CURRENT DEBT / EQUITY ISSUES IN A CROSS BORDER CONTEXT

CORPORATE TAX INTENSIVE TAXATION INSTITUTE OF AUSTRALIA
NOVEMBER 2007

MARTIN FRY
PARTNER
ALLENS ARTHUR ROBINSON
Current debt / equity issues in a cross border context

The purpose of this paper is to discuss recent income tax developments relating to the debt/equity classification of arrangements used by Australian corporate entities when raising funds from offshore.

1. Introduction

Australian corporate entities seeking to raise funds will often be called upon to consider the Australian tax implications of issuing a hybrid instrument to a non resident finance provider. In particular, it will be necessary to ascertain the debt/equity classification of the instrument and identify the tax implications of that classification.

For the Australian corporate entity the first issue to consider will be whether returns on the instrument will be frankable or deductible. Section 2 of this paper summarises the principles which will determine this issue.

Although the question of whether returns on the instrument are frankable or deductible will usually be the first issue to be considered by the Australian corporate, this paper focuses on:

(i) the withholding tax (WHT) implications of paying returns on the instrument; and
(ii) the WHT outcomes which flow from the debt/equity classification of the instrument under domestic law and under Australia's Double Tax Agreements.

Another key issue to be considered when an Australian corporate entity issues a hybrid instrument to a non resident finance provider will be the thin capitalisation implications of issuing the instrument, and the thin capitalisation outcomes which flow from the debt/equity classification of the instrument. These issues are not addressed in this paper.

In this paper statutory references are to the Income Tax Assessment Act 1936 (Tax Act 1936), Income Tax Assessment Act 1997 (Tax Act 1997) and the International Tax Agreements Act 1953 (International Act). Double Tax Agreements between Australia an another country are referred to as DTAs.

This paper does not discuss the operation of the provisions in Division 974 of the Tax Act 1997 which classify arrangements as debt interests or equity interests for certain tax purposes.
2. Whether Returns are Frankable or Deductible

When an Australian corporate entity evaluates a proposal involving the issue of a hybrid instrument to a non resident finance provider the first issue to consider is whether returns on the instrument will be frankable or deductible to the Australian corporate entity.

The following is a summary of the principles which will determine whether returns on the instrument will be frankable or deductible to the Australian corporate entity.

(a) Where the issuer of the instrument is an Australian company, returns on the instrument will generally be frankable where:

(i) if the instrument is in the form of a share:
   A the return is a dividend or is taken to be a dividend; and
   B the share is not characterised as a debt interest and does not form part of a larger interest characterised as a debt interest under Subdivision 974-B (section 202-45(d) of Tax Act 1997);

(ii) if the instrument is not in the form of a share:
   A the instrument is classified as an equity interest under Subdivision 974-C (which, by definition, means that the instrument is not characterised as a debt interest and does not form part of a larger interest that is characterised as a debt interest under Subdivision 974-B: section 974-70(1)(a));
   B the return is a distribution which is not debited to the share capital account or the non-share capital account of the issuing company (sections 974-115 and 974-120);
   C the distribution does not exceed the available frankable profits of the issuing company: section 215-15; and
   D if relevant, the instrument does not form part of the Tier 1 capital of an ADI (section 215-10);

(iii) whether the instrument is in the form of a share or not: the distribution does not offend relevant anti avoidance provisions specified in section 202-45, such as sections 45, 45A and 45B1.

(b) On the other hand, where the issuer is an Australian company, returns on the instrument will generally be deductible (and not frankable) where:

(i) the return satisfies the general criteria for deduction under section 8-12; or

---

1 This is not a comprehensive list of the circumstances in which a distribution will not be frankable. For example, a distribution under the NZ imputation regime is not frankable, and a demerger dividend is not frankable. Refer section 202-45.

2 For a discussion of principles relevant to this question refer to the ATO’s public rulings TR 2002/15 and TR 2002/16.
(ii) the instrument is characterised as a debt interest under Subdivision 974-B, and the return satisfies the criteria for deduction under section 8-1, or the return is deductible in accordance with section 25-85; and

(iii) the issue of the instrument does not cause the issuing company to exceed the thin capitalisation limits relevant to the issuer set out in Division 820 of the Tax Act 1997.

Available frankable profits

Where an instrument is not in the form of a share and is characterised as an equity interest under Division 974 of the Tax Act 1997, returns on the instrument will not be frankable to the extent that the payment of the returns exceed the 'available frankable profits' of the issuer company.

