TAX ISSUES IN FINANCING TRANSACTIONS

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INTRODUCTION

There are some well known but often overlooked provisions of our taxation laws that have for many years put Australia out of step with the international capital and project-finance markets. The result, apart from causing our taxation laws to be something of an international curiosity in these respects, has been a tendency to hinder the accessibility of these markets to Australian companies and, hence, to hinder their international competitiveness.

Various industry bodies such as this Association and the Law Council of Australia have campaigned for remedial action in these areas over the years.

It is pleasing to report that there has been some partial success in the last year. Other anomalies remain, however, and some new ones have been discovered, as we shall see, thanks to the intellectual ingenuity within the Australian Taxation Office (ATO).

Time does not allow a full run-through of recent tax developments relevant to financing transactions, but let us look at a few examples.

SECTION 261

The most notable success has been the repeal of section 261 of the Income Tax Assessment Act 1936 (the ITAA), with effect from 27 June 1996, by the Taxation Laws Amendment Act (No 2) 1996.

Section 261 had been the curse of all financing lawyers in every international secured financing by an Australian borrower. Without quoting the repealed section in full, it is sufficient to summarise its effect as follows:

> Any provision in a mortgage (defined, importantly, as including any form of security and any collateral or supplemental agreement) having the purpose or effect of imposing on a borrower the obligation to pay income tax on interest paid under the mortgage was rendered absolutely void.

Of course, in international finance transactions it is the universal practice (except in those limited cases where withholding tax absorption by the lender is specifically negotiated) that the borrower is required to "gross-up" all interest payments so as to keep the lender whole for any interest withholding tax that has to be deducted from the payments.

Section 261 made this difficult in financings to Australian borrowers. Various methods were employed in an attempt to achieve as effective a gross-up provision as possible consistent with the application of section 261,[1] but, as was confirmed by the decision of the High Court of Australia in *David Securities & Ors v Commonwealth Bank of Australia*,[2] the efficacy of many of the techniques used may be open to doubt.

In any event, the section has now gone, as regards mortgages entered into after the effective date, and so new secured financings can now safely proceed incorporating the usual form of gross-up clause.

SECTION 25(2)

This section of the ITAA, too, can only apply to secured financings.

Its effect is to deem interest payments to have a source in Australia where the loan on which the interest is paid is secured on property located in Australia.

This can produce some curious results, particularly where the secured property is movable, such as a ship or aircraft. In many cross-border transactions, such as leveraged leases, there will be a loan from a foreign lender to a foreign borrower, secured over property that is, either permanently or at least from time to time, located in Australia.

In many cases it will be possible to structure the loan so as to come within the exception in section 25(2) for "interest paid outside Australia to a non-resident on debentures issued outside Australia by a company". The usual practice, if the interest will otherwise qualify for this exception, is to ensure that the loan is evidenced by two or more notes or loan certificates.

Where that is not possible, however, or where the potential application of Australian tax is overlooked or not even contemplated (consider, for example, a financing for a European airline, where the aircraft secured happen to fly to Australia on an interest payment date), the section, on its face, would appear to apply. In the case of a foreign to foreign loan, it seems absurd for Australian interest withholding tax to apply to interest on the loan just because the loan is secured on property that happens to be located in Australia at the relevant time.

Indeed, it seems to be generally accepted as being the better view that the section should be read down so as not to apply where the borrower has no place of business or permanent establishment in Australia. In a transaction where the secured property is known to be located in Australia, it would be usual to seek representations from a foreign lender and borrower broadly to this effect.

The Law Council has advocated the repeal of section 25(2), but to date there has been no indication that the section's repeal is imminent.

SECTION 128F

Section 128F of the ITAA, commonly known as the "wide distribution" exemption, is well known to users of the offshore capital markets. It is the last remaining mainstream exemption from interest withholding tax on offshore borrowings by Australian companies.

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1 For an elaboration of several of the customary practices, see Ladbury, Fox and Nettle, "Current Legal Problems in Project Financing" (1981) *AMPLA Journal* 139.

2 (1992) 175 CLR 353.

The Existing Section

The broad effect of the section has been to provide an exemption from Australian interest withholding tax on interest paid outside Australia on "debentures" issued outside Australia by an Australian borrower for the purpose of raising a loan outside Australia, where the proceeds of the loan are applied in an Australian business and, importantly, where the Commissioner issues a certificate that he is satisfied that it is reasonable, having regard to the surrounding arrangements, to regard the debentures as having been issued "with a view to public subscription or purchase or other wide distribution among investors".

The most obvious shortcoming of the section is the impossibility of determining with certainty how wide an offering is wide enough. The question most often asked by issuers and underwriters or their lawyers is how many investors need to be offered, or to take up, notes in order to qualify for the exemption.

