Contact: Steve Whittington
Direct line: +61 2 9258 6547
Email: steve.whittington@ashurst.com

Ashurst Australia
Level 11
5 Martin Place
Sydney NSW 2000
Australia

GPO Box 9938
Sydney NSW 2001
Australia

Tel +61 2 9258 6000
Fax +61 2 9258 6999
DX 388 Sydney
www.ashurst.com

6 September 2022

BY Email: MNETaxintegrity@treasury.gov.au

Assistant Secretary
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Members of the Corporate and International Tax Division

1. INTRODUCTION

Thank you for the opportunity to provide feedback and comments on the policy issues and implementation considerations raised in the *Consultation Paper – Government election commitments: Multinational tax integrity and enhanced tax transparency* dated August 2022 (**Consultation Paper**).

Ashurst is a leading global law firm and in Australia (formerly known as Blake Dawson) is one of Australia's largest law firms. The Ashurst tax practice is one of the largest tax practices among the law firms. Ashurst advises clients across all industry sectors, including ASX-listed companies, large multinationals, private companies, funds, financial institutions, and governments.

This letter sets out our comments in response to certain issues raised/questions asked in the Consultation Paper. Section references below are to the *Income Tax Assessment Act 1997* (**ITAA97**) and the *Income Tax Assessment Act 1936* (**ITAA36**). We have also referred to the OECD report on *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update* (**OECD Report**).

We note that these comments are only our initial feedback with respect to the Consultation Paper, and we are available to discuss any of our submission points further with Treasury or to participate further in the consultation process. There will no doubt be more specific comments to be made and our submissions may evolve as consultation continues.

1. PART 1: MNE INTEREST LIMITATION RULES

General comments

We note that the proposed change to an earnings based safe harbour test is likely to materially impact the financial profile of many existing projects and investments. Many of these investments and projects are in areas of national and community significance (such as infrastructure, energy (including renewables), healthcare and the real estate sector, among others). Existing investment decisions, including financing arrangements in many significant projects, have been based on modelling and assumptions regarding the application of Australia's taxation rules, including the availability of interest deductions and the application of the thin capitalisation regime. In most instances, investments in these sectors are made with an intention of holding the asset for the long term, and on the basis of the modelling undertaken at the time of acquisition.

We assume that Treasury has undertaken modelling regarding the expected impact of the proposed thin capitalisation changes. It would be helpful if the expected implications of the proposed changes to the thin capitalisation regime were acknowledged and quantified. The Consultation Paper is silent on these matters. Our initial discussions with a range of taxpayers in different industries suggests that the impact on a number of existing projects is likely to be significant.

Given the above expected impact of the reforms, we consider that certain long term projects (such as certain infrastructure and similar projects) should be subject to grandfathering or a reasonable period of transition.

We further note that certain taxpayers may seek to refinance in order to fall within the revised earnings based safe harbour, but these taxpayers are likely to face potentially material break costs (as well as likely higher interest costs, given they are refinancing in an environment of higher interest rates than just a few months ago).

Accordingly, we consider that entities should be given the option to opt in to the revised rules from 1 July 2023, but that taxpayers should also be able to continue applying the current rules until 1 July 2024 (to give them time to make decisions around their capital structure). Taxpayers who will be adversely impacted by the measure should have at least a reasonable period of time to consider the impact of the measure, and (if they choose to) seek to renegotiate or secure alternative funding.

In addition (or alternatively), transitional measures should be put in place on an opt-in basis in order to ease the transition to the new rules. Potential options in this regard could be:

- To start with the percentage of EBITDA being a higher amount (say, 50% of EBITDA), and then reducing this amount down to 30% of EBITDA (e.g., at 5 percentage points per annum over four years). This is similar (although a more staged approach) to the approach adopted by the United States and Canada;
- To retain the current asset-based safe harbour (for five years) and supplement it with the earnings based safe harbour. In this scenario, debt deduction denials could be determined as the higher of:
    - The debt deduction denial calculated under the current safe harbour debt amount; and
    - The debt deduction denial calculated under the earnings-based safe harbour amount, multiplied by a relevant fraction (e.g., 1/5th for the year ending 30 June 2024, 2/5ths for the year ending 30 June 2025, ramping up at 20% per annum until the year ended 30 June 2028, when it would be fully operative).[1]

We have made more detailed comments in response to the specific consultation items below.

Implementation considerations- adopting an earnings base "safe harbour" test

1. *Considering the policy intent of limiting debt deductions to genuinely commercial amounts, should the fixed ratio rule rely on accounting or tax figures? On what basis do you say this?*

   We expect that industries will be affected in different ways depending on whether accounting or tax figures are relied on, and so we have no definitive views about whether adopting accounting EBITDA or tax EBITDA is preferable (and we express no view in that regard).

   One of the issues with adopting an EBITDA measure, in the absence of a rule allowing for the carrying forward and back of both denied interest deductions and excess thin capitalisation

[1] The purpose of retaining the asset-based safe harbour for those five years is so that no taxpayer is advantaged by the phasing in approach of the EBITDA measure.

capacity, is that both tax EBITDA and accounting EBITDA would exclude certain items from earnings where they are material to future earnings.

