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Dear Sir/Madam

Debt/Equity Integrity Rules Exposure Draft Submission - November 2016

Greenwoods & Herbert Smith Freehills (**G&HSF**) welcome the opportunity to comment on the proposed debt/equity amendments contained in the Exposure Draft (**ED**) legislation referred to above in respect of the debt/equity integrity rules, together with the associated Exposure Draft Explanatory Memorandum (**EDEM**) and the *Income Tax Assessment (Debt and Equity Examples) Declaration* 2016 (**ED Examples**) (together the **ED Materials**).

The proposed amendments implement the original recommendations from the Board of Taxation 'accelerated' report released by the government on 2 April 2015[1] (**Accelerated Report**) where the government announced that it would proceed by way of public consultation. The original recommendations have been incorporated into the ED Materials released by Treasury on 10 October 2016 for consultation concurrently with the press release by the Minister for Revenue and Financial Services, the Hon Ms Kelly O'Dwyer MP.

One of the key policy objectives of the amendments noted in the Accelerated Report is to address uncertainty around the operation of the related scheme and section 974-80 provisions by replacing these provisions with a new principles-based provision. However, we note there are still many uncertainties and unresolved issues contained in the ED Materials. Some of the matters identified for further consideration in this submission are intended to reduce the level of uncertainty consistent with this policy objective.

[1] Media release by the then Assistant Treasurer the Hon Josh Frydenberg MP.

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Matters for further consideration

1. How are the basic debt/equity tests applied to aggregated instruments in determining the debt/equity character of the 'single aggregated scheme' (i.e. how the core machinery provisions in Division 974 will apply once there has been aggregation)?

   This is a critical issue in applying the proposed law but none of the ED Materials appear to comment on it. The assumption seems to be that a taxpayer can simply apply the current basic debt/equity test to a scheme consisting of multiple instruments in a meaningful way without further legislative guidance. This may not be a simple exercise.

   For example, if a loan agreement with a performance period of 8 years is aggregated with ordinary shares which are perpetual, what is the performance period for the purpose of applying the basic debt test to the 'single aggregated scheme'?

   Further, what if there is a linear structure where funds from an equity raising are used to make a debt investment? This is a classic scenario where section 974-80 would need to be addressed and the clear policy outcome if section 974-80 applies is to re-characterise the debt interest issued to the connected entity as equity. However, we query how under the proposed new machinery provisions this is achieved and which financial benefits are to be evaluated under the core machinery provisions.

   We submit that the EDEM should include an example of how the current basic debt/equity tests are applied to a single aggregated scheme involving sequential and non-sequential component schemes.

2. Contextual comment – inclusion in EDEM with potential legislative backing

   To assist in putting the proposed single aggregated scheme integrity rules into context, we submit that an introductory comment suggesting that section 974-155 should only apply in limited circumstances may be of assistance.[2]

3. Aggregation of instruments issued at different times

   The related scheme provisions contained in subsections 974-15(2) and 974-70(2) are expressed to apply 'whether or not the constituent schemes came into existence at the same time'. There appears to be no equivalent requirement in the proposed new section 974-155, which introduces uncertainty as to whether an existing instrument can be aggregated and its classification effectively changed if another instrument is issued subsequently which then would result in a single aggregated scheme.

4. Examples generally – weighting of factors and alternate scenarios

   The evaluation of whether instruments are treated as a single aggregated scheme depends on how much weight is given to individual and potentially competing factors. The examples do not contain any guidance on the relative weighting of factors which might give rise to different outcomes.

   Some of the examples in the ED Examples include variations to the facts that are declared to be irrelevant on the one hand, or critical on the other. It would

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[2] For example, refer to the first sentence of paragraph 148 of Taxation Ruling TR 2012/4 and paragraph 230-55(4)(f) of the TOFA rules.

be useful if further work could be undertaken on the examples to cover variations which would assist taxpayers and the Australian Taxation Office (**ATO**) in applying the law.

