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## **DEBT/EQUITY HYBRIDS AND SYNTHETIC ARRANGEMENTS**

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## *Debt/equity hybrids: a case for reform*

### Current arrangements are largely based on form not substance

#### What are debt/equity hybrids?

7.1 A debt/equity hybrid is a financial instrument that contains both debt and equity characteristics. Hybrid instruments can be designed so that they exhibit changing proportions of debt and equity over time. In addition, hybrid instruments may incorporate derivative characteristics. Some of the better known hybrid instruments include certain classes of preference shares, convertible notes, capital protected equity loans, profit participating loans, perpetual debt, endowment warrants and equity swaps.

#### How are debt/equity hybrids taxed at present?

7.2 The tax treatment of debt/equity hybrids under the current income tax law is heavily influenced by the legal form of the hybrid instrument: instruments in the legal form of shares generally receive equity tax treatment while other instruments are accorded debt treatment. As well, anti-avoidance rules bear upon the availability of certain tax attributes of particular hybrid instruments. For example, section 46D of the *Income Tax Assessment Act 1936* (the Act) denies franking benefits and the intercorporate dividend rebate on dividends that are equivalent to interest on a loan ('debt dividends'). As well, section 82R is designed to deny deductibility for interest paid on convertible notes that are in substance deferred equity, where the noteholder has no real option but to convert.

7.3 This current legal form-based approach can produce results which do not accord with economic substance. The above-mentioned anti-avoidance rules are arguably *ad hoc* in nature and result in excessive uncertainty for particular hybrid instruments. Their application to certain instruments can result in punitive tax treatment applying to certain types of arrangements which may have commercial (non-tax) advantages. This is because the application of section 46D to a dividend results in the denial of franking for the dividend (consistent with its being 'interest' in economic substance) and, as well, it denies the tax deduction ordinarily associated with interest. Similarly, the application of section 82R denies the deduction for 'interest' payments on certain convertible notes (consistent with their equity-like character) without allowing franking of the dividend-like return.

7.4 The practical effect of the different classification of returns can be illustrated by a consideration of the different tax results that arise when, say, \$100 of assessable income is derived by a company and then distributed as a return on equity (that is, a dividend) or a deductible return on debt (that is, interest).

- If distributed as a dividend, the company pays \$36 tax and pays a fully franked dividend of \$64 (the after-tax amount); the \$36 tax paid by the company may be imputed to the recipient of the dividend.
- If distributed as interest, the company could distribute the full \$100 without paying tax (the \$100 assessable income being offset by a \$100 deduction); the recipient of the interest would then be liable to tax on the full amount.

7.5 If the recipient is a taxable resident, the \$100 derived by the company is effectively taxed at the recipient's marginal tax rate for both debt and equity (if the distribution is a dividend, the tax already paid by the company is imputed to the recipient). However, if the recipient is a non-resident or a tax exempt, the \$100 is taxed at the company tax rate if it is equity and is usually tax exempt if it is debt (interest withholding tax may claw a small proportion of this back). Thus from an aggregate, economy-wide perspective a loss to the revenue arises if a return on equity could be classified as a return on debt.

### ***Categorising an instrument as equity***

7.6 On an individual company basis the incentives for debt/equity hybrids to be classified as either debt or equity depend on individual company and investor circumstances. For example, a company in tax loss (and therefore unable to make immediate use of a tax deduction for interest payments) might prefer to raise finance by issuing debt-like instruments categorised as equity for tax purposes so as to provide the investor with a return in the form of dividends (which attract the section 46 rebate if the investor is a company — or provide a franking rebate to a personal shareholder): the benefit of the rebate would generally be shared with the issuer through a lower cost of finance. If the company has no franking credits from past profits then there would seem to be little advantage in such an arrangement where the shareholder is an individual or a private company. If the company has franking credits from past profits their distribution to resident shareholders would provide a tax benefit which can be denied under the franking credit trading measures or section 46D of the Act.

7.7 Another example could involve a company with a large franking account surplus in excess of current needs. The company might attempt to minimise the natural 'wastage' of the credits while they remain unused by 'selling' them to a purchaser by means of franked dividends paid on debt-like

instruments. Once again this may be prevented under section 46D or the franking credit trading measures.

