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OF AUSTRALIA
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Dear Ms Dyson

Review of the Debt and Equity Tax Rules

The Taxation Committee of the Business Law Section of the Law Council of Australia (**Taxation Committee**) supports a bright line distinction based on a defined scope of 'economic substance' between debt and equity concepts for the purposes of determining the character of returns on these arrangements for taxation purposes. We consider this method of distinction delivers the relevant certainty of taxation outcome in the majority of cases, even though there will be cases and circumstances which are 'at the margin' and which raise potential hybrid issues.

While there are questions of policy that need to be addressed, the Taxation Committee submits that the current legislation should be amended in certain respects to clarify the application of certain provisions .

The Taxation Committee understands that complete certainty will never be possible, and these additional 'at the margin issues' should be resolved through ruling where further clarification is necessary.

In this submission, the Taxation Committee does not address every question raised in the Board of Taxation's Report (**Report**) but rather focuses on some key areas. In relation to the questions raised about section 974-80, the Taxation Committee submits that the review of this provision be dealt with as a matter of priority. Given the proposed timeframe for the broader debt/equity review, we submit that a review of section 974-80 can be separated as a discrete part and that it be addressed as soon as possible in order to resolve the many uncertainties surrounding its application.

1. Difficulties with the Discussion Paper's Notion of what is "Contingent" (Issues/Questions Q4.4)

1.1 Q4.4(a) – 'ability or willingness to meet the obligation'

The Taxation Committee considers that subsection 974-135(3) should be redrafted. In this regard, using the phrase "not contingent" in the same provision as the word "obligation" and the apparent "exclusion" of the "ability or willingness to meet the obligations" from being a non-contingent obligation, is confusing. For example if an obligor is in fact insolvent or bankrupt, that fact of itself does not cause the obligation to become contingent. The rights of creditors to sue the obligor in liquidation are suspended and Court orders are required for an unsecured creditor to sue a company while in liquidation: see section 471B of the *Corporations Act 2001* and *Ford's Principles of Corporations Law 13th Ed* (Lexis Nexis, 2007) at [28.130]. However, the obligation is not made contingent at the time when the obligor in fact becomes insolvent or when the winding up or bankruptcy order is made.

Further, it is submitted that the suggestion that an unwillingness to pay or the potential for the obligor to become insolvent or bankrupt in the future affects the existence of the obligation at the time an obligation arises is inconsistent.

As noted by Lord Reid in *Winter v IRC* [1961] 3 All ER 855 at 859:

> "I would find it impossible to hold that in Scots Law that a contingent liability is merely a species of <u>existing</u> liability. <u>It is a liability which</u>, by reason of something done by a person [to be] bound, <u>will necessarily arise or come into being</u> if one or more certain events occur or do not occur"

In the first sentence of the above quotation, Lord Reid was disapproving of comments of Lord Greene MR in *Re Duffy; Lakeman v A-G* [1948] 2 All ER 756 at 759-760 which appear to suggest that a contingent obligation could be an existing liability before certain events occur or not occur.

A contingent obligation may be contrasted with a defeasible obligation. In the context of rights, the full Federal Court in *Walsh Bay Developments v FC of T* (1994-95) 31 ATR 15 at 27 said:

> "There is also a distinction between a contingent interest and a defeasible interest. The latter is a vested [existing] interest which is liable to be divested by a supervening event."

It is submitted that the "ability or willingness" exception in subsection 974-135(3) tends to confuse the legal distinction between contingent and non contingent obligations. While Division 974 is intended, in a defined manner, to extend its operation beyond mere "legal form" (subsection 974-10(2)), undermining the bedrock of the Division which is focused on "obligation" has not been helpful in interpreting the law.

The drafting in subsection 974-135(3) can be contrasted with paragraph 974-85(1)(a) where the phrase ("unwilling or unable") is used to elaborate on the phrase "contingent on economic performance" which is a phrase where the common commercial meaning of "contingent" would appear to be more apt rather than the legal meaning since "economic performance" is used with "contingent" tends to point to a commercial outcome: *Herbert Adams Pty Ltd v FC of T* (1932) 47 CLR 222 at 223.