5. Examples generally – illustration of application of Designed to Operate Test

   In all of the examples, if the Interdependence Test is satisfied so is the Designed to Operate Test (or it is ignored). There is a risk that the ATO may form a view with support from the examples that linkage equates to design.

   An additional example which clearly illustrates the differences between the Interdependence Test and the Designed to Operate Test would be of assistance.

6. Examples generally – Interdependence Test – illustration of difference between the 'dependent or linked' limb and the 'changes the economic consequences of' limb in the Interdependence Test

   The Interdependence Test can be satisfied if the pricing, terms and conditions of one or more schemes are either:

   - 'dependent on or linked to'; or
   - operate to 'change the economic consequences of'

   the pricing, terms and conditions of one or more other schemes.

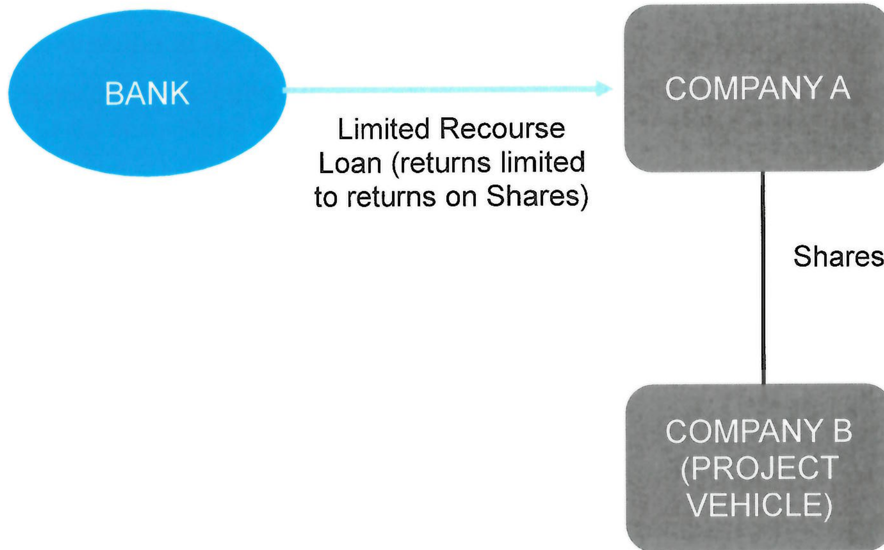
   Presumably the 'dependent on or linked to' limb of the test is a legal form test, and the 'change the economic consequences of' limb is a substance test (the EDEM provides at paragraph 1.31 that 'Economic interdependence requires a conclusion that the understanding of an obligation when looked at under an individual scheme is not the same when the schemes are looked at in aggregate').

   The examples where the Interdependence Test is found to be satisfied do not differentiate whether this is because the first limb or the second limb is satisfied. We submit that the inclusion of guidance in the ED Examples to assist in determining how or when one scheme operates to 'change the economic consequences of' another scheme would be useful.

7. Potentially unintended aggregation of limited recourse debt

   In our view there is a significant risk that limited recourse debt and any underlying asset to which the limited recourse debt relates (for instance shares) may be treated as a single aggregated scheme, and potentially characterised as an equity interest.

Reference is made to the following example, where Company A borrows $100 from Bank and subscribes for $100 of share capital in Company B, normal limited recourse provisions apply to the borrowing such that returns on the limited recourse loan can only be met with cash from returns on share capital in Company B.



The ATO appears to have accepted that limited recourse loans should be a debt interest notwithstanding these 'normal' limited recourse provisions[3].

In applying the proposed rules, we think that there is a real risk that aggregation would occur as the Interdependence Test should be satisfied (returns on the limited recourse loan are linked to and dependent on returns on the shares) and the Designed to Operate Test may well be satisfied (especially if Company B is a subsidiary of Company A). We note that the 'mere funding' exemption does not apply where the terms and conditions of one scheme are linked with the other.

