

Tax Brief

9 April, 2009

Debt for Equity Swaps

1. Introduction

It may be possible to find a silver lining in the cloud of economic woes being experienced by many struggling businesses unable to meet their interest and principal obligations. One option that may be open to a debtor is to recapitalise the business by entering into a debt for equity swap arrangement with its creditors under which:

- a creditor accepts equity in the debtor; and
- the whole or part of the debt owed by the debtor is discharged, released or extinguished.

The arrangements that might be negotiated between creditors and distressed debtors could take a number of forms, however, this Tax Brief only considers the tax outcomes for creditors and debtors of a 'plain vanilla' debt for equity swap. Interestingly, some of the specific tax measures that are discussed below were introduced by the Keating Government in the midst of the recession of the early 1990s to reinvigorate the Australian economy by providing a creditor with a tax deduction at an earlier time than would have been the case under the general tax deduction rules and at the same time allowing some debtors to restructure rather than cease trading or be forced into liquidation.

It is also interesting to note that on 21 November 2008 the Australian Taxation Office ('ATO') withdrew the vast majority of the ATOIDs it had issued dealing with the commercial debt forgiveness rules. This may indicate that the ATO is also considering these issues in more detail.

2. Income tax issues for the creditor

The immediate issue for a creditor that decides to accept equity in the debtor is the tax treatment of the debt that is now discharged. The second issue is the subsequent treatment of the equity that has been acquired.

2.1 Debts that are subject to the bad debt rules

Specific rules exist to provide a tax deduction for a creditor in respect of the loss suffered under certain debt for equity swaps. The key requirements to be satisfied are:

- the debtor must be a company, a public unit trust or a trading trust;

- either the debt must have been included in the creditor's assessable income (eg, a trade debt owed to a taxpayer that tax accounts on an accruals basis) or the debt is money lent by the creditor in the course of a money lending business. For a creditor that is a bank, this requirement should be easily satisfied in respect of the whole debt. However, where the creditor is neither a bank nor in the business of lending money, only that part of the debt that had been treated as assessable income (eg, proceeds of selling trading stock, or accrued interest) can qualify for the tax deduction; and
- the arrangement must involve the discharge, release or extinguishment of the debt in return for an issue of shares (except redeemable preference shares) or units in the debtor. (Interestingly, there is no formal correlation with the debt-equity rules and so the shares issued could potentially be debt interests, though not redeemable preference shares.)

Where the rules apply, the following tax consequences arise. First, a tax deduction may be available in respect of the debt that is released, extinguished or discharged under the arrangement; it is not necessary for the debt to be 'bad' before a creditor can claim the tax deduction.

The amount of the deduction is equal to the swap loss incurred by the creditor – this is the difference between the face value of the debt and the 'equity value' of the shares or units issued by the debtor. For example, if the debt had a face value of \$100 and the equity value of the ordinary shares issued is \$70, the amount of the swap loss that is deductible is \$30.

'Equity value' refers to the market value of the equity at the time of issue or the value recorded in the creditor's accounts, whichever is the greater. The rules do not specify how the valuation of the shares or units issued by a debtor is to be determined. Practically, there are a few issues to be kept in mind:

- The ATO has published guidelines around valuation of assets for certain income tax purposes. These guidelines may also assist for the purpose of determining the equity value of the shares or units. For example, if the shares in the debtor are listed, the market value of each share may be determined by reference to the quoted price, whilst the process is expected to be more complex in relation to unlisted shares.
- The method used to determine the value of the shares or units should be appropriate to the situation and properly documented.

These rules also prescribe the subsequent treatment of some transactions with the equity that has been acquired. Any profit realised or loss incurred on a subsequent disposal, redemption or cancellation of the shares or units, is treated as assessable income or allowed as a deduction (as the case may be) of the creditor, rather than capital gain or loss.

2.2 Other debts

All is not lost for creditors who are not entitled to a deduction under the specific debt for equity swap provisions. However, the tax outcome will not

be an immediate deduction but a capital loss to be applied against other capital gains, either in the current year or in later years under the carry forward rules. The amount of the loss should be the difference between the amount of the loan and the market value of the equity received. The same amount should then become the cost of those shares for CGT purposes.

