

THE CERTAINTY OF UNCERTAINTY: AN EXAMINATION OF THE PITFALLS OF AUSTRALIA'S UNIQUE DEBT-EQUITY REGIME

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ABSTRACT

The debt-equity distinction is a concept that has plagued policymakers and tax professionals for decades, with little consensus worldwide on how best to draw the debt-equity borderline. Australia embarked on a novel method of solving this vexing problem in 2001 when Division 974 of the *Income Tax Assessment Act 1997* (Cth) was enacted. These provisions were intended to bring stability, consistency and, most of all, certainty to the debt-equity paradigm. However, 13 years later, the problematic design of the rules has ensured that the only certainty is uncertainty.

This paper outlines and critiques the Australian debt-equity rules to determine whether the legislation has been successful in reducing the uncertainty it was designed to solve. An examination of the theoretical methods of making the debt-equity distinction, as well as the experience in the United States, is also undertaken. It is argued that the Australian reforms have not been as successful as originally lauded, largely due to the drafting deficiencies and structural design of Division 974. Accordingly, two alternatives are put forward for further reform in the Australian context.

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I. INTRODUCTION

Australia has historically treated equity and debt differently for taxation purposes.¹ The primary difference between debt and equity under tax law is that (in appropriate circumstances) returns on debt, but not equity, are deductible to the issuer. Conversely, the dividend imputation system allows franking of returns on equity.² However, differential tax treatment between debt, equity and hybrid instruments, notwithstanding the general equivalence of their respective cash flows, presents opportunities for tax arbitrage.³ Accordingly, the manner in which the debt-equity distinction is made is of paramount importance. Rules that purport to manage the divide must be not only determinative, but successful in dealing with uncertainty, anomalies and both financial engineering and innovation.⁴

Consequently, the debt-equity distinction has plagued policymakers and tax professionals for decades, with little consensus worldwide on how best to draw the borderline.⁵ Australia embarked on a novel method of solving this vexing problem in 2001 when Division 974 of the *Income Tax Assessment Act 1997* (Cth) (“*ITAA 1997*”)⁶ was enacted. The new regime introduced a comprehensive statutory framework for classifying instruments that straddle the debt-equity boundary, premised on the single organising principle of an effective obligation to return to an investor an amount at least equal to the amount invested.⁷ The rules were intended to bring stability, consistency and, most of all, certainty to the debt-equity paradigm. However, 13 years later, the problematic design of the rules has ensured that the only certainty is uncertainty.

The remainder of this paper is structured as follows. Section II provides some background, setting out the legal approach to the debt/equity divide prior to the introduction of Division 974. Section III describes the salient aspects of the debt/equity rules provided for in Division 974. Section IV identifies and explains the problems created through the lack of certainty inherent in the classification tests used within the current form of Division 974. Section V identifies several theoretical alternatives that may be used to address these identified problems with the present rules. Section VI canvasses the approaches adopted in comparable jurisdictions with recommendations provided in Section VII and concluding remarks set forth in Section VIII.

¹ Secretary of the Treasury and Commissioner of Taxation, 'Taxation of Financial Arrangements: An Issues Paper' (Issues Paper, Australian Taxation Office, December 1996) 63 ('*1996 Issues Paper*'); Tony Rumble and Richard Wood, 'Enhancing Corporate Tax Integration: Australian Reforms to the Taxation of Debt, Equity and Innovative Financing Contracts' (2003) 31 *Intertax* 409, 410.

² Rumble and Wood, above n 1, 410.

³ *Ibid.*

⁴ *Ibid.*; Richard Wood, 'The Taxation Debt, Equity and Hybrid Arrangements' (1999) 47 *Canadian Tax Journal* 49, 77.

⁵ Wolfgang Schön et al, 'Debt and Equity in Domestic and International Tax Law - A Comparative Policy Analysis' [2014] *British Tax Review* 146, 147.

⁶ All legislative references in this paper are to the *Income Tax Assessment Act 1997* (Cth) ('*ITAA 1997*') unless otherwise stated.

⁷ Commonwealth of Australia, *Parliamentary Debates*, House of Representatives, 28 June 2001, 28820 (Peter Slipper, Parliamentary Secretary to the Minister for Finance and Administration).

II BACKGROUND TO THE DEBT-EQUITY DIVIDE

Australia's debt-equity distinction is contained within Division 974 of the *ITAA 1997* ("Division 974"). The rules were enacted in 2001⁸ and are a product of the Review of Business Taxation ("RBT"), also known as the Ralph Review, which delivered its report ("RBT Final Report") to the Commonwealth Government in 1999.⁹ Accordingly, attention is given first to the debt-equity framework prior to 2001, then to the relevant aspects of the RBT.

2.1 *The Australian Debt-Equity Distinction Pre-Division 974*

Prior to the introduction of Division 974, the debt-equity distinction in Australia was largely drawn on a classical, legal form basis.¹⁰ For instance, a share is traditionally an equity interest and a bond is commonly debt finance. As such, the distribution of profits or the payment of interest would prima facie attract equity or debt treatment respectively.¹¹ Courts traditionally sought to distinguish between debt and equity interests by comparing the terms of instruments with the classic definitions.¹² Over time, continual financial instrument innovation¹³ made this task increasingly difficult.¹⁴

2.1.1 *Statutory Responses*

Pre-2001, Parliament attempted to curb abuses of the debt-equity border with targeted legislation, which was somewhat punitive in its effect. Examples include Division 3A of Part III of the *Income Tax Assessment Act 1936* (Cth) ("ITAA 1936"), which denied deductions for interest paid on convertible notes, despite the fact that they were also not frankable under other provisions of the tax legislation.¹⁵ In a similar vein, section 46D of the ITAA 1936 denied franking of so-called inter-corporate debt dividends that exhibited debt characteristics despite being legal form shares.¹⁶

2.1.2 *Common Law Approach*

⁸ *New Business Tax System (Debt and Equity) Act 2001* (Cth).

⁹ John Ralph, Rick Allert and Bob Joss, 'A Tax System Redesigned: More Certain, Equitable and Durable (Report, Review of Business Taxation, July 1999) (*RBT Final Report*)'.

¹⁰ Rumble and Wood, above n 1, 418; Philip Burgess et al, *Cooper, Krever & Vann's Income Taxation: Commentary and Materials* (Thomson Reuters, 7th ed, 2012) 746 [14.150].

¹¹ Explanatory Memorandum, New Business Tax System (Debt and Equity) Bill 2001 (Cth) 7-8 (*Debt/Equity EM*).

¹² Stuart O'Neill, 'Criticisms of the Debt-Equity Rules and Their Application to Modern Financial Instruments' (2003) 6 *The Tax Specialist* 160.

¹³ Eva Huang, 'Identifying Hybrids in Australia: Comparing the TOFA, Debt and Equity Rules and AASB 132 for a Definition of Shareholding' (2010) 9 *Journal of Law and Financial Management* 2, 4.

¹⁴ *Ibid.*

¹⁵ Australian Taxation Office, 'Effectively Non-Contingent Obligation In the Debt Test' (Discussion Paper, Australian Taxation Office, 26 September 2007) 6 [17] (*ENCO Discussion Paper*).

¹⁶ *Ibid.*

A number of key decisions formed the historical debt-equity demarcation in Australia,¹⁷ however the leading case is the High Court decision of *Boulder Perseverance*.¹⁸ There, a gold mining company issued ten year profit sharing notes in order to raise working capital.¹⁹ The notes entitled the holders to 10% p.a. earnings on the principal plus a share in half of the company's net profits pro rata.²⁰ The taxpayer sought to deduct the profit distribution in addition to the interest outgoing, arguing that the distribution was an expense necessarily incurred in securing capital and, consequently, attracted the same character as interest.²¹ The deduction was disallowed²² and, despite the taxpayer succeeding at trial, the High Court unanimously found in the Commissioner's favour.²³ The Court effectively disaggregated the arrangement and denied a deduction for the profit distribution, noting:

...when the debenture contract lets the debenture holder into participation in the 'trading profits' over and above his fixed interest charge, it gives his debenture capital an **additional characteristic, a characteristic inconsistent with that of a simple external loan** (emphasis added).²⁴

Although the Court nicely articulated the debt-equity distinction in *Boulder Perseverance*, the example is relatively simplistic and, by 2001, classification by comparison to classic definitions was extremely difficult.²⁵ For instance, converting preference shares and income securities were particularly troublesome given they were largely designed to manipulate the debt-equity border.²⁶ Moreover, classification of all instruments according to economic substance was unlikely to eventuate if the matter was left to judicial interpretation. Australian courts historically exercised extreme caution in discounting legal form in the absence of a statutory framework, given such a practice clearly departs from the rule of law.²⁷

2.2 Review of Business Taxation

Although commissioned to look at the business taxation regime as a whole, one of the RBT's central recommendations was to introduce a classification test for debt and equity.²⁸ Principally among the reasons for doing so was that for other areas

¹⁷ *Boulder Perseverance Ltd v Commissioner of Taxation (WA)* (1937) 58 CLR 223; *Federal Commissioner of Taxation v The Midland Railway Co of Western Australia Ltd* (1951) 85 CLR 306; *Federal Commissioner of Taxation v Radilo Enterprises Pty Ltd* 97 ATC 4123; *Federal Commissioner of Taxation v Broken Hill Pty Co Ltd* (2000) 179 ALR 593; *Firth v Commissioner of Taxation* [2001] FCA 1300.

¹⁸ *Boulder Perseverance Ltd v Commissioner of Taxation (WA)* (1937) 58 CLR 223.

¹⁹ *Ibid* 228.

²⁰ *Ibid*.

²¹ *Ibid*.

²² *Ibid*.

²³ *Ibid* 235.

²⁴ *Ibid* 231.

²⁵ O'Neill, above n 12, 163.

²⁶ Rumble and Wood, above n 1, 418-19.

²⁷ O'Neill, above n 12, 164.

²⁸ *RBT Final Report*, above n 8, 59.

of tax law, such as the thin capitalisation rules,²⁹ financing arrangements require characterisation as one or the other.³⁰

In a major departure from what was hitherto the status quo, the new debt-equity classification test was to be based on the economic substance of a financing arrangement, rather than its legal form. Hence, it was anticipated that Division 974's introduction would eliminate inappropriate tax outcomes arising from strict legal form classification. The franking of returns on debt interests and the claiming of deductions for returns on equity was one such concern, particularly with respect to complex hybrid instruments that exhibit both debt and equity characteristics.³¹ Thus, the former legal form analysis has been completely displaced by detailed statutory rules.³²

2.2.1 Suggested Methodologies for Drawing the Distinction - Consultation Stage

The second discussion paper to the RBT³³ put forward two different premises for making the classification. The first was a 'blanket' approach, whereby the financing arrangement would be classified as all debt or all equity. Alternatively, a 'bifurcation' approach was suggested, whereby the instrument would be partitioned into its respective debt or equity components and treated separately for tax purposes.³⁴ The latter approach accords more neatly with the financial accounting treatment of hybrid instruments.³⁵

The two suggested methods for actually making the classification were the 'facts and circumstances' approach and the 'single determinative factor' approach.³⁶ The former involves a multi-factorial assessment of the instrument itself to determine

²⁹ *ITAA 1997* div 820.

³⁰ The thin capitalisation regime, contained within Division 820 of the *ITAA 1997*, is merely one area (albeit a significant one) that relies on the debt-equity classification rules. In general terms, the rules seek to limit the proportion of expense an entity can deduct that relates to debt finance (eg, interest, borrowing costs). The regime applies to foreign entities investing in Australia and Australian entities investing abroad, if their debt to equity ratio exceeds prescribed limits. See Australian Taxation Office, *Thin Capitalisation: Purpose of the Rules* (6 November 2009) <https://www.ato.gov.au/Business/Thin-capitalisation/In-detail/Overview/Thin-capitalisation---what-you-need-to-know/?page=2#Purpose_of_the_rules>.

³¹ Board of Taxation, 'Review of the Debt and Equity Tax Rules' (Discussion Paper, Board of Taxation, March 2014) 5 (*Board of Taxation Review*); John Ralph, Rick Allert and Bob Joss, 'A Platform for Consultation - Discussion Paper 2: Building on a Strong Foundation' (Discussion Paper, Review of Business Taxation, February 1999) 198 (*RBT Discussion Paper*).

³² Ian Stanley, 'Australia' (2012) 97b *Cahiers de Droit Fiscal International: The Debt-Equity Conundrum* 69, 82.

³³ *RBT Discussion Paper*, above n 31. Hereafter referred to as "RBT Discussion Paper".

³⁴ *Board of Taxation Review*, above n 31, 200. See part 4.1 for a detailed analysis of both approaches.

³⁵ Australian Accounting Standards Board, *AASB 132: Financial Instruments: Presentation: For-Profit Entities* (18 December 2012)

<http://www.aasb.gov.au/admin/file/content105/c9/AASB132_07-04_FP_COMPdec12_01-13.pdf> (*AASB 132*). The former AASB 1033 was replaced by AASB 132 in January 2005, after Australia adopted International Accounting Standards Board (IASB) standards.

³⁶ *RBT Discussion Paper*, above n 31, 201-2. See part 4.2 for a detailed discussion of each methodology.

its characterisation.³⁷ The latter involves the identification of a single factor whereby the presence or absence of that factor determines whether an instrument represents debt or equity under the wider tax law.³⁸

The single determinative factor method was premised on using one or a combination of several different approaches. Notwithstanding the oxymoronic nature of using a combination of bases to underpin a *single* determinative factor assessment, the approaches the RBT suggested form the foundation of Division 974 as it currently stands.

