of Taxation ('the Board') was asked to undertake a review (the Review) combining a post-implementation review of the debt and equity rules with a review of whether there can be improved arrangements within the Australian tax system to address any inconsistencies between Australia's and other jurisdictions' debt and equity rules that could give rise to tax arbitrage opportunities.

1.2 On 4 June 2013, the following terms of reference were given to the Board.

## TERMS OF REFERENCE

1.3 The Board of Taxation is asked to undertake a post-implementation review of the debt and equity rules in the income tax law (Division 974 of the *Income Tax Assessment Act 1997*).

1.4 The debt and equity rules were introduced to classify certain financing arrangements as debt or equity for specified tax purposes (for example, the thin capitalisation rules and the interest and dividend withholding rules) on the basis of the 'economic substance' of the arrangement rather than merely on the basis of the legal form. The rules have now been in operation for over a decade.

1.5 The standing terms of reference for a post-implementation review requires the Board to consider whether the legislation:

- gives effect to the Government's policy intent, with compliance and administration costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure;
- is expressed in a clear, simple, comprehensible and workable manner;
- avoids unintended consequences of a substantive nature;
- takes account of actual taxpayer circumstances and commercial practices;
- is consistent with other tax legislation; and
- provides certainty.

1.6 In undertaking the post-implementation review, the Board is also asked to:

- examine whether there are any unintended misalignments between the debt and equity distinction and related concepts in the income tax law which could potentially result in inconsistent policy outcomes; and
- consider whether there can be improved arrangements within the Australian tax system to address any inconsistencies between Australia's and other jurisdictions' debt and equity rules that could give rise to tax arbitrage opportunities.

1.7 To the extent that there are unintended misalignments between the debt and equity distinction and related concepts in the income tax law, the Board should also examine the potential for broader application of the current debt and equity rules to ensure consistent policy outcomes.

1.8 The Government separately announced in a press release on 14 December 2013 that it intended to proceed with amendments to the integrity rule in section 974-80, however, the design of this measure would be considered as part of the Board's review of the debt and equity tax rules being conducted.

## THE REVIEW TEAM

1.9 The Board has appointed a Working Group of its members to oversee the review. The members of the Working Group are Teresa Dyson (Chair of the Working Group) and John Emerson. In addition, the Board has engaged Mr Frank O'Loughlin (a member of its Advisory Panel) and Mr John Smith, as consultants to assist with the review. The Board has also appointed an Expert Panel to provide further specialist assistance to the Board in understanding the complex operation of the relevant taxation law and its practical application.

1.10 The Working Group is being assisted by members of the Board's Secretariat and by staff from the Treasury and from the ATO.

1.11 The Board has also received assistance from a panel of senior tax experts comprising of members of its Advisory Panel, including Mr Patrick Broughan, Mr John Condon, Mr Larry Magid, Mr Andrew Mills (until December 2013 when it was announced he would be appointed as ATO Second Commissioner), Mr Richard Richards, Mr Hayden Scott and Mr Jeff Shaw.

1.12 The position and affiliations of the Board's members and Advisory Panel are listed on the Board's website.

## REVIEW PROCESSES

1.13 In conducting this review the Board proposes to consult widely and provide all stakeholders with the opportunity to participate in the review. To facilitate the public consultation process, the Board has developed this paper as a basis for further discussions. In developing this paper the Board held targeted preliminary consultation meetings with stakeholders in Sydney, Melbourne and Perth, and also consulted with the Expert Panel members, Treasury and the ATO.

1.14 The Board will consider the issues raised by stakeholders in their submissions and in consultation meetings. The Board's report and its recommendations will reflect the Board's independent judgement.

1.15 The Board is asked to report by the end of March 2015.

## MAKING SUBMISSIONS

1.16 The Board welcomes submissions on the issues raised in this discussion paper. The closing date for submissions is Friday, 23 May 2014. Submissions can be sent:

### By email to:

taxboard@treasury.gov.au

### By post to:

Review of the Debt and Equity Tax Rules  
Board of Taxation Secretariat  
C/- The Treasury  
Langton Crescent  
PARKES ACT 2600

1.17 Stakeholders making submissions should note that Board members, the Review team, and those assisting the Review, will have access to all submissions. All information (including name and contact details) contained in submissions may be made available to the public on the Board's website unless it is indicated that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like only part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request for a submission to be made available under the *Freedom of Information Act 1982* (Commonwealth) that is marked 'confidential' will be determined in accordance with that Act.





## CHAPTER 2: POLICY DESIGN OF DIVISION 974

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### APPLICATION OF DIVISION 974

2.1. Division 974 does not have any tax consequences in and of itself. Rather, its role is to classify debt and equity interests for the purposes of other tax rules. Division 974 does not apply to all areas of the tax law that draw a distinction between debt and equity or that turn on the existence of either a debt like or equity issue or holding.

2.2. At the time of introduction, the purpose of Division 974 was to provide a classification that was suitable for determining the tax treatment of returns on debt and equity for the following purposes:

- identifying distributions that may be frankable<sup>1</sup> (but not deductible) and subject to dividend withholding tax (DWT);
- identifying returns that may be deductible<sup>2</sup> (but not frankable) for entities paying the return and subject to interest withholding tax (IWT); and
- identifying debt capital for the purposes of the thin capitalisation rules (which place limits on the deductibility of interest).

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1 The use of the word 'may' connotes that whether a distribution is frankable or not depends upon the application of the relevant provisions in the *Income Tax Assessment Act 1936* (ITAA 1936) and ITAA 1997 including specific and general anti-avoidance rules, as the characterisation of an interest as an equity interest in Division 974 does not itself provide for frankability of distributions.

2 Likewise, the use of the word 'may' connotes that whether a return is deductible or not depends upon the application of the relevant provisions in the ITAA 1936 and ITAA 1997 including specific and general anti-avoidance rules, as the characterisation of an interest as a debt interest in Division 974 does not provide deductibility of returns.

## OPERATION OF DIVISION 974

2.3. Division 974 was introduced in 2001 following recommendations made by the 1999 Review of Business Taxation (the 'Ralph Review').<sup>3</sup> It was intended to provide a boundary between debt and equity that would:

- better reflect the economic substance of the legal rights and obligations of an interest, rather than its legal form, and in a more comprehensive way<sup>4</sup> that reflects commercial substance and the intention of the parties;<sup>5</sup>
- increase certainty of the tax treatment of hybrids;
- increase consistency about the classification of financial arrangements; and
- apply to specific areas of the tax law, for example, to secure the proper operation of thin capitalisation rules by ensuring the inclusion of in substance debt but legal form equity in an entity's debt.<sup>6</sup>

2.4. Due to inherent difficulties in drawing a clear borderline between debt and equity, it was not expected that the new rules would eliminate uncertainty completely.<sup>7</sup> However, the rules were intended to deliver tax outcomes that would better reflect the commercial reality of many financing arrangements, and would provide a clearer framework for assessing the appropriate outcome for those arrangements at that borderline.<sup>8</sup>

2.5. The new rules were enacted in Division 974 of the *Income Tax Assessment Act 1997* (the ITAA 1997). To minimise uncertainty and complexity, and to provide a more coherent, substance-based test less reliant on the legal form of a particular arrangement, the new rules were designed around a single organising principle: the effective obligation of an issuer to return to the investor an amount at least equal to the amount invested.

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3 Review of Business Taxation. Report Overview, Applying a cashflow/tax value approach, Debt/equity hybrids, July 1999, paragraphs 259-261. Retrieved from <http://www.rbt.treasury.gov.au/publications/paper4/overview/overview2.htm#apply>. Last accessed in January 2014.

4 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.2.

5 Ibid, paragraph 2.176.

6 Ibid, paragraphs 1.4 to 1.9. The first 3 objectives are contained in: Review of Business Taxation, Chapter 7: Debt/Equity hybrids and synthetic arrangements. The classification/thin capitalisation objective is not mentioned anywhere in the Review of Business Taxation, either in the consultation materials or the final report, but appears in the Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 1.2.

7 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraphs 1.9 and 5.36.

8 Ibid, paragraph 5.30.

2.6. This obligation is determined by an evaluation of the pricing, terms and conditions of the agreement between the issuer and the instrument holder<sup>9</sup> that set the parties' 'legal rights and obligations'.<sup>10</sup> The rules do not take a 'pure' substance approach as might be seen in countries like the United States (where all relevant facts and circumstances are examined,<sup>11</sup> but are also subject to a single central organising principle).<sup>12</sup> The rules largely limit their consideration to the economic substance of the legal rights and obligations that go to the right to receive or provide a financial benefit, included in an arrangement.

2.7. The criterion for assessing whether a financing arrangement is debt or equity focuses largely on the risk of the returns on those arrangements. Generally, and as noted above, returns on debt instruments have relatively less risk of not being made, while returns on equity instruments involve more uncertainty and a greater reliance on the economic performance of the issuing entity. The rules do not focus on whether an investor is granted membership interests, decision-making rights, or control of an entity as a result of their investment; rather, their focus is primarily on the risks of the returns associated with the investment.

## KEY FEATURES OF DIVISION 974

2.8. Division 974 uses a 'debt test' and an 'equity test' to look beyond the legal form of a financing arrangement and determine whether an interest is debt or equity in substance. The key features of these tests are briefly outlined in this section.

### Debt Test

2.9. There are five essential elements required to satisfy the debt test in relation to an entity:<sup>13</sup>

- there must be a 'scheme', which is very broadly defined as an arrangement or any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise;

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9 Ibid, paragraphs 1.9 and 2.2.

10 Ibid, paragraph 2.176.

11 For a discussion of the United States approach to the debt/equity classification of financial instruments, see: Joint Committee on Taxation, Present Law and Background Relating to Tax Treatment of Business Debt (JCX-41-11), July 11, 2011, p.15 (Distinguishing Debt from Equity).

12 Joint Committee on Taxation, p.3: 'In classifying an instrument as debt or equity, many factors have been applied by courts. In general, a debt instrument requires a fixed obligation to pay a certain amount at a specified date'.

13 Paragraphs 974-20(1)(a) to (e), ITAA 1997.

- the scheme must be a 'financing arrangement', or be an interest in a company or a member or stockholder of the company;<sup>14</sup>
- there must be a financial benefit<sup>15</sup> that is received, or will be received by the issuing entity or a 'connected entity'<sup>16</sup> of the issuing entity, under the scheme;
- the issuing entity, or its connected entity, must have an 'effectively non-contingent obligation'<sup>17</sup> (ENCO) to provide a future financial benefit; and
- it must be substantially more likely than not that the value of the financial benefit to be provided will at least be equal to or exceed the financial benefit received, and that the value provided and the value received are not both nil.<sup>18</sup>

## Equity Test

2.10. An equity interest must be in the form of a share, or issued under a scheme that is a financing arrangement. It is possible for an arrangement to exhibit characteristics that satisfy both the debt and equity tests. If an interest satisfies both tests, a 'tiebreaker' rule takes effect and the interest is treated as a debt interest.

2.11. Subject to those provisions, as a general rule when a scheme comes into existence an interest under the scheme will be an equity interest in relation to a company<sup>19</sup> if it is:

- an interest in the company as a member or stockholder of the company;
- an interest providing a right to a return,<sup>20</sup> where that right or the amount of the return is dependent upon the economic performance of the issuer or a connected entity;
- an interest providing a right to a fixed or variable return, if either the right or the amount of the return is at the discretion of the issuer or a connected entity; or

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14 Subsection 974-130(1), ITAA 1997 defines a 'financing arrangement'.

15 Subsection 974-160(1), ITAA 1997 defines a 'financial benefit'.

16 Subsection 995-1(1), ITAA 1997 defines 'connected entity'.

17 Section 974-135, ITAA 1997 defines an 'effectively non-contingent obligation'.

18 In some cases, the Commissioner may determine that a scheme satisfies the debt test: section 974-65, ITAA 1997.

19 While the equity test in subdivision 974-C, ITAA 1997 sets out the test for determining whether a scheme or a number of schemes give rise to an equity interest in a company, it also applies to determine whether schemes give rise to equity interests in certain entities which are not companies, but are taxed in an equivalent way to companies (such as public trading trusts and corporate unit trusts). Refer to the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001, paragraphs 3.21 and 3.22.

20 It is important to note that a return may be a return of the amount invested for the purposes of applying the equity test.

- an interest that gives its holder the right to be issued with an equity interest, or will or may convert into such an equity interest in the company or a connected entity.<sup>21</sup>

2.12. Division 974 determines whether a scheme is, on the whole, either debt or equity. This means that a hybrid scheme (or a set of related hybrid schemes) is classified as either entirely debt or entirely equity. Schemes are generally not bifurcated into their debt and equity components.

### Effectively non-contingent obligation

2.13. To reflect the economic substance of an arrangement better, the debt test adopts the concept of an ENCO.

2.14. An ENCO exists if the pricing, terms and conditions of the scheme create ‘in substance or effect’ a non-contingent obligation to return an amount at least equal to the amount of the investment. Artificial, contrived or immaterially remote contingencies tend to indicate that, in substance, the obligation is non-contingent. Any contingencies outside the legal rights and obligations of the scheme are generally ignored, particularly where such rights and obligations are consistent with arm’s length transactions of commercial substance and reflect the clear intention of the parties.<sup>22</sup>

2.15. Both the debt test and the equity test involve a number of additional elements to ensure that the debt or equity characterisation is reached on the basis of the economic substance of the pricing, terms and conditions of an arrangement:

- Related schemes – the tests can consider the combined effect of a set of related schemes. This prevents a classification being circumvented by entities merely entering into a number of schemes rather than a single scheme.
- Connected entities – the tests take into account financial benefits that are to be provided or received not only to, or by, the issuing and holding entities, but also to, or by, connected entities.
- Valuing the financial benefits – these are anything of economic value, including property or services. However, equity interests issued by an entity are deemed not to be the provision of financial benefits.<sup>23</sup> Arrangements where the issuer has an ENCO to provide financial benefits over 10 years or more use a modified

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21 Subsection 974-75(1), ITAA 1997.

22 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.176.

23 Section 974-30, ITAA 1997.

present-value test to determine whether the full investment is required to be repaid under the arrangement.

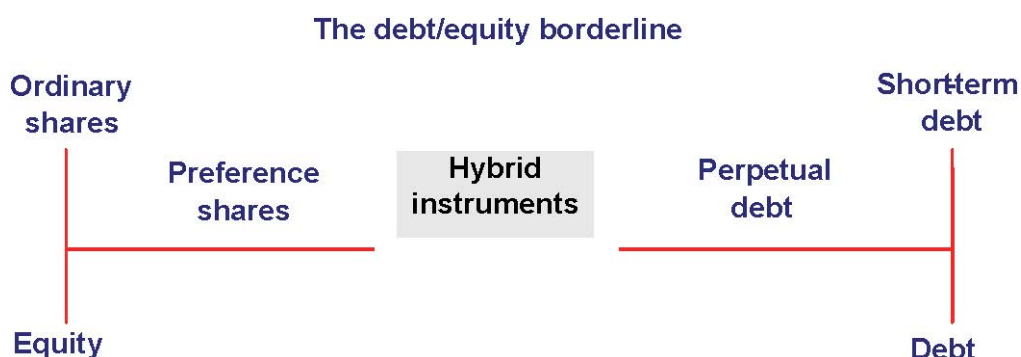
## BACKGROUND TO DIVISION 974

2.16. The distinction between debt and equity is important, as differently characterised financing arrangements receive different tax treatments.

2.17. Prior to the introduction of the debt/equity rules in Division 974, the distinction between debt and equity under general income tax principles could be said to have manifested itself into a distinction between the costs of operations that produce assessable income (in particular, the cost of debt), and returns to owners of a business after profits have been calculated (for example, dividends). In a general sense, returns on debt financing involve relatively less risk, while returns on equity financing are less certain and rely more heavily on the economic performance of the issuing entity.

2.18. While there may be clear differences between the nature of debt and equity, many financial instruments exhibit characteristics of both. As such, the debt/equity divide is not so much a clear delineation but a continuum. Prior to the introduction of the specific legislative provisions in Division 974, it is arguable that the tax treatment of interests in an entity was primarily driven by the legal form of the interest, regardless of its economic substance. This was consistent with the approach adopted in many countries.

2.19. Many, if not most, financial arrangements fall at or near either end of the continuum and could easily be classified under a legal form approach. However, due to the development of increasingly sophisticated hybrid instruments containing elements of both debt and equity, the characterisation of such instruments under a legal form approach often resulted in undesirable outcomes.



2.20. The legal form approach could produce results which did not accord with the economic substance of the instrument.<sup>24</sup> The inconsistent characterisation of hybrid instruments meant that, in some cases, situations arose where in substance creditors could receive frankable returns or where issuers could not deduct returns paid out in respect of in substance debt that was in the legal form of equity. In some instances, this could deliver unintended tax advantages to taxpayers, affecting the integrity of the corporate tax base. At the same time, policymakers were becoming increasingly concerned about the thin capitalisation of entities. A clear notion of debt and equity was therefore necessary both to facilitate the consistent and in substance classification of hybrid interests and to allow the development of new thin capitalisation measures.

2.21. It has been suggested that, with progressively sophisticated capital management techniques and the growing use of hybrid instruments, stakeholders were increasingly unhappy with classification outcomes that were inconsistent with economic substance. While specific rules could go some way to tempering the risk of these characterisation outcomes, the applicable rules were ad-hoc and could lead to confusing and inappropriate tax outcomes. They could also result in returns on financing instruments that were neither frankable nor deductible.<sup>25</sup>

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24 Review of Business Taxation, Discussion Paper 2: A Platform for Consultation: Building on a strong foundation, Volume 1, Taxation of financial assets and liabilities, Chapter 7: Debt/Equity hybrids and synthetic arrangements, February 1999, paragraph 7.3. Retrieved from: <http://www.rbt.treasury.gov.au/publications/paper3/download/ch7.pdf>. Last accessed on 4 February 2014.

25 For example, the application of section 46D to debt dividends and section 82R, ITAA 1936 to certain convertible notes.





## CHAPTER 3: CONTEXT FOR THE REVIEW

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### DEVELOPMENTS SINCE THE INTRODUCTION OF DIVISION 974

3.1 This chapter examines the operation of Division 974 amid significant developments since its introduction.

3.2 It provides a brief overview of how Division 974 has operated, in terms of:

- the reaction of markets to its enactment;
- the experience of entities, and their legal, accounting and financial advisors, in addition to academics, in applying the law;
- the experience of the ATO in administering it;
- changes in the tax law since 2001 that affect Division 974 — including the application of Division 974 to a range of additional areas of the tax law;
- international tax developments; and
- developments in the non-tax environment that have changed the context in which Division 974 now operates.

### THE OPERATION OF THE DEBT AND EQUITY RULES

3.3 Since its enactment, commentary by the academic and business community suggests that Division 974 has broadly operated as intended, improving certainty, and reducing, to a large degree, characterisation of debt and equity instruments contrary to their substance.<sup>26</sup> The debt/equity rules in Division 974 do not seem to provide different outcomes to those that would have arisen under the earlier rules for instruments whose debt or equity nature is relatively straightforward.

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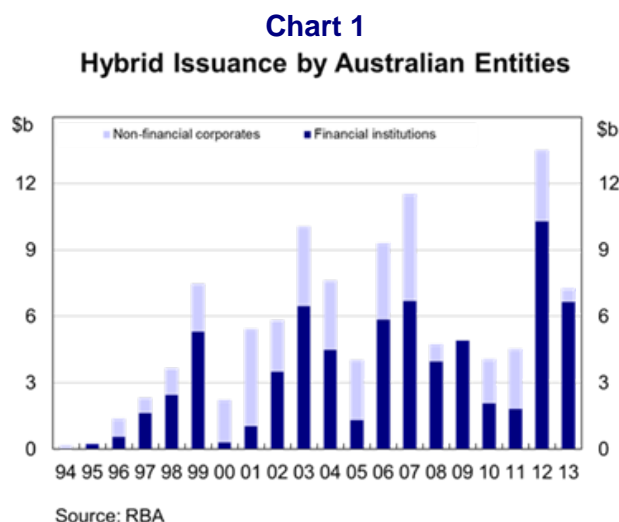
26 For example, Ward N, 'Debt-Equity — Where are we?', Deloitte Touche Tohmatsu, 2009, retrieved from [http://www.tved.net.au/index.cfm?SimpleDisplay=PaperDisplay.cfm&PaperDisplay=http://www.tved.net.au/PublicPapers/July\\_2009,\\_Sound\\_Education\\_in\\_Corporate\\_Tax,\\_Debt\\_Equity\\_\\_\\_Where\\_Are\\_We\\_.html](http://www.tved.net.au/index.cfm?SimpleDisplay=PaperDisplay.cfm&PaperDisplay=http://www.tved.net.au/PublicPapers/July_2009,_Sound_Education_in_Corporate_Tax,_Debt_Equity___Where_Are_We_.html) accessed on 4 February 2014; Of 27 tax professionals surveyed, 14 viewed Division 974 as having met its goals, 8 as not having done so, and 5 were neutral: Frost T and Cooper G, 'Trading one Uncertainty for Another? Ten Years' with the Debt/equity Regime', Unpublished (May 2012), p. 3.

3.4 Rather, the debt/equity rules provide some different outcomes from those under the previous law for hybrid instruments closer to the middle of the debt and equity spectrum, and whose tax treatment had been uncertain or seen, in terms of the substance, as falling on the inappropriate side of the boundary. There seems to be some consensus that Division 974 has not changed the outcome for all but for a very small number of exotic hybrid instruments that straddle the centre of that spectrum.

3.5 Hybrid instruments can include terms developed to meet diverse commercial objectives.<sup>27</sup> Since the early 1990s, significant changes in the commercial environment have spurred the development of the hybrid market, including:

- revolutionary regulatory reforms, including the Basel Committee on Banking Supervision's introduction of its 1988 Capital Accord;
- greater pressure from shareholders on more effective capital management; and
- the increasing investor risk appetite for higher-yield fixed income products in a low-interest environment.

3.6 Given the significant changes involved in moving from a form-based framework to a more substance-based framework, there was initially some uncertainty and concern from the business community that the rules might adversely affect the market for hybrids. The development of the hybrid market, – and certain types of hybrids in particular – appeared to slow down in the lead up to, and immediately following, implementation of Division 974.



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27 For explanations of commercial drivers of debt-like and equity-like features of hybrid instruments, see: International Fiscal Association, the Debt-Equity Conundrum, Cahiers de droit fiscal international, International Fiscal Association, 2012, vol. 97b, General Report.

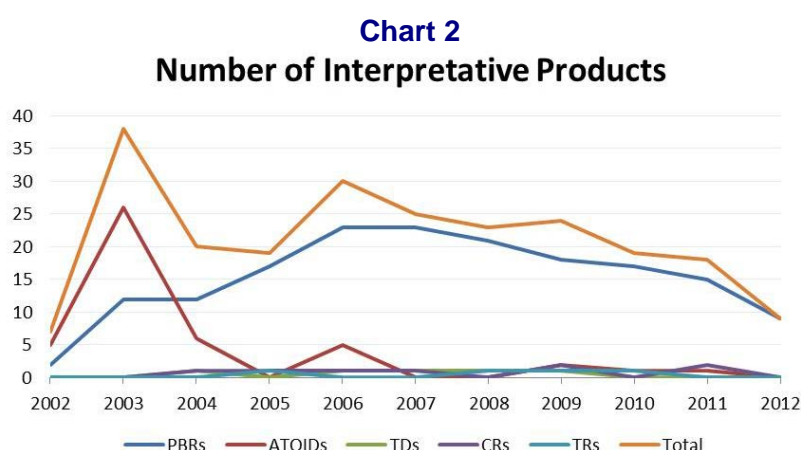
3.7 As indicated in Chart 1 above, it is evident that the hybrid market has grown since the early 2000s, despite a period of market and regulatory uncertainty as a result of the Global Financial Crisis (GFC).

3.8 The experience of the financial markets appears to be reflected in the views of academic commentators since the introduction of Division 974. Claims in the literature appear to broadly support the debt/equity rules, suggesting that they provide:

- ‘more certainty for the tax treatment of hybrid instruments’;<sup>28</sup> and
- ‘a solid foundation for innovation of new style hybrids’.<sup>29</sup>

3.9 However, growing commercial complexities as a result of financial innovation may have created new challenges for Division 974. One commentator stated that the ‘test is not comprehensive – there are some instruments that are simply not categorised by these rules’. The commentator then gave one example of such instrument: an 11-year interest-free loan.<sup>30</sup>

3.10 We understand from the ATO’s experience in administering Division 974 that uncertainty about the operation of the rules may have fallen to some degree after an initial transitional period. Certainly, there is an evident decline in the number of interpretative products required from the ATO since the introduction of Division 974 (Chart 2 below), even as the market for hybrids continued to grow. The ‘compliance and administration’ impact of Division 974 is discussed in chapter 9.



28 Ward, *supra* at note 26.

29 G. Mackenzie, *Impact of new Debt/Equity rules on the hybrid capital market: an empirical study*, Australian Banking and Finance Law Bulletin, 2005, p. 119.

30 Frost and Cooper, *supra* at note 26, p. 7. Interest-free loans over 10 years’ duration may not be classified as debts by Division 974, ITAA 1997 because the value of the repayment (in real terms) would be lower than the principal lent: Division 974, ITAA 1997 requires repayments to be valued in real (rather than nominal) terms if a loan is over 10 years’ duration, per section 974-35, ITAA 1997.

## DEVELOPMENTS IN THE TAX ENVIRONMENT

### Domestic tax developments

3.11 As stated in chapter 2, Division 974 was originally designed to determine the tax treatment of returns on financing instruments by reference to the risk of returns. Since its enactment, the application of Division 974 has been extended beyond its original focus. For example:

- in the Taxation of Financial Arrangements (TOFA) regime,<sup>31</sup> Division 974 is used to determine whether a transaction is a financial arrangement in certain circumstances<sup>32</sup>— an arrangement that satisfies the definition of an ‘equity interest’ or ‘non-equity share’ per Division 974 is deemed to be a financial arrangement to which the TOFA rules may apply; and
- in the consolidation regime,<sup>33</sup> Division 974 is partially integrated in the membership interest test which is used to determine the membership of an entity (and is not a financing concept). To consolidate, a company needs to wholly-own all membership interests in another company. ‘Debt interests’ and ‘non-share equity interests’ (under Division 974) do not give rise to a membership interest.<sup>34</sup>

3.12 There have been few cases, if any, which have dealt directly with the application of Division 974 itself until recently. A number of cases have involved arguments relating to the interaction of Division 974 with other provisions in the tax legislation, but have not dealt directly with the application of Division 974 itself.

3.13 The following table highlights some insights about the interpretation of Division 974 from the few court cases in which the application of the rules was either at issue, or merely commented on, as follows:

Case	Overview	Division 974 insight
<i>Macquarie Finance Limited v Commissioner of Taxation</i> 2004 FCA 1170	<p>Stapled income securities, consisting of a fully paid preference share and a beneficial interest in a perpetual note, were issued by a bank and a wholly-owned subsidiary of the bank (respectively).</p> <p>Amounts described as ‘interest’ on the notes were not deductible pursuant to section 8-1, on the basis that they were ‘capital in nature’ as they secured a permanent and enduring benefit, being the raising of Tier 1 Capital.</p>	<p>The stapled income securities were designed and issued prior to the introduction of Division 974.</p> <p>While the case indicates that form can provide a level of certainty, the decision in this case has limited application going forward as the deductibility of interest on stapled securities would generally be determined with reference to their classification under Division 974.</p> <p>It should be noted that stapled securities are now related schemes as defined under Division 974.</p>

31 Division 230, ITAA 1997.

32 This is used only when eligible taxpayers made an election to apply the fair value method, hedging financial arrangement or financial reporting method to the arrangement.

33 Part 3-90, ITAA 1997.

34 Subsections 703-30(1) and 960-130(3), ITAA 1997.

Case	Overview	Division 974 insight
<i>Deutsche Asia Pacific Finance Inc v Federal Commissioner of Taxation</i> 2008 ATC 20-058	The taxpayer, a resident and enterprise of the United States, acquired an interest in a limited partnership established in Australia. The interest was classified as a 'debt interest' under the debt/equity rules in Division 974. The question that arose was whether the distributions received by the taxpayer which were not interest in legal form were within the term 'interest ... determined with reference to the profits of the issuer' under Article 11(9)(a) of the Double Tax Agreement (DTA).	The characterisation of the payment as a return on a debt interest was relevant to the interpretation of 'interest' under the DTA, but the legal form remained relevant.
<i>St George Bank Ltd v Federal Commissioner of Taxation</i> 2009 ATC 20-103	St George Bank Ltd issued a US\$350 million subordinated debenture to a wholly-owned subsidiary, St George Funding Limited Liability Company (LLC), for the purpose of bringing back the proceeds raised by that LLC, from its issue of depository capital securities to US holders. The amounts raised were treated as Tier 1 capital of St George Bank Ltd on a solo and consolidated basis. St George Bank Ltd made a transitional election to bring the debenture into the debt/equity regime, so that it could be characterised as a debt interest that had the effect of raising deductible Tier 1 capital.	The transitional election made by St George Bank was insufficiently detailed and was not validly made. As the election was ineffective, the Court did not express any opinion on the operation of Division 974. The structure of the arrangement in this case is instructive in terms of the post-Division 974 potential application of section 974-80 to deductible Tier 1 arrangements.
<i>Noza Holdings Pty Ltd &amp; Ors v Federal Commissioner of Taxation</i> 2011 ATC 20-24	Noza Holdings, as head company of the Australian multiple entry consolidated (MEC) group, undertook a complex restructure that resulted in the Noza Holdings MEC group issuing redeemable preference shares (RPS) to a group company. The RPS were characterised as 'debt interests' for the purposes of section 25-90 (dealing with deductibility) and Division 974. A dividend of \$222.6 million was paid on the RPS (by endorsement of a promissory note). A deduction for the dividend was claimed by Noza Holdings MEC group under section 25-90. The issue before the Court was whether a debt was created on declaration of the dividend and whether the dividend on the RPS was incurred for the purposes of section 25-90 even if there were insufficient profits to pay the dividend.	The Court accepted that dividends which were treated as 'interest' under Division 974 would be deductible where they gave rise to a loss or outgoing that was incurred. The Court also acknowledged that, following the introduction of Division 974, the form of an instrument could not defeat its substance. The application of Division 974 was not an issue on appeal.
<i>Mills v Commissioner of Taxation</i> 2012 ATC 20-360	The Commonwealth Bank, in order to raise Tier 1 capital, issued Perpetual Exchangeable Resalable Listed Securities V (PERLS V) to Australian holders. PERLS V were stapled securities comprising of a preference share of the Bank stapled to an unsecured promissory note issued by the Commonwealth Bank's New Zealand Branch. Ordinarily, such an issue through the New Zealand Branch to non-resident holders would have attracted the operation of the concession in section 215-10 that did not require or permit the bank to frank those	It was accepted by both parties in the Federal Court that PERLS V were non-share equity interests in accordance with Division 974. The returns on the non-share equity interests were treated by the parties as non-share dividends and frankable distributions under Part 3-6. The application of Division 974 was not an issue on appeal.

Case	Overview	Division 974 insight
	<p>non-share equity interests that gave rise to Tier 1 capital for the Bank. However, issuing those non-share equity interests partly in Australia resulted in the distributions on those interests being frankable.</p> <p>Fully-franked distributions were therefore paid to PERLS V Holders on a quarterly basis.</p> <p>The issue before the Court was whether the Commissioner could make a determination under section 177EA(5)(b) to deny the franking credits attached to the distributions on those equity interests to the Australian holders.</p>	
<p><i>Blank v Commissioner of Taxation</i> [2014] FCA 87, at [71]</p>	<p>An issue in this case was whether the amounts the taxpayer received under the profit participation arrangement (PPA) entered into with his former employer were assessable under section 44(1) as either dividends under section 159GZZP or as non-share dividends under section 974-120.</p> <p>The taxpayer entered the PPA while employed by his former employer, Glencore International (GI). Under the PPA the taxpayer was issued with the profit participation interests (PPI) in GI and with shares in its majority shareholder, Glencore Holdings (GH). The taxpayer assigned the shares and PPIs back to respective companies upon termination of his employment. From that point, he would receive his profit participation share in GI over a 5-year period with interest.</p> <p>Division 974 issues commenced with whether the PPIs issued to the taxpayer were non-share equity interests. This in turn required consideration of whether the profit participation agreement and the shareholder agreement constituted one scheme; whether the scheme was a financing arrangement within the meaning of section 974-130 on the basis that it was either entered into to raise finance for GH by contribution of capital through share issue or for GI by contribution of capital by way of employee services in respect of which it paid a return; and if it was, and gave rise to an equity interest whether the tie breaker limb in subsection 974-70(1) applied.</p>	<p>Edmonds J drew a distinction between raising finance and raising capital in the context of the 'financing arrangement'. In his view, raising finance is narrower than raising capital, in that it requires '<b>sooner or later, expenditure of the amount raised</b>'.<sup>35</sup> He noted that ultimately, whether a scheme is a financing arrangement depends upon the conclusion one would draw from all the relevant facts and circumstances as to the purpose or the object of the scheme.<sup>36</sup></p> <p>The PPA scheme was held not to be a financing arrangement of either GI or GH. As such, it did not satisfy the equity test, and did not give rise to an equity interest in GI. It was therefore not necessary to decide on the other Division 974 issues.</p>

35 *Blank v Commissioner of Taxation* [2014] FCA 87, per Edmonds J at [70].

36 *Ibid*, [71].

## International tax developments

### Experiences with debt and equity distinction in other countries

3.14 Currently, there is no uniform approach in characterising debt and equity instruments among countries. As outlined in chapter 2, the characterisation of debt and equity instruments often represents a policy choice made by relevant revenue authorities that attempt to strike a balance among a set of objectives, for instance, economic substance, certainty, simplicity and flexibility.

3.15 A number of examples highlighting different approaches taken by other countries in distinguishing between debt and equity were highlighted in the paper, *'Debt/Equity: Recent Developments'*.<sup>37</sup> In addition to this, the Board has also summarised in chapter 10 a number of approaches taken in other jurisdictions, as it understands them. In summary, some of the different approaches include, for example:

- The New Zealand approach of specific carve-outs (equity carve-outs from accruals taxation) which relies upon the legal form of the instrument. While this approach gives the legislature some flexibility to respond to the development of new forms of financial instruments in the market, it arguably suffers from the flaws of other form-based approaches.
- The Canadian approach relies upon the 'substantive legal relationship' created by the arrangement (that is, the legal substance of the arrangement). While some suggest this is a 'purer' approach than the Australian one, given the latter's reference to the legal concept of an 'obligation', for this reason it may create more uncertainty.<sup>38</sup>
- The 'facts and circumstances' approach adopted by the United States attempts to reflect actual commercial circumstances rather than legal form. While some criticism suggests that such approach often produces an undesirable level of uncertainty and associated compliance costs given that it requires a facts-specific analysis, others suggest the approach is beneficial as it reduces the risk of financial engineering that naturally flows from having a 'sharp' dividing line between debt and equity.<sup>39</sup>

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37 Fry M & Schwartz B, *'Debt/Equity: Comments on Recent Developments, Overseas Experiences and Section 974-80'*, The Tax Institute of Australia, 2005.

38 Ibid.

39 Longhouse G, *'Making the Line a Gap: Edgar's Treatment of the Debt-Equity Boundary'*, Canadian Tax Journal, 2002, Vol. 50, Issue 1, page 238; Edgar T, *'The Income Tax Treatment of Financial Instruments: Theory and Practice'*, Canadian Tax Paper no. 105, Canadian Tax Foundation, 2000; Fry and Schwartz, *supra* at note 37.



- The United Kingdom approach focuses on the legal form of an arrangement, except where the arrangement's form is inconsistent with its economic substance and accounting treatment.

### Globalisation impacts

3.16 The deepening of integration of national economies and markets has substantially changed the way multi-national enterprises (MNEs) structure their businesses. Country-specific operations have been replaced in many cases with global supply networks in which production, financing, research & development (R&D) and sales each take place in different countries.

3.17 The global reach of MNEs, developments in information and communication technology and close integration of global financial markets, provides MNEs with a high degree of flexibility in how they structure their affairs. A key feature of MNE operations has been their increasing use of cross-border financing structures.

### Base Erosion and Profit Shifting — cross border hybrid mismatches

3.18 As discussed in chapter 10, in recent years, there has been growing international concern about the risks of tax base erosion and profit shifting (BEPS). Some of these concerns relate to differences in international tax rules that give rise to tax arbitrage opportunities.

3.19 Tax arbitrage opportunities in the form of hybrid mismatch arrangements can arise wherever economically equivalent entities, instruments or transfers are treated differently for tax purposes in two or more jurisdictions.<sup>40</sup> In some cases, it is possible that these mismatches would impose double taxation on businesses, making their preferred financing arrangements unviable.

3.20 On the other hand, these mismatches can also lead to a range of outcomes that can undermine corporate tax collections in Australia or overseas, including double non-taxation, double deductions, multiple tax credits and long-term or indefinite deferrals of tax.

3.21 For example, where a financial instrument has features of both debt and equity, it is possible that it would be treated as debt for tax purposes in one country and equity in another. Tax arbitrage arrangements can exploit these mismatches, in some cases resulting in a net tax loss where there is no net economic outgoing when the payer and recipient are aggregated.<sup>41</sup>

3.22 These arbitrage opportunities depend on the interaction between the specific rules that operate in different countries including rules that identify and characterise

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40 Treasury, Risks to the Sustainability of Australia's Corporate Tax Base, pp. 35.

41 Ibid, p. 16.



the entity that is taxed. It is possible for individual countries to take unilateral action to address the risks of base erosion in these cases. However, depending on the particular action taken, unilateral action could have negative impacts on cross-border trade and investment, such as imposing double taxation. Multilateral action is generally viewed as providing the best avenue for addressing these concerns.

3.23 The Organisation for Economic Co-operation and Development (OECD) Action Plan on BEPS is currently being advanced through the G20/OECD BEPS project and will examine the effects of hybrid mismatch arrangements. These actions aim to develop model treaty provisions and provide recommendations regarding the design of domestic rules to neutralise the effect of hybrid instruments and entities.<sup>42</sup> This work is scheduled for completion by September 2014. This review of Division 974 is a domestic review that is being carried out independently by the Board. Accordingly, stakeholders are encouraged to provide submissions to the Board regardless of the OECD Action's Plan status or actions.

## DEVELOPMENTS IN THE EXTERNAL ENVIRONMENT

### Accounting Standards

3.24 Australian entities regulated under the *Corporations Act 2001* are required to apply accounting standards in preparing their financial reports. Changes to those accounting standards may change the accounting treatment of an entity's financing instruments which could, for example, impact an entity's debt/equity ratio that investors use to measure the risk exposure of an entity. As a result, the classification of financial instruments will be a relevant consideration in relation to financing decisions of regulated entities.

3.25 The Australian Accounting Standards Board (AASB) is responsible for developing and issuing Accounting Standards applicable to Australian entities. In 2002, work commenced towards adopting standards that are the same as those issued by the International Accounting Standards Board, for application under the *Corporations Act 2001* for accounting periods beginning on or after 1 January 2005.

3.26 As part of this transition, new accounting standard AASB 132 *Financial Instruments: Disclosure and Presentation* replaced AASB 1033 *Presentation and Disclosure of Financial Instruments*. AASB 132 prescribes the presentation and disclosure requirements for financial instruments.

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42 OECD, Action Plan on Base Erosion and Profit Shifting, 2013, pp. 15-16.

## The Global Financial Crisis

3.27 A key development in the financing environment has, of course, been the GFC, which caused, among other things, problems with credit availability. This impacted the cost and composition of funding arrangements, and resulted in:

- banks shifting more to stable sources of funding (for example, towards retail deposits, long-term wholesale debt and equity, and away from short-term wholesale debt);
- corporations placing a stronger focus on managing liquidity (including by reducing dividend payouts and deleveraging); and
- regulatory reforms directed at banks to encourage a more conservative approach to risk in financial transactions.<sup>43</sup>

## Prudential policy

3.28 Australian banks that are prudentially regulated by the Australian Prudential Regulation Authority (APRA) are in the process of further strengthening their capital and liquidity frameworks through the Basel III reforms. Some of these new regulatory capital adequacy standards have also been extended to other APRA-regulated entities, such as life and general insurers.

3.29 Changes in prudential rules can interact with tax treatment and impact how those regulated entities structure their activities. For example, without changes to tax law, some Tier 2 legal-form debt instruments that include a non-viability condition (as required by the revised APRA prudential standard on new capital adequacy requirements)<sup>44</sup> may have been treated as equity for income tax purposes. This could have increased costs of funding for those regulated institutions, particularly relative to those institutions regulated by other countries which allowed deductibility.

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43 Gorajek A, and Turner G, 'Australian Bank Capital and Regulatory Framework', Reserve Bank of Australia Bulletin, September Quarter, 2010.

44 The new capital adequacy requirement is to ensure that instruments have the ability to absorb losses at the point of non-viability (as defined in Attachment J of the Prudential Standard APS 111 – Capital Adequacy: Measurement of Capital, p. 56-59).

## Other developments

3.30 A range of other developments have changed the landscape in which Division 974 operates. Some of the more notable changes include:

- Developments in the way rating agencies classify financial instruments as debt or equity, with greater emphasis placed on economic substance rather than legal form.
  - Rating agencies recently have redefined equity and credit with the overall effect that instruments previously classified as debt are now being classified as equity (some based on the substance of transactions).
  - The characterisation (in terms of ‘equity credit’) of the instrument by a rating agency will determine its attractiveness to the issuers (as it affects the issuers’ credit rating) and may have an impact on the cost of capital, capital adequacy and other metrics of the issuer.
- The significant growth of the Australian managed funds industry over the last decade, largely due to the increasing size of superannuation assets, and the consequent demand for interest-yielding products that are suited to their particular objectives. Currently, the industry manages over \$2 trillion of funds and this continues to grow rapidly.
  - Several stakeholders have said that the current debt and equity rules may not always give clear outcomes for the holder of the asset, as they cannot objectively determine how the rules apply to the issuer of a financial instrument.
- Financial market innovations such as the emergence of stapled entities.<sup>45</sup> These arrangements have been growing rapidly in the infrastructure and property investment sectors and have begun to spread to other parts of the economy in recent years, including finance, media and retail sectors.

