IDENTIFYING HYBRIDS IN AUSTRALIA

COMPARING THE TOFA DEBT AND EQUITY RULES AND AASB 132 FOR A DEFINITION OF SHAREHOLDING

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When corporations require financing, there are typically two methods — debt and equity. The return from debt financing is interest, which gives rise to a tax deductible expense for the company issuing the debt. Equity financing returns dividends, which are non-tax-deductible distributions of profit. Corporations may issue hybrid securities such as preference shares, convertible notes, profit sharing loans and perpetual loans for profit maximisation and tax minimisation. In turn, the holders of financial instruments may, for purposes such as tax planning, assign rights from an instrument, which may change the nature of the instrument and consequently, the relationship of the holder to the corporation. This paper is a comparative study of debt and equity rules in the Taxation of Financial Arrangements (TOFA) regime in Division 974 of the Income Tax Assessment Act 1997 (ITAA 1997) and the provisions in AASB 132. The focus of this study is to look at instruments that are either in form or in substance equity and their different treatments under accounting and tax rules in Australia, thereby identifying a more appropriate definition of shareholding for businesses to comply with in Australia.

INTRODUCTION

When corporations require financing, there are typically two methods — debt and equity. The return from debt financing is interest, which gives rise to a tax-deductible expense for the company issuing the debt. Corporations issue debt instruments such as debentures to fulfil debt-financing needs. In equity financing, dividends — non-tax-deductible distributions of profit — are raised by equity financial instruments such as ordinary shares. For profit maximisation and tax minimisation purposes, corporations may issue instruments that exhibit qualities of both, known as hybrid securities: examples include preference shares, convertible notes, profit sharing loans and perpetual loans. In turn, the holders of these financial instruments may, for tax planning reasons, assign rights from an instrument, which may change the nature of the instrument, and thus change the relationship of the holder to the corporation.

There is an increasingly prevalent trend for corporations to issue hybrid securities for financing purposes. This paper is a study of the debt and equity rules which companies have to comply with in Australia. It is a comparison between financial accounting standards, namely the definitions in AASB 132 and the tax law embodied in Division 974 of the ITAA 1997, commonly known as the debt and equity provisions of the TOFA regime. The focus of this study is to look at instruments that are either in form or in substance equity and their different treatments between the two sets of regulations, which allow for cross-regulatory arbitrage. [1] This comparison will help define shareholding, which will clarify the tax consequences for the corporation raising the finance and the holder of the financial instrument.

DEBT, EQUITY AND HYBRID

Empirical evidence[2] has shown that financially healthy companies, in terms of the liability to Owners' Equity ratio and Asset to Liability ratios from their balance sheets, issue equity-like hybrids after they have reaped the benefits of debt, and less leveraged companies issue debt instruments as they are in the position to do so. This evidence shows that companies choose to use hybrid instruments to either increase shareholding or debt level. The Debt to Equity distinction plays a crucial role in financing decision-making, and tax is a large contribution factor.[3] It
contributes in three ways:

1. On the part of the individual's income. The debt-equity divide is taken into account when distinguishing whether the person is in business/carrying on trade[4], or whether the person is deriving income from a debt claim.[5]

2. On the part of the company, the divide is clear when considering the classical system, where the corporation is taken to be a person, who came into existence from contracts, making it a taxpayer of its own right. It earns income, and its owners (shareholders) earn income from it, thus return on equity has been taxed twice [6]. Similar notions can be deducted from the imputation system and variations of the classical system with dividend relief or tax relief for the company.[7]

3. Internationally[8]. This paper will, however, narrow its ambit to the comparison of domestic tax regimes in the United Kingdom (UK), United States (US) and Australia. For the purpose of identifying a workable definition of shareholding based on debt and equity rules, it is necessary to refer to the definition of debt, equity and hybrid financial instruments commonly used in the commercial/financial world: one that is not legal, but based on economic substance[9] and commercial decision-making.

Generally, equity is viewed as the ownership interest in a business, where the holder of the interest permanently contributes funds to the company. There is no obligation for the company to repay the contribution, the interest holder has voting rights, they participate in profit-sharing and receive the residual value of the assets in the event of the failure of the company[10]. Debt represents a contractual claim on the issuer (company) to make specified payments over a specified term, and debt interests take priority over equity interests in the event of liquidation[11].