We note that paragraph 4.31 of the Discussion Paper dealing with contingencies apparently within the context of section 974-135 seems not to distinguish between obligations which are in existence and contingent obligations. This failure to distinguish between the two is referred to below.

1.2 Q4.4(b) and Q4.4(c) – subordination and ranking

The Taxation Committee considers that there needs to be clarification of the treatment as subordinated and non recourse debt in the Division. This also extends to solvency arrangements.

The views expressed on subordinated debt in the Discussion Paper, if they were to be implemented in legislation would severely curtail securitisation in Australia especially if the SPV vehicle were a company not acting in the capacity of trustee. In a similar fashion, it would also curtail project finance used in mining and infrastructure projects. In addition, it would also seem quite unwieldy to require Government to draft regulations to deal with requirements imposed by Regulators such as APRA to deal with subordination requirements imposed by the Regulator for purposes other than tax.

Under the current law, at least in so far as the types of subordination occurs in securitisation and project finance are concerned, it is submitted that there is no issue of "contingency".

The discussion of Example 2 in the Discussion Paper would appear to conflate a number of issues.

In paragraph 4.44, it is stated

> "Arguably, in example 2, the issuer only has a contingent obligation to provide financial benefits and this contingency is not within the "ability and willingness" exception. This is because even if the issuer had $1,000 in assets available for distribution after all other creditors are satisfied, it does not need to repay the borrower [sic] in full because the shareholders have a right to some part of the pool"

If paragraph 4.44 is, in fact, talking about example 2, then the subordination clause merely places all present and future creditors in front of the subordinated creditor, and the shareholders, as a matter of law, stand in priority behind the subordinated creditor. Further, in example 2, the subordinated obligation is assumed to be due and payable five years after the loan is made. In such circumstances, it is submitted that it is untenable to argue that such an obligation is "contingent".

If paragraph 4.44 is talking about example 3 where the subordinated creditor is subordinated to the same level as shareholders, it is submitted that there is still an existing obligation to repay the debt at the time the loan.

It would appear that the discussion in paragraph 4.44 is similar to the discussion in the ATO Discussion Paper on ENCO released on 26 September 2007 in that there is a conflation between the ENCO requirement in paragraph 974-20(1)(c) and the estimated "valuation" requirement in paragraph 974-20(1)(d). Such a conflation makes it difficult to discuss important policy issues such as this one.

It is submitted that paragraph 974-20(1)(d) already deals with the issue and nothing more needs to be done.

Under paragraph 974-20(1)(d), it is true that the financial benefit is measured in nominal terms if the 'performance period' of the obligation must end no later than 10 years from the date of issue of the instruments. This nominal measurement is confirmed by paragraph 974-30(3)b) which requires a financial obligation to be provided in the future to be the nominal value of the obligation to be provided in the future and also requires the market/present value (at the time of issue) of the obligation to provide a financial benefit in the future to be ignored. However, this nominal value is subject to a discount for a significant probability at the time of the issue of the scheme that the financial benefit will not be provided in the future. It is only if it is 'substantially more likely than not' that the nominal value of the future financial benefit is recognised.

It is submitted that for the sake of a workable rule, excluding present value calculations for ten year or less performance periods remains a sensible approach and the use of a probability test of the nominal financial benefit being provided is an adequate proxy of market value.

1.3 Q4.4(d) – limited recourse loan arrangements

If the view expressed in paragraph 4.50 of the Discussion Paper were to be adopted as the current interpretation of what would be regarded as a standard limited recourse loan, then project finance used in infrastructure (e.g. mining and construction projects) and in securitisation would be severely curtailed at least where the borrowing entity is a company not acting in the capacity of trustee. In addition, if this view were to be adopted, in view of the interaction with the "limited recourse debt provisions in Division 243 of the *Income Tax Assessment Act 1997* this could lead to double taxation of the same profit, preventing projects from being feasible.