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45 Stapled entities are entities in which all of the equity (or membership interests) are required to be traded together with the equity of another entity, with the result that the entities have common ownership.



## CHAPTER 4: OPERATION OF DIVISION 974

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4.1 Some preliminary views presented to the Board suggest that Division 974 has broadly operated as intended, both improving certainty and reducing, to a large degree, instances of characterisation of debt and equity instruments contrary to their substance.

4.2 At the same time, a number of specific problems have emerged with its operation and administration. The major areas consistently raised as problematic are the operation of the key concept of 'ENCO', the administration of the related scheme provisions and the Commissioner's ability to re-characterise an interest as an equity interest under section 974-80. The effects of changes to the terms of financing arrangements, the treatment of authorised deposit-taking institution (ADI) issued instruments, and the effect of solvency clauses have also been the subject of debate.

4.3 This chapter outlines the key provisions and concepts in Division 974 and identifies a range of issues that have been raised with them. Issues identified in respect of section 974-80 are addressed separately in chapter 5.

### THE DEBT AND EQUITY BORDER

4.4 The different tax treatment of debt and equity means that it is necessary to distinguish between the two types of financing. While there may be clear differences between 'pure' debt and equity, many financial instruments exhibit characteristics of both debt and equity. This means that the delineation between debt and equity is not always straightforward.

4.5 The Division 974 rules aim to draw a distinction between debt and equity for certain tax purposes. It was intended that the rules better reflect the economic substance of an interest, rather than its legal form which, with some exceptions, was the basis for the law prior to the introduction of Division 974.

4.6 The Explanatory Memorandum that accompanied the New Business Tax System (Debt and Equity) Bill 2001 (Explanatory Memorandum) explained why Division 974 was intended to reflect the economic substance of an interest.

The income tax law provides a tax treatment of returns to the shareholders of a company which differs from the tax treatment of returns to its creditors (debt holders) ... This differential tax treatment is fundamental to the tax law. It recognises the fundamental difference between the equity holders of a company, who take on the risks associated with investing in the activities of the entity, and its creditors, who, as far as possible, avoid exposure to the risks ... In recognising this fundamental difference, it is essential that the tax law draws the borderline separating the 2 (the debt/equity border) in such a

way that the legal form of an interest cannot be used to result in a characterisation at odds with its economic substance.<sup>46</sup>

4.7 The concept of debt and equity risk can be considered as a spectrum, with pure debt risk at one end and pure equity risk at the other. Moving away from either end toward the boundary distinguishing debt from equity, it is apparent that there is a 'grey' area where the characterisation is increasingly difficult and uncertain.

4.8 Preliminary views from some stakeholders were that a number of hybrid instruments with both debt and equity characteristics fall within this 'grey' area. Some stakeholders also indicated that there are gaps in the operation of Division 974 so that an interest is characterised as neither debt nor equity under the rules. For example, such an interest can be a loan issued with a term to maturity in excess of 10 years that fails to satisfy the present value debt test, and does not satisfy the equity test due to the absence of any contingency based upon economic performance.

### Tiebreaker rule

4.9 Where an interest is neither a debt interest nor an equity interest, that gap could be addressed by legislatively deeming such an interest to be either a debt interest or an equity interest. The operation of such a legislative provision could be similar to the operation of the current tiebreaker rule that deems an interest that satisfies both the equity and debt tests to be a debt interest.

4.10 The current tiebreaker rule does not apply to instruments that are neither debt nor equity instruments. If there were such a rule it may have no practical significance in some instances, for example, the deductibility of returns paid. However, it would have direct impact in other instances such as the application of the thin capitalisation rules.<sup>47</sup>

### Q 4.1 Issues/Questions

The Board seeks stakeholder comment on the debt/equity border, in particular whether:

- a. there are any major practical difficulties in applying Division 974 to commercially significant arrangements; and
- b. there are any commercially significant arrangements that are neither a debt or equity interest under Division 974; and if so, whether a tiebreaker rule that deems an interest to be either debt or equity would assist.

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46 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraphs 1.4 to 1.6.

47 See the discussion at paragraph 6.17 in this discussion paper.

## THE DEBT AND EQUITY TESTS

### THE DEBT TEST

#### Economic substance of financing arrangements

4.11 In order for a scheme to satisfy either the debt or equity test in relation to an entity, the scheme must be a financing arrangement for the entity.<sup>48</sup> The only exception to this is where the interest arising from the scheme is an interest as a member or stockholder of a company.<sup>49</sup> In that case the interest automatically satisfies the equity test. According to the Explanatory Memorandum, the exception for shares was included on the basis that they are inherently capital-raising instruments.<sup>50</sup>

4.12 Relevantly, Division 974 provides that a scheme is a 'financing arrangement' for an entity if it is entered into or undertaken to:

- raise finance for the entity (or a connected entity of the entity); or
- fund another scheme (or a part of it) that is a financing arrangement because it was entered into or undertaken to raise finance for the entity (or a connected entity of the entity); or
- fund a return (or a part of it) payable under or provided by another scheme that is a financing arrangement because it was entered into or undertaken to raise finance for the entity (or a connected entity of the entity).<sup>51</sup>

4.13 The Explanatory Memorandum states:

The raising of finance generally entails a contribution to the capital of an entity, whether by way of money, property or services, in respect of which a return is paid by the entity, be it contingent (connoting equity) or non-contingent (connoting debt).<sup>52</sup>

4.14 The meaning of 'financing arrangement' and related expressions such as 'to raise finance' has remained largely unexplored until the Federal Court decision in *Blank v Commissioner of Taxation*<sup>53</sup> (the *Blank* case).

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48 Paragraph 974-20(1)(a) and subsection 974-75(2), ITAA 1997.

49 Subsection 974-75(2), ITAA 1997.

50 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.5. The exception is broad enough to cover membership interests in companies limited by guarantee.

51 Subsection 974-130(1), ITAA 1997.

52 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.7.

53 [2014] FCA 87.

4.15 In *Blank*, Edmonds J considered the concept of ‘financing arrangement’, and said that it:

... requires the scheme to be entered into or undertaken “to raise finance for the entity”, not just capital. The two are not coterminous, and a conclusion that a scheme is entered into or undertaken to raise capital for prudential, management or other good governance reasons will not be entered into or undertaken to raise finance which contemplates, sooner or later, expenditure of the amount raised. Unless that dichotomy is observed, each and every raising of capital, irrespective of the objective purpose of the raising, will be a raising of finance. In my view, such a conclusion is not consistent with the legislative intention ...<sup>54</sup>

4.16 Debt and equity interests, in their ordinary sense, are both broadly seen as kinds of financial investments from the holder’s point of view and as capital from the issuer’s point of view.

4.17 However, the ‘financing arrangement’ requirement in the test for non-share equity interests (and in the absence of having to satisfy such a requirement in the test for shares on the basis that they are self-evidently a form of financing) was thought to express the underlying commercial conception of debt and equity interests for the purposes of Division 974.

4.18 Before the recent decision in *Blank*, this aspect of the law was not considered to present important issues. However, the decision in *Blank* suggests a distinction between raising finance and raising capital in the context of Division 974, which may cause uncertainty in practice.

4.19 The decision also exposes an apparent asymmetry in the tax treatment of shares (which are equity in substance) granted to employees and putative non-share equity interests granted to employees, which does not contribute to the Division’s goal of tax neutrality for instruments of the same substance but different legal form.

4.20 Nonetheless, a financing arrangement is not limited to the legal form of the arrangement. It is wider than ‘borrowing’ or ‘loan’, and encompasses some arrangements that are legally seen as dealings in property, for example, a cash repurchase agreement (or cash repo). This is consistent with the objects provision in Division 974 which emphasises the importance of economic substance. It provides that:

Another object of this Division is that the test ... 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.<sup>55</sup>

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54 *Blank v Commissioner of Taxation* [2014] FCA 87, per Edmonds J at [71].

55 Subsection 974-10(2), ITAA 1997.



4.21 Division 974 includes examples of schemes that are generally entered into to raise finance and those that generally are not. For example, bills of exchange, income securities and convertible instruments that will convert into equity interests, are cited as schemes that are generally entered into with a view to raise finance.<sup>56</sup> Derivatives used solely to manage financial risks and contracts for personal services that are entered into in the ordinary course of business, are cited as schemes that are generally not entered into for the purpose of raising finance.<sup>57</sup> The importance of hedging transactions has increased in recent times and some derivatives can have a financing aspect to them, for example, a swap contract with a prepaid leg.

4.22 Some arrangements are also specifically carved out from the concept of financing arrangement and are typically subject to specialised taxation regimes.<sup>58</sup> These are:

- leases or bailments, unless:
  - the property leased or bailed is the property to which Division 16D applies;
  - the lease or bailment is a relevant agreement for the purposes of section 128AC;
  - the lease or bailment is an arrangement to which Division 240 applies;
  - the leasee or bailee, or a connected entity of the leasee 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; or
  - Division 250 applies to a person and the property leased or bailed;<sup>59</sup>
- securities lending agreements under section 26BC;<sup>60</sup>
- life insurance or general insurance contracts undertaken as part of an issuer's ordinary course of business;<sup>61</sup> and
- a scheme for the payment of royalties, unless it is within specified exceptions relating to Division 16D, section 128AC or Division 250.<sup>62</sup>

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56 Subsection 974-130(2), ITAA 1997.

57 Subsection 974-130(3), ITAA 1997.

58 Subsections 974-130(4) and (5), ITAA 1997.

59 Paragraph 974-130(4)(a), ITAA 1997.

60 Paragraph 974-130(4)(b), ITAA 1997.

61 Paragraph 974-130(4)(c), ITAA 1997.

62 Paragraph 974-130(4)(d), ITAA 1997.

## Q 4.2 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the 'financing arrangement' concept in Division 974, in particular whether:

- a. in light of the decision in *Blank*, whether the distinction between raising finance and raising capital in the context of the 'financing arrangement' concept is problematic. If so, how could this be addressed;
- b. the treatment under Division 974 of non-share equity and shares that are granted to employees is problematic. If not, how could this be addressed;
- c. the application of the 'financing arrangement' concept to personal services contracts is problematic. If so, how could this be addressed;
- d. the existing commercial arrangement carve-outs from Division 974 is problematic and whether there should be any additional carve-outs; and
- e. the application of Division 974 to hedging arrangements is problematic. If so, how could this be addressed.

## Effectively non-contingent obligation

4.23 As discussed in chapter 2, the debt test in Division 974 uses the concept of an 'ENCO' to identify a scheme that has the economic substance of debt. This concept considers whether, having regard to the pricing, terms and conditions of the scheme, there is 'in substance or effect' a non-contingent obligation to return the value of the investment. For example, the finding of a formal contingency in a contract is not enough to conclude that the issuer does not have an ENCO. It is necessary to consider the effect of that contingency on the issuer's obligation. Section 974-135 explains that an obligation is non-contingent if it is not contingent on any event, condition or situation including the economic performance of the entity other than the ability or willingness of the entity to meet its obligations.

4.24 However, in recognition of the costs associated with determining the economic substance or effect of an arrangement in some circumstances, the rules do not take a pure substance approach. Rather, they attempt to strike a balance between the objective to reflect the economic substance of an arrangement, and the desire to maintain an appropriate degree of certainty and simplicity (in particular, by reducing compliance costs).

4.25 The rules do not require a far-reaching examination of the effect of an arrangement; rather, they limit the enquiry to the pricing, terms and conditions of the arrangement. The inevitable consequence of limiting the enquiry in this way means that, in some circumstances, the classification of a financing arrangement may not

reflect the broader economic substance of that arrangement. An action which an entity is not bound to take will satisfy the ENCO test if the entity is 'in substance or effect inevitably bound' to undertake the action<sup>63</sup> – the entity must be 'compelled' to act. However, a compulsion is not established merely by showing that there is some detriment that will be suffered if the obligation is not performed.<sup>64</sup>

4.26 Division 974 also sets out some specific guidance about generally disregarding contingencies. For example, subsection 974-135(6) provides that any artificial or contrived nature of contingencies must be considered. The Explanatory Memorandum provides further guidance and suggests, for example, that 'immaterially remote' contingencies should be ignored for the purpose of identifying ENCOs.

4.27 The steps to determine whether there is an ENCO include the identification of an obligation, an assessment of whether that obligation is affected by any contingencies and an assessment of whether those contingencies should be taken into account or disregarded. They also require postulations of actions that might be taken and an examination of the impact of the pricing, terms and conditions of arrangements if those actions are not taken.

4.28 The limited nature of the enquiry as to whether an obligation is an ENCO may lead to disconnects between the income tax characterisation and that of other regulatory regimes, such as, accounting standards and ratings agencies.<sup>65</sup>

### Q 4.3 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the ENCO requirement in the debt test, in particular whether:

- a. the 'pricing, terms and conditions' are the best determinants of the existence of an ENCO. If not, what should the determinants be; and
- b. differences between other regulatory regimes and the limited nature of the inquiry as to whether an obligation is an ENCO are problematic or whether this is something that stakeholders seek.

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63 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraphs 2.175 and 2.176.

64 Subsection 974-135(7), ITAA 1997.

65 For example, the accounting standards may require bifurcation of rights and obligations arising under hybrid instruments (comprising a host instrument and an embedded derivative): See AASB 132 and AASB 139.

## Contingencies

4.29 Contingencies that affect an obligation must be assessed for relevance. Division 974 contains a number of general and specific rules on what are relevant and irrelevant contingencies for this purpose.

4.30 There are some contingencies in Division 974 that could potentially be ignored, in particular:

- an obligation must be non-contingent ‘in substance or effect’<sup>66</sup> so that if a contingency is so remote as to be effectively inoperative (‘immaterially remote’) it is as if the contingency did not exist and may generally be disregarded;<sup>67</sup>
- contingencies that are ‘artificial or contrived’ are generally not considered in determining whether there is in substance or effect a non-contingent obligation;<sup>68</sup>
- a contingency attributable to the ability of a holder to convert an interest into equity does not of itself mean the obligation is not non-contingent;<sup>69</sup> and
- some contingencies arising from the regulatory regimes governing preference shares,<sup>70</sup> term subordinated notes<sup>71</sup> and perpetual subordinated notes<sup>72</sup> are ignored.

4.31 Some contingencies might be said to affect the existence of an obligation, while other contingencies might be said to affect the performance of the obligation. However, the distinction between contingencies affecting existence and performance may not be a robust one in practice. This is because whether or not an issuer will provide financial benefits at least equal to what has been received may be, as a practical matter, affected by contingencies that are not really categorised on that basis. Some stakeholders have suggested that, as a general proposition, Division 974 should be applied in a way that contingencies affecting the existence of an obligation will prevent the finding of an ENCO, whereas contingencies affecting the performance will not.

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66 Subsection 974-135(1), ITAA 1997.

67 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.178.

68 Subsection 974-135(6), ITAA 1997.

69 Subsection 974-135(4), ITAA 1997. This preserves to some extent the policy that generally applied under the income tax law in respect of convertible notes prior to the debt equity rules, in former Division 3A of Part III, ITAA 1936.

70 Subsection 974-135(5), ITAA 1997 and regulation 974-135C, Income Tax Assessment Regulations 1997 (ITAR 1997).

71 Regulations 974-135D and 974-135F, ITAR 1997.

72 Regulation 974-135E, ITAR 1997.

### Ability or willingness

4.32 A key area of debate is over the scope and meaning of the phrase ‘the ability or willingness ... to meet the obligation’ in subsection 974-135(3). The literal meaning is that there will be a non-contingent obligation if the obligation is only contingent on the ‘ability or willingness’ of the issuer to meet the obligation. On this interpretation, the ‘ability or willingness’ are contingencies that go to the existence of any obligation. However, it is acknowledged that the literal reading could lead to absurd outcomes.

4.33 The use of that same expression in section 974-85 could provide an indication of the intended meaning in subsection 974-135(3). Section 974-85 deals with the circumstances in which a right or return is contingent on economic performance for the purposes of the equity test. Paragraph 974-85(1)(a) provides that a right, or the amount of a return, is not contingent on an entity’s economic performance merely because it is contingent on ‘the ability or willingness of the entity to meet the obligation’ to satisfy the right to the return.

4.34 The literal reading of paragraph 974-85(1)(a) is also problematic. Read literally, it contemplates a circumstance where a right or return can be contingent on the ability or willingness of the entity to meet the obligation to satisfy that right or return. However, the Explanatory Memorandum specifically addresses this provision and explains that:

The right that a creditor has to a return may be said to be contingent on the debtor company being able to meet its debts when they fall due. That by itself will not be taken as meaning that the right is contingent on the economic performance of the company.<sup>73</sup>

4.35 It appears that paragraph 974-85(1)(a) is only intended to acknowledge the practical possibility that where a creditor has a right that falls due in the sense of due and payable, and the debtor might not be able (or willing) to pay that debt, the right to payment might be said to be contingent. In light of that, and perhaps out of an abundance of caution, it may have been thought appropriate to specify that this possibility will not be a relevant contingency in considering whether the right or return is contingent on economic performance. The ‘contingency’ is intended to be one that goes to the performance of an established obligation by the debtor, rather than one that would mean that the creditor’s right to payment will only exist if the debtor would be able or willing to satisfy the debt if it were to come into existence.

4.36 The intended operation of the ‘ability or willingness’ phrase in subsection 974-135(3) is not separately addressed in the Explanatory Memorandum. However, as this subsection and paragraph 974-85(1)(a) both use the same ‘ability or willingness’ phrase, and in both cases the application of the literal meaning could lead to similarly unlikely or absurd outcomes, it may be that the explanation in the

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<sup>73</sup> Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.30.

Explanatory Memorandum of the intended operation of paragraph 974-85(1)(a) should also be adopted for purposes of subsection 974-135(3).

4.37 If this is the correct view, the phrase does not operate as a true exception. It is merely intended to operate to forestall any argument that obligations to provide financial benefits that are due or payable are subject to a relevant contingency (in some sense) because, as a practical matter, whether that financial benefit is provided by performance of the obligation always depends on whether the relevant entity is able or willing to perform its obligations.

4.38 Some stakeholders consider that the literal interpretation can be appropriately applied and that the provision properly operates as a true exception. On this view, if an obligation is only contingent on the ability or willingness of a relevant entity to meet the obligation, that obligation must be taken as non-contingent. The matter is not settled and has arisen in considering the proper treatment of solvency clauses, limited recourse debt and related party transactions.

#### *Solvency clauses*

4.39 Some agreements include a solvency clause. Some solvency clauses have the effect that an issuer will not provide any financial benefits if to do so would place it in a position whereby it would no longer be solvent, that is, able to pay its debts as they fall due. For example:

##### **Example 1**

Prior to liquidation,

- payment of principal and interest shall be conditional upon issuer being solvent at the time the payment falls due;
- no payment shall be made in respect of the notes except to the extent that issuer may make such payment and still be solvent immediately thereafter; and
- otherwise, payment is unconditional.

4.40 The issue that arises under Division 974 is whether such a solvency clause affects the formation of the obligation, or merely sets out a circumstance in which the obligation subsists but may not be performed at or for a time. Consideration of this issue depends on the intended width of the 'ability or willingness to pay' provision discussed in paragraphs 4.32 to 4.38. On one view, the 'ability to pay' provision only applies to the consideration of solvency clauses where the non-provision of financial benefits might occur because of an insufficiency of funds of the issuer. The obligation is on foot (even after a winding up has commenced) but cannot be met. On another view, the provision applies more widely and would extend to a solvency clause that affects the existence of the obligation, with the effect that such a contingency would not prevent the finding of an ENCO.

4.41 This example demonstrates that obligations and their performance are not easily distinguishable when the issuer is in a sound financial position. They become more relevant when rights upon liquidation are considered.

#### *Subordinated debt*

4.42 A lender may agree to not be paid by a borrower until another party has been paid. This right to payment may be subordinated to below senior creditors, all other creditors, all other providers of capital except ordinary shareholders or equal with ordinary shareholders. Subordination is reflected in the pricing, terms and conditions of a scheme, and is a mechanism for risk allocation amongst providers of capital to an entity. It can have a real impact on whether the issuer will in fact provide financial benefits in the future. For example:

#### **Example 2**

A loan agreement ('loan agreement 1') that requires the principal amount of \$1,000 to be repaid on maturity in five years' time, but the lender agrees that the issuer must satisfy all other debt obligations first.

The subordination clause states:

*The lender subordinates any right to receive any payment with respect to this loan agreement to the payment or provision for payment in full of all present and future creditors of the borrower.*

4.43 Assuming the obligation is otherwise due and payable,<sup>74</sup> whether or not the issuer actually provides a financial benefit to the lender will depend upon whether the issuer has sufficient assets to do so. Such a contingency would appear to be one covered by the 'ability or willingness' exception.<sup>75</sup>

#### **Example 3**

In contrast, a different loan agreement ('loan agreement 2') requires the principal amount of \$1,000 to be repaid on maturity in five years' time, but that upon winding up, repayment is subject to all other creditors having their claims satisfied and repayment ranks with ordinary shareholders. Further, the lender has a right to participate in the liquidation of the borrower on an equal footing with ordinary shareholders only.

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74 The ability of a creditor to enforce the obligation has an effect on the issuer's position, and contributes to the certainty of returns that distinguishes debt from equity. However, it is arguable that all subordination involves a constraint in enforcement.

75 Subsection 974-135(3), ITAA 1997.



The subordination clause states:

*The lender subordinates any right to receive any payment with respect to this loan agreement, to the prior payment or provision for payment in full of all claims of all present and future creditors of the borrower in the event of the winding up of the borrower, except the claims of ordinary shareholders of the borrower which rank on the same priority as the claim of the lender.*

4.44 Arguably, in example 2, the issuer only has a contingent obligation to provide financial benefits and this contingency is not within the ‘ability or willingness’ exception. This is because even if the issuer had \$1,000 in assets available for distribution after all other creditors are satisfied, it does not need to repay the borrower in full because the ordinary shareholders have a right to some part of that pool. Alternatively, it might be argued that as the lender will receive the \$1,000 if the issuer has sufficient assets to meet the obligation, then the obligation is only contingent on the ability of the issuer to meet the obligation.

#### *Limited recourse debt/project finance*

4.45 In a limited recourse loan arrangement,<sup>76</sup> if the issuer does not repay the amount due at maturity, the lender’s only recourse is to a specified security or asset. The specified security or asset may be worth less than the amount outstanding. In that event, the borrower discharges its obligation by relinquishing the asset. At the time that the loan is entered into, the future value of the item at maturity is commonly uncertain.

4.46 An equity interest includes an interest that carries a right to a return that is in substance or effect contingent on the economic performance of a part of the company’s activities.<sup>77</sup> A right is not contingent on economic performance merely because it is contingent on ability or willingness to meet the obligation.<sup>78</sup>

4.47 Although it is necessary to examine clauses in the context of an agreement as a whole, consider the following examples of clauses in an agreement providing for limited recourse for the lender.

**Example 4** — liability to repay a loan but limited to profits from an asset:

1. The lessor shall repay the outstanding principal under a loan by paying the applicable principal instalment on each repayment date for that loan.

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76 A limited recourse loan arrangement is where the lender’s only recourse is to a specified security or asset for the loan if the issuer does not repay the amount due at maturity. It is to be distinguished from a loan arrangement under which the lender undertakes to acquire an asset for a specific price if the issuer does not repay the amount due at maturity.

77 Item 2 of the table in subsection 974-75(1), ITAA 1997.

78 Section 974-85, ITAA 1997.



2. The liability of the lessor to the lender under the loan is limited to the rental proceeds and the lender may not take any step to recover an amount that is payable by the lessor under the loan (except to the extent of those rental proceeds).

**Example 5** – liability limited to profits from an asset:

1. Despite any other provision of this Agreement, the liability of the Borrower to the Lender under this Agreement is limited to all amounts received or recovered by or on behalf of the Borrower under this Agreement.
2. The Lender waives all claims it may have against the Borrower under or in connection with this Agreement in respect of which the Borrower is not liable under paragraph 1.

4.48 These clauses have similar commercial effect. The lender is at risk in respect of the performance of an asset and the borrower's other assets are not exposed.

4.49 It is not interpretatively certain that schemes with such clauses pass the debt test. On one view,<sup>79</sup> there is, depending on the facts, likely to be an ENCO to provide a financial benefit.<sup>80</sup> The key question as to whether the debt test is passed will fall on whether the value of the financial benefit is likely to exceed the amount borrowed.<sup>81</sup>

4.50 A contrary view may be that there would not be an ENCO at all. It may be argued that where an issuer can provide cash or an asset, there is not an ENCO to provide either one. Where it is clear that something must be provided and whatever is provided will relevantly exceed what is borrowed, it would seem that there ought to be debt treatment. While this might be dealt with practically where it is concluded that the asset will be worth at least a particular amount in the future, the future value of the asset is commonly uncertain.<sup>82</sup>

4.51 The Explanatory Memorandum seems clear that the original policy objective was that (at least some) limited recourse loan arrangements would pass the debt test in Division 974.<sup>83</sup> The Board acknowledges that limited and non-recourse debt is a common mode of finance, particularly in project finance.

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79 See for example, Campbell E, 'Division 974 and Limited Recourse Debt', The Tax Institute of Australia, Financial Services Conference, 2010.

80 In accordance with paragraph 974-20(1)(c), ITAA 1997.

81 In accordance with paragraph 974-20(1)(d), ITAA 1997.

82 See also discussion at paragraphs 4.120 to 4.125 in the case of extensions to a scheme where there may be alternative patterns of financial benefits.

83 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, examples 2.31 and 2.32. The fact patterns contained in the Explanatory Memorandum examples are heavily qualified, and the Explanatory Memorandum does not provide guidance where limited recourse debt might not receive debt treatment.

4.52 If the debt test were not passed, there may be some circumstances that question whether the return to the lender is contingent on the economic performance of the issuer to raise the possibility of equity treatment.

### Convertible instruments

4.53 A convertible interest is defined for a company as an interest issued by a company (or connected entity) that gives its holder a right to be issued with an equity interest in the company (or connected entity), or which is an interest that will, or may, convert into an equity interest in the company (or connected entity).<sup>84</sup> Convertible interests may be classified as either debt or equity interests depending on the pricing, terms and conditions of the instrument. In this respect they are a form of hybrid instrument.

4.54 Convertible instruments may satisfy the debt test in circumstances where the issuer has an ENCO to redeem the instrument. The fact that the holder of a convertible instrument has a right to convert the interest into equity does not of itself make the issuer's obligation to repay the interest contingent, thereby preventing the finding of a debt interest.<sup>85</sup>

4.55 It may be more difficult to find an ENCO to redeem the instrument where the right to convert is held by the issuer as opposed to being held by the holder.<sup>86</sup> This is because the provision of an equity interest in the issuer (or connected entity) does not constitute the provision of a financial benefit.<sup>87</sup> The issuing of an equity interest on conversion would not be taken into account for purposes of determining whether an ENCO to provide a financial benefit exists and the optionality of the repayment of the principal means the possibility that it may be repaid is to be ignored.<sup>88</sup>

4.56 The provision of an equity interest does represent something of value to the holder for the purposes of applying Division 974. In the case of a 'dollar value convertible', the issuer can deliver a fixed dollar amount in shares rather than a fixed number of shares of uncertain value. The rule that deems a provision of an equity interest to not be a provision of a financial benefit results in 'dollar value convertibles' (with an issuer's option to convert) being generally characterised as equity interests. This characterisation from the issuer's perspective is arguably at odds with the substance of the scheme from the holder's perspective, that is, debt-like because it will

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84 Item 4 of the table in subsection 974-75(1), ITAA 1997. The definition includes connected entities.

85 Subsection 974-135(4), ITAA 1997.

86 Sub-section 974-135(4), ITAA 1997 which applies to convertibles with a holder's option to convert. See also TR 2008/3 in respect of certain convertibles with an issuer's option to convert.

87 Paragraph 974-30(1)(b), ITAA 1997.

88 However, a convertible note could still be a debt interest if there is an ENCO to provide sufficient financial benefits before conversion might occur.

receive either cash or shares of equivalent value. This demonstrates the importance placed on the issuer's perspective in the Division.

4.57 Convertible notes, commonly referred to as 'two-step convertible notes', which are structured as legal form debt on the basis of an obligation to repay the amount invested, will also not satisfy the debt test where the proceeds are applied towards the subscription of shares in the company (or a connected entity of the company).<sup>89</sup> This is because the redemption is taken not to be the provision of a financial benefit.

4.58 This is similar to converting interests, which mandatorily convert into equity interests at a future time. Such interests do not depend upon the exercise of an option by either the holder or issuer. Both convertible and converting interests are within the contemplation of an 'interest that will or may convert into another interest'.<sup>90</sup>

4.59 In some particular circumstances convertible instruments can be difficult to characterise under Division 974. For example, where a conversion ratio is very attractive at the date of issue (that is, there is a deep 'in the money option to convert'), depending on the circumstances, it may be commercially inevitable that the holder will exercise its right to convert the instrument into an equity interest in the issuer. This commercial compulsion – as reflected in the pricing, terms and conditions – in the holder is reflected by the issuer arguably not having, in substance or effect, a non-contingent obligation to redeem the instrument.<sup>91</sup>

### Structural contingencies

4.60 The certainty with which an issuer must pay a return is a key principle underpinning the finding of a debt interest. That certainty is broadly determined by the existence of an ENCO which requires an examination of the obligation, including its performance, and the contingencies affecting that obligation. Notably, it is the pricing, terms and conditions of the scheme that must be examined and not the broader facts and circumstances.

4.61 There may be instances where an examination of the pricing, terms and conditions of the scheme alone does not reveal a contingency, but the examination of some broader circumstances in which that obligation will operate reveals an effective or 'structural' contingency. Because Division 974 does not have regard to this type of contingency, the character of an interest involving such an obligation may not necessarily reflect its economic substance.'

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89 Paragraph 974-30(1)(b), ITAA 1997; Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.188 and example 2.18.

90 Section 974-165, ITAA 1997. This definition is relevant to item 4 of the table in section 974-75, ITAA 1997.

91 This example shows that the broad policy of non-deductibility for deferred equity remains notwithstanding the repeal of section 82SA, ITAA 1936, although the structures of that provision were replaced with an 'economic substance' test.

4.62 There are also provisions that effectively permit some contingencies sourced in other laws to be disregarded for certain instruments, described by their legal form or their features. For example, the payment of a redemption amount for a preference share is contingent under the *Corporations Act 2001* on the issuer having profits or making a fresh share issue. This contingency is disregarded because of a specific rule.<sup>92</sup>

#### ENCO and economic substance

4.63 Division 974 also addresses the proposition that economic compulsion arising from matters other than from the pricing, terms and conditions can transform a contingent obligation into one that is an ENCO.<sup>93</sup> 'Economic compulsion' in this context means that the issuer could or would suffer adverse commercial consequences if it were to exercise a certain discretion to not provide a financial benefit, and the prospect of these consequences is sufficient to conclude that the issuer would not exercise that discretion.

4.64 Under the rules it is clear that the manner in which an issuer subjectively perceives its obligation is not relevant to the question of whether or not it has an ENCO. However, it is not always clear how commercial realities or consequences should be taken into account. For example, a formally non-contingent obligation between related parties is not intended to be an ENCO if there are no practical consequences for non-performance. On the other hand, a formally contingent obligation between unrelated parties will not be an ENCO even if there are practical commercial consequences for non-performance. These outcomes can be reconciled.

4.65 The first situation is explained in the Explanatory Memorandum.<sup>94</sup> It demonstrates that a scheme can comprise more than what are presented as ostensibly binding terms and conditions and underlines the importance of properly identifying and considering all the circumstances and elements of the scheme.

4.66 The second situation illustrates the importance of confining the relevant enquiry to the pricing, terms and conditions of whatever comprises that scheme between the parties. In the second situation, the holder cannot take any action under the scheme to compel payment and the scheme itself does not have conditions that compel payment. Any detrimental practical or commercial consequences to the issuer of not providing the financial benefit (such as the anticipated adverse reaction of market participants that are not parties to this scheme) are not under the scheme's terms and conditions:

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92 Subsection 974-135(5), ITAA 1997.

93 Subsection 974-135(7), ITAA 1997.

94 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.181. See also the discussion in the Supplementary Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 1.43.

the mere prospect of those external consequences will not be sufficient to make the issuer's obligation effectively non-contingent.<sup>95</sup>

4.67 The relevance of circumstances in which an entity might be said to be compelled to act has revealed a tension in practice. For example, a small step-up in the return required to be paid could, depending on the issuer's circumstances, have been seen as enabling the finding of an ENCO to redeem (at least prior to the GFC), yet a dividend stopper condition (which may be commercially significant) might not itself cause an ENCO to exist. That is, a relatively small detriment of an increased interest rate could support the conclusion that an issuer had an ENCO to exercise a discretion to redeem rather than suffer that relatively small detriment.

4.68 In the other instance, if the issuer does not exercise a discretion to pay a financial benefit to the holder of an interest under a scheme, the terms provide that the issuer cannot pay dividends to holders of other ordinary shares. As a consequence this issuer could expect to suffer considerably greater commercial detriment if it did not exercise the discretion to pay than the issuer of the step-up instrument would if it did not exercise its discretion to redeem. But it seems that while the prospect of the interest step up might be sufficient to find an ENCO to redeem, the dividend stopper won't be sufficient to find an ENCO to make the discretionary payment. Again, it might be possible to explain these outcomes.

4.69 It is perhaps important to first note that the debt test is not one of 'economic compulsion' to take an action, and that term does not appear in the legislation. The test is whether there is an ENCO to take action. ENCOs will often reflect varying degrees of 'economic compulsion' but these are apparently only incidental to whether there is an ENCO.

4.70 The interest rate step-up found in the terms and conditions of an instrument might, depending on the circumstances, be thought at the time of issue to 'economically compel' the holder to eventually pay the redemption amount to the holder rather than pay the holder the increased interest. The advantages and detriments accrue between the parties to the scheme according to the terms and conditions.

4.71 The dividend stopper is more difficult to assess. For a start, the dividend stopper is a condition of the scheme. However, the detriments to the issuer if it does not exercise the discretion are ones that flow from the adverse reaction of parties that are external to the scheme because dividends are not paid.<sup>96</sup>

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95 Subsection 974-135(7), ITAA 1997.

96 In this sense the detriment is the one that is apparently contemplated by subsection 974-135(7), ITAA 1997. By operation of that subsection, that sort of detriment is explicitly not sufficient to compel the finding that there is an ENCO.

4.72 These matters all seem to underline the obvious importance of properly identifying the relevant scheme and the relevant elements of that scheme – the pricing, terms and conditions – that fall to be assessed. While ‘economic compulsion’ might be reflected in this exercise, it is not the test.

#### **Q 4.4 Issues/Questions**

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to contingencies that affect an obligation and the characterisation as either debt or equity, in particular whether:

- a. the phrase ‘ability or willingness to meet the obligation’ is problematic. If so, whether the removal of that phrase would clarify the operation of the law. Whether the phrase should only apply to consideration of the possibility that an issuer might be unable or unwilling to meet an obligation to provide a financial benefit that is due and payable;
- b. the treatment of the degree of subordination in Division 974 is problematic. If so, how could this be addressed;
- c. the treatment of interests that rank in a winding up with ordinary shares, or with other equity interests, in Division 974 is problematic. If so, how could this be addressed;
- d. the application of Division 974 to limited recourse loan arrangements is problematic. If so, how could this be addressed;
- e. the application of Division 974 to convertible instruments is problematic. If so, how could this be addressed;
- f. the application of Division 974 to solvency clauses is problematic. If so, how could this be addressed;
- g. the Division 974 treatment of structural contingencies is problematic. If so how could this be addressed;
- h. the distinction between ‘contingent on economic performance’ and ‘ability ... to provide financial benefits’ is problematic. If so, how should this be addressed;
- i. significant practical difficulties arise in determining, at the time of issue, whether a future step-up in interest is of sufficient magnitude to compel a finding that there is an ENCO to take an action. If so, how could this be addressed; and
- j. the distinction between economic compulsion arising under the pricing, terms and conditions and forms of economic compulsion that arise elsewhere is sufficiently clear. Whether that distinction is appropriate and if not, how could it be made

clearer.

## Aggregation and disaggregation of schemes

4.73 As stated, Division 974 determines whether a scheme gives rise to a debt or equity interest for tax purposes. As such, the identification of a 'scheme' is fundamental to the operation of Division 974.

4.74 To reflect the economic substance of particular transactions better, a holistic approach is adopted by both the debt and equity tests. Under this approach, it is necessary to look not only at single transactions, but at schemes, or a number of related schemes, comprising those transactions.

4.75 As the concept of a 'scheme' is broad, tensions may arise in practice between what is considered a single scheme or a number of related schemes representing a relevant transaction. A 'scheme' means any arrangement, scheme, plan proposal, action, course of action, or course of conduct whether unilateral or otherwise. An 'arrangement' means any agreement, understanding, promise or undertaking, whether expressed or implied, and whether or not enforceable (or intended to be enforceable) by legal proceedings.<sup>97</sup> This means that, as well as being perceived as separate related schemes, a particular course of conduct or action could well be seen as part of a larger single scheme.

4.76 In certain circumstances, a number of individual schemes will be 'related schemes' and will be effectively aggregated to comprise a 'notional scheme'.<sup>98</sup> The notional scheme is assessed against the debt and equity tests. The Commissioner has the ability to determine that the related scheme' provisions should not apply.<sup>99</sup> The operation of these provisions is discussed in more detail below. The Commissioner also has the discretion to determine that what would otherwise be a single scheme should be disaggregated into two or more separate schemes.<sup>100</sup> Issuers can apply to the Commissioner for determinations to disaggregate a single scheme and not aggregate related schemes.<sup>101</sup>

## Related schemes generally

4.77 To the extent that schemes are related and the combined effect of those schemes gives rise to a debt interest, the aggregated scheme may be characterised as 'debt' under Division 974 where certain conditions are satisfied.<sup>102</sup> Similarly, where the

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97 Subsection 995-1(1), ITAA 1997.

98 Subsections 974-15(2) and 974-70(2), ITAA 1997.

99 Subsections 974-15(4) and 974-70(4), ITAA 1997.

100 Subsection 974-150(1), ITAA 1997.

101 Section 974-112, ITAA 1997.

102 Subsection 974-15(2), ITAA 1997.



combined effect of related schemes gives rise to an equity interest, the aggregated scheme may be characterised as equity.<sup>103</sup>

4.78 The related scheme provisions in Division 974 operate in a three-stage process. To characterise an interest that arises under the related scheme provisions:

- (a) the schemes need to be related to one another;<sup>104</sup>
- (b) if related, they need to give rise to either a debt interest or an equity interest; and
- (c) the Commissioner must not make a determination that in the circumstances it would be unreasonable to apply the related scheme provisions.

4.79 In the first stage, the provision tests whether schemes are related. The general rule is that schemes will be related to each other if they are related in any way. This is a very broad test as many things will be relevantly related under this test. For example, schemes will be related where:

- (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 the rules.

4.80 While the related scheme provisions have a broad application, Division 974 does not intend to aggregate schemes that are related to each other by mere effect. For example, the schemes will not be related merely because one refers to the other or they have a common party. It is important to note that merely being related does not create tax consequences of itself. Tax consequences only occur under the second stage of the process.

4.81 The second stage involves a test as to whether two or more related schemes give rise to either a debt interest<sup>105</sup> or an equity interest.<sup>106</sup> This includes asking whether the notional scheme with the combined effect or operation of the constituent schemes would satisfy the debt or equity tests. And even if schemes fall within the broad

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103 Subsection 974-70(2), ITAA 1997.

104 Section 974-155, ITAA 1997.

105 Subsection 974-15(2), ITAA 1997.

106 Subsection 974-70(2), ITAA 1997.



definition of related schemes, and the resulting 'notional scheme' would give rise to debt or equity interests, it must also be reasonable to conclude that relevant parties 'intended ... the combined economic effects of the constituent schemes to be the same as, or similar to, the economic effects of ...' a debt or equity interest.<sup>107</sup> Further, the related scheme provisions do not apply if each of the constituent schemes which comprise the notional scheme individually gives rise to a debt interest or each gives rise to an equity interest.<sup>108</sup> If all the criteria are met, and the third stage does not apply, the schemes can give rise to a debt or equity interest with the tax consequences which flow from that.

4.82 The third stage of the process in each case involves the possibility that the Commissioner will make a determination to not apply the related scheme provisions. In making a determination, the Commissioner is not limited to, but must have regard to, certain specified criteria, for example, the objects of Division 974, the purpose and effect of the schemes, the rights and obligations of the parties and whether an assignment is facilitated and expected.<sup>109</sup> As noted at paragraph 4.76, an issuing entity can apply to have the Commissioner make that determination.

4.83 Once the interest from the related scheme is characterised, any return paid by the entity or company is taken to be paid in respect of that debt or equity interest, and not in respect of any component scheme or element.<sup>110</sup>

4.84 There are some concerns with the related scheme provisions. For example, in some cases the way the provisions operate gives rise to unnecessary uncertainty. The broad potential reach of the provisions and their flexibility is a key contributor to Division 974 operating on the basis of substance rather than form.<sup>111</sup> The issue is whether this uncertainty has been a real and practical problem. If it has been a real problem, a further issue is whether this is of a general nature or are there particular areas or types of transactions where it would be appropriate for there to be a safe harbour so the provisions need not be considered.

### Related schemes equity and section 974-80

4.85 Under Division 974, an equity interest can arise by virtue of the equity test in subsection 974-70(1), the related schemes equity test in subsection 974-70(2) or section 974-80.

4.86 Subsections 974-70(1) and (2) apply to characterise an interest arising under a scheme or notional scheme where that interest has particular equity-like characteristics.

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107 Paragraphs 974-15(2)(c) and 974-70(2)(c), ITAA 1997.

