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Dear Mr Regan

Improvements to the Debt and Equity Tax Rules Exposure Draft Law
EY Submission

We are pleased to provide this submission in response to exposure draft law (ED) and the accompanying draft legislative instrument released on 10 October 2016 concerning proposals to amend the Division 974 Income Tax Assessment Act 1997 (ITAA 97) debt-equity rules, in relation to when schemes should be aggregated for the purpose of the rules.

The ED follows the recommendations of the Board of Taxation in their December 2014 "accelerated report". This report was developed after many years of input by industry associations, the tax and accounting professional bodies and other interested parties, including by EY.

It is proposed that new rules will replace the current section 974-70 related schemes rules and section 974-80 integrity rule. Various other changes are proposed in the ED however we raise only our concerns with the core amendments in this submission.

The aggregated scheme rules contained in ED represent a substantial and worthwhile improvement to the complex and problematic rules they replace. Nonetheless, as set out below, there are a number of areas where appropriate amendments to the ED could more fully achieve the Board of Tax recommendations and would improve the application of the law.

We summarise our concerns as follows:

1. We are concerned that the replacement rules may apply more broadly than section 974-80 in that those rules were restricted to an instrument issued by a company, where it was issued to a connected entity and where the returns are traced back to the company. However there are no such restrictions in proposed section 974-115. This is confirmed in the draft explanatory material (draft EM) paragraphs 1.81 and 1.82 and in proposed amendments to section 26-26. Also, we are concerned whether the intended operation of section 26-26 is achieved.
2. Neither the ED law nor the examples contain guidance on how to determine whether an aggregated scheme would satisfy the debt test or equity test. This is a significant issue in the intended application of the proposed law, as identified by the Board of Taxation.
3. The drafting of paragraph 974-155(1)(b) does not appear to meet the Board of Taxation's recommendation that schemes would be aggregated if the dependence, link or operation referred to in paragraph (1)(a) would, if included as part of the scheme which gives rise to the

interest, change whether this Division treats an interest as a *debt interest or an *equity interest.

4. The carve outs are a welcome and very important aspect of the new rules to ensure that the scope of the proposed law does not overreach. However, the practical benefit of these carve outs would be enhanced if they explicitly encompassed further common terms and arrangements.
5. The "designed to operate" test does not establish a clear benchmark for the application of the provisions.
6. The series of examples included in the accompanying legislative instrument provides helpful clarity on the scope of the ED. Nonetheless, we think this innovative approach requires more legislative support that the examples can narrow the scope of the provisions.

   We also have some particular concerns with the legislative instrument examples, including with some inconsistent approaches between examples and the relevance of factors set out therein.
7. The transitional mechanism - reliance on the existing legislative protection rule is not a sufficient transitional rule. A clearer rule is needed.

We set out some further detail on our concerns and propositions below.

Item 1: Section 26-26

It is not clear how the proposed amendment to section 26-26 will work.

In particular, the section only applies if, among other things:

- a return has accrued on a *non-share equity interest of an entity; and
- the entity is not a company.

However, the defined term "non-share equity interest" is only defined by reference to an entity that is a company. Section 995-1(1) provides the following (original emphasis):

> *non-share equity interest in a company means an *equity interest in the company that is not solely a *share*

Therefore, we submit that either:

- Section 26-26 not be amended, on the basis that this broadens the scope of section 974-80 and the related scheme provisions (which was not a stated intention of the Government nor was it recommended in the Board of Taxation report); or
- If amended, consideration be given to updating the definition of non-share equity interest in subsection 995-1(1).

Item 2: Whether an aggregated scheme would satisfy the debt test or equity test

The Board of Tax Accelerated Report – link – recommended in this legislative scheme:

> "3.27 Under the Board's proposal, the initial test to determine whether two or more schemes should be aggregated and taken as one scheme would focus on whether one of the schemes is legally interdependent, or operates in a way that alters or affects the ultimate entitlements or economic consequences to the parties of another one of the schemes. The test is enunciated, in principle, as follows:

Two or more schemes will be aggregated and taken to be one scheme if the pricing, terms and conditions applicable under one scheme:
i. are dependent upon or linked to the pricing, terms and conditions applicable under one or more other schemes in a manner which would affect the application of the debt test or the equity test to one or more of those schemes; or
ii. operate in a way which would alter the economic consequences of the pricing, terms and conditions of one or more other schemes in a manner which would affect the application of the debt test or the equity test to one or more of those schemes." (emphasis added by EY)

We are concerned that recommendation of the Board, as emphasised by us above, has not been included in section 974-155 – specifically in paragraph 974-155(1)(b).