We would generally agree with the view expressed by Euan Campbell in "Division 974 and Limited Recourse Debt", Taxation Institute of Australia, Financial Services Conference, 2010, because it provides an independent operation of the requirements in paragraphs 974-20(1)(c) and 974-20(1)(d) in a manner consistent with the principles of interpretation summarised by McHugh, Gummow, Kirby and Hayne JJ. in *Project Blue Sky Inc v Australian Broadcasting Authority* 194 CLR 355 at [69]-[71]. As noted in 1.1 above, it is necessary to distinguish between existing obligations and contingent "obligations" which only arise on the happening or absence of a specified event. It is also necessary to distinguish between existing obligations which are defeasible by supervening events and those that are not. Having done this, it is only then necessary to consider whether the "pricing terms or conditions" and the deeming rules in subsection 974-135(4) or 974-135(6) overturn what would be the general law meaning of "contingent" and "obligation".

It is true that the drafting of limited recourse provisions can affect whether or not an obligation exists from the time a loan is taken out – refer Examples 4 and 5 in the

Discussion Paper. Other examples of drafting which may be clearer would involve drafting which provides that the obligation to repay is "discharged" by receipt of the rental proceeds or amounts received or recovered by or on behalf of the borrower.

1.4 Q4.4(f) - Solvency Clauses

On the drafting of Example 1 in paragraph 4.39 of the Discussion Paper, there is an ambiguity of what the expression "payment of principal and interest shall be conditional" means. Is it a condition precedent to the formation of the obligation or a condition subsequent?

If the drafting clearly pointed to a condition subsequent to the formation of the obligation such that the obligation is existing but defeasible then it is submitted that the only issue to consider is the anticipated valuation requirement in paragraph 974-20(1)(d).

As a matter of practice, it would appear that the law is not administered in a manner consistent with the above distinction.

This issue, together with subordination of a debt interest to the same priority as equity holder, creates impediments to the issue of (regulated) debt instruments. The perceived need to issue specific regulations is an inefficiency in the capital markets for banks, insurance companies and potentially corporate taxpayers in that, it is submitted, it may not be needed but is rather imposed, as a matter of practice.

1.5 Q4.4(g) - Structural Contingencies

A "facts and circumstances" test is the only way which the so-called structural contingencies referred to in paragraph 4.60ff could be cured. As noted in our introductory remarks, we believe that the "single organising principle" with its defined extensions and restrictions of legal form work well generally.

In passing we note the comments in paragraph 4.64:

> "A formally non-contingent obligation between related parties is not intended to be an ENCO if there are no practical consequences for non-performance."

While there are comments in the Explanatory Memorandum to New Business Tax (Debt and Equity) Bill 2011 (the 'Explanatory Memorandum') to this effect, it is submitted that they are not supported by the text of the Division. If related parties have the contractual intent to create an obligation for one party and there is nothing in the "pricing, terms or conditions" which would suggest that the obligation is "in substance or effect" not an existing one then it is an obligation to which section 974-135 can apply. It is submitted that it is not permitted to infer from subsection 974-135(7) that if there are no practical consequences if the obligor does not fulfil the obligation, then there is no ENCO since that provision deals with the converse situation.

Further, there is nothing in the case law to support a dichotomy as a matter of principle of the type of obligations between related parties on the one hand and unrelated parties on the other. Any difference would only be found as a matter of fact: *FC of T v Ashwick (Qld) No 127 Pty Ltd Ors* 2011 ATC 20-255 at [88] per Edmonds J.

2. Related Schemes (including Question 4.5 - The Interaction between a single scheme and a related scheme)

We agree that because the concept of a scheme is broad, there is a risk that a course of conduct or action could be seen as part of a larger single scheme (as described in paragraph 4.75).

