PROPERTY COUNCIL of Australia

THE VOICE OF **LEADERSHIP**

23 May 2014

Ms Teresa Dyson
Chair, Board of Taxation
The Treasury
Langton Crescent
Parkes, ACT 2600

Email: taxboard@treasury.gov.au

Dear Ms Dyson,

Review of Debt and Equity Tax Rules – Discussion Paper

Thank you for the opportunity to comment on the *Review of the Debt and Equity Tax Rules – Discussion Paper* (‘**Discussion Paper’**) released by the Board in March 2014.

The Property Council is the peak body representing the interests of owners and investors in Australia’s $670 billion property investment industry. The Property Council represents members across all four quadrants of property investment, debt, equity, public and private.

The Property Council welcomes the Board’s discussion paper on the debt and equity tax rules. The review offers the opportunity to improve the current legislation and provide greater certainty for industry.

For the most part, the current debt and equity rules are suitable and appropriate for the property industry.

Change should be limited to only the most critical matters identified below and the remainder should be left untouched.

This will preserve sensible industry practice that has developed since the rules were introduced in 2001, and minimise disruption to business decisions.

As noted in the Discussion Paper, there are situations where the debt and equity classification may not be consistent across similar instruments.

The aim of the review should not be to provide a legislative remedy to overcome the different outcomes.

Instead, the law should provide a clear position on what is considered to be debt versus equity for tax purposes. It should then be a commercial matter as to how financial arrangements are structured with the knowledge that similar structures may have different outcomes.

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Part 1 of our submission focuses on the critical matters for the property industry:

- **clarify the design and operation of section 974-80 by excluding stapled entity transactions or limiting its scope to the specific mischief it is trying to address** – this will overcome current uncertainty regarding the design and operation of the rules to stapled property groups; and
- **clarify that limited recourse debt will satisfy the debt test in all circumstances** by adjusting the notion of 'effectively non-contingent obligation' if necessary.

These are important areas that require legislative amendment to rectify current uncertainty and enhance the operation of the regime.

Part 2 of our submission seeks confirmation from the Board that the current treatment of units issued by trusts is not inadvertently changed or affected by the review.

1. Areas requiring remedy

This part of the submission focuses on the key areas where the current debt and equity provisions create uncertainty and/or impediments to the operations of participants in the property industry.

1.1 Improving the design and the operation of section 974-80 (questions 5.1 and 5.2)

Recommendation:

1. ***Exclude stapled entity transactions from the operation of section 974-80.***
2. ***Limit the scope of section 974-80 to the specific mischief it is trying to address by introducing a sole or dominant purpose test.***

Background

The history of section 974-80, the uncertainty about when and how it operates and the government's proposal for its reform are well recounted in chapter 5 of the Discussion Paper.

The original vision of section 974-80 (seen in the example to the section) dealt with sequenced instruments issued through a chain of wholly-owned entities – the return is paid up a chain between wholly-owned entities to fund a return to the ultimate investor.

The operation of the provision has been extended beyond that situation and made applicable to cross-staple instruments issued between entities that are not in a chain – the return is paid to a non-owned entity to fund a return to its investors.

There has been significant debate about whether section 974-80 should apply to transactions between stapled entities.

While the provision can be made to apply to such transactions, it appears from the example in the legislation and the three examples in the EM that the target of the provision was just sequenced instruments.

Furthermore, key concepts within the section are unclear:

- who is the ultimate recipient;

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- when is a scheme 'designed' to operate as described – is this determined having regard to amounts, or time of issue, or times of payment or some other factors;
- whose plans are considered to find the designer; and
- when is one instrument 'funding' the return to the ultimate recipient, especially if there is leakage or supplementing at the level of one or more connected entities.

Having regard to this uncertainty, it is critical that the section 974-80 is reformed.

