

TAX ASPECTS OF FINANCING TRANSACTIONS

By

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The concepts of time value or present value of money, arbitraging, and negative gearing provide the key to understanding tax based financing transactions. Time value explains why taxpayers enter into prepayment and deferral transactions and also the manner in which deferred interest securities are structured. Prepayments enable taxpayers to obtain deductions upfront at an accelerated pace while the deferral of income receipts entitle taxpayers to the free use of pre-tax money for the period of deferral. Timing differences in relation to deferred interest securities are discussed below. At the heart of the time value concept is acceptance of the fundamental fact that \$10 is more valuable today than a year later. Two different aspects of this have to be understood:

1. The receipt of \$10 today is preferred to the receipt of \$10 in a year's time. For this reason, where a person obliged to make a payment of \$10 today fails to do so, an upward adjustment of the amount owing will be made to compensate for the time value difference.
2. Conversely, a liability of \$10 in a year's time is preferable to it being liable now. Consequently, if a person to whom \$10 is to be paid next year requests payment immediately, a downward adjustment of the amount payable will follow.

Time value derives its significance from two factors, viz., inflation, and the opportunity cost factor, the latter flowing from the nature of the residual income available for consumption in a society where taxes are collected. Opportunity cost in this sense is the cost of not having the use of the funds to invest. Residual income under a Tax Act such as that of Australia is made to depend on the difference between assessable income and allowable deductions. It follows that if recognition of assessable income can be postponed for tax purposes, while having available the use of the funds then, the time value factor has been put to use in one's favour. In the same way, if outgoings can be accelerated and a deduction obtained while still having the use of such amounts, i.e. without actual payment, then the time value factor has again been put to one's advantage. The ideal is to have a combination of both, namely, delayed recognition of earnings with accelerated claims for outgoings. Such an arrangement would benefit parties at both ends of the spectrum.

Tax arbitrage involves the transfer of tax benefits from a party unable to exploit it, to a party that can so exploit it. The end result is a sharing of spoils between the transferor and transferee with lower costs to both parties. Classic examples in this category are the Leveraged Lease, the Redeemable Preference Share, the Convertible Note, and Property Financing. Such mutual tax benefits are not often arrived at through direct negotiations between the parties concerned (unless countervailing benefits to make good the difference are offered) but through the efforts of intermediaries who bring the different players together in the course of setting up markets.

Negative gearing involves the avoidance of impending tax liability by borrowing for reinvestment. Negative gearing in relation to Real Estate and Share Transactions are good

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** Unless otherwise specified, the sections referred to in this paper are to sections of the *Income Tax Assessment Act 1936 (Assessment Act)*.

examples of this. As an illustration A, who makes a pre tax profit of \$30 on an investment of \$100, instead of paying tax of \$15 (at 50%), borrows say \$200 at 15%. The interest liability of \$30 on the \$200 borrowing would absorb A's initial taxable income of \$30. A's task is now to invest the borrowed \$200 on an investment which would give A a return in excess of 15% pre tax, or 7½% post tax. A company that pays a franked dividend in excess of 7½% or an unfranked dividend in excess of 15% would be an appropriate choice for A.¹ Considering the present tax environment, this strategy provides perhaps the most useful avenue of obtaining tax relief.

Financing techniques in Australia, especially debt financing have changed dramatically in the last 20 years. Previously, lending was based on the security of the Debenture Trust Deed. The shift now has been to lending based on the cash flow position of the borrower. Two factors have contributed to this. The first is the revival of the Bill of Exchange (Trading and Accommodation Bills), and other Bill Financing techniques. The second is the move away from reliance on post event security (assets that could be realised under the Trust Deed in the event of default by the borrower along with the borrower's ability to service the debt based on certain ratios relating to debt, equity and earnings), to pre-event cash flow and earnings potential of the borrower. As a consequence, the nature of the instruments used, and the nature of the lending activity itself have changed. In connection with the former, the shift has been to shorter maturing instruments and to more tax efficient instruments. With the latter, the outlook has changed from one where the lender determined the terms of the loan to one where the borrower shops around for suitable terms. Additionally, borrowings no longer are from a single lender who bears the entire risk burden but are often from a consortium of lenders who share the risk burden. Examined below are some contemporary financing schemes that illustrate these changes in finance practice.