Although the Commissioner has the ability to determine that related scheme provisions should not apply, we consider that 'related schemes' are defined very broadly (as per paragraph 4.79). In particular, although it is acknowledged in the legislation that schemes are not related *merely because* one refers to the other or they have a common party, since the related scheme provisions are of broad application there is a risk that they will apply in unintended circumstances.

For instance, in circumstances where a special purpose vehicle is to be capitalised for the first time, it would be usual to expect a combination of debt and equity funding. Initial funding arrangements may give rise to a related scheme under sections 974-15 or 974-70 which can result in all the interests on issue initially being characterised as either wholly debt or wholly equity. Neither of these outcomes seems commercially sensible and in particular where the debt/equity character of the interests on issue will need to be re-determined when the debt interests have been repaid or refinanced.

Where both debt and equity interests are issued for a single initial financing or funding requirement – they may be related either because:

(b) one of the schemes would, from a commercial point of view, be unlikely to be entered into unless the other scheme was entered into; or
(d) one scheme complements or supplements the other.

In these circumstances, it may be clear that the parties did not intend the combined economic effects of the constituent schemes to be the same as, or similar to, the economic effects of a debt or equity interest. However, because of the potentially broad operation of the rules, the position is far from clear given the initial funding may be regarded as complementary in the context of an initial acquisition and initial funding issues are reasonably commonplace. This is in part because even where the capitalisation of equity precedes the debt funding, which would be usual, although a relevant consideration it may nonetheless be regarded as a single arrangement due to the broad definition of a 'scheme'.

This position could be improved with additional safe harbours for initial financing or by way of further examples in the regulations.

ATO ID 2003/870 provides an example of where shares and loan notes resulted in wholly debt interests arising. The facts in that ATO ID involved stapled shares and loan notes which is defined as a related scheme in 974-155. However, shareholder agreements which prescribe how debt and equity distributions are agreed to be made are commonly used and may also suggest that the schemes are related for these purposes, notwithstanding the parties' intentions.

It would be useful if the regulations (or the legislation) could provide some clear and commercial examples where two or more schemes are not related schemes as provided in 974-155(4). This could usefully include an initial capitalisation of debt and equity which will together fund a specific acquisition. For example, 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*".

3. Question 5.1 – Issues Questions re the existing operation of 974-80

One of the principal difficulties in applying section 974-80 is identifying the integrity concerns that it was directed to apply to, and identifying the limits to which it does apply.

Section 974-80 was originally introduced to counter certain financing structures being used by banks that qualified as Tier 1 capital for capital adequacy and regulatory purposes but which were characterised as debt interests for tax purposes.

Under such arrangements, a tax deduction could be obtained for interest payments despite the fact that, when viewed in its entirety, the structure provided contingent returns to the ultimate investor.

Examples 2.9 and 2.10 of the Explanatory Memorandum to the *New Business Tax System (Debt and Equity) Act 2001* (Cth) both deal with Australian resident banks establishing structures which provide ultimate investors with returns contingent on the economic performance of the bank but which, apart from the operation of section 974-80, would not give rise to an equity interest in the bank.

The example provided in the Explanatory Memorandum and included at paragraph 5.11 of the Report has the important feature that it may convert debt interests into equity interests 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.

Because 974-80 is intended to apply only where there is a scheme that has a deliberate design and purpose, for the reasons noted under the ‘related scheme’ rules, we consider that 974-80 should only apply where on an objective basis it would be concluded that the parties intended that the effect of the scheme is to be the same as or similar to the economic effects of a single equity interest.

It had been widely understood, given the background to the introduction of section 974-80 and the requirement that there be a scheme with a specific design, that the operation of section 974-80 was limited.

It is a result of recently shared views of the ATO's interpretation, that significant uncertainties now exist with the application of section 974-80.

