Australian Government
Inspector-General of Taxation
Taxation Ombudsman

Telephone: 1300 44 88 29
Facsimile: 02 8239 2100

GPO Box 551
Sydney NSW 2001

19 November 2020

Mr Jason Falinski MP
Chair
Standing Committee on Tax and Revenue
House of Representatives
Parliament House
CANBERRA ACT 2600

Dear Chair

Inquiry into the Development of the Australian Corporate Bond Market

The Inspector-General of Taxation and Taxation Ombudsman (**IGTO**) appeared before the Committee at a public hearing on 6 November 2020.

We provide our answers to two questions that were taken on notice at that hearing. The questions and answers are set out in the Annexures to this letter.

We also provide the following general summary of the tax position for a retail investor in shares versus corporate bonds for the benefit of the Committee. This summary is necessarily general in nature and is provided for completeness and comparative purposes. In summary the tax position for the retail investor is set out below.

Equity interests such as shares would generally be taxed in the hands of the 'retail' investor as follows:

- A gain or loss on disposal would generally be taxed on capital account;
  - resident individual investors are eligible for a 50% discount on the gain ($33^{1/3}$ % for superannuation funds) if the share has been held for 12 months or more;
  - a capital loss can be deducted against capital gains in the year of the loss or future years and for this purpose, can be carried forward indefinitely;
  - A disposal would include a share cancellation but share buy-backs raise additional complexities not dealt with here;
- dividends are generally taxed on a cash received basis; and
- dividends are also taxed in accordance with the full imputation system in Australia, which includes the ability to receive a refund of excess franking credits.

Debt interests such as corporate bonds would generally be taxed in the hands of the 'retail' investor as follows:

- A gain or loss on disposal or redemption is likely to be taxed on revenue account (assessable as ordinary income and deductible against ordinary income) **unless** the loss occurs as a result of a bad debt (for example, the debt is forgiven or extinguished as part of the company winding up).

- An extinguishment of a debt is not treated like a disposal of the security and accordingly is not likely to be eligible for a deemed 'revenue' account treatment (as a traditional or qualifying security).
- Accordingly the revenue versus capital divide considerations come into play for each individual retail investor in managing this risk. This raises uncertainty but would generally result in capital account treatment unless there are special circumstances.
- A capital loss can be deducted against capital gains in the year of the loss or future years and for this purpose, can be carried forward indefinitely;
- The gain or loss may be taxed on a cash received or accruals basis, depending on whether the security qualifies as a traditional security, a qualifying security or whether the taxpayer has made an election to be taxed under the Taxation of Financial Arrangement (TOFA) rules;

- Interest returns would be taxed on a cash received or accruals basis – subject to the taxpayer's circumstances.

Although the same transaction may result in a capital gains tax event and an amount of ordinary income or loss, there are override rules that generally result in the revenue outcome prevailing. These rules which prevent double taxation or double dipping have not been explored in this response - for simplicity. Further details and references to explain the summary above are set out in the Annexure attached.

We trust this information is useful and of assistance.

The IGTO thanks the Committee again for the opportunity to participate in this inquiry and to appear at the public hearing. If my office may be of any further assistance to the Committee, please don't hesitate to contact me by email [redacted] or via telephone on [redacted].

Kind regards,

[redacted]

Karen Payne
Inspector-General of Taxation and Taxation Ombudsman

Annexure A – Debt Equity International comparisons

CHAIR: When you say 'Our tax system is complex', it's complex around this capital debt issue, isn't it? Well, it's complex in a lot of areas, but this—

Ms Payne: Revenue capital divide is one of the complexities. Debt equity divide is another complexity. The—

CHAIR: Can I stop you on the debt equity divide. Are there countries that do it better than us?

Mr Dam: That's something that we would probably have to look into a little bit further. There is quite a bit to work through. It varies in a lot of different jurisdictions. If that's something that would be helpful to the committee, we would certainly take that on notice and look to see what the comparisons would reveal between different jurisdictions comparable to Australia.

CHAIR: I think it would be a matter of great interest to the parliament to understand. We have created quite a body of legislation around the division of debt and equity and revenue and capital and how those things get characterised and defined. I'm just wondering if there are other jurisdictions that have done it more simply than we have.

Ms Payne: Sure. We can take that on notice.

CHAIR: I was at a conference the other day where a number of people confidently stood up and said, 'We now have the largest tax act in the world'—bigger than the United States even.'

Ms Payne: If we look at the UK, USA, Canada and New Zealand, would they be the jurisdictions you'd probably—

CHAIR: You can take Canada out, if you like. In terms of the way that people generally get an issuance up, how does the ATO deal with that at the moment?

We have set out below some information that the IGTO has obtained through online research or confirmed through specific enquiry in relation to the taxation rules for debt (versus equity) in each of the following jurisdictions (as compared with Australia):

- New Zealand;
- the United Kingdom; and
- the United States of America.

We have drawn upon publicly available information in compiling the information set out in this response. In this regard, we note that there is a wealth of information available in this area. We have provided a list of useful reference materials at end of this annexure that may be of interest and relevance to the Committee's inquiry.

The information provided in this response is general in nature and is provided to assist the Committee with its inquiry and deliberations. It should not be considered as taxation advice and is not intended to represent advice for any specific taxpayer circumstances. For completeness we also note that it is not intended as a commentary on the taxation policy settings in Australia (or elsewhere) as these are not matters within the jurisdiction of the IGTO.

