

AGENDA ITEM III : TAXATION OF THE FINANCIAL SECTOR – INSTRUMENTS AND INTERMEDIARIES

Michael D'Ascenzo Commissioner Taxation (Australia)¹

WHAT ROLE IS PLAYED BY COMMON AND FUNDAMENTAL DISTORTIONS IN THE TAX TREATMENT OF DEBT VERSUS EQUITY?

The textbook approach to these issues is that debt is cheaper than equity because interest is deductible (and can therefore be serviced out of pre-tax earnings) and dividends are not (and thus must be paid out of post-tax profits); and because equity participants take a higher risk than lenders because investors can lose their money while lenders always seek to ensure they protect the assets and cashflows to ensure they get their money back. With tax effected at the Australian company tax rate of 30%, a 7.5% interest rate reduces to an effective after tax rate of 5.25%. The lower risk of the lender is reflected in the lower reward (the interest rate reflecting the time value of money and the credit risk of the borrower) while the equity participant gets all the (any) economic upside. Tax bias in favour of debt can also be reflected in the fact that bad debts may be able to be written off and be tax deductible on revenue account whereas equity losses are on capital account and are unlikely to be reflected as a deferred tax asset on balance sheets (unlike revenue losses).

The administrative difficulties presented by this bias are reflected in issues relating to transfer pricing, debt creation, thin capitalisation, TOFA (Taxation of Financial Arrangements), exempt dividends and the quantification and timing of income and expense streams of financial intermediaries and others using such strategies.

Distortions in the tax treatment between debt and equity create opportunities for arbitrage. Questions often arise as to the effectiveness of some arrangements that seek tax benefits from this dichotomy.²

However it is important to note that debt funding has quite a few advantages that are not tax driven (eg money can be placed and retrieved quickly; flows can take place in cases where losses would prevent dividend flows; Government restrictions on capital movements can be overcome; the greater the use of debt the greater ipso facto the return on equity). Accordingly, it is not at all clear that tax neutral treatment of debt and equity would totally compensate for the bias towards debt. And deductible dividends could be used as a means of stripping profits.

One answer might be to maintain the current market based dichotomy while ensuring that a company or branch operating in one's jurisdiction maintains sufficient equity in the jurisdiction to cover the level of business investment risk (ie the possibility of losses being incurred) so the company or branch can remain viable.³

¹ The contribution of Mr R. Brookes and Mr J. Killaly to this paper is acknowledged

² See for example the Australian Taxation Office (ATO) public ruling TR 2002/15 Income Tax: deductibility of payments incurred on moneys raised through the issue of perpetual notes; and TR 2002/16 Income Tax: the taxation consequences for taxpayers issuing certain stapled securities. Note also TR 2008/3 Income Tax: debt/equity – identification of any 'effectively non-contingent obligation' of an issue of a convertible note to provide 'financial benefits' for the purposes of Division 974 of the *Income Tax Assessment Act 1997 (ITAA 1997)* if the note can be converted at any time at the issuer's discretion into shares that are the equity interests in the issuer company. Also refer to Taxpayer Alerts TA 2009/2 – Certain cross-boarder Prepaid Forward Purchase Agreements and TA 2009/9 – Continued Cross-boarder arrangements that seek to generate tax deductions for non-assessable non exempt income.

³ See for example, KPMG International, 'Frontiers in Tax ': Adapting to the new era in Financial Services, June 2009, at p12.

Common and fundamental tax distortions:

The Australian Government, as early as 18 August 1992,⁴ identified distortions between the tax and capital market treatment of financial arrangements and sought to address these through the issue of a series of ongoing consultative papers⁵ and exposure drafts of legislation to industry, under the umbrella of the reform of the Taxation of Financial Arrangements (TOFA).⁶

These pre TOFA distortions were not limited to debt and equity characterisation, but extended to tax distortions in debt and equity's returns (interest, dividends, gains & losses), tax character (capital vs revenue) and tax timing (realisation and accruals) and included:

- if debt and equity are characterised for tax purposes on their legal form, labels can be persuasive, and this can lead to a situation where arrangements which have the same economic substance in the markets are treated differently for tax purposes;⁷
- whilst interest on debt and dividends are assessable, dividends may also be frankable and rebateable; interest on debt used for income producing purposes is deductible while dividends are not deductible;
- the full nominal value of the gain or loss to the holder from disposal of debt instruments were generally taxed on revenue account, whilst only the real gain or loss from the disposal of equity was generally taxed on capital account;⁸
- the timing of the recognition of interest under the law was different to that of dividends, the former sometimes being assessed on an accruals basis and the latter on a realisation basis;
- interest withholding tax rates were different to dividend withholding tax rates, whether or not a double tax treaty applied to cross border payments.