If there is a single aggregated scheme in the above example comprising the limited recourse loan and the shares, there is a question of whether it is a debt interest or an equity interest. If the characterisation is an equity interest this cannot be correct. We submit that there should be a new carve-out included in subsection 974-155(2)(a) of the ED that the Interdependence Test will not be satisfied on account of there being limited recourse debt. Alternatively, there should be some clear statements/analysis included in the EDEM and ED Examples that the Designed to Operate Test should not be satisfied in relation to limited recourse debt.

8. Designed to Operate Test – potentially unintended aggregation with sub-participation type interests

   Similar points to those addressed at item 7 above arise for sub-participation type interests. For example, banks frequently enter into funded sub-parts of both loans and equity (or swaps which have similar economic effects).

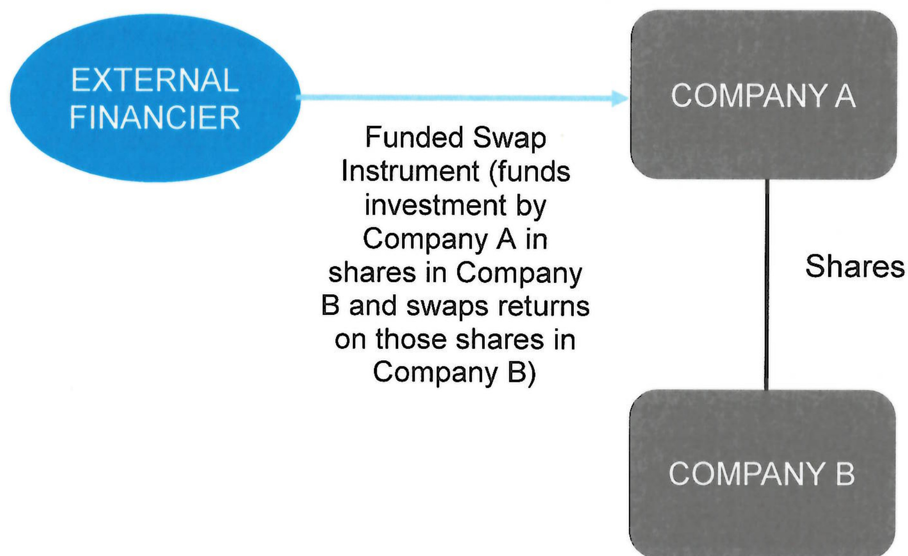
[3] Refer to 'Division 974 and Limited Recourse Debt' paper written and presented by Euan Campbell, Australian Taxation Office on 11-12 February 2010.

The example in paragraph 1.61 of the EDEM is helpful in relation to this. However, although it can be implied from the example that the Designed to Operate Test will not be satisfied because there is no involvement between the bank and the relevant company to which the dividend yield or share price is linked, it does not seem clear how this result is achieved under the provisions. The sense is that it is the involvement of the bank and the relevant company that is important rather than the bank and its customer.

We submit that the EDEM should explain why this is the case, and whether this would also be the case if the derivative was specifically structured between a bank and its customer.

9. 'Mere funding' exemption – Funded swap instruments

The purpose of this item is to raise a concern as to how the 'funding' ('receipts/turnover') exclusion applies. Reference is made to the example described below:



If a funded swap instrument funds an equity investment, and returns on the equity investment must then be paid out as returns on the funded swap instrument as a simple pass through of amounts, then the 'funding' ('receipts/turnover') exclusion provided in subparagraph 974-155(2)(a)(i) should, from a policy perspective, apply even though based on the current drafting, the funding exclusion would not apply as the funding is expressly included in the terms and conditions of the scheme.

If the funded swap instrument is aggregated with the equity investment by Company A in Company B, we query what happens. We submit that it should be confirmed, either in the ED or the EDEM, that the 'funding' ('receipts/turnover') exclusion will still apply and an example to reflect this should be included in the ED Examples.

10. 'Mere stapling' carve-out to Interdependence Test

Many private groups have an investors deed which includes attributes similar to those found in a stapling deed (which is more typical for public groups) but does not actually refer to stapling.