Hybrid securities are 'market-based instruments with debt and equity characteristics' [12], ratings agencies view hybrid securities in terms of the capacity of the instrument to generate 'equity credit':

- An obligation to make ongoing payments,
- Maturity, and
- Priority at liquidation[13]

Such a concept of equity is very important as a contributing factor to the definition of shareholding. The lesser the obligation to make ongoing payments, closer to perpetuity (no maturity) and the lower in priority for residual interest in assets at liquidation, the greater the likelihood of the security exhibiting equity characteristics. The following is a continuum of hybrid securities that generates different 'equity credit' adapted from Warren's paper[14]:

Equity →		Hybrid →					Debt
Ordinary Shares	Preference Shares	Redeemable Preference Shares	Convertible Stapled Instrument	Perpetual Debt	Subordinated Debt	Unsecured Debt	Secured Debt

Since the purpose of this paper is to find a definition of shareholding, the grey area is the focus.

THE TOFA REGIME

Empirical evidence has shown that the Australian market for hybrid securities has been engaging in rapid innovation in instrument design, which reflect the international experience, as the securities are targeted at an increasing rate at a retail investor audience rather than traditional corporate bond offerings, which has biased the instruments to have higher yields[15].

The features of key hybrid security sub-classes issued in Australia include[16]:

- Income securities which are perpetual securities with regular interest or coupon payments, which are only redeemable at the option of the issuer. (The perpetuity makes it look like shareholding).

- Perpetual step-up securities similar to income securities, except that the interest payment on the security increases if the issuer does not redeem the security on a certain date. (The increase in interest payment returns some debt features to the income security)

- Reset convertible preference shares/notes, where the issuer has the option to change the terms or redeem the securities on a predetermined date. The investor has the option to accept the new terms of the security, or to request an exchange. If an exchange is requested, the issuer decides whether it is for ordinary shares or cash.

(This is a hybrid that may be characterised as either debt or equity depending on the converted result).

In Australia, debt and equity for tax purposes are defined very clearly in Stage 1 of the Taxation of Financial Arrangement regime under Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997). The ITAA 1997 defines 'Company' in s 995-1:

A company means:
(a) a body corporate; or
(b) any other unincorporated association or body of persons; but does not include a partnership or a non-equity joint venture.

any other unincorporated association or body of persons; but does not include a partnership or a non-equity joint venture.

Mackenzie[17] in his paper surveyed the effects of the debt and equity rules on the Australian hybrid market. He targeted the period before 1999 and from 2001 to reflect the effects of those rules, especially on income securities[18], which have debt-like characteristics but no end date. The analysis was that the Australian debt/equity rules for tax purposes are to date effective, and hybrids drafted after the operation of Division 974 are all within the policy intent of the division.

The following is a survey of the Australian debt/equity rules under Division 974. The object of the Division is clearly specified in s 974-10. The note in subs(1) identifies clearly that the Division will prescribe clearly the characteristics of shareholding and debt holding. This paper looks at the debt test in relation to the equity test to establish the characteristics that do not contribute to shareholding in Australia.

Section 974-10(2) specifically provides that the test applied is based on economic substance rather than mere legal form, and the concept of 'scheme' defined in s 995 is used throughout the Division. Note 1 prescribes for the basic indicator of the economic character of a debt interest, which is the non-contingent nature of the returns — there is an obligation to pay. The basic indicator of the economic character of an equity interest is the contingent nature of the return or the convertibility into an interest of that nature; similar to the view taken in the UK, it is defined by the nature of the interest for the final beneficiary of the financial instrument. Examples were given in Note 2 to include denying deductibility for returns on schemes with the legal form of a loan but having returns exhibiting characteristics of an ordinary share dividend, and allowing deductions for returns on schemes showing characteristics of interest of a loan.

The Division's starting point is the identification of a debt interest in relation to an entity (debt interests), equity interests in relation to an entity (equity interests) are identified as interests that cannot be characterised as debt interests in s 974-70(1)(b).

