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CPA AUSTRALIA

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Ms Christine Barron
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The Treasury
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Dear Ms Barron

The Tax Institute, Institute of Chartered Accountants in Australia and CPA Australia (together the "**Joint Professional Bodies**") are pleased to present our views on the implementation of the Government's 2011-12 Budget announcement to clarify the scope of the integrity provision in section 974-80 of the *Income Tax Assessment Act 1997* ("**ITAA1997**").

The integrity provision

Section 974-80 was included in the debt/equity provisions in Division 974 as an integrity provision to allow the re-characterisation of instruments that satisfy the debt test in that Division but are used to fund an effective equity interest held by an ultimate investor.

After consultation with industry (including the joint Professional Bodies), the Government acknowledged that the potential scope of operation of this provision is wider than its policy intent and announced in the 2011-12 Budget that the law would be amended to bring the provision in line with its policy intent.

We are broadly supportive of the Government's efforts to restrict the application of section 974-80 to intended circumstances only, as set out in the relevant 2011-12 Budget announcement.

However, we are concerned that the proposed extent of reforms will not achieve their stated intent or resolve much of the current uncertainty for taxpayers.

These concerns are exemplified by the Australian Taxation Office's recent release of TR 2012/D5 in relation to the application of section 974-80 in the stapled entity context, which clearly demonstrates the ATO's view of the extent of application of section 974-80, both under the current and proposed section. The uncertainty caused by this draft tax ruling has caused widely reported market volatility.

The professional bodies' submissions:

- to the ATO on the 2007 draft Discussion Paper;
- to Treasury in response to Treasury's 2010 Consultation Paper; and
- to the ATO on TR 2012/D5;

raised a host of issues with both the current legislation and the ATO's interpretation. These submissions are attached to this letter as Appendices A, B and C for your ease of reference.

If the extent of proposed changes to section 974-80 is limited to those factors outlined in recent discussions, including at the ATO's NTLG Finance and Investment Sub-committee, it is our view that the proposed changes will not provide the necessary certainty. Our submission sets out our understanding of the changes proposed by Treasury, as well as further changes that are in our view necessary to clarify and restrict the application of this section to only those situations which give rise to an integrity concern.

We are cognisant that Treasury's remit to propose changes to section 974-80 is limited by the Government's 2011-12 Budget announcement. As such, we have also copied this letter to the Assistant Treasurer, The Hon. David Bradbury, MP.

We would be pleased to discuss the contents of this letter directly with Treasury prior to the public release of the relevant Exposure Draft.

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Should you wish to discuss the contents of this letter, please do not hesitate to contact The Tax Institute's Tax Counsel, Deepti Paton, in the first instance on (02) 8223 0044.

Regards

Steve Westaway President The Tax Institute	Paul Stacey Head of Tax Policy The Institute of Chartered Accountants in Australia	Mark Morris Senior Tax Counsel CPA Australia

CC: The Hon. David Bradbury, MP, Assistant Treasurer and Minister Assisting for Deregulation

CC: Ms Nan Wang, Manager, Corporate & International Tax Division, The Treasury

SUBMISSION

POLICY INTENTION OF SECTION 974-80

In applying the bright line tests in Division 974 to classify in-substance debt or equity instruments, section 974-80 is intended to protect the integrity of the debt and equity tests from the use of back-to-back instruments.

Specifically, it is our understanding that section 974-80 was introduced against the background of certain financing arrangements that sought to obtain tax deductions for interest payments, but provided contingent returns to the ultimate investor (e.g. certain Tier 1 arrangements entered into by financial institutions).

In this regard the policy intention of section 974-80 is succinctly outlined in paragraphs 2.41 – 2.45 of the Explanatory Memorandum to the *New Business Tax System (Debt and Equity) Bill 2001* (**the Explanatory Memorandum**).

Importantly, paragraph 1.28 of the Supplementary Explanatory Memorandum stated that section 974-80 is intended to operate "*only in those cases where the scheme or schemes are deliberately designed so that the return to the connected entity is in turn used to fund either directly or indirectly a return to the ultimate recipient*."