The 'available frankable profits' of an entity are determined by reference to section 215-10, which makes it necessary to ascertain the profits of the company which could be paid as dividends.

The meaning of 'profits' is not defined for these purposes, and the decision of the High Court in MacFarlane v FCT 86 ATC 4477 suggests that the meaning of profits for tax law purposes may be broader than for company law purposes. However, the requirement to ascertain profits that could be paid as dividends suggests that the quantum of profits to be taken into account for the purposes of section 215-10 is limited to the profits which a company could lawfully pay as dividends under company law principles (refer generally to Industrial Equity v Blackburn (1977) 137 CLR 567 and the requirement of the Corporations Act that dividends may only be paid out of profits of a company). In 2005 the High Court considered the meaning of 'profits' in the context of former section 160ZK of the Tax Act 1936 in FCT v Sun Alliance 2005 ATC 4955. Former section 106ZK made it necessary to ascertain the 'profits derived' by a company at a particular point in time. The High Court endorsed the classic formulation of 'profits' articulated by Fletcher Moulton LJ in Spanish Prospecting Company [1911] 1 Ch 92 that:

Profits implies a comparison between the state of a business at two specific dates usually separated by an interval of a year.

The fundamental meaning is the amount of a gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates.

For practical purposes these assets in calculating profits must be valued and not merely enumerated. An enumeration might be of little value. Even if the assets were identical at the two periods it would by no means follow that there had been neither gain nor loss, because the market value – the value in exchange – of these assets might have altered greatly in the meanwhile.

In Sun Alliance the High Court held that unrealised gains on assets owned by the taxpayer company where profits derived by the company for the purposes of section 160ZK.

The recent Full Federal Court decision in FCT v Condell 2007 ATC 4404 was also concerned with unrealised gains on assets. In that case Hewlett-Packard (a US company) reduced its retained earnings by $4.2bn when it distributed assets to its shareholders.
(being shares in its subsidiary, Agilent) with a market value of $29bn. The judgement of Kenny and Allsop JJ noted that the assets distributed to the shareholders had been recorded in the accounts of Hewlett-Packard at a value substantially lower than the current market value and stated:

that wholly unremarkable state of affairs did not alter the fact that from the point of view of Hewlett-Packard the distribution of the shares in Agilent had its source in retained earnings.

Kenny and Allsop JJ went on to find that the distribution was paid wholly from the profits of Hewlett-Packard and was therefore assessable as a dividend under subsection 44(1)(a) of the Tax Act 1936. For present purposes, the interesting question that arises is whether in equivalent circumstances the entire value of the distribution would be frankable.

The ATO's public ruling TR 2003/8 provides guidance on the ATO's approach to the meaning profits available for distribution to shareholders. However, unhelpfully, TR 2003/8 does not apply to non-share equity and non-share dividends.

**Section 25-85 of the Tax Act 1997**

Section 25-85 is a short but remarkably complex provision and its intricacies are worthy of a paper of their own. However in summary section 25-85 provides the following in relation to returns paid on a debt interest:

(i) a return on the instrument is not prevented from being deductible under section 8-1 merely because the return is contingent on the economic performance of the issuer or a connected entity, or the return secures a permanent or enduring benefit for the issuer or a connected entity;

(ii) if the return is a dividend, the issuer can deduct the return to the extent the return would have been deductible under section 8-1 if, broadly, the return were interest paid on finance raised by the issuer; and

(iii) the principles stated in (a) and (b) do not apply to the extent that the internal rate of return on the instrument exceeds 150 basis points above the issuer's benchmark rate of return.

The ATO's interpretative decisions ATOID 2006/102 and ATOID 2006/319 provide some limited guidance on the operation of section 25-85.

### 3. Withholding Tax Implications

#### 3.1 WHT Outcomes

Where an Australian corporate entity is raising funds by issuing a hybrid instrument to a non resident finance provider it will be necessary to determine the extent to which the Australian issuer is required to deduct WHT from returns paid on the instrument.

The extent to which the Australian entity is required to deduct WHT will be a function of:
the debt/equity classification of the instrument under Division 974 of the *Tax Act 1997*; 

- the integration of the debt/equity classification into the WHT provisions in Division 11A of the *Tax Act 1936*; and

- the debt/equity classification of returns on the instrument under the relevant DTA if the non resident finance provider is resident of one of Australia's treaty partners and the DTA otherwise applies.

