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INFRASTRUCTURE PARTNERSHIPS AUSTRALIA
BUILDING AUSTRALIA TOGETHER

23 May, 2014

Ms Teresa Dyson
Chair
Board of Taxation
C/- The Treasury
Langton Crescent
PARKES ACT 2600

By email: taxboard@treasury.gov.au

Dear Ms Dyson,

## RE: REVIEW OF THE DEBT AND EQUITY TAX RULES

Infrastructure Partnerships Australia welcomes the Board of Taxation's Review into the Debt and Equity Rules and is pleased to provide this response to the Discussion Paper. The debt and equity rules have been an issue of significance and concern for many of IPA's members. This is particularly true of Section 974-80, which is covered in Chapter 5 of the Discussion Paper.

As the Board correctly identifies, Section 974-80 has been the subject of Government announcements and consultations in recent years, particularly in response to concern about its operation with regard to stapled structures. However, no resolution has been achieved as yet.

Further, and despite the 2011-12 Federal Budget announcement that the section would be amended to give effect to its original intention, the ATO has been pursuing a number of stapled entities and applying section 974-80 to deny the deductibility of "interest" on cross staple financing instruments. Such instruments were not meant to be within the scope of section 974-80.

In light of the above, and the fact that the Board does not have to report until March 2015 (which realistically means that no legislation would be finalised until late in the second half of 2015) we recommend that the review of section 974-80 be excised from the current review and treated as a separate, and urgent matter.

IPA's strong preference is for Section 974-80 to be removed from Division altogether and, for any concerns that the ATO may have, to be dealt with by the other integrity rules in the Tax Act.

Treasury has previously received a significant number of submissions on this which could form the basis of the redrafting of section 974-80 so that the original intention of the sections application can be achieved. Ensuring the perceived application of section 974-80 stays within its original intention would also have a subsidiary benefit of cutting back on “red tape” for business.

Notwithstanding the above recommendation, we would also make the following comments regarding the questions raised in Chapter 5 of the Discussion Paper and, in particular, those relating to stapled vehicles in section 5.2.

As the Board states at paragraph 5.46:

*Stapled structures are a commercial reality and are a significant subset of the investment population. The current uncertainties about the potential application of section 974-80 to stapled structure arrangements should be removed. If there are any specific integrity concerns, any response should be proportionate and carefully targeted at genuine cases of mischief.*

IPA endorses these comments, and submits that:

- Stapled structures have been a part of the Australian investing landscape since the late 1980s and have been used extensively for investing in infrastructure and property assets. The operation of these structures is well-known; however, their taxation treatment remains the subject of debate, causing uncertainty.
- Despite having been aware of stapled structures for some time, for example through industry participation in NTLG meetings, the ATO has only relatively recently begun its review of such structures.
- Section 974-80 should not apply to stapled structures, and any perceived mischief should instead be addressed through the normal integrity rules, such as Part IVA or the related schemes provisions in Division 974.
- It should also be made clear that stapled entities are not connected entities for the purpose of the Act.

These comments are expanded upon in our detailed submission, which follows. In the meantime, should we be able to provide additional information or assistance, please contact Ms Zoe Peters, IPA’s Manager, Policy, on (02) 9240 2064.

Yours sincerely,

**BRENDAN LYON**
CHIEF EXECUTIVE OFFICER

# IPA SUBMISSION TO THE BOARD OF TAXATION DISCUSSION PAPER: *THE REVIEW OF THE DEBT AND EQUITY RULES*



## ABOUT INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

Infrastructure Partnerships Australia 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 recognises 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 submits that the operation of section 974-80 needs to be clarified as a matter of priority and urgency and should be dealt with as a separate matter. One of the principal difficulties in applying section 974-80 is identifying the integrity concerns to which it was directed to apply and the limits to which it does apply, including its interaction with the related scheme provisions.

We submit that section 974-80 is intended to apply in limited circumstances and only where there is a scheme that has a <u>deliberate design and purpose</u> (determined on an objective basis) to provide a return to investors which is to be the same as or similar to the economic effects of a single equity interest.

The example provided in the Explanatory Memorandum and included at paragraph 5.11 of the BOT Report has the important feature that it may convert into ordinary shares and accordingly is considered to provide an equity return to investors, who do not otherwise have direct equity in the holding company. The example notes specifically that there is an effective equity interest because these are related arrangements to fund an effective equity interest. The extension of section 974-80 beyond Eligible Tier 1 instruments and in particular to circumstances involving stapled instruments and arrangements is unwarranted and has created significant market confusion.

> *The extension of section 974-80 beyond Eligible Tier 1 instruments, and in particular to circumstances involving stapled arrangements, is unwarranted and has created significant market confusion.*

We consider that the ATO interpretation, adopting a literalist approach to the interpretation of certain elements of section 974-80 (despite statements to the contrary and the fact that the purposive approach to interpretation is generally preferred by the courts), has contributed to the uncertainties that now exist with the application of section 974-80.

