Australian Government

The Board of Taxation

REVIEW OF THE DEBT AND EQUITY TAX RULES

A report to the Government

the board of taxation

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The Board of Taxation

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FOREWORD

The Board of Taxation (the Board) is pleased to submit this report to the Assistant Treasurer following its review of the Debt and Equity Tax Rules in Division 974 of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) (the debt and equity rules).

The Board has made eight recommendations.

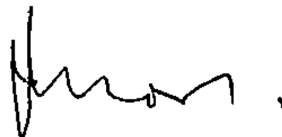
The Board established a Working Group of its members in May 2013 to oversee the review. The original members of the Working Group were Teresa Dyson as its Chair and John Emerson AM. After Ms Dyson's term as a member of the Board expired on 31 December 2014, the Working Group members have been Mr Emerson as its Chair and Peggy Lau Flux. In addition, the Board engaged Frank O'Loughlin (a member of its Advisory Panel) and John Smith, and since her retirement as a Board member, Teresa Dyson, as consultants, to assist with the review.

The Board appointed an Expert Panel consisting of Patrick Broughan, Deloitte; Steve Ford, PwC; Manuel Makas, Greenwoods & Herbert Smith Freehills; John Condon, BP Australia; Larry Magid, Allens Linklaters; Andrew Mills, (from September until December 2013); Hayden Scott, PwC; and Jeff Shaw, National Australia Bank. The Working Group was also assisted by officials from the Treasury and the Australian Taxation Office.

A Discussion Paper was issued in March 2014. The Board held discussions and targeted consultation meetings with a range of stakeholders, both before and after the release of the Discussion Paper. The Board received 12 written submissions, two of which were confidential.

The *ex officio* members of the Board — the Secretary to the Treasury, John Fraser PSM, the Commissioner of Taxation, Chris Jordan AO, and the First Parliamentary Counsel, Peter Quiggin PSM — have reserved their final views on the observations and recommendation in this report for advice to Government.

The Board would like to thank all of those who so readily contributed information and time to assist in conducting the review.



Michael Andrew
Chair, Board of Taxation

John Emerson AM
Chairman of the Working Group

EXECUTIVE SUMMARY

The terms of reference asked the Board to undertake a review combining a post-implementation review of the debt and equity rules with a review of whether there can be improved arrangements in the Australian tax system to address any inconsistencies between Australia's and other jurisdictions' debt and equity tax 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.

Application of the debt and equity rules over the past 14 years to the wide range of financing arrangements in the marketplace has revealed a number of areas of uncertainty and inconsistency. Uncertainty and inconsistencies have increased compliance costs for business and increased the cost of administration for the Australian Taxation Office (ATO). With the benefit of comments made in the course of consultation, the Board has sought to make recommendations that will reduce compliance costs.

The Board has made eight recommendations regarding the debt and equity rules.

An important concept in the debt and equity tax rules is that of an 'effectively non-contingent obligation' (ENCO). This concept has been the source of ongoing uncertainty and increased compliance costs for both taxpayers and the ATO. Three of the Board's recommendations would reduce uncertainty around the application of the ENCO concept. In particular, uncertainty and compliance costs would be reduced for limited recourse loans, loans involving subordination and those including special clauses dealing with insolvency.

Application of the debt and equity tax rules to interests that change over time has also been a source of ongoing uncertainty for taxpayers. The Board has recommended amendments to the law intended to reduce this uncertainty.

The Board's recommendations are also intended to reduce uncertainty and compliance costs for banks issuing Tier 2 capital, clarify the application of thin capitalisation provisions to interests that are neither debt nor equity and clarify the meaning of 'financing arrangement'. They also recommend the Government considers the interaction between subdivision 768-A and the controlled foreign company provisions.

CHAPTER 1: INTRODUCTION

BACKGROUND

1.1 On 14 May 2013, the Board was asked to undertake a review combining a post-implementation review of the debt and equity rules with a review of whether there can be improved arrangements in 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. 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).

2. 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.

3. 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.

4. 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 in 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.

5. 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.

The Board is asked to report to the Assistant Treasurer by March 2015.

1.3 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 post-implementation review of the debt/equity provisions.

1.4 Finally, as part of Government's deregulation agenda, the Treasurer appointed the Board as the Ministerial Advisory Council in relation to tax matters. A component of this review has focused on understanding the costs incurred in applying the debt and equity tax rules, and whether there are any administrative or legislative changes that could be implemented to ease the compliance burden for taxpayers and for the ATO in applying these rules.

REVIEW PROCESSES

Review team

1.5 The Board established a Working Group of its members in May 2013 to oversee the review. The original members of the Working Group were Teresa Dyson as its Chair and John Emerson AM. After Ms Dyson's term as a Board member expired on 31 December 2014, the Working Group members have been John Emerson as its Chair and Peggy Lau Flux. In addition, the Board engaged Frank O'Loughlin (a member of its Advisory Panel) and John Smith, and since her retirement as a Board member, Ms Dyson, as consultants, to assist with the review.

1.6 The Board also received assistance from an Expert Panel comprising Patrick Broughan, Steve Ford, Manuel Makas, John Condon, Larry Magid, Andrew Mills (until December 2013), Hayden Scott and Jeff Shaw.

1.7 Finally, the Working Group has been assisted by members of the Board's Secretariat and by staff from the Treasury and the ATO.

1.8 The position and affiliations of the Board's members are listed on the Board's website.

Consultation

1.9 The Board's consultation process has involved:

- release of a Discussion Paper in March 2014 to invite and facilitate submissions; and
- targeted consultation meetings with a number of key stakeholders, following the release of the Discussion Paper.

Submissions

1.10 The Board received 12 written submissions, including two confidential submissions, in response to the Discussion Paper.

Board's report

1.11 The Board has considered the issues raised by stakeholders in their submissions and at the consultation meetings, and the views of the members of the Expert Panel, Treasury and the ATO. However, the Board's recommendations reflect its independent judgment.

1.12 For completeness, the Board notes that this report follows the accelerated report that was provided to the Government in December 2014 relating to the related scheme and equity override integrity provisions following stakeholder feedback.

Chapter 2: Policy Design of Division 974

Background to Division 974

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

2.2 Prior to the introduction of the debt and equity rules, the distinction between debt and equity under general income tax principles could be said to have mainly manifested in 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.

2.3 While there are clear differences between debt and equity in many circumstances, many financial instruments exhibit characteristics of both. As such, the debt and equity divide is not so much a clear delineation but a continuum. Prior to the introduction of Division 974, the tax treatment of interests in an entity was primarily driven by the legal form of the interest, regardless of its economic substance, with a small number of exceptions that looked to deny equity treatment to some shares and to deny full debt treatment to some loan arrangements. This was consistent with the approach adopted in many countries.

2.4 Many, if not most, financial arrangements fall at or near either end of the continuum and can 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 tax outcomes not consistent with the substance of the arrangement.[1]

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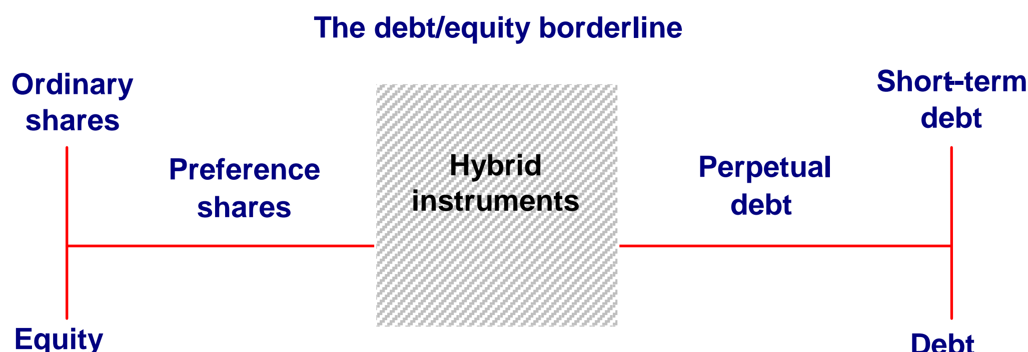
1 Review of Business Taxation, Discussion Paper 2: A Platform for Consultation: Building on a strong foundation, Volume 1, Taxation of financial assets and liabilities, Chapter 7: Debt/Equity hybrids and synthetic arrangements, February 1999, paragraph 7.3. Retrieved from: *http://www.rbt.treasury.gov.au/publications/paper3/download/ch7.pdf.*



2.5 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 tax system. At the same time, policymakers were becoming increasingly concerned about the thin capitalisation of entities.[2] 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.

2.6 While specific rules could go some way to tempering the risk of the characterisation outcomes, the applicable rules were ad-hoc and could lead to confusing, uncertain and inappropriate tax outcomes. They could also result in returns on financing instruments that were neither frankable nor deductible.[3]

2.7 Division 974 was introduced in 2001 following recommendations made by the 1999 Review of Business Taxation (the Ralph Review).[4] 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[5] that reflects commercial substance and the intention of the parties;[6]
- increase certainty of the tax treatment of hybrids;

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2 *Australia's Future Tax System, Final Report: Detailed Analysis*, Chapter B - Investment and Entity Taxation, Section B1-4 – Refining the Business Income Tax Base.

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

4 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* in January 2014.

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

6 Ibid, paragraph 2.176.

- 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.[7]

2.8 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.[8] 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.[9]

2.9 To reduce 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. However, in recognition of the potential difficulties associated with determining the economic substance or effect of an arrangement in some circumstances, the rules take a substance based approach guided by the pricing, terms and conditions of the agreement between the issuer and the instrument holder[10] that set the parties' 'legal rights and obligations'.[11] The rules attempt to strike a balance between the object of reflecting the economic substance of an arrangement, and the desire to maintain an appropriate degree of certainty and simplicity (in particular, by reducing compliance costs).

2.10 The Division 974 rules do not take a 'pure' substance approach as is applicable in the United States (where all relevant facts and circumstances are examined).[12]

2.11 The criterion for assessing whether a financing arrangement is debt or equity focuses largely on the risk of repayment of the finance provided and the risk of payment of the returns on those arrangements. Generally, and as noted above, returns on debt instruments have relatively less risk of not being paid, while returns on equity instruments involve more uncertainty and a greater reliance on the economic

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7 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, either in the consultation materials or the final report, but appears in paragraph 1.2 of the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001.

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

9 Ibid, paragraph 5.30.

10 Ibid, paragraphs 1.9 and 2.2.

11 Ibid, paragraph 2.176.

12 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).

performance or discretion of the issuing entity or both. The Division 974 rules do not focus on whether an investor is granted decision-making rights or control of an entity as a result of the investment; rather, the focus is primarily on the financial risks associated with the investment.

Application of Division 974

2.12 Division 974 does not have any direct 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.

2.13 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[13] (but not deductible) and subject to dividend withholding tax;
- identifying returns that may be deductible[14] (but not frankable) for entities paying the return and subject to interest withholding tax; and
- identifying debt capital for the purposes of the thin capitalisation rules (which place limits on the deductibility of interest).

Key features of Division 974

2.14 The key features of the 'debt test' and the 'equity test' are briefly outlined in this section.

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13 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 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.

14 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.

Debt test

2.15 There are five essential elements required to satisfy the debt test in relation to an entity:[15]

- 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;
- the scheme must be a 'financing arrangement';[16]
- there must be a financial benefit[17] that is received, or will be received by the issuing entity or a 'connected entity'[18] of the issuing entity, under the scheme;
- the issuing entity, or its connected entity, must have an 'effectively non-contingent obligation'[19] 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 the value provided and the value received must not both be nil.[20]

2.16 If a scheme has a term of 10 years or less, the value of financial benefits is calculated in nominal terms. If a scheme has a term of more than 10 years, the value of financial benefits is calculated in present value terms. The present value is calculated using 75 per cent of a benchmark rate of return. This benchmark rate is the annually compounded internal rate of return on an ordinary interest that is issued by the same issuer (or an equivalent entity) and that is comparable in specified respects with the interest that is being tests.

Equity test

2.17 An equity interest is an interest in a company. It must be in the form of a share, in a company, or an interest issued under a scheme that is a financing arrangement for a company and that satisfies a number of equity like criteria set out in the Division 974 rules. 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.

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15 Paragraphs 974-20(1)(a) to (e), ITAA 1997.
16 Subsection 974-130(1), ITAA 1997 defines a 'financing arrangement'.
17 Subsection 974-160(1), ITAA 1997 defines a 'financial benefit'.
18 Subsection 995-1(1), ITAA 1997 defines 'connected entity'.
19 Section 974-135, ITAA 1997 defines an 'effectively non-contingent obligation'.
20 In some cases, an alternative test allows the Commissioner to determine that a scheme satisfies the debt test when the primary test is substantially but not wholly satisfied: section 974-65, ITAA 1997.

