Institute of Chartered Accountants Australia

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Ms Christine Barron
The General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: financetax@treasury.gov.au

Customer Service Centre
1300 137 322

NSW
33 Erskine Street
Sydney NSW 2000

GPO Box 9985
Sydney NSW 2001

Phone 61 2 9290 1344
Fax 61 2 9262 1512

ACT
L10, 60 Marcus Clarke Street
Canberra ACT 2601

GPO Box 9985
Canberra ACT 2601

Phone 61 2 6122 6100
Fax 61 2 6122 6122

Qld
L32, 345 Queen Street,
Brisbane Qld 4000

GPO Box 9985
Brisbane Qld 4001

Phone 61 7 3233 6500
Fax 61 7 3233 6555

SA / NT
L29, 91 King William Street
Adelaide SA 5000

GPO Box 9985
Adelaide SA 5001

Phone 61 8 8113 5500
Fax 61 8 8231 1982

Vic / Tas
L3, 600 Bourke Street
Melbourne Vic 3000

GPO Box 9985
Melbourne Vic 3001

Phone 61 3 9641 7400
Fax 61 3 9670 3143

WA
L11, 2 Mill Street
Perth WA 6000

GPO Box 9985
Perth WA 6848

Phone 61 8 9420 0400
Fax 61 8 9321 5141

Dear Christine

Submission on discussion paper - Clarifying the definition of limited recourse debt

The Institute of Chartered Accountants Australia (Institute) welcomes the opportunity to comment on the discussion paper entitled *Clarifying the definition of limited recourse debt* (the Paper). The Paper sets out the design of the proposal to amend the definition of 'limited recourse debt' which was announced in the 2012-2013 Budget.

The Institute is the professional body for Chartered Accountants in Australia and members operating throughout the world. Representing more than 70,000 current and future professionals and business leaders, the Institute has a pivotal role in upholding financial integrity in society. Members strive to uphold the profession's commitment to ethics and quality in everything they do, alongside an unwavering dedication to act in the public interest.

In view of the current global economic climate and Australia's 'two speed' economy, we query whether the definition of limited recourse debt needs broadening. Given the heavy reliance on the resources sector to maintain Australia's prosperity and the key role of the private sector in infrastructure projects, we submit that the current proposal to broaden the definition of limited recourse debt is not needed and in fact may stifle activity in the resources sector, as well as other sectors.

Broadly, our key issues regarding the design of the proposed measure in the Paper include the following:

- We are concerned that in clarifying the definition of limited recourse debt as intended in the Paper, the definition of limited recourse debt will become too broad in application and encompass standard lending arrangements in businesses.
- The proposed application of the new measure to terminations occurring after 8 May 2012 has a retrospective effect in that it applies to pre-existing financing arrangements should they terminate.

We have set out our comments in detail in the attached submission.

If you would like to discuss any aspect of this submission or require any further information, please do not hesitate to contact me on 02 9290 5609 or Karen Liew on 02 9290 5750.

Yours sincerely

Paul Stacey CA
Tax Counsel
Institute of Chartered Accountants Australia

GENERAL COMMENTS

As stated in paragraph 33 of the Paper, the ‘limited recourse debt’ definition is being amended to achieve the policy objectives of Division 243 of the *Income Tax Assessment Act 1997* and provide the same tax treatment for arrangements that have the same economic and substantive outcome. However, this stated purpose must be considered and evaluated in light of the context in which limited recourse debt arrangements are generally utilized and the impact on business activity in the current economic climate.

As stated in the Paper (paragraph 3), limited recourse debt is a financing arrangement that is often used in projects, particularly long term projects. Such long term projects often encompass large infrastructure and mining projects, which inherently involve significant risk. The proposed amendment to the definition of limited recourse debt to broaden its scope will prove problematic and may be an impediment to projects obtaining funding, particularly in respect of start-up ventures.

