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

By Email: [MNETaxIntegrity@treasury.gov.au](mailto:MNETaxIntegrity@treasury.gov.au)

Dear Treasury,

## TREASURY LAWS AMENDMENT (MEASURES FOR FUTURE BILLS) BILL 2023: Removing the deduction for 768-5 NANE income

The Australian Banking Association (**ABA**) welcomes the opportunity to comment on the Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation (**the Bill**) and the Draft Explanatory Memorandum (**EM**). In this submission, we address *Schedule X – Thin Capitalisation and other amendments*.

Broadly, the proposed measures contained in the Bill regarding the new thin capitalisation regime do not impact ABA members as Authorised deposit-taking institutions (**ADIs**) are outside the scope of the new thin capitalisation regime, as acknowledged in the EM.

However, ADIs may be significantly impacted by proposed changes to s25-90 and s230-15(3). The ABA is concerned by the proposal to omit “*section 768-5, or*” from paragraphs 25-90(b) and 230-15(3)(c)<sup>1</sup> of the Income Tax Assessment Act 1997 (**ITAA**) (**The Proposed Changes**), which was unannounced prior to the release of the Bill and EM.

The Proposed Changes will remove the ability for ADIs to claim interest expense deductions on foreign equity distributions (being those treated as non-assessable non-exempt (**NANE**) income under section 768-5). As outlined in the Annexure, the Proposed Changes give rise to a number of Policy Anomalies: ADIs are excluded from the new income-based tests for calculating thin capitalisation yet they are impacted by the Proposed Changes. There is no ‘double benefit’ for ADIs as their interest deductibility capacity is already reduced under the thin capitalisation rules in respect of offshore subsidiaries and therefore further excluding deductions for those same offshore investments by way of the Proposed Changes would give rise to a ‘double- penalty’. In addition, ADIs are subject to extensive prudential regulation, leaving ADIs in a unique position.

The ABA understands that the Proposed Changes are based on the OECD agreed action item 4 to tackle base erosion and profit shifting (**BEPS**) and are informed by the OECD’s guidance.

The ABA refers to the OECD report on *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2016 Update* (the **OECD Report**)<sup>2</sup>, which addresses the “*unique characteristics*” of banks and insurance companies that are to be considered when addressing BEPS risk<sup>3</sup>. That report outlines the OECD expectation that ‘*...regulatory capital rules will be effective in protecting countries from excessive interest deductions in a bank...*’. Therefore, Australian regulatory

<sup>1</sup> As s230-15(3) achieves the same objective as s25-90, for simplicity purposes, references in this submission to s25-90 is also a reference to s230-15(3).

<sup>2</sup> *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update*; <https://www.oecd-ilibrary.org/docserver/9789264268333-en.pdf?expires=1681167433&id=id&accname=quest&checksum=6D1BBEA2E573BBB77BB5CD62720F7570>

<sup>3</sup> *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update*, pg. 171, p. 480.



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capital rules should be taken into consideration when considering the policy basis for the Proposed Change.

Given the settings of the regulatory capital system in Australia, the ABA is of the view that the risk of BEPS involving excessive interest deductions for ADIs is very low<sup>4</sup>. Therefore, the Proposed Changes in their application to ADIs will not mitigate any material risk of BEPS because there is no material risk.

Therefore, the ABA strongly recommends that s. 25-90 continue to apply to ADIs. This will ensure consistency with the continuation of the existing Thin Capitalisation rules for ADIs. Further, the Proposed Changes may adversely impact ADI's ability to invest competitively overseas. Detailed discussion is contained in the accompanying Annexure.

In addition to the key matter noted above, we also note the lack of provision of transitional arrangements. Should the government move forward with the Proposed Changes, the ABA strongly submits that the amendments should not commence until 1 July 2024 to allow for extensive and detailed consultations between Treasury, the Australian Taxation Office and ADIs over the intervening 15 months. We further note that this was the transition period allowed in 2013 when the Proposed Changes were previously consulted on.