For example, there is now uncertainty in a number of aspects in interpreting 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. However, the ATO Discussion Paper notes that the word 'return' in paragraph 974-80(1)(a) is not asterisked, and accordingly analyses why the defined meaning under 995-1 is appropriate in the circumstances. There is clearly potential for confusion where the word 'return' is used in two different senses in paragraph 974-80(1)(a) and 974-80(2). A consequence of the wider meaning applying in section 974-80(1)(a), is that 974-80 would apply where a connected entity makes an interest-free loan to the company, which is not appropriate or sensible.

- 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.

These examples do not even touch on the issue of the ATO's interpretation of 'connected entity', relevant to section 974-80(1)(b), which has certainly raised questions about whether their views on 'influence' between two entities can be supported.

The Taxation Committee submits that the application of section 974-80 needs to be clarified as a matter or priority and urgency.

For example, we consider that in the case of stapled arrangements, it should be made clear that 974-80 will not apply unless the overall effect is to produce a return on an overall equity interest. Where there is an equity interest in the debtor company as well as an equity interest in the creditor trust, then the cross staple debt interest should not be re-characterised to equity unless it is considered a related scheme to the subscription of the equity interests in the debtor/creditor entities . This should be clarified.

In summary, we consider that the policy objective of the related scheme rules may already deal with the integrity objectives that section 974-80 is also apparently or seemingly seeking to address. One way to ensure there is no overlap would be to exclude 974-80 in circumstances where the ultimate investor has an equity interest in the debtor company and accordingly is already a direct equity holder.

4. Related Schemes and Section 974-80

Given the issues raised above and throughout this paper highlighting the uncertainty surrounding the interpretation of section 974-80, there should be a consideration of whether section 974-80 should be retained. If it were repealed, its only replacement would be through the continued existence of the related schemes rule. The related scheme rule was introduced to address two or more related instruments which, when viewed as a single scheme, produce a notional equity interest in a company, despite the fact that when viewed separately, the actual interest in the company would not give rise to an equity interest.

In the context of stapled groups, it is important to note is that the related scheme rule was specifically contemplated for use in respect of stapled interests (refer the Explanatory Memorandum at paragraph 2.53).

There is an argument that the related schemes rule could apply to the scenarios targeted by section 974-80 without the same difficulties of interpretation outlined throughout this paper. As an example, the purpose test applied in the related schemes rule arguably operates with greater simplicity.

Importantly, subsection 974-70(4) also provides the Commissioner with the discretion to determine that the related schemes rule does not apply where it would be unreasonable. This being an important omission in section 974-80.

Where a related scheme includes a scheme which is based on stapled instruments, then the application of the related scheme rules in the context of a stapled financier trust raises unresolved questions. This includes:

(a) Are debt instruments between entities across a stapled group 'related' schemes because of the mere fact that there is a stapled group?

(b) Are debt instruments between entities across a stapled group to be re-characterised as 'equity' instruments because of the operation of section 974-80?

In the context of stapled groups, there is 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.

We submit that where a single initial financing or funding requirement is to be satisfied by the issue of both debt and equity interests, including debt interests across a stapled group, then neither the related scheme rules nor section 974-80 should have operation to re-characterise the debt interest into an overall equity interest or into a separate equity interest. This is because:

- The schemes should not be considered a single scheme;
- The schemes should not be considered 'related' merely because they are held by a common party;

- The schemes should not be considered ‘related’ because the parties intended that each of the debt interest and the equity interest serve different funding needs as part of the overall project finance;
- the parties would not on a subjective basis or an objective basis intend 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; and
- The schemes should not be considered ‘related’ because they are based on stapled instruments, where the stapled instruments are equity arrangements that are put in place to manage the commercially unacceptable risks of Division 6C of the *Income Tax Assessment Act, 1936* (**ITAA36**) applying.

We also consider that where schemes would not otherwise be considered ‘related schemes’, then section 974-80 should not operate to ‘override’ the debt and equity character outcome. Stapled entities should not be treated as ‘connected’ entities, simply because they are stapled and equally funding arrangements across stapled entities should not be treated as ‘related schemes’ simply because they are between stapled entities/groups.

