Australian Private Equity &
Venture Capital Association Limited

23 May 2014

Ms Teresa Dyson
Chair
Board of Taxation
c/- Department of the Treasury
Langton Crescent
PARKES ACT 2600

By email: taxboard@treasury.gov.au

Dear Teresa,

Review of the debt and equity tax rules

The Australian Private Equity and Venture Capital Association Limited (AVCAL) welcomes the opportunity to provide this submission in response to the Board of Taxation's 'Review of the debt and equity tax rules' discussion paper.

As you will be aware, AVCAL represents the venture capital (VC) and private equity (PE) industry in Australia, which has a combined total of over $24 billion in funds under management for domestic and offshore investors.

VC and PE firms invest billions of dollars in early stage and established businesses spanning right across almost every corner of our national economy. These investments help to support a total of around half a million jobs, and contribute over four per cent every year to our national economic output.

AVCAL believes that it is important that Australia presents to local and international investors an efficient and competitive environment for the financing and funding of investments, particularly within the PE and VC industries.

Maintaining certainty in the existing debt and equity tax rules

From the time of their implementation in 2001, the debt-equity tax rules have become a key foundational component of Australia's income tax system. As the Board is aware, over the years various reviews have been carried out in relation to this area of the law, including most notably the 2003 review by the Finance and Investment Subcommittee, which in some ways served as a catalyst for a range of minor technical amendments that were made to the rules since the time of introduction. Of course, there have also been some advances in the range of technical interpretative guidance issued by the Tax Office during that period.

AVCAL is very supportive of the Board's review into these rules.

We believe that this review provides an important opportunity to look at how the debt-equity rules can be modernised to ensure that they are seen to be less rigid and prescriptive, which can often create difficulties when trying to ascertain the original policy intent of certain key components of the legislative framework.

Ensuring that the rules provide the greatest level of long-term certainty for taxpayers should be an important feature of the Board's work as part of this review. For our industry, long-term certainty is a critical element of fostering and encouraging investment decisions in the Australian economy, because for many PE and VC firms the investment horizon can typically range from around five to seven years, on average.

Debt and equity tax rules – specific review areas

The Board's discussion paper is broad-ranging and raises a large number of important discussion points in relation to various aspects of the existing debt and equity rules, including consideration of whether or not amendments to other areas of the tax law are necessary for harmonisation and consistency purposes.

Whilst the specific debt and equity rules are complex to apply in the context of some financing arrangements, AVCAL believes that the Board should prioritise a close examination of the opportunities to recommend targeted changes to the existing rules that would help to remove ambiguity, while at the same time bringing about administrative and compliance cost savings wherever possible.

In this regard, AVCAL draws the Board's attention to the following areas or particular relevance to the PE and VC industry:

- ***Interaction with other areas of the income tax law - Venture Capital Limited Partnerships (VCLPs) and Early Stage Venture Capital Limited Partnerships (ESVCLPs)****:* VCLPs and ESVCLPs are currently only permitted to invest in legal form debt (i.e. 'permitted loans' under the *Venture Capital Act 2002 (VC Act)).* In AVCAL's view, there is no underlying policy rationale for this and we recommend that the definition of 'permitted loan' in the VC Act is harmonised with Division 974 to include all debt interests so characterised.
- ***Interaction with other areas of the income tax law - Employee share schemes****:* AVCAL believes that the existing application of the ESS rules to legal form shares should be retained.
- ***Employee share options:*** AVCAL notes that the decision in *Blank* should be regarded as good law and the debt and equity tax rules should not be amended to countenance the findings in that case.
- ***'Sufficiently certain' concept in TOFA:*** It would not be appropriate to infuse the debt and equity rules with 'sufficiently certain' considerations. In this context, it is relevant to be mindful of the fact that the TOFA regime is principally a timing mechanism rather than a characterisation regime (with potential permanent difference implications).
- ***Anti-arbitrage rules:*** In AVCAL's view, the tax treatment of instruments in the jurisdiction of the holder should not give rise to a disturbance of the principles, and the substance-over-form approach to the debt-equity rules, in Australia. Any arbitrage issues that may arise from differences in the tax treatment of such instruments should be left to the relevant overseas tax jurisdiction to address.
- ***Related party instruments and related schemes:*** The related party nature of an instrument should not receive different treatment to an arm's length instrument under the debt-equity rules.
- ***Benchmark rate of return:*** AVCAL supports any measures that would ease the administrative costs of determining a benchmark rate of return when there are no other instruments, or comparable instruments, on issue.
- ***Section 974-80:*** AVCAL supports measures that would address the uncertainties inherent in the interpretation of section 974-80. The potential application of this rule must be restricted to apply only in the narrow circumstances it was intended to address.