### ***Categorising an instrument as debt***

7.8 In other circumstances there is an incentive for the company to classify a debt/equity hybrid as debt. For example, under the entity tax regime proposed in *A New Tax System*, a company with untaxed profits and non-resident or tax-exempt shareholders might prefer to categorise a return on its shareholders' equity as deductible interest to avoid paying deferred company tax or domestic withholding tax. Or it might 'stream' a limited supply of franking credits to taxpayers best able to use them by issuing, for example, franked dividend-paying shares to residents and other financial instruments to non-residents which provide equivalent, but non-dividend, returns.

7.9 Synthetic arrangements, discussed later in this chapter, provide another example where a divergence of the legal form of an instrument or transaction from economic substance provides the potential for inappropriate tax outcomes.

## ***A strategy for reform***

### **Balance the need to protect the revenue and contain compliance costs**

7.10 The different treatments of returns to debt and equity and the associated incentives created for taxpayers mean that there is a case for provisions in the tax law aimed at enforcing the boundary line between debt and equity. Consistent with the overall objectives of business tax reform and the policy design principles outlined in *A Strong Foundation*, the challenge is to balance this objective against the compliance and administrative costs involved. At the same time, it is important that the method adopted for determining debt or equity tax treatment (either for the whole instrument, or for parts of it) should reflect economic substance and be as simple and certain as possible.

## *Practical issues*

### Where tax timing treatment should apply?

7.11 The timing adjustment method applicable to financial assets and liabilities has been discussed in Chapter 6. It is envisaged that the timing adjustment method could also be applied to instruments that are formed as combinations of these instruments, such as debt/equity hybrids, thereby providing greater consistency in tax timing treatment.

### Should a blanket or bifurcation approach apply to categorisation?

7.12 It is possible to adopt either a 'blanket' approach or a 'bifurcation' approach for determining the debt or equity characteristics of debt/equity hybrid arrangements.

- Under a 'blanket' approach, a particular hybrid instrument would be categorised either as wholly debt or wholly equity.
- Under a 'bifurcation' approach, the instrument would be 'bifurcated', or split, into separate debt and equity components.

7.13 Blanket treatment would result either in the whole of a periodic return on a hybrid instrument being a dividend or no part of it being a dividend, while bifurcation would enable part of the return to be a dividend and part not.

7.14 The advantage of bifurcation is that it reduces the sharpness of the discontinuity in tax treatment inherent in a blanket approach. Under a blanket approach, a minor change in the terms, conditions or characteristics attaching to some hybrid instruments could result in a very large change in the tax treatment of the whole instrument. A bifurcation approach would result in a change to a proportionate part of the instrument only. However, this advantage may come at a cost of increased complexity and special rules may be required where unique bifurcations are not possible.

### How would debt/equity categorisation be determined?

7.15 Listed below are options for determining whether a hybrid instrument, or parts thereof (if a bifurcation approach is adopted), would be accorded debt or equity treatment for the purpose of determining whether or not the whole or part of the periodic returns on the instrument is a dividend.

## Option 1: Weigh a number of facts and circumstances

7.16 Under this option, instruments would be classified according to their ‘debt’ features or ‘equity’ features. The following factors, identified in the 1996 Issues Paper, can be used to distinguish between debt features and equity features of a hybrid instrument:

- repayment of investment;
- stipulated rate of return;
- non-contingent payments;
- participation in gains and losses;
- priority on winding up;
- ownership and control;
- legal form; and
- other factors, including: automatic redemption, or redemption at the investor’s option; security given to the investor; guarantees given to the investor; a letter of credit to support payment; a put option to sell shares at a predetermined price; and relatively large amounts of retained profits available to distribute to the investor.

7.17 Because the separate ‘facts’ and the individual ‘circumstances’ relating to a particular hybrid instrument may be interrelated and interdependent in terms of their application and weighting, no simple and consistent weighting procedure seems practicable.

7.18 As the number, and variants, of hybrid instruments increase, rulings and guidelines would become necessary under this approach to determine which instruments are debt and which are equity, and even then some uncertainty would inevitably remain, particularly for new and complex instruments. This uncertainty would arise particularly in relation to hybrid instruments which are closest to the debt/equity border.

