Our ref: POD\MRY\DMS11492
Partner: Paul O'Donnell
Direct line: +61 2 9258 5734
Email: paul.o'donnell@ashurst.com
Contact: Marcus Ryan, Senior Associate
Direct line: +61 8 9366 8722
Email: marcus.ryan@ashurst.com

Ashurst Australia
Level 32, Exchange Plaza
2 The Esplanade
Perth WA 6000
Australia

GPO Box 9938
Perth WA 6000
Australia

Tel +61 8 9366 8000
Fax +61 8 9366 8111
DX 388 Perth
www.ashurst.com

10 August 2012

BY EMAIL: financetax@treasury.gov.au

Manager
Finance Tax Unit
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir

Submission on Discussion Paper "Clarifying the definition of limited recourse debt"

Thank you for the opportunity to comment on the Discussion Paper on the proposal to amend the definition of limited recourse debt in Division 243 of the Income Tax Assessment Act 1997 ("**ITAA 1997**").

1. SUMMARY

(a) The proposed amendments should only apply to limited recourse debt arrangements entered into from 7.30pm (AEST) on 8 May 2012 (**"Budget time"**). It should not merely apply to "terminations" that occur from Budget time. This is because:

(i) without this change, the amendments will unfairly apply to taxpayers who have no way of restructuring their affairs so that they do not become subject to the potentially serious consequences of Division 243 of the ITAA 1997 applying where there is a termination of a relevant debt arrangement; and

(ii) the amendments cannot merely be treated as a "clarification" of the law. The High Court of Australia confirmed that the current definition of limited recourse debt only applies where a creditor can be put into a position whether their recourse is *contractually* limited. Taxpayers have entered and structured their transactions based on this understanding of the law. It is inappropriate, and offends accepted principles of tax law design, to retrospectively subject taxpayers to provisions which they assumed in good faith would not apply to them when entering to a transaction. Further, this method of introducing amendments may operate to potentially undermine confidence in the tax system.

(b) A definition of limited recourse debt based on concepts of economic equivalence increases uncertainty for taxpayers because it requires a view to be taken on a wide range of factual circumstances rather than relying on the legal terms of a document. Consideration should be given to including so called "bright line" tests to provide certainty for relevant taxpayers (this has been adopted to some degree in the design of Division 974 of the ITAA 1997) and their unsecured creditors.

(c) If a test based on economic equivalence is to be introduced to the definition of limited recourse debt it will need to be carefully drafted so that it does not unintentionally capture a wide range of situations. For example, as noted by the judges in the BHP Billiton litigation on Division 243 of the ITAA 1997, an economic equivalence approach may result in funding arrangements for any start-up business being treated as limited recourse debt.

(d) Consideration should be given to whether the mechanism by which Division 243 of the ITAA 1997 operates achieves an appropriate balance between its impact on taxpayers and achieving its policy objectives. For example, it may be more appropriate to defer the inclusion of any amount in assessable income until the disposal of the relevant financed property (as was considered at the time Division 243 was introduced).

2. CURRENT DEFINITION

The current definition is set out in the Appendix.

Division 243 was introduced into the ITAA 1997 by the *Taxation Laws Amendment (No. 1) Act 2001* (originally introduced as the Taxation Laws Amendment Bill (No. 5) 1999).

The Explanatory Memorandum which accompanied the Bill (**"EM"**), indicates that the policy objective or introducing Division 243 of the ITAA 1997 was:

> To ensure that total deductions for allowable capital expenditure do not exceed the total amount actually expended by a taxpayer where the expenditure has been financed under hire purchase or limited recourse debt arrangements.

It was also noted in the EM that:

> 2.6 These measures have become necessary as taxpayers may currently obtain deductions greater than the total amounts they outlay in relation to capital expenditure under hire purchase or limited recourse debt. This occurs typically where the balance of an outstanding debt that has financed the expenditure is not paid and the financier can only recover a specific asset on the termination of the finance arrangement.
>
> 2.7 Under present law, capital allowances are based on the initial cost of an asset or specified capital expenditure but do not take into account any non-payment under related financing transactions.

