


TR 2002/15 - Income tax: deductibility of payments incurred on moneys raised through the issue of perpetual notes

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Taxation Ruling

Income tax: deductibility of payments incurred on moneys raised through the issue of perpetual notes

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Preamble

The number, subject heading, Class of person/Arrangement, Date of effect and Ruling parts of this document are a 'public ruling' for the purposes of Part IVAAA of the Taxation Administration Act 1953 to the extent to which they rule on the way in which a tax law applies. To that extent they are legally binding on the Commissioner. The remainder of the document is administratively binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.

What this Ruling is about

1. This Ruling considers whether payments incurred on moneys raised through the issue of perpetual notes are deductible under section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997').
2. In answering that question the Ruling considers whether:
 - (a) the payments are deductible under the positive limbs of section 8-1 of the ITAA 1997 as an expense of deriving income as opposed to the application of income derived;
 - (b) the payments are interest on a loan;
 - (c) the payments are of a capital nature within the negative limb of section 8-1 of the ITAA 1997.
3. This Ruling also considers whether the issuer of a perpetual note is obliged to pay or withhold tax on behalf of non-resident investors.
4. This Ruling does not consider the income tax consequences for investors who acquire the perpetual notes.
5. The cases cited in this Ruling that consider deductibility under subsection 51(1) of the *Income Tax Assessment Act 1936* ('ITAA 1936') have equal application to section 8-1 of the ITAA 1997. All references to subsection 51(1) of the ITAA 1936 should be taken as including a reference to section 8-1 of the ITAA 1997, and vice versa.

Class of person/arrangement

6. This Ruling only applies to perpetual notes ('Notes') with an undated or perpetual term. The Notes may be more commonly known as capital notes, floating rate capital notes, adjusting rate notes, subordinated notes, income notes or income securities (of the non-stapled, non-exchangeable, non-convertible or converting type). The class of persons to which this Ruling applies is all taxpayers who claim a deduction under section 8-1 of the ITAA 1997 for payments incurred on moneys raised through the issue of perpetual notes (subject to paragraphs 7 and 8).

7. The Ruling does not apply to perpetual notes that form part of a wider arrangement in which the holder, or an associate of the holder, of a perpetual note or an interest in a perpetual note has the right to acquire a share¹.

8. The Ruling does not apply to arrangements involving the issue of perpetual securities by a non-resident intermediary where the funds are on-lent to the resident corporate borrower, or an associate, at interest or brought back on-shore under a perpetual note that forms part of a wider arrangement².

Ruling**Are the periodic payments deductible under the positive limbs of section 8-1 of the ITAA 1997 as a loss or outgoing incurred in gaining or producing assessable income, or necessarily incurred in carrying on a business for that purpose?**

9. A distinction should be made between the expenses of deriving income and the application of income derived. A payment to discharge an obligation which arises because of acts done or omitted in the process of deriving income may be sufficiently connected to earning assessable income. However, a payment to discharge an obligation which arises because a derivation of income has occurred is not sufficiently connected.

¹ Such securities would constitute a 'convertible note' as defined in section 82L of the ITAA 1936 and may attract the operation of subsection 82R(3) of the ITAA 1936 depending upon the circumstances. Whatever the impact of the convertible note provisions, it should not be assumed that a deduction for the periodic payments on the notes will be allowable, as it may fall within the negative limb of paragraph 8-1(2)(a) of the ITAA 1997, as an outgoing of capital.

² Such arrangements structured on terms that have the effect of providing an overall enduring benefit of permanent capital to the borrower may attract the operation of Part IVA of the ITAA 1936.

10. Whether periodic payments on the Notes are sufficiently connected to the process of deriving income, given that they are variously expressed to be contingent on the existence and extent of a fund of net profits of the Issuer (or an associate of the Issuer) of a prior year of income, or payable out of such a fund directly or indirectly, is to be determined according to the terms and conditions of the relevant Instrument.

If the periodic payments satisfy the positive limbs of section 8-1 of the ITAA 1997, is a deduction for the payments denied under the negative limb in paragraph 8-1(2)(a) of the ITAA 1997 being a loss or outgoing of a capital nature?

11. Assuming the payments satisfy the positive limbs of section 8-1, the character of the advantage sought in the making of the periodic payments, based upon a weighing of all the relevant factors, is that of a permanent and enduring nature. The capital raised is non-refundable; it has a permanent, rather than ephemeral nature. It represents a permanent and unrestricted commitment of funds. In some circumstances the funds are treated as equity in the balance sheet of the company.

12. By investing in the perpetual notes, the investor contributes to the capital funds of the company. The cost of securing and retaining the use of the capital funds for the business is an outgoing which, although periodic, upon a weighing of all the relevant factors, is of a capital nature and therefore within the negative limb of paragraph 8-1(2)(a) of the ITAA 1997.

Date of effect

13. This Ruling applies to perpetual notes, as outlined in paragraph 6, other than perpetual notes in respect of which:

- the Issuer had entered into a binding agreement to issue; or
- the Notes had been offered for subscription,

prior to the date of withdrawal of Taxation Ruling IT 2411 **and** have been issued or allocated prior to 21 February 2001, being the date of issue of Draft Taxation Ruling TR 2001/D1.

Previous Rulings

14. Taxation Ruling IT 2411 considered whether a straight perpetual note (of the non-stapled, non-exchangeable, non-convertible or converting type) constituted a 'convertible note' for the purposes of Division 3A of Part III of the ITAA 1936. Taxation Ruling IT 2411 was withdrawn with effect from 5 November 1999.

Explanations

Description of the arrangements

15. The method of issuing the Notes to the successful applicants ('Holders') is usually in the form of the Issuer executing a global note in respect of all the Notes. The global note is an unsecured note for the purposes of the former section 1045 of the Corporations Law. A Note will be issued to a Holder when the name of the Holder is inscribed in a register as the holder of the Note. Under the global note, the Issuer undertakes to pay in respect of each Note to the Holders the outstanding principal amount, any interest payable and any other moneys payable in respect of the Note ('the Moneys Owning') in accordance with and subject to the terms and conditions applicable to the Note set out in the Trust Deed.

