INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

30 October 2023

International Tax Unit
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600
Attn: David Hawkins

Via Email: MNETaxintegrity@treasury.gov.au

## SUBMISSION TO THE TREASURY ON THE MULTINATIONAL TAX INTEGRITY – STRENGTHENING AUSTRALIA'S INTEREST LIMITATION (THIN CAPITALISATION) RULES EXPOSURE DRAFT

Infrastructure Partnerships Australia is an independent think tank and executive member network, providing research focused on excellence in social and economic infrastructure. We exist to shape public debate and drive reform for the national interest. As the national voice for infrastructure in Australia, our membership reflects a diverse range of public and private sector entities, including infrastructure owners, operators, financiers, advisers, technology providers and policy makers.

Infrastructure Partnerships Australia draws together the public and private sectors in a genuine partnership to debate the policies and priority projects that will build Australia for the opportunities and challenges ahead.

### Background and Content

Infrastructure Partnerships Australia would like to thank your time spent on 24 October 2023 discussing the proposed changes to Australia's thin capitalisation rules (as announced in the October 2023 Exposure Draft legislation).

Please find a submission attached, developed by Infrastructure Partnerships Australia's Tax Policy Taskforce.

### Further contact

We very much appreciate the opportunity to provide this submission and would be happy to discuss it further should you wish.

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Infrastructure Partnerships Australia looks forward to further assisting the Treasury in this matter. If you require additional detail or information please do not hesitate to contact Jamie Harrison, Senior Policy Adviser on 02 9152 6000 or jamie.harrison@infrastructure.org.au.

Yours sincerely,

**Adrian Dwyer**
Chief Executive Officer
Infrastructure Partnerships Australia

Attachment

# Third  Party Debt Test

# Scope of the credit support prohibition

The scope of the credit support prohibition is too broad

- Subsection 820-427A(3)(ca) prohibits recourse to assets otherwise covered by paragraph (c) where they are rights under or in relation to a guarantee, security or other form of credit support.
- The relevant paragraph of the EM states that:

  "The general prohibition on recourse to credit support rights is maintained. The prohibition ensures that multinational groups do not have an unfettered ability to 'debt dump' third party debt in Australia that is recoverable against the global group."

- The Tax Policy Taskforce submits that the drafting of the credit support prohibition is too broad and goes well beyond the intent of the EM for the following reasons:
  - It prohibits credit support provided between Australian members of an obligor group that relate to recourse provided wholly to Australian assets. These arrangements provide no ability (let alone an unfettered ability) for the third party debt to be recoverable against the global group.
  - It prohibits credit support regardless of whether it is provided by associated entities or non associated entities of the borrower. Only credit support provided by foreign associate entities should be relevant in targeting 'debt dumping' by multinational groups.
- The broad scope of the credit support prohibition means that it is incompatible with cross collateralisation arrangements provided within the Australian obligor group in standard multi entity wholly domestic project finance arrangements where there should be no policy concern of the sort indicated in the EM.
- Finally, to avoid any misinterpretation of the assets to be analysed in paragraph (c), a note should be included to confirm that to the extent that recourse provided to the third party lender may itself be considered an asset of that lender it should be disregarded in applying that paragraph. Rather, it should be the asset to which recourse is provided that are considered for the purposes of that paragraph.

Suggested drafting amendments for subsection 820-427A(3)(ca)

(ca) none of the assets mentioned in paragraph (c) are rights under or in relation to a guarantee, security or other form of credit support provided by a *foreign entity which is an associate entity;

**OR**

(ca) none of the assets mentioned in paragraph (c) are rights under or in relation to a guarantee, security or other form of credit support provided by an associate entity other than an associate entity that is the entity mentioned in subparagraph (c)(iii).

In addition, a note should be included in section to confirm that:

**Note: In applying paragraphs 820-427A(3)(c) and (ca) disregard the fact that recourse provided to the third party lender may itself be considered an asset of that lender.**

# Scope of the credit support prohibition (cont.)

<u>The scope of the credit support prohibition is ambiguous</u>

- Subsection 820-427A(3)(c) requires "*the holder of the debt interest has recourse **<u>only</u>** to the assets of the following kind* ..." (emphasis added)
- Where there is a parent company guarantee, it is an asset of the bank. It is not an asset held by the borrower (per paragraph 3(c)(1) or obligor group (per paragraph 3(c)(iii)). However, the bank still has 'recourse' to this asset and therefore may not satisfy the above requirement.
- The Taskforce submits that the drafting of the credit support prohibition is ambiguous. It potentially prohibits any parent company guarantee, security or credit support from satisfying the 'third party debt conditions'.

