RISK ALLOCATION IN AUSTRALIAN AND INTERNATIONAL CAPITAL MARKETS: A REVIEW OF RECENT TAX DEVELOPMENTS

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WITHHOLDING TAX

The observations that I am able to make on the paper are very much from the perspective of a banker; someone who deals with the issues on a practical basis from day to day.

The new debt/equity legislation is undoubtedly something which bankers will need to focus on but at this point in time its too early for me to be able to make any insightful comments. I myself am still seeking information from people such as Greg and Ian to identify the impact on our activities. Thin capitalisation is area of obvious importance but it is fair to say that this exercises the minds of issuers far more than bankers acting as intermediaries in transactions.

Having said that I will be focussing my commentary on a number of topical issues raised by Greg and Ian on withholding tax and the operation of the "public offer" test.

a) *Is the issuer or the dealers, managers or underwriters responsible for ensuring satisfaction of the public offer test?*

I would suggest that it is the issuer of the debenture who is responsible for satisfying the public offer test. It is the issuer who must make the assessment that the debentures have or have not been offered in a manner to satisfy the public offer test and whether or not a withholding is to be made from payments of interest to non-residents.

The ATO of course recognises that intermediaries are an integral part of the securities distribution process and accordingly the fifth method of satisfying the public offer test is to be found in the legislation.

For many bond or MTN or commercial paper issues, it is more often than not the case that the issuer will rely on the fifth method, that is the dealers satisfying the public offer test. More importantly, the dealers usually give an undertaking and make representations in the documentation under which the securities are issued, that the dealers will offer the securities in a manner to satisfy the public offer test. So whilst I would contend that it is the issuers who are responsible for satisfying the public offer test, in practice this is often not the case.

I must confess that I find it surprising that dealers so willingly take on the risk of satisfying the public offer test when there are arguably much better avenues available. When looking at the corporate MTN issues that have occurred over the years, very few have taken the option of the third method by listing the debentures. Those issuers in the domestic MTN market who have listed their issues tend to be the supra-nationals and kangaroo[1] issuers and for these issuers, satisfying the public offer test is not even necessary as being non-residents, interest payments do not have an Australian source and are outside the scope of the legislation.

Very few Australian-domiciled corporates have listed their issues. Where these issuers have equity listings on the ASX, the cost of a wholesale listing of the debt securities is marginal. The issuer is already subject to the ASX's continuous disclosure rules so there is no additional reporting requirements and in most in cases, the issuer is already paying the maximum listing fee (which is based on market capitalisation) to the ASX so a listing of debt securities will not result in extra fees.

It is somewhat surprising therefore that dealers are prepared to take on the risk of satisfying the public offer test when a "no cost" option is available to the issuer. If the securities are listed there can be no doubt that the notes have satisfied the public offer test whereas relying on one of the other methods the issuer must make its assessment based on the representations of the dealers.

I am not sure why listing of issues has not been taken up; some issuers have expressed reluctance to do so due to not wanting to be seen to be a ground breaker and others based on the perception of additional work and effort involved in a listing. I also think that dealers themselves have not actively pushed for the use of the listing option and have been too ready to accept responsibility for satisfying the public offer test.

I qualified my initial remarks on who is responsible for satisfying the test as being in relation to securities issues such as MTNs. For a loan note facility the practice tends to be different, either the issuer makes the offer or the arranger makes the offers to potential participants but the identities of the offerees have previously been disclosed to the issuer. Because the loan note market is principally a 'bank' market, parties do not have the same hang ups about disclosing the identities of the potential purchasers of the loan notes to the issuer or more particularly other banks in the arranger group.

b) *The need for a genuine offer to be made by the issuer which is capable of acceptance by all offerees and the absence of arrangements pre-determining the identity of the successful offerees;*

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1 A kangaroo issue is an A$ denominated issue by a non-resident issuer sold predominantly in the domestic Australian market

Notwithstanding the fact that the public offer test has been around for a number of years the offer process still presents something of a challenge for dealers. This is particularly so when dealing with private placements.