108 Subsections 974-15(3) and 974-70(3), ITAA 1997.

109 Subsections 974-10(5), 974-15(5) and 974-70(5), ITAA 1997.

110 Section 974-105, ITAA 1997.

111 This was arguably a design feature of the regime.

Section 974-80 only characterises a relevant interest as an equity interest if it would not otherwise be so characterised.<sup>112</sup>

4.87 Some stakeholders have suggested that there is no clear delineation between the scope of the operation of these provisions. In particular, two or more related schemes that give rise to an equity interest could also be seen as a single scheme. Also, if an interest is not an equity interest under subsection 974-70(1), it could be equity by operation of both the related schemes equity provisions in subsection 974-70(2) and section 974-80.

4.88 The interaction of these equity provisions has also caused uncertainty in practice. For example, there have been problems in characterising interests issued within the financier trust stapled group arrangements described in chapter 5.

4.89 Depending on the facts and circumstances of a particular financier trust stapled group arrangement, the issue of instruments within the stapled group could be seen as two or more related schemes which give rise to a single equity interest. Alternatively, it could be seen as a scheme giving rise to an interest subject to section 974-80. Where both the related schemes equity test and section 974-80 can apply to an interest issued within the financier trust stapled group arrangement, it may not be clear which test takes (or should take) priority.

### Shareholder loans

4.90 Some stakeholders have identified the possible application of the related scheme provisions to shareholder loans and shares as an aspect of Division 974's operation that has the potential to cause taxpayers significant uncertainty. The particular concern is over the possibility that these provisions would combine the debt and equity holdings of a company's shareholders.<sup>113</sup>

4.91 Schemes giving rising to shareholder loans and shares conceivably could be aggregated under the related scheme provisions. However, the mere fact that the same party is the holder of both a loan and a share in the company is not enough to trigger the application of these rules. Nor would the rules necessarily be applied where the same party holds both an ordinary share that is issued under one scheme and some other form of debt interest (that is not a loan) that is issued by that same company under a separate scheme (such as a certain type of redeemable preference share that satisfies the debt test and is issued by the same company). In particular, the related scheme provisions will not apply if it is not possible to draw the reasonable conclusion that is discussed above at paragraph 4.81 about the intentions of one or more of the parties.

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112 Paragraph 974-80(1)(c), ITAA 1997

113 Frost and Cooper *supra* at note 26, pp. 20-26.

4.92 Similarly, an interest that arises under a single scheme and has both a right to discretionary returns and a right to redemption would not, without more, be disaggregated. The Commissioner's ability to disaggregate a scheme by making a determination is constrained by the requirements of subsection 974-150(2).

4.93 The aggregation or disaggregation of schemes depends on the particular facts and circumstances. But in any event, it can be difficult in practice for taxpayers to determine how these complex provisions apply to their holdings. It may be that there is some scope to identify common situations where it could be made clear that the provisions will not have any operation.<sup>114</sup>

#### *Related party transactions*

4.94 Division 974 does not contain any provisions that specifically modify the ENCO test for dealings with related parties (or connected entities). Specific rules were introduced in the original Division 974 bill but did not proceed.

4.95 Nonetheless the Explanatory Memorandum does contain some statements as to the intended application of the tests where an instrument is created between related parties:

Conversely, the *effectively non-contingent* test also identifies formally non-contingent obligations that, having regard to the circumstances of the scheme, are such that there is no non-contingent obligation as a matter of substance or effect. This may be the case, for example, where related parties enter into formally binding obligations which, because of matters such as the relationship between the parties, are in substance or effect not obligations at all because failure to perform the so-called obligation will have no practical consequences. This can be contrasted with ordinary cases involving formally non-contingent obligations, where failure to perform an obligation would expose the non-performer to legal or economic sanctions.<sup>115</sup>

4.96 The appraisal of practical consequences in related party transactions may be difficult. Issues can arise as to the construction of the contract. For example, the meaning of a term or condition that is unique between the parties and that has no comparable term in a transaction between unrelated parties, may be of uncertain effect. Such a term or condition could be an ability to defer performance of a formal obligation indefinitely,<sup>116</sup> or a very long dated instrument (such as 90 years).

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114 Note, for example, that paragraph 974-155(4)(b), ITAA 1997 allows for regulations that specify circumstances in which two schemes are not related to one another.

115 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.181.

116 An example is where, although the failure to repay a loan on the due date constitutes an event of default, there may be no practical consequences of that default, in circumstances where the related party lender can treat the amount outstanding as being at their call.

4.97 The need to evaluate the practical consequences pointedly raises the interplay between the existence of an obligation and its performance. Arguably, an obligation that practically might never need to be performed is on one view not an obligation in substance or effect at all.

#### **Q 4.5 Issues/Questions**

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the aggregation and disaggregation of schemes, in particular whether:

- a. the interaction between the single scheme and related scheme provisions in Division 974 is problematic. If so, how could this be addressed;
- b. there are any practical examples of where the application of the related scheme provisions is difficult. In particular:
  - i. how the differences in timing of cash flows between individual instruments and entities are accommodated;
  - ii. how the absence of any legal relationship between two issuers are accommodated;
  - iii. what degree of interconnection, or other characteristics ought to be required before two schemes are related;
  - iv. whether there is a need for a reconstruction power where related schemes are concerned. For example, where there is a related scheme equity interest, is there sufficient certainty when dealing with franking balances;
  - v. whether there is a need for additional criteria that the Commissioner should have regard to in the exercise of the discretion;
- c. there are any identifiable circumstances that could define a safe harbour treatment, such that the related party rules could be disregarded;
- d. the potential application of the related scheme provisions to shareholder loan arrangements is problematic. If so, how could this be addressed; and
- e. there should be a specific rule modifying the ENCO test for dealing with related parties or connected entities.

#### **Holder's perspective**

4.98 The identification of a scheme or schemes from the issuer's perspective can result in various difficulties for a holder of an instrument. In particular, it can cause problems

in the application of the provisions which rely on Division 974 and which were designed to tax the instrument holders.

4.99 Further, a holder of an instrument (or its custodian) may not have complete information to assess whether they hold a debt interest or an equity interest. An inability to assess the debt/equity characterisation of an interest may lead to the holder or custodian not knowing when additional obligations are placed on them, or when there is a new taxation treatment that applies to that interest.<sup>117</sup>

4.100 By way of example, a holder may hold an instrument that appears to be a debt interest but subsequent to issue, there is a situation causing a re-characterisation of that instrument. Such a situation could include the application of the related schemes equity provisions or section 974-80. This re-characterisation affects the type of return or distribution on the holders' interest, in addition to any withholding tax obligations the holder (including a custodian) may have.

4.101 The focus in the debt/equity characterisation on the issuer's perspective<sup>118</sup> can result in a disconnect with the holder's perspective.<sup>119</sup> The holder may focus on concepts of ownership rather than take purely a financing perspective. Division 974 was designed to take into account financing aspects. Where there is a substantial disconnect, it is questionable whether the economic substance has been identified appropriately.

#### Q 4.6 Issues/Questions

The Board seeks stakeholder comment about whether the approach in Division 974 to characterisation from the issuer's perspective is problematic for holders of instruments. If so, how could this be addressed?

#### Valuation and discounting issues

4.102 Division 974 does not have regard to the term of the instrument itself as a factor to be weighed up in assessing its characterisation.<sup>120</sup> However, there is a need to compare the value of what is received and what is to be provided. This raises the

117 For example, a holder that is within the TOFA regime but has not made any elections may find that it can no longer accrue gains and losses from the re-characterised instrument (or financial arrangement).

118 Under Division 974, ITAA 1997 each single instrument is examined in relation to the issuer's perspective.

119 The holder from a commercial perspective would examine its position in relation to all its relationships with the company, for example, a stapled security as a whole.

120 Although the term of the instrument is relevant to whether an ENCO exists in some cases: refer to the 30 year term set out in Regulation 974-135D, ITAR 1997.

question of how to deal with the concept of the time value of money where transactions take place at different times.

4.103 Division 974 outlines when nominal values are to be used, and when present values are to be used.<sup>121</sup> The demarcation point depends on the 'performance period'.

4.104 The performance period is the period within which the issuer must meet its ENCOs to provide financial benefits. If this period must end no later than 10 years after issue, the value of each financial benefit received or provided is calculated in nominal terms. However, if the period must or may end more than 10 years after issue, the value is calculated according to a formula that gives an approximation of a present value. It is possible that an interest can have a life that is longer than its 'performance period' as contingent benefits might be provided at a later time.

4.105 The use of the nominal approach is intended to reduce the compliance costs associated with identifying and applying the benchmark rate of return required for the present value approach (which more accurately represents the economic substance of an arrangement). This recognises that the difference between the two approaches is relatively small for arrangements with short performance periods (meaning that nominal valuations provide a reasonable proxy for the economic substance), but that the difference becomes more pronounced as the performance period increases.

4.106 The valuation tests can arguably produce some anomalous results. For example, if an issuer receives two financial benefits, one at the time of issue and another at year two, but the 'performance period' in which it must provide benefits is greater than 10 years from the time of issue, the benefit received by the issuer at year two would be reduced below its nominal value. This is because all financial benefits provided and received by the issuer are valued according to the specified present value formula, even though all financial benefits were to be received by the issuer within 10 years. The following example illustrates another anomalous outcome.

#### Example 6

**Instrument 1** — An interest is issued at T0. The issuer only has ENCOs to pay interest annually for the first 10 years, and returns thereafter are contingent.<sup>122</sup> The performance period is 10 years. Financial benefits are valued in nominal terms.

**Instrument 2** — An interest is issued at T0. The issuer only has ENCOs to pay interest annually for the first 11 years, and returns thereafter are contingent. The performance period is longer than 10 years. All 11 financial benefits are to be valued in terms of their

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<sup>121</sup> Section 974-35, ITAA 1997.

<sup>122</sup> For example, the interest might be convertible at the issuer's discretion after 10 years.

present values: the first 10 financial benefits that the issuer has an ENCO to provide in the first 10 years are not valued in their nominal terms.

4.107 If the interest payments for both instruments are 10 per cent per annum of the issue price, Instrument 1 will be a debt interest but Instrument 2 will not, even though the issue price of each instrument is the same, the financial benefits provided by each issuer in the first 10 years are the same, and the issuer of Instrument 2 is obliged to pay more than the issuer of Instrument 1. Because Instrument 1 meets the debt test, all contingent and non-contingent returns on that interest paid during and after the performance period would be potentially deductible. Instrument 2 could be characterised as an equity interest – and if so, the returns will not be deductible.<sup>123</sup>

### Benchmark rate of return

4.108 The benchmark rate of return is the annually compounded internal rate of return on an 'ordinary debt interest'<sup>124</sup> that has been issued around the same time by that issuer or an equivalent entity, in the same currency and market, with the same subordination and credit rating, and with a comparable maturity date to the interest being tested. If there is no actual ordinary debt interest that meets those conditions, the benchmark rate of return is the return on an interest that is closest to the test interest in those specified ways, but adjusted as appropriate to account for the differences between the interest and the test interest.

4.109 The benchmark rate of return<sup>125</sup> performs two important functions. Its primary function in the debt test is to provide the rate that is reduced by 25 per cent to become the 'adjusted benchmark rate of return'. That adjusted rate is used to calculate the present value of financial benefits where required under the debt test to determine whether it is substantially more likely than not that the issuer will return sufficient financial benefits to the holder.

4.110 The second function is to provide the basis for limiting deductions for returns on debt interests when those returns are dividends contingent on economic performance or secure permanent or enduring benefits for the issuer or a connected entity. Deductions for those returns are effectively limited to no more than the benchmark rate of return plus 150 basis points.

4.111 Difficulties could arise when calculating the benchmark rate of return where, for example, the test interest is a unique or exotic instrument or where there is no readily comparable ordinary debt interest.

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123 The nature of the contingency might mean that the interest is an equity interest.

124 In section 974-140, ITAA 1997, an ordinary debt interest is broadly a debt interest on which there are no returns that are in substance or effect contingent on economic performance.

125 Section 974-145, ITAA 1997.



4.112 The discount factor used to calculate the present values of financial benefits is 75 per cent of a benchmark rate of return. The Explanatory Memorandum<sup>126</sup> notes that the 25 per cent reduction is to allow for an assumed reduction in the periodic rate of return that is received by the holder and that the reduction represents the cost of an assumed equity component of the return on a hybrid instrument that the holder enjoys. The basis for this reduction might be questionable in some cases, particularly where an instrument is in the legal form of a debt interest that only provides for non-contingent returns for a performance period greater than 10 years, and provides no return that could be said to be an equity component.

#### **Q 4.7 Issues/Questions**

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to valuation, discounting and the benchmark rate of return, in particular whether:

- a. the operation of the performance period rules and the 10 year performance period borderline is problematic. If so, how should this be addressed;
- b. the application of the present value method to perpetual instruments is problematic. If so, how could this be addressed;
- c. there are significant practical difficulties associated with the present value method. If so, how could this be addressed? For example, should all financial benefits received or provided under an ENCO be valued in present value terms, regardless of when they were to be provided;
- d. the calculation of the benchmark rate of return is problematic for issuers in determining whether interests satisfy the debt test. If so, how could this be addressed; and
- e. the 25 per cent reduction of the benchmark rate of return is appropriate in all circumstances. If not, how this could be addressed.

## **THE EQUITY TEST**

### **‘Contingent on economic performance’**

4.113 A criterion of the equity test is that an interest has a return that is contingent on economic performance. An exception to a return being contingent on economic

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126 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.192.



performance is if the return is contingent merely on 'the receipt or turnover of the entity or the turnover generated by those activities'.<sup>127</sup>

4.114 The Explanatory Memorandum notes that there may be contracts where turnover is a close proxy for an economic performance indicator other than turnover, such as profitability. Some stakeholders have queried whether a return that is based on turnover, but one that is triggered only once a specified level of turnover is reached should be within the exception.

#### **Q 4.8 Issues/Questions**

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the application of the equity test, in particular whether:

- a. the application of the turnover exception to a return being contingent on economic performance is problematic. If so, whether the exception should apply more narrowly so that it does not apply when turnover is a reasonable proxy for economic performance;
- b. the application of the 'contingent on economic performance' test in determining whether an instrument is characterised as equity is problematic. If so, how should this be addressed; and
- c. there are any aspects of the 'contingent on economic performance' test that are problematic, including where returns are contingent on the economic performance of a particular business asset of the entity rather than its economic performance as a whole. If so, how this could be addressed.

## **ACCOMMODATING CHANGE**

### **Changes to pricing, terms and conditions**

4.115 A scheme that gives rise to an equity interest at the time it comes into existence can be treated as a debt interest if there is a subsequent change to the scheme or schemes. If there is a change to a scheme or one or more schemes and after that change the characterisation of the interest changes from debt to equity (or vice versa), there will have been a trigger point for re-application of Division 974. The term 'material change' used in the section heading is not a precondition for re-testing; rather, it is a description of a change that has had the effect of converting the equity interest into a debt interest, or vice versa.

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<sup>127</sup> Paragraph 974-85(1)(b), ITAA 1997.

4.116 If the scheme is changed, and the tests are re-applied with a different resulting characterisation, there is a new scheme. There are different views as to when the new scheme is taken to have been issued (as opposed to when it 'came into existence'). On one view, the new scheme is taken to have been issued at the time of the change. The alternative view is that the scheme continues to be taken to have been issued when it was originally issued, albeit with those terms which have been changed, terms which have not been changed continuing and with the changed tax treatment applying from the time of the change.

4.117 On a literal reading of the provision any change, no matter how trivial, triggers a need to consider whether or not the character of the interest has changed. This is whether or not such a change affects the substantive rights of the interest and the debt/equity characteristics of the instrument. This may include, for example, an instrument issued in the past which has a minor term changed for regulatory reasons, and which objectively does not affect the economic substance of the interest. If interest rates changed since its issue, on one view there is a need to retest an instrument and it may potentially fail the debt test.

4.118 There also seems to be a gap in relation to this provision's operation where the scheme was neither debt nor equity to begin with.

4.119 Other changes may impact an instrument, but will not require a change in the instrument's characterisation. For example, these may include:

- consolidation of the taxpayer;
- change in status of a connected entity;
- change in regulatory regimes;
- subsequent events that affect the assessment of the reality of contingency; and
- change in market variables:
  - For example, step-ups (after the GFC, a step-up takes on a different complexion).
  - Changes in interest rates can result in two instruments (of more than 10 years' duration) with the same terms, having a different debt/equity characterisation. This presents particular compliance burdens for custodians who provide investors with certain information about their holdings.

### Extensions to the scheme

4.120 One area of uncertainty in Division 974 may be where an extension or roll-over of a debt interest is not provided for in the terms and conditions of the instrument, but is undertaken at its maturity date. This could be done, for example, by entering into a

new arrangement, or rolling over the debt into a new consolidated debt. The effect of such extensions or roll-overs is that an arrangement that arguably has the substance of a scheme that has a term of more than 10 years may be characterised on the basis of a series of schemes, each one of less than 10 years. This has an effect on the way in which financial benefits are valued.

4.121 This raises the issue as to how Division 974 should, if at all, deal with extensions of a scheme that are not within the pricing, terms and conditions of the scheme.

4.122 The application of the law is arguably not clear in such circumstances. It may be that in order for the scheme to be a debt interest, all of the alternative patterns of providing financial benefits should be assessed separately, and each alternative must meet the debt test before the scheme can be a debt interest. The following paragraphs illustrate some of the issues.

4.123 The terms and conditions of a scheme comprising a loan may provide that the scheme will terminate after a period of less than 10 years, but may also provide one party with the right to extend, so that the loan may continue for a period greater than 10 years. If the scheme is ultimately extended, the issuer must provide additional interest payments after 10 years and the principal also will be repayable after 10 years. In these circumstances, it seems that it is intended that all the financial benefits that the issuer must provide must be measured in terms of present values, because the performance period 'may' end more than 10 years after issue. The performance period is the period in which the ENCOs of the issuer to provide a financial benefit must be met. However, there might be some difficulties in reconciling and applying the relevant provisions, as the following example demonstrates:

#### **Example 7**

- Consider a loan where the terms and conditions specify that the loan will terminate after a period of nine years but there is a right for one party to extend for another five years.
- In the first instance, the issuer must provide financial benefits, as interest payments for the first nine years and the repayment of principal at the end of year nine. Whether any payments are made after year nine depends upon whether the loan is extended. The provision of the interest financial benefits in years 10 to 14 is therefore contingent upon the loan being extended. The issuer must still provide the repayment of the principal financial benefit if the loan is extended, but the timing of the provision of that benefit will be in year 14. Because the principal financial benefit may be repaid after 10 years, the performance period may end more than 10 years after the loan is issued.

4.124 It seems reasonably clear that, in the above example, section 974-35 requires that each of the financial benefits that the issuer has an ENCO to provide – the interest payments in years one to nine and the principal – must be measured in their present

values. However, it is not entirely clear whether the principal financial benefit is to be measured in its present value on an assumption that it is to be repaid in year nine or in year 14. And if, as seems likely, it is correct to measure the principal in its present value as if it were to be repaid in year 14, the question arises as to whether the law allows or requires that additional interest financial benefits (that is the interest that would be payable in years 10 to 14 if the loan was extended) be counted, and in their present values.

4.125 In considering these issues, it is important to note that a financial benefit to be provided by an issuer under a scheme is taken into account in determining the value of all the financial benefits that the issuer must provide under the scheme only if it is one that the issuer has an ENCO to provide.<sup>128</sup> Any interest payment financial benefits in years 10 to 14 are contingent on the loan being extended.

#### **Q 4.9 Issues/Questions**

The Board seeks stakeholder comment on the accommodating change provisions, in particular whether:

- a. the Division 974 treatment of subsequent changes to a scheme or schemes is problematic. If so, how this could be addressed; and
- b. the Division 974 treatment of varying patterns of financial benefits is problematic. If so, how this could be addressed.

#### **General Questions**

- a. Is there a different way of distinguishing between debt and equity characterisation for tax purposes, through a different legislative formulation, or through use of an independent process or body that could make the determination on a case by case basis?
- b. Are there any other issues with the operation of Division 974 that the Board has not raised in this discussion paper?

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<sup>128</sup> Paragraph 974-20(4)(a), ITAA 1997.

## CHAPTER 5: THE APPLICATION OF SECTION 974-80

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5.1 This chapter addresses a specific provision in Division 974, namely section 974-80. Section 974-80 is an integrity provision that is intended to ensure that what, in substance, is the provision of equity finance is not classified as debt financing because of structuring involving returns being passed through a chain of related entities.

5.2 In the past decade, a number of concerns have been raised about the operation of section 974-80 and, in particular, how the provision is applied to stapled security arrangements. In response to concerns raised by industry and taxpayer groups, the ATO issued a discussion paper to members of the National Tax Liaison Group (NTLG) Finance and Investment Subcommittee in March 2007 regarding the interpretation and policy matters of section 974-80. The discussion paper outlined the ATO's preliminary and considered views on the application of the provision. Comments were sought on the views proposed in the discussion paper.

5.3 A further round of consultation was conducted by the ATO with industry and professional bodies following the release of that discussion paper. During this consultation, there was general agreement that section 974-80, as enacted, did not operate as intended despite there being different views about its intention. The industry and professional bodies agreed that they would write to the Government to detail their concerns and request that section 974-80 be amended, and the ATO agreed that it would withdraw the discussion paper, which it did.

5.4 In the 2011-12 Budget, the then Government announced, with retrospective date of effect to the commencement of Division 974 (generally 1 July 2001), that section 974-80 would be amended to ensure that the provision would apply only to arrangements where both the purpose and effect was that the ultimate investor had, in substance, an equity interest in the issuer company.<sup>129</sup> Additionally, the provision would not apply where the Commissioner considered that it would be unreasonable for the provision to apply.<sup>130</sup> Consultation and feedback received by the Government after this announcement suggested that the proposed changes did not provide the necessary certainty.

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129 As highlighted, section 974-80, ITAA 1997 has been the subject of much commentary and debate over the past decade. A significant amount of consultation regarding the operation of the provision has been conducted. The Board's review draws on, as best possible, previous work completed, and consultations regarding the operation of section 974-80, ITAA 1997.

130 Federal Government, 'Debt/Equity tax rules — clarification of the scope of an integrity provision', Budget Paper No 2 — Part 1: Revenue Measures, Budget 2011-12.

5.5 The current Government announced in a press release on 14 December 2013 that it intended to proceed with amendments to the integrity rule in section 974-80, however, the design of this measure would be considered as part of the post-implementation review of the debt/equity provisions being conducted by the Board.

5.6 The Board's review aims to ensure that the integrity of Division 974 is not undermined, but at the same time, ensure financing arrangements that do not raise integrity concerns are not impeded. The Board's review of section 974-80 is not restricted to any proposals previously announced.

5.7 This chapter first explains the design features of section 974-80, including its intended operation and its purpose. It then outlines some of the main concerns expressed by stakeholders about the scope and potential operation of the provision, as the Board understands those concerns. The Board is aware that there have been consultations in the past between the then Government and stakeholders on the provision both before and subsequent to the Government announcement, but as the Board was not a party to them, submissions made on this Discussion Paper relating to section 974-80 should stand alone and not assume detailed knowledge of those consultations.

5.8 This chapter also describes a typical financier trust stapled security arrangement, and uses this to discuss a number of section 974-80 issues that arrangements of this sort can trigger.

## OPERATION AND PURPOSE OF SECTION 974-80

5.9 The provision broadly deals with structured situations where the ultimate recipient has an effective equity interest in a company by virtue of the terms of its indirect interest in the company through one or more interposed entities, despite having no direct interest in the company. Where certain requirements are met resulting in a legal form debt interest that is in substance or effect an equity interest, section 974-80 can reclassify the interest issued by the company as an equity interest.

5.10 As stated in the Explanatory Memorandum,<sup>131</sup> section 974-80 was intended to apply where there is an effective equity interest in a company even though the holder of the interest had no direct interest in the company. It was not intended to apply to situations where the interest held by the ultimate recipient, despite having equity-like

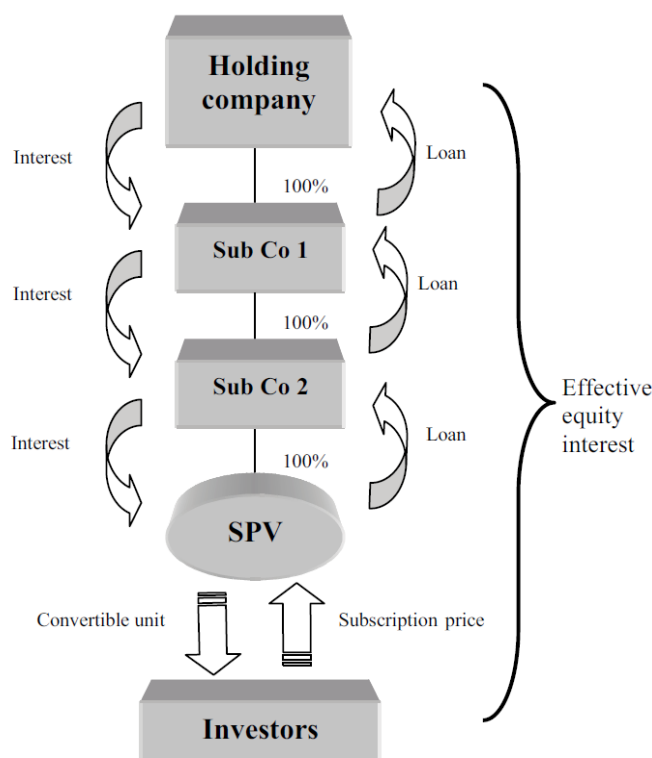
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131 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.41.

features, would be characterised as a debt interest (or formed part of a larger interest that gave rise to a debt interest) under section 974-20.<sup>132</sup>

5.11 The following diagram taken from the Explanatory Memorandum illustrates a scenario in which section 974-80 was intended to apply,<sup>133</sup> specifically, where a series of related arrangements entered into by the company and connected entities culminates in the payment of a return to an investor in respect of an interest which provides the investor with an effective equity interest in the company, but which is deductible to the issuer.<sup>134</sup>

**Diagram 2.1**



5.12 As explained in the Explanatory Memorandum,

[2.43] ... Diagram 2.1 [shows] there is a series of related arrangements under which the ultimate investors have obtained an effective, but not actual, equity interest in the holding company. The investors hold units in the SPV which provide returns contingent on the profits of the holding company and which may convert into ordinary shares of that company. The subscription price has been on-lent, at interest, by the SPV to the holding company through its subsidiaries. The holding company has funded the

132 Ibid, paragraph 2.49.

133 Ibid, paragraphs 2.42 to 2.49.

134 Ibid, paragraph 2.49.

contingent returns paid by the SPV by way of the payment of interest through its subsidiaries. Assuming the SPV is a trust, the investors do not have a direct equity interest in any company. The structure relies not only on the interest on loans made by the subsidiaries being deductible, but also the returns paid by the SPV being deductible, perhaps under the terms of a foreign tax law, notwithstanding that the latter are profit-contingent. This is designed to ensure that the holding company's corporate group has received a net tax deduction for the funding of effective dividends to effective shareholders in the holding company.

[2.44] The appropriate tax outcome for situations like this one where related arrangements comprise an effective equity interest is to treat the related arrangements which effectively fund the payment of the returns on the effective equity interest (that is the returns to the investors in the SPV in Diagram 2.1) as equity interests. Thus the loans by the subsidiary companies in Diagram 2.1 would be equity interests rather than debt interest because they are interests issued by related companies which are used to fund the payment on the deemed equity interest.

5.13 For the provision to apply, a number of key requirements must be met, including:

- the company in question has on issue an interest that is a financing arrangement held by a connected entity that, but for the operation of the provision, would not be an equity interest;
- there is a scheme, or series of schemes, designed to operate so that the return to the connected entity is used to fund (directly or indirectly) a return to the ultimate recipient; and
- the interest held by the ultimate recipient meets any of the equity characteristics set out in an *equity test* (other than the ultimate recipient being a member or stockholder of the company) in respect of the company or a connected entity of the company, provided that the interest issued by the company does not form part of a larger interest that is a debt interest.

## POTENTIAL ISSUES WITH THE CURRENT OPERATION OF SECTION 974-80

5.14 A number of potential issues have been identified by stakeholders, both before and subsequent to the 2011-12 Budget announcement, seeking greater certainty about the applicability of section 974-80 and making submissions about how the provision ought and ought not to operate.

### The 'designed to operate'/purpose test

5.15 Section 974-80 is intended to apply only where there is a deliberate design and purpose that the deductible return to the connected entity is used to fund, either



directly or indirectly, a return to the ultimate recipient.<sup>135</sup> Specifically, for the provision to apply, the scheme must be 'designed to operate' in such a manner. The phrase 'designed to operate' is not a defined term. It therefore takes on its plain and ordinary meaning,<sup>136</sup> having regard to the context in which the phrase appears.<sup>137</sup>

5.16 There has been some debate as to whether the test of design is objective or subjective. Some stakeholders have argued that the test is objective on the basis that the provision only applies where an objective conclusion can be reached from surrounding facts and circumstances and that the language of the provision, when read as a whole, is directed towards the nature of the arrangement entered into and not the subjective purpose, motive or intention of the parties to the arrangement.<sup>138</sup> Other stakeholders have argued the alternative view that the test is quite deliberately framed around subjective purpose; that design implies consciousness, which is not a word that implies merely outcomes, nor unintended results; and that facts and circumstances are not evidence of design (while they may be evidence of result, they are not evidence of design).<sup>139</sup>

5.17 The Supplementary Explanatory Memorandum and correction to the Explanatory Memorandum that accompanied the New Business Tax System (Debt and Equity) Bill 2001 (Supplementary Explanatory Memorandum) states that section 974-80 is generally intended to apply where there is a plan constituted by documented rights and obligations that provide for the direct or indirect funding of a return to the ultimate recipient. However, a lack of documentation does not preclude the application of section 974-80 if the design (or the purpose) was clear from the surrounding facts and circumstances. Mere association between the parties is not a sufficient indicator of the relevant design.<sup>140</sup>

5.18 Some stakeholders have argued that the provision does not require a sufficiently strong nexus to be drawn between the return on the interest issued by the underlying company and the return provided to the ultimate recipient, with the result that section 974-80 could be triggered where there is no specific purpose of back-to-back

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135 Supplementary Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 1.28.

136 *Cody v. JH Nelson Pty Ltd* (1947) 74 CLR 629 per Dixon J. at 647.

137 *Avondale Motors (Parts) Pty Ltd v. Federal Commissioner of Taxation* (1971) 45 ALJR 280 per Gibbs J. at 283.

138 ATO Draft Discussion Paper, 'Section 974-80: Interpretative and policy matters concerning the application of section 974-80 of the Income Tax Assessment Act 1997', March 2007, (Withdrawn).

139 Joint submission on the ATO Discussion Paper by the Taxation Institute of Australia, Corporate Tax Association, The Institute of Chartered Accountants in Australia, Law Council of Australia, Australian Bankers' Association Inc., Certified Practicing Accountants Australia, Property Council of Australia, National Institute of Accountants and Australian Financial Markets Association (March 2007)

140 Supplementary Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 1.29.

funding an equity return to the ultimate recipient. On the other hand, there are arguments that section 974-80 was never intended to be limited to back-to-back arrangements where the return on the debt interest to the connected entity funds a return to the ultimate recipient. This is on the basis that the funding test was expressed to cover indirect as well as direct funding arrangements and was not based upon the ability to trace in the sense that one could trace the payment of that return from the company to the ultimate recipient all the way through.

5.19 In order to address these issues and uncertainties, some stakeholders have suggested that the causal link between the interest issued by the underlying company and the interest held by the ultimate recipient be re-expressed to clearly and precisely define the required nexus. In doing so, the law should clarify that a mere ‘factual’ coincidental link between two interests is not sufficient to trigger the operation of section 974-80. It has also been suggested that the meaning of the term ‘designed to operate’ be clarified to ensure that section 974-80 only applies where it is clear that the arrangement was designed, planned or put together with the intention that a return on the debt interest would be used to fund a return on the equity interest.

5.20 In response to issues and uncertainties raised, the then Government announced in the 2011-12 Budget that section 974-80 would be amended to include a ‘purpose and effect’ test. Some stakeholders suggested that an enquiry into purpose would raise its own uncertainties; but that if a purpose test is used it should be a ‘dominant purpose’ test. If such threshold were adopted, section 974-80 would not apply if there is a significant but not dominant purpose that the company provided the ultimate recipient with, what is in substance or effect, an equity interest in the relevant company or connected entity of the company.

#### Application of the debt test override rule

5.21 The Explanatory Memorandum explains how the debt test override rule should operate in practice.<sup>141</sup> The intention is that, where the interest held by the ultimate recipient is itself a debt interest, despite having one or more of the equity-like characteristics specified in subsection 974-80(2), the provision would not apply to reclassify the debt interest in the issuing company.

5.22 Most stakeholders acknowledge that this is the policy intent of the debt test override rule, and agree that it is ambiguously expressed in the provision as enacted. Subsection 974-80(2) states that a debt interest in the issuing company will be reclassified as an equity interest only if the other requirements are met and 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’.<sup>142</sup> This

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141 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.49.

142 Subsection 974-80(2), ITAA 1997.

weighing of the equity characteristics against the debt test is consistent with the rest of Division 974, including the tie-breaker test that provides that where an interest satisfies both the debt test and the equity test, it is to be treated as a debt interest.

5.23 Some stakeholders have raised concerns about the application of the provision as it is difficult to determine, with any certainty, which ‘interest’ is being referred to in the provision. Stakeholders have argued that a reading of the provision does not produce an effective debt test override as intended. While the Explanatory Memorandum clearly expresses that the debt test override rule was intended to apply by reference to the characterisation of the interest held by the ultimate recipient, in reality, the provision refers only to whether the interest forms part of a larger interest characterised as debt.

5.24 In order to address uncertainties and give effect to the original policy intent, it has been suggested that the debt test override rule be amended to make clear that the test is applied to the interest held by the ultimate recipient, thereby overriding section 974-80. Where the interest satisfies the debt test, or forms part of a larger scheme that gives rise to a debt interest under the related scheme provisions, then section 974-80 should not apply to the arrangement.

#### Return on the debt interest partially used to fund the return to the ultimate recipient

5.25 According to the Explanatory Memorandum, it was intended that section 974-80 would only apply where the return on the debt interest issued by the company has been deliberately constructed to provide funds which allow the connected entity to fund a return, either directly or indirectly, to the ultimate recipient.<sup>143</sup>

5.26 One interpretation of the use of the italicised words in the phrases in paragraph 974-80(1)(d) ‘*the return to the connected entity*’ and ‘*used to fund a return ... to the ultimate recipient*’, support the phrase ‘directly or indirectly’ in that there is no requirement for the return on the debt interest to the connected entity to be paid to the ultimate recipient, but merely to fund a return to the ultimate recipient. This interpretation provides that the funding test could still be satisfied in circumstances where the connected entity uses another source of funds to make a return to the ultimate recipient.

5.27 For example, it has been suggested that the indirect funding of a return to the ultimate recipient could involve the ultimate recipient indirectly receiving a return through, for example, the set-off of existing liabilities from the connected entity of the issuer of the interest to the ultimate recipient.

5.28 There is currently no *de minimis* exception contained within the provision. This may have the effect of section 974-80 applying in circumstances where less than

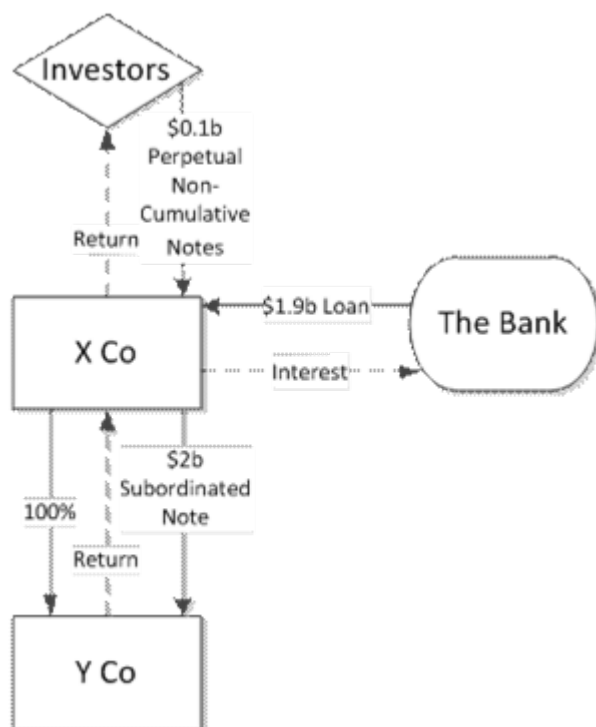
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143 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001.

substantially all of the return on the debt interest held by the connected entity funds the return to the ultimate recipient or where the return on the debt interest funds only a small portion of the return to the ultimate recipient. For example, section 974-80 could potentially apply to the following example:

**Example 8:**

X Co issues perpetual non-cumulative notes and raises \$0.1 billion. The notes are equity interests. X Co also borrows \$1.9 billion from an independent external lender, the Bank. It uses the funds raised to subscribe for a \$2 billion subordinated note in its wholly-owned subsidiary Y Co. The subordinated note is a debt interest. Here, only part of the return on the subordinated note is designed to fund the return on the perpetual non-cumulative notes (it is assumed that the interest rate on the subordinated note and the external loan is the same). It is suggested that the entire \$2 billion debt interest held by X Co could potentially be reclassified as an equity interest under section 974-80.



5.29 More generally, it has been said that section 974-80 lacks an explicit power of apportionment where an interest is both designed to fund another interest in a way attracting the operation of the provision and also to fund other activities.

**Equity-like features of which entities should be tested**

5.30 The Explanatory Memorandum provides examples of the application of section 974-80 to reclassify a debt interest as an equity interest if it is part of a scheme, or series of schemes, designed to provide an investor with an effective equity interest in the company.

5.31 Subsection 974-80(2) incorporates the second, third and fourth elements of the equity test in section 974-75. As is the case with section 974-75, subsection 974-80(2) determines if there are any equity-like characteristics by reference not only to the issuing company, but also to its connected entities. As such, the equity limb of the provision essentially operates wherever the ultimate recipient holds an interest with an equity-like feature in a connected entity of the issuing company.

5.32 The application of equity-like criteria to any connected entity of the issuing company (including the issuer of the interest held by the ultimate recipient) means that subsection 974-80(2) could be satisfied in any case where the interest held by the ultimate recipient is anything other than legal form debt.<sup>144</sup> It is often the case that the interest held by the ultimate recipient is itself issued by a connected entity. The equity-like feature of the ultimate recipient's own interest could therefore affect the issuer's position.

5.33 This presents a potential flaw in the design of section 974-80 as some suggest that the provision should only be operative where there is an equity-like relationship between the issuer of the debt interest and the ultimate recipient (that is in situations where an entity is interposed to provide the issuing company with the tax benefits of having issued debt).

5.34 To address this issue, some stakeholders have suggested that subsection 974-80(2) should be amended to limit the identification of equity-like characteristics to features relevant to the issuing company alone, and not to a connected entity of the issuing company. This means that equity-like features of the interest held by the ultimate recipient would be determined by examining the relationship with the issuing company and not with any connected entity.

5.35 Others have suggested that this amendment would be inconsistent with the main equity test in section 974-75 and could result in the integrity provision not applying where it ought to. This is because the equity test could be avoided by ensuring that there is no equity exposure to the issuing company while having such an exposure to a connected entity of the company. Others have suggested that, to address that concern, the entities being tested should be limited to the issuing company and any downstream connected entity of the issuing company.

5.36 If the interest held by the ultimate recipient is a debt interest, subject to the enactment and application of the debt test override rule, it would seem to, and arguably should, override any equity-like characteristics that also exist as part of the interest.

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144 Magid L, 2010, 'How can section 974-80 be fixed?', Tax Institute of Australia.

### Remoteness of ultimate recipient

5.37 The words in subsection 974-80(1) indicate that the provision only applies where the ultimate recipient is a person other than the issuing company and the connected entity. That is, there must be at least three participants to the relevant arrangement – the issuing company, a connected person (or several connected persons) and the ultimate recipient.

5.38 Some concerns have been raised that the reference to ‘another person’ is somewhat ambiguous and that section 974-80 does not appropriately define the boundaries of the parties to the relevant arrangement, in terms of the minimum number of participants required and the identity of parties requiring examination.

5.39 In this regard, some have suggested that an issuing company should not be required to consider the possible existence of ultimate recipients who may receive returns other than from connected entities of the company. One basis for this suggestion is that it is not reasonable to expect an issuing company to know, or find out about, arrangements between entities which are not its connected entities and to which it is not a party. On the other hand, it might be reasonable to conclude that the design and purpose test in paragraph 974-80(1)(d) is not satisfied in these types of arrangements, unless the arrangements have been structured to raise equity from the ultimate recipients through special purpose non connected entities (for example, those established by offshore structured firms) that is brought back to the connected entity through interposed entities.

### Discretion not to apply section 974-80

5.40 The Commissioner currently has no formal discretion not to apply section 974-80. However, as mentioned, it was announced in the 2011-12 Budget that section 974-80 would not apply where the Commissioner considered that it would be unreasonable for the provision to apply. A number of factors could be taken into account in determining whether the discretion should be exercised. For example, the following factors could be considered:

- the flow of funding and returns on funding between the company and the ultimate recipient through the interposed entities;
- the role and function of the interposed entities; and
- the relationship between the company and the interposed entities, including the extent to which the company or the interposed entities have, in substance or effect, a direct or indirect ability to affect the payment of a return (whether in terms of timing or amount or otherwise) to the ultimate recipient or to prevent the payment of such return.