In the most straightforward example, project-based businesses or start ups will typically have nil or negative EBITDA in early years, with (if successful) growth in EBITDA occurring over time. Adopting an earnings based safe harbour will consequently increase the cost of funding, even if a rule providing for the carrying forward (and back) of denied debt deductions and unused thin capitalisation capacity is implemented. We recommend that Treasury conduct analysis of the expected impact of the cost of funding in these scenarios, including whether the increased cost of funding could impact the viability of certain projects. This analysis should also include the impact of providing for the carrying forward of denied debt deductions (and unused thin capitalisation capacity).

To take a further example, it is common in certain sectors to willingly take reduced earnings in early years in order to grow the consumer base or attract anchor consumers. This is common not only in the technology sector, but also in the real estate sector. In the real estate sector, we often see landlords enter into certain forms of tenant incentives (such as rent free periods or tenant fitout incentives) that for tax purposes may have the effect of reducing taxable income upfront, and for accounting purposes may be amortised over the life of the lease. In other words, income is given up or expenses are incurred in the early period to secure material leases with future income earning potential. Adopting an EBITDA test (whether tax or accounting[2]) is likely to result in debt deduction denials in the early years, and potentially excess thin capitalisation capacity in the later years. Accordingly, rules to allow the carry forward and back of both debt deduction denials and excess thin capitalisation capacity, as have been implemented in the UK, should be adopted to mitigate earnings volatility caused by timing differences.

Furthermore, and again regardless of whether a tax EBITDA or accounting EBITDA approach is adopted, careful consideration will need to be given to the impact of adopting an EBITDA measure in the case of non-consolidated groups, whether those vehicles are flow through or otherwise. In many instances, the tax and accounting EBITDA of upstream entities will be materially different to the tax and accounting EBITDA to downstream entities. To take a simple example:

- Assume a wholly-owned trust (or company) invests in real estate or other depreciable assets, and derives $50 of assessable income (e.g., in the form of rent), and claims depreciation for tax purposes of $25, leaving it with net (or taxable) income of $25. On a tax EBITDA basis, it has EBITDA of $50.
- Assume further that the parent vehicle is presently entitled to the income of the wholly-owned trust or is paid a fully franked dividend. The parent vehicle, in this scenario, has EBITDA of $25. As a consequence, gearing at the parent vehicle would result in much lower thin capitalisation capacity, in the absence of appropriately designed associate entity rules.

The current rules would (generally) not give rise to different thin capitalisation outcomes where the debt was borrowed by the subsidiary vehicle or the parent vehicle. The proposed rules, in the absence of material alteration to the associate entity rules (or some form of de facto grouping rule), would. Accordingly, amending the associate entity rules (or re-introducing a thin capitalisation grouping concept) requires careful consideration.

In our view, the associate entity rules should accommodate picking up excess thin capitalisation capacity of downstream entities, including non-wholly owned entities. This should include downstream flow through entities in which 10% or more of the equity is held, noting the recent legislative changes to prevent so-called double gearing structures.

We have made more detailed comments with respect to a potential approach below.

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2 Note that we have assumed accounting EBITDA would not recognise any amortisation of items such as tenant incentives, although obviously an adjusted EBITDA measure could be used to capture these.

2. *What factors influence an entity's current decision to use the safe harbour test (as opposed to the arm's length debt test or the worldwide gearing test)?*

   In our experience, the safe harbour debt amount is presently used by the majority of taxpayers that are subject to the thin capitalisation regime. This is primarily because the current safe harbour debt amount is currently relatively straightforward to calculate, there are substantial compliance costs associated with determining and documenting the arm's length debt amount, and there are restrictions on the use of the worldwide gearing debt amount.

   Importantly, there is less conditionality and subjectivity associated with the safe harbour debt amount compared to the arm's length debt amount. In addition, the current safe harbour debt amount generally reflects the maximum level of gearing that is offered by third party financial institutions, other than in the context of project finance or SPV-based financing arrangements (where higher levels of gearing are permitted).

3. *Are there specific types of entities currently using the safe harbour test that would be affected by the introduction of a fixed ratio (earnings based) rule? If so, how would they be affected?*

   We consider that entities operating in capital intensive industries, such as the infrastructure and real estate sectors, will be materially affected by the introduction of a fixed ratio earnings based rule. We further consider that entities that are in the growth stage of their lifecycle – such as start up or early stage project-based entities – are likely to be adversely impacted by the introduction of a fixed ratio earnings based rule.

   Having regard to the infrastructure and real estate sectors, it is worth considering some standard terms of very common debt arrangements with genuine third party lenders (such as Australian banks). In the real estate sector, it is common for banks to lend to vehicles holding real estate assets on a 50%-60% LVR basis (if not higher), with an interest coverage ratio of 1.5 to 2. Assuming yields in the real estate sector are (say) 5%, an ordinary commercial arrangement with a third party bank will result in a denial of interest deductions. In this scenario, if we assume a real estate value of $10 million, the rental income would be $500,000, the interest expense (at a 4% interest rate and 50% LVR) would be $200,000, resulting in a debt deduction denial of $50,000.