<u>Suggested drafting amendments for subsection 820-427A(3)(c)</u>

(c) having regard to the Australian assets held by the entity and the members of the obligor group, the holder of the debt interest has recourse only to the assets of the following kind ...

OR

By inclusion of a Note to the drafting as proposed in the previous slide.

# Credit support carve out does not assist many infrastructure development projects

<u>Scope of the credit support development carve out in subsections 820-427A</u>

- The Taskforce welcomes the expansion of the credit support development carve out in the Exposure Draft beyond rights that relate solely to the development of a CGT asset that is real property (as was the case in the Bill). However, the Taskforce remains concerned that the carve out will still exclude credit support provided to many important Australian infrastructure development projects that we understand, from a policy perspective, are intended to be covered.

- Unlike real estate developments, many infrastructure projects have the following features:

  a) **The constructed assets may comprise principally or even wholly of moveable assets.** In this case the land may simply be the site on which the infrastructure assets are located which may not constitute use of the land. Even where they could be considered connected with the use of the land there is doubt as to whether they would be incidental to that use. Rather it would be the case that the use of the land should be considered incidental to the use of moveable assets. In this regard, the Taskforce notes the long line of case law confirming the key distinguishing feature between a fixture and a chattel/moveable property is that the former is attached to the land with the objective of the better <u>use</u> and enjoyment of the land rather than the land merely being a convenient site for the use of the asset.

  b) **The land access rights may be a licence or other non-exclusive right of access (not ownership or a lease of the relevant land).** As there is no ownership or lease of land the moveable property could not be considered incidental to that ownership of the land. The only very limited exception to this would be where the landowner or lessee was considered the user of the assets (eg in the case of social infrastructure Public Private Partnership projects where the state government uses assets constructed by the consortium).

  c) **The assets may not be attached to the land at all (for example offshore wind assets, railway rolling stock procurement etc).** As there is no ownership or lease of land the moveable property could not be considered incidental to that ownership or use of the land.

  d) **There may be intangible assets created in connection with the development of the tangible assets (eg project deeds and concession deeds).** As part of financing, constructing and operating of infrastructure asset the consortium may enter into a project deed or concession agreement which provides certain rights (eg the right to charge users) and obligations (eg the obligation to construct and operate the infrastructure according to agreed standards). The creation of the intangible asset could be considered connected to the development of the land and moveable assets. Accordingly, to the extent that the credit support could be seen to be, directly or indirectly, resulting in the creation of an intangible assets that would not satisfy the requirements of the carve out.

# Credit support carve out does not assist many infrastructure development projects

<u>Suggested drafting amendments to section 820-427A(4)-(6)</u>

(4) For the purposes of subparagraph (3)(c)(ii), disregard a right if:

(a) the right relates wholly to the financing, creation or development of one or more CGT assets that comprise, or are reasonably expected to comprise, real property situated in Australian or moveable assets that are to be used solely within Australia (including Australian territorial waters) (together "**the development assets**").

(aa) For the purposes of subsection (a) disregard any CGT assets that comprise intangible assets arising solely in connection with the creation of the development assets.

(b) assuming that the holder of the right exercised the right, the right would not reasonably be expected to allow, directly or indirectly, the holder or another entity to have recourse for payment of the debt mentioned in paragraph (3)(c) against a *foreign entity that is an *associate entity of the holder.

Note: Intangible assets for these purposes would include concession deeds or project deeds which impose an obligation on the counterparty to construct the relevant development assets.

(5) For the purposes of paragraph (4)(a), in determining whether a right relates wholly to the creation or development of a *CGT asset of a kind mentioned in that subsection, disregard the extent (if any) to which the right relates incidentally to another matter.

Remove section 820-427A(6)

# Third Party Debt Test – Hedging

Issue

- The definition of debt deduction in s820-40 is proposed to be expanded by repealing the carve-out in s820-40(3)(a) for losses and outgoings associated with hedging or managing financial risk
  - The EM states that this is to ensure that the definition of debt deduction captures interest and amounts economically equivalent to interest in line with the OECD best practice guidance and that interest related costs under swaps, such as interest rate swaps, are captured by the definition (para 2.158 and 2.159).
  - The OECD's *Limited Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update* report provides that foreign exchange gains and losses on foreign currency hedging instruments connected with the raising of finance are not generally economically equivalent to interest. However, a country may wish to treat some or all foreign exchange gains and losses on these instruments as economically equivalent to interest.
  - It is unclear whether foreign exchange losses on hedging instruments in respect of a debt interest are captured by the repeal of s820-40(3)(a).
- Under the third party debt test, a debt deduction that is referable to an amount paid or payable to a non-associate entity and that is directly associated with hedging or managing interest rate risk in respect of a debt interest can be taken into account in the calculation of an entity's third party earnings limit (s820-427A(2)). Equivalent provisions in the conduit financing rules enable such an amount to be passed on to the borrower under the on-loan (s820-427C(2)(d) and (e)).
- The current drafting of the Bill does not allow a deduction under the third party debt test for foreign exchange losses arising under a hedging arrangement with an external counterparty (e.g., cross currency interest rate swap and foreign currency swap), nor does it allow for such losses to be recovered by a conduit financer from the borrower.

