Greenwoods & Freehills

Tax Brief

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Deductibility of Interest on Subordinated Debt

In a recent decision, the Federal Court has again ventured into the troubled area of the debt-equity distinction, again with surprising and concerning results. The case concerned the deductibility of over AUD$250m of interest paid by St George Bank in 5 income years under a US$350m subordinated debenture it had issued. The Court held the interest non-deductible on the basis that it was capital in nature.

A second issue in the case raises a significant warning about the process for making elections so that they are valid and effective. This part of the judgment gives it wider and ongoing significance in a post-2001 world with a statutory debt-equity regime.

Facts

The judge's decision in the case turns largely on two factual matters:

- his analysis of the purpose for which St George had borrowed the funds; and
- the terms of the various instruments used in the capital raising.

In order to understand the case fully, it is, regrettably, necessary to spend some time outlining the facts surrounding the capital raising and the terms of the instruments used.

The debenture had been issued as part of a capital raising undertaken by St George consequent upon its merger with Advance Bank in 1997. St George executives had concluded that the merger would leave it in a position where it would not meet the Reserve Bank's capital adequacy requirements for holding a domestic banking licence. The judge accepted the evidence of the Bank's executives that the overriding goal of the transaction was to raise further capital and restore the Bank's capital adequacy ratios. The judge also set out in some detail the extensive negotiations between St George and the Reserve Bank about how the capital raising would be effected in order for the Reserve Bank to be satisfied that St George now met those ratios.

The capital raising was to be undertaken in two legs: funds were raised by a US company by an issue of shares and these funds were then to be lent to St George.

In order to accomplish the first leg, a special purpose company ("**LLC**") incorporated in the US raised US$350m by issuing US$243m preference shares ("**Series A Capital Securities**") to US investors, and US$107m ordinary shares to St George group companies resident in Australia. Approximately $250m out of the $350m funds were intended to qualify as Tier 1 capital of the St George group (considered as a group) for the Reserve Bank's capital adequacy requirements. In order for the funds to

qualify as Tier 1 capital, the transaction documents had to contain certain important provisions.

These provisions and their effects would be at the heart of the tax dispute. The documents provided:

- LLC could only use the funds it raised from the share issue to subscribe for the debenture issued by St George;
- holders of Series A Capital Securities were entitled to receive non-cumulative dividends at a rate of 8.485% payable semi-annually in arrears. The rate of dividend increased to 8.985% from 1 July 2017 and to 9.485% from 1 July 2022;
- a dividend could only be paid if LLC had first received interest on the debenture from St George;
- the payment of a dividend could be thwarted by St George issuing a “Dividend Blocking Notice” to the Directors of LLC. This Notice could be issued by St George if the amount of the interest it paid to LLC plus the dividends it paid on its other shares exceeded the St George group’s distributable profits;
- any surplus funds held by LLC after paying the periodic dividend were to be returned to St George via further dividends; and
- St George guaranteed the performance of the obligations of LLC but this was subordinated to other claims against St George.

Another important feature concerned the duration of the funding. In order to qualify as Tier 1 capital, shares typically have to be non-redeemable, but the documents provided that Series A Capital Securities issued by LLC were to be redeemed on 30 June 2017. However, on that date, the company had an option to put to the shareholder a Series B Capital Security in LLC in lieu of repayment in cash. The Series B Security was to be redeemed on 30 June 2022, but on that date, the company had a further option to put another share – either a non-redeemable share in St George or a Series C Capital Security (issued by some other US company) in lieu of repayment in cash, and in either case, the shareholder was obliged to transfer their Series B Capital Securities to St George. In effect, the subscribers for Series A Capital Securities had no legal right to recover the cash they had invested in LLC, although there was evidence that holders of these kinds of shares would expect in practice to be repaid, largely because of the increasing interest rate. The Reserve Bank was apparently satisfied that these terms amounted to a sufficiently permanent injection of capital into the St George group to amount to Tier 1 capital.