Attempts were made pre TOFA to address these tax distortions

- for a number of years courts dealt with one off divergences between legal form and economic substance occasionally having regard to the terms and conditions of issue;⁹
- a body of piecemeal specific anti-avoidance provisions also built up to address specific financial products which took advantage of this non alignment;¹⁰

⁴ Refer 1992-93 Budget announcement.

⁵ Commonwealth Treasury, Taxation of Financial Arrangements, A Consultative Document, December 1992; Commonwealth Treasury, Taxation of Financial Arrangements, An Issues paper, December 1996; Review of Business Taxation, A Platform for Consultation, Building a Strong Foundation, February 1999; Review of Business Taxation, A Tax System Redesigned, Report July 1999.

⁶ TOFA comprised 4 stages - Stage 1 – Debt and Equity – date of effect 1 July 2001; Stage 2 – Foreign Exchange Gains & Losses – date of effect 1 July 2003; Stage 3 – Hedging – mandatory date of effect for relevant taxpayers 1 July 2010 (optional early elect in date 1 July 2009); Stage 4 – Tax timing – mandatory date of effect for relevant taxpayers 1 July 2010 (optional early elect in date 1 July 2009).

⁷ For example, pre TOFA, vanilla redeemable preference shares were equity, irrespective of the fact that they were economically equivalent to a bond. Perpetual profit contingent notes were claimed to be debt, irrespective of the fact that in the hands of the issuer they were treated as permanent capital as the issuer could defer payment of the profit contingent returns and principle until a winding up.

⁸ Commonwealth Treasury, Taxation of Financial Arrangements, Issues Paper, December 1996, at 23. Richard Wood, Commonwealth Treasury, 'The Taxation of Debt, Equity and Hybrid Arrangements', 1998, at 6.

⁹ The High Court in *DCT (WA) v. Boulder Perseverance Ltd* (1937) 58 CR 223 upheld the disallowance of a deduction by the Commissioner of a distribution of profits in excess of the 10% per annum coupon on a note on the basis that it was a payment of net profits; the High Court in *Midland Railway C. of WA Ltd* (1952) 85 CLR 306 held that a payment to note holders to enable them to redeem certain notes was deductible.

¹⁰ For example section 46D *ITAA 1936* denied franking benefits and the inter-corporate dividend rebate on dividends that were equivalent to interest on a loan; section 82R *ITAA 1936* denied deductions for interest on non complying convertible notes – ones with equity features.

- the Tax Office challenged the characterisation of hybrid financial instruments used to provide deductible equity for non-bank corporates or deductible Tier 1 capital for banks, both administratively¹¹ and through the courts;¹²
- limited specific accruals rules applied to debt, e.g. by application of common law¹³ or specific legislative provisions.¹⁴ Outside their purview, tax treatments did not adequately take into account the time value of money or provide for an appropriate allocation of economic income over time;¹⁵
- again, ad hoc specific provisions were introduced over the years, for example the traditional security rules treat the gains and losses on disposal or redemption as on revenue account.¹⁶

Fundamental tax distortions:

- create uncertainty in the marketplace;
- lead to economic inefficiency which impedes the operation of the financial markets;
- prevent certain financial instruments from being used, or fall out of favour in the market;
- lead to non neutrality. A neutral tax system is one that does not distort the economic decisions of taxpayers. Neutrality suggests that taxation should be consistent across financial arrangements with the same economic substance;¹⁷
- increase tax planning – i.e. structuring financial arrangements to meet tax profiles of specific issuers and holders;¹⁸
- increase cross border arbitrage;¹⁹
- play off the tax status of issuers' who prefer debt;²⁰

¹¹ TR 2002/15 : and TR 2002/16 *op cit.*.

