TAX ISSUES IN FINANCING TRANSACTIONS

COMMENTARY

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SCOPE OF WITHHOLDING TAX EXEMPTION

i) Transitional issues.

ii) The offshore borrowing subsidiary and the replacement of old section 128F(6) with new section 128F(8):

- removal of "wholly controlled" test;
- removal of "no profit" requirement.

iii) No rectification of section 159GW restriction on deep discounted and deferred interest securities that are exempt from withholding tax.

UNINTENDED SCOPE OF NEW WITHHOLDING TAX ANTI-AVOIDANCE PROVISIONS

i) Expansion of the definition of interest and potential unintended consequences requires clarification:

"(1AB) For the purposes of this Division:

interest includes an amount, other than an amount referred to in subsection 26C(1), that:

(a) is in the nature of interest; or

(b) could reasonably be regarded as being:

(i) equivalent to interest; or

(ii) in substitution for interest; or

(iii) received in exchange for a right to receive interest.

(1AC) An example of an amount in the nature of interest is an amount representing a discount on a security.

(1AD) An example of an amount in substitution for interest is a lump sum payment made instead of payments of interest.

(1AE) For the purposes of this Division, if a lender assigns a loan, or the right to interest under a loan, any payment from the borrower to the assignee that represents an amount that would have been interest if the assignment had not taken place is taken to be a payment of interest.

(1AF) To avoid doubt, for the purposes of this Division, if a person acquires a security on a cum interest basis, any payment from the issuer of the security to that person that represents an amount that would have been interest if the acquisition had not taken place is taken to be a payment of interest."

ii) New section 128AF on interposed tax exempt bodies:

"2.67 ***New Section 128AF*** will be inserted to deem amounts paid through tax exempt interposed entities to have been paid by the resident directly to the non-resident. ***New section 128AF*** will apply when:

- a payment of dividends, interest or royalties is received by a non-resident through one or more interposed companies, partnerships, trusts or other persons; and

- one or more of the interposed entities is exempt from income tax at the time at which the payment was received by the non-resident."

The concept of attribution is not without difficulty.

iii) Part IVA and Interest withholding tax:

A new section 177CA is to be inserted into Part IVA. This section will extend the operation of Part IVA to arrangements which avoid an amount of withholding tax which would otherwise be levied under section 128B of the Act. The amount on which withholding tax is not paid is termed a *tax benefit* for the purposes of Part IVA. A *tax benefit* will have both of the following characteristics:

- As result of entering into or the carrying out of a scheme, the taxpayer is not liable to pay withholding tax on the amount;

- There is a reasonable expectation that, if the scheme had not been entered into or carried out, then a liability to the taxpayer for withholding tax on that amount, would have arisen. Proposed subsection 221YQA(1) ensures that the **payer** of the relevant interest, dividend or royalty will become liable to pay the amount of withholding tax due to the Commissioner. Further, the payer will be liable to pay the Commissioner an amount of additional tax by way of penalty for late payment of withholding tax (subsection 226(1)(1A));

- Under 221YQA(2) the payer may recover the payments made to the Commissioner under 221YQA(1) from the taxpayer.

Unlike the general anti-avoidance provisions contained in Part IVA which apply to schemes entered into on or after 27 May 1981, Item 19 Schedule 2 of the Bill states that the above measures, "will apply to interest, dividend and royalty payments made after 7.30 pm EST on 20 August 1996". This means that these provisions will operate retrospectively in the sense that they will apply to schemes entered into prior to 20 August 1996 where a payment under this scheme occurs after this date.

However, the Senate Standing Committee for the Scrutiny of Bills has criticised the withholding tax avoidance provisions of Taxation Laws Amendment Bill (No 2) 1997 in a number of respects (and has sought the Treasurer's advice). One of the criticisms made was that the proposed application of Part IVA can apply retrospectively to any interest payment made after 20 August 1996 pursuant to contractual arrangements entered into *before* that date, and the retrospective application of the amendments for royalties already being paid under contracts.

Currently, the Bill has passed the House of Representatives without amendment. It has been referred to the Senate Economics Legislation Committee for report by 30 May 1997. This means that the Bill will not be debated in the Senate until at least the end of May.