One suggested approach was to liken a financing instrument to a creditor/debtor relationship, in which a payment of an amount gives rise to a right to receive, or obligation to pay, an amount at least equal to the amount disbursed.³⁹ The RBT also suggested an effective company/shareholder relationship be used as a determinative factor, whereby financing relationships that effectively represent an equity stake are treated as such, notwithstanding legal form.⁴⁰ These suggestions are the precursors to the central elements of Division 974 - being the debt test, the effectively non-contingent obligation ("ENCO") test and the equity test.⁴¹

Importantly, a third (and, ultimately, discarded) approach was either to:

- value (according to well-accepted methods) the debt and equity components of an arrangement, whereby the component with the greatest value would determine the treatment of the entire instrument;⁴² or
- partition the instrument into equity and debt components and treat them separately for tax law purposes - consistent with common financial accounting practice under AASB 132 (formerly AASB 1033).⁴³

2.2.2 Final Report of the Review of Business Taxation

The RBT formally adopted the 'blanket' and 'single determinative factor' approaches in the RBT Final Report.⁴⁴ In weighing up the options, a more punitive yet cleaner technique in the 'blanket' method was seemingly preferred. The concept was defined as follows:

The proposed approach minimises uncertainty at the border between debt and equity by focusing on a single determinative factor...this factor - the **contractually guaranteed return of the original investment** - brings to the fore

³⁷ Ibid 201. As discussed in the *RBT Discussion Paper*, relevant factors included an assessment of the rate of return, repayment of investment, non-contingent payments, participation in gains and losses, priority on winding up, option of redemption, legal form, etc.

³⁸ Ibid 202 [7.21].

³⁹ Ibid 202.

⁴⁰ Ibid.

⁴¹ Each concept is discussed at length in Chapter II.

⁴² *RBT Discussion Paper*, above n 31, 202 [7.22].

⁴³ Ibid.

⁴⁴ *Board of Taxation Review*, above n 31, 200 [7.14]; *RBT Final Report*, 59 [260].

the lower level of economic risk that distinguishes debt from equity (emphasis added).⁴⁵

The first point to be made is that the RBT designed the classification framework based on the distinction between debt interests and membership interests. An interest was to be a membership (i.e. equity) interest if the taxpayer fell within the familiar categories of membership, held substantial rights in management or control of an entity, or had rights to returns that were a share of profit or were contingent on the economic performance of the issuer.⁴⁶

The debt definition was designed as a carve out from membership interests. The first aspect of the test had two alternate, equally weighted limbs.⁴⁷ Under the terms in which the interest is issued, if the interest gave rise to (a), an effective or contractually 'non-contingent' right of the holder to receive, or (b), an effectively or contractually 'non-contingent' obligation of the issuer to pay, a specified amount or amounts equal to or in excess of the amount paid for the interest; then the interest would not be a membership interest.⁴⁸ Valuation was to be in nominal terms for interests that are non-convertible or have an ascertainable date of maturity within 20 years, or in present value terms for all other interests.⁴⁹ Non-contingent rights and obligations were to include those that were, as a matter of commercial substance, not affected by contingencies imposed by the terms of the instrument because of their remote or artificial character.⁵⁰

It is notable that Division 974 is not entirely representative of the recommendations in the RBT Final Report. Foremost, the debt test⁵¹ is not a carve-out from the equity test;⁵² it sits independently. Second, the test was refined to one limb only, focusing on the perspective of the issuer.⁵³ The 'single

⁴⁵ *RBT Final Report*, above n 8, 446-7.

⁴⁶ *Ibid* 442-3.

⁴⁷ *Ibid* 445; Kai Zhang, 'The Concept of ENCO' (2008) 12 *The Tax Specialist* 16, 21.

⁴⁸ *RBT Final Report*, above n 8, 445.

⁴⁹ *Ibid*.

⁵⁰ *Ibid*. It has been argued that the debt test in the *RBT Final Report* gives economic substance a negative role, in that it cannot positively establish an effective or contractual non-contingent right or obligation. To illustrate such, consider the following example from the *RBT Final Report*. An issuer has a option to redeem an instrument at the issue price, with an entitlement (of the holder) to accelerated returns over time which would make non-redemption (by the issuer) uneconomic. Therefore, despite no legal obligation to redeem, the issuer would be effectively compelled to redeem which gives rise to the non-contingency. One commentator argues that the interest would fail the first limb of the debt definition because there is no contractual obligation to redeem, and no effective obligation to redeem either, because economical compulsion alone cannot amount to a contractually guaranteed return (given the definition of single determinative factor). However, notwithstanding Zhang's view, it is put forward that the debt definition would be satisfied on the second limb only, as the holder's right to repayment is non-contingent due to the economic compulsion of the issuer to redeem. The author questions whether the definition of single determinative factor is intended to be a qualifier to the proposed definition given it does not form part of that definition. The test is "effective or contractual". Hence, it is difficult to see why an issuer does not have an effective (but obviously not contractual) obligation to redeem which in turn, coincides with the contractual right of the holder to receive redemption payment (with the contingency of non-redemption disregarded on the commercial grounds that it would be uneconomic for the issuer not to redeem). See Zhang, above n 47, 21-2.

⁵¹ *ITAA 1997* s 974-20. See part 2.1.

⁵² *Ibid* s 974-75. See part 2.2.

⁵³ Zhang, above n 47, 22.

organising principle', not 'single determinative factor', was framed as the effective obligation of the issuer to return to the investor an amount at least equal to the amount invested.⁵⁴ It would seem that the drafters intended to make clear the role for economic substance was a positive one and that a two limb test was not required.⁵⁵ It is also notable that dispensing with the second limb of the RBT Final Report debt definition discarded a level of conformity with financial accounting standards. AASB 132 does give some regard to the rights of the holder,⁵⁶ contrary to what the Explanatory Memorandum ("EM") professes.⁵⁷

III DIVISION 974 INCOME TAX ASSESSMENT ACT 1997 (CTH)

The two main organs of Division 974 are the 'debt test' within subdivision 974-B and the 'equity test', within subdivision 974-C. These key classification provisions do not set out tax consequences themselves.⁵⁸ They provide taxpayers with a definitive determination of form, ensuring a financing arrangement is appropriately classified for treatment under other areas of tax law.⁵⁹ Interests that satisfy both the equity test and the debt test are treated as wholly debt for tax purposes.⁶⁰

3.1 *The Debt Test*

The debt test relies on the following five key elements⁶¹ which, if satisfied, confirm the existence of a 'scheme' giving rise to a 'debt interest':⁶²

- the existence of a 'scheme';⁶³
- the scheme is a 'financing arrangement'⁶⁴ for the entity;⁶⁵
- a 'financial benefit'⁶⁶ flows or will flow to the issuing entity or a 'connected entity'⁶⁷ of the issuing entity under the 'scheme';⁶⁸

⁵⁴ Although defined differently in Division 974 than in the RBT, the terms 'single determinative factor' and 'single organising principle' are generally synonymous and are treated as such in this paper.

⁵⁵ *Ibid.* It would seem that the drafters of Division 974 may have anticipated the argument by Zhang in relation to a negative role for economic substance (in the RBT debt definition). They conceivably decided to make clear that 'effective' meant that a circumstance where it would be uneconomic for the issuer not to redeem would be an effective, but not contractual, non-contingent obligation of the issuer to pay the holder. See Zhang, above n 47, 22.

⁵⁶ *AASB 132*, above n 35, 25 [18].

⁵⁷ Zhang, above n 47, 22; *Debt/Equity EM* 44 [2.151].

⁵⁸ Teresa Dyson, 'Review of the Debt/Equity Tax Rules' (Paper presented at 2014 Financial Services Conference, Gold Coast, 19-21 February 2014) 7.

⁵⁹ For example, the thin capitalisation regime. See *ITAA 1997* div 820.

⁶⁰ *Ibid* s 974-5(4).

⁶¹ *Ibid* s 974-20.

⁶² *Ibid* s 974-15.

⁶³ *Ibid* ss 974-15, 974-20(1).

⁶⁴ *Ibid* s 974-30(1). In general terms, a scheme will be a 'financing arrangement' if it is undertaken to raise finance for the entity or to fund another scheme that is a 'financing arrangement'.

⁶⁵ *Ibid* s 974-20(1)(a).

⁶⁶ *Ibid* s 974-160(1). A financial benefit for the purposes of Division 974 essentially means anything of economic value, but does not include an equity interest.

⁶⁷ *Ibid* s 995-1(1)(definition of 'connected entity').

⁶⁸ *Ibid* s 974-20(1)(b).

- the issuing entity, or both the entity and connected entity have an 'ENCO'⁶⁹ to provide a 'financial benefit' to one or more entities; and
- it is substantially more likely than not that the value of the 'financial benefit(s)' provided will be at least equal to the value received,⁷⁰ where both the values provided and received are not zero.⁷¹

The definition of 'scheme'⁷² is essentially a collection of synonymous terms; and is therefore interpretively unhelpful yet evidently broad. Section 974-15(2) expressly sets out that 'related schemes' also fall within the meaning of a 'debt interest'. Section 974-155(1), in defining 'related scheme', states that schemes will be related if they are related in any way. This was obviously an attempt to negate technical loopholes and capture the substantive commercial realities of certain arrangements.⁷³

3.2 The Equity Test

The test for an 'equity interest'⁷⁴ is set out in s 974-75(1). A 'scheme'⁷⁵ will constitute an 'equity interest' in a company⁷⁶ if that interest is both a 'financing arrangement',⁷⁷ and:

- an interest in the company as a member or stockholder; or
- an interest providing a right to return, where the right or return is contingent on the economic performance of part or all of the issuing entity or a connected entity; or
- an interest that carries the right to variable or fixed return(s) from the company, if the right or amount of return is at the discretion of the company or a connected entity; or
- an interest that gives the holding entity a right to be issued with an equity interest, or is an interest that may or will convert to an interest in the company, or a connected entity.

It is not necessary to examine the many ancillary definitions that underpin the debt and equity tests. For instance, Division 974 sets out complex rules for the valuation of financial benefits, and prescribes an arbitrary and contentious⁷⁸ 10 year limitation on the nominal valuation and discounting of 'financial benefits'. This is an issue in itself and beyond the scope of this paper.

⁶⁹ Ibid s 974-135(1).

⁷⁰ Ibid s 974-20(1)(d).

⁷¹ Ibid s 974-20(1)(e).

⁷² Ibid s 995-1(1)(definition of 'scheme'). The term is defined as any arrangement, scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise.

⁷³ Garry Bourke, 'Drawing a Sharp Line in the Sand of the Debt-Equity Desert: Division 974 - Oasis or Mirage?' (2004) 33 *Australian Tax Review* 24, 38. See also *ITAA 1997* s 974-10(3).

⁷⁴ *ITAA 1997* s 974-70.

⁷⁵ Same meaning as for 'debt interest'.

⁷⁶ Including entities taxed equivalently to companies.

⁷⁷ *ITAA 1997* s 974-30(1).

⁷⁸ See *Board of Taxation Review*, above n 31, 50-1. See also Tony Frost and Graeme Cooper, 'Trading One Uncertainty for Another? Ten Years' Experience With the Debt-Equity Rules' (2013) 17 *The Tax Specialist* 2, 7.

3.3 The ENCO Concept

3.3.1 Operative Provision - Section 974-135(1)

The ENCO concept is the central component of the debt test, which essentially aims to ensure that the economic substance of an instrument is the basis for debt or equity classification. An ENCO will exist where, taking into account the pricing, terms and conditions of a 'scheme', there is in substance or effect an 'ENCO' to take action.⁷⁹ 'Action', for ENCO purposes, is the requirement to provide a 'financial benefit' under the 'scheme' or to terminate the 'scheme'.⁸⁰

3.3.2 Qualifying Subsections to the ENCO Operative Provision

Section 974-135(3) states:

an obligation is non-contingent for the purposes of the section if it is not contingent on any event, condition or situation (including economic performance of the entity having the obligation or a connected entity of that entity), other than the ability or willingness of that entity or connected entity to meet the obligation.

At first glance, it would seem that a section stating that an obligation is non-contingent, if it is indeed not contingent, is somewhat pointless and inherent in the operative provision. Further, this subsection has been criticised given a literal interpretation of 'ability or willingness' can conceivably result in an absurd outcome.⁸¹ For instance, in its current form, the debt test would be satisfied in circumstances where a lender advances money and the borrower is obliged to repay the facility only if they are willing or able, which is seemingly an unintended result.⁸² Nonetheless, the crux of the subsection is to ensure that subsisting contingent obligations represent equity, not debt interests and obvious contingencies such as insolvency and subjective will to comply are disregarded. To that extent, this provision evinces the economic substance intent of Division 974 and, hence, has a purpose, notwithstanding some faults in the drafting.

Section 974-135(4) has been similarly described as poorly drafted.⁸³ It states that the existence of a right of an instrument holder to convert their interest into equity in the company does not of itself make the issuer's obligation 'not non-contingent'. Put differently, the fact that an interest is convertible does not make the obligation to provide a return contingent. This subsection is really not required given such a conclusion can be drawn in its absence.⁸⁴

Sections 974-135(5) to (7) are drafted in a similar vein and, like the preceding subsections, have anti-avoidance characteristics. Section 974-135(5) sets out that an obligation to redeem a preference share is not contingent merely because of a

⁷⁹ ITAA 1997 s 974-135(1).