Division 243 implicitly sends a negative message, as the application of Division 243 will depend upon the success or failure of a project, with failure being punished by the inclusion of an amount in the debtor’s assessable income. The practical effect was highlighted by both the primary judge and the Full Federal Court in *BHP Billiton* and restated by the High Court in *Commissioner of Taxation v BHP Billiton Limited & Others* [2011] HCA 17 (BHP Billiton) at paragraph 37 of the judgment:

> Both the primary judge and the Full Court expressed concern that, if the Commissioner's construction of s243-20(1) and (2) were accepted, reversal of capital allowance deductions by including equivalent amounts in assessable income would depend on the success of projects, which would be particularly significant for special purpose project companies with few assets at the time of borrowing. Edmonds J considered that this would have the practical effect that new projects could only be undertaken easily in established companies with unencumbered assets which, at the time of borrowing, exceed the borrowing in value.

Ultimately, the proposed measure to broaden the ‘limited recourse debt’ definition may discourage risk taking and innovation in Australia. Furthermore, in light of the tighter lending environment, it would also provide a greater barrier to the commencement and survival of start-up and struggling projects.

The impact on business in Australia was also considered by Edmonds J (Full Federal Court) if the Commissioner’s broader construction of section 243-20(2) was accepted (*Commissioner of Taxation v BHP Billiton Finance Limited* [2010] FCAFC 25 at paragraph 107):

> While it is undoubtedly true that the construction for which the Commissioner contends does not lead to the result that the debt of every unsecured creditor, regardless of the contractual arrangements between the parties, would be treated as "limited recourse debt", cf., the primary judge's reasons at [216], even the Commissioner conceded that would be the case if the borrower were a start-up company with no or little assets at the time of borrowing to fund the expenditure, such as a special purpose project company. Moreover, whether or not Div 243 applied to reverse capital allowance deductions by including equivalent amounts in assessable income would then depend on the success of the project. If it ultimately failed and the debt could not be fully repaid, the Division would apply. The only way to avoid that consequence would be to undertake the project in an established company the unencumbered assets of which were, at the borrowing time, greater than the anticipated borrowing. That would place business in this country, particularly for those involved in resources and infrastructure projects, in a "tortuous straight jacket", the likes of which could never have been part of the policy or the intention of the Parliament in enacting Div 243. For that reason alone, the Commissioner's construction must be rejected.

Overall, the proposed measure would impact current and future projects’ ability to survive and prosper, the consequences of which would flow on to reduced business activity in general. Given Australia’s current two speed economy and its heavy reliance on the resources sector to maintain Australia’s prosperity, a measure affecting a project’s ability to survive and prosper in the current economic climate, would be contrary to the broader policies of the current federal government.

The proposed measures also appear inconsistent with other measures that seek to encourage investment in infrastructure through special purpose vehicles. For example, the paper Tax Loss Incentive for Designated Infrastructure Projects issued by Treasury on 26 October 2011 appears to provide an incentive for designated infrastructure projects undertaken by SPVs.

DETAILED COMMENTS

1. Clarifying the scope of the measure

The main point of these comments is to sharpen the focus of the proposed measure so that the legislation eventually enacted will better match the stated goal, being:

> 2. The proposed measure will affect the financing of projects where the borrower is a special purpose entity that has minimal or no other assets or income from other sources apart from the project assets.

The substance of the proposal outlined in the Paper is in paragraph 35:

> 35. Section 243-20 will be amended to define a limited recourse debt as including arrangements where at the beginning, the creditor's rights against the debtor, in the event of default in payment of the debt, are limited wholly or predominantly (whether or not by contract) to certain rights in respect of the financed property or other property.

The following comments focus on the way this paragraph is expressed.

a. The references to 'rights' and 'limits'

The formulation of the proposal is apparently to capture situations where there is de facto, though not in law, limited recourse debt:

> 31. The reversal of capital allowance deductions is not intended to be restricted to situations where the arrangement specifies conditions that limit the recourse of the creditor.

The Paper has no detail on how to define debt that is 'economically and substantively' limited recourse debt (paragraph 33). Indeed, the Paper is confusing because it switches between two different ideas:

- a test which refers to the presence of limits on rights – '… the creditor's rights against the debtor, in the event of default in payment of the debt, are limited …' (paragraph 35); and
- a test in which the creditor's rights are not limited, but some other circumstance exists at the relevant time which has the same effect that a limit on rights would achieve.