### Q 5.1 Issues/Questions

The Board seeks stakeholder comment regarding potential issues and uncertainties raised with the existing operation of section 974-80, in particular:

- a. with regard to the designed to operate/purpose test, stakeholder views are welcomed with regard to the following:
  - i. the 'purpose and effect' test proposed in the 2011-12 Budget;
  - ii. how purpose and effect should be tested in practice;
  - iii. whether the test for design should apply objectively or subjectively and whether this causes any significant problems in practice;
  - iv. whether a test of dominant purpose, or some other level of purpose, would deliver the policy intent and reduce the uncertainty about the applicability of section 974-80;
  - v. more specifically, whether a purpose test should be applied from the perspective of whether an entity has a significant, but not dominant purpose, to provide the ultimate recipient with what is in substance or effect an equity interest in the company or connected entity;
- b. the most appropriate way to apply a debt test override rule to section 974-80. For example, would it be sufficient to make clarifying amendments to the current test of subsection 974-80(2) or is something more required;
- c. to the extent that clarifying amendments to the current text of subsection 974-80(2) are sufficient, should:
  - i. subsection 974-80(2) be amended to clarify that the interest referred to at the end of the subsection is the interest held by the ultimate recipient;
  - ii. such amendment clarify that an alternative basis for exclusion from section 974-80 is that the interest itself is not to be characterised as a debt interest, or forms part of a larger interest that is characterised as a debt interest under the related schemes debt test;
- d. whether the funding test in paragraph 974-80(1)(d) is working appropriately. In particular, whether the interpretation of the direct or indirect funding of the return concept articulated in paragraph 5.26 gives effect to the policy intent of section 974-80;
- e. whether section 974-80 should adopt an apportionment approach to reclassify the underlying debt interest as an equity interest, but only to the extent that the return on that interest is used to fund an equity return to the ultimate recipient. If not,



- whether another solution is preferred;
- f. whether a *de minimis* rule in section 974-80 should apply where the quantum of the interest held by the ultimate recipient is relatively insignificant when compared with the quantum of the debt interest. If so, what should the *de minimis* rule look like;
  - g. to the extent an operative debt test override rule applied, what problems would arise if the characterisation of the interest included not only the issuing company but also any connected entity;
  - h. whether the entities being tested to determine if an effective interest exists should be limited to the issuing company and any downstream connected entity (or entities) of the issuing company;
  - i. whether section 974-80 should be amended to clarify the chain of interests in which the issuing company must consider;
  - j. whether section 974-80 would remain an effective integrity provision if the 'ultimate recipient' in respect of which it applies must be an entity which receives a return which is either (i) paid or provided by a connected entity of the issuer company, or (ii) paid or provided pursuant to an arrangement to which the issuer company or one or more of its connected entities is a party;
  - k. alternatively, if the proposals in (j) above were adopted, whether the original policy intent of section 974-80 would be undermined by the ability to interpose entities between connected entities and ultimate recipients that these changes would allow. Further, would the 'paid or provided' requirement conflict with the 'fund a return (directly or indirectly)' requirement in the design and purpose test in paragraph 974-80(1)(d);
  - l. whether section 974-80 should include a residual discretion in the Commissioner not to apply the section in cases where that would be unreasonable or would other corrective amendments address the issue of section 974-80 potentially applying where that would be unreasonable; and
  - m. to the extent that a residual discretion is required, whether the factors identified in paragraph 5.40 are sufficient. If not, whether there are other factors that should be taken into account in determining whether the discretion should be exercised.



## APPLICATION OF SECTION 974-80 TO STAPLED STRUCTURES

5.41 The Board understands that one of the key current tax issues is the extent to which section 974-80 should apply to so-called *stapled structures*.

5.42 A stapled structure is generally created when two or more different securities are contractually bound together so that no one unit or share may be dealt with (for example, being traded) without similarly dealing with the attached unit or share of the other entity. While various types of securities can be stapled together, a common example is a share in a company stapled to a unit in a unit trust.

5.43 In Australia, stapled structures have been used in various industries including by real estate investment trusts (A-REITS) and for investment in the infrastructure industry. It appears that there is no single uniform type of stapled structure.

5.44 It is, nevertheless, evident that many stapled structures have been used in industries that encounter significant early stage losses, particularly through large non-cash expenses such as depreciation. Where dividends have not been able to be paid by the company to shareholders for a number of years, borrowings by the trust in the stapled structure have allowed cash to be returned to investors notwithstanding the loss-making status of the company.<sup>145</sup> That is, the constraints on companies to declare and pay dividends to shareholders when the company (or project) is not profitable, means that trusts may be better able to distribute available cash to investors. This is attractive for investors seeking a regular cash flow, particularly where they also have an exposure to the business activities funded by their investment.

5.45 Included among the benefits identified for using stapled structures are the expansion of the investor opportunity set, compliance with regulation at a lower cost, access to different tax treatments between trusts and companies, benefits from synergies (that is shared expertise and knowledge), internalisation of certain transactions and increased certainty referable to long-term contracts.<sup>146</sup>

5.46 The Board understands that stapled structures are a commercial reality and are a significant subset of the investment population. The current uncertainties about the potential application of section 974-80 to stapled structure arrangements should be removed. If there are any specific integrity concerns, any response should be proportionate and carefully targeted at genuine cases of mischief.

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145 With large depreciation expenses, the company would have positive cash flow yet negative retained earnings, preventing it from paying a dividend to shareholders. However, by stapling, cash could be returned to investors by paying interest.

146 See Davis K, 2002, 'Stapled Securities: Antipodean Anomaly or Adaptable Innovation?', Australian Centre for Financial Studies.

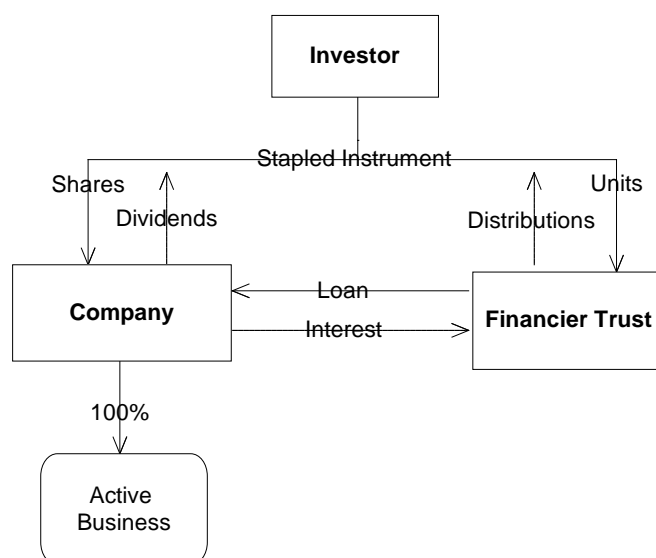
## Managed investment trusts regime

5.47 On 6 November 2013, the Treasurer and Assistant Treasurer announced that the Government would proceed with the new tax system for managed investment trusts (MITs). These amendments will implement tax law changes announced in response to the Board's review of the 'Tax Arrangements Applying to Managed Investment Trusts'. These amendments are intended to increase certainty, reduce complexity and reduce compliance costs for MITs trustees and beneficiaries.

5.48 Of particular note, the announced amendments will include, as recommended by the Board, the introduction of an arm's length rule. This is intended to prevent circumvention of the eligible investment business rules in Division 6C. As part of the submission process, some stakeholders have queried whether the new arm's length rule will remove the need for section 974-80 to operate in relation to MITs and related operating companies. By contrast, it must also be considered whether an arm's length rule will provide a complete solution to any specific integrity concerns in this area.

## Financier trusts stapled structures

5.49 The diagram below illustrates the type of stapled structure reviewed by the ATO in recent years in the context of applying section 974-80. It is understood that it is commonly used in the infrastructure industry. The trust acts solely as a financier for the stapled group, lending the funds subscribed by the stapled security investors to the company. The trust serves as a non-operating flow-through vehicle between the company and the investor. In some cases, including those reviewed by the ATO, the trustee does not have an obligation to return the loaned funds to the investors when the loan is repaid.<sup>147</sup>



<sup>147</sup> Variations to this stapled structure include property holding arrangements in which the financier trust derives income from sources outside the stapled group.

5.50 The stapled security in the diagram involves a number of related schemes.<sup>148</sup> On a stand-alone basis, for Division 974 purposes, the ordinary share issued by the company would be an equity interest and the unit issued by the trust would be neither a debt interest nor an equity interest. The stapled components continue to be separate assets of the holders.

5.51 In the above diagram, an ordinary legal form debt interest issued by a company is held by the stapled trust.<sup>149</sup> If the ownership, governance arrangements or the stapling of the trust and the company result in them being 'connected entities', section 974-80 becomes relevant. An issue that has been identified in this respect is that the phrase 'connected entity' in the context of stapled structure arrangements, which refers to the definition of 'associate' in section 318, is too broad to apply in practice given that it is largely based on the definition of 'sufficient influence'.

5.52 A key issue concerning the application of section 974-80 is the nature of the interest held by the investor in the financier trust (assuming for present purposes that this is the 'ultimate recipient' for section 974-80 purposes and that this is the relevant interest to be tested). A separate question is whether the debt and equity tests in Division 974 were intended to apply to distributions from a unit trust. If it was accepted that it did apply, the question is then whether section 974-80 is relevant to the scheme involving the trust. In particular, whether the distribution from the trust to the investor is contingent and, if so, whether it is a contingency that ought to be seen as sufficiently equity-like in terms of the policy of Division 974. To the extent that stapled structures vary, the answer to this question may vary.

5.53 A stakeholder concern is that where the trust deed of the stapled trust gives a degree of flexibility to the trustee as to what the trustee will distribute, section 974-80 could apply to re-characterise the loan as an equity interest in the stapled company, regardless of the fact that the trustee discretion has no consequence for the company.

5.54 It has also been suggested that the provision should not apply to fixed trusts where it is clear that the investor has an in substance debt interest in the company. A question in this regard is whether a fixed trust involves no discretion because, by nature, there is a fixed entitlement (that is, a vested and indefeasible interest).<sup>150</sup> However, it appears common that a trustee will have various discretions in trust deeds

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148 Financier trust stapled structures described in this section, are limited to the issue of stapled securities under the fact pattern in the financier trust diagram. This discussion does not address other financing arrangements for stapled structures to which section 974-80, ITAA 1997 may apply, for example, the issue of hybrid securities that are in substance or effect equity of the stapled group.

149 It could also be a hybrid instrument that is a debt interest under Division 974, ITAA 1997.

150 It should be noted that the investor does not really hold an in substance debt interest in the company in these structures, given the investor would not get a return of capital in the trust unless their stapled share is also redeemed.

and that it is quite unusual for trusts to qualify as ‘fixed trusts’ for tax purposes in the absence of the Commissioner exercising his discretion that they be treated as such.

5.55 A question arises as to whether, in circumstances where there are discretions or other contingencies, they are of a nature that ought to require equity classification of the loan between the trust and the company for Division 974 purposes or whether, on the other hand, they are not the sort of discretions or contingencies to which the Division should be directed. For example, it may be that a particular discretion goes to minor matters of administration of the trust and not to matters affecting the economic performance of the stapled group.

5.56 On the other hand, in a particular stapled structure the trustee discretion may be able to take into account the implications of distribution on the financial position of the company or the company together with the trust, as part of a financial accounting consolidated group. Having such discretion may be particularly important if the stapled group is highly geared.

## **Q 5.2 Issues/Questions**

The Board seeks stakeholder comment on whether any significant practical difficulties arise with the application of section 974-80 to stapled structures, in particular:

- a. with regard to the current operation of section 974-80 in relation to stapled structures:
  - i. what is the nature of discretions or other contingencies, if any, that are attached to the distribution from the trust to the investor in a stapled structure arrangement. If there are a range of discretions or contingencies, it would be useful to understand the differences between them;
  - ii. whether the connected entity test, in relation to stapled structures, is working as intended or whether there should be a specific connected entity test for stapled structures. If a specific connected entity test is preferred, what should the test be;
  - iii. whether the definition of ‘associate’ specifically treats entities that operate as effectively one economic entity in a financier trust stapled structure arrangement, as associates of each other;
- b. accepting that stapled structures are a commercial reality and a significant subset of the investment population, whether specific integrity concerns arise with stapled structure arrangements. To the extent there are such concerns, what is the best way to address them;
- c. with regard to the interaction of the related scheme provisions:
  - i. whether, as a matter of policy and ignoring section 974-80, arrangements in

- which the trust acts solely as a financier of the stapled group should be subject to the related scheme provisions;
- ii. does the law need to be clarified as to whether, and how, the related scheme provisions apply to stapled structure arrangements; and
- d. as a matter of determining legislative priorities, where both the related scheme provisions and section 974-80 can both apply to an arrangement, which provision should take precedence. Should that priority setting apply in all cases or in limited specified cases.

### General Questions

- a. Does the 2011-12 Budget announcement to amend section 974-80 address the concerns relating to its application. If not, what changes would address the problems and retain the integrity of the provision while ensuring it does not overreach?
- b. Given the operation of the general anti-avoidance provision in Part IVA, is there a need for a specific integrity provision in Division 974. If so, to what extent does section 974-80 perform this function?
- c. Whether an integrity measure, other than section 974-80, should apply to stapled structures. If so, what is the mischief that would be an appropriate measure and how should it be applied to, for example, financier trust stapled structure arrangements?
- d. Having regard to the issues identified with the current operation of section 974-80, would it be best to repeal section 974-80 and introduce a more specific integrity measure that directly targets the mischief originally intended to be covered by the measure?
- e. Whether the need for the integrity measure, combined with the practical administration difficulties, overstates the compliance concern where MNEs are free to choose whether they fund their associates with debt or equity and are already subject to the Australian thin capitalisation provisions?



## CHAPTER 6: INTENDED INTERACTIONS

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6.1 Division 974 does not apply for general purposes of the ITAA. Rather, it interacts with a limited number of operative provisions, such as the rules regulating general deductions, restrictions on deductions for some returns on capital raised (for example, thin capitalisation and returns paid on convertible notes with particular features) and the imputation and withholding tax regimes.

6.2 Division 974 was enacted to provide a mechanism for determining whether an arrangement is to be characterised as either debt or equity for specific tax provisions.<sup>151</sup> Division 974 is generally relevant for the purposes of the following:

- whether a return paid by an issuer in respect of corporate financing instruments, including non-share dividends paid by ADIs on certain Tier 1 hybrid instruments, is deductible<sup>152</sup> or frankable;<sup>153</sup>
- whether a financing arrangement is ‘debt capital’ for thin capitalisation purposes;<sup>154</sup>
- whether the forgiveness of a financing instrument is captured by the commercial debt forgiveness rules;<sup>155</sup>
- the appropriate taxation treatment of on-market or off-market share buy-backs; and
- the boundary between DWT and IWT.

6.3 Division 974 operates as an interpretative tool to:

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151 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 3.1. See also paragraph 3.3, where it is indicated that the concept of non-share equity is not intended to be used in the provisions relating to ownership of companies, including those about the transfer and use of losses, grouping concessions, definition of public and private companies and tests of ownership and attribution under the CFC rules.

152 Division 974, ITAA 1997 replaced the previous regime which placed some restrictions on deductions for returns on capital raised (for example, returns paid on convertible notes with particular features) or on certain deductions (for example, denial of the inter-corporate rebate for debt-dividends). The model adopted was to prevent the deductibility of returns on equity interests and remove some bars to the deductibility of returns on certain debt instruments.

153 This affected the operation of the imputation rules and therefore a new imputation regime (Part 3-6) was introduced in 2002 (with parts of the former rules in the ITAA 1936 being progressively replaced). The application of the anti-avoidance measures to returns that became frankable as a result of the debt/equity rules was also affected.

154 A new thin capitalisation regime (Division 820) was introduced in 2001.

155 Formerly contained in Schedule 2C, ITAA 1936 and re-written into the ITAA 1997 as Division 245, ITAA 1997 in 2010.

- define debt and equity for a provision; and/or
- modify, by extension or reduction, the coverage of a provision.

6.4 An understanding of the policy objectives of these provisions is required to assess the effectiveness of Division 974. This involves an enquiry as to whether the debt/equity tests, and the subsequent modifications, are appropriate for those purposes.

## GENERAL DEDUCTIONS

6.5 To give tax effect to an instrument's substance, Division 974 was intended to clarify that returns on debt interests are deductible and non-frankable, and thus treated in the same way as interest on a loan for tax purposes.<sup>156</sup> Returns will generally be deductible (and non-frankable) in circumstances where, for example:

- the return satisfies the general criteria for deduction under section 8-1;<sup>157</sup> or
- the instrument is characterised as a debt interest in accordance with subdivision 974-B, the return satisfies the general section 8-1 criteria, or is deductible under section 25-85.<sup>158</sup>

6.6 Included in the category of deductible and non-frankable returns are:

- returns on hybrid instruments that satisfy the debt test and which would be deductible under the general deductibility provisions in the tax law, principally section 8-1, if not for having equity-like features;<sup>159</sup>
- returns on interests that are either contingent on economic performance or secure a permanent or enduring benefit to the issuer, such as dividends paid on mandatory redeemable preference shares (MRPS). This requires the focus to be on the economic or financial features of an instrument as opposed to other features that may simply be formalistic.

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156 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraphs 2.135 to 2.137.

157 A general deduction will generally be available under section 8-1, ITAA 1997 where there is a loss or outgoing to the extent that it is incurred in gaining or producing assessable income or is necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.

158 Section 25-85, ITAA 1997 provides that, in certain circumstances, the issuer of a hybrid instrument which is a debt interest may deduct the dividend return on the instrument. Although, in accordance with subsection 25-85(4A), ITAA 1997, a deduction is not available under section 25-85, ITAA 1997 where the instrument is a financial arrangement under Division 230, ITAA 1997.

159 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraphs 2.135 to 2.137; See also TR 2002/15 and TR 2002/16 generally.



6.7 Australian courts historically distinguished different forms of financing arrangements in various and, at times, uncertain ways. For example, in *Federal Commissioner of Taxation (WA) v Boulder Perseverance Ltd* (1937) 58 CLR 223, the key issue was whether the payment made in respect of certain notes should be characterised as a return on finance raised or instead a distribution of profits derived by the company. The court disaggregated the notes and treated the distribution of profits and the interest payments as separate amounts each with its own character. The interest payment was an expense incurred on the note, while the distribution of profits was a right to share in the profits derived by a company. The High Court broadly noted that the deductibility of a return requires a determination that the payment is not contingent on profits but rather is an expense incurred in deriving such profits.

6.8 Where the return is a dividend on a non-equity share, a deduction is generally allowed to the same extent that the return would have been deductible under section 8-1 if the issuer had been obliged to pay the return as interest paid on finance it had raised.<sup>160</sup> However, a deduction for a return on a non-equity share and other amounts which are contingent on economic performance, or which secure a permanent advantage, will be disallowed to the extent that the internal rate of return on the instrument exceeds 150 basis points above the issuer's benchmark rate of return. This 'cap' was intended to protect the revenue from a distribution of profits as a deductible payment on a hybrid instrument artificially characterised as a debt interest, rather than as a frankable dividend.<sup>161</sup>

6.9 Similarly, returns on equity interests, such as dividends and non-share distributions, are frankable but non-deductible (discussed in the imputation section below).<sup>162</sup>

### Neither debt nor equity

6.10 The deductibility of a return paid on an instrument that fails to satisfy either the debt or equity tests will be determined by applying the relevant tax provision under which the deduction is sought. For example, to be deductible under the general deductibility provision in section 8-1, the deductibility of a return paid on an instrument that is characterised as neither debt nor equity will depend on whether the 'nexus' test is satisfied and the character of the loss or outgoing.

6.11 That is, the expense must be incurred in gaining or producing assessable income, or be necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. Further, the expense must not, for example, be of a capital, private or domestic nature if it is to be deductible.

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160 Section 25-85, ITAA 1997.

161 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraphs 2.138 and 2.139.

162 Subsection 26-26(2), ITAA 1997.

6.12 The classification of an instrument is determined on the facts and circumstances of each particular case. This adds another level of complexity, uncertainty and increases compliance costs. It can also result in a different treatment of returns on instruments that are, economically, substantially identical, but differ in legal form.

6.13 For example, an Australian resident company issues an instrument for \$20 million which is repayable 11 years from the date of issue. The company is also required to pay an annual return of 5 per cent of sales from two stores. The instrument is not characterised as a debt interest because the principal repaid is less than the \$20 million received (in present value terms). Likewise, the instrument would not be characterised as an equity interest because the return is calculated based on turnover and is not contingent on the economic performance of the Australian resident company.

## THIN CAPITALISATION

6.14 The general policy behind the thin capitalisation rules is to maintain the integrity of Australia's tax base, by preventing MNEs from allocating excessive amounts of 'debt capital' to Australian operations and exploiting the different tax treatment of debt and equity to minimise their Australian tax liability.<sup>163</sup>

6.15 'Debt capital' is a defined term.<sup>164</sup> The definition incorporates 'debt interests' that are 'on issue'. A debt interest is only on issue while an entity has an unfulfilled ENCO to provide financial benefits.<sup>165</sup> However, in a general and practical sense, a 'debt interest' can be on issue even after an issuer no longer has ENCOs to provide financial benefits — after some point an issuer might only have contingent obligations, but these contingent obligations could still give rise to deductible outgoings (see also the discussion at paragraph 4.104-107).

6.16 The thin capitalisation rules generally disallow an amount of the debt deduction that a non-authorised deposit taking institution ('non-ADI') can claim against its Australian assessable income when its debt-to-equity ratio exceeds certain limits. Similarly, an amount of the debt deduction that an ADI can claim will generally be denied if the equity capital used by the ADI to fund its Australian operations is less than minimum thresholds.

6.17 Problems can arise under the thin capitalisation rules where entities use instruments that are classified as neither debt nor equity to fund their Australian operations. Instruments of this nature could avoid or distort the application of the thin

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163 Section 820-30, ITAA 1997.

164 Section 995-1, ITAA 1997.

165 Paragraph 974-55(1)(e), ITAA 1997.

capitalisation rules leading to an impairment of the Australian tax base. This is generally inconsistent with the underlying policy intent of the thin capitalisation rules.

## COMMERCIAL DEBT FORGIVENESS

6.18 The commercial debt forgiveness rules are intended to ensure that when a commercial debt is forgiven or settled for less than its full value, the debtor loses the entitlement to deduct revenue and capital losses that they would otherwise have been able to claim. This prevents a double deduction where the creditor is entitled to a tax deduction or a capital loss for the forgiven debt.<sup>166</sup>

6.19 The net forgiven amount of a commercial debt forgiven is applied to reduce tax attributes of the debtor, that is, its revenue and capital losses.<sup>167</sup> This prevents the debtor from applying those deductions and losses against its taxable income for the year,<sup>168</sup> or carrying them forward to apply in later years.

6.20 The commercial debt forgiveness rules initially relied on the legal concept of debt, the focus of which was a legally enforceable obligation to pay an amount.<sup>169</sup>

6.21 Division 974 extends the general concept of 'debt' in Division 245 to non-equity shares.<sup>170</sup> However, because they rely on the ordinary notion of debt, the Division 974 rules can still, in some instances, apply to instruments that are characterised as non-share equity interests.<sup>171</sup>

## IMPUTATION — FRANKABILITY

6.22 The imputation system alleviates double taxation of corporate profits between 'corporate tax entities'<sup>172</sup> and members (as defined) that have a sufficient economic interest in those entities, by crediting members for tax paid by the entity on its profits.<sup>173</sup>

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166 Explanatory Memorandum to Taxation Laws Amendment Bill (No. 2) 1996, paragraphs 6.2, 6.5 to 6.7. The rules were intended to eliminate the scope for double deductions.

167 The rules operate by reducing the tax debtor's tax attributes in the following order: accumulated revenue losses, net capital losses, amounts of certain un-deducted expenditure, and costs bases of certain assets by the net forgiven amount.

168 Section 245-2, ITAA 1997.

169 Section 245-15 of Schedule 2C, ITAA 1936.

170 Section 245-15, ITAA 1997.

171 In ATOID 2004/377, the Commissioner took the view that non-share equity interests that meet the definition of a commercial debt could be subject to the commercial debt forgiveness rules.

172 Corporate tax entities are defined in section 960-115, ITAA 1997 as companies, corporate limited partnerships, corporate unit trusts and public trading trusts.

173 Sections 200-5 and 201-1, ITAA 1997.

6.23 Australian income tax paid by corporate tax entities is able to be passed on (or imputed) to their members through the allocation of franking credits pro rata according to the profit distribution to which each member is entitled. Franking credits create a tax offset that can be used to reduce the amount of income tax that the recipient will have to pay. If the credits are not needed to satisfy a tax liability, the recipient may be refunded the excess credits. This mechanism ensures that distributed corporate profits are effectively only taxed once (at the member's marginal tax rate).<sup>174</sup>

6.24 Corporate tax entities are required to keep a franking account. This franking account tracks the availability of franking credits reflecting tax paid for allocation, and frankable distributions it has both received from subsidiaries or other corporate tax entity and made to its shareholders.<sup>175</sup>

6.25 The integration of the debt and equity rules in Division 974 into the imputation system means that dividends, including returns taken to be dividends, (excluding those paid on non-equity shares) and non-share dividends can be franked.<sup>176</sup> A non-share dividend is generally frankable if the instrument is an equity interest,<sup>177</sup> the return is a distribution that is not debited to the share capital account or non-share capital account,<sup>178</sup> the distribution does not exceed the available frankable profits,<sup>179</sup> and the ADI concession does not apply.<sup>180</sup> This was intended to give effect to the rationale that returns on equity interests should be treated alike for tax purposes, regardless of their form.<sup>181</sup> Whether the instrument is in the form of a share or not, imputation is not available if specific anti-avoidance provisions apply.<sup>182</sup>

6.26 Anomalies in the integration of Division 974 with the imputation system may arise from the selective criteria used by Division 974 to distinguish between debt and equity interests. The Division 974 rules largely focus on the contractual obligations and returns associated with investments from an issuer's perspective. They do not consider whether an investor is granted broader features of membership interests, decision-making rights, or control over an entity's distribution of its profits.

6.27 In some commercial circumstances, debt interest holders could be considered economic owners of an entity, while equity interest holders may have little by way of control or ownership. For example, a holder of a redeemable preference share that is

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174 Sections 200-5 and 201-1, ITAA 1997.

175 Section 200-15, ITAA 1997.

176 Subdivisions 202-C and 215-A, ITAA 1997.

177 Paragraph 974-70(1)(a), ITAA 1997.

178 Sections 974-115 and 974-120, ITAA 1997.

179 Section 215-15, ITAA 1997.

180 Section 215-10, ITAA 1997.

181 Subdivision 215-A, ITAA 1997.

182 Section 202-45, ITAA 1997; sections 45, 45A and 45B, ITAA 1936.

characterised as debt under Division 974 could exercise a significant degree of control over the company and its profits by virtue of the voting rights attached to the share.

## IMPUTATION — INTEGRITY PROVISIONS

6.28 The imputation system was designed according to the principle that income tax paid by a corporate tax entity should be attributed to the true economic owners of the shares, to the extent that those taxpayers are able to use the franking credits and in proportion to their interest in the entity.<sup>183</sup>

6.29 The imputation system's integrity provisions were intended to counteract the undermining of these principles:

- by franking credit trading schemes that allowed people who were either not exposed, or insufficiently exposed, to the risks and opportunities of share ownership to obtain the full offsetting value of franking credits;<sup>184</sup> and
- by 'dividend streaming' in which entities would allocate franking credits on the basis of which share, or interest holders, could benefit more from them rather than on a basis proportionate to their shareholding.<sup>185</sup>

6.30 The imputation integrity rule in Division 208 limits the ability of resident owners of a company to benefit from franking credits generated while the company was effectively wholly-owned by non-residents or by a tax exempt entity.<sup>186</sup> The purpose of this integrity rule is to prevent manipulation of the imputation system through a form of franking credit trading involving residents and non-residents.

6.31 Ownership of an entity is based on the concept of a membership interest. Unlike the rest of the imputation rules, Division 208 does not rely on Division 974 to determine whether an entity is effectively owned by non-residents.<sup>187</sup> Division 208

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183 Explanatory Memorandum to Taxation Laws Amendment Bill (No. 2) 1999, paragraphs 4.6 and 4.7. It is acknowledged that, in certain circumstances, it is not appropriate for some taxpayers to receive franking credits.

184 Franking credit trading is where real owners of interests in companies who have no use, or a relatively limited use from franking benefits, divert their franked distributions to a person who has a relatively greater use for them, but who is not in substance the owner of an interest in the company; Supplementary Explanatory Memorandum to Taxation Laws Amendment Bill (No. 3) 1998, paragraph 2.3.

185 See the Treasurer's Press Release No. 47 of May 2007, 'Measures to prevent trading in franking credits', retrieved from <http://www.budget.gov.au/1997-98/press/pr47.asp>. Last accessed 25 March 2013. For example, dividend streaming occurs in circumstances where a franked distribution is paid to a resident shareholder and an unfranked distribution paid to a non-resident shareholder.

186 See generally Division 208, ITAA 1997, and in particular sections 208-5 and 208-15, ITAA 1997.

187 Subdivision 960-G, ITAA 1997.

specifically excludes non-equity shares in determining whether an entity is effectively owned by non-residents.<sup>188</sup>

## APPLICATION OF SECTION 177EA

6.32 Section 177EA is a general anti-avoidance rule that was intended to prevent the manipulation of the imputation system by schemes allocating imputation benefits to entities that either have no substantial economic interests in the corporate entity distributing them, or are select equity holders who receive a disproportionate amount of the imputation benefit over other equity holders.<sup>189</sup>

6.33 Section 177EA may be applied where a franked distribution is paid, payable or flows indirectly to a taxpayer under a scheme, and, having regard to the circumstances of the scheme, it would be concluded that a person entered into a scheme for a more than incidental purpose of obtaining the imputation benefit.<sup>190</sup> Since all equity interest holders are intended to be treated equally for tax purposes, section 177EA applies consistently to share and non-share equity interests.<sup>191</sup>

6.34 Section 177EA is primarily concerned with manipulations involving the conferral of imputation benefits. It concerns itself with purposes of obtaining imputation benefits (whether or not the dominant purpose but not including an incidental purpose), and may be applied in circumstances where unusable or surplus imputation benefits are directed to persons lacking real ownership in the company.

6.35 The ATO expressed a view in Taxation Ruling (TR) 2009/3 indicating that section 177EA may apply to deny imputation benefits attaching to interest payments made on certain 'dollar value' convertible notes. Where this applies, one of the consequences of Division 974's characterisation of these notes as non-share equity interests is effectively cancelled. This ruling emphasises that the relevant conclusion that section 177EA requires is not drawn by 'asking whether the relevant instrument is too debt-like' and explains this position in some detail.<sup>192</sup>

6.36 Some stakeholders have questioned whether the conclusions and consequences of TR 2009/3 are appropriate where these instruments serve a real commercial purpose, as the law gives issuers no choice about franking instruments that are classified as equity interests.<sup>193</sup> They note that issuers or investors are penalised if

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188 Section 208-30, ITAA 1997.

189 Supplementary Explanatory Memorandum to Taxation Laws Amendment Bill (No. 3) 1998, paragraph 2.3.

190 Section 177EA, ITAA 1936.

191 Subsection 177EA(12), ITAA 1936.

192 TR 2009/3, paragraph 11.

193 Frost and Cooper, *supra* at note 26, p. 21.

mandatorily franking the returns on these instruments is considered contrary to policy and section 177EA is applied.<sup>194</sup>

6.37 Further, these stakeholders observe that in determining the purpose of a relevant person, one of the factors that section 177EA directs attention to is whether an amount is in the nature of or similar to interest.<sup>195</sup> Non-share equity interests classified as equity by Division 974 would commonly be expected to yield returns that are interest on instruments in the legal form of debt. It is difficult to know how much weight should be placed on this factor in assessing any application of section 177EA to these non-share equity interests. Some stakeholders cite this example as illustrating the need for refinement of the interaction between section 177EA and the Division 974.<sup>196</sup>

6.38 The application of the section 177EA anti-avoidance rule is generally guided by the presence of factors other than those directed at determining the characterisation of a particular interest as either debt or equity under Division 974. Nonetheless, there is potential for section 177EA to apply with the result that returns on these instruments are neither deductible nor frankable.

## SHARE BUY-BACKS

6.39 Division 16K (the share buy-back rules) sets out specific tax consequences for share buy-back transactions.<sup>197</sup>

6.40 The Division was enacted to deal with share buy-backs permitted by the Corporations Law.<sup>198</sup> The original object of the rules was to eliminate any double taxation that could arise from these share buy-back transactions.<sup>199</sup> With the enactment of the Division 974, this object was expanded. The rules were amended to treat buy-backs of all equity interests consistently (regardless of whether they are 'shares').<sup>200</sup>

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194 Ibid.

195 Paragraph 177EA(17)(h), ITAA 1936.

196 Frost and Cooper, *supra* note 26.

197 Explanatory Memorandum to Taxation Laws Amendment Bill (No. 3) 1990, clauses 15, 17 and 29.

198 Section 257A, *Corporations Act 2001* enables the company to buy-back its shares (including its RPS), provided the buy-back does not materially prejudice the company's ability to pay its creditors and certain procedures set in sections 257B to 257Y, *Corporations Act 2001* are followed.

199 Review of Business Taxation, Discussion Paper 2: A platform for consultation: Building on a Strong Foundation, Vol. 1, Preventing double taxation of buy-backs, redemptions and liquidations, February 1999, p. 453. Retrieved from <http://www.rbt.treasury.gov.au/publications/paper3/download/Ch20.PDF>. Last accessed 25 March 2014.

200 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 3.5.



6.41 However, the scope of the Division was not reduced to exclude legal form shares that are 'debt interests'. The buy-back of non-equity shares continues to be subject to the Division, but any deemed dividend will be an unfrankable distribution.<sup>201</sup>

6.42 The share buy-back rules apply where a company buys back a share (or a non-share equity interest) in itself from its shareholder (or equity holder), and cancels the share.<sup>202</sup> There are two subsets of the rules: one for shares that are listed on the stock exchange and bought back in the ordinary course of trading on that stock exchange (an 'on-market buy-back') and another for all other buy-backs (an 'off-market buy-back').

6.43 The rules treat the purchase price<sup>203</sup> the shareholder receives in an on-market buy-back as consideration for the disposal of the share.<sup>204</sup> No part of this purchase price is taken to be a dividend.<sup>205</sup>

6.44 In an off-market buy-back, the rules treat the purchase price the shareholder receives, which is equal to the amount debited to the company's share capital (or non-share capital account) in respect of the buy-back, as consideration for the disposal of the share.<sup>206</sup> However, where the purchase price exceeds the amount debited against the share capital (or non-share capital) account in respect of the off-market buy-back, the difference is taken to be a dividend paid to the shareholder by the company out of available profits on the day of the buy-back.<sup>207</sup> The dividend will generally be frankable, subject to the availability of franking credits. The dividend will be partly unfrankable if the purchase price in the buy-back from the company's member<sup>208</sup> exceeds the share's market value, the excess over the market value is not frankable.<sup>209</sup>

6.45 Tax consequences relating to a shareholder in both an on-market and off-market context depend on whether the shareholder holds the share on revenue or on capital account.

6.46 Although there are generally no income or capital gains tax consequences for a company cancelling its shares under a buy-back scheme,<sup>210</sup> an on-market share

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201 Subsection 202-45(d), ITAA 1997.

202 Note that subsection 257H(3), *Corporations Act 2001* requires the company to cancel the shares it buys back.

203 An amount of money, and/or value of any property the shareholder has received or is entitled to receive as a result or in respect of the buy-back is the purchase price in respect of the buy-back; section 159GZZZM, ITAA 1936.

204 Section 159GZZZS, ITAA 1936.

205 Section 159GZZZR, ITAA 1936.

206 Section 159GZZZP, ITAA 1936.

207 Subsection 159GZZZP(1), ITAA 1936.

208 As defined in section 960-130, ITAA 1997.

209 Subsection 202-45(c), ITAA 1997.

210 Section 159GZZZN, ITAA 1936.



buy-back could potentially result in a franking debit to the company's franking account.<sup>211</sup> This is calculated by determining the notional dividend that would have been paid if the on-market share buy-back were instead an off-market share buy-back.<sup>212</sup>

6.47 Although they were enacted to deal with share buy-backs under the Corporations Law, the share buy-back rules are not expressly limited to that. A purchase is a 'buy-back' for purposes of the rules 'where a company buys a share (or non-share equity) in itself from a shareholder (or an equity holder) in the company'.<sup>213</sup>

## DIVIDEND AND INTEREST WITHHOLDING TAX

6.48 The withholding tax rules set a mechanism for the taxation of returns on an inward investment held by a foreign resident. Withholding tax is a final tax imposed at the time the return is paid on the investment. This ensures that non-resident investors pay an appropriate amount of tax on Australian sourced income.<sup>214</sup> It was intended that the withholding tax rules would be an effective mechanism to collect tax imposed on non-resident investors, protecting the integrity of the Australian tax base.<sup>215</sup>

6.49 The DWT rules apply to dividends, or amounts treated as dividends, paid to non-residents in respect of certain inward equity investments in Australian resident companies.<sup>216</sup> An obligation is imposed on an Australian resident company to withhold an amount equal to the DWT from unfranked dividends paid, credited or distributed to foreign residents.<sup>217</sup> Australia commonly imposes withholding tax on dividends at a rate of 30 per cent of the gross dividend, subject to double tax agreements.<sup>218</sup>

6.50 DWT will not be payable on the franked component of a dividend paid to a non-resident investor,<sup>219</sup> or where the dividend represents conduit foreign income.

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211 See generally Division 203, ITAA 1997.

212 Item 9 in section 205-30, ITAA 1997. If the company does not have a franking benchmark percentage set for that period, it is taken to be 100 per cent.

213 Section 159GZZZJ and subsection 159GZZZK(a), ITAA 1936 compare with the definition of 'buy-back' in section 9, *Corporations Act 2001*.

214 Review of Business Taxation – A platform for consultation – Discussion Paper 2 – Building on a Strong Foundation, February 1999, p. 635. Review of Business Taxation, Discussion Paper 2: A platform for consultation: Building on a Strong Foundation, Vol. 1, Investment in Australia by non-residents, February 1999, p. 635. Retrieved from <http://www.rbt.treasury.gov.au/publications/paper3/download/Ch30.PDF>. Last accessed 25 March 2014.

215 Ibid.

216 Section 128B, ITAA 1936.

217 Sections 128B, ITAA 1936 and 12-210 of the Schedule 1 to the Taxation Administration Act 1953.

218 Regulations 40 and 41, Taxation Administration Regulations 1976.

219 Paragraph 128(3)(ga), ITAA 1936. The exemption will not operate if the debt overlay in subsection 128B(3A), ITAA 1936 applies.

Other exemptions may also apply to former exempting entities<sup>220</sup> and to ADIs where an unfrankable non-share dividend is paid on a non-share equity interest which qualifies as Tier 1 capital (and satisfies certain other conditions).<sup>221</sup>

6.51 The IWT rules apply to interest, or amounts treated as interest, paid to non-residents by an Australian resident receiving the interest through an offshore permanent establishment in respect of certain inbound debt investments in an Australian resident companies or non-resident companies with Australian permanent establishments.<sup>222</sup> An obligation is imposed on an Australian resident company or a non-resident company operating in Australia through a permanent establishment, to withhold tax on interest paid to the non-resident.<sup>223</sup> Australia commonly imposes withholding tax on interest at a rate of 10 per cent of the gross interest,<sup>224</sup> subject to double tax agreements.<sup>225</sup>

6.52 The distinction between interest and dividends for domestic withholding tax purposes generally (but not always) reflects the debt/equity distinction determined under Division 974. Accordingly, the extent to which an Australian resident company is required to withhold tax is broadly a function of:

- the debt/equity classification of the inbound investment by Division 974;
- the integration of the debt/equity classification into the withholding tax provisions Division 11A; and
- if applicable the debt/equity classification of the return on the investment under the relevant double tax agreement.

6.53 The specific rules within the withholding tax regime that are concerned with the levels of ownership were not intended to, and do not, rely on the debt and equity concepts.<sup>226</sup> Consistent with the general policy objective of Division 974, the use of debt/equity concepts in the withholding tax regime was broadly intended to create a clear dividing line between DWT and IWT, and ensures that returns subject to withholding tax are taxed consistently.

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220 Subparagraphs 128B(3)(ga)(ii) and (iii), ITAA 1936.

221 Paragraph 128B(3)(aaa), ITAA 1936 and section 215-10, ITAA 1997.

222 Section 128B, ITAA 1936.

223 Ibid.

224 Unless a domestic exemption is satisfied such as the public offer test in section 128F, ITAA 1936 or an exemption arises under one of Australia's DTAs.

225 Regulation 41, Taxation Administration Regulations 1976.

226 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 3.6.

6.54 Returns on non-share equity interests<sup>227</sup> are subject to DWT in the same way as dividends on ordinary shares.<sup>228</sup> For example, interest paid on convertible notes issued by an Australian company that are not legal form shares, may be subject to DWT if the terms of the convertible note result in it being characterised as an equity interest under Division 974. Similarly, returns on non-equity shares are subject to IWT in the same way as interest-like returns.<sup>229</sup> For example, dividends paid on mandatory redeemable preference shares will generally be subject to IWT if the terms of the instrument cause the mandatory redeemable preference shares to be characterised as debt interests under Division 974 where they are redeemable for their issue price within 10 years.

6.55 The definition of 'interest' for withholding tax purposes does not include all returns on debt interests and also applies to some amounts that are not paid in respect of debt interactions.<sup>230</sup>

## NON-SHARE DIVIDENDS OF ADIs

6.56 Certain non-share dividends paid by ADIs on Tier 1 hybrid instruments issued at, or through, a branch in a listed country are generally unfrankable, provided certain conditions are satisfied.<sup>231</sup>

6.57 The purpose of this treatment is to align the tax treatment of foreign branches of Australian ADIs with that of foreign subsidiaries of Australian ADIs and foreign independent entities. As Australian ADIs are subject to APRA regulations, there are advantages for ADIs to raise Tier 1 capital through branch structures rather than foreign subsidiaries.

6.58 With the introduction of the debt/equity rules in Division 974, some hybrid interests were re-characterised as non-share equity interests thereby creating the requirement for returns on these instruments to be franked. Section 215-10 was designed to relieve any requirement to frank the relevant instruments in order to remove the competitive disadvantage that would have otherwise been created.

6.59 Since the introduction of section 215-10, Australian banks have issued a number of non-share equity interests that are designed either to satisfy, or not to satisfy, the requirements of section 215-10. The ATO has also issued a number of private binding rulings (PBRs) confirming these outcomes.

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227 Other than returns paid from the share capital account or the non-share capital account of the issuer.

228 Subsection 128AAA(1), ITAA 1936.

229 Subsection 128A(1AB), ITAA 1936.

230 Ibid.

231 Section 215-10, ITAA 1997 replicated the original provision, section 160APAAAA, ITAA 1936, which was repealed from 30 June 2002 with the introduction of the new simplified imputation system.

