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Ms Teresa Dyson
Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

23 May 2014

Dear Teresa

Re: Submission: Review of the Debt and Equity Tax Rules

We are pleased to provide our submission in response to the Discussion Paper issued by the Board of Taxation in relation to the Review of the Debt and Equity Tax Rules.

Detailed comments in Appendix A attached

Appendix A attached sets out our detailed submission on the following areas:

- Difficulties in applying the "material change" rules
- Comments on the application of s 974-80 generally
- Specific comments on the application of s 974-80 to stapled structures.

Comments on the "ability and willingness" exception

In the context of subordination/solvency clauses, our experience has been that the "ability or willingness" exception often presents interpretational difficulties (and significant scope for dispute) in determining whether the debtor has an effectively non-contingent obligation (**ENCO**) to provide financial benefits under the arrangement. The competing views are usually along the lines of whether subordination/solvency clauses merely defer the performance of an ENCO that was created on entry into the financing arrangement, or whether such clauses affect the creation of the ENCO in the first place.

In our view, the purpose of the "ability or willingness" exception is simply to confirm that the risk that a debtor may default on its obligations does not mean an obligation is not ENCO; accordingly subordination/solvency clauses (which simply affect a creditor's exposure to default risk) should generally not result in the debtor's obligations being considered not to be ENCO. In any event, an outcome of the review should be to clarify the operation of Division 974 in this area, as the term "ability or willingness" is too imprecise.

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In this regard, we submit that the Board recommends that the operation of Division 974 be clarified by the inclusion of a rule that states that subordination/insolvency clauses merely defer the performance of an obligation, and are not to be regarded as making the obligation not non-contingent.

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Once you have considered our submission, we would welcome the opportunity to discuss these issues with you in further detail. In the meantime, should you have any questions in relation to our submission, please contact me on (03) 9671 7541.

Yours sincerely

Aldrin De Zilva
Director
Deloitte Tax Services Pty Ltd

Appendix A

CHAPTER 4 – ACCOMMODATING CHANGE

Q 4.9 Issues/Questions

The Board seeks stakeholder comment on the accommodating change provisions, in particular whether:

a. the Division 974 treatment of subsequent changes to a scheme or schemes is problematic. If so, how this could be addressed; and

b. the Division 974 treatment of varying patterns of financial benefits is problematic. If so, how this could be addressed.

As acknowledged in paragraph 4.116 of the Board of Taxation report, there are differing views as to the broader effect of s 974-110. We consider that these differing views arise as a result of the confusion inherent in the language of the provision and the manner in which it interacts with the operative provisions of the debt and equity tests.

When contemplating whether a change to a scheme (or schemes) is sufficient to result in a reclassification of an interest arising under that scheme from equity to debt (or vice versa), s 974-110 deems the relevant scheme to have 'come into existence when the change occurred'[1]. It is unclear to what extent events that have happened in the past under the 'former' scheme should be taken into account in ascertaining the effect of the 'new' scheme.

For example, where a change is made to the pricing, terms and conditions of convertible preference shares such that the issuer's right to convert is moved to the holder, in reapplying the debt test having regard to the deemed coming into existence of the scheme at the time of the change, it is questionable whether the issuer can be said to have received a financial benefit under the scheme by virtue of the fact that the payment of the subscription price by the holder will have occurred prior to the time at which the new scheme comes into existence.

In the edited version of Private Binding Ruling (**PBR**) 43739, the Commissioner adopts what would appear to be a purposive approach to dealing with this issue stating that:

> *The scheme as it exists immediately after the change cannot be explained without taking into account the unaltered terms and conditions of the* [scheme in question].

Followed by:

> *Thus, Division 974 of the ITAA 1997 is to be applied to the scheme as if the* ***events that occurred prior to the amendment****, such as the issue of the* [scheme in question]*,* ***occur at the time the amendment is made****. It is this 'scheme' which is taken to come into existence when the changes occur, and this is the relevant 'scheme' for the purposes of Division 974 of the ITAA 1997.* [**emphasis added**]

The effect of the Commissioner's view in PBR 43739 meant that the receipt of the face value by the issuer of securities issued by it was taken into account in applying the debt text to the new scheme notwithstanding that it had been received prior to the new scheme having come into existence.