   In our experience, vehicles investing in real estate assets and infrastructure assets would commonly have levels of gearing and rental yields consistent with the above example, and those arrangements are entered into with genuine third parties. Accordingly, we expect that the proposed measure will have a material adverse impact on the cost of capital in these sectors.

   Similarly, in the start up sector it is common to raise finance by way of convertible debt instruments, such as convertible notes. In many instances, cheaper finance can be raised in this manner by way of creating exposure to potentially material upside in the case of a conversion (which is typically at the election of the holder). For these entities, the impact of an earnings-based safe harbour is likely to be at the point in the business lifecycle when they can least afford it. Accordingly, we consider that it may be prudent to provide an exemption (e.g., for seven years) from the thin capitalisation regime for start up vehicles.

4. *Should there be any changes to the existing thin capitalisation rules applicable to financial entities and authorised deposit-taking institutions?*

   We agree with the comments in the Consultation Paper that the fixed ratio rule should not apply to financial entities and ADIs should be excluded from the fixed ratio rule, and further that these entities should continue to be subject to the existing thin capitalisation rules.

   Consideration should be given to expanding the concept of financial entities to allow certain entities that invest for the long term in capital intensive sectors, such as real estate and infrastructure, to elect to be treated as a financial entity. In these cases, it may generally be expected that the lower amount (used for financial entities) would be the "adjusted on-lent amount" which uses a 3/5th ratio (rather than the "total debt amount", which applies a 15/16th ratio), but if there are concerns in this regard, the adjusted on-lent amount could be mandated for those entities electing (potentially with an exclusion for the "on-lent amount" steps in the relevant method statement).

Debt is typically cheaper than equity, and so the proposed thin capitalisation measures are likely to result in an increase in the cost of capital to Australian vehicles and a consequential impact on Australia as an attractive source for foreign capital, which will be felt most keenly by those operating in these capital intensive sectors.

From a tax policy perspective, and consistent with the rationale for the current thin capitalisation rules, certain multinationals (whether inbound or outbound) may be able to obtain certain tax advantages from the use of debt in comparison to equity. In particular, for example, the interest withholding tax cost of capitalising Australian entities with international related party debt is materially lower than the corporate income tax rate and the tax treatment of returns to non-residents (10% as compared to 30%). Similarly, because Australia's corporate income tax rate is comparably high by international standards, it can make economic sense to gear Australian operations higher than operations in other jurisdictions.

However, there are certain vehicles, such as withholding MITs, where there is only a slight difference between the tax cost of international related party debt (withholding at 10%) and equity (withholding at 15%, potentially at 10% for clean building MITs). Similarly, a 15% tax rate on the returns on equity is internationally competitive, meaning that there is little reason to load debt into Australia.

Accordingly, and with respect to withholding MITs in particular, the overriding rationale for the use of debt reflects that debt is a cheaper source of capital than equity, rather than the tax treatment of debt compared to equity. In our view, therefore, it may be prudent to allow withholding MITs (or vehicles controlled by withholding MITs) to elect out of the earnings-based thin capitalisation measures, and instead allow them to elect to be treated as financial entities, potentially with a requirement for such vehicles to be required to calculate their safe harbour under the adjusted on-lent amount (using a 3/5ths ratio).

In order to do this, a withholding MIT could be allowed to elect to be classified as a financial entity (potentially for a certain period of time (such as 5 years), to prevent annual elections being made depending on the thin capitalisation profile). As debt may sit in a downstream entity from the withholding MIT, the upstream withholding MIT could be entitled to deduct its share of downstream deductions that were denied under the earnings based rule, where the withholding MIT satisfied the modified safe harbour for financial entities. In addition, the existing asset-based rules could be supplemented to provide that a withholding MIT is prohibited from making or relying on an election where the withholding MIT has debt deductions (or has a share of a downstream entity's debt deductions) arising in respect of any cross-border related party arrangements.

Fixed ratio rule – implementation considerations

5. *Would the existing $2 million de minimis threshold be an appropriate threshold for the fixed ratio rule, to exclude low-risk entities?*

Our view is that the $2 million de minimis threshold for the application of the fixed ratio rule should be materially increased. The $2 million de minimis threshold is included in section 820-35. The threshold was originally set at $250,000 when the current thin capitalisation rules were introduced in 2001. The threshold was increased to $2 million in 2014.

To eliminate compliance costs and to set a threshold that takes into account inflation (since 2014 and the next 5+ years) and increasing interest rates, we consider an appropriate de minimis limitation would be in the region of $10 million. This limit also reflects the current environment of higher international interest rates.

One further rationale for increasing the de minimis threshold is that the proposed definition of "net interest expense" is not clear (and may include amounts that would not presently be classified as debt deductions), and that it is not clear whether net interest expense is intended to replace the concept of "debt deductions" (or whether the concept of debt deductions will be retained).

If the net interest expense concept is intended to replace the debt deduction concept, then the de minimis should increase to reflect the inclusion of other items. To take some examples, "net interest expense" for accounting purposes will typically include net receipts and payments under the terms of relevant swap arrangements, and may also include foreign exchange gains or losses recognised as interest expense. Both of these items are presently excluded from the concept of "debt deductions".