A private placement will often start with a telephone call between a dealer and potential investor. The ATO has stated that reverse enquiries are not meant to be excluded from section 128F but the issue of the debentures must satisfy one of the public offer test methods.

If the transaction has for all intents and purposes been initiated via a telephone call what method does the dealer use to satisfy the test?

If the issuer is prepared to issue securities at the indicated price, in many cases the identity of the investor is to some extent predetermined. Fortunately, for a dealer having an issuer who is prepared to issue notes at a given price means that there is a good opportunity to sell further notes at the same price, so the sales force will swing into action to try and sell more notes. At this point a terms sheet will often be prepared and sent out to potential investors thus enabling the first or possibly second methods of the test to be met.

However what if the reverse inquiry is for a security with features that makes it most unlikely that you would expect other investors to want to purchase the notes? Or the issuer has clearly stated that it will not issue further notes?

At this point dealers tend to rely on their prior distribution of the Information Memorandum. The presumption being that the distribution of the Information Memorandum and other publicity in the financial press concerning the programme has created the awareness with the investor. The ATO in the taxation determination 1999/16 has indicated that "it is not considered necessary for investors to confirm with the issuing company that they acquired the debentures as a result of having seen the publicity initiated by the issuer. The publicity itself, in the manner described [in the determination], constitutes satisfaction of this aspect of the public offer test". Consequently the dealer who is satisfying the test on the issuer's behalf, doesn't enquire if the investor saw the publicity and everybody carries on in blissful ignorance.

Sometimes the initiation of the negotiation is by way of distribution of a terms sheet. Does a terms sheet constitute a 'Marketing Document'[2]?

The taxation determination on the subject expects a Marketing Document to have been prepared by or on behalf of the issuer. Typically the issuer will never see the terms sheet that is initially distributed to potential investors let alone prepare it. As securities programmes usually have strict limitations on the

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2 Taxation Determination 1999/16

information that the issuer authorises a dealer to provide on its behalf, arguably the terms sheet has not been prepared on its behalf and therefore is not a Marketing Document.

Setting aside that little technicality ...

Is there any expectation as to the length of time between the Marketing Document or other publicity and the offer.

The Information Memorandum can received broad distribution at the time a programme is arranged. It may be some years though after the distribution of the Information Memorandum that an offer of securities is made. Does this matter? I don't know the answer to that one.

c) *What publicly available information sources will be used?*

Insofar as electronic sources are concerned the ATO determination refers to information sources such as Reuters and Bloomberg. With intermediaries increasingly focussing on technology as a means to delivering services, it is questionable whether or not the proprietary internet-based trading systems that some banks have would satisfy the requirements. Such systems are not accessible to the public at large but are accessible to the institutions client base who would be either professional investors carrying on a business of providing finance or investing in securities or alternatively persons who have acquired or would be likely to acquire securities. I believe that such an offering would certainly be in accord with the spirit of the legislation but perhaps not within the letter.

d) *What evidence should be obtained as to the nature of offers made by dealers, managers or underwriters for the purposes of the fifth method?*

Obtaining 'evidence' is an area which can be problematic. From my own, that is ANZ's perspective, we do not as a general rule keep detailed information as to which method was used to satisfied the test. If we have prior knowledge that an issuer will seek some evidence in relation to say a one off discrete series of MTNs we will document the offer (by keeping a list of the potential investors approached for example). However, the private placement of an MTN issue as mentioned earlier is one where it is often more difficult to put your finger on exactly what method was used. Dealers can be reasonably confident that the issue was undertaken in a manner to comply with the public offer test but going into print to specify which method was used and the detail is something which dealers would much rather avoid.

Dealing in short term securities such as CP is different to the long end of the market. CP is almost traded like a commodity with the rating being the key determinant in price, daily turnover is significant and it would be an administrative burden to have to document such offers.

