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Interest payments might be tax deductible while dividend payments never are. Dividend payments might be frankable while interest payments never are. So working out whether something is debt or equity can have huge tax consequences. But how to tell one from the other?

Given the sophistication of modern day financial markets, this can be quite tricky.

Debt or Equity

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Why does it matter whether an instrument is debt or equity for income tax purposes? Because the law treats debt and equity interests very differently for income tax purposes.

Payments for a debt interest are tax deductible (to the extent of s 8 – 1 (s 25-85)) but not frankable. Payments for an equity interest on the other hand are frankable, but not tax deductible.

And income tax law has its own set of rules, different to corporate law. Redeenable preference shares for example are always equity under corporate law, but might be treated as debt for income tax purposes.

How do you determine whether an instrument is debt or equity under Div 947?You run the debt test. If that fails, you run the equity test. And if that fails, you apply common law. Debt always prevails. Even if an interest passes both the debt and equity test, it is treated as a debt interest. This is called the tie-breaker rule. But let’s go through this one by one in more detail.

Debt Test

Does the instrument pass the debt test in 974-20 ITAA97?

The debt test says that a financing arrangement is a debt interest if there is an effectively non-contingent obligation to return to the investor a financial benefit that is substantially more likely than not equal or greater than the amount received.

Before we break this into smaller chunks, please remember that the two key concepts of the debt test are Effectively non-contingent obligation (ENCO) and Financial Benefit. If you got that, you are on the home run.

Step 1 – Is there a scheme?

If there is no scheme, you can stop. But there is almost always a scheme, unless you have an Aunty-Daisy-Gives-Little-Peter-$100 scenario.

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Step 2 – Is there a financing arrangement?

A financing arrangement is a scheme to raise finance for an entity or its connected entity. It usually involves the contribution of funds in some form.

A loan agreement between an investor and a company would be an example of a basic financing arrangement.

Some schemes are explicitly excluded from being financing arrangements. They are:

1. Certain lease or bail-out arrangements, like hire purchase arrangements, leasing of luxury cars;
2. Securities-lending agreements under 26BC ITAA36;
3. Life and general insurance contracts as part of the issuer's ordinary course of business;
4. Schemes for the payment of royalties.

So unless you have one of these exceptions, the scheme is usually a financing arrangement if it involves the transfer of funds.

If the interest is an interest as a member of the company (e.g. a shareholder), there is no requirement that it must be a "financing arrangement" for the purpose of the debt test: s 974-20(1). So for shareholdings you can skip step 2.

Step 3 – Has the issuer received a financial benefit?

A financial benefit per s 974-160 ITAA97 is anything of economic value and includes money, property, services and anything else meeting the definition.

Having an obligation to repay the benefit does not prevent it from being a financial benefit received. So a company taking out a loan would receive a financial benefit, even though eventually the company has to pay it back.

Step 4 – Does the issuer have an effectively non-contingent obligation to provide a financial benefit in return?

So here is the most important concept to grasp: Effectively non-contingent obligation (ENCO). This is the point of make or break.

The issuing entity must have an effectively non-contingent obligation to provide a future financial benefit in return for the financial benefit received.

But what is an effectively non-contingent obligation to provide a financial benefit?

a) Obligation

To start with we need an obligation. The issuer must have an obligation to the investor. No Obligation = No Debt.

b) Financial Benefit

Next it must be an obligation to provide a financial benefit.

Not everything the issuer provides back to the investor counts as a financial benefit. The issue of shares for example doesn't.

The issue of an equity interest in the entity or a connected entity does not count as a financial benefit for the purposes of Div 947 (974-30).

So if a company issues shares on interest-bearing convertible notes, the value of those shares does not constitute a financial benefit for the purposes of Div 947. Only the interest counts as a financial benefit to be

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provided.

The financial benefit the issues has to provide back to the investor could be a single amount or numerous amounts over time like interest payments for example.

c) Effectively Non-Contingent

And last but not least, the obligation to provide a financial benefit must be effectively non-contingent.

s 974-135 ITAA97 gives a definition of “effectively non-contingent obligation” but that definition isn’t really that helpful. Whether an obligation is effectively non-contingent can be very difficult to determine in practice.

You would think for example that if an entity is unable or unwilling to pay, that this would make the obligation no longer effectively non-contingent, but it doesn’t. Even if the issuer is unable (insolvent) or unwilling to pay, there is still an effectively non-contingent obligation to pay.

And the fact that the law requires to service redeemable preference shares out of profits or through the issue of new equity, also has no bearing on the question of ENCO.

There is an entire Taxation Ruling on economic compulsion – TR 2010/5. Its title is:

Income tax: the relevance of “economic compulsion” in deciding whether an issuer of financing arrangement has an ” effectively non-contingent obligation” for the purposes of section 974-135 of the Income Tax Assessment Act 1997

That is 34 words for a …. title. Somebody clearly… But we digress.

