Corporate Tax Update

1 April 2014

Liquidator not required to retain monies

In Australian Building Systems Pty Ltd v Commissioner of Taxation [2014] FCA 116, the liquidators of Australian Building Systems Pty Limited (the taxpayer) sought a declaration that they were not required by section 254 of the Income Tax Assessment Act 1936 (Cth) to retain an amount from the disposal of real property owned by the taxpayer to meet any income tax liability that might arise on assessment from the disposal under the capital gains tax rules. The case also involved the taxpayer appealing against the Commissioner’s objection decision on a private ruling request which posed the same question.

At first instance, Justice Logan agreed with the liquidators and the taxpayer that section 254 imposed no such obligation. Justice Logan went on to say however that - “A prudent liquidator, like a prudent trustee of a trust estate or executor of a will, would be entitled to retain the gain for a time against other expenses which might arise in the course of the administration. Further, in relation to income tax, the liquidator would at the very least be entitled to retain the gain until the income tax position in respect of the tax year in which the CGT event had occurred had become certain by the issuing of an assessment or other advice from the Commissioner that, for example, no tax was payable in respect of that income year.”

The Commissioner has now lodged an appeal against the decision at first instance with the Full Federal Court.

Review of the Debt and Equity tax rules

On 25 March 2014, the Board of Taxation (BoT) released a discussion paper titled Review of the Debt and Equity Tax Rules. The Review follows a request by Government on 14 May 2013 for the BoT to undertake a post-implementation review of the debt and equity tax rules in the Income Tax Assessment Act 1997 (Cth) (ITAA 1997) including whether there can be improved arrangements within the Australian tax system to address any inconsistencies between Australia’s and other jurisdictions’ debt and equity rules that could give rise to tax arbitrage opportunities.

Notably tax arbitrage opportunities using ‘hybrid financing instruments’ is one of the matters being considered by the Organisation for Economic Cooperation and Development (OECD) under Action 2 of the Base Erosion and Profit Shifting (BEPS) Action Plan. Action 2 calls for the development of model tax treaty provisions and recommendations for the design of domestic tax rules to neutralise the effect of ‘hybrid mismatch’ arrangements. A hybrid mismatch opportunity may arise where an instrument is classified in the jurisdiction of the issuer as debt and in the jurisdiction of the holder as equity (and vice versa).

The debt and equity tax rules were introduced in 2001 through the enactment of Division 974 of the ITAA 1997 and other consequential amendments to that Act. Generally, under those rules, returns on debt interests may be tax deductible and not frankable, and returns on equity interests may be frankable and not tax deductible.

As noted in the BoT discussion paper, Division 974 was intended to provide a boundary between debt and equity that would:

- better reflect the economic substance of the legal rights and obligations of an interest, rather than its legal form, and in a more comprehensive way that reflects commercial
substance and the intention of the parties;
• increase certainty of the tax treatment of hybrids;
• increase consistency about the classification of financial arrangements; and
• apply to specific areas of the tax law, for example, to secure the proper operation of thin capitalisation rules by ensuring the inclusion of in substance debt but legal form equity in an entity’s debt.

In the discussion paper, the BoT outlines aspects of the debt and equity rules that have either been raised as problematic or are the subject of debate. These include:

• the key concept - effectively non-contingent obligation (ENCO)
• the administration of the related scheme provisions
• the Commissioner’s ability to re-characterise an interest as an equity interest under section 974-80 of the ITAA 1997
• the effects of changes to the terms of financing arrangements
• the treatment of authorised deposit-taking institution (ADI) issued instruments, and
• the effect of solvency clauses in loan agreements.

The discussion paper also raises other uncertainty issues as areas of uncertainty including the definition of 'financing arrangement.' This definition is cornerstone to the operation of the debt and equity rules since, except for shares issued by a company, an interest cannot satisfy the debt or equity classification under Division 974 unless the interest is a 'financing arrangement.'

In relation to this issue, the BoT notes the recent Federal Court decision in Blank v Commissioner of Taxation [2014] FCA 87 where in his judgement, Justice Edmonds suggests a distinction between a scheme that is entered into to raise finance (which will be a financing arrangement) and a scheme entered into to raise capital (which according to his Honour will not be a financing arrangement). With respect to his Honour's decision, the BoT also expresses the view that “the decision exposes an apparent asymmetry in the tax treatment of shares (which are equity in substance) granted to employees and putative non-share equity interests granted to employees, which does not contribute to the Division's goal of tax neutrality for instruments of the same substance but different legal form.” According to the view expressed by Justice Edmonds, this asymmetrical position arises because a share issued to an employee under an employee share scheme will be classified as equity under Division 974 (there being no requirement that the scheme be a financing arrangement) whereas in the case of the issue to an employee of a hybrid instrument (i.e. an instrument other than a share) the hybrid cannot be an equity interest if it was issued to provide a reward or incentive to the employee - as in this case the hybrid would not be issued to raise finance and thus could not be a financing arrangement.