Section 3.2 below discusses the manner in which the debt/equity classification of an instrument under Division 974 is integrated into the WHT provisions in Division 11A of the Tax Act 1936. Section 3.3 below discusses the debt/equity classification of returns on an instrument under relevant DTAs.

However, it is relevant to first note the different WHT outcomes which arise from the debt/equity classifications.

The WHT outcomes can be summarised as follows:

(a) To the extent that returns paid on the instrument are recognised as *interest or amounts treated as interest under Division 11A* of the *Tax Act 1936*, interest WHT will be imposed at 10%, unless a domestic exemption is satisfied such as the public offer test in section 128F.

However, subject to the following, where a DTA is applicable and where the return is recognised as *interest under the DTA*, the Interest Article of the DTA will generally limit Australia's right to tax the amount to 10%.

(i) Under the terms of the DTAs with the United States and the United Kingdom, Australian WHT will be eliminated if the non resident finance provider is entitled to the benefits of the relevant DTA and is able to satisfy the 'financial institutions' exemption or the 'governmental function' exemption.

(ii) Australia's DTA with France has been renegotiated and the new French DTA will also provide for a 'financial institutions' exemption, and a 'governmental functions' exemption which is similar to that exemption under the US DTA and UK DTA. The Australian parliament has passed the necessary legislation for enactment of the new French DTA, however the French parliament is yet to do so. It is hoped that the French parliament will pass the necessary legislation in early 2008. If and when that occurs:

A the new French DTA will enter into force on the first day of the second month following the exchange by Australia and France of diplomatic notes confirming completion of the necessary domestic requirements; and

3 For guidance on the financial institutions exemption refer to the ATO's public ruling TR 2005/5.
B in the case of Australia, the new French DTA will then apply to WHT on income derived on or after 1 January in the year next following the year in which the diplomatic notes were exchanged. As such, if for example diplomatic notes are exchanged in March 2008, the new limits on Australia WHT would apply to income derived by residents of France on or after 1 January 2009.

(iii) On 3 August 2007 it was announced that Australia and Japan had reached agreement in principle on the terms of a new DTA. The announcement indicates that the new DTA will also provide for exemption from interest WHT along the lines of the ‘financial institutions’ exemption and ‘governmental functions’ exemption under the existing US DTA and UK DTA.

(b) To the extent that returns paid on the instrument are recognised as dividends or are treated as dividends under Division 11A of the Tax Act 1936:

(i) WHT is prima facie payable at 30% of the gross amount of the dividends;
(ii) to the extent that the dividends are franked, WHT is not payable on the franked part (section 128B(3)(ga)); and
(iii) other exemptions can apply under the terms of Division 11A. For example, dividend WHT exemptions can apply to former exempting entities (s.128B(3)(ga)(ii) and (iii)) and to ADIs in respect of non share equity interests which qualify as Tier 1 capital and satisfy certain other conditions (s.128B(3)(aaa) and section 215-10).

However, subject to the following, where a DTA is applicable and where the return is recognised as a dividend under the DTA, the Dividend Article of the DTA will generally limit Australia’s right to tax the amount to 15%. Further:

(i) Under the US DTA and the UK DTA:

A Australian dividend WHT will be limited to 15%, unless B or C are satisfied;
B subject to C, the rate of WHT will be limited to 5% if the beneficial owner of the dividends is a company that holds directly at least 10% of the voting power of the Australian entity; and
C no WHT will be payable if, broadly, the beneficial owner of the dividends is a company that has owned shares representing 80% or more of the voting power of the Australian entity for the requisite 12 month period and the beneficial owner of the dividends is otherwise entitled to the benefits of this particular DTA exemption.

(ii) Under the new French DTA:

A Australian dividend WHT will be limited to 15% unless B or C are satisfied;
subject to C, the rate of WHT will be limited to 5% if the beneficial owner of the dividends is a company which directly holds at least 10% of the voting power of the Australian issuer;

C no WHT will be payable if the dividends are paid from profits that have borne the normal rate of company tax and the dividends are paid to a company which directly holds at least 10% of the voting power in the Australian issuer.

It is relevant to note the following in relation to the exemption from dividend WHT under the new French DTA.

A Unlike the corresponding exemption under the US DTA and UK DTA:
  - the voting power threshold is set at 10% rather than 80%;
  - there is no requirement for the French resident company to hold the voting power for a minimum period.
  - the exemption is not subject to a specific limitation on benefits rule. Rather, the recipient of the dividends will be entitled to the exemption if it is a company which is a resident of France and directly holds at least 10% of the voting power of the Australian issuer.