Overall, our research has revealed generally similar approaches across the different jurisdictions in relation to their tax treatment of debt. That is, interest receipts on loans are treated as income and are included in the taxpayer's assessable income for tax purposes, while interest expenditure and other payments are in most cases deductible, subject to certain limitations. The exact form of these limitations may differ and include for example - caps on the amount of interest deductible, or broader rules aimed at ensuring that these deductions do not result in inappropriate outcomes – e.g., thin capitalisation rules, transfer pricing or anti-hybrid mismatch rules. We have not delved into these complex areas of tax law as part of our response.

One significant point of difference to which we draw the Committee's attention is the dividend imputation systems that operates in Australia and New Zealand. Our research suggests that in addition to Canada, Chile, Malta and Mexico, no other country continues to operate a full imputation system.[1] Some jurisdictions, such as the United Kingdom, were noted to have moved away from a full imputation system towards a partial imputation system that is not based on the actual amount of corporate tax paid.[2] The United States of America does not appear to operate any imputation system, either fully or partially. The research considered by the IGTO did not directly identify whether the existence of a full imputation system contributed to investor preferences towards debt or equity.

Australia

We wish to clarify that in Australia, an Australian retail investor would ordinarily treat any gain or loss on the disposal of a share on capital account unless:

- the security was acquired as part of a profit-making undertaking or scheme (this is a question of fact);
- the individual is a share trader or a trader in financial securities (this is question of fact);
- the disposal occurs by way of a share buy-back (which enlivens other taxation rules and provisions which differ between on-market and off-market buy-backs and which are complex and detailed and therefore outside the scope of this response).

Conversely, an Australian retail investor would ordinarily treat any gain or loss on the disposal or extinguishment of a corporate bond on capital account unless:

- the gain or loss arises arises on the disposal or redemption of a traditional security (as defined in sections 26BB and sections 70B of the *Income Tax Assessment Act 1936*). This security must either:
    - not have an eligible return[3] – the sum of payments (other than interest) exceed

[1] Andrew Ainsworth, *Dividend Imputation: The International Experience*, Centre for International Finance and Regulation Working Paper (March 2016) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2747721>; See also Deloitte, *Franking Credits Who Is Right?* (November 2014) p 5 <https://www2.deloitte.com/content/dam/Deloitte/au/Documents/finance/deloitte-au-fas-infrastructure-series-franking-credits-2014.pdf>.

[2] Ainsworth, ibid. Subject to certain conditions being satisfied, tax exemptions may apply to foreign dividends received by a UK company – see *Corporation Tax Act 2009* (UK), Part 9A.

[3] *Income Tax Assessment Act 1936*, s 159GP(3) - For the purposes of this Division, there shall be taken to be an eligible return in relation to a security if at the time when the security is issued it is reasonably likely, by reason that the security was issued at a discount, bears deferred interest or is capital indexed or for any other reason, having regard to the terms of the security, for the sum of all payments (other than periodic interest payments) under the security to exceed the issue price of the security, and the amount of the eligible return is the amount of the excess.

the issue price of the security; or

- have an eligible return where the precise amount of the eligible return is able to be ascertained at the time of issue of the security and is less than 1.5%.[4]

- the gain or loss arises on the disposal or redemption of a qualifying security (as defined in Division 16E of the *Income Tax Assessment Act 1936*)[5].

- The debt instrument converts to an ordinary share (in which case the traditional and qualifying security rules are excluded and a capital gains tax rollover election may also be available);

- the individual taxpayer has made an election to be taxed under the Taxation of Financial Arrangements (TOFA) as set out in Division 230 of the *Income Tax Assessment Act 1997* (a formal election must have been made because individuals are ordinarily excluded from this Division, and if an election is made it is irrevocable and applies to ALL financial arrangements);

- the security was acquired as part of a profit-making undertaking or scheme (this is a question of fact);

- the individual is a trader in financial securities (this is question of fact).

Although a loss on disposal or redemption of a traditional security is deductible under section 70B, this deduction is not allowable in certain circumstances, including in circumstances where the debt is

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[4] *Income Tax Assessment Act 1936*, s 26BB.

[5] The Explanatory memorandum to Taxation Laws Amendment Bill (No. 2) 1986 explains the background to the introduction of Division 16E of the *Income Tax Assessment Act 1936* and the interaction between Division 16E and sections 26BB and 70B of the *Income Tax Assessment Act 1936*.

Under the existing law, the gain to a taxpayer from investing in these kinds of securities [***traditional securities***] is taxed only at maturity or earlier redemption, i.e., when it is received in cash. This treatment has created tax deferral advantages associated with the use of these securities by comparison with traditional interest-bearing securities. The amendments proposed in this Bill are designed to eliminate those tax deferral advantages. By the amendments, a resident taxpayer holding one of these securities will be taxed annually on that part of the income accruing on the security that is attributable to the period the taxpayer held the security during a year of income. Taxing the accruing income in this way should also ensure that the after-tax effective yield on the types of securities concerned reasonably equates with that from a traditional security having the same nominal yield.

Subject to certain exceptions, parallel treatment is to be accorded in relation to deductions to issuers of these securities for the discount or other "interest" component payable.

Three basic tests will need to be satisfied before a security is affected by the new measures -

a. it will need to have been issued after 16 December 1984;
b. its expected term will, or is likely to, exceed one year; and
c. the sum of all payments (other than payments of periodic interest) under the security will exceed its issue price.