We take it – from paragraphs 6 and 7, for example – that the intended test is the second.

If that is so, the focus of the test for de facto limited recourse debt needs to be expressed differently from the verbal formula used in paragraph 35 of the Paper, and avoid the references to 'rights [that] … are limited …' Such a formulation seems to lend itself to exactly the same problem of interpretation that arose in BHP Billiton. Or, to put it another way, the change to the text from 'rights that are capable of being limited', to 'rights [that] … are limited' seems to have the odd result of producing a test that is even more restrictive.

Nevertheless, simply removing the reference to 'are limited' in the verbal formula and replacing it with words that indicate the possibility/practical capability of the rights being limited, is not appropriate either as the test would become excessively broad. Furthermore, simply modifying the verbal formula (as above), would mean that any entity that has a separate legal personality, which finances the acquisition of certain assets by debt, and the debt is quarantined to that legal entity (i.e. no cross guarantees), irrespective of other assets held, runs the risk of Division 243 applying when the financing arrangement terminates. This could capture a whole range of standard lending arrangements that are not 'project financing' arrangements - entities with a separate legal personality, such as companies, are used in business enterprises of all sizes and industries, as a mechanism of separating the liability of the persons interested in the enterprise to the liabilities of the enterprise itself.

2. Some possibly relevant circumstances

If the formulation of the test is stripped of the references to 'rights' and 'limits,' the real issue comes more clearly into focus: what set of circumstances must exist at the time that the loan is made for the Division 243 consequences to be triggered if the loan is subsequently not repaid in full?

The Example in the Paper (paragraphs 36 ff) is intended to demonstrate a situation where the rule would be triggered but it is not clear from the Example whether the rule is being triggered because:

- the level of debt is too high relative to the level of equity injected into the entity – i.e. a special purpose vehicle (SPV) must have an equity to debt ratio greater than 1 to 4; or

- the level of debt is too high relative to the value of the assets held by the entity (measured presumably after the financed property has been acquired) – i.e. an SPV must have assets worth at least 125% of the debt taken on by the SPV; or

- Bank B only has recourse to the assets and revenue of Company C irrespective of the level of equity or the value of the assets of Company C.

There are obviously circumstances where the difference between these formulations will matter – for example, if the entity can buy the financed property at a discount to market value, or if the debt was being taken on by an existing entity that already had negative equity.

We take it that the intended test is one of these, but the Paper needs to make clear which one.

Based on other parts of the text of the Paper, it seems intended that Division 243 is meant to be triggered if:

- the lender can recover against all the assets and income of the borrower, but the borrower has only the financed asset at the time of the loan; or

- the lender can recover against all the assets and income of the borrower, there are other assets in the borrower at time of the loan which are available to meet the claim of the creditor, but they are insufficiently valuable at that time; or

- the lender can recover against all the assets and income of the borrower, there are other assets in the borrower at time of the loan, but because this creditor's claim is subordinated to the claims of secured creditors, the value of the assets available to this lender is insufficient (assuming none / only some of the assets over which other creditors have security were available to this lender).

This suggests a test based on the level of debt relative to the value of available assets is what is meant. Nevertheless, the Paper should make clear what the offending circumstance is.

a. Focus of the proposed measure

The Paper mentions in several places that this proposal is meant to apply only where the borrower is 'a special purpose entity' – for example in paragraphs 2, 6, 7 and 37 – in a project finance context.

No such limit is expressed in paragraph 35. It is important that this precondition to triggering Division 243 not be lost in the exercise. This precondition makes the scope and operation of the provision much clearer and compliance much more manageable.

b. Exceptions

Next, if a test based on the level of debt relative to the value of assets is used (say), there will need to be exceptions for a variety of common and innocuous circumstances where the test might be inappropriately triggered.

c. Security and guarantees

Even if the amount borrowed by the SPV seems large on the debt to value test, there will need to be adjustments where the debt is either secured or guaranteed.

