CPA Australia Ltd
ABN 64 008 392 452

Level 20, 28 Freshwater Place
Southbank VIC 3006 Australia

GPO Box 2820 Melbourne
VIC 3001 Australia

P 1300 737 373
Outside Aust +613 9606 9677

cpaaustralia.com.au

International Tax Unit
Corporate and International Tax Division
Treasury
Langton Cres
PARKES ACT 2600

Email: MNETaxintegrity@treasury.gov.au

30 October 2023

Dear Sir/Madam,

Multinational Tax Integrity – strengthening Australia's interest limitation (thin capitalisation) rules

CPA Australia is Australia's leading professional accounting body and one of the largest in the world. We represent the diverse interests of more than 173,000 members in over 100 countries and regions. We make this submission in response to the Treasury's **Multinational Tax Integrity – strengthening Australia's interest limitation (thin capitalisation) rules** (Exposure draft) on behalf of our members and in the broader public interest.

We make the following comments and key points for your consideration which we believe would further improve the efficacy of the proposed amended **thin capitalisation legislation** (Schedule 2 to the Bill).

1. Debt deduction creation rules (Subdivision 820-EAA)

We raised in our previous **submission** our concerns with the debt deduction creation rules in that there is no tax purpose test to limit the rules applying to its stated purpose of attacking debt creation schemes that lack commercial justification. For example, they will continue to apply in denying debt deductions where an entity borrows to purchase trading stock from a related entity. We maintain our significant concerns with the lack of a tax purpose test for the rules in light of the changes proposed in the Exposure Draft (see below).

The rules also continue to apply to wholly domestic schemes that do not involve payments being transferred offshore despite the EM referring to profit-shifting arrangements, unlike the former Division 16G of *the Income Tax Assessment Act 1936* (ITAA 1936), which these rules are modelled on, had sensible exclusions for these exact kinds of ordinary transactions.

The rules will also apply to cash pooling situations, requiring tracing of funds to determine whether in managing the business group's overall cash position, the debt deduction creation rules would apply to deny debt deductions.

The rules also have no grandfathering such that it could apply in relation to post-1 July 2023 debt deductions that relate to pre-22 June 2023 asset acquisitions, instead providing a one-year grace period to those rules. As was raised in our previous submission, it could be an asset transferred to an associate entity in 1995 that is still held by the associate entity. This requires significant compliance costs to consider how every single asset held post-1 July 2023 was historically acquired. The old Division 16G had a sensible rule such that it only applied to assets acquired after the start date of the rules, i.e., 1 July 1987.

Given the issues raised above, our biggest concern is the new ordering between the debt deduction creation rules and all other thin capitalisation provisions in Division 820, including the three new alternative tests, i.e., fixed ratio test, group ratio test and third party debt test. The new section 820-31 states that an entity first works out if its debt deductions are disallowed under the debt deduction creation rules. To the extent their debt deductions are disallowed under those rules, the disallowed debt deductions are disregarded for the purposes of applying all other provisions in Division 820.

Because of the lack of a tax purpose test, this new ordering means unless the limited number of exceptions apply, the majority of the debt deductions in respect of the newly amended ‘financial arrangements’ will potentially be denied deductions under the amended debt deduction creation rules. This is irrespective of whether the arrangements have genuine commercial justification or not, as long as debt deductions are disallowed to the extent the borrowings do not satisfy the requirements of the debt deduction creation rules. This will reduce the amount of deductible debt, increase the tax and that will decrease investment in Australia. It will also significantly increase the compliance burden for taxpayers in tracing their use of funds and acquisitions of assets.

We recommend that for the new ordering, the debt deduction creation rules insert a tax purpose test to refine its application to only targeting arrangements lacking genuine commercial justifications.

2. De minimis threshold

We also raised in our previous submission the Government should consider changing the $2 million de minimis threshold from a gross basis to a net basis given the introduction of a “net debt deduction” concept. This would prevent taxpayers from being caught where amounts are duplicated within a group and being counted twice. As an example, an amount borrowed and on-lent to a related party resulting in $1 million of interest on each leg of the back-to-back loan would result in $2 million total debt deductions in the group. Under a net debt deduction test there would more appropriately be $1 million of net debt deductions as the interest income derived by the interposed entity would reduce the $2 million gross amount to a $1 million net amount.

3. Issues with the third party debt test

As was raised previously, there are currently major deficiencies in the third party debt conditions in s 820-427A(3). In particular, the limited recourse rule in s 820-427A(3)(c) is maintained in the Exposure Draft, that the third party lender does not have recourse to a guarantee, security or other form of credit support, other than the carveout relating to credit supports on the creation or development of Australian real property assets including moveable property, provided that the credit support rights do not give recourse against a foreign associate. This prohibition is maintained due to the concerns of multinational groups having an unfettered ability to ‘debt dumb’ third party debt in Australia that is recoverable against the global group. The fact is very few third party lenders will lend having recourse to the assets of the borrowing entity only, instead they will require assets of related entities as security and guarantees. In its revised form, most third party lenders will not satisfy the third party debt test. To address the Government’s concern, the test should specify a purpose test that the debt deductions are disallowed where ‘debt dump’ of third party debt in Australia that is recoverable against the global group occurs.

Furthermore, as was previously raised, the test also does not make sense considering the concept of obligor group in s 820-48, which results in entities also being deemed to make a third party debt test choice where they provide a guarantee or security in relation to a debt incurred by an entity that made a Third party debt test (TPDT) election. This deemed choice only makes sense if a lender can have recourse to the assets of entities other than the borrower in the first place. However, where this borrowing is done via a related “conduit” that satisfies the conduit financing conditions in s 820-427C, the rules appear to allow the lender to now have recourse to the assets of entities that are members of the obligor group (refer to s 820-427B(4)(b)(i)). This is the appropriate outcome and the treatment of borrowing via a related conduit borrowing from an external lender directly should be treated similarly.

4. Adoption of an associate entity excess rule with respect to excess capacity

The amendment in the Exposure Draft allows trust distributions form an entity’s tax earnings before interest, taxes, depreciation, and amortisation (tax EBITDA) for entities holding less than ten percent and eligible unit trusts that hold more than fifty percent to benefit from the excess tax EBITDA amendment. However, entities that hold between ten and fifty percent, such as joint ventures, are excluded to benefit from the amendment. The changes to allow eligible unit trusts to transfer their excess tax EBITDA amounts to other eligible unit trusts is welcome, however it is still very narrow in scope as the majority of non-consolidated entities and trusts will not be able to benefit.

As discussed, in a non-consolidated structure, such as a head trust or a sub-trust, where the debt is incurred at the head entity level to fund equity in the subsidiary, the proposed rules effectively deny all material debt deductions. This is because the parent entity’s tax EBITDA is likely to be minimal or nil if it only consists of distributions from the subsidiary entity. The subsidiary entity may have no debt at all and may have large excess capacity, for example, large profits but no debt deductions. While the removal of distributions from tax EBITDA prevents “double counting" of benefits, it also unfairly attacks structures where there is no double counting, but debt is merely at the wrong level, that is, at the parent entity level.

If you have any queries, contact Bill Leung, Tax technical Advisor on (03) 9606 9779 or **bill.leung@cpaaustralia.com.au**.

Yours sincerely,

Elinor Kasapidis

Elinor Kasapidis
Head of Policy and Advocacy