The EM explains the definition of "limited recourse debt" as follows:

> 2.72 The notion of limited recourse specified in new subsection 243-20(1) is that the creditor's rights as against the debtor, if there is default in the payment of debt or interest, are limited wholly or predominantly to property that has been financed by the debt (the financed property) or is security for the debt, or rights in relation to such property. (See the definition of 'financed property' and 'debt property' in new section 243-30) Such rights would include the use of the property, goods or services produced by means of the property and rights on the loss or disposal of the property. Other limitations are security over the property (or other property) and rights under financial obligations to the debtor of a person who uses the financed property.
>
> 2.73 Under new subsection 243-20(2), a debt is also limited recourse if, notwithstanding that there may be no specific conditions to that effect, it is reasonable to conclude that the creditor's rights against the debtor are able to be limited, directly or indirectly, to those property rights specified in new subsection 243-20(1) in relation to the financed property. In reaching such a conclusion, regard is had to:

- the debtor's assets;
- arrangements the debtor is a party to;
- whether all of the debtor's assets would be available to discharge the debt; and
- whether the debtor and creditor are acting at arm's length.

> 2.74 New subsection 243-20(3) applies in a case where there is no debt property in relation to the debt, ie. property financed by the debt or provided as security for the debt. (See the definition of debt property in new subsection 243-30(3)) The debt in such a case may be limited recourse if the creditor's rights are capable of being limited having regard to the same matters listed in new subsection 243-20(2). ...

Even if a debt is a limited recourse debt under subsection 243-20(1), subsection 243-20(5) of the ITAA 1997 can operate to treat the debt as not being a limited recourse debt if the creditor's recourse is not in a practical sense limited because there is adequate security over other assets of the debtor.

In addition, if a debt is a limited recourse debt under any limb of the definition, subsection 243-20(6) of the ITAA 1997 can operate to treat the debt as not being a limited recourse debt if it would be unreasonable for it to be treated as limited recourse debt. The EM suggests that it might be unreasonable to treat a debt as limited recourse if:

> ... all but a very minor component of a debtor's relevant deductible capital expenditure has been funded by limited recourse debt and, in a practical sense, the debtor is fully at risk of loss for the expenditure. The debt would not, in a practical sense, be limited recourse if it is fully secured by assets other than the financed property.

3. BHP BILLITON LITIGATION

The proposal to amend the definition of limited recourse debt is a response to the High Court's decision in *Commissioner of Taxation v BHP Billiton Limited* [2011] HCA 17 (the **"BHP Case"**), which considered the second limb of the definition of limited recourse debt in subsection 243-20(2) of the ITAA 1997.

In the BHP Case, BHP Billiton Finance Limited (**"BHP Finance"**) was a subsidiary of BHP Billiton Limited (**"BHP"**), the head company of a tax consolidated group. BHP Finance was an in-house finance company set up for the purpose of borrowing funds and re-lending them to various BHP Group companies. The BHP Case considered a project carried on by BHP subsidiary (**"BHP Iron"**) to design, construct and commission an iron briquette processing plant and associated facilities which were financed by BHP Finance.

A loan facility was provided by BHP Finance to BHP Iron on BHP Finance's standard loan terms. In particular, the standard loan terms provided that in the event of default by BHP Iron, BHP Finance enjoyed all the rights of an unsecured creditor (ie it was a full recourse loan). It was found as an evidentiary matter that at the time the loan was made by BHP Finance it expected the loan would be repaid in full by BHP Iron with interest.

The project experienced difficulties and further funding was provided by BHP Finance on the same full recourse terms. Independent experts were engaged to value of BHP Iron and, on the basis of that valuation, BHP Finance determined to write off a substantial portion of the loan as bad.

BHP Iron claimed capital allowance deductions in relation to its expenditure on the plant during the income years from 1996 to 2002 and, for the income years from 2003 to 2006, BHP claimed capital allowance deductions for BHP Iron's expenditure as head company of its tax consolidated group.

The Commissioner of Taxation sought to apply Division 243 of the ITAA 1997 to include amounts in assessable income and effectively claw back the capital allowance deductions

claimed. This was on the basis that the depreciable plant was financed by "limited recourse debt" as defined in subsection 243-20(2) (the second limb of the definition). The Commissioner argued that the rights of BHP Finance as against BHP Iron in the event of default of the debt or of interest were "capable of being limited in the ways mentioned in subsection [243-20](1)".