Bill Financing

A Bill of Exchange is essentially a negotiable instrument evidencing an assignable debt.² They are broadly classed as Trade Bills, and Accommodation or Finance Bills. The former is the more traditional and in the case of transactions for other than the supply of goods and services, is used to accelerate receipt or delay payment by the stipulation of the 90 day draw down period. An Accommodation Bill is one where the acceptor (the principal debtor), accepts the instrument not for valuable consideration but to enable another person (who may or may not be a party to the Bill), to raise money on it. In both cases the Bills are negotiable in the market place. The principal purpose of having an accommodation party accept a bill of exchange is that the commercial value of the bill is enhanced because of the credit worthiness of the accommodation party.

Interest payable on a Bill is deductible within the terms of the Assessment Act. At common law, interest expense accrues on a day to day basis and deductions may be claimed on this basis.³ The position with respect to discounts on Bills is more complex and is examined below.

Redeemable Preference Shares

A shareholder of this type, instead of subscribing for 100 x \$1 shares, subscribes for 1 x \$1 share at a premium of \$99. The dividend payable on the single Redeemable Preference Share would be the same as the total dividend that would have been paid on the 100 x \$1 shares. Redeemable Preference Share holders are shareholders in name only as they have many of the characteristics of debenture holders and other debt finance security holders. For example

1. For simplicity this example assumes the tax rate both for companies and the marginal investor to be 50 per cent.
 2. Dr. G. de Q. Walker, *The Australian Revival of the Bill of Exchange* (1978) 52 *Australian Law Journal* 244.
 3. See *Alliance Holdings Ltd v Federal Commissioner of Taxation* (1981) 81 ATC 4637; *Federal Commissioner of Taxation v Australian Guarantee Corporation Ltd. B* (1984) 84 ATC 4642.

they are entitled to a specified rate of return before ordinary shareholders, and are entitled to have the amount of their paid up capital re-paid. This is unlike the position with respect to ordinary shares which can only be redeemed (because of the capital maintenance provisions) by court approval under section 123 of the Companies Code. The effect of such a redemption is like the repayment of a loan. Thus their capital subscription for preference shares does not in reality form part of the company's paid up capital and the issue document normally greatly restricts the rights of such shareholders.

Companies issuing Redeemable Preference Share securities are those that usually can do without (or are prepared to forego) further deductible expenses for the sake of overall cheaper finance. Conversely, subscribers to such shares are those financiers who could benefit by receiving after tax income, where the overall post tax gain will ultimately be greater than the available pre-tax gain. Thus both parties to the transaction benefit with the cost of finance remaining lower than what it would be otherwise. This manner of "borrowing", also helps the issuer to avoid contravening borrowing limitations imposed by any pre-existing Debenture Trust Deeds. The subscriber in turn is granted a put option⁴ by a party related to the issuer, exercisable if the shares are not redeemed or the dividends remain unpaid at the specified time. Often the subscriber relies also on some form of external security such as a Letter of Credit from a Bank which can be resorted to if the put option itself is not honoured.

The very successful exploitation of these instruments attracted a series of legislative amendments.⁵ Briefly, the legislature's approach has been to characterise the payments as forming a debt rather than an equity obligation. In this way the amount paid out as a dividend is made deductible as an interest payment⁶ to the issuer and is assessable to the subscriber. The intended and formal character of the payment as a non-deductible and non-assessable dividend thus fails. Hence the term "debt dividend". The strategy for achieving this outcome has taken various forms. Initially, the legislation denied the otherwise available intercorporate dividend rebate where, in the Commissioner's view, the transactions amounted to a "finance arrangement" under which the debt dividend is paid. Then, with the introduction of dividend imputation in 1987, the dividend rebate entitlement was limited only to the franked part of a dividend⁷. Not being successful in limiting the practice, the legislation has now proceeded to deny the rebate altogether on such dividends⁸ and to declare dividends payable in these transactions "unfrankable"⁹. The result is that, even after tax, dividends fail to qualify as franked dividends in these circumstances. Additionally, the legislation also denies the issuer a deduction on the dividend paid out. This result has been achieved by not extending the interest deduction previously available under s. 67AA, to transactions falling within s. 46D.