We submit that subparagraph 974-155(2)(a)(ii) be clarified so that it does not specifically require the interests to be formally stapled. The agreement in an

investors deed that investors may only dispose of one kind of instrument if they also dispose of another kind of instrument should be sufficient to benefit from the carve-out.

11. Example in Part 3 of the ED Examples – Chain of debt and equity: No aggregation

    The structure in Part 3 of the ED Examples is a sequence of instruments with interest paid by a company to a second company which then pays a dividend to its shareholders. Broadly, the ATO has correctly accepted the view in Taxation Determination TD 2015/2 that if the income of the second company is supplemented by other amounts, section 974-80 does not apply; the supplementary income breaks the link between the interest received and the dividend paid.

    The example in Part 3 also holds that the new aggregation rule would not apply, but the rationale is based on the terms of the loan not referring to the terms on which dividends will be paid.

    We submit that the ED Examples should address whether, if the terms of the loan and the share issue did refer to each other, the taxpayer would be able to rely on the current reasoning in Taxation Determination TD 2015/2 in circumstances where the interest income is being supplemented or comingled with other income earned by the paying company.

    In addition, can the example be extended to include a change to the facts specified at subsection 15(9) of the ED Examples such that UK Holding Co does not have any other assets apart from the shares in Dutch Co (with all other facts remaining the same)?

    This should clarify the relevance of the fact specified in this subsection, noting that the fact specified in this subsection does not feature in the reasons explained at section 17 of the ED Examples as to why the Interdependence Test is not satisfied in this example.

12. Example in Part 5 of the ED Examples – Contra-put scheme: aggregation

    The outcome of the example in Part 5 of the ED Examples is that the option scheme and the loan scheme are a single aggregated scheme which is an equity interest.

    We submit that the example should explain, for clarity, whether or not the loan satisfies the basic debt test as a stand-alone instrument, having regard to paragraph 974-30(1)(b) and the fact that the Issuer and the Parent Company are connected entities of one another.

    If this is the case then the proposed new paragraph 974-155(1)(b) would appear not to be satisfied with the effect that the schemes would not be aggregated.

13. Express linkages vs control – focusing on Examples in Part 2 and Part 9 in particular

    Many of the examples find evidence of linkage if documents refer to one another, or if documents provide for express control by one entity over another, and find no evidence of linkage if they do not.

    This tends to favour legal form over substance, goes against the policy objective of the debt/equity rules, and is more likely to trigger aggregation of instruments held by widely held entities as compared to closely held entities.

In closely held scenarios documentation of interdependences is generally not commercially necessary, whereas in widely held scenarios the reverse applies.

In comparing the example in Part 2 of the ED Examples with the example in Part 9, it would appear that critical to the outcome under the example in Part 9 is:

- S Co's ability to control Trustee Co (despite Trustee Co being owned by a professional trustee company) (paragraph 66(4)(c)); and
- contrary to usual fiduciary obligations which would be placed on Trustee Co, it must not exercise its power only in the interests of the unitholders of R Trust and must have regard to the interests of S Co's shareholders (paragraph 66(4)(c)).

Many of the other factors mentioned in section 72(2) of the ED Examples are unlikely of themselves to cause the Interdependence Test to be satisfied in respect of the share scheme, the unit scheme and the internal loan scheme, and may be carved out under the exceptions contained in paragraph 974-155(2)(a).

Reconciling examples

As a general comment, we submit that neither the EDEM nor the ED Examples adequately spell out what the policy/integrity concerns are as between the different outcomes of the different structures. For example, this is particularly relevant for why there is no aggregation under the 99/1 structure in Part 6 but there is aggregation under the financing structure in Part 9, given both involve stapled groups.

Subordination exclusion

One of the key carve-outs is the subordination exclusion in paragraph 974-155(2)(a)(iii), which provides:

> 'the arranging for an obligation to pay a return on a *debt interest arising from one of the schemes to be subordinate to an obligation to pay a return on a debt interest arising from another of the schemes, if neither obligation is contingent on the performance of the other'.

