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Ref: AMK

22 November 2016

General Manager
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The Treasury
Langton Crescent
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Dear Sir/Madam,

EXPOSURE DRAFT LEGISLATION – IMPROVEMENTS TO THE DEBT AND EQUITY TAX RULES

A. General comments

Thank you for the opportunity to provide comments on the Exposure Draft Legislation ("**ED**"), Explanatory Memorandum ("**EM**"), and Exposure Draft Instrument ("**EI**") concerning the *Tax and Superannuation Laws Amendment (Debt and Equity Scheme Integrity Rules) Bill 2016*.

We support the Government's intention to give effect to the recommendations made by the Board of Taxation ("**BOT**") in the Accelerated Report that was released in December 2014. Section 974-80 and the "related scheme" provisions have been the source of much complexity and uncertainty for taxpayers and the attempt to ameliorate these concerns is welcomed.

Furthermore, we believe that introducing a legislative instrument that encompasses detailed examples of how the new law will apply will provide a more pronounced mechanism through which the intention of Parliament may be ascertained.

However, we are of the view that the ED, in its current form, will result in significant uncertainty for taxpayers seeking to apply the new measures. We demonstrate this through a number of examples contained in **Appendix A, which** illustrate arrangements to which the existing provisions currently do not seem to apply and demonstrate how the proposed law may create uncertainty.

We therefore submit that a number of amendments to the proposed provisions should be considered in order to provide some degree of certainty for taxpayers considering these provisions. We have made a number of submission points which we believe help to address some of these areas of uncertainty and potentially address the issues raised in **Appendix A**.

B. Submission Points

This section contains our main submission points. Our suggestions are aimed at trying to providing increased certainty for taxpayers and the Commissioner of Taxation in seeking to apply the proposed new provisions.

1. Clarification of "connected entity"

By repealing section 974-80 and removing explicit reference to "connected entity" in the new law, the proposed section 974-155 appears to provide greater scope to capture arrangements which would otherwise fall outside section 974-80.

In particular, the "connected entity" limb is implicitly replicated, and perhaps broadened, in the proposed subsection 974-155(1)(c)(iv) which would require one to consider the "relationships between any of the parties to any of the schemes".

Relevantly, the EM notes at paragraph 1.68 that a relationship between parties in an aggregated scheme may be established if they are "related parties, associated or connected entities". We note that the EM (effectively) describes the purpose of this new test as not being dissimilar to the current test. This is because, by virtue of the definition in section 995-1, "connected entity" includes an "associate". However, the EM introduces a new concept of "related parties". Given that this is in addition to "associates", it is extremely unclear as to the scope of "related parties" and how much broader that term is intended to be in comparison to an "associate".

We understand that the purpose of the broader test is to allow for stapled vehicles to be captured within the new provision. However, in our view, it would be simple to:

i. Retain a connected entity test; and

ii. Deem entities under an arrangement to be "connected entities" for the purpose of the provision where they are stapled or where all, or substantially all, of the membership interests in the two entities are held by the same persons.

As demonstrated by the examples in Appendix A, common financing arrangements are currently excluded from section 974-80 due to the application of the connected entity test. In our view, the proposed removal of this test and its replacement by paragraph 974-155(1)(c)(iv) makes it unclear as to whether these common financing arrangements would be caught within the proposed new provision.

Finally, we highlight that the EI only seems to comment on the "relationship" test where entities are "wholly owned" (Part 4 and Part 5). In the absence of legislative clarification, we believe that the EI would benefit from providing examples that considers how factors similar to the "connected entity" test (i.e. proposed subsection 974-155(1)(c)(iv)) are to be applied in the proposed "aggregated scheme rules."

Submission point 1
We recommend that the new provision retain the exclusion for arrangements not involving "connected entities". While this may exclude certain stapled arrangements (and like arrangement), we believe that these can be brought into the proposed rules by way of a specific provision. We also submit that the EI should contain examples highlighting the application of proposed subsection 974-155(1)(c)(iv) where parties are not "related".