Recommendation 1: exclude stapled entity transactions from the operation of section 974-80

Transactions between stapled entities should be excluded from the application of section 974-80 for the following reasons:

- *for payments between entities that then flow to resident investors* (eg by way of a trust distribution) – there is no obvious mischief in denying the company a deduction when the amount will be liable to PAYG and assessable at marginal rates in the hands of investors; and
- *for payments between entities that then flow to a non-resident investor* – the thin capitalisation rules should prevent excessive interest deductions depleting the Australian tax base where there is a material level of foreign investors in that entity.

Recommendation 2: limit the scope of section 974-80 to the specific mischief it is trying to address by introducing a sole or dominant purpose test

If transactions between stapled entities are not specifically carved out of section 974-80, its scope must be clearly limited to the specific mischief it is trying to address.

It should be clear that section 974-80 can only apply where the objective of achieving that mischief is the sole or dominant purpose for entering into the arrangement.

In the case of stapled groups, the rules should also not adversely impact the ability for trustees to administer the trust in a commercial manner.

That is, the trustee should be able to exercise discretions that are in a trust deed, allocate capital on a reasonable basis, retain cash, extract cash from companies where dividend traps might otherwise arise, etc without any adverse section 974-80 implications.

For this reason, section 974-80 should only apply to clear "back-to-back" sequenced arrangements or transactions where the sole or dominant purpose is to achieve, in substance, a "back-to-back" sequenced arrangement.

For the avoidance of doubt, section 974-80 should allow stapled groups to have a financing entity where the entity's sole purpose is to provide loans to members of the stapled group, and not to achieve a back-to-back arrangement.

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1.2 Improving the "effectively non-contingent obligation" test (question 4.4)

Recommendation:
3. Clarify that limited recourse debt will satisfy the debt test in all circumstances.

Background

The stated purpose of the "effectively non-contingent obligation" (ENCO) test is to determine whether a financing instrument is debt or equity for tax purposes, based on 'economic substance rather than mere legal form' (section 974-5(1)).

As such, the ENCO test in section 974-135 is critical to the operation of the debt and equity provisions.

Currently, there is significant uncertainty as to when the ENCO test is satisfied for limited recourse loans.

The clauses in loan agreements which constrain the rights of creditors can be drafted in many ways. As the Discussion Paper notes (para 4.45 of the Discussion Paper, examples 4 and 5), some clauses will satisfy the ENCO test while others may not.

This uncertainty conflicts with the intent of the ENCO test.

A rule which captures 'the economic substance' of debt, will recognise that limited recourse debt is debt, except in exceptional circumstances.

The ENCO test will then be satisfied, irrespective of different fashions in legal drafting.

Recommendation 3: clarify that limited recourse debt will satisfy the debt test in all circumstances

The debt and equity legislation should clearly and unequivocally accept that limited recourse debt is a 'debt interest' for all purposes of the Act.

In the event that the full amount owed is not repaid, then other consequences (including, for example, the commercial debt forgiveness rules, TOFA and Division 243) will be triggered at that time.

The ENCO treatment of limited recourse loans can be fixed with minimal changes to the debt test.

The current debt test includes the following two steps:

1. there is an ENCO to provide financial benefits;
2. it is substantially more likely than not that the value of those financial benefits provided will be at least equal to the value of the financial benefits received under the financing arrangement.

The debt test must clearly apply these two steps separately.

That is, factors which impact on the valuation of financial benefits should not impact whether there is an ENCO to provide those benefits.

Limited recourse debt should always be debt.

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2. Topics where no change is needed

Recommendation:

4. Maintain the existing treatment of unit trusts – i.e. confirm that units in a unit trust cannot be an equity interest.

At present, a unit in a trust cannot be an equity interest.

This treatment should remain.

If this is to be reviewed, this should not be done until the tax treatment of trusts in general (ie Division 6) is reviewed.

Please contact Belinda Ngo (on 0400 356 140) or me if you have any queries.

We look forward to your reply.

Yours sincerely,

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