16. Issuers have stated that the reasons why they have elected to issue Notes, as opposed to other forms of capital raisings, include improvement of their capital structure and maturity profile by taking advantage of the particular characteristics of perpetual notes, in addition to further strengthening of their balance sheet.

Use of the proceeds

17. The use of the proceeds of the Note issues have been variously described by the Issuers as: to repay existing debt, to raise working capital, to recapitalise subsidiaries and to fund capital expansion or reconstruction.

Periodic payments

18. Periodic payments are described by the Issuers in the Prospectus and Trust Deed as 'interest'. The payments on the Notes are said to 'accrue' quarterly in arrears at a floating or fixed spread above a benchmark rate such as the 90 Day Bank Bill Rate ('BBR') and are calculated as follows:

$$\text{Interest} = \frac{\text{Interest Rate} \times A \times D}{365}$$

where A is the amount paid up on the Note and D is the number of days elapsed in a quarter during which the amount has been paid up on the Note.

19. The Issuer usually offers a minimum rate of 'interest' for an initial period of up to 12 months being the greater of the spread above the benchmark rate, or a specified percentage.

Periodic payment obligations

20. A payment which is said to have 'accrued' is not 'due and payable' on the Notes on an 'interest payment date' at the end of a quarter if, for example, the payment would exceed the Issuer's 'Distributable Profits' on that date. 'Distributable Profits' are defined as the Issuer's operating profits after income tax attributable to members of the Issuer for the immediately preceding financial year less:

- (a) the aggregate amount of payments previously made on the Notes during the current financial year; and
- (b) the aggregate amount of any dividends paid on any preference and ordinary shares of the Issuer during the current financial year.

21. There are several variations across different Note issues on the terms governing the restriction on the Issuer's obligation to pay the periodic payments. These terms may be that the payments are not 'due and payable':

- if no dividend was declared or approved in respect of the ordinary shares of the Issuer, or alternatively the Issuer's parent, for the immediately preceding financial year and a dividend has still not been declared; or
- if there are no profits legally available for the payment of dividends of the preceding financial year; or
- if the Issuer's net operating profits before income tax for the preceding year after accounting for all interest expenses and excluding abnormal losses for that year does not exceed zero and the directors determine that no 'interest' should be payable on that payment date.

22. Where a payment is said to have 'accrued' but is not 'due and payable' in accordance with the above terms, it is usually deemed, on and after the relevant payment date, never to have 'accrued' and never to be payable; that is, the payment is non-cumulative. Issuers may, however, have the option to make a payment (together with any

accrued interest thereon) that has been deemed never to be 'due and payable', or they may have the obligation to make the payment (together with any accrued interest thereon), once a dividend has been declared or approved on its ordinary shares.

Dividend blockage/stopper

23. Where the payment is said to have 'accrued' but is said never to be 'due and payable', the Issuer is usually prohibited from paying dividends on their ordinary and preference shares until either an optional payment has been made or one year's worth of periodic payments have been made on the Notes.

Redemption events

24. The Notes are undated and are only redeemable or repayable at the option of the Issuer upon the occurrence of specific redemption events. Apart from these redemption events, the only method available for the Holder to realise their investment in the Notes is to sell them on the ASX at the prevailing market price.

25. Redemption at the option of the Issuer is contingent upon the occurrence of:

- a tax event;
- a regulatory event;
- an early redemption event; or
- a buy-back.

26. A *tax event* essentially occurs when the Issuer is advised that there would be more than an insubstantial risk that the Issuer may be exposed to an increase in its costs in relation to the Notes as a result of an increase in taxes from an amendment, clarification or change to the tax laws, or an administrative action (a published or private ruling, notice or announcement) or change to a previous administrative action.

27. A *regulatory event* occurs when there would be more than an insubstantial risk that the Issuer may be exposed to an increase in its costs in relation to the Notes as a result of action by a regulatory authority (including fiscal, monetary, supervisory bodies such as the central bank or government).

28. An *early redemption event* is the ability of the Issuer to redeem the Notes on or after the fifth anniversary of the issue date.

29. A *buy-back redemption event* means an on-market buy-back of the Notes by the Issuer conducted by the ASX or by private treaty.

30. Redemption is usually at the amount paid up on the Note plus 'accrued' payments which are said to have become 'due and payable' as a result of satisfying the periodic payment obligations. In one Note issue identified, redemption is at an amount equal to the weighted average market price of all Notes sold on the ASX during a specified number of trading days immediately preceding the date of the exercise notice plus payments 'due and payable'.

31. Apart from the above redemption events Issuers may have a right at any time to redeem the Notes held by the underwriters.

Events of default

32. An event of default usually occurs if the Issuer acknowledges in writing that it is unable to pay its debts within the meaning of the Corporations Law, or a liquidation event has occurred.

33. An example of an event of default is where the payment is said to be 'due and payable' but the payment is not paid by the Issuer because the Issuer is unable to pay its debts as they fall due. The payment may be 'due and payable' but not paid by the Issuer in circumstances where an event of default does not crystallise, for example, where the Issuer is able to pay its debts as they fall due but elects not to meet the obligation to make the payment.

34. A liquidation event constituting an event of default includes proceedings commenced for the dissolution, winding-up or liquidation of the Issuer, or the appointment of a provisional liquidator, liquidator, administrator, controller or similar official in respect of the Issuer over all or substantially all of its property.

Consequences of an event of default

35. Upon the occurrence of an event of default and the notification of such an event by the Issuer to the Holders, the Holders may, in Note issues only where the trustee takes no action, declare that their Notes are due and payable. Consequently, the face value shall become due and payable subject to the terms of the subordination of the Holder's rights. Under some Note issues, the Holders may also seek to recover the payments which have 'accrued' but not been paid under a Note. Under other Note issues, any payments said to have 'accrued' but not paid, or any optional payments 'due and payable' but not paid, shall cease to be 'due and payable' and shall be deemed never to have 'accrued' or been 'due and payable'.