As the abovementioned paragraphs from the Explanatory Memorandum and Supplementary Explanatory Memorandum indicate, section 974-80 was intended to apply to schemes which were deliberately (or, in our view, predominantly) designed to ensure an equity-like return is paid on a debt interest to a connected entity, which then on-pays that return (including via one or more back-to-back payments) to an ultimate investor.

Section 974-80 was never intended to be applicable to re-characterise all related-party debt funding arrangements as equity.

ATO APPROACH

Notwithstanding, in 2007 the ATO issued a Draft Discussion Paper indicating that in its view section 974-80 applied to a wider range of circumstances than those set out in the paragraphs above. For example, the ATO stated in paragraph 47 of that Draft Discussion Paper that section 974-80 may apply even in circumstances where there is no effective equity interest in the company. The ATO even opined that section 974-80 may apply where one debt instrument is designed to fund another debt instrument held by the ultimate recipient.

Similarly, in the context of the funding arrangements of stapled groups, under which a trust raises funds by issuing units, and then lends those funds to stapled company, with the objective being to use interest on the loan to fund distributions to unit holders (as outlined in TR 2012/D5) the ATO's interpretation would result in an equity characterisation for almost any such intra-stapled group lending arrangements in which the stapled entities are regarded as connected entities.

For example, even if the returns on the loan from the trust and the company are non-discretionary and not contingent on the economic performance of the company (i.e. the trust does not have any equity-like interest in the company), it would appear that by adopting the type of interpretation taken by the ATO in the Draft Discussion Paper, subsection 974-

80(2)(a)(iii) would invariably be satisfied because technically the rights to distributions from the unit trust are based on the net income of the unit trust (that is, the unit holder's right to income distributions under most trust deeds are technically contingent on the economic performance of the unit trust).

Such an interpretation would be inappropriate because the funding arrangements of stapled groups are actually intended to provide debt-like returns to the ultimate investors, rather than seeking to provide an equity-like exposure to the stapled company. Stapled structures have historically been favoured in the infrastructure and other industries that encounter significant early stage losses; these early stage losses restrict the ability of the company to pay dividends for a number of years. The stapled structure provides a solution to this commercial problem by providing for bond-like cash returns to be paid to investors notwithstanding the loss-making status of the company. Thus, rather than facilitating a disguised equity investment in an underlying company, the investor's interest in the funding trust is intended to provide debt-like returns.

A stapled group's funding arrangements therefore contrast quite starkly with the Example under s 974-80(2) and Examples 2.9 and 2.10 in the Explanatory Memorandum - in those Examples the schemes are clearly designed to procure deductibility for amounts that are used to fund an ultimate investor's return on an effective equity interest in the underlying company.

EFFECT OF ONGOING UNCERTAINTY AND ATO VIEW

It is our view that the ATO's interpretation of section 974-80 has become too strict, and importantly, the ATO's interpretation (as expressed in the 2007 Draft Discussion Paper) is being applied with retrospective effect to arrangements that were entered into many years preceding the release of that Draft Discussion Paper and were originally thought not to offend section 974-80. This has generated significant uncertainty which has had a detrimental impact on investment into Australia.

Moreover, the ATO has been utilising its interpretation of the connected entity issue in TR 2012/D5 as a springboard upon which to base audit activity in relation to the funding activities of many stapled groups.

To this end, we are aware that the ATO has formed a "Stapled Security Project Team" whose remit is to review almost all stapled group funding arrangements in the particular context of section 974-80. This is a significant development, especially given the amounts that have been invested in infrastructure and utilities via stapled structures prior the release of the ATO Draft Discussion Paper. The analyst reports and media reports [refer to Appendices 1, 2 and 3] illustrate the material impact that the ATO's approach to section 974-80 has had in the particular context of stapled groups. Of particular note is the report attached at Appendix 2 shows an analyst's assessment that the ATO's audit activity in relation to Sydney Airport could result in ongoing distributions being reduced by as much as one-third.

Other stapled groups have upwards of $2 billion in funding arrangements that could be adversely impacted by what now appears to be a change in the interpretation of the reach of section 974-80.

Moreover, the interpretation of section 974-80 makes the characterisation of even straightforward funding arrangements excessively confusing. Take for example the situation under which a holding company makes an interest bearing loan (which otherwise satisfies the definition of a debt interest) to a wholly-owned subsidiary. As the interest paid on that loan might be used to fund dividends to the holding company's shareholders, section 974-80 could be applied to re-characterise that loan as an equity interest.