⁸⁰ Ibid s 974-135(2).

⁸¹ *Board of Taxation Review*, above n 31, 33 [4.32].

⁸² The Tax Institute, Submission to The Board of Taxation, *Review of the Debt and Equity Tax Rules*, 30 May 2014, 5; Law Council of Australia, Submission to The Board of Taxation, *Review of the Debt and Equity Tax Rules*, 23 May 2014, 2. The Tax Institute and the Law Council have both submitted that this provision be redrafted, given the unintended outcome that flows from a literal interpretation.

⁸³ Bourke, above n 73, 40

⁸⁴ Zhang, above n 47, 20.

legislative requirement that the redemption amount come from profit or an equity issue. This appears to be a reference to section 254K of the *Corporations Act 2001* (Cth); an inclusion that had to be made in order to disregard a legislatively enshrined contingency.

Section 974-135(6) attempts to clarify that, during the process of determining whether an ENCO exists 'in substance or effect', regard must be had to the artificiality or contrived nature of any contingency. The existence of such, according to the supplementary note to that subsection, would indicate that an ENCO does in fact exist. Although this provision does not appear to have any adverse effect, its general aim can again be evinced from the operative provision. It is difficult to see how it would assist in discounting a contingency that was not already discounted by 974-135(1).⁸⁵

Section 974-135(7) states that an obligation is not non-contingent merely because detrimental practical or commercial consequences would arise if the obligation is not fulfilled. In a strangely constructed manner, the intent of this provision appears to be to prevent substantively contingent obligations satisfying the ENCO test, and therefore the debt test, for the sole reason that commercial consequences would flow from non-compliance. The legislation, in the supplementary note to the provision, uses ADI⁸⁶ issued income securities as an example. Contingent payments made on the security are 'not non-contingent' merely due to the effect non-payment would have on the ADI's business. As Fry and Schwartz point out, the contingency to make payments under the security would commonly stem from the availability of profits.⁸⁷

The drafting of s 974-135(7) is a statutory interpretation nightmare, principally due to the apparent contradiction between it and s 974-135(1). Not only is this provision poorly crafted but it also fails to evince clearly its real intention, with that intention being unclear itself. On a plain reading, an ENCO may exist pursuant to s 974-135(1) in the absence of legal obligation but the presence of economic compulsion;⁸⁸ however s 974-135(7) would seem to preclude the ENCO arising based on detrimental commercial consequence to the issuer if the obligation is unfulfilled.⁸⁹ The Commissioner of Taxation ("the Commissioner") has sought to clarify the correct interpretation of s 974-135(7) in TR 2010/5,⁹⁰ following complaints from the profession that it is contradictory to the EM's illustration of an ENCO.⁹¹ The EM provides that an issuing entity possessing a right (but not a legal obligation) to redeem a financing arrangement, in circumstances where an unexercised right triggers accelerated returns and renders

⁸⁵ Ibid.

⁸⁶ Authorised deposit-taking institution.

⁸⁷ Martin Fry and Brad Schwarz, *Debt/Equity: Recent Developments* (21 December 2005) Allens <<https://www.allens.com.au/pubs/pdf/tax/paptaxdec05.pdf#page=28&zoom=auto,-178,384>> 7.

⁸⁸ For detailed discussion on this point, see part 2.3.2.

⁸⁹ Zhang, above n 47, 20.

⁹⁰ Australian Taxation Office, *Income tax: The Relevance of 'Economic Compulsion' in Deciding Whether an Issuer of a Financing Arrangement has an 'Effectively Non-Contingent Obligation' for the Purposes of Section 974-135 of the Income Tax Assessment Act 1997*, TR 2010/5 (22 September 2010) para 25 ('TR 2010/5').

⁹¹ Ibid para 22.

the instrument commercially unviable, is essentially under an ENCO to redeem which in turn represents a debt interest. One reasonable construction is that the uneconomic nature of non-redemption that forms the ENCO is a 'detrimental practical or commercial consequence' that specifically does *not* give rise to an ENCO according to s 974-135(7).⁹² However, the Commissioner's view is that the example in the note to s 974-135(7) makes the subsection's intent clear, which states that profit contingent returns on an income security are necessarily contingent on the economic performance of an entity. Therefore, the return is based on an 'event, condition or situation', which fails the ENCO test. The Commissioner also notes that the economically unsustainable consequences that are specifically contemplated under the 'scheme' (and are not indirect) are relevant for ENCO establishment purposes. External and indirect consequences such as creditworthiness are, in the Commissioner's interpretation, the detrimental consequences that s 974-135(7) attempts to target.⁹³

Section 974-135(8) allows for regulations to be proclaimed⁹⁴ on what constitutes an ENCO, 'non-contingent' or 'not non-contingent' obligation. The inclusion of this provision is clear evidence of Parliament's expectation that this test was not watertight and that problems could arise. Indeed they have. When much of the literature on Division 974 was written, no regulations had been introduced. However, the growing complexity of financial instruments has seen the introduction of regulations since 2004 in respect of, for example, redeemable preference shares and subordinated notes.⁹⁵

3.3.3 Further Interpretative Problems with the ENCO Test

When considered in detail, the ENCO concept is quite difficult to comprehend. This, in part, is because the words 'effectively non-contingent obligation' actually do not, and cannot, have any meaning themselves as 'ENCO' is a defined term.⁹⁶ It is therefore to be understood only in its defined sense, which the High Court has made quite clear in other contexts.⁹⁷ However, this did not prevent the Commissioner from implying that the term 'effectively' is meant to aid the interpretive process on whether or not an ENCO exists.⁹⁸ The nature in which s 974-135 is drafted indicates only when an ENCO arises, as opposed to what the term itself actually means.⁹⁹

The first issue is the interpretative uncertainty of 'in substance or effect a non-contingent obligation' within s 974-135(1). The EM explains the concept as follows:

... the *effectively non-contingent* test also identifies formally non-contingent obligations that, having regard to the circumstances of the scheme, are such that there is no non-contingent obligation as a matter of **substance or effect**. This

⁹² Ibid para 27; CPA Australia et al, Submission to the Australian Taxation Office, *Draft Tax Determination TD 2008/D14*, 31 October 2008.

⁹³ Ibid 28-31.

⁹⁴ *Income Tax Assessment Regulations 1997* (Cth) div 974.

⁹⁵ Ibid subdiv 974F.

⁹⁶ Zhang, above n 47, 17.

⁹⁷ *Gibb v FCT* (1966) 118 CLR 628, 635.

⁹⁸ See *ENCO Discussion Paper*, above n 15, 20.

⁹⁹ Zhang, above n 47, 17.

may be the case, for example, where related parties **enter into formally binding obligations which, because of matters such as the relationship between the parties, are in substance or effect not obligations at all** because failure to perform the so-called obligation will have **no practical consequences**. This can be contrasted with ordinary cases involving formally non-contingent obligations, where failure to perform an obligation would expose the non-performer to legal or economic sanctions (emphasis added).¹⁰⁰

There are differing views on whether one or both of the terms 'substance' and 'effect' qualify one or both of 'non-contingent' and 'obligation'.¹⁰¹ One commentator argues, somewhat strangely, that 'substance' and 'effect' qualify 'non-contingent' and 'obligation', but may only be used interchangeably to qualify 'non-contingent' but not 'obligation'.¹⁰² Zhang puts forward that the EM's inference that a formal obligation is insufficient for an ENCO is an incorrect use of the word 'substance', as the 'substance' of a debtor's obligation would be to repay the debt, and the 'effect' of such an obligation is that the debtor may face legal action in the event of default.¹⁰³ Therefore, he argues that formal legal obligations will always be 'in substance' obligations which cannot be extinguished, even if it is predictable that no punishment would result from default.¹⁰⁴ As a consequence of this analysis, Zhang concludes that economic compulsion should not be regarded as an 'in substance' obligation.¹⁰⁵

This particular interpretation of 'in substance' would appear to be an incorrect one. Not only does the definition of scheme contemplate non-legal obligations,¹⁰⁶ the Oxford Dictionary defines substance as "the most important or essential part of something; the real or essential meaning" or "quality of having a solid basis in reality or fact".¹⁰⁷ Narrowly reading 'substance' to mean a legal obligation is completely contrary to the objects of the legislation.¹⁰⁸ The purpose of 'substance' within 974-135(1) would appear to require an inquiry past the legal form of the matter to what the arrangement is in reality.

The latter characterisation consequentially means that there may be situations whereby there is no legally binding obligation, but economic compulsion is enough to constitute an ENCO.¹⁰⁹ This view accords with that of the Commissioner, who has ruled that an obligation for the purposes of s 974-135(1)

¹⁰⁰ *Debt/Equity EM 50* [2.181].

¹⁰¹ Australian Taxation Office, *Does Subsection 974-135(1) of the Income Tax Assessment Act 1997 (Cth) Only Apply to a Legally Enforceable Obligation?*, TD 2009/1, 14 January 2009, 4-5 [11]-[19] ("TD 2009/1"); Zhang, above n 47, 18.

¹⁰² Zhang, above n 47, 18.

¹⁰³ *Ibid.*

¹⁰⁴ *Ibid.*

¹⁰⁵ *Ibid.*

¹⁰⁶ TD 2009/1, above n 101, 5 [15]. Scheme is defined in *ITAA 1997* to include 'arrangement', which is itself defined to include agreements that are express or implied, legally enforceable and non-legally enforceable. See *ITAA 1997* s 995-1(1) (definition of 'scheme'), (definition of 'arrangement').

¹⁰⁷ Oxford University Press, *Substance* (2014) Oxford Dictionaries <<http://www.oxforddictionaries.com/definition/english/substance>>.

¹⁰⁸ See *ITAA 1997* s 974-10.

¹⁰⁹ Zhang, above n 47, 19. See also Gordon Mackenzie and Alfred Tran, 'Risk As a Measure in Taxing Financial Arrangements' (2011) 26 *Australian Tax Forum* 665, 675.

does not have to be a legally enforceable one.¹¹⁰ However, the Commissioner has acknowledged the ambiguity in whether ‘substance or effect’ qualifies one or both of ‘non-contingent’ and ‘obligation’. A narrow interpretation may imply that the provision extends to an obligation that is ‘in substance or effect’ non-contingent, as opposed to ‘in substance or effect’ an obligation that is ‘in substance or effect’ non-contingent.¹¹¹ However, his opinion is that both terms are qualified, which can be ascertained by a natural reading and consideration of extrinsic material.¹¹² The differential views on the interpretation of the ENCO concept are illustrative of a significant problem with the current debt-equity framework. Despite the ENCO concept being the key underpinning principle of the debt-equity rules, poor structure and drafting¹¹³ of the legislation has created interpretive problems which subsequently creates uncertainty.

The second problem is the conceptual difficulties regarding the limited assessment of 'pricing, terms and conditions' within the ENCO test. It has been suggested by the ATO¹¹⁴ that the phrase should be construed in a contractual context and not in a 'facts and circumstances' context,¹¹⁵ given the design of the debt test makes clear that a single organising principle rather than a broad factual assessment is to be employed.¹¹⁶ However, it is difficult to see how an effective obligation or remote or artificial contingencies can be clearly established without due consideration to the wider factual matrix.¹¹⁷ Therefore, it could easily be argued that in an attempt to create efficiencies by limiting the assessment scope, the objective of Division 974 is impeded.¹¹⁸

Indeed, cost and practicality reasons were cited as principal reasons for limiting the assessment scope.¹¹⁹ However, as Dyson has recently pointed out, the consequence of curtailing the ENCO assessment has the effect of (for some complicated arrangements) applying a classification unrepresentative of economic substance,¹²⁰ which would appear to suggest that Parliament defined the boundaries of the ENCO assessment too narrowly. Indeed, members of the profession have complained that important external factors that may impact returns, for example interest rates and related party matters, should be considered but are ignored.¹²¹ Further, the trade-off of limiting the inquiry is that income tax treatment becomes inconsistent with accounting standards, ratings regimes and prudential standards.¹²²

3.3.4 Similarities with Financial Accounting Concepts

¹¹⁰ *TD 2009/1*, above n 101, 1 [1].

¹¹¹ *Ibid* 4 [11].

¹¹² *Ibid*; *Acts Interpretation Act 1901* (Cth) s 15AB.

¹¹³ Zhang, above n 47.

¹¹⁴ Australian Taxation Office.

¹¹⁵ *ENCO Discussion Paper*, above n 15, 21 [86]-[88].

¹¹⁶ *Ibid*.

¹¹⁷ Zhang, above n 47, 19.

¹¹⁸ *Ibid*.

¹¹⁹ *Board of Taxation Review*, above n 31, 30.

¹²⁰ Dyson, above n 58, 9.

¹²¹ Frost and Cooper, above n 78, 5.

¹²² *Ibid*.

Although the approach of Division 974 does not accord with financial accounting principles,¹²³ a comparison between the ENCO test and AASB 132 demonstrates that the legislative drafters of Division 974 certainly borrowed foundation concepts from the accounting standard. For instance, both clearly adopt a substance over form approach to classification of financial instruments.¹²⁴ AASB 132 states:

The issuer of a financial instrument shall classify the instrument, or its component parts...in accordance with the **substance of the contractual arrangement** (emphasis added).¹²⁵

A **critical feature** in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party...(the issuer) either to deliver cash or another financial asset to the other party (the holder) (emphasis added).¹²⁶

The **substance of a financial instrument, rather than its legal form**, governs its classification...Substance and legal form are **commonly consistent, but not always**. Some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities (emphasis added).¹²⁷

Therefore, it is not difficult to see why the drafters used the concept of contingency to frame the core of the debt-equity divide. However, it would seem that departure from the basic 'substance over form' and 'repayment obligation' principles by introducing, inter alia, sections 974-135(3) to (7) and a limited assessment scope of pricing, terms and conditions, was not altogether wise.