Section 974-15 defines a debt interest in terms of single scheme and related schemes. For a single scheme to give rise to a debt interest, it has to satisfy the debt test in subs 974-20(1) when it comes into existence[19]. In terms of related schemes (the constituent schemes), subs 974-15(2) provides that together they give rise to a debt interest, under the following circumstances:

(a) the entity enters into, participates in or causes another entity to enter into or participate in the constituent schemes; and

(b) a scheme with the combined effect or operation of the constituent schemes (the notional scheme) would satisfy the debt test in subs 974 20(1) in relation to the entity if the notional scheme came into existence when the last of the constituent schemes came into existence; and

(c) it is reasonable to conclude that the entity intended, or knew that a party to the scheme or one of the schemes intended, the combined economic effects of the constituent schemes to be the same as, or similar to, the economic effects of a debt interest.

This is so whether or not the constituent schemes come into existence at the same time and even if none of the constituent schemes would individually give rise to that or any other debt interest.

Subsection 974-15(4) gives the Commissioner discretion to determine when related schemes do not give rise to a debt interest. Subsection 974-15(5) prescribes the criteria for the Commissioner's discretion to include the 'purpose' and 'effects' of the schemes, the 'rights and obligations of the parties to the schemes', 'whether the schemes … provide the basis for, or underpin, an interest issued to investors with the expectation that the interest can be assigned to other investors', 'whether the schemes … comprise a set of rights and obligations issued to investors with the expectation that it can be assigned to other investors' and 'any other relevant circumstances'. In every instance, the Commissioner must consider the schemes both individually and in combination in exercising his power to make a determination.

Section 974-20 is the test for a debt interest. A scheme satisfies the test under subs 974-20(1) if:

(a) the scheme is a financing arrangement[20] for the entity (defined in s 974-130); and

(b) the entity, or a connected entity of the entity, receives, or will receive, a financial benefit[21] under the scheme[22] ; and

(c) the entity or the entity and a connected entity has an effectively non-contingent obligation under the scheme to provide a financial benefit or benefits to one or more entities[23].

Subs 974-20(1) (d) and (e) provide for the value provided and received; they are more likely than not to equal and they both cannot be nil. Section 974-25 lays out the exceptions to the debt test, which include the financial benefit not being a liquid or monetary asset, an amount of money, or a combination of both; and rules on the timing of the provision and receipt of financial benefits.

Section 974-30 are rules on providing a financial benefit, subs(1) prescribes that issuing equity interests do not constitute providing a financial benefit. Subsection 974-30(2) takes the financial benefit to be provided to an entity, when it is provided to the entity, or on its behalf, or for its benefit.

Section 974-65 gives the Commissioner power to determine when a scheme gives rise to a debt interest where the scheme does not satisfy the criteria in subs 974-20(1)(d) if in the Commissioner's view[24]:

(i) it is substantially more likely than not that the value of the financial benefit to be provided by the entity (or a connected entity of the entity) under the effectively non contingent obligation will be at least equal to the substantial part of the value of the financial benefit received or to be received by the entity (or its connected entity) under the scheme;

(ii) it is substantially more likely than not that other financial benefits will be provided by the entity (or its connected entity) to one or more entities under the scheme;

(iii) it is substantially more likely than not that the sum of the values of the financial benefits mentioned in subparagraphs (i) and (ii) will be at least equal to the value of the financial benefit received by the entity (or its connected entity) under the scheme.

Section 974-70 defines an equity interest in terms of a single scheme and related schemes. For a single scheme to give rise to an equity interest, it has to satisfy the equity test in s 974-75 when it comes into existence [25] and it is not a debt interest, nor part of a debt interest[26]. In terms of related schemes (the 'constituent schemes'), subs 974-70(2) provides that they are taken together to give rise to an equity interest under circumstances similar to those referred to in s 974-15 for a debt interest.

Subsection 974-70(4) gives the Commissioner discretion to determine when related schemes do not contribute to an equity interest, whilst subs 974-70(5) prescribes the criteria for the Commissioner's discretion similarly to subs 974-20(5).