For example, assume A lends 100, B lends 30, the funds are spent on a single asset worth 130 and the debt : value ratio included within the revised Division 243 is 125%. If A's debt is secured this situation should not trigger Div 243, and the same should apply if B's loan is guaranteed by an entity with available assets worth, say, 20.

d. Time for measuring

The proposal in paragraph 35 suggests that Division 243 will only be triggered if the relevant circumstances exist '… at the beginning …' This formulation is appropriate because it excludes situations where the financed assets were adequate but decline in value and turn out to be sufficiently valuable. It is also not open to abuse where the assets were not sufficiently valuable but become sufficiently valuable – Division 243 would not be triggered.

But there may be some timing issues in deciding what is 'the beginning' –

- there will need to be some time allowed after the initial debt has been raised by an SPV to allow it to acquire/construct the relevant assets; or
- a geared construction project may face the same problems as the amount of finance advanced will often exceed the value of the construction project at that time.

This suggests that the date for measurement of the value of the financed assets should be a window which extends beyond the date of issue of the loan.

e. Multiple and sequential lenders

The rules will also need to be capable of dealing appropriately with:

- multiple contemporaneous lenders financing a single asset – presumably, the test would need to compare all debt to the value of the financed asset; and
- subsequent lender financing improvements to an existing asset.

3. Application date - proposed rules should only apply for new borrowings from 8 May 2012

The proposed application of the new provisions to terminations occurring after 8 May 2012 would mean that pre-existing arrangements would be subject to the proposed measure should they terminate. Given that the proposed amendments will operate to change the existing law, as confirmed in the recent High Court decision in BHP Billiton, it is inappropriate for the proposed measured to have retrospective effect to pre-existing borrowing arrangements as at 8 May 2012.

We recommend that the proposed integrity rules should only apply for new arrangements entered into after the date of introduction of the legislation into parliament (given the significant clarification in scope of the measures required since the 8 May 2012 announcement).

If the application to terminations after 8 May 2012 is maintained, then at the very least, taxpayers should be given the opportunity to restructure their existing financing arrangements as a transitional measure. Since many existing financing arrangements, which are not currently limited recourse debt, may become limited recourse debt (depending on the final amended definition of limited recourse debt), it is appropriate that there be a transitional measure for these arrangements.

4. Other comments

We also note the following:

- If the revised Division 243 is triggered, the additional amounts included in the taxpayer's assessable income should be limited to deductions actually claimed or claimable. For example, if capital allowance deductions claimed in prior years gave rise to a tax loss that has subsequently been denied due to a failure of the tests required to carry forward income tax losses, the assessable amount should not include these denied deductions.

- The existing rules are severe in effect. Extending the definition of limited recourse debt, without correspondingly softening other parts of Division 243, could have cumulatively a draconian impact. Examples of where parts of Division 243 could be softened include:

    - Section 243-20(7) - if a debtor and creditor do not deal at arm's length in relation to limited recourse debt, this debt is classified as non-arm's length limited recourse debt. Any refinancing of limited recourse debt using non-arm's length limited recourse debt is ignored in calculating the amount included in assessable income when the primary debt terminates. If the definition of limited recourse debt is to be amended as intended under paragraph 35 of the Paper, then any related party refinancing of a SPV may be classified as non-arm's length limited recourse debt. Accordingly, in practice, an entity would never refinance third party debt using related party debt (or run the risk of this debt being classified as non-arm's length). In times of tightened lending criteria amongst financial institutions, this could result in an SPV having refinancing difficulties as third parties may not lend to the SPV due to its reduced capacity to make repayments but then a related party could not lend funds to the SPV without running the risk of triggering Division 243.

    - Section 243-25 - a limited recourse debt can effectively terminate 'in substance', for example where a debt becomes a bad debt. As such, where an SPV borrows from a creditor and the creditor considers that the debt has gone 'bad', based on internal forecasts and policies of the creditor, the limited recourse debt rules could potentially apply to include an amount in the assessable income of the SPV. With a broader definition of limited recourse debt, the current tighter lending environment and the ability of a creditor to unilaterally trigger Division 243, this could have a severe impact on the ability of start-up projects or struggling projects to survive the current economic climate.

- The Paper does not discuss income tax consolidation interactions. For the avoidance of doubt the measures should confirm that when applying the proposed definition of limited recourse debt, the single entity rule in section 701-1 applies for the purposes of characterising the relevant debt.