That means that the draft law goes significantly further than recommended by the Board which, we understand, was to be adopted by the government.

We recommend that paragraph 974-155(1)(b) be redrafted along the lines of:
"(b) the dependence, link or operation referred to in paragraph (1)(a) would, if included as part of the scheme which gives rise to the interest, change whether this Division treats an interest as a *debt interest or an *equity interest;"

Item 3: Carve out improvements

The proposed carve-out for "mere" stapling is too restrictive and should be expanded. The drafting of paragraph 974-155(2)(a)(ii) will not exclude many common stapling arrangements.

The law should at a minimum support the examples and therefore the carve-out should also apply where there are restrictions under the stapling arrangement not to consolidate or subdivide or reorganise one kind of interest unless there is a corresponding transactions with another kind of interest.

The carve-out should be expanded to include customarily included stapling terms in the property and infrastructure sectors, so as to apply to the majority of stapled groups. In particular:

- It is common for the company and trust issuing the shares and the units to enter into the stapling arrangement which then dictates the terms on which they will issues the shares and units, rather than the holders of the interests "agreeing to staple the interest";
- It is also common, however, for the holders of the interests to agree to staple the interests, as currently described in paragraph 974-155(2)(a)(ii);
- It is not clear, based on the current wording of paragraph 974-155(2)(a)(ii), whether stapling arrangements that concern more than just restriction on disposal and cancellation (which are typically included to facilitate the harmonious operation of stapled structures) will fall outside the exclusion.

Therefore, we recommend that paragraph 974-155(2)(a)(ii) be redrafted along the lines of:
(ii) 2 or more kinds of interest being stapled together, including by the holders of interests agreeing to staple the interests, to form stapled securities;

This is consistent with the wording in section 124-1045 and should be interpreted in line with common commercial understandings.

Item 4: Designed to operate test

The ED's 'designed to operate' requirement in paragraph 974-155(1)(c) requires some improvement and clarifications.

The ATO has previously argued in relation to section 974-80 that the term "designed to operate" requires an objective purpose. Importantly, the purpose need not be the sole, main or dominant purpose.[1]

The current draft legislation merely requires there to be "a purpose" to produce the schemes' combined economic effect.

We submit that:

- This threshold is too low, since achieving combined economic effect of two schemes could almost always be found to be "a purpose" where there is knowledge or suspicion of the probable economic outcomes;
- This low threshold was a source of considerable uncertainty in the application of section 974-80 and the same mistake should be avoided if possible;
- The examples provided support the use of, and are consistent with, a higher threshold; and
- The items listed in paragraphs 974-155(1)(c)(i) to (vi) do not sufficiently limit the operation of this paragraph because they are all encompassing (see item (vi)).

The threshold should therefore be increased to be "primarily designed to operate" or "mainly designed to operate", in order to appropriately narrow the application of the proposed legislation.

Item 5: Statutory interpretation – use of legislative instrument examples

We recognise the relatively innovative use of examples in a legislative instrument in a sensitive area of tax law. Our submission is focused on ensuring that this innovative approach, suggested by the Board of Taxation, achieves the desired outcomes of simpler tax legislation but at the same time providing practical certainty to taxpayers.

Our concerns are magnified by the proposed subsection 974-155(3) and EM paragraph 1.79 statement that the instrument making power would enable the maker to extend or narrow the operation of the law.

The Acts Interpretation Act 1901 Sec 15AD states:

> "Examples
> If an Act includes an example of the operation of a provision:
> (a) the example is not exhaustive; and
> (b) the example may extend the operation of the provision."

We question whether, therefore, the judiciary will follow any 'narrowing' of the law in the legislative instrument as desired. It is important that the examples will have legislative force in dealing with taxpayer disputes and in court proceedings.