DEPRECIATION OF FIXTURES EXTENDS TO LESSORS IN LIMITED CIRCUMSTANCES

Also held up in the current legislative logjam is Taxation Laws Amendment Bill (No 3) of 1997. Schedule 8 contains amendments proposed to deal with the depreciation of assets "owned by financiers where they are leased to lessees in circumstances where they become fixtures". This has been a continuing issue with the Australian Taxation Office for some years now and the amendments, if and when enacted, will operate from 1 July 1996.

The legislation as proposed preserves the notion, however, that the item must be plant or articles for the purposes of depreciation but for the affixation by the lessee. Proposed section 54AC establishes the requirement as to the eligibility of the lessor for such beneficial treatment. As can be seen below, the inherent requirement must be that the item in question can be severed or removed from the property without causing substantial damage to the property or the land.

54AC – Eligible lessor – right of removal of property

Right of removal

(1) Where a unit of property is a fixture on land owned by the lessee of the property, then, for the purposes of subsection 54AB(1), the lessor is an eligible lessor in relation to that property if:

(a) the lessor has a right, in addition to any other right, to sever and remove the property from the land in the event of default under, or termination of, the lease (a ***right to remove***); and

(b) the property can be removed without causing substantial damage to the property or to the land.

Effective right of removal

(2) Where the property is a fixture on land owned by a person other than the lessee, then, for the purposes of subsection 54AB(1), the lessor is an eligible lessor in relation to the property if:

(a) the lessee has a right to sever and remove the property from the land; and

(b) the property can be removed without causing substantial damage to the property or to the land; and

(c) under the lease, the lessor has a right against the lessee to recover the property (an ***effective right to remove***).

Lessor not an eligible lessor if right to remove, or effective right to remove, is lost

(3) The lessor is not an eligible lessor in relation to the property if:

(a) although the lessor has a right to remove, or an effective right to remove, the property, the lease expires or is otherwise terminated without the lessor exercising that right; or

(b) there is an event of default under the lease and the lessor ceases to have a right to remove, or an effective right to remove, the property; or

(c) the lessor disposes of his or her interest in the lease, including the residual interest in the property; or

(d) the lessee discharges his or her obligations under the lease and the property is not returned to the lessor; or

(e) the property is lost or destroyed.

Whether the removal of property causes "substantial damage to the property or to the land" has been considered in two contexts. In Australian law it has traditionally been one test in deciding there is an intention to permanently fix a chattel to the land and therefore make it a fixture. Also, English courts, and to a lesser extent, Australian courts, have developed the concept of "tenants fixtures" which are chattels annexed to the land for the tenant's trade, domestic or ornamental use. These "tenants fixtures" may be able to be removed from the property (unlike normal fixtures) subject to the proviso that the removal does not cause "substantial damage to the realty or the object itself".

In both cases the fact that damage might be caused is one of several elements in objectively determining the intention of the parties regarding the character of the annexation when the object was installed.

Reference to the UK approach was made by Starke J in *Greita Sebea v Territory of Papua*[1] when he said:

> "... the size and permanence and the general character and object of the structures and buildings may lead one to the conclusion that they are not tenant's fixtures but something permanently annexed to the land; ... for the removal must be capable of being effected without material injury to the land or the destruction of the fixture."[2]

Jordan CJ in *Australian Provincial Assurance Co Ltd v Coroneo*[3] considered that if a thing has been securely fixed, and in particular if it has been so fixed that it cannot be detached without substantial injury to the thing itself or to that which it is attached, this supplies strong, but not necessarily conclusive evidence that a permanent fixing was intended.[4]

The cases he refers to as a basis for that principle are *Holland v Hodgson*[5] and *Spyer v Phillipson.*[6]

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1 (1941) 67 CLR 544

2 (1941) 67 CLR 544 at 544.

3 (1938) 38 SR (NSW) 700.

4 (1938) 38 SR (NSW) 700 at 712.

5 (1872) LR 7 CP 328 at 335.

6 [1931] 2 Ch 183.