Under the second leg, the funds raised by the issue of the Series A Capital Securities would be lent by LLC to St George under the terms of the debenture. These funds would qualify as Lower Tier 2 capital of St George (considered as a stand-alone company) for the Reserve Bank’s capital adequacy requirements. The documents were clearly designed:

- to match St George’s obligations to LLC under the debenture to the entitlements of the Series A and Series B Capital Security holders under the share issue; and
- to ensure that the debenture would qualify as Tier 2 capital of St George.

Again, the provisions which did this, and the way they meshed with the terms of the Capital Securities, would be at the heart of the tax dispute.

The documents provided:

- the interest rate on the debenture was 8.485% payable semi-annually in arrears. The rate increased to 8.985% from 1 July 2017 and to 9.485% from 1 July 2022. These rates matched the dividend rates payable by LLC on the Series A and Series B Capital Securities, and that promised for the Series C Capital Securities;
- the interest was payable to LLC on the same date that it had to pay its dividends to holders of Capital Securities;
- interest was only payable if the payment would not leave St George insolvent;
- the debenture would be repaid on 30 June 2023. (This differed from the terms of the Capital Securities, whose holders had no right to be repaid in cash. But, when the loan principal was repaid, the funds would actually flow back to St George as it would by then be the holder of the Capital Securities because of the option arrangements. This meant the funds lent to St George did not leave the group on the repayment of the debenture); and
- in the event of default by St George in payment of interest or principal, the rights of the lender were subordinated to the other creditors of St George.

The first part of the case considered the deductibility of the interest on the debenture. Initially, the Commissioner had offered a battery of possible justifications for denying the deductibility of the interest, including Part IVA, but he subsequently abandoned most of them. In the end, this part of the case revolved around whether the interest on the debenture was capital or of a capital nature.

Interest as a capital outgoing

In essence, the taxpayer argued that the interest on the debenture was deductible because it secured the use of the funds raised under the debenture for each year of the term of the debenture. The Commissioner, on the other hand, argued that the interest on the debenture was not deductible because it secured the permanent use of the funds raised under the Capital Securities and on-lent under the debenture.

The judge agreed with the Commissioner. He accepted that,

> *ordinarily, interest will be an allowable deduction under s 8-1, if incurred in the course of an income-producing activity or business … because, usually, it is a recurrent or periodic payment securing an advantage not of an enduring kind, but the use by the borrower of money during the term of the loan*

But in this case, he said that the legal rights created by the documents were designed to effect a permanent injection of capital for St George:

> *There can be no doubt that the capital raised by LLC by the issue of the Series A Capital Securities provided, for* [St George]*, long-term capital in order to improve the business structure of* [the St George group]*. The satisfaction of the RBA that the securities were sufficiently long-term and irredeemable was an advantage,*

> *not of LLC, but of* [St George] *and its group for its and their banking business. Central to the satisfaction of the RBA, as a condition of* [St George's] *banking licence, was* [St George's] *capital adequacy ratio position. Thus, the capital raising by LLC was not an affair of revenue, but of capital – the improvement in the underlying structure of* [St George] *and its group for the establishing or enlarging of the profit-yielding subject of* [St George's] *business…*

The judge considered this advantage made the interest capital in nature and non-deductible.

There was clearly much argument before the Court about whether it was appropriate and permissible for the Court to elide the effect of the two instruments and to characterise the interest payable by St George on the (temporary) debenture in light of the (more permanent) funding raised under the Capital Securities issued by LLC. The judge emphasised that he was not prepared to consider the nature of the advantage secured by the debenture in isolation. He said it was 'impermissible' –

> *to have the interest payable under the Debenture analysed by reference primarily, if not wholly, to the rights and obligations created under the* [debenture]*, without regard to the whole of the surrounding arrangement…* [Such an approach] *ignores the essential requirement to view the legal rights and obligations created by the parties, and payments and outgoings made thereunder, in their whole legal and commercial context, in order that the characterisation, from a business and practical point of view, of the payment or outgoing by reference to the relevant legal relationship can be undertaken.*

The ineffective election

The second part of the case involved the question whether St George had validly made an election to bring the debenture into the statutory debt-equity regime. If so, the deductibility of the interest for the 2002 and 2003 years would have been governed by those rules, rather than the general law on deductibility which the judge had just applied in respect of the earlier years.