B The exemption will apply to dividends paid out of profits that have borne the normal rate of company tax in Australia. This raises an interesting question where the payer of the dividend is the head company of an Australian tax consolidated group. In that case, the head company will have been liable for company tax on the profits, but the profits from which the dividends are paid by the head company may have been profits made by a subsidiary member which have been distributed to the head company by way of dividends within the consolidated group. Such intra group dividends are not recognised in the purposes of determining the head company’s liability for income tax (section 701-1, Tax Act 1997) and, as such, they are not subject to Australian tax. It is clear that the Single Entity Rule in section 701-1 does not apply for the purposes of determining liability for WHT. However when the Single Entity Rule is disregarded for the purposes of analysing this issue, the legal fact remains that the head company is liable for and pays tax on the profits which are made by the subsidiary member. This issue can only be resolved by taking a sensible approach to tracing the distribution of the profits from the subsidiary member to the head company.

Another interesting aspect of this exemption is the relationship of this test with the Australian dividend imputation system. It would
ordinarily be the case that a dividend which is paid from profits which have borne the normal rate of company tax in Australia would be a fully franked dividend. In that case, the dividend would generally be exempt from Australian dividend WHT under the domestic exemption for franked dividends provided by subsection 128B(3) (ga) of the Tax Act 1936. However the requirement is only that the dividends be paid from profits which have borne the normal rate of company tax in Australia. As such, a question will be how the exemption applies in circumstances where it is possible to demonstrate that the profits have borne the normal rate of company tax in Australia, but where the dividend is unfranked or the franking credits on the dividends are recognised as being received by an entity other than the French resident company receiving the dividend.

Finally, note that section 325 of the Tax Act 1936 contains a similar concept of 'normal company tax rate' for the purposes of the CFC provisions.

(iii) Although there are few details, the announcement of the agreement between Australia and Japan to enter into a new DTA indicates that the Dividend Article under the new DTA will provide for the following:

• subject to the following, Australian dividend WHT will be limited to 10%;
• Australian dividend WHT will be limited to 5% if the beneficial owner of the dividends has an ownership interest in the Australian company of 10% or more;
• Australian dividend WHT will not apply if the beneficial owner of the dividends has an ownership interest in the Australian company of 80% or more.

In light of the WHT outcomes outlined above, it is useful to analyse the WHT treatment of a hybrid instrument issued to a non resident finance provider in two stages.

The first stage is to identify the manner in which the debt/equity classification of the instrument under Division 974 of the Tax Act 1997 is integrated into Division 11A of the Tax Act 1936 – refer 3.2 below. As outlined above, this will determine whether returns on the instrument are recognised as interest or dividends for WHT purposes under domestic law and, therefore, will determine the rate of WHT under domestic law.

The second stage is to then examine the debt/equity classification of returns paid on the instrument under a relevant DTA – refer 3.3 below. As noted above, the classification of the return as interest or dividends under the DTA can operate to reduce the Australian WHT that would otherwise be payable under the domestic WHT provisions.
### 3.2 Debt/Equity and WHT

The integration of the debt/equity classification under Division 974 of the *Tax Act 1997* into the WHT provisions in Division 11A of the *Tax Act 1936* is governed by the following principles.

For the purposes of discussion reference will be made to redeemable preference shares (RPS) and a *Variable Note* issued by an Australian company. It is to be assumed that the Variable Note is an instrument in the form of a note issued by an Australian corporate entity, under which the issuer undertakes to pay returns which are contingent on the economic performance of the issuer.

(a) Subsection 128AAA(1) provides that the WHT provisions in Divisions 11A apply to distributions paid on non-share equity interests (other than distributions paid from the share capital account or the non-share capital account of the issuer) in the same way as the WHT provisions apply to dividends paid on shares.

The result is that although the Variable Note referred to above is in the form of a note and not in the form of a share, and although distributions on the Note are not dividends at law, distributions on the Variable Note are subject to dividend WHT if the terms of the Note cause it to be classified as an equity interest under Division 974. This would generally be the case if, for example, the Variable Note is a perpetual instrument.

(b) Subsection 128A(1AB) extends the definition of *interest* for WHT purposes to include dividends paid on non-equity shares. Correspondingly, the definition of *dividend* in subsection 128A(1) excludes dividends paid on non-equity shares.