It is one thing to apply section 974-80 to the loan where the arrangement is simply a back-to-back arrangement similar to the Tier 1-capital arrangements that section 974-80 was designed to address, but in practice the application (or non-application) of section 974-80 in this straightforward example is made even more confusing by the "designed to operate" requirement – for example, to what extent is the analysis impacted where the holding company has other sources of income from which to fund dividends, or where the company distributes some of the interest receipts as dividends and retains or reinvests the balance? It is our view that there needs to be greater clarity on such arrangements to ensure that taxpayers are not inappropriately impacted by section 974-80.

POLICY CONSISTENCY IS REQUIRED

Our understanding of the policy intention of section 974-80 is set out above.

Whilst the policy intent of section 974-80 is to re-characterise a debt interest issued by a company if the return on such a debt interest has certain equity-like features, it does so only if the returns are paid to a connected entity under a back-to-back arrangement culminating with those returns being on-paid to an ultimate investor.

By contrast, if the ultimate investor instead directly held that same debt interest in the underlying company (with its attendant equity-like returns), section 974-80 would not be enlivened. Thus section 974-80 is not actually offended by debt interests that are deliberately designed to have equity-like returns; instead section 974-80 is only concerned with the use of connected entities to on-pay such returns to third parties.

The Professional Bodies submit that there needs to be policy consistency across the board on the treatment of debt interests that are structured to include equity-like returns, irrespective of whether those interests are held by connected entities or are part of a back-to-back arrangement.

In this regard, it seems anomalous that there are two integrity provisions that address equity-like returns arising on debt interests (namely section 25-85 and section 974-80), but each have quite different outcomes even though they both seek to address what is essentially the same problem.

Section 25-85 applies in relation to debt interests that feature certain equity-like returns (irrespective of whether or not those debt interests are held by related or unrelated parties) not by re-characterising the entire debt interest, but instead by restricting the amount of the debt deduction to the benchmark rate of return for the debt interest plus 150 basis points.[1] Section 25-85 implicitly recognises that such instruments consist of both a debt-like return and an equity-like return, and only disallows a debt deduction for the part of the return that is equity-like. As the Explanatory Memorandum notes:

[1] Section 25-85 is replicated for Division 230 financial arrangements via subsections 230-15(4) – (6). References in this paper to section 25-85 apply equally to the corresponding provisions in subsections 230-15(4) – (6).

2.138 As a revenue safeguard it is necessary to prevent excessive deductible payments on debt/equity hybrids that satisfy the debt test. The risk to the revenue is that a company could distribute its profits as deductible payments in lieu of frankable dividends by making the distribution in respect of a hybrid that has been artificially characterised as debt. The artificiality of the characterisation would be indicated by a return on the interest considerably in excess of the interest payable on an equivalent interest without any equity component (i.e. straight debt).

2.139 Therefore the deduction for returns on debt/equity hybrids is capped by reference to the rate of return on an equivalent straight debt interest, increased by a margin to recognise the premium paid for the increased risk of non-payment because of the contingency. That rate of return is referred to as the 'benchmark rate of return', and the margin is 150 basis points…

Thus there are currently two integrity provisions that address debt interests that have equity-like returns. However the outcomes of those two provisions are very different and it is unclear as to why such different approaches are needed to address what is essentially the same problem.

TREASURY'S PROPOSALS

We understand from earlier discussions, including at the ATO's Finance and Investment Sub-group, that Treasury is currently of the view that the scope of section 974-80 would be adequately clarified by amending the provision to include the following modifications:

- a **debt override rule:** under which section 974-80 would not apply where the interest held by the ultimate recipient is a debt interest;

- a **purpose and effect rule:** under which 974-80 would apply only if would be concluded there is a purpose of the ultimate recipient having, in substance or effect, an equity interest in the company or connected entity of the company; and

- **allowing Commissioner's discretion:** under which the Commissioner would be given a discretion not to apply section 974-80 where it is reasonable to conclude that the scheme was not designed to produce an effective equity interest in the company.

