Partner: Paul O'Donnell
Direct line: 02 9258 5734
Email: paul.o'donnell@ashurst.com
Contact: Ian Fullerton
Direct line: 02 9258 6396
Email: ian.fullerton@ashurst.com

Ashurst Australia
Level 36, Grosvenor Place
225 George Street
Sydney NSW 2000
Australia

GPO Box 9938
Sydney NSW 2001
Australia

Tel +61 2 9258 6000
Fax +61 2 9258 6999
DX 388 Sydney
www.ashurst.com

12 November 2012

The Manager
Finance Taxation Unit
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email to financetax@treasury.gov.au

Dear Sir

PROPOSED LEGISLATION TO AMEND THE DEFINITION OF LIMITED RECOURSE DEBT

We welcome the opportunity to comment on *Exposure Draft Tax Laws Amendment (2012 Measures No.6) Bill 2012: limited recourse debt* and the accompanying draft explanatory material.

Legislative references in this submission are to the *Income Tax Assessment Act 1997* (Cth).

We have the following concerns about the draft bill and explanatory material:

(a) The implications of the proposed amendments for business in this country would seem to be significant. The commercial debt forgiveness rules in Division 245 deal with situations in which obligations to repay debt are terminated without the debt being repaid in full. Those rules are based on a principle that it is appropriate for debt forgiveness to result in a reduction in the tax attributes (such as tax losses) of the borrower but inappropriate for forgiveness to result automatically in the inclusion of an amount in the assessable income of the borrower. It seems to us that one reason for that policy is to ensure that lenders are not discouraged by the possibility that a borrower may incur a tax liability simply as a result of the termination of the borrower's obligations under the debt. Against that background, we are not aware that the implications of broadening the scope of Division 243 have been assessed in order to determine whether the proposed measures would in fact produce a net benefit for the country or the Revenue, given the potential of the proposed measures to discourage and/or increase the cost of asset-based lending. We believe that as part of this assessment it would be appropriate to consider confining the application of the broader definition of limited recourse debt to situations in which the lender and borrower are associates, as in the case referred to in point (b) below and/or confining the application of the whole of Division 243 to situations in which the benefit of capital allowance deductions has resulted in actual tax savings for the borrower or another entity as part of a scheme with a main purpose of obtaining those deductions.

(b) The scope of the proposed measures is uncertain, and this in itself is likely to impede normal commercial business. For example, if a bank lends $100,000 on a full recourse basis to a start-up company which uses the borrowed money and $40,000 of shareholders' funds to acquire two assets with a total value of $140,000, will the $100,000 loan be a

"limited recourse loan" under the amended definition, and if so, on what basis? The examples in the draft explanatory materials refer to situations in which a single asset is acquired using borrowed funds to the extent of 100% or 80%. It would be helpful to have a clearer indication of the meaning of "predominantly" in the draft legislation and in the explanatory materials.

(c) It seems to us that paragraphs 1.8, 1.9 and 1.12 of the draft explanatory material contradict statements made by the Full Federal Court in *FCT v BHP Billiton Finance Ltd* (2010) 76 ATR 472 and the High Court *FCT v BHP Billiton Ltd* (2011) 79 ATR 1. Paragraph 1.8 of the draft explanatory material states that "the current definition of "limited recourse debt" in section 243-20 is intended to include contractually limited recourse debt arrangements as well as debt arrangements where recourse is effectively limited through arrangements". Paragraph 1.9 contains a similar assertion. In paragraph 1.12 the draft explanatory material suggests that the proposed amendments "clarify" the definition of limited recourse debt "to ensure that the limited recourse debt provisions achieve their original policy intention". Yet in *BHP Billiton Finance* Edmonds J (at 525, Sundberg and Stone JJ concurring) said that the Commissioner's argument as to the meaning of limited recourse debt (a meaning which the proposed amendments to the definition of limited recourse debt seek to introduce) would have consequences that "could never have been part of the policy or the intention of the Parliament in enacting Div 243". This statement was referred to with approval in the joint judgment of French CJ, Heydon, Crennan and Bell JJ in the High Court case (at 14). It may perhaps be more accurate to say in the explanatory materials that the proposed amendments give effect to what the Government considers the existing law should have meant.