7.19 Some of the uncertainties inherent in the ‘facts and circumstances’ approach may be reduced by locating the debt/equity borderline as close as is possible to either end of the debt/equity spectrum rather than in the middle. However, this would result in an inappropriate categorisation of some instruments and detract from the objective of the measure. There is also some risk in moving far from financial accounting approaches (discussed below).

7.20 The blanket approach would be applicable to this option where it attempts to categorise hybrid instruments ‘on balance’.

## Option 2: Select a single determinative factor

7.21 The uncertainty involved in weighing up a number of factors to determine whether a hybrid instrument is to be accorded debt or equity treatment can be limited by selecting a single factor. The presence or absence of this factor would determine whether debt or equity treatment is to be applied to the whole instrument, or to a separable part of the instrument referable to that factor.

7.22 One approach may be to use well-accepted valuation methods or financial measures to determine the debt or equity components of a hybrid instrument. If valuation methods are applied, whichever component has the greatest value would determine the tax treatment of the whole instrument (under a blanket approach), or the instrument could be bifurcated on the basis of the respective values. In this regard, accounting standards may assist in identifying the debt and equity components of a hybrid instrument (particularly AASB 1033 which requires a separate valuation of the debt and equity elements of hybrids).

7.23 It may also be possible to use a definition of a debtor/creditor relationship as the single determinative factor. Such a relationship might be defined, for example, as one where there is the payment of an amount that gives rise to a right to receive, or an obligation to pay, another amount that will equal or exceed the first amount.

7.24 As an alternative to a debtor/creditor relationship being the single determinative factor, or in conjunction with it, a definition of an effective company/shareholder relationship might be used. This would result in the recategorisations of hybrid instruments which, though not shares in legal form, nevertheless clearly establish an effective company/shareholder relationship, for example, certain profit participating loans. If used in conjunction with the debtor/creditor relationship test, this would result in the recategorisations of hybrid instruments at both ends of the debt/equity spectrum (that is, debt-like shares and equity-like debt).

### ***Relevance of legal form in applying Option 1 or 2***

7.25 Legal form is not necessarily irrelevant when categorising hybrid instruments, and could be used as the starting point for determining debt or equity tax treatment. Thus the categorisation of a hybrid, at first instance, could depend on its legal form but the instrument could then be recategorised in certain cases based on the relevant facts and circumstances, or according to the selected determinative factor(s). If there is no recategorisation, legal form would prevail.

## Would specific anti-avoidance rules still be required?

7.26 As noted above, incentives to structure debt/equity instruments to access a tax benefit fundamentally depend on the circumstances of the individual company and investor. The above options may not sufficiently take into account individual circumstances and therefore may need to be supplemented by anti-avoidance rules. The question arises as to what circumstances warrant anti-avoidance rules taking into account the tax incentives facing particular taxpayers.

7.27 The prevention of the tax avoidance arrangements discussed at the beginning of this chapter could involve the use of a provision based on the current section 177EA of the Act (to prevent the inappropriate usage of franking credits), and section 82SA of the Act (to prevent deferred company tax avoidance). Alternatively, reliance on a general anti-avoidance rule may be possible.

## What are the consequences of categorisation of a hybrid instrument as debt or equity?

7.28 Applying any of the above options to a hybrid instrument can result in a categorisation for tax purposes of an instrument, or a part of an instrument, which is at variance with its legal form. For example, a hybrid instrument may be a share in legal form but may be effectively recategorised as debt for tax categorisation purposes under one of the options; conversely, a debt instrument may be effectively recategorised as equity.

7.29 Current legislation aimed at preventing exploitation of the different tax treatments of debt and equity is punitive in its approach in that where an instrument is recategorised as debt the issuer is not allowed a deduction for returns on the instrument. Similarly where an instrument is recategorised as equity the returns may not be franked. This reflects an intention for the law to prevent the use of such instruments.