Further detail on AVCAL's submission in relation to the Board of Taxation's discussion paper is set out in the Attachment to this letter. If you would like to discuss any aspect of this submission further, please do not hesitate to contact me or Dr Kar Mei Tang on 02 8243 7000.

Yours sincerely,

Yasser El-Ansary
Chief Executive
AVCAL

Attachment: Review of the debt and equity tax rules

Consultation Questions

Question 4.2(a): Whether in light of the decision in *Blank*, whether the distinction between raising finance and raising capital in the context of the 'financing arrangement' concept is problematic. If so, how could this be addressed.

The meaning of 'financing arrangement' and related expressions such as 'to raise finance' has remained largely unexplored until the Federal Court decision in *Blank v Commissioner of Taxation* [2014] FCA 87.

As noted in the Discussion Paper, before the recent decision in *Blank*, this aspect of the law was not considered to present important issues.

AVCAL is of the view that the Federal Court's decision in *Blank* should be regarded as good law and that the debt and equity tax rules should not be amended to countenance the decision in that case.

The decision does not expose an apparent asymmetry in the tax treatment of shares (which are equity in substance) granted to employees and putative non-share equity interests granted to employees. Also, the decision in *Blank's* case does not detract from Division 974's goal of tax neutrality for instruments of the same substance but different legal form.

The explanatory memorandum to the Debt-Equity legislation when it was introduced to Parliament suggests that a purposive approach be taken in interpreting the rules. Accordingly, it is necessary to look at the purpose for which an interest was issued in an entity when determining whether the interest is one of debt or equity. The Court's view regarding the term 'raising finance' represents a considered position having regard to previous guidance issued in the Explanatory Memorandum introducing Division 974 and is an appropriate application of the income tax in the context of the specific circumstances in that case. In this regard, AVCAL refers to paragraph 79 of the decision of Edmonds J:

> *2.7 The raising of finance generally entails a contribution to the capital of an entity, whether by way of money, property or services, in respect of which a return is paid by the entity, be it contingent (connoting equity) or non-contingent (connoting debt). It is important, however, to consider all the relevant circumstances and features of a particular arrangement to determine whether, in substance, it is appropriately characterised as a financing arrangement or not. In this regard, the intentions of the parties to the arrangement may be relevant, but are not determinative.*
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> *2.8 In the vast majority of cases it is readily apparent whether a particular arrangement constitutes the raising of finance. The issuing of a debt/equity hybrid instrument, whether in consideration for money (as would usually be the case), property or the provision of services, would, for example, constitute a financing arrangement. Conversely, a financing arrangement is not created from a contract for personal services entered into in the ordinary course of business where, in consideration for the provision of services, the employer provides a return in the form of salary commensurate with the value of the services provided. This is the case even if there is some delay between the provision of services and the payment of the salary, as occurs when, for example, an employer provided long service leave payments in recognition of services provided several years before ...*
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> *2.9 However, the example of an employment contract demonstrates how important it is to consider all the relevant circumstances and features of a particular arrangement to determine whether, in substance, it is appropriately characterised as a financing arrangement or not. This is because in certain, albeit unusual, circumstances an employment contract may constitute a financing arrangement, as Example 2.4 shows. The example illustrates an exception to the general rule that employment contracts do not constitute financing arrangements.*

Question 4.5(e): Whether there should be a specific rule modifying the ENCO test for dealing with related parties or connected entities.