Convertible Notes

Convertible Notes, like Redeemable Preference Shares, are hybrid securities, i.e. securities having the characteristics of both debt and equity. They are debt in that they are initially a loan advanced in return for interest payments. However, the right of convertibility inherent

4. A *put option* is an option permitting its holder to sell a certain stock or commodity at a fixed price for a stated quantity and within a stated period. Such a right is purchased for a fee paid to the one who agrees to accept the stock or goods if they are offered. The buyer of this right to sell expects the price of the stock or commodity to fall so that he can deliver the stock or commodity (the put) at a profit. If the price rises, the option need not be exercised. The reverse transaction is a *call option*. See *Black's Law Dictionary* 5th edn, 1979, West Publishing Co.

5. See s. 46D *Assessment Act*.

6. See s. 67AA.

7. See s. 46D.

8. See s. 46D as was amended in 1989.

9. See paragraph (f) of definition of "frankable dividend" in s. 160APA.

in them takes them out of the realm of mere debt. Viewed in terms of the issuer, the issue of such notes entitles the issuer to an interest deduction as against a non-deductible dividend payment on shares. In terms of the noteholder, it produces income which can be used to offset deductions arising from other transactions. Thus the viability of such notes depends on obtaining the tax deductions on interest paid on such notes. To achieve this, the stipulations contained in s. 82SA have to be satisfied, the more important of which are that:

1. The notes be convertible only at the option of the note holder and for fully paid shares not carrying any special conversion provisions;
2. The option be exercisable between 24 months and 10 years after its issue (even where the note is intended to mature more than 10 years after the date of issue);
3. The interest rate be non-variable during the period of the loan (except for certain interest rate linked variations);
4. The rights and obligations of the noteholder not be variable in the noteholder's favour by reason of the length of the period for which the note is held; and
5. The conversion price be not less than the greater of the par value of the share or 90% of the market value of an equivalent share in the company's capital at a valuation date 6 weeks before the notes are first offered for subscription.

Failure to satisfy the above requirements means that the interest payment will not be available as a deduction, but will be treated as a dividend paid by the company. Unfortunately, the payment may fail to qualify in the category of "frankable dividend" by reason of s. 46D. Failure to strictly satisfy the requirements of s. 82SA, therefore, will cause the issuer to miss out on both fronts — as an interest deduction, and as a frankable dividend. Great care must be taken on this.

For Capital Gains Tax purposes the conversion of a note, to a share, is deemed not to involve a disposal¹⁰ so that gains and losses are effectively deferred until the shares have been disposed of. But the mode of determining the cost base of a share under sections 160 ZZ and ZZA effectively precludes any indexation being available on the amount outlaid to acquire the note as distinct from the share. This is because under these sections the cost base of the note is its cost plus any additional amount payable to acquire the share upon conversion, with the date of acquisition of the share being the date of actual conversion rather than the date of acquisition of the note. Given this, where the note has risen in value, the solution would be to sell the note, claim the benefit of indexation, and then acquire the share. Additional problems arise where the note is issued at a discount, at a premium, or with a put option. The granting of these concessions must be provided for at the time of issue of the notes with a view to ensuring that rights and obligations of the noteholder do not vary according to how the noteholder exercises his option, as such a consequence would be in violation of the requirements of s. 82SA.