2. Multiple debt schemes.

The Australian Taxation Office ("**ATO**") has confirmed that the current section 974-80 does not apply where the interest held by the ultimate recipient is characterised as a "debt" interest. This conclusion reflects the view that the operative provision of the section, being subsection 974-80(2), is intended to test whether the interest held by the ultimate recipient should be taken to be effectively an equity interest in the company (or a connected entity of the company: see TD 2015/3)[1].

The ED suggests that subsection 974-80(2) will be replaced by the proposed subsection 974-155(1)(b). While the EM seems to suggest that the intention of the proposed provision is consistent with the view expressed in TD 2015/3, it is noted that a requirement to "aggregate" two schemes and determine whether an "aggregated scheme" is to be treated as debt or equity results in a significant increase in the required analysis of the debt and equity provisions. Arguably this is also required under the current "related scheme" provisions contained in subsection 974-70(1)(b), however, in practice the current provisions are not commonly applied in that manner.

In our view, the proposed aggregated scheme provision should make it easier for taxpayers to determine whether an arrangement would be within the scope of the new provisions. Accordingly, to the extent that all of the arrangements in an aggregated scheme would otherwise be a "debt interest", we believe that the provision should not have application, and that a specific carve-out should be introduced.

With reference to Example 1 in Appendix A, we highlight that this exclusion would mean that the arrangement would not be within the scope of the new provision (as all "legs" to the arrangement are classified as a "debt interest").

While we believe that proposed subsection 974-155(1)(b) is intended to provide this same type of exclusion, the drafting of the provision requires one to apply Division 974 to a hypothetical aggregated scheme. That is, not only does Division 974 need to be applied individually to each "leg" of the arrangement, it also needs to be applied to a hypothetical arrangement (whereby the terms are not explicitly in any legal aggregated form, but instead are to be determined by the person applying the provisions to the arrangement).

[1] Taxation Determination TD 2015/3.

To be clear, we are not opposed to the retention of the proposed subsection 974-155(1)(b) where an exclusion is provided as outlined above. The exclusion will simply make it easier for taxpayers to determine how proposed subsection 974-155(1)(b) applies.

Submission point 2
The aggregated scheme provision should have no application where all "legs" to an arrangement are,in themselves, considered a debt interest. This exclusion would greatly reduce the uncertainty and compliance required associated with analysing the application of Division 974 to a hypothetical aggregated scheme (in addition to the application of Division 974 to each of the "legs" of the arrangement).

3. Potential for a low-value threshold carve-out for SMEs

As outlined above, the proposed aggregated scheme provision is complex and will, in our view, result in significant uncertainty and complexity for taxpayers. We believe that requiring SMEs to apply this new provision would result in a disproportionate compliance requirement for SMEs as compared to any integrity risks that may otherwise occur.

Under Division 974, "at-call" loans are treated as debt interests, irrespective of whether they otherwise meet the equity test criteria (section 974-75(6)). This exclusion can be applied where the GST turnover of the entity is less than $20 million.

We believe that this provides an appropriate threshold for determining whether an entity should be required to consider the new provisions. Accordingly, we request that an exemption is provided to entities under the new section 974-155 where they issue an instrument under the aggregated scheme would otherwise individually satisfy the requirements of subsection 974-75(6)(b).

Submission point 3
In order to reduce the disproportionate compliance burden that would otherwise apply to SME taxpayers, we request that an exclusion be provided where all entities that issue an instrument under the "aggregated scheme" would otherwise individually satisfy the requirements of subsection 974-75(6)(b) (i.e. the $20 million GST turnover test).

4. More clarity in the EI examples on the "interdependent test" and the "design test"

New proposed subsection 974-155(1)(a) contains the proposed new "interdependence test" (i.e. to determine whether one scheme depends on another). Proposed subsection 974-155(1)(c) contains the proposed "design test" (i.e. to determine whether there was a design to produce a "combined economic effect"). Accordingly, we understand that the first test is looking to determine whether the two schemes are "interdependent" such that they can be combined and, if so, whether the two arrangements were "designed" to be a combined arrangement.