It is unclear, however, where in the words of the applicable provisions or the relevant extrinsic materials the Commissioner finds support for the availability of this interpretation.

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[1] Paragraph 974-110(1)(c) and paragraph 974-110(2)(c).

To further compound the predicament, we direct the Board of Taxation's attention to comments made on the operation of s 974-110 in table 6.16 of the Explanatory Memorandum (**EM**) to the Tax Laws Amendment (2010 Measures No. 1) Bill 2010 (enacted as the *Tax Laws Amendment (2010 Measures No. 1) Act 2010*) explaining amendments made to s 974-110 so that it can apply in a case where part of an interest ceases to exist. The EM gives the example of the case where a redeemable preference share and an ordinary share are stapled together and together constitute a debt interest for the purposes of the debt/equity rules. The EM explains that in the absence of the proposed amendment to s 974-110(1)(b) contained in the Bill, on redemption of the redeemable preference share, there was no clear mechanism available under those rules to re-characterise the remaining ordinary share as an equity interest, so it continued to be a debt interest. However, once taken into account, the amendment enables the 'remaining interest' to be properly characterised as an equity interest. In arriving at this view, it would appear that Parliament intended that a substantial part, if not all, of the former scheme be ignored. That is, the redeemable preference share is effectively ignored. In this sense, therefore, it would appear that the view set out in the EM conflicts with the Commissioner's view espoused in PBR 43739 in which elements of the former scheme played a role in classifying the interest arising under the new scheme.

Confusion as to the proper interpretation of s 974-110 may have significant practical implications. For example, consider the example of a 5 year interest bearing loan of $100, the terms of which provide for annual repayments of principal in equal proportions. At the time the loan is made it will clearly pass the debt test, as the value of financial benefits provided by the holder will exceed those received. However, if a change is made to the terms of the loan at the commencement of the third year with the effect that the loan becomes interest-free, it is apparent that the diverging views on the interpretation of s 974-110 can cause quite different outcomes.

Scenario 1 – Receipt of loan proceeds and existing repayments of principal taken into account in determining the effect of the change to the scheme

Under this scenario, the change will not result in the scheme failing the debt test as all of the financial benefits received and provided under the scheme (with or without the exception of interest paid) are taken into account. Accordingly debt/equity character of the loan will not change. That is, the borrower will take into account the $100 received under the loan but also the $20 of principal repaid prior to the change.

Scenario 2 – Receipt of loan proceeds taken into account in determining the effect of the change to the scheme but existing repayments of principal not taken into account

Under this scenario, the change will result in the scheme failing the debt test as the financial benefits received under the scheme, $100, will be greater than the financial benefits to be provided, $80. Nor, however, will it give rise to an equity interest as none of the criteria set out in s 974-75 are met, and will thus fall outside the debt/equity rules. This is quite clearly an anomalous outcome, given that as a matter of substance the scheme quite clearly remains debt following the change.

Scenario 3 – No events prior to the change are taken into account in determining the effect of the change

As was the case in scenario 2, the change will have the consequence that the scheme gives rise to neither a debt nor equity interest following the change. The debt test is failed by virtue of the borrower not receiving a financial benefit under the scheme, and the equity test is failed because none of the relevant criteria are met. Again, this is quite clearly an anomalous outcome.

While the scenarios set out above are simplistic, they are capable of demonstrating the apparent deficiency in the manner in which the debt/equity rules approach a change to a scheme (or schemes). Accordingly, we believe that there is a genuine need for either formal clarification of the Commissioner's interpretation of s 974-110 to a variety of

circumstances, or, where the Commissioner acknowledges a deficiency in the provision, a legislative remedy to assist the debt/equity rules in meeting their stated objects.

As highlighted above, confusion also arises as a consequence of the manner in which s 974-110 interacts with the operative provisions of the debt and equity tests. In particular, we have concerns as to whether or not, on the occurrence of a change to a scheme (or schemes) a new benchmark rate of return must be ascertained that reflects that change for the purposes of applying the debt test.