2.18 Subject to that rule, generally speaking an interest under a scheme will be an equity interest in relation to a company[21] if it is:

- an interest in the company as a member or stockholder of the company;
- an interest providing a right to a return,[22] 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
- 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.[23]

2.19 The Division 974 rules determine whether a scheme is either debt or equity without bifurcation into its debt and equity components. A hybrid scheme (or a set of related hybrid schemes) is classified as either entirely debt or entirely equity.

Effectively non-contingent obligation

2.20 To reflect the economic substance of an arrangement better, the debt test adopts the concept of an 'effectively-non contingent obligation' (ENCO).

2.21 An ENCO to take an action (for example, make a payment) exists if the pricing, terms and conditions of the scheme are such that there is in substance or effect a non-contingent obligation to take that action, for example, make that payment. Artificial, contrived or immaterially remote contingencies do not tend to indicate that, in substance, the obligation is contingent, notwithstanding the legal form indicates that it is.

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21 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.

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

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

2.22 Both the debt test and the equity test involve a number of additional rules 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:

- for 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;
- for 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; and
- the concept of financial benefits extends to anything of economic value, and includes property and services. Equity interests issued by an entity are deemed not to be the provision of financial benefits by that entity.[24]

24 Section 974-30, ITAA 1997.

CHAPTER 3: OPERATION OF DIVISION 974

INTRODUCTION

3.1 Submissions made in response to the Board's Discussion Paper suggest that Division 974 has broadly operated as intended, both reducing uncertainty and reducing instances of characterisation of debt and equity instruments contrary to their substance. However, submissions suggested that Division 974 has presented difficulties for hybrid financial arrangements that have features of both traditional debt and equity.

3.2 This chapter considers a number of specific problems that have emerged with the operation and administration of Division 974. Areas that have been consistently raised as problematic include:

- the ENCO concept, in particular the application of the 'ability or willingness' exception and whether it is relevant to financial arrangements that include solvency clauses, subordination of some creditors' entitlements, recourse to a limited pool of assets, or project financing;
- accommodating changes to the pricing, terms and conditions of a scheme;
- regulations made for Australian Prudential Regulation Authority (APRA)-regulated entities; and
- non-arm's length transactions (that is, certain instruments between related parties).

3.3 The distinction between 'financing arrangement' and 'raising capital' following *Blank v Commissioner of Taxation* [2014] FCA 87 (the *Blank* case), which is also covered in this chapter, has been a more recent issued that has arisen.

THE ENCO PRINCIPLE

3.4 As discussed in chapter 2, the debt test in Division 974 uses the concept of an 'ENCO' as a critical aspect of the test 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 take an action (for example, make a payment).

3.5 Contracts that have obligations that are formally expressed to be contingent may, subject to the pricing, terms and conditions viewed substantively, effectively be

non-contingent obligations; and other arrangements where there is no formal obligation at all may, having regard to the pricing, terms and conditions of the arrangement viewed substantively be such that, an ENCO exists. 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[25] — 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.[26]

3.6 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.

3.7 The Division 974 rules also set out some specific guidance for when contingencies are to be disregarded. 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.

3.8 The steps to determine whether there is an ENCO include the identification of a relevant 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. In the reverse situation where no obligation of any kind exists, contingent or otherwise, the steps to determine whether an ENCO exists 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.

3.9 The limited nature of the ENCO enquiry may lead to a difference between the income tax characterisation of an interest as debt and the classification of that same interest for non-tax purposes – for example, under accounting standards or by ratings agencies.[27]

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

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

27 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.

Ability or willingness

3.10 The subsection 974-135(1) definition of ENCO is supplemented by subsection 974-135(3) which provides that:

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

3.11 The phrase *the ability or willingness of that entity or connected entity to meet the obligation* (the ability or willingness carve out) is relied upon by some as the foundation for concluding that some interests that have contractual arrangements affecting the issuer's obligations to make payments or provide financial benefits are debt interests, notwithstanding those contractual arrangements affect the issuer's obligations to make payments or provide financial benefits.

3.12 This construction of the ability or willingness carve out, if correct, could undermine the Division 974 regime.

3.13 On this interpretation an arrangement may be regarded as a non-contingent obligation for Division 974 purposes when in substance, and by reference to its express terms, the circumstances in which any payment might be made are contingent on economic performance, or an economic state of affairs, or on the discretion of the issuer in the arrangement; all undeniably hallmarks of an equity interest.

3.14 The use of a very similar expression in the ability or willingness carve out in paragraph 974-85(1)(a) 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.

3.15 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 yet not be recognised as a right that is contingent on economic performance of an entity.

3.16 The Explanatory Memorandum specifically addresses paragraph 974-85(1)(a) 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.[28]

3.17 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' that is to be ignored is intended to be one that goes to the performance of an established obligation by the debtor, rather than one that limits the creditor's right to payment by reference to the debtor's ability or willingness to make any payment at all.

3.18 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 outcomes, it may be that the explanation in the Explanatory Memorandum of the intended operation of paragraph 974-85(1)(a) should also be adopted for the purposes of subsection 974-135(3).

3.19 If this is the correct view, the ability or willingness carve out does not operate as an exception. It is intended merely to forestall any argument that obligations to provide financial benefits that are due or payable are subject to a relevant contingency (in some sense). This is 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.

3.20 Some stakeholders consider that the literal interpretation is the appropriate interpretation and that the ability or willingness carve out properly operates as a true exception. On this view, if an obligation is only contractually 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 subordination arrangements, solvency clauses, limited recourse debt and related party transactions.

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28 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.30.

Views in submissions

3.21 Deloitte submits that, in the context of subordination/solvency clauses, the ‘ability or willingness’ exception often presents interpretational difficulties (and significant scope for dispute) in determining whether the debtor has an ENCO to provide financial benefits under the arrangement. Deloitte recommends that the operation of Division 974 be clarified by the inclusion of a rule that states that subordination/insolvency clauses merely defer the performance of an obligation, and are not to be regarded as making the obligation not non-contingent.

3.22 The Law Council of Australia (LCA) considers that subsection 974-135(3) (relating to the ability or willingness to meet the obligation phrase) should be redrafted. In this regard, using the phrase ‘not contingent’ in the same provision as the word ‘obligation’ and the apparent ‘exclusion’ of the ‘ability or willingness to meet the obligations’ from being a non-contingent obligation, is confusing.

3.23 The LCA submits that the ‘ability or willingness’ exception in subsection 974-135(3) tends to confuse the legal distinction between contingent and non-contingent obligations. The drafting in subsection 974-135(3) can be contrasted with paragraph 974-85(1)(a) where the phrase (‘unwilling or unable’) is used to elaborate on the phrase ‘contingent on economic performance’ which is a phrase where the common commercial meaning of ‘contingent’ would appear to be more apt rather than the legal meaning since ‘economic performance’ is used with ‘contingent’ tends to point to a commercial outcome (*Herbert Adams Pty Ltd v FC of* T (1932) 47 CLR 222 at 223).

3.24 The LCA notes that the Board’s Discussion Paper does not distinguish between obligations which are in existence and contingent obligations.

3.25 The Tax Institute (TTI) is of the view that a literal interpretation of the phrase is problematic because it can lead to surprising outcomes, and that the phrase was not intended to be applied in this way.

3.26 TTI noted that a similarly worded expression is used in paragraph 974-85(1)(a) for the purposes of the equity test. The provision recognises that the mere fact that the debtor may be unable or unwilling to satisfy its obligation to pay the amount when it becomes due and payable does not itself mean that the amount is contingent on the economic performance of the debtors. TTI submits that this interpretation should be appropriate for subsection 974-135(3). TTI does not recommend removing the entire phrase from the legislation.

Board’s Consideration

3.27 The ability or willingness carve out is a source for real uncertainty and~~,~~ is relied upon by some as the foundation for a conclusion that some financing arrangements are debt interests. It is asserted this carve out means that subordinated debt, limited recourse debt and solvency clauses in financing arrangements do not cause those arrangements to fail the debt test.

3.28 The Board considers that the wording of the ability or willingness carve out does not always provide sufficient clarity about the circumstances in which an issuer having insufficient assets to pay an obligation that is due, or, having assets, is simply unwilling to pay an obligation that is due in breach ought to prevent the finding of an ENCO, and those in which it ought not.

3.29 The Board considers that a reading of the ability or willingness carve out that results in any formal contingency as to the issuer's financial position coming within it does not provide a uniformly consistent basis for differentiating between arrangements that are debt-like, and to be treated as debt for Division 974 purposes, and those that are not. More to the point, such a literal reading has the potential to allow instruments that have all the hallmarks of equity interests to be treated as debt interests thereby undermining the intended purposes of the Division.

3.30 The Board is of the view that, because the ability or willingness carve out is often relied on to explain why financing arrangements with solvency clauses, limited recourse conditions and subordination of creditors' rights are debt interests, it is necessary to address the potential problems and difficulties with those features of financing arrangements together with the ability or willingness carve out.

3.31 The Board recommends that subsection 974-135(3) should be amended to clarify the meaning of the ability or willingness carve out. In the Board's view, the ability or willingness carve out should be expressed to the effect that whether an entity, which is subject to an obligation is able or willing to perform an obligation when due, is not relevant to whether the obligation is contingent, within the meaning of subsection 974-135(3). This is consistent with the view that the provision is directed to inability or unwillingness to perform obligations in accordance with their terms.

Recommendation 1

The Board recommends that subsection 974-135(3) is amended to clarify the ability or willingness carve out. The Board recommends that the ability or willingness carve out should be expressed so as to ensure that an inability or unwillingness to perform an obligation when due does not of itself make an obligation contingent within the meaning of subsection 974-135(3).

Subordinated debt

3.32 A lender may agree to postpone its right to be paid by a borrower until another party has had its right to payment satisfied. The subordination of the lender's right to payment may be limited to senior creditors, all other creditors, or all other providers of capital except ordinary shareholders or, in rarer cases, so as to rank on equal terms with ordinary shareholders.

3.33 Subordination is reflected in the pricing, terms and conditions of a scheme, and is a mechanism for risk allocation amongst providers of finance/capital to an entity. It can have a real impact on whether the issuer will in fact provide financial benefits to the lender in the future, notwithstanding a continuing obligation to do so in most cases.

3.34 Subordination terms have the most significance in the event of insolvency, or threatened insolvency, of the borrower. However, there is no single mechanism by which an obligation can become subordinated to another. Subordination may be effected as between lenders, with or without the borrower being a party. Subordination clauses may state that the borrower's obligations to the subordinated lender otherwise remain unaffected (even if the ability to enforce the obligation is postponed until the satisfaction of the senior creditor's rights).

3.35 Subordination clauses that clearly preserve the obligation and operate merely to postpone enforcement of that obligation to a time after other creditors are paid do not affect the existence of a debt-like ENCO. It may be noted that this may result in indefinite deferral of the performance of the obligation, because senior creditors may never be paid in full. However, if ultimately the subordinated claim may receive less than the full amount owing, or no part of the amount owing, only because the borrower has insufficient assets to repay both the senior creditor and the subordinated claim in full or at all, then the obligation is not affected.

3.36 In other cases, the manner in which a subordination clause is drafted could reflect upon the existence of an obligation.

3.37 Questions may arise regarding the application of the debt and equity tax rules if subordination results in a claim that ranks equally with shareholders upon a winding up. In these cases, it is likely that the relevant documentation includes other terms that impact on the application of the debt and equity tests. In particular, it would be unusual for a debt to rank equally with equity in the event of insolvency, but for the lender to be able to sue to recover the full amount of the debt outside of the insolvency context.

Views in submissions

3.38 The LCA considers there needs to be clarification of the treatment of subordinated and non-recourse debt. This also extends to solvency arrangements.

3.39 The LCA notes that the views expressed on subordinated debt in the Discussion Paper, if they were to be implemented in legislation, would severely curtail securitisation in Australia especially if an SPV vehicle is a company not acting in the capacity of trustee. The LCA also stated that this would curtail project finance used in mining and infrastructure projects noting that it would seem quite unwieldy to require Government to draft regulations to deal with requirements imposed by Regulators such as APRA to deal with subordination requirements imposed by the Regulator for purposes other than tax. The LCA submits that there is no issue of contingency under the current law (for example, subordination in securitisation and project finance).