Ranking

36. The Notes are said to constitute unsecured and subordinated obligations of the Issuer. The Notes rank *pari passu* amongst themselves and behind the claims of all unsecured subordinated indebtedness of the Issuer, but normally rank ahead of both ordinary and preference shareholders.

Status and subordination - recovery of amounts payable upon a liquidation event

37. The rights and claims of the Holders are, upon a liquidation event, subordinated to the claims of senior creditors of the Issuer so that all claims of senior creditors must be paid in full before any claims of the Holders are paid.

Status and subordination - recovery of amounts payable prior to the commencement of a liquidation event

38. Prior to a liquidation event occurring, the obligations of the Issuer to make payments of the 'Moneys Owing' in respect of the Notes is conditional upon the Issuer being solvent at the time the payments owing fell due, and no payment of those moneys can be made in respect of the Notes unless the Issuer remains solvent immediately after that payment. The Issuer is solvent if it is able to pay its debts as they fall due, if an ordinary creditor is not entitled to accelerate repayment of any financial indebtedness (this contingency does not exist in all Note issues) and the Issuer's assets exceed its liabilities.

Accounting treatment

39. Some arrangements have been treated as equity for accounting purposes under SAC 4 -together with AASB 1033 and AASB 1034 - in the balance sheet. For accounting profit and loss purposes, the periodic payments on the notes are not taken into account in calculating the earnings of the Issuer, but are treated as a payment out of appropriated profits. That treatment is consistent with AASB 1033. Several Issuers have, however, treated the periodic payments on the notes as interest expense, and the notes as long-term borrowings.

Are the periodic payments deductible under the positive limbs of section 8-1 of the ITAA 1997?

40. This question requires a consideration of the principle that a distinction needs to be made between the expenses of deriving income and the application of income derived. The principle was reviewed by

Professor Ross Parsons in *Income Taxation in Australia*, LBC, 1985 at paragraph 6.302:

‘A payment to discharge an obligation which arises because of acts done or omitted in the process of deriving income may be sufficiently connected. But a payment to discharge an obligation which arises because a derivation of income has occurred is not sufficiently connected.’

41. The decisions of the High Court in *DCT (WA) v. Boulder Perseverance* (1937) 58 CLR 223 (*Boulder Perseverance*) and in *FC of T v. The Midland Railway Co of Western Australia Ltd* (1951) 85 CLR 306 (*Midland Railway*) are illustrations of this principle. Neither of those cases concerned the issue of perpetual notes by a company.

42. In *Boulder Perseverance* the High Court, in upholding the disallowance of a deduction by the Commissioner of a distribution of profits in excess of the 10% per annum coupon on certain securities, said at 234:

‘The nature of the contract in the present case appears to be clear enough. The parties adopted a contract for the division between them of the ultimate net profit made by the company. It is more than a payment contingent upon the making of net profits and proportional to their amount. It is a payment of part of the net profits under that description. ...**What is important, however, is the fact that the fund which under the contract the company divides with the debenture or note holders is the fund of profit cleared of all other charges whatsoever, with the contingent exception of the tax or taxes thereon**’ (emphasis added).

43. In *Midland Railway*, Dixon J considered *Boulder Perseverance* and said at 312-313:

‘The issue is not whether the payment when made possessed the character of interest on borrowed money, borrowed for the purpose of the business. It is not whether the obligation in pursuance of which it was paid had taken this or that form... Further it is not decisive of the issue under section 51(1) that it was paid or payable out of profits, that is so long as it was not payable out of the precise fund called by the Act taxable income.’

44. Professor Parsons reviews the decision in *Boulder Perseverance* at paragraph 6.304 and states:

‘The distinction between “a payment contingent upon the making of net profits and proportional to their amount”, which may be deductible, and a “payment of part of the net profits under that description” may be thought verbal only, and the

reference to the purpose of the statute, towards the end of the judgment, as not “confined to the taxation of profits that are available to shareholders and no one else” serves no more than to limit the decision in the case to the operation of the particular statute. One would have thought that, consistent with the approach taken in cases which rest on the purpose of the payment, the question of deductibility might have been resolved by asking whether the function of the payment was to service the borrowing or to effect a distribution of profits. A conclusion that it was the latter required a denial of the deduction.’

45. In some of the Note arrangements considered in this Ruling, periodic payments to the Holders are made contingent on the existence (and extent) of profits after tax of a previous year, or appear to be payable out of such a fund. In others, the periodic payments are contingent, directly or indirectly, on the profits (after tax) of associates of the Issuer.

46. If the payment to the Holder is contingent upon the existence (and extent) of profits after tax of a previous year, or it appears to be payable from such a fund, it will not be incurred in gaining or producing assessable income. On the other hand, if the payment is merely contingent on net profits of the entity, the payment will be incurred in gaining or producing assessable income. In any event, the application of the principle expressed above will be a question of fact, depending on the relevant terms and conditions of the Instrument.

47. As a practical matter, if a deduction is denied for the periodic payments under the positive limbs of section 8-1 ITAA 1997, it is not necessary to consider the question of whether the payments are nevertheless on capital account.

Are the periodic payments made by the Issuer to the Holders payments of interest on a loan?

48. In determining this question, the issues to be addressed include:

- the form of the transaction and the labels attached to it by the parties;
- the nature of interest and the nature of a loan; and
- what the transaction entered into by the parties by its terms effects.

The form of the transaction and the labels attached to it by the parties

49. In *Australia and New Zealand Savings Bank Limited v. FC of T* 93 ATC 4370 at 4390; (1993) 25 ATR 369 at 392 ('ANZ Savings'), Hill J, in determining whether the transaction under examination was one of a loan or an annuity, referred to *NM Superannuation Pty Ltd v. Young* (1993) 113 ALR 39 at 56 and said:

'the label used by the parties will not be determinative..., [but] it does not follow that the label used between the parties will be totally irrelevant.'