Arguably, the benchmark rate of return used as part of the process of valuing financial benefits received or provided under a scheme for the purposes of the debt test should reflect the nature of the scheme at the time that the debt test is performed. It would appear, however, that the words of the relevant provisions do not necessarily support such an interpretation. Pursuant to s 974-145, the benchmark rate of return does not attach itself to the concept of a 'scheme', but rather to the 'test interest'. This seems to be to ensure consistency with the words of s 974-50, concerning the valuation of financial benefits in present value terms, in relation to which the benchmark rate of return forms part of the relevant calculation methodology. A broader consideration of the valuation rules, particularly s 974-30, concerning the general rules for the valuation of financial benefits, demonstrates that the 'test interest' is analogous to the concept of the 'interest arising from the scheme'.

It would appear that in circumstances where a change is made to a scheme, in order for the benchmark rate of return to reflect the revised nature of the new scheme taken to have come into existence when the changed occurred, it must be arguable that this also gives rise to the issue of a new interest. It is unclear whether the extension of the fiction imposed by s 974-110 in this regard is possible, particularly where contractual terms are clear as to the time that the relevant interest was issued.

Where the existing benchmark rate of return is used to value financial benefits received or provided under a new scheme, this may give rise to anomalous outcomes where the risk profile of the new scheme has changed considerably in comparison to the former scheme.

The same reasoning may also have a broader impact on whether financial benefits received or provided under a new scheme are to be valued in nominal or present value terms. If it cannot be said that the new scheme results in the issue of a new interest, then it would appear that the commencement of the 'performance period' for the new scheme remains the same as that of the former scheme.

It is not known whether the Parliament intended for the operation of s 974-110 to compel a reconsideration of the benchmark rate of return and/or the valuation of financial benefits in nominal or present value terms. In light of this, and the uncertainty in the law itself, we recommend that the Board of Taxation consider undertaking further consultation on the impact of s 974-110 with the goal of drafting an avoidance of doubt provision reflecting a settled view on the intended effect of that provision.

CHAPTER 5 - APPLICATION OF SECTION 974-80

5.2 General Questions

a. Does the 2011-12 Budget announcement to amend s 974-80 address the concerns relating to its application. If not, what changes would address the problems and retain the integrity of the provision while ensuring it does not overreach?

b. Given the operation of the general anti-avoidance provision in Part IVA, is there a need for a specific integrity provision in Division 974. If so, to what extent does s 974-80 perform this function?

[…]

d. Having regard to the issues identified with the current operation of s 974-80, would it be best to repeal s 974-80 and introduce a more specific integrity measure that directly targets the mischief originally intended to be covered by the measure?

e. Whether the need for the integrity measure, combined with the practical administration difficulties, overstates the compliance concern where MNEs are free to choose whether they fund their associates with debt or equity and are already subject to the Australian thin capitalisation provisions?

1. Preliminary comments

Section 974-80 was intended to act as an integrity provision to ensure that for tax purposes, debt treatment is not extended to returns on funding arrangements for a company where the purpose of the arrangement is to provide an ultimate recipient with what is effectively an equity interest in an underlying company.

To this end, Diagram 2.1 and Examples 2.9 and 2.10 in the Explanatory Memorandum to the *New Business Tax System (Debt and Equity) Act 2001* (**the EM**) illustrate that s 974-80 was intended to apply to schemes where the ultimate recipient's return is, amongst other things, based on the economic performance of the underlying company. Those Examples in the EM and under s 970-80(2) illustrate the "effective equity interest" concept with schemes where the ultimate recipient's return is referable to the economic performance of the underlying company and, in some cases the interests held by the ultimate recipient being convertible to shares in the underlying company. The role of the interposed connected entities in those Examples is essentially to act as conduit for the payment of equity-like returns to the ultimate investor. It is also significant that s 974-80 was introduced against the specific background of certain financing structures that sought to obtain deductions for returns on Tier 1 capital raised by financial institutions.