The result is that dividends paid on the RPS referred to above will be subject to interest WHT if the terms of the RPS cause the RPS to be classified as debt interests under Division 974. This would generally be the case if, for example, the RPS are the subject of mandatory redemption for their issue price in the ten year period after issue.

(c) Subsection 128B(3)(ga) provides, in broad terms, that dividend WHT will not apply to dividends paid to a non-resident to the extent that the dividends are franked.

However, this exemption from dividend WHT will not operate if the *debt overlay* in subsection 128B(3A) applies.

In broad terms, subsection 128B(3A) provides that the dividend WHT exemption for franked dividends will not apply where:

- the dividends are derived by the trustee of a trust or a partnership;
- an amount attributable to the dividends is paid to (or applied for benefit of) a taxpayer being a beneficiary of the trust or a partner in the partnership; and
• the amount paid to (or applied for the benefit of) the taxpayer may reasonably be regarded as equivalent to the payment of **interest on a loan**.

**Interest on a loan**

In determining whether an amount may reasonably be regarded as equivalent to interest on a loan, subsection 128B(3C) directs attention to the way in which the amount is calculated, conditions applying to the payment or application of the amount, and any other relevant matters.

Although subsection 128B(3C) provides factors to be taken into account in determining whether a payment is equivalent to interest on a loan, the meaning of 'interest' is not defined.

Interest has been described by the courts as "compensation for delay in payment"\(^4\) and "recompense for loss of the use of capital during a period of time in which it would earn income."\(^5\) It is "the return or consideration or compensation for the use or retention by one person of a sum of money belonging to, in a colloquial sense, or owed to, another."\(^6\)

As a general rule there are two conditions which must be in existence for a payment to be interest in character. First, there must be a sum of money by reference to which the payment is calculated or otherwise determined\(^7\). Second, that sum of money must be an amount which is owed to the person entitled to receive the payment\(^8\).

In the context of an Australian corporate entity issuing a hybrid instrument to a non-resident it will usually be relevant to consider the extent to which the payment of alleged interest in properly characterised as a distribution of the profit of the Australian entity. In **Commr. Of Taxation v Boulder Perseverance** (1937) 58 CLR 223 the High Court found that payments on a debenture were distributions of profit rather than interest in circumstances where the payments were calculated as a share of the profits of the issuing company. Latham CJ, Dixon and McTiernan JJ said:

---

\(^4\) **Bond v Barrow Haematite Steel** [1902] 1 Ch 353, Farwel J at 363.

\(^5\) **Federal Warf Co Ltd v DCT** (1930) 44 CLR 24, Rich J at 28.

\(^6\) **Re Firth** 2002 ATC 4346, Hill J at para 13; **FCT v Broken Hill Co Ltd** 2000 ATC 4659 at para 40; **ReFarm Security Act** [1947] 3 DLR 689, R and J at 703.

\(^7\) "It is the essence of interest that it be referable to a principal sum": **Commr of Taxation v Myer Emporium** (1987) 163 CLR 199 at 217-218.

\(^8\) "It will generally be a necessary factor that there be money payable, whether by reason of a loan of credit, before what is paid will be called interest": **Commr of Taxation v BHP** 2000 ATC 4659 at para 42.
“It is not denied that the fixed interest charges on debenture capital constitute a prior deduction in the calculation of the ‘profits made by the company’. Such charges are regarded as an ordinary business expenditure. But when the debenture contract lets the debenture holder into participation in the ‘trading profits’ over and above his fixed interest charge, it gives his debenture capital an additional characteristic, a characteristic inconsistent with that of a simple external loan by a creditor looking only for security for his capital and a certain regular remuneration for its use…It may be that the possibility of sharing in profit formed an inducement to the note or debenture holders, but it is the interest at 10 per cent per annum that alone represents the actual compensation for the use in the business of the capital so raised for which a deduction should be made in finding the business profits. The share in the profits appears to us to represent a right to the distribution of the fund finally earned by the business, the taxable fund.

However, the High Court decision in Midland Railway v Commr. of Taxation (1950) 81 CLR 384 establishes that a payment does not lose its character as interest merely because the liability to make payment is contingent on the issuer company having a sufficient level of profits.