However, for the reasons noted earlier, we consider that this 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 to be the same as or similar to the economic effects of a single debt or equity interest. This will include in particular where a debt interest may convert into an equity interest and where that conversion may reasonably be considered likely;
- Section 974-80 should be abolished or at least confined to its original targeted integrity consideration – that is, section 974-80 should not apply where the ’ultimate investor’ has an existing equity interest in the company that is funding a return on a debt interest because in these circumstances, the ultimate investor has an existing opportunity to receive returns on its equity interests in the company and accordingly the debt interest should only be re-characterised to be considered as an equity interest where it is in fact a related scheme and where the notional ‘related’ scheme meets the overall ‘equity’ test.

5. Stapled structures (including Question 5.2 – are there any significant practical difficulties which arise with the application of section 974-80 to stapled structures?)

(a)(i) - Nature of discretions or contingencies

Subsection 974-80(2)(b) currently provides that an interest under subsection 974-80(1) will be equity where the right to the return on the interest or the amount of the return is at the discretion of the company or a connected entity of the company. We submit that subsection 974-80(2) is not so broad as to capture all discretions and should be clarified to confirm this.

In the context of a staple with a loan from the trust to the stapled company, there are usually two types of loans made; interest free and interest bearing. The interest bearing loans may give rise to additional discretions on the part of the stapled trust as there will be interest income.

That said, it is always open for two parties to a contract to vary the contract, and hence, it is always open for the company and the stapled trust to vary the terms of the loans via mutual agreement, including the interest rate and maximum term.

It is generally uncommon for the terms of the loans to allow one party any discretion, other than a discretion on the part of the lender to demand repayment at any time, and the borrower to be able to repay the loan at any time. There may be subordination terms for the protection of senior lenders to the stapled company group which may fetter such a discretion.

(a)(ii) and (iii) - Connected entity and Associate

The definition of a 'connected entity' is provided by section 995-1 which directs the reader to the definition of 'associate' in section 318 of the ITAA36..

The word 'associate' is given an extremely broad meaning by section 318 of the ITAA36. In particular, 'associate' is defined to include an entity which 'sufficiently influences' the primary entity or another entity which is 'sufficiently influenced' by the primary entity (or an associate of the 'primary entity'). While section 318 reads in a rather convoluted manner, it is clear that the intention of the drafters was to make this an extremely wide-reaching provision. Subsection 318(6) provides that:

> *a company is sufficiently influenced by an entity or entities if the company, or its directors, are accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of the entity or entities (whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts).*

The Taxation Committee submits that the fact that a company is required under a stapling deed to consider doing any thing at the request or direction of the financier trust does not alter the fact that the directors of the company still need to make their own decision that to do so is in the interests of the company. In particular, *Buzzle Operations Pty Ltd (In Liq) v*

Apple Computer Australia Pty Ltd (2011) 81 NSWLR 47 suggests that 'acting in accordance with' does not merely mean complying with the directions, instructions or wishes of another but doing so without any effective decision making on the part of the principal entity.

Practically, there will always be some kind of relationship between stapled entities, and stapled entities can be expected to operate with their interests aligned (as they have common investors by definition). However, this should not of itself amount to stapled entities being associates on the basis that one sufficiently influences the other.

(b) - Specific integrity concerns

Stapled structures by their nature allow another layer between a company and its investors where interests are issued by the company to a stapled entity. It can also be expected that the objectives of the stapled entities will be aligned to some extent, as both will wish to maximise value for their investors (whether or not they have common governance).

Where distributions flow through to investors, there is no mischief in holding different interests in stapled entities. The debt/equity outcomes for the stapled company should be the same as if the investors held the interests in the company directly. If the distributions do not flow through to investors, then to the extent that they do not flow back to the stapled company there is similarly no mischief. In the case of a loan repayment, it is always open for the lender and the borrower to agree to readvance the borrowing. This occurrence should be dealt with in the same way as what would occur under the ordinary debt/equity rules.