7.30 Alternatively, if the purpose of the law is to facilitate the use of hybrid instruments by taxing them appropriately then it follows that, where an instrument is recategorised from its legal form to debt or equity, the recategorisation should operate symmetrically. That is, if the instrument is categorised as a debt instrument returns should be deductible to the issuer (subject to assessable income nexus tests being satisfied), and if it is categorised as an equity instrument the returns should be able to be franked. Under a bifurcation approach these principles could be applied to any part of an instrument thus recategorised.



### Accounting treatment for debt/equity hybrids

International accounting standards require that the components of hybrid financial instruments (those exhibiting both liability and equity components) are accounted for separately.

For Australian accounting purposes, the distinction between equity and liability instruments is established by *Statement of Accounting Concepts SAC 4, Definition and Recognition of the Elements of Financial Statements*, issued in March 1995. SAC 4 defines a liability as ‘the future sacrifice of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events’ (paragraph 48). Equity is defined as the ‘residual interest in the assets of the entity after deduction of its liabilities’ (paragraph 78). These definitions rely on economic substance in the classification of particular elements.

Australian Accounting Standard AASB 1033 *Presentation and Disclosure of Financial Instruments* requires that, where a contract gives rise to both a financial liability and equity, the elements should be recognised separately. AASB 1033 defines ‘financial liability’ as:

‘Any liability that is a contractual obligation to:

- deliver cash or another financial asset to another entity; or
- exchange financial instruments with another entity under conditions that are potentially unfavourable.’

AASB 1033 also requires that the classification of interest and dividends must be consistent with the balance sheet classification of the related financial instrument. That is, the classification of a payment to an instrument holder as either a dividend or interest derives from the source of the payment and is not subject to any additional decision making.

The practical application of the definitions of liabilities, financial liabilities and equity has presented some difficulties.

One issue is addressed in *Exposure Draft ED 98, Presentation and Disclosure of Financial Instruments: Proposed Amendments to AASB 1033/AAS 33*, issued in October 1998. ED 98 proposes that a financial instrument that converts on a mandatory basis into ordinary equity instruments of the issuer must be classified as a financial liability by the issuer on initial recognition to the extent that the holder of the instrument is not exposed to changes in the fair value of the issuer’s ordinary equity instruments. If the number of shares to be issued on conversion of a converting financial instrument is fixed, the converting financial instrument will be classified as equity because the holder of the converting financial instrument is exposed to the movements in share price from the date of issue of the converting financial instrument.

## *Synthetic arrangements: a case for reform*

### Current arrangements allow scope for exploitation and unintended outcomes

#### What are synthetic arrangements?

7.31 Through the development of innovative ways of dealing in risk, financial engineering has promoted greater market completeness, risk transference opportunities and financial efficiencies. At the same time financial engineering has opened up new opportunities for tax deferral and tax arbitrage. One financial engineering technique involves the creation of synthetic instruments which mimic the economic performance of other transactions with a different legal form. Financial instruments can also be combined to achieve a synthetic disposal (for instance, a shareholder buys an option to sell a share at a pre-determined future date and price and simultaneously sells an option to buy the share at that date and price). Appendix A explains some techniques for creating synthetic arrangements.

7.32 Synthetically creating debt or a disposal entails the same techniques as that for hedging, namely removal or reduction of economic risk. Accordingly, an arrangement with commercial motivations may have the effect of producing an unintended tax benefit. The challenge for tax policy is to ensure that commercially motivated hedging activities are not unnecessarily affected by rules directed at preventing unacceptable tax outcomes. One possibility is, in certain circumstances, to exclude temporary hedging arrangements from the tax rules for synthetics.

7.33 The tax benefits arising from franked dividends in certain synthetic arrangements are shown in Appendix A.

7.34 Tax benefits accessible on the basis of legal ownership but without regard to the risks and benefits of economic ownership provide opportunities for tax benefits to be transferred, using synthetic arrangements, from economic owners not able to use them (for example, because they are tax-exempt) to legal owners who can. For example, if legal ownership were the sole criterion for determining access to franking credits, equity swaps explained in Appendix A to this chapter could be used to transfer franking credits from taxpayers unable to fully benefit from them (for example, non-residents) to taxpayers with a greater use for them (for example, taxable residents).

7.35 In addition, in a situation where some returns are taxed over the life of the instrument (for example, as a result of timing adjustment arrangements), and others are taxed on maturity or disposal, synthetic instruments can be constructed to exploit these timing differences.