The subordination arrangements described at subsection 68(2) of the ED Examples are customary in that the deferral (whilst the senior debt is outstanding) by Trustee Co on the making of the claim against S Co pending consent by the security trustee is part of the mechanics for postponing enforcement by Trustee Co of the obligation on the part of S Co to repay the internal loan.

Whilst paragraph 72(2)(c) of the ED Examples provides:

> 'if S Co were to default under the internal loan, Trustee Co cannot make any claim against S Co without the consent of the external financiers (see subsection 68(2))',

the claim can proceed once the external debt has been repaid, thereby affecting the ordering contemplated by the subordination arrangements.

We submit that the subordination arrangements described in subsection 68(2) of the ED Examples are consistent with the ATO guide[4] in relation to the debt and equity rules, which provides:

> 'Subordination
>
> Subordination clauses that preserve the obligation, and operate to merely postpone enforcement of that obligation to a time that other creditors are paid, do not prevent there being a non-contingent obligation. This may result in the performance of the obligation not occurring, because senior creditors may never be paid in full. Nevertheless, if ultimately the subordinated claim may receive less than the full amount owing only because the debtor has insufficient assets to repay both the senior creditor and the subordinated claim in full, then meeting the obligation is dependent only on the debtor's ability to pay and this is not enough to make the obligation contingent.
>
> However, where the creditor's right to repayment is subordinated to the level of ordinary equity interests, such that the obligation to, in a winding up, repay the creditor is contingent on paying the ordinary equity interest holders, the obligation will be contingent.'

If the subordination exemption contained in paragraph 974-155(2)(a)(iii) and the ED Examples do not operate to achieve a similar outcome then we submit that they should be amended to do so.

Control

The Note to subsection 72(2) of the ED Examples provides that:

> 'These factors mean there is no effective obligation of S Co to repay the internal loan. It is up to S Co to decide if, when and to what extent it repays the internal loan, and whatever it decides cannot be challenged.'

This Note is presumably concluding on the factors addressed at subsection 72(2) from the perspective of identifying a link or changed economic operation, to identify a single aggregated scheme. The single aggregated scheme is then tested under the basic debt/equity test to determine its character. As noted above, the conclusion appears to have been made because of the control aspects.

However, it is not clear from the example in Part 9, or subsection 72(2) in particular, how the existence of the borrower controlling the lender actually results in the pricing, terms and conditions of the share and unit scheme being regarded as being 'linked to' and being said to 'operate to change the economic consequences of' the pricing, terms and conditions of the internal loan scheme.

Subsection 72(3) of the ED Examples goes on to explain the effect of the conclusion, which we assume is worked out by applying the basic debt/equity test to the single aggregated scheme found to exist earlier. Subsection 72(3) provides:

> 'These factors in subsection (2) would cause these schemes (if they were treated as a single aggregate scheme) to no longer give rise to a debt interest in S Co because any obligation on S Co to repay the internal loan funds is, for all practical purposes, at S Co's discretion.

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[4] https://www.ato.gov.au/Business/Debt-and-equity-tests/In-detail/Guides/Debt-and-equity-tests--guide-to-the-debt-and-equity-tests/.

Note: The internal loan scheme would no longer give rise to a debt interest because S Co does not have an effectively non-contingent obligation under the loan to provide financial benefits (see paragraph 974-20(1)(c) and section 974-135 of the Act).'

It reaches the conclusion for the same reasons as noted in subsection 72(2), rather than for example considering the impact of the share scheme and the unit scheme in aggregate, where R Trust would tend to act as a circuit breaker in determining whether there is an effectively non-contingent obligation to pay the unitholders. That is, even if there was an effectively non-contingent obligation under the internal loan, when aggregated with the units in R Trust the combined effect is to introduce contingencies.