In addition, we note that the current application of the de minimis threshold includes the debt deductions of associates. Given the very broad associate tests (which, for trusts for example, include all of the beneficiaries of that trust), many taxpayers effectively have to assume they are subject to the rules on the basis that debt deductions of associates are not known (and there is no way of obtaining this information from the associates, many of which may hold relatively small interests). Accordingly, the current de minimis inclusion of associates should be limited by only including associates which hold material interests in or by the vehicle (such as 40% or more).

6. *Are there specific sectors more likely to experience earnings volatility that may cause entities to explore using one of the alternative tests instead (e.g. arm's length test)?*

Earnings volatility

Earnings volatility is a significant issue in a number of different sectors. The manner in which the proposed earnings base rule will respond to and reflect volatility in earnings is one of the most significant implementation considerations.

Earnings variability arises in a number of different ways. Some projects or activities may experience "lumpy" earnings profiles that reflect the underlying nature of the relevant activities. Many projects involve a significant period in which assets are developed or constructed before material earnings arise. Common examples include:

- Greenfield infrastructure projects that have a long lead time for the construction of assets. This is true of greenfield projects in a number of sectors including energy (electricity and gas projects, solar, wind, hydrogen, battery), toll roads and other significant social infrastructure (hospitals, schools, student accommodation, affordable and social housing);
- Greenfield economic and social infrastructure projects (e.g. construction of renewable energy). Very broadly, greenfield projects are projects that are constructed from scratch. In these cases, there is a construction period where there are no earnings and earnings will only start to be generated during the operations phase of the project. Construction periods can take a number of years and can be anywhere between 1 – 5 years (if not longer);
- Common property transactions that involve the development of property assets. Following development (which for larger projects may easily take 4 - 5 years), it is common for the property holder to be in a tax loss position, at least for the first couple of income years. This arises in part because of depreciation (which will presumably be reversed in determining the relevant EBITDA), but also (as noted above) because of the provision of tenant incentives. These incentives may take the form of a rent-free period (which defers income earning to later years), or fit-out incentives (which may be deductible upfront to the landlord). From an accounting perspective, these incentives are often amortised over the life of the lease arrangements secured (reflecting that they represent an upfront cost to inducing a party to enter into a long term lease); and

- Start ups and the tech sector, where many participants sacrifice earnings in the early years in order to grow large consumer bases. In many instances, many of today's largest tech companies made losses for a substantial number of years (or, in some instances, continue to make losses). These participants sacrifice earnings to establish larger market share, which will often then result in future earnings. Again, adopting an annual approach seems inconsistent with the business models adopted by these vehicles and unfairly punitive (in the absence of rules providing for carrying forward and back denied debt deductions and unused thin capitalisation capacity).

Variability in earnings can also arise due to unforeseen external factors, including market downturns, loss of a significant client or contract, market conditions, etc.. Many businesses, such as those in the hospitality sector and the property sector, were (and are) materially impacted by COVID-19 (and the associated Governmental responses to COVID-19). These conditions may result in material volatility in earnings between different periods.

In our view, the new earnings based rule should have in-built mechanisms to cushion the impact of such situations (e.g., perhaps an averaging of earnings option (which could be the highest earnings from two of the last three years, to isolate years with unusual trading conditions), or use of prior year earnings when those business are less able to afford the interest denial/additional tax costs). Similarly, we consider that start up ventures should be exempted from the thin capitalisation for a period of time (e.g., seven years), so that the impact of increasing their cost of capital does not adversely impact their growth when it is least affordable.

Many capital-intensive projects (including greenfield projects) or start ups are financed by a relatively high proportion of debt, reflecting that debt is typically cheaper to obtain than equity. The financing profile of these projects primarily reflects commercial considerations rather than, for example, the taxation treatment of financing costs. The financing mix is often driven by factors such as the cash flow profile of the project. Construction lag times or the importance of obtaining market share before material earnings arise can be significant and is commonly in the 2 to 5 year range (or even a longer period for more significant infrastructure projects or network-based industries). Attempting to move the funding mix for many of these significant projects or ventures from debt to equity is likely to be expensive and raises a question as to whether these projects or ventures would continue to be pursued (at least in Australia).

Specific rules to address earnings volatility

Consistent with other jurisdictions and the OECD Paper, our view is that earnings volatility needs to be addressed by specific measures in the proposed earnings based safe harbour rule. These measures would include, at a minimum, rules that allow:

- the carry forward of unused interest capacity;
- the carry forward and carry back of disallowed interest deductions; and
- the use of average earnings from prior years to smooth variations in earnings (such as allowing the use of the highest earnings from two of the previous three years).

All of these measures are important in seeking to address earnings volatility issues.

The period in which the above rules apply needs to reflect the earnings profile of relevant projects that are referred to above. Given that there is no "one size fits all" earnings profile for relevant projects, our view is that the carry forward and carry back rules should have no relevant period limitation, or if any period is implemented, it should be significant (at least 10 years).