Whilst each of these proposals would be positive developments, they are unlikely to resolve fully the uncertainties associated with section 974-80 for the following broad reasons:

- The debt override rule would not assist in many straightforward scenarios where the ultimate investor does not hold a debt interest, such as the simple holding/subsidiary company funding arrangement described on pages 4 - 5; nor would it be of assistance in many straightforward funding arrangements undertaken by stapled groups as discussed on pages 4 and 8 - 9.

- The purpose and effect rule would likely create a new source of uncertainty and possible expansion (as opposed to a "restriction") of the application of section 974-80 because it would essentially rest upon:

  - an inquiry into the “purpose” of an arrangement – in this regard it should be noted that other provisions that require a conclusion as to purpose (e.g. sections 177D, 177EA and 45B of the *Income Tax Assessment Act 1936*) are inherently uncertain; and

  - an assessment as to whether an arrangement resulted in an “in-substance” equity interest – this would present its own complexities in interpreting what actually constitutes an “in-substance” equity interest given that the question would arise only where the underlying investor does not have an actual equity interest in the underlying company.

- Given the Commissioner’s current views in relation to the potential wide application of this provision, it is difficult to see how the Commissioner’s discretion would in a practical sense assist.

SUGGESTED AMENDMENTS

In light of the above, we recommend that Treasury also consider the need for broader amendments that would rectify this ongoing uncertainty, as set out below. It is our view that such amendments would appropriately restrict section 974-80 to its policy intention.

Given section 974-80 is an integrity provision, a “dominant purpose” test (rather than the “purpose and effect” test) should be introduced, which would be a similar threshold to that required for the application of section 177D.

Alternatively, and as we have highlighted above, there are currently two integrity provisions (sections 25-85 and 974-80) that address debt interests that are structured to have equity-like returns. However the outcomes of these two provisions are very different and it is unclear as to why such different approaches are needed to address what is essentially the same problem.

A simple means of achieving greater certainty and policy consistency would be to include an amendment to the effect that section 974-80 does not apply where the return on the relevant debt interest issued by the underlying company does not exceed the benchmark rate of return for the relevant debt interest plus 150 basis points.

Such an amendment would be consistent with the Budget announcement that “the changes [to section 974-80] will ensure that this provision will only apply to arrangements where both the substance and effect is that the ultimate investor has, in substance, an equity interest in the issuer company.” This is because, under a back-to-back arrangement which is designed to procure deductibility for equity-like returns paid on debt interests, it is only the excessive interest payments (i.e. the amount that exceeds the benchmark rate of return plus 150 basis points) that should be regarded as simulating an in-substance equity interest.

Thus, where a relevant debt interest caries a return that is less than that benchmark amount, the debt interest should be regarded as being sufficiently debt-like not to enliven section 974-80.

APPLICATION DATE OF REQUIRED AMENDMENTS

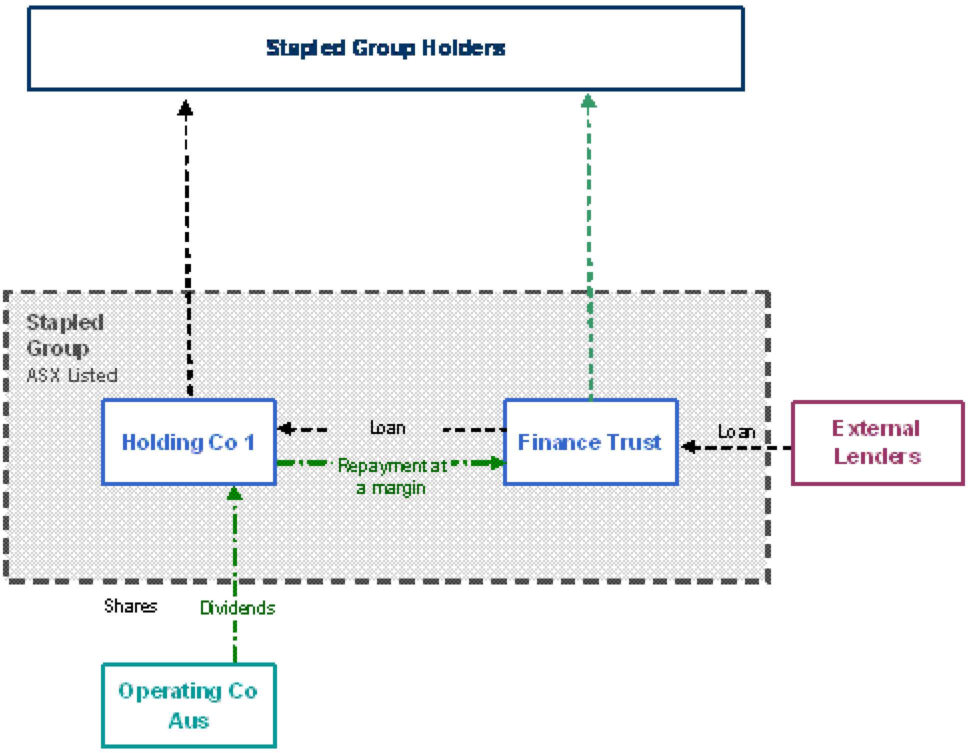
Many funding arrangements have been in existence for a long time and in many cases pre-date the section 974-80 controversy that has been brought about as a result of the ATO's Draft Discussion Paper and the release of TR 2012/D5.

