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The Manager
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Dear Sir

Treatment of certain term subordinated notes as debt for the purposes of the debt/equity tax rules.

Draft *Income Tax Assessment Amendment Regulations 2009*

The Taxation Institute of Australia (**Taxation Institute**) is pleased to provide comments on draft *Income Tax Assessment Amendment Regulations 2009* (**draft regulations**) in relation to the treatment of certain term subordinated notes as debt for the purposes of the debt/equity tax rules released for public comment on 22 April 2009.

The purpose of the draft regulations is to ensure that 'solvency clauses' do not preclude certain term subordinated notes from being debt for the purposes of the debt/equity tax rules. The Taxation Institute believes that the draft regulations should broadly achieve their intended purpose. However, the Taxation Institute has identified some issues for further consideration and identified some suggested amendments to the draft regulations to clarify their operation.

The Taxation Institute's comments, which are included in Appendix 1, focus on identifying any matters which may give rise to inappropriate outcomes given the stated purpose of the draft regulations.

If you require any further information or assistance in respect of our submission, please contact Joan Roberts on 03 9611 0178 or the Taxation Institute's Senior Tax counsel, Dr Michael Dirkis, on 02 8223 0011.

Yours sincerely

Joan Roberts
President

Appendix 1

Treatment of certain term subordinated notes as debt for the purposes of the debt/equity tax rules.

Draft *Income Tax Assessment Amendment Regulations 2009*

All legislative references are to the *Income Tax Assessment Act 1997* (**1997 Act**), unless otherwise specified.

1. Background

1.1 The following submission relates to the application of the draft regulations to term subordinated debt instruments that are subject to 'solvency clauses'. While solvency clauses are commonly found in Lower Tier 2 (**LT2**) term subordinated notes issued by authorised deposit-taking institutions (**ADIs**), the draft regulations will apply to all issuers.

1.2 For ADIs, LT2 capital consists of term subordinated debt, limited life redeemable preference shares and any similar debt or capital instrument as approved by the Australian Prudential Regulation Authority (**APRA**) that satisfy the criteria of *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (**APS 111**) and Guidance Note AGN 111.2 (**AGN 111.2**).

2. Policy framework

2.1 Solvency clauses are commonly used in subordinated debt instruments, allowing the issuer to defer payment on the note where the payment would result in the issuer becoming insolvent or not maintaining its capital adequacy ratio.

2.2 For the purposes of satisfying the debt test in Division 974 of the 1997 Act, the effect of solvency clauses on the existence of Effectively Non Contingent Obligations (**ENCOs**) has been the subject of robust debate for several years now.

2.3 The draft regulations were introduced to ensure that solvency clauses do not preclude certain term subordinated notes from being debt for the debt/equity rules in Division 974.

3. Our submissions

3.1 Subregulation (1), paragraphs (a) and (b), limits the application of the draft regulations to term cumulative subordinated notes with terms of not more than 25 years. The Taxation Institute is concerned about whether 25 years is a sufficient maximum term to cover LT2 instruments in the marketplace. In particular, the Taxation Institute is concerned about whether 25 years is a sufficient term to cover LT2 instruments issued by non-banks (such as insurance companies).

3.2 The draft regulations purport to apply only to payments of interest. The scope of the draft regulations, therefore, is limited by this wording to payments of interest and does not appear to include payments that are not interest. This exclusion does not appear to be consistent with the remainder of Division 974, where "*financial benefit" is used as a defined term with respect to ENCO. Pursuant to 974-160(1):

> "***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;".*

Furthermore, limiting the application to the payment of interest would appear inconsistent with the requirements of LT2 as set out in AGN 111.2. This guidance note uses the terminology "payments" and "repayments", as well as "dividend or interest payments" when describing LT2 criterion. Therefore, the Taxation Institute suggests that references to "interest" in the regulations be amended to "financial benefit*" to encompass both payments of interest and other payments.

3.3 Subregulation (1), paragraph (b) refers to the "power to extend the term of the note". In this context, the use of the word "power" does not clearly state or define what means of extending the terms of notes the paragraph intends to capture. In this regard, the Taxation Institute suggests that the word "power" be replaced with the word "unconditional right" to provide further clarity and certainty in the application of the draft regulations.

3.4 Subregulation (1), paragraph (c), subparagraphs (iii) and (iv) refer to ADIs that are regulated by APRA or a foreign regulator comparable to APRA. There may be other issuers, such as life companies, that are regulated by APRA or foreign regulators comparable to APRA that must maintain certain capital adequacy ratios. The Taxation Institute suggests that the draft regulations in this context should apply to all issuers, including ADIs or foreign ADIs that are regulated by APRA or a foreign regulator comparable to APRA.

3.5 Subregulation (2) purports to prevent debt deductions where certain Tier 1 capital instruments are reclassified as Tier 2 capital of ADIs. The Taxation Institute considers that this subregulation to be an unnecessary inclusion in the draft regulations, as Tier 1 capital instruments will never satisfy the requirements of this subregulation. This is because subregulation (2) only applies to term cumulative subordinated notes and Tier 1 instruments, by definition, only include ordinary shares and perpetual instruments.

3.6 Section 974-135(8) of the 1997 Act provides that the regulations may make further provisions relating to the following:

(a) what constitutes a non-contingent obligation;
(b) what does not constitute a non-contingent obligation;
(c) what constitutes an effectively non-contingent obligation; and
(d) what does not constitute an effectively non-contingent obligation.

The drafting of subregulation (3) currently describes characteristics or circumstances that would render a term cumulative subordinated note "not a contingent obligation". This does not appear to fall strictly within any of the prescribed regulation making powers listed above. Therefore, the Taxation Institute suggests that the wording of this paragraph be amended to refer to "non-contingent obligation(s)".

3.7 Subregulation (3), as drafted, applies where the reason for the deferral is either immediately before or immediately after the payment would be made or is made, the issuer is or would be insolvent. The Taxation Institute suggests that paragraph (a) should be broadened, in the interests of clarity and certainty, to also include the time at which the payment is made.

3.8 Subregulation (5) describes the circumstances in which an issuer may be insolvent. Specifically, paragraph (a) limits the requirements of insolvency to a situation where an issuer cannot pay its debts to its creditors. Whilst the Taxation Institute acknowledges that there is minimal scope for a debt to be owed to a party that is not a "creditor", as this is nonetheless possible the Taxation Institute suggests the words "or others" should be included so that this paragraph covers debts owing to all parties.