After discussing the areas of uncertainty, the BoT raises a number of issues/questions for consideration by interested parties including, in the light of the decision in Blank v Commissioner of Taxation, whether the distinction between the raising of capital and the raising of finance is problematic.

With respect to the ENCO concept, the discussion paper considers a number of matters that have been raised as giving rise to uncertainty in the classification of interests as debt under Division 974 including:

• applying an in substance approach having regards to the pricing terms and conditions of the arrangement
• the 'ability and willingness to pay' exception in section 974-135 of the ITAA 1997
• solvency clauses
• debt subordination clauses
• limited recourse finance arrangements, and
• structured contingencies.

In the case of solvency clauses, the paper poses the question as to whether these clauses are 'covered' by the 'ability and willingness to pay' exception, such that 'obligations' affected by a solvency clause are treated as ENCOs in applying the debt test under Division 974. With respect to this issue, the paper asks interested parties to comment on whether the phrase 'ability or willingness to meet the obligation' is problematic, and if so, whether removal of the phrase would clarify the operation of the law. From the perspective of taxpayers, the better approach for addressing this issue would be for the legislature to provide certainty by legislating the effect that a solvency clause has on determining whether 'obligations' meet the ENCO criteria.

With respect to debt subordination, the paper provides two examples of
subordination. In the case where the subordination has the effect of ranking the lender behind other creditors, with priority over shareholders being retained, the paper states that "such a contingency would appear to be one covered by the ability and willingness exception" and thus the obligations would be ENCOs. On the other hand, where the lender through subordination ranks behind all other creditors and then ranks equally with shareholders, the paper states that arguably "the issuer only has a contingent to provide financial benefits and this contingency is not within the ability AND willingness exception". The paper goes on to ask interested parties to comment on whether the treatment of the degree of subordination in Division 974 is problematic and if so, how this could be addressed.

On the question as to whether obligations under limited recourse finance arrangements are ENCOs, and if so how are they valued, the paper notes that the explanatory memorandum to the enacting legislation in 2001 "seems clear that the original policy objective was that (at least some) limited recourse loan arrangements would pass the debt test in Division 974." The paper however notes that there is a view in interpreting Division 974 that there are no ENCOs at all under these arrangements. As with other uncertainties identified by the BoT, the solution to this uncertainty should be addressed by the legislature so that taxpayers entering into these commercial arrangements have certainty at the outset, and thus are able to make an informed decision before committing to the particular investment.

In a number of areas of the paper, the BoT raises the uncertainty created by the requirement in section 974-135 to take into account the pricing, terms and conditions of the particular arrangement in determining whether there is an ENCO to take a particular action. An example given in the paper is the issue of a convertible note where at the date of issue, "there is a deep in the money option to convert." In this case, the BoT notes that because of the pricing terms and conditions, arguably the issuer would not have an ENCO to redeem the note, and the note could not be a debt interest under Division 974. Clearly a solution to this uncertainty would be to prescribe through legislation, the level of discount that is acceptable for the redemption to be treated as an ENCO.

The paper includes substantial comments with respect to section 974-80 of the ITAA 1997 including its application to stapled structures where commonly, a unit trust, the units in which are 'stapled' for trading purposes to the shares in a company, provides loan funds to the company with the effect that interest on the loan is distributed by the trust to unit holders on a before tax (or subject to withholding tax) basis. The paper asks interested parties to respond to a number of questions including:

- whether section 974-80 should be subject to a de minimis rule which compares the quantum of the interest held by the 'ultimate recipient' with the quantum of the debt interest to which section 974-80 would apply but for the de minimis rule
- whether the Commissioner should have a discretion to not apply section 974-80, and if so what factors should the Commissioner need to consider in determining whether or not to exercise the discretion
- whether in the case of stapled structures, the 2011-12 Federal Budget announcement to amend section 974-80 addressed the concerns relating to its application
- whether in the case of stapled structures, there should be some other integrity provision that applies i.e. instead of section 974-80 , and
- whether in the case of stapled structures, the need for the integrity measure, combined with the practical administration difficulties, overstates the compliance concern where multi-national enterprises are free to choose whether they fund their associates with debt of equity and are already subject to the thin capitalisation rules in Division 820 of the ITAA 1997.

Interested parties are required to make their submissions to the BoT by 23 May 2014.

If you require further information regarding the discussion paper, or are interested in having PwC assist you in making a submission to the BoT, contact your usual PwC adviser or contact Peter Collins on (03) 8603 6247.
Let’s talk

For a deeper discussion of how these issues might affect your business, please contact:

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