6.60 The ATO issued Tax Determination TD 2012/19 (the Tax Determination) on 18 July 2012 which addressed when an unfrankable non-share equity interest would be 'issued at or through a permanent establishment' of the ADI in a listed country, as paragraph 215-10(1)(c) requires. The Tax Determination states the ATO's view of the necessary pre-conditions including the requirement that the Tier 1 capital raising is a transaction of the business carried on by the ADI at or through the relevant permanent establishment.<sup>232</sup>

6.61 Some stakeholders, in particular the banking industry, argue that the current ATO interpretation being applied to section 215-10 has rendered the section unworkable and inconsistent with its purpose. This view is not shared by the ATO and the Treasury, who have both confirmed that the outcome reached in the TD is consistent with the policy rationale for section 215-10.

6.62 Recent Basel III compliant Tier 1 capital raisings by Australian ADIs have typically involved the issue of Additional Tier 1 capital instruments paying franked distributions to Australian resident investors and not instruments issued through offshore branches.

## OTHER INTERACTIONS

6.63 When Division 974 was enacted, several provisions were amended to give effect to the general intention to treat equity interests, whether share or non-share interests, alike. These provisions include anti-avoidance measures, such as capital streaming<sup>233</sup> and dividend substitution<sup>234</sup> rules. Rules for tax treatment of bonus shares<sup>235</sup> were also amended as were the specific dividend stripping anti-avoidance measure within the Part IVA,<sup>236</sup> and Division 7A.

### Capital streaming and dividend substitution

6.64 The abolition of par value and related concepts in the Corporations Law in 1998 prompted the enactment of rules relating to capital streaming, dividend substitution and taxation of bonus shares. The capital streaming and dividend substitution rules were enacted to protect the revenue from companies distributing profits to shareholders as preferentially taxed capital. The bonus shares rules were intended to ensure effective taxation of bonus share issues in the new Corporations Law environment.<sup>237</sup>

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232 TD 2012/19, paragraph 1.

233 Section 45A, ITAA 1936.

234 Section 45B, ITAA 1936.

235 Section 6BA, ITAA 1936.

236 Section 177E, ITAA 1936.

237 Explanatory Memorandum to Taxation Laws Amendment (Company Law Review) Bill 1998.

6.65 The capital streaming rule applies where a company streams the provision of capital benefits to those shareholders who would receive greater benefit from them, and it is reasonable to assume that other shareholders have received or will receive dividends.<sup>238</sup>

6.66 The dividend substitution rule is directed at schemes under which the taxpayer is provided with a capital benefit. It applies where the taxpayer obtains a tax benefit, and it is concluded, having regard to the relevant circumstances of the scheme, that the person or one of the persons who entered into the scheme did so for the more than incidental purpose of enabling the relevant taxpayer to obtain the tax benefit.<sup>239</sup> Where either the capital streaming or the dividend substitution rule applies, the Commissioner can determine that whole or part of the capital benefit provided is treated as an unfranked dividend paid out of profits.<sup>240</sup>

6.67 With the enactment of Division 974, the provision of a capital benefit for either the capital streaming or the dividend substitution rule includes a non-share capital return. The non-share capital return is taken to be a distribution of share capital to the equity holder for the purpose of these rules.<sup>241</sup>

### Bonus Shares

6.68 The taxation of bonus shares rules were intended to ensure that the bonus shares issued on post-CGT shares for no consideration are generally not taxed as dividends. Instead the rules were intended to, and provide a mechanism for, the cost base of original shares to be generally spread over both the original shares and the bonus shares.<sup>242</sup> The rules apply to non-share equity interests as well as shares.<sup>243</sup>

### Dividend stripping

6.69 Section 177E is an anti-avoidance provision that applies to a dividend stripping scheme, or schemes that have substantially the effect of a dividend stripping scheme.<sup>244</sup> The provision is essentially concerned with the release of profits by the company to its shareholders in a non-taxable form, instead of the form of taxable dividends. Where it applies, the section makes the scheme subject to Part IVA. It entitles the Commissioner to make a determination to include in the taxpayer's assessable income the tax benefit obtained in connection with the dividend stripping scheme, or the scheme that has substantially the same effect as a dividend stripping scheme.<sup>245</sup> The section is also

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238 Section 45A, ITAA 1936.

239 Section 45B, ITAA 1936.

240 Subsection 45A(2), paragraph 45B(3)(b) and section 45C, ITAA 1936.

241 Subsections 45A(3A) and 45B(7), ITAA 1936.

242 Section 6BA, ITAA 1936.

243 Ibid, paragraph 7.

244 Subsection 177E(1), ITAA 1936.

245 Ibid.

intended to apply to schemes where profits are released in non-taxable form, instead of taxable non-share dividends.<sup>246</sup>

## Division 7A

6.70 Division 7A is intended to treat some loans (for example, loans that are not in writing or do not have certain commercial characteristics) and other advances, including debts forgiven, by private companies to their shareholders (and their associates) as dividends paid out of profits to a shareholder, and consequently included in assessable income.

6.71 At the time Division 974 was enacted, Division 7A was amended to ensure that it applies to non-share equity interests in private companies in the same way it applies to shares.<sup>247</sup>

### Q 6.1 Issues/Questions

The Board seeks stakeholder comment on whether there are any significant practical difficulties with the interaction of Division 974 and the following:

- a. the general deductions regime;
- b. the thin capitalisation provisions;
- c. the commercial debt forgiveness rules;
- d. the imputation system;
- e. the anti-avoidance provisions;
- f. the share buy-back rules;
- g. the dividend and interest withholding tax provisions;
- h. offshore banking unit activities; and
- i. whether there are any other intended interaction issues that stakeholders consider problematic.

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<sup>246</sup> Subsection 177E(2A), ITAA 1936.

<sup>247</sup> Section 109BA, ITAA 1936; Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 3.5.

## CHAPTER 7: SUBSEQUENT INTERACTIONS

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### SIGNIFICANT DEVELOPMENTS POST-2001

7.1 There were significant developments in the tax law after Division 974 was introduced in 2001. These included the enactment of:

- the consolidation regime;
- stages 3 and 4 of the TOFA regime; and
- the MIT regime.

7.2 Many of the rules introduced or modified were, depending on the purpose of a particular regime, intended to integrate the concepts from the debt/equity regime in Division 974 either partially or completely.

7.3 As the MIT regime is currently the subject of amendment and, at the date of this discussion paper, the amendments have not yet been released, this chapter does not consider the subsequent interaction of the MIT regime with Division 974. A brief overview of the MIT regime changes and application to stapled structures has been included in chapter 5.

7.4 To determine how effectively Division 974 was integrated into the consolidation and TOFA regimes, it is necessary to understand the policy objectives of those regimes, as well as the objectives of the Division 974. It is also necessary to consider the operation of Division 974 within the context of those provisions.

### CONSOLIDATION

7.5 The consolidation regime was enacted shortly after Division 974.<sup>248</sup> The regime was intended to allow wholly-owned groups of entities to consolidate so that they are treated as a single entity for the purposes of determining their income tax liability.<sup>249</sup>

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248 Refer to the New Business Tax System (Consolidation) Act (No.1) 2002.

249 Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 1.15; see also Review of Business Tax System, 'A Tax System Redesigned', 1999, p. 517, Recommendation 15.1.



7.6 The regime entitles an Australian resident head company and all its Australian resident wholly-owned subsidiary members to elect to be treated as a single entity for income tax purposes.<sup>250</sup>

7.7 The single entity rule may be construed to affect the application of the equity test. Item 2 of the Table in subsection 974-75(1) refers to an interest having a right to a return that is contingent upon the economic performance of a part of a company's activities. An otherwise non-contingent loan to a subsidiary member of a consolidated group is, as a matter of general law and absent any parent or other related company credit support, recoverable only from that subsidiary member. For that reason, the right to the return on that loan may be seen to be contingent upon the economic performance of that part of the notional single entity's activities which consist of that subsidiary member.

#### Division 974 and the 'membership interest'

7.8 The enactment of the consolidation regime was accompanied by the introduction of the concept of membership interest into the tax law. This concept is central to the consolidation provisions and to a number of other taxing provisions that are outside the scope of the Board's review. Division 974 was generally intended to be used in, and was designed for, the provisions that tax the issuers of financing arrangements.<sup>251</sup> The rules are concerned with the risk of return on financing arrangements as distinguishing criterion between debt and equity interests. They do not focus on the control or ownership of an entity conferred on the holder of an interest issued by the entity.

7.9 Nonetheless, Division 974 interacts with several regimes which are concerned with the control or ownership of an entity, and which rely on the 'membership interest' concept.<sup>252</sup> The test for a 'membership interest' partially integrates the Division 974 concepts: it adopts the concept of a 'debt interest', but does not have regard to non-share equity interests.

7.10 At the time the 'membership interest' test was enacted, it was considered that debt interests (such as many RPS) and certain non-share equity interests (such as many convertible notes) generally do not establish control in an entity.<sup>253</sup> Debt interests are specifically carved out from the 'membership interest' test without exception. Under

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250 Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 1.15.

251 As noted in chapter 6, these include thin capitalisation, imputation and withholding tax provisions.

252 Such as, for example, the consolidations regime; certain CGT roll-overs (transfers of assets between certain trusts in subdivision 126-G, ITAA 1997, the scrip for scrip roll-over in subdivision 124-M, ITAA 1997); Division 208, ITAA 1997; and the benchmark rule in the imputation system (but refer to ATOID 2010/53 which states that the imputation system, including the benchmark rule, applies to the non-share equity interests as it applies to membership interests).

253 Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, at paragraphs 3.68 and 3.70; see also Review of Business Tax System, 'A Tax System Redesigned', 1999, Recommendations 12.11 and 15.2(a)(i).



the test, each interest by virtue of which its holder is a member of a company, trust or partnership is a membership interest.<sup>254</sup> A member of a company is its member or a stockholder, a partnership is its partner, and a trust is its beneficiary, unit holder or an object. However, the holder of a debt interest (or debt interests) only is not a member of the entity which issued the debt interest (or debt interests).<sup>255</sup>

7.11 As the 'membership interest' test relies on legal form, it does not take into account holders of all instruments, such as those classified as non-share equity interests for tax purposes. It also does not take into account debt interests that may possess some of the indicia of ownership or control (such as voting rights).

7.12 These exclusions may appear to be inconsistent with the policy rationale underlying the 'membership interest' concept, and the general policy of the provisions concerned with the ownership or control conferred by the instrument on its holder. They also cause significant issues in the interaction of Division 974 and the control or ownership based regimes. For example, in some instances they allow for the effective transfer of control outside of the consolidated group without causing a deconsolidation. They also cause difficulties in the application of the imputation rules for exempting and former exempting entities.<sup>256</sup>

7.13 There are several options for addressing the issues arising from the interaction of the membership interest concept with Division 974. For example, the membership interest test could be:

- amended to include those non-equity shares that confer ownership or control, and exclude only certain debt and equity interests which do not confer ownership or control;
- replaced with the existing tax concepts about ownership or control (such as, for example, the 'continuity of ownership' test in the carry forward loss rules);<sup>257</sup> or
- replaced by a completely new substance based tax concept of ownership and control which could be applicable to all provisions dealing with ownership and control.

### Membership in the consolidation regime

7.14 In order to form a consolidated group, a company and its subsidiaries must meet membership requirements in the consolidation regime.<sup>258</sup> For instance, the head

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<sup>254</sup> Section 960-130, ITAA 1997.

<sup>255</sup> Section 960-130(3), ITAA 1997.

<sup>256</sup> Division 208, ITAA 1997.

<sup>257</sup> Division 165, ITAA 1997.

<sup>258</sup> Sections 703-10 and 703-15, ITAA 1997. There are also special rules for MEC groups in Division 719, ITAA 1997.

company of the group must be a resident company that is taxed at the corporate tax rate and is not wholly-owned by another such company.<sup>259</sup> The subsidiary members may be companies, partnerships or trusts which are wholly-owned by the head company or another subsidiary member of the group, but must not be non-profit companies.<sup>260</sup>

7.15 While they are within the consolidated group, the head company and its subsidiary members are treated as a single entity for the purposes of determining their income tax liability, and the amount of any tax, firm or net capital losses.<sup>261</sup> A subsidiary entity which ceases to be wholly-owned by the head company (or another subsidiary member of the group) leaves the income tax consolidated group, as it is no longer entitled to be part of that consolidated group.<sup>262</sup>

7.16 The consolidation membership rules determine whether an entity is wholly-owned by reference to the holding of its membership interests. Essentially, where all the membership interests in an entity are beneficially owned either directly or indirectly by the head company, that entity will be a member of the consolidated group.<sup>263</sup> As noted above, membership interests for these purposes are based on legal form and not Division 974 concepts, and debt interests are specifically carved out from the membership concept.<sup>264</sup>

7.17 These features of the membership rules may be exploited to bring about tax outcomes that are arguably inconsistent with the economic outcomes of a particular transaction or situation. For example, a company can be a subsidiary member of a consolidated group despite the fact that some interests in that company, which confer a level of control, are held by the entities outside of the group.

7.18 Example 9 (below) illustrates a case where tax consequences may be avoided, or at least deferred, where a consolidated group divests itself of an economic interest in a subsidiary member without causing it to leave the consolidated group. This would appear to be an anomalous outcome and inconsistent with the intent of the consolidation provisions.

**Example 9:**

A consolidated group wishes to sell a 50 per cent interest in a subsidiary member to an unrelated third party purchaser. The arrangement comprises the following steps:

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259 See Item 1 of the Table in subsection 703-15(2), ITAA 1997.

260 Ibid; section 703-30, ITAA 1997.

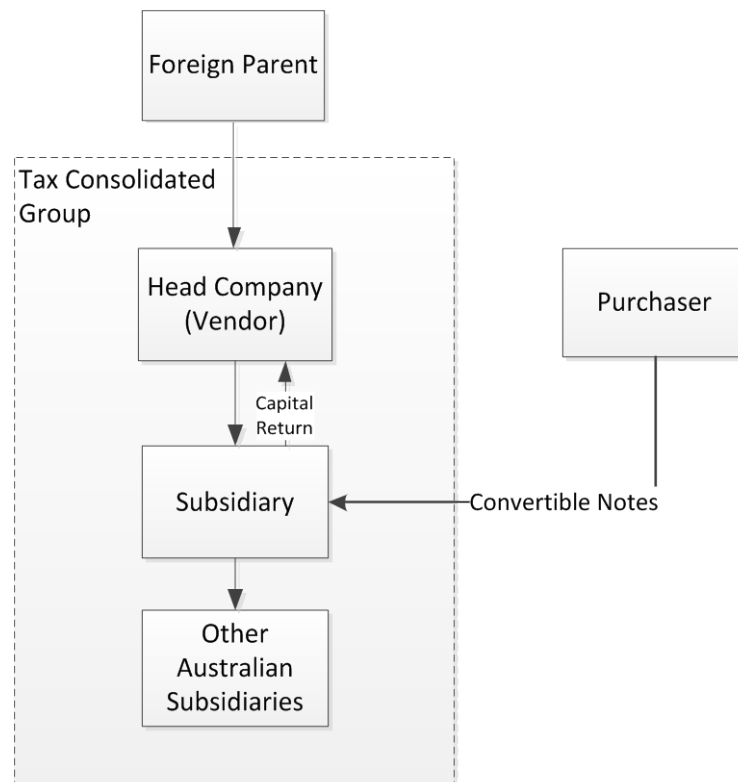
261 Section 701-1, ITAA 1997.

262 Subsection 703-15(2) and section 703-30, ITAA 1997.

263 Sections 703-30 and 960-130, ITAA 1997.

264 Subsection 960-130(3), ITAA 1997.

1. The consideration to be provided in exchange for the 50 per cent acquisition of the entity is \$50 million.
2. The subsidiary entity issues convertible notes to the purchaser for \$50 million. The notes broadly mimic the ordinary shares of its subsidiary in many ways — that is, they are issued in perpetuity, carry somewhat similar rights to the ordinary shares, and could be converted into ordinary shares. The notes are classified as equity interests under Division 974, but the purchaser is not considered a ‘member’ under the ‘membership interest’ test.
3. The subsidiary cancels 50 per cent of its shares and distributes \$50 million as consideration for the share cancellation.



By the issue of convertible notes rather than shares, the sale is implemented in a manner that avoids the sold down subsidiary leaving the consolidated group and thereby prevents a CGT liability from arising for the vendor head company at that time.

The potential Part IVA implications of this scheme are beyond the scope of this discussion paper.

7.19 Other examples include the use of instruments that bring about a ‘synthetic’ disposal of a revenue stream of a subsidiary member to parties outside of the group without causing the subsidiary entity to exit the consolidated group.

7.20 Another example of potentially anomalous interaction between Division 974 and the consolidation regime is illustrated by the application of the material change provisions to the interests of the entities that consolidate.<sup>265</sup>

### Q 7.1 Issues/Questions

The Board seeks stakeholder comment on whether the interaction of Division 974 with the tax consolidation regime is problematic. If so, what changes would address the problem.

## CORPORATE LIMITED PARTNERSHIPS

7.21 Some limited partnerships are taxed as a company, and not as a partnership, for Australian tax purposes.<sup>266</sup> The rationale for this treatment is that the structure of a limited partnership bears some similarities to that of a company. The liability of a 'limited partner' is generally limited to the amount of their investment, as with shareholders in a company.

7.22 Like shareholders, limited partners do not have an active role in the management of the partnership. If taxed under the partnership rules, these partners would be able to access partnership losses that exceed their investment. As such, it was intended that they be treated similarly to shareholders of companies, and the taxation of corporate limited partnerships be aligned with that of companies.<sup>267</sup>

7.23 The rules generally ensure that a limited partnership is treated as a company for almost all purposes of the tax law.<sup>268</sup> For example, the concept of a 'share' is extended to an interest in a corporate limited partnership,<sup>269</sup> and the concept of 'dividend'<sup>270</sup> is extended to include a distribution made by the corporate limited partnership to a partner in the partnership.<sup>271</sup>

7.24 A corporate limited partnership can issue equity interests, unlike a partnership or trust. The interest of a partner (general or limited) is treated in the same way as a share, and satisfies the equity test.

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265 Refer to the 'Accommodating change' section in chapter 4 of this discussion paper.

266 Division 5A of Part III, ITAA 1936.

267 Refer to the Explanatory Memorandum to Taxation Laws Amendment Bill (No. 6) 1992, Background to Legislation.

268 Except for the R&D concession, Division 355, ITAA 1997.

269 Section 94P, ITAA 1936.

270 As defined in section 6, ITAA 1936.

271 Division 6B of Pt III, ITAA 1936.

7.25 The real question that often arises is whether or not the interest of a partner satisfies the debt test, and is characterised as a debt interest under Division 974. Partnership deeds may contain provisions for the redemption of an interest (for example, in respect of a mandatorily redeemable partnership interest), for the amount subscribed plus any accumulated returns.

### Q 7.2 Issues/Questions

The Board seeks stakeholder comment on whether the interaction of Division 974 with the corporate limited partnership regime is problematic. If so, what changes would address the problem.

## TAXATION OF FINANCIAL ARRANGEMENTS (TOFA)

7.26 The TOFA regime was introduced with effect from 1 July 2010<sup>272</sup> to provide a comprehensive framework for the taxation of financial arrangements. The object of the regime is to minimise tax-induced distortions to trading, investment and financing decision-making, to better align tax and commercial recognition of gains and losses from financial arrangements, and to take account of and minimise compliance costs.<sup>273</sup>

7.27 Gains and losses, and the timing of their recognition, are determined using a method set out in the rules, some of which are elective. The available methods<sup>274</sup> are accruals and realisation, fair value, foreign exchange retranslation, hedging financial arrangement, reliance on financial reports and the balancing adjustment on ceasing to have financial arrangements method.<sup>275</sup>

7.28 The TOFA rules apply to financial arrangements,<sup>276</sup> but whether they apply to a particular financial arrangement will depend upon when it was entered into, how it satisfies the definition of financial arrangement, and what elections the taxpayer has made.

7.29 A financial arrangement may consist of rights and obligations (whether legal or equitable) under an arrangement that is cash settleable.<sup>277</sup> A financial arrangement may also consist of non-equity shares,<sup>278</sup> at least from the perspective of the holder. Further,

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272 Taxpayers could elect to apply the rules earlier, from 1 July 2009. Taxpayers could also elect to apply the rules in respect of their existing financial arrangements.

273 Section 230-10, ITAA 1997.

274 Note that there is an order as to which methods can be applied to a particular financial arrangement.

275 Section 230-40, ITAA 1997.

276 Section 230-15, ITAA 1997. The TOFA rules apply from income years starting on or after 1 July 2010, unless the taxpayers elect to apply them for the income years starting on or after 1 July 2009.

277 Section 230-45, ITAA 1997.

278 Subsection 230-530(2), ITAA 1997.

an equity interest, and an arrangement to provide or receive equity interests, is a financial arrangement.<sup>279</sup>

7.30 In some cases, the application of TOFA will depend upon whether the taxpayer is the holder or issuer of the financial arrangement.

7.31 Some TOFA methods cannot be applied in respect of equity interests, whether held or issued.<sup>280</sup> Other TOFA rules apply differently to financial arrangements that are equity interests that are held by a taxpayer within TOFA, and not otherwise excluded,<sup>281</sup> and such financial arrangements issued by a taxpayer. Generally, equity interests held will be taxed under TOFA if the fair value or financial reports election has been made.<sup>282</sup> Equity interests from the issuer's perspective will generally not be taxed under TOFA.<sup>283</sup>

7.32 For example, ordinary shares recognised at fair value through profit and loss for accounting purposes will be subject to TOFA for the holder of those shares, where a financial reports election has been made. However, TOFA will not apply to the issuer of those ordinary shares in respect of that financial arrangement.

7.33 The concept of 'equity interest' established by Division 974 is used by the TOFA rules generally to exclude from its scope such financial arrangements for the issuer. However, the concept of 'equity interest' is also used by the TOFA rules to at times expand its scope from the holder's perspective.

7.34 The TOFA rules provide an example of using Division 974 concepts to determine the scope of a taxing regime for the holder.

## TOFA and debt interests

7.35 The TOFA concept of financial arrangement does not use the Division 974 concept of 'debt interest'. TOFA deals with the concept of 'financial arrangement which requires there to be cash settleable rights and obligations, but no other rights and obligations that are not cash settleable and that are not insignificant. 'Debt interest' requires, amongst other things, that there be a financing arrangement that has an

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<sup>279</sup> Section 230-50, ITAA 1997.

<sup>280</sup> Neither the accruals and realisation method, nor the foreign exchange retranslation method can be applied: see paragraph 230-40(4)(e) and subsection 230-270(1), ITAA 1997 respectively.

<sup>281</sup> For example, rights or obligations in relation to an interest in a partnership or trust where that interest is an equity interest in the partnership or trust are generally outside the scope of TOFA: subsection 230-460(3), ITAA 1997.

<sup>282</sup> Paragraph 230-410(1)(d), ITAA 1997. Exclusions for issuers can be found at paragraphs 230-225(1)(a) [fair value], 230-415(1)(a) [financial reports] and subsections 230-330(1) [hedging method] and 230-270(1) [foreign exchange retranslation (general)], ITAA 1997 respectively.

<sup>283</sup> An exception is an equity interest issued by a taxpayer and used as a foreign currency hedge, under the hedging method: see subsection 230-300(7) and section 230-330, ITAA 1997.

ENCO. Although most debt interests should be financial arrangements, not all financial arrangements will be debt interests under Division 974.

7.36 At first blush, this is an anomalous feature of the TOFA rules.<sup>284</sup> A question arises as to whether the application of TOFA to the financial arrangements of a taxpayer should extend to all debt interests held or issued, as this is not expressly provided for in the TOFA rules. Specific rules ensure that non-equity shares are financial arrangements to which TOFA can apply.<sup>285</sup>

7.37 This raises additional questions about the role of the different aggregation and disaggregation approaches in Division 974 and the TOFA rules. Division 974 focuses on the scheme with scope for aggregation or disaggregation in limited circumstances,<sup>286</sup> whereas the TOFA regime is a wider ranging enquiry.

7.38 For example, a debt interest that consists of two or more related schemes may not be the same 'arrangement' identified through consideration of the matters set out in section 230-55 as a question of 'fact and degree'.<sup>287</sup> A stapled instrument (for example, a share and a loan note) is likely to be a 'financial arrangement' under section 230-45<sup>288</sup> yet may give rise to separate characterisations.

7.39 Another difference is that the aggregation rules in Division 974 cannot take two or more schemes, each of which gives rise to a debt interest only, and combine them as a single interest, whereas the TOFA aggregation rules could have this effect.

7.40 A further consideration is whether or not there are debt interests (that are also not non-equity shares) that are outside TOFA. For example, a convertible note with a holder option to convert may not be a financial arrangement for an issuer despite being a debt interest if the shares are not readily convertible into money.<sup>289</sup>

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284 A proposal was announced to extend the definition of 'financial arrangement' within section 230-45, ITAA 1997 to 'debt interest'; see also Assistant Treasurer's Press Release No. 43 of 2009, 'Further steps to modernise Australia's financial taxation system'. Retrieved from <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/043.htm&pageID=003&min=njsa&Year=&DocType>. Last accessed 25 March 2014. Section 230-45, ITAA 1997 was subsequently extended with the practical effect that some additional debt interests came within scope of 'financial arrangement'.

285 Subsection 230-530(2), ITAA 1997.

286 That is, the related scheme provisions, the integrity rule in section 974-80, ITAA 1997 and powers to disaggregate.

287 Section 230-55, ITAA 1997.

288 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.49.

289 Paragraph 230-45(2)(f) and subsections 230-45(3) to (5), ITAA 1997 respectively, as amended.



## ENCO and sufficient certainty

7.41 The debt interest test centres upon the identification of an ENCO. The accruals method in TOFA centres upon the concept of 'sufficient certainty', which tests financial benefits in terms of a reasonable expectation that they will occur and that their quantum is fixed or determinable with reasonable accuracy.

7.42 This raises the possibility of having an obligation to provide financial benefits that is not an ENCO (according to Division 974), but the provision of which is sufficiently certain (according to the TOFA rules). This is significant because the ENCO test indirectly affects which financial instruments can be subject to accruals taxation under TOFA.

7.43 Generally, the debt test does not examine the likelihood of future performance in determining whether there is an ENCO.<sup>290</sup> Further, it addresses the question of quantum in aggregate, but at least primarily, only in relation to ENCOs.<sup>291</sup>

7.44 The obligation to pay a dividend under a RPS will not be taken into account in finding a debt interest under the primary test because it is not an ENCO regardless of how certain that cash-flow might be.

7.45 This, in conjunction with the valuation rules, can result in arguably anomalous outcomes. Consider the following two RPS examples:

### Example 10

RPS 1 is a preference share redeemable for its face value plus any accumulated returns in just under ten years' time. It offers a return of 20 per cent per annum, but an annual return is only paid or accumulated if there are current year profits. If that condition is satisfied, the latest that return can be provided is the time of redemption. The issuer is a start-up company that intends to bring a new invention to market in six years' time.

### Example 11

RPS 2 is a preference share redeemable for its face value, plus any accumulated returns, in just over 10 years' time. It offers a return on the same terms as RPS 1. However, the issuer operates in a heavily regulated and mature market, with strong history of profitability, strong retained earnings and low volatility in generating its profits. Assume that there is a reasonable expectation that some dividends will be paid.

7.46 RPS 1 is likely to be characterised as a debt interest, notwithstanding the riskiness of the venture undertaken by the issuer and lack of certainty of its returns on the

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290 Paragraph 974-20(1)(d), ITAA 1997.

291 By contrast, the accruals rules take into account the likelihood of future performance and the quantum in respect of each financial benefit individually.



investment. RPS 2 is clearly an equity interest. Where both issuers are TOFA taxpayers, the issuer of RPS 1 may potentially accrue some returns (after Year six), whereas the issuer of RPS 2 cannot.<sup>292</sup> This is notwithstanding that there is a very high degree of confidence that at least some dividends will be paid or accumulated on RPS 2.

### Q 7.3 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the interaction of Division 974 with the TOFA regime, in particular whether:

- a. the fact that the TOFA regime does not adopt the concept of a debt interest, as characterised under Division 974, is problematic. If so, what changes would address the problem;
- b. the use of the 'sufficient certainty' concept in the TOFA regime, instead of 'ENCO' in Division 974, is problematic? If so, what changes would address this problem; and
- c. the concept of sufficient certainty of the provision of financial benefits should be considered in applying the debt test in Division 974, including the operation of the valuation rules.

## NON-SHARE DIVIDENDS AND AVAILABLE FRANKABLE PROFITS

7.47 Distributions paid on non-share equity interests debited to non-profit sources (for example, share capital) are unfrankable. A company cannot frank non-share dividends unless it has available frankable profits (or can anticipate them), worked out under a formula. This is intended to result in returns on non-share equity being treated in the same way as dividends paid on shares debited to non-profit sources. In the absence of such a rule, returns on non-share equity could be used to stream franking credits.

### Q 7.4 Issues/Questions

The Board seeks stakeholder comment on whether the treatment of returns paid on share and non-share equity is problematic. If so, what changes would address the problem.

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292 The TOFA accruals method does not apply to gains and losses from equity interests.



## CHAPTER 8: NON-INTERACTIONS

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8.1 As stated in chapter 6, Division 974 was originally intended to serve as an interpretative mechanism for a specific set of operative provisions. The rules were not intended to apply for all purposes of the income tax law. The Board has been asked to determine whether the debt/equity rules in Division 974 should play a greater role in the income tax law.

8.2 The current form of Division 974 largely reflects this original intention. There are areas of the tax law where the debt/equity rules have no role to play, but which use related concepts of debt and equity, for example 'borrowing' or 'share'. The concepts in these other areas of the tax law are generally regime specific, form-based, and differ in their coverage. Questions often arise as to whether the related concept used in another area of the tax law is appropriate, given its policy intent or whether the relevant concept in Division 974 should be extended to other areas of the tax law.

8.3 The benefits of standardisation of concepts across the tax law are clear, but achieving this is not an end in itself. Any standardisation must be consistent with the promotion of the underlying policy objectives of those areas of the tax law that are being examined.

### **Q 8.1 Issue/Question**

A number of areas of the tax law use concepts of debt and equity but not specifically the debt and equity rules and concepts contained in Division 974. The Board is interested in any key areas in the tax law, whether or not addressed in the discussion paper, where consideration should be given to whether Division 974 concepts should be applied.

## THE INTENDED USE OF THE CONCEPTS IN DIVISION 974

8.4 As stated above, the debt and equity concepts were never intended to be used for all purposes. For example, it was not intended that the concept of a 'non-share equity interest' would be used in rules that enquire into the ownership of companies to achieve their policy outcomes. This was because non-share equity interests were considered to be 'rarely relevant' for determining ownership of companies.<sup>293</sup> For example, they were considered irrelevant for the rules relating to the transfer and use

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293 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 3.3.

of losses, grouping concessions, public and private company definitions, the controlled foreign company (CFC) and foreign investment fund (FIF)<sup>294</sup> rules and sections 23AJ, 23AI, and 23AK.<sup>295</sup> Those rules were intended to continue to apply as if the debt/equity rules were never enacted.<sup>296</sup>

### Trusts and debt/equity concepts

8.5 The equity test was only intended to apply to interests issued by a company, and by extension, to those entities that are considered to be appropriately taxed as a company (such as some limited partnerships, public trading trusts and corporate unit trusts). A significant feature of Division 974 is that the equity test does not extend to trusts, unless expressly extended in the operative rules outside of the division.<sup>297</sup> On the other hand, the debt test, and related scheme debt test, applies more broadly to financing arrangements for an entity (which includes trusts).<sup>298</sup>

8.6 This means that interests issued by trusts can only be characterised as debt interests (or not) under the current rules in Division 974<sup>299</sup> irrespective of the interests' economic substance.<sup>300</sup> For example, whilst certain debt interests issued by companies can be re-characterised as equity interests or give rise to a related schemes equity interest on the basis that they are in substance or effect equity interests, the same debt interests issued by a trust cannot be so re-characterised. This is because they are debt interests not issued by a company, or debt interests in respect of which the company is not a party, nor has caused the trust to enter into or participate in.

8.7 In addition, although the economic substance or effect of a debt interest may be the raising of equity, for example in the form of permanent hybrid equity capital by the trust, the negative capital limb of section 8-1 does not deny the deduction for all of the returns on that debt interest in the calculation of the trust's net income. This is because that limb is affected by paragraph 25-85(2)(b), which is drafted on the basis that once an interest is characterised as a debt interest under Division 974 (including where subsection 974-70(2) and section 974-80 do not apply), its substance or effect should not be seen as giving rise to securing a permanent or enduring benefit.

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294 The FIF rules were repealed by the Tax Law Amendment (Foreign Source Income Deferral) Act (No. 1) 2010 on 14 July 2010.

295 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 3.3.

296 Ibid, paragraph 3.17.

297 Subsection 974-70(2) and section 974-75, ITAA 1997.

298 Section 974-20 and subsection 974-20(2), ITAA 1997.

299 Subsection 974-70(2) and section 974-75, ITAA 1997.

300 By contrast, the thin capitalisation regime contains rules for what is an equity interest in a trust.

**Q 8.2 Issue/Question**

The Board seeks stakeholder comment on the intended use of the concepts in Division 974 and, in particular, whether a modified equity test should apply to entities other than companies. If so, for what purposes should a modified equity test apply or not apply.

**Financing and Ownership provisions**

8.8 The provisions that use concepts related to the debt/equity distinction, but not specifically the concepts of debt and equity in Division 974, generally fall into two broad categories – provisions relating to financing and provisions relating to ownership.

8.9 Table 8.1 below lists operative provisions that do not specifically rely on the concepts of debt and equity and then explains the related concept that the provision in question relies on. In contrast to the Division 974 concepts, which apply from the perspective of the issuer of an instrument, all regimes mentioned in the table below are directed to the tax position of the holder, although the tax position of issuers are sometimes affected as well.<sup>301</sup> Each of the regimes identified in the Table are discussed in further detail below.

**Table 8.1 — Operative provisions that rely on concepts which are related to the debt and equity distinction**

<b>Financing provisions</b>		
<b>Regime</b>	<b>Concept</b>	<b>Explanation of concept</b>
Division 16E	'security' (in 'qualifying security')	Obligations that are essentially debt-like in nature (must meet additional criteria to be a 'qualifying security').
Sections 26BB and 70B	'security' (in 'traditional security')	Obligations that are essentially debt-like in nature (must meet additional criteria to be a 'traditional security' including that it is not a 'qualifying security').

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<sup>301</sup> For example, under Division 16E, ITAA 1997 or as part of the consequential cost base adjustments.

Ownership provisions		
Regime	Concept	Explanation of concept
General CGT roll-overs <sup>302</sup>	'share'	A share in the capital of the company, and includes stock.
	'redeemable shares'	Shares that are liable to be redeemed (whether at the option of the issuer or not).
CGT roll-over for demergers <sup>303</sup>	'ownership interest'	A share in a company or unit in a trust (or an option, right or similar interest issued by the company that gives the owner an entitlement to acquire a share in the company or unit in the trust).
CGT roll-over for intra-group transactions <sup>304</sup>	'wholly-owned group'	The test focuses on beneficial ownership of shares in a company and persons 'in a position to affect rights'.
Employee share schemes (ESS) Rules <sup>305</sup>	ESS interest	A beneficial interest in a share in the company, or a right to acquire such an interest (including stapled securities where at least one of the stapled instruments is a share).
Foreign source income for example, CFC regime <sup>306</sup>	'control interest'/ 'attribution interest'	Broadly determined having regard to the paid up share capital, the rights to vote and participate, and the entitlements to distributions of capital or profits in the CFC.
Section 23AJ exemption	'non-portfolio dividend'	A dividend (other than an eligible finance share dividend or a widely distributed finance share dividend) paid to a company that has a voting interest amounting to at least 10 per cent voting power in the company paying the dividend. <sup>307</sup>

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302 Roll-overs include disposal or creation of assets to a wholly-owned company (subdivisions 122-A and 122-B, ITAA 1997); exchange of shares/units, or rights or options (subdivisions 124-E and 124-F, ITAA 1997); exchange of shares in one company for shares in another company (subdivision 124-G, ITAA 1997); exchange of units for shares (subdivision 124-H, ITAA 1997); disposal of assets by a trust to a company (subdivision 124-N, ITAA 1997); and scrip for scrip (subdivision 124-M, ITAA 1997).

303 Subdivision 125, ITAA 1997.

304 Subdivision 126-B, ITAA 1997.

305 Division 83A, ITAA 1997.

306 Part X, ITAA 1936.

307 Subsection 317(1), ITAA 1936.

Ownership provisions		
Regime	Concept	Explanation of concept
CGT exemption for foreign residents <sup>308</sup>	'membership interest'	Each interest by virtue of which its holder is a member of a company, trust or partnership (that is a share, a partnership interest or a unit in a trust). The holder of a debt interest alone is not a member of its issuer.
CGT participation exemption <sup>309</sup>	'share'	A share in the capital of the company, and includes stock.

## FINANCING PROVISIONS

8.10 The accruals provisions in Division 16E, as well as sections 26BB and 70B, set out a mechanism for the taxation of gains and losses from certain securities. Provided these gains and losses are not otherwise subject to the TOFA rules in Division 230, these taxing regimes generally:

- ensure the holders and issuers of 'qualifying securities' are taxed on an accruals basis;<sup>310</sup> and
- tax gains and losses on redemption or disposal of 'traditional securities' on revenue account.<sup>311</sup>

### The 'security' and the debt/equity concepts

8.11 Division 16E and sections 26BB and 70B all use the concept of 'security' as a basis for operation.

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308 Division 855, ITAA 1997.

309 Subdivision 768-G, ITAA 1997.

310 If the discount or premium paid or payable on the security would be assessable under another provision, the 'accrual amount' specifically calculated for the set 'accrual period' is treated on revenue account and assessed for the holder under section 159GQ, ITAA 1936; the issuer is generally entitled to a corresponding deduction under section 159GT, ITAA 1936.

311 A gain on the disposal or redemption of a traditional security is assessed under section 26BB, ITAA 1936 in the income year of the disposal or redemption. A loss on the disposal or redemption is generally an allowable deduction under section 70B, ITAA 1936 in the income year of the disposal or redemption of the traditional security. Special rules apply to traditional securities that are convertible or exchangeable into ordinary shares, see subsections 26BB(4) and (5), and subsection 70B(2C), ITAA 1936.

8.12 The concept of 'security' is broadly defined. It means obligations that are essentially debt-like in nature, that is, a stock, bond, debenture, certificate of entitlement, bill of exchange, promissory note or other security, a deposit with a bank or other financial institution, a loan, or any other contract under which a person is liable to pay an amount or amounts.<sup>312</sup> However, shares are not thought to be within the scope of the term, regardless of how 'debt-like' they may be.<sup>313</sup>

8.13 Unlike the concepts in the debt/equity rules, the concept of 'security' does not require that the relevant arrangement be a 'financing arrangement'.

8.14 Broadly, a 'security' is:

- a 'qualifying security' if it is issued after 16 December 1984 for a period that is reasonably likely to exceed 12 months, under terms whereby it is reasonably likely that the security will produce receipts (other than of periodic interest) which exceed the issue price by 1.5 per cent;<sup>314</sup> and
- a 'traditional security' if it is issued after 10 May 1989, and not issued at a discount of more than 1.5 per cent, does not bear deferred interest and is not capital indexed.<sup>315</sup>

## Intention

8.15 Division 16E was enacted to overcome the tax deferral advantages associated with certain discounted or deferred interest securities.<sup>316</sup> The intention was to broadly achieve symmetry between the tax treatment of lenders and borrowers.<sup>317</sup> Division 16E applies to a *qualifying security* and only sets the timing for the deductibility or assessability of an original issue discount (or redemption premium or deferred interest).<sup>318</sup> Although the division can bring forward the recognition of assessable income and deductions for both holders and issuers, it has greater significance for holders because many issuers, such as financial institutions, could deduct the outgoing on an incurred basis prior to payment.

8.16 On the other hand, sections 26BB and 70B were intended to treat gains and losses on redemption or disposal of *traditional securities* on revenue account.<sup>319</sup> These sections

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312 Subsection 159GP(1), ITAA 1936.

313 See broadly the Explanatory Memorandum to Taxation Laws Amendment Bill (No. 3) 1989.

314 Subsection 159GP(1), ITAA 1936; TR 96/14, paragraph 19.

315 Subsection 26BB(1), ITAA 1936; TR 96/14, paragraph 2.

316 Explanatory Memorandum to Taxation Laws Amendment Bill (No. 2) 1986; Income Tax (Securities and Agreements) (Withholding Tax Recoupment) Bill 1986, Notes to Clauses, Clause 16.

317 TR 96/3, paragraph 7.

318 Sections 159GX and 159GT(2), ITAA 1936.

319 See broadly the Explanatory Memorandum to Taxation Laws Amendment Bill (No. 3) 1989, Taxation of traditional securities, Clauses 10, 11, 13 and 18.



assess or allow deductions for amounts which may not have otherwise been taxable or deductible on revenue account. However, unlike Division 16E, they only apply to the holders of the security.<sup>320</sup>

8.17 The traditional security provisions removed such gains from CGT treatment, which at the time permitted indexation, averaging and sheltering by capital losses. Although indexation and averaging have been removed, the 50 per cent CGT discount is now available to some holders instead. Furthermore, some holders who are within TOFA will bring gains and losses to account as revenue items.

8.18 With the enactment Division 230, some traditional securities, as well as many qualifying securities, have become subject to the TOFA regime.

8.19 Traditional securities will generally be subject to TOFA, as opposed to sections 26BB and 70B,<sup>321</sup> where it is a financial arrangement and the holder is subject to the TOFA regime. All qualifying securities will be subject to TOFA where they are a financial arrangement acquired or issued after 1 July 2010,<sup>322</sup> unless they were acquired within 12 months from the end of their term.<sup>323</sup> As such, the residual application of Division 16E appears to be limited.