A further basic test is that where the amount of the excess in paragraph (c) can be established at the time a security is issued, e.g., in the case of a zero-coupon discounted security, the new measures will not apply unless the excess is greater than 1.5 per cent of the sum of those payments multiplied by the number of years and part years in the term of the security.

The accruals method is not to apply to prescribed securities within the meaning of section 26C of the *Income Tax Assessment Act 1936*.

written off as a bad debt. This is in contrast to the position outlined in the Explanatory Memorandum to *Taxation Laws Amendment Bill (No. 2) 1986* which introduced Division 16E and as outlined in section 159GQ of the *Income Tax Assessment Act 1936* – Tax Treatment Of Holder Of Qualifying Security. Similarly, section 70B(4)[6] was inserted by Act No 224 of 1992 to prevent a loss arising on disposal or redemption of a traditional security where (other conditions being satisfied):

> *…it would be concluded that the disposal or redemption took place for the reason, or for reasons that included the reason, that there was an apprehension or belief that the issuer was, or would be likely to be, unable or unwilling to discharge all liability to pay amounts under the security.*[7]

The following extracts taken from ATO Public Ruling TR96/14 *Income Tax: Traditional Securities* – provide some further background.[8] The ruling sets out the ATO view that a debt waiver or forgiveness (for example as part of the winding up of a company or liquidation) does not qualify as a disposal. This could result in capital treatment in these circumstances, a risk that investors would factor as part of their investment allocation decisions.

> *Disposal: debt forgiveness*
>
> *48. Subsection 70B(2) provides that where 'a taxpayer disposes of a traditional security ... the amount of any loss on the disposal ... is allowable as a deduction from the assessable income of the taxpayer of the year of income in which the disposal ... takes place'.*
>
> *49. We have been asked whether, prior to 1 July 1992, a traditional security can be disposed of by forgiving or waiving the debt of the issuer of the security.*
>
> *50. The word 'dispose' is defined in subsection 26BB(1) as follows:*
>
> *'" dispose ", in relation to a security, means sell, transfer, assign or dispose of in any way the security or the right to receive payment of the amount or amounts payable under the security.'*
>
> *51. Forgiving the obligation of a debtor is not the same as selling, transferring or assigning a debt. And when a debt is forgiven, the liability of the debtor to the creditor is extinguished. When a debt is sold, transferred or assigned, the debtor's liability does not cease to exist. Accordingly, for the act of forgiveness to satisfy the definition of 'dispose' in subsection 26BB(1) it would have to fall within the phrase 'dispose of in any way' within that definition.*
>
> *52. There should be no difficulty in establishing whether a security or the right to receive payment has been sold, transferred or assigned. But the meaning of the clause 'dispose of in any way', in the context in which it appears in the above definition, is open to interpretation.*
>
> *53. In F C of T v. Wade (1951) 84 CLR 105, Dixon and Fullagar JJ, when considering the term 'disposed of' in the former section 36 of the Act, said (at 110):*

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[6] Inserted by the *Tax Laws Amendment Act (No 5) 1992*, s 19.
[7] *Tax Laws Amendment Act (No 5) 1992*, s 19.
[8] Australian Taxation Office, *Taxation Ruling TR96/14 Income Tax: Traditional Securities* (30 July 2008) <https://www.ato.gov.au/law/view/document?locid=%27TXR/TR9614/NAT/ATO%27&PiT=2005072000000>.

'The words "disposed of" are not words possessing a technical legal meaning, although they are frequently used in legal instruments. Speaking generally, they cover all forms of alienation.'

54. In Henty House Pty Ltd (In Voluntary Liquidation) v. F C of T (1953) 88 CLR 141, Williams ACJ, Webb, Kitto and Taylor JJ said (at 152):

'... the words "is disposed of" are wide enough to cover all forms of alienation, ... and they should be understood as meaning no less than "becomes alienated from the taxpayer", whether it is by him or by another that the act of alienation is done.'

55. The above cases did not deal with the traditional securities' provisions and the comments noted clearly relate to a general understanding of the clauses 'disposed of' and 'is disposed of'. They indicate that all forms of alienation will usually effect a disposal, as that term is generally understood. However, the comments do not go as far as suggesting that a general, unqualified understanding of those clauses means that all acts of disposal must necessarily effect an alienation.

56. Accordingly, in our opinion, a general understanding of acts of disposal would ordinarily include certain actions which do not effect an alienation of the security or right to payment. If not for the specific definition (at section 26BB(1)), the word 'dispose' in the traditional securities' provisions might take the general meaning and encompass actions which do not bring about an alienation of property. Similarly, if the clause 'dispose of in any way' stood unqualified and by itself, it could embrace actions which do not effect an alienation of a security or a right to payment. But there is a specific definition of 'dispose', and 'dispose of in any way' does not stand by itself in that definition. That clause is preceded in the definition by the words 'sell, transfer, assign' and those words all describe means by which property is alienated. More fundamentally, the subject property continues to exist after being disposed of by any of those specific means.

57. Application of the ejusdem generis principle requires that the interpretation of the clause 'dispose of in any way' should evidence any genus apparent in the specific terms which precede it in the definition of 'dispose'. The genus in the words 'sell, transfer, assign' suggests that the form of disposal should effect an alienation of the security or right to payment from the holder, and, at the very least, that the security or right to payment should continue to exist after the action.