While the impact of the current section 974-80 controversy on stapled groups in particular is illustrated by the media and analyst reports provided in Appendices 1, 2 and 3, as noted above, other funding structures and industry sectors also continue to be affected.

Given the delay in enacting this measure, the retrospective nature of the amendments and ongoing confusion as to the extent and nature of the amendments especially as between the ATO and taxpayers, we recommend that the amendments have retrospective effect, but be subject to a no detriment rule.

As noted in our joint submission of 2010, we recommend that the restated provision be treated as elective for instruments on foot as at the date of Royal Assent to the Act which makes the amendment. That is, in the period from 1 July 2001 to the date of Royal Assent, the issuing company may elect to apply the current section 974-80 (rather than the revised version) until the relevant instrument is either terminated or materially varied. Such an election could be made at the issuing company's discretion by the first due date for lodgment of that company's tax return after the date of Royal Assent.

DEMONSTRATED APPLICATION – STAPLED ENTITIES



The ATO uses this Example in TR 2012/D5 to consider whether Holding Co 1 and Finance Trust are connected entities. In this example, the Finance Trust borrows from External Lenders and on-lends those funds to Holding Co 1 at a margin, with the margin to be distributed to unit holders.

Although TR 2012/D5 only considers whether Finance Trust and Holding Co 1 are connected entities for the purposes of section 974-80, the fact that the ATO chose to use such an example in that Draft Ruling illustrates the potentially startling reach of section 974-80 to stapled groups. Broadly, the diagram appears to suggest that the ATO might consider that the loan from Finance Trust to Holding Co 1 could be subject to section 974-80, notwithstanding that the funds were sourced from External Lenders.

In light of the ATO's views in its Draft Discussion Paper on section 974-80, there is a risk that the loan between Finance Trust and Holding Co 1 could be re-characterised as equity under section 974-80, given that the margin derived by the Finance Trust will fund distributions to the unit holders (and thus could be covered by section 974-80(1)(d)), and given the risk that the distribution to unit holders could be construed to be covered by section 974-80(2)(a)(iii).

It is one thing to analyse the application of section 974-80 to the lending of the unit capital to the stapled company, however it is startling that section 974-80 could have potential application to the repayment of the Finance Trust loan that was sourced from External Lenders, as the on-lending of the funds borrowed from External Lenders at a margin to Holding Co 1 cannot be regarded as a scheme to provide an effective equity interest in Holding Co 1for the unit holders.

The effect of such an interpretation is that the external interest payments would effectively become non-deductible for no reason other than the fact that a related unit trust was used to intermediate the loan – this would be a capricious and absurd result.

The above example illustrates the risk that, if stapled structures are not properly addressed in the design of the amendments to section 974-80, the result could be that the ATO might take the view that section 974-80 could apply to all intra-stapled group lending and would undermine the conduit approach to trust taxation. However, if it is the case that either the Government or the ATO has an overriding concern with all related party loans, or with the concept of character flow through for trusts that undertake related party transactions, we would submit that this policy intention should be clearly stated, rather than relying on a provision such as section 974-80 to re-characterise such transactions.

For information on Appendix 1, 2, 3, A, B, & C
Please contact Tax Policy via email at taxpolicy@taxinstitute.com.au