(c)(ii) - Clarification of the law

As stated above, the Taxation Committee submits that the law needs to be clarified as to whether, and how, the related scheme provisions apply to stapled structure arrangements. The following comments apply to loans from a stapled trust to a stapled company.

The definition of a related scheme is potentially wide enough to treat shares issued by a company to investors and loans issued by the company to a stapled trust as related schemes where, as a consequence of the terms of the loans, they would unlikely have been entered into without the shares being issued (refer paragraph 974-155(2)(b)). As there must be at least two parties to a loan, a loan would not be entered into unless the terms were either favourable to both parties, unless there exists another interest which hedges the economic outcome of the loans (eg the shares). Hence, the determination of whether the loans are related to the shares is likely to be influenced by whether the terms of loan are arm's length.

However, as a consequence of the existence of the stapled entity, it is submitted that it is highly unlikely that paragraph 974-15(2)(c) or paragraph 974-70(2)(c) would be satisfied. This is because from the perspective of the company, the economic effects should be reflective of their legal form. Any other parties' intentions can only be imputed to the company if they were a party to the scheme. The trust only holds the receivable side of the loan so there could be no combined impact imputed via the trust. The intention of the investors could be imputed as they would be party to one of the schemes, being the shares. But the investors do not hold the loan. For the investors to intend (and the company to know) that the combined impact of the schemes to be the same or similar to the economic effects of an equity interest they would need to trace through the trust.

(d) - Priority - related scheme or section 974-80

Arguably, through the operation of section 974-80(2) which states that the interest specified in section 974-80(1) is an equity interest 'if the interest does not form part of a larger interest that is characterised as a debt interest... under Subdivision 974-B', there already exists a priority arrangement in that the related schemes rule overrides section 974-80.

That said, as stated above, we submit that section 974-80 should be abolished or at least confined to its original targeted integrity consideration – that is, the issue of equity by banks which qualified as Tier 1 capital for capital adequacy and regulatory purposes but which was characterised as debt interests for tax purposes.

If section 974-80 is not abolished or confined in this way it should at least be confined to situations where there is an arrangement between the company and the connected entity to 'pass back' non-contingent returns to the company thereby resulting in the interest in the company being an equity interest from an economic substance perspective.

If a decision is made to retain section 974-80, we submit that the reference to 'return' in subsection (1) should be amended to read '*return' so as to ensure that section 974-80 does not apply to a return of principal.

We consider that the policy objective of the related scheme rules may already deal with the integrity objectives that section 974-80 is also apparently or seemingly seeking to address. One way to ensure there is no overlap would be to exclude section 974-80 from applying in circumstances where the ultimate investor has an equity interest in the debtor company and accordingly is already a direct equity holder.

6. Question 10.2 – Tax Arbitrage

The Taxation Committee considers that Australia has an appropriate debt versus equity divide for Australian tax purposes supported by robust tax integrity rules, including anti-avoidance rules to deal with any tax arbitrage or hybrid issues as they may affect the Australian Revenue. It is submitted that such rules would need to be framed in conjunction with our trading partners to ensure such rules were effective. Accordingly, and subject to the details of any specific rules to address hybrid arrangements (such as removing dividend exemptions), we would expect that such rules should not ordinarily alter the debt versus equity character of finance instruments for Australian tax purposes.

Further, should it be necessary to make changes to our rules, then there needs to be a transitional rule that preserves the existing treatment for existing financial arrangements.

We note that it would be difficult for any changes to be made on a unilateral basis without giving rise to the potential to create double taxation. Accordingly, it would be preferable that changes are co-ordinated on a multi-lateral or at least bi-lateral basis. If the latter, then perhaps the focus could be on the jurisdictions that are seen to give rise to the highest tax risk.

We trust these comments are of assistance. Please do not hesitate to contact the Committee Chair, Mark Friezer, on 02-9353 4129 or by email: mfriezer@claytonutz.com should you wish to discuss these matters further.

Yours sincerely,

John Keeves
Chairman, Business Law Section