While the purpose of these two tests seems simple, we are finding it extremely difficult to understand when an arrangement would satisfy the requirements of paragraph (a) but would not satisfy the requirements of paragraph (c). To add to this confusion, we note that none of the examples in the EI demonstrate a case where paragraph (a) is satisfied without paragraph (c) also being satisfied.

We submit that the EI needs to include examples that, at the very least, identify when the "interdependence test" is satisfied but the "design test" is not satisfied.

Submission point 4
In order to provide some clarity as to the "interdependence test" and the "design test", the EI must include examples of when the "interdependence test" in proposed subsection 974-155(1)(a) would be satisfied, yet the "design test" in proposed subsection 974-155(1)(c) would not be satisfied.

5. Transitional Relief

We believe that the EM, at paragraphs 1.89-1.90, should clarify the scope of the protection afforded to taxpayers who rely on the 2011-12 Budget announcement concerning changes to section 974-80.

Relevantly, the EM should clarify the extent to which taxpayers can rely on the Board of Taxation's Debt/Equity Accelerated Report released in December 2014 (as well as other subsequent announcements from Government)[2] and specify how these "related documents" (as per section 170B(4)(b) of the *Income Tax Assessment Act 19*36 *(*"**ITAA 36"**)) interact with the new "aggregated scheme" exposure draft materials.

We believe that it would be fair and equitable for taxpayers who rely solely on the 2011-12 Budget announcement to be afforded transitional protection under section 170B of the ITAA 36. The release of the "aggregated scheme" exposure draft materials should not affect how taxpayers interpret the 2011-12 Budget announcement if the taxpayer has not chosen to rely on this material. Furthermore, to the extent that a taxpayer has relied on the BOT report, the ED, EM or EI, then this should also be covered by the "related documents" as contained in section 170B. The final EM should articulate this scope of applying section 170B.

In our view, in considering the 2011-12 Budget announcement, it would be completely reasonable for a taxpayer to have assumed that: (a) section 974-80 and the related scheme provisions would have been repealed; (b) the replacement provision would have had limited scope; (c) any exclusions currently provided in the current section 974-80 and the related scheme provision would also be covered in new replacement provision; (d) only "in substance" equity arrangements would be included; and (e) the Commissioner's discretion would ensure that the new provision would not be targeted at ordinary debt financing arrangements. It would be useful for the EM to therefore clarify that these assumptions would be warranted when applying the transitional rule.

[2] For example, http://www.joshfrydenberg.com.au/guest/mediaReleasesDetails.aspx?id=129.

Submission point 5
The EM should be more specific as to the scope of the protection afforded to taxpayers who rely on the Budget 2011-12 announcement under section 170B of the ITAA 36.

*** ***

We again thank you for the opportunity to provide our submission on the proposed provisions. If you would like to discuss any aspect of our submission, please feel free to contact me on 03 8610 5170.

Yours sincerely

A M KOKKINOS
Executive Director

APPENDIX A – EXAMPLES

A. Background

The following examples are used to demonstrate the uncertainty of the application of proposed section 974-155 to arrangements which we believe would ordinarily be excluded from the operation of section 974-80.

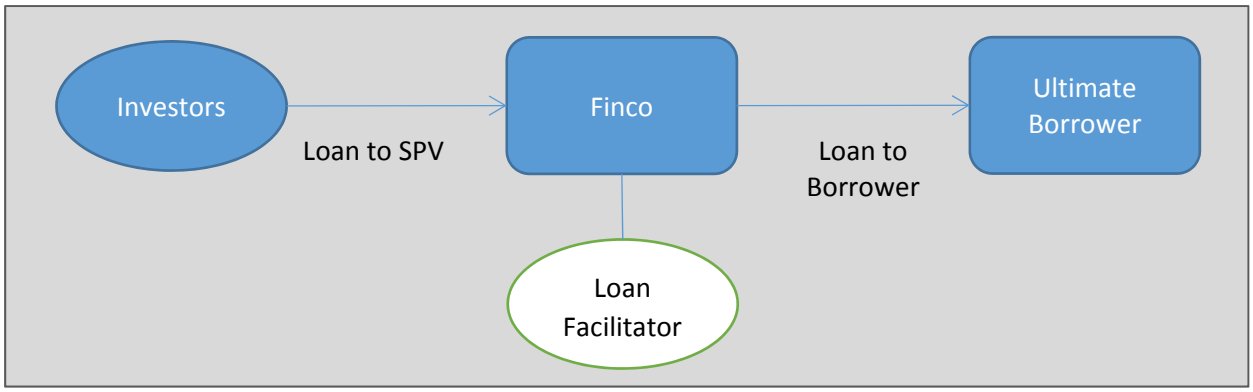
The arrangements contained in this Appendix are ordinary financing arrangements that are commonly used in the middle market to provide "bridging finance". Bridging finance generally involves debt arrangements that provide the bridge between "equity" injected by the owners and bank financing.