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[1] ATO Discussion Paper on section 974-80 dated 19 March 2007.

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We submit that clearer drafting is needed given this sensitive area of the law, to ensure the package interacts with the apparent desire that the examples can be definitively used to determine how the proposed law operates and that they might narrow the application of the legislation.

Alternatively, it would be helpful if Treasury could point to other non-tax legislation where this approach has been adopted and possibly considered by the courts.

Item 6: Concerns relating to selected examples

Our concerns with the legislative examples are in relation to:

A. Broad gaps in the coverage of examples
B. Apparently inconsistent approach re relevance of facts and if they change – which are "context", which are material
C. Wording used in the examples
D. Specific issues relating to the example in Part 2
E. Property fund stapled structures, which require additional facts (examples Parts 6, 7 and 8)
F. Specific issues relating to the example in Part 8

6.A. Gap in coverage of examples

None of the examples highlight a circumstance where the 'interdependence' test is satisfied and the 'designed to operate' test is not (and vice versa). In some cases the designed to operate test is simply not considered once it is determined that the interdependence test is not satisfied.

To assist in interpreting the provision (and to avoid the two tests being conflated by the ATO or the courts) it would be useful to have some commentary in the EM or the examples illustrating when the conclusions reached on the interdependence test and 'designed to operate test' may differ.

Also the conclusions in the examples in Part 6 (item 37), Part 7 (item 50) and Part 8 (item 62) should be amended to reflect that if the interdependence test would not be satisfied then it is not necessary to consider whether the design test would be satisfied, rather than "As neither the interdependence test nor the design test is satisfied, the aggregation rule does not apply".

6.B. Inconsistent approach to a change in facts

There is some inconsistency in the approach between the examples which should be improved.

We welcome the inclusion of material which sets out changes that would or may cause the aggregation rule to apply, for example in Division 2 for the Part 2 'Shareholder loan: no-aggregation' example. However this approach is not followed for all the examples.

It is important that the relevance of changes of facts is considered and if possible drawn out in the other examples. That is which facts are included as mere "context" and not material and which are material to the determination of applying the rules and if they change will have some impact on that assessment.

We set out some specific changes of facts that should be included for example Part 8 below.

6.C. Wording used in the examples

We submit that the wording used in the examples should, to the extent possible, be consistent with existing concepts in tax law. Using existing concepts, which may have been considered by the courts, will provide greater clarity for taxpayers and avoid introducing new concepts which are not others elements of the tax law.

For example:

- 41(1) should refer to "associate" and not "associated entity";
- 41(3) should refer to "arm's length rate" and not "market rate";
- 54(1) should only reference "land" (in accordance with Division 6C) and not confuse the issue by referring to "affixed improvements";
- 54(3) should only refer to "control", a concept on which there is considerable case law, and not include the new concept of "rights relating to the appointment of directors" (which may be a factor in determining whether there is control in any event) – it should read as "Q Co does not control the trustee of…"; and
- 57(1) should refer to "lease" and not "lease agreement."

6.D Specific issues relating to the example in Part 2

The example in Part 2 is critical to the operation of the new law and should provide as much certainty as possible that common debt and equity funding arrangements are not intended to be caught by the aggregation rule.

We submit that the fact in paragraph 7(4) that "the loan agreement does not expressly refer to the ordinary shares or their value" is too broad and does not align with common commercial practice. In reality, the loan agreement may refer to the ordinary shares in an incidental manner, including acknowledging that the company has ordinary shares on issue, or in an operative manner, including a prohibition on paying dividends if certain cash reserve requirements are not satisfied. Neither of these features should cause the operation of the aggregation rule and that should be clarified in Part 2.

Therefore, we submit that paragraph 7(4) be amended to read as follows:

> (4) The amount of the loan principal is proportionate to the subscription value of the ordinary shares. However, the loan agreement does not expressly refer to the value of the ordinary shares.