Because of the requirements imposed by s. 82SA attempts are made to split the note into a debt bond evidencing the primary debt obligation, and a non-detachable conversion bond, which confers the right of conversion. Interest is paid on the debt bond but not on the conversion bond. While the conversion bond under this structure is itself a convertible note, the failure to satisfy the requirements of s. 82 SA may not be all that disastrous as no interest is paid on the conversion bond. Care, however, should be taken with s. 82L(2). It provides that two or more related instruments which by their combined effect operate in the nature of a convertible note are to be a convertible note.¹¹ However, where the exercise of the option leaves the note debt outstanding, the definition of convertible note may not apply, in which

10. Section 160 ZYZ.

11. See in this connection Rulings IT 2427 and IT 2234.

case the interest under the note may be deductible if the normal tests under section 51(1) are satisfied.

Leasing

The tax advantage obtainable under leasing agreements is that the lessee is entitled to a deduction for the periodic payments it makes to the lessor while the lessor is entitled to depreciate the cost of the asset and deduct interest expenses incurred on the acquisition of the asset. As the lessor is treated as owner for purposes of the *Assessment Act*, it is able to take advantage of depreciation, accelerated depreciation and investment allowances and pass on these benefits in the form of reduced rental payments under the lease. Viewed in terms of the lessee then, leasing transactions save the lessee costly upfront expenses otherwise needed to buy the asset and claim depreciation on it, or in the alternative, borrowing funds to acquire the asset and depreciate it. Leasing transactions, therefore, are off-balance sheet financing mechanisms. They are also a form of arbitrageing because the lessee may not be in a tax position to take advantage of investment and depreciation deductions while the lessor is able to do so. The ultimate benefit is when the lessee, under the terms of the agreement, becomes owner of the asset itself upon final payment of the lease rentals. Agreements of this latter type are commonly described as Financial leases. Agreements which do not provide for transfer of ownership of the asset are referred to as Operational leases. Tax jurisdictions around the world have attempted to limit the tax benefits of leasing to Operational leases alone, treating Financial leases as equivalent to hire-purchase agreements under which the hirer is entitled to depreciation deductions and to interest payments on borrowings. The Commissioner of Taxation has sought to achieve this by way of a series of Rulings, the most notable of which is IT 28 dated July 1960. Others that have followed include IT 2287, IT 2215. Furthermore, since 1987 Accounting Standards (AAS 17) has required lessees to distinguish between the two types, with Financial leases being required to be treated as a depreciable asset.

Leverage Leases

Leverage Leases are a form of Finance leasing except that the amounts involved start around \$5 million and extend to special classes of purchases, for example, air-craft financing. The term "leverage" derives from the notional owner — the lessor's relatively small equity commitment to the transaction, generally around 20 per cent of the total costs of the equipment. The lessor however is able to claim all of the investment and depreciation deductions. But as noted earlier, what makes the whole venture viable is that these benefits are passed on in the form of lower leasing rentals to the lessee. Under the standard schemes there are at least 4 groups to the transaction with membership of each group extending to several parties. These include, the Financier or lender to the Lessor, the Lessor (normally a partnership to take advantage of the direct pass through nature of the investment and depreciation deductions), the Lessee, and the Manager of the venture. The Financier's position is that of a non-recourse lender limited in its claims to recovery to the rental payments and to the equipment leased in the event of default. The lessee for its part is able to deduct the rental payments and rely in various ways on the comfort of the residual clause. However, these types of arrangements also require the lessee to underwrite that the leased equipment will have the residual value ascribed to it by the parties at the commencement and to agree also to meet any shortfall on the agreed residual value at the termination of the lease where necessary. Other essential terms of such leasing arrangement include a prohibition against early termination. Early termination would cause the lessee to make full payment of all the rentals outstanding with appropriate discounting for such early payment. The long term nature of the arrangements and the large number of parties to the transaction both reflect the large amounts of money involved in these transactions.

