AUSTRALIAN BANKERS' ASSOCIATION INC.

Submission

Review of the Debt and Equity Tax Rules

May 2014

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Contents

Executive Summary

The Australian Bankers' Association (**ABA**) thanks the Board of Taxation (**Board**) for the opportunity to comment on its extensive *Review of the Debt and Equity Tax Rules Discussion Paper* (**Discussion Paper**).

The ABA commends the Board for the breadth and comprehensive scope of the Discussion Paper. However, given that breadth and scope the ABA has restricted its comment to those issues in the Discussion Paper which are most pertinent to Australia's banking industry.

The context which frames a particular debt equity tax issue for the banking sector and which gives it relevance are:

- the global and domestic prudential regulatory environment within which Australia's banks operate; and
- the commercial need for Australian banks to raise funds in global markets, given the relatively small domestic savings pool, ignoring superannuation assets.

As the Board will be aware international banking regulators have, as a consequence of the global financial crisis and through the Third Basel Accord process, significantly increased the minimum level of capital which banks are required to hold as a buffer against unanticipated losses. Included within this development is a greater prescription as to which instruments can be classified as capital, in particular a requirement for mandatory conversion clauses in the event of insolvency.

This prudential regulatory change has led not only to an increase in capital held by banks, but a change in the composition of that capital. There has been an increase in Additional Tier 1 (**AT1**) and Tier 2 (**T2**) capital, as distinct from Common Equity Tier 1 capital, which is comprised of equity as more traditionally understood.

The global tax regulatory response has lagged global prudential regulatory developments. However, it is increasingly the norm for countries with significant and developed financial markets to introduce specific rules to make clear and ensure that AT1 and T2 capital continue to be treated as debt for tax purposes.

It is of fundamental importance to the continued health of the Australian banking industry that Australia's tax laws similarly make clear that AT1 and T2 capital is also treated as debt for tax purposes. Accordingly, the ABA strongly recommends that Division 974 be amended to align tax characterisation with prudential characterisation.

A related and allied concern is that Australia's tax laws are not interpreted by the Australian Taxation Office in a manner which restricts the ability of Australian banks to raise funds off-shore. This has occurred in recent times and as a result Australian banks have largely ceased raising AT1 capital through foreign branches. The specifics of this issue are briefly discussed at item 26.

The ABA's other specific comments in relation to issues and questions raised in the Discussion Paper are given in the balance of our submission.

1. Question 4.1a. - The debt-equity border

"The Board seeks stakeholder comment on the debt-equity border, in particular whether: there are any major practical difficulties in applying Division 974 to commercially significant arrangements."

The ABA observes that Australian banks have encountered a number of major practical difficulties in applying Division 974, including:

- the need to obtain private binding rulings (**PBRs**) to confirm whether certain regulatory capital securities are debt or equity for tax purposes and whether the distributions paid on these regulatory capital securities are frankable distributions. In a self-assessment tax system it should not be necessary for taxpayers to routinely seek PBRs in order to determine the tax consequences of routine transactions;
- uncertainty around whether the distributions on certain non-share equity interests, that form part of an Authorised Deposit-taking Institutions (**ADIs**) Tier 1 capital, are required to be franked, in particular whether the instruments will be considered to have been issued "at or through" an offshore branch of the ADI (refer specific comments on section 215-10 at item 22);
- difficulties in satisfying the effectively non-contingent obligation (**ENCO**) test in relation to certain regulatory capital securities that are required by APRA to contain solvency conditions or in the case of Basel III compliant instruments loss absorption mechanisms (such as conversion or write down features)(refer specific comments at Item 5); and
- significant delays in developing effective regulations under section 970-135(8), in particular the regulations relating to instruments that were classified as Upper Tier 2 capital under APRA's Basel II regulatory capital framework.

2. Question 4.2a. - "Financing arrangement" concept

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

a. in light of the decision in Blank, whether the distinction between raising finance and raising capital in the context of the 'financing arrangement' concept is problematic. If so, how could this be addressed;"

The ABA observes that the notion of a "financing arrangement" is critical to Div 974. In the early Exposure Drafts of the debt-equity rules no such concept existed; it was a late addition to the text. The need for such a concept is obvious because without it any incomplete transaction could give rise to a debt interest. Ignoring para (a), the debt test in s. 974-20 looks to whether there is an unsatisfied obligation to provide an economic benefit of sufficient size. On its own this could lead to all kinds of incomplete arrangements (e.g. operating leases, software licensing arrangements, a sale of goods yet to be delivered, casualty insurance, construction contracts and so on) being treated as amounting to a loan to an entity. This is clearly not an appropriate outcome. The existence of some notion which serves the purpose of excluding arrangements which do not represent an investment in an entity is thus critical.

At present, the definition is insufficiently detailed to ensure that all arrangements which do not represent an investment in an entity are excluded from the debt-equity regime. For example, while personal services arrangements and derivatives are excluded in s. 974-130(3) and operating leases, software licensing arrangements and casualty insurance are excluded in s. 974-130(4), construction contracts and incomplete contracts for the sale of goods are not mentioned by name. Also omitted, for example, are warranties and indemnities, arrangements which involve personal licences rather than leases, interests in superannuation, and payments owed as a consequence of settling litigation. None of these arrangements should be within the debt-equity regime and the concept of "financing arrangement" is the logical point at which they could be excluded.

There is a separate issue as to whether the current expression of that concept in the term "financing arrangement" in s. 974-130 is adequate to the task. As the Board has observed, comments by Edmonds J in *Blank v FCT* [2014] FCA 87 have cast some doubt on the current drafting. His Honour's comments are particularly significant for the characterisation of hybrid Tier 1 capital securities (usually equity under Division 974) and hybrid T2 capital securities (usually debt under Division 974) issued by ABA members regulated by APRA.

Edmonds J held that, having regard to all of the relevant facts and circumstances, when a holding company issued shares to an employee of the corporate group in connection with the employee rewards programme, this did not involve the holding company in "raising finance". This was relevant to the Division 974 characterisation of a (different) non-share interest issued by a connected entity of the holding company. Consequently, paragraph (a) of the s. 974-130(1) definition of the term "financing arrangement" was not satisfied in relation to that non-share interest.

That conclusion was unremarkable but in the course of the judgment Edmonds J drew a distinction between "raising finance" and "raising capital", the former being narrower than the latter in his view. The relevant comments are underlined in the text of paragraph 71 which is extracted below:

> *"Equally, the amount of capital raised by the issue of shares will not, of itself, be determinative of whether the arrangement is entered into or undertaken to raise finance for the company issuing the shares. But para (a) of the definition of 'financing arrangement' 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 to be discerned from the text of s 974-130(1), viewed in the context of Div 974 of the 1997 Act as a whole." [emphasis added]*

In our view, Edmonds J's comments are aimed at emphasising the end result of the application of Division 974 which is that some securities do not satisfy the debt test because they have characteristics reflecting the fact that they are intended to provide capital for a company (such as the characteristics required by APRA for securities to qualify as hybrid Tier 1 capital for a bank).

In our view, the dintinction between whether the purpose of the arrangement was to raise capital or funding is not relevant to Division 974. When a bank raises capital, it does not put it "under the bed" and fail to put it to use. Capital is money or funding which is then put to use in the business. It might be possible to interpret that Blank's case suggests all funding initially raised as capital should not be equity under Division 974 and that all funding raised for non-capital purposes should be debt. However, we believe that this would lead to adverse outcomes.

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. If the purpose of the arrangement was to raise capital, particularly regulatory capital; it is clear that the general anti-avoidance rules should not apply (because the sole purpose of the arrangement is not to obtain a tax benefit). If the arrangement had non-capital purposes, then other surrounding circumstances may need to be considered before determining whether or not the general anti-avoidance provisions should apply.

Whether or not this explanation of His Honour's reasoning is accurate, these comments are inconsistent with both the regulations that have been issued on the assumption such capital instruments do involve raising finance and with long-standing ATO practice. Recent examples of notes for which the ATO has issued a public ruling include ANZ Capital Notes 1 and 2 (CRs 2013/55 and 2014/22), Macquarie Group Capital Notes (CR 2013/46), CBA PERLS VI (CR 2012/101) and Westpac Capital Notes (CR 2013/17). All were regarded as issued to "raise finance".

ABA recommendation

The ABA recommends that the Board should take steps to clarify this 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 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.

3. Question 4.4b. - Practical difficulties in relation to contingencies

> *"The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to contingencies that affect an obligation and the characterisation as either debt or equity, in particular whether:…*
>
> *b. the treatment of the degree of subordination in Division 974 is problematic. If so how could this be addressed?"*

The ABA observes that subordination of debt is a common feature in financing transactions and allows capital providers to invest on different risk and return profiles. The degree of subordination of a particular obligation will vary from transaction to transaction, but broadly the more deeply subordinated a particular obligation the greater the risk to the holder of non-repayment. Nonetheless, the 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.

ABA recommendation

The ABA 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.

4. Question 4.4d. - Application of Division 974 to limited recourse loan arrangements

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

d. the application of Division 974 to limited recourse loan arrangements is problematic. If so, how could this be addressed?"

As acknowledged by the Board, limited and non-recourse debt is a common mode of finance, particularly in the project finance space and a number of large infrastructure projects rely heavily on limited recourse debt.

Limitations of a lender's rights against the borrower to recover money is in almost all circumstances not an element of the scheme's pricing, terms or conditions that impacts upon whether the borrower has an effectively non-contingent obligation to repay an amount to the lender.

In limited recourse arrangements the current rules are problematic when forming a judgement as to whether the value of the financial benefits to be received are "substantially more likely than not" to at least equal those provided. This forward looking valuation exercise leads to uncertainty as to whether the debt test has been passed.

ABA recommendation

The ABA recommends that:

a) the law be clarified to note that the existence of limited recourse rights does not impact the existence of an effectively non-contingent obligation, and

b) the nature of the valuation exercise required be clarified 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 for a more certain outcome.

5. Question 4.4f. - Division 974 and solvency clauses

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

f. the application of Division 974 to solvency clauses is problematic. If so, how could this be addressed?"

Solvency clauses have the effect that an issuer will not provide any financial benefits if to do so would place it in a position whereby it would no longer be solvent, i.e. unable to pay its debts as they fall due. As set out in the Board's paper there has been interpretational uncertainty as to whether solvency clauses impact the existence of an ENCO.

ADIs are subject to regulation by APRA. APRA has placed restrictions on the ability of 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. These regulations have largely been successful in addressing ADI's concerns with the interpretation of Division 974 in relation to solvency clauses.

However, the specific nature of the regulations leaves ADIs exposed to regulatory changes made by APRA and there is a consequential need to continually update the regulations for regulatory changes.