For example, there is now uncertainty in relation to the following aspects of section 974-80:

- In the 19 March 2007 discussion paper released by the ATO on the application of section 974-80 (ATO Discussion Paper), the ATO takes the view that subsection 974-80(2) can be satisfied where the interest held by the ultimate recipient is a debt interest. This is in direct conflict with the Explanatory Memorandum (refer paragraph 2.49) which states *'...the test applies in relation to the interest held by the ultimate recipient – if that satisfies the debt test then the funding interests will not be equity interests.'*

- In the ATO Discussion Paper, the Commissioner took the view that the word 'return' in paragraph 974-80(1)(a) should adopt the statutory definition in section 995-1, however the word 'return' in subsection 974-80(2) takes a broader meaning which encompasses a repayment of principal. This view has caused much confusion – whether the word 'return' in paragraph 974-80(1)(a) should adopt the definition given by section 995-1 but where it is used in subsection 974-80(2) it should adopt a wider meaning which encompasses returns of principal. A consequence of these differing views is that under the former, section 974-80 would have application in cases where a connected entity makes an interest-free loan to the company.

- In the ATO Discussion Paper the ATO outlined its view that the words 'designed to operate' (refer section 974-80(1)(d)) cannot be construed to mean 'mainly designed to operate'. The ATO Discussion Paper states, *'[a] construction, where the word 'mainly' is implied in the provision, cannot be reached from the words used in the statute, even where regard is had to the context and purpose of the provision'* (refer page 12). While this is the conclusion the ATO reached, with obvious regard to the context and purpose of the provision, it is not a view shared by all. There remains debate about the basis for including the requirement regarding the design of the scheme and therefore whether it was and is intended that section 974-80 only apply where a *significant* or *key* feature of the design of the scheme is that the return to the connected entity be used to fund a return to the ultimate recipient.

In the context of stapled groups there is also no clear indication as to how the provisions are intended to apply and indeed no clear policy rationale or mischief that is intended to be addressed. In addition, the ATO's interpretation of the meaning of 'connected entity' as outlined in TR 2012/D5 is problematic. Further comments are included on these issues below.

We consider that the policy objective of the related scheme rules already deals with the integrity objectives that section 974-80 is also apparently or seemingly seeking to address. That is, the related scheme rules could apply to the scenarios targeted by section 974-80 without the same difficulties of interpretation outlined throughout this paper. Alternatively, any integrity concerns could be dealt with through Part IVA.

One way to ensure there is no overlap would be to abolish 974-80. If this is not possible then section 974-80 could be limited to the original mischief – deductible Tier 1 instruments.

We consider (for the reasons noted earlier) that the operation of section 974-80 should be clarified in the law, including:

- an express statement should be included in the law to confirm that Parties will not be taken to have intended that the combined economic effects of the constituent or notional scheme to be the same as or similar to the economic effects of a single debt or equity interest merely because a debt and equity interest are issued at the same time or in respect of the financing of a single initial investment;
- two schemes should only be related for these purposes where on an objective basis it would be concluded that the parties intended that the combined economic effects of the constituent or notional scheme would be the same as or similar to the economic effects of a single debt or equity interest. This would include in particular where a debt interest may convert into an equity interest and where that conversion may reasonably be considered likely; and
- 974-80 should be abolished or at least confined to its original targeted integrity consideration – deductible Tier 1 instruments (as issued by banks).

## APPLICATION OF SECTION 974-80 TO STAPLED GROUPS

**Summary**

In this section we have provided comments in relation to the application of section 974-80 to stapled groups. This submission concludes that the application of section 974-80 is inappropriate for stapled financing structures on the basis that the application of section 974-80 to stapled financing groups unfairly discriminates against and disadvantages stapled groups as compared with the use of a single company or trust. We note that this acts as an impediment to attracting investment in infrastructure in Australia.

We recommend that legislation be enacted to repeal the application of section 974-80 in its entirety or at least mitigate its application to stapled groups. Alternatively the application criteria of section 974-80 could be redrafted so that it is more targeted and does not rely on, or be tainted by, the very broad (and excessively complex) associate definition in section 318 of the ITAA 1936 and eliminate the ambiguities of section 974-80.

In providing these recommendations this submission outlines the following:

- key observations in relation to the stapled structures in the infrastructure industry, the nature of the projects involved, the characteristics of investors, and the considerations affecting the choice of legal structure;
- the technical application of section 974-80 to stapled structures;
- the consequences of the application of section 974-80 to stapled structures; and
- further details in relation to recommended courses of action.

**Observations and assumptions in relation to infrastructure projects**

In considering the specific application of section 974-80 to stapled structures, it is first important to understand some key characteristics of:

- the relevant infrastructure projects where stapled structures are used;
- the typical investors; and
- the legal structures used and why those structures are preferred.

***Characteristics of infrastructure projects***

Infrastructure investment exhibits the following characteristics:

- High up front capital costs – regularly the capital cost of an infrastructure project is in the hundreds of millions, if not billions of dollars. There may often be further significant lumpy capital costs for asset overhauls and upgrades at key points in the life of the investment.
- A long term investment horizon – often the investment will have a finite project life, with the asset being handed back to the government or retendered at the conclusion of the investment term, which may be 20 years, but is commonly 40 or 99 years.
- The investment may generally have a number of phases – these include a construction phase; a “ramp up” phase; and a mature operations phase.
- The investment pay-back is in the form of regular cash flow yields over the operating life of the investment – there is typically no expectation of returns being derived from long term appreciation in the value of the infrastructure asset.

