It's time for certainty on the debt front

3 November 2014

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Abstract: The equity override rule in s 974-80, which is part of the debt/equity rules contained in Div 974 of the Income Tax Assessment Act 1997 (Cth), is clearly in need of reform in order to provide taxpayers and the ATO with the certainty, coherence and simplicity once promised by the debt/equity rules. Some current developments, including a review by the Board of Taxation, have given hope that that reform will be achieved. This article sets out the background of s 974-80, its uncertain purpose, scope and application (including some particular areas of uncertainty), and then provides some context to the need for reform, including consideration of the ATO's administration of the provision. The article has particular regard to the section's application to the infrastructure industry, where the uncertainty created by s 974-80 has affected listed entities and future investment structures.

Introduction and context

In 2001, Australia introduced comprehensive debt/equity rules contained in Div 974 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). These rules were designed to provide "greater certainty, coherence and simplicity".[i] By this measure, there is little doubt that the equity override rule contained in s 974-80 is broken and needs to be fixed.

Taxpayers and the ATO appear to be aligned in this respect[ii] and the taxpaying community have lived with hope for reform since the 2011-12 Budget announcement "Debt/equity tax rules — clarification of the scope of an integrity provision".

With the debt/equity rules now the subject of a Board of Taxation review,[iii] and s 974-80 a key feature of this review, there is again hope for reform of this troublesome provision — hopefully providing taxpayers and the ATO with the certainty, coherence and simplicity once promised by the debt/ equity rules.

This article will set out the background of s 974-80, its uncertain purpose, scope and application (including some particular areas of uncertainty), before providing some context to the need for reform, including consideration of the ATO's administration of the provision. The authors will have particular

regard to the section's application to the infrastructure industry, where the uncertainty created by s 974-80 has affected listed entities and future investment structures.

Background and policy intention

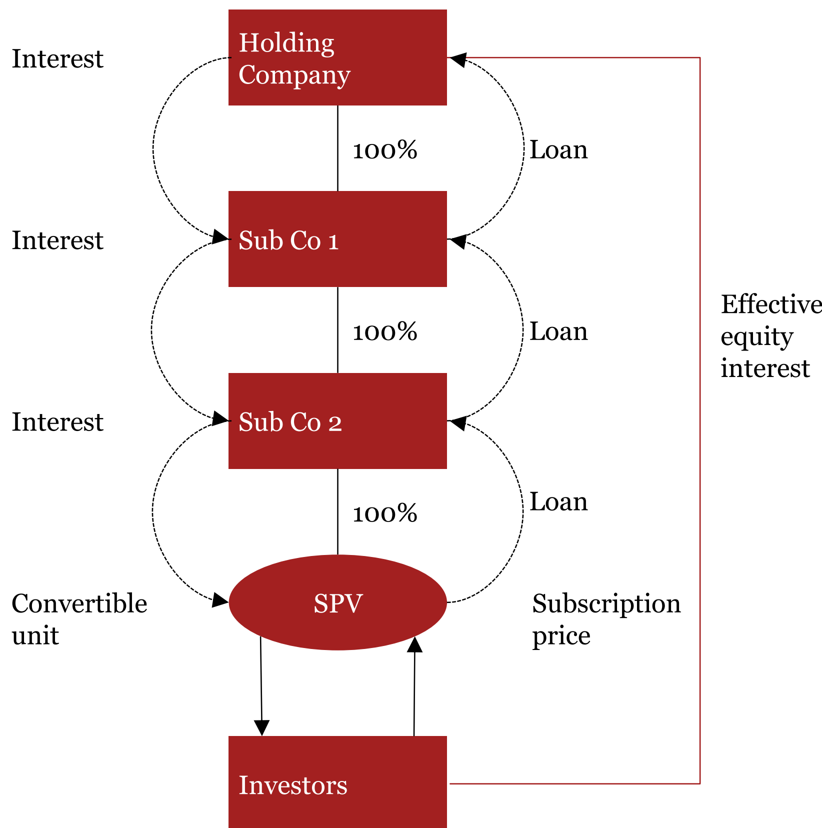
Section 974-80 was introduced in July 2001 as part of the comprehensive debt/equity rules. The policy intention of the section appears to have been directed towards preventing the deductibility of equity-like regulatory capital.[iv] However, the scope and application of the provision has been unclear from the time when it was first introduced.

The explanatory memorandum to the New Business Tax System (Debt and Equity) Bill 2001 emphasised s 974-80's application to structured finance arrangements with the illustrative diagram (see Diagram 1) and both examples (examples 2.9 and 2.10) concerning the raising of deductible regulatory capital.

Notwithstanding the explanatory memorandum's focus on structured finance arrangements in the examples of s 974-80's application, the purpose of the provision is otherwise expressed more broadly within the explanatory memorandum. This is well summarised by the Board of Taxation's review of the debt and equity tax rules which suggests the intention of the provision was:

"... to apply where there is an effective equity interest in a company even though the holder of the interest had no direct interest in the company."