Recently, the benefits of leverage leasing have been further enhanced by the use of the “double dip”, whereby both the lessor and the lessee are able to claim investment allowances and accelerated depreciation in their two different tax jurisdictions. Tax write offs in these transactions are obtainable at a much more rapid pace and are far more advantageous than claiming deductions for periodic lease rental repayments. The practice had its origin in the United Kingdom and United States jurisdictions, and came into maturity in the early 1980’s. Advantage was taken of the United Kingdom depreciation allowance which was available to persons with title to the asset, and the United States provisions which granted such benefit to the user of the asset. Initial arrangements applied in relation to United Kingdom resident lessors and United States resident lessees. Both jurisdictions have now introduced clamps on the exploitation of these benefits. In the Australian context, such deals are still capable of being struck between Australian resident taxpayers on the one hand and German, Japanese, French and South Korean resident taxpayers on the other. Under such schemes, an Australian resident taxpayer A, having acquired an asset enters into a sale and leaseback arrangement with the foreign taxpayer. The foreign taxpayer leases the asset to Australian resident taxpayer B (the financier to the transaction). B takes on the role of sub-lessor and leases the asset on to A. B as well as the overseas taxpayer are able to claim investment and depreciation deduction benefits in their respective jurisdictions as lessors, while A is entitled to rental deductions as lessee. Following the success of these schemes there was a response from the Treasurer to the effect that these schemes would be taken to hand, but the statement went on to say also that such transactions would not be viewed with hostility if the impact of the second part of the double dip transaction was on the overseas tax jurisdiction alone without any adverse effect on Australian Tax Revenue.¹²

Lease agreements entered into by tax exempt authorities and persons using property outside Australia to produce exempt income are governed by Division 16D of the *Income Tax Assessment Act*. Such agreements are treated as loan transactions. Consequently, amounts received by the lessor are apportioned into amounts of repayment of capital and interest income based on actuarial calculations. However, amounts normally claimable as deductions in relation to these transactions are disallowed by operation of s. 51AD.

Property Financing

The standard scheme used was a Unit Trust under which different units were held by the Financier and the Developer. The Financier contributed the capital necessary for which it received limited income rights while the Developer held the continuing interest in the Trust. Put and Call options provided for the takeout of the Financier. Under the scheme, the Financier was rewarded by a pass through of the tax free income (arising from investment allowances and accelerated depreciation). The scheme has, however, confronted difficulty on two fronts. First, the Commissioner, by Ruling IT 2512 purports to assess these receipts as income to the Financier under sections 25(1), 26(b), (previously under 25A and 26AAA). Secondly, s. 160ZM would, for Capital Gains Tax purposes, reduce the cost base of the units held by the Financier by the tax free amounts received. To overcome these, a structure whereby the Financier does not become a unit holder in the Trust has been suggested.

Discount and Deferred Interest Securities

There is a wide and varying range of securities issued in the market though they could be commonly grouped into one of the following three types:

- (1) Where, under the terms of issue of the security, an amount is specifically identified as interest (Deferred Interest Securities or DFI);

12. Treasury Statement of 17 December 1986

- (2) where no amount is so identified but the lender or the holder of the security receives a higher amount than that which was lent (zero coupon bond); and
- (3) a hybrid where the security is both discounted and entitled to interest payments — both benefits being less than that offered under (1) and (2) above.

General tax law attributed different tax consequences to each of these situations. The interest element in the first and third situations was generally held assessable, while the difference (the excess) received in the second and third situations was held to be a receipt of capital unless the taxpayer was a trader of such securities. This approach, with its focus on the type of security offered rather than overall result, left the way open for securities to be structured so as not to attract tax liability. Conversely, the Commissioner of Taxation was able to deny deductions claimed by way of interest payments on these latter types of securities. Consequently, securities were structured to pass on the benefit of non-assessability so as to compensate the disadvantage of non-deductibility. The advent of Capital Gains Tax, however, has made these transactions less attractive.

Even transactions relating to interest bearing securities could be structured to bring in tax benefits. This was done by taking advantage of the benefit of deferral. The standard scheme was the deferred interest security under which the holder of the security was not assessed to tax on the interest component of the security until actual receipt while the issuer was able to claim deductions on interest accrued but not yet paid. The scheme reached perfection where the holder was a non-resident. Even though interest paid to non-residents is liable to withholding tax, this was avoided by the security being sold back to a resident before maturity (at a price near enough to its maturity price) and the claim that what the non-resident received was a capital receipt or income having an ex-Australian source.