Section 974-75 is the equity test, which is the tax law's answer to shareholding. There are four items of interest as defined in subs 974-75(1) which include:
(1) An interest in the company as a member or stockholder of the company';

(2) An interest that carries a right to a variable or fixed return from the company if either the right itself, or the amount of the return, is in substance or effect contingent on the economic performance (whether past, current or future) of:
(a) the company; or
(b) a part of the company's activities; or
(c) a connected entity of the company or a part of the activities of a connected entity of the company.
The return may be a return of an amount invested in the interest.

(3) An interest that carries a right to a variable or fixed return from the company if either the right itself, or the amount of the return, is at the discretion of:
(a) the company; or
(b) a connected entity of the company.
The return may be a return of an amount invested in the interest'; and

(4) An interest issued by the company that:
(a) gives its holder (or a connected entity of the holder) a right to be issued with an equity interest in the company or a connected entity of the company; or
(b) is an interest that will, or may, convert into an equity interest in the company or a connected entity of the company.

Subsection 974-75(2) provides that the scheme has to give rise to a financing arrangement; this is similar to the provision in the debt test. Subsection 974-75(6) looks at related party at call loans that may be characterised as equity interests (shareholding).

Section 974-85 defines 'right or return contingent on economic performance', which is of vital importance in characterising equity interest, hence shareholding. Subsection (1) negates two issues that may on the surface contribute to the definition, where the entity may be able or willing to meet the obligation to satisfy the right to the return; or the receipts or turnover are of the entity or generated by those activities. Subsection (2) and (3) allow the regulations to prescribe when a right or return is or is not contingent on the economic performance of an entity or a part of an entity's activities. Subsection (4) allows the regulations to characterise an interest away from equity on a factual basis according to how much contingency there is and the significance of the contingency.

Section 974-100 treats the interest arising from convertible and converting interests as a new interest. This is consistent with the view of the IFRS, as discussed in paragraphs 28 and 29 of AASB 132, discussed later in the paper.

Section 974-110 provides that the characterisation of the scheme may change as the interest changes. Hence shareholding may come into existence or leave the company as the characterisation of the financial instruments (schemes) change.

Section 974 130 defines 'financing arrangement' to include activities that are in substance raising finance for a company. Examples were given in subs(2) to include a bill of exchange, income securities and a convertible interest that will convert into an equity interest.

Section 974 160 (1) defines 'Financial Benefit':
(a) means anything of economic value; and
(b) includes property and services; and
(c) includes anything that regulations made for the purposes of subsection (3) provide is a financial benefit;
even if the transaction that confers the benefit on an entity also imposes an obligation on the entity.

The benefits and obligations are to be looked at separately and not set off against each other .

Section 974-165 defines convertible and converting interests.

The provisions in Division 974 do conform to the economic substance over form approach. Since it came into effect in 2001, the tax administrative effects are still relatively unclear[28].

DEFINITIONS IN THE INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

Empirical research has shown that the AASB 132 definition allows deviation from a substance over form approach, and annual financial statements arising from following these standards may be seriously misleading[29]. Financial accounting has a different purpose to taxation — unlike the public purpose for revenue collection, financial accounting is the means of record keeping to satisfy a private purpose[30].

Paragraph 11 in AASB 132 defines different financial instruments that assist the definition of shareholding. The financial instruments are categorised into financial assets, financial liabilities and equity instruments. Financial assets are not the focus of this paper as they do not contribute to the raising of capital and consequently affect the definition of shareholding.

According to Paragraph 11, AASB 132:

> A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. …
>
> A *financial liability* is any liability that is:
>
> (a) a contractual obligation :
> (i) to deliver cash or another financial asset to another entity; or
> (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
>
> b) a contract that will or may be settled in the entity's own equity instruments and is:
> (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
> (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.
>
> As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.
>
> An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

This is the interest of shareholders, thus is the definition of shareholding for accounting purposes. The accounting standard takes an economic substance view[31] in relation to characterisation of financial instruments.

Paragraph 15 specifies:
The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.

Paragraph 16 looks clearly at what constitutes an equity instrument, given rise to shareholding:
When an issuer applies the definitions in paragraph 11 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

(a) The instrument includes no contractual obligation:
(i) to deliver cash or another financial asset to another entity; or
(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:
(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also for these purposes the issuer's own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 16A and 16B or paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.