Radilo Enterprises

The phrase ‘equivalent to the payment of interest on a loan’ was the subject of the decision of the Full Federal Court in FCT v Radilo Enterprises 97 ATC 4151. The court found that the phrase requires there to be two conditions satisfied: first, the payment must be equivalent to interest; and second, the payment must be able to be regarded as interest on a loan. It was said that the phrase will be satisfied where the dividend performs the same function as the payment of interest on a loan. Radilo involved the issue by ANZ of CP Shares which qualified as Tier 1 capital for ANZ. The Shares conferred a right to participate in a winding up, but no right of redemption. It was held that dividends paid on the CP Shares could not be regarded as equivalent to interest on a loan. The primary basis for the decision was that as ANZ was under no obligation to redeem the Shares, no relationship of borrower and lender arose between ANZ and the CP Shareholders. It was found that the dividends could not be regarded as equivalent to the payment of interest on a loan in the absence of such a relationship.

Relevant aspects of s.128B(3A)

It is relevant to note the following in relation to the ‘debt overlay’ in subsection 128B(3A):

(i) Clearly this debt overlay is not relevant to the simple case of an Australian company issuing RPS or a Variable Note directly to a non resident finance provider. However, it will be highly relevant if the financing involves, for example, an Australian company establishing an Australian trust or partnership in circumstances where the non resident effectively provides
finance to the Australian company by investing in the trust or partnership established by the Australian company.

(ii) The premise of the debt overlay in subsection 128B(3A) is that a frankable return on an equity interest (that is, a return on an instrument which satisfies the equity test, but does not satisfy the debt test, and is therefore frankable) may nevertheless be regarded as equivalent to interest on a loan. This can arise where, as part of an overall arrangement, the interposition of a transparent entity such as a trust or partnership has the effect of separating a frankable equity-like instrument from a non-frankable debt-like instrument. In this sense, the continued existence of subsection 128B(3A) perhaps reflects a lack of confidence in the operation of the 'related scheme' provisions in Division 974. That is, it might be expected that the related scheme provisions in Division 974 are intended to ensure that the frankable instrument is characterised as a debt interest on the basis that it formed part of a larger interest that was characterised as a debt interest (refer section 974-70(1)(b)).

(iii) The debt overlay in subsection 128B(3A) was the subject of a recent ATO interpretative decision, being ATOID 2007/157. It considered an arrangement under which:

- a non resident finance provider subscribed for 50% of the units in an Australian resident trust, under terms which required the units to be redeemed for their issue price after eight years;
- the Australian trust subscribed for preference shares in an Australian company, with dividends on the preference shares being fixed at 5% per annum on the issue price; and
- the Australian company paid franked dividends on the preference shares to the trust, and these were distributed to the non resident finance provider in proportion with its 50% interest in the trust.

The ATOID concludes that subsection 128B(3A) applied to this arrangement and, as such, the dividend WHT exemption for franked dividends did not apply.

In essence, the ATOID concludes that the combined effect of the fixed rate of dividends on the preference shares and the mandatory redemption of the units in the trust is sufficient to cause the distribution to the non resident unitholder of its share of the trust's dividend income to be characterised as equivalent to interest on a loan. That is, although the legal structure had the effect of separating the frankable equity instrument (ie the preference shares) from the non-frankable debt-like instrument (ie the units with a fixed redemption at year eight), the ATOID conducted that the effect of the overall arrangement was to produce a return which was equivalent to interest on a loan.
According to the ATOID, the mandatory redemption of the units was sufficient to establish a loan relationship (as distinct from the shares in *Radilo*, which were not subject to mandatory redemption), and the 5% fixed rate was sufficient to conclude that the dividends were equivalent to interest on a loan. In this regard it is relevant to note the following:

A The non resident finance provider held 50% of the units in the trust, and the ATOID aggregates the fixed rate of dividends on the preference shares with the mandatory redemption of those units in arriving at the conclusion that the dividends were equivalent to interest on a loan. As the non resident only received its 50% pro rata distribution of the dividends, presumably the balance of the dividends were distributed to other unit holders. If the units held by the other unitholders were not subject to mandatory redemption (ie if the other units were perpetual, equity-like instruments) would that not make it difficult to conclude that the dividends on the preference shares "may reasonably be regarded as equivalent to the payment of interest on a loan"? Certainly, as the non resident was not the sole member of the trust it could not be argued that the non resident was absolutely entitled to 50% of the trust's dividend income. As such it would seem to be difficult to aggregate the dividends paid on the preference shares with the particular debt-like units held by the non-resident in the manner of the ATOID.

B The ATOID arrives at its conclusion by aggregating the fixed rate of dividends on the preference shares with the mandatory redemption of the units in the trust. For its own domestic reasons the non resident finance provider will often require that the interest in the trust (or partnership) be the subject of mandatory redemption. However, would the ATOID arrive at a different conclusion if the fixed rate preference shares were, instead, ordinary shares with no fixed dividend rate?

