Greenwoods
& Freehills

Tax Brief

5 June 2009

Deductibility of Interest on Subordinated Debt

In an earlier Tax Brief [available at http://www.gf.com.au/477_634.htm] we reported on a case denying St George Bank a deduction for interest paid on a subordinated loan issue. The Full Federal Court recently heard the taxpayer's appeal in this case and unanimously confirmed that the interest expense was not deductible. In this Tax Brief we review the Court's reasoning and the ongoing significance of this case.

Background

The relevant facts involved a debenture issued by St George Bank in 1997, prior to the commencement of the debt-equity rules on 1 July 2001, and interest paid on the debenture in years before and after the commencement of those rules. Although the taxpayer had attempted to elect to bring the relevant instrument into the debt-equity regime, the case was decided on the basis of the former law for reasons that are described below.

The facts and the important terms of the various documents are set out in detail in our earlier Tax Brief. In short, the dispute arose from the following facts:

- a special purpose limited liability company ("**LLC**") in the US raised US$250m through the issue of redeemable preference shares (which qualified as Tier 1 capital of the St George consolidated group for the capital adequacy requirements of the Reserve Bank, the regulator of the banking industry at that time);
- although the shares were redeemable, LLC had the option of putting another share in LLC to the investors in lieu of repaying the amount subscribed, and then a further share and so on. (However, the dividends under each succeeding share issue became larger and so it was expected in the market that at some stage St George would re-finance and redeem the shares for cash);
- LLC lent the funds raised to St George at interest under the debenture arrangement (the debenture qualified as Lower Tier 2 capital for regulatory purposes for St George on a stand alone basis);
- although the debenture was to be repaid by St George to LLC at the expiry of the term, surplus funds remaining after redeeming the shares

would then flow back to St George (as it would at that time be the only investor in LLC);

- the dates and rates of interest payable by St George on the loan exactly matched the dates and rates of dividends to be paid by LLC to its investors; and
- the rights of LLC under the debenture were subordinated to other creditors of St George and St George could also prevent LLC from paying a dividend to the holders of the redeemable preference shares if necessary.

The net effect of the two transactions satisfied the regulator that St George had effectively raised US$250m in additional, sufficiently permanent, funds to amount to Tier 1 capital for the St George consolidated group.

Interest as a capital outgoing

The Full Federal Court confirmed the decision of the judge at first instance that the interest paid on the debenture was not deductible.

The Court approached the issue on the basis that the structure of a company's capital can be a structural advantage of a capital nature, especially in those cases where a regulatory obligation (in this case, the capital adequacy requirements of the regulator) imposes particular requirements about the company's capital structure. And where that was the case, the cost of meeting the regulatory requirement may be capital in nature. The Court drew an analogy with the cost of acquiring and holding a particular kind of licence such as a TV broadcasting licence. So, in this case, meeting the regulator's capital requirements went to the ongoing ability of St George to operate as a bank. The Court was not dissuaded from this view by St George's arguments that the arrangement only secured the additional funds for a limited term, nor by the fact that the interest expense to maintain this structure was recurrent.

Electing into the debt-equity rules

The second part of the case concerned whether St George had validly elected to bring the debenture into the debt-equity regime which had begun on 1 July 2001. The company had sent a notice to the ATO in February 2002 purporting to do so, but argued before the Court that its efforts had been ineffective because the notice was flawed.

The Court agreed with St George that its election had not met the statutory requirements for a valid election – it lacked certain prescribed details and misstated other information. The Court was not prepared to accept the ATO's argument that the notice contained enough information for the ATO to be able to identify the instrument, and this was sufficient for the election to be valid. Again, the decision at first instance was upheld.

Comments

In the banking industry, it is generally understood that no deduction is allowable for the costs of Tier 1 capital but the cost of Lower Tier 2 capital would ordinarily be regarded as deductible. On one reading, perhaps this judgment is merely an example where a Court characterised the debenture (Lower Tier 2 capital for St George on a stand-alone basis) in the same way as the money raised by LLC (Tier 1 capital for the St George group) because the links between the two instruments were so closely established – that is, when St George paid interest on the debentures it should really be viewed as paying the dividends on the shares issued by LLC. If that were the proper reading of the case, it might not be too surprising.

Unfortunately, the judgment of the Full Federal Court does not put the matter in this way. Rather the Court said:

> *when commercial circumstance, or regulatory obligation, impose upon a company particular requirements as to its capital structure, the cost of meeting those requirements may, in some cases, be capital in character.*

But this analysis is incomplete. There is a critical distinction for tax purposes between the costs of establishing a capital structure or capital asset (which will typically be non-deductible) and the costs of servicing or maintaining it (which will typically be deductible). The amounts in question in this case were more akin to the costs of servicing or maintaining the capital – not the costs of putting it in place. The judgment does not acknowledge this distinction. Moreover, the judgment contains passages which tend to cast some doubt on the distinction – taken too far they would put in doubt the ability to deduct the cost of mandatory audits, premiums paid to insure a capital asset, amounts paid to repair a capital asset and so on.

We noted above that similar instruments would now be governed by the debt-equity rules and clearly the ATO was keen to test the transaction under those rules.

Moreover, 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 significance of the part of the judgment concerning elections should also be noted. The Court adopted a very strict reading of the requirements of the section for the election to be valid. It did so in the face of what would ordinarily be a less than appealing argument – that the taxpayer was able to escape the consequences of its actions because of its own mistakes.

At this stage it is not clear whether St George will seek leave to appeal to the High Court.

For further information, please contact

Sydney

Ernest Chang

ernest.chang@gf.com.au

phone 61 2 9225 5965

Simon Clark

simon.clark@gf.com.au

phone 61 2 9225 5957

Tony Frost

tony.frost@gf.com.au

phone 61 2 9225 5982

Paul King

paul.king@gf.com.au

phone 61 2 9225 5972

Andrew Mills

andrew.mills@gf.com.au

phone 61 2 9225 5966

Melbourne

Adrian O'Shannessy

adrian.o'shannessy@gf.com.au

phone 61 3 9288 1723

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.

Greenwoods & Freehills Pty Limited
ABN 60 003 146 852
Level 39 MLC Centre Martin Place Sydney NSW 2000 Australia
Facsimile (02) 9221 6516 Telephone (02) 9225 5955
Liability limited by a scheme approved under Professional Standards Legislation