3 November 2023

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

By electronic upload

Dear Director,

Multinational Tax Integrity – strengthening Australia's Interest Limitation (thin capitalisation) Rules

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to the exposure draft parliamentary amendments to the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023 (**draft amending Bill**) and accompanying supplementary draft explanatory memorandum (**draft amending EM**).

In the development of this submission, we have closely consulted with our National Large Business & International Technical Committee to prepare a considered response that represents the views of the broader membership of The Tax Institute.

The Tax Institute is pleased to see that the draft amending Bill proposes some welcome amendments to the exposure draft legislation (**original draft Bill**) and accompanying explanatory materials (**original draft EM**) that were introduced into the Parliament on 22 June 2023. However, there are some outstanding significant concerns that require further consideration and amendment before the proposed changes should progress.

Our comments in this submission are limited to the application of the new thin capitalisation framework to Trusts, debt deduction creation rules (**DDCR),** third-party debt test (**TPDT**), the proposed date of the reforms, and comments regarding the revised EM.

Our recommended further amendments to the draft amending Bill and draft amending EM may be summarised as follows:

- allow general class investors holding an interest of 10%-49.9% in a trust to be able to recognise their share of tax EBITDA from the trust;
- extend the concept of 'excess tax EBITDA' beyond trusts to companies and partnerships where dividends and partnership income is excluded from tax EBITDA;
- consult further on the DDCR to resolve significant issues;

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- amend the DDCR to include measures equivalent to those of the conduit financing rules such that back-to-back debt arrangements involving a loan between an entity and its associate that are back-to-back with a loan from an unrelated lender and the associate are not caught by the DDCR;
- correct technical issues in the drafting in respect of guarantees, security or other forms of credit support provided for the purposes of TPDT; and
- defer the proposed start date so that taxpayers have enough time to understand the implications of existing arrangements.

Our detailed response and recommendations to improve the draft amending Bill and draft amending EM are contained in **Appendix A**. We have attached at **Appendix B** our earlier submission to the Treasury consultation on Treasury Laws Amendment (Measures for Future Bills) Bill 2023 proposing refinement of the new thin capitalisation framework dated 14 April 2023 (**April Submission**). We have attached at **Appendix C** our submission to the Senate Economics Legislation Committee dated 21 July 2023 on the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023 **(Senate Committee Submission).** Our comments in this submission should be read together with our April Submission and Senate Committee Submission, particularly to the extent to which certain issues remain unresolved.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all.

If you would like to discuss any of the above, please contact our Senior Counsel – Tax & Legal, Julie Abdalla, at (02) 8223 0058.

Yours faithfully,

Scott Treatt
Chief Executive Officer

Jerome Tse
National Council Member

APPENDIX A

We have set out below our detailed comments and observations in relation to the proposed changes to Australia's thin capitalisation regime for your consideration.

Tax EBITDA & trust excess tax EBITDA – application to trusts

In our Senate Committee Submission, we noted that the proposed new thin capitalisation framework would result in the inadvertent disallowance of interest deductions on transactions involving trust structures. We recommended changes to resolve this. The Senate Economics Legislation Committee Report released on 22 September 2023 in paragraph 2.131 also recommended technical amendments to thin capitalisation rules so they better accommodate trust structures.

The revised draft Bill introduces a new section 820-60 which amends the tax EBITDA calculation and proposes to allow the transfer of excess tax EBITDA amount between trusts – similar to the manner in which the current associate entity excess amount works. This proposed provision is applicable only to unit trusts and managed investment trusts, subject to the satisfaction of certain conditions including, among other things, the unitholder having a TC direct control interest of 50% or more in the trust at any time in the income year.

The Tax Institute welcomes this amendment because it provides relief to common 'hold trust/project trust' structures prevalent in the infrastructure and real estate sectors, and in secondary sales, and ensures the same thin capitalisation outcome can be reached regardless of whether the debt is borrowed at the holding trust or project trust level.

The result is that an entity that holds less than a 10% interest in a trust will be able to include distributions for tax EBITDA purposes, and an entity that holds a 50% or more interest in a trust will be able to utilise the proposed concept of trust excess tax EBITDA.

