SUBMISSION 10

Mr Stephen Boyd
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House Standing Committee on Economics
Parliament House
Canberra
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Dear Stephen,

Limited Recourse Debt – Exposure Draft Legislation

Thank you for the opportunity to comment on Tax Laws Amendment (2012 Measures No. 6) Bill 2012 to clarify the definition of limited recourse debt.

The Property Council is the peak body for owners and investors in Australia's $600 billion property investment sector. The Property Council represents members across all four quadrants of property investment - debt, equity, public and private.

Where the limited recourse debt provisions are triggered, they claw back capital allowance deductions previously claimed.

The industry is concerned that several critical issues we addressed in our submission dated 13 August 2012 (attached) have not been addressed.

Specifically:

- **The definition of limited recourse debt is significantly broader than the policy announcement made in the 8 May 2012 Budget.**

  The proposed changes to the definition of limited recourse debt may apply to many standard financial arrangements. This creates uncertainty and jeopardises current and future legitimate projects.

- **The examples do not clarify the proposed new definition of "limited recourse debt".**

  It is unclear what set of circumstances must exist at the time that the loan is made for the Division 243 consequences to be triggered if the loan is subsequently not repaid in full.

- **The proposal is retrospective - it applies to debt already in place.**

  This unfairly penalises existing debt as loans that were not limited recourse debt may become limited recourse debt.

To demonstrate the adverse impacts of the proposed amendments, an example is included in Appendix A.

The simple solution to achieve certainty for taxpayers is a carve out (safe harbour).

A safe harbour would assist taxpayers to determine whether it is "reasonable to conclude" that the debt is limited recourse. Without a safe harbour there would be considerable uncertainty for taxpayers.

The safe harbour provides that:

- Loans are not specifically limited in recourse to particular assets of the debtor (ie. if the debt falls within s. 243-20(1) it would be limited recourse regardless of the gearing); and
  - Gearing within the entity is less than the thin cap safe harbor – ie. liabilities less than 75% of assets; or
  - Gearing is more than 75% but the lender has recourse to all assets of the debtor, and the loan is on arm's length terms.
- The assets of the entity that give rise to capital allowance deductions represent less than 50% of the entity's total assets.

At a minimum, the provisions should be amended to clarify that the provisions will have no operation where the relevant debt is fully repaid. As currently drafted, the complex provisions may be triggered even where the relevant debt has been fully repaid.

If the industry's submissions are not accepted, further clarity is required in relation to the operation of s. 243-20(6). Under this provision, an obligation will not be treated as limited recourse debt (by virtue of s. 243-20(1) to (3)) if, having regard to all the "relevant circumstances", it would be unreasonable to do so.

There is currently little guidance as to the practical operation of this provision. This could be addressed by including additional examples in the Explanatory Memorandum.

For instance, an example should be included to clarify that it would not be reasonable to treat an arm's length loan as limited recourse debt where the loan is fully repaid on disposal of the underlying property (refer to example in Appendix A which demonstrates how a loan may be treated as limited recourse debt even if is fully repaid).

Further details are contained in the attached submission.

Please do not hesitate to contact us if you have any queries.

Yours sincerely

Andrew Mihno

Executive Director International & Capital Markets

Property Council of Australia

Appendix A

1. Example of application to single property owning trust

Assume the following facts:

Trust A:

- is established with $20 of equity;
- enters into a debt facility with Bank A and draws down $80;
- acquires Property Z for $100.

Trust A provides security over all of its assets to Bank A in respect of the debt facility provided.

The $100 paid to acquire Property Z is determined to comprise the following:

Land and non-depreciable expenditure	$60
Buildings eligible for Div 43 allowances	$20
Plant & Equipment eligible for Division 40 allowances	$20

Trust A disposes of Property Z in Year 10 for $80 at which time:

- $5 of Division 43 deductions have been claimed;
- $20 of Division 40 deductions have been claimed;
- $0 of the debt has been repaid (as all of the income derived by Trust A has been distributed to its unitholders). The $80 proceeds from the sale are used to repay the debt.

The proposed amendments to Division 243 would apply to Trust A as Bank A in substance only has security over the financed property, being Property Z.

Division 243 treats the unpaid debt to be the debt that remains outstanding ignoring any of the debt that has been repaid from sales proceeds (s.243-15(3)(b) and s.243-35(4)). Therefore, for Division 243 purposes, the unpaid debt of Trust A in this example is $80, even though the debt has been fully repaid.

The method statement at s.243-35(4) broadly operates as follows:

	Original expenditure	Funded by debt	Revised expenditure (Limit)
Division 43	20	16	4
Division 40	20	16	4

The amount included in assessable income is worked out under s.243-40 and 243-35(1) as follows:

	Actual deduction	Limit	Assessable amount
Division 43	5	4	1
Division 40	20	4	16
	25	8	17

In this example, Trust A would be required to rely on s.243-20(6) that it would be unreasonable for the obligation to be treated as limited recourse debt otherwise an amount of $9 would be included in its assessable income. This occurs even though Bank A cannot claim a bad debt deduction.

The inequity is heightened where Trust A is 100% owned by another trust (Head Trust), and Head Trust provides the debt to Trust A (instead of Bank A). In this case, the beneficiaries of Head Trust are fully at risk for any loss on Property Z, but an amount is still included in the assessable income of Trust A which cannot be offset by the capital loss Head Trust will realise on winding up Trust A.

2. Proposed carve – out

2.1 Explanation

The effect of the proposed amendments to Division 243 is demonstrated in the example above. In our view, a safe harbour would help taxpayers to determine whether it is "reasonable to conclude" that the debt is limited recourse. Without a safe harbour there would be considerable uncertainty for taxpayers.