However, s 974-80 was never intended to re-characterise all related party debt funding arrangements as equity; nor does the provision appear to have been intended to re-characterise all debt interests that carry equity-like returns. However, as a consequence of the release of the ATO's Draft Discussion Paper in 2007 (**the ATO Discussion Paper**), a view has emerged that the application of s 974-80 to related party financing arrangements has become too uncertain and there appears to be a risk that the provision has potential to apply in straightforward situations that bear no resemblance to the abovementioned Examples in the EM or the Example under s 974-80(2).

Given that an objective of Division 974 was to "provide greater certainty, coherence and simplicity than is attainable under [the tax law that existed before the commencement of Division 974]", [2] it is clearly undesirable for the characterisation of related party financing arrangements to be subject to unnecessary uncertainty due to the broad drafting of s 974-80.

2. Illustration of potential overreach of s 974-80

In the context of related-party funding arrangements, the uncertainty and potential overreach associated with the application of s 974-80 is driven mainly by the following:

[2] Paragraph 19 of the EM

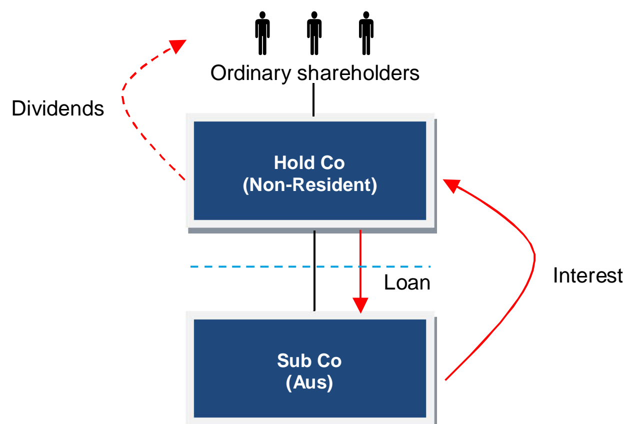
(i) Rather than identifying an "effective equity interest" as a threshold, s 974-80 simply looks to returns paid by a company to a connected entities and asks whether those payments might be used to fund equity-like returns to a third party.

(ii) Unlike the Examples in the EM and under s 974-80(2), there is no particular requirement for the returns on the debt interest[3] issued by the underlying company to be traced to the returns that might be paid to the ultimate recipient.

(iii) The requirement for the existence of an equity-like return under s 974-80(2) is tested not only with reference to the underlying company, but also with reference to any connected entity of the company. This in practice means that almost any interest bearing loan that a company might make to a connected entity could fall within the ambit of s 974-80

Example 1 below uses a simplistic example to illustrate the potential overreach that can arise in applying s 974-80 to straightforward intra-group funding scenarios.

Example 1



In this example, a non-resident holding company (**Hold Co**) advances an interest bearing loan (which otherwise satisfies the definition of a debt interest) to its Australian resident wholly-owned subsidiary (**Sub Co**). Sub Co uses the funds from that loan to invest in its business activities. For the purposes of this example, assume that:

- the loan carries a fixed rate of interest based on an arm's length rate and has no equity-like features
- Sub Co derives profits from its business activities which might be used to pay dividends to Hold Co from time to time
- Hold Co periodically pays dividends to its ordinary shareholders, although the dividends may or may not match the annual interest receipts derived by Hold Co from the loan to Sub Co.

As Hold Co and Sub Co are connected entities, dividends that Hold Co pays to its shareholders *prima facie* satisfy the equity-like criteria set out in s 974-80(2) – thus s 974-80 could apply to this arrangement even though the loan to Sub Co has no equity-like characteristics and the overall arrangement bears no resemblance to the effective equity interests discussed in the Examples in the EM and under s 974-80(2). This illustrates that testing the equity-like returns with reference not only to the underlying company but also to a connected entity means that s 974-80(2) is likely to be satisfied for almost any related party financing arrangement.

[3] Although the threshold requirement under s 974-80(1)(c) is simply that the interest issued by the underlying company must not be an equity interest, our examples will base the analysis on that interest being a debt interest given that in practice the concern with s 974-80 is usually about debt interests being recharacterised as equity interests.