Further consideration should also be given to whether it is appropriate to apply integrity rules to the ability to carry forward unused interest capacity or the carry forward and carry back of disallowed interest deductions. While one approach would be to impose similar integrity rules to those that apply to the carry forward and utilisation of other tax attributes (e.g., the rules that apply to tax losses such as continuity of ownership tests, etc.), further analysis needs to be undertaken as to whether the rationale for such rules is applicable in the context of many greenfield infrastructure projects or start up vehicles. In our experience, it is often that case that these projects or vehicles may involve a different ownership profile for different phases of the project (e.g., development and construction versus ongoing operation, or exit by the founder once the business has become mature). It is not clear to us that the policy basis for applying, for example, highly complex integrity rules that are based on the rules that currently apply to other tax attributes such as tax losses are appropriate in the context of financing costs associated with many greenfield projects.

Finally, if the capacity to carry forward and use debt deduction denials or unused thin capitalisation capacity are to be subject to those integrity rules that apply to other tax attributes, a same/similar business test should be implemented for trust vehicles (noting these vehicles are currently subject generally to the 50% stake test, with no capacity to access the same or similar business tests). The rules should not favour certain legal forms of vehicle over others.

Interaction with other tax rules

The implementation of any rules that allow the carry forward or carry back of unused interest capacity or disallowed debt deductions needs to also carefully consider the interaction with other rules in the Tax Act. Given many projects are conducted using trust structures, careful consideration needs to be given as to how any new rules will operate with existing rules that apply to trusts. One particular example that we have considered is the interaction of these rules with the existing taxation rules for trusts in Division 6 of the ITAA36 and the capital gains tax (**CGT**) measures in Part 3-3 of the ITAA97.

With respect to carrying back deductions (or excess thin capitalisation capacity), this would be expected to decrease net income in respect of prior years, and therefore decrease the assessable income of upstream unitholders for those years (and, where relevant, the amount of MIT withholding tax that should have been remitted). Rules allowing upstream unitholders to amend their income tax returns as a consequence of downstream changes in net income of flow through vehicles should be reviewed to ensure they are adequate, and rules to allow for the refund of excess MIT withholding tax should be introduced.

More generally, adopting an EBITDA test is likely to result in increased debt deduction denials, particularly in those sectors which invest via trust vehicles (such as infrastructure and real estate). Given this may result in net (i.e., taxable) income being higher than the cash available to distribute, rules allowing the cost base of the interests in these vehicles to increase in this scenario should be implemented (similar to CGT event E10 for AMITs).

Finally, the use of any carried forward denied interest deductions should not be subject to the operation of section 51AAA. For many projects, the carry forward will only be of value in the year of sale of any underlying assets, as it is only at this point that sufficient taxable income would be generated (from capital gains) to use the carried forward deductions.

7. *What features of fixed ratio (earnings-based) rules in other jurisdictions are most significant (relevant) for implementing a fixed ratio rule in the Australian context?*

Grouping rules

One issue that is not expressly discussed in the Consultation Paper is how the proposed changes will impact the associate entity rules, which (very broadly) allow upstream entities to pick up excess thin capitalisation capacity arising from the downstream entities. These rules generally apply by disregarding the value of the associate entity equity that the upstream entity holds in the downstream entity, and then including the excess thin capitalisation capacity of the downstream entity (along with the premium excess amount).

Moving to an earnings-based test will materially alter the way these rules will need to work. Achieving a comparable treatment to the current grouping rules would require the following (noting there are potentially other options):

- First, the earnings-based thin capitalisation limit of a downstream entity would be determined;
- Second, the earnings-based thin capitalisation limit of an upstream entity would be determined, but disregarding any earnings arising from distributions from associate entity equity and associate entity debt; and
- Third, included in the thin capitalisation limit of the upstream entity would be its pro rata share (by reference to its associate entity equity) of the excess thin capitalisation capacity of the downstream entity.

This will require substantial amendments to the associate entity provisions. Consideration will also be required to how the grouping provisions interact with the classification of vehicles within a group (e.g., if an upstream general entity holds associate entity equity in a financial entity). There may well be alternative ways to achieve a similar outcome (such as some form of thin capitalisation consolidation or grouping).

In the absence of specific grouping rules, vehicles could end up with quite materially different thin capitalisation outcomes. To take an example, a holding vehicle that receives no distributions from downstream entities (and so has no earnings) would have no thin capitalisation capacity in the absence of specific grouping rules.

As explained earlier, a property/operating entity will have materially higher thin capitalisation capacity than a holding entity (which only receives distributions or dividends), even where the holding entity holds (indirectly) 100% of the property/business. This is because at the property/business level, the EBITDA will (presumably) include all assessable income and exclude tax depreciation. However, the upstream entity may either not receive distributions or, if it does, it will receive taxable distributions after the impact of items such as interest, tax, depreciation, and amortisation.

Similarly, where an entity borrows from an external party and on-lends the amount to an associate entity, the first entity is treated under the current rules (in effect) as not having any debt (as the on-lent amount reduces the adjusted average debt, assuming the on-lent amount is classified as associate entity debt). Again, changes will be required as a result of moving to an earnings based test to ensure on-lending arrangements are not captured twice. We assume that this will be achieved by way of the determination of "net interest expense" – i.e., that where any entity borrows externally and on-lends on the same terms, that that entity will have net interest expense of nil (and, therefore, no thin capitalisation denial).

