SUBMISSION 8

Institute of Chartered Accountants Australia

20 December 2012

Committee Secretary
Standing Committee on Economics
PO Box 6021
Parliament House
CANBERRA ACT 2600
AUSTRALIA

By email: economics.reps@aph.gov.au

Dear Sir or Madam

Limited recourse debt amendments in the Tax Laws Amendment (2012 Measures No. 6) Bill 2012

The Institute of Chartered Accountants in Australia (**Institute**) welcomes the opportunity to comment on the legislation (**the Bill**) and accompanying explanatory material (**EM**) to amend the definition of "limited recourse debt" in Division 243 of the *Income Tax Assessment Act* 1997 (**ITAA 1997**) which is contained in Schedule 6 of the Bill (**the Division 243 Amendments**).

The Institute is the professional body for Chartered Accountants in Australia and members operating throughout the world. Representing more than 70,000 current and future professionals and business leaders, the Institute has a pivotal role in upholding financial integrity in society. Members strive to uphold the profession's commitment to ethics and quality in everything they do, alongside an unwavering dedication to act in the public interest.

The proposed amendments broaden the scope of Division 243. As the provisions of Division 243 were originally introduced in a simpler form, expanding the definition of "limited recourse debt" runs the risk of inadvertently capturing ordinary commercial lending arrangements which are not intended to be caught by Division 243. If this was to occur the amendments would have the unintended outcome of stifling economic activity to some degree at a time of economic fragility for many industries.

To limit the risk of this adverse outcome occurring the Institutes recommends that:

- the Bill be amended to include a *de minimis* threshold for small businesses; and
- the EM be amended to provide greater clarity as to the ordinary commercial circumstances which will not be caught by the expanded definition of limited recourse debt.

The drafting approach taken by Treasury relies heavily on section 243-20(6) to prevent inappropriate outcomes from occurring. Section 243-20(6) applies to disregard the classification of a borrowing as limited recourse debt where "having regard to all relevant circumstances, it would be unreasonable for the obligation to be treated as limited recourse debt".

Customer Service Centre
1300 137 322

NSW
33 Erskine Street
Sydney NSW 2000

GPO Box 9985
Sydney NSW 2001

Phone 61 2 9290 1344
Fax 61 2 9262 1512

ACT
L10, 60 Marcus Clarke Street
Canberra ACT 2601

GPO Box 9985
Canberra ACT 2601

Phone 61 2 6122 6100
Fax 61 2 6122 6122

Qld
L32, 345 Queen Street,
Brisbane Qld 4000

GPO Box 9985
Brisbane Qld 4001

Phone 61 7 3233 6500
Fax 61 7 3233 6555

SA / NT
L29, 91 King William Street
Adelaide SA 5000

GPO Box 9985
Adelaide SA 5001

Phone 61 8 8113 5500
Fax 61 8 8231 1982

Vic / Tas
L3, 600 Bourke Street
Melbourne Vic 3000

GPO Box 9985
Melbourne Vic 3001

Phone 61 3 9641 7400
Fax 61 3 9670 3143

WA
L11, 2 Mill Street
Perth WA 6000

GPO Box 9985
Perth WA 6848

Phone 61 8 9420 0400
Fax 61 8 9321 5141

However, the EM provides limited guidance to taxpayers and the Australian Taxation Office alike as to the likely types of circumstances in which it is intended section 243-20(6) will apply to prevent the inappropriate application of Division 243. The EM should be expanded to include a range of real life like examples which illustrate where section 243-20(6) has work to do. The Institute includes three such examples in this submission.

If you have any queries regarding the content of this submission, please do not hesitate to contact me on 02 9290 5609 or Karen Liew 02 9290 5750.

Yours sincerely

Paul Stacey
Tax Counsel
The Institute of Chartered Accountants in Australia

Submission

1. Exclusion - De minimis threshold for small businesses

Consistent with the Government's policy of simplifying the tax system for small businesses, we recommend a de minimis threshold for the application of Division 243 based on the value of the debt. We suggest that a debt arrangement of $1 million or less be excluded from the definition of "limited recourse debt".

2. Examples of ordinary commercial transactions

The Institute is concerned that the amendments will inadvertently catch a range of normal lending arrangements which are not intended to be caught by Division 243 of the ITAA 1997.

We understand that the policy intent of the Division 243 Amendments is to ensure the limited recourse debt rules apply to special purpose vehicles (**SPV**s). This is evident from the EM accompanying the Division 243 Amendments.[1]

However, the amendments do not, for conceptual reasons, seek to achieve that purpose by inserting a statutory definition of SPV to which Division 243 applies. Instead, the drafters sought to achieve the policy intent by expanding the definition of "limited recourse debt" in section 243-20 of the ITAA 1997. This approach will have the effect of expanding the scope of the definition to encompass a range of continuing businesses not intended to be caught, subject to the operation of section 243-20(6).

It is therefore of critical importance that the EM provide clear guidance on the circumstances in which section 243-20(6) will operate. In the Institute's view the current level of guidance provided in the EM is insufficient. It should be expanded to include a number of examples based on real life scenarios, such as the three following examples.

Example 1 – An entity severely impacted by the global financial crisis

Subsidiary Co is an established company owned by an offshore company. In June 2007 it acquired a depreciating asset for $3.25 million financed by $650,000 of equity (contributed by its offshore parent) and $2.6 million of debt borrowed from Bank B. The debt is secured over all the assets of Subsidiary Co and not just the depreciating asset. Subsidiary Co depreciates the asset for tax purposes on a straight line basis over a 10 year period.