3.40 The LCA noted that paragraph 4.4 in the Discussion Paper conflates a number of issues and notes the similarities with the ATO's 2007 discussion paper on ENCO (the conflation between the ENCO requirement in paragraph 974-20(1)(c) and the estimated valuation requirement in paragraph 974-20(1)(d)). LCA submits that paragraph 974-20(1)(d) already deals with the issue and nothing more needs to be done. LCA submits that, for the sake of a workable rule, excluding present value calculations for 10 year or less performance periods remains a sensible approach and the use of a probability test of the nominal financial benefit being provided is an adequate proxy of market value.

3.41 The Australian Bankers Association (ABA) submitted that subordination of a repayment obligation should only result in non-repayment if the issuer has insufficient assets to do so at the time repayment is due and payable. It recommends that any contingency created by the subordination of an instrument falls within the ability and willingness exception and the law (by regulations or otherwise) should be clarified to make this clear.

3.42 Similarly, TTI submitted that subordination of a particular debt to the satisfaction of some or all other creditors should be covered by the 'ability or willingness' exception. Like ABA, it submitted that a legislative amendment or regulation should be made to clarify that the subordination of a debt should not, of itself, prevent the finding of an ENCO in respect of the debt, if there are any doubts about this conclusion.

3.43 During the Working Group meetings, the ATO expressed its view that the following circumstances are not relevant to determining whether there is an ENCO:

- where a lender has granted priority of payment rights to other lenders pursuant to a subordination arrangement (as that fact goes to the performance of an obligation and not its existence); and
- where subordination arrangements have been entered into between lenders unconnected with the borrower.

Board's Consideration

3.44 The Board considers that mere subordination of a debt to other debts does not raise questions about its character as debt, unless a debt is subordinated to the point of ranking equally with the equity of a company, or other factors affecting the obligation to repay the debt accompany subordination.

3.45 If a 'debt' is subordinated to the point where the claims of a debt holder rank equally with a company's shareholders, then the debt will usually fail the ENCO test and will be reclassified as equity. In such cases, there will usually be other features of the arrangement that cause it to fail the ENCO test. For example, it would be unusual for a debt that is subordinated to rank equally with equity to also be enforceable without limitation whilst the company is a going concern.

3.46 Subordination deeds typically include a number of clauses that have a range of implications for the rights and obligations of the parties. For example, some deeds include 'sunset' clauses, which provide that the relevant debt is no longer subordinated after a period of time; other common clauses provide for suspension of any right of a subordinated creditor to pursue a remedy for default until claims of one or more senior creditors are satisfied.

3.47 Given the range of factors that must be considered when applying the ENCO test to a subordinated debt, the Board considers that uncertainty around the application of the debt and equity tax rules could be addressed by the ATO providing additional guidance for taxpayers with worked examples.

3.48 During this review, the ATO has refined its thinking on these issues and has published updated guidance, which can be accessed at: https://www.ato.gov.au/Business/Debt-and-equity-tests/In-detail/Guides/Debt-and-equity-tests--guide-to-the-debt-and-equity-tests/[29]

3.49 That guidance indicates that subordination clauses preserve the obligation to pay, but operate to postpone performance of that obligation to a time when other creditors have been paid, do not prevent there being a non-contingent obligation to pay. This may result in the obligation not being performed, because senior creditors may never be paid in full or because insufficient assets remain after paying the senior creditors to pay the subordinated creditors. Nevertheless, if ultimately the subordinated claim may receive less than the full amount owing only because the debtor has insufficient assets to repay both the senior creditor and the subordinated claim in full, the failure to perform the obligation is only a consequence of the debtor's inability to pay and this is not enough to make the obligation itself contingent.

29 See, in particular, Part A: Explaining the tests for debt and equity interests, How do you determine whether an interest is a debt interest?, Fourth element – the issuing entity (or connected entity) must have an effectively non-contingent obligation to provide a future financial benefit.

3.50 However, where the creditor's right to repayment is subordinated to the level of ordinary equity interests, such that the obligation to, in a winding up, repay the creditor is contingent on paying the ordinary equity interest holders, the obligation will be contingent.

3.51 In addition, to ensure that the common commercial reality of subordination of debts does not give rise to uncertainty, and to reduce compliance costs for taxpayers and the ATO, the Board recommends that the legislation be amended to include a note to the effect that subordination arrangements merely affecting priorities of creditors do not prevent the existence of an ENCO being recognised as between lenders and borrowers. The insertion of this legislative note is particularly important in the context of the Board's view that the ability or willingness carve out is not intended to operate to save financing arrangements that have associated subordination arrangements from failing the debt test, and that such arrangements usually have an ENCO enabling their characterisation as debt interests under the provisions.

Recommendation 2

Consistent with the Board's view that the ability or willingness carve out is not intended to operate to prevent financing arrangements that have associated subordination arrangements from failing the debt test, and that such arrangements usually have an ENCO enabling their characterisation as debt interests under the provisions, the Board recommends that the legislation be amended to include a note to the effect that subordination arrangements merely affecting priorities of creditors do not prevent the existence of an ENCO being recognised as between lenders and borrowers.

The Board also recommends that the ATO further update its administrative guidance, including worked examples, as to how it proposed to administer the rules.

Limited recourse debt and solvency clauses

3.52 In a limited recourse loan arrangement,[30] if the borrower does not repay the amount due, 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 at the time the payment falls due. In that event, the borrower discharges its obligation by relinquishing the asset to the lender. At the time that the loan is entered into, the future value of the asset is commonly uncertain.

30 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.

3.53 Whether some schemes with limited recourse clauses satisfy the debt test is not clear because the value of financial benefits to be returned to the lender might not equal or exceed the amount borrowed.[31]

3.54 The Explanatory Memorandum indicates that the original policy objective was that (at least some) limited recourse loan arrangements would satisfy the debt test in Division 974.[32] The Board acknowledges that limited and non-recourse debt is a common commercial mode of finance, particularly in project finance.

3.55 If the debt test were not satisfied, 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. 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.

3.56 Similarly to limited recourse loan arrangements, some modern lending terms and conditions include various forms of relief for the borrower in the event that meeting a payment obligation would cause insolvency. Such clauses, known as solvency clauses, have the effect that a borrower is not required to provide any financial benefit if to do so would place it in a position that it would no longer be solvent.

3.57 Solvency clauses may differ according to what happens if the solvency condition is not met (that is, the borrower is not solvent, or would not be if payment were made) at the time the obligation would otherwise become due and payable. Two broad categories are:

- first, the obligation does not remain in existence and no amount becomes payable at any time; or
- second, the obligation becomes due and payable at some later time, possibly as late as in a winding up.

3.58 The making of Regulations 974-135D, 974-135E and 974-135F has substantially reduced the practical significance of solvency clauses in the limited range of circumstances to which the regulation relates.

3.59 For loans with solvency clauses that are not dealt with by Regulations 974-135D, 974-135E and 974-135F, there is a view that the ability or willingness carve out operates to ensure that they continue to be debt interests.

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

32 Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 examples 2.31 and 2.32. The fact patterns 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.

Views in submissions

Limited recourse debt

3.60 The Property Council of Australia (PCA) submitted that there is significant uncertainty as to when the ENCO test is satisfied for limited recourse loans. Clauses in loan agreements which constrain the rights of creditors can be drafted in many ways and some clauses will satisfy the ENCO test while others may not. It noted that this uncertainty conflicts with the intent of the ENCO test.

3.61 The PCA recommends that the rules should be clarified such that limited recourse debt will satisfy the debt test in all circumstances. In the event that the full amount owed is not repaid, then other consequences (including, for example, commercial debt forgiveness rules, Taxation of Financial Arrangements (TOFA) rules and Division 243) will be triggered. It submitted that the debt test should apply the steps in the ENCO test separately such that factors which impact on the valuation of financial benefits should not impact where there is an ENCO to provide those benefits. Limited recourse debt should always be debt.

3.62 ABA submits that in limited recourse arrangements, the current rules are problematic when forming a judgment as to whether the value of the financial benefits to be received is 'substantially more likely than not' to at least equal those provided. This forward valuation exercise leads to uncertainty as to whether the debt test has been satisfied. ABA recommended:

- clarification of the law, noting the existence of limited recourse rights does not impact the existence of an ENCO; and
- clarification of the valuation exercise required when determining the likelihood of a sufficient future repayment. For example, the ability to make certain assumptions about the future value of assets to which the lender has recourse would help provide a more certain outcome.

3.63 The LCA submitted that, if the view expressed in paragraph 4.50 of the Discussion Paper were to be adopted as the current interpretation of what would be regarded as a standard limited recourse loan, then project finance used in infrastructure (for example, mining and construction projects) and in securitisation would be severely curtailed at least where the borrowing entity is a company not acting in the capacity of trustee. The LCA also stated that, if this view were to be adopted, in view of the interaction with the limited recourse debt provisions in Division 243, this could lead to double taxation of the same profit, preventing projects from being feasible.

3.64 The LCA considers that the requirements in paragraphs 974-20(1)(c) and (1)(d) operate independently in a manner consistent with the principles of interpretation in *Project Blue Sky Inc v Australian Broadcasting Authority* 194 CLR 355 at [69]-[71]. It notes that it is necessary to distinguish between existing obligations and contingent

obligations which only arise on the happening or absence of a specified event. It is also necessary to distinguish between existing obligations which are defeasible by supervening events and those that are not. Having done this, the LCA states that it is only then necessary to consider whether the pricing, terms and conditions and the deeming rules in subsections 974-135(4) or 974-135(6) overturn what would be the general law meaning of contingent and obligation.

3.65 The LCA agrees with comments made in the Board's Discussion Paper that the drafting of limited recourse provisions can affect whether or not an obligation exists from the time a loan is taken out (Examples 4 and 5 in the Discussion Paper). Other examples of drafting which may be clearer would provide that the obligation to repay is discharged by receipt of the rental proceeds or amounts received or recovered by or on behalf of the borrower.

3.66 TTI also agrees that limited recourse features of arrangements can be drafted in many different ways such that some will give rise to an ENCO, while others will not.

3.67 Similarly, TTI submitted that limited recourse loans should be treated as giving rise to an ENCO for the purposes of Division 974 and the income tax character should not turn upon the various means of legal drafting. TTI is of the view that Division 974 should be amended to clearly state that the limited recourse feature of an arrangement does not, of itself, prevent the arrangement from giving rise to the requisite ENCO under Division 974.

3.68 TTI also states that, even if the requisite ENCO exists, there remains a further hurdle in terms of debt interest characterisation – that is, it must be substantially more likely than not that the value of the financial benefits provided must be greater than the value of the financial benefits received. This test will still need to be satisfied having regard to the expected performance of the underlying assets. It also states that if it transpires that the full amount of the limited recourse loan is not repaid, then income tax consequences would be triggered at that time under other regimes in the tax legislation, for example the 'commercial debt forgiveness' rules, the 'limited recourse debt' provisions and the TOFA provisions.

3.69 The LCA noted ambiguity in the drafting of Example 1 in paragraph 4.39 in the Discussion Paper, stating that it is unclear what the expression 'payment of principal and interest shall be conditional' means (that is, whether it is a condition precedent to the formation of the obligation or a condition subsequent).

3.70 If the drafting clearly pointed to a condition subsequent to the formation of the obligation such that the obligation is existing but defeasible then it submitted that the only issue to consider is the anticipated valuation requirement in paragraph 974-20(1)(d).

3.71 The LCA submitted that the law is not administered in a manner consistent with the above distinction. It further states that this issue, together with subordination of a debt interest to the same priority as an equity holder, creates impediments to the issue of (regulated) debt instruments. The perceived need to issue specific regulations is an inefficiency in the capital markets for banks, insurance companies and potentially corporate taxpayers in that, it submitted, it may not be needed but is rather imposed, as a matter of practice.

Solvency clauses

3.72 ABA noted that APRA has placed restrictions on the ability of authorised deposit-taking institutions (ADIs) to raise certain debt like regulatory funding without the inclusion of solvency clauses. Where these restrictions are imposed, regulations have been enacted to ensure that entities regulated by APRA are able to issue regulatory capital that is debt for Division 974 purposes. While regulations have largely been successful, the specific nature of the regulations leave ADIs exposed to regulatory changes made by APRA and there is a consequential need to continually update the regulations for regulatory changes.

3.73 ABA recommended that, to give ADIs certainty, the existing regulation should be simplified so that solvency clauses in any Tier 2 capital instrument would not of themselves cause the instrument to fail the ENCO test.

