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Manager
Finance Tax Unit
The Treasury
Langton Crescent
PARKES ACT 2600

By email: financetax@treasury.gov.au

Dear Sir/ Madam

SUBJECT: SUBMISSION ON EXPOSURE DRAFT LEGISLATION ON LIMITED RECOURSE DEBT AMENDMENTS

CPA Australia represents the diverse interests of more than 140,000 members in 114 countries throughout the world. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders.

Against this background we provide this submission concerning the proposed amendments to the limited recourse debt provisions contained in the exposure draft of Tax Laws Amendment (2012 Measures No.6) Act and its accompanying explanatory memorandum which was issued by Treasury on 25 October 2012.

CPA Australia is concerned with the significant adverse impact the proposed amendments may have on the ordinary business practices of various taxpayer entities who do not finance the acquisition of assets using a special purpose vehicle (SPV) especially during a period of economic downturn and debt re-organisation.

In our view the potential breadth of the provisions is totally inconsistent with the underlying purpose of the amendments.

Paragraph 1.4 of the explanatory memorandum states that the purpose of the limited recourse debt provisions is '… to recoup excess capital allowance deductions claimed with respect to capital expenditure where the taxpayer has not been fully at risk in relation to the expenditure because it is financed by a limited recourse debt and has not fully repaid the debt upon termination.' Furthermore, paragraph 1.10 of the explanatory memorandum provides that the proposed amendments are needed to ensure these provisions capture arrangements that are in substance limited recourse arrangements so that the provisions operate as originally intended.

However, the proposed amendments go further than this, by effectively broadening the operation of Division 243 of the Income Tax Assessment Act (1997) (the ITAA (1997) so that the provisions will apply where almost any secured debt that is owed by a company is forgiven by the creditor, irrespective of whether the business has been at risk or not. We have provided an example contained in attached Appendix A to indicate our grave concerns on the scope of this proposed legislation.

We believe it is imperative that the Treasury and the Federal Government more appropriately target the provisions so that they apply to arrangements that they believe should be caught within the limited recourse debt provisions being those arrangements that are truly in substance "limited recourse' due to the SPV nature of the entity used.

In that regard, we believe that the following options should be seriously considered by Treasury in further developing this amending legislation to ensure that ordinary business dealings are not inadvertently treated as limited recourse arrangements and subject to adverse tax consequences.

1. The proposed new test (contained in proposed section 243-20(2)(b)(i)) should refer to ‘financed property’ rather than ‘debt property’. The definition of the term “debt property” is not helpful in identifying a case that is (in substance) limited recourse debt or an SPV.

2. Alternatively, section 243-20(3A) should include a test that considers the extent to which ‘debt property’ has been used as security as compared to the ‘financed property’ during the arrangement. The current test in section 243-20(3A)(c) requires ‘all of the other property’ to have been available. The current test does not cater for a situation where a highly valuable building has been used as security for the loan (being only one of many assets available).

3. The current exclusion contained in section 243-20(5) operates where (in practice) the debt is not really limited recourse debt. However, the provision only applies to “legal” arrangements (i.e. those covered by section 243-20(1)) and would not extend to the proposed new test contained in proposed section 243-20(2). It is imperative that the exclusion in section 243-20(5) be extended for the whole purpose of the section.

4. The current exclusion contained in section 243-20(5) may not operate appropriately where there is a sudden drop in the value of the secured assets (i.e. due to an economic downturn). That is, the debt could be ‘bona fide’ recourse debt up until that time. It would be inappropriate to therefore apply the proposed new test in such a case as this would make the exclusion effectively redundant. We submit that section 243-20(5) should also apply if (in practice) the only reason for not satisfying section 243-20(5) is due to circumstances outside of the control of the relevant entity (i.e. such as an economic downturn).

The main effect of the above proposed amendments to the proposed provisions in the exposure draft legislation would be to identify those arrangements that are not in substance limited recourse debt. Thus, the debt forgiveness provisions in Division 245 of the ITAA (1997) would apply to such arrangements rather than the limited recourse debt provisions. This is demonstrated by the example contained in Appendix A which effectively removes an ordinary business loan from being considered limited recourse debt.