In our Example 1, the issue that would ultimately determine whether s 974-80 operates to recharacterise the loan to an equity interest is whether s 974-80(1)(d) is satisfied – that is, whether the interest received by Hold Co from the loan could regarded as being part of a scheme that is ***designed to operate*** such that the interest ***is to be used to fund*** an equity-like return to an ultimate recipient (which in this case could be the ordinary shareholders).

Quite unlike the Examples in the EM and the Example under s 974-80(2), the question that arises under s 974-80(1)(d) is not whether the ordinary shareholders have an "effective equity interest" in Sub Co, with the connected entity (i.e. Hold Co) acting as conduit for the payment of equity returns on that imputed "effective equity interest". Instead, the question under s 974-80(1)(d) is simply whether the overall arrangement could be regarded as being "designed to operate...to fund" an equity-like return to an ultimate recipient via an interposed connected entity.

In Example 1, a superficial glance at the diagram could suggest that s 974-80(1)(d) might be satisfied given that the interest would appear to be capable of funding dividends from Hold Co to the ordinary shareholders. But in practice the facts are never quite as simplistic; and in this regard the possibility that dividends paid by Hold Co might not in fact reflect the interest paid by Sub Co, or that dividends paid by Hold Co could be paid out of other sources (such as dividends from Sub Co, or from other sources of profit derived by Hold Co) is not well accommodated by the "designed to operate…to fund" test.

It should be noted however that s 974-80 would not apply if the ultimate recipient directly held the relevant interest in the underlying company, even if that interest carried significant equity-like returns. This fact makes explaining the purpose and operation of s 974-80 to non-resident parent companies of Australian subsidiaries extraordinarily difficult.

3. Specific responses s 974-80 issues

a. Does the 2011-12 Budget announcement to amend s 974-80 address the concerns relating to its application. If not, what changes would address the problems and retain the integrity of the provision while ensuring it does not overreach?

Whilst the proposals to implement the 2011-12 Budget announcement would provide some improvement to s 974-80, they would not fully resolve the uncertainties associated with s 974-80 due to the following shortcomings:

(i) As a **debt override rule** (where s 974-80 would not apply if the ultimate recipient's interest is a debt interest) would not apply where the ultimate recipient's interest is not a debt interest, it would be too limited in its application to address many of the systemic issues associated with s 974-80. For example, the debt override rule would provide no assistance for the situations described in our Example 1 above; nor would it assist most existing stapled structures because an ordinary unit in a unit trust does not usually satisfy the definition of a debt interest, even where the trustee is expected to distribute promptly all of its net receipts from its lending activities to its unit holders. Furthermore, there is a risk that if a debt override rule were to be introduced it could be inappropriately interpreted as suggesting a statutory presumption that s 974-80 should apply wherever the ultimate recipient's interest is not a debt interest.

(ii) Reliance on a **purpose and effect test** to restrict the application of s 974-80 would simply create new sources of uncertainty. The first issue would be how to determine exactly what an "effective equity interest" or an "in-substance equity interest" looks like – this may be no easy task given that the question would arise only where the ultimate recipient does not have an actual equity interest in the underlying company. Furthermore, any inquiry into the "purpose" of an arrangement (whether objective or subjective) would be inherently uncertain.

(iii) It is difficult to see how the **Commissioner's discretion** would in a practical sense assist with rectifying any structural defects associated with s 974-80. Consideration would also need to be directed towards how this discretion is to be administered. It would also be an unsatisfactory solution to the s 974-80 conundrum for straightforward intra-group funding arrangements if taxpayers were regularly required to apply for the exercise of the Commissioner's discretion or obtain private binding rulings to address structural shortcomings in the legislation.

b. Given the operation of the general anti-avoidance provision in Part IVA, is there a need for a specific integrity provision in Division 974. If so, to what extent does s 974-80 perform this function?

[…]

d. Having regard to the issues identified with the current operation of s 974-80, would it be best to repeal s 974-80 and introduce a more specific integrity measure that directly targets the mischief originally intended to be covered by the measure?

In our view there is little need for a specific integrity provision in Division 974 that takes the form of the present s 974-80.

