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Tax Insights

Exposure draft to improve the debt equity rules

Snapshot

On 10 October 2016, the Government released exposure draft (ED) legislation and explanatory memorandum (EM) setting out proposed amendments to improve the debt-equity rules in Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997) as recommended by the Board of Taxation (BoT) in its March 2015 report.

The ED proposes to introduce a new rule (the scheme aggregation rule) for determining when two or more schemes should be treated as a single scheme for debt-equity purposes. The scheme aggregation rule is intended to replace the existing related schemes provisions and the overarching integrity provision in section 974-80.

The Government has also released an ED legislative instrument which sets out a number of examples to guide taxpayers on how the new scheme aggregation rule should apply in various circumstances. Importantly, such instruments have legislative character and have the purpose of ensuring new provisions, once enacted, are easy to understand and use.

The ED proposes to introduce a new rule, “the scheme aggregation rule”

Why are the amendments required?

The debt-equity tax rules in Division 974 ITAA 1997 were introduced in July 2001 to provide a means by which financing arrangements were to be characterised as debt or equity interests for taxation purposes. The rules look broadly to the economic substance of arrangements, rather than their legal form.

However, following a broader review of the debt-equity tax rules in 2014, the BoT noted that significant uncertainty was created by two aspects of the debt-equity rules: the related schemes provisions and section 974-80. The BoT recommended that these rules be replaced with a new single provision to identify when schemes should be aggregated for the purposes of the debt-equity rules.

The history of the amendments contained in the ED is captured in the following timeline.

March 2007	• ATO released discussion paper to NTLG members on section 974-80 interpretation and policy
November 2007	• ATO withdraws discussion paper following consultation with industry and professional bodies
May 2011	• Government announces amendments to section 974-80 with retrospective effect (ie. 1 July 2001) in 2011/12 Federal Budget
May 2013	• Government announces BoT's Post Implementation Review of the Debt and Equity Rules as part of its 2013/14 Federal Budget
March 2014	• BoT Discussion Paper released on Review of the Debt and Equity Rules
December 2014	• BoT accelerated report on Related Scheme (section 974-15 and 974-70) and Equity Override Integrity Provisions (section 974-80) provided to Government (report released to the public on 2 April 2015)
March 2015	• BoT final report on Review of the Debt and Equity Rules provided to Government (report released to public on 4 June 2015)
October 2016	• Government releases Exposure Draft legislation, explanatory memorandum and legislative instrument on 10 October 2016
November 2016	• Submissions close on 21 November 2016
Start date	• The amendments are proposed to apply to transactions entered into on a date fixed by Proclamation, or if there is no Proclamation, 6 months after Royal Assent

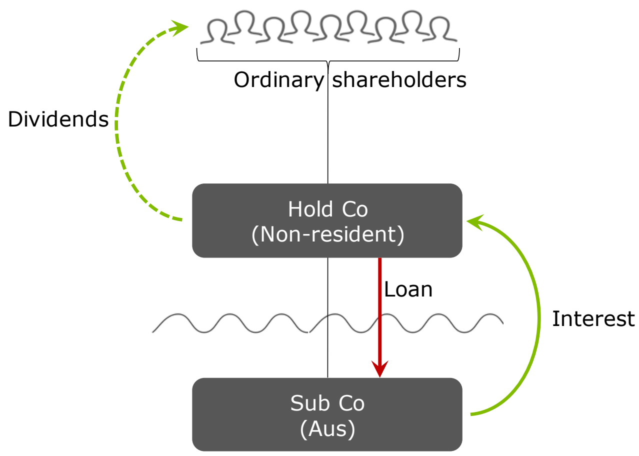
Equity override integrity provision (section 974-80)

The current section 974-80 was introduced as an integrity provision to ensure that for tax purposes, debt treatment would not be extended to certain arrangements where, broadly, a debt interest is issued to a connected entity, and the return paid to the connected entity is used to fund an equity-like return on securities held by a third person (the “ultimate recipient”).

The effect of section 974-80 is to re-characterise the debt interest issued by the underlying company as an equity interest, which effectively denies deductibility for the interest that the underlying company might pay in respect of the arrangement.

There are a number of specific examples in the ED legislative instrument which set out how the law is to apply in a range of scenarios

The operation of section 974-80 has been of concern for many years because of its far reaching application in a number of circumstances. To illustrate the potentially broad application of section 974-80, take the following simple example:



In this example, Hold Co (a non-resident company) lends an amount to Sub Co at a fixed rate of interest and the loan has no equity-like features. The loan would ordinarily satisfy the debt test in Division 974. Sub Co uses those loan funds to invest in its business activities. Hold Co periodically pays dividends to its shareholders (the "ultimate recipients") that may or may not match the annual interest receipts derived from its loan to Sub Co. Section 974-80 could potentially apply to the above example even though the loan from Hold Co to Sub Co has no equity-like features. This is because:

- Hold Co and Sub Co are connected entities;
- The return paid by Sub Co to Hold Co (the connected entity) is used to fund an equity-like return on a security held by a third person (the shareholders in Hold Co); and
- There may be a scheme that is designed to operate such that the return to Hold Co is used to fund a return to an ultimate recipient (the ordinary shareholders).

If section 974-80 applies, the loan from Hold Co to Sub Co could be classified as an equity interest for tax purposes, and Sub Co would be denied a deduction for interest payments made to Hold Co.

What is proposed in the ED?

