



Law Council
OF AUSTRALIA

Business Law Section

The Treasury
Langton Crescent
PARKES ACT 2600
Via email: lawdesign@treasury.gov.au

22 November 2016

Dear Sir/Madam

Exposure Draft, *Tax and Superannuation Laws Amendment (Debt and Equity Scheme Integrity Rules) Bill*

The Business Law Section of the Law Council of Australia welcomes the opportunity to provide its submission on the Exposure Draft of the *Tax and Superannuation Laws Amendment (debt and equity scheme integrity rules) Bill* and accompanying Explanatory Memorandum and *Income Tax Assessment (Debt and Equity Examples) Declaration 2016* (together, the **new integrity rules**). The submission below represents the views of the Taxation Committee of the Business Law Section (the **Committee**).

As set out in the Explanatory Memorandum, the new integrity rules will amend the debt-equity rules in Division 974 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**) with the intention of ensuring that multiple schemes are treated as a single scheme only where this accurately reflects the economic substance of the schemes.

This letter contains the Committee's comments on the new integrity rules.

1. General comments

As a general comment, the Committee supports the repeal of the related scheme rules and section 974-80 and replacement with a simpler scheme aggregation rule.

In previous submissions to the Board of Taxation, the Committee had stated that section 974-80 could be repealed and a single related scheme provision operate to cover both.

The carve outs for minor cases of interdependence is also supported by the Committee. There needed to be clarity that mere cases of stapling or subordination will not give rise to an aggregation of interests.

The Committee however has reservations with the proposed inclusion of examples in a legislative instrument declared by the Minister.

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2. The interdependence test

The introduction of an interdependence test appears to follow the recommendations of the Board of Taxation.

The recommendation of the Board of Taxation was, broadly, that the gateway to aggregation should be an interdependency or economic effect which relevantly affected the application of the debt or equity test.

The Committee submits that proposed section 974-155 does not actually reflect the Board's recommendation.

The Board of Taxation's recommendation carried a qualification that the interdependency or economic effect needed to be such that the pricing, terms and conditions of one or more of the schemes would affect the economic consequences of the pricing, terms and conditions of the other scheme or schemes in a manner which would affect the application of the debt or equity test. This qualification is absent from the now proposed interdependency test.

The proposed interdependency test can be satisfied by any linkage between the pricing, terms and conditions of the two schemes, regardless of whether that linkage is relevant to the debt or equity test (subject of course to the carve outs, assuming any one applied – this appears the only limitation, as noted at paragraph 1.29 of the Explanatory Memorandum).

The Committee supports the view and recommendation of the Board of Taxation. We submit that the interdependency test needs to be amended to align with the recommendation of the Board of Taxation, in order to ensure that the new test does not suffer from the same overly broad potential application as the existing definition of 'related schemes'.

3. The design test

Even where the interdependency test is satisfied, the schemes will not be aggregated unless the design test can be satisfied. The design test is an objective test which, having regard to certain factors, requires the Commissioner to be able to conclude that the schemes were designed to operate together to produce the scheme's combined economic effect.

The prescribed factors include the nature and extent of the involvement of the parties, the way in which the schemes were carried out, relationships between the parties, normal commercial understandings and any other relevant factors.

The Committee supports the objective nature of the test, but notes that while subjective and actual intentions are not relevant, the facts and circumstances of the particular taxpayer(s) need to be considered in applying the factors. In this regard, we note that the commentary at paragraphs 1.69 to 1.70 of the Explanatory Memorandum in relation to the normal commercial understandings factor should make note that it requires an

assessment of the commercial understandings and practices in the circumstances, having regard to the transaction in question.