The relevance of control is not mentioned in the ED itself or in the EDEM. If the result of the example in Part 9 from the ED Examples is because of the 'control' then it is an illustration of the ED Examples extending the law. This is because it is only introduced in the ED Examples, which are, pursuant to subsection 974-155(3), imputed back into the test in section 974-155.

In the example in Part 2 the lender controls the borrower, but in the example in Part 9 the borrower controls the lender. It is the borrower's obligations which determine whether there is an effectively non-contingent obligation as expressed in the Note under subsection 72(3) in the ED Examples.

In the example in Part 2 of the ED Examples if there was one shareholder then in substance the one shareholder can control both the borrower and the lender and achieve the same outcomes as the example in Part 9 of the ED Examples.

We submit that the fact that a borrower can control a lender should not from a policy perspective cause the loan not to be treated as a debt interest, and the legislation should reflect this policy outcome. For example, from a policy perspective a holding company should be able to borrow from a subsidiary company where the borrowing is not precluded from being a debt interest (which would be relevant assuming that they are not members of a tax consolidated group), or else there would be a fundamental change to the law. If this is the policy outcome then we submit that the policy appears to discriminate against widely held entities which typically rely on express control rather than merely exercising control via a controlling shareholder.

We assume that it is an important fact that pursuant to the stapling deed described in paragraph 66(4)(c) of the ED Examples that Trustee Co must not exercise its powers only in the interests of R Trust's unit holders and must have regard to the interests of the S Co shareholders, because, absent this, S Co's ability to control the Trustee would not be sufficient to determine, say, that R Trust would not take legal action against S Co to recover the loan if there is a default. The non-exercise of its rights could otherwise cause the Trustee to breach its fiduciary obligations. It would be useful if this were explained in the example.

In relation to the Designed to Operate Test, our comments above equally apply.

Clarity regarding application of debt test to the internal loan on a stand-alone basis

We submit that for clarity, the example in Part 9 of the ED Examples include a comment which explains why the internal loan satisfies the basic debt test on a stand-alone basis.

14. Relevance of investors being entitled to demand a return of investment and relevance of an external financier – example in Part 6

In the example in Part 6 of the ED Examples (the 99:1 stapled structure), which concludes 'no aggregation', and in the alternatives described under the example in Part 9, the ED Example refers to a fact that (the language below is taken from Part 6):

> '(3) The investors borrow $99 million from an independent external financier (the external loan). The investors use the loan funds and $1 million of their own money to acquire the stapled securities.
>
> ....
>
> (5) The investors are entitled to demand the return of invested trust capital, or the distribution of trust income, without this being subject to:
>
> (a) any limitations in M Trust's deed, the stapling agreement or other instruments; or
>
> (b) N Co's ability to return share capital or distribute profits to its shareholders.'

It is unusual from a commercial perspective for unitholders to be able to demand a return of investment capital. This is a fundamental factor which gives rise to the investment in the Trust being considered to be equity.

We are not sure why this requirement is necessary in finding under the example in Part 6 that there is no aggregation. If it were, then it would imply that the mere interposition of the M Trust would trigger aggregation of the loan with the units.

We are also not sure of the relevance of the External Financier effectively having a back-to-back arrangement in respect of the units in the Trust. We submit that the example should clarify whether this is necessary or not, and if so, why.

15. Relevance of ownership / control of trustee company – example in Part 7 (Debt raised by Property Trust: no aggregation)

Following on from the points addressed at item 13 above, the example in Part 7 of the ED Examples, which involves debt raised by a stapled Property Trust, includes as an assumption at subsection 41(4) of the ED Examples that:

> 'Y Co has no control over the trustee of X Trust, and no rights relating to the appointment of directors (assuming the trustee is a body corporate).'

This fact is then expressed as a reason that there is no aggregation of the unit scheme and the share scheme at paragraph 47(2)(b) of the ED Examples.

The example in Part 7 is silent as to who owns the Trustee (assuming that it is a company), but it can be implied from the fact that Y Co has no control over the Trustee of X Trust that the Trustee is not owned by Y Co.

