Institute of Chartered Accountants Australia

13 November 2012

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By email: financetax@treasury.gov.au

Dear Nan,

Limited recourse debt amendments exposure draft legislation

The Institute of Chartered Accountants in Australia (**Institute**) welcomes the opportunity to comment on the exposure draft legislation (**ED**) and accompanying explanatory material (**EM**) to amend the definition of "limited recourse debt" in Division 243 of the *Income Tax Assessment Act* 1997 (**ITAA 1997**), which was released on 25 October 2012 (**Division 243 Amendments**).

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.

The Institute raised a key concern regarding the retrospective nature of the Division 243 Amendments in our previous submission on the discussion paper entitled *Clarifying the definition of limited recourse debt*. As the application of the Division 243 amendments has not changed in the ED, we reiterate our concern regarding the retrospective impact.

The new law should not apply to pre-existing debt arrangements. It would be unfair to require taxpayers to revisit their loan documentation again to reclassify their existing debt. Taxpayers would have entered into their debt arrangements with comfort that their debt arrangements were not limited recourse debt under existing tax law. Therefore, we submit that the application of the Division 243 Amendments should be changed to debt arrangements entered into on or after 8 May 2012.

The proposed amendments also broaden the scope of Division 243. As the provisions of Division 243 was originally introduced in a simpler form[1], expanding the definition of "limited recourse debt" bears the risk of inadvertently capturing ordinary commercial lending arrangements which were not intended to be caught by Division 243. We submit that some exclusions be introduced to focus the scope of Division 243 on the type of debt arrangements that were originally intended to be caught.

[1] See the regulation impact statement for Taxation Laws Amendment (No. 1) Act 2001 which introduced Division 243. We refer to the conclusion for the option chosen to implement Division 243.

> "Option 1 is preferred. It requires less complex legislative drafting and its application on the termination of the relevant financial transaction eliminates any additional adjustments that may be necessary if the capital expenditure adjustment were to apply on disposal of the underlying asset."

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Our detailed comments on the ED and EM and suggested exclusions are set out in the attachment.

If you have any queries regarding the content of this submission, please do not hesitate to contact me on 02 9290 5609 or Karen Liew 02 9290 5750.

Yours sincerely

Paul Stacey
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The Institute of Chartered Accountants in Australia

Submission

1. Affected taxpayers are not just special purpose vehicles

It is not entirely clear from the ED whether the amendments are intended solely to capture special purpose vehicles (**SPVs**) or whether they are also intended to capture existing taxpayers wholly exposed to lenders. The draft EM suggests that the scope of the Division 243 Amendments is limited to SPV arrangements. Paragraph 1.7 of the EM states:

> "Creditor's rights to recourse can be limited by contractual terms or by arrangements, *such as an arrangement involving the use of a special purpose entity as the debtor* which predominantly holds and operates the financed assets. In both situations, the debtor is not fully at risk with respect to ..." (emphasis added).

The Institute understands this to be the intended scope of the amendments. Further, such scope accords with the policy intents of earlier government amendments to introduce Division 243 in 1999 and 2001, from which it is evident that Division 243 was not intended to apply to:

- An individual taxpayer, who is a sole proprietor or investor, and is fully exposed to a lender;
- A trust conducting a business which is not established as a SPV; and
- A company which is the principal business entity and is not established as a SPV.

However, because the draft provisions to amend the definition of "limited recourse debt" do not expressly focus the measure on SPVs, not only do the provisions capture SPVs but they also capture the situation of the principal business entity which is wholly exposed to a lender, e.g. all its assets are security for the debt.

The Institute recommends a number of further exclusions to narrow the scope of the Division 243 Amendments to SPVs. We also recommend that a safe harbour for entities be introduced which would provide more certainty for entities applying Division 243.

2. Exclusions

a. De minimis threshold for small businesses

Consistent with the government's policy of simplifying the tax system for small businesses, we recommend a de minimis threshold for the application of Division 243 based on the value of the debt. We suggest that a debt arrangement of $1 million or less be excluded from the definition of "limited recourse debt".

b. Extension of the exclusion in subsection 243-20(5) to proposed subsection 243-20(2).

The way the Division 243 Amendments are currently drafted, an established business entity which has wholly exposed its assets to a lender, as a result of a loan to fund the business, could be caught by Division 243 if its debt arrangement 'terminates' after 8 May 2012. Furthermore, it is uncertain how the current subsections 243-20(5) and (6) will interact with the Division 243 Amendments.

To focus the Division 243 Amendments on SPVs, the exclusion in subsection 243-20(5) could be extended to the proposed subsection 243-20(2). The test time for this exclusion would be at the start of the arrangement when the obligation is imposed on the debtor. This would carve out the above business entities from the scope of Division 243 if the value of their 'other property' offered as security for the debt is greater than the value of debt at the time the debt obligation is imposed.

The proposed amended subsection 243-20(5) could be drafted along the lines of the following:

> "(5) However, an obligation that is covered by subsection (1) **or subsection (2)** is not a limited recourse debt if the creditor's recourse is not in practice limited due to the creditor's rights in respect of a mortgage or other security over property of the debtor (other than the financed property) the value of which exceeds, or is likely to exceed, the amount of the debt **at the time the obligation is imposed**."

c. Entity with minimal or ancillary depreciating assets

We are of the view that Division 243 should not apply to entities that have minimal depreciating assets. For instance, if a loan is made to a trading entity for the refinancing of debt used for normal funding of the business and that entity has depreciating assets equal to 10% of total gross assets, Division 243 should have no application.