4. Examples in the legislative instrument

A legislative instrument

The Committee acknowledges that it has called for examples to be included in the legislation to support these provisions. In a submission to the Board of Tax in 2014, the Committee noted as follows in relation to the related scheme rules:

It would be useful if the regulations (or the legislation) could provide some clear and commercial examples where two or more schemes are not related schemes as provided in 974-155(4). This could usefully include an initial capitalisation of debt and equity which will together fund a specific acquisition. For example, an express statement should be included in the law to confirm that "Parties will not be taken to have intended that the combined economic effects of the constituent or notional scheme to be the same as or similar to the economic effects of a single debt or equity interest merely because a debt and equity interest are issued at the same time or in respect of the financing of a single initial investment".

These calls for examples were based on the examples being drafted by Treasury and approved by Parliament, as part of the legislation.

We acknowledge that the Board of Taxation did suggest the inclusion of examples in a legislative instrument, but as a means to assist the judiciary in interpretation of rules that have been and will continue to be complex. We consider that the Board of Taxation's suggestion was around developing examples that could assist interpretation within the legislative framework rather than having the examples, as is ordinarily the case, in the Explanatory Memorandum.

The proposal that the Minister would have the ability to declare examples is not supported by the Committee.

The Committee is particularly concerned with the proposition, as clearly outlined at paragraph 1.79 of the EM that the instrument making power would enable the maker to extend or narrow the operation of the law.

The Committee respectfully submits that this aspect of the proposed measures be amended.

Utility of the examples

We note in Chapter 2 of the Examples both a simple shareholder loan and a more complicated loan to an intermediate holding company in a global group are used as the bases for examples. Both of these examples conclude that the interdependency test would not be satisfied, even where in the first example the shares and the loan are stapled. This is because:

- (i) the company's obligations under the loan are not dependent on the terms of the shares; and
- (ii) nothing in the terms of the shares affects the amounts payable under the loan, how the rights under loan can be exercised or anything else about the loan.

The Examples in Chapter 2 seem to demonstrate that the intention of the integrity provisions is to capture arrangements where there is a direct or indirect link between the returns paid on the two schemes – for example, the terms of the loan prohibited repayment without a proportionate buy-back by the company of shares.

While these examples are helpful, the Committee submits that more detailed and 'grey' examples would be of utility. It would be useful if existing rulings and determinations were reviewed for the purpose of using a number of those as the basis for an example. For example, ATO ID 2003/870 provides an example of where shares and loan notes that were stapled together were regarded as related schemes under section 974-155 with the result that wholly debt interests were considered to be issued. It would be useful to apply the proposed new interdependency and design tests to these facts to provide a view on whether the outcome would differ.

Additionally, specifically in relation to two examples:

- (i) The drafting of the shareholder loan example should make it clearer that there would be no aggregation where there are two or more shareholders all of whom have agreed to make loans or to acquire debt interests pro rata to their respective shareholdings. At present, the example is one shareholder with a suggestion that there is no difference if there were more than one shareholder, but does not say that those additional shareholders also make loans. Additionally, the example refers to loans and specifically to mandatorily redeemable preference shares that give rise to a debt interest in the Company. We query why the example is limited to mandatorily redeemable preference shares and recommend that, to make it of more utility, it instead refer to any financing arrangement that gives rise to a debt interest in the Company; and
- (ii) Of the four stapling examples, only the one where aggregation would apply includes in its facts that the trustee is authorised to take into account the interests of the shareholders as well as those of the trust beneficiaries. That is of course a very common, if not universal feature of stapling. We query the omission of this aspect from the facts in the other three examples, and are concerned that it raises a question about whether those examples are generally applicable. Their facts should be aligned better with common commercial practice to give them practical relevance (especially since the stapling carve out in subsection 974-155(2) is relatively simple, being limited to transferability only, and therefore may be of very limited use). We consider that the normal incidents of a stapling arrangement would not lead one to conclude, as in the one stapling example where aggregation would apply, that the company debtor can control whether or not it repays the loan.

If you have any questions in relation to this submission, in the first instance please contact the Committee Chair, Adrian Varrasso, on 03 8608 2483 or via email: adrian.varrasso@minterellison.com.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'RMS', written in a cursive style.

Rebecca Maslen-Stannage, Deputy Chair
Business Law Section