3.74 TTI expressed the view that common types of solvency clauses should be covered by the 'ability or willingness' exception. In circumstances where an obligation to make a payment is dependent on the solvency of the debtor, it is clear that the only relevant event, condition or circumstance affecting this will be the debtor's "ability" to meet the relevant obligation. It said this conclusion is reinforced by section 95A of the Corporations Act 2001. Accordingly, where an issuer's obligation to make a payment is made contractually contingent on its solvency, the issuer's obligation to pay should remain non-contingent for the purposes of subsection 974-135(3). TTI indicated that it would welcome any amendment which clarified this position.

3.75 TTI noted that Regulations 974-135D (certain term cumulative subordinated notes) and 974-135E (certain perpetual cumulative subordinated notes issued by ADIs) should be extended to cover many instruments that contain solvency clauses.

3.76 The TTI's view is that major revision is not necessarily warranted as it might lead to unexpected changes in administrative views or practices.

Board's consideration

3.77 The Board acknowledges the uncertainty expressed regarding limited recourse debt during the consultation process. The Board recognises that an obligation does not cease to exist, or cease to be an ENCO, by reason only that the lender has recourse to a specific asset or pool of assets in the event of default by the borrower.

3.78 The Board considers that, depending on the facts and circumstances, there may be an ENCO to provide a financial benefit and the key question is whether the value of the financial benefit is likely to exceed the amount borrowed and associated obligations of the borrower (that is, it comes down to whether it is substantially more likely than not that the value provided will be at least equal to the value received and not the mere existence of an ENCO).[33] The fact that the repayment is limited to an asset should not by itself result in the arrangement not satisfying the debt test or being characterised as 'equity' under the debt and equity tax rules.

3.79 The Board is aware that drafting of limited recourse clauses in loan agreements has evolved over time, particularly in a project financing context. Company directors are increasingly trying to protect themselves from personal liability for insolvent trading and so limited recourse (or 'insolvent trading') clauses are used in loan agreements to help give effect to this protection. Commonly the clause will ensure that no legal obligation exists to be performed in the event that insufficient assets would be available to perform were it to exist. These clauses are generally used only if there is a sufficient pool of assets at inception.

3.80 Where an insolvent trading clause or traditional limited recourse loan clause has the effect of preventing or terminating the existence of an obligation, the loan agreement on its own will not give rise to an ENCO in respect of that obligation. However, when looked at in conjunction with the arrangements for the provision of a security over assets, that are unconditional, it may be accepted that an ENCO exists to provide a financial benefit. This is not an illustration of the ability or willingness carve out having any intended operation but rather a question of identification and valuation of the financial benefits to be provided to the lender in satisfaction of the loan.

3.81 The Board notes that the Regulations 974-135D, 974-135E and 974-135F cover a range of solvency clauses, however, not all. The Board also considers that it is inappropriate to rely on an ability or willingness carve out because that gives the ability or willingness carve out an operation that would allow other financing arrangements which have all the hallmarks of equity to be treated as debt for tax purposes contrary to the objects of Division 974.

3.82 The Board considers that whether a solvency clause prevents a finding that an ENCO exists lies in whether the clause destroys a payment obligation (that is, the

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

payment obligation no longer exists) or merely defers the point at which it can be enforced (that is, the payment obligation is still in existence but performance is deferred to a later time).

3.83 To ensure that the common commercial reality of limited recourse debt and provisions in debt agreements to prevent the borrower falling into an insolvent trading position do not give rise to uncertainty, and to reduce compliance costs for taxpayers and the ATO, the Board recommends that the legislation be amended to include a note to the effect that:

- of themselves, limited recourse and insolvent trading clauses in loan agreements do not prevent the existence of an ENCO being recognised; and
- clauses in loan agreements affecting the time at which an obligation to pay must be performed or can be enforced do not of themselves prevent recognition of an ENCO.

3.84 The insertion of this legislative note is particularly important in the context of the Board's view that the ability or willingness carve out is not intended to operate to save financing arrangements that are limited in recourse, or contain provisions to prevent insolvent trading from failing the debt test, and that such arrangements usually have an ENCO enabling their characterisation as debt interests under the provisions.

3.85 Given the range of factors that must be considered when applying the ENCO test to limited recourse debt and financing arrangements containing provisions to prevent insolvent trading, the Board considers that uncertainty around the application of the debt and equity tax rules could be addressed by the ATO providing additional guidance for taxpayers.

Recommendation 3

Consistent with the Board's view that the ability or willingness carve out is not intended to operate to prevent loans with limited recourse clauses or insolvent trading clauses from failing the debt test, and that such arrangements usually have an ENCO enabling their characterisation as debt interests under the provisions, the Board recommends that the legislation be amended to contain a note to the effect that:

- a clause which merely limits recourse to certain assets does not of itself prevent the recognition of an ENCO; and
- a clause which merely postpones the time of payment of an obligation where to make the payment would result in insolvency of the debtor does not of itself prevent recognition of an ENCO.

The Board notes the guidance provided by the ATO during this review and recommends that the ATO further update its administrative guidance, including worked examples, as to how it proposes to administer the rules.

Long-dated instruments with a limited obligation to pay

3.86 Division 974 does not contain any provisions that specifically modify the ENCO test for non-arm's length dealings between related parties (or connected entities).

3.87 The existence of an ENCO is established by reference to the pricing, terms and conditions of the scheme. The pricing, terms and conditions form an effective framework for appraising the substance or effect of an obligation where contracting parties act in their own best commercial interests to ensure those obligations are performed and take enforcement action if they are not.

3.88 However, where parties are not at arm's length the relationship of the parties may be such that a formal obligation which constitutes an ENCO need not be performed, or may be deferred for an extensive period (or indefinitely)[34] such that it cannot be said that the obligation will have any practical consequences for the issuer, unlike the same formal obligation as between unrelated parties.[35]

3.89 The consequence of having terms that in form establish an ENCO but which the issuer has no economic imperative to perform is that the debt test is less likely to be satisfied. However, such a characterisation will not reflect its substance where for example extended deferral of performance is permitted for periods that would not be acceptable to arm's length parties. In such cases, the interest may in substance be considered to be equity, despite its formal terms. Specific rules for parties who do not act at arm's length were proposed in the New Business Tax System (Debt and Equity) Bill 2001 as first introduced to Parliament, but did not proceed because it was felt that they were too widely drawn; they may have extended in their effect beyond the character of the interest to other matters, such as the relative amount of debt, that are dealt with by other parts of the Act.

Views in submissions

3.90 AVCAL noted that Division 974 does not contain any provisions that specifically modify the ENCO test for dealings with related parties (or connected entities). It submits that the related party nature of an instrument should not give rise to separate debt and equity rules nor specific rules in relation to the application of the existing debt and equity rules.

3.91 AVCAL submits that a single classification code should apply to instruments regardless of whether a particular interest is issued between related parties or arm's

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34 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.

35 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 2.181 refers to related parties who enter into formally biding obligations which are not obligations at all because failure to perform the purported obligation will have no practical consequences.

length parties. AVCAL is of the view that there are identifiable policy objectives for related party instruments to be subject to separate rules.

3.92 The reference to the terms and conditions of the scheme raises consideration of the contractual elements of the arrangements undertaken. This underscores the primacy of the legal and contractual obligations of the parties under the relevant scheme when considering if the ENCO test is satisfied. The mere fact that a particular instrument is issued between related parties should not diminish this fundamental aspect of the application of the ENCO test.

Board's consideration

3.93 The Board is of the view that the pricing, terms and conditions of a scheme is the appropriate framework for determining the substance or effect of an obligation. Establishing the way in which the obligations of an entity operate through a consideration of the 'pricing, terms and conditions' of a scheme is a fundamental design feature of the debt and equity rules. The Board does not consider supplementary rules are required to assist with this task.

3.94 The Board notes that the integrity of the test depends on parties behaving in an arm's length way in relation to the performance of the relevant obligations. Consequently it accepts that the current form of the test may give rise to inappropriate outcomes where that is not the case. Specifically, the test will not give rise to an appropriate outcome where a debt interest between related parties is enforced in a way that in substance treats it as an equity interest. Where related parties act in a manner that is inconsistent with the form of their obligations, or in a manner that is not consistent with how an arm's length party would act, the debt and equity rules should, in principle, treat this as a change to the operation of the scheme.

3.95 The Board considered, but rejected as ineffective, setting a maximum limit to the time in which an ENCO must be performed. It was thought that instruments would simply be rolled over at the limit. The Board thought that conceivably an appropriate approach to the problem would be to strengthen the specific anti-avoidance rule (specifically, section 82KK) that deals with timing arbitrages between deduction and assessable income or withholding tax, but this was a matter that was outside of the scope of the terms of reference.

3.96 A general arm's length terms substitution test may have effects that travel beyond the question of the appropriate characterisation of an interest for Division 974 purposes. A practical issue with such a test where the terms of a scheme are, on their face, at arm's length but are not being enforced, or where non arm's length extended deferral is permitted but not required by the terms of the scheme, is determining the point at which the character of the interest is to be re-evaluated and the consequences at that time. Accordingly, the Board does not recommend a general legislative change at this time. However, should evidence emerge of more widespread issues, legislative change could be warranted.

3.97 However, the debt and equity rules should in principle deal with omission to perform an ENCO between related parties where that failure is inconsistent with the circumstances in which parties acting at arm's length might reasonably be expected to require performance. The Board considers that this should be monitored and, if abusive practices are identified as a significant problem, then consideration could be given to addressing this integrity issue (if appropriate, through regulations under paragraph 974-135(8)(b) or through the material change provision).

Blank's case - the distinction between 'financing arrangement' and 'raising capital'

3.98 The concept of a financing arrangement is an integral part of both the debt and equity tests. For arrangements not involving the issue of shares to be either a debt or equity interest, it is necessary for that arrangement to be a financing arrangement. A financing arrangement is defined in subsections 974-130(1) and 974-130(2):

> **974-130(1):** A scheme is a financing arrangement for an entity if it is entered into or undertaken:
>
> a) to raise finance for the entity (or a connected entity of the entity); or
>
> b) to fund another scheme, or part of another scheme, that is a financing arrangement under paragraph (a); or
>
> c) to fund a return, or a part of a return, payable under or provided by or under another scheme, or a part of another scheme, that is a financing arrangement under paragraph (a).
>
> **974-130(2):** The following examples of schemes that are generally entered into or undertaken to raise finance:
>
> a) a bill of exchange;
>
> b) income securities;
>
> c) a convertible interest that will convert into an equity interest.
>
> Note: Paragraph (a) is likely to be relevant for debt interests, paragraph (b) for equity interests and paragraph (c) for both.

3.99 The meaning of 'financing arrangement' and related expressions such as 'to raise finance', as used in the definition of financing arrangement, had not received judicial comment until the Federal Court decision in *Blank*.

3.100 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 …[36]

3.101 Debt and equity interests, in their ordinary sense, are both seen as types of financial investments from the holder's point of view and as sources of funding from the issuer's point of view.

3.102 The absence of a financing arrangement requirement in both the debt and equity tests in respect of shares is founded on an assumption that share capital is a form of financing. The *Blank* decision casts significant doubt on this assumption.

3.103 Before the decision in *Blank*, this aspect of the law was not generally considered problematic. 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.

Views in submissions

3.104 AVCAL submitted that the Federal Court decision in *Blank* should be regarded as good law and the debt and equity tax rules should not be amended to counter the findings in that case.

3.105 It stated that the decision does not expose 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. Also, the decision in *Blank's* case does not detract from Division 974's goal of tax neutrality for instruments of the same substance but different legal form. The Court's view regarding the term 'raising finance' represents a considered position having regard to previous guidance issues in the Explanatory Memorandum introducing Division 974 and is an appropriate application of the income tax in the context of the specific circumstances in that case.

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

3.106 TTI submitted that an approach that does not distinguish between raising capital and raising finance should be maintained (as a distinction between raising finance and raising capital does not seem to have been in contemplation when Division 974 was enacted – as noted in paragraph 2.7 in the Explanatory Memorandum).

3.107 TTI also submitted that the distinction suggested by the Federal Court has caused confusion and uncertainty for taxpayers, tax administrators and tax practitioners alike. If uncertainty is unable to be resolved by administrative means, then consideration should be given to amending the definition of 'financing arrangement' by legislation to put it beyond doubt that it includes the raising of capital.

3.108 ABA submitted that the notion of a 'financing arrangement' is critical to Division 974 and the need is obvious because, without it, any incomplete transaction (that is, operating leases, software licensing arrangements etc.) could give rise to a debt interest (which is not appropriate). *Blank* casts doubt over the current drafting of this concept, particularly in relation to the characterisation of hybrid Tier 1 capital securities (usually equity under Division 974) and hybrid Tier 2 capital securities (usually debt under Division 974) issued by ABA members regulated by APRA.