ABA recommendation

The ABA recommends that to give ADIs certainty the existing regulations be simplified so that solvency clauses in any T2 capital instrument would not of themselves cause the instrument to fail the ENCO test.

6. Question 4.4i. - Time of determining future step-up in interest re ENCO test

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

i. significant practical difficulties arise in determining, at the time of issue, whether a future step-up of interest is of sufficient magnitude to compel a finding that there is an ENCO to take an action. If so, how could this be addressed?"

An interest rate step up feature is potentially a term of a scheme relevant to determining whether an effectively non-contingent obligation exists. In particular, the step-up feature may be such as to economically compel the issuer to repay the holder, rather than pay the higher rate. Currently, performing analysis in these situations is uncertain and practically difficult.

ABA recommendation

The ABA recommends inserting a bright line test capable of application on creation of the interest. Such a test could be based upon the concept of the benchmark rate of return, with a step-up to specified level above the current benchmark rate of return indicating an effectively non-contingent obligation to repay.

7. Question 4.5a. - Interaction between single & related schemes

> *"The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the aggregation and disaggregation of schemes, in particular whether:*
>
> *a. the interaction between the single scheme and related scheme provisions in Division 974 is problematic. If so, how could this be addressed."*

The ABA agrees that the "scheme" and "related scheme" provisions, and how they interact, can be problematic.

The provisions are difficult for taxpayers to apply in practice given the broad conceptual terms on which they have been drafted. Any position adopted by a taxpayer is also uncertain given the Commissioner of Taxation's (**Commissioner**) discretion to aggregate and disaggregate schemes.

The ABA agrees that the treatment of shareholder loans is an example of when uncertainties can arise – in particular, when both share and loan arrangements are entered into at the same time – for instance, a holding company capitalising a subsidiary or an investor acquiring (non-stapled) share and loan interests in an investment vehicle.

The ABA acknowledges that these issues will be difficult to address in a general sense in the legislation, assuming that the "scheme" and 'related scheme' concepts are retained. Nonetheless, the ABA comments on the below two specific issues that could be addressed.

7.1. Instruments issued by separate entities

The related scheme provisions are particularly problematic when the related schemes involve:

- instruments/interests issued by different entities; and/or
- a combination of assets and liabilities from the perspective of the issuer(s).

For instance, precisely how the related scheme provisions apply (or are intended to apply) in the context of stapled instruments issued by separate entities is not clear. The debt/equity rules seem to assume that, even in the context of related schemes, the relevant instruments/interests are issued by a single entity. However, it seems possible that such stapled instruments could be treated as related schemes and as a single equity interest.

7.2. Interaction with TOFA

In addition to the interaction between the Division 974 scheme and related scheme provisions, there is a broader issue in terms of how those concepts interact with the TOFA concept of an "arrangement" under Division 230, and whether they should or will necessarily align in any given scenario.

A Division 974 equity interest is specifically treated as a TOFA "financial arrangement" (s.230-50), which effectively overrides the concept of an 'arrangement' in Division 230. However, there is no equivalent rule for debt interests. It is also not clear whether an equity interest can, despite being specifically treated as a TOFA 'financial arrangement', also form part of a broader 'financial arrangement'.

ABA recommendation

The ABA recommends:

a) ***in relation to instruments issued by separate entities that the related schemes provisions be clarified both in terms of the underlying policy and the actual operation of the provisions; and***

b) ***the ATO should issue a public binding ruling clarifying the general interaction between the Division 974 scheme/related scheme provisions and TOFA financial arrangement concepts, including examples.***

8. Question 4.7b. - Present value method & perpetual instruments

> *"The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to valuation, discounting and the benchmark rate of return, in particular whether: …*
>
> *b. the application of the present value method to perpetual instruments is problematic. If so, how could this be addressed."*

It is clear that perpetual instruments are intended to be capable of satisfying the debt test under the present value method – there are examples in the original Explanatory Memorandum for Division 974 to this effect and regulations have been introduced to assist debt interest classification for certain perpetual instruments.

However, the ABA notes two particular problems with applying the present value method to perpetual instruments:

- *Present value formula.* Arguably the formula in s. 974-50(4) does not contemplate and does not strictly work for perpetual instruments because it assumes financial benefits must be provided by a certain date – the examples of perpetual instruments in the Explanatory Memorandum refer to performing a calculation that approximates s. 974-50(4).
- *Benchmark rate of return.* Determining the benchmark rate of return for a perpetual instrument can be difficult, especially if it is not a publicly offered instrument with the return payable determined by the market.

ABA recommendation

The ABA recommends that:

a) a specific formula for perpetual instruments be included in the present value formula; and

b) the legislation include specific rules for determing the benchmark rate of return for a perpetual instrument.

9. Question 4.7c. - Practical difficulties with the present value method

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

c. there are significant practical difficulties associated with the present value method. If so, how could this be addressed? For example, should all financial benefits received or provided under an ENCO be valued in present value terms, regardless of when they were to be provided."

The ABA agrees that there are often significant practical difficulties associated with the present value method – the treatment of perpetual instruments discussed in Question 4.7b. is one such example.

In particular, there are often difficulties and uncertainties surrounding the determination of the benchmark rate of return for an interest under s. 974-145. It is often the case that there is no comparable ordinary debt interest that meets all of the conditions in s. 974-145(1), meaning that taxpayers have to rely on the approach in s. 974-145(2) of determining the internal rate of return in respect of an interest that is similar to the test interest, adjusted appropriately to take account of relevant differences. This process can involve significant time, cost and uncertainty.

For ordinary debt interests that are publicly offered and pay a return that is set by the market (such as under a competitive book-build), the benchmark rate of return must, at least as a practical matter, equal the internal rate of return of the instrument itself. It may also be possible to introduce certain benchmark rate of return 'safe harbours' to address this issue, although we acknowledge that this may be difficult and complex.

The ABA agrees that the present value method can arguably produce anomalous results, such as where the performance period for an interest is only slightly more than 10 years.

The ABA considers that some of these anomalous results could be mitigated by valuing financial benefits to be provided/received under an ENCO in the first 10 years in nominal terms, and only those to be provided/received after 10 years in present value terms.

The ABA strongly believes that applying the present value method to all financing arrangements (i.e. including those with a performance period of 10 years or less) is not the appropriate/correct approach. This would substantially increase the complexity of Division 974 and the compliance burden it entails. In particular, as noted above, determining the benchmark rate of return for an interest is often difficult/uncertain and taxpayers should not be required to apply this concept to all of their financing arrangements. Applying the present value method to all financial benefits would also mean that interest-free loans would never satisfy the debt test.

ABA recommendation

The ABA recommends that:

a) for ordinary debt interests that are publicly offered and pay a return that is set by the market (such as under a competitive book-build) that the legislation be amended to provide that the benchmark rate of return must, at least as a practical matter, equal the internal rate of return of the instrument itself; and

b) the present value method should not be applied to all financing arrangements.

10. Question 4.9a. - The accommodating change provisions

> *"The Board seeks stakeholder comment on the accommodating change provisions and, in particular whether: …*
>
> *a. the Division 974 treatment of subsequent changes to a scheme or schemes is problematic. If so how could this be addressed?"*

The discussions under paragraph 4.117 of the *Review of Debt and Equity Rules Discussion Paper* (**Discussion Paper**) highlight the issue that any change to the terms of an instrument, no matter how trivial, triggers the need to consider whether or not the characterisation of the interest has changed. For example, a minor change to a term to accommodate regulatory changes (e.g. T2 ranking in winding up the issuer) to an existing debt interest would require a retest of the instrument even when the change does not affect the economic substance of the interest. The retesting of an instrument with a term longer than 10 years requires the net present value to be determined based on the interest rate at the time of change. If the interest rate changes post issue, the recalculation in net present value could cause the instrument to fail the debt test.

ABA recommendation

The ABA recommends that:

a) the need to retest under section 974-110 should be limited to material changes e.g. changes affecting the effectively non-contingent obligations in respect of the financial benefits provided or received under the scheme; and

b) when determining the present value of the financial benefits under section 974-35, the reference to the benchmark rate of return used in the present value calculation under section 974-50 should be the benchmark rate of return immediately before the relevant instrument was actually issued, rather than at the time of any amendment to the terms of the instrument.

11. Question 5.1 - Section 974-80 generally

"The Board seeks stakeholder comments regarding potential issues and uncertainties raised with the existing operation of section 974-80 …"

The ABA observes that section 974-80 is a provision without a clear policy rationale. This is evident in the discussion in chapter 5 of the Discussion Paper. The absence of a clear policy objective for the provision explains why it has proved to be so problematic: since no-one can agree what it is there to address, no-one can agree on when it is or isn't enlivened. What makes the provision especially problematic is that its scope and role are very contentious, the possibility of triggering it unwittingly are high, and the consequences of enlivening the section are very serious.

If the section were repealed this would not detract from the integrity of the tax system because:

- where payments flow to onshore entities, there is no systemic and inexorable danger to revenue if payments are treated as deductible/assessable, compared to treating them non-deductible/frankable; and
- where payments flow offshore, the thin capitalisation rules already prevent excessive interest deductions depleting the Australian tax base and these rules should be the gatekeeper for determining what is and is not permitted.

Alternatively, the section could be reconstructed as an anti-avoidance rule if its putative purpose is to prevent avoidance. That is, involving related parties and triggered by a finding that the sole or dominant purpose of the parties to the arrangement was to give the ultimate recipient an equity interest in the company. The reconstructed provision's scope must be clearly limited to the specific mischief it is trying to address. It should be made clear that s. 974-80 can only apply where the objective of achieving that mischief is the sole or dominant purpose for entering into the arrangement.

Even if a purpose test is added to the existing requirements, concepts within the existing section need to be made much clearer:

- who is the ultimate recipient?
- when is a scheme "designed" to operate as described – is this determined having regard to amounts, or time of issue, or times of payment or some other factors?
- whose plans are considered to find the designer?
- when is one instrument "funding" the return to the ultimate recipient, especially if there is leakage or supplementing at the level of one or more connected entities, and so on?

Finally, the ABA submits that even a reconceived provision which emphasises a dominant tax avoidance purpose should be limited through clear and unambiguous safe harbours. For example:

- a company should be able to organise its affairs so as to avoid dividend traps without triggering adverse consequences under s. 974-80;
- there should be consideration of a *de minimis* threshold before the section is potentially triggered; and

- there should be a carve out if the returns flowing between the various entities are either (i) supplemented by other amounts or (ii) dissipated in ways other than funding the next instrument.

ABA recommendation

The ABA recommends that section 974-80:

a) be repealed because the section is so thoroughly riddled with difficulties and uncertainty; or failing that;
b) be reconstructed as a clear limited scope specific anti-avoidance provision.