58. This meaning of the words 'dispose of' in the definition of 'dispose' for the purposes of the traditional securities' provisions was approved by Purvis J in Case 23 95 ATC 249 at 256; Case 10,116 (1995) 30 ATR 1269 at 1277, where he held that:

'It is clear then that the meaning to be ascribed to the words "dispose of" is one consistent with alienation. The words "sell", "transfer" and "assign" all convey this sense of alienation. An extinguishment of a debt, ... will not then satisfy the definition of "disposal" for the purposes of s 70B.'

A general summary of the position seems to be that:

Equity interests such as shares would generally be taxed in the hands of the 'retail' investor as follows:

- A gain or loss on disposal would generally be taxed on capital account;
  - resident investors are eligible for a 50% discount on the gain if the share has been held for 12 months or more;
  - a capital loss can be carried forward indefinitely but is only available to offset future capital gains;
  - A disposal would include a share cancellation but share buy-backs raise additional complexities not dealt with here;
- dividends are generally taxed on a cash received basis; and
- dividends are also taxed in accordance with the full imputation system in Australia, which includes the ability to receive a refund of excess franking credits.

Debt interests such as corporate bonds would generally be taxed in the hands of the 'retail' investor as follows:

- A gain or loss on disposal or redemption is likely to be taxed on revenue account (assessable as ordinary income and deductible against ordinary income) unless the loss occurs as a result of a debt forgiveness (for example, a 'bad debt' because the debt is forgiven or extinguished as part of the company winding up).

  - An extinguishment of a debt is not treated like a disposal and accordingly is not likely to be eligible for a deemed 'revenue' account treatment (as a traditional or qualifying security).
  - Accordingly the revenue versus capital divide considerations come into play for each individual retail investor. This raises uncertainty but would generally result in capital account treatment unless there are special circumstances.
  - The gain or loss may be taxed on a cash received or accruals basis, depending on whether the security qualifies as a traditional security, a qualifying security or whether the taxpayer has made an election to be taxed under the Taxation of Financial Arrangement (TOFA) rules; and
- Interest returns would be taxed on a cash received or accruals basis – subject to the taxpayer's circumstances.

Accordingly the capital versus revenue divide on disposal, redemption or extinguishment of the security would appear to be a relevant tax consideration for the retail investor. We note that there is potentially an asymmetric outcome for corporate bonds for retail investors since, on the one hand gains are reported as revenue gains but losses on the other may not be claimed as a deduction – that is, in cases of extinguishment arising as a result of the insolvency of the issuing entity. We appreciate that there may be other rules dealing with the tax treatment of commercial debt forgiveness for the issuer and it is not our intention to discuss these in detail.

Furthermore, we note that certain rules, such as the Managed Investment Trust capital account election, were introduced, in part to provide investor certainty and confidence in relation to the capital versus revenue divide.[9] These rules 'allow the trustee of an eligible MIT to choose to apply the capital gains tax (CGT) provisions for the taxation of gains and losses on disposal of certain eligible assets, rather than on revenue account.'[10] Whether the capital versus revenue divide continues to be an area

[9] Australian Taxation Office, *Managed investment trusts: election into capital treatment* (9 May 2016) <https://www.ato.gov.au/general/trusts/in-detail/managed-investment-trusts/capital-treatment-elections/>.
[10] Ibid.

of investor uncertainty that is driving particular investment decisions may be an area for the Committee's further inquiry.

We also wish to draw the Committee's attention to the Board of Taxation's 2015 *Review of the Debt and Equity Tax Rules* – a post implementation review of the divide in these rules. The Board made 8 recommendations.[11] That report may be of assistance to the Committee:
https://taxboard.gov.au/consultation/debt-and-equity-tax-rules

The Board's website notes that:

> *In undertaking the post-implementation review, the Board is also asked to:*
>
> - *examine whether there are any unintended misalignments between the debt and equity distinction and related concepts in the income tax law which could potentially result in inconsistent policy outcomes; and*
> - *consider whether there can be improved arrangements within the Australian tax system to address any inconsistencies between Australia's and other jurisdictions' debt and equity rules that could give rise to tax arbitrage opportunities.*
>
> *To the extent that there are unintended misalignments between the debt and equity distinction and related concepts in the income tax law, the Board should also examine the potential for broader application of the current debt and equity rules to ensure consistent policy outcomes.*

Classifying Debt and Equity

Division 974 of the *Income Tax Assessment Act 1997*, introduced in 2001, seeks to classify financial arrangements as either debt or equity for Australian taxation purposes. These rules focus on the economic substance of the arrangement, rather than the legal form. This classification is relevant for both the issuer (the company) and the investor since generally returns on debt issuances are deductible and non-frankable and returns on equity issuances are frankable and non-deductible.

As the Board of Taxation points out in its 2015 report:

> *While there are clear differences between debt and equity in many circumstances, many financial instruments exhibit characteristics of both. As such, the debt and equity divide is not so much a clear delineation but a continuum.*[12]

Taxation of Financial Arrangements

Financial arrangements[13] may be taxed under the Taxation of Financial Arrangement (TOFA) Rules. The TOFA Rules may apply to certain entities mandatorily (unless exempted).[14] It is important to note that where an entity meets the threshold requirements to have TOFA mandatorily applied, it will