Section 974-80 is intended to address situations in which an equity-like return in respect of a company is on-paid to an ultimate investor via an interposed connected entity of the company. By contrast, if the ultimate recipient directly held a debt interest in the underlying company that carried significant equity-like returns, s 974-80 would not be applicable. Thus, as an integrity provision s 974-80 is not actually offended by companies obtaining deductions in respect of the payment of equity-like returns; instead s 974-80 is only concerned with the use of connected entities of the company to on-pay such returns to third parties.

In this regard, there are presently two integrity provisions that address equity-like returns arising on debt interests (namely s 25-85 and s 974-80), each having quite different outcomes even though they both seek to address what appears to be essentially the same problem.

Section 25-85 applies to debt interests that feature certain equity-like returns (irrespective of whether or not those debt interests are held by connected entities of the company) not by re-characterising the entire debt interest as equity, but instead by restricting the amount of the debt deduction to the benchmark rate of return for the debt interest plus 150 basis points.[4] Section 25-85 implicitly accepts that such instruments carry 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 to the *New Business Tax System (Debt and Equity) Act 2001* notes:

> 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 two integrity provisions that address debt interests that carry 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.

We submit that the treatment of debt interests issued by companies that fund equity like returns should generally be the same regardless of whether those debt interests are held by a connected entity. There are two simple means of achieving greater certainty and policy consistency in this regard:

(i) Repealing s 974-80, leaving s 25-85 as the relevant integrity provision to restrict excessive debt deductions for payments that effectively represent the holder's equity participation in the underlying company.

[4] Section 25-85 is replicated for Division 230 financial arrangements via s 230-15(4) – (6).

(ii) Amending s 974-80 to the effect that s 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.

These suggested amendments would be consistent with the Budget announcement that “the changes [to s 974-80] will ensure that his provision will only apply to arrangements where both the substance and effect is that the ultimate recipient 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 a return attributable to an in-substance equity interest. Where the return on the debt interest does not exceed that threshold, the returns to the ultimate recipient should be regarded as sufficiently debt-like not to enliven s 974-80.

e. Whether the need for the integrity measure, combined with the practical administration difficulties, overstates the compliance concern where MNEs are free to choose whether they fund their associates with debt or equity and are already subject to the Australian thin capitalisation provisions?

In our view, it is not necessary to have a provision such as s 974-80 to address the apparent international tax policy issues raised in the above question. The thin capitalisation provisions and the transfer pricing provisions are the appropriate provisions to address base erosion issues that may arise from the choice to fund Australian subsidiaries of MNEs with excessive amounts of debt rather than equity capital.

Furthermore, debt-equity mismatches are presently being addressed by the OECD’s base erosion and profit shifting (**BEPS**) Project – particularly the proposals to eliminate hybrid instrument mismatches as outlined in the OECD Discussion Draft *BEPS Acton 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws).* An integrity provision such as that which presently exists in s 974-80 should not be required if Australia adopts the recommendations of the OECD in that Discussion Draft.

CHAPTER 5 - APPLICATION OF SECTION 974-80 TO STAPLED STRUCTURES

Q 5.2 Issues/Questions

The Board seeks stakeholder comment on whether any significant practical difficulties arise with the application of s 974-80 to stapled structures, in particular:

a. with regard to the current operation of s 974-80 in relation to stapled structures:

i. what is the nature of discretions or other contingencies, if any, that are attached to the distribution from the trust to the investor in a stapled structure arrangement. If there are a range of discretions or contingencies, it would be useful to understand the differences between them;

ii. whether the connected entity test, in relation to stapled structures, is working as intended or whether there should be a specific connected entity test for stapled structures. If a specific connected entity test is preferred, what should the test be;

iii. whether the definition of 'associate' specifically treats entities that operate as effectively one economic entity in a financier trust stapled structure arrangement, as associates of each other;

b. accepting that stapled structures are a commercial reality and a significant subset of the investment population, whether specific integrity concerns arise with stapled structure arrangements. To the extent there are such concerns, what is the best way to address them

Q 5.2 General Questions

c. Whether an integrity measure, other than s 974-80, should apply to stapled structures. If so, what is the mischief that would be an appropriate measure and how should it be applied to, for example, financier trust stapled structure arrangements?