12. Question 5.2a.i. - Stapled structures discretions

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

a. with regard to the current operation of section 974-80 in relation to stapled structures:

i. what is the nature of discretions or other contingencies, if any, that are attached to the distribution from the trust to the investor in a stapled structure arrangement. If there are a range of discretions or contingencies, it would be useful to understand the differences between them;"

Most trust deeds have a distribution clause that allows considerable flexibility as far as distributions are concerned. Normally the distribution clause requires a distribution to be made that, at a minimum, is at least equal to the taxable income of the trust (technically the "net income" of the trust). However, there are normally very few limitations on the maximum distribution and in particular it is quite common for trustees to be able to distribute capital to unitholders. Normally distributions exceed taxable income but are less than trust, or accounting, income. This is to allow for the possibility of tax deferred distributions attributable to depreciation and other accelerated allowances.

ABA recommendation

The ABA makes no recommendation.

13. Question 5.2a.ii. - Stapled structures and connected entity test

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

a. ii. whether the connected entity test, in relation to stapled structures, is working as intended or whether there should be a specific connected entity test for stapled structures. If a specific connected entity test is preferred, what should the test be;"

The connected entity test is intended to address the use of a two entity structure designed to change the nature of a return. In the case of staples the use of an associated, stapled, entity is to satisfy the constraints of Division 6C.The question of whether a specific connected entity test is required for stapled trusts should not be asked prior to deciding whether the rationale for section 974-80 has any application to a listed stapled entity.

ABA recommendation

The ABA recommends that the Board consider whether section 974-80 should have no application to listed stapled entities.

14. Question 5.2a.iii. - Financier stapled trust and associate test

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

a. iii. whether the definition of 'associate' specifically treats entities that operate as effectively one economic entity in a financier trust stapled structure arrangement, as associates of each other;"

The existing definition of associate is, on balance, sufficiently wide to cover stapled structures, however, as noted above the preliminary question should be whether section 974–80 should apply to stapled structures.

ABA recommendation

The ABA considers that no amendments to the definition of associate are necessary due to the application of section 974-80 to stapled trusts.

15. Question 5.2b - Stapled trusts and integrity issues

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

*b. accepting that stapled structures are a commercial reality and a significant subset of the investment population, whether specific integrity concerns arise with stapled structure arrangements. To the extent there are such concerns, what is the b*est way to address them;"

Stapled structures are a commercial reality due to the fact that Division 6C has long prevented a trust from operating the business associated with their real estate asset. For example, whilst a trust may own a tollway it is normally the case that the operator is a company that will pay rent to the trust. The trust and the company will normally be "stapled", in that units in the trust and shares in the company cannot be owned separately. If Division 6C were to be modified so that it did not operate in respect of managed investment trusts (**MITs**) that owned real property then stapled structures would be much less common.

ABA recommendation

The ABA makes no recommendations as the stapled structures predominantly exist as a function of Division 6C, rather than specific integrity issues arise as a function of stapled trusts.

16. Question 5.2c. - Stapled structures and related scheme provisions

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

c. with regard to the interaction of the related scheme provisions:

i. whether, as a matter of policy and ignoring section 974-80, arrangements in which the trust acts solely as a financier of the stapled group should be subject to the related scheme provisions;

ii. does the law need to be clarified as to whether, and how, the related scheme provisions apply to stapled structure arrangements; and"

The Government is currently considering the introduction of specific tax laws for MITs. As part of these laws it is intended that there be an arm's length rule for MITs such that a trustee will be taxable at the top marginal tax rate on an amount in excess of an arm's length price received from a related party. Any amendment in this area should be consistent with the proposed change in this area.

ABA recommendation

The ABA recommends that any amendment should be consistent with the MIT law changes.

17. General Question 5.2a. - Budget 2011-12 announcements

"a. Does the 2011-12 Budget announcement to amend section 974-80 address the concerns relating to its application? If not, what changes would address the problems and retain the integrity of the provision while ensuring it does not overreach?"

The announcement does not adequately address industry concerns about the section. In particular the introduction of discretion for the Commissioner is of limited use due to the fact that such administrative discretions are used reluctantly. A change that would assist would be to deny the operation of the section where a stapled group is listed on the Australian stock exchange. This would acknowledge that the perceived mischief that led to the introduction of the section would be unlikely to exist in the case of listed entities.

ABA recommendation

The ABA does not consider that the measures announced in the 2011-12 Budget sufficiently address industry concerns.

18. General Question 5.2b. - Is the GAAR sufficient?

"b. Given the operation of the general anti-avoidance provision in Part IVA, is there a need for a specific integrity provision in Division 974. If so, to what extent does section 974-80 perform this function?"

The purpose of Division 974 is to attempt to classify securities as either debt or equity. For various regulatory reasons there will often be an attempt to make an equity instrument more debt like (e.g. redeemable preference shares with a set rate of return) or debt instruments more equity like. This has been the case for decades and will only be intensified with the current focus on capital arising from the Basel Accords. Consequently if the Government decides it is necessary to have a statutory rule to distinguish between debt and equity, then it will normally be the case that various parties in Government will insist upon a specific anti avoidance rule. Section 974-80 seeks to fulfil this role but, like many anti avoidance provisions, has too wide an application and has caused difficulties for legitimate situations.

ABA recommendation

The ABA recommends that section 974-80 be amended to narrow its scope, or abolished and reliance placed on Part IVA.

19. General Question 5.2c. - Should there be a SAAR for stapled structures

> *"c. Whether an integrity measure, other than section 974-80, should apply to stapled structures. If so, what is the mischief that would be an appropriate measure and how should it be applied to, for example, financier trust stapled structure arrangements?"*

Firstly, it is suggested that any integrity measure should not apply to listed stapled structures as the commercial exigencies will normally mean that arrangements have a commercial objective not just a tax objective. Secondly, in the case of non-listed financier trust stapled structures the arrangement is normally designed to ensure investors receive a cash flow in the initial years prior to the project becoming profitable. Such cash flow may be required in order to meet the funding costs of investors.

ABA recommendation

The ABA does not recommend that there be a specific anti-avoidance rule (SAAR) for stapled structures.

20. General Question 5.2d. - Repeal of section 974-80

> *"Having regard to the issues identified with the current operation of section 974-80, would it be best to repeal section 974-80 and introduce a more specific integrity measure that directly targets the mischief originally intended to be covered by the measure?"*

ABA recommendation

The ABA recommends that section 974-80 be repealed and replaced with a SAAR that directly targets the intended mischief.

21. General Question 5.2e. - Is the compliance concern overstated?

"e. Whether the need for the integrity measure, combined with the practical administration difficulties, overstates the compliance concern where MNEs are free to choose whether they fund their associates with debt or equity and are already subject to the Australian thin capitalisation provisions?"

The mischief to which the section is directed is the changing of an equity return into a debt return. Given that debt is subject to thin capitalisation rules and withholding tax (for non-resident recipients) any mischief is likely to be minimal.

ABA recommendation

The ABA agrees that the compliance concerns are overstated.

22. Question 6.1d. - The imputation system and non-share dividends of ADIs

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

d. the imputation system"

The ABA has significant concerns around the current interpretation of section 215-10 of the Act dealing with the franking requirements for non-share equity interests that form part of an ADI's Tier 1 capital. The ABA considers that the views expressed by the ATO in Tax Determination TD 2012/19 have made it very difficult for Australian ADIs to raise AT1 capital through an offshore branch without being compelled to attach franking credits to the associated distributions.

The original purpose of section 215-10 was to remove a competitive disadvantage that Australian ADIs would otherwise have suffered from the introduction of the debt/equity rules (refer - para 2.92, EM to *New Business Tax System (Debt and Equity) Bill 2001*).

Prior to the introduction of the debt/equity rules the foreign branches of Australian ADIs competed to raise capital on, broadly, an equal footing with foreign independent entities and foreign subsidiaries. The debt/equity rules introduced re-characterised certain instruments as either debt or equity for tax purposes, in particular certain Tier 1 hybrid instruments issued by ADIs through their offshore branches became classified as equity, requiring distributions (including distributions to non-resident investors), to be franked. Recognising this outcome would increase the cost of raising capital for Australian ADI's foreign branches compared to other foreign independent entities and foreign subsidiaries, section 215-10 sought to remove this competitive disadvantage by exempting qualifying distributions from franking. This approach was consistent with the approach taken to Tier 1 capital raisings in overseas jurisdictions.

Section 215-10 was initially uncontroversial and Australian ADIs issued a number of Tier 1 capital instruments through foreign branches in reliance on section 215-10. The ATO also issued a number of positive PBRs confirming the franking exemption for specific issuances. The ABA is aware of seven positive PBRs issued prior to 25 July 2009.

Following the release of draft Taxation Determination TD 2009/D2 (which was finalised as TD 2012/19) the ATO adopted a new restrictive view of the "issued at or through a permanent establishment" requirement. The ATO approach in effect now requires branches to operate independently of the ADI Head Office and for branch decisions to be made without regard to the practical necessity for parts of the ADI Head Office to be involved in the relevant capital raisings.

The ABA had significant engagement with Treasury and the ATO during the development of TD 2012/19 and numerous concerns were raised over the approach taken by the ATO (refer Appendix).

It is practically very difficult for ADIs to satisfy the new ATO interpretation. The ABA understands that only one section 215-10 PBR has been issued in recent years and it concluded that the provision was not satisfied[1]. This was a surprising conclusion given the relevant fact pattern.

As a consequence Australian ADIs have largely ceased raising Tier 1 capital through foreign branches. The effect of the new ATO interpretation has been to defeat the purpose of the provision and limit its application. As a result the competitiveness of Australian banks has been eroded and Australian banks have lost the ability to access foreign capital markets for AT1 capital, in a form that is capable of paying unfranked distributions.

With Australian banks now operating under stricter Basel III capital requirements it is critically important for Australian banks to have a diversified investor base and be able to access all available financial markets on competitive terms, especially in times of market dislocation as was experienced during the GFC. The current tax policy settings have led Australian banks to only issue Basel III compliant AT1 capital instruments (with loss absorption features) in franked form to domestic investors. This outcome is undesirable from an investor concentration perspective.

The requirement to frank AT1 capital instruments issued through the offshore branches of ADIs is clearly inconsistent with the Government's push to cut red tape for business and its declaration that Australia is "open for business". Australian banks need the operation of section 215-10 to be clarified so that a clear and certain pathway is provided for Basel III compliant AT1 capital to be raised in a manner that is capable of satisfying the franking carve-out.

Further, in respect of existing transactions, there is inequitable treatment for certain taxpayers who are now facing potential exposure for issuances undertaken prior to the ATO's change in view. Certain of these taxpayers may have also obtained rulings on similar transactions, or otherwise understood the treatment adopted was acceptable, as the transaction(s) may have been disclosed to the ATO on an informal basis (at the time of execution or during a client risk review) and the ATO did not have concerns at that time.