In such cases where the institution might have a securities sales force of a dozen or more people each with a dozen accounts and there is broad awareness of an issuer's funding activities, it is not difficult though to confidently assert that the offer would have been in a manner to satisfy the public offer test but to actually be able to demonstrate or prove that in respect of a particular issue is something else.

As was noted by the earlier speakers, the drafting of the amendments left much to be desired and the determinations provided only some practical help in dealing with the test as a practical matter.

Associates

It was noted by Greg in his paper that: the public offer test is not satisfied if the issuer knows, or has reasonable grounds to suspect at the time of issue, that the debentures were acquired by an "associate" of the issuer and that if the requirements of section 128F(5) are not satisfied, all the debentures of that issue are affected and cannot benefit from the exemption from interest withholding tax at any time.

Whilst I agree with this view, it is not universally held. Only two weeks ago, a withholding tax analysis was provided in respect of a large structured transaction in which the view was expressed that:

"Section 128F(3) defines the public offer test in relation to the issue of **a** debenture and section 128F(5) provides that the issue of **a** debenture by a company does not satisfy the public offer test if, at the time of issue the company knew or had reasonable grounds to suspect, that **the** debenture was being, or would later be, acquired either indirectly or directly by an associate of the company."

The emphasis on "a" and "the" was added by the legal adviser. The party went on to advise that:

"Interpreting section 128F(5), it is clear that it operates in respect of each debenture which is part of a debenture issue, rather than all debentures which are issued as part of a debenture issue. The implication that can be taken from that interpretation is that the tainting of particular debentures will not result in the tainting of all the debentures issued as part of a single debenture issue."

A qualifier was added though "However, some comments made by the ATO in TD 2001/3 (in the context of ruling upon when a company will be taken to have the requisite knowledge or suspicion that the debenture will be acquired by an associate) could be taken to mean that the ATO considers that a tainting of one debenture will operate to taint the entire debenture issue."

In this case the transaction involved domestic associates of the dealers also taking an equity interest in the issuer. Whatever the merit of the legal arguments as to whether an individual debenture is tainted or all of the debentures in the series are tainted, from a practical perspective in the context of the normal operation of the market it would not be possible to have some debentures comprising a single series of notes to be public offer test compliant while other debentures are not. Dealers would not be able to readily identify whether they are trading public offer test compliant debentures with serious implications for non-resident holders not to mention pricing implications or how the registrar identifies who is holding non-compliant notes when they have been lodged in a clearing system and the clearing system is the only holder appearing on the registrar.

The practical way around this problem is, as was suggested by the legal counsel involved, to have two series of debentures, identical but for the fact that one series would be public offer test compliant and the other not. Being different series they would be distinguishable by different ISINs and trading would not be a problem.

With the changes to the definition of associate so that it is much more focussed on control, the issue of who is an associate has become less contentious but as Greg/Ian noted the allocation of responsibility between issuers and dealers is still a major point of discussion and negotiation.

What constitutes knowledge or suspicion is a key issue. Taxation determination 2001/3 provides that "When subsection 128F(5) refers to the knowledge or suspicion of the company, knowledge or suspicion of all company personnel involved with the issue itself, and other personnel who are concerned in or take part in the overall management of the company, would be relevant. Accordingly, issuing officers will need to undertake enquiries to ensure that other officers of the company do not have such knowledge or suspicion, otherwise the subsection may operate."

When a dealer undertakes to not to sell notes to an associate it is important, particularly in the context of global financial institutions that the knowledge is limited to the particular officer of the dealer who is involved in the offer of the debentures. To extend it to other officers who are concerned in or take part in the overall management of the financial institution could broaden the application to personnel who because of their role of may be aware that the investor is an associate but the person actually executing the trade is not. An easy example of this is the relationship manager whose very job is to know the company intimately, that relationship manager could be well aware that XYZ is a subsidiary of ABC; but this is not apparent from the company name or even the type of business and it would not be reasonable to expect the dealer to ask all points in the bank whether or not a particular investor is an associate before a sale is made to XYZ.