3.109 ABA also submitted that the decision in *Blank* is inconsistent with both the regulations that have been issued on the assumption that such capital instruments involve raising finance and long-standing ATO practice. ABA submits that the distinction between whether the purpose of the arrangement was to raise capital or funding is not relevant to Division 974. Rather, the distinction between whether the purpose of the arrangement was to raise capital or funding should be considered as relevant to, notwithstanding a given result from the application of Division 974 whether the general anti-avoidance rules apply.

3.110 ABA's submission recommends that steps be taken to clarify the confusion and (i) retain some concept which serves the same function as the current term 'financing arrangement' but (ii) clearly re-instates the long-standing position that these hybrid instruments, even though issued for regulatory reasons, are a financing arrangement and do involve the raising of finance. In the event that this cannot be addressed by a public ruling by the ATO, legislative amendments should be made to Division 974.

Board's consideration

3.111 The Board is of the view that there should be no distinction between raising capital and raising finance for the purpose of Division 974. Further, it should not be necessary to consider what the money raised would be used for as an element of whether there is a financing arrangement. The mere availability of money raised, or the enhanced resources represented by the money raised, ought to be sufficient.

3.112 Further, in a system that calls for an analysis, and test, to be undertaken at the time an arrangement comes into existence, it is inappropriate to have tests that look into the future to predict uses of money for the purpose of characterising the

instruments by which that money was raised. Division 974 calls for an immediate characterisation of arrangements which involve raising of money, irrespective of its ultimate use, in accordance with the economic substance of the arrangement entered into.

3.113 Unless there is legislative change, the decision in *Blank* would render some arrangements entered into to raise money for corporate uses, neither debt nor equity interests. This would have the effect that returns on those arrangements might be non-frankable when the policy intent is that they be frankable as returns on non-share equity interests, or would be non-deductible when the intended outcome is that they ought to be deductible as returns payable on debt interests. Similarly, arrangements entered into to raise money might not be included in thin capitalisation calculations as either debt or equity, compromising the operation of the thin capitalisation regime.

3.114 The Board considers that a minimalist amendment could make it clear that a financing arrangement would include a scheme entered into or undertaken to raise or replace capital for the entity (or a connected entity).

Recommendation 4

The Board recommends that a legislative amendment be made to section 974-130 to make it clear that a financing arrangement includes a scheme entered into or undertaken to raise or replace capital for the entity (or a connected entity).

ACCOMMODATING CHANGE

Changes to pricing, terms and conditions

3.115 Section 974-110 is designed to prevent parties entering into a scheme which produces one tax characterisation under Division 974 and then changing the terms of the scheme so as to bring about a different substantive characterisation of the scheme.

3.116 As currently worded, section 974-110 requires a financing arrangement or share issue to be tested for debt or equity status whenever changes are made to the arrangement. The object of the provision being, if upon retesting the Division 974 debt or equity status changes as a result of the changes to the arrangement, then the arrangement is afforded the changed characterisation from the time of the change.

3.117 If the arrangement before the change was a debt interest, but would be an equity interest if it had come into existence at the time the change occurred, then the changed arrangement is to be recognised differently in accordance with its post change characterisation. The same applies for an equity interest which changes to debt.

3.118 Similarly, subsection 974-110(2) provides that a relevant change in characterisation can occur where a new scheme is entered into, which relates to an

existing scheme. If the existing scheme was an equity interest, but the schemes together (that is, the existing scheme and the new related scheme) would be a debt interest (if they had all come into existence when the scheme were entered into), then, from the time the new scheme is entered, the schemes together are treated for Division 974 purposes as a debt interest.

3.119 As mentioned above, where the characterisation of a scheme changes, the scheme (or combined schemes) is deemed to have come into existence when the change occurred. Division 974 is then reapplied to the scheme(s) on this basis. In this way, what was once an equity interest will become a debt interest or vice versa.

3.120 There are a number of inherent problems with the current implementation of this provision reflected in views in submissions and the Board's consideration below.

3.121 The three principal areas of difficulty are;

1. Firstly, the absence in the legislation of any specification of the types of changes that are required before any financing arrangement is re-tested against the Division 974 rules;

2. Secondly, the absence of a provision for changes to financing arrangements that are neither debt nor equity interests in the first place that would or could become debt or equity interests after the change occurs, and the converse situation where changes to debt or equity interests that would or could become neither after the changes occur; and

3. Thirdly, to what extent should the prior history of a scheme before the change occurs or before the related scheme is entered into, if at all, be included in the consideration of the scheme or related schemes after the changes occur or the related scheme is entered into.

Views in submissions

3.122 Deloitte submitted that the differing views regarding section 974-110 arise as a result of the confusion inherent in the language of the provision and the manner in which it interacts with the operative provisions of the debt and equity tests. When contemplating whether a change to a scheme (or schemes) is sufficient to result in a reclassification of an interest arising under that scheme from equity to debt (or vice versa)… it is unclear to what extent events that have happened in the past under the former scheme should be taken into account in ascertaining the effect of the scheme after the changes are made.

3.123 Deloitte noted that the Commissioner adopted a view in Private Binding Ruling (PBR) 43739 that 'the scheme as it exists immediately after the change cannot be explained without taking into account the unaltered terms and conditions…' The PBR also stated that 'events that occurred prior to the amendment… occur at the time the

amendment is made. It is this scheme which is taken to come into existence when the changes occur, and this is the relevant scheme'. Deloitte submits that it is unclear where the words of the applicable provisions or the relevant extrinsic materials the Commissioner finds support for this interpretation. It notes that the view set out in the Explanatory Memorandum conflicts with the Commissioner's view in the PBR.

3.124 Deloitte also submitted that there is a genuine need for either formal clarification of the Commissioner's interpretation of section 974-110 to a variety of circumstances, or, where the Commissioner acknowledges a deficiency in the provision, a legislative remedy to assist the rules in meeting their objects.

3.125 Deloitte also noted its concerns as to whether, on the occurrence of a change to a scheme (or schemes) a new benchmark rate of return (BRR) must be ascertained that reflects that change for the purposes of apply the debt test. It notes that it appears the words of the relevant provisions do not support an interpretation that the BRR used as part of the process of valuing financial benefits received or provided under a scheme for the purpose of the debt test should reflect the nature of the scheme at the time that the debt test is applied.

3.126 The BRR does not attach itself to the concept of scheme but rather to the test interest. It would appear that, in circumstances where a change is made to a scheme, in order for the BRR to reflect the revised nature of the new scheme taken to have come into existence when the change occurred, it must be arguable that this also gives rise to the issue of a new interest. Where the existing BRR is used to value financial benefits received or provided under a new scheme, this may give rise to anomalous outcomes where the risk profile of the new scheme has changed considerably in comparison to the former scheme. The same reasoning may also have a broader impact on whether financial benefits received or provided under a new scheme are to be valued in nominal or present value terms.

3.127 Deloitte also submitted that it is unknown whether the Parliament intended the operation of section 974-110 to compel a reconsideration of the BRR and/or the valuation of financial benefits in nominal or present value terms. Deloitte recommends that the Board undertake further consultation on the impact of section 974-110 with the goal of drafting an avoidance of doubt provision to reflect a settled view on the intended effect of that provision.

3.128 The ABA submitted that the need to retest under section 974-110 should be limited to material changes (for example, changes affecting the ENCO in respect of the financial benefits provided or received under the scheme).

3.129 The ABA also submitted that, when determining the present value of the financial benefits under section 974-35, the reference to the BRR used in the present value calculation under section 974-50 should be the BRR immediately before the

relevant instrument was actually issued, rather than at the time of any amendment to the terms of the instrument.

Board's consideration

Where the starting point or the ending point is neither debt nor equity

3.130 If the starting point is that there is a scheme which is neither a debt interest nor an equity interest, if a new scheme is entered into which is related to the original scheme, Division 974 will apply to the new schemes to test whether these related schemes give rise to a debt interest or equity interest. But this is achieved by application of subsections 974-15(2) or 974-70(2) respectively, and not by application of section 974-110.

3.131 However, where there is only one scheme that is characterised as neither debt nor equity under Division 974, and that scheme is changed, neither the related scheme nor the accommodating change provisions will apply.[37] Consequently, it is possible that newly related schemes considered in the preceding paragraph will be classified as debt or equity by Division 974, but an amended scheme can avoid classification under the Division even though the amended scheme is substantially identical to those related schemes.

3.132 Similarly, the provision does not apply if something, which is a debt interest or an equity interest, is changed such that the result is neither a debt interest nor an equity interest.[38] An anomalous illustration of the current operation of section 974-110 is an interest that is a non-share equity interest that has its terms changed such that it is neither a debt nor equity interest under Division 974. Such an interest may continue to give rise to frankable outgoings in circumstances where the substance of the financing arrangement after the change is not intended to give rise to that outcome.

3.133 In a setting where it is necessary to prevent manipulation of the rules by entering into one type of financing arrangement producing one outcome under the Act and changing its terms so as to produce an in substance different financing arrangement, it is anomalous that the section not cover the field with possible combinations of circumstances. As currently formulated, the section allows scope for manipulation where a financing arrangement that is neither debt nor equity is entered into but is subsequently changed to one which would be debt or equity. Similarly, it is anomalous that the section does not cover a circumstance where a financing arrangement that is debt or equity is subsequently changed to an instrument that is neither debt nor equity.

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37 For example, a long term low interest rate loan entered into at Time 0 (and is neither debt nor equity), varied to add a conversion option at Time 1 (not under a related scheme but as provided for under the original scheme). The current provision contemplates (subsection 974-110(2)) that a relevant change can arise from entering into a new related scheme as well as otherwise than from entering into a related scheme.

38 Assume the loan is issued with an option at Time 0 (an equity interest) but at Time 1 the conversion option is agreed to be excised, such that the remaining scheme is neither debt nor equity.

The latter circumstance leaves open potential for abuse in exploiting section 25-85 for what would otherwise be a non-deductible outgoing.

Changes which do not go to the substance of the debt/equity tests

3.134 Whenever there is any change to a scheme, section 974-110 calls for a test to be undertaken to determine whether the ongoing scheme continues to have the same character. The section does not identify what changes call for retesting - the unlimited language of the section compels a conclusion that any change to a scheme technically requires that course of action.

3.135 The debt test in particular looks at the provision of financial benefits and an ENCO to provide those benefits and when those benefits are to be provided. Those being integers used in the debt test, it is appropriate to re-test what starts life as a debt interest if any of those integers change. If, however, there are other changes not affecting these integers it may be seen as inappropriate, and unnecessary to undertake a retesting process if the financial matters concerning obligations to provide financial benefits are left unaltered.

3.136 If a financial arrangement is altered in a way that does not involve financial obligations and commitments, the current rules make it possible for such a change to cause a debt or equity test outcome to alter.

3.137 Similarly, it seems an unnecessary imposition to require a financial arrangement that is already characterised as a debt interest to be retested upon changes to pricing, terms and conditions which could only make the arrangement more debt-like. For example, it is an unnecessary imposition to retest where the changes to the pricing, terms and conditions of the financing arrangement are to remove discretions and/or remove conditions associated with the provision of financial benefits. For equity interests, it is an unnecessary imposition to require retesting of a financing arrangement that is an equity interest when changes are made that increase conditions or discretions associated with the provision of financial benefits.

3.138 The problem of inappropriate changes to debt and equity characterisation upon a retesting and the burden of unnecessary testing could be avoided by requiring retesting only when there are changes to the pricing, terms and conditions of the arrangement that are used in undertaking the debt or equity test and only where such changes are of a character contrary to the pre-existing character of the interest, for example, changes are made to a debt interest that are of an equity character and vice versa. For example, a change that results in an interest becoming more debt-like and vice versa should not warrant retesting.

3.139 This is consistent with paragraph 2.129 and 2.130 in the Explanatory Memorandum that the section is intended to address radical changes to the economic substance to a scheme.

The extent to which prior history and circumstances are relevant

3.140 The legislation does not provide for what, if any, prior history and circumstances associated with the financing arrangement are included in any testing to see whether the character of a debt or equity interest changes. If prior history is relevant then the term of the financing arrangement to be tested will differ from the term of a financing arrangement to be tested if the prior history was ignored. That can have an obvious effect on the valuation test required, namely whether it is undertaken in nominal terms or on a present value basis.

