IPA SUBMISSION – TAX AND SUPERANNUATION LAWS AMENDMENT (DEBT AND EQUITY SCHEME INTEGRITY RULES) BILL

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ABOUT INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

Infrastructure Partnerships Australia (IPA) is the nation's peak infrastructure body – formed in 2005 as a genuine and enduring policy partnership between Australia's governments and industry.

IPA's formation recognizes that through innovation and reform, Australia can extract more from the infrastructure it's got, and invest more in the infrastructure we need.

Through our research and deep engagement with policymakers and industry, IPA seeks to capture best practice and advance complex reform options to drive up national economic prosperity and competitiveness.

Infrastructure is about more than balance sheets and building sites. Infrastructure is the key to how Australia does business, how we meet the needs of a prosperous economy and growing population and how we sustain a cohesive and inclusive society.

Infrastructure Partnerships Australia draws together the public and private sectors in a genuine partnership to debate the policy reforms and priority projects that will build Australia for the challenges ahead.

INTRODUCTION

IPA welcomes the release of the Exposure Draft Bill and Explanatory Memorandum and fully supports the approach adopted to repeal section 974-80 of the Income Tax Assessment Act (ITAA) 1997 and the related scheme provisions, and to replace them with a new aggregation rule (the "**New Aggregation Rule**"). We believe that this will significantly reduce compliance costs and remove concerns about unintended consequences of the rules.

IPA acknowledges that there are some interpretational issues that remain concerning the application of the new rules. However, the introduction of the examples in the Income Tax Assessment (Debt and Equity Examples) Declaration 2016 will, as a practical matter, limit uncertainty. IPA believes a short consultation period targeting resolution of a limited number of technical issues and allowing introduction of the bill in Parliament in early 2017 should be the goal. IPA would support an introduction of the rules, even in their current form, as preferable to having a further extended delay, given the significant amount of time that has already passed between the announcement that section 974-80 would be repealed in the May 2011 Budget and the extensive consultation during the Board of Tax process.

The areas in which some clarifications or amendments would be helpful are summarised below.

- Confirmation of the way in which the transitional rules will apply to existing arrangements. We believe that section 170B of the ITAA 1936 should apply to all schemes entered into before the Schedule commences provided the schemes are either (a) not aggregated under the new rules or (b) aggregated and treated as an aggregate debt scheme. There is some uncertainty about how section 170B operates to protect arrangements entered into prior to the May 2011 budget announcements and whether section 974-80 could be enlivened for such arrangements post the Schedule commencing.

- We believe that the example headed Finance Trust and Company Staple at Part 9 of Chapter 3 (hereafter termed Example 9), dealing with "stapled finance trusts", does create uncertainty. Whilst we think that that example has a very limited operation, we acknowledge that views have been expressed that all stapled finance trusts would be aggregated under the new rules based on some of the comments that are outlined within that example. We think Example 9 should either be removed or its limited application clarified.

- Example 1 (Part 2 – Shareholder Loan: no aggregation) is a very practical example, and will apply to many situations. We think that a couple of points should be made clear, particularly with respect to non-aggregation of certain redeemable preference shares and non-aggregation of interest free loans and ordinary equity.

- We believe Example 8 could provide additional certainty if the description of the stapling arrangement made specific reference to key features and terms commonly seen in such arrangements.

We would be pleased to discuss these issues with you.

TRANSITIONAL RULES

The Exposure Draft Explanatory Memorandum provides that section 170B of the ITAA 1936 will be extended so that it protects taxpayers that anticipated that the 2011-12 Budget measure would be legislated ***as it was then announced***. It also states that the protection applies from the date of the 2011-12 Budget announcement (May 2011).

The 2011-12 Budget announcement stated: *"The Government will amend the debt/equity tax rules to restrict the application of an integrity provision that deems an interest from an arrangement that funds a return through connected entities to be an equity interest under certain circumstances. The changes will ensure that this provision will only apply to arrangements where both the purpose and effect is that the ultimate investor has, in substance, an equity interest in the issuer company. Additionally, the integrity provision will not apply where the Commissioner considers that it would be unreasonable for the provision to apply."* The Government further stated that the amendments to section 974-80 would apply with retrospective effect to the commencement of Division 974 (generally 1 July 2001).