(d) Under the current law, the question of whether a debt is a limited recourse debt is determined when the debt comes into existence. Paragraph 1.14 of the draft explanatory material confirms that this will still be the case after the amendments are enacted. The proposed amendments are stated to apply to "in relation to debt arrangements terminated at or after 7.30pm on 8 May 2012". This seems to mean that the proposed amendments would reclassify some debts that are not limited recourse debts under the existing law as limited recourse debts by requiring that the extended definition of limited recourse debt be applied retrospectively at the time the debt came into existence, which may be many years earlier. This is likely to be impractical in some cases and also seems to us to expose the country to criticism concerning a lack of business certainty.

For example, consider the situation of two companies which each borrowed an amount in 2005 and used that amount to acquire a depreciating asset. Assume that neither amount was a limited recourse debt under the current law but both would be limited recourse debts under the amended law, and assume that one debt became "bad" on 7 May 2012 and the other on 9 May 2012. On the first debt becoming bad, Div 243 had no effect, whereas on the second debt becoming bad, an amount might be included in the company's assessable income under Div 243 even though, at the time both loans were entered into, neither was a limited recourse debt under the law as it existed at that time. Clearly, the second taxpayer had no opportunity to arrange its affairs at the time of borrowing the money to ensure that the limited recourse debt rules would not apply on a termination of the debt (for example, by arranging for a parent company to guarantee the repayment of the debt). It would seem, therefore, that the change of law imposes a tax that is unequal in its application to two taxpayers whose circumstances are very similar. The transactions that are relevant to the question of whether a limited recourse debt came into existence both occurred in 2005. The only difference between the two situations is that in one case a debt relating to an asset acquired in 2005 became bad before 8 May 2012 and in the other case it became bad after 8 May 2012 – and those events are unlikely to have been within the control of the taxpayers.

We note that recent retrospective changes to transfer pricing rules and the interaction between the tax consolidation rules and the taxation of financial arrangements rules attracted a lot of public criticism. We note, too, that Justice Gordon recently expressed concern, extra-judicially, that in some circumstances a retrospective law which, on enactment, imposes different tax burdens on different taxpayers who are in substantially the same position, may not be constitutional (*8th Annual Tax Lecture, Melbourne Law School, University of Melbourne*, 29 August 2012)..

(e) The existing limited recourse debt measures operate particularly unfairly when an obligation to repay a limited recourse debt is novated. If a debtor pays another party an arm's length amount to take on the debtor's obligation to repay all or part of the amount owed, it seems to us that the amount paid by the original debtor as consideration for the novation of the debt should be treated in the same way as a repayment of all or part of the amount owed on the debt. This issue will become more significant if the definition of limited recourse debt is extended.

(f) Example 1.1 in the draft explanatory material incorrectly states that "Company C only incurred $65 million for the asset". The amount incurred by Company C in acquiring the asset was clearly $325 million. Of this amount, $260 million was funded by debt that is stated to be limited recourse debt. The fact that no part of the $260m debt was repaid does not mean that the full cost of the asset was not incurred. Similarly, Example 1.1 states that Company C's "actual expenditure" was $65m, whereas Company C's expenditure on the asset was clearly $325 million. Div 243 does not recharacterise an amount "incurred" or "expended" as an amount not "incurred" or "expended"; it specifically assesses an amount by reference to the difference between net capital allowances properly claimed in respect of amounts "incurred" or "expended" and capital allowances that would have been available if the amount "incurred" or "expended" had been reduced by the unpaid amount of a limited recourse debt that has been terminated.

We would be pleased to discuss these issues further.

Yours faithfully

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