[11] Board of Taxation, *Review of the Debt and Equity Tax Rules* (2015) <https://taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2015/07/Debt_Equity_Final_Report.pdf>.
[12] Ibid, p 5.
[13] As defined in sections 230-45 and 230-50 of the *Income Tax Assessment Act 1997*; See also: Australian Taxation Office, *Section 230-45 Financial Arrangements* (10 June 2016) <https://www.ato.gov.au/Business/Taxation-of-financial-arrangements-(TOFA)/In-detail/Guide-to-the-taxation-of-financial-arrangements-(TOFA)/?page=5>; Australian Taxation Office, *Section 230-50 Financial Arrangements* (10 June 2016) <https://www.ato.gov.au/Business/Taxation-of-financial-arrangements-(TOFA)/In-detail/Guide-to-the-taxation-of-financial-arrangements-(TOFA)/?page=6>.
[14] *Income Tax Assessment Act 1997*, s 230-455.

continue to be subject to the TOFA Rules even if its aggregated turnover, value of assets or value of financial assets subsequently falls below the requisite thresholds.[15]

Under the TOFA Rules, any gain made from a financial arrangement is included in the entity's assessable income[16] while any loss is deductible to the extent that it was used in gaining or producing assessable income or was necessarily made in carrying on a business to gain or produce assessable income[17].

A gain or a loss is calculated by netting the costs and proceeds from a financial arrangement. The ATO summarises costs and proceeds as follows:

> Costs from a financial arrangement include financial benefits that either:
> - are provided, or to be provided, under the arrangement
> - play an integral role in determining whether an entity will make a gain or loss from the financial arrangement[18].
>
> Proceeds from a financial arrangement include financial benefits that either:
> - are received, or to be received, under the arrangement
> - play an integral role in determining whether an entity will make a gain or loss from the financial arrangement[19].

Where a financial benefit applies to more than one financial arrangement, a process of apportionment may be necessary.[20]

Entities that are not mandatorily subject to the TOFA Rules may elect to have all of their financial arrangements taxed under these rules.[21] The ATO warns that 'TOFA elections are complex, and cannot be revoked. Before making any TOFA elections, you should carefully consider your circumstances and seek professional assistance if necessary'.[22]

Complexities and investor considerations regarding bond investments

The foregoing discussion has illustrated some of the tax complexities that may arise for investors. Whilst it is not our intention to delve into the detail, it is conceivable that a prospective bond investor would need to consider, amongst other things:

- whether the investment is a traditional or qualifying security, including for the purposes of TOFA, which is dependent upon whether at the time of its issue it:[23]
  - *will, or is reasonably likely to, exceed one year*
  - *is reasonably likely to result in the sum of the payments (excluding periodic interest) exceeding the issue price. For a fixed-return security, this excess is greater than 1.5% of the sum of the payments multiplied by the number of years in the term of the security.*

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[15] Australian Taxation Office, *Guide to the Taxation of Financial Arrangements (TOFA)* (10 June 2016) <https://www.ato.gov.au/Business/Taxation-of-financial-arrangements-(TOFA)/In-detail/Guide-to-the-taxation-of-financial-arrangements-(TOFA)/?page=2#Who_the_rules_apply_to>.
[16] *Income Tax Assessment Act 1997*, s 230-15(1).
[17] *Income Tax Assessment Act 1997*, s 230-15(2).
[18] Income Tax Assessment Act 1997, s 230-60(1)).
[19] Income Tax Assessment Act 1997, s 230-60 (2)).
[20] Australian Taxation Office, *Calculating gains or losses* (10 June 2016) <https://www.ato.gov.au/business/taxation-of-financial-arrangements-(tofa)/in-detail/guide-to-the-taxation-of-financial-arrangements-(tofa)/?page=10>.
[21] Australian Taxation Office, Above n 15.
[22] Ibid.
[23] *Income Tax Assessment Act 1936*, s 159GP(1).

- *The downside risk in the event the principal sum or capital is not returned;*
- Is the investor a share trader and undertaking a profit making enterprise?

The IGTO discussed at the hearing that it is open to issuers of bonds to provide some degree of comfort and certainty to prospective investors through obtaining a public ruling (such as a class ruling) on the tax treatment of the particular product. Prospective investors are able to rely upon the ruling where their circumstances are not materially different to those set out in the ruling. It is also open to prospective investors to seek a private ruling from the ATO, at their own expense, to obtain legally binding advice that will be specific to their tax affairs.

New Zealand

The New Zealand tax system, like Australia's, maintains a divide between revenue and capital, income and expenditure, and debt versus equity distinctions. New Zealand also has an imputation system, similar to Australia's.

The New Zealand Inland Revenue website notes the following:[24]

> *Imputation lets shareholders receive tax credits with the dividends they receive, by allowing the company to pass on credits for the income tax it has already paid.*
>
> *Companies keep track of how much income tax they pay and can attach this as an imputation credit to the dividends they pay out. The dividends are part of each shareholder's income, but the imputation credit reduces the income tax they have to pay personally. This means company profits are not taxed twice.*

Trans-Tasman imputation lets Australian companies keep an imputation credit account in New Zealand, and pass on imputation credits to their New Zealand shareholders. In a similar way, New Zealand companies may also be able to use the Australian franking system.[25]

Interest derived by a company is treated as income, and may be required to be reported on either an accrual basis depending upon the financial arrangement rules applicable to that entity. Where there is no requirement, interest income is recognised as and when it is received – on a cash basis.

Similar to the practices in Australia, interest that is incurred by most companies is deductible. The deductibility of the interest income will be subject to thin capitalisation, transfer pricing and anti-hybrid mismatch rules.