At first instance[1], Gordon J noted

> 228. Subsection (2) is clearly intended to catch those debts which bear no existing legal limitation of the kind specified in subsection (1) but where "it is reasonable to conclude that the rights" in the event of default are "capable" of being limited to those rights specified in sub-s (1). As the applicants submitted, subsection (2) is intended to catch those arrangements which have the capacity to bring about the limitation described in sub-s (1). The form of that capacity is, unsurprisingly, broad and extends, for example, to "any *arrangement to which the debtor is a party". It is an objective test. Whether the capacity of the kind described exists is, of course, a question of fact to be resolved having regard to the matters listed in paragraphs (a) to (d) of sub-s (2). As the earlier analysis of the cases dealing with limited recourse debts demonstrates there is no and can be no prescribed form for such arrangements.
>
> 229. However, I do not consider that s 243-20(2) adopted or incorporated a test of economic equivalence (such as that adopted in Div 974 of the 1997 Act). That was the substance if not the form of the Commissioner's submissions – that the section necessitates an assessment of whether more than 50% of the property owned by the debtor is related to property acquired with the relevant loan proceeds. If that were the correct approach (which I reject) the result would be that funding arrangements at the start of a business would be limited recourse within Div 243 and would then fall in or out of the division depending on whether the venture was a success or a failure. The terms of the funding arrangements (whether limited in the sense of sub-s (1) or considered more broadly under sub-s (2)) would simply be irrelevant. That is not consistent with the express words of the section. If the drafters had intended the issue to be approached in that manner, they would have said so. They did not.
>
> (our emphasis)

The High Court and the Full Federal Court (per Edmonds J, Stone and Sundberg JJ agreeing) upheld the primary judge's comments on this point. In particular, Gummow J agreed with Edmond J's finding (at [104]) that subsection 243-20(1) and 243-20(2) of the ITAA 1997:

> ... are to be construed so that their application is confined to situations where, at the time of borrowing, the debtor is not fully at risk in relation to the expenditure because of contractual limitations on the lender's rights of recourse on a relevant event of default or, where, at the time of borrowing, the debtor or someone else has the capacity to subsequently bring about that state of affairs.
>
> (emphasis added)

In other words, it is only where the creditor's right are capable of being *contractually* limited.

Accordingly, the correct interpretation of the existing definition of limited recourse debt in subsections 243-20(1) and 243-20(2) has been upheld by no fewer than 9 judges. Taxpayers should therefore be entitled to rely on this interpretation for existing funding arrangements they have entered into.

---

[1] *BHP Billiton Finance Limited v Commissioner of Taxation* [2009] FCA 276

4. RETROSPECTIVITY

4.1 Laws should only apply retrospectively in extraordinary cases

The proposed amendments to the definition of limited recourse debt in Division 243 of the ITAA 1997 will have retrospective effect because it will apply to existing arrangements. We submit that there is no valid reason to apply the proposed amendment in this way and that the amendments should only apply to debt arrangements entered into on or after Budget time.

Concerns in relation to applying taxation laws retrospectively are well documented. In the Asprey review of the tax system in 1975 it was stated:

> 11.48. There is a well-established, fundamental and sound principle that legislation, especially fiscal legislation, should not have a retrospective operation. That which was lawfully done should not, after the completion of the act by which it was done, be made unlawful and subjected to a penalty. There is a strong presumption against retrospectivity because it manifestly shocks one's sense of justice. .... In the opinion of the Committee, it will be proper, therefore, to safeguard any legislation that may be introduced ... from the vice of retrospectivity penalising any bona fide transaction where the rights and obligations of the parties are involved irrevocable.

In Australia's Future Tax System, Report to the Treasurer (the Henry review), section 2.1 set out general design principles for the tax and transfer system. These include equity, efficiency, simplicity and policy consistency.

We submit that the proposed arrangement should not affect existing debt arrangements. In our submission to do so would:

- be unfair to taxpayers and be inconsistent with principles of equity and efficiency for the design of tax law;
- create uncertainty for taxpayers; and
- reduce confidence in the Australian tax system.