8.20 The application of TOFA too many, if not most, qualifying securities and some traditional securities, raises the issue of general utility of these provisions in the tax law. Against these developments, there is a policy question as to whether the qualifying and the traditional security provisions ought to be retained, or whether they could be repealed without any significant change to the tax base but with the advantage of simplification of the tax law.

### Q 8.3 Issues/Questions

The Board seeks stakeholder comment on whether the fact that Division 16E and sections 26BB and 70B use the concept of security and not concepts in Division 974, is problematic. If so, what changes would address the problem and is there a practical need to retain Division 16E and sections 26BB and 70B.

## OWNERSHIP PROVISIONS

8.21 As stated in chapter 7, Division 974 does not focus on the control or ownership of an entity conferred on the holder of an interest issued by the entity. Rather, the rules

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320 Subsections 26BB(2) and 70B(2), ITAA 1936.

321 Section 230-20, ITAA 1997.

322 Or earlier, if so elected by the taxpayer under items 103 or 104 in Schedule 3 of Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009.

323 Section 230-455, ITAA 1997.

partially interact with other regimes concerned with control or ownership. These interactions arise because, for example, specific references are made to 'debt' interests,<sup>324</sup> or to a legal form concept of 'share' in both Division 974 and the specific provision concerned with the ownership or control of an entity.

8.22 Provisions other than Division 974 can often include legal form concepts such as 'redeemable shares' or 'eligible finance shares'. Accordingly, some concepts related to debt or equity, but not specifically defined as such under Division 974, result in non-interactions between Division 974 and other regimes that use related concepts. A number of these non-interactions, including relevant concepts, are discussed below. For consideration against the background of ownership and control, as well as the holder's perspective, is whether any changes to the concepts in these provisions should be made, and if yes, whether they should be based on Division 974.

## CGT Roll-overs

8.23 The CGT provisions are, like many other ownership based regimes, drafted from the holder's perspective. They also generally rely on form-based concepts, such as 'shares', 'debentures',<sup>325</sup> 'financial instruments',<sup>326</sup> or 'units'.

8.24 The CGT provisions were amended when Division 974 was enacted with minor consequential amendments that introduced the concept of equity interest into the regime. These amendments provided that neither the creation of a non-share equity interest nor the grants of an option to acquire a non-share equity interest are caught by CGT events D1 and H2.<sup>327</sup> The 'convertible interest' concept was also introduced.<sup>328</sup> Other potential amendments to the CGT rules were not considered at the time.<sup>329</sup>

8.25 To lower compliance costs for small business in respect of related party at call loans, follow up amendments were made so that the issue of non-equity shares does not give rise to a capital gain.<sup>330</sup>

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324 Refer to the discussion about 'membership interest' in chapter 7 of this discussion paper.

325 Paragraph 104-30(1)(b), ITAA 1997.

326 Refer to CGT event G3 in section 104-145, ITAA 1997, in particular, subsection 104-145(3), ITAA 1997 which defines the financial instruments in the section as debentures, bonds or promissory notes issued by the company, loans to the company, futures contracts, forward contracts or currency swap contracts relating to the company and rights or options to acquire any of those instruments or shares in the company.

327 Paragraphs 104-35(5)(c) and 104-155(5)(c), ITAA 1997; Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraphs 3.28 to 3.42.

328 Ibid.

329 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 3.29.

330 Paragraphs 104-35(5)(c) and 104-155(5)(c), ITAA 1997; Explanatory Memorandum to Tax Laws Amendment (2005 Measures No. 5) Bill 2005, paragraph 6.40.

8.26 While certain parts of the current CGT regime rely on debt/equity concepts (specifically, equity interest and non-equity shares), most of the CGT regime is based on specific form-based concepts.

8.27 The CGT roll-over provisions are relevant, in particular:

- Disposal or creation of eligible assets by individuals, trustees or partners to a wholly-owned company in subdivisions 122-A and 122-B.
- Exchange of shares, or rights or options to acquire such shares, in the same company in subdivisions 124-E and 124-F.
- Exchange of shares in a company, or units in a trust, for shares in an interposed company in subdivisions 124-G and 124-H.
- Scrip for scrip roll-over in subdivision 124-M.
- Disposal of assets by a trust to a company in subdivision 124-N.
- Demerger relief in Division 125.
- Disposal or creation of assets involving companies in the same wholly-owned group in subdivision 126-B.

8.28 These CGT roll-overs broadly apply in two situations:

- where assets are transferred to a company for shares, and the ownership of the assets and the company are aligned; or
- where there is a reorganisation of holders' interests whereby original shares are replaced by shares in a different company.

8.29 Though they are drafted from the holder's perspective, roll-overs rely on the concept of shares and the exchange of interests in companies. As such, consideration should be given as to whether they should be closer aligned to the debt/equity concepts in Division 974.

#### Disposal or creation of assets to wholly-owned company: Subdivision 122-A and 122-B

8.30 CGT roll-over relief may generally be available if an individual, trustee or a partner disposes of an asset or all the assets of a business, or creates rights in a company, and receives shares (but not redeemable shares) in the company.<sup>331</sup>

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<sup>331</sup> Refer generally to Subdivisions 122-A and 122-B, ITAA 1997.

8.31 This roll-over was intended to provide CGT relief where the legal ownership of an asset changes, but its underlying ownership remains the same.<sup>332</sup> As such, conditions for the roll-over include that the market value of the shares is substantially the same as the asset disposed of or the right created, and, that immediately following the CGT event in respect of which the roll-over is sought, the transferee(s) owns all the shares in the company.<sup>333</sup> For the roll-over to be available, the shares received as consideration cannot be redeemable shares, as defined.<sup>334</sup>

8.32 The exclusion for redeemable shares focuses on a single feature of an interest – redeemability – as a proxy for shares that does not meet the policy objective of the roll-over relief. Although many redeemable shares will be debt interests, this is not invariably the case. Under the current law, some redeemable shares will in fact be equity interests.

8.33 An individual who transfers assets to a company, in which it owns all the shares, in exchange for shares in that company will generally:

- Qualify for relief, even if a 3<sup>rd</sup> party owns non-share interests that deliver substantial control over the company.
- Qualify for relief if the exchanged shares are agreed to be bought back.
- Not qualify for relief if the company has issued shares to a 3<sup>rd</sup> party that are debt interests, even if the 3<sup>rd</sup> party has rights only akin to a creditor.
- Not qualify for relief if the exchanged shares are redeemable.

8.34 A question arises as to whether the issuer's perspective should be relevant to roll-over eligibility that is justified in policy terms because relevant ownership has not changed. Alternatively, there is no obvious reason why CGT may be deferred if an asset is transferred for consideration of in substance debt in the form of shares, but there is no CGT deferral if the transfer consideration is cash, deferred consideration, or vanilla debt.

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332 Explanatory Memorandum to Income Tax Assessment Amendment (Capital Gains) Bill 1986, Division 1 – Interpretation, Section 160ZZN: Transfer of asset to wholly-owned company.

333 Refer generally to Subdivisions 122-A and 122-B, ITAA 1997.

334 Subsection 122-20(2), ITAA 1997.

### Reorganisation roll-overs — shares in same entity: Subdivision 124-E and 124-F

8.35 CGT roll-over relief may be available where a company cancels or redeems all shares of a particular class, and issues replacement shares to taxpayers who held that class of shares.<sup>335</sup>

8.36 A roll-over on similar conditions may be available where units in a trust are redeemed or cancelled, and the replacement units of the same market value are issued to the original unit holder.<sup>336</sup>

8.37 Taxpayers may also be entitled to a roll-over where their rights or options to acquire shares in a company, or units in a trust, are replaced with new corresponding rights or options of the same market value, as a result of the share or unit consolidation or subdivision.<sup>337</sup>

8.38 The eligibility conditions for the roll-over set out the circumstances which must exist for the replacement shares to be considered as a substitute for the original shares.

8.39 The roll-overs were intended to extend the relief to reorganisations of share capital within a company or unit capital within a trust where, as part of the reorganisation, the taxpayer surrenders all their holdings in respect of a particular class of shares or units in exchange for the replacement holdings.<sup>338</sup>

8.40 The exchange of a non-share equity interest for a different non-share equity interest, or rights thereof, cannot qualify for the roll-over.

8.41 By contrast, the roll-over may be available in some cases where a debt-like share is exchanged for another debt-like share, even if the earlier and later interests do not have the same character under Division 974. The equivalence of the interests is judged by limited criteria, being legal form, market value and paid-up capital of the issuer.

### Reorganisation roll-overs — shares in different entity: Subdivision 124-G and 124-H

8.42 CGT roll-over relief may be available where the shares in a company (or units in a trust) are exchanged for shares in another company.<sup>339</sup> Shares received by the

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335 Subdivisions 124-E and 124-F, ITAA 1997. The conditions for the roll-over include that the replacement shares, just after they are issued, are at least equal to the market value of the original shares just before they are redeemed or cancelled, that the paid up share capital of company does not change and the replacement shares are the only consideration the taxpayer receives for cancellation or redemption.

336 Section 124-245, ITAA 1997.

337 Subdivision 124-F, ITAA 1997.

338 Explanatory Memorandum to Income Tax Assessment Amendment (Capital Gains) Bill 1986, Notes on Clauses, Section 160ZZP: Exchange of shares in the same company; Explanatory Memorandum, Taxation Laws Amendment Bill (No.3) 1988, Clause 49: Insertion of new sections, Section 160ZZPAA — Exchange of units in the same unit trust.

339 Subdivisions 124-G and 124-H, ITAA 1997.

shareholder in exchange cannot be redeemable shares (whether redeemable at the option of the issuer or holder).

8.43 These roll-overs were intended to provide CGT relief in situations where a resident company is interposed between shareholders and an existing resident company (or between the unit holders and the trust), and the shareholders (or unit holders) dispose of their shares in the existing company solely in exchange for shares in the interposed company.<sup>340</sup>

8.44 Several conditions for roll-over relief apply and vary depending on whether the original shares or units are disposed of, redeemed or cancelled.<sup>341</sup> At a high level, these conditions set out legislative criteria for when one group of shares (or units) can be considered as equivalents to a different group of shares for the purposes of deferring a CGT taxing point.

#### Subdivision 124-M: Scrip for scrip roll-over

8.45 Scrip for scrip roll-over was enacted in 1999 to enable share or unit holders to defer the recognition of a capital gain resulting from a scrip for scrip exchange.<sup>342</sup> This concession was generally intended to remove income tax impediments to corporate acquisitions, and enhance the functioning of, and value creation by, the corporate sector in Australia.<sup>343</sup>

8.46 There are several criteria that need to be met before scrip for scrip roll-over relief is available.<sup>344</sup> Broadly, the taxpayer may be able to choose roll-over relief if it makes a capital gain<sup>345</sup> when it exchanges:

- a share in a company for a share in another company (or a similar interest issued by the company that can be converted into a share in the company for a similar interest in another company);<sup>346</sup> or
- a unit in a trust for a unit in another trust where each of the units entitles the holders to a fixed return of income and capital from their respective trusts (or a

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340 Explanatory Memorandum to Taxation Laws Amendment Bill (No.3) 1988, Clause 50: Section 160ZZPC: Company schemes of arrangement — exchange of shares in original company for shares in interposed company.

341 Section 124-360, ITAA 1997.

342 Explanatory Memorandum to New Business Tax System (Capital Gains Tax) Bill 1999, paragraph 2.3.

343 Ibid, paragraphs 2.3 and 2.5.

344 Subdivision 124-M, ITAA 1997.

345 Subsections 124-780(3) and 124-781(3), ITAA 1997.

346 Section 124-80, ITAA 1997.

similar interest issued by the trust that can be converted into a unit in the trust for a similar interest in another trust).<sup>347</sup>

8.47 An exchange must be in consequence of a single arrangement, which results in another company (or trust, depending on what is being exchanged), owning at least 80 per cent of the voting shares in the original company (or the original trust).<sup>348</sup>

8.48 Where roll-over relief is obtained, the tax on any capital gain is deferred and the cost base for the replacement interests is set by reference to the cost base of the original interests.<sup>349</sup>

8.49 Notably, roll-over can apply in respect of all original shares (whether debt interests or equity interests), provided the exchange has a sufficient nexus with an arrangement that results in an acquisition of at least 80 per cent of the voting shares of the company.<sup>350</sup>

8.50 Since it applies to legal form shares, roll-over relief could be available in respect of the exchange of the RPS classified as debt interests under Division 974.<sup>351</sup> Conversely, it is not available for the exchange of non-share instruments such as convertible notes, which are generally classified as non-share equity interests under Division 974.

8.51 In December 2013 the Government announced that it would proceed with the 2012-13 Budget measure to amend the CGT scrip for scrip roll-overs integrity provisions to remove significant tax minimisation opportunities.<sup>352</sup>

#### Reorganisation roll-overs — trust interests for shares in company: Subdivision 124-N

8.52 CGT roll-over relief may be available where the trust disposes of all of its CGT assets to a company in certain trust restructures. Roll-over relief can apply at the level of the transferee trust and transferor company, as well as the holder.<sup>353</sup>

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347 Section 124-781, ITAA 1997.

348 Paragraph 124-780(1)(b), subsection 124-780(2), paragraph 124-781(1)(c), subsection 124-781(2), ITAA 1997; note special rules for events after 6 January 2010 in subsections 124-780(2A) and 124-781(2A), ITAA 1997.

349 Section 124-782, ITAA 1997.

350 The definition of 'voting share' is linked to the *Corporations Act 2001*, which defines a 'voting share' as any share that carries a voting right beyond certain listed rights which are of a limited nature (for example a right to vote during a winding-up).

351 Refer to ATOID 2003/893.

352 See the Assistant Treasurer's Press Release on 14 December 2013, 'Integrity restored to Australia's taxation system', retrieved from <http://axs.ministers.treasury.gov.au/media-release/008-2013/>. Last accessed 25 March 2014.

353 Sections 124-855 and 124-870, ITAA 1997.



8.53 The conditions for roll-over relief include that each entity that owned interests in the transferor trust must own shares in the transferee company in the same proportion as their original interests. The market value of those original interest and replacement shares must be at least substantially the same.<sup>354</sup>

8.54 As the test relies on the legal form 'share', roll-over relief is available regardless of whether the replacement shares are equity or debt interests. However, roll-over relief is not available where the replacement interests are non-share equity, even if economically similar in terms of ownership rights or returns.

#### Demerger relief: Division 125

8.55 Holders of ownership interests in the head entity of a demerged group may be entitled to demerger relief in respect of a CGT event that happens to their interests under the demerger.<sup>355</sup> The object of the relief is to ensure that CGT is not an impediment to the business restructures.<sup>356</sup> It entitles the owners of the head entity have their capital gains from the demerger disregarded, and the cost base for the new interests received under the demerger set.<sup>357</sup>

8.56 The relief may be available where a taxpayer owns an ownership interest in a company or trust which is a head entity of the demerger group to which the demerger happens.<sup>358</sup> An ownership interest for a company is defined as a share in the company (or an option, right or similar interest issued by the company that gives the owner an entitlement to acquire a share in the company).<sup>359</sup>

8.57 Because an ownership interest is defined by reference to a 'share' in a company, the shares that are classified as debt interests under Division 974 will be taken into consideration in determining whether the taxpayer is entitled to a demerger relief. On the other hand, non-share equity will not.

#### Asset reorganisation: transfer of assets within wholly-owned group: Subdivision 126-B

8.58 Subdivision 126-B was originally enacted to provide CGT roll-over relief for the transfer or creation of assets between the companies in a wholly-owned group.<sup>360</sup> With

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354 Subsection 124-860(6), ITAA 1997.

355 Division 125, ITAA 1997.

356 Section 125-5, ITAA 1997.

357 Section 125-80, ITAA 1997.

358 Section 125-55, ITAA 1997.

359 Section 125-60, ITAA 1997. There are specific rules dealing with dual listed company structures.

360 Tax Law Improvement Bill (No. 1) 1998, B. Outline of the Divisions in Parts 3-1 and 3-3, Division 126.



the enactment of the consolidation regime, this roll-over has, to a great extent, become redundant and domestically its operation has been phased out.<sup>361</sup>

8.59 Roll-over relief can apply for the transfer, or creation, of a CGT asset within the same wholly-owned group of companies where at least one company is a foreign resident.<sup>362</sup> Further, the roll-over is available to these companies only in respect of some CGT events, and only in specific circumstances.<sup>363</sup>

8.60 Whether a company is wholly-owned is determined by examining the share ownership in a company.<sup>364</sup> Where all shares in a company are:

- beneficially held by another company ('holding company') or a wholly-owned subsidiary, or by the holding company and a wholly-owned subsidiary; or
- together with the shares of another company wholly-owned by the same holding company; and
- the holding company and/or its wholly-owned subsidiaries will be part of the wholly-owned group. However, if either the holding company or its wholly-owned subsidiary's rights in relation to the company can be affected by another person,<sup>365</sup> the companies will not be part of the wholly-owned group for the purposes of the test.<sup>366</sup>

#### **Q 8.4 Issues/Questions**

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the non-interaction of Division 974 and the CGT roll-over relief provisions, in particular:

- a. whether the fact that the CGT roll-over relief provisions, as discussed at paragraphs 8.21 to 8.60, do not use Division 974 concepts is problematic. If so, what changes would address the problem;
- b. whether the limitation of the CGT roll-over relief provisions to legal form shares, as discussed at paragraphs 8.21 to 8.60, is problematic. If so, what changes would address the problem;

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361 Refer to amendments New Business Tax System (Consolidation) Bill (No. 1), 2002, paragraphs 13.5 and 13.25.

362 Sections 126-40 and 126-45, ITAA 1997.

363 Section 126-45, ITAA 1997.

364 Section 975-505, ITAA 1997.

365 Section 975-150, ITAA 1997.

366 Subsections 975-505(3) and (4), ITAA 1997.

- c. the role, if any, that Division 974 should play in establishing whether an interest is an appropriately equivalent replacement for another; and
- d. whether it would be appropriate to have a separate substance-based test operating from the holder's perspective rather than Division 974 or form-based concepts.

## EMPLOYEE SHARE SCHEMES

8.61 The ESS rules were intended to tax employees who received benefits under the ESS at their marginal tax rate, and not the employer under the fringe benefits tax. The rules were also intended to increase the extent to which the employees' interests are aligned with those of their employers by providing tax concessions to encourage lower and middle income earners to acquire shares under the ESS.<sup>367</sup>

8.62 Broadly, the ESS rules assess the taxpayers on any discounts on shares, rights or stapled securities they or their associates acquire under the ESS.<sup>368</sup> Taxpayers who acquire ordinary shares under ESS may be entitled to have the amount of any discount included in their assessable income reduced, or deferred.<sup>369</sup> Where the taxpayer's amount of assessable income is reduced, the employer is entitled to a corresponding deduction.<sup>370</sup>

8.63 The current ESS rules<sup>371</sup> apply to the schemes under which ESS interests in a company are provided to the employees of the company or its subsidiaries, or the employees' associates, in relation to the employees' employment.<sup>372</sup> An ESS interest in a company is a beneficial interest in a share in the company, or a right to acquire a beneficial interest in a share in the company.<sup>373</sup> If at least one of the stapled interests in a stapled security is a share, the rules apply to a stapled security in the same way as they apply to a share in a company.<sup>374</sup>

8.64 As the ESS rules apply to shares, any non-equity shares issued under the ESS will also be subject to the concessions. This raises the question of how the issuing of a debt interest to an employee provides the incentive that the policy is intended to encourage.

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367 Section 83A-5, ITAA 1997.

368 Section 83A-25, ITAA 1997.

369 Subdivision 83A-B and 83A-C, ITAA 1997.

370 Section 83A-205, ITAA 1997.

371 The ESS rules in Division 83A apply to ESS interests acquired on or after 1 July 2009. ESS interests acquired before this date are subject to Division 13A or section 26AAC, ITAA 1936.

372 Subsection 83A-10(2), ITAA 1997.

373 Section 83A-10, ITAA 1997.

374 Section 83A-335, ITAA 1997.

8.65 It is also noted that non-share equity interests that are economically similar to shares will not qualify for the concession. If this type of interest is capable of aligning the interests of employees and employers, then this will be relevant to any consideration of the appropriateness of the legal form test.

### Q 8.5 Issues/Questions

The Board seeks stakeholder comment on whether the use of the concept of legal form share in the ESS rules instead of Division 974 concepts, is problematic. If so, what changes would address the problem.

## FOREIGN SOURCE INCOME AND CONTROLLED FOREIGN COMPANIES

8.66 When the debt/equity rules were introduced, the foreign source income rules consisted of the calculation of a net income of a non-resident trust estate for the purposes of attribution where the trust is covered by Division 6,<sup>375</sup> the transferor trust provisions,<sup>376</sup> CFC rules in Part X,<sup>377</sup> and the FIF rules in Part XI.<sup>378</sup> As they were intended to be dealt with within the Review of International Taxation Arrangements (2003),<sup>379</sup> these rules were specifically carved out from the application of Division 974.<sup>380</sup>

8.67 Following that review, the deemed present entitlement rules and the FIF rules have been repealed.<sup>381</sup> Of particular relevance for this review are the CFC rules (including section 23AJ), and related provisions such as sections 23AJ.

### CFC Rules

8.68 The CFC rules were introduced in 1990 to ensure that the taxation of a resident on a foreign source income is not avoided by the interposition of a CFC by a resident between the source of the income and the resident.<sup>382</sup>

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375 Refer to sections 96A to 96C, ITAA 1936 repealed by the Tax Laws Amendment (Foreign Source Income Deferral) Act 2010, Act No. 114 of 2010.

376 Division 6AAA, ITAA 1936.

377 See Part X, ITAA 1936.

378 See Part XI of the ITAA 1936 repealed by the Tax Laws Amendment (Foreign Source Income Deferral) Act 2010, Act No. 114 of 2010.

379 There was a further Review into Anti-deferral Regimes (2008).

380 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraphs 3.16 to 3.17.

381 Tax Laws Amendment (Foreign Source Income Deferral) Act 2010, Act No. 114 of 2010.

382 Explanatory Memorandum to Taxation Laws Amendment (Foreign Income) Bill 1990, Main Features – Credit for foreign taxes paid in respect of attributed income. See also, Explanatory Memorandum to the Tax Laws Amendment (2007 Measures No. 4) Bill 2007, paragraph 1.5.

8.69 Under the CFC rules Australian residents are broadly taxed on their pro rata share (attribution percentage) of income accumulated offshore in foreign companies (attributable income), unless that income is comparably taxed offshore, or the foreign company satisfies the active income test.<sup>383</sup>

8.70 The attributable income of the CFC is, subject to certain modifications, calculated in the same manner as income of Australian resident companies.<sup>384</sup> The amount of attributable income depends on whether the CFC is a member of a listed or an unlisted country and whether the active income test exemption applies.<sup>385</sup>

8.71 As originally intended, Division 974 is 'carved out' from the CFC rules. The Division is therefore disregarded when calculating the attributable income of the CFC.<sup>386</sup> As the Division requires an assessment from the issuer's perspective, its application in the context of the CFC rules that seek to assess the holder would arguably lead to practical problems of the type outlined in paragraphs 4.98 to 4.101 of chapter 4. In particular, it may be difficult to obtain relevant information that would enable classification of instruments for the purposes of Division 974 in the CFC context.

8.72 Some stakeholders have also suggested that the resulting compliance costs would disproportionately outweigh any revenue that would be collected as a result.<sup>387</sup> On the other hand, extending the application of Division 974 to the CFC rules would give effect to the policy that there should be few exceptions to applying the income tax law in the CFC context,<sup>388</sup> and the effect of announced amendments to section 23AJ would need to be considered.<sup>389</sup>

#### Eligible finance shares, widely distributed finance shares and transitional finance shares

8.73 The CFC regime uses specific form-based concepts to distinguish payments on certain debt like instruments. These are the concepts of 'eligible finance share', 'widely distributed finance share' and 'transitional finance share'.

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383 Section 456, ITAA 1936; Explanatory Memorandum to Taxation Laws Amendment (Foreign Income) Act 1990, Main Features – Controlled Foreign Companies.

384 Sections 382 to 385, ITAA 1936.

385 Refer to Subdivision C of Division 3, Division 7 and Subdivision A of Division 8, Part X, ITAA 1936.

386 Section 389A, ITAA 1936.

387 See, for example, KPMG Submission to Treasury, Discussion Paper – Foreign source income attribution rules, p. 5, retrieved from <http://archive.treasury.gov.au/documents/1577/PDF/KPMG.pdf>. Last accessed in February 2014; CPA Australia, Submission to Treasury, Discussion Paper – Foreign source income attribution rules, p.3 retrieved from [http://archive.treasury.gov.au/documents/1577/PDF/CPA\\_Australia.pdf](http://archive.treasury.gov.au/documents/1577/PDF/CPA_Australia.pdf). Last accessed in February 2014.

388 Treasury, 'Discussion Paper – Foreign source income attribution rules', 12 May 2009, p. 11, retrieved from [http://archive.treasury.gov.au/documents/1526/RTF/income\\_anti\\_tax\\_deferral\\_attribution\\_rules.rtf](http://archive.treasury.gov.au/documents/1526/RTF/income_anti_tax_deferral_attribution_rules.rtf). Last accessed in February 2014.

389 Refer to Greenwoods & Freehills, Submission to Treasury, Discussion Paper – Foreign source income attribution rules, 9 June 2009, p. 22, retrieved from [http://archive.treasury.gov.au/documents/1577/PDF/Greenwoods\\_Freehills\\_Pty\\_Limited.pdf](http://archive.treasury.gov.au/documents/1577/PDF/Greenwoods_Freehills_Pty_Limited.pdf). Last accessed in February 2014.

## 8.74 Broadly, a share is:

- An *eligible finance share* if it is issued by a company to an Australian Financial Institution ('AFI') or its subsidiary (that is not an associate of the company) in its ordinary course of business, and having regard to the relevant criteria in paragraph 327(d), the payments of the dividends in respect of that share may be reasonably regarded as equivalent to the payment of interest on a loan where the interest accrues at intervals not exceeding 12 months and is paid not later than 12 months after it accrues.<sup>390</sup>
- A *widely distributed finance share* if it is in either an eligible listed company or a company that has 90 per cent or more of its eligible share interests held by the eligible listed company. A widely distributed finance share is by its definition similar to an eligible finance share, except it is not issued to an AFI (or its subsidiary), but can be reasonably regarded as having been issued with a view to public subscription or purchase or other wider distribution among investors. The payment of dividends on a widely distributed finance share need only be reasonably regarded as equivalent to the payment of interest on a loan (there are no specific requirements as to how such an interest should accrue or be paid).<sup>391</sup>
- A *transitional finance share* which is a type of finance share that is funded by the issue of the widely distributed finance shares in a related CFC.<sup>392</sup> The concept of transitional finance share was introduced in the CFC rules in 1992 to exclude from the calculation of the attributable income of a CFC the dividends it paid on the transitional finance share.<sup>393</sup> The exclusion is transitional.<sup>394</sup>

8.75 More generally, the eligible finance share concept was introduced in the CFC regime to carve out certain financial intermediaries with active business receipts which could be perceived as passive income.<sup>395</sup> The introduction of the widely distributed finance share concept was to carve out arm's length financiers of a CFC whose only interest in the CFC was to ensure repayment of the invested funds and regular payment of dividends in a form which is, in effect, substitute for interest on a loan.<sup>396</sup>

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390 Section 327, ITAA 1936.

391 Section 327A, ITAA 1936.

392 Section 327B, ITAA 1936.

393 See broadly the Explanatory Memorandum to Taxation Laws Amendment Bill (No. 2) 1992, Transitional Finance Shares, Background to Legislation.

394 It only applies in respect of the shares funded by the issue of widely distributed shares before the 12 April 1989, and for dividends paid on transitional finance shares before 1 July 1998, see section 327B, ITAA 1936.

395 Keating P.J., 'Taxation of Foreign Source Income — An Information Paper forming part of the Economic Statement', April 1989, p. 45.

396 Taxation Laws Amendment Bill (No. 2) 1992, Background to Legislation.

8.76 The effect is that that an AFI will not be subject to the attribution of the CFC income merely because it holds eligible finance shares in a CFC.<sup>397</sup> Also, widely distributed finance shares or transitional finance shares are disregarded when determining their holders' attribution interests in a CFC.<sup>398</sup> The attributable income of other CFC shareholders does not include amounts that relate to the eligible finance share, widely distributed finance share or transitional finance share dividends, as the CFC is entitled to deduct these amounts when calculating its attributable income.<sup>399</sup>

8.77 As discussed below, eligible finance share dividends and widely distributed finance share dividends are also excluded from the non-portfolio dividend calculation for the purposes of section 23AJ. The exclusion was intended to ensure that these shares are 'afforded special tax treatment equating them to debt instruments'.<sup>400</sup>

8.78 The common feature of the eligible finance share, widely distributed finance share and transitional finance share concepts is the requirement that the payment of a dividend on a share may be reasonably regarded 'as equivalent to the payment of interest on a loan'. Matters relevant to determining whether the payment of a dividend may be reasonably regarded as equivalent to the payment of interest on a loan include:

- the manner in which the amount of dividends in respect of the share are to be calculated,
- the conditions applicable to the payment of dividends in respect of the share, and
- any other relevant matters.<sup>401</sup>

8.79 The focus of the eligible finance share, widely distributed finance share and transitional finance share concepts on how the dividends are paid and calculated suggests some alignment with the debt test, as these matters form part of the pricing, terms and conditions. However, the eligible finance share concept, for example, is also relevant to what is considered under the CFC control/ownership tests. As such, the use of the debt interest in this area may not be consistent with the policy underpinning the CFC rules, particularly where a debt interest contains indicia of ownership or control. This is because the CFC concepts are regime specific to achieve specific policy outcomes.

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397 Subsections 350(5), 356(4), and 366(5), ITAA 1936.

398 Subsection 356(4), and 366(5), ITAA 1936.

399 Section 394, ITAA 1936.

400 Taxation Laws Amendment Bill (No. 4) 1997, paragraph 10.

401 Refer paragraphs 327(d), 327A(3)(b) and subsection 327B(2), ITAA 1936.

## Control interests

8.80 Whether a foreign company is a CFC is determined by applying specific tests in the CFC rules – a strict control test,<sup>402</sup> assumed controller test,<sup>403</sup> or the de-facto control test.<sup>404</sup> All of these tests rely on the concept of control interest<sup>405</sup> and involve a practical examination of who owns the company (by reference to that control).

8.81 There are special rules for determining control interests. These are broadly based on the entity's interests in the issued capital in the company, the rights to vote and participate in the CFC, and the entitlements to distributions of capital or profits.<sup>406</sup> As noted, eligible finance shares in the company are ignored for the purposes of the test.<sup>407</sup>

## Attribution interests

8.82 Australian residents who are assessed on their attribution percentage of the CFC's attributable income are the 'attributable taxpayers'.<sup>408</sup> The attributable taxpayer's attribution percentage of the CFC's attributable income is the total of the taxpayer's direct and indirect attribution interests in the CFC.<sup>409</sup> Similar to the control interests, the attribution interests are determined having regard to the paid up capital, the rights to vote and participate in the CFC, and the entitlements to distributions of capital or profits.<sup>410</sup> Again, eligible finance shares, widely distributed finance shares and transitional finance shares in the CFC are ignored.<sup>411</sup>

## SECTION 23AI, 23AJ AND 23AK

8.83 Sections 23AI and 23AK were intended to exempt from tax those profits that have already been assessed under the CFC or FIF rules.<sup>412</sup> Section 23AI relies on the CFC rules. Consistency between concepts used in the CFC regime and section 23AI is required for the effective operation and interaction of the rules. Responses to questions relating to the use of definitional concepts for CFC purposes will inform any

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402 Five or fewer Australian entities with an interest of at least 1 per cent in the foreign company have an aggregate associate-inclusive control interest in a foreign company of at least 50 per cent, refer paragraph 340(b), ITAA 1936.

403 A single Australian entity has an associate-inclusive control interest in a foreign company of at least 40 per cent and there are no unrelated controllers of the company, refer paragraph 340(b), ITAA 1936.

404 Five or fewer Australian entities either alone or with its associates control the foreign company, refer paragraph 340(c), ITAA 1936.

405 Sections 340 to 342, ITAA 1936.

406 Sections 349 to 355, ITAA 193.

407 Subsection 350(5), ITAA 1936.

408 Section 361, ITAA 1936.

409 Subsection 362(1), ITAA 1936.

410 Section 356, ITAA 1936.

411 Subsection 356(4), ITAA 1936.

412 TD 2006/52, paragraph 13; Explanatory Memorandum to Tax Laws Amendment (Foreign Source Income Deferral) Bill (No. 1) 2010, paragraph 1.24.



consideration of the use of relevant concepts for section 23AI. As the application of section 23AK is limited after the repeal of the FIF rules, its interaction with Division 974 will not be open to additional scrutiny in this Review.

### Section 23AJ

8.84 Section 23AJ is a general provision that was intended to exempt from tax non-portfolio dividends sourced from Australian companies' foreign investments which is taxed at a rate comparable to Australia.<sup>413</sup>

8.85 The policy to exempt dividends received by an Australian company, sourced from a non-portfolio investment in a foreign company, is intended to ensure that the tax system does not discourage the expansion of Australian companies overseas. Section 23AJ relies on the legal form of the distribution – a dividend – and on the recipient company having a sufficient voting interest in the paying company.<sup>414</sup> Dividends paid on eligible or widely distributed finance shares (that have debt-like features) cannot attract the concession.<sup>415</sup>

8.86 Notably, the policy underpinning the concession focuses on the relationship between the paying and receiving companies, that is, identifying the economic owners of the company and not on the certainty or uncertainty of the return.

8.87 A policy question raised is whether the form of the return to the holder should be taken into account in determining the scope of the concession. For example, whether all returns on capital instruments of the entity with a sufficient economic interest qualify and whether returns on in substance debt instruments should be carved out.

8.88 The present rule looks to the voting rights attached to a share as a proxy for economic ownership.

8.89 The Government announced in the 2009-10 Budget that it would amend section 23AJ to limit the application of the exemption to returns on interests that are 'equity' interests under Division 974. This means that the exemption will no longer be available for dividends received on interest that are legal form shares but qualify as 'debt' interests under Division 974 (that is RPS).

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413 Explanatory Memorandum to Taxation Laws Amendment (Foreign Income) Bill 1990, Main Features – Foreign Credits Tax System, Dividends received from foreign companies (Clause 8).

414 Section 23AJ and 317, ITAA 1936.

415 Section 317, ITAA 1936.



### Q 8.6 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the non-interaction of the foreign source income and CFC rules with Division 974, in particular whether:

- a. the calculation of attributable income in the CFC rules using concepts other than Division 974 concepts, is problematic. If so, what changes would address the problem;
- b. the control interest test in the CFC rules should be based on the concept of an 'equity interest' in the definition in Division 974;
- c. there would be any practical difficulties, practical efficiencies or improvements if the concepts of eligible finance share, widely distributed share or transitional finance share were changed to reflect Division 974 concepts; and
- d. the calculation of the attribution percentage in a CFC using concepts other than Division 974 concepts is problematic. If so, what changes would address the problem.

## DIVISION 855

8.90 Foreign residents are subject to CGT in Australia in relation to capital gains relating to only some CGT assets. There are five categories of assets to which CGT may apply to foreign residents.<sup>416</sup> All other capital gains or losses made by a foreign resident are disregarded.<sup>417</sup>

8.91 This limitation is intended to improve Australia's position as an attractive place for business and investment.<sup>418</sup> The primary policy for which assets of a foreign resident are to remain within the Australian CGT base is to include interests (directly or indirectly) in an entity if 'the entity's underlying value is principally derived from Australian real property'.<sup>419</sup>

8.92 However, the interest in an entity held by a foreign resident to which CGT could apply must be a membership interest that passes the 10 per cent non-portfolio interest test or principal asset test, as modified for these CGT rules.<sup>420</sup> The rules do not take into account non-share equity interests. Further, debt interests held by foreign residents are

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<sup>416</sup> Section 855-15, ITAA 1997.

<sup>417</sup> Section 855-10, ITAA 1997.

<sup>418</sup> Paragraph 855-5(1)(a), ITAA 1997.

<sup>419</sup> Paragraph 855-5(2)(b), ITAA 1997.

<sup>420</sup> Section 855-25 and 960-190 and subsection 855-30(2), ITAA 1997.

outside the scope of the Australian CGT rules, notwithstanding those foreign residents can participate in the upside attributable to the underlying Australian real property.

## NON-SHARE EQUITY AND SUBDIVISION 768-G

8.93 A capital gain or loss made by an Australian company or its CFC on shares that it owns in a foreign company may be reduced to the extent of the foreign company's active foreign business assets.<sup>421</sup> The reduction is available where the holding company holds a direct voting percentage in the foreign company of 10 per cent or more throughout a continuous 12 month period in the period of two years before the CGT event occurs.

8.94 The reduction is only available in respect of CGT assets that are shares, which are not eligible finance shares and widely distributed finance shares. This exclusion was intended to ensure that the shares which are 'in substance, the equivalent to a debt rather than an equity investment' are not able to qualify for the concession.<sup>422</sup>

8.95 The reduction is not available for non-share equity, even if held by an Australian resident that qualifies for the treatment in respect of its shares.

### Q 8.7 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the non-interaction of Division 855 and Subdivision 768-G with Division 974, in particular whether:

- a. the use of legal form share concepts and the exclusion of shares that are debt interests in Division 855 is problematic. If so, what changes would address the problem;
- b. any inappropriate tax outcomes are obtained because Division 855 uses legal form share concepts but excludes shares that are debt interests; and
- c. the use of concepts, other than Division 974 concepts, in subdivision 768-G is problematic. If so, what changes would address the problem.

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421 Subdivision 768-G, ITAA 1997.

422 Explanatory Memorandum to New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004, paragraph 1.22.

## SMALL BUSINESS ENTITIES — DIVISION 328

8.96 Division 328 provides eligibility criteria for access to a range of concessions for small business entities. Where a small business meets these eligibility criteria it can choose to use the small business tax concessions, subject to satisfying any additional conditions that apply for the particular concessions.

8.97 A ‘small business entity’ is an entity that operates a business for all or part of the income year and has less than \$2 million aggregated turnover. Aggregated turnover is the annual turnover of the entity plus the annual turnover of any entity connected with the small business and any affiliates of the small business.

8.98 Generally, an entity is connected with another entity if one entity controls the other entity or both entities are controlled by a third entity.<sup>423</sup> An entity is an ‘affiliate’ of another entity if one entity would be expected to act in accordance with the other entity’s directions.<sup>424</sup> The provisions establish whether turnover of another business must be included in calculating the aggregated turnover of an entity. Without these provisions a larger entity could separate its activities into different entities to access small business concessions.

8.99 Division 974 concepts are not incorporated in determining whether an entity is connected with another entity or whether an entity is an affiliate of another entity.

### Q 8.8 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the non-interaction of the small business concession regime with Division 974.

## OFFSHORE BANKING UNIT IN PARAGRAPH 121D(1)(A)

8.100 The Offshore Banking Unit (OBU) rules contained in Division 9A were introduced in 1992 to provide a concessional 10 per cent income tax regime for certain eligible OBU activities, thereby complementing an equivalent withholding tax exemption that was previously introduced in 1987. The purpose of the concessional OBU tax regime was to help facilitate offshore banking activities in Australia and help Australia become an expanded financial centre in the Asia Pacific region.<sup>425</sup>

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<sup>423</sup> Section 328-125, ITAA 1997.

<sup>424</sup> Section 328-130, ITAA 1997.

<sup>425</sup> Refer to One Nation, Statement by the then Prime Minister, The Honourable PJ Keating MP 26 February 1992.

8.101 As a safeguard to ensure that only appropriate activities of offshore persons attract the relevant tax concessions, the legislation sets out a definition of eligible offshore banking activity (OB activity) in section 121D(1). This definition lists various permitted activities that an OBU can conduct including 'a borrowing and lending activity'.<sup>426</sup>

8.102 In order for borrowing or lending activity to be an eligible OBU activity it must involve:

- borrowing in currencies other than A\$ from an offshore person or A\$ from unrelated offshore persons;
- lending in currencies other than A\$ to an offshore person or A\$ to offshore persons other than offshore branches of Australian residents; or
- borrowing or lending gold from offshore persons.

8.103 When Division 974 was introduced in 2001 no interaction was created between the debt test in section 974-20 and permitted borrowing and lending activity for the purposes of subsection 121D(1)(a). It is therefore possible that permitted borrowing and lending activity for the OBU regime could involve financial arrangements that do not necessarily satisfy the debt test. Once such example would be borrowing and lending activity involving an instrument that is legal form debt, but an equity interest for the purposes of Division 974. Conversely borrowing or lending activity involving a share that is a debt interest would not currently be permitted under subsection 121D(1)(a).

8.104 The Government announced in November 2013 that 'it will proceed with offshore banking unit reform but with a targeted integrity measure instead of excluding all related-party transactions. The government will work closely with stakeholders to develop the targeted rules to address the integrity issues with the current rules'.<sup>427</sup> On 30 January 2014, the Government announced that 1 July 2015 will be the start date for these reforms.<sup>428</sup>

## Q 8.9 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the non-interaction of the OBU regime with Division 974.

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<sup>426</sup> Paragraph 121D(1)(a) and subsection 121D(2), ITAA 1936.

<sup>427</sup> See the Treasurer and Assistant Treasurer's joint press release, 'Restoring Integrity in the Australian Tax System', 6 November 2013, retrieved from <http://jbh.ministers.treasury.gov.au/media-release/017-2013/>. Last accessed 25 March 2014.

<sup>428</sup> Offshore Banking Unit Reforms, Assistant Treasurer's press release, 30 January 2014.

## CHAPTER 9: COMPLIANCE AND ADMINISTRATION

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9.1 Division 974 and the accompanying measures formed part of the broad ranging New *Business* Tax System legislative program that followed the Ralph Review.

9.2 The New *Business* Tax System was intended to provide Australia with an internationally competitive business tax system. It was also intended to provide a basis for more robust investment decisions, achieved by:

- using consistent and clearly articulated principles;
- improving simplicity and transparency;
- reducing the cost of compliance through principled tax laws that are easier to understand and comply with; and
- providing fairer and more equitable outcomes.<sup>429</sup>

9.3 The terms of reference for this Review ask the Board to consider, among other things, whether these listed objectives have been achieved. To provide a basis for consideration this chapter discusses transitional arrangements and the impact of the structure and style of Division 974 on compliance and administration costs. It also outlines post-enactment legislative developments, taxpayers' experience in complying with the law and the ATO's experience in interpreting and administering the law.