The ED is based on the BoT's proposals for a new integrated rule as set out in its accelerated report to Government in December 2014. The ED proposes a new scheme aggregation rule for determining when schemes should be aggregated for Division 974 purposes and proposes to repeal section 974-80 ITAA 1997. Under the proposed scheme aggregation rule, schemes would be aggregated if the following two tests are satisfied:

- **the interdependence test** – which is satisfied if the pricing, terms and conditions of the schemes are interdependent in a way that would change their debt or equity treatment under Division 974. Specific carve-outs mean that if the interdependence test would only be satisfied because a related scheme merely:

  - funds a return, or
  - is stapled to, or
  - is subordinated to, or
  - merely involves the taking of security over another scheme,

  then the interdependence test would not be satisfied.

- **the design test** – under this test it must be objectively concluded that the schemes were **designed to operate** together to produce their combined economic effect. However, a link that is accidental, without any element of design, would not be sufficient to cause the schemes to be aggregated. In determining whether the design test would be satisfied, regard must be had to each of the following factors:

  - the nature and extent of any involvement of the parties to one of the schemes in any of the other schemes;
  - the way the schemes are entered into or carried out;
  - any dealing, between any of the parties to any of the schemes, that is not at arm's length;
  - the relationships between any of the parties to any of the schemes;
  - normal commercial understandings and practices; and
  - any other relevant matters.

Two or more schemes that satisfy the proposed scheme aggregation rule would be treated as a single scheme for the purposes of the debt-equity rules. The ED also contains a discretion for the Commissioner not to apply the scheme aggregation rule to particular schemes if he or she considers that applying the rule would be unreasonable.

In addition, there are a number of specific examples in the ED legislative instrument which set out how the law is to apply in a range of scenarios.

We expect that where taxpayers are setting up new structures or restructuring their business entities, they are likely to closely align their affairs to the examples in the ED legislative instrument.

The proposed amendments are intended to apply to transactions entered into on or after the commencement of the day fixed by Proclamation or, if there is no Proclamation, 6 months after Royal Assent. If the commencement date is made by Proclamation, a notice will generally appear in a government gazette.

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Transitional protection has also been proposed in the ED for those taxpayers that anticipated that the 2011/12 Budget announcement would be legislated as it was then announced. If a taxpayer relied on the 2011/12 Budget announcements, the Commissioner cannot amend an assessment between 10 May 2011 (the date of the 2011/12 Budget announcement) and the day before the amendments proposed in the ED commence.

Submissions on the ED are due by 21 November 2016.

Cross border financing

The Commissioner has indicated that cross border financing is a key focus area for the ATO. This raises a range of issues including the debt-equity rules, transfer pricing, thin capitalisation, interest withholding tax, and the general anti avoidance rule, amongst others.

The ATO's position has been strengthened in a series of recent cases: *Chevron* (transfer pricing), Orica (loan-ups and the general anti avoidance rule), *D Marks* (limited partnership provisions) and *Millar's case* (interest withholding tax). We have also recently seen a series of Taxpayer Alerts issued addressing various cross border financing arrangements.

Aside from the proposed changes to Division 974 in the ED, it will also be necessary to anticipate the announced anti-hybrid measures and the diverted profits tax (DPT). The DPT will take effect from 1 July 2017. At this stage, we have only seen the Treasury discussion paper (May 2016) but it is expected that an ED or legislation will be released shortly. A key area will be whether, and how, the DPT will operate in respect of financing arrangements. In addition, the Government has committed to introduce measures to give effect to the OECD BEPS Action 2 recommendations on hybrids. The hybrid measures could take effect from as early as 1 January 2018 (although this will require Royal Assent by 30 June 2017). The BoT and Treasury are still considering matters relevant to the design of the hybrid measures. No ED or legislation has yet been circulated. Collectively, the Division 974 changes, DPT and hybrid measures will significantly reshape the environment in which taxpayers need to plan to manage cross border financing, both existing arrangements and future funding.

Collectively, the Division 974 changes, DPT and hybrid measures will significantly reshape the environment in which taxpayers need to plan to manage cross border financing, both existing arrangements and future funding.

Taxpayers should be reviewing cross border financing arrangements in light of recent Court decisions, the current practice and views of the ATO and impending legislative amendments.

Submissions on the ED are due by 21 November 2016.

If taxpayers have comments or concerns with the ED, please speak with your Deloitte adviser or one of our contacts below.

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Contacts

David Watkins
Partner

Tel: 61 2 9322 7251
Mobile: +61 498 344 000
Email:
dwatkins@deloitte.com.au

Patrick Broughan
Partner

Tel: +61 3 9671 6606
Mobile: +61 420 278 389
Email:
pbroughan@deloitte.com.au

Mark Hadassin
Partner

Tel: + 61 2 9322 5807
Mobile: +61 419 970 163
Email:
mhadassin@deloitte.com.au

Tim Carberry
Partner

Tel: +61 3 9671 6634
Mobile: +61 404 832 852
Email:
tcarberry@deloitte.com.au

Jacques Van Rhyn
Partner

Tel: +61 7 3308 7226
Mobile: +61 414 586 241
Email:
jvanrhyn@deloitte.com.au

John Rawson
Partner

Tel: +61 8 8407 7158
Mobile: +61 414 407 166
Email:
jorawson@deloitte.com.au

Jonathan Schneider
Partner

Tel: +61 8 9365 7315
Mobile: +61 413 608 461
Email:
joschneider@deloitte.com.au