## Deferring accrued gains

7.36 An asset or liability can be synthetically disposed of by transferring or selling the economic ownership, that is the economic risks and benefits of ownership: see Appendix A for examples of instruments that can be used to produce this effect. As noted earlier, it is important that the tax system identify such transactions and treat them on the basis of their economic substance rather than legal form.

## Wash sales

7.37 A legal disposal of an asset which results in a loss may be accompanied by an arrangement — either immediate or close in time — to re-acquire the asset or to acquire an economically equivalent asset. This leaves the taxpayer in a similar economic position before and after disposal and is sometimes referred to as a ‘wash sale’. It could be motivated by the desire to realise accrued losses on the asset. Anti-wash sale rules preventing the accessing of tax losses until the taxpayer genuinely disposes of the relevant asset would ensure that the economic substance of a taxpayer’s position prevails over legal form.

7.38 Possible means for implementing an effective wash sale rule may include its automatic application whenever a taxpayer acquires a substantially identical asset (or enters into a transaction which provides a substantially identical economic position) within a specified period of the disposal of an asset on which a tax loss has accrued. For example, if a taxpayer holds a parcel of shares in a company and sells them (thereby realising a tax loss) but then immediately afterwards (or beforehand) acquires an identical parcel, a time-based wash sale rule would deny the tax loss. Alternatively, a purpose-based anti-avoidance rule may be more appropriate, although difficulties could arise in establishing the relevant purpose.

## Straddles

7.39 Another example of exploiting timing differences is the holding of an asset and liability whose values offset each other, and the disposal of the item that has decreased in value and retention of the one that has increased in value until a future income period. This tax-based arrangement is sometimes referred to as a ‘straddle’. Any rules against straddles which delay the availability of the tax loss until realisation of the matching gain would reflect the principle that, in certain cases, connected offsetting positions of the taxpayer need to be integrated to better reflect the taxpayer’s overall economic position.

7.40 Effective rules against straddles require the identification of offsetting positions of the taxpayer and, in certain cases, associates of the

taxpayer. The issue that has to be addressed is how to identify positions which relevantly offset other positions.

## Finding an appropriate balance

7.41 While tax is predominantly levied on a realisations basis these kinds of problems will be endemic in the system. The degree of complexity and legal uncertainty involved in rules attempting to separate such tax-motivated transactions from more commercially orientated ones may be significant. The question is whether an appropriate balance can be struck between increased complexity and uncertainty on the one hand, and the creation of a more equitable and efficient tax system that, for example, minimises interference with commercial risk management, on the other.

7.42 Tax rules for synthetic arrangements will be affected in their nature and scope by the ultimate shape of the overall tax framework. In that sense, they have a residual role. Judgment is required to determine how far to have, on the one hand, tax rules for synthetic arrangements in order to support the overall tax framework while, on the other hand, not interfering with the markets' processes of managing and shifting risk.

7.43 Issues that need to be considered in determining such rules include the following:

- To what extent does risk have to be transferred or borne for the tax status to change or be affected?
- How should the rule reflecting the risk position of the taxpayer be formulated so as to be as clear and certain as possible?
- How should economic ownership and risk, or appropriate proxy characteristics, be defined and measured?
- To what extent should the costs of transferring risk be taken into account in determining whether there is unacceptable tax deferral or tax arbitrage?
- Should tax rules for synthetics be based on the effect of the arrangement or on the purpose? If the latter, on what basis should the purpose be determined?
- How could synthetic arrangements resulting from the combination of two or more separate instruments be identified?
- How should tax rules for synthetics apply in relation to portfolios?

## *Synthetic arrangements*

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A.1 The following examples explain how synthetics could enable taxpayers to access tax benefits without bearing the economic risks of holding the assets from which the benefits are derived. This could facilitate the transfer of such benefits.

### Equity swaps

A.2 An equity swap can have the effect of transferring ownership of shares from one party to another in return for a loan: the cash flows on the shares and loan are ‘swapped’. Equity swaps can be used for commercial risk management purposes, including effectively changing the asset mix of a portfolio.