Since the 2011-12 Budget announcement, the following announcements/ publications are relevant:

- On 14 December 2013, the Government issued a press release announcing that it intended to proceed with amendments to section 974-80 but that the design of the measure would be considered as part of the Board of Taxation's post-implementation review of the debt and equity tax rules.
- In December 2014, the Board of Taxation reported to the Government in respect of the accelerated report dealing with section 974-80. That report was released to the public in April 2015 and is termed the "Review of the debt and equity tax rules - the related scheme and equity override integrity provisions report". The Board concluded that the changes to section 974-80 announced in the 2011-12 Budget would not provide the necessary certainty for the tax community and recommended that they should not proceed as announced (paragraph 2.20). The Board recommended that the protection provision in section 170B of the ITAA 1936 should be amended to protect taxpayers that relied on the announcements in the 2011-12 Budget (paragraph 2.26). **The Board acknowledged that the date of application of any changes is a matter for Government, but stated that it considers the protection provision should be extended to the date that an amendment to the provision is enacted (assuming that the new provision commences from the date of enactment).**

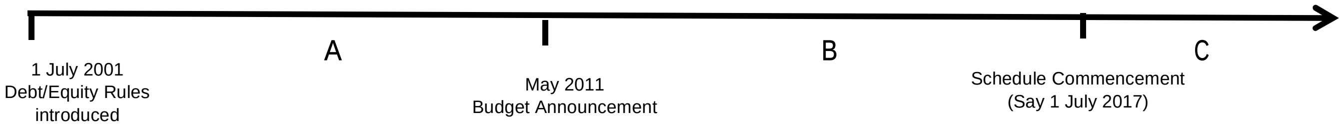
Under the protection provision in section 170B of the ITAA 1936, the hypothetical amendment must reasonably reflect the 2011-2012 Budget measure in order for the protection provision to apply.

In IPA's view, the New Aggregation Rule reasonably reflects the 2011-2012 Budget measure.

Accordingly, IPA considers that it would be appropriate to consider that arrangements should be protected to the extent they would either (a) not be aggregated under the New Aggregation Rule, or (b) be aggregated under the New Aggregation Rule, but treated as a combined debt scheme. In other words, the New Aggregation Rule is effectively used to determine which arrangements were intended to be entitled to protection from section 974-80 under the 2011-2012 Budget measure and ensure those arrangements are protected retrospectively.

IPA believes that there are three sets of distinguishable circumstances to consider under the protection provision as it relates to section 974-80, in order to determine the arrangements that may be protected under section 170B of the ITAA 1936, as follows:

A. Arrangements entered into before the May 2011 Budget measure announcement.
B. Arrangements entered into post the May 2011 Budget measure announcement but prior to the Schedule commencing; and
C. Arrangements entered into or materially varied post the Schedule commencing.



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• Arrangements entered into prior to May 2011 Budget announcement. • Under a notional application of the New Aggregation Rule, schemes not aggregated or aggregated but treated as a combined debt scheme should have the benefit of the protection provision. Schemes aggregated as a combined equity scheme should not have the benefit of transitional relief. • There is some uncertainty about how the new measures would treat these arrangements post commencement of the new schedule i.e. would section 974-80 be effectively enlivened or would these arrangements continue to be protected post commencement of the new schedule. IPA's view is that	• Arrangements entered into post May 2011 Budget Announcement but pre Schedule commencement. • Under a notional application of the New Aggregation Rule, schemes not aggregated or aggregated but treated as a combined debt scheme should have the benefit of the protection provision. Schemes aggregated as a combined equity scheme should not have the benefit of transitional relief. • These arrangements should continue to benefit under section 170B post the commencement of the new Schedule. This is because the arrangements were entered into in reliance upon the May 2011-2012 Budget announcement, and therefore the classification at the time the schemes were entered into. Accordingly, these arrangements should have the	• Arrangements entered into post Schedule commencement, e.g. 1 July 2017. • These arrangements are tested under the technical application of the New Aggregation Rule, and the protection provision is not relevant.

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such arrangements should continue to be protected and this view should be consistent with section 170B of the ITAA 1997.	benefit of the protection provision and section 974-80 should have no application to them prior to or post the commencement of the new Schedule.	

We believe that taxpayers would benefit by the following confirmations being made by Treasury:

- the New Aggregation Rule reasonably reflects the 2011-2012 Budget measure and, accordingly, arrangements should be protected to the extent they would either (a) not be aggregated under the New Aggregation Rule, or (b) be aggregated under the New Aggregation Rule, but treated as a combined debt scheme
- Section 974-80 is not enlivened post enactment of the new Schedule, to arrangements entered into both pre and post the May 2011-2012 Budget announcement. For example, a taxpayer that fits within the following fact pattern will be protected:
  - Arrangement entered into pre 2011-2012 Budget announcement;
  - Section 974-80 could have applied to the arrangement to treat it as an equity interest;
  - However, the purpose and effect of the arrangement was not that the ultimate investor had, in substance an equity interest in the issuer company.
  - Therefore, when the 2011-2012 Budget announcement was made, the taxpayer relied on it and treated the arrangement as debt in its tax return;
  - The arrangement would not be aggregated under the New Aggregation Rule.