So in this TR the Commissioner looked at economic compulsion. Does an obligation become effectively non-contingent if not meeting this obligation would mean adverse economic consequences? Think of a public call to boycott the issuer’s products or worse.

And the answer is that yes. You have to consider the pricing, terms and condition of the relevant scheme, but if a reasonable person in the position of the issuer would conclude at the time of issue that the issuer was inevitably bound to pay rather than suffer the adverse economic consequences of not paying, then yes, there is an effectively non-contingent obligation.

So now you got your effectively non-contingent obligation, or ENCO for short.

Step 5 – Is it substantially more likely than not that the financial benefit to be provided will be at least equal or exceed the benefit received?

So there are two questions here. 1) Will the issuer give back at least equal or more than it received? And 2) Is it substantially more likely than not that this will actually happen?

a) At Least Equal

We already worked out that the issuer has to provide a financial benefit. But the question now is whether that financial benefit is at least equal to the financial benefit it received.

The benefit to be provided might include the return of the initial investment amount.

Let’s say the company received a loan of $1m from the investor. If the issuer has to repay the full $1m plus interest at some stage in the future, then the financial benefit to be provided ($1m plus interest) will at least equal to the financial benefit received (loan of $1m) – assuming the interest will exceed any discounting of the original debt.

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b) Discounting to Net Present Value

The value of the financial benefit to be provided depends on the performance period of the arrangement, which is the period within which the issuer has to meet its effectively non-contingent obligations. In our example, this would be the loan period.

If the term is 10 years or less, you take the nominal value.

If the term is more than 10 years, you use the net present value. The net present value is the nominal value, discounted, using the adjusted benchmark rate of return.

The benchmark rate of return is the internal rate of return on an investment if it were an ordinary debt of the issuer or an equivalent entity, compounded annually and otherwise comparable with the interest under consideration.

The adjusted benchmark rate of return is 75% of the benchmark rate of return.

If an instrument passes this test, in other words if the answer to each of these questions is a YES, you treat the instrument as a debt interest.

So the debt test is quite tough. You need five clear shouts of YES.

If there is just one NO in the mix, the debt test is a fail. And you move on to the equity test.

Tie Breaker Rule

If you have an instrument that passes both the debt and equity test, the tie-breaker rule says that it is a debt instrument. So although in theory you are meant to first run the equity test and then the debt test, in practice it makes more sense to first look at the debt test. Because if the debt test is a pass, you can stop right here and don’t need to worry about the equity test.

Equity Test

The equity test consists of 4 questions. If you answer yes to any, you got an equity interest if the instrument is a financing arrangement where required.

1) Shareholder

Is the instrument an interest in a company as a member (shareholder) or stockholder?

This includes shares as well as stockholder interests in companies limited by guarantee.

2) Contingent on economic performance

Is it an interest that carries a right to a variable or fixed return contingent on the economic performance (current, past, future) of the company, a part of it, or a connected entity?

A connected entity is an associate of the entity or another member of the same wholly owned group.

An example is a hybrid instrument where the returns are dependent on the company’s profts.

This does not cover situations where an employee’s remuneration is contingent on the economic performance of a company.

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Even if the answer is yes, the interest can only be an equity interest if it is a financing arrangement.

3) At the discretion of the company

Is it an interest that carries a right to a variable or fixed return at the discretion of the company or a connected entity?

Even if the answer is yes, the interest can only be an equity interest if it is a financing arrangement.

4) Right to equity

Does the interest give its holder a right to the issue of equity? Will or may the interest convert into equity?

Even if the answer is yes, the interest can only be an equity interest if it is a financing arrangement.

So this is the equity test. If you answer Yes to at least one of the four questions, you have an equity instrument. However, it is only equity if it fails the debt test.

Common Law

What do you do if the interest fails both the debt and equity test? You apply common law and use s 8-1 ITAA97 to determine whether an amount is deductible.

At-call Loans

Private companies often receive a loan from a shareholder or shareholder's associate, usually without documentation, specific terms or a repayment date.

As the lender usually can demand repayment of the funds at any time, the loan is payable on demand, hence the name "at-call".

These loans usually don't pass the debt test since there is no effectively non-contingent obligation. The shareholder might or might not call the loan.

But these loans usually pass question 3 of the equity test since repayment is at the discretion of the company. So based on the general debt/equity classifications rules, at-call loans are equity for income tax purposes.

However, there is a carve-out rule that allows to treat at-call loans as debt if the company's turnover for GST purposes is less than $20m. The carve-out rule per s974 – 75 (6) applies if:

1. The loan does not have a fixed term; and
2. The loan is repayable on demand or on the death of the individual connected entity.

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