IV THE CERTAINTY PROBLEM

Division 974's introduction was intended to provide greater certainty, coherence and simplicity for taxpayers.¹²⁸ Similarly, it is apparent that integrity of the taxation base was also a motivating factor for reform. Franking of non-share equity interests, deductibility of contingent returns and circumvention of the thin capitalisation rules were indeed concerns for the Howard Government.¹²⁹

The new regime envisaged a system providing greater clarity around the classification of hybrid instruments in close proximity to the debt-equity border, although it was not expected that the new rules would eliminate uncertainty entirely.¹³⁰ While the 2001 reforms provided a substantive framework for taxpayers, it was suggested in 2003 that Division 974 had both moved the tax system closer to an ideal state and also, largely achieved certainty.¹³¹ In 2015 that statement would appear to be, at the very least, bold.

¹²³ In accordance with the recommendations of the *RBT Final Report*, the decision was made to depart from instrument bifurcation contrary to AASB 132. See *RBT Final Report*, above n 8, 447. The merits and pitfalls of bifurcation are discussed later in this paper. See part 4.1.1.

¹²⁴ Bourke, above n 73, 55.

¹²⁵ *AASB 132*, above n 35, 20 [15].

¹²⁶ *Ibid* 25 [17].

¹²⁷ *Ibid* [18].

¹²⁸ *Debt/Equity EM* 6 [1.9].

¹²⁹ *Ibid* [1.7]; Burgess et al, above n 10, 749 [14.190].

¹³⁰ *Board of Taxation Review*, above n 31, 6 [2.3]-[2.5]; *RBT Final Report*, above n 8, 447.

¹³¹ Rumble and Wood, above n 1, 429-30.

4.1 Uncertainty's Relationship with the Common Law

The fact that Division 974 has received virtually no judicial consideration since 2001 has arguably exacerbated the uncertainty problem that has haunted the debt-equity rules. Whilst some cases have discussed the interaction of Division 974 with other provisions, none have dealt with the application of the legislation itself.¹³² Notwithstanding this, Division 974 has still invited judicial criticism. Justice Perram of the Federal Court, in a brief critique of the rules, articulated the everlasting problem of the debt-equity divide when describing their intent:

Many people might think that debt and equity form a spectrum and that the lofty aim announced by s 974-1 might be the equivalent of telling one where on the rainbow violet stops and mauve starts or, correspondingly, the precise height below which people are short.¹³³

His Honour regarded the legislation as essentially aimed at replacing Dixon J's fundamental principle of 'capital in nature' from *Sun Newspapers*¹³⁴ with 31 pages that increase rather than reduce uncertainty.¹³⁵ Furthermore, he notes that although the *Sun Newspapers* test did contain ambiguity, it was surrounded by a readily conceptualised metric which has now been displaced by a dozens of vague terms with no guiding conceptual framework. Put differently, a comprehensible vagueness displaced by an incomprehensible kind, thus exacerbating the problem it was designed to address.¹³⁶

His Honour clearly favours the Court's role in the legal process over the promulgation of whimsical statutory provisions that exacerbate uncertainty, which is a sound argument. However, Perram J also acknowledges the obvious paradox that exists. Precedent relies on litigation to give it life.¹³⁷ It is unsurprising that legislators could not ignore the growing debt-equity problem during the tax reform period of the late 1990s and subsequently introduced a statutory framework. Further, faced with complex instrument innovation, it is difficult to envisage how the judiciary could have articulated the debt-equity divide without reference to at least a degree of statutory overlay. Over a decade of experience with the provisions has merely shown that it could have been done better.

4.2 Interference of the ATO Ruling Regime

A notable source of the lack of case law, and consequently interpretative uncertainty concerning Division 974, is the rulings regime. In addition to an expansive public ruling regime, taxpayers can relatively easily obtain a private ruling on the application of taxation law to their particular arrangement.¹³⁸

¹³² *Board of Taxation Review*, above n 31, 16 [3.12]. The only decision of note is the recent Federal Court case of *Blank v Commissioner of Taxation* [2014] FCA 87, which somewhat modified the widely understood meaning of 'financing arrangement' within s 974-130 *ITAA 1997*. However, a discussion of this case is not particularly relevant and beyond the scope of this paper.

¹³³ Justice Nye Perram, 'The Perils of Complexity: Why More Law is Bad Law' (2010) 39 *Australian Tax Review* 179, 185.

¹³⁴ *Sun Newspapers Ltd v Federal Commissioner of Taxation* (1938) 61 CLR 337.

¹³⁵ Perram, above n 133, 185.

¹³⁶ *Ibid.*

¹³⁷ *Ibid.* 186.

¹³⁸ *Taxation Administration Act 1953* (Cth) sch 1 s 359-10. Private rulings are binding on the Commissioner.

Therefore, unless a taxpayer decides to discount the Commissioner's opinion and litigate further, the opportunity for judicial consideration does not arise. High Court decisions of significance are indeed a rarity.

Moreover, although a taxpayer may successfully litigate an assessment for one tax year, there is an overwhelming likelihood that Parliament will simply legislate to codify the Commissioner's view.¹³⁹ Hence, the aforementioned factors, rather than the overwhelming success of Division 974, would appear to be the reason for the lack of litigation.¹⁴⁰

4.3 *Inability to Classify Instruments*

Despite differing opinion on Division 974's success, it appears clear that the contrived nature of the division has, predictably, resulted in situations where taxpayers are left with an unclassifiable instrument.¹⁴¹ There has reportedly been situations in which the absence of a sufficient ENCO has resulted in a failure of the debt test where the equity test is not satisfied either.¹⁴² As a tiebreaker rule only operates to classify an instrument as debt in circumstances where *both* debt and equity tests are met,¹⁴³ the inability of the rules to classify an instrument that satisfies *neither* test appears to be a massive oversight in the drafting of the division. It leaves taxpayers and practitioners in a situation where an instrument is neither frankable nor deductible according to Division 974. It is therefore left to the general deductibility provision in section 8-1 to make a determination, a situation that is less than ideal.¹⁴⁴

To this extent, it would seem the operative concepts of Division 974 were poorly constructed. The manner in which the debt and equity tests are modelled is, arguably, incorrect for self-executing classification legislation. As Division 974 and the tax system rely on a financing instrument satisfying at least one test, it is imperative that the legislation operate to ensure that in fact occurs. Currently, that is not a certainty, which illustrates that the design of legislation is just as important as the key concepts. Consider the following problem in the context of a convertible note:

It may be more difficult to find an ENCO to redeem the instrument where the right to convert is held **by the issuer as opposed to being held by the holder**. This is because the provision of an equity interest in the issuer (or connected entity) **does not constitute the provision of a financial benefit**.¹⁴⁵ The issuing of an equity interest on conversion would not be taken into account for purposes of determining whether an ENCO to provide a financial benefit exists and the

¹³⁹ An excellent example of this conduct is the decision of *Commissioner of Taxation v Anstis* (2010) 241 CLR 443. The Commissioner denied the taxpayer a deduction for self education expenses claimed against Youth Allowance income that were, quite obviously, deductible pursuant to s 8-1 *ITAA 1997*. After the High Court unanimously upheld the decision of the Full Federal Court in favour of the taxpayer, Parliament changed the legislation to specifically disallow self education expenses against centrelink payments which remain, for all purposes, assessable income.

¹⁴⁰ Contrary to the assertion of Patricia Brown, 'General Report' (2012) 97b *Cahiers de Droit Fiscal International: The Debt-Equity Conundrum* 17, 41.

¹⁴¹ Frost and Cooper, above n 78, 5.

¹⁴² *Ibid.*

¹⁴³ *ITAA 1997* s 974-5(4).

¹⁴⁴ *Board of Taxation Review*, above n 31, 77-78 [6.10]-[6.12].

¹⁴⁵ *ITAA 1997* s 974-30(1)(b).

optionality of the repayment of the principal means the possibility that it may be repaid is to be ignored.¹⁴⁶

Unfortunately, the debt test and the equity test in their current form are more illustrative of common, non-classification provisions. Take for instance the positive and negative limbs for deductibility under s 8-1. In this example, if the legislative test is not made out,¹⁴⁷ then that expense is simply not deductible save for a specific deduction provision. This is the end of the inquiry and there are no further consequences for the tax system. However, in the Division 974 context, failure of both debt and equity tests is an unacceptable outcome. A financing instrument must be debt or equity. It can conceivably be both, but it cannot be neither.

This point has not escaped the Board of Taxation's notice as the review has specifically sought comment on whether there are commercially significant arrangements that are unclassifiable under Division 974 as it currently stands.¹⁴⁸ Without alluding to the form in which it might take, comment has also been invited on whether a tiebreaker rule, similar to the one contained within s 974-5(4) for schemes satisfying both tests, would be practically useful. In the absence of any significant redrafting of the structure of Division 974, it would appear that the obvious answer is yes.¹⁴⁹ It has been noted, in a brief survey conducted and published recently, that some practitioners are concerned about this problem.¹⁵⁰ It was similarly pointed out that the need for such a supplementary tiebreaker provision is demonstrative of a wider problem.¹⁵¹ Although legislation is seldom infallible, tiebreakers and qualifying subsections indicate that the operative provisions of the debt and equity tests are not watertight.¹⁵² Moreover, sentiment from the profession appears to be that Division 974 provides confirmation of tax treatment in relatively vanilla cases, however hard cases, such as undated and long dated instruments, convertibles and debt with contingent returns, remain difficult.¹⁵³ This raises the issue of how far Division 974 has really gone in reducing overall uncertainty at the edge of the debt-equity borderline.¹⁵⁴

4.4 The Commissioner's Intervention Power

¹⁴⁶ Ibid s 974-135(4); *Board of Taxation Review*, above n 31, 38 [4.55].

¹⁴⁷ For instance, a circumstance where an expense does not pass the positive limbs or is disallowed by a negative limb.

¹⁴⁸ *Board of Taxation Review*, above n 31, 26 [4.9]-[4.10].

¹⁴⁹ Note that the Tax Institute has recommended against the adoption of a tiebreaker. It has put forward that some instruments should remain uncharacterised by Division 974; and that such an addition may have unintended TOFA and thin capitalisation consequences. None of these concerns are fully or convincingly articulated and such a view would broadly appear contrary to the spirit of the legislation as it stands. See The Tax Institute, Submission to The Board of Taxation, *Review of the Debt and Equity Tax Rules*, 30 May 2014, 3.

¹⁵⁰ Frost and Cooper, above n 78, 5.

¹⁵¹ Ibid.

¹⁵² Ibid.

¹⁵³ Ibid. This is due to a variety of factors, including the discounting requirement in s 974-35 *ITAA 1997* for financial benefits with a performance period over 10 years, the identification and valuation of ENCOs, and determining whether or not a contingency is relevant.

¹⁵⁴ Ibid.

Amongst the inherent uncertainties built into Division 974 are the wide determinative powers of the Commissioner.¹⁵⁵ The existence of such is unfortunate in the debt-equity context, as the framework is sufficiently uncertain in its absence.¹⁵⁶

The most prominent example is the Commissioner's power to make determinations as to the existence of a 'debt interest', notwithstanding the fact that a 'financing arrangement' may not meet the criteria stated in section 974-20(1)(d) – that the value provided be at least equal to the value received.¹⁵⁷ It has been argued that this section introduces an unnecessary level of uncertainty into the regime.¹⁵⁸ It appears to target subversions of the debt test by way of providing a return in the form of several 'financial benefits', rather than a singular one. In essence, it is an integrity provision. It is curious however that s 974-20(1)(d) was not merely qualified to extend to several 'financial benefits'. Doing so would largely remove the need for s 974-65. However, the drafters clearly intended to reserve the power for the Commissioner, which is where the uncertainty lies as opposed to the substance of s 974-65 itself.

There are several other instances where the Commissioner has power to make a determination notwithstanding the operative provisions of Division 974. The most notable are sections 974-15(4) and 974-70(4), which state that the Commissioner may determine that two or more schemes do not give rise to a 'debt interest' or 'equity interest' respectively, if he believes that such an outcome would be unreasonable. Amongst a number of substance based considerations¹⁵⁹ that must be taken into account when making a determination, the provision affords the Commissioner freedom to consider 'any other relevant circumstances'.¹⁶⁰ The interpretive liberty afforded by these provisions is much wider than that granted to the taxpayer in, for instance, determining the existence of an ENCO. That inquiry is limited to pricing, terms and conditions.¹⁶¹

Finally, the presence of sections 974-60(4) and (5) are further pillars of uncertainty in respect of establishing a 'debt interest'. The operative provision attempts, in an unclearly expressed fashion, to resolve who the issuing entity is in circumstances where multiple entities have obligations under a 'scheme' or 'schemes'. It essentially prescribes that the entity with the largest obligation will

¹⁵⁵ Fry and Schwarz, above n 87, 9 [4.1].