(d) Note that section 128F contains its own debt/equity classification rule for the purposes of the public offer exemption. In broad terms, the public offer exemption is available to instruments being:

(i) debentures (as defined in section 995-1 of the Tax Act 1997); and

(ii) debt interests, provided they are:

A non-equity shares (for example RPS subject to mandatory redemption at year ten or less);

B two or more related schemes, of which one is a non-equity share;

C syndicated loans as defined in subsection 128F(8); or

D prescribed by regulations to be eligible for the public offer exemption.
3.3 Debt/Equity and DTAs

Australia’s DTAs generally provide extended definitions of ‘dividends’ and ‘interest’ for the purposes of dealing with returns paid on hybrid instruments.

The intention behind the extended definitions is to align the DTA definition of ‘dividend’ with the domestic law concept of dividends and other equity-like returns, and to align the DTA definition of ‘interest’ with the domestic law definition of interest and debt-like returns.

The approach adopted in the US DTA

The US DTA provides as follows.

(a) For the purposes of the Dividends Article of the US DTA, sub-clause 10(6) provides:

"The term ‘dividends’ as used in this Article means income from shares, as well as other amounts which are subjected to the same taxation treatment as income from shares by the law of the State of which the company making the distribution is a resident for the purposes of its tax."

(b) For the purposes of the Interest Article of the US DTA, sub-clause 11(5) provides:

"The term ‘interest’ in this Article means interest from government securities or from bonds or debentures (including premiums attaching to such securities, bonds or debentures), whether or not secured by mortgage and whether or not carrying a right to participate in profits, interest from any other form of indebtedness, as well as income which is subjected to the same taxation treatment as income from money lent by the law of the Contracting State in which the income arises. Income dealt with in Article 10 (Dividends) and penalty charges for late payment shall not be regarded as interest for the purposes of this Article."

Hence, under the US DTA, an amount is a ‘dividend’ if it is income from shares or is taxed in the same way as income from shares under Australian domestic law. An amount is ‘interest’ if it is interest from debt or it is income which is taxed in the same way as income from loans under Australian domestic law, provided it is not covered by the definition of dividend.

The New Zealand DTA is similar to the US DTA in the way that it defines both dividends and interest.

The Canadian DTA is also similar, however it does not feature the tie breaker under which the dividend definition prevails over the interest definition, ie it does not state that an amount is not interest if it is covered by the definition of ‘dividend’.

In each case the key indicator that an amount is a dividend for the purposes of the DTA is that the amount represents income from shares. This clearly creates difficulties in circumstances where an Australian company issues a share with debt-like features to raise funds from a US, Canadian or New Zealand resident.
finance provider. For example, where the Australian company issues RPS which are subject to mandatory redemption in the ten year period after their issuance, dividends paid on the RPS will represent income from shares but the RPS will generally be characterised as debt interests under Division 974 of the Tax Act 1997.

In these circumstances the definitions of ’dividends’ and ’interest’ under US, New Zealand and Canadian DTAs create a tension between the debt/equity classification under the domestic law and the corresponding classification under the DTAs. An example of this is provided in the ATO's interpretative decision ATOID 2007/172. This ATOID was issued in respect of the period prior to the introduction of subsection 3(2A) of the Agreements Act (which is discussed below), and concludes that the Dividend Article of the US DTA applied to dividends payable on RPS which were classified as debt interests under Division 974 of Tax Act 1997.

The approach adopted in the UK DTA

The UK DTA is similar, but more comprehensive.

(a) For the purposes of the Dividends Article of the UK DTA, sub-clause 10(4) provides:

"The term 'dividends' as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident and also includes any other item which, under the laws of the Contracting State of which the company paying the dividend is a resident, is treated as a dividend or distribution of a company."

(b) For the purposes of the Interest Article of the UK DTA, sub-clause 11(5) provides:

"The term 'interest' as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, and income from any other form of indebtedness. The term 'interest' also includes income which is subjected to the same taxation treatment as income from money lent by the law of the Contracting State in which the income arises. The term 'interest' shall not include any item which is treated as a dividend under the provisions of Article 10 of this Convention."

The key point of distinction with the UK DTA is the fact that income from 'debt claims' is carved out of the definition of 'dividend'. If dividends paid on the RPS noted above can be characterised as income from 'debt claims', then the dividends would effectively be allocated to the Interest Article of the DTA and, as such, the DTA itself would overcome the
tension between the domestic law debt/equity classification and the corresponding classification under the DTAs noted above.