Note that the above point relating to on-lending is also material in non-related party situations, such as non-bank lenders where those lenders do not presently qualify as financial entities for thin capitalisation purposes.

Exclusion for public infrastructure projects

The United Kingdom has legislated (consistent with the OECD Report) a public benefits infrastructure exemption. We have made a number of comments above about how an earnings-based safe harbour is likely to adversely impact genuine third party debt arrangements in capital intensive sectors, such as infrastructure and real estate.

It is worth noting that the UK exemption extends to certain investments in real estate. In particular, it extends to the provision of rental properties as part of a business to unrelated parties on a short term basis (being 50 years or less). This would cover most elements of the rental real estate sector.

Where this exemption applies (and noting that the exemption is elective), qualifying entities are effectively allowed deductions for all of their interest expenses in respect of third party arrangements, but no deductions are allowed for related party debt arrangements. This approach seems reasonable, noting the comments above that related party debt is less attractive for many of these investments, given they are often held through withholding MITs. The exclusion of interest from the test in respect of third party arrangements would require looking through related-party arrangements where there is on-lending, provided the ultimate source of the debt capital was from a third party.

In respect of making the election, and given that entities' roles may change over time, the election is made for a fixed period of time (5 years), and then subsequent elections can be made. We also consider that this feature of the regime makes sense.

If an entity elects into this treatment, it is then excluded from any group in determining relevant group ratios (i.e., so that its higher level of gearing and net interest expense does not end up increasing other entities' thin capitalisation capacity). Again, this approach seems reasonable.

We consider that such an exemption could operate in Australia to effectively exempt non-tax driven arrangements from the 30% EBITDA test, while ensuring it was not exploited by creating an incentive to gear with related party debt. Accordingly, we would support the implementation of such an exemption.

Group ratio rule

10. What types of entities currently use the existing worldwide group test?

The Consultation Paper notes that the OECD's preferred approach contains a group ratio rule, which considers the net interest expense of the worldwide group. The Consultation Paper notes that Australia's current thin capitalisation rules include a group ratio rule in the form of the worldwide gearing debt amount.

Our view is that consistent with other jurisdictions, a group ratio rule should also be a feature of any new thin capitalisation provisions. In addition, we also consider that the current worldwide gearing test requires amendment and our view is that it would be appropriate to include a new group ratio rule rather than relying on the worldwide gearing test. In other words, both the current worldwide gearing debt amount concept should be retained (with amendments), and a further group ratio rule should be introduced (noting the two tests operate by reference to different bases – debt as a percentage of assets, and net interest expense as a percentage of EBITDA)

The current worldwide gearing debt amount has a number of restrictions which limit its application. For example, certain general entities are prohibited from using the worldwide gearing debt amount, such as inward investing general entities where the audited consolidated financial statements for the entity do not exist, or where the average value of Australian assets exceeds 50% of the value of the worldwide assets of the entity.

Our view is that some of the exceptions that currently apply to the worldwide gearing debt amount should be reconsidered, noting the exclusions may be particularly inequitable for entities controlled by foreign investment entities which do not prepare consolidated financial statements. This includes foreign investment entities, such as pension funds, which generally consolidate on an equity basis (with the consequence that debt, and associated interest expense, sitting in downstream entities is not recognised in the accounts).

We are aware that the UK rules, in similar circumstances, allow the group ratio rule to operate by reference to the highest entity in the chain of entities that does prepare audited consolidated financial statements. This allows access to the group ratio rule for those entities where there are not consolidated financial statements at the level of the ultimate controller, due to their status as an investment entity (or other exception relating to the production of audited consolidated financial statements). We consider that similar rules should be implemented in the Australian context.

Fixed ratio rule: the role of arm's length debt test

11. *Would introducing a fixed ratio rule encourage entities not currently using the arm's length debt test to shift to an arm's length test? If so, why? Are there specific sectors where this type of behavioural response is likely to be more evident?*

    It is possible that the introduction of an earnings-based safe harbour may result in additional taxpayers seeking to rely on the arm's length debt amount, particularly in the capital intensive sectors or start up/tech sectors referred to above. This is the case because taxpayers in these sectors are likely to have net interest expense exceeding the 30% EBITDA test, but also because taxpayers in these sectors typically rely on genuine third party debt (noting that this is not a pre-requisite for applying the arm's length debt amount).

    In our view, it would be prudent to monitor how many taxpayers are relying on the arm's length debt amount following the introduction of the earnings-based safe harbour, rather than pre-meditating an increase in its use and seeking to limit the use of the arm's length debt amount. If there are concerns around the integrity of the arm's length debt amount and there is an increase in the number of taxpayers relying on it, further consideration can be given at that time to potential reform. However, there are a number of elements to the current arm's length debt amount which do require amendment to make it easier to comply with (particularly in the case of genuine third party debt arrangements) and reduce compliance costs. These are referred to below.

12. *For entities currently using the arm's length debt test, would replacing the current 'standalone entity' rule to require consideration of the entity being a member of a worldwide group reduce compliance costs? If not, why?*

    We consider that the current treatment of explicit or implicit credit support in determining the arm's length debt amount is problematic, and substantially increases the compliance burden for taxpayers (and the ATO). We consider a range of changes should be made in this regard.

