

## Taxation Law Committee

### Improvements to the Debt and Equity Tax Rules

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#### Submission of the NSW Young Lawyers Taxation Law Committee

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The NSW Young Lawyers Taxation Law Committee (**Committee**) makes the following submission in response to the Improvements to the Debt and Equity Tax Rules exposure draft bill, Instrument and Explanatory Memorandum.

## NSW Young Lawyers

NSW Young Lawyers is a division of the Law Society of New South Wales. NSW Young Lawyers supports practitioners in their professional and career development in numerous ways, including by encouraging active participation in its 16 separate committees, each dedicated to particular areas of practice. Membership is automatic for all NSW lawyers under 36 years and/or in their first five years of practice, as well as law students. NSW Young Lawyers currently has over 15,000 members.

The Committee consists of tax practitioners from a broad range of organisations including law firms, accounting firms, corporates and the Australian Taxation Office. The Committee covers all aspects of Federal and State taxation, with a primary focus on income tax, GST and stamp duty. The Committee also examines issues relating to Australian international taxation (including tax treaties), superannuation, tax administration, land tax and payroll tax.

The Committee thanks the Treasury for the opportunity to make submissions on the Treasury's proposed legislative improvements to the rules regarding the taxation of debt and equity.

## Summary of Recommendations

The Committee observes that:

1. The Income Tax Assessment (Debt and Equity Examples) Declaration 2016 (**the Instrument**) is designed to “give guidance as to how the new aggregation rule will apply in particular circumstances” (Explanatory Memorandum (**EM**) at [1.78]).

The Committee has concerns in relation to how the proposed aggregation rule will operate in practice and considers that the nature of the tests that must be considered under the new rule (Tax and Superannuation Laws Amendment (debt and equity scheme integrity rules) Bill Part 1) requires supplementary provision of guidance and examples in order to ensure that a degree of certainty is provided. This is particularly important given that the proposed scheme aggregation rule may cover a wider range of circumstances than those addressed by the current

equity integrity provision, *Income Tax Assessment Act 1997* (Cth) section 974-80, and the inherently subjective nature of the interdependence and design tests.

Therefore, the Committee recommends that:

2. Greater factual specificity and range be included in the examples set out in the Instrument, particularly with regard to how practitioners can expect the interdependence test to be applied.

Observations about selected examples in the Instrument are offered for the Treasury's consideration.

## Introduction

The Committee appreciates the background to the proposed changes to the debt and equity rules, including prior publications released by the Board of Taxation (**the Board**), which have identified issues concerning the existing section 974-80 and, more broadly, how related schemes are aggregated.

The Committee notes that the policy behind the debt and equity rules is to give effect to the economic substance rather than the legal form of a transaction (subsection 974-10(2)).

This submission focuses on the proposed interdependency test and the adequacy of the examples set out in the Instrument accompanying the amendments. The Committee observes that the Board recommended that the Commissioner use its powers under the proposed amendments to give “commercially relevant examples” that “give rise to questions about debt and equity characterisation.”

In the Committee's view, there are some deficiencies in the examples included, as set out below.

## The Instrument

### Essential finding

The Committee observes that the examples set out in the Instrument serve as basic illustrations of how proposed subsections 974-155(2) and (3) will operate. The Committee appreciates that the Instrument cannot provide a comprehensive set of examples. Interestingly, the examples provided appear to form part of the Declaration itself, lending them a quasi-legislative complexion.

However, the factual variations to the examples provided in Chapter 2 Part 2 Division 2, and Chapter 3 Part 7 Division 3 and Part 9 Division 3 have little extra utility in illustrating the operation of the aggregation rule in addition to the original scenario, often giving rise

to questions about the nature and details of each broadly-stated variation and whether any change in these would alter the outcome of the rule's application.

The opportunity to explore the consequences of a further level of factual variation, for example, where factual variations both supporting and suggesting against interdependency of schemes are compounded, or where a particular type of factual variation is made in varying degrees, is narrow. The Committee submits that the examples therefore fail to elucidate the effect of the new section 974-155 in less straightforward scenarios – such as those giving rise to questions about debt and equity characterisation, as the Board identified.