In addition, the section has not kept pace with developments in the capital markets. As a result, various other anomalies in its application have developed over time. For example:

(a) The issuing of notes denominated in Australian dollars, after the abolition of relevant exchange control restrictions in the mid-1980s, raised the difficulty that, even if an Australian dollar loan was ostensibly raised offshore and interest paid offshore, the currency to fund such a loan and such interest must necessarily emanate from Australia. For a time it was difficult, for this reason, to gain acceptance from the ATO that an Australian dollar loan could ever be raised, or Australian dollar interest paid, "outside Australia" so as to qualify for the exemption, but this approach was subsequently rectified as a matter of administrative practice, as confirmed in IT 2515.

(b) The development of the commercial paper market meant that issues of short-term paper (with terms as short as seven days) would be made frequently under a single program. The strict language of section 128F, and the interpretation of it by the ATO, both suggest that each issue is to be viewed separately when considering eligibility for exemption under section 128F. On this basis it would often be impracticable to apply for a section 128F certificate in respect of each individual issue, let alone to receive the necessary certificate of exemption before maturity of the relevant notes.

    Fortunately an administrative practice developed within the ATO under which a borrower would be allowed to "group" in a single application for an exemption certificate all issues made in a three- or six-month period, and (provided the circumstances of issue of the notes continued to comply with those disclosed at the inception of the program) to make without deduction of withholding tax any payments of interest that fell due before the three- or six-monthly application was lodged and processed.

(c) The related development of "reverse enquiry" issues caused similar problems. These issues come about when one or more of the dealers appointed under a program approaches the issuer and indicates that it is able to place a certain quantity of paper at a specified price. If the issuer decides to issue notes in response to such an invitation, the notes will be issued to that dealer only. In the context of an overall program, such issues will generally serve to increase the breadth of distribution of the issuer's paper, but looked at in isolation such an issue to a single dealer might be thought not to qualify. The ATO's treatment has not always been consistent on this issue.

Amendment Proposals

In an attempt to deal with these and other issues, the then Treasurer, Mr Willis, announced in December 1995 that the Government planned to amend the section 128F exemption so as to remove the "end use of proceeds" requirement (this was intended to assist the raising of offshore loans to fund the securitisation of home loans, for which the proceeds do not, at the level of the ultimate borrower, generate assessable income or constitute an "Australian business") and to introduce a self-policing "public offer" test to replace the requirement of obtaining a certificate from the Commissioner in relation to the existing wide distribution test.

After the intervening change of Government, the new Treasurer, Mr Costello, made a statement in June 1996 and released draft legislation in August 1996 giving further detail about what was proposed. Pending the introduction of the new legislation, issuers were to have the choice of claiming exemption from interest withholding tax under the existing legislation or under the proposed amendments which, it was indicated, would apply from 1 January 1996.

With the exception of a limited number of issues that have been made to fund home loans, for which there is no basis for claiming an exemption under the existing legislation, the market has steadfastly declined to use the proposed new provisions. This has been caused by a combination of:

(a) a reluctance to rely on exposure draft legislation ultimately coming into force in the same form (ie, legislation by press release); and

(b) the practical shortcomings of the new proposals as articulated to date.

Following the release of the draft legislation in August 1996, the Government invited comment. The submissions lodged included a joint industry submission by the Corporate Tax Association, the Australian Financial Markets Association, the Australian Bankers Association, the International Banks and Securities Association of Australia and the Taxation Institute of Australia (supported by opinions from various professional firms) and a submission, including suggested revised draft legislation, from the Law Council of Australia.

After further discussion with the ATO and Treasury representatives, the Government announced in December 1996 one change to the proposals as set out in the exposure draft legislation (to allow borrowings to be made by companies that are incorporated in the United States or other countries to be listed in regulations and that are wholly owned subsidiaries of Australian-incorporated companies), and subsequently released revised amendments to section 128F as part of the Taxation Laws Amendment Bill (No 2) 1997.

Despite further submissions on the revised form of the legislation and further discussions between representatives of the Law Council and the ATO, the indications at the time of writing are that the legislation is likely to be amended in the form of the Bill. The legislation is expected to pass sometime in the Winter session of Parliament (scheduled to run until late June 1997) and to come into force by mid-July. Unfortunately, there are several aspects of the legislation which will add to the confusion (and embarrassment) of Australian issuers in the international capital markets, and their lawyers.

The New Section 128F

The key features of the proposed new section 128F, and some of its deficiencies, may be summarised as follows:

(a) *The new section 128F will replace the present section 128F in its entirety.* The new section will apply to debentures issued on or after 1 January 1996, but for debentures issued in the period from that date until the date of Royal Assent to the amendment, issuers will have the choice of satisfying the old or the new requirements for exemption.