The Division 243 Amendments will result in a greater risk that entities of this type will be subject to Division 243 where they allow the debt to be secured against all of its assets. As such, we recommend an exclusion be included in Division 243 for entities where the total market value of their assets that give rise to capital allowance deductions is less than the total market value of the assets that do not give rise to capital allowance deductions.

The exclusion provision could be drafted as follows:

> "(3B) An obligation that is covered by subsection (1) or subsection (2) is not a limited recourse debt if at the time the obligation was imposed the sum of the *market values of the assets of the debtor that give rise to *capital allowance deductions is less than the sum of the *market values of the assets of the debtor that do not give rise to *capital allowance deductions."

d. Individuals

The Division 243 Amendments could potentially capture an individual who has purchased a rental or investment property, with a bank loan secured against the property, and holds no other significant assets. We recommend that individuals should be excluded from Division 243 in this situation.

We also recommend individuals should be excluded from these provisions in certain circumstances like bankruptcy and marriage breakdown. Unlike other entities (companies and trusts), the implications of bankruptcy for an individual are more profound than deregistration, liquidation or winding-up (for example, the impact on future borrowing capacity, professional employment and ability to act as a director of a company).

3. Safe harbour

The effect of the Division 243 Amendments is to treat full recourse debt as "limited recourse debt" if it is reasonable to conclude that recourse is effectively limited. We believe a safe harbor is needed to help taxpayers to determine whether it is "reasonable to conclude". Without a safe harbour there would be considerable uncertainty for taxpayers.

Broadly speaking, taxpayers should not be concerned if:

- Loans are not specifically limited in recourse to particular assets of the debtor (i.e. if the debt falls within subsection 243-20(1) it would be limited recourse regardless of the gearing)
- Gearing within the entity is less than the thin capitalisation safe harbour – i.e. liabilities less than 75% of assets
- Gearing is more than 75% but the lender has recourse to all assets of the debtor, and the loan is on arm's length terms (potentially maybe only allow this where the debtor and creditor are not related).

Suggested drafting for the safe harbour could be along the lines of the following:

> "(3C) An obligation that is covered by subsection (2) is not a limited recourse debt if the obligation is not also covered by subsection (1); and
> (a) the debtor's liabilities are less than 75% of its assets; or
> (b) the debtor and creditor are dealing at arm's length in relation to the debt."

Given the term such as "liabilities" and "assets" are defined terms for the purposes of other provisions, we suggest that the liabilities and assets of the debtor could be determined in accordance with the accounting principles of the debtor.

4. Test time for classification of limited recourse debt

Whenever a debt is terminated or deemed to be terminated this requires consideration of whether a debt arrangement is limited recourse debt to determine whether Division 243 is applicable. The classification is imperative if the borrower has any questions about its financial stability or ultimate capacity to repay.

According to current law, the test time to classify whether a debt arrangement is limited recourse debt is the start of the arrangement. This is acknowledged in the EM at paragraph 1.14.

Furthermore, taxpayers will typically take the view that the relevant classification was to be made in the year of borrowing based on a reading of section 243-15 which provides that:

> "(1) This Division applies if:
> (a) **limited recourse debt has been used* to wholly or partly finance or refinance expenditure; and
> (b) at the time that the debt *arrangement is terminated, the debt has not been paid in full by the debtor; and ...." (emphasis added)

The borrower might also take comfort from the decision of the High Court in the *Commissioner of Taxation v BHP Billiton Limited* [2011] HCA 17 (at paragraphs 53 and 54, approving the comments of Edmonds J in the decision of the Full Court of the Federal Court).

Given the test time for classifying the debt is an important threshold issue for the application of Division 243, we recommend that that the test time be included in the legislation for clarity.

In addition, we note that the EM has added a new dimension to classifying the debt which adds uncertainty for taxpayers. Paragraph 1.14 states that "consistent with the current law, the question of whether the creditor's rights against the debtor are limited in substance or effect is determined at the start of the arrangement *(as varied prior to the termination of the debt)."* (emphasis added).

It is unclear what the words "is determined at the start of the arrangement *(as varied prior to the termination of the debt)"* actually means. It seems the practical consequence means that each time the debt arrangement is varied, a borrower would have to look at all its loan documentation and consider the classification of the debt arrangement again. This would impose an ongoing compliance burden in relation to a debt which was not a limited recourse debt at its commencement.

The variation of debt raises a whole series of issues that expose the problem with not having a clear legislative explanation of when to apply the definition of limited recourse debt in section 243-20. Some scenarios which require legislative clarification include the following:

- A debtor company or trust or individual investor borrowed in 2005 a relevant debt with, say, a five year term capable of extension. In 2009, the debt was extended for 10 years. Is this a variation and how does this fit into the law?

- As in the above example, however in 2009 the debtor company or trust or individual fixed the interest rate. Is this a relevant variation for reclassification? We suggest it is not intended to be.
- As in the above example, however in 2009 the debtor company or trust or individual extended the original loan for 10 years with the same lender, pursuant to a new loan agreement being executed. Is this a relevant variation? We suggest that it should not be, but is probably caught by the proposal.

Also, as certain variations to the debt arrangement are deemed terminations under section 243-25, Division 243 will need further legislative clarification to be clear as to:

- What variations are relevant to the reclassification of the debt arrangement for Division 243 purposes
- What variations are deemed terminations with the remaining debt not being treated as new debt
- What variations are deemed terminations with the remaining debt being treated as new debt.