While retrospective application of tax legislation may have merit in some instances (for example, where there is an obvious mistake in the drafting of a law), we submit that this is not one such instance. This is because:

- Division 243 of the ITAA 1997 has been in place for over 10 years and the Australian Taxation Office has not published any ruling which supports its interpretation of the law;
- there is no evidence that the interpretation of Division 243 upheld by the High Court has resulted in taxpayers actively exploiting a "loophole" in the law;
- taxpayers could not be said to have been on notice that the law would be changed. On the contrary, taxpayers should be entitled to rely on the conclusions of the courts.

Accordingly, we submit that there is no justification for the proposed amendments to apply to debt arrangements which already existed at Budget time.

4.2 Not a mere clarification of the law

In our submission the retrospective application of the proposed amendment cannot be justified on the basis that it is a mere clarification of the law. The proposed amendments

could result in significantly more taxpayers being subject to Division 243 of the ITAA 1997. In addition it is in our view untenable to describe amendments to support an interpretation of the law that was rejected by 9 judges as being a "clarification".

The proposed amendment represents a substantive change to the law and its introduction should be assessed in that light.

4.3 Potential for discrimination between taxpayers

The retrospective application of the proposed amendments to the definition of limited recourse debt may also lead to discrimination between taxpayers. The need to apply taxation laws in a consistent manner between taxpayers was recognised in a report of the Inspector-General of Taxation[2] In that report it was noted:

> A3.130 In the English case of *IRC v National Federation of Self Employed & Small Businesses Ltd* [1982] AC 617, Lord Scarman noted that:
>
> > I am persuaded that the modern case law recognises the legal duty owed by the revenue to the general body of the taxpayers to treat taxpayers fairly; to use their discretionary powers so that, subject to the requirements of good management, discrimination between one group of taxpayers and another does not arise; to ensure that there are no favourites and no sacrificial victims.
>
> A3.131 This decision has been cited with approval in Australia in a number of Federal Court decisions including *Bellinz Pty Ltd v Federal Commissioner of Taxation* (1998) 615 FCA, and *Pickering & Ors v Deputy Commissioner of Taxation* (1997) 37 ATR 41. In the latter case, Cooper J expressed the view that:
>
> > ... there is a growing body of academic and judicial opinion that persons in like situations are entitled at law to receive like treatment. (article references and citations omitted)

For example, suppose that two joint venture parties entered into an unincorporated joint venture before Budget time and funded their participation in the joint venture with contractually full recourse debt (and therefore no limited recourse debt under the current definition of that term in Division 243 of the ITAA 1997). Suppose further that the debt was found to be "limited recourse debt" under the proposed amendment to the definition.

If a debt of one of the joint venture parties becomes bad because of extraneous circumstances (such as a parent guarantor going into administration because of an unrelated activity), there would be a a "termination" for that joint venture party. However, the other joint venture party would be unaffected. This is an example of how the tax law would then apply differently as between the two taxpayers as a result o fthe proposed amendment.

5. UNCERTAINTY

We note that the Discussion Paper has not provided any outline of how the proposed extension to the definition of limited recourse debt will be drafted. The drafting will be critical to ensuring that taxpayers are clearly able to establish when Division 243 of the ITAA 1997 may apply to them in relation to a debt arrangement.

We submit that the drafting of the definition will need to ensure that:

- it does not inadvertently capture arrangements to which Division 243 of the ITAA 1997 (eg start-up companies which rely on significant debt funding);

---

[2] Review of the Remission of the General Interest Charge for Groups of Taxpayers in Dispute with the Tax Office, Report to the Minister for Revenue and Assistant Treasurer, 5 August 2004.

- the meaning of "predominantly" is clear. This could involve introducing some form of "bright line" test. For the purposes of section 51AD of the *Income Tax Assessment Act 1936* the Australian Taxation Office has regarded predominately as more than 50% (refer Taxation Ruling TR 96/22). If this is intended this should be stated in the law rather than taxpayers being required to rely on a ruling of the Australian Taxation Office; and

- examples are included in the legislation and any explanatory memorandum to provide guidance on when a debt arrangement will and won't be caught by the extended definition.