However, entities such as joint ventures and consortiums that hold an interest between 10% and 49.9% in trusts will not be able to access either of these outcomes as such a unitholder will be required to disregard its share of the trust's taxable income and distributions in calculating its tax EBITDA (subsections 820-52(6) and (6B)) and the unitholder cannot transfer the trust's excess tax EBITDA. There is no clear policy rationale for the gap which is not present under the equivalent associate entity excess amount rules.

Further, the draft amending EM does not provide any policy rationale for allowing only trusts to transfer excess tax EBITDA. The Tax Institute considers that there is no reason why this provision should also apply equally in respect of companies and partnerships to the extent that the shareholders or partners are required to disregard dividends or partnership income in calculating their own tax EBITDA.

Debt deduction creation rules

The debt deduction creation rules contained in proposed new Subdivision 820-EAA were not part of the original policy and scope of these measures when first announced. As noted in our Senate Committee Submission, we have concerns that the rules may unintentionally and unfairly apply to common and low-risk arrangements.

We also remain concerned about the potential retrospective application of these rules, despite the effective deferral of their start date for financial arrangements entered into before 22 June 2023. This is because ordinary, low risk arrangements entered into before the DDCR take effect will still be caught by the DDCR from 1 July 2024. Further, greater clarity is required to confirm that refinancing arrangements made during the transitional period should not be caught within the scope of the specific anti-avoidance provision contained in the proposed new section 820-423D. Such arrangements (given that they will be entered into after 22 June 2023) would otherwise trigger the application of the anti-avoidance provision.

We continue to hold the view that the DDCR would benefit from further robust consultation to ensure the practical impact is proportionate to the intended policy outcome. It is preferable that these rules are excluded from the proposed new thin capitalisation framework until such further consultation has been undertaken.

We also note the Coalition Senators' Dissenting Report to the Senate Economics Legislation Committee released on 22 September 2023 as part of the Senate Economics Legislation Committee Report, which, at paragraph 1.67, noted that there is overwhelming evidence that the proposed DDCR is not fit for purpose and should not proceed as drafted. It was recommended that the DDCR be removed from the original draft Bill and be subjected to full and comprehensive consultation.

However, if these rules are to progress, we have set out below some key issues which we consider are imperative to address as a matter of urgency.

Financial arrangements involving associate pairs

The replacement of subsection 820-423A(5) in the amending draft Bill has resulted in the deletion of the express requirement that was proposed in paragraph 820-423A(5)(b) of the original draft Bill. In the original draft Bill, it was proposed that that subsection 820-423A(5) applies only where there is a borrowing between associates. Paragraph 1.38 of amending draft EM suggests that paragraph 820-423A(5)(f) is intended to impose the related party condition, but the language adopted is vague in the context of a provision dealing with debt used to fund payments to associates, i.e. a deduction for interest on borrowing from a third party may be 'referable to an amount paid…to an associate' where the borrowing is used to fund a payment to an associate.

We submit that a clear condition (equivalent to paragraph 820-423A(5)(b) of the original draft Bill) should be included in place of paragraphs 820-423A(2)(e) and (5)(f) of the amending draft Bill, that requires that the deduction be in respect of a debt interest issued between associates.

Equivalent conduit financing rules to DDCR

The original draft EM in paragraphs 2.145, 2.146 and 2.149 makes it clear that the DDCR will only apply in respect of related party borrowings. To ensure unintended outcomes do not arise, we consider that the DDCR should be amended to include rules similar to the conduit financing rules which ensure that a borrowing from a related party is treated as not being a related party borrowing where it is back-to-back with an external borrowing. For example, where there is a loan from third party bank to FinCo, FinCo on-loans the proceeds (on relevantly back-to-back terms) to OpCo, and OpCo uses those funds to make a payment (to an associate or otherwise), the DDCR should contain conduit financing rules which treat OpCo as having borrowed from an entity that is not a related party, such that the DDCR does not apply. That is, the interposition of a financing company should not alter the application of the rules.

While the proposed paragraph 820-423A(5A) would apply to prevent the DDCR operating to deny deductions to FinCo in the above example, without further amendment it seems as though the DDCR would (we consider, unintentionally) apply to deny deductions to OpCo in that example.