50. More recently, in *Broken Hill Pty Co Ltd v. Commissioner of Taxation* [1999] FCA 1628 at para 51 Kenny J said that the:

'fact that the payment is called "interest" on the purchase agreement is not determinative of its character which may, on examination, turn out not to be interest in the true sense at all.'

51. The form of the payment is not determinative: see Dixon J in *Midland Railway* (supra).

52. Merely because the agreements evidencing the Note issue have been drafted to give the issue of the Notes the gloss of a loan using labels associated with a loan such as 'moneys owing', 'principal', 'interest', 'redemption amount' and 'debt obligation', does not necessarily characterise the transaction as a loan.

The nature of interest; the nature of a loan

53. Halsbury's Laws of England, 4th Edition, Volume 32, paragraph 106, provides that '**Interest is the return or compensation for the use or retention by one person of a sum of money belonging to or owed to another...**' It cites the following cases in support of this proposition: *Re Farm Security Act 1944* [1947] SCR 394 at 411; *Dunn Trust Ltd v. Feetham* [1936] 1 KB 22, CA; *Bennett v. Ogston (H.M Inspector of Taxes)* (1930) 15 TC 374; *Bond v. Barrow Haematite Steel Co* [1902] 1 Ch 353; and *Riches v. Westminster Bank Ltd* [1947] AC 390, [1947] 1 All ER 469, HL.

54. Interest was described by Rowlatt J in *Bennett v Ogston* (Inspector of Taxes) (1930) 15 TC 374 at 379 as being a '**payment by time for the use of money**'. It has been said that this 'definition' highlights the two requirements which must normally be satisfied for a payment to amount to interest, namely:

- (a) there must be a sum of money by reference to which the payment is to be ascertained (which might loosely be called the principal sum or the principal debt); and

- (b) that sum must be a sum which is due to the person entitled to the interest, unless the right to the interest has been assigned to a third party. (“Interest”, King JC, *Taxation in Australia*, Vol. XV, No. 1, July 1980 at p.3).

55. Interest is a charge for the use or enjoyment of the principal sum for a fixed period of time because a loan is ephemeral in nature. In *Australian National Hotels Limited v. FC of T* 88 ATC 4627; (1988) 19 ATR 1575 at 1582 (*Australian National Hotels*), Bowen CJ and Burchett J said at 4633:

‘If the capital is raised by loan, an investment of the borrowed moneys in a business will ordinarily remain an investment of capital, and the same consequences will follow. **But there is a special feature of loan capital, which flows from the ephemeral nature of a loan...**’ (emphasis added).

56. This passage was referred to with approval by the High Court in *Steele v. FCT* 99 ATC 4242 at 4248; (1999) 41 ATR 139 at 148 (*Steele*). Gleeson CJ, Gaudron and Gummow JJ described the character of interest as being a recurrent payment to secure the use for a limited term of loan funds:

‘As was explained in *Australian National Hotels Ltd v. FC of T*, **interest is ordinarily a recurrent or periodic payment which secures, not an enduring advantage, but, rather, the use of borrowed money during the term of the loan.** According to the criteria noted by Dixon J in *Sun Newspapers Ltd v. FCT* it is therefore ordinarily a revenue item. This is not to deny the possibility that there may be particular circumstances where it is proper to regard the purpose of interest payments as something other than the raising or maintenance of the borrowing and thus, potentially, of a capital nature. **However, in the usual case, of which the present is an example, where interest is a recurrent payment to secure the use for a limited term** of loan funds, then it is proper to regard the interest as a revenue item...’ (emphasis added).

57. The periodic payments to the Holders of the Notes that are discussed in this Ruling are in substance akin to payments of dividends to preference shareholders. The rights of preference shareholders are not protected in the same way as those of debenture holders. Professor Gower (*Modern Company Law*, 4th Edition, 1979, at 419) has said:

‘But though they share the disadvantages of debenture holders they lack their advantages. They can only receive a return on their money if profits are earned and dividends declared, they rank after creditors on a winding-up, and they have less

effective remedies for enforcing their rights. Suspended mid-way between true creditors and true members they get the worst of both worlds.’

58. A debt is **moneys outstanding to be repaid at a fixed or determinable time or on demand**: ‘Chitty on Contracts’, 27th ed. 1994, para 36-202.

59. In *FC of T v. Radilo Enterprises Pty Ltd* 97 ATC 4151 at 4161; (1997) 34 ATR 635 at 646 the joint judgment of Lehane and Sackville JJ refers to Dr Pannam’s description of a loan of money:

‘A loan of money may be defined, in general terms, as a simple contract whereby one person (‘the lender’) pays or agrees to pay a sum of money in consideration of **a promise by another person (‘the borrower’) to repay the money upon demand or at a fixed date**. The promise of repayment may or may not be coupled with a promise to pay interest on the money so paid. The essence of the transaction is the promise of repayment. As Lowe J put it in a judgment delivered on behalf of himself and Gavan Duffy and Martin JJ: **“Lend” in its ordinary meaning in our view imports an obligation on the borrower to repay.**” (*Ferguson v O’Neill* [1943] VLR 30 at 32.) Without that promise, for example, the old *indebitatus* count of money lent would not lay. **Repayment is the ingredient which links together the definitions of ‘loan’ to be found in the Oxford English Dictionary, the various legal dictionaries and the text books. In essence then a loan is a payment of money to or for someone on the condition that it will be repaid.**

CL Pannam, *The Law of Money Lenders in Australia and New Zealand* (1964) at 6. See also *Brick and Pipe Industries Ltd v. Occidental Life Nominees Pty Ltd* (1991) 9 ACLC 324, at 357-358; [1922] 2 VR 279, at 321-323, per Ormiston J.’