Taskforce Submission

- Hedging arrangements that manage foreign exchange risk are common and often necessary to enable businesses to manage foreign exchange risk in relation to financial arrangements that are denominated in a foreign currency.
- The Taskforce submits that the references to "hedging or managing the interest rate risk" in s820-427A(2) and s820-427C(2)(d) and (e) be amended to "hedging or managing the financial risk" to enable foreign exchange losses that fall within the proposed expanded definition of debt deduction to be taken into account in the calculation of the third party earnings limit.

# Debt deduction creation rules

# Conduit finance from third party re-characterised as related party finance

<u>Debt creation rule and related party debt</u>

The debt creation rules apply where a group finances a related party transaction with related party debt. For subsections 820-423A(2) and (5) to apply to a debt deduction, the related party condition must be satisfied (paragraphs 820—423A(2)(e) and 820-423A(5)(f)). Broadly, the funds must be borrowed from an associate pair.

However, in an infrastructure context, funds sourced from external third party lenders are commonly borrowed by a special purpose finance entity on behalf of the group and on-lent within the group. A special purpose finance entity is generally used for the following reasons:

1. Where the group comprises a number of entities and assets, security is generally provided over the portfolio of assets and the lender lends to a pool of assets. In this case, it is easier for the lender to lend to a single entity (the special purpose finance entity) who can then on-lend to the entity requiring the funds within the group; and

2. It is a clean, simple and efficient structure that is well understood by the market.

Where the special purpose finance entity on-lends amounts borrowed from a third party to another entity within the group (who is likely to be an associate pair), this external third party debt will be recharacterised as related party debt under the debt creation rules.

Subsections 820-423A(2) and (5) do not trace the funds to its source. It applies mechanically and does not discriminate between funds sourced internally within a group and funds sourced externally from a third party lender. Any related party lending between associate pairs is caught as the debt creation rules are agnostic as to the source of the funds.

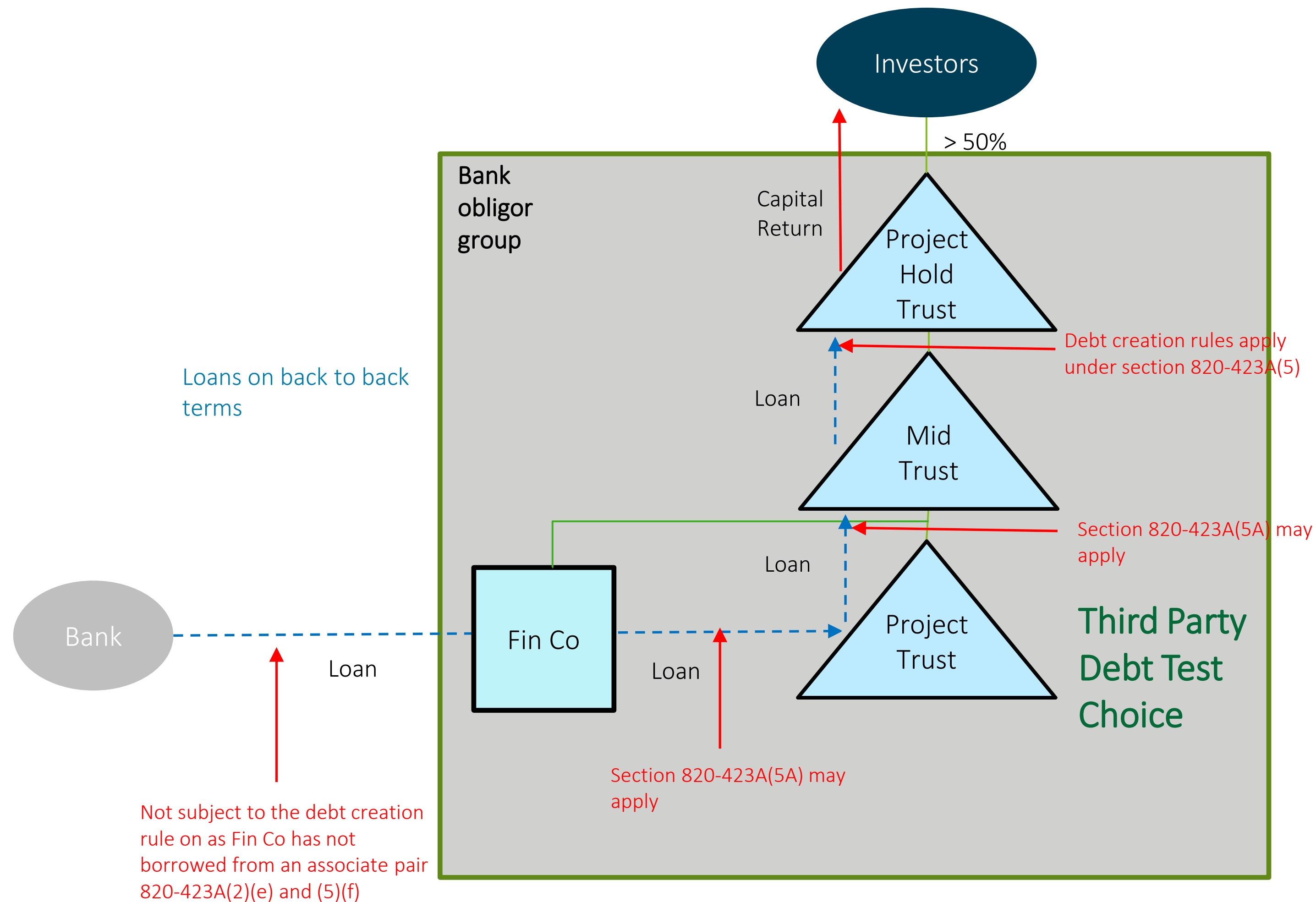
The intent of the debt creation rules is to counter transactions that have no economic cost (refer EM para 1.39). Accordingly, where the source of the related party borrowings have originated from the third party lenders that have been on-lent on-back to back terms within a group to fund transactions (such as distributions), the debt creation rules should not apply.