The standard also specifically prescribes that the following instruments are equity instruments, thus giving rise to shareholding:

Paragraph 16A refers to puttable financial instruments that include 'a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put' and have the following features:

(a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:
(i) dividing the entity's net assets on liquidation into units of equal amount; and
(ii) multiplying that amount by the number of the units held by the financial instrument holder.

(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:
(i) has no priority over other claims to the assets of the entity on liquidation, and
(ii) does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.

(c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.

(d) Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, and it is not a contract that will or may be settled in the entity's own equity instruments as set out in subparagraph (b) of the definition of a financial liability.

(e) The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument).

Paragraph 16B prescribes that in order for an instrument that meets paragraph 16A to give rise to shareholding, the issuer must not have other financial instrument or contract that has:

(a) total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract) and
(b) the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of an instrument described in paragraph 16A that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the puttable instrument as an equity instrument.

Paragraph 16C prescribes for 'instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation' to give rise to shareholding if 'the obligation arises because liquidation either is certain to occur and outside the control of the entity (for example, a limited life entity) or is uncertain to occur but is at the option of the instrument holder' and if 'it has all the following features':

(a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:

(i) dividing the net assets of the entity on liquidation into units of equal amount; and

(ii) multiplying that amount by the number of the units held by the financial instrument holder.

(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:

(i) has no priority over other claims to the assets of the entity on liquidation, and

(ii) does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.

(c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments must have an identical contractual obligation for the issuing entity to deliver a pro rata share of its net assets on liquidation.

Paragraph 16D prescribes that the issuer cannot have other financial instrument or contract that has:

(a) total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract) and

(b) the effect of substantially restricting or fixing the residual return to the instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of an instrument described in paragraph 16C that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the instrument as an equity instrument.

Paragraph 28 and 29 provide that compound financial instruments should be treated as having separate elements to the instrument, and each element should be considered according to their substance.

A COMPREHENSIVE DEFINITION OF SHAREHOLDING BASED ON ECONOMIC SUBSTANCE

As mentioned previously, taxation has a public purpose whilst financial accounting has a private purpose. The definition of shareholding needs to reflect the economic substance of financing transactions, in order to determine the shareholding in a company.

It is difficult to propose detailed rules for shareholding, however, looking at the TOFA regime, and the definitions in AASB 132 representing the view taken by financial accounting standard setters, general principles of shareholding can be deducted. The focus should be the economic substance of the transaction, based on the views taken by the business community discussed earlier in this paper:

The five factors in s 385(b) of the US *Inland Revenue Code*[32] (IRC) need to be considered:

(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
(2) whether there is subordination to or preference over any indebtedness of the corporation,
(3) the ratio of debt to equity of the corporation,
(4) whether there is convertibility into the stock of the corporation, and
(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

- The view taken by the UK's tax law[33] to look at the resulting interest for the beneficiary of the instrument needs to be included in the definition;
- The view taken by both Division 974 of the Australian ITAA 1997 and paragraphs 28 and 29 of AASB 132, that for convertible or converting interest, the converted interest needs to be viewed as a separate interest needs to be included;
- The rule should either prescribe for the possibility of delegated legislation[34], following the view taken by s 385 of the US IRC and Division 974 of ITAA 1997 in Australia; or allow someone like the Commissioner the discretion to characterise debt/equity transactions, or combined/separate transactions to be considered as composite instruments or single instruments.
- The rule should provide definitions similar to those applied in the commercial world on terms such as 'financing', 'financial benefit', 'contingent/non-contingent on the economic activities of the entity', 'interest', 'dividend/distribution' and 'perpetuity'.
- The form of return needs to be specified in terms such as 'cash' or 'convertible to cash', where convertibility means the market value of the non-cash payment.

CONCLUSION

Empirical studies have shown that there is an increasing trend for companies to issue hybrid instruments to raise finance. It is hard to distinguish when these instruments contribute to increasing the shareholding of the company. This is especially significant for tax purposes, as the returns to shareholders are not deductible as expenses, but the returns to debt holders are deductible. Shareholding needs to be defined on an economic substance over form basis. This paper proposes the principles that contribute to arriving at a definition which can be applied by Australian companies.