Subsection 3(2A) of the Agreements Act: Income from Shares and Profit Participation

This tension between the debt-equity classification under domestic law and the DTAs lead to the introduction of subsection 3(2A) of the Agreements Act.

Subsection 3(2A) provides:

> a reference in an agreement to income from shares, or to income from other rights participating in profits, does not include a reference to a return on a debt interest (as defined in Subdivision 974-B of the Income Tax Assessment Act 1997).

According to Explanatory Memorandum to the International Tax Agreements Amendment Act 2003, the introduction of subsection 3(2A):

> ensures alignment between the treaty treatment and the domestic law treatment, so that such returns are debt interests and generally only subjected to the terms of the Interest Articles in Australia's tax treaties (including the tax rate specified in those Articles), as intended.

The effect of subsection 3(2A) of the Agreements Act will generally ensure that dividends paid on shares are subject to the Interest Article of the DTAs referred to above where the shares are characterised as debt interests under Division 974 of the Tax Act 1997.

As noted above, under the UK DTA the debt/equity borderline is addressed in the Dividend and Interest Articles by reference to the phrase 'debt claims'. That is, income from 'debt claims' is included in the definition of interest and is carved out of the definition of dividends for the purposes of the Dividend and Interest Articles. There can be circumstances in which a share is redeemable or can otherwise be viewed as debt-like but is not classified as a debt interest under Division 974 – for example, a share which is subject to mandatory redemption eleven years after the date of issue and which pays dividends which are entirely contingent on available profits of the issuer may be viewed as debt-like but may not satisfy the debt test in Subdivision 974-B of the Tax Act 1997. In these circumstances the question is whether the share can be viewed as a 'debt-claim' and, if so, whether dividends on the shares will be taxed as equity under the Australian domestic law, but subject to the terms of the Interest Article of the UK DTA.

It is also relevant to note the operation of subsection 3(2A) in the context of the existing Japan DTA and the Singapore DTA. Subsection 3(2A) does nothing more than state that a reference in a DTA to 'income from shares' does not include a reference to returns on shares which are characterised as debt interests under Division 974 of the Tax Act 1997. However, the Dividend Articles in the existing Japan DTA and the Singapore DTA do not
seek to define the term 'dividends' and, as such, they do not use the phrase 'income from shares'. The result is that the curing effect of subsection 3(2A) does not apply to these DTAs, and the tension between the domestic low characterisation of returns paid on mandatory RPS, and the treatment of such returns under the DTAs, will tend to arise. Note that under both the Japan DTA and the Singapore DTA, Article 2(4) provides that domestic law definitions will generally apply to undefined terms such as 'dividends'.

**Article 11(9) of the US DTA : an equity overlay**

As noted above, the effect of subsection 3(2A) of the Agreements Act would be that dividends paid on the mandatory RPS would generally be subject to the Interest Article of the US DTA.

The potential benefit of this outcome is that, subject to the following, Australian interest WHT on dividends paid on the mandatory RPS may potentially be eliminated where the RPS are held by a non resident finance provider which is a qualifying financial institution for the purposes of the financial institution exemption in Article 11(3).

However, the financial institution exemption is subject to an *equity overlay* in Article 11(9). In broad terms, under Article 11(9) Australia may impose tax at a rate not exceeding 15% in circumstances where the dividends paid on the RPS are ‘determined by reference to the profits’ of the Australian issuer. As such, where Article 11(9) applies, the benefit of the financial institutions exemption will be lost.

Although Australia’s taxing right under Article 11(9) is limited to 15%, the relevant domestic rate of tax would generally be 10% interest WHT (ie on the basis that the mandatory RPS would generally be classified as debt interests under Division 974).

The ATO recently issued interpretative decision ATOID 2007/2, under which the ATO discusses its approach to the meaning of 'determined by reference to profits' in the context of a non resident finance provider holding a redeemable limited partnership interest in an Australian corporate limited partnership. (ATOID 2007/2 replaced ATOID 2006/133, and reflects a change in the ATO's interpretation of 'profits' in this context).

It is relevant to note that there is no equivalent to Article 11(9) in the UK DTA. This will, of course, be beneficial if the non resident finance provider is able to qualify for the ‘financial institution’ or ‘governmental function’ exemption from interest WHT under the UK DTA. The same comment holds for the new French DTA.