It is common for "bridging finance" to be organised by a facilitator on behalf of a borrower, whereby a number of lenders are collectively sourced to provide the finance. The following examples demonstrate common structures used in practice.

B. Example 1 – Collective loan financing via an interposed company

1. Background to the example

The following diagram outlines the arrangement.



In this arrangement the Ultimate Borrower wishes to obtain finance over and above ordinary banking finance (e.g. a second ranking mortgage, subordinated debt, mezzanine finance, development project finance etc). The Loan Facilitator is engaged to organise finance for the Ultimate Borrower and thus source the relevant financing from Investors.

A collective vehicle is used being a company, Finco, whereby Investors provide loan financing to Finco, which in turn provides loan financing to the Ultimate Borrower.

The terms of the loan from the Investors to the Finco broadly replicate the terms of the loan from Finco to the Ultimate Borrower, but for:

i. A margin fee is paid to the Loan Facilitator; and

ii. The loan from the Investors is generally limited recourse (i.e. to the assets of Finco and to cash received by Finco).

2. Assumptions

For the purpose of this example, the following assumptions have been made (to ensure that the analysis of both section 974-80 and the proposed section 974-155 can be simplified):

i. The arrangement under which Finco lends money to the Ultimate Borrower (the internal loan) would give rise to a debt interest;

ii. The loan provided by Investors to Finco would give rise to a debt interest;

iii. The Ultimate Borrower, Finco and the Investors are not associates; and

iv. Finco and the Facilitator may be associates (i.e. Finco may be a company that is owned by the Facilitator).

3. Section 974-80 analysis

We are of the view that section 974-80 ought not to apply to the type of scheme detailed in this example. This is based on two exclusions that currently exist:

i. The interest held by the ultimate recipient (i.e. the Investors) is a debt interest. Paragraph 2.49 of the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 states:

> … the debt test … does not apply individually to each of the interests identified in section 974-80 which fund the return to the ultimate recipient. Instead, the test applies in relation to the interest held by the ultimate recipient – *if that satisfies the debt test then the funding interests will not be equity interests*. (Emphasis added)

This conclusion is also supported by the view expressed by the Commissioner of Taxation in Taxation Determination TD 2015/3, that subsection 974-80(2) will not apply in such circumstances.

ii. Furthermore, on the basis that Finco should not be considered to be a "connected entity" of the Ultimate Borrower, neither subsection 974-80(1)(b) nor (d) would be satisfied.

4. Proposed section 974-155 analysis

It is unclear whether the application of proposed section 974-155 will apply to re-characterise the loan between Finco and the Ultimate Borrower.

Unlike the Explanatory Memorandum that introduced section 974-80, there is no overt wording in the EM which articulates that proposed section 974-155 should not apply to the type of scheme set-out in this example. A clear statement of this nature would, in our view, be beneficial in clarifying the policy intent of the measures in this regard. In the absence of clear policy intent, one is left to apply the draft legislation on its plain words.

The first requirement for proposed section 974-155 is that the pricing, terms and conditions are interdependent in a way that would change their treatment under Division 974. As the fact pattern indicates, the terms of each of the respective loans are 'broadly replicated' and both schemes satisfy the debt test under Division 974. Accordingly, there would be a risk that both the "interdependence test" and the "design test" could potentially be satisfied in this example.