(b) *Interest must meet five basic tests* – set out in paragraphs (a) to (e) of proposed section 128F(1) – if it is to qualify for exemption. In each case the interest must be paid in respect of a "debenture" and must be paid by a "company".

For this purpose "debenture" includes bills of exchange and promissory notes, as well as any other securities of the issuing company as set out in the definition in section 6(1) of the ITAA (see proposed section 128F(9)). States, and Commonwealth and State authorities, are treated as companies and as being resident in Australia (see proposed section 128F(7)).

The five tests are that:

(i) the company must be a resident of Australia at the time the debenture is issued;

(ii) the company must be a resident of Australia at the time the interest is paid;

(iii) the company must issue the debenture outside Australia for the purpose of raising finance outside Australia;

(iv) the interest must be paid outside Australia; and

(v) the issue of the debenture must satisfy the "public offer" test in any of the ways set out in proposed section 128F(3) and (4).

Most attention will focus on the public offer test, discussed below, but it should be noted at this point that the new legislation perpetuates the use terminology (such as "debenture" – and the definition of that term – and "offered for issue") that does not always fit with the terminology used in the capital markets, and this can create uncertainty and confusion as to whether the exemption applies in particular cases.

For example, would a "debenture" for this purpose include a transferable loan certificate, a certificate of deposit, a banker's acceptance, a depositary receipt or a convertible note? Is a debenture "offered for issue" if an invitation is made to subscribe for or purchase the debenture? Are "reverse enquiry" issues adequately included?

(c) *The "public offer" test, in turn, can be met in any of five basic ways* – set out in paragraphs (a) to (e) of proposed section 128F(3) – subject to the overriding provision that the test will *not* be satisfied in the circumstances set out in proposed section 128F(5). Again, the drafting is unfortunate and will create considerable uncertainty unless clarified.

In summary, the public offer test will be met if "the issue resulted from the debenture being offered for issue" in any of the following ways:

(i) to at least ten professional investors (none of whom may be known or suspected by the issuer to be an "associate" of another of them);

(ii) to at least 100 persons (who need not be professional investors, but whom it must be reasonable for the issuer to regard as having previously acquired debentures or as being likely to be interested in doing so);

(iii) by being accepted for listing on a stock exchange outside Australia (where the issuer was required to seek such listing under the terms of an agreement with a dealer, manager or underwriter);

(iv) as a result of negotiations being initiated publicly in electronic form, or in another form, that was used by financial markets for dealing in debentures; and

(v) by placement to a dealer, manager or underwriter who, in turn, under an agreement with the issuer, offers the debenture for sale within 30 days in any of the four ways listed above.

These ways of meeting the test will be overridden, and the test not satisfied, if, at the time of the issue, the issuer knew or had reasonable grounds to suspect that the debenture (or an interest in it) was being, or would later be, acquired (except in the capacity of a dealer, manager or underwriter) by a resident of Australia or by an associate of the issuer (see proposed section 128F(5)).

As a matter of drafting, much of this is gobbledegook. For example:

- The lead-in words ("offered for issue") do not work with all of the five ways of meeting the test.

- By focusing on each debenture individually, the language suggests that each individual debenture (as opposed to debentures generally within a particular tranche) has to be offered to multiple people – what if they all accept?!

- With issues made through a dealer, manager or underwriter, it is unclear whether it is that party or the issuer whose knowledge is relevant for determining compliance with other aspects of the public offer test.

In addition, it is unclear whether the disqualifying test requires the issuer to have reasonable grounds to suspect that a *particular* debenture would be acquired by an Australian resident (or by an associate) or whether knowledge that there is some trading in Australia in Euronotes issued by Australian issuers would be a sufficient disqualification.

Note also that purchases by a resident of Australia in the course of carrying on business at or through a permanent establishment outside Australia – previously permitted by administrative practice – will not be eligible for the exemption except where the purchase is in a capacity as a dealer, manager or underwriter.

(d) There are two other aspects of the proposed section 128F that are intended to align the scope of the exemption with certain aspects of market practice:

(i) *The issue of a global note or bond to a clearing house* (such as Euroclear or CEDEL), where the rights conferred in relation to the global note or bond are offered in a way that satisfies the public offer test, will itself be regarded as satisfying the test, provided that interests in the global note or bond are exchangeable for definitive notes or bonds (see proposed section 128F(4) and (10)).

The requirement for exchangeability ignores the fact that in many issues the underlying holder gains equivalent rights under a deed of covenant or similar document granted by the issuer.

(ii) *The issue of a debenture through a wholly-owned, non-resident subsidiary of a company*, where the subsidiary raises finance in (or, according to the explanatory memorandum, where the subsidiary is resident in) a country listed in the Income Tax Regulations, is treated as an issue by the parent company (see proposed section 128F(8)).