Financial arrangements which involve the deferral of the payment of consideration are taxed by the Financial Arrangement Rules (FA Rules). Examples of where these rules may apply include New Zealand tax residents obtaining a loan to buy a rental property, a US Treasury bond or a foreign currency bank account.[26]

[24] New Zealand Inland Revenue Department, *Imputation for Companies* <https://www.ird.govt.nz/income-tax/income-tax-for-businesses-and-organisations/income-tax-for-companies/imputation-for-companies>.
[25] New Zealand Inland Revenue Department, *Imputation between Australia and New Zealand* <https://www.ird.govt.nz/income-tax/income-tax-for-businesses-and-organisations/income-tax-for-companies/imputation-for-companies/imputation-between-australia-and-new-zealand>.
[26] New Zealand Inland Revenue Department, *Financial Arrangements Rules* <https://www.ird.govt.nz/income-tax/income-tax-for-businesses-and-organisations/types-of-business-income/interest-and-dividends/financial-arrangements-rules>.

Tax Treatment of Corporate Bonds in New Zealand

In relation to the treatment of Corporate Bonds in New Zealand, we have reached out to our networks for their insights. We understand that the retail investment of Corporate Bonds in New Zealand is often made through Portfolio Investment Entities (PIEs, which usually take the form of unit trusts and are generally treated as companies for New Zealand taxation purposes). Under a PIE, the trustee pays income tax for the investors at the prescribed investor rate (PIR). The present PIRs are set out below.[27]

Taxable income was:	and taxable income plus PIE income	PIR
$14,000 or less	$48,000 or less	10.5%
$48,000 or less	$70,000 or less	17.5%
All other cases		28%

The top PIR is presently lower than the top marginal tax rate for individual taxpayers (33%).[28]

From one view, the differences in tax rates may be considered to encourage retail investors to make non-equity investment via funds. Other aspects of the New Zealand tax system which may tend to encourage investment of this kind may be the reduced requirements for reporting gains from financial arrangements through an income tax return. One scenario where this may occur is if the taxpayer invests in a bond directly, with resident withholding tax being deducted at source and a certificate issued to the taxpayer confirming the amount withheld and remitted to the Inland Revenue Department. Provided the taxpayer agrees with the certificate and earns salary and wages, no income tax return is required to be lodged.[29]

The IGTO acknowledges the assistance and insights provided by Ms Joanne Dunne in completing this section of the response.

United Kingdom

The United Kingdom (UK) broadly permits the deduction of funding costs, primarily fees and interest expenses, even if those amounts are capital in nature. The deduction is subject to thin capitalisation rules and the corporate interest restriction (CIR). The CIR essentially limits the amount of tax relief that a company (or group of companies) can receive from deducting net interest and other financing costs. It only applies where the company or group intends to deduct more than £2 million within a 12 month period.[30]

Taxation rules for lending and borrowing by companies are set out in the UK *Corporation Tax Act 2009* (CTA 2009) and are predicated on the existence of a 'loan relationship'.[31] There are also certain arrangements which do not meet the definition of a 'loan relationship' but are nonetheless treated as

[27] New Zealand Inland Revenue Department, *Using Prescribed Investor Rates* <https://www.ird.govt.nz/roles/portfolio-investment-entities/using-prescribed-investor-rates>.
[28] New Zealand Inland Revenue Department, *Tax Rates for Individuals* <ird.govt.nz/income-tax/income-tax-for-individuals/tax-codes-and-tax-rates-for-individuals/tax-rates-for-individuals>.
[29] New Zealand Inland Revenue Department, *Income Tax for Individuals* < https://www.ird.govt.nz/income-tax/income-tax-for-individuals >
[30] Gov.UK, *Restriction on Corporation Tax relief for interest deductions* <https://www.gov.uk/guidance/corporate-interest-restriction-on-deductions-for-groups#if-youll-deduct-less-than-2-million>.
[31] *Corporation Tax Act 2009* (UK), s 302.

loan relationships for the purposes of the CTA 2009. These deemed loan relationships fall into three categories:

- Money debts that do not arise from the lending of money i.e. relevant non-lending relationships;[32]
- Investments in certain types of investment fund and mutual arrangement;[33] and
- Arrangements that give an interest-like return.[34]

The law in the UK is specific about the debits and credits that are taxable and that must be brought into account. The debits and credits which must be brought to account are impacted by whether the loan relationship is classified as 'trading' or 'non-trading'.[35]

Subject to certain exclusions,[36] profits arising from loan relationships are taxed as income.[37] Companies are entitled to tax relief for borrowing costs as set out in Part 5 of the CTA 2009.[38] The UK's revenue authority, Her Majesty's Revenue and Customs, has published guidance on the types of borrowing expenses that are allowable as deductions.[39] In this regard, the UK appears to have adopted a scheduled approach to the deductibility of borrowing costs.

Where companies make payments of interest, there is a general requirement to withhold and remit 20%, subject to certain exclusions.[40]

As with other jurisdictions, there are specific and complex rules relating to the tax treatment of financial instruments, derivatives and cross-border transactions, etc.