Broadly speaking, taxpayers should not be concerned with Division 243 if:

- Loans are not specifically limited in recourse to particular assets of the debtor (ie, if the debt falls within s. 243-20(1) it would be limited recourse regardless of the gearing); and
    - Gearing within the entity is less than the thin cap safe harbour – ie, liabilities less than 75% of assets; or
    - Gearing is more than 75% but the lender has recourse to all assets of the debtor, and the loan is on arm's length terms.
- The assets of the entity that give rise to capital allowance deductions represent less than 50% of the entity's total assets.

2.2 Recommended Amendment

Include new subsection 243-20(3B):

(3B) An obligation that is covered by subsection (2) is not a limited recourse debt if the obligation is not covered by subsection (1); and

(a) the debtor's liabilities are less than 75% of its assets;

(b) the debtor and creditor are dealing at arm's length in relation to the debt; or

(c) less than 50% of the cost of the debtor's assets qualifies for capital allowances.

Limited Recourse Debt

Property Council of Australia
August 2012

Submission

The Property Council's concerns with Treasury's paper 'Clarifying the definition of limited recourse debt' (the Proposal) are further detailed below.

(1) Executive summary

The PCA is of the view that the proposed changes contained within paragraph 35 of the proposal are much broader than contemplated by the Budget announcement. The proposed breadth of the amendments need to be consistent with the intention of the proposal.

If such broad proposals are implemented it would be necessary to:

- exclude subsidiary trusts of widely held unit trusts; and/or
- allow transitional rules so entities can restructure their affairs before the rules commence.

(2) Breadth of definition of limited recourse debt

Paragraph 2 of the proposal states that the proposed measure will affect the financing of projects where the borrower is a special purpose entity that has minimal or no other assets or income from other sources apart from the project assets.

Further, paragraph 35 of the proposal states that '*Section 243-20 will be amended to define a limited recourse debt as including arrangements where at the beginning, the creditors rights against the debtor, in the event of default in payment of the debt, are limited wholly or predominately (whether or not by contract) to certain rights in respect of the financed property or other property'*.

It is not clear what set of circumstances must exist at the time that the loan is made for the Div 243 consequences to be triggered if the loan is subsequently not repaid in full.

The Example [paras 36 ff] is intended to demonstrate a situation where the rule would be triggered but it is not clear from the Example whether the rule is being triggered because:

- the level of debt is too high relative to the level of equity injected into the entity – ie, an SPV must have an equity to debt ratio greater than 1 to 4; or
- the level of debt is too high relative to the value of the assets held by the entity – ie, an SPV must have assets worth at least 125% of the debt taken on by the SPV; or
- Bank B only has recourse to the assets and revenue of Company C irrespective of the level of equity or the value of the assets of Company C.

The proposal mentions in several places that this proposal is meant to apply only where the borrower is 'a special purpose entity' – for example in paragraphs 2, 6, 7 and 37. There is no acknowledgment in paragraph 35 that the measure is only intended to extend to special purpose entities.

It is important that the stated precondition to triggering Div 243 applies. This precondition makes the scope and operation of the provision much clearer. Read literally, the proposals contained within paragraph 35 could apply to any entity that has a borrowing not just special purpose entities (point 3 above).

Having regard to above discussion, the PCA submits that the changes to Division 243 should be limited to the changes contemplated in the Budget

announcement. That is, borrowings by entities other than special purpose vehicles that have been established to undertake a specific project should not be caught by the new measures.

This could be achieved through the introduction of thresholds/safe harbours designed to exclude relatively lowly geared entities. We would be happy to discuss this further with you.

(3) Exclusions from proposed changes

For various commercial and historic reasons, a widely held unit trust group typically has a large number of subsidiary trusts (and to a lesser extent companies) that hold investments in real estate assets. It may be the case that the subsidiary trusts and companies have significant loans from the parent widely held trust (or intermediate trusts or companies).

It is not possible for the widely held trust group to form a tax consolidated group, as the requisite requirements to do so are not satisfied. The PCA submits that subsidiaries of a widely held unit trust should not be subject to the revised Division 243 rules on the basis that such an exclusion provides a comparable outcome to the treatment of tax consolidated company groups.

To ensure the integrity of this exclusion, a requirement could be included that the exclusion is conditional upon the debt-to-equity ratio of the widely held unit trust group, when viewed as a whole. We would be happy to discuss the nature of this integrity measure with you further.

(4) Transitional provisions

The transitional rules associated with the revised measure should be considered in detail. In particular, we believe there is an element of retrospectivity to the proposal application date. By applying the new rules to loans already in place at 8 May 2012, existing loans that were not "limited recourse debt" may become limited recourse debt. Accordingly taxpayers who have acted in good faith under existing rules, and have made a loss on the underlying investment, will now also be faced with the unexpected outcomes that arise from debt being treated as limited recourse debt. We believe that the new definition of "limited recourse debt" should not apply to arrangements that commenced before 8 May 2012.

As a fall back, those entities not previously caught by Division 243 should be afforded the opportunity to restructure their affairs (in a tax effective manner) prior to the commencement of the revised Division 243.

(5) Other comments

If the revised Division 243 is triggered, the additional amounts included in the taxpayer's assessable income should be limited to deductions actually claimed or claimable. For example, if capital allowance deductions claimed in prior years gave rise to a tax loss that has subsequently been denied due to a failure of the tests required to carry forward income tax losses, the assessable amount should not include these denied deductions.