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NOTES

[1] E Huang, 'Cross-Regulatory Arbitrage: An Illustration from Leasing' (2009) 8(1) *Journal of Law and Financial Management* 8–13.

[2] J Fenech, V Fang and G Tanewski, 'Debt-like vs Equity-like Hybrids: The Australian Security Issuance Dilemma' (Paper presented at the 21st Australasian Finance and Banking Conference 2008). See http://ssrn.com/abstract=1259604.

[3] G Mackenzie, Taxation as a Driver for Designing Hybrid Securities' (2006) 1(1) *The Journal of Applied Research in Accounting and Finance* 31–42.

[4] The different jurisdictions used different terminology in their legislations. In this paper, the general meaning of business is used, where a person, either natural or legal, engages in activities that will give rise to income, and the activities do not relate to providing labour to another party.

[5] W Schoen et al, *Debt and Equity: What's the Difference? A Comparative View* (2009) Max Planck Institute for Intellectual Property, Competition and Tax Law Research Paper 09-09 <http://ssrn.com/abstract=1457649> at 16 June 2010.

[6] Ibid.

[7] H J Auld et al, *Comparative Income Taxation: A Structural Analysis* (3rd ed, 2010) 349–54.

[8] W Schoen et al (2009), above n 5.

[9] E Huang and B Yang, 'Substance over Form? Principle-based vs. Rules-based Drafting? Why Doesn't This Good Theory Work in Reality in Drafting Income Tax Laws? The Difficulties from Two Different Worlds' (Paper presented at Other Governance: Business Regulation in China, UNSW, Sydney, 10 February 2010).

[10] C Viney, *McGrath's Financial Institutions, Instruments & Markets* (3rd ed, McGraw-Hill Companies, Sydney, 2000) 9.

[11] Ibid 10.

[12] P U Ali, 'The Australian Hybrid Market' (2002) 20 *Company and Securities Law Journal* 299.

[13] G Mackenzie, above n 3.

[14] A C Warren Jr, 'The Corporate Interest Deduction: A Policy Evaluation' (1974) 83(8) *Yale Law Journal* 1585.

[15] T M Carlin, N Finch and G Ford, 'Hybrid Financial Instruments, Cost of Capital and Regulatory Arbitrage — An Empirical Investigation' (2006) 1(1) *The Journal Of Applied Research In Accounting And Finance* 43–55.

[16] Ibid.

[17] G Mackenzie, 'Taxation as A Driver for Designing Hybrid Securities', (2006) 1(1) *The Journal of Applied Research in Accounting and Finance* 31–42.

[18] Australian Prudential Regulation Authority (APRA) disallowed perpetual debt securities at around the same time as the passing of Div 974.

[19] Section 974-15 (1).

[20] Subsection (1)(a).

[21] Defined in s 974-160.

[22] Subsection (1)(b), subsection (5) applies this also to two or more financial benefits either at the same time or over a period of time.

[23] Subsection (1)(c).

[24] Subsection (1)(b).

[25] Section 974-70 (1).

[26] Section 974-70 (1)(b).

[27] Subsection (2).

[28] Research for this paper did not return significant articles and comments by the ATO on the administration of the division.

[29] T M Carlin, N Finch and G Ford, 'Hybrid Financial Instruments, Cost of Capital and Regulatory Arbitrage –An Empirical Investigation' (2006) 1(1) *The Journal Of Applied Research In Accounting And Finance* 43–55.

[30] M D'Ascenzo and A England, 'The Tax and Accounting Interface', 15th Australasian Tax Teachers

Association Conference, University of Wollongong, January 2003.

[31] E Huang and B Yang, above n 9.

[32] Further research for this paper has identified the debt/equity rules in the tax laws of the UK and the US, which contributes to this definition. They are discussed in a later paper.

[33] Ibid.

[34] E Huang and B Yang, above n 9, and B Yang and E Huang, 'Characteristics of the Chinese Tax System and Its Cultural Reasons in Comparison with the West' (Paper presented at Other Governance: Business Regulation in China, UNSW, Sydney, 10 February 2010).

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