EXPLANATORY STATEMENT

Select Legislative Instruments No.

[Issued by authority of the Assistant Treasurer]

Income Tax Assessment Act 1997

Income Tax Assessment Amendment Regulations 2012 (No.)

Section 909-1 of the *Income Tax Assessment Act 1997* (the Act) provides, in part, that the Governor-General may make Regulations prescribing matters required or permitted by the Act to be prescribed, or which are necessary or convenient to be prescribed for carrying out or giving effect to the Act.

The Regulation amends the *Income Tax Assessment Regulations 1997* (ITAR 1997) to remove uncertainty concerning the tax treatment of certain hybrid capital instruments as a result of Australia's implementation of the Basel III capital reforms.

Debt and equity tax rules

Division 974 of the Act outlines rules to distinguish between debt and equity for various income tax purposes. One important implication of the debt-equity distinction is that returns on debt interests may be deductible but are not frankable. Returns on equity interests may be frankable but are not deductible.

Broadly, the debt-equity distinction focuses on a single organising principle: whether, in substance, an issuer has a non-contingent obligation to repay the investment. An obligation that meets this basic test is referred to as an 'effectively non-contingent obligation'.

Section 974-135 of the Act sets out what, in a technical sense, constitutes a non-contingent obligation and an effectively non-contingent obligation. To be a non-contingent obligation, the obligation must not depend on any event, condition or circumstance, including the economic performance of the entity with the obligation. There is an effectively non-contingent obligation to take an action if, having regard to the pricing, terms and conditions of the relevant scheme, the obligation is in substance or effect a non-contingent obligation to take that action.

Paragraphs 974-135(8)(a) and (b) of the Act provide that regulations may make further provisions relating to what constitutes and what does not constitute a non-contingent obligation for the purposes of section 974-135 of the Act.

Prudential capital adequacy requirements and the debt-equity tax rules

The Australian Prudential Regulation Authority (APRA) applies capital adequacy regulations to certain financial entities to ensure they have sufficient capital to meet their liabilities to their depositors. APRA uses a tiered classification of capital under their capital adequacy guidelines. Tier 1 capital is equity-like in nature while Tier 2 capital has some hybrid or debt-like characteristics.

Currently, there are Regulations (Regulations 974-135D and 974-135E of the ITAR 1997) which facilitate the debt tax treatment of certain Lower Tier 2 term subordinated notes and Upper Tier 2 perpetual cumulative subordinated notes under the existing prudential framework.

The Basel III capital reforms apply to APRA regulated entities from 1 January 2013. To implement these capital reforms, APRA's prudential regulations have to be amended. Among other things, the Basel III capital reforms consolidate Tier 2 capital into a single group, and require all regulatory capital to be capable of absorbing losses of the entity if required to do so (the non-viability condition). Broadly, it requires that a regulatory capital instrument (including a Tier 2 instrument) be written off or converted to common equity if APRA or a comparable foreign regulator considers that the issuer would be non-viable (or require public injection of funding) without the write off or conversion.

Overview of the Regulations

The purpose of the Regulations is to facilitate debt tax treatment of certain term cumulative subordinated notes issued by entities that are regulated for prudential purposes by APRA and comply with the Basel III Tier 2 capital requirements.

The Regulations provide that an obligation to pay the principal or interest on the relevant note is not precluded from being a non-contingent obligation (and therefore the note is not precluded from being a debt interest) by the non-viability condition contained in the notes. The existence of such a condition is necessary for the note to be recognised in the issuer's capital base for prudential purposes. Without the Regulations, this condition may make the obligation a contingent obligation, as the obligation would be contingent on the non-viability condition not being triggered.

While facilitating the debt treatment of these notes, the Regulations do not of themselves deem such notes to be debt interests or make returns on the notes tax deductible.

Details of the Regulations are set out in the Attachment.

The Regulations commence on and apply from 1 January 2013.

The Regulations are a legislative instrument for the purposes of the *Legislative Instruments Act 2003*.

The Act specifies no conditions that need to be satisfied before the power to make the Regulations may be exercised.

ATTACHMENT

Details of *Income Tax Assessment Amendment Regulation 2012 (No.)*

Regulation 1 — Name of Regulations

This regulation provides that the title of the Regulations is the *Income Tax Assessment Amendment Regulation 2012 (No.)*.

Regulation 2 — Commencement

This regulation provides that the Regulations commence on 1 January 2013.

Regulation 3 — Amendment of *Income Tax Assessment Regulations 1997*

This regulation provides that the *Income Tax Assessment Regulations 1997* (the Principal Regulations) are amended as set out in Schedule 1.

Schedule 1 — Amendments

[Items 1 and 2]

Items 1 and 2 update the title of regulations 974-135D and 974-135E to clearly distinguish between the regulations that apply to the different subordinated notes.

[Item 3] — regulation 974-135F

Item 1 inserts a new regulation 974-135F (regulation) into Subdivision 974-D of the Principal Regulations.

The regulation provides that, for certain notes, the obligation to pay the principal or interest is not precluded from being a non-contingent obligation for the purposes of the debt test if the obligation is contingent on certain conditions.

Structure of the regulation

Subregulation 974-135F(1) sets out that the regulation applies to obligations to pay the principal or interest on a ***relevant*** term cumulative subordinated note on or after 1 January 2013.