Division 974 does not contain any provisions that specifically modify the ENCO test for dealings with related parties (or connected entities).

AVCAL submits that the related party nature of an instrument should not give rise to separate debt and equity rules nor specific rules in relation to the application of the existing debt and equity rules. AVCAL submits that a single classification code should apply to instruments regardless of whether a particular interest is issued between related parties or arm's length parties. AVCAL is of the view that there is identifiable policy objective for related party instruments to be subject to separate rules.

AVCAL submits that the existing tax law sufficiently requires a consideration of the matters identified by the Board in its discussion in Section 4.

In this regard, we note that section 974-135 provides that an ENCO to take an action under a scheme will exist if, having regard to the "pricing, terms and conditions" of the scheme, there is in substance or effect a non-contingent obligation to take that action.

The reference to the "terms and conditions" of the scheme raises consideration of the contractual elements of the arrangements undertaken. This underscores the primacy of the legal and contractual obligations of the parties under the relevant scheme when considering if the ENCO test is satisfied.

The mere fact that a particular instrument is issued between related parties should not diminish this fundamental aspect of the application of the ENCO test.

Question 4.7(d): Whether the calculation of the benchmark rate of return is problematic for issuers in determining whether interests satisfy the debt test. If so, how could this be addressed.

The benchmark rate of interest is the internal rate of return on an instrument issued by the entity or an equivalent entity to a third party, where that other instrument is otherwise comparable to the instrument under consideration.

The Board has noted that difficulties arise when calculating the benchmark rate of return where the test interest is a unique or exotic instrument, or where there are no readily comparable 'ordinary debt interests' on issue by the relevant entity.

The lack of other debt instruments (or lack of comparable debt instruments) on issue can be particularly relevant in the PE and VC context where investee companies often raise finance by way of shareholder and mezzanine debt which have features unique to that funding, and which are not directly comparable to other forms of funding that the company may have on issue. This creates a significant compliance burden on investee companies.

AVCAL would welcome any administrative concessions for calculating the benchmark rate of return.

For example, where a PE or VC fund holds the same or similar type of instrument across multiple portfolio companies, a single benchmark study which takes into account the specific characteristics of the particular type of instrument should be accepted as providing a reasonable basis for determining the relevant benchmark rate of return for all portfolio companies with similar credit risk profiles that have issued the same or similar instrument within a particular timeframe of the study being undertaken (e.g. three years).

Question 5.1: The Board seeks stakeholder comment regarding potential issues and uncertainties raised with the existing operation of section 974-80.

Section 974-80 is a specific integrity rule introduced into the debt and equity rules to address a specific and narrow set of circumstances where an instrument that satisfies the debt test is used to fund an effective equity interest held by an ultimate investor.

From a policy perspective, section 974-80 was and is intended to apply to schemes that 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” (paragraph 1.28, supplementary explanatory memorandum to the *New Business Tax System (Debt and Equity) Bill 2001)*. It was not intended to apply to re-characterise all related-party part debt funding arrangements as equity.

However, as currently drafted this integrity measure encompasses complex “connected entity” rules which may lead to an unexpected re-characterisation of what might otherwise be a debt interest of an entity to that of an equity interest. In particular, there has been some uncertainty concerning the extent of the application of the provision, and concerns have been raised with the ATO’s views on the application of the rules.

The significant uncertainty in relation to the operation of section 974-80 follows the ATO’s (subsequently withdrawn) draft tax ruling TR2012/D5 issued in relation to stapled company and debt structures and when the interest deductions incurred on debt of a company, stapled to an affiliated public trust, could potentially be disallowed under the debt-equity rules. That draft ruling retrospectively adopted an unacceptably broad interpretation of the existing provision.