60. The periodic payments made on the Notes described as ‘interest’ by the parties are *calculated* with reference to the amount paid up on the Note. The payments are therefore calculated in the same way as interest on a loan is calculated.

61. The periodic payments, however are not interest on a loan. A loan requires the existence of a debtor-creditor relationship underpinned by the obligation to repay the principal sum lent.

62. The Note issue is for a perpetual term, that is, it is undated; the Issuer has the use of the funds for an indefinite period of time, so that the capital raising lacks the ephemeral nature of a loan.

63. The Issuer is under no obligation to repay the funds raised except on the satisfaction of several contingencies, including an event

of default constituted by the Issuer being unable to pay its debts within the meaning of the Corporations Law, or a liquidation event.

64. In addition, it is a term of the parties' bargain that noteholders only participate in a surplus in accordance with conditions that provide for subordination of their claim to general creditors of the company. That is, even when those contingencies are satisfied, the rights of the Holder to the face value of the Notes are subordinated to the claims of all senior creditors, that is, all senior creditors must be paid in full prior to the claims of the Holders being met.

65. The critical question then is whether there is a **debt** in existence prior to the happening of the contingencies and subject to the terms and conditions of the notes, or whether the obligation to repay Moneys Owing is merely contingent.

66. An analogous situation arises with a guarantor's right of indemnity. Before payment by the guarantor, the right is subject to contingencies, namely the default by the debtor then a request for payment by the creditor.

67. The Court of Appeal in *Re A Debtor* [1937] 1 All ER 1 confirmed a long line of authority supporting the proposition that the debt due to the guarantor by the debtor under the implied contract does not arise until the guarantor has been called on to pay, and does pay, the creditor under the guarantee. Greene LJ commented at 8:

'The implied undertaking to indemnify is an undertaking to reimburse the guarantor upon the happening of a contingency, viz., payment by the guarantor to the creditor, and **until that contingency happens, there is no debt.**'

68. In the case of a Note, on one view there is no debt until a contingency occurs, being an event of default (such as the insolvency of the Issuer), or a liquidation event.

69. Another view is that there is no debt at all. Upon winding-up, the Holders' rights are subordinated until all claims of senior creditors are paid in full. The Holders may never receive the full face value of the Notes. In fact, the Holders do not have a right to sue for the sum due as a debt but may merely have a contractual right to enforce their claims behind those of the senior creditors.

70. Perpetual floating rate notes such as those described in this Ruling do not give the Holders an absolute entitlement to the repayment of the face value of the note except in accordance with the terms of the Note.

71. The only right of the Holder to repayment of 'Moneys Owing' occurs where the Issuer is wound up, or upon insolvency. In these circumstances – having regard to the terms of the Note as a whole and especially its degree of subordination to general creditors - there is no

obligation on the Issuer to repay the face value of the Notes. Instead the Holder accepts, in lieu of repayment of face value, a right to claim a portion of a surplus in a winding up of the Issuer after the claims of general creditors have been paid.

72. It is a feature of the chose in action that a Holder is only entitled to participate in the surplus in accordance with the arrangements specified in the terms of the Note. There is no 'debt'. The terms of payment (that is, what is paid under the Note) are part of the bargain upon the basis of which the Notes are purchased: see *Australian Finance Law*, Mallesons Stephen Jaques (BLEC, Melbourne 1989) at pp. 226-227 para. 2.2.3.3 and the authorities cited therein.

73. On either view we consider that, at least prior to an event of default, there is no loan evidencing a debt due that the Holders can sue for in the sense set out in the judgment of Hill J in *ANZ Savings*.

74. In the United States a debt instrument generally gives the holder the right to sue for recovery of the principal sum in debt if the issuer fails to make the scheduled payment: see *Charles E. Curry* 43 TC 667, 686 16 (1965); *Luden's Inc. v. United States*, 196 F. Supp 526, 633 (E.D Pa. 1961). However, the absence of a fixed maturity date has been held generally to constitute conclusive evidence that the instrument is not debt: *Texas Farm Bureau v United States* 725 F.2d 307, 313-14 (5th Cir. 1984); *Jewel Tea Co v United States*, 90 F. 2d 451, 453 (2d Cir. 1937). (See also Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369, 625-32 (1971) at 413.) A small minority of courts have treated securities as debt when they were to mature only upon a default in the payment of interest: see *Helvering v Richmond*, F.&P.R.R, 90 F. 2d 971 (4th Cir. 1937).

Alternative views

75. The terms and conditions in the Trust Deed that govern the issue of the Notes give rise to a debtor-creditor relationship between the Issuer and the Holder of the Notes. In *Webb v. Stenton and Others, Garnishees* [1883] 11 QBD 518 at 526 the Court held that 'a debt is a sum of money which is now payable or will become payable in the future by reason of a present obligation.'

76. In other contexts the term 'debt' has a wider meaning. For example, it is unquestioned that the debts payable by a company which are provable in a winding-up include debts 'present or future, certain or contingent, ascertained or sounding only in damages' (subsection 553(1) of the Corporations Law). Again, in the decision of *N. Joachimson v. Swiss Bank Corporation* [1921] 3 KB 110, the English Court of Appeal accepted without question that a sum

constituted a debt of the bank despite the fact that the bank's obligation to pay the sum to a customer was conditional upon an actual demand for payment.

Response

77. Prior to the satisfaction of the contingencies, the obligation is not present but contingent. This is not the case of a presently existing obligation to pay a certain sum at a future date. No Holder has the right to demand payment unless and until there is an event of default, which is purely contingent. There is, at best, a contractual agreement to share in an unquantified surplus on winding up of the Issuer.

78. The Corporations Law provisions concerning proof of debts and claims that are provable in a winding-up which are widely drafted to extend to both future and contingent debts, inter alia, are to be read in their context, and in the framework of the statutory purposes of that law, that is, for the protection of creditors' rights. We are concerned in this Ruling with whether an amount of 'interest' is payable in respect of a 'debt' at law.