[1] Refer ATO Edited Private Ruling Authorisation Number 1012084509682

ABA recommendation

The ABA recommends:

a) that the ATO revisit its interpretation of section 215-10 in TD 2012/19 so as to give the provision practical effect, or alternatively:

b) Section 215-10 be amended to delete the words "at or through a permanent establishment", so that the test is constructed in a manner that is the equivalent of raising capital through an offshore subsidiary.

23. Question 6.1e. - The anti-avoidance provisions

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

e. the anti-avoidance provisions"

The ABA observes that the interaction between s177EA and the debt/equity rules continues to create difficulties. This primarily arises from the "meaning of relevant circumstances of a scheme" as set out in s177EA(17) and is a consequence of the history of these provisions with the relevant s177EA(17) indicia pre-dating the introduction of Division 974. This can create situations for taxpayers where Division 974 applies such that a financing arrangement is determined under one set of indicia to be equity and the taxpayer is required to frank any distributions in accordance with the imputation rules, but s177EA applies a contradictory set of indicia such that the equity is determined to be "too debt like" and coupled with the too low non-incidental hurdle in s177EA, an avoidance purpose is purported to apply. As the Board have noted, TR 2009/3 illuminates an example of such a case where a taxpayer can issue an instrument serving a real commercial purpose, be required to frank distributions (it is not possible to choose not to) but have s177EA applied. Another example can be found in *Mills v. Commissioner of Taxation* [2012] HCA 51 where ultimately the ATO was unsuccessful in applying s177EA to a Tier 1 hybrid instrument issued by a bank for the purpose of raising regulatory capital and which was clearly characterised as equity under Division 974.

This issue is of particular relevance to the banking industry due to the requirements for banks to hold regulatory capital and the prescribed and very limited forms of acceptable Tier 1 capital that qualifies for prudential purposes. One such security that APRA accepts as AT1 capital is a perpetual note, however, hybrid securities such as these by their very nature include both debt and equity characteristics. These characteristics are a function of regulatory requirements (e.g. non viability clauses) but also investor appetite (e.g. some investors may be precluded from holding legal form shares).

ABA recommendation

The ABA recommends that a single clear and consistent scheme in the tax law apply to securities that are issued for real commercial purposes and not conflicting indicia.

24. Questions 6.1h. and 8.9 - OBUs

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

h. offshore banking unit activities"

"The Board seeks stakeholder comment on whether any significant practical difficulties arise in relation to the non-interaction of the OBU regime with Division 974."

The ABA observes that whilst there are certainly broader issues around the need to modernise the offshore banking unit (**OBU**) rules, some practical difficulties for taxpayers could be resolved through a better integration of the debt/equity rules into eligible offshore business activities. This issue is another arising as a consequence of the history of these provisions, with the OBU rules pre-dating Division 974.

For example, practical difficulties arise due to the definition of a lending activity in section 121D(2) and "lend" in section 121C. As a consequence of the different legal forms in which a bank may provide funding to a customer, uncertainty can arise as to whether a particular arrangement is a lending activity. Trade Finance is such an example where banks may provide short term funding to offshore exporters or importers or provide funding to foreign banks who have issued letters of credit to their customers. Whilst the industry typically adopts standard agreements to document these types of funding arrangements, it is not usually through a traditional loan agreement and therefore uncertainty can arise due to legal form.

ABA recommendation

The ABA recommends that there be better integration of the debt/equity rules into eligible Offshore Business activities so as to alleviate some of the existing practical difficulties, i.e. linking the definition of "lend" in s121C to the definition of a debt interest.

25. Question 7.3 - Interaction between Division 974 and Division 230 generally

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

With the exception of the comments at item 7.2 above, the ABA does not consider there are any significant practical difficulties that arise in relation to the interaction of Division 974 with the TOFA regime. The use of different terminology such as "debt interest", "financial arrangement", "sufficiently certain" and "ENCO" add some level of complexity to the structure of the law that ideally could have been avoided. However, these issues do not cause sufficient practical concern to make any required law change a high priority in the current legislative environment.

ABA recommendation

The ABA makes no recommendation in relation to question 7.3.

26. Question 9.1b. - Aligns tax characterisation with prudential characterisation

"The Board seeks stakeholder comment regarding the compliance and administration of Division 974 since its enactment, in particular whether:…

b. there should be a legislative provision for entities regulated by APRA that aligns tax characterisation with prudential characterisation, with a regulation-making power available to exclude particular items."

The ABA considers that there should be a legislative provision for entities regulated by APRA that aligns tax characterisation with prudential characterisation. It is also submitted that T2 capital and AT1 capital should be tax deductible to ensure Australian banks (or an entity regulated for prudential purposes by APRA) remain internationally competitive.

Background

Australian ADIs regulated by APRA are required to meet prudential standards. These standards require regulated entities to hold a minimum level of capital to act as a buffer against the risk (unanticipated losses) arising from their activities.

The types of regulatory capital that APRA requires regulated entities to hold/issue are Common Equity Tier 1 (**CET1**), AT1 and T2 capital. CET1 capital typically includes ordinary shares, retained and current year earnings. AT1 and T2 capital instruments are required by the prudential standards to have certain features and as a result, are not conventional debt or equity.

Where such capital is classified as equity for tax purposes, the cost of capital is non-deductible. This is an additional cost which puts Australian banks (and other entities regulated by APRA) at a competitive disadvantage compared with:

a) non-regulated corporate taxpayers which can raise capital without restrictions imposed by the prudential standards; and

b) non-Australian banks in jurisdictions where capital raising costs are treated as tax deductible.

26.1. T2 capital

Current approach

In Australia, attempts have been made to clarify the application of the debt/equity tax rules as the features of hybrid capital instruments change to conform with changes in regulatory requirements.

However, Australian income tax law has not necessarily kept pace with recent developments in global and Australian regulatory standards on capital adequacy. This means that the tax rules do not always adequately deal with hybrid capital instruments.

In recognition of this issue, the Government announced in the Federal Budget 2012/13 that following the Basel III capital reforms, T2 capital instruments issued by Australian banks can be treated as debt for income tax purposes. Regulation 974-135F now confirms that certain characteristics of T2 capital (i.e. the loss absorbency clause) will not result in the instrument failing the debt test. However, the regulation only addresses certain regulatory characteristics of a T2 capital instrument, and the instrument still needs to pass the other requirements of the debt test to be characterised as debt for tax purposes.

Tax law amendments in response to changes in regulatory standards have tended to be limited and ad hoc in nature. Whilst regulations (such as Regulation 974-135F, discussed above, and Regulations 974-135D and 974-135E)[2] 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 confirm that the notes satisfy the debt test.

Basel III regulatory changes

Contingent convertible securities (**CoCos**) are essentially debt instruments which mandatorily convert into the issuer's ordinary shares upon breach of a specified prudential trigger, such as non-viability or breaching a capital ratio threshold.

The Basel III rules are being developed for CoCos, however certain regulators (the UK and Switzerland) have specifically incorporated CoCos into the capital requirements of their local banks and consequently developed their regulations on CoCos in advance of other regulators.

Under APRA's Basel III, T2 instruments are required to be convertible to ordinary shares upon a non-viability trigger event. Currently regulation 974-135F ensures conversion under such conditions does not prevent T2 instruments from being debt interests.

However, in the offshore market, T2 has been used as the "host instrument" for CoCos that convert to ordinary shares upon a capital trigger which is set above the prescribed regulatory minimum to restore viability to the bank, rather than traditional operation of T2 capital that provides depositors an extra layer of capital support for a failed bank. It is submitted that the Division 974 regulation should be extended to ensure T2 instruments which contain capital triggers of this nature retain their debt interest characterisation. This would allow Australian banks to maintain their competitiveness internationally and increase financial stability in Australia.

Alternatively, the discussions above highlight the issue which arises when a change in the prudential requirements leads to a change in the tax characterisation of an instrument. This leads to inefficiencies as a result of the tax regulations being required to be updated. It is submitted that a more efficient approach to provide banks with certainty would be to provide a legislative alignment whereby prudential T2 instruments are treated as debt interest for tax purposes.

[2] Regulation 974-135D of the Income Tax Assessment Regulations 1997 ensures that conditions of insolvency or capital adequacy do not preclude Lower Tier 2 instruments from being treated as debt for tax. Regulation 974-135E ensures that conditions of profitability, insolvency or negative earnings do not preclude upper T2 instruments from being treated as debt

26.2. AT1 capital

Current approach

The current debt/equity rules contained in Division 974 operate to treat ATI capital instruments issued by Australian ADIs as equity interests for tax purposes and as a result no tax relief arises for distributions on these instruments. This outcome arises notwithstanding that these instruments themselves are typically accounted for as liabilities.

Basel III regulatory changes

The GFC and associated Basel III reforms significantly increased the volume and quality of core capital through higher capital targets for CET1 capital and increase capital deductions against CET1 capital. As a result, shareholder equity of Australia's four major banks doubled between 2007 and 2013, with CET1 capital increasing its percentage of gross prudential capital by circa 25%. Over the same period deductible Tier 2 in Australia has fallen by broadly an equivalent amount.

With less reliance upon subordinated capital securities, a large number of overseas jurisdictions (e.g. United Kingdom, Singapore, Japan and most of Europe including Netherlands, Italy, France and Germany) have legislated, or confirmed by other means, to ensure that AT1 securities are tax deductible.

From a tax policy perspective these settings place Australian ADIs at a competitive disadvantage to certain other international banks that are able to issue tax deductible AT1 capital in their home jurisdictions.

Approach adopted in other jurisdictions

A number of other countries, including the UK, Netherlands and Singapore, have taken steps to ensure that AT1 and/or T2 capital instruments continue to be treated as debt (and that payments on the instruments are deductible) for tax purposes.

In the UK Statutory Instrument 2013 No.3209 and Her Majesty's Revenue and Customers (HMRC): *The Taxation of Regulatory Capital Securities 2013* have the effect that distributions on certain qualifying AT1 instruments (i.e. legal form debt) issued by UK incorporated banks will be deductible for UK tax purposes. This tax treatment will apply to distributions arising after 1 January 2014. The possible extension of these rules to the UK branches of foreign banks is currently being considered.

In Singapore, the Monetary Authority of Singapore Notice 637 provides that distributions on AT1 instruments issued by Singapore incorporated banks (excluding their foreign branches) will be deductible for Singapore tax purposes. This tax treatment will apply to distributions accrued in the basis period for the 2015 year of assessment and thereafter.

The Dutch Deputy Minister of Finance on 16 December 2013 announced that banks will be able to deduct, for tax purposes, the returns realised on AT1 capital even if issued after 1 January 2014.