¹⁵⁶ There are several examples throughout the wider tax law of the Commissioner's desire to have it both ways. A good illustration is Division 142 *A New Tax System (Goods and Services Tax) Act 1999* (Cth). In short, the legislation prescribes that in circumstances where GST is incorrectly remitted to the ATO on a non-taxable supply, the Commissioner will likely refuse a refund to prevent a windfall gain flowing to the taxpayer. However, this obviously results in a windfall gain to the Commissioner. See Chris Sievers, *Refunds of Overpaid GST: From s 105-65 to Division 142 – Where Did We Come From, How Did We Get Here and Where Are We Going?* (30 July 2013) All About GST In Australia <<http://chrissievers.com/the-commissioners-approach-to-real-property-transactions/from-s-105-65-to-division-142-a-look-at-the-tortured-history-of-gst-refunds/>>.

¹⁵⁷ *ITAA 1997* s 974-65.

¹⁵⁸ Fry and Schwarz, above n 87, 9 [4.1].

¹⁵⁹ *ITAA 1997* ss 974-15(5), 974-70(5).

¹⁶⁰ *Ibid* ss 974-15(5)(f), 974-70(5)(f).

¹⁶¹ *Ibid* s 974-135(1).

be the issuer.¹⁶² Nevertheless, the Commissioner has the ability to overrule that outcome with regard to his determination of economic and commercial substance.¹⁶³

V THEORETICAL METHODOLOGIES FOR CATEGORISING FINANCIAL ARRANGEMENTS AND INSTRUMENTS

5.1 *The Categorisation Choice - Blanket Treatment or Bifurcation*

Notwithstanding the various ancillary forms in which the debt-equity divide can be drawn,¹⁶⁴ there are two main methodologies for treatment and classification of arrangements. With the classification of, for instance, shares and bonds being uncontroversial in their legal equity or debt character, the question of how hybrids are classified essentially depends on a policy choice. Hybrids may either be apportioned and their debt or equity characteristics treated separately for tax purposes; or simply classified as one holistic instrument as debt *or* equity with regard to a deciding principle. The RBT Discussion Paper canvassed both alternatives,¹⁶⁵ which are referred to as blanket¹⁶⁶ or bifurcated¹⁶⁷ treatment. Although the TOFA¹⁶⁸ regime deals with the actual tax recognition of gains and losses in respect of financial arrangements,¹⁶⁹ the traditional blanket and bifurcation frameworks used for taxing such are somewhat transferrable to the debt-equity classification paradigm. Once this overarching method is determined, there is clearly more scope, particularly in the blanket treatment context, for creativity in the design of a classification principle.

5.1.1 *The Bifurcation Approach*

A bifurcation, or apportionment methodology to the classification of arrangements, involves that arrangement being split into its respective debt and equity components.¹⁷⁰ Each component is subsequently treated differently for the

¹⁶² *Debt/Equity EM*, 45 [2.156].

¹⁶³ *ITAA 1997* ss 974-60(3)-(4)

¹⁶⁴ For instance, common law principles and legislative carve outs.

¹⁶⁵ *RBT Discussion Paper*, above n 31, ch 7.

¹⁶⁶ The blanket approach (synonymous with aggregation or integration approach) involves classifying an instrument as wholly debt or wholly equity, without regard to component parts.

¹⁶⁷ Bifurcation (synonymous with disaggregation) involves dissecting an instrument into its distinct debt and equity components.

¹⁶⁸ Taxation of Financial Arrangements. The TOFA regime falls within Division 230 *ITAA 1997* and regulates the consequences of a Division 974 classification. The rules provide for the timing and tax treatment of gains and losses on financial arrangements, and will commonly apply to large taxpayers. See Australian Taxation Office, *Taxation of Financial Arrangements* (17 July 2014) <<https://www.ato.gov.au/Business/Taxation-of-financial-arrangements/In-detail/Overview/Guide-to-the-taxation-of-financial-arrangements-%28TOFA%29/>>.

¹⁶⁹ It should be noted that the TOFA regime, and the debt-equity regime within Division 974, are not completely harmonised. For instance, the manner in which a debt interest arises within s 974-20 is not identical to the manner in which it is assessed under the TOFA regime, despite the tests being within the same Act. However, this is an issue in itself and beyond the scope of this paper. See *Board of Taxation Review*, above n 31, 292. The *Board of Taxation Review*, above n 31, has sought comment on whether the lack of harmonisation between the regimes and their interaction is problematic.

¹⁷⁰ *RBT Discussion Paper*, above n 31, 200 [7.12]. It should be noted that bifurcation in this chapter is discussed in a general manner. There are several ways in which instruments can be bifurcated, which involve consideration of the accrual and realization of anticipatable and non-

purposes of the wider tax law,¹⁷¹ largely as if those components were issued independently of each other.¹⁷²

In theory, disaggregation of hybrid instruments is both beneficial and logical, as it provides for the separation of aggregated components that comprise a hybrid.¹⁷³ This in turn, as Weisbach argues, promotes horizontal equity and reduces tax arbitrage, given the holder of a complex hybrid instrument is treated no differently to a holder of a component part.¹⁷⁴ Sharp discontinuity at the debt-equity borderline is avoided.¹⁷⁵

Hence, a key benefit of bifurcation is its inherent ability to respond to new financial instruments, notwithstanding their holistic design. Components can be partitioned as debt or equity according to their true economic character. Doing so, it is suggested, allows for a more meaningful and consistent application of the conventional tax treatment of debt and equity, as is the case at the far ends of the spectrum.¹⁷⁶ In contrast, legislated blanket approaches, by their very nature, are contrived and result in classifications (and therefore tax treatment) of hybrids that would not result if each component were autonomous.¹⁷⁷

Bifurcation also accords neatly with the required treatment of all hybrid arrangements under Australian financial accounting standards.¹⁷⁸ Although a detailed analysis of the entirety of AASB 132 is beyond the scope of this paper, the standard clearly requires dissection of what it calls 'compound financial instruments'.¹⁷⁹ For instance, the issuer of a convertible bond would recognise a financial liability in the form of a contractual obligation to deliver cash or a similar benefit.¹⁸⁰ However an equitable call option which, at the option of the holder, may convert into an ordinary shareholding in the issuer, is similarly recognised.¹⁸¹ The valuation of those disaggregated components is dealt with by AASB 139.¹⁸²

Harmony between financial accounting and tax treatment of hybrids would also seemingly result in a more realistic representation of corporate debt-equity ratios.¹⁸³ Blanket treatment for tax purposes generally enables engineering activity

anticipatable cash flows, and also deductibility and frankability of periodic payments under the instrument. In depth discussion of these matters is beyond the scope of this paper. See Rumble and Wood, above n 1.

¹⁷¹ Ibid 200 [7.13].

¹⁷² A C Warren, 'US Income Taxation of New Financial Products' (2004) 88 *Journal of Public Economics* 899, 906.

¹⁷³ David Weisbach, 'Financial Contract Innovation' (1995) 50 *Tax Law Review* 491, 507.

¹⁷⁴ Ibid 493. See also Wood, above n 4, 63.

¹⁷⁵ Wood, above n 4, 60.

¹⁷⁶ Ibid 69.

¹⁷⁷ Weisbach, above n 173, 508.

¹⁷⁸ AASB 132, above n 35.

¹⁷⁹ Ibid 30 [28].

¹⁸⁰ Ibid.

¹⁸¹ Ibid.

¹⁸² Ibid 31 [31]. The role of AASB 132 is discussed further at part 4.3.

¹⁸³ The debt-equity distinction is important given the treatment of an entity's financing arrangements will affect its overall debt/equity ratio. As the debt/equity ratio is essentially an

by entities seeking to achieve subjective gearing targets. Economic asymmetry that arguably results from such conduct would be cured through bifurcation. Furthermore, it would appear clear that a great deal of the uncertainty that stems from the blanket approach would simply not arise where an instrument is apportioned. As indicated earlier, the possibility of classifications contrary to economic substance can be an unfortunate consequence of either limiting the scope of an ENCO inquiry, or merely poor drafting of the legislation.¹⁸⁴ In addition, integrity concerns surrounding exploitation of frankable dividends disguised as deductible payments on debt would not arise either, as each debt and equity component would be deductible and frankable respectively. For instance, using the EM's simple example of a 10 year subordinated debenture with a face value of \$1 million, the coupons at 5% p.a. would simply be deductible and the 5% p.a. entitlement to distributable profits would be frankable.¹⁸⁵ In theory, this method would appear, *prima facie*, not only to remove uncertainties but also achieve the general stated aim of ensuring instruments are classified according to economic substance.

However, the bifurcation method is not without its strident critics.¹⁸⁶ Commentators have argued that taxation law's relationship with the apportionment of instruments has been a troublesome one.¹⁸⁷ Indeed, the necessary valuation and execution of an instrument into its respective debt and equity components may introduce unfavourable practical complexities and cost burdens to the classification framework.¹⁸⁸ The question of whether an instrument is bifurcated according to the features of the whole arrangement, or the components themselves, is one suggested basis of practical complexity.¹⁸⁹ Another view is that assessing an instrument in its combined form is the only sound way of ascertaining the purpose and expected returns of the arrangement.¹⁹⁰ Whether correct or not, bifurcation remains much less prevalent than its alternative and was indeed abandoned in the United States after a brief experiment with the methodology.¹⁹¹ Furthermore, the IFA¹⁹² concluded in 1995 that after comprehensive reviews conducted in many jurisdictions, due to the analytical complexity and the uncertainty inherent in subjective assessment of component

indicator of an entity's capital structure and therefore profitability, long term financial stability and solvency, management of this ratio is important from a stakeholder confidence perspective. See Pamela Hanrahan et al, *Commercial Applications of Company Law* (CCH Australia Limited, 14th ed, 2014) 384-5. See also Wayne Lonergan, 'Own It, or Owe It? The Debt/Equity Conundrum of Converting Instruments' [1998](4) *JASSA* 2. Note that reporting entities, therefore businesses likely to engage in hybrid instruments, have an obligation to lodge financial statements with the Australian Securities and Investments Commission pursuant to s 295 *Corporations Act 2001* (Cth). Pursuant to s 296 *Corporations Act 2001* (Cth), the financial statements must comply with AASB guidelines.

¹⁸⁴ See part 3.5.

¹⁸⁵ *Debt/Equity EM* 41-2 [2.138]-[2.142].

¹⁸⁶ For example, see Warren, above n 172; Richard Wood, 'Financial Capital and Taxation Policy' (2006) 27 *Fiscal Studies* 127, 133; Jeff Strnad, 'Taxing New Financial Products in a Second-Best World: Bifurcation and Integration' (1995) 50 *Tax Law Review* 545.

¹⁸⁷ Warren, above n 172, 906.

¹⁸⁸ Wood, above n 186, 133.

¹⁸⁹ *Ibid.*

¹⁹⁰ *Ibid* 134.

¹⁹¹ *Ibid* 133-4.

¹⁹² International Fiscal Association.

parts, the bifurcation method should not be adopted for tax purposes.¹⁹³ It is notable though that this statement was made 19 years ago and uncertainty is still prevalent amongst many nations that classify instruments in aggregate.

5.1.2 *The Blanket Approach*

The blanket methodology entails a hybrid being classified as a singular unit, therefore as wholly debt or wholly equity.¹⁹⁴ There is no scope for the franking and deductibility of component parts,¹⁹⁵ which in turn largely disregards how a hybrid may be otherwise classified.¹⁹⁶

In many forms, the blanket methodology is a much cleaner and simpler means of classifying hybrid arrangements.¹⁹⁷ Certainly, any bifurcation complexity in the identification and partitioning of an instrument is simply avoided. It has also been argued (albeit unconvincingly) that classifying an instrument in aggregate form does provide the best indication of overall economic substance.¹⁹⁸ The administrative ease of this method indicates why it has been, historically, the overwhelming preference of policymakers both domestically and internationally. However, it does appear objectively strange that in the debt-equity classification context, the blanket approach has been looked upon so favourably; administrative ease aside. The argument that the economics of a hybrid is different from that of its disaggregated form has been strongly countered,¹⁹⁹ with suggestion that classification of hybrids in aggregate *creates* market and tax system asymmetry.²⁰⁰ Although blanket treatment is appropriate for synthetic arrangements,²⁰¹ it is conceptually unnatural for hybrids. Hybrid instruments are by definition a combination of separate instruments,²⁰² therefore treatment as a whole is inherently contrary to what would otherwise result if it were treated in parts.²⁰³ Further, deconstruction of a hybrid combats design innovation by reclassifying components to fit within existing tax frameworks,²⁰⁴ preventing changes to a holistic instrument having sweeping ramifications on its tax treatment.²⁰⁵ It is difficult to envisage how blanket treatment is more

¹⁹³ Charles T Plambeck, H David Rosenbloom and Diane M Ring, 'General Report' (1995) 80b *Cahiers de Droit Fiscal International: Tax Aspects of Derivative Financial Instruments* 653, 689-90.

¹⁹⁴ *RBT Discussion Paper*, above n 31, 200 [7.12]; Weisbach, above n 173, 493.

¹⁹⁵ *RBT Discussion Paper*, above n 31, 200 [7.14].

¹⁹⁶ Strnad, above n 186, 546.

¹⁹⁷ *RBT Discussion Paper*, above n 31, 200 [7.14]; Wood, above n 186, 133-4.

¹⁹⁸ Wood, above n 186, 134.

¹⁹⁹ Weisbach, above n 173, 521. See also Wood, above n 4, 70.