While it is expected that the aggregation of the schemes should result in the combined scheme being treated as debt, it is not entirely clear that this would occur for the purpose of the exclusion under proposed subsection 974-155(1)(b). Accordingly, **Submission point 2** would help to provide certainty that this is the case.

Furthermore, we highlight that while all parties are unrelated and are dealing with each other at arm's length, it is not entirely clear whether this would be sufficient to turn off the operation of the "design test" in proposed subsection 974-155(1)(c)(iv). Accordingly, **Submission point 1** would help to provide certainty that this is the case.

Finally, we do not believe that there are any examples in the EI that can applied to this example. We therefore believe that (in accordance with **Submission point 2** and **Submission point 4**) an appropriate example should be used to assist in the analysis of this type of common example.

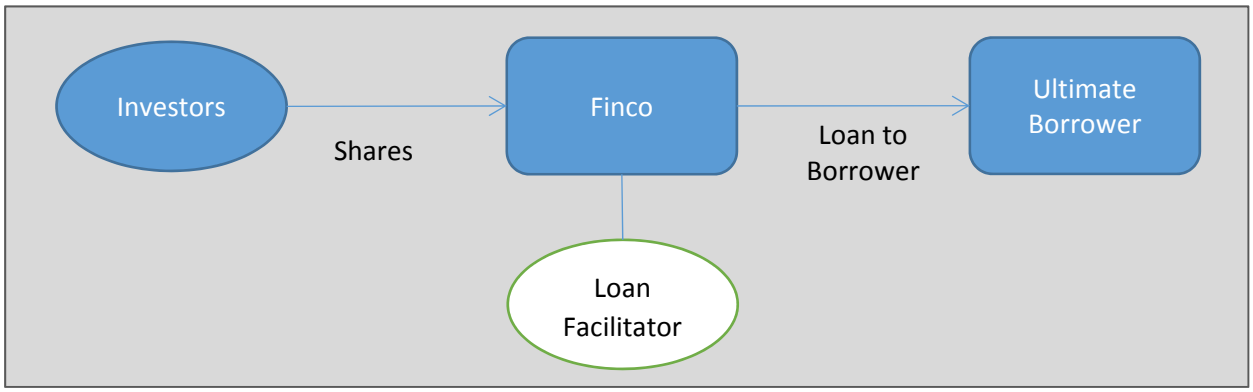
5. Conclusion

While we believe that this example should be clearly outside of the scope of the aggregated scheme provisions, we highlight that the drafting of the proposed new rule provides some degree of uncertainty. We note that this uncertainty may be addressed if a number of our submission points are adopted.

C. Example 2 – Collective loan financing via an interposed company

1. Background to the example

The arrangement in this example is similar to Example 1 except for the fact that the financing provided by the Investors to Finco is instead treated as equity under Division 974.



2. Assumptions

For the purpose of this example, the following assumptions have been made (to ensure that the analysis of both section 974-80 and the proposed section 974-155 can be simplified):

i. The arrangement under which Finco lends money to the Ultimate Borrower (the internal loan) would give rise to a debt interest;

ii. The shares held by the Investors in Finco (the share scheme) are ordinary shares that give rise to an equity interest;

iii. There is no mandatory redemption date in respect of the share scheme;

iv. The Ultimate Borrower, Finco and Investors are not associates; and

v. Finco and the Facilitator may be associates (i.e. Finco may be a company that is owned by the Facilitator).

3. Section 974-80 analysis

We are of the view that section 974-80 ought not to apply to the type of scheme detailed in this example. As Finco is not a "connected entity" of the Ultimate Borrower, neither subsection 974-80(1)(b) nor (d) would be satisfied.

Accordingly, we believe that section 974-80 would not apply to recharacterise the loan between Finco and the Ultimate Borrower as an equity interest.

4. Proposed section 974-155 analysis

It is unclear whether the application of proposed section 974-155 will apply to recharacterise the loan between Finco and the Ultimate Borrower.

The first requirement for proposed section 974-155 is to apply that the pricing, terms and conditions are interdependent in a way that would change their treatment under Division 974. It is likely that the offer documents provided to potential investors would emphasise that the equity returns to investors in Finco would ultimately be funded by debt returns paid by the Ultimate Borrower to Finco. Accordingly, and although not free from doubt, we believe that there is a risk that proposed subsection 974-155(1)(a) would be satisfied.