These characteristics translate to the following cashflow, tax and accounting profiles throughout the investment life:

| ***Perspective*** | ***Construction<br>e.g. years 1-2*** | ***Ramp up<br>e.g. years 3-5*** | ***Mature operation<br>e.g. year 6+*** |
|---|---|---|---|
| Cashflow | Significant cash outflows.<br>Minimal revenue inflows. | Cash inflows exceed cash outflows. | Extent by which cash inflows exceed cash outflows is relatively stable and predictable |

| | | | |
|---|---|---|---|
| Accounting | Costs are generally capitalised. Project may be in a small loss or a relatively neutral accounting position | Project has accounting profits, however, since revenues will generally be cash revenues but expenses will include significant non-cash expenses for depreciation / capital allowances, cash will exceed accounting profits. | Accounting profit, but when timing differences reverse (i.e. depreciation), accounting profit will exceed tax profit. Cash continues to exceed accounting profit due to non-cash expenses. |
| Tax | Tax losses due to deductions for construction interest and various other statutory deductions e.g. for establishment costs for debt and equity | Tax losses due to carry forward tax losses from construction – further, the use of diminishing value depreciation for tax compared with straight line for accounting means that accounting profit would be higher than tax profit position. | Tax profit, but when timing differences reverse (i.e. depreciation), accounting profit will exceed tax profit |

***Characteristics of infrastructure project investors***

Because of the long project duration and the return profile of infrastructure assets, investors attracted to this investment class are commonly investors with a long term investment horizon who are attracted to regular and (relatively) stable returns. Such investors include superannuation / pension funds, sovereign wealth funds and life insurance companies: domestic and foreign. The investment in infrastructure will commonly be part of an allocation to an "other investments" class in the investor's portfolio of investments. Such investors will generally be concessionally taxed, and are often tax exempt in their home jurisdictions.

It is common to consider the investors in infrastructure projects purely in the context of equity investors, however, in reality, in order to reduce the overall cost of the project and to reduce its required rate of return, invariably a significant portion of the cost of the project will be funded using debt. Accordingly, a significant portion of the returns from an infrastructure project will be received as interest in the hands of the debt financiers. Further, given the size of the funding required for an infrastructure project, it is not uncommon for there to be different tranches of debt, with at least one tranche of debt being subordinated to the senior project debt.

The equity and debt investors for infrastructure assets are increasingly global in their outlook, irrespective of whether they have a local or foreign base. These investors are not constrained to investing in projects only in Australia. The competition for their funds is global and it is fierce.

Accordingly, in evaluating any given infrastructure investment, from a tax and regulatory perspective the following factors will be considered:

- Is the investment structure clear and easy to understand?

- What is the effective rate of tax payable on the project and at how many levels is tax extracted? In this respect, the interaction of income tax, withholding tax, and tax credit / rebate rules will be relevant. Ideally, tax should only be payable once; being in the hands of the investor, and at the investor's marginal tax rate.
- Is the tax treatment of the investment structure certain and can the investor be confident that the treatment of the structure will be predictable / stable / consistent over the long term project timeline?
- What are the compliance / regulatory obligations in respect of the structure and what are the costs and practicalities of compliance (e.g. residence of board members, locations of meetings, number, frequency and complexity of lodgment obligations, risks and consequences of non-compliance)?
- Will tax losses be preserved, and at least able to be carried forward to offset future project income?
- Will interest be deductible?

***Choice of appropriate legal structure for infrastructure investment***

It is now appropriate to consider the choice of structure for investment in infrastructure, bearing in mind the characteristics of infrastructure projects and of infrastructure investors as set out above. The below discussion considers a stand-alone project in a special purpose vehicle. Due to the size of infrastructure projects, it is common for such projects to be financed and managed in a stand-alone special purpose vehicle.

To the extent there are structural impediments or inefficiencies created by a legal structure, this can have the ultimate consequence of reducing the price an investor would be willing to pay for their investment, or, where a change occurs that is unpredicted, this can affect the ongoing financial security or viability of the project and / or the quality of services provided to customers of the project. As such, structural problems and inefficiencies have real consequences in an environment where Australian governments are promoting the development of infrastructure projects and the recycling of major infrastructure assets.

*Use of a simple corporate structure*

At the simplest level investors may invest using a company structure. Such a structure would have some advantages from a tax and commercial perspective:

- The tax treatment of companies is relative clear, certain and understandable, even to a foreign investor;
- For a domestic superannuation fund, Australia's imputation system should broadly mean that dividends are taxed at the superannuation fund's tax rate,
- Tax losses generated during the early years of the project should generally be able to be carried forward to offset project income either by virtue of the continuity of ownership test, or, failing that, the same business test. Further, the recently enacted infrastructure loss rules may preserve the real value of carry forward losses when the project is a designated project.
- A company structure provides protection for investors in terms of limitation of liability.

However, a company also has some very significant structural deficiencies for infrastructure projects:

- Even after the amendments to section 254T of the Corporations Act 2001, there were difficulties in a company paying distributions in the absence of accounting profits (and the new section 254T has not completely resolved these difficulties). In the absence of profits, a capital return is required for a company seeking to distribute free cash flow to shareholders.
- Lenders to infrastructure projects evaluate a project's debt service coverage ratios (DSCR) for the purposes of sizing and pricing the project debt. In calculating the DSCR for a company, the base calculation focuses on post-tax income. In the case of a flow through vehicle, with tax paid in the hands of the investor rather than by the vehicle, the DSCR is calculated by reference to pre-tax income. This potentially enables greater leverage and better debt terms in the entity and thereby enables an overall lower cost of funds.
- During the ramp up phase of the project, should a company seek to distribute excess cash to investors, such distribution would be in the form of an unfranked dividend. Accordingly, notwithstanding that the project is in tax losses at this time, tax would be payable in the hands of the investor on this distribution. Therefore, the nature of company taxation brings forward the payment of tax to a time when the project is in tax losses.
- Even more importantly, in circumstances where excess cash is distributed as unfranked dividends in the early years of a project life, in the later years of a project, when timing differences reverse (for example, accounting straight line depreciation exceeds tax diminishing value depreciation), a company may have insufficient accounting profits to pay out imputation credits in the form of franking credits. The effect of this is that the infrastructure project can end up being subject to double tax: one impost of tax in the hands of the investor and a second impost of tax in the hands of the company. Whilst companies should pay their fair share of Australian tax, most people would acknowledge that it is not the intention of a fair tax system that a project be subject to a double impost of income tax.