We also note that some of the research we encountered cautioned that the present rules dealing with financial arrangements may change in the future as a result of Brexit.[41]

United States of America

Similar to the other jurisdictions that we examined, the United States of America (USA) treats interest and other amounts received under a loan (other than repayments of the principal) to be ordinary taxable income which must be taken into account when determining the taxpayer's net income during the relevant tax period.[42]

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[32] *Corporation Tax Act 2009* (UK), Part 6, Chapter 2.
[33] *Corporation Tax Act 2009* (UK), Part 6, Chapters 3 - 5.
[34] *Corporation Tax Act 2009* (UK), Part 6, Chapters 2A, 6 – 11.
[35] See for example: *Corporation Tax Act 2009* (UK), ss 297(3), 297(4), 301. See also: Sue Mainwaring and Tolley, *Taxation of Loan relationships* <https://www.icaew.com/~/media/corporate/files/join%20us/join%20a%20faculty/0315035%20taxation%20loan%20relationships.ashx>.
[36] *Corporation Tax Act 2009* (UK), s 465.
[37] *Corporation Tax Act 2009* (UK), s 295.
[38] Thomson Reuters Practical Law, *Tax on Corporate Lending and Bond Issues in the UK (England and Wales): Overview* (1 July 2017) <https://uk.practicallaw.thomsonreuters.com/9-502-0437?__lrTS=20200201160509440&transitionType=Default&contextData=(sc.Default)&firstPage=true>.
[39] Her Majesty's Revenue and Customs, *Loan relationships: computational rules: expenses allowed as debits*, para CFM33060 <https://www.gov.uk/hmrc-internal-manuals/corporate-finance-manual/cfm33060>.
[40] PwC, *United Kingdom Corporate – Withholding Taxes* (10 July 2020) <https://taxsummaries.pwc.com/united-kingdom/corporate/withholding-taxes#:~:text=Interest%20WHT,to%20withhold%20tax%20at%2020%25>.
[41] Thomson Reuters Practical Law (1), Above n 38.
[42] Thomson Reuters Practical Law (2), *Tax on Corporate Lending and Bond Issues in the United States: an Overview* (1 May 2015) <https://content.next.westlaw.com/Document/I4cf89667ef2a11e28578f7ccc38dcbee/View/FullText.html?contextData=(sc.Default)&transitionType=Default&firstPage=true>.

A corporate borrower is also entitled to claim a deduction for interest paid on a loan which, like other jurisdictions, has the effect of reducing the company's overall taxable income and its income tax liability.[43] There are a number of situations where a deduction may be disallowed or deferred. These include:[44]

- *If the debt instrument has a maturity of more than five years, has interest that is not paid at least annually and/or is issued with significant original issue discount, and has a yield to maturity that is 500 basis points or more above the "applicable federal rate" (a rate determined monthly that approximates the yield on US treasury obligations) for the month of issuance; then a portion of the taxpayer's deduction for interest and original issue discount can be deferred until it is paid and a portion of the deduction (the amount that exceeds the applicable federal rate plus 600 basis points) may be permanently disallowed. These rules are known as the applicable high yield discount obligation rules.*

- *If the debt is issued to acquire stock of another corporation (or at least two-thirds of the corporation's assets), the debt is subordinated to the borrower's trade creditors and the debt is convertible into (or issued with a warrant to acquire) stock of the borrower; interest on a debt instrument issued by a corporation is disallowed.*

- *If the debt instrument is held by or guaranteed by a person related to the borrower and such related person is not subject to US tax, any interest and original issue discount deduction related to the debt can be limited or deferred.*

- *If the debt is payable in (or by reference to) the equity of the borrower or a related person, interest can be disallowed. If the debt is convertible into equity at the option of the holder, the disallowance rules will apply only if, at the time the debt is issued, there is a substantial certainty the option will be exercised.*

- *If the debt instrument is not in registered form (that is, bearer bonds) in many cases a deduction for interest and original issue discount is disallowed.*

There is also a limitation on the deductibility of business interest:[45]

> *The amount allowed as a deduction under this chapter for any taxable year for business interest shall not exceed the sum of—*
>
> *(A) the business interest income of such taxpayer for such taxable year,*
>
> *(B) 30 percent of the adjusted taxable income of such taxpayer for such taxable year, plus*
>
> *(C) the floor plan financing interest of such taxpayer for such taxable year.*
>
> *The amount determined under subparagraph (B) shall not be less than zero.*

[43] Internal Revenue Code (USA) § 163.
[44] Thomson Reuters Practical Law (2), Above n 42.
[45] Internal Revenue Code (USA) § 163(j). It is noted that this provision was temporarily modified as part of the *Coronavirus Aid, Relief, and Economic Security Act* which increased the percentage of adjusted taxable income from 30% to 50%

The USA does not impose any federal stamp or transfer duties on the issue of bonds.[46] However, certain States and local taxing authorities may impose stamp duties in relation to certain financial transactions.[47] The transfer of bonds may also give rise to gains or losses which are relevant when determining the taxable income of the transferor.[48]

[46] Thomson Reuters Practical Law (2), Above n 42.
[47] Ibid.
[48] Ibid.