    First, explicit credit support should not be excluded for the purposes of the arm's length debt amount where the support is of a kind that, although typically included by an independent third party lender, does not affect the amount of debt the borrower cost access. This is consistent with the recommendation of the Board of Taxation arising from its 2014 Review of the Thin Capitalisation Arm's Length Debt Test.

    Second, explicit credit support provided by entities within the Australian group (i.e., holding Australian assets) should not be excluded. The use of entities holding Australian assets to provide credit support illustrates that the debt is supportable by reference to the Australian assets of the group, and that the credit worthiness of foreign vehicles is not being used to increase the level of gearing in Australia. It may be necessary to include a requirement that where an entity relies of the arm's length debt amount and includes credit support by associate entities holding predominantly Australian assets in determining the arm's length debt amount, the associate entities must also apply the arm's length debt amount (effectively, to prevent double gearing where the associate entity is then geared with related party debt).

    Third, implicit credit support should not be excluded for the purposes of the arm's length debt amount. Again, this is consistent with the recommendation of the Board of Taxation arising from its 2014 Review of the Thin Capitalisation Arm's Length Debt Test.

    Fourth, a particular issue arises in the infrastructure sector and the real estate sector for development debt, being debt to develop a material asset over a number of years. It is common for third party lenders to seek a parental guarantee in these circumstances, as the underlying entity will not be income earning. In addition, in the absence of this parental guarantee, it is likely the third party lender would not provide the debt (or provide a much lower quantum of debt). In this case, satisfying the arm's length debt amount can be difficult.

However, most arrangements of this nature are not structured to increase the gearing of development assets in Australia compared to the gearing of development assets offshore (i.e., are not motivated by base erosion or profit shifting). We consider that in the case of development assets, it should be possible to take into account parental guarantees or other forms of credit support, as this reflects international practice in developing large infrastructure and real estate assets.

13. *Would differentiating between external (third-party) debt and related-party debt simplify the operation of the test?*

We consider that it would. One option would be to introduce a statutory safe harbour that in the case of external (third party) debt, the arm's length debt amount analysis is only required to be performed when the debt arrangement is entered into or at the time of material changes to the debt arrangement, and that (in these cases) the documentation requirements will be satisfied if they are put in place at the commencement of the arrangements.

2. PART 2: DENYING MNES DEDUCTIONS FOR PAYMENTS RELATING TO INTANGIBLES AND ROYALTIES PAID TO LOW OR NO TAX JURISDICTIONS

General comments

The Consultation Paper considers that taxpayers can use arrangements involving intangibles and royalties to shift profits out of Australia to low or no tax jurisdictions, and that the growth of the digital economy has exacerbated these practices.

As an initial observation, the measure as described in the Consultation Paper appears to go well beyond the Labor Party policy announced during the election campaign. The Labor Party's policy was directed towards limiting "the ability of large multinationals to abuse Australia's tax treaties while holding intellectual property in tax havens from 1 July 2023". The Consultation Paper goes well beyond this, raising a range of integrity issues including those raised by the ATO in a number of Taxpayer Alerts (e.g., TA 2018/2, TA 2020/1 and TA 2022/2). We make several observations in this regard.

First, it is not clear to us that the proposal to disallow deductions for payments and royalties relating to intangibles and royalties is appropriate to address all of these integrity concerns. For example, the relationship between this proposal (to disallow deductions for intangible related payments) and the issues raised by the migration of Australian intangibles to related offshore entities is not clear, and it is difficult to see how this proposal would adequately address those concerns.

Second, it is also not clear to us why a specific new set of taxing rules is necessary to address those concerns, and the policy rationale for the implementation of a new set of rules is not adequately made out in the Consultation Paper. We note that the arrangements referred to in the Consultation Paper would appear to be dealt with by other specific tax regimes such as the transfer pricing regime, the principal purpose test under relevant Double Tax Agreements, the CFC regime and general anti-avoidance regime and (further) that payments may be required to be apportioned to determine royalty elements. The concern appears to us to relate to difficulties in the enforcement of existing rules, rather than a concern that the existing rules are inadequate from a policy perspective.

Turning first to the specific measure announced by the by the Labor Party in the election campaign, the concern to which this measure is addressed would appear to be "treaty shopping". If that is the concern, then the rationale for this measure is unclear. There are already a number of anti-avoidance rules available to the ATO to challenge abusive arrangements (see, for example, those referred to in TA 2022/2). If a particular arrangement is not within the scope of the anti-avoidance rules referred to, then the justification for this new rule is not clear, as the non-application of an anti-avoidance rule would suggest that the treaty is appropriately being availed of for a non-tax avoidance purpose.

Turning next to "embedded royalties", the Australian royalty withholding tax regime, and Australia's tax treaties, all contain a requirement to apportion payments to the extent the payment is a royalty. If a payment for goods or services includes a component that is a royalty, Australian withholding tax applies to that extent. While it may be difficult to determine the component that is a royalty (and this is likely to be heavily fact dependant on a case by case basis), a blanket formula-based rule will almost certainly result in the incorrect characterisation of amounts as royalties. The real concern here is the difficulty associated with proving what part, if any, of a payment may be properly characterised as a royalty. But this difficulty does not justify an abandonment of longstanding international principles of taxation.