Equity investor members of IPA have advised that the combined effect of these last two bullet points: the bringing forward of taxation; and the imposition of double tax, would have a material effect on the cost of an infrastructure project and accordingly its pre-tax required rate of return.
It is our experience that this issue is not well understood outside the infrastructure community and that misunderstanding of this issue gets lost in the tax debate

*Use of a trust structure*

The above considerations would suggest that a trust structure would be a preferable investment vehicle for an infrastructure project as compared with a company structure. Key advantages of a trust structure include:

- Referring back to the table outlining the cash, accounting and tax profiles of an infrastructure project, during the ramp up phase of the project, since the project is in a tax loss position, free cash could be readily distributed as a return of capital without the need for accounting profits. This mitigates the disadvantages of a company structure in terms of the bringing forward tax and the double taxation of project income.
- For a trust structure, tax would be paid once – in the hands of the investor – and broadly at the investor's marginal tax rate. Where the investor is foreign, withholding taxes will generally apply. Such withholding taxes will often be imposed as final taxes, thereby reducing the foreign investor's Australian tax compliance obligations. In some cases, the Managed Investment Trust regime may apply. This regime was implemented specifically to encourage foreign investment into Australia.

There are, however, also some disadvantages in using trust structures:

- Unless the trust is a widely held listed trust, the trust would not be able to rely on the same business test in the event there is a change in majority underlying ownership in the trust. Whilst we have indicated that generally it is expected that infrastructure investors will have a long term investment horizon, there are a variety of commercial reasons why an investor may divest its interest:
    - The infrastructure investment may have been part of a specific allocation for example to the "other investments class", and with changes in market values, such as during the GFC, the investor may have been required to divest certain assets to maintain its portfolio distribution within its published proportions;
    - The investor may simply be acting in accordance with modified portfolio investment weightings;
    - An investor may have been a construction company or builder which, as part of its involvement in the consortium, was required to have some equity "skin in the game" during the construction ramp up phases of the project but which, now significantly de-risked, is seeking to recycle its capital into new ventures.

- The concept of a trust is generally less widely understood by investors, particularly foreign investors, than a company. This complexity is compounded where it becomes necessary to use a stapled structure.

Unfortunately, in the case of infrastructure projects, it is rarely possible simply to use a simple structure involving a single trust. This is because of the application of Division 6C of the *ITAA 1936*. Division 6C (and its threshold requirement that the trust invests in eligible investment business which is relevantly defined to include an investment "in land for the purpose, or primarily for the purpose, of deriving rent") effectively imposes complexity on the structuring of infrastructure projects. As examples, licence fees, tolls, port charges, gas transmission tariffs and generation income are generally not rentals. The discussion of section 974-80 in relation to stapled structures is only necessary because Division 6C effectively forces infrastructure projects to use stapled structures.

If it is accepted that double taxation of an infrastructure project is unfair and not consistent with the government's intention of encouraging infrastructure investment, and if it is accepted that prima facie an equity investor may also be a debt investor in an infrastructure project (and that abusive debt arrangements can be managed through the application of the thin capitalisation regime, the transfer pricing rules and the general anti-avoidance provision) then Division 6C should be redrafted so as to include income derived from defined infrastructure activities as an eligible investment business.

In the absence of this sensible reform, it is necessary to consider specifically how section 974-80 applies in the context of stapled structures.

***Application of section 974-80 to a stapled structure***

Any application of section 974-80 to a stapled trust/company, as outlined in the discussion paper, is initially dependent upon whether the stapled trust and company are connected entities. In turn this rests on whether or not an entity is "sufficiently influenced by" another entity. The analysis to arrive

at this conclusion in the context of a financier trust stapled structure of the type set out in section 5.49 of the discussion paper, however, is complex and far from self-evident.
Section 974-80(1) provides that:

(1) This section deals with the situation in which:

(a) an interest carries a right to a variable or fixed return from a company; and

(b) the interest is held by a connected entity of the company; and

(c) apart from this section, the interest would not be an equity interest in the company; and

(ca) the scheme that gives rise to the interest is a financing arrangement for the company; and

(d) there is a scheme, or a series of schemes, designed to operate so that the return to the connected entity is to be used to fund (directly or indirectly) a return to another person (the ***ultimate recipient*** ).

*Connected Entity*
Accordingly, as set out in subsection 974-80(1)(b), there must be a debt interest that is held by a connected entity of the company. The section 995 definitions set out that a:

*connected entity* of an entity means:

(a) An associate of the entity; or

(b) Another member of the same wholly owned group if the entity is a company and it is a member of such a group.

Applying these tests to a stapled structure, 974-80 may apply where the debt interest in the company is held by the trust and the trust is considered an associate of the company.
This takes us to the definition of associate in section 318 of the *ITAA 1936*.
Since the trust in a stapled structure would generally be a public unit trust entity (it is a breach of this definitional test in Division 6C that has necessitated the use of the stapled structure in the first place), paragraph 318(5)(a) indicates that the trust is to be treated as if it were a company rather than a trustee.