1. Preliminary comments

We agree with the Board of Taxation's proposition at paragraph 5.46 of the Discussion Paper that the current uncertainties about the potential application of s 974-80 to stapled structure arrangements should be removed. Particularly in the context of stapled structures, there is a widespread perception that the ATO's interpretation of s 974-80 has become too strict, and importantly, the ATO's interpretation (as expressed in the ATO's 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 s 974-80. This has generated significant uncertainty which can only have a detrimental impact on investment into Australia.

Stapled group funding arrangements are intended to simulate a debt-like return to ultimate recipients

In the context of the financing arrangements that take place within stapled groups, we have a general view that where the financing arrangement between the company and the stapled funding trust satisfies the debt test, it would generally be inappropriate for s 974-80 to recharacterise that arrangement as equity.

As the Board of Taxation's Discussion Paper notes, stapled structures have historically been favoured in the infrastructure and other industries that encounter significant early stage accounting losses driven by large depreciation and amortisation expenses, restricting the ability of the company to pay dividends for a number of years.

The stapled structure addresses this commercial problem by allowing for regular cash returns in the form of interest on a loan to be distributed to investors notwithstanding the inability of the company to pay dividends due to its lack of accounting profit. 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, especially where interest on the loan between the funding trust and the stapled company is not discretionary nor contingent on the economic performance of the company.

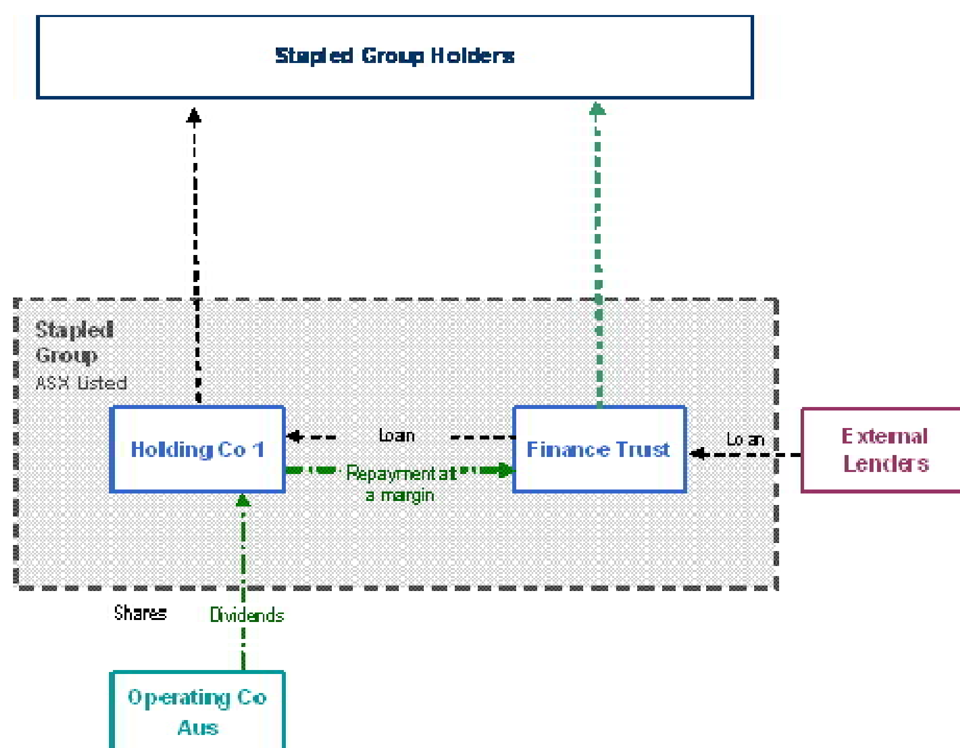
Getting a regular cash flow return when the stapled company is making losses is the antithesis of the concept of a disguised equity interest. Instead, the return to the unit holder represents a distribution of interest, and s 974-80 should not apply to displace this basic economic outcome.

Technical reach of s 974-80 is too broad for stapled structures

We note that in the Discussion Paper, the Board of Taxation has focused its analysis on funding arrangements of stapled groups under which a trust raises funds by issuing units, and then lends those funds to a stapled company, with the objective being to use interest on the loan to fund distributions to unit holders.