A.3 Equity swaps can also be used to transfer tax benefits from a party that cannot use them to one that can, without a change in risk. Specifically, under the swap agreement one party lends money to the original shareholder, who transfers shares to the lender; the lending party pays the original shareholder an amount equivalent to the dividend on the shares, plus any increase in share value, and the counterparty pays the lender a floating rate interest, plus any reduction in share value. Because of the swap arrangement, the new (legal) owner of the shares receives the same returns as on a debt, while the original shareholder continues to enjoy the economic benefits (and risks) of share ownership.

A.4 Even though the legal owner of the shares in an equity swap effectively has obtained a return on debt, until the introduction of the franking credit trading measures announced in the 1997-98 Budget the arrangement was designed to provide the legal owner the franking benefits from dividends paid on the shares. This ability to access franking benefits without assuming the risks of equity ownership would provide an opportunity to transfer franking credits from a taxpayer unable to use them fully to a taxpayer able to do so.

A.5 Table A.1 demonstrates the tax benefits available to the legal owner of shares subject to a swap agreement if the dividends are franked and rebatable. The figures are based on the following assumptions:

- the shares subject to the swap are valued at \$1,000,000 (which is also the basis for calculating interest payments by the swap counterparty);
- dividends paid on the shares are fully franked;
- the interest rate paid by the counterparty is 6 per cent;
- the term of the swap is one year;
- 25 per cent of the value of the franking benefit is passed on to the counterparty (the value of the franking credits retained is not included in the calculation of the gains);
- the legal owner of the shares has other income which enables losses and rebates to be used; and
- the legal owner of the shares is a company.

A.6 The before-tax gain in the second column of Table A.1 represents the interest received by the legal owner of the shares reduced by the value of the franking benefit attaching to any dividend paid on the shares which is passed on to the counterparty (25 per cent in this example). The after-tax gain is then calculated by reducing the before-tax gain by tax paid on the interest and, where applicable, adding back any rebate received by the legal owner from the dividend.

A.7 For example, row 2 of the table assumes a 1 per cent (\$10,000) dividend yield. The franking rebate associated with a \$10,000 dividend is \$5,625 ( $\$10,000 \times 36/64$ ). Therefore the before-tax gain of the legal owner of the shares is the \$60,000 interest it receives less the amount it passes on to the counterparty (25 per cent of the franking rebate), that is \$58,593 (no net dividend is received because the swap agreement requires the dividend to be on-paid to the counterparty). The after-tax gain in column 3 represents the before-tax gain reduced by the tax payable. The tax payable is \$17,493, calculated as follows:

- \$23,118 tax on a taxable income of \$64,218 (representing assessable income of \$60,000 interest and \$15,625 grossed-up dividend, less allowable deductions of the cash amount of the dividend and 25 per cent of the franking rebate passed on to the counterparty); less
- the franking rebate of \$5,625.

A.8 The after-tax gain in column 5 represents the before-tax gain (which is also the taxable income) reduced by tax payable on that gain (note that the dividend in this case would not be grossed-up because the rebate is denied).

**Table A.1: Equity swaps**

Dividend yield	Before-tax gain	After-tax gain to legal owner if franking rebate allowed (and consequent effective tax rate on before-tax gain)		After-tax gain if franking rebate not allowed (and consequent effective tax rate on before-tax gain)	
Column 1 %	Column 2 \$	Column 3 \$	Column 4 %	Column 5 \$	Column 6 %
0	60,000	38,400	(36)	38,400	(36)
1	58,593	41,100	(30)	37,500	(36)
2	57,188	43,800	(23)	36,600	(36)
3	55,781	46,500	(17)	35,700	(36)
4	54,375	49,200	(10)	34,800	(36)
5	52,968	51,900	(2)	33,900	(36)
6	51,563	54,600	(-6)	33,000	(36)
7	50,156	57,300	(-14)	32,100	(36)
8	48,750	60,000	(-23)	31,200	(36)

## Synthetic equity

A.9 Synthetic equity is created when an instrument which is not in the legal form of a share is structured to provide the same cash flows as shares. For example, synthetic equity notes can be issued by an Australian resident institution to non-resident investors to provide the non-residents with an exposure to particular Australian shares. The issue (and redemption) price of the notes would be matched to the underlying shares, and would pay ‘interest’ equal to the dividends paid on the shares (perhaps grossed up for franking). Such arrangements could be advantageous for the non-residents in circumstances where foreign ownership restrictions prevent them from having a direct shareholding in the Australian shares, while (prior to the introduction of the franking credit trading measures) the issuer could obtain tax advantages from the issue if it held the underlying shares. These tax advantages arise from the operation of the imputation system; however, they are particularly valuable to the issuer because they are not accompanied by the equity risks usually associated with the obtaining of franking benefits.