79. Further, it has been stated that the Corporations Law recognises perpetual debt and, therefore, the amounts raised by the Note issue are debt since they are in fact repayable, although only upon insolvency or liquidation. In the decision of *Re Cuban Land and Development Co (1911) Ltd* [1921] 2 Ch 147 at 151, the court recognised that a borrowing may be 'perpetual' in the sense that no fixed or ascertainable date for repayment is set.

80. The case concerned competing priorities between classes of debenture holders on a winding-up. The court considered that debenture stock of a perpetual nature could be validly issued according to the former section 14 *Companies Act 1907* (UK). In effect, all the court did in that case was to acknowledge that the statute provided that 'debentures' may be perpetual, putting an end to previous doubts.

81. Former section 1050 of the Corporations Law provided that notwithstanding any rule of law or equity to the contrary, companies had the power to issue debentures made irredeemable or redeemable only on the happening of a contingency however remote or at the end of a period however long.

82. Section 1050 has been repealed by Schedule 3 Item 57 *Corporate Law Economic Reform Program Act 1999*. A company has the power to issue 'debentures': paragraph 124(1)(b) of the Corporations Law (as amended by Act No. 61 1998). 'Debentures' is widely defined in section 9 of the Corporations Law but the term does not include debentures that are irredeemable.

83. The relevant corporate law provisions do no more than validate instruments which otherwise might be invalid. The description of these instruments as 'debentures' for company law purposes is irrelevant to the characterisation of an outgoing in terms of section 8-1 of the ITAA 1997. For tax law purposes, the relevant concepts are those referred to in the case law above, particularly in the passage in the judgment of Bowen CJ and Burchett J in *Australian National Hotels* where they refer to the 'special features of loan capital which flow from the ephemeral nature of a loan.' See also the passage in *Steele's* case referred to above.

What is the legal relationship between the parties evidenced by the transaction?

84. If the transaction is not a loan, then what is the legal relationship between the Issuer and Holders? It is doubtful that it is an annuity as the Holders are not entitled to receive 'a yearly payment of a certain sum of money': Lord Coke in *Co. Litt 144b* referred to in *ANZ Savings* 93 ATC at 4385; 25 ATR at 387. Nor is it the grant of a certain sum of money: *Lumley's Laws of Annuities and Rent Charges* referred to in *ANZ Savings* 93 ATC at 4385; 25 ATR at 387.

85. The legal relationship may be simply described as contractual. Capital is contributed to the Issuer on contractual terms that entitle the Holders to a share of the profits of the Issuer.

86. The identification of the true legal relationships entered into by the parties is important but is not necessarily determinative of whether the periodic payments made on the Notes are deductible. Deductibility depends, not necessarily upon the legal nature of the transaction, but upon what the payment secures from a practical and business point of view: *BP Australia Ltd v. FC of T* (1965) 112 CLR 386; *United Energy Ltd v. FCT* 97 ATC 4796; (1997) 37 ATR 1.

In the event that the periodic payments satisfy the positive limbs of section 8-1 of the ITAA 1997, is a deduction for the payments denied under the negative limb paragraph 8-1(2)(a) of the ITAA 1997 being a loss or outgoing of a capital nature?

87. It only becomes necessary to consider the negative limbs in subparagraph 8-1(2)(a) of the ITAA 1997 if it has already been concluded or accepted by hypothesis that one or other of the positive limbs applies (refer the High Court decision of *Steele* 99 ATC at 4247; 41 ATR at 146).

88. This discussion as to whether the periodic payments on the Notes are on capital account proceeds on the hypothesis that a deduction is not denied under the positive limbs of section 8-1 of the

ITAA 1997. That is, on the assumption that the payments on the Notes are an outgoing incurred in gaining or producing assessable income or necessarily incurred in carrying on a business for that purpose.

89. In this regard it is important to note that the negative capital limb in subparagraph 8-1(2)(a) of the ITAA 1997 is truly an exception to the positive limbs of section 8-1 of the ITAA 1997. This was confirmed by Dixon J in *John Fairfax & Sons Pty Ltd v. FCT* (1959) 101 CLR 30 at 34.

The character or relevance of the periodic payments

90. When considering the character of a payment, Dixon J in *Hallstroms Pty Ltd v. FCT* (1946) 72 CLR 634 at 648-9 said you look to:

‘...what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process.’

91. The full Federal Court in *FC of T v. Email Limited* 99 ATC 4868 at 4872; (1999) 42 ATR 698 at 703 referred to the passage above and stated that this examination:

‘...involves both a consideration of the character of the expenditure and in many cases an examination of the business structure and the operations of the business in the course of which the expenditure has been incurred.’

92. Accordingly, the relevant questions to be addressed in determining the character of the expenditure by the Issuers of the Notes include an examination from a practical and business point of view into:

- the relationship between the Holders and the Issuers;
- the nature of the capital raising; and
- the business structure and operations of the Issuers of the Notes in the course of which the periodic payments have been incurred.

The relationship between the Holders and the Issuers

93. As noted earlier, the legal relationship between the Holders and Issuers is not a debtor-creditor relationship. From a practical and business point of view, the Holders can only realise their investment in the Notes through trading in the secondary market on the ASX. In respect of the periodic payments on the Notes, the Holders may have an *expectation* that payments will always be made. However, the

Issuers will retain the use of the capital subscribed even in the event that payments are not due and payable. Furthermore, non-payment of amounts that are due and payable where the Issuer is able to pay, does not constitute an event of default so as to entitle the Holders to recover the amount invested.

The nature of the capital raising

94. The raising of capital through the Note issue can be contrasted with borrowing money. The joint judgment of Bowen CJ and Burchett J in *Australian National Hotels* 88 ATC at 4633; 19 ATR at 1582 supports this distinction.

95. Given that the character of the capital raised is non-refundable, it has a permanent, rather than an ephemeral nature.