¹² The Full Federal Court in *Macquarie Finance Limited v Commissioner of Taxation* [2005] FCAFC 205 denied deductions of interest on a perpetual note stapled to a non dividend paying preference share, on the basis that the payments were of a capital nature in that the character of the advantage sought was a permanent and enduring one to raise Tier 1 capital; similarly the Full Federal Court denied deductions of interest on a term subordinated note that funded an offshore Tier 1 capital raising as part of a wider arrangement for the bank in *St. George Bank Limited v FCT* [2009] FCAFC 62, note that St. George Bank Limited has sought special leave to appeal to the High Court.

¹³ Refer for example *Coles Myer Finance Ltd v. FCT* (1993) 25 ATR 95 (*Coles Myer*) where the High Court held that discounts on promissory notes and bills of exchange for the finance company were on revenue account and should be apportioned on an accounting straight line basis over the terms of the relevant note or bill; *Coles Myer* was later followed by the High Court in *FCT v Energy Resources Australia* (1996) 33 ATR 52.

¹⁴ Refer Division 16E *ITAA 1936*. These provisions were targeted at deferred interest securities e.g. Dingo Bonds.

¹⁵ Explanatory Memorandum, *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008* at 3.

¹⁶ Sections 26BB and 70B *ITAA 1936*.

¹⁷ This requires that the cash flow pattern or profile – as constituted by the amount, timing and riskiness of the cash flows – be taxed in the same way irrespective of the form of the transaction or transactions giving rise to it, or of the formal classification of the institution undertaking the transaction. So for example, as debt, equity and hybrids perform functionally similar financing and risk management roles in the market they should be taxed the same: Commonwealth Treasury, *Taxation of Financial Arrangements, Issues Paper, December 1996*, at 27 ; Wood, R, Commonwealth Treasury, 'The Taxation of Debt, Equity and Hybrid Arrangements', 1998, at 2.

¹⁸ Example, debt for issuers with a need for deductibility to reduce taxable income and for non-resident holders not able to utilise franking credits; equity for issuers paying tax to utilise franking credits to resident holders.

¹⁹ Obvious examples are debt/equity arbitrage – where for example hybrid instruments (certain types of convertible notes) are treated as equity in Australia, debt in New Zealand; where redeemable preference shares issued by Australia to the U.K, U.S. and Canada, generate foreign tax credits offshore and franking credits onshore; or where redeemable preference shares issued to Australia facilitate the channelling of exempt income under section 23AJ *ITAA 1936* that enables the foreign entity to access deductions for interest in Australia under section 25-90 *ITAA 1997*, whilst avoiding tax in the foreign jurisdiction by basing the offshore entity in a low tax jurisdiction or generating foreign tax credits through a related entity.

²⁰ Cottarelli, C, International Monetary Fund, 'Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy', Fiscal Affairs Department, 12 June 2009 at 8:

- increased leverage as one of the factors in the global financial crisis;²¹
- create changes in regulatory capital guidelines;²²
- increase takeover activity - e.g. leverage buyouts, merger & acquisition activity that were funded by private equity.²³

HOW, AND TO WHAT EXTENT, DO THESE PRINCIPLES CONFLICT WITH ADMINISTRABILITY? HOW CAN THESE CONFLICTS BE MITIGATED?

The lack of tax neutrality leads to conflicts in administration including the increased need to:

- implement ad hoc and piecemeal administrative and legislative approaches to the taxation of financial instruments which leads to complex legislation which still potentially leaves open opportunity for financial engineering that side-steps the legislative intent.;
- devote greater resources to providing advice due to increased uncertainty in the market as to the potential tax treatment;
- increased compliance activities and to test the effectiveness of attempts to exploit the non alignment between the legal form approach to characterising debt and equity with the economic substance of the arrangement.