In the March 2014 German federal/local tax authority meeting it was foreshadowed that taxation regulations permitting coupons on AT1 securities to be tax deductible would be released shortly for sign off by all 16 Corporate Tax division heads of the German states. Sign-off is expected in the coming days.

In addition, France, Japan and Italy have also confirmed their commitment to provide tax deductibility for AT1 coupons.

The OECD in its paper, *BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws),* also recognised the need for special attention for hybrid capital instruments to ensure that payments on these instruments were not denied deductibility. This point was considered as part of a proposal for a general rule denying a deduction for payments under hybrid financial instruments where the payee does not treat the payment as assessable income. The OECD noted that payments on regulatory capital instruments should not necessarily be denied deductibility if the general rule were to be adopted.[3] The ABA understands that the OECD is actively considering an exclusion for banks from any new hybrid rules.

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. The UK legislation appears to be a good model for Australia to adopt.

ABA recommendation

The ABA recommends that Division 974 be amended to make clear that AT1 and T2 prudential instruments be treated as debt for income tax purposes.

[3] Paragraphs 158 to 162 of the OECD paper, *BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)*

Appendix

(See attached letter dated 20 August 2012)

AUSTRALIAN BANKERS' ASSOCIATION INC.

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20 August 2012

Ms Nan Wang
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Dear Nan,

Application of section 215-10 and Taxation Determination TD2012/19

Further to recent discussions, the Australian Bankers' Association (ABA) requests that Treasury review the operation of section 215-10 of the Income Tax Assessment Act 1997, following the release by the Australian Taxation Office (ATO) of Taxation Determination TD 2012/19. It is the ABA's view that the current interpretation being applied to section 215-10 has rendered the section unworkable and inconsistent with its purpose.

1. Background

Section 215-10 provides that certain non-share dividends paid by authorised deposit-taking institutions (ADIs) on Tier 1 hybrid instruments issued at, or through, a branch in a listed country are unfrankable provided certain conditions are satisfied. The policy intent of the provision, as stated in the explanatory memorandum to the New Business Tax System (Debt and Equity) Bill 2001 ("the EM"), is to align the taxation treatment of returns on eligible hybrids issued at, or through, a foreign branch with that of a foreign subsidiary of an ADI and foreign independent entities. Specifically, this section is intended to allow an Australian ADI to issue hybrid capital at, or through, a foreign branch without the requirement to frank distributions. This would therefore place the Australian ADI on a par with a foreign issuer with regards to the cost of that capital.

The ATO has recently issued Taxation Determination TD 2012/19 (the TD) (a copy of which is enclosed), which sets out the conditions under which the requirement (contained in s215-10(1)(c)) to issue the non-share equity interest at, or through, a permanent establishment of the ADI in a listed country would be satisfied.

2. Issued at, or through, a permanent establishment

2.1. Personnel involved in the issuance

The ATO has detailed when it will be concluded that a non-share equity interest will be issued at, or through, a permanent establishment in paragraphs 55 through 59 of the TD. Primarily the requirements outlined in those paragraphs relate to taking (at the permanent establishment) the final step or series of steps which invest the holders with complete control over the securities. The ATO has also identified that the marketing of the non-share equity interests must be undertaken from the place of business of the permanent establishment.

In the examples provided in the TD, key factors taken into account in the determination of whether section 215-10(1)(c) applies include how the decision to issue the hybrid is made (see paragraphs 2, 11 and 24), who undertakes marketing of the hybrid (see paragraphs 5 and 57), obtaining approval from regulatory bodies (see paragraphs 6, 15 and 26) and who has responsibility for the overall project co-ordination (see paragraphs 4, 14 (first sentence) and 18).

In example 1 (the example in which s215-10 applies) of the TD there is significant involvement of "personnel conducting the business at the... permanent establishment". Paragraph 45 of the TD provides that the business conducted at the permanent establishment must be banking business and paragraphs 46 through 48 describe which activities will comprise banking business. Banking business in these contexts is client facing activities and transactions, such as "borrowing or lending of money or like financial transactions" (para 48 of the TD). In paragraph 48, it is provided that "the capital raising must be a transaction of the business carried on at the permanent establishment".

Examples 2 and 3 of the TD (the examples in which s215-10 does not apply) focus on the involvement in the process of the preparation, marketing and issuance of the securities by staff who perform a group function, such as Group Treasury or Group Legal personnel. These examples distinguish between staff operating within such group functions and staff conducting the business of the branch.

In a recent private binding ruling (edited PBR number 1012084509682 ("the PBR") (a link to which is included below)) the ATO concluded that section 215-10(1)(c) was not satisfied despite the fact that the hybrid was originated and its issuance was managed by offshore Group Treasury personnel:

http://www.ato.gov.au/corporate/content.aspx?doc=/rba/content/1012084509682.htm

We understand that certain matters were relevant to the ATO's decision making process in coming to their decision in the PBR. While the facts outlined in the PBR and the ruling made thereon are specific to the recipient of the ruling, and may not apply to the offshore operations of other ADIs, they are indicative of the relevance being applied to specific functions undertaken by personnel of ADIs. In particular, the ATO viewed the following facts as being relevant:

- Members of Group Treasury (who are located in the offshore branch location) involved in the issuance of the hybrid provide services to various parts of the bank, not just to the particular offshore branch.
- Group Treasury staff in the offshore branch location report through to the CFO (who is in Australia), rather than directly through to a branch management structure.
- Members of Group Treasury involved in the issuance of the hybrid do not, as individuals, conduct the client business activities of the bank at the permanent establishment (such as the making of loans).

In a modern banking entity of any scale, there is segregation of front office and client facing activities and the personnel conducting those activities from the support functions that underpin those activities and the ADI's group operations and structure. Group Treasury and Group Legal functions of ADIs are in place to support the client facing activities of the financial institutions. The staff members have the particular skills required to (amongst other functions):

- manage group capital and funding requirements
- interact with regulators, investors and financial markets
- manage the group's interaction with rating agencies

- negotiate the issuance documentation[1]
- negotiate the legal instruments documenting the relationship with investment banks conducting the issuance.

Personnel conducting the front office and client facing activities of the ADI (the "banking business" of the ADI per the TD) will generally not have the above skill set.

Non-share equity issuance is also a function for which the Board will typically have personal liability, through the prospectus. They will direct Group Treasury and Legal to manage the process and the risk and not branch personnel. There is a fundamental difference between 1 year senior debt issued by the branch and group Tier-1 hybrid terms. It would be unreasonable to expect that the branch personnel have responsibility for the overall project management of the security issuance, as they will have no practical experience in this area and hence may increase the operational risk of the security for the bank and its board. It is also why the marketing of the issuance will not be led by the branch staff.

Following the exclusion of Group Treasury and Group Legal personnel from the category of persons that are conducting the business of the permanent establishment, the following facts included in example 1 are unlikely to ever be capable of being replicated to the satisfaction of the ATO by a typical ADI:

- overall project co-ordination and timetable management is delegated by the board of ABC Bank to management based in New York
- marketing of the convertible note will primarily be undertaken by personnel conducting the business at the permanent establishment
- the notes are allocated by branch personnel to the subscribers
- personnel conducting the business at the permanent establishment have taken all the necessary steps for issuing the notes.

2.2. Issuance of Tier 1 capital

Section 215-10(1)(b) requires that the non-share equity interest form part of the ADI's Tier 1 capital. By its very nature, regulatory capital is that of the ADI as a whole and cannot be separated between head office and branch. The issuance of Tier 1 capital must be a whole of entity decision, which forms part of the overall capital management function of the ADI.

Branch capital requirements (to the extent they even exist) may not be completely aligned with the overall ADI capital strategy. The technical local regulations may be different and even conflict with APRA and group regulations as to the terms and conditions required to be capital.

ADIs must actively manage their capital to balance the requirements of various stakeholders (regulators, rating agencies, depositors and shareholders). This is achieved by optimising the mix of capital while maintaining adequate capital ratios.

In paragraph 1 of the TD, it is identified that the Tier 1 Capital must be offered to investors in the course of the business conducted by an ADI at or through the permanent establishment. However, the offering of Tier 1 capital is not an activity that may be undertaken by the permanent establishment in isolation. Personnel of the permanent establishment will not always have the appropriate level of access to, and understanding of, the ADI's overall capital management policy, nor the requisite skill and experience base to adequately consider the risk factors and its place in the group capital structure and independently issue a capital instrument into the market.

[1] There are two functions: one is drafting the terms of the instrument (as a capital instrument, only the Treasury staff would have the experience to draft and negotiate the terms of the instrument with lawyers, ratings agencies, investors/investment banks etc; two is the issuing of document (the prospectus) including discussion of Group and Risk profile therein as well as that of the instrument;

The issuance of Tier 1 capital necessarily requires the involvement of both head office personnel and personnel undertaking group functions (such as Group Treasury and Group Legal personnel). Head office personnel are abreast of the overall requirements and strategies of the ADI, understand the risks of the group and the security, both in the prospectus and marketing material, and must be involved in a decision to raise Tier 1 capital. They will also be the personnel maintaining the relationships with regulators and the key relationships with investment banks that will likely support any capital issuance by the branch. Group Treasury personnel are inherently involved in and direct the capital management strategies of the ADI, for example:

- APRA's proposed Basel III rules will require Tier 1 capital instruments to be convertible into ordinary shares or subject to write-off when APRA determines that an ADI is no longer viable. Conversion must be into ordinary shares of the ADI or its parent. As such, the issuance of an eligible hybrid will require an assessment as to the overall impact on Tier 1 Capital, including the possible conversion of such eligible hybrid to common equity;
- APRA is proposing that regulatory capital instruments issued by ADIs must be subject to Australian law.

2.3. Requirement that the funds be used for banking business at the PE

As noted above, the raising of funding through the issuance of Tier 1 Capital is, by its very nature, a whole of entity decision, and the issuance of an eligible hybrid requires the involvement of specialist personnel, including Group Treasury and Group Legal personnel. The issuance must also be considered in light of the ADI's overall capital and funding requirements, on a whole of entity basis.

The involvement of Group Treasury and Group Legal personnel in example 2 leads to a conclusion that the funds raised are for the ADI as a whole and not specifically for the business of the ADI at the permanent establishment:

> *"This is evidenced, in part, by the fact that Group Treasury and Group Legal have overall management of the capital raising and are responsible for all major steps leading up to the issue..."*

The involvement of Group Treasury and Group Legal personnel in the issuance of the non-share equity interest is a necessary requirement stemming from the nature of the security as Tier 1 capital and the particular skills and knowledge of these personnel. It is the ABA's view that the necessary involvement of such personnel should not result in a negative inference being drawn as to the intended use of the funds within the permanent establishment and, therefore, should not taint whether the eligible hybrid is issued at or through the permanent establishment. Nor should the involvement of such staff in the issuance of the eligible hybrid taint the particular use to which the funds are put and whether such use meets the permitted purpose requirements contained in s215-10(1)(d) and (2). Where an ADI is seeking to issue a non-share equity interest in compliance with the TD, the ADI would need to minimise the involvement of such specialist personnel, to the possible detriment of the issuance process, the ADI's negotiating position and, ultimately, the cost and risk of the funding obtained through the issuance.