Division 16E attempts to halt these practices. The Division has as its target the holder of the security, and where it applies, the holder is assessed on the interest component on an accruals basis re-establishing correspondence between the deductibility claimed by the issuer and assessability on the part of the holder. The Division, by its definition of “security” and “eligible return on a security” does away with the distinction between deferred interest, zero coupon, deeply discounted, and the like, thereby giving emphasis to the end result rather than to the form. However, the scope of the Division is not all embracing in that it does not apply to non-resident taxpayers (leaving alone non-resident taxpayer liability to withholding tax) and to holders in whose hands such securities constitute trading stock (who will be liable on an accruals basis anyway). The Division does not apply to securities whose term is less than a year and this makes it possible to straddle an issue advantageously over two tax years. Nor does it apply to securities where the precise amount of the “eligible return” (calculated in accordance with a formula) cannot be ascertained, and to pure interest bearing securities payable on a regular basis of one year or less (though they would be assessable on an annual basis anyway).

Interest Withholding Tax

Payments made to non-resident taxpayers are subject to withholding tax in Australia, whether they take the form of dividends or interest.¹³ Liability on dividends paid to non-residents are subject to certain exemptions, the most important of which is in relation to franked dividends.

The most notable exemptions with respect to interest payments is that found in s. 128F relating to Bearer Debentures. To qualify for the exemption, such debentures must be issued

13. Sections 128A — 128K *Assessment Act*.

overseas to raise foreign currency, the issue should be widely held (that is, issued to a large number of subscribers), and the interest should be paid outside Australia. There exist a few other exemptions from withholding tax though their range is limited. However, it has not been the case that interest payments to non-residents falling outside these categories of exemptions fall to be assessed for withholding tax. This is because it has been possible to give such receipts a source outside Australia and, therefore, avoid the imposition of Australian tax. By so doing taxpayers have been able to avoid not only the tax on interest, but also the tax on profit arising from the discounting of the security. Amendments were, therefore, introduced to overcome these practices and certain other arrangements that had evolved in connection with hire purchase and leasing arrangements, and to indemnity and reimbursement agreements. In relation to discounted and deferred interest securities, s. 128AA now assesses all non-residents to withholding tax on the deemed interest earned on the security where the transfer by the resident to the non-resident is at a price higher than the issued price or the reduced issue price of the security. To prevent the section from operating unfairly in situations where the security has been transferred between several non-residents before the sale to the resident, a system of clearance certificates from the Commissioner of Taxation has been established¹⁴. Such a Clearance Certificate is obtainable only if liability to tax on the higher transfer price has been recognised at some point of transfer between the non-residents. If no such liability has been recognised, then the last holder will be assessed on the difference between the original share price and the redemption price. The purpose of the Clearance Certificate is to prevent double taxation on any overlap. Section 128AC assesses for withholding tax, notional interest payments on hire purchase agreements and on the lease of plant and equipment. Finally, s.128AD subjects to liability amounts remitted by a resident drawer to an offshore acceptor as payments in the nature of reimbursement or indemnity. Previously there was doubt as to whether such payments were liable to withholding tax as being receipts of capital rather than interest.¹⁵

Company Liquidations

The general law position is that distributions by a liquidator are distributions of a capital nature and, therefore, not assessable.¹⁶ Section 47(1) of the Assessment Act changed this position. The section reads:

“Distributions to shareholders of a company by a liquidator in the course of winding-up the company, to the extent to which they represent income derived by the company (whether before or during liquidation) other than income which is or has been properly applied to replace a loss of paid up capital, shall, for the purposes of this Act, be deemed to be dividends paid to the shareholders by the company out of profits derived by it.”