### TRANSITIONING TO THE NEW ARRANGEMENTS

#### Application provisions

9.4 The debt/equity rules generally applied from 1 July 2001 to transactions in relation to interests issued on or after 1 July 2001. The Bill, as presented to the House of Representatives, proposed that the rules would also apply to transactions after 1 July 2001 on interests issued before 1 July 2001, unless the issuer elected that the new rules were not to apply until 1 July 2004. However, Senate amendments resulted in the application of the pre-Division 974 law until 2004 unless the issuer elected that the new rules would apply.<sup>430</sup>

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429 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraphs 5.1 to 5.5.

430 Ibid., paragraphs 5.30 to 5.32; note also that there were separate application provisions for consequential amendments to the CGT rules. The elective application of the new laws that is discussed above did not apply to those amendments.

9.5 The Supplementary Explanatory Memorandum in relation to the Senate amendments noted that the change to the election process from an 'elect out' to an 'elect in' model, for interests issued before July 2001, would reduce taxpayers' compliance costs and the administrative burden. However, in order to make an election an issuer was required to 'physically' lodge it with the ATO. Usually, any requirement to physically lodge elections with the ATO is an inconvenient approach for both taxpayers and the ATO. In this instance, as anticipated, very few elections into the measures were lodged so any compliance and administrative costs arising from this requirement were negligible.

9.6 During the transitional period issuers had to consider their pre-1 July 2001 arrangements that would continue beyond 30 June 2004. If necessary, they would have to take appropriate action to ensure that interests received their preferred treatment from 1 July 2004. It was expected that taxpayers would incur costs in conducting these reviews and implementing any changes.

9.7 It is also noted that the new provisions had a small period of retrospective operation. While the measures applied from 1 July 2001, the ATO could not give taxpayers formal advice on the operation of the measures before 1 October 2001, when Royal Assent was granted.

#### Related party at call loans — transitional arrangements

9.8 The debt/equity rules also contained special transitional rules that were originally intended to ensure that certain at call loans entered into after 20 February 2001 between related parties were treated as debt interests until 31 December 2002.<sup>431</sup> These transitional provisions were subsequently extended to 30 June 2005. *Tax Laws Amendment (2005 Measures No. 5) Act 2005* (TLAB 5) ultimately introduced amendments to ensure that related party at call loans of small companies with an annual turnover of less than \$20 million would continue to be treated as debt interests for the purposes of Division 974.<sup>432</sup> Shortly after these amendments received Royal Assent, the ATO published a comprehensive guide to the at call loans measures on its website.<sup>433</sup>

9.9 The Explanatory Memorandum that accompanied TLAB 5 noted that the deemed debt treatment of related party at call loans was expected to reduce compliance costs for small business because those loans would not be equity interests. Therefore, small business would not incur the costs of maintaining the records that are prescribed for

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431 Subsection 974-75(4), ITAA 1997 as originally enacted contained this transitional measure.

432 Subsection 974-75(6), ITAA 1997.

433 Debt and equity tests: guide to at-call loans, ATO, retrieved from: [http://www.ato.gov.au/Business/Debt-and-equity-tests/In-detail/Guides/Debt-and-equity-tests-guide-to-at-call-loans/?page=1#About\\_this\\_guide](http://www.ato.gov.au/Business/Debt-and-equity-tests/In-detail/Guides/Debt-and-equity-tests-guide-to-at-call-loans/?page=1#About_this_guide). Last accessed 24 March 2014.

non-share equity interests, or of formalising those loans in a way that would otherwise ensure debt treatment.

## STRUCTURE AND DRAFTING STYLE

9.10 It was intended that Division 974 would be drafted using clearly articulated principles which, among other things, would reduce the cost of compliance.<sup>434</sup> A central feature of the Division is a single organising principle to distinguish debt from equity interests, that is, whether there is an ENCO for an issuer to return to an investor an amount at least equal to the amount invested. However, there are significant amounts of prescriptive 'black letter' provisions in the Division, for example, the rules on valuation of financial benefits.<sup>435</sup>

9.11 Other features of the Division include that its objects are set out in the operative provisions of the law and require that the debt and equity tests are to operate on the basis of the economic substance of rights and obligations rather than mere legal form.<sup>436</sup> The Division also gives the Commissioner the ability to make determinations in a number of areas, and permits regulations to be made to meet changing commercial practices, conditions and products and to give more detailed guidance if necessary on the operation of specific provisions.<sup>437</sup>

9.12 The new law was expected to reduce compliance and administration costs for a number of reasons. In particular, it was considered that the test for distinguishing debt interests from equity interests, with the focus on the existence of an ENCO, would provide greater certainty, coherence and simplicity than could be achieved under the pre-Division 974 law.<sup>438</sup> Following on from this there was an expectation that the new provisions would result in less reliance on specific anti-avoidance rules, with consequent compliance and administrative savings for both taxpayers and the ATO.<sup>439</sup>

9.13 It was also expected that the extensive consultation undertaken during the development of the measures<sup>440</sup> would facilitate the introduction, and interpretation, of the new provisions. One of the consequences of this consultation was expected to be that the parties most likely to be affected would have a reasonable degree of familiarity with the new law, and that would in turn reduce initial compliance costs. There was also a large amount of explanatory material that accompanied the Bill.

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434 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 5.4.

435 Sections 974-35 to 974-50, ITAA 1997.

436 Subsections 974-10(1) and (2), ITAA 1997.

437 See also subsections 974-10(6) and (7), ITAA 1997.

438 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 1.9.

439 Ibid, paragraph 5.30.

440 Ibid, paragraph 5.37 to 5.40.



9.14 Following Royal Assent, the ATO published a substantial *Guide to the Debt and Equity Tests* to explain the operation of the new measures and to provide specific examples of their application. After Royal Assent, the ATO was also able to provide taxpayers with formal binding advice about the application of the law to particular arrangements.

## POST-ENACTMENT DEVELOPMENTS IN THE LAW

### Amendments to the law

9.15 A number of technical and more substantive issues were identified following the commencement of the new provisions. A number of issues were addressed by amendments to the law and others by regulations.

9.16 The most substantial amendments to Division 974 were included in TLAB 5. This Act introduced the carve-out for certain related party at call loans discussed earlier at paragraphs 9.8. The Explanatory Memorandum noted that the Act also made 'a number of minor technical amendments to ensure that the debt/equity rules work as intended'. These amendments were to have effect from 1 July 2001 and were expected to have a negligible compliance cost.<sup>441</sup>

### Regulations

9.17 Regulations made under Division 974 have been used to clarify intended outcomes in the operation of section 974-135 (the ENCO provision). These regulations affected the classification of certain Upper Tier 2 instruments issued by ADIs that were banks (discussed below),<sup>442</sup> Lower Tier 2 instruments issued by credit unions and building societies,<sup>443</sup> RPS,<sup>444</sup> term subordinated debt instruments containing 'solvency clauses'<sup>445</sup> and term subordinated notes issued by APRA-regulated entities.<sup>446</sup>

9.18 The development of the Upper Tier 2 regulation<sup>447</sup> referred to above was particularly problematic. The Government announced in 2003 that this regulation would be developed, and the regulation as originally proposed seemed relatively straightforward. In general terms, the regulation was intended to provide that certain Upper Tier 2 interests issued by APRA-regulated entities would not be denied debt treatment under Division 974 merely because the APRA provisions required that the issuer could not pay compound interest on deferred payments to holders. However,

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441 Explanatory Memorandum to Tax Laws Amendment (2005 Measures No. 5) Bill 2005, Chapter 6.

442 Regulation 974-135E, ITAR 1997.

443 Regulations 974-135A and 974-135B, ITAR 1997.

444 Regulation 974-135C, ITAR 1997.

445 Regulation 974-135D, ITAR 1997.

446 Regulation 974-135F, ITAR 1997.

447 This regulation is made under section 974-135 which prescribes conditions relevant for an ENCO to exist.



subsequent examination of the specific terms of issue of the relevant interests revealed that significant additional matters of broader application were involved which had to be appropriately addressed.

9.19 Some complicating factors were considering any consequences of solvency clauses and the effect of an issuer's option to convert interests into equity interests. Another complication was in ensuring that the material change provisions<sup>448</sup> did not operate adversely after it was realised that some interests had to be amended to be brought within the scope of the proposed regulation. The review of regulatory capital standards as a result of the GFC may also have contributed to the difficulty in developing a robust and enduring regulation. Because of these matters, the development of the regulation was protracted and complex, and the final regulation was not in place until 2011.

9.20 The Upper Tier 2 regulation was relevant to banks. The experience in developing this regulation has prompted a number of stakeholders to suggest that it would be more efficient to make a broad regulation to ensure that the tax debt treatment of APRA-regulated banks is aligned with the APRA features for Tier 2 instruments. Thus banks would be assured that Tier 2 instruments would always receive debt treatment for tax purposes.

9.21 Some stakeholders have suggested that this approach would provide certainty to banks in structuring capital raisings and result in more timely capital raisings because interests could be based on APRA guidance. They have also suggested that if there were any subsequent changes to APRA's Tier 2 requirements which led to any inappropriate tax results, further regulations could then be introduced to deliver the required outcomes.

9.22 It should also be noted that this proposal could to provide banks with tax debt treatment for some instruments that would not be debt interests if they were issued with the same terms and conditions by other taxpayers that are not subject to APRA's regulations. Division 974 would apply to classify these other taxpayers' interests without the benefit of the suggested regulation.

## APPLYING THE LAW

### ATO interpretative material

9.23 The ATO's website lists 52 current ATO Interpretative Decisions (ATOIDs) published between 2002 and 2012 that relate in some way to Division 974. Of these, 25 were published in 2002 and 2003, and none were published in 2013.

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448 Section 974-110, ITAA 1997.

9.24 The chart at paragraph 3.10 gives an indication of the extent to which taxpayers and product issuers sought binding assurance from the Commissioner on the operation of Division 974. When one considers the level of certainty that large issuers and the market for debt/equity products usually demand, the published ATOIDs, the number of PBRs sought and the issues on which those rulings were sought do not suggest that there have been overwhelming uncertainties or difficulties for most taxpayers in adapting to Division 974. That being said, despite the ATO guidance material, stakeholders have raised a number of areas of concern.

### The NTLG Finance and Investment Subcommittee

9.25 In September 2003, the ATO convened a Finance and Investment Subcommittee (FIS) which operated until February 2013 and reported to the NTLG. The FIS was a forum for the identification, prioritisation and discussion of technical and administrative issues in relation to debt and equity and other finance and investment matters. It was chaired by an Assistant Commissioner of the ATO, and met 20 times. Membership was drawn from major industry bodies, tax professional organisations, ATO and the Department of the Treasury.<sup>449</sup>

9.26 A FIS meeting on 9 November 2005 was dedicated to discussing debt and equity issues, and the participants agreed that the four items of greatest concern to them were the:

- meaning of an ENCO;
- related scheme provisions;
- application of section 974-80; and
- application of Division 974 to certain related party 'at call' loans.<sup>450</sup>

9.27 The concern about at call loans was effectively addressed by legislative amendment and in the guide material that was subsequently published by the ATO, (see the discussion at paragraphs 9.9 above). The other three issues were more complex and are discussed in detail in chapters 4 and 5. The consideration of these issues by the FIS is briefly outlined.

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449 Minutes of meetings have been published on the ATO website: <http://www.ato.gov.au/Tax-professionals/Tax-practitioner-consultation/In-detail/Other-forums/Finance-and-Investment/F-I-minutes,-2003-to-2010/>; <http://www.ato.gov.au/Tax-professionals/Tax-practitioner-consultation/In-detail/Other-forums/Finance-and-Investment/F-I-minutes,-February-2013/>. Last accessed in February 2014.

450 For the minutes of the meeting, please see: <http://www.ato.gov.au/Tax-professionals/TP/Finance-and-Investment-Sub-committee---Debt-Equity-Discussion-Day---9-November-2005/>. Last accessed in February 2014.

9.28 In the case of the three remaining FIS issues, ENCO, related schemes and section 974-80 concerns, the ATO initially considered that the review of the issues was somewhat hampered by a lack of 'real life' examples that sufficiently illustrated practical concerns. In order to progress matters, the ATO issued two comprehensive discussion papers in 2007 for consideration by the FIS: one considered the operation of section 974-80, and the other considered ENCO issues. Each paper proposed views on the operation of the relevant legislative provisions.

9.29 In response to the ENCO discussion paper and subsequent review of the issues by the FIS, the ATO issued two public rulings. One stated that an 'obligation' for the purposes of an ENCO does not have to be a legally enforceable obligation.<sup>451</sup> The other addressed the relevance of 'economic compulsion' in finding an ENCO.<sup>452</sup>

9.30 ENCO and associated valuation issues that seem particularly relevant to limited recourse arrangements have not yet been formally addressed by the ATO. While there are potential issues here, the ATO has advised that it has not encountered them to any significant extent outside the FIS for example, in providing PBRs.

9.31 A comprehensive discussion of the operation of section 974-80 and proposals for amending the provision are set out in chapter 5. The ATO's discussion paper on section 974-80 was to a large extent the catalyst for the Board's detailed review of the measures.

9.32 In relation to the concern about the related scheme provisions raised in the FIS, it was agreed that the ATO would circulate a list of identified related scheme issues to the FIS for consideration. However, after discussing these issues and the ATO's general views, the FIS agreed that the related schemes issue should no longer be seen as a high priority. The FIS was to maintain a watching brief on the issue, and members were to raise any relevant concerns as they arose.

9.33 Despite the apparent breadth of operation of the related schemes measures, the ATO advised that its general experience outside the FIS has been that very few interests have been denied the taxpayer's expected debt or equity classification because of an application of these provisions.

### Other ATO guidance material

9.34 The following TDs and TRs issued by the ATO are in addition to those noted earlier, and also relate directly or incidentally to Division 974:

- **TD 2004/83** discussed the meaning of a financing arrangement, to determine whether the assignment of intra-consolidated group debt to an entity outside of

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451 TD 2009/1, paragraph 1.

452 TR 2010/5, paragraph 4.

the consolidated group will generally satisfy the definition of a financing arrangement.

- **TD 2006/1** ruled that an issuer's unfettered discretion to reset interest rates payable to the holder means the issuer has no ENCO after any interest rate change might occur, unless that discretion should be disregarded in the light of the full consideration of the pricing, terms and conditions of the scheme under which the instrument was issued.
- **TD 2007/26** ruled that a share that falls within item 1 of the table in subsection 974-75(1) will also be a convertible interest if it satisfies item 4 of that table.
- **TD 2008/20** ruled on an aspect of the interaction between the Division 974 and Division 13 of Part III.
- **TD 2012/19** ruled on when a non-share equity interest will be taken to have been 'issued at or through a permanent establishment' for the purposes of paragraph 215-10(1)(c).
- **TR 2005/5** adopted elements of the approach in Division 974 to distinguish between debt and equity in deciding the appropriate meaning to be given to 'debt finance' for certain purposes of the Australia/United States DTA or the Australia/United Kingdom DTA.
- **TR 2008/3** considered whether there is an ENCO to provide a financial benefit if the issuer can convert the note into an equity interest in the issuer.
- **TR 2009/3**: addressed the application of section 177EA to deny franking benefits to particular arrangements involving interests that were classified as equity interests under Division 974, and therefore frankable.

## ATO compliance

9.35 The ATO has advised that it has conducted broad reviews of large corporate taxpayers' treatment of hybrid instruments and has not observed many instances where it considered that taxpayers' treatment was of concern. However, in the course of these reviews some cases have been identified where the application of section 974-80 is in dispute.

9.36 The ATO has received requests for PBRs on the application of section 974-80. In 2012, the ATO released a draft TR titled 'Income tax: debt and equity interests: when is a public unit trust in a stapled group a connected entity of a company for the purposes of paragraph 974-80(1)(b)'. The draft TR was subsequently withdrawn and the ATO advised in February 2013 that it would instead consider issuing a practice statement as guidance for ATO staff which incorporated the substantive views in the withdrawn draft Ruling.

9.37 The ATO has advised the Board of another area of the law that has presented some difficulties for its administration of Division 974. That is, transactions between related parties, particularly where the pricing, terms and conditions contain clauses which would not be found in a scheme between non-related parties, and are not the product of a commercial bargaining process.

9.38 In addition, the ATO advised that in its view the rules can create opportunities for parties to develop unusual forms of financing arrangements to achieve particular outcomes that may be contrary to outcomes intended under the rules.

9.39 For example, the 'dollar value convertible' instruments that were the subject of TR 2009/3 were debt for purposes other than Division 974, but by the specific operation of the measures they were classified as equity interests, and therefore frankable. That is, the application of the measures appears to have facilitated the sort of 'frankable debt' that the measures aimed to prevent.<sup>453</sup> TR 2009/3 explains that anti-avoidance rules could apply to these arrangements. It is important to note, however, that the ATO has advised that it has generally not observed that instances of the 'frankable debt' types of arrangements are commonplace.

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<sup>453</sup> See for example Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 5.9.

## Formal challenge to ATO interpretations

9.40 The operation of Division 974 and its interactions with other provisions of the law has largely been unexplored by the Courts or the Administrative Appeals Tribunal. However, in the recent decision in *Blank*, Edmonds J considered (amongst other matters) an application of Division 974 and the definition of ‘financing arrangement’ in section 974-130.<sup>454</sup> While the ATO has had some disputes about classification of certain hybrids, none of these cases have developed into appeals to the Federal Court or the Administrative Appeals Tribunal.

9.41 The ATO advises that its overall experience to date in administering the debt/equity rules suggests that compliance with Division 974 has not been unduly complicated or costly for relatively straightforward instruments, and that these comprise the majority of financing arrangements. However, the ATO also suggests that the consideration and classification of some hybrid instruments has consumed a disproportionate amount of ATO resources.

### Q 9.1 Issues/Questions

The Board seeks stakeholder comment regarding the compliance and administration of Division 974 since its enactment, in particular whether:

- a. the use of the regulation making power has resulted in greater certainty and clarity about the operation of the tax law;
- b. there should be a legislative provision for entities regulated by APRA that aligns tax characterisation with prudential characterisation, with a regulation-making power available to exclude particular items; and
- c. there are any comments on the structure and style of drafting employed in delivering Division 974 and its impact on the compliance and administration of the rules.

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<sup>454</sup> *Blank v Commissioner of Taxation* [2014] FCA 87 per Edmonds J.

## CHAPTER 10: — INTERNATIONAL TAXATION

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10.1 The terms of reference for the review ask the Board to consider whether there can be improved arrangements within the Australian tax system to address any inconsistencies between Australia's and other jurisdiction's debt and equity rules that could give rise to tax arbitrage opportunities.

10.2 The Board recognises the correlation between its review of the debt and equity rules in this context and the OECD/G20 review of BEPS, including hybrid mismatch arrangements, that is happening at the same time. This paper discusses the details of the OECD BEPS work on hybrid mismatch arrangements. The OECD released two consultation papers on hybrid mismatch arrangements on 19 March 2014, one focused on recommendations for domestic law and the other focused on treaty issues. The Board would welcome submissions on any relevant issues raised by the OECD in its hybrid mismatch arrangements consultation papers insofar as those issues fall within the scope of the Board's post-implementation review of the debt and equity rules in Division 974 and specific questions raised in this discussion paper. The Board intends to follow the progress of the OECD's program of work on BEPS and, where practicable, facilitate business and community input into that program as part of the Board's review.

10.3 Tax arbitrage in an international context refers to tax planning that takes advantage of different tax treatment relating to the same or similar transaction or event, in two or more jurisdictions. Sometimes at least one outcome sought is to reduce the taxpayer's tax liability in more than one jurisdiction, sometimes referred to as *less than single taxation*. The outcome where no tax is payable in either of two relevant jurisdictions is referred to as *double non-taxation*. In addition to this pure form of cross-border arbitrage, there may be instances where legitimate arbitrage opportunities are constructed or created by virtue of Australia's existing tax law, such as the exemption provided in section 23AJ.

10.4 As highlighted in chapter 3, cross-border arrangements using debt/equity hybrid instruments to take advantage of differences in the tax treatment in two or more countries ('hybrid mismatch arrangements') may be used to access differences in countries' tax rules and achieve results such as:

- the deduction of a payment in the payer's resident country without a corresponding inclusion in taxable income in the payee's resident country (deduction/no income);
- multiple tax credits for a single amount of foreign tax paid; and

- multiple deductions of the same expense in different countries using a hybrid entity (a 'double dip').

10.5 Tax outcomes arising because of differences in the treatment of debt and equity could influence capital structures of MNEs, especially given the flexibility that MNEs have in determining where financing can occur and how debt will be allocated within the group. In ensuring appropriate taxation in Australia, the Board recognises that there may be a need to balance a range of considerations. For example, a balance may need to be struck between the desire to provide a predictable and stable taxation environment, the need to minimise compliance costs and complexity for business and ensuring situations where business may be faced with incidences of double or no taxation are avoided.

10.6 While this chapter focuses on concerns raised in connection with the use of hybrid mismatch arrangements in the context of debt and equity rules in both Australia and other jurisdictions, it is also necessary to acknowledge the importance of inbound investment to the Australian economy and the comprehensive and robust domestic tax rules already introduced to address integrity concerns and protect Australia's corporate tax base.

## POLICY ISSUES AND INTERNATIONAL BUSINESS TRANSACTIONS

10.7 As a net capital importer, foreign investment plays an important and beneficial role in the Australian economy. Foreign investment provides additional capital for economic growth, creates new employment opportunities, improves consumer choice and promotes competition. Foreign investment can also improve Australia's competitiveness and productivity by introducing new technology, infrastructure, access to global supply chains and markets while enhancing our skill base.

10.8 The Board recognises that it is important for Australia that the tax system allows businesses to compete on a neutral basis, does not unduly hinder business decisions, and enhances Australia's status as an attractive place for business and investment.

10.9 In considering the benchmark for assessing taxation in Australia, the Ralph Review stated that:

Australia must ensure that its international tax arrangements attract desirable inbound investment, do not detract from the incentives Australian entities have to remain



domiciled here, recover an appropriate return from both inbound and outbound investment, and further the competitiveness of the economy generally.<sup>455</sup>

10.10 The general approach in Australia is to tax individuals and ‘passive’ business income on a worldwide basis and ‘active’ business income earned overseas by Australian companies on a territorial basis.<sup>456</sup> The effect of this is that active business income earned overseas is generally not taxed in Australia, irrespective of whether the income is subject to tax in the foreign country.<sup>457</sup> Australia’s move to a more territorial style tax system is consistent with the general trend away from a worldwide tax model by OECD member countries such as the United Kingdom.<sup>458</sup>

10.11 International tax arbitrage, including hybrid mismatch arrangements, can arise where neither jurisdiction intends that outcome, but where the arrangement is consistent with the domestic tax policy of each jurisdiction. Hybrid mismatch arrangements can also arise where the domestic tax policies of the jurisdictions are inconsistent with each other.

10.12 The inconsistencies that give rise to hybrid mismatch arrangements can arise from one jurisdiction taking a substance-over-form approach and the other taking a form-over-substance approach. By way of example, the Australian treatment of MRPS as debt interests would typically be consistent with its treatment as a liability for financial accounting and commercial purposes, while treatment as equity in a foreign jurisdiction would be consistent with the form of the instrument as a ‘share’.

10.13 It may be noted that double non-taxation may also arise from jurisdictional differences at a more technical level, such as differences in, or interpretation of, definitions.

10.14 Where tax treatment of an instrument accords with the policy intention of the relevant jurisdiction, the question of why the arbitrage outcome should be of a policy concern arises. Recent OECD papers on hybrid mismatch arrangements<sup>459</sup> explain that hybrid mismatch arrangements raise a number of tax policy issues for national governments, affecting, for example:

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455 Review of Business Taxation, Discussion Paper, Chapter 6: Establishing framework objectives and principles, November 1998, p.77, retrieved from <http://www.rbt.treasury.gov.au/publications/paper1/html/Ch6.htm>. Last accessed 25 March 2014.

456 Australian Government, ‘Risks to the Sustainability of Australia’s Corporate Tax Base’, July 2013, p. 12.

457 Ibid.

458 The United States is one of the few countries that operate a worldwide tax model.

459 OECD (2012), Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, p. 11-12.

- **Economic efficiency.** Where a hybrid mismatch is available, investment patterns can be distorted, giving rise to non-neutral economic outcomes. This has two dimensions:
  - A cross-border investment may be made more attractive by the mismatch, than an otherwise equivalent domestic investment in the investor's jurisdiction. This would be contrary to the principle of *capital export neutrality*, which is achieved when an investor faces the same effective tax rate irrespective of the country it invests in.
  - The availability of the international tax arbitrage may also make the cross-border investment more attractive than an otherwise equivalent domestic investment by a resident of the jurisdiction in which the investment is made. This would be contrary to the principle of *capital import neutrality*, which is achieved when both domestic and foreign investors face the same effective tax rate.
- Unilateral action by a target country to correct mismatches can raise the cost of investment in that country compared to other target countries that do not take such action. There is also a risk that such unilateral approach could result in double taxation if trading partners seek to expand their trading rights and foreign revenue authorities become more active. This is a particularly important consideration for Australia as a small, net capital importing country.
- **Competition.** Some businesses, such as those which operate cross-border and have access to sophisticated tax expertise, may benefit disproportionately from hybrid mismatch opportunities. This can give those businesses a competitive advantage compared with other businesses, such as small and medium-sized and domestically focused enterprises that cannot easily exploit mismatch opportunities.
- **Tax revenue.** International hybrid mismatch arrangements typically lead to a reduction of the overall tax paid by all parties involved as a whole in a hybrid mismatch arrangement, but it is difficult to estimate the magnitude of these losses.

10.15 Arguably, Australia has one of the most robust tax regimes amongst the OECD member countries. Specific rules have been introduced to protect Australia's ability to exercise its jurisdiction to tax, with these rules being enforced vigorously and consistently by the ATO. This has been widely recognised, with the American Chamber of Commerce in Australia noting in a submission to the Australian Government that:

Australia is very well known internationally as having a highly effective set of tax laws to protect Australian revenue. The ATO is widely known as being one of the more effective and skilful tax administrations within the members of the OECD.<sup>460</sup>

10.16 Moreover, Australia has a long history of actively enforcing transfer pricing provisions to address the challenge of how to ensure that appropriate valuations apply to cross-border transactions and thin capitalisation rules to address profit shifting through the excessive allocation of debt to Australia.<sup>461</sup> The rules have been further strengthened by recent reforms to transfer pricing and the general anti-avoidance rule in Part IVA.

10.17 The Department of the Treasury suggested in their 2013 scoping paper entitled '*Risks to the sustainability of Australia's corporate tax base*'<sup>462</sup> that there is unlikely to be substantial additional policy reforms that could be enacted unilaterally in the short term to address BEPS, however, it acknowledged the need for governments to be able to respond to emerging risks. In light of the concerns raised, and somewhat consistent with the Department of the Treasury's comments in the scoping paper, the OECD Action Plan on BEPS and the consultation paper, aims to address hybrid mismatches through multilateral development of coherent anti-hybrid rules.<sup>463</sup>

10.18 Finally, it is worth noting that there is a growing concern in many countries that the current consensus on international tax rules, usually implemented through a network of bilateral treaties, is not resulting in appropriate tax outcomes for national governments, in particular due to profit shifting practices of MNEs.<sup>464</sup> While ideally these concerns would be addressed through multilateral efforts, there is a risk that countries may instead act unilaterally. From an Australian perspective, the implementation of such measures by other jurisdictions may either increase the risk of double taxation or result in a reduction of Australia's corporate tax base.<sup>465</sup>

## USE OF HYBRID INSTRUMENTS BY AUSTRALIAN MNE

10.19 The Board understands that many Australian MNEs use a variety of funding sources including equity, long-term debt and short-term debt which, used in combination, enable these groups to match their operational funding requirements. These typically fall into working capital, medium-term investment strategies and

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460 American Chamber of Commerce in Australia, 2013, *Response to the Treasury Issues Paper: Implications of the Modern Global Economy for Taxation of Multinational Enterprises*, 6 June 2013, p.2

461 OECD (2012), *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, p. 11-12.

462 Australian Government, '*Risks to the Sustainability of Australia's Corporate Tax Base*', July 2013.

463 OECD (2012), *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, p. 11-12.

464 Ibid.

465 Ibid.

long-term investment that enables Australian MNEs to expand their operations worldwide and compete on a global platform.

10.20 Some stakeholders have suggested that the use of hybrid instruments is generally not the norm for Australian MNEs with good credit ratings though can be attractive for those that have a borderline credit standing and need to manage this in order to continue to access debt.

10.21 Some MNEs choose to raise external debt (and equity) centrally. Debt raised centrally can be cheaper as it takes advantage of the multinational group's credit rating which is generated from the entire portfolio of assets over which it exercises control. External debt is raised in the world's major debt capital markets where the availability of lenders is strong and pricing is competitive.

10.22 It is also worth noting that the OECD action item<sup>2</sup> is developing model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (for example, double non-taxation, double deduction, long term deferral) of hybrid instruments and entities. Lessons from Australia's experience with Division 974, in particular, could help inform the OECD's recommendations. Equally, the OECD's work could inform Australia's domestic legislation in the future.

## INTERNATIONAL EXPERIENCES WITH DEBT AND EQUITY DISTINCTION

10.23 As different countries enforce their own rules for characterising and taxing debt and equity, it is useful to understand, at least at a high level, the characterisation of debt and equity in other jurisdictions. The following seeks to summarise the domestic tax rules relating to the characterisation of instruments as either debt or equity in a sample of comparative OECD jurisdictions, as the Board understands them. This is not intended to be a comprehensive analysis of the tax law in these jurisdictions.

### United States

10.24 There are no prescriptive rules in the United States Code or Treasury Regulations to distinguish between debt and equity.<sup>466</sup> Accordingly, the distinction between debt and equity in the United States is determined by a 'facts and circumstances' analysis that was primarily developed by case law. Under this approach, the United States Courts extract and compare the equity-like characteristics and the debt-like characteristics of an arrangement and then determine whether it is 'debt' or 'equity'.

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466 Dalton, J, 2013, 'How to deal with debt-equity in the US', International Tax Review last accessed on 18 March 2014 at <http://www.internationaltaxreview.com/Article/3146496/How-to-deal-with-debt-equity-in-the-US.html>. Last accessed 25 March 2014. The IRS will ordinarily not provide individual taxpayers guidance on whether an arrangement is debt or equity for taxpayers because it views this distinction as being one of fact. Therefore, Federal common law is the principal source of guidance for distinguishing debt and equity.

10.25 In their effort to distinguish between debt and equity, the United States courts have cited a number of factors that require consideration. Such factors have included, but are not limited to, whether there is a reasonable expectation of payment, the intent of the parties (that is the form of the transaction including label characterisation for non-tax purposes such as accounting, regulatory reporting and rating agency reports; what the papers look like and actions of the parties both before and after the instrument is put in place), debt-to-equity ratio, existence of an unconditional promise to pay a sum on demand/or at a fixed maturity date, whether the holder has a right to enforce payments, existence of subordination or preference with respect to other creditors, holder's potential risk of loss or opportunity to share in profits, holder's right to participate in management, availability of other sources of credit, degree of independence between equity holders and the holders of the instruments in question and collateral.<sup>467</sup>

10.26 While both Australia and the United States essentially adopt a 'substance-over-form approach', the United States approach is different to the 'sharp line' approach to the debt and equity distinction adopted in Division 974. There has been some criticism that the facts and circumstances approach often produces an undesirable level of uncertainty and associated compliance costs. However, others have suggested that one of the key benefits of this approach is that it avoids the financial engineering that naturally follows from having a 'sharp' dividing line between debt and equity.<sup>468</sup>

## New Zealand

10.27 Unlike Australia, New Zealand does not have specific 'debt/equity' tax rules. Rather, the New Zealand approach to the debt and equity distinction is captured in the 'equity carve out' from accruals taxation that is provided for shares and certain interests in shares.<sup>469</sup> Under this approach, arrangements are analysed by reference to the legal rights and obligations that they create ('legal form') rather than by reference to their economic substance. The legal form is not determined solely by the labels given

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467 International Fiscal Association, 2012, United States Submission; Dalton, J, 2013, 'How to deal with debt-equity in the US', International Tax Review, retrieved from <http://www.internationaltaxreview.com/Article/3146496/How-to-deal-with-debt-equity-in-the-US.html>. Last accessed 18 March 2014; A total of 13 factors were identified by the United States Tax Court in *PepsiCo Puerto Rico Inc., et al. v. Commissioner*, T.C. Memo. 2012-269.

468 Longhouse, *supra* at note 39; Fry and Schwartz, *supra* at note 39.

469 It is understood that the New Zealand accruals regime applies to 'financial arrangements' which is broadly defined in EW 4(1) and (2) of the Income Tax Act 2004 to include any arrangements whereby a person obtains money or money's worth in consideration for a promise to provide money or money's worth at some future time. Common examples of financial arrangements are loans, bonds, government stock, mortgages, bank accounts, swaps and options. However, an arrangement is then carved out of the accruals regime if it is covered by one of the excepted financial arrangements. Shares, which are defined to include any interest in the capital of a company and certain debentures, and certain options to buy and sell shares are generally carved-out from accruals taxation. See EW4 and EW5, Income Tax Act 2004.

to a transaction by the parties, but by the actual rights and obligations they have created.

10.28 The form-based approach adopted by New Zealand contrasts with the Australian substance-based approach. For example, in Australia, an arrangement that satisfies both the debt and equity test will be characterised as a debt interest in accordance with the tiebreaker rule, however, in New Zealand, 'equity' arrangements are carved out of the accruals regime for financial arrangements. As stated in chapter 3, while this gives the legislature some flexibility to respond to the development of new forms of financial instruments in the market, it suffers from the flaws of other form-based approaches.

## Canada

10.29 The distinction between debt and equity in Canada generally follows form, and is based upon, the applicable non-tax (generally commercial) law characterisation of the instrument which is determined by reference to the 'substantive legal relationship' created by the arrangement (that is, the legal substance of the arrangement).<sup>470</sup> In determining the legal relationships created by an arrangement, Canadian Courts will generally examine the intention of the parties as reflected in the contractual arrangements, the terms and conditions of the arrangement, the overall course of conduct of parties and all of the surrounding circumstances with the overarching objective of ascertaining the dominant character of the arrangement in question.<sup>471</sup>

10.30 One of the key differences between the Australian and Canadian approaches is illustrated by looking at the treatment of certain preference shares. While both countries will essentially deem RPS to be 'debt' for tax purposes, it is the specific elements of the tests that draw the biggest distinction. Under Canadian rules, a RPS will be deemed debt where, amongst other things,<sup>472</sup> the terms and conditions of the share issue make it 'reasonable to expect' that the issuer or a related person will redeem, acquire or cancel the shares. However, in contrast, the Australian rules adopt the ENCO test to determine the substance of the arrangement. While the Canadian test focusses on the 'likelihood of redemption', the Australian test turns on whether there is an effective obligation for the issuer to return the investor's investment by way of redemption (or coupons).

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470 International Fiscal Association, *The Debt-Equity Conundrum*, Cahiers de droit fiscal international, 2012, vol. 97b, Canada Submission.

471 Ibid.

472 Ibid. Similar to the United States, to classify hybrid instruments, their debt-like and equity-like features are evaluated and weighed to ascertain which are more dominant and determine the legal substance of the instrument. The features are considered in light of the intention of the parties and surrounding circumstances to determine the dominant character of the instrument.



## United Kingdom

10.31 The characterisation of an arrangement in the United Kingdom as either debt or equity is determined by reference to the legal form of an arrangement, except where the arrangement's form is inconsistent with its economic substance and accounting treatment (which, per IAS 32, seeks to classify an instrument according to its economic substance).

10.32 Debt and equity features are broadly classified according to the instrument's risk profile and nature of the return it generates. A legal obligation to pay interest and repay debt generally characterises an arrangement as debt. On the other hand, equity is characterised by reference to profit participation without fixed entitlements, or a fixed return at a rate making the instrument speculative.<sup>473</sup> Although the United Kingdom currently adopts a less formalistic approach, the system still pays considerable respect to the legal form of a transaction.<sup>474</sup>

10.33 Unlike the Australian system, the United Kingdom has introduced a comprehensive set of rules to deal with characterisation problems and to counter tax avoidance, particularly in connection with cross-border transactions. For example, as discussed later in this chapter, the United Kingdom has introduced targeted legislation that applies in the following circumstances where:

- there are two deductions for tax purposes in relation to the same expense;<sup>475</sup>
- in respect of a payment, there is a deduction for tax purposes in the United Kingdom but no corresponding taxable receipt in relation to that payment; and
- foreign tax credit generators are used resulting in a credit from a scheme or arrangement which has the obtaining of credit relief as one of its main purposes and the scheme falls within one of five specified circumstances.<sup>476</sup>

10.34 In addition, a general measure to tackle tax avoidance and evasion was announced in the United Kingdom Budget for 2014 which is targeted at avoidance schemes involving the transfer of corporate profits between companies within a group in order to gain a corporate tax advantage. The legislation has immediate effect.

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473 International Fiscal Association, *The Debt-Equity Conundrum*, Cahiers de droit fiscal international, 2012, vol. 97b, United Kingdom Submission.

474 Rafael Minervino Bispo, *Cross-Border Intra-Group Hybrid Finance: A Comparative Analysis of the Legal Approach Adopted by Brazil, the United Kingdom and the United States*, Bulletin for International Taxation, 2013, IBFD, p.369.

475 Section 244 of the *Taxation (International and Other Provisions) Act 2010*.

476 OECD (2012), *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, pp. 15-21.

## POTENTIAL TAX ARBITRAGE OUTCOMES

10.35 The following section illustrates some examples of transactions in respect of which the differences in countries' tax rules (including Australia's) results in mismatched outcomes. It is important to emphasise that these particular examples have been used to illustrate areas in which international arbitrage opportunities may arise and are not intended to provide a rationale for tax reform in and of themselves.

10.36 This section discusses only the tax implications of the arrangements described. These arrangements do occur in a vacuum; commercial, governance, legal and structural considerations are all relevant and important and should not be underestimated or ignored.

### Domestic mismatches with debt/equity characterisation

10.37 Double non-taxation arises due to another jurisdiction failing to fully exercise their right to tax an amount of income. This situation arises where, for example, a deduction is claimed in one jurisdiction while an income exemption is applied in another. It is arguable that Australia itself has introduced certain tax concessions, not necessarily replicated in other jurisdictions, that provide opportunities for taxpayers to structure their investments free from Australian tax.

10.38 As identified in chapter 8, one example is the operation of the section 23AJ exemption which applies to dividends received by an Australian company that are sourced from a non-portfolio investment in a foreign company. Under the current law, dividends paid by a foreign company on legal form shares will be NANE income where the Australian company shareholder holds at least a 10 per cent voting interest in the foreign company.

10.39 The then Government announced in the 2009-10 Budget that it would amend section 23AJ to limit the application of the exemption to returns on interests that are 'equity' interests under Division 974. This means that the exemption will no longer be available for dividends received on interests that are legal form shares but qualify as 'debt' interests under Division 974 (that is, many RPS or MRPS).

10.40 While the proposed amendment is designed to address an arbitrage opportunity created by the mis-alignment of the provision with the debt and equity concepts in Division 974, it could make the section 23AJ exemption available for distributions paid on legal form debt that are characterised as equity interests under Division 974. Should this be the case, the exemption from Australian tax could be available where a foreign company that has issued legal form debt is also claiming a deduction for the distribution paid on the loan in the foreign company's country of residence. The Board understands that the Government is in the process of enacting these amendments but draft legislation has not yet been released.



10.41 Similarly, as stated in chapter 8, in response to the policy objective to enhance Australia's status as an attractive place for business and investment, a non-resident CGT exemption is available to non-residents which limit the circumstances in which they are subject to Australian tax on capital gains derived. As CGT is only applicable to membership interests (the definition of which does not include debt interests), the provision confers an opportunity for non-residents to structure their Australian investments through, for example, a RPS that is characterised as a debt interest. Upon disposal, any gain derived would be disregarded which suggests that this exemption acts against the Australian tax base.

### Deduction/no income arbitrage

10.42 The Board understands that the interaction between Division 974 and section 25-85 can give rise to the tax outcome of enabling a deduction with no income pick up ('deduction/no income'). This outcome generally arises when certain hybrid instruments such as MRPS<sup>477</sup> have features that satisfy either the debt or equity test in different jurisdictions.

10.43 This is a simple example of a situation where Australia may treat the MRPS as a debt interest for tax purposes and the investors' resident country treats it as an equity interest. In this situation, tax arbitrage involving a deduction/no income relies on the tax deductibility of dividends paid on MRPS issued by an Australian subsidiary (characterised as debt per Division 974) to a foreign investor whereby the returns are either not taxed, or are concessionally taxed, under a so-called participation exemption regime for non-portfolio investment. Examples of jurisdictions that have either not taxed or concessionally taxed dividends on MRPS, despite their deductibility in Australia, include Japan<sup>478</sup> and the Netherlands.<sup>479</sup>

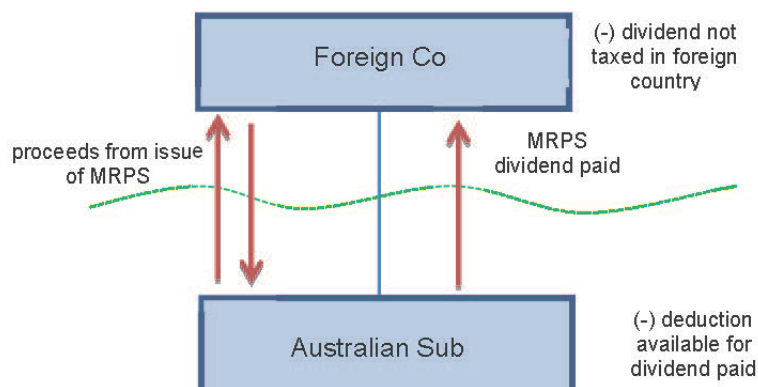
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477 Other hybrid instruments that could be used include profit sharing loans and perpetual loans. A MRPS is a redeemable preference share typically with mandatory redemption within 10 years from the issue date and a non-cumulative semi-annual coupon (calculated as a percentage of the face value of the shares), subject to the availability of profits in the issuing company. The fixed redemption date is considered a debt-like feature while the non-cumulative semi-annual coupon that is subject to profits is considered an equity-like feature.