3.141 Similarly, if the valuation basis is present value, a BRR and an adjusted BRR are to be included in the analysis. If the prior history and circumstances are to be included in the analysis then the BRR and adjusted BRR will be determined prior to the date of change, and if the prior history and circumstances are ignored then the BRR and adjusted BRR would be determined at the date of change. It is readily apparent that those rates of return would usually differ. The difference can have an impact on the outcome of applying the debt test.

3.142 In the majority of circumstances, a changed financing arrangement has its origin in the original provision of finance or financial accommodation and the appropriate approach to substantive characterisation of the arrangement would seem to require an examination of the pricing, terms and conditions and structure of the financing arrangement over its entire life. Accordingly, it would be appropriate to test the ongoing financing arrangement after the changes are made to its pricing, terms and conditions on the basis that the ongoing arrangement was entered into at the time of entering the original arrangement and the history and circumstances relevant at that time ought also be used in the analysis.

3.143 Adopting such an approach would accommodate recognition of the term of the arrangement starting from the date of entering the original arrangement and BRR and adjusted BRR applicable at that time.

3.144 An integrity override is necessary to ensure that the modified rule is not misapplied.

Recommendation 5

The Board recommends that:

- The section should apply where the arrangement entered into before the changes are made to its terms are neither a debt nor equity interest, but after the changes could be such an interest, and, conversely, the section apply where the arrangement after the change to its terms is neither a debt nor equity interest whereas before the change it was such an interest.
- The section only call for retesting where the change is made to a term or condition that is incorporated in either or both the debt or equity tests and is of a nature that is contrary to the pre-existing characterisation of the financing arrangement. That is, retesting should not be required if the change is such as would tend to make a debt interest more "debt-like" or an equity interest becoming more "equity-like".
- Section 974-110 clarify that the primary testing approach for varied arrangements be that the original financing arrangement continues, and its prior history and factors relevant during that prior history, are to be incorporated in the debt or equity tests applied at the time of change. Further, there be an integrity rule preventing misapplication of the primary approach.

These changes would be assisted if section 974-110 were to have an introductory objects clause.

POSSIBLE NEW PROVISION FOR APRA-REGULATED ENTITIES

3.145 Regulations made under Division 974 have been used to specify what is and is not an ENCO for Division 974 purposes. These regulations have addressed the classification of certain Upper Tier 2 instruments issued by ADIs that were banks (discussed below),[39] Lower Tier 2 instruments issued by credit unions and building societies,[40] Redeemable Preference Shares (RPS),[41] term subordinated debt instruments containing 'solvency clauses'[42] and term subordinated notes issued by APRA-regulated entities.[43]

3.146 In 2003, the Government announced that Regulations would be developed for characterising Upper Tier 2 instruments issued by APRA-regulated entities so that they would not be denied Division 974 debt treatment merely because they complied with APRA requirements concerning payments to their holders.

3.147 For a variety of reasons, including the global financial crises, the Regulations were not made until 2011.

3.148 The experience in developing this regulation has prompted a number of APRA-regulated 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.

3.149 This approach would provide certainty in structuring capital raisings and result in more timely raisings.

Views in submissions

3.150 ABA submitted as follows:

- That there should be a legislative provision for entities regulated by APRA that aligns tax characterisation with prudential characterisation. It is also submitted that Tier 2 capital and Additional Tier 1 (AT1) capital should be tax deductible to ensure Australian banks (or an entity regulated for prudential purposes by APRA) remain internationally competitive.
- With regard to Tier 2 capital, that tax law amendments in response to changes in regulatory standards have tended to be limited and ad hoc in nature. ABA stated that whilst regulations (such as Regulations 974-135D,

39 Regulation 974-135E, ITAR 1997.
40 Regulations 974-135A and 974-135B, ITAR 1997.
41 Regulation 974-135C, ITAR 1997.
42 Regulation 974-135D, ITAR 1997.
43 Regulation 974-135F, ITAR 1997.

974-135E and 974-135F) have been implemented in an attempt to ensure that certain regulatory conditions of hybrid capital instruments do not preclude tax debt characterisation, these regulations do not deem the notes to be debt interests and further analysis is then required to be undertaken to confirm that the notes satisfy the debt test.

- It has concerns with Basel III regulatory changes in relation to 'contingent convertible securities' (CoCos). ABA submitted that Division 974 regulations should be extended to ensure Tier 2 instruments which contain capital triggers (such as non-viability clauses or breaching a capital ratio threshold) retain their debt interest characterisation. This would allow Australian banks to maintain their competitiveness internationally and increase financial stability in Australia. ABA stated that a number of issues arise when a change in the prudential requirements leads to a change in the characterisation of an instrument (which leads to inefficiencies as a result of the tax regulations being updated). ABA submits that, alternatively, a more efficient approach to provide banks with certainty would be to provide a legislative alignment whereby prudential Tier 2 instruments are treated as debt interests for tax purposes unless a contrary specific Regulation is made.

- The current rules treat AT1 capital instruments as equity interests for tax purposes and no tax relief arises for distributions on these instruments (notwithstanding that they are typically accounted for as liabilities). ABA states that Australian ADIs are at a competitive disadvantage to certain other international banks that are able to issue tax deductible AT1 capital in their home jurisdiction (jurisdictions such as the UK, Singapore, Japan, Netherlands, Italy, France etc. have confirmed the tax deductibility of AT1 capital). ABA submits that, in line with international developments relating to the tax treatment of regulatory capital, Australia should also move to allow AT1 capital to be tax deductible. It states that the UK legislation appears to be a good model for Australia to adopt.

Board's consideration

3.151 The Board met with a representative from APRA who advised that APRA will adopt what it considers to be appropriate policies based on prudential regulation considerations rather than taxation considerations.

3.152 The Board considers there are advantages in having a regulation stating that the inclusion of APRA-required features in a financing arrangement does not of itself prevent an obligation from being a non-contingent obligation.

3.153 This will avoid making regulations from time to time stating that particular APRA requirements do not prevent an obligation from being non-contingent. This would also provide increased certainty to the banking sector regarding the tax treatment of Tier 2 capital following any changes to APRA policies. It would also

reduce compliance costs for the banking sector as there would be less need to take tax considerations into account, or seek advice on likely future tax treatment, in decisions about the issuance of Tier 2 capital.

3.154 In the event that the revenue impact of a particular change to Tier 2 capital is unacceptable to Government, it would always be possible for the Government to make a regulation to counteract that outcome.

Recommendation 6

The Board recommends that a Regulation should be made that the inclusion of APRA-required features in a financing arrangement to satisfy the APRA characterisation as Tier 2 does not of itself prevent an obligation from being a non-contingent obligation.

PERPETUAL INSTRUMENTS

3.155 The debt test in Subdivision 974-B requires an assessment of whether it is substantially more likely than not that the financial benefits to be provided will be at least equal to the benefit received or to be received.

3.156 If the term of an instrument is more than 10 years, the value of the benefit must be calculated in net present value (NPV) terms. Subsection 974-50(4) provides a formula for calculating the NPV of the benefit provided by an instrument with a term of more than 10 years.

Views in submissions

3.157 ABA submitted that there are two issues with applying the NPV formula to perpetual instruments. In the first instance, the formula does not, in strict terms, apply to perpetual instruments.

3.158 The second issue relates to the determination of the BRR. ABA stated that the BRR, as an input to the statutory formula for a perpetual instrument, can be difficult to determine in circumstances where it is not a publicly offered instrument with the return payable determined by the market.

Board's consideration

3.159 Following discussions of the Working Group, the ATO has amended its guidance to the debt and equity tax rules on its website. The amendments clarify that the formula in subsection 974-50(4) can be approximated by the amount or value of financial benefits in nominal terms/adjusted BRR for a perpetual instrument.

3.160 The amendment[44] clarifies that:

> Where an instrument is perpetual it is mathematically impossible to apply the present value calculating formula in subsection 974-50(4) literally. Accordingly, where the value or the amount of the financial benefit on the perpetual instrument is the same for each year, the total value of the benefit on a present value basis can be approximated as amount or value of financial benefit in nominal terms/adjusted BRR.
>
> Because the number of returns on the perpetual instrument is indefinite, this approximation is a reasonable and intended application of the present value formula in subsection 974-50(4). It results in an appropriate reflection of a present value of a financial benefit provided on the perpetual instrument.

3.161 The Board commends the ATO's willingness to develop and update administrative guidance regarding the uncertainty with perpetual instruments.

WIDELY HELD INSTRUMENTS

3.162 The holder of an instrument (or its custodian) may not have complete information to assess whether it holds a debt interest or an equity interest. An inability to assess the debt or equity characterisation of an interest may lead to tax uncertainties. 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 interest. 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.

3.163 Issues related to applying Division 974 to widely held instruments could be reduced by issuers providing information to holders. The incentives for issuers to provide such information are aligned with the interests of holders via market mechanisms. There are also various processes in place for private or class rulings from the ATO which should enable issuers to obtain relative certainty about the tax treatment of particular instruments in a timely manner before providing information to holders.

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[44] The amendment can be found at: https://www.ato.gov.au/Business/Debt-and-equity-tests/In-detail/Guides/Debt-and-equity-tests--guide-to-the-debt-and-equity-tests/?page=4#Fifth_element___it_must_be_substantially_more_likely_than_not_that_the_value_of_the_financial_benefit_to_be_provided_will_be_at_least_equal_to_or_exceed_the_financial_benefit_received

CHAPTER 4: INTERACTIONS

INTRODUCTION

4.1 Division 974 does not apply for general purposes of the ITAA 1997. 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.

4.2 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 (these are known as 'intended interactions').[45]

4.3 There were significant developments in the tax law after Division 974 was introduced in 2001 (namely, the consolidation, Taxation of Financial Arrangements (TOFA) and Managed Investment Trust (MIT) regimes). Many of the rules introduced or modified were, depending on the purpose of a particular regime, intended to integrate the concepts from the debt and equity regime in Division 974 either partially or completely. These are known as 'subsequent interactions'.

4.4 There are areas of tax law where the debt and equity tax 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. These are known as 'non-interactions'.

General deductions

4.5 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

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45 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 Controlled Foreign Company (CFC) rules.

in the same way as interest on a loan for tax purposes.[46] 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; or
- the instrument is characterised as a debt interest in accordance with subdivision 974-B, and the return satisfies the general section 8-1 criteria, or is deductible under section 25-85.[47]

4.6 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;[48] and
- 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. 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.

4.7 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.

4.8 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

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

47 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.

48 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.

had raised.[49] 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.[50]

4.9 Similarly, returns on equity interests, such as dividends and non-share distributions, are frankable but non-deductible (discussed in the imputation section below).[51]

Views in submissions

4.10 Submissions did not comment on the debt and equity rules as they relate to general deductions.

Board's consideration

4.11 The Board is of the view that this area of law is operating as intended and does not require further attention at the present time.

Imputation — frankability

4.12 The imputation system alleviates double taxation of corporate profits as between 'corporate tax entities'[52] 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.[53]

4.13 Australian income tax paid by corporate tax entities can be passed on (or imputed) to 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).[54]

4.14 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

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49 Section 25-85, ITAA 1997.
50 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraphs 2.138 and 2.139.
51 Subsection 26-26(2), ITAA 1997.
52 Corporate tax entities are defined in section 960-115, ITAA 1997 as companies, corporate limited partnerships, corporate unit trusts and public trading trusts.
53 Sections 200-5 and 201-1, ITAA 1997.
54 Sections 200-5 and 201-1, ITAA 1997.

frankable distributions it has both received from subsidiaries or other corporate tax entities and made to its shareholders.[55]

4.15 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.[56] A non-share dividend is generally frankable if the instrument is an equity interest,[57] the return is a distribution that is not debited to the share capital account or non-share capital account,[58] the distribution does not exceed the available frankable profits,[59] and the ADI concession does not apply.[60] 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.[61] Whether the instrument is in the form of a share or not, imputation is not available if specific anti-avoidance provisions apply.[62]

4.16 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.

Imputation — integrity provisions

4.17 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.[63]

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55 Section 200-15, ITAA 1997.
56 Subdivisions 202-C and 215-A, ITAA 1997.
57 Paragraph 974-70(1)(a), ITAA 1997.
58 Sections 974-115 and 974-120, ITAA 1997.
59 Section 215-15, ITAA 1997.
60 Section 215-10, ITAA 1997.
61 Subdivision 215-A, ITAA 1997.
62 Section 202-45, ITAA 1997; sections 45, 45A and 45B, ITAA 1936.
63 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.

4.18 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; [64] 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.[65]

4.19 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.[66] The purpose of this integrity rule is to prevent manipulation of the imputation system, for example, through a form of franking credit trading involving residents and non-residents.