If Treasury would like to discuss further, please do not hesitate to contact Mitchell Frater-Baird at [Mitchell.Frater-Baird@ausbanking.org.au](mailto:Mitchell.Frater-Baird@ausbanking.org.au).

Kind regards,

Emma Penzo  
Head of Economic Policy

### About the ABA

The Australian Banking Association advocates for a strong, competitive and innovative banking industry that delivers excellent and equitable outcomes for customers. We promote and encourage policies that improve banking services for all Australians, through advocacy, research, policy expertise and thought leadership.

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<sup>4</sup> Interest related BEPS risks was addressed extensively in the International Banking Federation submission to the OECD, dated 9 September 2016, copy **enclosed**.



## ANNEXURE

### 1. ADIs not included in new Fixed Ratio Tests

The EM states that financial entities and ADIs will continue to be subject to their existing asset-based thin capitalisation safe harbour and worldwide gearing tests, as acknowledged in the EM as follows:

*“Financial entities and ADIs will otherwise continue to be subject to their existing asset-based thin capitalisation safe harbour and worldwide gearing tests. This is because the OECD recognised that the earnings-based tests are unlikely to be effective for these types of entities, partly as they are net lenders and subject to regulatory capital rules.”*

Treasury has accepted this separate treatment in respect of the applicable tests.

The EM also states that the “...new earnings-based tests is to limit the amount of deductible interest expense by reference to earnings – that is, an entity is only able to increase its net interest deductions in Australia by increasing earnings in Australia.<sup>5</sup>” The EM therefore concludes that the Proposed Changes are necessary to achieve the “...policy outcomes underlying the new rules as it gives rise to a double benefit; the benefit of the income being NANE income and the benefit of a deduction for the interest expenses incurred to derive such NANE income.<sup>6</sup>”

The Bill seeks to “...**address this double benefit**<sup>7</sup> and ensure the effectiveness of the thin capitalisation rules, sections 25-90 and 230-15 are amended so that they do not allow a deduction for interest expenses incurred to derive the NANE income under section 768-5.<sup>8</sup>”

However, the earnings-based approach made in thin capitalisation part of the Bill will not apply to ADIs as they will remain subject to the 3 existing tests, none of which rely on earnings.

, Treasury has accepted that ADIs have a separate treatment with the continuation of the existing thin capitalisation rules for ADIs. Given the policy rationale provided in the EM, outlined above, does not apply to ADIs, the ABA strongly recommends that this separate treatment should extend to include the continuation of s.25-90 for banks.

### 2. The Importance of s.25-90 and s.230-15 to Banks

#### 2.1 Safe Harbour Test

The ADI thin capitalisation regime requires ADIs to hold a sufficient average equity capital relative to their taxable Australian assets.

Under the existing rules, determining the ‘Safe Harbour’ capital amount requires a bank to calculate its minimum capital amount. The Safe Harbour’ capital calculations are broadly based on the methodology of the capital adequacy requirements prescribed by Prudential Regulators. The Safe Harbour capital amount is a level of equity capital that an ADI must allocate to its Australian operations. For offshore equity investments the thin capitalisation rules require ADIs to subtract, in whole, the value of the equity investment in the controlled foreign entity from average equity capital. This means that ADIs must have an amount of domestic equity capital equal to or greater than the value of any offshore equity investments for thin capitalisation purposes.

If an ADI does not have an amount of domestic equity capital equal to or greater than the value of any offshore equity investments, then the ADI’s adjusted average equity capital will be less than its minimum capital amount. Therefore, a proportion of its otherwise allowable debt deductions cannot be deducted. An investment in an offshore subsidiary therefore has the effect of either requiring an ADI to

<sup>5</sup> Explanatory Memorandum pg 23, p 1.119.

<sup>6</sup> Explanatory Memorandum pg 23, p 1.119.

<sup>7</sup> Bolding added

<sup>8</sup> Explanatory Memorandum pg 23, p 1.120.



hold a greater amount of domestic equity capital or potentially reducing amount of debt deductions accessible to that ADI.