Accordingly, it is necessary to consider the tests in subsection 318(2) (rather than subsection 318(3)). Relevantly, subparagraph 318(2)(d)((i)(a) effectively provides that the trust will be an associate of the company where the trust is sufficiently influenced by the company.

The concept of "sufficiently influenced" is a defined term and at its weakest it is agreed that it may merely require that the trust might reasonably be expected to act in accordance with the wishes of the company. This is argued to be a lower threshold than actual control, and if breached, the company given the label "controlling entity" (which implies the trust is seen as a "controlled entity"). The test is argued to be lower than for control, but the use of the label "control" sets up a presumption / inference that there may be something not quite legitimate about the arrangement. As set out above, however, there is nothing inherently mischievous about an investor providing debt as well as equity. In the context of an infrastructure project it is normal and expected. The thin capitalisation rules assume that an equity investor may also invest in the form of debt but set some boundaries around this.

Extensive submissions around the operation of the connected entities provisions and stapled entities were made by the IPA and professional bodies in the context of draft ruling TR 2012/D5. That draft ruling was subsequently withdrawn. There was a clear difference of views in relation to this issue between the ATO and the profession generally. The differences related to the level of influence/ control required generally, the impact of cooperation provisions in stapling deeds and cross staple loans and security arrangements. The market has been left with significant uncertainty as to how connected entities provisions will be applied, particularly with respect to listed stapled entities.

*Mechanical operation of the provision*

The IPA submits that the gateway tests in 974-80(2)(a) and (b) are drafted far too broadly and hence almost invariably a taxpayer company is left to consider the "designed to operate" test in 974-80(1)(d) to avert a section 974-80 application. This has lead to the need to clarify what arrangements should be caught and why, and leads to anomolous outcomes, particularly in relation to stapled groups.

Subsection 974-80(2) provides as follows:

> "The interest is an ***equity interest*** in the company if:
>
> (a) the amount of the return to the ultimate recipient is in substance or effect * contingent on the economic performance (whether past, current or future) of:
>
> (i) the company; or
>
> (ii) a part of the company's activities; or
>
> (iii) a * connected entity of the company or a part of the activities of a connected entity of the company; or
>
> (b) either the right itself, or the amount of the return to the ultimate recipient, is at the discretion of:
>
> (i) the company; or
> (ii) a connected entity of the company; or ......"

The flow through of principal and interest loan repayments through an interposed connected entity (company or unit trust) to the ultimate investors, typically triggers subsection 974-80(2)(b)(ii) for the reasons set out below. This then puts significant pressure on the analysis as to whether 974-80(1)(d) is satisfied in an exceptionally wide range of unintended circumstances.

Figures 1 to 4 below show four examples of alternate ways in which a company may be debt funded by investors. The terms of the loan to the company in each example case would be identical.

Figure 1 shows a Parent Company Loan to Company A. Figure 2 shows a Parent Unit Trust Loan to Company B. Figure 3 shows a direct loan from Investors to Company C. Figure 4 shows a Stapled Unit Trust Loan to Company D.

In each instance, the borrowing company would, (absent the application of Section 974-80) be taken to have a tax debt interest with respect to the loan, as there is a non-contingent obligation of the company to repay the principal and interest to the lender within a ten year term.

We do not believe that there is any logic for treating the loan to the company as an equity interest in the company pursuant to the section 974-80 equity override rule in any of the circumstances depicted. We will look at each of Figures 1 to 4 individually, but particularly in comparison to the stapled arrangements in Figure 4 to demonstrate the problems of interpretation created by section 974-80.