²⁰⁰ O'Neill, above n 12, 166; Ian McNeill, *CPE Supplement 2 - Debt Equity: Five Years On* (December 2007) Television Education Network <http://www.tved.net.au/index.cfm?SimpleDisplay=PaperDisplay.cfm&PaperDisplay=http://www.tved.net.au/PublicPapers/December_2007,_Sound_Education_in_Taxation,_CPE_Supplement_2__Debt_Equity__Five_Years_On.html>.

²⁰¹ Weisbach, above n 173, 526. Synthetics are arrangements that attempt to mimic the characteristics of transactions with a different legal form, for example wash sales and straddles. See *RBT Discussion Paper*, above n 31, 205.

²⁰² Weisbach, above n 173, 507.

²⁰³ *Ibid.*

²⁰⁴ *Ibid.*

²⁰⁵ *RBT Discussion Paper*, above n 31, 200 [7.14]. Changes would include changes to terms, conditions or characteristics. Indeed, changes to pricing, terms and conditions of a scheme may

representative of economic substance, when the methodology essentially attempts to apply an either/or proposition to what is a continuum.

5.2 Determination of Categorisation - Competing Methods

It is possible to perform the debt-equity characterisation in several different ways, after the aggregation or disaggregation theory is selected. Two generally accepted and prominent methods are examined, being the 'facts and circumstances' and the 'single organising principle' approaches.

5.2.1 Facts and Circumstances Assessment

The 'facts and circumstances' approach is a purely substance based method of making the debt-equity distinction.²⁰⁶ The approach involves a weighing process of an arrangement's debt and equity features to determine its correct commercial classification, without reference to any prescribed formula.²⁰⁷ The facts and circumstances that may be taken into account include, but are not limited to, reasonable expectation of payment, the rate of return, contingency or non-contingency of payments, priority on winding up, participation in gains and losses, redemption right, existence of a put option and enforceability.²⁰⁸

There are considerable benefits to approaching the debt-equity divide in this manner. Principally, the method is sufficiently flexible to respond to new, hitherto unanticipated financial instruments,²⁰⁹ therefore constraining activity designed to exploit the different tax treatment of interest and dividends.²¹⁰ In an Australian context, courts and the ATO would seemingly be able to make a holistic assessment pursuant to economic substance, in consideration of the interdependency and interrelatedness of a hybrid's particular facts and circumstances.²¹¹ It also conceivably reduces arbitrage and engineering that occurs when tax professionals have a defined debt-equity boundary that may be manipulated.²¹² Further, from the perspective of a holder or issuer of a hybrid, it removes the possibility of a classification contrary to the intent of the parties, in comparison to statutory classification rules that are blind to the wider factual matrix.

However, it has been argued that the facts and circumstances approach is a source of uncertainty and increased compliance cost, given the absence of any robust framework within which classifications are made.²¹³ The interrelatedness and interdependence of the individual facts and circumstances of various hybrids presents classification problems in a practical sense, due to the absence of any

have impacts on the existence of an ENCO for the purposes of the debt test in Division 974. See also Wood, above n 4, 60.

²⁰⁶ *Board of Taxation Review*, above n 31, 7 [2.6].

²⁰⁷ Bourke, above n 73, 26; Gordon Longhouse, 'Making the Line a Gap: Edgar's Treatment of the Debt-Equity Boundary' (2002) 50 *Canadian Tax Journal* 238, 239.

²⁰⁸ *RBT Discussion Paper*, above n 31, 201 [7.16].

²⁰⁹ Bourke, above n 73, 26.

²¹⁰ Tim Edgar, *The Income Tax Treatment of Financial Instruments: Theory and Practice* (Canadian Tax Foundation, 2000) 305.

²¹¹ *RBT Discussion Paper*, above n 31, 201 [7.17].

²¹² *Board of Taxation Review*, above n 31, 19 [3.15].

²¹³ *Board of Taxation Review*, above n 31, 145 [10.26].

definitive technique in respect of how factors are weighted to make a determination.²¹⁴ Parties to an instrument may come to different interpretations on whether the instrument is debt or equity, which indicates the inherent subjectivity of the approach.²¹⁵ Anecdotal reports also indicate that arbitrage is not eliminated in the absence of a statutory borderline, given the significant amount of engineering by tax specialists that occurs to ensure arrangements have the correct mix of facts and circumstances to achieve the classification desired by the parties.²¹⁶ As a result, reactive responses from revenue authorities are required to close engineered loopholes.²¹⁷

5.2.2 Single Organising or Determinative Principles

A single determinative principle approach essentially limits the scope of a characterisation inquiry. The classification of an arrangement as debt or equity pivots on the existence or non-existence of one factor,²¹⁸ amounting to a demonstration of what tax law commentators refer to as line drawing in the tax law.²¹⁹ Although this particular method provides design liberty, particularly in respect of the factor (or indeed factors) chosen to be the determinant, the international experience indicates that the constant in the equation is a 'substance over form' objective.²²⁰ Further, 'one element' theories are considered to be favourable methods for capturing the substance of an arrangement without the inefficiencies, and arguable uncertainties, of performing a full 'facts and circumstances' assessment.²²¹

Classification of financial instruments with regard to a singular determinative principle is certainly, aside from the correctness or incorrectness of the choice, a more widely utilised concept internationally than 'facts and circumstances'.²²² It would seem however that the concept would be more aptly named a 'multi-factorial determination', given analogous schemes that have been suggested or employed commonly combine a limited number of prescribed factors in order to make the determination. For instance, the Australian approach centres around the principle of an ENCO to return to an investor at least the invested amount. However, in practice, that principle is actually defined by pricing, terms and conditions, not to mention the remaining prescriptions within the ENCO definition.²²³

Other determination bases include the use of a debtor/creditor assessment, separately or in conjunction with a company/shareholder assessment.²²⁴ Alternatively, a 'safe harbour' benchmarking test that classifies debt on the basis

²¹⁴ Wood, above n 4, 60.

²¹⁵ Ibid.

²¹⁶ Brown, above n 140, 41.

²¹⁷ Ibid.

²¹⁸ *RBT Discussion Paper*, above n 31, 202 [7.21].

²¹⁹ David Weisbach, 'Line Drawing, Doctrine and Efficiency in the Tax Law' 84 *Cornell Law Review* 1627.

²²⁰ Brown, above n 140, 33.

²²¹ Ibid 34.

²²² Ibid.

²²³ *ITAA 1997* s 974-135(1).

²²⁴ *RBT Discussion Paper*, above n 31, 202 [7.23]-[7.24].

of whether a lender has a right to be repaid the initial outlay at least, and possibly, in the event of insolvency, has been floated as another formulation.²²⁵ A further suggestion by the RBT was that debt and equity components of a hybrid be valued; with the component of greatest value deciding the overall classification.²²⁶ Despite the initial logic of this latter approach, it would also seem somewhat punitive. For instance, in a blanket treatment context, classifying an instrument that closely straddled the debt-equity border as one or the other, if both components were of similar value, would seem arbitrary. Moreover, it would also seem that such a method would be open to abuse, as it shares its foundation with a similar regulatory failure in the United States.²²⁷

Regardless of the specific formulation of a single factor theory, it is clear that a test centred around the obligation (or not) of a lender to be repaid is the widely preferred principle.²²⁸ This is not surprising and it is difficult to argue with the rationale. The existence of a right to repayment is, in essence, the quintessential distinction between equity and debt.²²⁹ However, it is equally clear that the success of this method largely depends on context. Great care needs to be taken in the legislative design of a single determinative factor to ensure it remains a *single* principle, or as close to such as possible.

5.3 Classification Of Arrangements According To Accounting Principles

Barring some notable exceptions,²³⁰ it is interesting to observe that Australia and other international jurisdictions have strayed from using financial accounting principles to determine tax treatment, especially in the context of financial instruments and the debt-equity border.²³¹ What is more, the general sentiment of the literature broadly supports the status quo. For instance, Edgar argues accounting and tax systems have different overall objectives and in that context, there is no reason to believe that accounting treatment is a more relevant classification principle than legal form.²³² Bourke similarly argues against harmonising accounting and tax classification of debt and equity.²³³ Both concede, though, that accounting concepts are a good starting point,²³⁴ which demonstrates why many nations have used some elements of financial accounting

²²⁵ Stijn Vanoppen, 'Belgium' (2012) 97b *Cahiers de Droit Fiscal International: The Debt-Equity Conundrum* 113, 127.

²²⁶ *RBT Discussion Paper*, above n 31, 202 [7.22].

²²⁷ See part 5.1.

²²⁸ Vanoppen, above n 225, 127; Gerrit De Keizer and Michiel Sunderman, 'Netherlands' (2012) 97b *Cahiers de Droit Fiscal International: The Debt-Equity Conundrum* 489, 498.

²²⁹ Vanoppen, above n 225, 127 citing H Lamon, F Weynants and D Berckmans, 'Tax Treatment of Debt Instruments Without Fixed Rights to Redemption' (2001) *Derivatives and Financial Instruments* 143,163.

²³⁰ Both Germany and France use accounting principles to draw their debt/equity divide. See Schön et al, above n 5, 148. See also Jean-Yves Hemery and Siamak Mostafavi, 'France' (2012) 97b *Cahiers de Droit Fiscal International: The Debt-Equity Conundrum* 285; Hardy Fischer and Allit Lohbeck, 'Germany' (2012) 97b *Cahiers de Droit Fiscal International: The Debt-Equity Conundrum* 307, 308.

²³¹ Brown, above n 140, 32.

²³² Edgar, above n 210, 134.

²³³ Bourke, above n 73, 57.

²³⁴ *Ibid*; Edgar, above n 210, 134.

to inform their classification methodologies.²³⁵ Indeed, as indicated earlier, many of the underlying concepts of the ENCO test have been borrowed from AASB 132.²³⁶

With respect to all commentators, the literature in this area is currently devoid of a convincing argument as to why accounting standards are an inappropriate basis for the debt-equity classification. Although taxation law and financial accounting rules serve different purposes,²³⁷ it is difficult to conceptualise why disconnects between the two are seen to be unproblematic or, in fact, favourable. The benefits of aligning the two approaches appear so starkly clear. Not only does bifurcation prevent components of an instrument being classified contrary to their substantive form, which in turn captures economic substance; economic asymmetries from unintended or arbitrary reclassifications no longer arise. Further, such an approach would seemingly result in increased confidence and efficiency at taxpayer level, whilst also removing temptation to engage in tax planning aimed at manipulating a contrived debt-equity border.

VI THE INTERNATIONAL EXPERIENCE

Taxation authorities around the world have struggled to keep pace with the evolution of complex financing arrangements at the debt-equity borderline. Most jurisdictions have reactively responded with gradual regulation that is both domestically targeted and also highly detailed and complex.²³⁸ However, the piecemeal introduction of regulation has resulted in reforms that add new layers of complexity to existing arrangements. They have largely failed to grasp the elusive aspiration of introducing, *inter alia*, an element of consistency and stability to the taxation framework.²³⁹

There is currently no global consensus on how best to approach debt-equity classification.²⁴⁰ However, it is clear that many OECD²⁴¹ nations have struggled to devise workable frameworks to make the distinction that do not place at least some reliance on legal form. Indeed, legal form is heavily relied upon in other advanced economies analogous to Australia, including Canada, the United Kingdom²⁴² and New Zealand.²⁴³ In fact, Canadian courts have expressly rejected substance over form characterisation of hybrid instruments.²⁴⁴ The exception is the United States, which has opted for a substance based approach to instrument

²³⁵ Brown, above n 140, 34.

²³⁶ See part 2.3.4.

²³⁷ Huang, above n 13, 7.

²³⁸ Wood, above n 186, 128.

²³⁹ *Ibid.*

²⁴⁰ *Board of Taxation Review*, above n 31, 19 [3.14].

²⁴¹ Organisation for Economic Cooperation and Development.

²⁴² The United Kingdom, contrary to Australia, operates a schedular taxation system and accordingly, is not a particularly relevant model when considering reform in the context of a global taxation system.

²⁴³ Alan Judge and Casey Plunkett, 'New Zealand' (2012) 97b *Cahiers de Droit Fiscal International: The Debt-Equity Conundrum* 513, 524-5; Jodi Kelleher and Dean Kraus, 'Canada' (2012) 97b *Cahiers de Droit Fiscal International: The Debt-Equity Conundrum* 157; *Board of Taxation Review*, above n 31, 146 [10.29], 147 [10.31].

²⁴⁴ Kelleher and Kraus, above n 243, 158; *Shell Canada Ltd v Canada* [1999] 3 S.C.R 622, 641 [39] (McLachlin J).

classification, similar to Australia.²⁴⁵ Therefore, this paper compares the US and Australian approaches, in the context of differing methodologies within a substance based policy paradigm.