However, the wording of s 974-80 may further expand the application of the provision to external funding arrangements. In this regard, we note with concern the following example from the (now withdrawn) TR 2012/D5 which suggests that the ATO may consider that s 974-80 could apply to undermine external funding arrangements.

Example 1 from TR 2012/D5



The ATO used 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 considered whether Finance Trust and Holding Co 1 are connected entities for the purposes of s 974-80, the fact that the ATO chose to use such an example in that Draft Ruling illustrates the potentially startling reach of s 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 s 974-80, notwithstanding that the funds were sourced from External Lenders.

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

This would clearly be an inappropriate application of s 974-80. It is one thing to analyse the application of s 974-80 to the lending of the funds raised from unit holders to the stapled company, as the policy issue in those circumstances is a question of whether the unit holder's unit capital being lent to a stapled company provides the unit holder with an effective equity interest in the company. However it is startling that s 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 possibly be regarded as a scheme to provide an effective equity interest in Holding Co 1. But the effect of such an adverse interpretation is that the external interest payments would effectively become non-deductible to the stapled group for no reason other than the fact that a stapled unit trust was used to intermediate the loan – this would be a capricious and absurd result.

This illustrates a specific shortcoming of the "designed to operate…to fund" test in s 974-80(1)(d) which should be addressed for stapled groups.

2. Specific responses to s 974-80 issues for stapled groups

i. what is the nature of discretions or other contingencies, if any, that are attached to the distribution from the trust to the investor in a stapled structure arrangement. If there are a range of discretions or contingencies, it would be useful to understand the differences between them;

Distributions of interest are likely to satisfy s 974-80(2)(a)(iii)

In the context of the funding arrangements of stapled groups, a significant contingency that presents practical difficulties is that trust distributions of interest will almost invariably satisfy s 974-80(2)(a)(iii) because rights to distributions from a unit trust are usually based on the net income of the unit trust.

Trust deeds will typically be structured to ensure that all of the net income of the trust is effectively distributed to unit holders by the end of each income year to ensure that the trustee is not assessed to a material amount of taxable income pursuant to s 99A of the *Income Tax Assessment Act 1936*. As the distribution clauses of most trust deeds usually provide that each unit carries a right to given proportion of the net income of the trust (a concept that can be seen as analogous to profit), the unit holder's right to income distributions under most trust deeds could be regarded as being technically contingent on the economic performance of the unit trust.

Thus, even if the returns on the loan are non-discretionary and not contingent on the economic performance of the company (i.e. there are no equity-like payments from the company to the trust), and even given that the trust will typically be obliged to distribute all of its net interest receipts to its unit holders, there is a risk that s 974-80(2)(a)(iii) will invariably be satisfied, notwithstanding that the arrangement is structured to achieve bond-like returns of interest for the unit holders, irrespective of the level of profitability of the stapled company.

This would lead to inappropriate outcomes given that rather than facilitating a disguised equity investment in an underlying company, the funding trust is designed to provide bond-like returns to its investors by passing on the debt-like returns paid by the company to the funding trust.

c. Whether an integrity measure, other than s 974-80, should apply to stapled structures. If so, what is the mischief that would be an appropriate measure and how should it be applied to, for example, financier trust stapled structure arrangements?

b. accepting that stapled structures are a commercial reality and a significant subset of the investment population, whether specific integrity concerns arise with stapled structure arrangements. To the extent there are such concerns, what is the best way to address them;

As indicated in the preceding discussion on s 974-80 generally, s 25-85 provides an appropriate integrity provision which applies where a stapled group seeks to distribute excessive amounts to its investors via one or more debt interests in the company held by the stapled funding trust.

Thus we submit that either of the two amendments previously suggested would provide an appropriate integrity measure for stapled groups, namely:

(i) Repealing s 974-80, leaving s 25-85 as the relevant integrity provision to restrict excessive debt deductions for payments that effectively represent the holder's equity participation in the underlying company; or

(ii) Amending s 974-80 to the effect that s 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.