The debt-equity regime, which was enacted in 2001, did not apply to instruments on foot at 1 July 2001. However, a taxpayer could make an election to bring an existing instrument into that regime. In early 2002, St George had sent to the Commissioner a document which purported to bring into the new statutory regime an instrument described as "US$350m Subordinated Debentures."

In order for the election to be valid, the legislation required the taxpayer to notify the Commissioner in writing of certain details of the instrument. His Honour held that the document sent by St George lacked some of these details – the number of interests on issue, the three different coupon rates, the three possible terms, the maturity date and redemption details were incorrect. Because the document was insufficiently detailed, the election was not validly made, even though the judge tacitly agreed with the Commissioner that the document contained sufficient information to allow the Commissioner to identify the instrument without any serious doubt.

Implications for the future

The particular instrument – the debenture – under which the interest arose was classified by the Reserve Bank as Lower Tier 2 capital of St George. Typically under current and former law, banks would claim a deduction for interest on debt instruments classified as Lower Tier 2 capital, so the result is concerning. However, it seems that because the Tier 2 instrument was so closely linked to a Tier 1 instrument, and the overall arrangement gave rise to Tier 1 capital for the group as a whole, the judge considered the interest on the Tier 2 instrument was affected. The case appears to say nothing about the deductibility of interest on a discrete and independent Tier 2 instrument.

For the future, under the debt-equity regime, it might be thought that the Reserve Bank's classification of the debenture as Tier 2 capital would be an end to the matter. The former government announced in March 2003 that regulations would be issued to ensure that Tier 2 capital instruments issued by banks in the form of perpetual subordinated notes would be treated as debt for taxation purposes. It remains to be seen whether the regulation, if it eventually emerges, would apply only to discrete and independent instruments that are Tier 2 capital.

The former government also announced in October 2005 that further regulations would be made to ensure that solvency clauses found in certain instruments (including Lower Tier 2 term subordinated notes) would not prevent an instrument from being classified as debt for tax purposes. We await the issue of that regulation as well.

It is interesting to note that the judge did not comment on the apportionment issue that the structure raises. Just under 1/3rd of the interest paid by St George flowed back to St George in the form of dividends on the US$107m ordinary shares in LLC held by St George group companies resident in Australia. The judge treats the interest on the debenture as a single expense and does not differentiate between the interest that ultimately ended up in the hands of the US investors and the interest that returned to St George.

In the longer term, similar instruments will be analysed under the statutory debt-equity regime. (The case straddles the start of the statutory debt-equity regime – the instrument was issued before these rules began but the interest was paid after these rules were in operation.) One provision enacted as part of the debt-equity regime should render irrelevant the issue at the heart of this case – that the interest payment was incurred to secure a permanent injection of capital.

Certainly, the Commissioner seems to have been keen to have the question answered under the statutory debt-equity regime for the 2001 and 2002 years. The judge, who heard argument on the effect of the regime, concluded that the new regime was not applicable and decided the case without resort to those provisions. He, therefore, declined the opportunity to venture his views on how the statutory debt-equity regime might have applied.

The second part of the judgment raises some concerns about how to make an election so that it is valid and effective. The case seems to set a very high bar for meeting precisely the statutory requirements. There can be little doubt that the document which the taxpayer executed and sent to the Commissioner contained enough information to allow the Commissioner to identify the relevant debenture.

The election in the debt-equity provisions was perhaps more detailed than many that are required – the legislation stipulated with great precision exactly what pieces of information the taxpayer had to detail. But the case suggests that strict conformity is the standard for an effective election; close enough is not good enough.

At the time of writing, St George has yet to announce whether it will appeal.

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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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