This is a change between the equivalent example (being Example 3) contained in the Accelerated Report. In the background facts to Example 3 in the Accelerated Report, the corporate member of the staple (Y Co or Company Y), acts as responsible entity for the trust member of the staple (X Trust), i.e. Y Co owns the Trustee of X Trust.

We submit that the ownership by Y Co of the Trustee (itself subject to the usual fiduciary obligations) should not cause aggregation of the unit scheme and the share scheme (or the internal loan scheme, the share scheme and the unit scheme) and the example in Part 7 should be amended to confirm that this is the case.

16. Reliance and application of the ED Examples

The ED provides at subsection 974-155(3) that the examples may extend or narrow the operation of the aggregation provision and the note under this subsection states that 'None of the examples will be exhaustive'.

There is a question mark around how closely a taxpayer's circumstances have to match the examples before either the ATO or a taxpayer can rely on them. In reality, it will be rare for an actual fact pattern to fall exactly within the examples. It is therefore important to understand whether the examples are meant to be understood as:

- precise instances where the rules are deemed to produce this outcome (whether the rules would otherwise produce this outcome or not); or
- representative of a broader class of situation with similar but not identical features.

<u>We submit that</u> Treasury should take this opportunity to codify its intention rather than leaving it up to a Court to try to discern it.

17. Relevance of normal commercial understandings and practices – utilising example in Part 2 of the ED Examples

The example in Part 2 of the ED Examples takes the view that the shares and loan are not aggregated 'because the company must perform its obligations under the loan agreement regardless of the pricing, terms and conditions attached to the issuing of the shares' and 'nothing about the shares affects … anything … about the loan'.

That is true on the facts of the example, but one is left wondering about what to do if there are other reasons for not aggregating. For example, if the terms of the share issue and loan instrument were linked, would the two instruments be aggregated or would they remain disaggregated by virtue of the Designed to Operate Test because 'normal commercial understandings and practices' do not treat a shareholder's shares and loans as a single arrangement?

18. Consequential amendments – subsection 26-26(3)

We refer to the proposed new subsection 26-26(3) and paragraph 1.82 of the EDEM.

We understand that the new subsection 26-26(3) is not intended to switch on the debt/equity rules generally for trusts where the trust interest is not aggregated with an interest in a company. We submit that this should be made clear in the EDEM.

19. Application Date and Material Change overlay

We include below extracts from the ED, the EDEM and the media release issued by the Hon Kelly O'Dwyer on 10 October 2016, which relate to the Application Date of the proposed amendments.

Paragraph 1.88 of the EDEM:

> 'The amendments in this Exposure Draft apply to transactions entered into on or after the commencement of this Schedule. The Schedule commences on a day fixed by Proclamation (or if there is no Proclamation, 6 months after Royal Assent).'

Commencement information – column 2 of the ED:

> 'A single day to be fixed by Proclamation. However, if the provisions do not commence within the period of 6 months beginning on the day this Act receives the Royal Assent, they commence on the day after the end of that period.'

10 October 2016 Media Release by the Hon Kelly O'Dwyer MP:

> 'The final legislation will apply prospectively from a day to be fixed by proclamation or six months after Royal Assent, whichever is later.'

We assume that the words in the Media Release should say 'whichever is earlier', because the start date would always be uncertain if proclamation could occur at any time in the future, and recommend that this be clarified.

Material Change

We also submit that the proposed law be clarified as to which set of rules should be used to classify an instrument if there is a change after the Application Time to an instrument issued before the Application Time (or a change to related arrangements relevant to applying the debt/equity integrity rules). This is the ambit of section 974-110 and the amendments proposed in the ED do not appear to provide any clarification on this issue.

In providing such clarification, it will be important to clarify what type of change triggers a material change. For example, if the instrument issued in its current form after the Application Date would give rise to an equity interest but if issued before the Application Date would give rise to a debt interest?

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Should you have any questions in relation to the above, please contact Aldrin De Zilva on +61 3 9288 1903.

Yours sincerely

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