478 The Japanese National Tax Agency released a public ruling on 30 March 2012 confirming that dividends on Australian MRPS are entitled to a 95 per cent participation exemption under Japanese Corporate Tax Law. This means that only 5 per cent of the dividend received on the MRPS is taxed at the Japanese corporate tax rate of 41 per cent. PricewaterhouseCoopers. Provocative thought: Japan Tax Update. 17 May 2012, retrieved from <http://www.pwc.com/jp/en/taxnews-international-asia-pacific/assets/australia-mrps-e.pdf>. Last accessed 18 January 2014.

479 This is based on a 2012 court case. It appears that the Netherlands tax authorities will not, however, give an advance ruling that the participation exemption will apply where the instrument in question is used to obtain a tax benefit from a mismatch in tax treatment between two jurisdictions. NL: AC Amsterdam (Gerechtshof Amsterdam), 7 June 2012, 11/00174, VN 2012/40.11, ECLI:NL:GHAMS:2012:BW8340, at <http://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:GHAMS:2012:BW8340>. Last accessed 18 January 2014.

10.44 Diagrammatically, this can be illustrated as follows:



10.45 It would appear that some other jurisdictions also allow a deduction for dividends paid on certain MRPS, although this is not as clearly reflected in their tax law as is the case in Australia. For example, the United States tax law requires an examination of a wide range of facts and circumstances to extract the equity-like characteristics and the debt-like characteristics of an instrument. Until recently, the United States tax authorities would not issue advance rulings on the debt/equity classification of an instrument, so the classification of an instrument in the United States is somewhat unclear.

10.46 Nevertheless, as noted above, it appears that the deduction/no income scenario is not limited to the Australian tax treatment of certain MRPS.

### Multiple tax credits for a single amount of foreign tax paid

10.47 The debt/equity arbitrage in the MRPS example above,<sup>480</sup> is also used as a basic building block in multiple tax credit arrangements such as, for example, foreign tax credit generators and tax paid arrangements, where multiple tax credits can arise in relation to a single amount of foreign tax paid.<sup>481</sup> All things being equal, an entity is generally indifferent to the reduction of a tax liability (or obtaining a refund) through the availability of a deduction or a tax credit or rebate.

10.48 The multiple tax credit arrangements are typically observed with an Australian company seeking low cost finance from a foreign company, although the reverse can also occur. A worked example of how the multiple tax credit outcomes could arise is outlined at Appendix B.

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480 Although MRPS are typically used in this structure, other hybrid instruments such as mandatory redeemable limited partnership interests are used.

481 In this instance the foreign tax paid from the perspective of the non-resident, is tax paid in Australia.

## Double deduction using hybrid entities

10.49 This Review focuses on the use of cross-border hybrid instruments to effect a deduction/no income outcome and multiple tax credits for a single amount of foreign tax paid. While outside the scope of this Review, the Board acknowledges that another outcome that may arise in hybrid mismatch arrangements is a multiple deduction of what is economically the same expense in more than one country using hybrid entities.

### Q 10.1 Issues/Questions

The Board seeks stakeholder comment on whether there are any potentially significant tax arbitrage opportunities or outcomes resulting from differences in Australia's and other jurisdictions' tax rules, in particular whether:

- a. structures that use Australia's debt and equity rules to achieve significant cross-border arbitrage are prevalent and problematic in practice;
- b. there are significant non-tax (that is commercial, legal or regulatory) factors that encourage or discourage the use of hybrid instruments by MNEs. If so, what are they; and
- c. the structure of Australia's debt and equity rules itself contribute to, or enhance opportunities for, cross-border tax arbitrage. If so, what changes would address the problem.

## POLICY OPTIONS PROPOSED BY THE OECD

10.50 In its Action Plan on BEPS, and the consultation paper, the OECD promotes the development of new comprehensive international standards to ensure the coherence of business income taxation in a BEPS context, and the implementation of those standards in a streamlined manner, through the development of model treaty provisions and recommendations on the design of domestic rules to neutralise the effect (for example double non-taxation, double deduction, long-term deferral) of hybrid mismatch arrangements.<sup>482</sup>

10.51 So far, the existence of more than 3,000 bilateral treaties has been underpinned by a framework of broad international consensus on taxation norms. Uncoordinated, unilateral or limited responses by governments to BEPS would replace that framework with competing sets of international standards that could result in the risk of double or even multiple taxation for business, with negative global consequences for investment,

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482 OECD (2013) Action Plan, Action 2, p.15.

growth and employment.<sup>483</sup> BEPS issues have, in the main, not yet been dealt with in OECD standards nor in bilateral treaties.<sup>484</sup>

10.52 The OECD previously identified<sup>485</sup> other, in-principle domestic law options to address hybrid mismatch arrangements, such as the use of:

- general anti-avoidance rules to address hybrid mismatch arrangements;<sup>486</sup>
- specific anti-avoidance rules to address hybrid mismatch arrangements; and
- domestic rules which specifically address certain hybrid mismatch arrangements. Under these rules the domestic tax treatment of an instrument would be linked to their tax treatment in the foreign country, aiming to prevent the possibility of mismatches. For this approach to work, agreement would have to be reached on which country's tax treatment would take precedence in the event of a clash requiring tie-breaker rules.

10.53 The OECD has recognised that the design of domestic tax systems is a matter for sovereign governments. However, in a globalised world where economies are increasingly integrated, it is essential to consider how tax systems interact with each other. The challenge is to develop agreed multilateral approaches which command broad support, can be effectively implemented, address the underlying problem and do not impose unwarranted costs on business. The OECD relies on the G20 Leaders' commitment to multilateralism as the 'best asset' to solve global economic problems including BEPS.<sup>487</sup>

10.54 The OECD released its consultation paper on 19 March 2014 on hybrid mismatch arrangements with recommendations for domestic laws. The recommendations in the consultation paper target three broad categories of hybrid mismatch arrangements:

- *Hybrid financial instruments* (including transfers) – where a deductible payment made under a financial instrument is not treated as taxable income under the laws of the payee's jurisdiction;

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483 Ibid, p.10-11; OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing, p.8. <http://dx.doi.org/10.1787/9789264192744-en>.

484 OECD (2013) Action Plan, p.13.

485 OECD (2012), Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, pp 13-14.

486 Although, as highlighted in OECD (2014), BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (recommendations for domestic laws), p.5 – while general anti-avoidance rules can be effective, they do not always provide a comprehensive response to cases of unintended double non-taxation through the use of hybrid mismatch arrangements.

487 OECD (2013) Action Plan, p.11, citing: G20 (2012), Leaders Declaration, Los Cabos, Mexico, paragraph 8, 48.

- *Hybrid entity payments* – where differences in the characterisation of the hybrid payer result in a deductible payment being disregarded or triggering a second deduction in the other jurisdiction; and
- *Reverse hybrid and imported mismatches* – which cover payments made to an intermediary payee that are not taxable on receipt.<sup>488</sup>

10.55 Following an extensive review, the OECD consultation paper recommends changes to domestic law designed to reduce the incidence of hybrid mismatches. It also recommends the use of ‘linking rules’ that specifically target the mismatch in tax outcomes under hybrid mismatch arrangements. It is understood that, in order to mitigate the risk of double taxation, the linking rules would be divided into a primary rule, which would apply whenever a hybrid mismatch arose, and a secondary (or defensive) rule which would only apply in circumstances where the primary rule did not apply in the jurisdiction of the counterparty.<sup>489</sup> The OECD states that this choice has been made to ensure that the hybrid mismatch rules are ‘effective’ and ‘relatively easy to apply’.<sup>490</sup>

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488 OECD (2014), BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (recommendations for domestic laws), p.15. With regard to reverse hybrid and imported mismatches, there are two kinds of arrangements targeted by these rules, (1) arrangements where differences in the characterisation of the intermediary result in the payment being disregarded in both the intermediary jurisdiction and the investor’s jurisdiction (reverse hybrids), and (2) arrangements where the intermediary is party to a separate hybrid mismatch arrangement and the payment is set-off against a deduction arising under that arrangement (imported mismatches).

489 OECD (2014), BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (recommendations for domestic laws), p.16.

490 Ibid.

10.56 A summary of the OECD's recommendations made taken from its consultation paper released on 19 March 2014, is as follows:

Table 1. Summary of Recommendations

Category	Hybrid element	Type of Mismatch	Recommended changes to domestic law	Recommended Linking rule		
				Primary Response	Defensive rule	Scope
<b>Hybrid Financial Instruments &amp; Transfers</b>	Differences in the tax treatment of the instrument mean that payments under the instrument have a different character	D/NI	No dividend exemption for deductible payments  Proportionate limitation of withholding tax credits	Payer jurisdiction denies deduction	Payee jurisdiction includes payment as income	Under consideration
<b>Hybrid entity payments</b>	Differences in the tax treatment of the entity or arrangement mean that payments made by the entity or under the arrangement are characterised differently under the laws of two or more jurisdictions.	D/NI	-	Payer jurisdiction denies deduction	Payee jurisdiction includes payment as income	Related parties (incl. persons acting in concert) & structured arrangements.
		DD	-	Investor jurisdiction denies deduction	Subsidiary jurisdiction denies deduction	Primary rule no limitation. Defensive rule limits to related parties (incl. persons acting in concert) & structured arrangements.
<b>Reverse hybrids</b>	Differences in the tax treatment of the entity mean that payment is not included in income by the payee	D/NI	Intermediate jurisdiction implements tax filing and information requirements	Investor required to include income  Intermediate jurisdiction follows tax treatment of controlling investor if no inclusion by that investor	Payer jurisdiction denies deduction	Members of controlled group (incl. persons acting in concert) and anti-abuse
<b>Imported mismatches</b>	Payment is offset against expenditure incurred under a hybrid mismatch arrangement.			Introduce anti-hybrid rules		

10.57 Relevant to this Review is the OECD's recommendations for hybrid financial instruments and transfers. To align the tax outcomes, the OECD recommends that the primary response be that the payer is denied a deduction for payments made under a hybrid financial instrument with the country of receipt applying a secondary rule that requires a deductible payment to be included in its ordinary income (for example, where the payer was located in a jurisdiction that did not apply the primary rule).<sup>491</sup>

10.58 This means that countries that have a dividend/participation exemption regime to alleviate double taxation would be required to 'switch off' the exemption in situations where the payment is also deductible in the country. The OECD has also stated that the types of financial instruments captured by these rules would ultimately be left to domestic law. However, it recommended that the rules be broad and should include anything that is treated as either debt or equity under the domestic law or other arrangements that are used by MNEs as an alternative to debt and equity.<sup>492</sup> The rules would apply to the hybrid element in the financial instrument only. The OECD outlines two approaches to the scope of the hybrid mismatch rule but does not provide a conclusion.

<sup>491</sup> Ibid.

<sup>492</sup> Ibid, p. 25. Payments caught would include any kind of accrual, credit, debit or distribution of money or money's worth.

10.59 One potential limitation regarding the operation of the proposed rules is that outside of related party transactions, issuers may not always know or be able to ascertain the tax treatment of the foreign holders of their instruments in order to determine whether a deduction should be denied.

10.60 A number of other countries have already independently introduced specific rules to deny benefits from certain hybrid mismatch arrangements.<sup>493</sup> These rules seek to address various types of mismatch in different ways, for example, by:

- denying a deduction where there would otherwise be two or more deductions for the same expense or payment;
- denying a deduction where the payment is not included in the taxable income of the recipient;
- denying the exemption of income where the payment is deductible to the payer; and
- denying claims for foreign tax credits which are seen as inappropriately exploiting differences in tax treatment between jurisdictions.

10.61 With regard to the deduction/no income outcome, countries such as Austria, Denmark, Germany, Italy, New Zealand and the United Kingdom have introduced rules that deny a participation exemption where the payment is also deductible in the jurisdiction of the payer. The rules are clearly directed to situations where dividends are deductible in the payer's jurisdiction.

10.62 Similarly, countries such as the United Kingdom and the United States have introduced rules to address 'abusive' foreign tax credit transactions that inappropriately exploit differences in countries' laws resulting in multiple tax credits for a single amount of foreign tax paid. Of particular note, for example, the United Kingdom's rules target foreign tax credit generators where the credit results from a scheme or arrangement which has the obtaining of credit relief as one of its main purposes and the scheme falls within one of five specified circumstances.

10.63 With regard to the 'double dip' outcome, Germany, New Zealand, the United Kingdom and the United States have rules which, in certain circumstances, deny the deduction of expenses which are also deductible in another country. For example, New Zealand has dual resident company rules that prevent loss offsets from any company that is resident in New Zealand and also resident elsewhere, even if no deduction is taken in another country. Similarly, in Germany, dual resident companies are prevented from deducting the same loss in both Germany and another country.

10.64 The OECD considers that the experience of countries undertaking these types of action has been relatively positive. The rules have generally been found to be effective

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493 OECD, Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, pp 15-21.



in reducing mismatches and increasing certainty about the treatment of the mismatch arrangements.<sup>494</sup>

10.65 At the same time, a view expressed is that the rules require ongoing monitoring and, if necessary, may need to be amended. The implementation of similar rules also requires reference to the tax treatment in the other jurisdiction, which may cause some difficulties. The effect of these kinds of rules would require Australia to determine the outcomes that arise under foreign tax rules, which is not an area of Australian expertise. However, it is anticipated that such difficulties should decrease as exchange of information and tax authorities' communications with each other increase.

10.66 The OECD has observed that the operation of these country-specific rules have not caused serious concerns to date, probably because only sophisticated taxpayers engage in such arrangements and they would be deterred by the risk of double taxation from entering into them.<sup>495</sup>

10.67 It is to be noted that those countries that have introduced anti-hybrid mismatch rules did not change the framework for how hybrid instruments are classified for tax purposes under domestic legislation. Rather, they addressed the arbitrage issue by focusing on what gave rise to the mismatch and then changed the domestic tax outcome.

## OPTIONS TO ADDRESS HYBRID MISMATCH ARRANGEMENTS

10.68 Having regard to the experiences of other countries highlighted above, one option to address inconsistencies between Australia's and other jurisdiction's debt and equity rules that could give rise to tax arbitrage opportunities (at least in terms of the deduction/no income scenario), is to adopt the recommendation in the OECD consultation paper to deny payments made under a hybrid financial instrument as being deductible. This may be contrary to the substance-over-form approach taken in Division 974 as, for example, the deductibility of debt interests in the form of shares (that is, MRPS) would be denied where the payee jurisdiction does not include the payment in its ordinary income. If this approach was adopted, and the payer country does not deny the deduction, an option could be the denial of a dividend/participation exemption by the payee jurisdiction.

10.69 The Board notes that another approach is for a country to take action to remove a potential arbitrage opportunity without reference to the tax treatment in the other jurisdiction. An example is the decision by the Government<sup>496</sup> to proceed with changes to the section 23AJ exemption, as identified above.

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494 OECD, Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, pp. 23-24.

495 Ibid, p. 24.

496 See the Treasurer and Assistant Treasurer's joint press release, 'Restoring Integrity in the Australian Tax System', 6 November 2013, retrieved from <http://jbh.ministers.treasury.gov.au/media-release/017-2013/>. Last accessed 25 March 2014.



**Q 10.2 Issues/Questions**

The Board seeks stakeholder comment on ways to address inconsistencies between Australia's and other jurisdictions' debt and equity rules that give rise to tax arbitrage opportunities, including in relation to the following issues:

- a. whether the Australian domestic tax law constructs or creates significant arbitrage opportunities. If so, what changes would address the problem;
- b. whether any practical significant difficulties would arise if specific domestic rules were introduced to address the mismatch of hybrid arrangements, including identification of prioritisation rules in the event of multi-jurisdictional application of such rules;
- c. if Australia introduced specific domestic rules to address the mismatch of hybrid arrangements and eradicate mismatches in tax outcomes:
  - i. whether the rules should be targeted to hybrid arrangements between related parties, specific types of instruments or limited in some other way. Why or why not;
  - ii. whether there would be a significant commercial impact for MNEs entering into cross-border transactions. If so, whether the investment decisions made by MNEs would be affected;
  - iii. whether the rules should contain any carve-outs;
- d. what role does the existing general anti-avoidance rule in Part IVA play in the context of hybrid mismatch arrangements? Whether the general anti-avoidance rule in Part IVA sufficiently deal with hybrid mismatch arrangements. If not, how significant are the problems in practice and how could these problems be addressed;
- e. whether Australia's international tax laws strike an appropriate balance between competing policy considerations, including efficiency, certainty, compliance costs and tax revenue considerations; and
- f. on the other hand, whether there are any circumstances where the use of hybrid instruments result in significant adverse tax outcomes such as, for example, double taxation in Australia and the other jurisdiction. If so, what changes would address the problem.



## APPENDIX A: QUESTIONS

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### CHAPTER 4:

#### Q 4.1 Issues/Questions

The Board seeks stakeholder comment on the debt-equity border, in particular whether;

- a. there are any major practical difficulties in applying Division 974 to commercially significant arrangements; and
- b. there are any commercially significant arrangements that are neither a debt or equity interest under Division 974; and if so, would a tiebreaker rule that deems an interest to be either debt or equity assist.

#### Q 4.2 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the 'financing arrangement' concept in Division 974, in particular whether:

- a. in light of the decision in *Blank*, whether the distinction between raising finance and raising capital in the context of the 'financing arrangement' concept is problematic. If so, how could this be addressed;
- b. the treatment under Division 974 of non-share equity and shares that are granted to employees is problematic. If not, how could this be addressed;
- c. the application of the 'financing arrangement' concept to personal services contracts is problematic. If so, how could this be addressed;
- d. the existing commercial arrangement carve-outs from Division 974 is problematic and whether there should be any additional carve-outs; and
- e. the application of Division 974 to hedging arrangements is problematic. If so, how could this be addressed.

#### Q 4.3 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the ENCO requirement in the debt test, in particular whether:

- a. the 'pricing, terms and conditions' are the best determinants of the existence of an ENCO? If not, should the determinants be; and

- b. differences between other regulatory regimes and the limited nature of the inquiry as to whether an obligation is an ENCO are problematic or whether this is something that stakeholders seek.

#### Q 4.4 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to contingencies that affect an obligation and the characterisation as either debt or equity, in particular whether:

- a. the phrase 'ability or willingness to meet the obligation' is problematic. If so, whether the removal of that phrase would clarify the operation of the law. Whether the phrase should only apply to consideration of the possibility that an issuer might be unable or unwilling to meet an obligation to provide a financial benefit that is due and payable;
- b. the treatment of the degree of subordination in Division 974 is problematic. If so, how could this be addressed;
- c. the treatment of interests that rank in a winding up with ordinary shares, or with other equity interests, in Division 974 is problematic. If so, how could this be addressed;
- d. the application of Division 974 to limited recourse loan arrangements is problematic. If so, how could this be addressed;
- e. the application of Division 974 to convertible instruments is problematic. If so, how could this be addressed;
- f. the application of Division 974 to solvency clauses is problematic. If so, how could this be addressed;
- g. the application of Division 974 treatment of structural contingencies problematic. If so how could this be addressed;
- h. the distinction between 'contingent on economic performance' and 'ability...to provide financial benefits' is problematic. If so, how should this be addressed;
- i. significant practical difficulties arise in determining, at the time of issue, whether a future step-up in interest is of sufficient magnitude to compel a finding that there is an ENCO to take an action. If so, how could this be addressed; and
- j. the distinction between economic compulsion arising under the pricing, terms and conditions and forms of economic compulsion that arise elsewhere sufficiently clear. Whether that distinction is appropriate and if not, how could it be made clearer?

#### Q 4.5 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the aggregation and disaggregation of schemes, in particular whether:

- a. the interaction between the single scheme and related scheme provisions in Division 974 is problematic. If so, how could this be addressed;
- b. there are any practical examples of where the application of the related scheme provisions is difficult. In particular:
  - i. how the differences in timing of cash flows between individual instruments and entities are accommodated;
  - ii. how the absence of any legal relationship between two issuers are accommodated?
  - iii. what degree of interconnection, or other characteristics ought to be required before two schemes are related;
  - iv. whether there is a need for a reconstruction power where related schemes are concerned? For example, where there is a related scheme equity interest, is there sufficient certainty when dealing with franking balances; and
  - v. whether there is a need for additional criteria that the Commissioner should have regard to in the exercise of the discretion;
- c. there are any identifiable circumstances that could define a safe harbour treatment, such that the related party rules could be disregarded;
- d. the potential application of the related scheme provisions to shareholder loan arrangements is problematic; If so, how could this be addressed; and
- e. there should be a specific rule modifying the ENCO test for dealing with related parties or connected entities.

#### Q 4.6 Issues/Questions

The Board seeks stakeholder comment about whether the approach in Division 974 to characterisation from the issuer's perspective is problematic for holders of instruments. If so, how could this be addressed.

#### Q 4.7 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to valuation, discounting and the benchmark rate of return, in particular whether:

- a. the operation of the performance period rules and the 10 year performance period borderline is problematic. If so, how should this be addressed;
- b. the application of the present value method to perpetual instruments is problematic. If so, how could this be addressed;
- c. there are significant practical difficulties associated with the present value method. If so, how could this be addressed. For example, should all financial benefits received or provided under an ENCO be valued in present value terms, regardless of when they were to be provided;
- d. the calculation of the benchmark rate of return is problematic for issuers in determining whether interests satisfy the debt test. If so, how could this be addressed; and
- e. the 25 per cent reduction of the benchmark rate of return appropriate in all circumstances. If not, how could this be addressed.

#### Q 4.8 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the application of the equity test, in particular whether:

- a. the application of the turnover exception to a return being contingent on economic performance is problematic. If so, whether the exception should apply more narrowly so that it does not apply when turnover is a reasonable proxy for economic performance;
- b. the application of the 'contingent on economic performance' test in determining whether an instrument is characterised as equity is problematic. If so, how should this be addressed; and
- c. there are any aspects of the 'contingent on economic performance' test that are problematic, including where returns are contingent on the economic performance of a particular business asset of the entity rather than its economic performance as a whole. If so, how could this be addressed.

### Q 4.9 Issues/Questions

The Board seeks stakeholder comments on the accommodating change provisions and, in particular whether:

- a. the Division 974 treatment of subsequent changes to a scheme or schemes is problematic. If so, how this could be addressed; and
- b. the Division 974 treatment of varying patterns of financial benefits is problematic. If so, how this could be addressed.

### General Questions

- a. Is there a different way of distinguishing between debt and equity characterisation for tax purposes, through a different legislative formulation, or through use of an independent process or body that could make the determination on a case by case basis?
- b. Are there any other issues with the operation of Division 974 that the Board has not raised in this discussion paper?

## CHAPTER 5:

### Q 5.1 Issues/Questions

The Board seeks stakeholder comments regarding potential issues and uncertainties raised with the existing operation of section 974-80, in particular:

- a. with regard to the designed to operate/purpose test, stakeholder views are welcomed with regard to the following:
  - i. the 'purpose and effect' test proposed in the 2011-12 Budget;
  - ii. how purpose and effect should be tested in practice;
  - iii. whether the test for design should apply objectively or subjectively and whether this causes any significant problems in practice;
  - iv. whether a test of dominant purpose, or some other level of purpose, would deliver the policy intent and reduce the uncertainty about the applicability of section 974-80;
  - v. more specifically, whether a purpose test should be applied from the perspective of whether an entity has a significant, but not dominant purpose, to provide the ultimate recipient with what is in substance or effect an equity interest in the company or connected entity;

- b. the most appropriate way to apply a debt test override rule to section 974-80. For example, would it be sufficient to make clarifying amendments to the current test of subsection 974-80(2) or is something more required;
- c. to the extent that clarifying amendments to the current text of subsection 974-80(2) are sufficient, should:
  - i. subsection 974-80(2) be amended to clarify that the interest referred to at the end of the subsection is the interest held by the ultimate recipient;
  - ii. such amendment clarify that an alternative basis for exclusion from section 974-80 is that the interest itself is not to be characterised as a debt interest, or forms part of a larger interest that is characterised as a debt interest under the related schemes debt test;
- d. whether the funding test in paragraph 974-80(1)(d) is working appropriately. In particular, whether the interpretation of the direct or indirect funding of the return concept articulated in paragraph 5.26 gives effect to the policy intent of section 974-80;
- e. whether section 974-80 should adopt an apportionment approach to reclassify the underlying debt interest as an equity interest, but only to the extent that the return on that interest is used to fund an equity return to the ultimate recipient. If not, would another solution be preferred;
- f. whether a *de minimis* rule in section 974-80 should apply where the quantum of the interest held by the ultimate recipient is relatively insignificant when compared with the quantum of the debt interest. If so, what should the *de minimis* rule look like;
- g. to the extent an operative debt test override rule applied, what problems would arise if the characterisation of the interest included not only the issuing company but also any connected entity;
- h. whether the entities being tested to determine if an effective interest exists should be limited to the issuing company and any downstream connected entity (or entities) of the issuing company;
- i. whether section 974-80 should be amended to clarify the chain of interests in which the issuing company must consider;
- j. whether section 974-80 would remain an effective integrity provision if the 'ultimate recipient' in respect of which it applies must be an entity which receives a return which is either (i) paid or provided by a connected entity of the issuer company, or (ii) paid or provided pursuant to an arrangement to which the issuer company or one or more of its connected entities is a party;



- k. alternatively, if the proposals in (j) above were adopted, would the original policy intent of section 974-80 be undermined by the ability to interpose entities between connected entities and ultimate recipients that these changes would allow. Further, would the 'paid or provided' requirement conflict with the 'fund a return (directly or indirectly)' requirement in the design and purpose test in paragraph 974-80(1)(d);
- l. whether section 974-80 should include a residual discretion in the Commissioner not to apply the section in cases where that would be unreasonable or would other corrective amendments address the issue of section 974-80 potentially applying where that would be unreasonable; and
- m. to the extent that a residual discretion is required, are the factors identified in paragraph 5.40 sufficient? If not, what other factors should be taken into account in determining whether the discretion should be exercised.

## Q 5.2 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise with the application of section 974-80 to stapled structures, in particular:

- a. with regard to the current operation of section 974-80 in relation to stapled structures:
  - i. what is the nature of discretions or other contingencies, if any, that are attached to the distribution from the trust to the investor in a stapled structure arrangement. If there are a range of discretions or contingencies, it would be useful to understand the differences between them;
  - ii. whether the connected entity test, in relation to stapled structures, is working as intended or whether there should be a specific connected entity test for stapled structures. If a specific connected entity test is preferred, what should the test be;
  - iii. whether the definition of 'associate' specifically treats entities that operate as effectively one economic entity in a financier trust stapled structure arrangement, as associates of each other;
- b. accepting that stapled structures are a commercial reality and a significant subset of the investment population, what specific integrity concerns arise with stapled structure arrangements. To the extent there are such concerns, what is the best way to address them;

- c. with regard to the interaction of the related scheme provisions:
  - i. whether, as a matter of policy and ignoring section 974-80, arrangements in which the trust acts solely as a financier of the stapled group should be subject to the related scheme provisions;
  - ii. does the law need to be clarified as to whether, and how, the related scheme provisions apply to stapled structure arrangements; and
- d. as a matter of determining legislative priorities, where both the related scheme provisions and section 974-80 can both apply to an arrangement, which provision should take precedence. Whether that priority setting should apply in all cases or in limited specified cases.

### General Questions

- a. Does the 2011-12 Budget announcement to amend section 974-80 address the concerns relating to its application. If not, what changes would address the problems and retain the integrity of the provision while ensuring it does not overreach?
- b. Given the operation of the general anti-avoidance provision in Part IVA, is there a need for a specific integrity provision in Division 974. If so, to what extent does section 974-80 perform this function?
- c. Whether an integrity measure, other than section 974-80, should apply to stapled structures. If so, what is the mischief that would be an appropriate measure and how should it be applied to, for example, financier trust stapled structure arrangements?
- d. Having regard to the issues identified with the current operation of section 974-80, would it be best to repeal section 974-80 and introduce a more specific integrity measure that directly targets the mischief originally intended to be covered by the measure?
- e. Whether the need for the integrity measure, combined with the practical administration difficulties, overstates the compliance concern where MNEs are free to choose whether they fund their associates with debt or equity and are already subject to the Australian thin capitalisation provisions?

## CHAPTER 6:

### Q 6.1 Issues/Questions

The Board seeks stakeholder comment on whether there are any significant practical difficulties with the interaction of Division 974 and the following:

- a. the general deductions regime;
- b. the thin capitalisation provisions;
- c. the commercial debt forgiveness rules;
- d. the imputation system;
- e. the anti-avoidance provisions;
- f. the share buy-back rules;
- g. the dividend and interest withholding tax provisions;
- h. offshore banking unit activities; and
- i. whether there are any other intended interaction issues that stakeholders consider is problematic.

## CHAPTER 7:

### Q 7.1 Issues/Questions

The Board seeks stakeholder comment on whether the interaction of Division 974 with the tax consolidation regime is problematic. If so, what changes would address the problem.

### Q 7.2 Issues/Questions

The Board seeks stakeholder comment on whether the interaction of Division 974 with the corporate limited partnership regime is problematic. If so, what changes would address the problem.

### Q 7.3 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the interaction of Division 974 with the TOFA regime, in particular whether:

- a. the fact that the TOFA regime does not adopt the concept of a debt interest, as characterised under Division 974, is problematic. If so, what changes would address the problem;
- b. the use of the 'sufficient certainty' concept in the TOFA regime, instead of 'ENCO' in Division 974, is problematic. If so, what changes would address this problem; and

- c. the concept of sufficient certainty of the provision of financial benefits should be considered in applying the debt test in Division 974, including the operation of the valuation rules.

#### Q 7.4 Issues/Questions

The Board seeks stakeholder comment on whether the different treatment of returns paid on share and non-share equity is problematic. If so, what changes would address the problem.

## CHAPTER 8:

#### Q 8.1 Issues/Questions

A number of areas of the tax law use concepts of debt and equity but not specifically the debt and equity rules and concepts contained in Division 974. The Board is interested in any key areas, whether or not addressed in the discussion paper, in the tax law where consideration should be given to whether Division 974 concepts should be applied.

#### Q 8.2 Issues/Questions

The Board seeks stakeholder comment on the intended use of the concepts in Division 974 and, in particular, whether a modified equity test should apply to entities other than companies. For what purposes should a modified equity test apply or not apply.

#### Q 8.3 Issues/Questions

The Board seeks stakeholder comment on whether the fact that Division 16E and sections 26BB and 70B use the concept of security and not concepts in Division 974, is problematic. If so, what changes would address the problem and is there a practical need to retain Division 16E and sections 26BB and 70B.

#### Q 8.4 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the non-interaction of Division 974 and the CGT roll-over relief provisions, in particular whether:

- a. the fact that the CGT roll-over relief provisions, as discussed at paragraphs 8.21 to 8.60, do not use Division 974 concepts is problematic. If so, what changes would address the problem;
- b. the limitation of the CGT roll-over relief provisions to legal form shares, as discussed at paragraphs 8.21 to 8.60, is problematic. If so, what changes would address the problem;
- c. the role, if any, that Division 974 should play in establishing whether an interest is an appropriately equivalent replacement for another; and

- d. it would be appropriate to have a separate substance-based test operating from the holder's perspective rather than Division 974 or form-based concepts.

#### Q 8.5 Issues/Questions

The Board seeks stakeholder comment on whether the use of the concept of legal form share in the ESS rules instead of Division 974 concepts, is problematic. If so, what changes would address the problem.

#### Q 8.6 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the non-interaction of the foreign source income and CFC rules with Division 974, in particular whether:

- a. the calculation of attributable income in the CFC rules using concepts other than Division 974 concepts, is problematic. If so, what changes would address the problem;
- b. the control interest test in the CFC rules should be based on the concept of an 'equity interest' in the definition in Division 974;
- c. there would be any practical difficulties, practical efficiencies or improvements if the concepts of eligible finance share, widely distributed share or transitional finance share were changed to reflect Division 974 concepts; and
- d. the calculation of the attribution percentage in a CFC using concepts other than Division 974 concepts is problematic. If so, what changes would address the problem.

#### Q 8.7 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the non-interaction of Division 855 and Subdivision 768-G with Division 974, in particular whether:

- a. the use of legal form share concepts and the exclusion of shares that are debt interests in Division 855 is problematic. If so, what changes would address the problem;
- b. any inappropriate tax outcomes are obtained given that Division 855 uses legal form share concepts but excludes shares that are debt interests;
- c. the use of concepts, other than Division 974 concepts, in subdivision 768-G is problematic. If so, what changes would address the problem.

### Q 8.8 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the non-interaction of the small business concession regime with Division 974.

### Q 8.9 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the non-interaction of the OBU regime with Division 974.

## CHAPTER 9:

### Q 9.1 Issues/Questions

The Board seeks stakeholder comment regarding the compliance and administration of Division 974 since its enactment, in particular whether:

- a. the use of the regulation making power has resulted in greater certainty and clarity about the operation of the tax law;
- b. there should be a legislative provision for entities regulated by APRA that aligns tax characterisation with prudential characterisation, with a regulation-making power available to exclude particular items; and
- c. there are any comments on the structure and style of drafting employed in delivering Division 974 and its impact on the compliance and administration of the rules.

## CHAPTER 10:

### Q 10.1 Issues/Questions

The Board seeks stakeholder comment on whether there are any potentially significant tax arbitrage opportunities or outcomes resulting from differences in Australia's and other jurisdictions' tax rules, in particular whether:

- a. structures that use Australia's debt and equity rules to achieve significant cross-border arbitrage are prevalent and problematic in practice;
- b. there are significant non-tax (that is commercial, legal or regulatory) factors that encourage or discourage the use of hybrid instruments by MNEs. If so, what are they; and
- c. the structure of Australia's debt and equity rules itself contribute to, or enhance opportunities for, cross-border tax arbitrage. If so, what changes would address the problem.

## Q 10.2 Issues/Questions

The Board seeks stakeholder comment on ways to address inconsistencies between Australia's and other jurisdictions' debt and equity rules that give rise to tax arbitrage opportunities, including in relation to the following issues:

- a. whether the Australian domestic tax law constructs or creates significant arbitrage opportunities. If so, what changes would address the problem;
- b. whether any practical significant difficulties would arise if specific domestic rules were introduced to address the mismatch of hybrid arrangements, including identification of prioritisation rules in the event of multi-jurisdictional application of such rules;
- c. if Australia introduced specific domestic rules to address the mismatch of hybrid arrangements and eradicate mismatches in tax outcomes:
  - i. whether the rules should be targeted to hybrid arrangements between related parties, specific types of instruments or limited in some other way. Why or why not;
  - ii. whether there would be a significant commercial impact for MNEs entering into cross-border transactions. If so, whether the investment decisions made by MNEs would be affected;
  - iii. whether the rules should contain any carve-outs;
- d. what role does the existing general anti-avoidance rule in Part IVA play in the context of hybrid mismatch arrangements? Whether the general anti-avoidance rule in Part IVA sufficiently deals with hybrid mismatch arrangements. If not, how significant are the problems in practice and how could these problems be addressed;
- e. whether Australia's international tax laws strike an appropriate balance between competing policy considerations, including efficiency, certainty, compliance costs and tax revenue considerations; and
- f. on the other hand, whether there are any circumstances where the use of hybrid instruments result in significant adverse tax outcomes such as, for example, double taxation in Australia and other jurisdictions. If so, what changes would address the problem.





## APPENDIX B: EXAMPLE — MULTIPLE TAX CREDITS

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The simplified legal form of the generic arrangement is effected through the Australian company, Aus Co:

- establishing a special purpose company (SPC) in Australia that is outside its consolidated tax group, with nominal value ordinary shares;
- subscribing for equity interests issued by the SPC;

and the foreign company, For Co:

- either directly (or indirectly via an offshore SPC), subscribing for nominal value ordinary shares in the SPC;
- subscribing for debt interests, for example MRPS, issued by the SPC on terms that provide For Co with an effective control and ownership of that SPC.

Aus Co's ordinary shares in SPC carry 25 per cent of the voting rights and a right to appoint one out of three directors. For Co's effective control and ownership of the SPC through 75 per cent of the voting rights and the right to appoint the remaining two directors, is not through its ordinary shareholding as one would expect, but is effectively achieved by its holding of the MRPS in the SPC.<sup>497</sup>

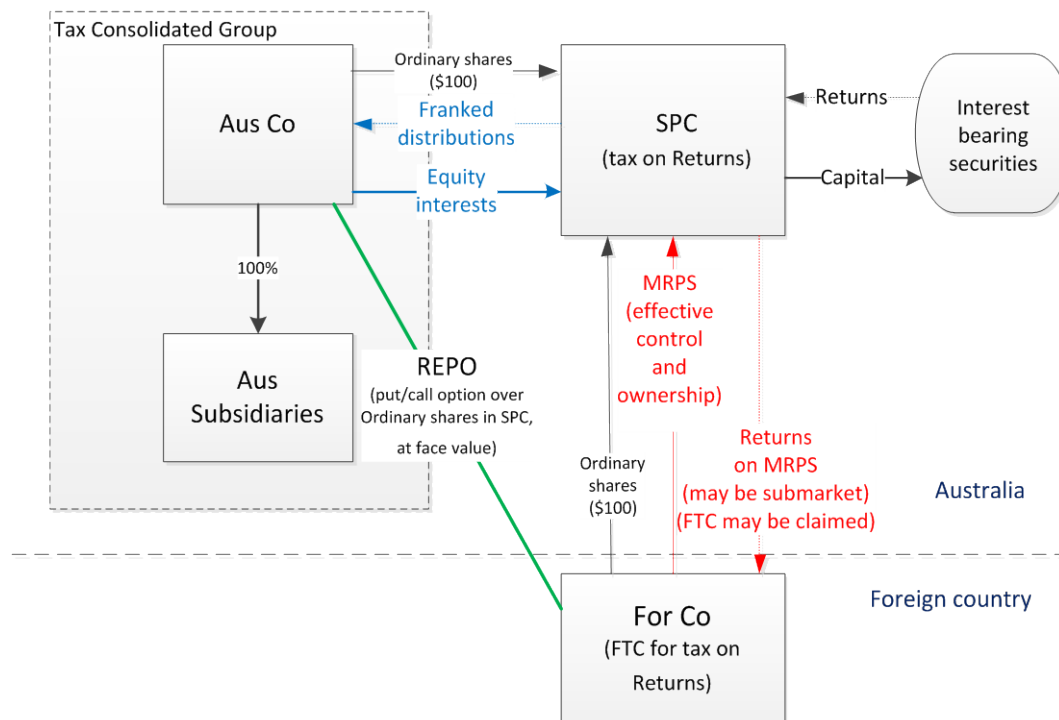
Further,

- Both Aus Co and For Co enter into fixed price short term, for example five years, repurchase agreements over the ordinary shares each one holds in the SPC (REPO);
- The SPC invests its capital in interest bearing securities to generate an income stream on which it pays tax in Australia and franked distributions to the Australian tax consolidated group;

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<sup>497</sup> The bifurcated interests held by For Co comprising the MRPS and ordinary shares may be related schemes as defined in section 974-155, ITAA 1997.

A simplified diagram of the arrangement is as follows:



The foreign country treats For Co as the owner of the SPC by virtue of its holding of MRPS (and its Repo over the ordinary shares) that provide effective control over the SPC. The foreign country therefore allows foreign tax credits in respect of the same Australian tax paid that generates Australian franking credits.

The economic substance of the arrangement is that of a five year net loan by For Co to Aus Co, the below market return on which is calculated having regard to the tax benefits generated in each jurisdiction. The arrangement is wound up at year five through exercise of the repurchase agreements.

The hybrid instrument arbitrage in the arrangement is affected through the use of the MRPS that are characterised as debt interests in Australia, and equity in the foreign country;

- in the foreign country, either an exemption for dividends is received, or foreign tax credits generated;
- in Australia, the returns on the MPRS may be deductible and the dividends on the equity interest to the consolidated tax group may be frankable.

The fact that For Co has the effective ownership and control over the SPC is ignored for the purpose of certain franking credit trading rules, such as, for example, the

exempting entity and former exempting entity franking credit trading provisions.<sup>498</sup> These rules are based on the membership interest concept.<sup>499</sup> As discussed in chapter 7, that concept specifically excludes a debt interest<sup>500</sup> on the basis that it was considered not to provide the holder with rights of ownership and control.<sup>501</sup>

This outcome illustrates, that a MRPS which, because of its economic substance, is characterised as a debt interest, can result in cross-border arbitrage opportunities or outcomes. This is because the debt/equity rules are applied outside of their original policy intent, to determine effective ownership or control of a company, and the overseas treatment is different.<sup>502</sup>

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498 Division 208, ITAA 1997 limits franking credit trading by prescribing that franked distributions paid by corporate tax entities, which are effectively owned by non-residents or tax-exempt entities, will provide franking benefits to members in limited circumstances only and quarantining the franking surpluses of corporate tax entities which were formerly effectively owned by non-residents or tax-exempt entities.

499 Refer sections 960-130 and 960-135, ITAA 1997, and paragraph 3.68 of the New Business Tax System (Consolidation) Bill (No. 1) 1992.

500 Effective ownership for the purposes of the Division 208 is determined by section 208-25, ITAA 1997. That section is based on the concept of an 'accountable membership interest', defined in section 208-30, ITAA 1997 as, broadly, a prescribed set of membership interests in the company (or the entity taxed like company).

501 A debt interest that provides for effective control through inter alia voting rights, is excluded from the definition of a membership interest (subsection 960-130(3), ITAA 1997) and therefore can never satisfy the definition of an 'accountable membership interest'. Division 208, ITAA 1997 is therefore inoperative in these circumstances and cannot be applied according to its original policy intent.

502 This outcome may not be supportable under Division 974 though, if the related schemes comprising the MRPS and the ordinary shares give rise to a notional scheme that is an equity interest in SPC.