Short-term loans used to repatriate cash

Our understanding from our members is that it is not uncommon for Australian headquartered multinational groups to have subsidiaries place money on deposit in Australia on a short-term basis (e.g., where there are local law issues in repatriating that cash to Australia without delay). Foreign tax law generally ordinarily requires the subsidiary to charge interest on that amount. If multiple subsidiaries were to deposit cash with the Australian head company then it would seem that subsection 820-423A(5) would be triggered as each loan to the Australian head company could be said to increase its ability to make interest payments on any of the other loans. There is, in our view, clearly no mischief in such a case, and it therefore seems to be an unintended consequence for deductions to be denied in this scenario.

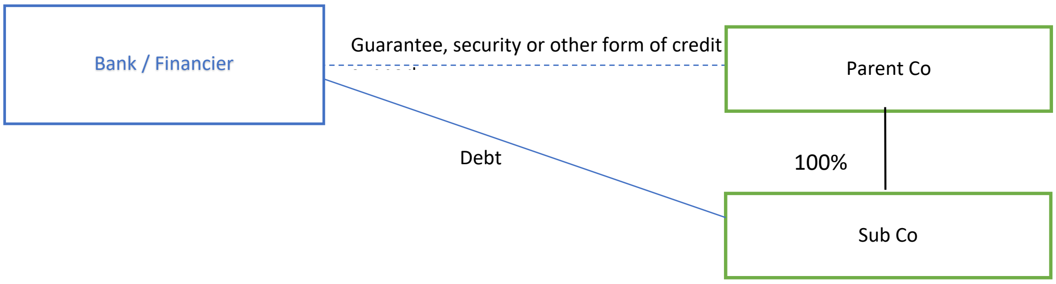
Third-Party Debt Test

Guarantee, security, or other forms of credit support

Proposed subsection 820-427A(3) of the original draft Bill lists the conditions for a debt interest to pass the TPDT. Paragraph 820-427A(3)(ca) (which, together with a new paragraph 820-427A(3)(c), is proposed to replace proposed paragraph 820-427(3)(c) of the original draft Bill) provides that a guarantee, security, or other form of credit support cannot be assets for the purposes of the proposed new paragraph 820-427A(3)(c) and therefore cannot satisfy the TPDT.

Our members have raised concerns that, as currently proposed, there continues to be a technical deficiency with the provisions inappropriately narrowing debt interests that otherwise satisfy the TPDT conditions.

The issue can be illustrated in a simple example, whereby an Australian parent company (**Parent Co**) provides a guarantee to the bank or financier on behalf of its Australian subsidiary (**Sub Co**). Parent Co and Sub Co are part of the same obligor group, but they have not formed a tax consolidated group. The bank or financier lends money to Sub Co at a market rate of interest, taking into consideration the credit rating, risk profile and assets of both Parent Co and Sub Co.



From a policy perspective, the debt interest in this example should satisfy the TPDT. However, this does not seem to occur when the provisions of the draft amending bill are worked through. In particular, the debt interest issued by the bank or financier would satisfy the following:

- paragraph 820-427A(3)(a) – the entity issued the debt interest (bank or financier) to an entity (Sub Co) that is not an associate entity (the bank or financier is not an associate entity as it does not hold a TC control interest of 20% or more) of the entity (Sub Co); and
- paragraph 820-427A(3)(b) – the debt interest is not held at any time in the income year by an entity that is an associate entity (Parent Co) of the entity (Sub Co);

However, paragraph 820-427A(3)(c) is not satisfied.

The guarantee is an asset of the bank. It is not an asset held by a member of the obligor group (per subparagraph 820-427A3(c)(iii)). However, as the bank has 'recourse' to this parent guarantee asset, it therefore does not satisfy the requirement that '*the holder of the debt interest has recourse **only** to the assets of the following kind* ...' (***emphasis added***). The holder of the debt interest (bank or financier) has recourse not 'only' to the assets of the obligor group but also has recourse to the 'guarantee, security or other form of credit support' from Parent Co.

Even if the guarantee, security or credit support were provided to Sub Co and all of the conditions in paragraph 820-427A(3)(c) were satisfied, paragraph 820-427(3)(ca) would prevent the debt from satisfying the TPDT conditions.