**Figure 1 – Parent Company Loan**

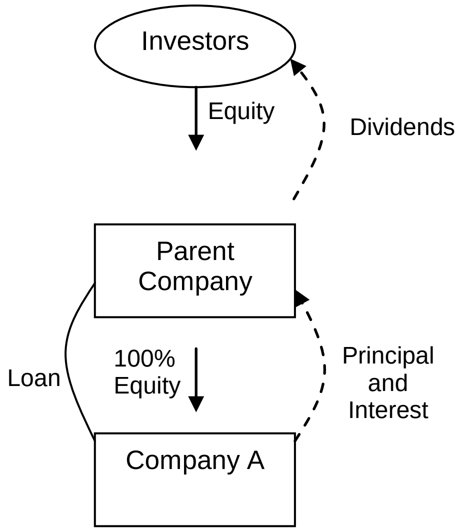



**Figure 2 – Parent Unit Trust Loan**

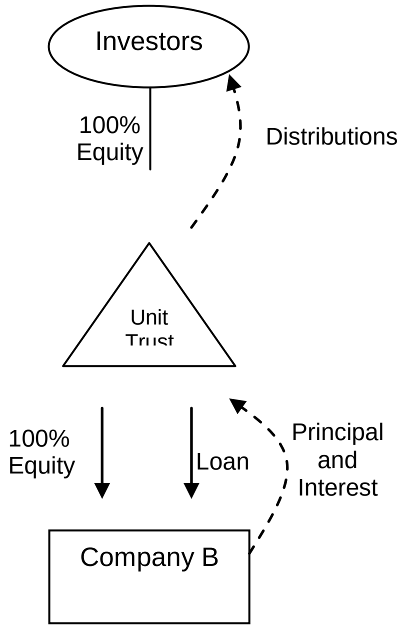



**Figure 3 – Investors Direct Loan**

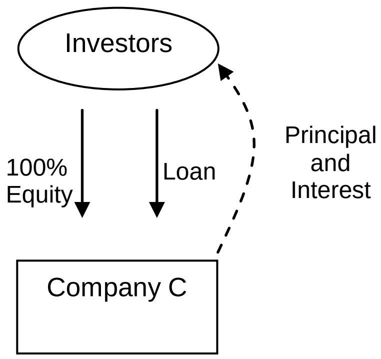
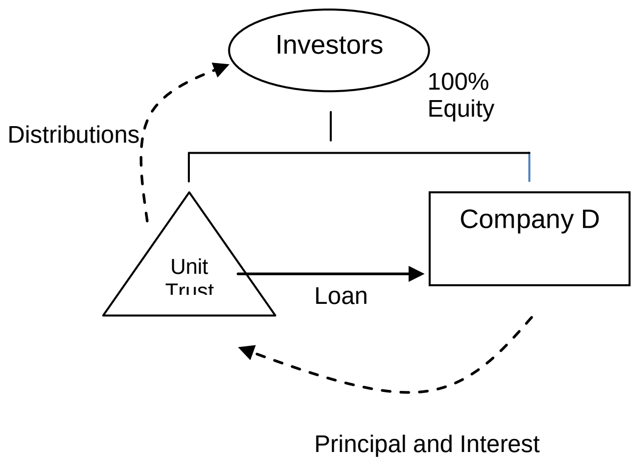



**Figure 4 – Stapled Trust/Company**



In Figure 1, a collective investment vehicle in the form of a Parent Company is chosen to pool investors and to hold shares in Company A. The Parent Company is a connected entity of its wholly owned subsidiary Company A and may use funds received as interest or principal repayments on the loan to Company A as a source of funding of its returns to its investors. The Parent Company would have a discretion over its dividend policy and hence as a connected entity of Company A, this would mean that 974-80(2)(b)(ii) is arguably satisfied. The only defence left to Company A to prevent an application of 974-80 is to argue that 974-80(1)(d) is not satisfied as there is no scheme or series of schemes which are designed to operate to fund returns to the ultimate recipients. That is, a Parent Company debt funding a subsidiary company with an ordinary interest bearing loan should not be regarded as a scheme designed to operate to fund returns to ultimate investors.

In Figure 2 a collective investment vehicle in the form of a Unit Trust is chosen to pool investors and hold shares in Company A rather than a Parent Company as per Figure 1. In Figure 2 the Parent Unit Trust is a connected entity of Company B, and may use principal and interest repayments on the loan to Company B to fund trust distributions of income or capital to the investors in Parent Unit Trust, being the ultimate recipients.

The unit trust deed of Parent Unit Trust would typically provide that investors are presently entitled to the net income of the unit trust, and would therefore generally require the distribution of an amount at least equal to the net income of the unit trust to the investors. The trust deed would typically permit the trustee flexibility to distribute additional amounts received that do not form part of net income (e.g. principal repayments forming part of the capital of the trust).

The above features of a unit trust mean that the trustee would arguably be regarded as having a discretion on the amounts of distributions it makes and that would likely satisfy either paragraphs 974-80(2)(a) and/or (b), and hence Company B would be in the same position as Company A in needing to rely on subsection 974-80(1)(d) so that section 974-80 did not apply.

Company B might have a more difficult task in establishing that the arrangement is not designed to operate to fund a return to an ultimate recipient, given that there is less discretion/flexibility with respect to amounts of interest received that flow through the Parent Unit Trust as compared to a Parent Company which may have a complete discretion as to retention of funds. This outcome is, in our view, completely illogical as there seems no cogent reason why the identical loans to Company A or Company B should be treated differently. In fact, arguably Company A's circumstances (where the Parent Company can retain funds in an economic group comprising itself and the controlled Company A, more easily, as compared to Company B's circumstances involving a parent unit trust where income must be distributed, should be more readily viewed as equity. The greater control over ultimate distributions to investors held by Company A's parent is more equity like.

Figure 3 shows investors directly owning Company C and loaning funds to it. On the basis that the company is widely held, none of the investors is a connected entity of Company C, and hence the tax debt characterisation for Company C is not impacted by section 974-80.

In our view there is not a cogent rationale as to why using a pooled collective investment vehicle in Parent Company or Parent Unit Trust at Figure 1 or 2 respectively should result in a different debt/equity classification on the loan at Company A or B level than the direct ownership approach at Company C.

The argument for equity treatment is that the pooled investment vehicle gives the connected entity some control/ discretion over repaying the loan and hence the interest and principal is retained in an economic group. If this were really a concern then arguably all parent company/subsidiary loans could be treated as equity.

Figure 4 shows a Stapled Unit Trust and company structure. The investors hold the equity investment in Company D directly, and hold the loan to Company D through a collective investment vehicle in the form of a unit trust.

If Stapled Unit Trust is taken to be a connected entity of Company A, then for the same reasons set out as relevant at Figure 2 in relation to Parent Unit Trust, 974-80(2)(a) and (b) may be triggered. That is, there is a loan from Stapled Unit Trust to Company D. Repayments of principal and interest payments made by Company D would flow through the Stapled Unit Trust, and would be subject to the flexibilities in the trust deed. Assuming that the Stapled Unit Trust is a connected entity of Company D, the ultimate recipients would effectively be funded by amounts that flow through the Stapled Unit Trust.