There is also a need to enhance the Tax Office's relationships with other revenue authorities in terms of alerting them through increased spontaneous exchanges of information that identify cross border arbitrage or avoidance.²⁴

Australia has sought to mitigate the abovementioned conflicts by wholesale tax reform that is based upon aligning the tax treatment with the economic substance of the financial instruments, thus bringing them closer to the principle of tax neutrality and closer to market treatment. Such reform, narrowing down or eliminating distortions and moving towards limited tax neutrality has occurred over a long period of time with:

The introduction of the imputation system

- Australia's bias towards debt, was arguably greater prior to the introduction of our imputation system in 1987;²⁵

In the U.S. 'tax-exempt investors – pension funds, charitable foundations, sovereign wealth funds – clearly prefer debt finance: for them indeed there is a clear arbitrage gain in lending to tax paying corporations and taking the interest untaxed.'

²¹ This was observed by Carlo Cottarelli, op cit at 1:

'Tax distortions are likely to have encouraged excessive leveraging and other financial market problems evident in the global financial crisis. These effects have been little explored, but are potentially macro-relevant. Taxation can result, for example, in a net subsidy to borrowing of hundreds of basis points, raising debt-equity ratios and vulnerabilities from capital inflows.'

Note however, it was probably a combination of factors including increased leverage over poor quality assets.

²² Arguably, as a result of the bias towards tax debt and the increase in innovative financial instruments, bank regulators are increasingly allowing innovative hybrid instruments to form part of a banks' Tier 1 capital.

²³ The Senate, Standing Committee on Economics, Private Equity Investment in Australia, August 2007, at 18:

'In Australia, the value of completed private equity transactions increased to around A\$14 billion, contrasting with an average of around A\$2 billion for each of the previous 5 years.'

²⁴ This role is supported by Australia's membership of the OECD Working Party No. 8 Aggressive Tax Planning Focus Group on Hybrids. Through this focus group Australia works in a collaborative manner with other major revenue authorities (e.g. IRS, HMRC, NZIRD) to identify new and emerging hybrid arrangements through active support and use of the OECD ATP Directory – a secure database of cross border tax schemes. Australia also has a lead role in exchanging and sharing information and best practices through its membership of the Joint International Tax Shelter Information Centre (JITSIC)

- Australian Treasury recently stated that:

'The current imputation system ...removes the distortions that can arise in a classical system of taxation and also, provides a more neutral tax treatment between debt and equity.'²⁶

Taxation of financial arrangements – stage 1

- Division 974 *ITAA 1997* now classifies an interest in a company as equity or debt according to the economic substance of the rights and obligations of an arrangement rather than its mere legal form in a more comprehensive way than the current law, pre 1 July 2001;
- The test for distinguishing debt interests from equity interest focuses upon a single organising principle – debt is evident when an issuer has an effective obligation to return to the investor an amount at least equal to the amount invested.

Taxation of financial arrangements – stages 3 & 4

- Division 230 *ITAA 1997* modernises the accruals and realisation rules for determining gains and losses from financial arrangements. It sets out four new methods (in addition to the default accruals and realisation methods) that taxpayers may elect to use in working out their gains and losses from financial arrangements. The four new elective methods are:
 - fair value;
 - foreign exchange retranslation;
 - hedging, and
 - a method to rely on financial reports.
- Division 230 *ITAA 1997*, by way of comparison to the previous law on the taxation of financial arrangements, will:
 - largely remove the distinction between capital and revenue
 - treat most gains and losses as being on revenue account, and
 - provide that losses are deductible and gains are assessable.
- Division 230 *ITAA 1997* contains the two overarching objectives underpinning Division 230 *ITAA 1997*, i.e. greater efficiency and the lowering of compliance costs. Greater efficiency, in this context, means minimising the extent to which the taxation of financial arrangements (by providing inappropriate impediments or stimulation) distorts a taxpayer's trading, financing, investment, pricing, risk taking and risk management decisions. Removing such distortions involves the development of an enhanced and more comprehensive and coherent tax law framework.²⁷
- Greater efficiency is also achieved through a closer alignment of tax and commercial recognition of gains and losses from financial arrangements. The framework explicitly takes into account a closer alignment with accounting standards.
- However problems remain given the chameleon character of the subject matter, and the new provisions also bring into them further layers of complexity.

²⁵ *Taxation Laws Amendment (Company Distributions) Act 1987* inserted Part IIIA encompassing our dividend imputation system into the *Income Tax Assessment Act 1936* with a date of effect of 1 July 1987.