Example 1 of the TD provides a fact pattern in which the New York branch requests approval to issue an eligible hybrid. As noted, such a request could not be made in isolation of the overall funding requirements and capital structure of the ADI. A branch's size and scope of operations are such that its funding will generally be materially different in size, term, cost, complexity of terms and investor class such that the decision to issue an eligible hybrid must be led by the parent and not by the branch.

The size of a capital raising will generally be outside the requirements of the particular branch as to size, term, pricing etc, and would generally be on-lent elsewhere in the group. This mismatch will grow, with offshore regulators requiring banking operations to be locally incorporated to enhance local regulatory oversight, especially under stressed scenarios. Further, raising capital via a foreign subsidiary (especially an SPV) is not burdened by any requirement to use the funds solely for its own domestic requirements.

The requirement that the funds be used domestically within the location of the offshore permanent establishment as a necessary factor for the eligible hybrid to be regarded as having been issued at or through the permanent establishment is contrary to the policy intention of s215-10 to align offshore branches with foreign subsidiaries and foreign independent entities. Such inclusion additionally renders superfluous the specific inclusion in s215-10(1)(d) and (2) of the permitted purpose requirements for the use of the funds.

2.4. Application of s215-10 is inconsistent with the policy intent

The policy intent of section 215-10 is to align the taxation treatment of foreign branches with that of foreign subsidiaries of the ADI in relation to the issue of eligible hybrid capital. Where a foreign subsidiary of an ADI issues eligible hybrids into the market, this may also be undertaken having regard to the ADI's overall capital management strategy and personnel of the ADI (and in particular, the ADI's Group Treasury team) may be heavily involved in the origination, marketing and project management of the capital issuance. It cannot be said that such involvement by the ADI's management in this respect would negate the ability of the foreign subsidiary to effectively issue the eligible hybrid in the foreign location where the subsidiary is based. Therefore, the particular focus on personnel involvement in the application of section 215-10 is not consistent with the policy intent.

2.5. Application of s215-10 increases uncertainty and cost

Application of s215-10 in line with the TD introduces various nebulous concepts that increase the uncertainty as to when section 215-10(1)(c) will be satisfied. This will hinder the ability for ADIs to have timely access to the markets and create additional expense within the ATO as any issuance will require applying for a private binding ruling prior to the issue.

For example, as discussed above, the TD requires the allocation of the non-share equity interest to be undertaken by "personnel conducting the business of the branch" and in this the ATO appears to be referring to the banking business of the issuer conducted through the branch. However, there is no guidance offered in the TD as to when the ATO will consider employees of the ADI to be acting for the permanent establishment as part of the issuer's banking business. Similarly, given the blurred line provided in the examples as to what constitutes acceptable involvement of head office and group personnel, any involvement by such personnel in the decision to issue Tier 1 capital and the issuance process will cause an unacceptable level of uncertainty.

2.6. Investors

In example 2 of the TD and in paragraphs 58 and 59 of the TD, it is provided that an issuance to Australian residents will likely not satisfy s215-10(1)(c) because the "security passes in Australia". The functional connection of an issuance to the offshore branch should not be reliant on the parties to whom the security is marketed and issued. Such limitation is contrary to the principle that Australian ADIs not be made worse off in comparison with foreign subsidiaries of Australian banks and foreign independent entities. Foreign subsidiaries of Australian banks and foreign independent entities are freely able to market and issue eligible hybrids to Australian residents without the need to frank such securities and, therefore, without the imposition of this additional cost.

3. Submission

The issues highlighted above set out the ABA's position as to why section 215-10 has been rendered unworkable in practice. The TD leaves the industry with greater uncertainty as to the ability for any issuer to comply with the provision in practice, which highlights the need for legislative change.

The domestic capital market is not able to fully absorb the total capital requirements of Australian ADIs. ADIs will therefore need to access offshore capital markets to meet their total capital needs. Sufficient certainty regarding the application of section 215-10 is required to enable issuers to access offshore markets with confidence and in a timely manner. The current uncertainty requires ADIs to undertake difficult and lengthy private ruling processes with the ATO which limit an ADI's ability to effectively raise capital.

The ABA requests that Treasury recommends an amendment to section 215-10 in order to give effect to the policy intentions for which it was initially enacted.

We look forward to your early response to this issue, which is of considerable importance to the ABA.

Yours sincerely,

Tony Burke

Encl: TD 2012 / 19

.cc Louise Clarke, ATO
Andrew Werbik, ATO

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Taxation Determination

Income tax: when is a non-share equity interest 'issued at or through a permanent establishment' for the purposes of paragraph 215-10(1)(c) of the *Income Tax Assessment Act 1997*?

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If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

Ruling

1. A non-share equity interest will be taken to have been 'issued at or through a permanent establishment' for the purposes of paragraph 215-10(1)(c) of the *Income Tax Assessment Act 1997* (ITAA 1997)[1] where the capital raising is a transaction 'of' the business carried on by an authorised deposit-taking institution (ADI) at or through the permanent establishment in a listed country. This means that:

- the non-share equity interest must be offered to investors in the course of the business conducted by an ADI at or through the permanent establishment in a listed country; and
- the non-share equity interest must be allocated to the investor by personnel conducting the business of the permanent establishment; and
- the transaction documents are executed at the permanent establishment; and

[1] All legislative references are to the ITAA 1997 unless otherwise indicated.

- the transaction documents provide that the non-share equity interest is transferred to the investor at the permanent establishment and consequently the non-share equity interest is transferred at the permanent establishment; and
- at the time of transfer, the personnel conducting the business at the permanent establishment relinquishes all control over the non-share equity interest.

Example 1

2. ABC Bank is an ADI in Australia with a branch located in New York.[2] *ABC Bank's New York Branch needs to raise US$500 million for use in the New York Branch's business of lending money in New York. The New York Branch intends to market and sell the notes to United States (US) retail and institutional investors through a local investment firm.*

3. The convertible note will qualify as Group and Parent Additional Tier-1 capital under Australian Prudential Regulation Authority (APRA) Basel III regulations.

4. The New York Branch requests approval from the Board of ABC Bank for the Branch to issue US$ denominated convertible notes and upon receiving that approval, branch personnel together with personnel from ABC Bank's Group Legal and Group Treasury, prepare an offer document, the transaction documents and undertake the necessary due diligence. The transaction documents are settled and executed by personnel conducting the business at the New York permanent establishment. Overall project co-ordination and timetable management is delegated by the Board of ABC Bank to management based in New York who is conducting the business at the permanent establishment in New York.

5. The marketing of the convertible note will primarily be undertaken by personnel conducting the business at the permanent establishment but Group Treasury executives from Sydney will also be involved to address any questions concerning the Bank and the Tier-1 classification of the capital raised.

6. Some tasks relating to the capital raising are done solely in Australia. Namely, personnel based in Australia from Group Legal and Group Treasury, obtain approval from APRA, obtain the necessary Australian Securities and Investment Commission (ASIC) and Australian Stock Exchange (ASX) waivers and prepare and issue announcements to the ASX and foreign stock exchanges.

7. Upon acceptance of the offer by the US investors, the notes are allocated by branch personnel to the subscribers. The New York Branch then transfers the notes to the US investors in accordance with the transaction documents.

8. The convertible notes will be classified as non-share equity interests for the purposes of Division 974 and returns paid in respect of the convertible notes will be taken to be non-share dividends.

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[2] The United States of America is a listed country for the purposes of section 215-10 of the ITAA 1997. 'Listed country' means a foreign country, or a part of a foreign country, that is declared by the regulations to be a listed country for the purposes of Part X of the *Income Tax Assessment Act 1936* (ITAA 1936): see section 320 of the ITAA 1936 and subsection 995-1(1) of the ITAA 1997. At the time this Determination is published, the Income Tax Regulations 1936 provide that Canada, France, Germany, Japan, New Zealand, United States of America, United Kingdom of Great Britain and Northern Ireland are listed countries for the purposes of Part X of the ITAA 1936.

9. The convertible notes are taken to be issued at or through the permanent establishment of the ADI in New York because that is the place where the capital raising is undertaken and the capital raising is undertaken as a transaction of the business conducted by the ADI at the permanent establishment. In other words, the permanent establishment is the place where personnel conducting the business at the permanent establishment have taken all the necessary steps for issuing the notes, including the final step whereby the notes are transferred to the investors. It is also the place where the investors acquire control over the notes issued. Accordingly, paragraph 215-10(1)(c) is satisfied.

10. Assuming that all of the other conditions in section 215-10 are met, the returns paid in respect of the convertible notes will be unfrankable.

Example 2

11. XYZ Bank is an ADI in Australia with a permanent establishment in London.[3] *XYZ Bank would like to issue an A$ denominated stapled security comprising of a fully paid preference share in the ADI and a fully paid note from the London Branch to raise Group and Parent Additional Tier-1 Capital under APRA Basel III regulations. The funds are to be used to replace Tier-1 capital previously raised offshore.*

12. Under proposal 1, XYZ Bank proposes to use LMN Investment Bank, a non-resident entity, as an intermediary for the issue.

13. The transaction documents which create the note will be executed at the London Branch and the notes will be acquired by LMN Investment Bank. LMN Investment Bank will also acquire the preference shares from XYZ Bank and will staple each note to a preference share. The stapled securities will then be offered to investors by LMN Investment Bank, on behalf of the XYZ Bank. XYZ Bank has stipulated that the stapled securities be sold to a mix of Australian and United Kingdom retail investors. XYZ Bank will allocate the stapled securities once the offer period has closed.

14. Following the Board of XYZ Bank's approval of the issue of the stapled security, personnel from XYZ Bank's Group Legal and Group Treasury prepare the offer document, the transaction documents and undertake the necessary due diligence for the capital raising. The transaction documents pertaining to the issue of the note are settled and executed by personnel conducting the business at the London permanent establishment, while the transaction documents pertaining to the preference share are settled and executed by personnel in Australia.

15. Personnel based in Australia obtain approval from APRA, obtain the necessary ASIC and ASX waivers and prepare and issue announcements to the ASX and foreign stock exchanges. Australian based personnel are also responsible for appointing the investment bank and negotiating the terms of the stapled instruments and the terms of their issue to investors.

[3] The United Kingdom is a listed country for the purposes of section 215-10.