The analysis is no different to that set out in relation to Figure 2. We do not believe that in a typical Stapled Unit Trust scenario, there is a scheme or schemes that are designed to operate to fund a return to the ultimate recipients/investors. Just like in Figure 1 and Figure 2, the borrower entity can use the principal and/or interest to fund distirbutions or to reinvest. However the application of Section 974-80 has caused, and continues to cause, extreme uncertainty in the scenarios in Figures 1, 2 and 4.

We submit that the interposition of a Parent Company/Parent Unit Trust or Stapled Unit Trust between ultimate investors and a company as a collective investment vehicle should not be subject to any special integrity rule (like section 974-80). Rather, the general anti-avoidance provision should be left to apply where the dominant purpose of the interposition or some particular feature attaching to the circumstances of an arrangement is seen as being introduced for the dominant purpose of obtaining a tax benefit, after considering the commercial rationale for the interposition.

Some further observations in relation to the application of section 974-80 to stapled structures include:

- Section 974-80(1)(a) requires there to be an interest in the company that carries a fixed or variable "return". The concept of a return in this context implies something over and above the refund of the principal of the investment – the basis of the application of the provision is that the investor is seeking to turn a disguised dividend into a deductible interest payment. Where the payment is merely refunding principal arguably this should not be considered to constitute a relevant "return".

- In the case of an infrastructure investment, where a payment is paid at a time when the project in is an accounting loss position, this could not be considered to be a disguised dividend. In the context of other integrity measures which have been enacted to protect against deductions being granted for disguised dividends (for example, section 108 of the *ITAA 1936)*, the courts have accepted that where the entity is in accounting losses, there could not be a disguised dividend.

- Section 974-80(01)(d) further refers to the return to the trust being used to fund a return to the investor. It is contended that the reference to "a return" in paragraph (d) similarly should require a payment of an underlying project "profit" to the investor, and not merely a refund of their principal. Further, it is recommended that at the very least, paragraph (d) be amended as follows:

  (d) there is a scheme, or a series of schemes, such that the return to the connected entity is both (a) to fund (directly or indirectly) a return to another person (the ***ultimate recipient*** ).

In circumstances where the infrastructure project is in accounting losses, the payment of excess cash in the form of deductible interest creates a deduction for the company and an assessable amount for the investor. There is symmetry in this treatment, and absent thin capitalisation breaches or transfer pricing abuses, this is a fair result. At the same time, whilst in accounting losses, treatment of the payment as an equity payment should not give rise to an assessable amount to the investor, since the receipt would not be a dividend – instead it would be a repayment of capital.

It is considered that the gate of "connected entity" is an inappropriate test. This test is not relevant to whether or not a payment that is ostensibly interest should be re-characterised as a non-deductible amount. By including it as a core test in the application of section 974-80 to a stapled structure focuses the analysis on an irrelevant matter. The current drafting then gives the arrangement the label "control" and thereby suggests a level of illegitimacy.

If the rules are to be substantively retained, the focus should be on subsection 974-80(2) which provides that the interest will be an equity interest in the company if the amount of the return to the investor is, in substance or effect, contingent on the economic performance of the company.
We are aware that in the context of a stapled structure using a financier trust similar to the structure outlined in section 5.49 of the discussion paper, the ATO has argued that the payment to the investor satisfy this requirement because unless the "interest" payments from the company to the trust are sufficient to pay the interest on the senior debt and the operating costs of the trust, the payments to the unitholders will be contingent on the economic performance of the company. This analysis however, ignores the fact that in substance the unitholder debt is acting similar to subordinated debt, and that this alone should not be sufficient to deny the deductibility of that debt. As we have noted above, it is not uncommon for an infrastructure project to have tranches of senior and subordinated debt.

**Conclusions and recommendations**

- There are fair and reasonable reasons why investors may seek to invest in infrastructure projects using transparent project vehicles, including trusts. From a tax perspective, use of a corporate structure could have the consequence of creating double taxation of project income.

- Structural impediments, in particular the outmoded potential application of Division 6C, effectively prevent the use of a single trust entity as the project vehicle. Accordingly, in order to obtain flow through tax treatment it is necessary to use alternative structures – a common example of which is a stapled trust and company structure. The use of a stapled structure is inherently more complicated that the use of a single project vehicle (as any adviser who has tried to explain a stapled structure to a foreign investor would attest). Infrastructure investors would much prefer to invest using a single transparent vehicle.

- The nature of infrastructure investments with their long term reliable periodic cash flows is such as to attract not only investors of equity capital and providers of debt capital, but also investors who seek exposure to a combination of exposures to equity and debt risks. Thus, given the nature of the infrastructure project cash flows and the investment preferences of the investors (superannuation funds, sovereign wealth funds) it is common for those investors to seek to participate in the project with two separate risk/ reward objectives: one which exposes the investor to volatility, market risks etc. (the “equity” investment), and the other which exposes the investor to the more stable bond-like returns (the “debt” investment).

- Our tax system recognises that equity investors may also be debt investors into a vehicle. Our thin capitalisation regime is predicated on this fact. Prior to the modern form of our thin capitalisation regime, the thin capitalisation regime applied where a foreign parent was considered to have provided an excessive level of debt relative to equity into its domestic subsidiary. Transfer pricing rules further protect against excessive debt deductions.