We also submit that the following common commercial arrangements should be covered by paragraph 12 'Changes that would not cause the aggregation rule to apply':

- "changes to the equity scheme so that the company issues ordinary shares to the investor instead of the acquirer acquiring existing ordinary shares" – the issue of new shares, as opposed to the acquisition, should not affect the conclusions providing that the other facts described do not change (alternatively, if the intention is to aggregate these arrangements then this should be made clear in the example);
- "changes to the loan scheme so that the company obtained the loan funds by issuing the investor with *convertible interest that give rise to a debt interest in the company" – the provisions should clarify that the legal form of the debt interest does not affect the outcome under these provisions, which is the intention of the law, and should cover the common use of convertible interest (as defined in s.995-1) funding arrangements; and

- "the equity scheme and debt scheme giving rise to interests in a trust instead of a company" – clarification should be provided that the nature of the issuer should not affect the application of the provision.

These amendments are required to provide taxpayers certainty over the scope of the new rules and are consistent with the draft EM and the example itself.

6E. Property fund stapled structures require additional facts (examples Parts 6, 7 and 8)

Ownership of the trustee (company) of the stapled trust by the company in the staple (or its subsidiary) is very common in structures used in the property funds industry, including in listed funds, and should be confirmed as not requiring aggregation.

In a registered managed investment scheme the trustee is the responsible entity (RE) for the fund and it holds the Australian financial services licence. The fact that the company in the staple can prima facie control the composition of the directors of the trustee (RE) does not alter the requirements of the RE to carry out its duties including to act in the best interests of the members of the trust. There is therefore no effective control by the company/subsidiary.

Examples Parts 6, 7 and 8 should be amended or Division 3 'effect of changes to the facts' parts should be added, to confirm that if the trustee (RE) of each respective trust was owned by the stapled company or its subsidiary this would not change the analysis and would not cause the aggregation rule to apply. Updates should be made as follows:

- In example Part 6 – address scenario where N Co owns the shares in the trustee of M Trust (a RE)
- In example Part 7 – address scenario where Y Co owns the shares in the trustee of X Trust (a RE)
- In example Part 8 – address scenario where Q Co owns the shares in the trustee of P Trust (a RE)

6.F. Specific issues relating to the example in Part 8

The various references to the following in example 'Part 8 – Trust and company staple: no aggregation' should be considered as context and any change in these should not change the analysis:

- The amount that the external financiers lend to P Trust;
- The potential for the periodic interest payable by P Trust to be capitalised;
- The amount that P Trust lends to Q Co under the internal loan; and
- The term or the interest rate on the internal loan (since the nature of this as a debt interest is confirmed at 58(1)(d)).

Additional facts that could be added/clarified in the example include:

- In respect of the stapling arrangement, inclusion of additional terms that are common to infrastructure stapling deeds/investor agreements such as P Trust/Q Co consent arrangements for new borrowings/acquisitions etc;
- That the boards of P Trust and Q Co may be common; and
- Clarification of the form of guarantee referred to in paragraph 56 (d) of the example.

We think that paragraphs 61(1)-(6) are unnecessary given that each component scheme is clearly a debt interest and if aggregated the combined scheme would also be a debt interest.

Item 7: Specific transitional rule is needed

A specific transitional rule is needed to cover arrangements entered into before the commencement of these changes.

As drafted it appears that any legislative protection for taxpayers that anticipated the announcement (anticipated-pre-ED transactions) will only apply until the proposed amendments commence. The ED amendments would not apply to such anticipated-pre-ED transactions as they only apply to transactions entered into on or after their commencement. So there is an apparent gap for past arrangements that continue post the commencement date which should be covered by a transitional rule.

The legislative protection is also drafted to only apply from the date of the 2011-12 Budget announcement. This is as not appropriate as that announcement was that "The amendments will apply from the commencement of the debt/equity tax rules (generally 1 July 2001)".The protection should therefore apply from 1 July 2001.

We are concerned how section 170B Income Tax Assessment Act 1936 would apply in relation to the announcement and how taxpayers can assess if the approach they took is covered. It would be more appropriate to include a transitional rule rather than to rely on the section 170B "protection".

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Should you have any queries in relation to the above please do not hesitate to contact either Richard Lambkin on 02 8295 6817, Simon Jenner on 02 8295 6367, Paul Laxon on 07 3243 3735 or Tony Stolarek on 03 8650 7654.

Yours sincerely

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