EXAMPLE 9 – FINANCE TRUST AND COMPANY STAPLE

IPA believes that Example 9 (Part 9 of Chapter 3) is best considered as demonstrating a simple principle. That principle is that in circumstances where a debtor controls the creditor and effectively controls whether the debtor has to service and repay the debt, then that repayment obligation may be regarded as contingent (i.e. not effectively non-contingent). The result is that the financial arrangement should not be treated as a tax debt scheme.

Example 9 involves a stapled finance trust and a company staple. A "finance trust" is a general reference to a unit trust that raises equity capital and loans an amount equal to that equity capital across the staple to an operating company (either as the only loan principal as per Example 9 or in conjunction with other funds it may have raised from third party debt financiers).

In these circumstances, IPA considers that is unnecessary to aggregate other schemes with the debt scheme. Those other arrangements being shares in the creditor company or units in the debtor trust, to achieve the outcome that the debt scheme is treated as an equity scheme. Having said this, IPA is not opposed to leaving Example 9 in the examples, on the basis that it is made very clear that this example is providing certainty in a circumstance. That certainty is only relevant to a situation where the creditor company controls the trustee of the trust and hence repayment of the debt scheme.

Not to clarify this matter in relation to the arrangement may lead to a significant uncertainty as to whether all finance staples (including those where there is no arrangement in place permitting the company to control the trust with respect to enforcement of its rights under the debt scheme) could be aggregated under the arrangements.

The critical factors in the Example in our view are as follows:

- 66 "3(c) S Co has the right to nominate 2 of the 3 directors of Trustee Co"

  3(d) S Co has the option of acquiring Trustee Co

  "3(e) R Trust's only assets is to be a loan"

  "4(c)(ii) Trustee Co must have regard to the interests of the S Co's shareholders"

- 69 "(2) The combined effect of the arrangements referred to in 66 to 68 is that

  (a) R Trust's unit holders are unable to require Trustee Co to enforce its rights against S Co …

  (b) S Co is able to control Trustee Co … and when and to what extent it repays those funds."

In the above circumstances IPA has no issue with the loan being regarded as an equity interest. We think that the Aggregation Rule is not required to achieve this outcome as the obligation of S Co to repay the loan (not merely the performance of that obligation) is a contingent obligation. If the example removes uncertainly over this issue by aggregation then that is acceptable. The problem is that the example contains a number of irrelevant additional facts that exist in many stapled schemes and raise concern that those arrangements may be aggregated (even though the trustee of the relevant finance trust is not controlled by the debtor company). The irrelevant factors include:

- The facts concerning the rights of R Trust's unitholders in respect of distributions from R Trust;
- The facts concerning any external loan;
- The facts concerning any expectation of application of funds by R Trust on a repayment of the loan.

We believe that paragraph 75 of the Income Tax Assessment (Debt and Equity Examples) Declaration 2016 could have a further paragraph (3) in the following terms:

"The conclusion in paragraph 74 would change if S Co did not control R Trust. That is, if parties other than S Co controlled Trustee Co, then there would be no aggregation required. An example of this circumstance would be where there was an external responsible entity as Trustee that was not related to the unitholders. Another example would be a special purpose trustee company that was owned by unitholders in the same proportion to their unitholdings, provided of course that none of the unitholders individually controlled both S Co and the Trustee Co. In this circumstance Trustee Co of R Trust would have the right to demand payment of the loan and S Co would have an effectively non-contingent obligation to repay the loan and there will be no aggregation."

EXAMPLE 1 - CONFIRMATIONS

Part 2 of Chapter 2 – Shareholder Loan: No Aggregation sets out an example of shareholders contributing loans and equity to a company.

At Division 2 paragraph 12, there are a range of variations that are discussed as not impacting the issue of aggregation of the shares/loans.

Example 1 is left as the principal example in relation to a number of funding scenarios. These are scenarios where a debt scheme and an equity scheme is held in the same company. The examples that are covered include ordinary loans, interest free loans, redeemable preference shares – which may take many forms, but are in essence where any of those forms have the character as a debt scheme.

In all of these circumstances, Example 1 is the main example demonstrating the non-aggregation of the two schemes (i.e. the debt scheme with the equity scheme).