Due to the serious implications that these provisions will have on ordinary business arrangements, we believe it is critical that further exposure draft legislation be released by Treasury in an attempt to address the above concerns and recommend that it incorporate the proposed amendments outlined in this submission.

Should you have any questions regarding this submission, please do not hesitate to contact me on (03) 9606 9860 or via email at mark.morris@cpaaustralia.com.au.

Yours sincerely

Mark Morris FCPA
Senior Tax Counsel

APPENDIX A - EXAMPLE APPLYING EXPOSURE DRAFT AMENDMENTS TO ORDINARY BUSINESS ARRANGEMENTS

In order for the limited recourse provisions to apply, 'financed property' must first be identified. This requirement is contained in section 243-15(1). Financed property simply requires a nexus between the loan and the relevant capital expenditure property.

Once financed property has been identified, the proposed limited recourse debt provisions can apply where 'the rights of the creditor as against the debtor in the event of default in payment of the debt or of interest are in substance or effect limited wholly or predominantly to rights (including the right to money payable) in relation to … the *debt property or the use of the debt property' as set out in proposed section 243-20(2)(b)(i).

Debt property is defined broadly in section 243-30(3) to include property that is 'provided as security for the debt'.

A company (Aco) could borrow funds to acquire a depreciable asset costing $1 million, whereby the loan is secured against the depreciable asset, as well as a building owned by the same company valued at $1.5 million. Assume the loan is interest only.

Prima facie, this arrangement would seem to satisfy the conditions of the proposed section 243-20(2)(b)(i).

As the asset to debt ratio is 2.5:1 in this example, it is difficult to understand why this arrangement should prima facie be regarded as limited recourse debt. Accordingly, the scope of the current proposals is well beyond those aimed at targeting an SPV arrangement.

Assume Aco has never had carry forward tax losses and has traded profitably for all years in question. Also, assume that the depreciation expense on the financed property has been taken into account in those calculations.

For purposes of illustration it is further assumed the depreciable asset has been fully tax depreciated. A subsequent economic downturn could see the value of the building decrease to $800,000. As security limits may be breached in this example, Aco may seek to re-organise its debt with the bank to ensure that it can remain solvent. Assume the bank agrees to forego interest on the loan for the next 18 months and forgives an amount of the loan by $200,000.

The arrangement with the bank results in a 'termination' as defined in section 243-25(1)(c), which is triggered as soon as the debt is reduced. The remaining debt is treated as refinanced debt under section 243-25(3). Due to the non-charging of interest on the new loan of $800,000, it is not clear whether the remaining debt will be regarded as 'non-arm's length debt' or not.

The above arrangement could give rise to assessable income under section 243-40. In this example, at the time of the 'termination', the amount of the debt repaid will be dependent on whether the loan of $800,000 is regarded as arm's length or not. If the new debt is not arm's length, this will give rise to excess deductions of $1 million under section 243-35. If the new debt is arm's length, this will give rise to excess deductions of $200,000. Accordingly, the company would be required to bring to account either $1 million or $200,000 as assessable income and would be required to pay tax of either $300,000 of $60,000 at the time of termination.

Given the re-organisation of debt under the current circumstances in the example, the significant taxation burden associated with either scenario would likely result in Aco becoming insolvent. Accordingly, the debt re-organisation is likely to simply bring forward the company's liquidation.

If the limited recourse debt provisions did not apply in this example, the debt forgiveness provisions would instead apply. This would mean that the likely outcome would have been that the building would have a reduction in cost base equal to $200,000 under Division 245 of the ITAA (1997). This would therefore give rise to a future tax obligation on the disposal of the building. The key difference between the two provisions is that the debt forgiveness provisions will give rise to a future tax obligation, rather than a current obligation.

In the circumstances, we believe that the debt forgiveness provisions more appropriately target this scenario and that this ordinary business arrangement should not be considered a limited recourse debt arrangement.