At the time of borrowing the market value of the financed asset and other assets of Subsidiary Co comfortably covered the value of the debt. However, due to financial difficulties caused by the ongoing global financial crisis Subsidiary Co on 30 November 2012 is no longer able to service its debt to Bank B and the value of its assets are less than the value of the debt. Subsidiary Co defaults on its repayments and Bank B appoints an administrator.

Issue

Under proposed paragraph 243-20(2)(b) Subsidiary Co's debt with Bank B will be limited recourse debt. This is because Bank B's rights against Subsidiary Co, in the event of default,

[1] Paragraph 6.7 of the EM states "[a] creditor's rights of recourse can be limited by contractual terms or by the overall effect of an arrangement, for example, where *a special purpose entity debtor* predominantly holds and operates the financed assets. In both situations, the debtor is not fully at risk with respect to…" (emphasis added).

are in effect limited to “the debt property” per draft subparagraph 243-20(2)(b)(i) as all of Subsidiary Co’s assets were security for the debt.[2]

The bank debt was not limited recourse debt at its inception in early 2007. The debt will be retested at the date of default. It is understood that Treasury considers that at this time section 243-20(6) will apply to prevent the debt being reclassified as limited recourse debt at that time.

If section 243-20(6) were not to apply then Subsidiary Co would have to include within its current year income tax return a claw back of excess capital allowances claimed over the amount of debt repaid for the last five years.[3] This would have the effect increase its tax burden at a time it is suffering financial difficulties as a result of the global financial crisis.

Example 2 – Business debt reorganisation

ABC Co is an established company running a business of manufacturing widgets. As part of its ordinary funding, ABC Co has external borrowings from XYZ Bank, which has been used to fund assets (including depreciable assets) as well as being used to provide working capital to the business. ABC Co provides XYZ Bank with a general (floating) security for the borrowings, over all asset of the business. The asset value of the other business assets is well in excess of both the debt and the depreciable assets at the time of borrowing.

Due to an economic downturn, ABC Co subsequently fails to meet its banking covenant requirements. ABC Co is placed into administration. As ABC Co is a profitable business, the XYZ Bank agrees to a debt reorganisation and a partial waiver of the bank finance. At that time, the relevant depreciable assets have been written down (for tax purposes) to nil. The entity does not have any tax losses, as the entity has traded profitably in the past.

Issue

Due to the proposed test contained in subparagraph 243-20(2)(b)(i) ABC Co’s debt is likely to be limited recourse debt. This is because XYZ Bank’s rights against ABC Co, in the event of default, are effectively limited to “debt property”, which includes a situation where security is provided over all assets of the business.[4] The debt property does not need to be the financed property.

As (historically) the debt was used to directly fund the acquisition of depreciable assets (i.e. defined as “financed property”), the requirements of section 243-15 would also be satisfied.

As the depreciable assets have been written off to nil for tax purposes, the debt reorganisation with XYZ Bank will result in an immediate amount being included as assessable income pursuant to section 243-40,[5] subject to the operation of section 243-20(6). Importantly, this would give rise to an immediate tax bill, which (if substantial enough in this example) could jeopardise the ‘administration’ process and the debt reorganisation arrangement.

Under the current law, the debt reorganisation would not result in an application of Division 243 (as the debt would not be limited recourse debt), but would instead result in a debt forgiveness under Division 245 of the ITAA 1997. As there are no losses in this case, the tax cost of assets would be reduced, giving rise to ‘future’ tax consequences, rather than an immediate tax consequence.

---

[2] According to subsection 243-30(3), property is debt property if it is the financed property or the property is provided as security for the debt.
[3] Pursuant to section 243-40.
[4] Per the current definition of “debt property” contained in subsection 243-30(3).
[5] Subsection 243-35(1) will determine that there has been excessive capital allowance deductions. Section 243-40 requires the excessive deductions to be included in the debtor’s assessable income for the income year in which the termination occurs.

Again, it is understood that Treasury considers that section 243-20(6) would apply to prevent this adverse outcome. This should be clearly illustrated in the EM.

Example 3 – Entity with minimal or ancillary depreciating assets

Operating Co is a services business. It has total assets of $10,000 and a debt facility of $8,000. The debt is secured over all of the assets of Operating Co. No other security is provided. At the time the debt facility was entered, of Operating Co's total assets, $1,000 comprised Division 40/Division 43 assets. Due to financial difficulty, Operating Co subsequently defaults on its debt facility and is unable to repay any portion of the facility.

Issue

Under proposed paragraph 243-20(2)(b) Operating Co's debt will prima facie be limited recourse debt. This is because the lender's rights against Operating Co, in the event of default, are in effect limited to "the debt property" per draft subparagraph 243-20(2)(b)(ii) as all of Operating Co's assets were security for the debt.

Accordingly, Operating Co will prima facie be required to include an amount in its assessable income, clawing back the capital allowances claimed, as a consequence of the operation of Division 243. It is considered that the initial policy intent of Division 243 was not to apply to entities with minimal or ancillary depreciating assets.

The Institute similarly understands that Treasury considers this that section 243-20(6) will apply to prevent the debt in this example from being treated as limited recourse debt. This should be made clear in the EM.

SUBMISSION 8