A.10 Table A.2 demonstrates the tax benefits available to the issuers of synthetic equity notes if the dividends paid on the underlying shares are franked and rebatable. The figures are based on the following assumptions:

- the synthetic equity notes are matched with underlying shares held by the issuer;

- \$1,000,000 of notes are issued (with a corresponding value of underlying shares held by the issuer);
- the issuer has other income which enables losses and rebates to be used; and
- the issuer is an Australian resident company.

A.11 The before-tax gain or loss of the issuer (column 3) is calculated as the dividend received on the shares reduced by the interest paid to the investor. Column 4 of the table illustrates that if the issuer pays the noteholder more than the dividend it receives the issuer could still make an after-tax gain (assuming it is allowed a rebate for the dividend). Of course, the gain to the issuer is even greater if it pays the noteholder less in interest than the dividend it receives. Usually, however, these amounts (that is, the dividend yield and interest paid) would be the same.

A.12 For example, row 1 of Table A.2 assumes a 4 per cent (\$40,000) dividend yield and an interest payment to the noteholder of the same amount. Therefore the before-tax gain of the issuer is zero. The after-tax gain in column 4 represents the difference between the franking rebate on a \$40,000 dividend of \$22,500 and the \$8,100 tax payable on a taxable income of \$22,500 (representing assessable income of \$62,500 grossed-up dividend, less allowable deductions of the cash amount of the dividend).

A.13 The after-tax gain in column 5 reflects a taxable income of zero because the dividend received is offset by a matching deduction representing interest paid (again, the dividend would not be grossed-up because the rebate is denied).

**Table A.2: Synthetic equity notes**

Dividend yield	'Interest' paid to investor	Before-tax gain/loss of issuer	After-tax gain to the issuer if franking rebate allowed	After-tax gain if franking rebate not allowed
Column 1 %	Column 2 %	Column 3 \$	Column 4 \$	Column 5 \$
4	4	0	14,400	0
4	6	-20,000	1,600	-12,800
4	2	20,000	27,200	12,800

## Endowment warrants

A.14 An endowment warrant is a long-dated call option over particular shares which has a variable exercise price and date. The usual term of an endowment warrant is about ten years. The premium paid for the warrant is



usually between 30 per cent and 65 per cent of the market value of the underlying shares at the time of its issue; the exercise price is the difference between the premium and the market value at that time, increased by interest and reduced by distributions paid on the shares. When the outstanding amount is reduced to zero, the investor is entitled to acquire the underlying shares with nothing further to pay.

A.15 As with equity swaps and synthetic equity (described above), an issuer of endowment warrants who holds the underlying shares has no economic risk in respect of its shareholding, and economically derives no net dividend (because it is credited to the warrant holder). However, notwithstanding the absence of risk and the lack of a net dividend, the issuer would, but for the franking credit trading measures, still be able to access the benefits of franking.

A.16 Table A.3 demonstrates the tax benefits available to the issuers of endowment warrants if the dividends paid on the underlying shares are franked and rebatable. The figures are based on the following assumptions:

- the issuer of the warrants holds the underlying shares;
- \$1,000,000 of underlying shares are held;
- the issuer has other income which enables losses and rebates to be used; and
- the issuer is an Australian resident company.

**Table A.3: Endowment warrants**

Dividend yield	Dividend credited to warrant holder	Before-tax gain of warrant holder	After-tax gain to issuer if franking rebate allowed	After-tax gain if franking rebate not allowed
%	%	\$	\$	\$
4	4	0	14,400	0
6	6	0	21,600	0
0	0	0	0	0