6.1 *The United States*

The approach to the debt-equity distinction in the world's largest economy stands a world apart from that of Australia. The United States has adopted through common law the so called 'facts and circumstances' approach to debt-equity classification,²⁴⁶ discussed earlier.²⁴⁷

Despite the US Internal Revenue Service ("IRS") possessing the power to promulgate regulations prescribing the manner in which the debt-equity distinction be drawn,²⁴⁸ there currently remains no fixed legal method of doing so.²⁴⁹ After experimenting with some specifically targeted regulation in this area some years ago, which was quickly abandoned before implementation,²⁵⁰ it would appear that the US has viewed the matter as a legislative minefield best avoided. However, there are a number of provisions designed both to frustrate abuses of the *Internal Revenue Code*²⁵¹ ("IRC") and resolve areas of confusion.²⁵²

The American approach has therefore been one that has evolved by courts filling the legislative void left by Congress and the IRS.²⁵³ The judiciary generally engages in an assessment of all facts and circumstances surrounding an instrument, including (but not limited to) matters such as expectation of repayment, creditor status, fixed maturity date, collateral requirements, debt-equity ratios, enforceability²⁵⁴ and management participation rights, in addition to the factors outlined previously.²⁵⁵

As courts have historically been careful not to give one factor disproportionate weight,²⁵⁶ all factors are equally weighed and a determination is subsequently

²⁴⁵ See part 4.2.1.

²⁴⁶ Edgar, above n 210, 305; Joe Dalton, 'How To Deal With Debt-Equity in the US' (2013) 24 *International Tax Review* 45.

²⁴⁷ See part 4.2.1.

²⁴⁸ *Internal Revenue Code* 26 USC § 385 (Cornell University Law School, 1992).

²⁴⁹ Diane Ring, 'United States' (2012) 97b *Cahiers de Droit Fiscal International: The Debt-Equity Conundrum* 771, 772.

²⁵⁰ *Ibid* 780.

²⁵¹ *Internal Revenue Code* 26 USC (Cornell University Law School, 1992).

²⁵² Ring, above n 249, 772.

²⁵³ Katherine Pratt, 'The Debt-Equity Distinction in a Second-Best World' (2000) 53 *Vanderbilt Law Review* 1055, 1067-7.

²⁵⁴ Considered to be a strong indicator of debt (creditor status), not equity. See Schön et al, above n 5, 191.

²⁵⁵ Ring, above n 249, 772; Joint Committee on Taxation, Congress of the United States, *Present Law and Background Relating to Tax Treatment of Business Debt* (2011) 16-7. See also part 4.2.1.

²⁵⁶ Pratt, above n 253, 1068; Wolfgang Schön et al, 'Debt and Equity: What's the Difference? A Comparative View' (Research Paper No 9, Max Planck Institute for Tax Law and Public Finance, 8 July 2009) 76; Thomas Greenway and Michelle Marion, 'A Simpler Debt-Equity Test' (2012) 66 *The Tax Lawyer* 73, 77; *Tyler v Tomlinson*, 414 F 2d 844, 848 (5th Cir, 1969); *John Kelley Co v Commissioner*, 326 US 489 (1943). The weighting of factors has been said to depend on the facts and circumstances of each individual case. See *NA General Partnership & Subsidiaries, Iberdrola Renewables Holdings, Inc. & Subsidiaries (Successor In Interest to NA General Partnership &*

made on whether the arrangement, as a whole, is to be debt or equity for tax purposes.²⁵⁷ Notably, the weighing process is designed to inform an assessment of *economic*, rather than legal, substance.²⁵⁸ This notion aligns the Australian and US approaches and expressly differentiates the approach of, for instance, the Canadian judiciary.²⁵⁹

The fact is that US taxpayers have enjoyed enormous liberty in the structure and classification of instruments.²⁶⁰ This is largely due to a raft of case law citing a myriad of relevant factors, that generally support any reasonable contention.²⁶¹ However there appears to be no appetite to curb that liberty even when it is invited. Intriguingly, in difficult situations, the IRS will generally not be amenable to issuing advance rulings on a debt or equity classification if one is requested, as they see the issue as a question of fact.²⁶² The onus is on the taxpayer to demonstrate why a compelling reason exists to do so.²⁶³ This view is a peculiar one and stands in stark contrast to the ATO, which is generally acquiescent to such a request. Arguably, the entire rationale of an advance ruling framework is to provide taxpayers with a binding opinion on the applicable law to the factual matrix at hand. It would seem the debt-equity divide is one area that the IRS does not employ the aggressive stance to which it is internationally renowned. It would also seem to indicate that a 'facts and circumstances' regime may operate with greater certainty in Australia.

However, the US has attempted over time to curtail the broad freedom afforded to taxpayers with a collection of targeted tax rules that affect specific aspects of the debt-equity framework. These rules are somewhat confined in their reach. For instance, earnings stripping rules²⁶⁴ exist to prevent entity owners from extracting profit via loans (and the interest payable on such) to reduce taxable income.²⁶⁵ In practise, section 163(j) IRC cancels most or all of an interest deduction if gearing is unacceptably high and the related party incurs no tax liability on that interest.²⁶⁶ Other targeted abuse rules include denial of deductions (in excess of USD 5 million) on high risk debt issued to fund corporate stock or assets, in cases where

Subsidiaries) v *Commissioner of Internal Revenue* (United States Tax Court, 525-10, 19 June 2012) 17.

²⁵⁷ Fry and Schwartz, above n 87, 10 [4.3].

²⁵⁸ *Hardman v. United States*, 827 F 2d 1409, 1411 (9th Cir. 1987).

²⁵⁹ Kelleher and Kraus, above n 243, 158.

²⁶⁰ Schön et al, above n 5, 189.

²⁶¹ Ibid; Adam Emmerich, 'Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation' (1985) 52 *University of Chicago Law Review* 118, 121; *Estate of Mixon v United States*, 464 F 2d 394 (5th Cir, 1972); *Fin Hay Realty Realty Co. v United States*, 398 F 2d 694 (3d Cir, 1968); *Roth Steel Tube Co. v Commissioner*, 800 F 2d 625 (6th Cir, 1986); *NA General Partnership & Subsidiaries, Iberdrola Renewables Holdings, Inc. & Subsidiaries (Successor In Interest to NA General Partnership & Subsidiaries) v Commissioner Of Internal Revenue* (United States Tax Court, 525-10, 19 June 2012).

²⁶² Ring, above n 249, 781; Joint Committee on Taxation, above n 255, 15.

²⁶³ Ring, above n 249, note 35.

²⁶⁴ *Internal Revenue Code* 26 USC § 163(j) (Cornell University Law School, 1992).

²⁶⁵ Ring, above n 249, 784.

²⁶⁶ Ibid.

the debt is either subordinated, has conversion rights or the issuer is highly geared.²⁶⁷ As is evident, these rules treat symptoms and not the cause. Another unique aspect of the US regime is the stipulation in section 385(c)(1) IRC that the characterisation of an instrument by the issuer at issuance is binding on both issuer and holder(s). However, if a holder is to treat the instrument differently, that inconsistency must be disclosed on their income tax return.²⁶⁸ Further, section 385(a) IRC was introduced in 1989 allowing bifurcation of an instrument.²⁶⁹ This seems to be another unutilised concept, with only a few cases applying the legislation.²⁷⁰ Convertible bonds for instance, a key candidate for a bifurcation scheme, are treated in the US as simple debt until conversion takes place (pursuant to IRS regulation), essentially abrogating the need to bifurcate.²⁷¹ The Australian regime includes no analogous rules.

In the context of this comparative analysis, attention should be given to the fact that the US experimented and spectacularly failed with debt-equity line drawing²⁷² some fifteen years before Australia's Division 974 enactment.²⁷³ Although the rules were not nearly as detailed or wide ranging as Division 974, the approach targeted hybrids and had hallmarks of a very similar classification method suggested in the RBT Discussion Paper.²⁷⁴ In essence, the regulations allowed debt characterisation provided that fixed payments amounted to more than half of the instrument's (presently valued) cost.²⁷⁵ Clearly, the scheme was wide open to abuse (it was obviously not difficult to ensure the quota was reached) and the IRS withdrew the regulations after having admitted as much.²⁷⁶ The scheme was also heavily criticised for its complexity and lack of comprehensiveness.²⁷⁷

The problem with the US method is that the purity of the scheme has proved problematic for the IRS. Despite possessing a considerable arsenal to redesign the architecture, its response has been reactionary to a predictable push by the profession to manipulate the loose system carefully²⁷⁸ to ensure a desirable result for taxpayers. This has been the case even when targeted rules have been introduced,²⁷⁹ which has required US Governments to hose down spot fires on many fronts as they come to pass.²⁸⁰ Despite this, there still remains no identifiable path for specific reform in the US, notwithstanding the debt-equity problem attracting significant attention.²⁸¹ Some commentators argue that this

²⁶⁷ Ibid 787; *Internal Revenue Code* 26 USC § 279 (Cornell University Law School, 1992).

²⁶⁸ *Internal Revenue Code* 26 USC § 385(c)(2) (Cornell University Law School, 1992); Joint Committee on Taxation, above n 255, 18.

²⁶⁹ Joint Committee on Taxation, above n 255, 19.

²⁷⁰ Schön et al, above n 256, 78.

²⁷¹ Joint Committee on Taxation, above n 255, 18.

²⁷² Ibid 19; Pratt, above n 253, 119.

²⁷³ *A New Business Tax System (Debt and Equity) Act 2001* (Cth).

²⁷⁴ *RBT Discussion Paper*, above n 31, 202 [7.22].

²⁷⁵ Emmerich, above n 261, 130.

²⁷⁶ Ibid 132.

²⁷⁷ Schön et al, above n 256, 80.

²⁷⁸ Ring, above n 249, 788.

²⁷⁹ Ibid.

²⁸⁰ Ibid.

²⁸¹ Ibid 791.

attention has morphed into what could be construed as a single organising principle: do the parties to the transaction reasonably expect the funds would be repaid in full?²⁸² Greenway and Marion suggest that the entirety of the 'facts and circumstances' approach is encapsulated within that single principle, whereas in contrast, loosely articulated multifactor tests have inherent stability problems.²⁸³ Indeed, the US judiciary has expressed similar sentiments about multifactor tests in a different context, with Judge Posner noting:

multifactor tests with no weight assigned to any factor are bad enough from the standpoint of providing an objective basis for a judicial decision; multifactor tests when none of the factors is concrete are worse.²⁸⁴

It is true to say, though, that the multifactor test has suffered due to the US judicial structure²⁸⁵ and the unclear way in which state and federal governments regulate tax and corporate law.²⁸⁶ The considerable problem of inconsistent judgements²⁸⁷ would not be a transferrable one if Australia adopted a 'facts and circumstances approach', as the architecture of the Australian court hierarchy and the coherence of binding precedent removes this issue. Further, the fact the US still imposes double taxation on companies²⁸⁸ is yet another motivation for arbitrage in the US. This problem would not exist in an Australian iteration of 'facts and circumstances' classification.²⁸⁹

In essence, the Australian regime has the opposite problem to the US. Australia no longer requires the enactment of specific debt-equity abuse rules, given the all encompassing substance-based nature of Division 974. Indeed, the complaint from the profession is that the ENCO definition and Division 974 are perhaps too detailed and narrow in their scope of relevant factors.²⁹⁰ Conversely, the US experience is that the multitude of relevant categorisation factors have produced an expansive and illusive landscape that regulators have struggled to contain. Regardless of US commentators reflecting upon the 'facts and circumstances' approach as unpredictable,²⁹¹ unclear and overly flexible from a taxpayer perspective,²⁹² there are some commendable aspects. Although the method is internationally unique,²⁹³ it is without doubt the best way of giving due consideration to all aspects of an arrangement before characterising an instrument. Classifications contrary to the substantive nature of an instrument appears to be a largely non-existent issue in the US, save for arrangements that amount to a sham or are abuses that the IRS has curtailed with specific rules. Hence, in order to achieve an equilibrium of efficiency, certainty and clarity, a legislative test that codifies some (but not all) of the US classification factors, in accordance with an

²⁸² Greenway and Marion, above n 256, 74.

²⁸³ Ibid 80.

²⁸⁴ Ibid 80 citing *Menard, Inc. v Commissioner*, 560 F 3d 620, 622-3 (7th Cir. 2009).

²⁸⁵ Ibid 80.

²⁸⁶ Schön et al, above n 256, 75.

²⁸⁷ Ibid 80-1.

²⁸⁸ Schön et al, above n 5, 196.

²⁸⁹ Australia removed the issue of double taxation of corporate profits several years ago, upon introduction of the imputation system.

²⁹⁰ Frost and Cooper, above n 78, 5; See also part 4.5.

²⁹¹ Greenway and Marion, above n 256, 80.

²⁹² Emmerich, above n 261, 127-8.

²⁹³ Brown, above n 140, 33.

organising principle, may indeed be a harmonious outcome in the Australian context.

VII WHERE TO FROM HERE - RECOMMENDATIONS FOR REFORM

This paper has critiqued the current form of the Australian debt-equity rules and the various methodologies of drawing the distinction, both in theory and in practice globally. An apparent fact is that further reform is required in respect of the Australian regime to increase confidence and certainty surrounding the classification of hybrid financial instruments. As a result of the poor structuring and drafting of Division 974, the single organising principle that the regime is based upon lacks the prominence it deserves. Secondly, the legislation is designed in a strange manner whereby testing for debt and equity occur disjunctively; which is manifestly unhelpful for a classification regime. These factors, it is argued, are the source of much of the uncertainty inherent in the Australian debt-equity classification framework.

Moreover, the sheer lack of judicial guidance stemming from the ATO rulings regime requires near perfection in the drafting of provisions that draw lines in the debt-equity spectrum. As such, this paper puts forward two proposals to ensure the debt-equity divide in Australia is as certain as possible for taxpayers. Although the United States 'facts and circumstances' approach has certain benefits, it would seem the regime, like Division 974,²⁹⁴ is not simply replicated across jurisdictions. The only method of adopting such in Australia would be to codify the principles developed in US case law over decades into the *ITAA 1997*. However, Division 974 is already founded on a prominent factor of the US regime: the right or expectation of the holder to repayment, which is a common underpinning principle globally.²⁹⁵ As such, it would seem that an entire departure from the current legislative framework, save for harmonisation with accounting standards, would be an unhelpful development and may exacerbate uncertainty.