AVCAL submits that measures should be introduced in relation to the operation of section 974-80 to clarify its operation to only the narrow set of circumstances it was intended to apply. In particular, section 974-80 should be amended to 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.

AVCAL submits that a simple shareholder loan arrangement into an investee company, in which that lender also holds an equity stake, should not be captured by this particular integrity measure.

AVCAL also submits that the policy intent of section 974-80 is not to apply debt interests issued to collective investment vehicles (CIVs) which hold a number of different equity and debt investments, such that the returns investors receive from the CIV are not only a pass-through of the returns on the debt interests issued by a particular investee.

Question 7.3(b): Whether the use of the ‘sufficiently certain’ concept in the TOFA regime, instead of ‘ENCO’ in Division 974, is problematic. If so, what changes would address this problem.

Question 7.3(c): Whether the concept of sufficient certainty of the provision of financial benefits should be considered in applying the debt test in Division 974, including the operation of the valuation rules.

The 'sufficiently certain' concept used in the TOFA regime is different to the ENCO test used in Division 974. The differences are not unexpected given that the two regimes deal with different issues, notwithstanding that both can apply in respect of the same instrument. In particular, the ENCO concept in Division 974 is relevant for determining the character of an instrument as debt or equity, whereas the ‘sufficiently certain’ concept in Division 230 looks principally to the timing of recognition of returns for tax purposes under the TOFA accruals tax timing method.

While there is a degree of overlap in both concepts (e.g. the contractual obligations under the relevant instrument), the 'sufficiently certain' concept (which tests whether there is a ‘reasonable expectation’ that you will receive or provide the relevant financial benefits) is more dependent on the facts and circumstances associated with the relevant instrument.

Factors such as past and current economic performance of the issuer, the industry the issuer operates in, and the distribution payout history of the issuer on similar instruments can be relevant. This approach is appropriate in the context of the TOFA regime which is mainly a timing mechanism for which no permanent distortions would arise when having regard to the more ephemeral facts and circumstances that are taken into account under the 'sufficiently certain' and 'reasonable expectation' concepts.

Given the purpose of the debt and equity tax rules which operate to characterise the nature of an instrument at the time of issue (or material change), AVCAL submits that it would not be appropriate to apply the 'sufficiently certain' TOFA concept in the context of Division 974. Division 974 relies on the primacy of the legal and contractual obligations under the terms of the relevant instrument to provide certainty regarding the tax characterisation of the instrument, based on the legal substance of the arrangement. AVCAL submits that any perceived asymmetry between the debt and equity rules and TOFA should be addressed through the TOFA rules.

Question 8.1: A number of areas in the tax law use concepts of debt and equity but not specifically the debt and equity rules and concepts contained in Division 974. The Board is interested in any key areas, whether or not addressed in the discussion paper, in the tax law where consideration should be given to whether Division 974 concepts should be applied.

Investments made by Venture Capital Limited Partnerships (VCLPs) and Early Stage Venture Capital Limited Partnership (ESVCLPs) are governed by both the tax law and the Venture Capital Act 2002 (VC Act). In particular, the VC Act sets out several requirements for VCLPs and ESVCLPs to retain their registration as such.

Under the VC Act, a VCLP / ESVCLP can only hold a debt interest (as characterised under Division 974 of the tax law) if it is a "permitted loan".

The term "permitted loan" is defined in section 9-10 of the VC Act and broadly means a loan made to a company or trust where the VCLP / ESVCLP holds at least 10 per cent of the "equity interests" in company or trust. A "permitted loan" also includes a loan that is repaid within six months.

Under the definition of "permitted loan" in the VC Act, VCLPs / ESVCLPs are only permitted to invest in loans which are legal form debt. Accordingly, investments by VCLPs / ESVCLPs which are characterised as debt for tax purposes under Division 974 but are not legal form debt (e.g. non-equity shares) would not meet the definition of "permitted loan" (notwithstanding the other relevant requirements are met, such as the 10 per cent equity interest threshold).