However, if the relevant debt that is being exchanged was issued as a 'convertible interest' or an 'exchangeable interest,' CGT rollover relief may automatically apply on conversion of the debt into equity – ie, there is no immediate capital loss for the creditor. If CGT rollover applies then any tax consequences for the creditor arise only on disposal of the shares.

3. Income tax issues for the debtor

The income tax issues for a borrower will depend on its tax attributes and the particular circumstances in which the debt was incurred and discharged. Accordingly, the following discussion focuses only on the key tax issues that will typically arise for the debtor.

3.1 Discharge of the debt

In most instances, it is not expected that the debtor would generate ordinary income on the economic gain that arises from having its liability extinguished or discharged, unless the debtor is a bank or financial institution.

However, a few Australian court decisions have held that the economic gain arising from an extinguishment of a liability may be treated as income under ordinary concepts in some limited circumstances. Accordingly, whether or not the amount of the gain would be treated as ordinary income of the debtor is a significant issue that will need to be carefully analysed and considered. It might, for example, mean that interest which has already been deducted but is later forgiven could be added back to the debtor's assessable income in certain circumstances.

For a debtor that is a bank or a financial institution, a conclusion that economic gains made on the extinguishment or discharge of borrowings are on revenue account would be more readily reached, unless the particular circumstances indicate otherwise.

No CGT consequences should arise for the debtor because a debt is not considered to be a CGT asset of the debtor.

3.2 Commercial debt forgiveness ('CDF') rules

If the gain on discharge or extinguishment of a debt does not give rise to assessable income for the debtor, then the application of the CDF rules will also need to be considered.

If the CDF rules apply, any gain is not directly assessable to the debtor, but the 'net forgiven amount' of the debt is applied in reducing the following tax attributes of the debtor (in order):

- revenue losses incurred in the years of income before the forgiveness occurred;
- net capital losses incurred in the years of income before the forgiveness occurred;
- other expenditure that would be deductible in the current or future years; and
- cost bases of certain CGT assets held at the beginning of the year in which the forgiveness occurred.

Special valuation rules apply in working out the 'net forgiven amount' of the debt. In addition, if the creditor and debtor companies are resident companies under common ownership, they can agree that the creditor will forego some or all of its capital loss or deduction, in which case, the impact on the debtor is adjusted accordingly. If the creditor agrees to forego its entire loss, the CDF rules should have no impact on the debtor company.

If the issue of the shares results in the debtor company failing the continuity of ownership test for the forgiveness year of income (and the same business test cannot be satisfied instead), the 'net forgiven amount' is applied to reduce just the amount of the deductible expenditure or cost bases of certain CGT assets. (The carry forward revenue and net capital losses of the debtor that would ordinarily be affected will already have been eliminated because of the failure to maintain continuity or the same business.)

Where there are insufficient tax attributes to be reduced, the balance is ignored in applying the net forgiven amount. Whilst there is no flexibility in the order of application, there is flexibility within each category – eg, a consolidated group may select those losses with the lowest available fraction.

3.3 Other income tax issues

Depending on the particular situation of the debtor, there may be other income tax consequences that should be considered prior to entering into a debt for equity swap arrangement.

Impact on the continuity of ownership. Where the debtor has carry forward revenue or capital losses or bad debt deductions, the impact on its ability to demonstrate the continuity of majority ownership for the relevant income years, needs to be carefully considered. If continuity of majority ownership cannot be demonstrated as a result of the share issue, the debtor will need to rely on the satisfaction of the strict same business test to recoup its losses or deduct its bad debts.

Potential application of share capital tainting rules. Generally, a debt for equity swap arrangement should not result in the share capital account of the debtor company becoming 'tainted' for income tax purposes. There is an exclusion from the operation of the share tainting rules where an arrangement to extinguish or discharge a debt is in return for shares in the debtor company. This exclusion does not apply if the shares issued by the

debtor company are redeemable preference shares. There is, in addition, a special qualification where the value of the shares issued is less than the amount of the debt being discharged.

Tax consolidation rules. Where the debtor is a subsidiary member of a tax consolidated group, the interaction between the tax consolidation regime and other tax rules may also give rise to challenges. For example, an issue of shares by a debtor that is a subsidiary member of a tax consolidated group will result in deconsolidation of that debtor.