16. The stapled security, as a whole, is classified as a non-share equity interest for the purposes of Division 974 and returns paid on the stapled security will be taken as non-share dividends. Section 215-10 will not apply to treat the non-share dividends as unfrankable because paragraph 215-10(1)(c) will never be satisfied. Although the transaction documents creating the notes are executed at the London Branch, this is insufficient for a conclusion that the non-share equity interest is issued at or through the London Branch. That is, it cannot be said that the non-share equity interest, which includes the preference share which is required under Basal III APRA regulations to be issued directly by the ADI in Australia, was issued at or through the permanent establishment in London.

17. *While the fact that the preference share must be issued by the ADI directly from Australia is sufficient for concluding that the non-share equity interest was not issued at or through the permanent establishment, there are two other factors which indicate that the non-share equity interest was not issued at or through the permanent establishment*.

18. Firstly, the capital raising does not have sufficient nexus with the business conducted at the permanent establishment such that it could be concluded that it was a transaction of the business conducted at the permanent establishment. The funds raised are for the ADI as a whole and not specifically for the business of the ADI at the permanent establishment. This is evidenced in part by the fact that Group Treasury and Group Legal have overall management of the capital raising and are responsible for all major steps leading up to the issue except for the execution of the notes.

19. Secondly, when the notes are transferred to LMN Investment Bank, XYZ Bank will retain control over the notes. Therefore, XYZ Bank in Australia will retain control over the stapled securities right up until they are allocated and transferred to the retail investors.

20. Accordingly, it is XYZ Bank that issues the non-share equity interests to the retail investors.

21. Under proposal 2, XYZ Bank will issue a stapled security that is similar to that under proposal 1 but the preference share will remain unpaid until the note is extinguished. The note and the preference share will be classified as two separate equity interests under Division 974, with the note being treated as a non-share equity interest. Returns in respect of the notes will be taken to be non-share dividends.

22. Once again section 215-10 will not apply to treat the non-share dividends as unfrankable because paragraph 215-10(1)(c) will not be satisfied. As with proposal 1, although the transaction documents creating the notes are executed at the London Branch, this is insufficient for a conclusion that the notes are issued at or through the London Branch. As with proposal 1, the capital raising is not a transaction of the business carried on at the permanent establishment and when the notes are transferred to LMN Investment Bank, XYZ Bank will retain control over the notes.

23. Accordingly, it is XYZ Bank that issues the non-share equity interests to the retail investors.

Example 3

24. QRS Bank is an ADI in Australia with a permanent establishment in London.[4] *QRS Bank would like to issue US$500 million denominated perpetual notes. The funds raised will be Group and Parent Additional Tier-1 Capital under APRA Basel III regulations. The funds are to be used to replace Tier-1 capital previously raised offshore. Group Treasury have identified institutional investors in Asia and Europe as potential acquirers of the notes. As a consequence, Group Treasury is considering the possibility of issuing the notes through their London Branch.*

25. The Board of QRS Bank gives its London Branch the necessary approvals and directs Group Treasury to project manage the process for the capital raising. Group Treasury personnel together with Group Legal personnel draft, prepare and settle the offer document, the transaction documents and undertake the necessary due diligence. The Management Committee responsible for conducting the business at the QRS London Branch are advised by Group Treasury of the details of the proposed capital raising and the Management Committee is advised that when all the preliminary steps are settled, the Chair and the Secretary of the Management Committee will be required to execute the transaction documents. The Management Committee is advised by Group Treasury that the funds will be used to repay capital previously contributed to the London business by the ADI.

26. Personnel based in Australia obtain approval from APRA, obtain the necessary ASIC and ASX waivers and prepare and issue announcements to the ASX and foreign stock exchanges. Australian based personnel are also responsible for appointing the investment bank and negotiating the terms of the stapled instruments and the terms of their issue to investors.

27. Upon acceptance of the offer by the investors, the notes are allocated by Group Treasury personnel to the subscribers. The London Branch then transfers the notes to the investors.

28. The perpetual notes will be classified as non-share equity interests for the purposes of Division 974 and returns paid in respect of the perpetual notes will be taken to be non-share dividends.

29. The perpetual notes are not taken to be issued at or through the permanent establishment of the ADI in London because the capital raising is not a transaction of the business of the ADI in London. The only role personnel conducting the business at the permanent establishment have in the capital raising is the execution of the transaction documents and transferring the notes to the investors. Accordingly it cannot be said that the permanent establishment is the place where personnel conducting the business at the permanent establishment have taken all the necessary steps for issuing the notes. Accordingly, paragraph 215-10(1)(c) is not satisfied.

30. Assuming that all of the other conditions in section 215-10 are met, the returns paid in respect of the convertible notes will be frankable.

[4] The United Kingdom is a listed country for the purposes of section 215-10.

Date of effect

31. This Determination applies to years of income commencing both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
18 July 2012

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

Explanation

32. Generally, under the imputation system, distributions made by an Australian resident company out of realised profits, regardless of the source of those profits, are frankable.[5] Exceptions to the general rule are expressly provided for in the tax law: section 215-10 is one such exception.

33. Section 215-10 permits certain non-share dividends paid by an ADI to be unfrankable provided certain conditions are satisfied. Subsection 215-10(1) provides:

> A *non-share dividend paid by an ADI (an authorised deposit-taking institution) for the purposes of the *Banking Act 1959* is ***unfrankable*** if:
>
> (a) the ADI is an Australian resident; and
>
> (b) the non-share dividend is paid in respect of a *non-share equity interest that:
>
> (i) by itself; or
>
> (ii) in combination with one or more *schemes that are *related schemes to the scheme under which the interest arises;
>
> forms part of the ADI's Tier 1 capital either on a solo or consolidated basis (within the meaning of the prudential standards); and
>
> (c) the non-share equity interest is issued at or through a permanent establishment of the ADI in a *listed country; and
>
> (d) the funds from the issue of the non-share equity interest are raised and applied solely for one or more purposes permitted under subsection (2) in relation to the non-share equity interest.

34. Section 215-10 of the ITAA 1997 was enacted in 2002 (originally inserted as section 160APAAAA of the *Income Tax Assessment Act* 1936 (ITAA 1936)), as a consequence of the introduction of the debt/equity rules in Division 974 of the ITAA 1997 which would have resulted in certain legal form debt instruments being characterised as equity interests for income tax purposes, and distributions paid in respect of those instruments being frankable.

[5] Subject to the operation of any relevant integrity rules in the tax law.

35. The broad policy intent of section 215-10 was to '*remove a competitive disadvantage that Australian ADIs would otherwise suffer from the introduction of the new debt and equity rules*': see paragraph 2.92 of the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 (the Explanatory Memorandum). Paragraphs 2.93 and 2.94 of the Explanatory Memorandum elaborate on the policy intent:

> 2.93 Australian ADIs are subject to APRA regulations under which there are advantages for the ADI to raise Tier 1 capital through branch structures rather than through foreign subsidiaries. At present, foreign branches and subsidiaries of Australian ADIs compete, broadly, on an equal footing with foreign independent entities which raise capital overseas by the issue of hybrid instruments. These instruments form part of the Tier 1 capital of the Australian ADI under APRA prudential standards. The new debt/equity rules will result in some hybrid instruments which are currently treated as debt interests for income tax purposes being recharacterised as non-share equity interests (eligible hybrids). A consequence is that an Australian ADI (i.e. the entity legally liable in the head office/branch structure) would need to frank the returns on these instruments (i.e. non-share dividends). This is an inherent additional cost of raising capital overseas which would not be incurred if the Australian ADI issued eligible hybrids through a foreign subsidiary and is a cost which may not be incurred by a foreign independent entity raising capital in the same way.
>
> 2.94 This measure prevents the disadvantage from arising by treating the returns on the eligible hybrids as unfrankable dividends of the ADI. Aligning the taxation treatment of foreign branches with that of foreign subsidiaries of the ADI and foreign independent entities in relation to the issue of eligible hybrids will assist Australian ADIs to grow their businesses conducted through foreign branches.

36. The purpose of section 215-10 is best understood when considered in the context of the Australian imputation system. Classical company tax systems affect the cost of capital for moneys raised in the form of equity to the extent that they impose an additional layer of taxation on profits earned by that capital. A decrease in the after-tax return on an equity investment attracts demand by investors for a higher pre-tax return, thus increasing the cost of capital. The Australian imputation system is directed at removing double taxation for Australian resident investors in respect of income that is taxed in Australia; and hence puts them in the same position as resident recipients of Australian sourced interest. Franking does not have an equivalent effect for foreign residents, where it will often only relieve an interest withholding tax liability (which may in any event have resulted in a foreign tax credit in the foreign jurisdiction, thus leaving the overall tax burden unaffected). Requiring the franking of returns for non-residents receiving income from non-share equity issued offshore results in wastage of franking credits, thus effectively increasing the issuer's cost of capital (compared with issuing non-frankable instruments to the same non-residents).

37. 'Wastage' is usually an intended feature of the system, at least for inward foreign equity investment, because it represents the intended Australian source tax on profits attributable to that investment. Dividend streaming rules are enacted to prevent the avoidance of intended wastage by the selective targeting of resident and non-resident equity investors.

38. The purpose of section 215-10 is to prevent unintended wastage for *non-resident investors* making an equity investment *in a foreign jurisdiction*. Outward equity investment is generally outside the imputation system, the result of confining franking accounts to resident companies. A foreign investor in a non-resident company earning profits not sourced in Australia generally has no Australian tax exposure, and the company therefore faces no cost of capital consequences for that equity from the Australian imputation system. However, a resident company with an offshore branch earning foreign source income that has non-resident investors faces the possibility that a distribution to investors will have to be franked, resulting in the wastage of franking credits. This problem arises regardless of the form of the equity,[6] but in the case of *non-share* equity competitive neutrality is involved. Non-share equity (that is, legal form debt) may be deductible in a foreign jurisdiction. Moreover, most other countries now operate some form of modified classical company taxation, which has the effect of making investors indifferent to whether the company invests on-shore or off-shore.

39. When non-share equity capital is raised and used in a foreign jurisdiction it will attract local tax consequences, that is, there may be a deduction for the cost of the capital in the foreign jurisdiction, and in the case of branches of foreign companies operating there, usually also exemption or a tax credit in the home jurisdiction for income *net of any deduction*. If, in addition, but only for Australian resident companies, it also attracts an adverse franking consequence in Australia, that consequence will of course increase the cost of capital for Australian companies compared with other companies operating in the same jurisdiction, putting Australian companies at a competitive disadvantage. For ADIs the cost of capital may be crucial for commercial success and this disadvantage correspondingly significant. Section 215-10 is intended to put a foreign branch of a resident ADI in the same position for the issue of the same instrument by other banks conducting business in that jurisdiction. Therefore, the section 'turns off' the Australian company tax imputation rules so that the advantages and disadvantages of the local company tax rules should apply equally to all.