Useful Resources

- Andrew Ainsworth, *Dividend Imputation: The International Experience*, Centre for International Finance and Regulation Working Paper (March 2016) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2747721>;
- Australian Taxation Office, *Guide to the Taxation of Financial Arrangements (TOFA)*(10 June 2016) <https://www.ato.gov.au/Business/Taxation-of-financial-arrangements-(TOFA)/In-detail/Guide-to-the-taxation-of-financial-arrangements-(TOFA)/?page=2#Who_the_rules_apply_to>.
- Australian Taxation Office, *You and Your Shares 2020* <https://www.ato.gov.au/uploadedFiles/Content/IND/Downloads/You-and-your-shares-2020.pdf>.
- Board of Taxation, *Review of the Debt and Equity Tax Rules* (2015) <https://taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2015/07/Debt_Equity_Final_Report.pdf>.
- Deloitte, *Franking Credits Who Is Right?* (November 2014) p 5 <https://www2.deloitte.com/content/dam/Deloitte/au/Documents/finance/deloitte-au-fas-infrastructure-series-franking-credits-2014.pdf>.
- Gov.UK, *Restriction on Corporation Tax relief for interest deductions* <https://www.gov.uk/guidance/corporate-interest-restriction-on-deductions-for-groups#if-youll-deduct-less-than-2-million>.
- Her Majesty's Revenue and Customs, *Loan relationships: computational rules: expenses allowed as debits*, para CFM33060 <https://www.gov.uk/hmrc-internal-manuals/corporate-finance-manual/cfm33060>.
- New Zealand Inland Revenue Department, *Financial Arrangements Rules* <https://www.ird.govt.nz/income-tax/income-tax-for-businesses-and-organisations/types-of-business-income/interest-and-dividends/financial-arrangements-rules>.
- PwC, *Financing Options: Debt versus Equity – A country overview* (2016) <https://www.pwc.nl/nl/assets/documents/pwc-financing-options-debt-versus-equity.pdf>.
- Sue Mainwaring and Tolley, *Taxation of Loan relationships* <https://www.icaew.com/~/media/corporate/files/join%20us/join%20a%20faculty/0315035%20taxation%20loan%20relationships.ashx>.
- Thomson Reuters Practical Law (1), *Tax on Corporate Lending and Bond Issues in the UK (England and Wales): Overview* (1 July 2017) <https://uk.practicallaw.thomsonreuters.com/9-502-0437?__lrTS=20200201160509440&transitionType=Default&contextData=(sc.Default)&firstPage=true>.
- Thomson Reuters Practical Law (2), *Tax on Corporate Lending and Bond Issues in the United States: an Overview* (1 May 2015) <https://content.next.westlaw.com/Document/I4cf89667ef2a11e28578f7ccc38dcbee/View/FullText.html?contextData=(sc.Default)&transitionType=Default&firstPage=true>.

Annexure B – The definition of 'high net worth individual'

Mr THISTLETHWAITE: In your submission, Karen, you talk about high-net-worth individuals. Can you define the level that kicks in?

Ms Payne: This is something taken from the Deloitte Access Economics report, which FIIG Securities will be appearing on later today. You could check with them as to how they have defined it, otherwise I can come back to you on that.

Mr THISTLETHWAITE: Yes; okay.

Ms Payne: It's not our definition; it's their definition.

The Deloitte Access Economics report defines 'High Net Worth Individuals' (HNWIs) to be those with more than $2 million of investable assets.[49]

Mr van Manen, during discussions at the public hearing, referred the Committee to section 708(8) of the *Corporations Act 2001*. This section provides a definition for 'sophisticated investor' – as the Corporations Act does not use the term 'High Net Worth Individuals'.

The definition in section 708(8) is set out as follows:

> ***Sophisticated investors***
>
> *(8) An offer of a body's securities does not need disclosure to investors under this Part if:*
>
> *(a) the minimum amount payable for the securities on acceptance of the offer by the person to whom the offer is made is at least $500,000; or*
>
> *(b) the amount payable for the securities on acceptance by the person to whom the offer is made and the amounts previously paid by the person for the body's securities of the same class that are held by the person add up to at least $500,000; or*
>
> *(c) it appears from a certificate given by a qualified accountant no more than 6 months before the offer is made that the person to whom the offer is made:*
>
> ***(i) has net assets of at least the amount specified in regulations made for the purposes of this subparagraph; or***
>
> ***(ii) has a gross income for each of the last 2 financial years of at least the amount specified in regulations made for the purposes of this subparagraph a year****; or*
>
> *(d) the offer is made to a company or trust controlled by a person who meets the requirements of subparagraph (c)(i) or (ii).*
>
> [Emphasis added]

[49] Deloitte Access Economics, *The Corporate Bond Report 2018* (2018), p 2 <https://www2.deloitte.com/content/dam/Deloitte/au/Documents/Economics/deloitte-au-economics-corporate-bond-report-2018-030518.pdf>.

Regulation 6D.2.03 of the Corporations Regulations 2001 provides:

> *(1) For subparagraph 708(8)(c)(i) of the Act, **$2.5 million** is specified.*
>
> *(2) For subparagraph 708(8)(c)(ii) of the Act, **$250 000** is specified.*
>
> [Emphasis added]

Accordingly, it appears to us that while the Deloitte Access Economics report's reference to HNWIs is similar to the *Corporations Act 2001*'s reference to sophisticated investor, they are not the same.

For completeness, we note that a different definition again may apply in a taxation context. The Australian Taxation Office applies a number of different definitions to administratively stratify taxpayers of different wealth levels. We have set these out below for the information and reference of the Committee:[50]

- **Private groups** - economic groups with an annual turnover of greater than $2 million that are not public groups or foreign-owned.
- **Wealthy Australians -** Australian-resident individuals who, together with their associates (often including small business enterprises), effectively control an estimated net wealth of between $5 million and $30 million.
- **High Wealth Individuals -** Australian-resident individuals who, together with their associates, effectively control an estimated net wealth of $30 million or more.

[50] Australian Taxation Office, *Privately owned and wealthy groups demographics* (26 September 2018) <https://www.ato.gov.au/Business/Privately-owned-and-wealthy-groups/What-you-should-know/About-privately-owned-and-wealthy-groups/privately-owned-and-wealthy-groups-demographics/>.