4.20 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.[67] Division 208 specifically excludes non-equity shares in determining whether an entity is effectively owned by non-residents.[68]

4.21 Section 215-10 of the ITAA 1997 provides an exception to franking requirements for Australian resident ADIs that issue Tier 1 capital at or through a permanent establishment. The section is intended to overcome a competitive disadvantage that would otherwise be imposed on Australian ADI's as a result of the debt and equity rules.

4.22 During a recent consultation with banking industry representatives, it was submitted that the view in the determination was causing significant and unintended practical problems for banks in legitimately gaining access to the concession provided by the section. The ATO then reviewed the determination.

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64 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.

65 http://www.budget.gov.au/1997-98/press/pr46.asp. 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.

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

67 Subdivision 960-G, ITAA 1997.

68 Section 208-30, ITAA 1997.

4.23 The ATO intends to issue a replacement determination in due course. The ATO has indicated that the replacement determination will take a considerably narrower view of the concept of 'issued'.

Consolidation

4.24 The consolidation regime was enacted shortly after Division 974.[69] 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.[70]

4.25 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.[71]

4.26 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'

4.27 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.[72] 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.

4.28 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.[73] The test for a 'membership interest' partially integrates the Division 974

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

70 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).

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

72 As noted in Chapter 6, these include thin capitalisation, imputation and withholding tax provisions.

73 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,

concepts: it adopts the concept of a 'debt interest', but does not have regard to non-share equity interests.

4.29 At the time the 'membership interest' test was enacted, it was considered that debt interests (such as many redeemable preference shares) and certain non-share equity interests (such as many convertible notes) generally do not establish control in an entity.[74] Debt interests are specifically carved out from the 'membership interest' test without exception. Under the test, each interest by virtue of which its holder is a member of a company, trust or partnership is a membership interest.[75] 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).[76]

4.30 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).

4.31 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 the consolidated group without causing a deconsolidation. They also cause difficulties in the application of the imputation rules for exempting and former exempting entities.[77]

4.32 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;

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).

74 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, at paragraphs 3.68 and 3.70, and A Tax System Redesigned, Recommendations 12.11 and 15.2(a)(i).

75 Section 960-130, ITAA 1997.

76 Section 960-130(3), ITAA 1997.

77 Division 208, ITAA 1997.

- 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);[78] 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.

4.33 Changes to the membership interest test, as opposed to changes to the debt and equity rules, fall outside the scope of this review. Further, the Board does not consider that a case has been made out that the best solution to interactions between consolidation and debt and equity rules would be to amend the debt and equity rules. Accordingly, the Board notes the above issue for potential consideration by any future review of the consolidation provisions.

Membership in the consolidation regime

4.34 In order to form a consolidated group, a company and its subsidiaries must meet membership requirements in the consolidation regime.[79] For instance, the head 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.[80] 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.[81]

4.35 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, film or net capital losses.[82] 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.[83]

4.36 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.[84] As noted above, membership interests for these purposes are based on legal

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78 Division 165, ITAA 1997.
79 Sections 703-10 and 703-15, ITAA 1997. There are also special rules for MEC groups in Division 719, ITAA 1997.
80 See Item 1 of the Table in subsection 703-15(2), ITAA 1997.
81 Ibid; section 703-30, ITAA 1997.
82 Section 701-1, ITAA 1997.
83 Subsection 703-15(2) and section 703-30, ITAA 1997.
84 Section 703-30 and 960-130, ITAA 1997.

form and not Division 974 concepts, and debt interests are specifically carved out from the membership concept.[85]

4.37 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 the group.

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

4.39 Another example of a 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.[86]

4.40 The Board notes the above issues for potential consideration by any future review of the consolidation provisions.

GST grouping

4.41 The consolidation rules draw on Division 974 and exclude debt interests in determining membership interests for a tax consolidated group. By contrast, the GST grouping rules reference voting power, dividends and capital distributions to determine the boundaries of a GST group. This difference can result in different groups for GST compared to other taxes.

Views in submissions

4.42 A confidential submission stated that a group that is consolidated for income tax purposes may have to be administered as two or more separate GST groups and the separate GST sub-groups would be required to raise tax invoices and account for the transaction between these groups, including payment of GST and related cash flow consequences for the two sub-groups.

4.43 As an alternate solution, the confidential submission proposed that the current membership requirements to form a group for GST purposes be extended to also include members of the same consolidated group for income tax purposes. The confidential submission noted the advantage of being able to assess their relevant instruments uniformly.

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

86 Refer to the 'Accommodating change' section in chapter 4.

Board's consideration

4.44 The Board notes this issue for possible consideration by any future review of the consolidation provisions.

Thin capitalisation

4.45 The general policy behind the thin capitalisation rules is to maintain the integrity of Australia's tax base, by preventing multinational enterprises 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.[87]

4.46 'Debt capital' is a defined term.[88] 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.[89] 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.

4.47 The thin capitalisation rules generally disallow an amount of the debt deduction that an entity that is not an 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.

4.48 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 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.

Views in submissions

4.49 The submissions to the Board did not express any views on the interaction of the debt and equity tax rules with the thin capitalisation provisions.

Board's consideration

4.50 The Board observes that certain forms of legal indebtedness may be neither a debt interest nor an equity interest under Division 974. Amounts in the nature of interest paid in respect of this indebtedness will generally be deductible under section 8-1 if they possess the necessary nexus with the gaining or producing of assessable income.

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87 Section 820-30, ITAA 1997.
88 Section 995-1, ITAA 1997.
89 Paragraph 974-55(1)(e), ITAA 1997.

4.51 The thin capitalisation provisions do not apply to such section 8-1 deductions nor take into account the indebtedness in the calculation of maximum allowable debt for interests that are not formally characterised as debt interests under Division 974. The former is because the definition of 'debt deductions' applies only to costs incurred in relation to debt interests, and the latter because the definition of 'debt capital' only includes debt interests.

4.52 The Board is of the view that the thin capitalisation provisions should apply to all deductions in respect of debt, whether or not technically in respect of debt interests. The thin capitalisation provisions may be circumvented by the use of forms of financial accommodation whose cost is deductible under section 8-1 but fall outside the definition of debt interest.

4.53 The Board considers that two legislative amendments could be made to address this problem. First, the definition of 'debt deduction' could be altered to ensure that any deduction for an amount in the nature of interest is a debt deduction even if it is not technically in respect of a debt interest. Secondly, the definition of debt capital could be changed to refer to any form of indebtedness the cost of which is, or would be, a debt deduction within the amended definition.

4.54 The Board has informed Treasury that entities may use instruments that are classified as neither debt nor equity to fund their Australian operations and such instruments are not addressed under the thin capitalisation rules. This could potentially lead to the erosion of the Australian tax base.

Recommendation 7

The Board recommends that:

- the thin capitalisation provisions should be amended so that any deduction for an amount in the nature of interest or for corresponding deductions under Division 230, whether technically in respect of a debt interest or not, should be treated as a debt deduction; and
- the definition of debt capital should be changed to refer to any form of indebtedness, the cost of which is, or would be, a debt deduction.

Dividend and interest withholding tax

4.55 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 tax on Australian sourced income.[90] 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.[91]

4.56 The dividend withholding tax (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.[92] 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.[93] Australia commonly imposes withholding tax on dividends at a rate of 30 per cent of the gross dividend, subject to double tax agreements.[94]

4.57 DWT will not be payable on the franked component of a dividend paid to a non-resident investor,[95] or where the dividend represents conduit foreign income. Other exemptions may also apply to former exempting entities[96] 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).[97]

4.58 The interest withholding tax (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 Australian resident companies or non-resident companies with Australian permanent establishments.[98] 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.[99] Australia commonly imposes withholding tax on interest at a rate of 10 per cent of the gross interest,[100] subject to double tax agreements.[101]

4.59 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:

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90 Refer to Review of Business Taxation — A platform for consultation — Discussion Paper 2 — Building on a Strong Foundation, February 1999, p. 635.
91 Ibid.
92 Section 128B, ITAA 1936.
93 Sections 128B, ITAA 1936 and 12-210 of the Schedule 1 to the Taxation Administration Act 1953.
94 Regulations 40 and 41, Taxation Administration Regulations 1976.
95 Subsection 128(3)(ga), ITAA 1936. The exemption will not operate if the debt overlay in section 128B(3A), ITAA 1936 applies.
96 Subparagraph 128B(3)(ga)(ii) and (iii), ITAA 1936.
97 Paragraph 128B(3)(aaa), ITAA 1936 and section 215-10, ITAA 1997.
98 Section 128B, ITAA 1936.
99 Ibid.
100 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.
101 Regulation 41, Taxation Administration Regulations 1976.

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

4.60 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.[102] Consistent with the general policy objective of Division 974, the use of debt and 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.

4.61 Returns on non-share equity interests[103] are subject to DWT in the same way as dividends on ordinary shares.[104] 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.[105] 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.

4.62 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 (for example, a 'repo' transaction which is in substance debt).[106] The Australian tax law simply requires a determination of whether something is 'interest' or 'in the nature of interest', which generally requires an examination of common law definitions for the meaning of interest.

Views in submissions

4.63 The submissions to the Board did not express any views on the interaction of the debt and equity tax rules with the dividend and interest withholding tax provisions.

Board's consideration

4.64 Upon consideration of the interaction of the debt and equity tax rules and the withholding tax provisions, the Board has reached a view that the complexities of any

102 Explanatory Memorandum to New Business Tax System (Debt and Equity) Bill 2001, paragraph 3.6.
103 Other than returns paid from the share capital account or the non-share capital account of the issuer.
104 Subsection 128AAA(1), ITAA 1936.
105 Subsection 128A(1AB), ITAA 1936.
106 Ibid.

recommendation for the change to the rules would outweigh the benefits of such a change.

4.65 The Board acknowledges that the operation of certain provisions in the withholding tax regime, such as, for example, section 128AA of the ITAA 1936,[107] has potential to disturb the clear dividing line between the DWT and IWT, which was intended by the use of debt and equity concepts in the withholding tax regime. The potential for some instruments to impinge on the dividing line between the DWT and IWT does not currently present an urgent case for legislative amendment.

4.66 The Board's analysis also confirmed that some returns on debt interests are not subject to withholding tax. However, the Board concluded that any recommendation to address this would involve a wider review of the withholding tax regime and would involve a range of wider considerations than the intended dividing line between IWT and DWT. The Board understands that it was always intended that some returns on debt interests would not be subject to the withholding tax provisions.

4.67 Accordingly, the Board does not recommend any change in this area. The use of debt and equity concepts in the withholding tax regime, therefore, in the main achieves the clear dividing line which was intended.

Observation 1

The Board considers that the use of debt and equity concepts in the withholding tax provisions generally achieves their intended objectives and no amendment is required to these provisions.

The 'new' subdivision 768-A and its interaction with the CFC provisions

4.68 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. The amendment would have the effect of eliminating the exemption for dividends received on interests that are legal form shares but qualify as 'debt' under Division 974 (for example, mandatory redeemable preference shares or redeemable preference shares).

4.69 The result of this announcement was the enactment of the new subdivision 768-A in 2014, which seeks to exempt from Australian tax returns on interests that are 'equity' interests under Division 974.

107 Returns on qualifying securities that are equity interests could be subject to either IWT or DWT, depending upon their form. This section could be amended such that it did not apply to qualifying securities that are equity interests.

4.70 There is a view that the revision and re-enactment of the foreign non-portfolio dividend exemption in subdivision 768-A has created a potential hybrid mismatch in the domestic Australian tax law.

4.71 One of the key points of differences is that section 23AJ did not extend non-assessable non-exempt (NANE) income treatment to distributions on non-share equity interests. However, subdivision 768-A does extend NANE income treatment to qualifying equity distributions. This includes non-share dividends paid on non-share equity interests.

Views in submissions

4.72 The submissions to the Board did not express any views on whether the Australian domestic tax law, in particular the repealed section 23AJ or new subdivision 768-A exemption provisions, constructs or creates significant arbitrage opportunities.

Board's consideration

4.73 The Board has observed that the controlled foreign company (CFC) provisions disregard Division 974 in the calculation of the attributable income of a CFC. As a result of this non-interaction, it may be possible that an Australian resident corporate tax entity could receive a foreign equity distribution in the form of non-share dividends on non-share equity held in a CFC. Such distribution would be NANE income under subdivision 768-A. The same distribution could be treated as a notional allowable deduction on the basis that the non-share equity interest is debt in legal form and the provisions of Division 974 are disregarded in determining the attributable income.