As the first leg of the scheme is treated as an equity interest (i.e. the share scheme), it is likely that the combined scheme would be treated as equity. We note that this is not free from doubt and would depend on the terms of the scheme. That is, for example, ATO ID 2003/870 demonstrates that a combined share and debt scheme can be treated as debt. Accordingly, significant analysis may be required to determine whether, or not, the requirements of proposed subsection 974-155(1)(b) would be satisfied.

The third requirement for the proposed section to apply is that it would be concluded, having to regard to the listed factors, that the schemes were designed to operate together to produce the schemes' combined economic effect.

i. Subparagraphs (i) and (ii) may be satisfied given that the relationship between the loan and the shares would form a significant part of the offer documents provided to potential investors.

ii. Finco and the Ultimate Borrower are not related parties and the arrangement is at arm's length. Accordingly, we would expect that proposed subsections 974-155(1)(c)(iii) and (iv) would not be satisfied.

Given the above, it is reasonably unclear as to whether the "design test" would be satisfied. In addition to the above, we note that proposed subsection 974-155(2)(a)(i) may apply to deem proposed subsection 974-155(1) to not apply where the use of a return from one scheme is used to fund a return from another scheme if this is not part of the terms and conditions of either scheme. It is noted, however, that it is unclear whether this exception can be applied given that the debt returns provided to Finco and the equity returns provided by Finco are likely to be a key feature in the offer documents.

We highlight that **Submission point 1** would help to provide certainty that this arrangement would not fall within the new aggregated scheme provision. Furthermore, in accordance with **Submission point 4**, an appropriate example could be used to assist in the analysis of this type of common example where there are competing items for the purpose of the "design test".

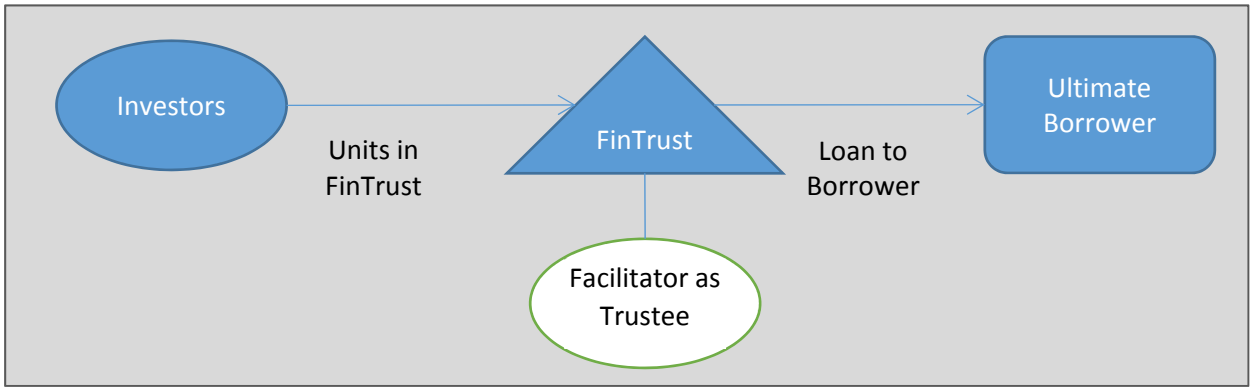
5. Conclusion

While we believe that this example should be clearly outside of the scope of the aggregated scheme provisions, we highlight that the drafting of the proposed new rule provides some degree of uncertainty. We note that this uncertainty may be addressed if a number of our submission points are adopted.

D. Example 3 – Collective loan financing via a trust

1. Background to the example

The arrangement in this example is similar to Example 2 except for the fact that the collective investment vehicle is a unit trust.



The collective investment vehicle used in this example (FinTrust) is a unit trust that is likely to be a managed investment scheme (registered or unregistered). Investors would subscribe for units in FinTrust. FinTrust would then uses the capital to provide a loan to the Ultimate Borrower.