Section 820-423A(5A) only applies to the entity that has **on-lent** the proceeds received from another debt interest.

<u>Taskforce Submission</u>

A conduit financing rule is required for the debt creation rules. For example, a deduction referable to a debt interest that satisfies conduit financing conditions in section 820-427C, ***other than the conditions contained in section 820-427C(1)(f) and (h) ,*** could be excluded from section 820-423A. Paragraph 820-427(1)(h) should not be relevant on the basis that the exclusion for conduit financing should apply to all entities, not just entities that have elected to apply the third party debt test.

# Conduit finance from third party recharacterised as related party finance



# Payments and distributions to non-associate pairs

## Issue

Paragraph 1.43 of the EM states "that debt deductions to which section 820-423A(5) applies are now disallowed on a proportionate basis. This provides a more appropriate and clearer basis for the disallowance of the debt deductions."

Relevantly, subsection 820-423B(2) provides:

> *If the conditions in subsection 820-423A(5) are met, the amount of the debt deduction disallowed under subsection 820-423A(1) is the amount of the debt deduction to the extent that the relevant entity mentioned in subsection 820-423A(5) incurred it in relation to the proceeds mentioned in paragraph 820-423A(5)(b) or the use of those proceeds.*

However, section 820-423A(5)(b) refers to proceeds used to fund, facilitate the funding of, or increase the ability of an entity to make one or more payments or distributions to one or more other entities (**a recipient**), regardless of whether the recipient is an associate pair of the payer or not.

## Taskforce Submission

The Taskforce submits that a payment or distribution made to a recipient that is not an associate pair of the payer should not be caught by the debt deduction creation rules.

Accordingly, it is submitted that the debt deduction disallowed under section 820-423B(2) be **clarified** by specifically providing that the denial be limited to the proceeds referred to in section 820-423A(5)(b) to the extent that they are used to fund, facilitate the funding of, or increase the ability of an entity to make one or more payments or distributions to an entity that is an associate pair of the payer.

# Retrospective application

<u>Issue</u>

It is proposed that the debt deduction creation rules apply in relation to all debt deductions for income years beginning on or after 1 July 2024, regardless of when the financial arrangements to which the debt deductions relate were entered into (section 820-50, *Income Tax (Transitional Provisions) Act 1997*).

<u>Taskforce Submission</u>

The Taskforce submits that the retrospective application of the debt deduction creation rules by reference to financial arrangements entered into prior to 1 July 2024 is inequitable.

The Taskforce submits that the debt deduction creation rules apply to debt deductions for income years beginning on or after 1 July 2024 and in relation to which relevant financial arrangements were entered into on or after 1 July 2024.