40. When regard is had to what is said in the Explanatory Memorandum, as well as to how section 215-10 operates as an exception to the general operation of the imputation system, it is clear that section 215-10 is intended to ensure that ADIs do not incur the additional cost of franking returns in respect of capital that is both raised and used offshore: see paragraph 2.93 of the Explanatory Memorandum. The reference to 'raising capital overseas' in the Explanatory Memorandum is consistent with the requirement that the relevant equity interest be 'issued at or through a permanent establishment' of the ADI. Then, paragraph 215-10(1)(d) ensures that the concession only applies when the capital is used offshore in the course of the business conducted by the ADI at the permanent establishment. Accordingly, section 215-10 puts a business conducted at a permanent establishment in the same position with respect to their cost of capital for use in the business to that of a foreign resident company conducting business in the same jurisdiction.

[6] While it might seem desirable in principle for foreign source income to be distributable from Australian companies to foreign residents without wastage of franking credits, there is a practical problem of identifying the income as foreign source and not inadvertently permitting dividend streaming. Conduit rules attempt to address these problems.

The meaning of 'issued at or through a permanent establishment'

41. Having regard to the meaning of 'at or through a permanent establishment' in the context of whether a business is being carried on at a permanent establishment, section 215-10 will only apply when the non-share equity interest is a transaction *of* the business conducted by the ADI at the permanent establishment in the listed country; and as such the interest must be issued at the place where the business is conducted.

42. A 'permanent establishment' is defined for the purposes of section 215-10 of the ITAA 1997, via section 995-1 of the ITAA 1997, in section 6 of the ITAA 1936. The definition provides that a 'permanent establishment' in relation to a person means:

> '[A] place at or through which the person carries on any business and…includes a place where the person is carrying on business through an agent…'

43. Thus, a permanent establishment is a *place of business*. The preposition 'at' denotes the location of something in space: here it means that the business is done *there*, at that place. The preposition 'through' conveys a sense of instrumentality or agency, which is used to accommodate the extension of the definition to a place where someone else, an agent, carries on the person's business at that place. Hence the fundamental conception of a permanent establishment is that of a fixed place where business is transacted by a person or by a person's agent. For an agent to be taken to be carrying on the person's business at a permanent establishment, the agent must have the general authority to bind the person to contracts, and that agent must habitually exercise its general authority to negotiate and conclude contracts on behalf of the person: see *National Commercial Bank v. Wimborne* (1979) 11 NSWLR 156. The mere existence of a general authority to conclude contracts is not sufficient to constitute carrying on business at or through a permanent establishment. There must also be a habitual exercise of that authority: see *Unisys Corporation Inc v. FC of T* [2002] NSWSC 1115 2002 ATC 5146; (2002) 51 ATR 386.

44. To identify a permanent establishment, there needs to be identification of transactions which constitute the carrying on of a business at a place. A business is not carried on unless there is some repetition or continuity: see *Thiel v. Federal Commissioner of Taxation* (1990) 171 CLR 338; 90 ATC 4717; (1990) 21 ATR 531. Personnel need to be located at the place to undertake the transactions of the business.

45. For the purposes of section 215-10, the business conducted at the permanent establishment must be a banking business.

46. Section 995-1 provides that an ADI is an authorised deposit taking institution within the meaning of the *Banking Act 1959*. It therefore means a body corporate which has been authorised to carry on 'banking business'. 'Banking business' means:

> (a) a business that consists of banking within the meaning of paragraph 51(xiii) of the Constitution; or
>
> (b) a business that is carried on by a corporation to which paragraph 51(xx) of the Constitution applies and that consists, to any extent, or
>
> > (i) both taking money on deposit (otherwise than as part-payment for identified goods or services) and making advances of money; or
> >
> > (ii) other financial activities prescribed by the regulations for the purposes of this definition.

47. Thus, broadly speaking, the business of an ADI is that of a banking business which will consist of the borrowing or lending of money or like financial transactions. The permanent establishment of an ADI will be a place at which it carries on banking business. It may also carry on other business at the permanent establishment, but for section 215-10 to apply an ADI must carry on some banking business at or through a permanent establishment. The requirement that there must be some banking business is drawn from the fact that section 215-10 is dealing with Tier-1 capital which, put simply, is the equity capital an ADI must hold in regard to its banking liabilities to provide security against losses of its banking business.

48. To summarise, the identification of borrowing and lending transactions at a particular place is of the essence for the identification of a permanent establishment of an ADI at that place. In order for a non-share equity interest to be taken to have been issued at or through the permanent establishment for the purposes of section 215-10, the capital raising must be a transaction of the business carried on at the permanent establishment.

49. While the term 'issued' is not defined for the purposes of paragraph 215-10(1)(c), its meaning in relation to shares and debentures issued by a company has been considered by the courts on a number of occasions. The High Court considered the meaning of the term 'issue' in relation to when shares could be taken to be issued in *Central Piggery Co Ltd v. McNicoll and Hurst* (1949) 78 CLR 594. Latham CJ observed in his decision that:

> The issue of the shares is the act which ends the transaction and ends in the issue of the shares to a specific person...

50. Rich J came to a similar conclusion. His Honour stated that:

> 'The word 'issue' is one which has not any very definite legal import with reference to shares,' (*Spitzel v. The Chinese Corporation Ltd*). In the instant case the phrase to be construed is 'proceed to the issue,' a phrase which predicates a course of action ending in the issue. Shares are turned from nominal into effective capital upon being issued… It is not the first step which counts but the final step.'

51. Dixon J also made a similar finding when he observed, at pages 599 – 600, that:

> …. Speaking generally the word 'issue' used in relation to shares means, where an allotment has taken place that the shareholder is put in control of the shares allotted. A step amounts to issuing shares if it involves the investing of the shareholder with complete control over the shares. *Re Ambrose Lake Tin and Copper Co* (*Clarke's Case*) makes that quite clear. Cockburn L.C.J. said 'inasmuch as the term 'issue' is used, it must be taken as meaning something distinct from allotment, and as importing that some subsequent act has been done whereby the title of the allottee becomes complete, either by the holder of the shares receiving some certificate, or being placed on the register of shareholders, or by some other step by which the title derived from the allotment may be made entire and complete.

52. These observations when read together support the view that shares are issued by a company when the final step, or final series of steps are taken, which invest the shareholder with complete control over the shares. See also *Re Buckley Earthmoving Pty Ltd (in liq)* (1995) 15 ACSR 732, citing *Central Piggery Co Ltd v. McNicoll and Hurst* (1949) 78 CLR 594 as well as *National Westminster Bank plc v. Inland Revenue Commissioners* [1994] 3 All ER 1.

53. In an earlier case, *Grenfell v. The Commissioners of Inland Revenue* (1875-76) LR 1 Ex D 242, the English Divisional Court had to answer a slightly different question. Rather than determine when a security was issued, the court had to consider where a security had been issued. That is, the court had to decide whether certain bonds had been issued in the United Kingdom and thus taxable in the UK, or issued in New York. The court held that the bonds were issued in New York because that was the place where the issuing company parted with possession and control over the bonds. Kelly J. observed, at page 247, that:

> [T]he company is an American company, having its place of business in New York, and there the shares were offered to the public. Some of the bonds were taken up by the public, and then the company entered into negotiations with Messrs. Morton, Bliss & Co., for the purchase by them of the remainder. Carrying out these negotiations, the company sold the bonds, and parted with their interest in them and control over them.

54. Pollock J. made a similar observation when he said, at page 249, that:

> If I understand the word 'issue', not giving to it any technical meaning, the issue of a bond is its first creation by the company, who give thereby a right of action in favour of some person to whom the bond is given. In the present case that was done, and done completely, in New York; because, although no bond was actually handed over in the first instance, a binding contract took place, whereby Messrs. Morton, Bliss & Co. were entitled, on the one hand, to call upon the company to transfer and issue to them a number of the bonds, and, on the other hand, they incurred the correlative obligation of taking and accepting the whole of the liability upon them.

55. Having regard to these cases, it is concluded that a non-share equity interest will be issued at, or through, a permanent establishment for the purposes of section 215-10 when:

- the non-share equity interest is offered to investors in the course of the business conducted by an ADI at or through the permanent establishment in a listed country;
- the non-share equity interest is allocated to the investor by personnel conducting the business at the permanent establishment;
- the transaction documents are executed at the permanent establishment;
- the transaction documents provide that the non-share equity interest is transferred to the investor at the permanent establishment;
- the non-share equity interest is transferred to the investor at the permanent establishment by the personnel conducting the business of the permanent establishment; and
- at the time of transfer, the business conducted at the permanent establishment relinquishes all control over the non-share equity interest.

56. It is not enough that the transaction documents which create the non-share equity interests are prepared and executed at the place where the ADI conducts business. It must also be the case that the steps necessary to complete the process of transferring the non-share equity interests to the investor such that the ADI has 'parted with their interest and control' over the interests are done at the place of business.

57. Paragraph 215-10(1)(c) is satisfied when the transaction documents for creating the non-share equity interests are executed at the place of business, and the marketing and allocation of the non-share equity interests is undertaken from the place of business such that the investor is placed in possession and control of the instrument by the permanent establishment.

58. The answer is no different when a non-share equity interest is transferred to an intermediary and stapled to an equity interest. The non-share equity interests are not issued until the point in time when they are transferred to the investors by an intermediary. Where the permanent establishment of the Australian ADI has issued the non-share equity interests and satisfies all of the conditions in paragraph 55 of this Determination, the capital has been raised offshore. It will generally be the case that the non-share equity interests will have been acquired predominantly by non-resident investors.

59. When the ADI, or an intermediary on their behalf, has marketed non-share equity interests to Australian residents, it is unlikely that paragraph 215-10(1)(c) will be satisfied as the ADI will not have relinquished all control of the non-share equity interests up until the time of the transfer. When an ADI intends to offer a non-share equity interest to Australian resident investors, it is the usual practice for the documents which create the non-share equity interests to be executed at the place where the permanent establishment conducts business, but the ADI retains control over the newly created non-share equity interests of the transfer. Control is generally retained until the non-share equity interests are transferred to the ultimate investors. In retaining control the ADI usually dictates that the interests be transferred to particular intermediaries, who in turn sell the interests to the ultimate investors, after the ADI, or the intermediary on their behalf, has marketed the interests and decided to whom the interests should be sold. Where this is the case, the non-share equity interests are not issued at, or through, the permanent establishment. They are not issued until they are transferred to the Australian investors, and they are issued in Australia by the ADI or an intermediary on the ADI's behalf.

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TD 2009/D2

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