Whether the country list is for the place of incorporation of the subsidiary or the place of raising the finance needs to be fundamentally clarified.

(e) *Interest paid to an associate of the issuer* (unless the issuer was unaware of the association and had no reasonable grounds to suspect it) is ineligible for exemption (see proposed section 128F(6)).

"Associate" is defined by incorporating the definition in section 159GZC of the ITAA, which uses (among other things) a 15% shareholding threshold.

There is currently no exception to this disqualification to allow an associate to act as a paying agent or as a clearing house in relation to an issue, or to cover situations where an associate is a trustee of a managed fund which invests in the debentures. These are obvious deficiencies that will be a practical market hindrance, and for no good reason. In addition, where an associate acts as a dealer, manager or underwriter, the disqualification will cause the exemption to be lost if the associate, despite its best efforts, has been unable to on-sell the debenture before the next interest payment date.

It is to be hoped that, despite present indications, the opportunity will be taken to remedy these deficiencies before the legislation is enacted.

SECTION 128AC

Perhaps the most curious recent development has been the ATO's changed stance on cross-border leasing, and its relation to section 128AC of the ITAA.

That section sets out a statutory formula for determining a deemed "interest" component of payments under a hire-purchase agreement, and provides for withholding tax to be payable on that component. The section was inserted into the ITAA in 1986 (applying with effect from the date of an earlier announcement made on 16 December 1994), with a view to imposing a liability to withholding tax where previously there was none. Since that time section 128AC has been regarded by practitioners – and accepted by the ATO – as being an exclusive code for determining the liability of hire-purchase payments to withholding tax.

That changed earlier this year. In a paper presented to the National Convention of the Taxation Institute of Australia on 19 March 1997, the Commissioner of Taxation, Mr Carmody, announced that the ATO was undertaking a review of cross-border lease transactions. The stated intent of the review was to determine whether a withholding tax liability may arise in relation to those transactions by virtue of the definition of "royalty" or, in the alternative, under the proposed amendments contained in Taxation Laws Amendment Bill (No 2) 1997 to Part IVA of the ITAA.

Most cross-border lease transactions undertaken by Australian lessees take the form of hire-purchase transactions, and are used as a means of reducing the cost of financing an asset rather than as a source of financing in themselves. Typically the Australian end-user of the asset makes an upfront payment to satisfy in full all its hire-purchase payment obligations, and gains a benefit from the present-value difference between the required payment and the cost of the asset. This benefit, unless the end-user is a tax-exempt body such as a State public authority, will constitute assessable income of the end-user.

Where the upfront payment is made to the lessor as a prepayment of the hire-purchase payment obligations, the statutory formula in section 128AC determines the amount of any deemed interest component of the prepayment. If the prepayment amount is equal to or less than the cost of the asset and there are no further payments to be made under the agreement, the amount of deemed interest will be zero, and so, therefore, will be the amount of the withholding tax liability determined under section 128AC.

The Commissioner's concern, as evinced by his paper to the Taxation Institute, is as much for the protection of the tax revenues of the foreign jurisdictions in which the lessors are based as for those of Australia. Indeed, he could not be concerned that the transactions will cause any direct loss of Australian tax revenues, for the simple reason that:

- the amount of withholding tax, if payable at either the interest or royalty withholding tax rate, would in almost all cases exceed the net benefit otherwise available from a cross-border lease transaction, and so the transactions would not proceed if withholding tax were payable,

  which means that:

- the Commissioner would be depriving the Australian revenue of tax on the assessable benefit available from the transactions.

The Commissioner's overriding concern, therefore, must be the (gratuitous) protection of the tax revenues of other countries in which the cross-border lessors are based. Putting aside the question whether this is a legitimate function of the Commissioner and ATO, this approach is causing Australian lessees to lose international competitiveness as their overseas counterparts continue to avail themselves of the available benefits.

Michael Price will be elaborating on these and other economic aspects of the Commissioner's apparent stance, and so I shall not dwell on them further here.

As a matter of statutory interpretation, however, it is difficult to see how the Commissioner's concerns as regards the Australian revenue can be supported. Even if it is accepted that payments under a hire-purchase agreement can constitute a "royalty" within the definition in section 6(1) of the ITAA or in an applicable double tax agreement, the specific provisions of section 128AC will apply as the source of the imposition of withholding tax to the exclusion of the more general royalty provisions, where the hire-purchase payments include an interest component. It would be a curious and novel interpretation that allowed the more general provision to be revived just because the application of the formula in section 128AC determines that the amount of the interest component is zero. In my view such an interpretation would be plainly wrong.

It would not be a welcome development if the ATO, in its eagerness to pursue what it sees as the protection of the revenues of other countries, were allowed to override the correct interpretation of Australia's tax laws.