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New Business Tax System (Debt and Equity) Bill 2001

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No. 68 2001–02

New Business Tax System (Debt and Equity) Bill 2001

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New Business Tax System (Debt and Equity) Bill 2001

Date Introduced: 28 June 2001

House: House of Representatives

Portfolio: Treasury

Commencement: 1 July 2001. However, also refer to the Application section at the end of this Digest.

Purpose

To introduce a statutory test to distinguish between debt and equity interests for certain provisions of taxation law.

Background

The classification of an instrument as either a debt or equity interest in a company can have important taxation implications. For example, returns on equity (dividends) can be subject to franking so that the recipient receives a credit for tax paid by the company while there is no deduction available to the company for dividends paid. Payments relating to debt interests on the other hand are not subject to franking and the company can generally claim a deduction for such payments. The distinction is also important for the 'thin capitalisation' rules which deny a deduction for debt payments where a certain debt to equity ratio is exceeded.

In most cases the distinction between debt and equity is clear. For example, the holding of shares listed on a stock exchange is clearly an equity investment while holding debentures which pay a guaranteed rate of return is clearly a debt situation. However, the line between the two can be blurred in complicated legal arrangements which attempt to combine the more investor attractive components of debt and equity investments in the one instrument, so that the investor may be able to receive franking credits while still facing minimal investment risk through arrangements such as a guaranteed return.

The distinction between equity and debt interests was considered as part of the Review of Business Taxation (Ralph Report). The issue was referred to in terms of membership

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interests (equity) and non-membership interests (debt) with the primary distinction between the two being seen as the degree of risk borne by the investor. However, the level of risk was not seen as providing a 'basis for a practical and general distinction between all debt and equity interests.'[1] The Ralph Report therefore recommends a number of tests to determine if an interest is a membership interest:

- Does the person fall within any of the following categories:
  - a member of a company for purposes of the Corporations Law
  - a member of a registered managed investment scheme under the Corporations Law
  - a partner of a limited partnership, or
  - a person who has a beneficial interest in the income or capital of a trust estate or has an interest in the proper administration of a trust as they can be a beneficiary under a discretion that may be exercised by the trustee.
- Does the person have an interest in the entity which confers rights in respect of the management or administration of the entity (other than voting rights under the Corporations Law), or
- Does the person have a right to a fixed or variable return from an entity where the existence of the right, rather than its value, is dependent on the exercise of a discretion or is contingent on the performance of the entity.[2]

The Ralph Report also recommended that certain interests which may fall within the above categories be excluded from the definition of membership interests:

- Where the interest is such that the holder has an effectively non-contingent right to receive an amount equal to or greater than the amount paid for the interest or there is a similar obligation on the supplier of the interest
- Where, as a matter of commercial substance, the interest is non-contingent on the performance of the entity, or
- The arrangement is not of a commercial nature.[3]

An exposure draft of the Bill was released by the Treasurer on 21 February 2001 but there has been little public comment on the Bill. Most comment has centred on the application dates of the measures. Under these provisions entities may elect that the new measures are not to apply to the status of an instrument until 2004 if the entity so elects. The election must be made within 28 days of the Bill receiving the Royal Assent in respect of each class of instrument issued by the entity. The executive director of the Corporate Tax Association is reported as stating:

> Even for an ordinary corporate it will be difficult, let alone a financial institution.

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> A better way would be to keep the status quo except where you want the new law to apply. This would mean a significant saving on compliance.[4]

Main Provisions

Item 34 of Schedule 1 of the Bill will insert a **new Division 974** into the *Income Tax Assessment Act 1997* (ITAA97).

Debt Test

Proposed section 974-20 contains the test for determining if there is a debt interest. There will be a debt interest where:

- There is a scheme (ie arrangement, plan, proposal, action or course of action) which is a financial arrangement for the entity
- The entity or a connected entity receives a financial benefit under the scheme
- The entity or the entity and a connected entity have an effectively non-contingent obligation to provide a financial benefit to one or more other entities and it is substantially likely that the value provided will be equal to or greater than the value received by the entity.

The term 'effectively non-contingent obligation' is defined in **proposed section 974-135** to include:

- If an obligation is not contingent (ie not conditional) on any event or situation, such as the performance of the entity, other than the ability or willingness of the entity to meet the obligation
- That having regard to the structure of the scheme there is in substance a non-contingent obligation. In determining whether an obligation is contingent or not the following rules apply:
  - the existence of a right to convert an interest to equity does not necessarily mean that the interest is non-contingent
  - certain obligations to redeem preference shares to equity will not necessarily be contingent (and therefore included in the category of non-contingent obligations) because there is a legislative requirement for the conversion to be met out of profits or the issue of new interests
  - Regard is to be had to any artificial or contrived contingency.

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- An interest will not be included in the definition merely because there will be negative commercial implications because an obligation is not fulfilled.

There will also be substantial powers to make regulations as to what is a non-contingent obligation.