6. RECONSIDER CLAWBACK MECHANISM

Where it applies, Division 243 of the ITAA 1997 effectively operates to clawback depreciation deductions which relate to expenditure which has been funded by unpaid limited recourse debt. It does this by including an amount in assessable income when there a relevant debt arrangement is "terminated". A debt arrangement may be terminated merely because a debt has become bad and Division 243 of the ITAA 1997 can be triggered without any act by the taxpayer debtor.

The consequences of Division 243 applying to a taxpayer may be harsh, particularly considering that such a taxpayer is likely to already be in financial difficulty. The application of Division 243 may result in a taxpayer having a tax liability which may jeopardise its ability to recover from adverse financial circumstances. This will also affect the ability of unsecured creditors (such as contractors to a project company) to recover amounts owed to them because they may be competing with the Commissioner of Taxation.

The EM outlined a second option, which would have involved incorporating a capital expenditure adjustment rule into existing balancing adjustment and income calculations which apply on the disposal of relevant debt property.

By deferring any impact of Division 243 of the ITAA 1997 applying, this may in fact provide taxpayers with a better chance of recovering from a situation of financial distress.

Another part of Division 243 of the ITAA 1997 which should be reconsidered is when a debt arrangement will be taken to be terminated (refer section 243-25). The concept of termination is currently very wide. For example, a termination can happen:

- merely as a result of a debt going bad;
- if a debt is novated (ie legally terminated) as a result of a debt restructure or the creditor transferring its interest in a debt (and notwithstanding that the borrower continues to owe an amount or that the borrower provides arm's length consideration for another party to assume their obligations).

These events may not be consistent with a taxpayer ceasing to be at risk in relation to expenditure taken into account for capital allowance purposes.

We submit that consideration be given to this or other options which may soften the impact of Division 243 on taxpayers and their unsecured creditors while also maintaining its policy objectives.

Yours faithfully

Ashurst Australia

ASHURST AUSTRALIA

ashurst

APPENDIX

Section 243-20 of the ITAA 1997 currently defines "limited recourse debt" as follows:

(1) A limited recourse debt is an obligation imposed by law on an entity (the debtor) to pay an amount to another entity (the creditor) where the rights of the creditor as against the debtor in the event of default in payment of the debt or of interest are limited wholly or predominantly to any or all of the following:

(a) rights (including the right to money payable) in relation to any or all of the following:

(i) the *debt property or the use of the debt property;

(ii) goods produced, supplied, carried, transmitted or delivered, or services provided, by means of the debt property;

(iii) the loss or disposal of the whole or a part of the debt property or of the debtor's interest in the debt property;

(b) rights in respect of a mortgage or other security over the debt property or other property;

(c) rights that arise out of any *arrangement relating to the financial obligations of an end-user of the *financed property towards the debtor, and are financial obligations in relation to the financed property.

(2) An obligation imposed by law on an entity (the debtor) to pay an amount to another entity (the creditor) is also a limited recourse debt if it is reasonable to conclude that the rights of the creditor as against the debtor in the event of default in payment of the debt or of interest are capable of being limited in the way mentioned in subsection (1). In reaching this conclusion, have regard to:

(a) the assets of the debtor (other than assets that are indemnities or guarantees provided in relation to the debt);

(b) any *arrangement to which the debtor is a party;

(c) whether all of the assets of the debtor would be available for the purpose of the discharge of the debt (other than assets that are security for other debts of the debtor or any other entity);

(d) whether the debtor and creditor are dealing at *arm's length in relation to the debt.

(3) An obligation imposed by law on an entity (the debtor) to pay an amount to another entity (the creditor) is also a limited recourse debt if there is no *debt property and it is reasonable to conclude that the rights of the creditor as against the debtor in the event of default in payment of the debt or of interest are capable of being limited. In reaching this conclusion, have regard to:

(a) the assets of the debtor (other than assets that are indemnities or guarantees provided in relation to the debt);

(b) any *arrangement to which the debtor is a party;

(c) whether all of the assets of the debtor would be available for the purpose of the discharge of the debt (other than assets that are security for other debts of the debtor or any other entity);

(d) whether the debtor and creditor are dealing at *arm's length in relation to the debt.