4.74 The Board considers that the mismatch could be removed by an amendment which disallows the notional allowable deduction in respect of the distribution where subdivision 768-A applies (or would apply to the recipient). There may be some timing issues with this proposal on the basis that subdivision 768-A applies on a cash basis while the notional allowable deduction may be claimed on an accruals basis.

4.75 An alternative approach may be to exclude from subdivision 768-A any distribution in respect of which a notional allowable deduction has been claimed in calculating the attributable income.

4.76 Treasury has been advised of this potential mismatch and has informed the Board that it intends to revisit the interaction between subdivision 768-A and the CFC rules at the completion of the OECD Base Erosion and Profit Shifting (BEPS) process. This is on the basis that subdivision 768-A was originally being developed in conjunction with the re-write to the CFC provisions, which were put on hold while the OECD BEPS project is developing an international standard for these rules.

Recommendation 8

The Board considers that the interaction of the new subdivision 768-A and the CFC rules should be considered by Treasury as soon as practicable.

Chapter 5: International taxation

5.1 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.

5.2 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.

5.3 Often 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 Subdivision 768-A.

5.4 As noted in the discussion paper, the Board recognises that there is a correlation between its review of the debt and equity tax rules and the OECD/G20 review of hybrid mismatch arrangements as part of its broader BEPS review. That being said, the Board's review has predominantly focused on the domestic debt and equity tax rules.

Views in submissions

5.5 Stakeholders generally agreed that Australia has appropriate debt and equity tax rules that are supported by robust tax integrity rules, including anti-avoidance rules to deal with any tax arbitrage or hybrid issues. Given the parallel work being conducted by the OECD/G20, stakeholders also suggested not proceeding with this part of the review until there is more clarity about the outcomes from the OECD/G20.

5.6 Stakeholders also noted that any action taken to address hybrid mismatch arrangements needed to be on a multilateral basis and that difficulty will arise if countries tried to tackle these issues unilaterally (for example, double taxation).

5.7 The LCA submitted that the introduction of any tax arbitrage rules in Australia would need to be framed in conjunction with our trading partners to ensure they are effective. The LCA noted that such rules should not ordinarily alter the debt and equity character of finance instruments (subject to the details of any specific rules). If it is deemed necessary to make changes to our rules, the LCA suggested that a transitional rule is needed to preserve the existing treatment for existing financial arrangements.

5.8 The LCA noted the difficulty of changes occurring on a unilateral basis without giving rise to the potential to create double taxation. It is preferable that any changes occur on a multi-lateral basis. If bi-lateral, then it should focus on jurisdictions that seek to give rise to the highest tax risk.

5.9 PwC noted the risks associated with the OECD/G20 review. Specifically, it noted that there is a risk of inconsistencies emerging as countries push back on proposed changes which are inconsistent with national interests. It also signified that there is a real danger of increased instances of double taxation and disputes with revenue authorities across the globe and that international trade and investment could be hampered.

5.10 Similar to other submissions, PwC recommended caution in dealing with these issues, particularly if unilateral action were to be taken. It also submitted that Australia has a comprehensive tax regime, which includes a general anti-avoidance regime, that sufficiently deals with hybrid mismatch arrangement concerns.

5.11 AVCAL submitted that Australia should not seek to disturb the operation of Australia's domestic debt and equity tax rules by having regard to how instruments are taxed in the jurisdiction of the holder. To the extent that perceived tax arbitrage arises in an overseas tax jurisdiction, AVCAL submits that addressing that in Australia as the issuer jurisdiction would undermine the achievement of the policy intent and objective of Australian tax legislation.

5.12 AVCAL stated that adoption of such an approach would create uncertainty in the operation of the Australian debt and equity tax rules. It stated that it would also inevitably require Australian taxpayers to analyse and consider the corresponding foreign tax treatment adopted by overseas jurisdictions in respect of the holder of the instrument.

5.13 If such an approach were to be adopted, AVCAL noted that it would create significant uncertainty and complexity, particularly for inbound investors into Australia, and increase the risk of double taxation. In this respect, AVCAL submitted that the better approach to address international arbitrage could be for the overseas jurisdiction (as the holder jurisdiction) to introduce specific rules which apply to the holder of the relevant instrument.

5.14 Of a similar view, Ernst & Young (EY) recommended against wide-ranging policy initiatives in respect of hybrid securities pending OECD/G20 actions underway. EY submitted that the issue of hybrid securities and cross-border hybrid tax treatment mismatches between Australia and other tax jurisdictions' debt and equity tax rules should be left to the OECD and G20 BEPS process.

5.15 EY noted that cross border tax mismatches will always arise as a natural result of each jurisdiction enacting their own tax laws. Such differences may result in legitimate arbitrage opportunities in line with decisions taken by a jurisdiction to support or

promote business in their country including to help local businesses compete internationally.

5.16 EY submitted that Australian action in isolation to the wider international approach is dangerous for Australia as a capital importing country. EY state that it would be 'quite inappropriate' for Australia to entertain options which might be inconsistent with international policy thinking. It further stated that for Australia to be inconsistent could be counter to our national interest, if it meant denial of interest deductions in bona fide transactions by public and other widely held entities that have tax exempt foreign investors.

BOARD'S CONSIDERATION

5.17 The Board recognises that, as a net capital importer, foreign investment plays an important and beneficial role in the Australian economy. It provides additional capital for economic growth, creates new employment opportunities, improves consumer choice and promotes competition. The Board also notes that Australia's competitiveness and productivity can be improved by introducing new technology, infrastructure, access to global supply chains and markets while enhancing our skill base.

5.18 The Board observes that the OECD/G20 is predominantly concerned with double non-taxation or very low effective tax rates. A view has been expressed that, in some respects, tax competition giving rise to (reasonable) arbitrage opportunities is 'healthy' provided that non-residents and residents are treated equally in the relevant country (thereby respecting a country's sovereign choices and allowing tax policy to influence investment choices to a degree). This respects a country's sovereign choices and allows tax policy to influence investment choices to a degree.

5.19 The Board is of the view 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.

5.20 The Board also understands that Australia has one of the most robust tax regimes amongst OECD member countries. Specific rules have been introduced to protect Australia's ability to exercise its jurisdiction to tax. The rules have been further strengthened by recent reforms to transfer pricing and the general anti-avoidance rule in Part IVA.

5.21 The Board is of the view that the Australian debt and equity tax rules are fundamentally different to tax rules in other jurisdictions. Despite the differences, the Board considers that the Australian debt and equity tax rules do not, in and of themselves, create international arbitrage opportunities such that the domestic rules should be amended to address these potential mismatches.

5.22 It is acknowledged that this area is currently the subject of review by the OECD/G20, with a preliminary report having been released outlining the proposed recommendations.

5.23 The preliminary report recommends that countries should adopt standard definitions of structured arrangements, related parties, distributions, and other basis terms so that the rules will operate the same in each country, and then sets out a model rule that would require the deduction to be 'switched off' where related parties create a hybrid mismatch under a structured arrangement.

5.24 The recommendations, if adopted and enacted, would require the deduction to be switched off in respect of non-equity shares where the recipient has more than a 25 per cent interest (or is in the same control group). Conversely, the participation exemption would be switched off for the recipient if the source country failed to disallow the deduction. At present, the Australian Government has not made any announcements that the recommendations of the OECD/G20 would be adopted.

Observation 2

Changes to the domestic debt and equity tax rules to address any inconsistencies between Australia's and other jurisdiction's debt and equity tax rules may be required depending on the Government's response to the recommendations of the OECD/G20.

GLOSSARY

ABA	Australian Bankers' Association Inc
ADI	Authorised Deposit-taking Institution
APRA	Australian Prudential Regulation Authority
ATO	Australian Taxation Office
AVCAL	Australian Private Equity & Venture Capital Association Limited
BEPS	Base Erosion and Profit Shifting
BRR	Benchmark Rate of Return
CFC	Controlled Foreign Company
Commissioner	Commissioner of Taxation
DTA	Double Tax Agreement
DWT	Dividend Withholding Tax
G20	The Group of Twenty
GST	Goods and Services Tax
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
IWT	Interest Withholding Tax
LCA	The Taxation Committee of the Business Law Section of the Law Council of Australia
MIT	Managed Investment Trust
NANE	Non-assessable Non-exempt
NPV	Net Present Value
OECD	Organisation for Economic Co-operation and Development

PCA	Property Council of Australia Limited
TOFA	Taxation of Financial Arrangements
TR	Taxation Ruling
TTI	The Tax Institute
UK	United Kingdom
US	United States

APPENDIX A: SUMMARY OF RECOMMENDATIONS AND OBSERVATIONS

RECOMMENDATION 1

The Board recommends that subsection 974-135(3) is amended to clarify the ability or willingness carve out. The Board recommends that the ability or willingness carve out should be expressed so as to ensure that an inability or unwillingness to perform an obligation when due does not of itself make an obligation contingent within the meaning of subsection 974-135(3).

RECOMMENDATION 2

Consistent with the Board's view that the ability or willingness carve out is not intended to operate to prevent financing arrangements that have associated subordination arrangements from failing the debt test, and that such arrangements usually have an ENCO enabling their characterisation as debt interests under the provisions, the Board recommends that the legislation be amended to include a note to the effect that subordination arrangements merely affecting priorities of creditors do not prevent the existence of an ENCO being recognised as between lenders and borrowers.

The Board also recommends that the ATO further update its administrative guidance, including worked examples, as to how it proposed to administer the rules.

RECOMMENDATION 3

Consistent with the Board's view that the ability or willingness carve out is not intended to operate to prevent loans with limited recourse clauses or insolvent trading clauses from failing the debt test, and that such arrangements usually have an ENCO enabling their characterisation as debt interests under the provisions, the Board recommends that the legislation be amended to contain a note to the effect that:

- a clause which merely limits recourse to certain assets does not of itself prevent the recognition of an ENCO; and
- a clause which merely postpones the time of payment of an obligation where to make the payment would result in insolvency of the debtor does not of itself prevent recognition of an ENCO.

The Board notes the guidance provided by the ATO during this review and recommends that the ATO further update its administrative guidance, including worked examples, as to how it proposes to administer the rules.

RECOMMENDATION 4

The Board recommends that a legislative amendment be made to section 974-130 to make it clear that a financing arrangement includes a scheme entered into or undertaken to raise or replace capital for the entity (or a connected entity).

RECOMMENDATION 5

The Board recommends that:

- The section should apply where the arrangement entered into before the changes are made to its terms are neither a debt nor equity interest, but after the changes could be such an interest, and, conversely, the section apply where the arrangement after the change to its terms is neither a debt nor equity interest whereas before the change it was such an interest.

- The section only call for retesting where the change is made to a term or condition that is incorporated in either or both the debt or equity tests and is of a nature that is contrary to the pre-existing characterisation of the financing arrangement. That is, retesting should not be required if the change is such as would tend to make a debt interest more "debt-like" or an equity interest becoming more "equity-like".

- Section 974-110 clarify that the primary testing approach for varied arrangements be that the original financing arrangement continues, and its prior history and factors relevant during that prior history, are to be incorporated in the debt or equity tests applied at the time of change. Further, there be an integrity rule preventing misapplication of the primary approach.

These changes would be assisted if section 974-110 were to have an introductory objects clause.

RECOMMENDATION 6

The Board recommends that a Regulation should be made that the inclusion of APRA-required features in a financing arrangement to satisfy the APRA characterisation as Tier 2 does not of itself prevent an obligation from being a non-contingent obligation.

Recommendation 7

The Board recommends that:

- the thin capitalisation provisions should be amended so that any deduction for an amount in the nature of interest or for corresponding deductions under Division 230, whether technically in respect of a debt interest or not, should be treated as a debt deduction; and
- the definition of debt capital should be changed to refer to any form of indebtedness, the cost of which is, or would be, a debt deduction.

Recommendation 8

The Board considers that the interaction of the new subdivision 768-A and the CFC rules should be considered by Treasury as soon as practicable.

Observation 1

The Board considers that the use of debt and equity concepts in the withholding tax provisions generally achieves their intended objectives and no amendment is required to these provisions.

Observation 2

Changes to the domestic debt and equity tax rules to address any inconsistencies between Australia's and other jurisdiction's debt and equity tax rules may be required depending on the Government's response to the recommendations of the OECD/G20.

APPENDIX B: LIST OF PUBLIC SUBMISSIONS

Australian Bankers' Association Inc

Australian Private Equity & Venture Capital Association Limited

Chartered Accountants Australia and New Zealand

CPA Australia Ltd

Deloitte

EY

The Law Council of Australia

Pitcher Partners

Property Council Australia Limited

PwC

The Tax Institute

In addition, the Board received two confidential submissions