If the debt test is satisfied, there are certain cases where the interest will not be deemed to be debt. This is where:

- the scheme creates an equity interest in a company (see below for the equity test), and
  - the parties have not dealt at arm's length and it is reasonable to conclude that there would have been an equity interest if the parties had dealt at arm's length (this is basically an anti-avoidance scheme to prevent deduction being claimed for interest deductions in relation to the interest)
- the financial benefit is a liquid or monetary asset and benefit is, and is required to be, provided within 100 days of the receipt of the initial benefit for the entity (this would cover matters such as short term loans), or
- the scheme contravenes the regulations relating to short term (ie less than 100 days) schemes (**proposed section 974-25**).

'Financial benefit' will not include the issue of an equity interest or a payment towards an equity interest (**proposed section 974-30**).

Proposed section 974-65 gives the Commissioner power to treat an interest as a debt interest where the debt interest test would be satisfied except that it is not substantially likely that the value provided will be equal to or greater than that received. However, the Commissioner's discretion may be exercised where the Commissioner considers that:

- It is substantially more likely than not that the value of the financial benefit provided under the non-contingent obligation will be 'equal to the substantial part of the value' of the financial benefit the entity receives
- It is substantially more likely than not that other financial benefits will be provided to other entities under the scheme, and
- It is substantially more likely than not that the value of all of the above benefits will be equal to or greater than the benefit received.

Equity Test

Equity interests in companies are dealt with in **proposed subdivision 974-C**. There will be four basic types of interests that satisfy the equity test in **proposed section 974-75**:

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- An interest as a member or stockholder of a company.
- An interest that carries a right to a fixed or variable return which is contingent on the economic performance of the company, a part of the company's activities, a connected entity or part of a connected entity.
- A right to a fixed or variable return where the right or rate of return is at the discretion of the company or a connected entity.
- An interest issued by the company that:
  - gives its holder, or a connected entity, a right to be issued an equity interest in the company or a connected entity or
  - an interest that will or may be converted into an equity interest in the company or a connected entity.

Even if one of the above is satisfied, to be equity the interest must also be part of a financing arrangement (ie the entity enters into the arrangement to raise finance for the entity or a connected entity. Examples given include bills of exchange and convertible interests that will convert into an equity interest. Examples of excluded arrangements include derivatives used to manage financial risk – **proposed section 974-130**).

Where there is a right to a variable or fixed return from a company to a person and other entities are imposed in the chain between the company paying the return and the receipt by the individual **proposed section 974-85** will apply. If the ultimate return to the person is dependent on the performance of the entity or a connected entity or is at the discretion of either of these entities, the interest will be considered to be equity if the entity which ultimately receives the return has a right to be issued with an equity interest or an interest which may or will be converted to equity. This will not apply where the interest has been classified as a debt interest.

An interest will not necessarily be considered to be contingent because it is based on economic performance or is dependent on the willingness of the entity to meet the obligation or the receipts and turnover of the entity (**proposed section 974-85**).

Proposed section 974-85 also provides a wide power to make regulations to determine if a right is to be taken to be contingent or non-contingent. Similarly, **proposed section 974-90** provides that regulations may be made to determine the situations under which a right or amount of return is to be considered to be at the discretion of a company or connected entity.

Tiebreaker

If an interest qualifies as both a debt and an equity interest, it is to be treated as a debt interest (**proposed section 974-5**).

General

With the extension of equity interests to include more than shares, the Bill introduces the concept of non-share distributions and dividends. A non-share distribution will be made where:

- The recipient holds a non-share equity interest in a company and
- The distribution is of money, other property or a credit (**proposed section 974-115**).

Non-share dividends will be non-share distributions except where the distribution is debited against the company's non-share capital account or its share capital account (**proposed section 974-120**). Dividends debited to the above accounts will be defined as a non-share capital return (**proposed section 974-125**).

Application

The debt/equity definitions contained in the Bill will only apply to specified areas of taxation legislation. The operative provisions to be effected by the change in definitions are contained in the *Income Tax Assessment Act 1936* (ITAA36) and are listed in Table 3.1 of the explanatory memorandum for the Bill. Briefly, the changes fall within four broad categories:

- Including non-share dividends in areas where share dividends are currently taken into account
- Including non-share equity in cases where share equity is currently taken into account
- Applying the imputation system to non-share equity as well as share equity, and
- Providing that a non-equity share may be included in debt (**Part 2 of Schedule 1 of the Bill**).

The amendments will apply from 1 July 2001, however, as noted above, the issuer of an interest (whether debt or equity) may elect that the new rules do not apply until 1 July 2004. Such an election may only be made in respect of interests issued before 21 February 2001 and must be made within 28 days of the Bill receiving the Royal Assent. Such an election is irrevocable and the issuer seeking to make such an election must provide a wide range of information to the ATO, including the claimed tax treatment under current law to be provided due to the election (**item 118**).

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Endnotes

1 Review of Business Taxation, p. 443.

2 ibid.

3 ibid., pp. 445–447.

4 The *Financial Review*, 10 September 2001.

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