Diagram 1



Moreover, unfortunately for those desiring clarity in the scope of application of the provisions, the statutory text is similarly non-finance specific and therefore is potentially broad in application. This potentially broad application was highlighted (controversially) in the ATO's discussion paper released through the National Tax Liaison Group Finance and Investment Sub-committee discussed below.

Current issues with s 974-80 and interpretative products

Despite the 2007 discussion paper commencing with an acknowledgment of the provision's specific purpose noting that:[v]

"At the time section 974-80 was introduced, instruments marketed as 'deductible Tier 1' instruments were being issued by some banks. Such instruments were said to provide returns to investors that were deductible under tax law while qualifying as Tier 1 capital for regulatory purposes for the issuing bank."

It would seem that section 974-80 was enacted to prevent a deduction arising under these arrangements.

However, it quickly departs from this relatively uncontroversial notion by setting out a series of interpretive principles relating to the provision which means that s 974-80 could apply to even the most vanilla of arrangements.

Some of the controversial notions suggested in the 2007 discussion paper included interpretations relating to:[vi]

- "the nature of the interest which must be held by an ultimate recipient;
- the degree of connection between the return on the interest issued by the relevant company and the return to be paid to the ultimate recipient;
- when an interest should be considered to be part of a larger debt interest; and
- the identification of the relevant parties to the transaction."

The joint bodies (including The Taxation Institute of Australia, the Institute of Chartered Accountants of Australia, CPA Australia and the Corporate Taxpayer's Association) set out a detailed submission to this discussion paper suggesting that:

- s 974-80 should be properly interpreted as only applying where the ultimate recipient holds an equity interest (rather than also applying to circumstances where intermediate entities held equity-like interests);
- the section should only apply when "there is a clear and identifiable relationship between the return paid on the interest issued by the company and the return paid on the interest held by the ultimate recipient and every interest in between"; and
- s 974-80(2), particularly the suffix that "the interest does not form part of a larger interest that is characterised as a debt interest in the entity in which it is held, or a connected entity", should be interpreted as asking "does the entire arrangement (that is, considering the instruments issued by the company and all connected entities) conclude with a debt interest held by the ultimate recipient?".

These significant differences in opinion were never ultimately resolved and the 2007 discussion paper was withdrawn later in 2007. This continued uncertainty led to a proposal for legislative reform in the 2011-12 Budget. The 2011-12 Budget contained an announcement entitled a "clarification of the scope of an integrity provision" that discussed amending s 974-80 so that it would only apply where "both the purpose and effect is that the ultimate investor has, in substance, an equity interest in the issuer company" and also suggesting giving the Commissioner discretion to not apply the provision if it was unreasonable.

However, since the 2011-12 Budget announcement, there has been no public discussion of concrete legislative reform. Further, the ATO has continued to undertake compliance activity (particularly in relation to the infrastructure sector and stapled entities) consistent with the views expressed in the 2007 discussion paper.

TR 2012/D5 represents a public example of the uncertainty regarding the interpretation and application of s 974-80 that has continued even after the 2011-12 Budget announcement.

This draft ruling was entitled "Income Tax: debt and equity interests: when is a public unit trust in a stapled group a connected entity of a company for the purposes of s 974-80(1)(b) of the Income Tax Assessment Act 1997" and was released for public consultation on 25 July 2012 before being withdrawn on 6 November 2013 after a series of negative submissions. The draft ruling was principally concerned with setting out the circumstances where stapled trusts and companies would be connected entities, which is a necessary condition to establish in order to apply s 974-80 to cross-staple loans.

Given the critical importance of this interpretational issue, it is a sad indictment that the submissions from professional bodies and accounting firms were nearly universal in condemning the paucity of reasoning in the ruling and recommending its amendment or withdrawal.[vii] The ATO responded by withdrawing the draft ruling on 6 September 2013. However, the withdrawal notice suggested it would be replaced by a practice statement which has yet to be issued (though rumours suggest that a practice statement regarding s 974-80 may be released imminently).

Accordingly, taxpayers (particularly taxpayers in the infrastructure and property sectors) are continuing to labour without guidance in respect of a critical issue relating to s 974-80, while the ATO has continued to actively undertake compliance activity in the area. Certain listed groups have provided significant detail in respect of ongoing audits, for example, SP AusNet (now Ausnet Services) noted in its 2014 half-year accounts that it is being audited by the ATO. The report stated:

"On 11 Sep 13, ATO formally notified SP AusNet of its intention to review the Group's intra-group financing arrangements.

Primary Audit scope to consider application of debt and equity rules, under Division 974 of the Tax Act 1997, focussing on classification of loans between SP AusNet Finance Trust ('Finance Trust') and group companies … Section 974-80(2) does not apply to SP AusNet

Finance Trust Loans, because the loan principal and interest payment obligations are noncontingent obligations; the payment of interest and returns from Finance Trust to unit holders is nondiscretionary; and the Finance Trust loans do not confer a right to be issued with an equity interest."