The role that the capital raising plays in the business structure and operations of the Issuers

96. For banks, some other financial institutions and their consolidated groups, the funds raised through the issue of perpetual notes must comply with the Australian Prudential Regulation Authority (APRA) capital adequacy guidelines in Prudential Statement C1 'Capital Adequacy of Banks' (PS C1). PS C1 defines capital as 'the cornerstone of a bank's strength'. Two essential characteristics of capital are that it should 'represent a permanent and unrestricted commitment of funds' and 'be freely available to absorb losses and thereby enable a bank to keep operating whilst any problems are resolved'.

97. The funds raised by banks, some financial institutions and their consolidated groups through the issue of perpetual notes may constitute either Tier 1 or Upper Tier 2 capital under PS C1. Tier 1 capital or core capital comprises the highest quality capital elements. Tier 2 capital or supplementary capital imparts strength to a bank's position but to a lesser degree than Tier 1 capital.

98. For all corporate Issuers, the raising of permanent capital through the issue of perpetual notes also represents a permanent and unrestricted commitment of funds. This is irrespective of whether the Issuer or their consolidated group treats the funds as equity for accounting purposes and shows them as shareholder's equity in their balance sheet. Where the Issuer treats the funds as equity, the Issuer may be able to use the funds to retire existing debt, having a positive effect on the gearing levels of the Issuer and thus enabling them to borrow money at a lower rate of interest. Such an improvement in their gearing ratios may enhance their credit rating.

99. Irrespective of the business of the Issuer, a Note issue does not dilute the existing ordinary shareholding. Another effect is the preservation of franking credits for their ordinary shareholders.

Determining whether the periodic payments made on the Notes are on revenue or capital account

100. In determining that periodic payments made under the perpetual notes are on capital account, we are not relying upon the characterisation of the payments as being for the creation or acquisition of an asset. The payments made by Associated Newspapers Ltd in *Sun Newspapers Ltd and Associated Newspapers Ltd v. FC of T* (1938) 61 CLR 337 (*Sun Newspapers*) did not, in the words of Latham CJ at 355, ‘result in obtaining a new capital asset of a material nature, but they did obtain a very real benefit or advantage for the companies, namely the exclusion of what might have been serious competition’. Latham CJ continues at 355:

‘When the words “permanent” or “enduring” are used in this connection it is not meant that the advantage which will be obtained will last forever. The distinction which is drawn is that between more or less recurrent expenses involved in running a business and an expenditure for the benefit of the business as a whole: See per Rowlatt J. in *Anglo-Persian Oil Co. Ltd. v. Dale* (1932) 145 L.T. at p 532, where consideration is given to the significance of the word “enduring” in this connection.’

101. Moreover, Dixon J said at 359-361:

‘The distinction between expenditure and outgoings on revenue account and on capital account corresponds with the distinction between the business entity, structure, or organization set up or established for the earning of profit and the process by which such an organization operates to obtain regular returns by means of regular outlay, the difference between the outlay and the returns representing profit or loss. The business structure or entity or organisation may assume any of an almost infinite variety of shapes and it may be difficult to comprehend under one description all the forms in which it may be manifested...

...But in spite of the entirely different forms, material and immaterial, in which it may be expressed, such sources of income contain or consist in what has been called a “profit-yielding subject”, the phrase of Lord Blackburn in *United Collieries Ltd. v. Inland Revenue Commissioner* [(1930) S.C. 215 at 220]...

...The result or purpose of the expenditure may be to bring into existence or **procure some asset or advantage of a lasting character** which will enure for the benefit of the organization or system or “profit-earning subject”. It will thus be distinguished from the expenditure which should be recouped by circulating capital or by working capital’ (emphasis added).

102. In arrangements considered in this Ruling, while the periodic payments will not procure an asset for the taxpayer, they will procure an advantage of a lasting character which will enure for the benefit of the profit-yielding subject. That is, the funds contributed on a permanent basis by the issue of the Notes will strengthen the taxpayer’s capital structure.

103. Dixon J then stated at 363 the passage which was subsequently referred to by Hill J in *Smithkline Beecham Laboratories (Australia) Ltd v. F C of T* 93 ATC 4629 at 4634 26 ATR 260 at 266 as ‘the classic statement’:

‘There are, I think, three matters to be considered, (1) the character of the advantage sought, and in this its lasting qualities may play a part, (2) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (3) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment.’

Identifying the relevant factors

104. In determining whether the periodic payments on the Notes are on revenue or capital account we adopt the reasoning used by Jacobs J in *Cliffs International Inc v. FC of T* 142 CLR 140 at 173-175; 79 ATC 4059 at 4078; 9 ATR 507 at 529; that is, to identify then weigh-up the relevant factors.

105. In arrangements considered in this Ruling, the following factors are relevant:

- (a) the payments are made to raise permanent capital, that is, a permanent contribution to the capital of the Issuer or the consolidated group. This can be distinguished from the ephemeral nature of a loan;
- (b) the payments are calculated at above-market rates of interest on ordinary debt. This reflects the higher cost of acquiring permanent capital over the cost of raising

- term debt. In some cases the rate reflects the contingent nature of the obligations;
- (c) the payments may be viewed as recurrent;
 - (d) for banks, some financial institutions and their consolidated groups, the payments give rise to a strengthening of the balance sheet where the capital raised is treated by APRA as either Tier 1 or Upper Tier 2 capital. In every case the capital raising also represents a permanent and unrestricted commitment of funds;
 - (e) the capital raising on the Notes where it is treated by the Issuer as equity for accounting purposes and shareholder's funds in their balance sheet, improves the capital base, maturity profile and gearing levels and enables the Issuer to raise ordinary debt at a cheaper rate possibly through improved credit ratings.