4. Taxation of Financial Arrangements Rules

The *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009*, was recently passed by Parliament and has now received Royal Assent. In broad terms, the regime applies to taxpayers (over various turnover and asset thresholds) in respect of all financial arrangements entered from 1 July 2010, although elections exist to accelerate adoption to 1 July 2009 and to include pre-existing financial arrangements. (Different dates apply to taxpayers with tax year ends other than 30 June.)

Under the TOFA rules, there are various tax timing methods that may be used to determine the amount of any gains or losses made from financial arrangements, and gains or losses are typically treated as being on revenue account, rather than capital account. It is possible, therefore, that the consequences under the TOFA rules of a debt for equity swap (in respect of debts incurred after the start of TOFA) may differ in some respects from the treatment under current rules.

Where the debt has arisen from sales of goods, real property or services on credit terms, a financial arrangement will not arise unless the term of the loan exceeds 12 months. Hence the TOFA rules will ordinarily not apply to either party to a debt for equity swap (although the interest held by the creditor may be within TOFA if it has made a fair value election.)

If the debt arose in other circumstances, a creditor which was not a money lender or financial institution would ordinarily expect the loss suffered on the debt for equity swap to be on capital account under current law. Even though the TOFA rules would apply to a loan made in such circumstances, they contain a number of provisions designed to prevent this loss being treated as a revenue loss.

For a debtor, the application of the CDF rules take precedence over the TOFA rules. However, where the amount of the gain that is calculated under the TOFA rules is greater than the 'net forgiven amount' calculated under the CDF rules, the TOFA rules may still apply to include the amount of that excess in the debtor's assessable income.

5. GST

There will also be a number of GST issues to consider arising from a debt for equity swap arrangements. Unlike the income tax, there are no special GST rules to accommodate debt for equity swaps, and so the application of the ordinary rules has to be determined.

5.1 GST treatment of transaction

As outlined above, a debt for equity swap arrangement will generally involve a creditor accepting shares or units in the debtor and the whole or part of the debt owed to the creditor being discharged, released or extinguished. In these circumstances, it is likely for GST purposes that the debtor and creditor will each be regarded as making input taxed financial supplies – the debtor by issuing the shares and the creditor by abandoning the debt. No GST liability will arise from these transactions.

Because these transactions will be regarded as input taxed, the debtor and creditor will generally be denied input tax credits for acquisitions related to making those supplies (ie, their transaction costs). However, reduced input tax credits may be available for specified acquisitions connected with the swap transaction.

The creditor will also need to consider whether the arrangement gives rise to a GST adjustment if the relevant debt arose in connection with a taxable supply. The receipt of the shares in such a situation, may be viewed as altering the consideration for the original supply, especially if they have a lower market value than the face value of the debt. The creditor may wish to claim a decreasing adjustment at the time of the swap. So far as the debtor is concerned, the payment of the invoice by issuing shares raises difficult questions whether this represents a change to the invoiced price.

5.2 Other GST issues for the debtor

The conversion of debt into equity may also have some GST consequences for a debtor. Where the debtor used the borrowed funds in relation to its taxable activities (eg, to purchase plant and equipment), it may have been able to rely on a special provision enabling it to claim full input tax credits for acquisitions relating to the loan. However, where the debt is exchanged for equity, this provision will probably no longer apply (even if the equity happens to satisfy the debt test in income tax law).

Also, any change in the debtor's ownership structure may affect the debtor's entitlement to remain a member of an existing GST group. Where a debtor ceases to be a member of a GST group, any supplies made between the debtor and members of that GST group will be subject to GST, which could result in GST leakage.

For further information, please contact

Sydney

Andrew Mills

andrew.mills@gf.com.au

phone 61 2 9225 5966

Jane Michie

jane.michie@gf.com.au

phone 61 2 9225 5915

Joshua Cardwell

josh.cardwell@gf.com.au

phone 61 2 9225 5887

Andrew Howe

andrew.howe@gf.com.au

phone 61 2 9225 5919

Melbourne

Hayden Scott

hayden.scott@gf.com.au

phone 61 3 9288 1545

Adrian O'Shannessy

adrian.o'shannessy@gf.com.au

phone 61 3 9288 1723

Richard Buchanan

richard.buchanan@gf.com.au

phone 61 3 9288 9103

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