7.1 Alignment with Accounting Principles

It is argued that the only way in which uncertainty will be completely removed is by harmonising the accounting and taxation treatment of debt-equity hybrids. By their very definition, hybrid instruments are combinations of multiple debt and/or equity instruments. Capturing the true character of an instrument for tax purposes will seemingly never be achieved if an instrument is not bifurcated and the component parts treated separately for tax purposes. Furthermore, the Australian tax law has sporadically relied on financial accounting concepts over time. Courts have had regard to accounting treatment prior to Division 974²⁹⁶ and notably, the TOFA regime currently relies on AASB standards to measure consequences of debt-equity classifications that are financial arrangements for the purposes of that

²⁹⁴ Brown, above n 140, 41.

²⁹⁵ Ibid 42.

²⁹⁶ However the High Court has historically stopped at allowing commercial and accounting rules to usurp legislation, despite relying on them to inform the nature of a transaction. See *Arthur Murray v Federal Commissioner of Taxation* (1965) 114 CLR 314, 320 (Barwick CJ, Kitto and Taylor JJ).

regime.²⁹⁷ Hence, the suggestion that accounting concepts are not appropriate for tax classification of debt-equity hybrids is a strange one. Indeed, the 1996 Issues Paper on Taxation of Financial Arrangements recommended further harmony with Generally Accepted Accounting Principles (GAAP),²⁹⁸ however this goal seemed to be, perhaps incorrectly, departed from in respect of debt-equity classification. Classifying instruments for tax purposes in accordance with AASB 132 would also seem a better method of targeting the economic substance of the arrangement. Division 974 has the unfortunate problem of not ever being able to classify a hybrid pursuant to what it essentially is, given it operates to classify instruments in aggregate form.

It would therefore seem that adopting financial accounting treatment of hybrids, which is also based on an economic substance approach, has several benefits. Firstly, the difficult goal of targeting economic substance via a blanket method, whilst trying to avoid unintended classifications, becomes redundant. There is no apparent need for highly detailed legislation to ensure a somewhat contrived test for debt and equity operates with stability. Further, economic imbalances that stem from having asymmetrical tax and accounting treatment of the same instrument are eliminated.

In addition, most if not all entities subject to tax are profit driven. It is therefore an inconvenient truth that tax minimisation and avoidance strategy will be an everlasting quandary for regulators where there is legislation to be manipulated. However, harmonisation of debt-equity tax classification with AASB 132 removes the ability of taxpayers to disguise debt as equity and vice versa, given debt and equity components are treated disjunctively regardless of an instrument's aggregated form. Both the temptation and need to engage in intricate and detailed instrument design would likely be nullified.

It is important that the manner in which harmonisation is achieved is given careful consideration. In order to avoid effective delegation of the law making function of Parliament to the AASB,²⁹⁹ classification rules contained in AASB 132 will have to be replicated into the *ITAA 1997* as opposed to mere incorporation of the standard into law. Replication will ensure taxpayers have certainty as to the stability of the legislation and that adjustments to the framework would require an amending act as opposed to unilateral amendment by the AASB.

7.2 Restructure of Division 974

This alternative is essentially a second-best option. It appears unlikely that Parliament will be inclined to stray too far from the existing legislative framework, notwithstanding the current Board of Taxation Review. The grounding of Australia's single organising principle is sound in that investments are seldom made where loss on the initial outlay is suspected.³⁰⁰ It is therefore suggested that the operative classification provisions be redesigned to provide

²⁹⁷ Stanley, above n 32, 80.

²⁹⁸ *1996 Issues Paper*, above n 1, 45.

²⁹⁹ Edgar, above n 210, 132.

³⁰⁰ William Natbony, 'Worthlessness, Debt-Equity and Related Problems' (1981) 32 *Hastings Law Journal* 1404; Schön et al, above n 5, 160.

greater certainty. However it should be noted that the following recommendations consider the core classification tests in isolation. Reform to ancillary rules and definitions in Division 974, such as the reassessment and integrity provisions, are beyond the scope of this paper. Although, it is argued that Division 974 requires significant reduction to basic principles rather than pages of vague provisions that add to the uncertainty that they attempt to solve.

The current architecture of Division 974 would appear to be poorly crafted. It has a number of limbs that do not interact neatly. A classification framework that begins with hurdle definitions of 'scheme', 'debt interest' and 'equity interest', which then requires satisfaction of one or both of the debt and equity tests, is disjointed and requires remodeling. The single organising principle has been expanded so widely by other provisions that it has been lost in a myriad of complexities at the fringes.

In addition to the restructure outlined below, further amendments are needed. One notable one is the removal of the wide ranging power of the Commissioner to make determinations of debt interests notwithstanding a Division 974 classification.³⁰¹ The Commissioner already has sufficient means of targeting specific abuses.³⁰²

7.2.1 Form of Proposed Restructure

Element 1 - Does a 'financing scheme' exist?

The existence of a 'financing scheme' would be the first hurdle requirement. As previously mentioned, 'scheme' is currently widely defined.³⁰³ This definition should be shortened to 'arrangement, plan or course of action whether unilateral or otherwise'. There is no need for unhelpful synonymous terms and there is certainly no need to define 'scheme' as a scheme. Utilising the new term 'financing scheme' also prevents inconsistency caused by the unhelpful recycling of defined terms across interacting legislation.³⁰⁴

A second limb should also be inserted to ensure all relevant equity or debt interests' fall within the ambit of the regime. A stipulation that a scheme has the consequence of availing finance or capital to an entity, in the form of:

- a) money, or
- b) liquid financial or monetary asset

would be sufficient. Doing so would conceivably remove the need for a separate definition of 'financing arrangement'.³⁰⁵

Element 2 - Is there an ENCO?

³⁰¹ See Chapter III.

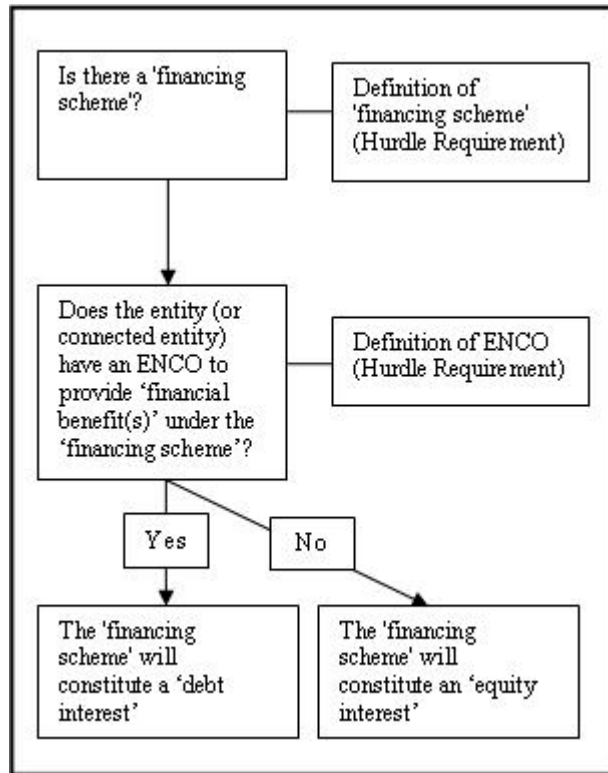
³⁰² For instance, the GAAR. See *Income Tax Assessment Act 1936* (Cth) Part IVA.

³⁰³ *ITAA 1997* s 995-1(1).

³⁰⁴ For instance, the definition of 'scheme' within the *Income Tax Assessment Act 1936* (Cth) differs from that of the *ITAA 1997*.

³⁰⁵ *ITAA 1997* s 974-130. This concept currently sits within the debt and equity tests in s 974-20 and s 974-75 respectively. Placing it within the definition of 'financing scheme' ensures transactions not intended to interact with the rules are rebuffed via the first inquiry. It may also remove some of the issues caused by the decision of Justice Edmonds in *Blank v Federal Commissioner of Taxation* [2014] FCA 87. See Australian Bankers Association, Submission to The Board of Taxation, *Review of the Debt and Equity Tax Rules*, May 2014, 5-7.

The next inquiry should be whether an ENCO exists. The existence of an ENCO will give rise to a 'debt interest' and the absence of such will indicate an 'equity interest'. The current definitions of both equity and debt interests³⁰⁶ would require amendment to reflect that the outcome of the redesigned ENCO test (not the current debt and equity tests)³⁰⁷ determines the classification of a 'financing



scheme'.

It has been stated earlier that the design of a single determinative principle is critical to ensure it stays a *single* principle, or as close to such as possible. As the ENCO concept embodies the central principle in which Division 974 is meant to pivot, it deserves a greater role.

Restructuring the division in the manner illustrated in the graphic would ensure the single organising principle makes the determination of classification, as opposed to the satisfaction of one or both of the debt and equity tests. Moreover, the role of tiebreaker provisions becomes redundant when the legislation is structured in the suggested form.

The definition of 'financial

benefit' for the purposes of the ENCO test should remain in its current form, although the stipulation that an equity interest does not constitute the provision of a financial benefit³⁰⁸ should be repealed. This will ensure that current structures that fail the ENCO test due to, for instance, the issuer holding the conversion right³⁰⁹ would fall within the ambit of the redesigned regime.

Secondly, it is argued that the enquiry of 'pricing, terms and conditions' be expanded to include explicit consideration of whether the holder has the right to creditor status at any time during the life of the scheme, or alternatively, on winding up. The inclusion of such a consideration effectively pinpoints the 'in substance' distinction between debt and equity finance and strengthens the core economic substance objective of the legislation, without having to resort to a full 'facts and circumstances' assessment.

Thirdly, s 974-135(1) should be restructured to avoid confusion and interpretive uncertainty surrounding the phrase 'in substance or effect' and its relationship to 'obligation'. By separating out 'obligation' and splitting this phrase into two distinct limbs, aided by a qualifer, as follows:

³⁰⁶ ITAA 1997 ss 974-15, 974-70.

³⁰⁷ Ibid ss 974-20, 974-75.

³⁰⁸ Ibid s 974-30(1).

³⁰⁹ See part 3.3.

(1) ...an obligation:
(a) in substance, or
(b) in effect
that is non-contingent...

(1A) Without limiting subsection (1), 'obligation' for the purposes of this section is not confined to a legally enforceable obligation.

the intention of s 974-135(1) is evinced, as legal obligations and non-legal obligations, or lack thereof, are obviously captured.

Fourth, s 974-135(3) should be redrafted in the following manner:

(3) An obligation is **non-contingent** if it is not contingent on any event, condition or situation.

(3A) Without limiting subsection (3):

(a) an event, condition or situation includes the economic performance of the entity having the obligation or a connected entity of the entity; and
(b) the ability or willingness of the entity or connected entity to meet the obligation is disregarded.

This amendment would likely appease the existing interpretive uncertainty discussed previously.³¹⁰

Furthermore, ss 974-135(4) and (6) should be removed. It is difficult to see how an ENCO would not exist regardless of the option of conversion, or how an artificial or contrived contingency would survive a purposive interpretation of the 'in substance or effect' test.³¹¹

In respect of s 974-135(7), this section should also be removed.³¹² The tensions with s 974-135(1) are severe and to that extent, it has no useful role to play in the division that is not already inherent in s 974-135(1). By s 974-135(1) stating 'pricing, terms and conditions of the scheme',³¹³ concerns regarding detrimental or practical consequences indirect to the scheme itself are already addressed.

VIII CONCLUSION

Notwithstanding the comparatively small size the Australian economy, the prominence of the hybrid market places paramount importance on the success of the debt-equity distinction.³¹⁴ The apparent drafting and certainty issues with Division 974 and, in particular, the ENCO concept, are undoubtedly factors that

³¹⁰ See part 2.3.1.

³¹¹ Zhang, above n 47, 20. Especially in the redesigned form.

³¹² Despite the Commissioner outlining the correct interpretation of the provision. See *TR 2010/5*, above n 90.

³¹³ Or 'financing scheme', in the redesigned form.

³¹⁴ Paul Ali, 'The Accounting and Taxation Regulation of Hybrid Securities' (2006) 24 *Corporate and Securities Law Journal* 186. See also Huang, above n 13, 10.

spurred the current Board of Taxation review. When the single determinative factor envisaged by the RBT Final Report was so widely expanded by unclear supplementary provisions, Division 974 has had the unfortunate consequence of breathing new life into the very uncertainty it was meant to solve. Therefore, further reforms are needed in Australia to ensure the original objectives of the 2001 reforms are achieved. This paper has argued two methods of accomplishing such a result. First, that harmonisation of accounting and taxation treatment of debt-equity hybrids be adopted. In the alternative, a redesign of Division 974 should be undertaken to place greater emphasis on the single organising principle – the effective obligation to return at least the original investment to the investor. Albert Einstein once said that the hardest thing in the world to understand is the income tax.³¹⁵ In light of that observation, it is incumbent on policymakers to ensure tax legislation is as certain and robust as it can be.

³¹⁵ Internal Revenue Service, *Tax Quotes* (10 March 2014) < <http://www.irs.gov/uac/Tax-Quotes>>.

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