



AUSTRALIAN BANKERS' ASSOCIATION

Director

Level 3, 56 Pitt Street
Sydney NSW 2000
Telephone: 0500 892 250
Mobile:
Facsimile: 02 8298 0433

2 August 2001

Australian Taxation Office
2 Constitution Avenue
Canberra ACT 2600

Department of Treasury
Langdon Crescent
Parkes ACT 2600

Dear and

New Business Tax System (Debt and Equity) Bill 2001

Our review of the Bill has identified a number of issues where either amendment is required and/or further clarification is necessary.

Section 22



Section 22

Section 25-85

Section 25-85(3)

This section seeks to impose a cap on the deductible amounts for hybrid instruments that are treated as debt interests. The policy underlying the debt/equity rules is not based on bifurcation and it is inappropriate to use bifurcation to place a cap on the amount that is deductible in relation to a debt interest. There should be no cap.

As a result of the application of this section, the amount over and above the cap will not be deductible and will not be a frankable dividend.

If the Government chooses to persist with this approach the proposed cap of a benchmark rate plus 150bps should be increased to a benchmark rate plus 200 bps. While 150 bps may appear appropriate in the context of current market conditions, it is preferable that a rate be set that will stand up over the whole economic cycle where spreads do vary from time to time. This would be preferable to having to increase the rate at a later time using the Regulation powers when spreads inevitably increase. Given past experience, we question the ability of Regulations to be changed as quickly as would be required by potential issuers wishing to take advantage of market opportunities.



Deductibility of dividends on shares that are treated as debt interests for tax purposes

In the February 2001 Exposure Draft, it was very clear that dividends on shares (where they are debt interests for tax purposes) could now be deductible. Specifically, section 25-85 as it then stood provided as follows:

"A company that pays a *dividend in relation to a *share that is a *debt interest in the company can deduct the dividend to the extent to which it would have been a *general deduction under section 8-1 if:

- (a) the payment of the dividend had been the incurring by the company of a liability to pay the same amount as interest; and
- (b) that interest had been incurred in respect of the finance that was obtained by the company and in respect of which the dividend was paid."

By contrast, (and notwithstanding the comments at paras 2.136 & 2.137 of the EM) the latest draft of section 25-85 is not nearly as clear. Sub-section 25-85(1) now simply states that the section deals with a return that an entity pays on a debt interest. The rest of the section goes on to provide that the return will not be prevented from being a deduction in certain circumstances - but the circumstances do not include the fact that the return on an instrument is in fact a dividend and not interest. As matters now stand, it is not at all clear that the draft legislation is effective to ensure that a payment, which is, as a matter of company law, a dividend on a share, will in fact be potentially (ie prima facie) deductible for tax purposes.

There is no authority under Australian tax law and practice for dividends to be deductible, even if they resemble interest on a loan and the revised section 25-85 does not assist. For example, when section 46C of the Income Tax Assessment Act, 1936 ("ITAA 1936") was introduced to disallow a dividend rebate to the corporate recipient of certain "debt dividends", a specific section (section 67AA of the ITAA 1936) was introduced to provide for a deduction to the issuer/ payer of the dividends. Absent this section, no deduction would have been available. These particular provisions are no longer operational. The generally accepted view is that debt dividends to which section 46D of the ITAA 1936 now applies are not deductible – ie there is no equivalent provision to section 67AA and there is no sound basis to make a claim under the general deduction provision (section 8-1 of the Income Tax Assessment Act, 1997.) In relation to general principles, we refer you to paras 6.301 to 6.307, and in particular para 6.304, of *Income Taxation in Australia* by Prof Ross Parsons.

Further, it would be appropriate for other costs normally deductible on debt interests, such as foreign exchange losses, to also be made specifically (ie prima facie) deductible, provided the funds are used to produce assessable income or are used in a business which is carried on for that purpose. For example, assume that a company issues redeemable preference shares ("RPS") in USD and that the shares are regarded as a debt interest for tax purposes under the proposed new regime. If the company invests the funds in USD and makes a foreign exchange gain or loss on the asset, it will be taxable (under general principles, CGT rules or Division 3B depending upon the circumstances). If it converts the funds to AUD and takes out a currency hedge, generally any hedging



gain or loss would also be recognised for tax purposes. It would, consequently, be reasonable and proper to recognise both realised FX losses and gains upon maturity of the USD denominated RPS, so as to put the RPS in the same position as an economically equivalent USD loan. That is, if the company simply borrowed USD under a conventional loan then it would ordinarily be entitled to a deduction for a realised foreign exchange loss, and would be assessable on a gain, under Division 3B. There are some unsatisfactory aspects of Division 3B as a result of the High Court's decision in *FCT v Energy Resources of Australia* 96 ATC 4536, however the policy intent appears very clear.

The wording in the original (February 2001) drafting for section 25-85 should be reinstated, and indeed broadened, to make it clear beyond doubt that dividends, foreign exchange losses and other debt deductions (as defined) on shares (which are debt interests) can be deductible for tax purposes in the same way that such deductions would be available on standard debt interests. Foreign exchange gains should also be treated as being assessable.

Section 22



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