A further concern is what constitutes suspicion. The ATO does not provide a lot of guidance as to what constitutes suspicion or what dealers should do to ensure that there are no reasonable grounds for suspicion. The taxation determination on the subject simply states that:

"Suspicion needs to be looked at objectively in light of what is reasonable in the individual circumstances of the particular case."

Not a lot of help. What I as a banker think is completely reasonable could be quite different to what the ATO thinks is reasonable.

Given the work by regulators on customer due diligence for banks it would not be much of a stretch of the imagination for somebody to argue that the 'know your customer' standards put forward by the

Basel Committee on Banking Supervision have application in this area. In a recent Basel Committee paper[3] it was stated that:

"On the liabilities side, concentration risk is closely associated with funding risk, particularly the risk of early and sudden withdrawal of funds by large depositors, with potentially damaging consequences for the bank's liquidity. Analysing deposit concentrations requires banks to understand the characteristics of their depositors, including not only their identities but also the extent to which their actions may be linked with those of other depositors."

As the purchasers of securities are also often purchasing an institution's (that is the dealer's) own securities it could be argued that the dealer should know the ownership structure of each of its investors and by extension should be able to identify whether XYZ is an associate of ABC.

While this sounds good in theory, in practical terms I think few banks would have information databases that would allow this information to be captured let alone used effectively.

So on the assumption that "I don't know because I didn't ask" or ignorance is no defence, should a dealer be required to undertake some form of customer due diligence to make sure there is no association? This question to a large degree remains unanswered. Issuers are still keen to have the "reasonable grounds to suspect" included in dealer undertakings and on that basis one can assume that in the event that the public offer test compliance of the notes is called into question, the issuer may well seek to use the argument that a dealer should have suspected and is therefore responsible for the cost of any tax gross up.

It has been suggested in numerous transactions that issuers should provide a list of associates as a means of overcoming the issue and a number of issuers have provided such lists. I can recall one such issuer who had no problems providing the list of associates; it was emailed out to the dealers on an excel spreadsheet and contained in excess of 500 companies! Not all dealers are in favour of this as it then means they have to have systems in place which will prevent the sale of the securities to anyone on the list. Dealing personnel are notorious for their lack of attention to procedures at times and back office personnel are often processing huge volumes of trades and payments in a largely automated manner. Manual intervention in the process by low level staff is not the preferred approach of an operations manager.

Aside from the fact that not all dealers like receiving lists of associates, not all issuers favour providing a list, if in fact quite a few refuse to do it. To my mind this presents a serious conceptual problem; if the issuer is not prepared to provide a list of its associates because its too difficult, how is the dealer supposed to be in a position to know or suspect that a potential purchaser is or is not an associate.

Is the issuer unwilling to do this because of the administrative requirement it would impose upon them and which they make fail to observe or because the term control as used in the legislation includes a

3 Basel Committee on Banking Supervision, Customer due diligence for banks, Bank for International Settlements, October 2001, page 4

test of "sufficiently influenced"? Sufficiently influenced is an extremely broad concept and would appear to include influence which does not necessarily arise just through shareholding.

While also on the topic of associates, notwithstanding the announcement by press release close to a year ago that domestic associates would be excluded from the definition of associate, few issuers have taken advantage of this announcement. ANZ still issues securities on a non-public offer test compliant basis to allow the funds management arm to participate as an investor in issues. Alternatively other banks have maintained the approach of prohibiting the domestic associate's participation in order to have a public offer test compliant issue. Why is this so? It's simply because it takes so long to get these things into legislation and until some legislation is actually operative, I can't see this situation changing.

The same press release also dealt with associates acting in the capacity of a clearing house or custodian. In this case the market has ignored the current legislation on the basis that it would impinge upon the normal operation of the market. Prior to the public offer test being introduced banks acted as custodians for investors. Nobody seriously considers that an intended effect of the legislation was to prevent banks acting in such capacities so it has just been ignored. It would be nice to have some legislation though to correct the situation.