13 August 2012

Teresa Bostle
Finance Tax Unit
Business Tax Division
Treasury
Langton Crescent
Parkes ACT 2600

E-Mail: financetax@treasury.gov.au

Dear Teresa,

Limited Recourse Debt

Thank you for the opportunity to comment on Treasury's discussion paper "clarifying the definition of limited recourse debt" (the Proposal).

The Property Council is the peak body for owners and investors in Australia's $600 billion property investment sector. The Property Council represents members across all four quadrants of property investment - debt, equity, public and private.

The industry welcomes the Treasury publishing its early views on the definition of limited recourse debt and the opportunity to comment on your view before they are finalised.

However, the industry is concerned that:

- the proposal is significantly broader than the policy announcement made in the 8 May 2012 Budget and risks capturing all debt, not just limited recourse debt;
- the example does not contain sufficient information to properly apply the proposed new definition of "limited recourse debt"; and
- the proposal is retrospective - it applies to debt already in place.

Where the limited recourse debt provisions are triggered, they claw back capital allowance deductions previously claimed. The proposed changes to the definition of limited recourse debt may apply to many standard financial arrangements. This creates significant uncertainty and jeopardises current and future legitimate projects.

The simple solution is to:

- **ensure the expanded definition of limited recourse debt aligns with the policy announcement** – include only borrowings by special purpose vehicles established to undertake a specific project;
- **limit the additional assessable income to deductions actually claimed or claimable** – this ensures the revenue is protected without unfairly penalising taxpayers over and above any revenue at risk;

- **exclude subsidiaries of widely held unit trusts** from the expanded rules – this will align the treatment of wholly owned trust groups with wholly owned corporate groups;
- **expand the example** (paras 36-38) to explain exactly why and how the debt qualifies as a limited recourse debt; and
- **remove retrospective** rules that unfairly penalise debt existing on 8 May.

Please find further details in the attached submission.

We look forward to seeing further details on Treasury's proposed changes to the bad debts provisions so that we can provide our comments on those changes.

Please do not hesitate to contact us if you have any queries.

Yours sincerely

Andrew Mihno

Executive Director International & Capital Markets

Property Council of Australia

0406 45 45 49

Limited Recourse Debt

Property Council of Australia
August 2012

Submission

(1) Executive summary

The PCA is of the view that the proposed changes contained within paragraph 35 of the proposal are much broader than contemplated by the Budget announcement. The proposed breadth of the amendments need to be consistent with the intention of the proposal.

If such broad proposals are implemented it would be necessary to:

- exclude subsidiary trusts of widely held unit trusts; and/or
- allow transitional rules so entities can restructure their affairs before the rules commence.

(2) Breadth of definition of limited recourse debt

Paragraph 2 of the proposal states that 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.

Further, paragraph 35 of the proposal states that '*Section 243-20 will be amended to define a limited recourse debt as including arrangements where at the beginning, the creditors rights against the debtor, in the event of default in payment of the debt, are limited wholly or predominately (whether or not by contract) to certain rights in respect of the financed property or other property*'.

It is not clear what set of circumstances must exist at the time that the loan is made for the Div 243 consequences to be triggered if the loan is subsequently not repaid in full.

The Example [paras 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 – ie, an 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 – ie, 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.

The proposal 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. There is no acknowledgment in paragraph 35 that the measure is only intended to extend to special purpose entities.

It is important that the stated precondition to triggering Div 243 applies. This precondition makes the scope and operation of the provision much clearer. Read literally, the proposals contained within paragraph 35 could apply to any entity that has a borrowing not just special purpose entities (point 3 above).

Having regard to above discussion, the PCA submits that the changes to Division 243 should be limited to the changes contemplated in the Budget announcement. That is, borrowings by entities other than special purpose vehicles that have been established to undertake a specific project should not be caught by the new measures.

This could be achieved through the introduction of thresholds/safe harbours designed to exclude relatively lowly geared entities. We would be happy to discuss this further with you.

(3) Exclusions from proposed changes

For various commercial and historic reasons, a widely held unit trust group typically has a large number of subsidiary trusts (and to a lesser extent companies) that hold investments in real estate assets. It may be the case that the subsidiary trusts and companies have significant loans from the parent widely held trust (or intermediate trusts or companies).

It is not possible for the widely held trust group to form a tax consolidated group, as the requisite requirements to do so are not satisfied. The PCA submits that subsidiaries of a widely held unit trust should not be subject to the revised Division 243 rules on the basis that such an exclusion provides a comparable outcome to the treatment of tax consolidated company groups.

To ensure the integrity of this exclusion, a requirement could be included that the exclusion is conditional upon the debt-to-equity ratio of the widely held unit trust group, when viewed as a whole. We would be happy to discuss the nature of this integrity measure with you further.

(4) Transitional provisions

The transitional rules associated with the revised measure should be considered in detail. In particular, we believe there is an element of retrospectivity to the proposal application date. By applying the new rules to loans already in place at 8 May 2012, existing loans that were not "limited recourse debt" may become limited recourse debt. Accordingly taxpayers who have acted in good faith under existing rules, and have made a loss on the underlying investment, will now also be faced with the unexpected outcomes that arise from debt being treated as limited recourse debt. We believe that the new definition of "limited recourse debt" should not apply to arrangements that commenced before 8 May 2012.

As a fall back, those entities not previously caught by Division 243 should be afforded the opportunity to restructure their affairs (in a tax effective manner) prior to the commencement of the revised Division 243.

(5) Other comments

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.