At paragraph 1.26, the draft amending EM states that the general prohibition on recourse to credit support rights is maintained to ensure that multinational groups do not have an unfettered ability to 'debt dump' third part debt in Australia that is recoverable against the global group. While The Tax Institute does not disagree with this policy or the mischief to which it is directed, we have reservations where it may apply in other circumstances where there is no such mischief. For example, in the example above, there is clearly no 'debt dumping' by a multinational group, yet the TPDT would not be satisfied.

The Tax Institute is of the view that the drafting in relation to guarantee, security or other forms of credit support requires reconsideration and amendment to take into account scenarios such as the one discussed above. If this issue is not rectified, applying a blanket rule to deny debt deductions under the TPDT supported by guarantees, securities or other forms of credit support is likely to have inappropriate wide-reaching consequences.

Australian assets in the form of membership interests

The draft amending Bill updates the lender's recourse conditions in paragraph 820-427A(3)(c) to permit the granting of security over membership interests in the borrower, provided that the borrower does not have any direct or indirect legal or equitable right in an asset that is not an Australian asset. Paragraph 1.24 of the draft amending EM states that this update ensures membership interests cannot be representative of non-Australian assets.

The ability to grant security interests over membership interests in the borrower only if the borrower does not have any direct or indirect interests in non-Australian assets seems unduly limited since:

- it could be breached by *de minimis* assets such as a bank account with a non-Australian bank; and
- it imposes a stricter test than subparagraph 820-427A(3)(c)(iii) which permits the borrower to grant security over its Australian assets regardless of whether or not the Australian assets include, for example, membership interests in Australian entities which may themselves indirectly have non-Australian assets.

Proposed start date

The draft amending Bill does not extend the proposed start date of the application of the proposed new thin capitalisation framework from 1 July 2023, and does not include any transitional or grandfathering provisions, save for the effective deferral of the start date of the DDCR in relation to financial arrangements entered into before 22 June 2023.

The Tax Institute considers that this remains an inappropriate outcome as the proposed rules will result in the denial of deductions for interest under rules which did not exist at the time the debt was incurred and could not have been reasonably foreseen or acted on by taxpayers, given that the proposed rules were not in force and have been since their announcement, subject to significant uncertainty.

The Tax Institute maintains its strong view that the passing of legislation prior to its start date is a crucial feature of a properly functioning legislative process. Traditionally, retrospective application of law has been the exception rather than the rule. It has often been limited to unique circumstances and has usually been coupled with grandfathering or transitional provisions. We have serious concerns about the precedent the proposed approach sets, and the impact it has on taxpayers that are left in an uncertain and potentially historically non-compliant position that is difficult and costly to rectify. This issue is exacerbated by the lack of grandfathering and/or adequate transitional provisions in the proposed measures.

We reiterate our earlier position that the start date of the proposed new rules should be deferred for at least 12-months to allow time for taxpayers to understand and respond to the implications of the proposed changes and ensure that their internal reporting and systems are adequately prepared to manage the changes.

Comments regarding the original draft explanatory memorandum and draft amending explanatory memorandum

Consistent with our comments in our April Submission regarding the original draft EM, The Tax institute is of the view that the draft amending EM would benefit from further guidance, explanation and examples regarding the following:

- the broader range of costs taken into account under the term ‘debt deductions’ as used in paragraph 820-45(3)(a) of the original draft Bill;
- costs that are to be taken into account for purposes of determining amounts included in an entity’s assessable income for purposes of paragraph 820-45(3)(b);
- guidance that illustrates what would be considered an appropriate ‘use of the proceeds of issuing the debt interest’ by an entity to wholly fund its investments that relate only to assets:
  - that are attributable to the entity’s Australian permanent establishment;
  - the entity holds for the purpose of producing assessable income; and
  - its Australian operations.

Miscellaneous

Release of consolidated exposure draft materials

We note that the proposed amendments have been included in the draft amending Bill as a separate Bill to amend the original draft Bill which has not yet been passed. This has made the task of considering and cross-checking further proposed changes more onerous. This is exacerbated by the limited consultation period.

We consider that in cases like this, it would be preferable for all stakeholders for the proposed changes to be consolidated into a single Bill.

APPENDIX B

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APPENDIX C

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Submission - Senate