It is important to note that this audit commenced just one week after TR 2012/D5 was withdrawn, and that it concerns the application of s 974-80 to cross-staple loans. It is a good example of the difficulties that taxpayers are facing where the ATO are undertaking active compliance activities in the absence of public rulings or guidance. These difficulties are no doubt a contributory factor to the 45% decline in the number of ASX-listed infrastructure entities from 2007 to the date of this article.

Proposals for reform

It is in this context that the authors urge the Board of Taxation to propose urgent reform of this vexed provision and for the ATO to provide clear, appropriate guidance as to its interpretation in the interim.

It is important that this reform is comprehensive and considers all problematic aspects of s 974-80. In this respect, the authors suggest that the reform goes beyond the (welcome) changes recommend in the 2011-12 Budget announcement. The starting point of this reform should be whether s 974-80 is even required.

The debt/equity rules are generally effective in providing substance over form treatment of financing arrangements and the general anti-avoidance provisions should be appropriate for defeating artificial or contrived arrangements which may overcome those rules. As can be seen from the problems discussed above, targeted anti-avoidance rules suffer from a tendency to be unclear in application and breadth.

However, if total repeal of the section is unpalatable, then the authors would recommend that the provision be improved by all or some of the features discussed. One of the significant uncertainties in the current provision is the "designed to operate" requirement in s 974-80(1). This test should be clarified to ensure that it will only operate where there is a scheme with a sole or dominant design, and where that design can be adduced from objective evidence of a clear purpose.

The interpretation of "connected entity" should be clarified, particularly in respect to its application to stapled groups. Stapled entities should not be assumed to be connected unless there are particular unusual circumstances, eg an unusual unitholder agreement or trust deed. Further, and most importantly, there should be a consistency of interpretation among similar provisions (eg the definition of "associate" in s 318 of the Income Tax Assessment Act 1936 (Cth) or control for the purposes of Div 820 ITAA97).

Section 974-80(2) should be amended to incorporate the debt test contained in s 974-20 ITAA97 (eg in particular, clarifications around when an effectively non-contingent obligation exists and concessions in this respect such as s 974-135(5) ITAA97). This is vital to ensure that the substance over form nature of the debt/equity rules is preserved.

Finally, in acknowledgment of the inherent difficulties of such a targeted anti-avoidance rule, any reforms to s 974-80 should include providing a residual power to the Commissioner to not apply s 974-80 where no effective equity interest exists.

Until such reform is enacted, the authors would propose that urgent action is taken to provide an interim remedy in respect of the section:

- by repealing the existing provision while an alternative is drafted (if it is concluded that a complete repeal of the provision is not an appropriate outcome of the review); or
- by an ATO administrative concession which would provide that the ATO will not undertake further compliance action on this issue while any reforms recommended by the Board of Taxation are being developed and enacted. An administrative concession such as this would be consistent with the ATO's approach to many other significant tax announcements — see, for example, the ATO's administrative treatment[viii] in relation to CGT look-through treatment for earn-out arrangements.

Conclusion

In this article, it has been demonstrated that there are many issues with this most difficult of debt/equity provisions. The uncertainty regarding s 974-80 is significant and has made attracting capital (both foreign and listed) to Australia's infrastructure sector more difficult. Reform is urgent and is required and the current Board of Taxation represents the best opportunity for this reform. Finally, the authors have recommended some of the measures which could provide the certainty that taxpayers require.

Let's talk

To have a deeper discussion about these issues, please contact:

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[i] Para 1.9 of the explanatory memorandum to the New Business Tax System (Debt and Equity) Bill 2001.

[ii] Refer, for example, to the issuance and withdrawal of the ATO's discussion paper "Interpretative and policy matters concerning the application of section 974-80 of the Income Tax Assessment Act 1997" (the "2007 discussion paper") in respect of the ATO's equivocation on this matter, or the numerous private sector submissions in relation to this discussion paper for evidence of the private sector's disdain for the provision.

[iii] The "Review of the debt and equity tax rules" including the discussion paper of the same name.

[iv] For example, structures like those considered in St. George Bank v FCT [2009] FCAFC 62.

[v] For example, see the structure of the arrangement in Macquarie Finance Limited v FCT 2005 ATC 4829, although it was held by the Full Federal Court not to be deductible.

[vi] Joint bodies submission to the ATO in relation to the 2007 discussion paper.

[vii] See, for example, "Joint submission by Institute of Chartered Accountants Australia, The Tax Institute, Institute of Public Accountants, CPA Australia and Taxpayers Australia Draft Taxation Ruling TR 2012/D5" and "Draft Taxation Ruling TR 2012/D5 — PwC submission".

[viii] Available at www.ato.gov.au/General/Newlegislation/In-detail/Direct-taxes/Income-tax-oncapital-gains/Look-through-treatment-for-earnoutarrangements.Accessed 1 September 2014.

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