Subregulation 974-135F(2) is the primary operative provision. It provides that an obligation to pay the principal or interest on a ***relevant*** term cumulative subordinated note is not precluded from being a non-contingent obligation because of the ***non-viability condition*** in the note. The non-viability condition, upon being triggered, requires the note to be written off or converted into ordinary shares of the issuer. Without the regulation, the condition may cause the obligation to be considered to be contingent and may preclude the note from being a debt interest.

Subregulation 974-135F(3) sets out the features of a ***relevant*** term cumulative subordinated note to which the regulation applies.

Subregulation 974-135F(4) sets out what a ***non-viability condition*** means for the purpose of the regulation.

Subregulation 974-135F(5) sets out what a ***non-viability trigger event*** means for the purposes of the regulation.

Conditions on the obligations to which the Regulation applies

Subregulation 974-135F(1) provides that the regulation applies to an obligation to pay the principal or interest on a relevant term cumulative subordinated note issued on or after 1 January 2013. The application date aligns with the commencement of the Basel III capital reforms.

Subregulation 974-135F(4) sets out the ***non-viability condition***.

The condition is that the note is obliged to be written off or converted into ordinary shares of the issuer upon the occurrence of a ***non-viability trigger event***.

The ***non-viability trigger event*** is described in subregulation 974-135F(5) and constitutes either:

- the issuance of a written notice from APRA or a comparable foreign regulator to the issuer of the note stating that conversion or write-off of capital instruments issued by the issuer is necessary because, without it, APRA or the foreign regulator considers that the issuer will become non-viable; or

- the written determination from APRA or a comparable foreign regulator to the issuer that without an injection of capital, or equivalent support, from the government the issuer will become non-viable.

For the purposes of this regulation, a foreign regulator is not a comparable foreign regulator unless it issues and administers prudential standards that, in material respects, are substantially similar to those made and administered by APRA.

The ***non-viability condition*** is consistent with prudential standards which are standards made by APRA under:

- section 11AF of the *Banking Act 1959*;

- paragraph 230A(1)(a) of the *Life Insurance Act 1995*; and

- section 32 of the *Insurance Act 1973*.

But for the non-viability condition, the terms of the note would ordinarily mean that payments of principal and interest are non-contingent.

Features of the term cumulative subordinated note to which the regulation applies

A term cumulative subordinated note is a financial instrument generally used by companies to obtain finance. It has the following features:

- a *fixed term* by the end of which the note must be repaid; and

- payment is *subordinated* to the interests of more senior creditors.

Term cumulative subordinated notes that are subject to the regulation must have the following features:

Paragraph 974-135F(3)(a) — issuer

The note must be issued by an entity that is regulated by APRA. This includes entities which are required to comply with APRA's prudential standards, such as authorised deposit taking institutions and insurance companies, and those that have undertaken to comply with APRA's prudential standards dealing with capital adequacy.

Paragraph 974-135F(3)(b) — Tier 2 instrument

The relevant notes would ordinarily qualify as Tier 2 capital for prudential purposes under the Basel III capital reforms.

At the time of issuance, the note must not constitute, or meet the requirements of, a Tier 1 capital instrument.

A term subordinated note may have the characteristics of a Tier 1 capital instrument but not be classified as such for prudential purposes because the issuer, or a connected entity, has an 'excess of Tier 1 capital'. The regulation does not apply to 'Excess Tier 1 capital instruments'.

Paragraph 974-135F(3)(c) — term

The note must have a term of 30 years or less and there must be no unconditional right to extend the term of the note beyond a total term of 30 years.

Paragraphs 974-135F(3)(d) and (e) — cumulative

The note must contain a condition that any deferred interest must accumulate until such time as the payment is made or the ***non-viability trigger event*** occurs. The deferred payments do not have to compound, which means that interest does not have to be paid on any deferred payment.

Under the terms and conditions of the note, the issuer of the note must not have an unconditional right to decline to provide a financial benefit that is equal, in nominal value, to the issue price of the note to settle the obligations under the note. The limitation reflects the concept of a liability for financial accounting purposes; accordingly, the limitation is designed to ensure that the proposed regulation does not facilitate debt tax treatment for a note that is not a liability for financial accounting purposes.

Interaction between this Regulation and the rest of the income tax law

This regulation does *not* have the effect of deeming an instrument to be a debt interest where it would otherwise have been an equity interest.

It only provides, for the purposes of section 974-135 of the *Income Tax Assessment Act 1997* (the Act), that certain obligations are not prevented from being non-contingent obligations as a result of the ***non-viability condition*** contained in the note. In order for a note to be classified as a debt interest it will still need to satisfy the debt test in subsection 974-20(1) of the Act. Further, the regulation does not of itself provide that returns on eligible notes are deductible for tax purposes.

Further, the regulation does not override the need to consider whether a note to which this regulation applies is itself part of a related scheme. This can be relevant for the purposes of determining whether the note and a related scheme taken together satisfy the debt test or the equity test.

Example 1

Lyra Co has an obligation to make principal and interest payments on a note to which this regulation applies.

The effect of the regulation applying is that certain contingencies in relation to these obligations are disregarded for the purposes of determining whether Lyra Co has an effectively non-contingent obligation to make those payments.

As a result of the regulation applying, the scheme that is the note considered in isolation may be a debt interest for the purposes of Division 974 of the Act.

However, the note is itself part of a related scheme entered into with Bon Bon Co, a connected entity. There is nothing in this regulation that prevents the two schemes, constituted by the note and its related scheme, from being an equity interest as a result, for example, of subsection 974-70(2) of the Act applying.