The EM states that a dependency or link as per subparagraph 974-155(1)(a)(i) may be “indirect” (at [1.28]). However, the EM refers only to the low threshold of “mere referencing” i.e. a scheme's terms and conditions referring to the terms and conditions of another scheme. The elements identified in paragraph 974-155(2)(a), which may indicate the presence of an indirect link or dependency are specifically identified in that paragraph as being insufficient bases on which to aggregate the schemes. Therefore, the minimum requirement for indirect links/dependencies that *do* satisfy the test in section 974-155(1) are not addressed.

### **Main example – Shareholder loan: no aggregation**

The example in Part 2 Chapter 2 of the Instrument looks at the potential for interdependence as between a loan given by, and ordinary shares issued to, an investor. This example illustrates where the interdependence test would not be satisfied on the basis that the pricing, terms and conditions of either scheme are not dependent/linked or operate to change the economic consequences of the pricing, terms and conditions of the other scheme.

In qualification of the EM's exclusion of referencing as a link requiring aggregation of the schemes, paragraph 12(1)(c) of the Declaration provides that no aggregation would occur unless changes to the length of the loan period and calculation of the rate of interest are referable to the share scheme or matters related to it.

First, this raises the issue of how clear the “reference” need be – whether, for example, it must be explicit in the agreements. Alternatively, where the “reference” need not be explicit, correlating interest rates and distribution amounts may be enough. Secondly, the caveat may cast doubt on how safe the “safe harbours” in proposed paragraph 974-155(2)(a) are, even when they are read down. Certainly, the potential for inter-scheme referencing forming (among other features) part of scenarios meeting the interdependence test is increased. The Committee submits that a disproportionate emphasis is placed on the extent to which the terms and conditions of one scheme relate

to those of another, which has the possibility of undermining the policy objective of de-emphasising the importance of legal form.

In respect of the limited degree of factual variation in the instrument, it is observed that paragraph 12(1)(e) duplicates section 974-155(2)(a)(ii), as stated in subsection 12(4). The nature of the changes otherwise set out offer little elaboration on the application of the aggregation rule insofar as they relate to the stapling of interests.

The only flagged example modification which would cause the aggregation rule to apply, a prohibition on the company repaying the principal unless there was a proportionate buy-back (subsection 13(1)), requires that this cause the schemes to no longer give rise to a debt interest in the company (subsection 13(3)). This merely requires resolution of subsection 974-155(1) on a specific set of facts without advancing the Instrument's purpose of providing guidance to practitioners. Highlighting proportionate buy-backs as an example qualifying for aggregation may also create an aversion to the use of such schemes in combination with loans. The Committee submits that further examples of changes to the example are necessary to provide guidance on the interdependence test.

### **Lack of elaboration on “Design” test**

Although the objective approach to determination of whether or not schemes should be aggregated presumably continues to apply, there is little development of the design test. It is not considered in a number of examples and where it is applied, the reasoning tends toward straight-forward, clear factors like ownership by one company of another and their common involvement in the schemes (see paragraphs 24(a) and (b) of the Instrument) and the circumstance of external financiers and ratings agencies accepting that paragraphs 974-155(1)(b) and (c) are met (paragraph 73(2)(b)).

Repetition of the reasons that the design test is met occurs across different examples, for example, entry into the schemes in a holistic way with each component scheme being part of a unified whole (paragraph 73(2)(a)) is inverted in section 49(2)(a)). In keeping with the elementary nature of factual variations, it is noted that the design test is applied on simple, binary terms, for example, the fact of, or *absence* of any evidence of, parties entering into the schemes in a holistic way with each component being part of a unified whole (paragraphs 73(2)(a) and 49(2)(a) respectively).

### **Conclusion**

The examples in the instrument clearly illustrate the basic mechanics of subsection 974-155(1). However, the Committee is of the view that they only serve the purpose specified by the Board to a limited extent, failing to engage in analysis which is more than foundational. Critically, this precludes any demonstration of how the proposed test may

result in different outcomes to those resulting under the current test. However, the amount of repetition and cross-referencing between current and proposed tests suggests emphasis is placed on consistency, which offers some guidance.

The Committee considers that the proposed legislation may need to be supplemented by Australian Taxation Office Law Companion Guidelines, providing further examples and guidance on how the interdependence and design tests will be applied. Further, those examples that consider that the aggregation rule applies should be extended to include more detailed consideration of the debt test in section 974-20 and the equity test in section 974-75.

## Concluding Comments

NSW Young Lawyers and the Committee thank the Treasury for the opportunity to make this submission. If you have any queries or require further submissions, please contact the undersigned at your convenience.

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