²⁶ Australian Treasury, *Australia's Future Tax System*, Consultation Paper, Chapter 6 at 137, December 2008.

²⁷ Explanatory Memorandum, *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008* at 4.

Ongoing reform - consultation with the business and professional adviser community on the reform of Australia's tax system including the tax treatment of debt and equity

- Australia's tax system is currently undergoing reform through Australia's Future Tax System (AFTS) Review.
- A joint paper prepared by Peter Birch Sorensen, University of Copenhagen and Shane Matthew Johnson, Australian Treasury, examined possible long-term solutions to capital income tax reform including providing a tax deductible allowance for corporate equity – known as ACE – that mirrors the allowance for interest rate deductions. ACE is favoured by the IMF, their recommendation is that tax deductions for both profits and interest be fixed at the risk free rate. The ACE system has been adopted in Belgium, Latvia, a variation used in Brazil, adopted and abandoned in Croatia, Austria and Italy.²⁸
- No attempt is made here to recommend any policy prescription. We await the recommendations of the AFTS review, and the Government's response.

HOW CAN THESE PRINCIPLES BE APPLIED TO DETERMINE THE APPROPRIATE TAX TREATMENT OF COMPLEX SYNTHETIC INSTRUMENTS AND CONTEMPORARY FINANCIAL INTERMEDIARIES AND INSTITUTIONS?

Complex synthetic instruments

- Synthetic instruments consist of the combination of two or more legally distinct instruments to replicate the cash flow pattern associated with another legally distinct instrument.²⁹
- Tax neutrality is sought to be achieved to some extent in determining the appropriate tax treatment of financial arrangements including complex synthetic instruments, by seeking to align them with their economic substance. In theory, irrespective of the ability to replicate cash flow patterns, tax should follow the underlying economic substance. However the legislation in reflecting the complexity of the financial interaction brings with it its own complexities.
- Although Division 230 *ITAA 1997* did not include previously exposed specific synthetic rules that addressed synthetic disposals,³⁰ synthetic non disposals,³¹ creation of synthetic debt³²

²⁸ Sorensen, PB and Johnson SM, ;Australia's Future Tax System, Conference, Taxing Capital Income: Options for Reform in Australia;, University of Melbourne, 18-19 June 2009. Note that the Review does not propose to abolish dividend imputation, although it may be reviewed in the medium to long term and an alternative is a business expenditure tax : Henry, Dr Ken, 'Perspectives on company tax', Australia New Zealand Leadership Forum, 21 August 2009 at 3. See also Genser B, 'Business and Investment Tax Options: A European View', Australian Business Tax Reform in Retrospect and Prospect Evans C and Krever R (ed), Thomson Reuters, Sydney 2009 at p55 and Freedman J, 'Reforming the Business Tax System: Does size matter? Fundamental issues in Small Business Taxation' *ibid* at p183.

²⁹ Edgar, Tim 'The Taxation of Financial Arrangements (TOFA) Proposals: A Modest and Defensible Agenda for Reform', [2000] UNSWLawJI 39, at 3.

³⁰ This is where a taxpayer who holds a financial arrangement, enters into another arrangement with the effect of eliminating their economic exposure instead of disposing of the original arrangement directly. An example of such an arrangement was in *Lend Lease Custodian v DC of T* [2006] FCA 1790, where there was a disposal of shares under a forward purchase agreement subject to a Romalpa clause that retained the tax benefits of ownership (franked dividends) whilst eliminating economic exposure to movements in the share price during the period of the forward purchase agreement.

³¹ This occurs where a taxpayer holds and legally disposes of a financial arrangement, only to reacquire or synthetically create the same economic exposure under another arrangement e.g. a wash sale – the mischief is that the tax law recognises a disposal (transfer) when it ought to be ignored. Under Division 230 *ITAA 1997* TOFA may nevertheless recognise a balancing adjustment in these circumstances, although it is arguable otherwise.

³² Mischief in this area arises when gains and losses from a financial arrangement are not sufficiently certain and are therefore taxed on realisation, and another arrangement is entered into which results in those gains and losses becoming sufficiently certain.

there are several core rules in Division 230 *ITAA 1997* that might be capable of application in a way that obviates the need for specific rules.³³ However these are yet to be tested.