The Consultation Paper also raises certain issues that seem to have no relationship with Australian tax policy. For example, the concern that upstream non-Australian entities may be paying royalties to foreign residents which are "really" royalties for the Australian business is overreaching Australia's taxing rights under traditional international taxation principles. If the payment made by the Australian entity contains a component that is a royalty, as discussed above, Australian withholding tax will apply. If not, then Australia should apply its taxing rights in the usual way, by reference to customary residence and source rules, and in conformity with Australia's treaty obligations, rather than penalising the Australian payer by disallowing a deduction.

With respect, the proposal to disallow Australian taxpayers deductions in all of the circumstances outlined in the Consultation Paper appears to us to be designed to avoid Australia's treaty obligations, or to circumvent traditional international tax principles, by penalising Australian taxpayers rather than applying our treaty obligations. The existing tax rules are sufficient to deal with the issues identified in the Consultation Paper. Those rules, which have been designed with international tax principles and treaty obligations in mind, should not be discarded only because they might be difficult to apply in different fact patterns. We strongly submit that this is a very poor way to make tax policy.

If the measure is nonetheless to proceed, the Paper does not appear to allow the deduction of royalty amounts where the royalties are subject to Australia royalty withholding tax; it refers solely to whether the amounts are subject to no or low tax in the foreign jurisdiction. In circumstances where Australia collects royalty withholding tax on the amount, the treatment in the foreign jurisdiction should be irrelevant. This aligns with the original measure announced by Labor during the election campaign, which focussed on payments made to entities where the payment was considered to "abuse Australia's tax treaties" (i.e., was to an entity that was entitled to treaty benefits under Australia's tax treaty network). Given this is the intended target of the measure, we consider that:

- genuine third party arrangements should be excluded from the regime; and
- payments which are subject to a minimum amount of royalty withholding tax (such as, for example, a rate of 15%) should be deductible.

Finally, the rationale for a "low tax jurisdiction" rule is doubtful once the OECD's Pillar 2 is implemented and the 15% "global minimum tax" is in force. Careful consideration should be given to how any unilateral action by the Australian Government in this regard will interact with expected global rules that are likely to subject these payments to tax in a foreign jurisdiction (even if that jurisdiction is not the jurisdiction of receipt).

3. PART 3: MULTINATIONAL TAX TRANSPARENCY

General comments

With respect to the reporting of tax information on a country-by-country basis, we note the following:

- Any measure should limit taxpayer compliance costs by applying only to those entities that are presently required to compile this information (i.e., country-by-country reporting entities). Implementing a measure that requires public reporting of information that is presently not reported to the ATO would increase tax compliance costs, but also result in information being in the public domain where that information is not subject to ordinary ATO review processes;
- Any measure should be limited to non-flow through vehicles. As a consequence of certain existing public reporting, the media has often reported on trust or other flow through vehicles paying no tax in Australia, notwithstanding upstream entities include their share of the income in their income tax returns, and (in addition) that withholding tax may be withheld and remitted to the ATO. Releasing this information to the public serves not to inform them accurately of the tax affairs of the vehicle; rather it is misleading as it implies the income has not been subject to Australian tax when it fact it has.

With respect to reporting on "material tax risks" to shareholders, it is not clear to us how reporting on the presence of vehicles in so-called tax haven jurisdictions indicates Australian tax risk. Tax haven entities may be used for a range of reasons, including (for example) to manage foreign tax risks. Similarly, reporting to shareholders in respect of self-assessed PCG scores does not in our view provide any meaningful measure of tax risks. PCGs are not law, and do not have the status of public rulings. The purpose of a PCG is stated as follows in PCG 2016/1:

> *Practical compliance guidelines, on the other hand, are not prepared for the primary purpose of expressing a view on the way a tax law provision applies. They represent guidance material on how the ATO will allocate its compliance resources according to assessments of risk, and may outline administrative approaches that mitigate practical difficulties relating to the operation of tax laws. Accordingly, practical compliance guidelines will generally not be public rulings.*

In the light of the purpose of PCGs, they are inappropriate to be used as the basis for any reporting of "material tax risks" to shareholders. It is acknowledged that a taxpayer may be identified as having a "red" score on a PCG, notwithstanding that the arrangement is permitted by existing law. Accordingly, using PCGs to measure tax risk is likely to mislead rather than inform shareholders. We would make similar comments regarding Taxpayer Alerts, which tend to be very fact specific, contain very limited technical analysis and are an indication of the view of the Commissioner rather than representing a public ruling or law.

More generally, it is not clear to us why tax risk reporting is not adequately catered for under existing accounting standards. In our view, any proposed measure should start with existing requirements relating to reporting under existing accounting standards, and then identify and deficiencies or weaknesses in this regard, following which any measures could be appropriately targeted to require reporting on genuine tax risks.

If you have any queries on any of our comments above, please contact Steve Whittington on 02 9258 6547 or Sanjay Wavde on 02 9258 6135.

Yours faithfully,

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