Holland v Hodgson stated the principle that if the removal of the item caused damage then the onus was on the tenant to prove that the intention when the item was installed was that it should only be temporary. The court referred to an earlier case (*Hellawell v Eastwood* (1851)) and stated that what needed to be considered was whether the item, "can easily be removed *integre slave et commode* or without injury to itself or the fabric of the building."[7]

Spyer v Phillipson involved the removal of "valuable antique panelling, ornamental chimney pieces and so called 'period' fireplaces" and it best describes the principle regarding the extent of the damage resulting from removal that is required to make a chattel a fixture. In relation to the damage to the items Luxmore J stated:[8]

> "... *it is not that the damage done to the panelling will destroy it* or anything of the kind, all that is said is *if you take down panelling of this antiquity some damage will necessarily result; but the panelling will still remain valuable panelling* ..."

and in relation to the structure from which the panelling was removed:

> "... it is said that if these things are taken away there will be great damage to the structure. In my view when it is said that you must consider the damage done in removal, it does mean the damage to the structure. *It does not mean damage done merely to those things which form the decoration of the particular room; it is damage to the fabric of the structure* ... It is quite true damage will be done to the plaster and the ceilings, and so on, and when the fixtures are removed it will be necessary to replace some of them with skirting boards, window linings, etc. But those circumstances are not in my opinion sufficient to outweigh the other considerations."

Other cases which have adopted the principle are:

- *Weller v Everitt*,[9] in which it was found that an extension to a building could not be removed because the effect on the remaining house, "would be to leave a great hole in the house, leaving it useless as a house, and it would be impossible to say that his building could be removed without damage to the house of the plaintiff."[10] Despite the fact that the wall was rebuilt by the lessee, the principle still made the item a fixture, and not removable.

- *Pole-Carew v Western Counties and General Manure Company, Ltd*[11] where it was decided that certain structure on the land were fixtures and not removable because, "The real test is, can the thing be removed without its identity being destroyed? ... From the nature of these structures they could only be removed by reducing them to lead and wood."[12]

- *Webb v Frank Bevis, Ltd*[13] in which it was found that an iron shed constructed upon a concrete floor was removable, the tests being, "the subject-matter should not, by the process of removal, lose its essential character or value."[14]

Ipp J in *Eon Metals NL v Commissioner of State Taxation (WA)*[15] found that pumps, transformers and ball mill could be regarded as chattels as they could be readily removed from the land without

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7 (1872) LR 7 CP 328 at 336.

8 [1931] 2 Ch 183 at 199.

9 (1900) 25 VLR 683.

10 (1900) 25 VLR 683 at 687.

11 [1920] 2 Ch 97.

12 [1920] 2 Ch 97 at 111.

13 [1940] 1 All ER 247.

14 [1940] 1 All ER 247 at 251.

damage and would be economically worth moving. However, a shed, a day tank, fuel lines and associated pump should be regarded as fixtures as they were unlikely to be moved and more likely to be destroyed at the end of the life of the mine.

Other uses of the word "substantial" can also be found. The most relevant case seems to be *Tillmanns Butcheries Pty Ltd v Australasian Meat Industry Employees Union.*[16] The frequently quoted passage from Deane J is,

> "The word 'substantial' would certainly seem to require a loss or damage that is more than trivial or minimal. According to one meaning of the word the loss or damage would have to be considerable (see *Palser v Grinling* [1948] 1 All ER 1; [1948] AC 291 at 316-7). However, the word is quantitatively imprecise; it cannot be said that it requires any specific level of loss or damage. No doubt in the context in which it appears the notion imports a notion of relatively, that is to say, one needs to know something of the circumstances of the business affected ...".[17]

However, this decision, whilst being frequently referred to as being the decisive case on the issue, does not really come to any useful conclusion as to the meaning of the word "substantial".

Overall, the analysis suggests that considerable subtlety is involved in making the determination about whether substantial damage to the property or to the land will arise.

BUDGET PROPOSALS

Aside from the proposals discussed in John Field's paper and Michael Price's commentary, I believe one aspect of the more obscure budget proposals requires some scrutiny. Press Release No 60 proposes that property acquired under hire purchase or limited recourse finance will have restricted tax depreciability by limiting the aggregate allowable depreciation to the actual principal paid under the facility. This means in the event of default that there may be deemed depreciation recapture of the difference between the tax written down value and the unpaid principal component. The proposal is contemplated to apply to disposals after budget day. Thus pre-budget financings that go into default may have unintended tax depreciation recaptures.

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15 91 ATC 4841.

16 (1979) 27 ALR 367.

17 (1979) 27 ALR 367 at 375.