We think that here are at least two circumstances that need to be further highlighted to show that debt schemes and equity schemes are not aggregated. Those two examples are:

- Interest-free loans that are provided by a shareholder to a company, either at the time of acquiring the equity or subsequently. This appears to be intended by the legislation and the example but clarity would be appreciated.

- The second example is an example of a discretionary redeemable preference share. That is, the redeemable preference share carries a discretionary right to dividends, but there is a mandatory redemption of the share prior to year 10. This effectively makes the redeemable preference share a debt scheme. That circumstance should also be specifically referenced in Example 1.

The two examples above concern circumstances where a third party would not likely subscribe for the debt scheme unless they also held the ordinary equity. This of itself should not lead to aggregation of the two schemes, because there is no legal dependence of schemes and the debt scheme's pricing terms and conditions are not impacted by the equity scheme and vice versa.

EXAMPLE 8 – TYPICAL INFRASTRUCTURE STAPLED STRUCTURE

This examples reflects a typical infrastructure stapled structure that is commonly used for holding economic infrastructure investments. Additional certainty would be provided if the description of the stapling arrangement made reference to a number of key additional features and terms that are commonly seen in these arrangements, including:

1. That the boards of the trustee of P Trust and Q Co may be common
2. That Q Co and the trustee of P Trust must consult with each other prior to:
   - causing any act to be done or omission to be made which may materially affect the value of the stapled securities.
   - making an acquisition or disposal of an asset the value of which is 5% or greater of the net tangible assets of P Trust or Q Co (after having given at least 21 days' notice prior to such acquisition or disposal).
3. Q Co and the trustee of P Trust must jointly agree to the any material new third party borrowing or raising of money
4. Q Co and the trustee of P Trust agree that they will, in accordance with the terms of the stapling arrangement and if called upon by the other, do any act, matter or thing at the request or direction of the other in respect of:
   - Lending money to the other;
   - Guaranteeing any loan or other financing facility;
   - Entering into any covenant, undertaking, restraint or pledge at the request of the other;
   - Entering into any joint borrowing;
   - Guaranteeing their obligations or providing an indemnity or undertaking to a third party.

OTHER COMMENTS

- **Law Companion Guideline** - As with most/all new legislative provisions (for example Section 177DA of the 1936 Tax Act - MAAL provisions), we can expect the ATO to readily issue a Law Companion Guideline (**LCG**) on the new legislation with its views on how the Commissioner will apply the law as amended and, most particularly, offering certain examples of application and non-application of the law within the LCG.

  Firstly, it would be generally preferable that the ATO does not provide comprehensive additional examples within the LCG, particularly as these should be largely dealt with in the legislative instrument (per Section 974-155(3) which accompanied the release of the Exposure Draft legislation and which provides comprehensive examples to illustrate the operation of this new law).

  Secondly, we should be given the opportunity to review a draft of any proposed LCG on these new Debt/Equity Integrity Rules.

  Thirdly, as the LCG has the status of a "public ruling" for taxation purposes, it is critical that it provides a balanced, rational commentary on the new law and that confusing or ambiguous examples are not contained therein.

- **Payment priority clauses** - We refer to the example in Part 8 of the legislative instrument. In the example, the company agrees not to pay dividends or to do so only in accordance with the external loan and that the external loan, could, for example, permit paying dividends out of available post-debt service cash flows. The example does not deal with how the interdependence test would apply between the external loan and the share scheme. It would be desirable to have an example which clarifies how the interdependence and design tests apply in such a situation (with respect to payment priority clauses).

- **Interdependence test** - We refer to proposed clause 974-155(1)(a), in which one of the requirements for a scheme to be aggregated is if the pricing, terms and conditions of one or more of the schemes "are dependent on <u>or</u> linked to <u>or</u> operate to change the economic consequences" of the pricing, terms and conditions of one or more of the other schemes. Whilst whether or not a scheme is "dependent on" or "linked to" another scheme may be apparent from the wording of the relevant documentation, there appears to be limited practical guidance in the draft law or from the EM on what is meant by "operate to change the economic consequences". Further, the Examples provided do not appear to distinguish between the concepts of "dependent or linked" and "operate to change the economic consequences". Further guidance on the meaning of the concept "operate to change the economic consequences" would be most welcome.

- **Facts critical to the interdependence test -** We refer to the example in Part 2 of the legislative instrument. Per the facts the loan agreement does not expressly refer to the ordinary shares and vice versa. How important is this fact? What if the loan agreement does refer to the ordinary shares or vice versa, but the payment of the dividends and interest are not contingent on one another?