- In addition Part IVA *ITAA 1936* may apply, for example refer TR 2008/1 which sets out the Tax Office's view that Part IVA *ITAA 1936* may apply to synthetic non disposals such as wash sales – the Tax Office had success in this respect in *Cumins v FC of T* [2007] FCAFC 2; although it did not have similar success with its application to synthetic disposal arrangements such as the forward sale arrangement in *Lend Lease Custodians V DC of T* [2006] FCA 1790.
- The then Assistant Treasurer, Chris Bowen MP, announced on 26 March 2009, that the Government would monitor the reform of Australia's financial taxation system including giving consideration, against the background of Part IVA *ITAA 1936*, to the need for specific integrity measures to address synthetic arrangements.³⁴

Contemporary financial intermediaries and institutions

- The appropriate tax treatment of these entities in respect of our TOFA regime, is on an equal level with financial institutions, as most of these entities who use complex financial instruments including synthetics, fall within the categories of relevant taxpayers to whom TOFA applies on a mandatory basis, i.e. to:
 - authorised deposit taking institutions (ADIs), securitisation vehicles and financial sector entities with an aggregated annual turnover (based on the ordinary income the entity derives for an income year in the ordinary course of carrying on business plus the sum of the relevant annual turnovers of the entity, its connected entities and affiliates) of \$20 million or more;
 - superannuation entities (both regulated and unregulated), approved deposit funds, pooled superannuation funds, managed investment schemes and entities with a similar status under a foreign law to such a scheme if the value of their assets is \$100 million or more
 - other entities with an aggregated annual turnover of \$100 million or more, financial assets of \$100 million or more, or assets of \$300 million or more.

HOW CAN TAXATION PLAY A POSITIVE ROLE, OR AT LEAST A NEUTRAL ROLE, IN THE DEVELOPMENT OF FINANCIAL SYSTEMS AND MARKETS IN DEVELOPING ECONOMIES?

As can be seen, the chameleon character of the subject matter makes it difficult to categorise with certainly the nature of complex hybrid financial products. It seems inevitable that the developers and issuers of financial products will continue to seek the 'holy grail' of tax deductibility of funding costs and satisfaction of regulatory requirements in relation to capital adequacy.

In the development of financial systems and markets, certainty is a valued ingredient. The Australian Taxation Office (ATO) seeks to meet this need by engaging with financial institutions, industry bodies, experts in the field and other tax administrations to make sure the context and products are properly understood and transparency and cooperation, vital to the integrity of financial markets, is enhanced. In a practical sense the ATO provides certainty through binding rulings.

Progressively policy makers are looking for ways to reduce or eliminate the economic biases and financial system risks that can arise from the traditional dichotomy between debt and equity.

³³ These core rules include the ability to group and disaggregate arrangements, the ability to trigger a balancing adjustment where a financial arrangement ceases by reference to a risk and rewards test.

³⁴ Assistant Treasurer Media Release No. 22, 'Taxation of Financial Arrangements – Synthetic and Complex Arrangements, No. 22 of 26/03/2009.

The current Australian approach seeks to align the tax and economic substance of financial instruments or arrangements. It is important that those approaches recognise the different roles that debt and equity play in the operations and viability of businesses. However even such a comprehensive approach has its own (albeit fewer) interpretative demons as hybrid instruments mutate and evolve.

Inevitably, asymmetries in the way that different countries define what is debt and equity and in the way they tax the various components will continue to provide opportunities for tax arbitrage and avoidance. At least by actively engaging with the financial markets and other tax administrations the ATO is better placed to understand the issues, in the context of both the Australian and global markets. By acknowledging the dynamic and mobile nature of financial arrangements, and the possibility that an innovative financial arrangement designed for a particular case may become a trend, those links help the ATO to anticipate what may be coming over the horizon and form a view about any risk to the tax base.

Ultimately the goal in designing tax systems is to strike a balance between the need to remove barriers to the use of innovative financial instruments and to prevent abusive transactions that adversely impact on a country's tax base.