In particular, non-equity share instruments can be a common feature in VC and PE investments (such as Redeemable Preferences Shares or Convertible Redeemable Preference Shares which are debt interests for tax purposes). However, these instruments are not "permitted loans" for the purposes of the VC Act.

AVCAL submits that there is no underlying policy rationale, given the "at risk" requirements in respect of what is an eligible venture capital investment, for the asymmetry between Division 974 debt interests and the legal form debt requirement in the "permitted loan" definition of the VC Act. This asymmetry creates uncertainty and additional compliance costs to the PE and VC industries who are required to structure their debt funding arrangements in an alternative manner to accommodate this technical deficiency in the VC Act.

Accordingly, AVCAL recommends that the definition of 'permitted loan' in the VC Act is harmonised with Division 974 to include all debt interests so characterised under Division 974.

Question 8.5: The Board seeks stakeholder comment on whether the use of the concept of legal form share in the ESS rules instead of Division 974 concepts, is problematic. If so, what changes would address the problem.

As mentioned in the Board's discussion paper, the ESS rules are intended to tax employees who received benefits under the ESS at their marginal tax rate, and not the employer under the fringe benefits tax. In this context, an ESS interest in a company is a beneficial interest in a share in the company, or a right to acquire a beneficial interest in a share in the company.

As the ESS rules apply to shares, any non-equity shares issued under the ESS will also be subject to the ESS regime. In this regard, notwithstanding non-equity shares are debt for tax purposes, they are a share in the company and therefore provide the employee with some form of financial interest in the stock and capital of the company.

Given the inherent nature of shares as providing a financial interest in the capital of the company, there is an alignment of interests as between employees and employers.

Conversely, loans, notes or other legal form debt instruments generally do not provide the holder with a residual economic interest in the company other than up to the amount of the contributed funds plus an interest component.

The current application of the ESS rules to legal form shares is wholly consistent with the intention of the regime which is to capture benefits provided to employees in respect of the grant of rights which provide the employees with an interest in remaining employed with the company and in the company performing well. Accordingly, AVCAL submits that the existing application of the ESS rules to legal form shares should be retained.

Question 10.2: The Board seeks stakeholder comment on ways to address inconsistencies between Australia's and other jurisdictions' debt and equity rules that give rise to tax arbitrage opportunities.

AVCAL is concerned about the aspect of the review that addresses hybrid arbitrage arrangements. The Board asks how to address inconsistencies between Australia's and other countries' debt and equity rules, in framing Australia's rules. Options include whether Australia should remove potential arbitrage opportunities without reference to the tax treatment in other jurisdictions.

AVCAL is of the view that Australia should not seek to disturb the operation of Australia's domestic debt and equity tax rules by having regard to how instruments are taxed in the jurisdiction of the holder.

To the extent that perceived tax arbitrage arises in an overseas tax jurisdiction, AVCAL submits that addressing that in Australia as the issuer jurisdiction would undermine the achievement of the policy intent and objective of Australian tax legislation.

The adoption of such an approach would create uncertainty in the operation of the domestic debt and equity tax rules. It would also inevitably require Australian taxpayers to analyse and consider the corresponding foreign tax treatment adopted by overseas jurisdictions in respect of the holder of the instrument.

If such an approach were to be adopted, it would create significant uncertainty and complexity, particularly for inbound investors into Australia

In some circumstances, there may also be a risk that double taxation could arise.

AVCAL submits that the better approach to addressing any cross-border arbitrage that might exist could be for the overseas jurisdiction (as the holder jurisdiction) to introduce specific rules which apply to the holder of the relevant instrument.

Further, in relation to hybrid securities, AVCAL is of the view that it would be prudent for Australian policy development to be mindful of OECD and G20 consideration of hybrid entities and hybrid securities, under the Base Erosion and Profit Shifting (BEPS) action plan, given our status as a capital importing country.