- Section 974-80, as it is currently drafted, operates in a very convoluted way through the confusing and general terms of the associate test, and, as currently interpreted by the ATO, has the effect of saying “an equity investor in a stapled structure cannot also invest in a project by using debt”. This approach is contrary to the approach taken in respect of inbound companies subject to the inbound investor thin capitalisation rules.

- If this is the policy of the Government, such policy should be clearly and explicitly stated. Further, if this is the policy of Government, the Government should also clearly acknowledge that this policy imposes costs and inefficiencies on infrastructure projects and that it is the intention of the Government that this be the case.

- If the government’s policy is that any subordinated debt will be treated as equity, this policy should also be clearly and specifically articulated.

- In respect of existing structures, we recommend that section 974-80 be repealed or redrafted so as not to apply to stapled structures including financier trusts. In redrafting section 974-80, the focus should be whether or not the interest provides for payments which, in substance are disguised dividends. A payment in respect of subordinated debt would not necessarily be a disguised dividend, nor should it be so treated. In this regard, the current focus on connected entities is distracting and irrelevant. The thin capitalisation rules, transfer pricing rules and general anti-avoidance provisions in Part IVA are the relevant, rational and appropriate integrity measures to protect against abusive arrangements.

## RESPONSES TO DISCUSSION PAPER QUESTIONS

### 1. Stapled Structures Questions

| Question | Comment |
|---|---|
| The Board seeks stakeholder comment on whether any significant practical difficulties arise with the application of section 974-80 to stapled structures, in particular: | |
| a. with regard to the current operation of section 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; | The reference to "discretions" is relevant for a number of reasons. On the one hand, to the extent that the trust is considered to exercise its own discretion in the conduct of its affairs, this is a factor that would reduce the likelihood that the trust may be considered to act in accordance with the wishes of the company. To the extent the company has discretion over the payment of a return, this increases the likelihood that the interest may be considered an equity interest. It is considered that the extent to which the trustee has discretions under the trust deed in respect of additional payments that may be made to investors out of capital, in classifying items as income or capital under a standard unit trust deed, these routine matters should not be regarded as discretions that should make a loan from a connected company an equity interest. Further, in our view, it is not an influential consideration as to whether or not the interest is, in substance, an equity interest in the company. |
| 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; | It is submitted that the connected entity test is not working effectively for stapled structures, given the general market uncertainty that has been created by the comments in draft Taxation Ruling TR 2012/D5, particularly in relation to the listed stapled entities and the range of matters over which cooperation is required under stapling deeds. Its withdrawal after a number of lengthy technical submissions leaves the connected entity analysis for staples unclear. |

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| | We have outlined in the submission the explanation for this and have suggested solutions to this problem. |
| 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; | As currently interpreted by the ATO, whereby so long as an entity may be considered to be "expected to act in accordance with the wishes of the company", the ATO invariably treats a public unit trust entity as an associate of the company to which it is stapled. There is a strong alternate view that sufficient influence is a concept much closer to the concept of control, and that one stapled entity would not, in the ordinary instance, control the other entity where the boards/responsible entities of each entity act independently, albeit that they coordinate a number of administrative actions. |
| 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; | To the extent that there are integrity concerns associated with the use of stapled structures, it is considered that these can be dealt with through the thin capitalisation rules, the transfer pricing rules and the related scheme provisions |
| c. with regard to the interaction of the related scheme provisions: | |
| i. whether, as a matter of policy and ignoring section 974-80, arrangements in which the trust acts solely as a financier of the stapled group should be subject to the related scheme provisions; | It is appropriate to consider the related scheme provisions when assessing the integrity of a stapled structure involving a financier trust |
| ii. does the law need to be clarified as to whether, and how, the related scheme provisions apply to stapled structure arrangements; and | We have not focused on this question in this submission. |
| d. as a matter of determining legislative priorities, where both the related scheme provisions and section 974-80 can both apply to an arrangement, which provision should take precedence. Should that priority setting apply in all cases or in limited specified cases? | We have not focused on this question in this submission. |

### 2. General Questions

| Question | Comment |
|---|---|
| a. Does the 2011-12 Budget announcement to amend section 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? | We have not specifically discussed this question in our submission. It is very difficult to comment on this issue given that no exposure draft amended legislation has been released. Ultimately, we believe far too many situations will be left with determining whether 974-80(1)(d) applies based on the designed to operate test. The series of examples that were to be provided in the explanatory memorandum would need to be very extensive to give certainty as to arrangements, including stapled arrangements, for it to be an effective change. Any agreement as to the examples in the explanatory memorandum and where the boundary is drawn may prove very difficult. |
| 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 section 974-80 perform this function? | It is considered that the existing integrity provisions of Part IVA, thin capitalisation and transfer pricing currently address integrity concerns associated with the debt / equity distinction. |
| c. Whether an integrity measure, other than section 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? | It is considered that the existing integrity provisions of Part IVA, thin capitalisation and transfer pricing currently address integrity concerns associated with the debt / equity distinction. |
| d. Having regard to the issues identified with the current operation of section 974-80, would it be best to repeal section 974-80 and introduce a more specific integrity measure that directly targets the mischief originally intended to be covered by the measure? | It is considered that 974-80 should be repealed. Integrity concerns in respect of the characterisation of an instrument as debt or equity can be dealt with under the existing debt and equity tests in association with the general anti-avoidance rule in Part IVA and the thin capitalisation and transfer pricing rules. |
| 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? | We consider that the need for a specific integrity measure is overstated and that Part IVA, the thin capitalisation rules and the transfer pricing provisions can address integrity concerns. |