Under the section, distributions by a liquidator are deemed to be income if they constituted income derived by the company. As to what constituted income in the circumstances gave rise to the noted trilogy of cases, viz, *Federal Commissioner of Taxation v Fuller Pty. Ltd.*,¹⁷ *Gibb v Federal Commissioner of Taxation*,¹⁸ and *Harrowell v Federal Commissioner of*

14. See ss. 128AB and 265B.

15. See *Holder v Inland Revenue Commission* [1932] AC 624.

16. See *Inland Revenue Commissioner v Burrell* (1942) 2 KB 52.

17. (1959) 101 CLR 403.

18. (1966) 40 ALJR 394.

*Taxation.*¹⁹ The introduction of Section 47 (1A) since 10 December 1986 has turned the focus away from the reasoning adopted in these cases. Section 47 (1A) reads:

“A reference in Sub-section (1) to income derived by a company includes a reference to:

- (a) an amount included in the assessable income of the company otherwise than under Section 160ZO; or
- (b) an amount that would be included in the income of a company under Section 160ZO if:
 - (i) a reference in Part IIIA to the index cost base of an asset where a reference to the cost base of an asset;
 - (ii) Section 160ZC had not been enacted; and
 - (iii) for the purposes of Part IIIA:
 - (A) a capital gain were taken to have accrued to a taxpayer in respect of a year of income if a capital gain or capital gains accrued to the taxpayer during the year of income;
 - (B) the amount of the net capital gain that, under the Sub-sub paragraph (A), is taken to have accrued to the taxpayer in respect of a year of income were an amount equal to the capital gain or the sum of the capital gains referred to in that sub-sub paragraph.”

As provided by the section, any amount which is assessable income of a company (regardless of whether it was so derived by the company) is potentially a taxable dividend on a liquidator's distribution. Further the calculation of the taxable income of the company is modified such that the benefit of indexation of assets which are taxable pursuant to Part IIIA is ignored and net capital losses are not deducted from net capital gains. In other words, there is no pass through to shareholders of the benefits of indexation and deduction for capital losses available to the company. The section, therefore, significantly alters the ability to move profits from a company to its shareholders in a tax free form by way of a voluntary liquidation. The exemptions left behind now are those relating to replacement of lost paid-up capital, exempt income, and gains realised on assets which are not subject to Part IIIA of the Act, that is, mainly pre-September 1985 assets.

With respect to the application of the dividend imputation provisions, two matters should be noted. First, s. 160APA permits the franking of deemed dividends such as those under s. 47(1). Secondly, while a tax free return of “loss of paid up capital” or tax exempt distribution can be made along the line of cases such as *Archer Bros. Pty. Ltd. v Federal Commissioner of Taxation*²⁰ and *Glenville Pastoral Co. Pty. Ltd. (In Liq.) v Federal Commissioner of Taxation*,²¹ it is also possible for a franked dividend to be payable on a liquidation. Thus depending on the needs of the particular shareholder one or other of these alternatives may be adopted.

The Capital Gains Tax consequence of liquidation distributions centre on s. 160M (3) (b) and (c). According to the former, the cancellation, release, discharge, satisfaction, surrender, forfeiture or expiry of an asset which is an interest or right in or over property amounts to disposal, while according to the latter, a share is disposed of on redemption or cancellation. As liquidator's distributions are distributions in effect on cancellations of shares or by way of satisfaction of shareholders' rights, they should, for the purposes of Part IIIA, be considered

19. (1967) 116 CLR 607.

20. (1953) 5 AITR 528.

21. (1963) 9 AITR 118.

as consideration in respect of a disposal of an asset. For this reason, the provisions of s. 160ZL should have no application as that section is limited to payments to shareholders which are not dividends and are not in respect of disposals of shares. Furthermore, where part of a liquidator's distribution is an assessable dividend pursuant to s. 47 and the remainder is a non-assessable distribution, the provisions of s. 160ZA(4) should apply so as to reduce the amount of any capital gain realised. Where assets are distributed *in specie*, ss 160ZD and 160ZH attribute market value for disposal and acquisition purposes respectively. The appointment of a liquidator in itself is deemed not to have any Capital Gains Tax consequences on the property of the company. Section 160W(c) deems the vesting of assets of companies in liquidators to be irrelevant for capital gains tax purposes with the company deemed to continue to own the assets.