Units in FinTrust would provide the unit holders with a right to income and capital distributions. This would be sourced from the receipts from the Ultimate Borrower.

The terms of the units in FinTrust would generally not provide any special rights to Investors and would be held in perpetuity subject to the trust vesting (i.e. there would be no redemption rights etc). However, rights to the distribution of income and capital of the unit trust would mean that receipts of the FinTrust from Ultimate Borrowers would broadly be on-paid to the Investors; but for a margin (fee) that is paid to the Loan Facilitator as the trustee of the trust.

We highlight that there are a substantial number of arrangements in the market place that fall into this category. These arrangements are typically referred to as “contributory mortgage schemes” and can be used to provide first ranking and second ranking mortgage loans. However, the arrangements can also take the form and name of a simple unit trust structure.

2. Assumptions

For the purpose of this example, the following assumptions have been made (to ensure that the analysis of both section 974-80 and the proposed section 974-155 can be simplified):

i. The arrangement under which FinTrust lends money to the Ultimate Borrower (the internal loan) would give rise to a debt interest;

ii. The units to be held by the Investors in FinTrust (the unit scheme) would not give rise to either an equity interest or a debt interest for Division 974 purposes;

iii. There is no mandatory redemption date in respect of the unit scheme (however the trust would mandatorily vest within 80 years);

iv. The Ultimate Borrower and FinTrust are not associates;

v. The Investors would be associates of FinTrust by virtue of being a beneficiary of the trust (subsection 318(3)(a) and (6)(a)); and

vi. FinTrust and its trustee, Facilitator, would not ordinarily be associates under section 318.

3. Section 974-80 analysis

We are of the view that section 974-80 ought not to apply to the type of scheme detailed in this example. As FinTrust is not a "connected entity" of the Ultimate Borrower, neither subsections 974-80(1)(b) nor (d) appear to be satisfied.

Accordingly, we believe that section 974-80 cannot apply to recharacterise the internal loan as an equity interest.

4. Proposed section 974-155 analysis

It is unclear whether the application of proposed section 974-155 will apply to re-characterise the loan between FinTrust and the Ultimate Borrower.

On the assumption that the application of proposed section 974-155 must result in the single aggregate scheme being characterised as either a debt interest or an equity interest, proposed subsection 974-155(1)(b) is likely to be satisfied in this example as the unit scheme is not otherwise characterised as either an equity interest or a debt interest. Again, we note that this conclusion can be simplistic given the view contained in ATOID 2003/870 (as outlined earlier). However, due to the uncertainty of this test, we assume that this proposed subsection could therefore be satisfied.

In relation to the "interdependence test", we note that the issue of units in a collective investment vehicle will require some form of offer document to investors (e.g. an information memorandum or product disclosure document). This would outline the financing arrangement and the connection between the various returns and arrangements.

It is likely that the offer documents provided to potential investors would emphasise that the equity returns to investors in Finco would ultimately be funded by debt returns paid by the Ultimate Borrower to Finco. Accordingly, and although not free from doubt, we believe that there is a risk that proposed subsection 974-155(1)(a) would be satisfied.

It is noted that proposed subsection 974-155(2)(a)(i) ("the funding safe harbour") might apply to deem proposed subsection 974-155(1)(a) not to be satisfied. However, the need for this (and other) 'safe harbours' suggests that proposed subsection 974-155(1)(a) has a broad reach.

That being said, we are entirely clear that the funding safe harbour will apply in this case. That is, the exclusion only has application if the return on the internal loan is used to fund the return on the unit scheme and it "is not part of the terms and conditions of any of the schemes". It is not clear whether this would be the case given that the fact of this linkage would be an essential feature of the offer documents provided to potential Investors of the FinTrust.

Finally, it is not clear how proposed subsection 974-155(1)(c) would apply in this example. We refer to the analysis in Example 2, which would equally apply in this example.

5. Conclusion

While we believe that this example should be clearly outside of the scope of the aggregated scheme provisions, we highlight that the drafting of the proposed new rule provides some degree of uncertainty. We note that this uncertainty may be addressed if a number of our submission points are adopted.