A weighing-up of the factors

106. Whilst not all of the above factors are present in every Note issue, the main factors are those listed in (a), (b) and (c). For banks, some other financial institutions and their consolidated groups, factors (d) and (e) are also important. The recurrent nature of the payments [factor (c)] may suggest a revenue flavour, despite the potential lack of periodicity. Against this might be factor (b); that is, the obligation to make the payments may be contingent. Also, the payments are intended to secure a permanent advantage, whether or not a payment is made.

107. Of those factors, all but factor (c) suggest an enduring advantage is being sought by the Issuer in making the payment. That characterises the payments as being on capital account.

Conclusion

108. It is the Commissioner's view that the main purpose of the Note issues is to raise capital for an indefinite duration, thereby obtaining a permanent and enduring advantage. The capital raising does not possess that 'special feature of loan capital, which flows from the ephemeral nature of a loan'. This advantage has the effect, particularly where the Issuer is a bank, of strengthening the Issuer's capital base. Obtaining capital through the issue of perpetual Notes is not part of the process by which the Issuer operates to obtain regular returns. The periodic payments are therefore of a capital nature and not deductible under section 8-1 of the ITAA 1997.

Alternative views

109. The payments on the Notes are characterised as payments of interest on a loan. There is an obligation to repay the principal amount on a winding-up. If that obligation is not met the Trustee or, failing that, the Holders have the right to sue for the debt due. The payments of interest are of a recurrent nature and the only advantage sought is the use of the principal for working capital for the quarterly interest period. The payments are therefore deductible under the second positive limb of section 8-1 of the ITAA 1997.

110. The costs are of a revenue nature where the payments made on Notes are a regular, recurrent cost to a bank or finance company Issuer of raising and securing access to funds for on-lending to other entities in the group as part of ordinary business.

Response

111. The alternative view is said to be supported by the documentation evidencing the Note issue, however that documentation does not evidence a loan. In addition the alternative view concentrates upon the application and use of the funds raised, as opposed to the character of the advantage sought by the Issuer in making the payments under the Notes.

112. For banks, some finance companies and their consolidated groups, raising Tier 1 or Upper Tier 2 capital is not a recurrent event undertaken in the ordinary course of their business as there is a finite limit required by APRA on their ability to raise such capital in this form. It is a one-off event, unlike a borrowing to raise funds.

Obligation of the Issuer to pay or withhold tax on behalf of non-residents

113. For the reasons set out in paragraphs 50 to 76 above, the periodic payments on the notes are not considered to be payments of interest, nor do they come within the extended definition of 'interest' in subsection 128A(1AB) of the ITAA 1936. It follows that the Issuers are not required to withhold tax under Subdivision A of Division 11A of the ITAA 1936.

114. Where, however, the non-resident Holder has an Australian tax liability in respect of the payments, the Issuer may be required under section 255 of the ITAA 1936 to retain out of those payments sufficient funds to pay the tax which is or will become due by the non-resident.

Examples

115. Under a Prospectus dated 15 October 1999 for the issue of perpetual notes, an Offer was made which was stated to be open for subscription from 1 November 1999. The notes were to be issued under a 'Global Note' to the Underwriters named in the Prospectus, who are recorded as the Initial Holders in the register. The Prospectus containing the Offer is valid for a period of two years.

116. The Offer is said to be for \$200 million with provision for oversubscriptions of up to \$200 million. In the Trust Deed governing the issue of the notes, the maximum amount which the Issuer may issue under the notes is \$1 billion.

117. As at the time of withdrawal of IT 2411 (5 November 1999), notes to the face value of \$400 million had been issued. The notes were allocated on 30 November. There is thus provision under the Trust Deed to issue further tranches of notes up to the \$1 billion limit, which would constitute notes of the same Series as the outstanding notes.

118. A further issue of notes under the Global Note to the value of \$600 million was made under the existing Offer, on 21 February 2001.

119. Having regard to the date of effect of this Ruling, IT 2411 continues to have application to the notes to the value \$400 million as offered for subscription and accepted under a binding agreement and allocated prior to the date of issue of this Ruling. The further \$600 million tranche of notes issued on 21 February 2001 pursuant to the Trust Deed under the Offer made 1 November 1999 is subject to the Ruling. As a consequence, the payments made to Holders will not be deductible to the Issuer.

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<i>Previous draft:</i>	- Corps Law 553(1)
Previously issued in draft form as TR 2001/D1	- Corps Law 1050
	- Corps Law 124(1)(b)
	- Corporate Law Economic Reform Program Act 1999 Sch 3 Item 57
<i>Related Rulings/Determinations:</i>	- ITAA 1936 Pt III Div 3A
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	- ITAA 1936 128A(1AB)
<i>Subject references:</i>	- ITAA 1936 Part IVA
- capital	- ITAA 1936 82L
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- deductions	- TAA 1953 Pt IVAAA
- income securities	
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- non-cumulative	<i>Case references:</i>
- periodic payments	- Anglo-Persian Oil Co. Ltd. v Dale (1932) 145 L.T 529; (1932) 1 K.B. 124
- perpetual notes	
- Tier 1 capital	- Australia and New Zealand Savings Bank Limited v. FC of T 93 ATC 4370; (1993) 25 ATR 369
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<i>Legislative references:</i>	
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- Australian National Hotels Limited v. FC of T 88 ATC 4627; (1988) 19 ATR 1575
 - Bennett v. Ogston (H.M. Inspector of Taxes) (1930) 15 TC 374
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 - Helvering v. Richmond F.&P.R.R., 90 F. 2d 971 (4th Cir. 1937)
 - Jewel Tea Co v United States 90 F. 2d 451, 453 (2d Cir. 1937)
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 - John Fairfax & Sons Pty Ltd v FCT (1959) 101 CLR 30
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 - Re Cuban Land and Development Company (1911) Ltd [1921] 2 Ch 147
 - Re Farm Security Act 1944 [1947] SCR 394
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 - Smithkline Beecham Laboratories (Australia) Ltd v. FC of T 93 ATC 4629; (1993) 26 ATR 260
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