Off Balance Sheet Financing and Debt Defeasance Arrangements

Off Balance Sheet Financing

Existing statutory disclosure requirements under the *Companies Code* and the requirements of the Australian Accounting Standards Board cope adequately with accounting practices relating to recording of the incidence of the traditional loan arrangement, *viz*, the extent of the liability, if that liability is secured over any assets of the company details of such, and the terms of repayment and the current interest rate charged. For a variety of reasons, however, financial directors have attempted to structure transactions in such a way as to avoid disclosure requirements and ensure that loan liabilities are not recorded on the face of the balance sheet. Such transactions are termed "Off Balance Sheet". Two reasons are commonly advanced for this practice:

- (1) To improve or prevent a deterioration in those balance sheet ratios traditionally used by lenders and credit rating agencies and
- (2) To prevent borrowing limits imposed by debenture trust deeds being exceeded.

Stated another way, to a borrower, a balance sheet that does not disclose the liability relating to a loan agreement is more favourable than a balance sheet which does.

Strategies adopted by financial directors to achieve these ends have ranged from: (1) Choosing investment vehicles whose liabilities need not be included in group accounts; (2) Arranging off-balance sheet financing coupled with non-recourse liability; and (3) Defeasing existing secured credit facilities such as mortgage debentures and the obtaining of unsecured "negative-pledge" loans. Commonly used methods to achieve the first have included the interposition of non-corporate entities such as joint ventures and partnerships, special purpose non-subsidiary companies, and consolidation on a net assets basis. Limited or non-recourse arrangements have included asset and liability offsetting arrangements and the transfer of liabilities with recourse. Debt defeasance arrangements are discussed below. The ethics of such practices have been much debated with the various Standard Setting Boards throughout the world that try to regulate them, albeit with little success.

Debt Defeasance Arrangements

Debt defeasance arrangements involve the transfer of funds by the debtor to a third party with the provision that the third party pay the creditor the debt owed. Such arrangements are entered into for several reasons ranging from the need to re-arrange existing secured credit to credit on an unsecured basis (having first defeased existing debt), to preserve the benefits of borrowings obtained at historically low interest rates but yet have the debt obligation set aside so as to improve borrowing capacity, to the exploitation of tax advantages. An example of the latter would be where a debt of \$100 million owed to B and due 5 years hence is defeased to a third party X by a transfer to X of \$60 million (assume that \$60 million matures into \$100 million in 5 years time). Under the arrangement B will get the \$100 million at the time it is due,

X will not be liable on the difference of \$40 million because X has the corresponding liability to pay out that amount, while A continues to pay interest on the \$100 million loan to B which is deductible for tax purposes. (It must be noted that A continues to remain liable to B on the loan under the debt defeasance arrangement. X is a conduit and it is not a condition that X assume B's liability.) The Commissioner of Taxation, however, has by Ruling IT 2495 of 15 September 1988 made it known that first, the difference between the amount transferred to X (\$60 million) and the actual loan owed to B (\$100 million) would be assessed to A as a gain under section 25(1), and, secondly, that the continuing interest obligation by A to B on the \$100 million original loan would not be allowable as a deduction. Presumably, the interest on the \$60m borrowed to pay off the \$100m debt would be deductible.

Conclusion

As would have been apparent, the scope for tax driven strategies of the first two types mentioned at the outset of this paper, *viz*, exploitation of time value advantages and arbitrage, have been almost eliminated. The noteworthy remaining exceptions are leverage leasing and convertible note issues. Opportunities for negative gearing are still available and will continue to be available. This, to a large extent, is because of the difficulty in targeting legislation to eliminate this practice. For instance, even if transaction's that cause concern can be identified, it is almost impossible to attribute the interest deduction claimed to that particular problem. Stated another way, if interest deductions on share purchases are denied, taxpayers will buy shares out of funds that would normally be used for other business purposes while using borrowed funds to finance their normal business activities. Therein lies the difficulty for the legislature. Therein lies the opportunity for the taxpayer.