In the ABA's opinion, ADIs should continue to operate under s25-90 as the existing capitalisation rules as it would be highly anomalous for interest deductions to be denied in relation to dividend income originating from those same offshore equity investments that are already subtracted from the ADIs average equity capital for thin capitalisation purposes. This would be directly opposite of a double benefit – i.e. it is a double penalty.

## 2.2 Prudential Regulation

The thin capitalisation regime for ADIs is based on APRA's capital adequacy requirements for ADIs, which generally require a subtraction from capital for the value of equity investments.

Put another way, the regulatory capital rules generally require ADIs to hold capital, rather than debt, against offshore equity investments. It is difficult to conceive of the policy rationale for the tax system to operate contrary to the prudential regulations.

Further, APRA encourages that this capital be held onshore. APRA's requirements effectively encourages offshore assets to be funded with offshore debt; or to put it the other way, it encourages onshore debt will be used to fund onshore assets.

This prudential requirement has the effect of limiting the use of domestic debt to fund offshore investments and consequently limiting ADIs' use of s.25-90 and s.230-15.

The EM highlights that “...*Financial entities and ADIs will otherwise continue to be subject to their existing asset-based thin capitalisation safe harbour and worldwide gearing tests. This is because the OECD recognises that the earnings-based tests are unlikely to be effective for these types of entities, partly as they are net lenders and **subject to regulatory capital rules***”<sup>9</sup> (emphasis added). The OECD Report states that these “...*regulatory capital rules often require the value of this investment to be deducted from the bank or insurance company's own equity when assessing whether it meets capital adequacy ratios*”<sup>10</sup>. As is the case in Australia, with the Safe Harbour test discussed above.

The OECD report concludes that while, ‘...*it is not possible to conclude there is no material risk of BEPS involving interest in the banking and insurance sectors...*’ it acknowledges that the risk

<sup>11</sup> ‘...*varies between countries and may also vary between sectors within a country.*’<sup>12</sup> [OBJ]

Given Australia's particularly robust Prudential Regulation, it is clear that the Proposed Changes are not essential to limiting the BEPS risk. The EM and the OECD make clear the significant impact that Prudential Regulation has on an ADIs gearing, the ABA is therefore of the view that ADIs should continue to operate under s.25-90 and s.230-15 as any BEPS risk that might justify the Proposed Change is limited or removed by existing Prudential Regulation.

## 3. Competitiveness

Ultimately, the impact of the Proposed Changes could make the Australia banking sector less competitive internationally. Other countries, which have adopted the BEPS Action Item 4, have a more favourable deductibility rules, often allowing a deduction for interest expense incurred in earning untaxed income. For example, under the United Kingdom's Thin Capitalisation Rules ADIs are included in the move to income-based tests. However, the income-based rules, in effect, have no impact on ADIs as they typically have net interest income so there is no net interest expense to deny under the tax EBITDA test. In the UK, ADIs are consistently treated, receiving the same benefits and costs from their inclusion in the UK's income-based tests. Conversely under the Proposed Changes, Australian banks are inconsistently treated, being excluded from any potential benefits under the income-based tests but included the broader policy changes. These deductibility rules are in addition to the lower tax environment many international ADIs, including in the UK, operate in. In the ABA's view allowing ADIs

<sup>9</sup> Explanatory Memorandum, Paragraph 1.7.

<sup>10</sup> *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, pg. 179, p. 497.

<sup>11</sup> *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update*, pg. 172, p. 481.

<sup>12</sup> *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update*, pg. 172, p. 481.



to continue operating under s. 25-90 will support them to compete internationally at minimal cost and risk to the Australian Taxpayer.

## Timing

For the reasons provided above, s25-90 and s230-15(3) should continue to apply for ADIs in their current form. The ABA does not support the Proposed Change applying to ADIs.

However, if the Government was to proceed with these proposed amendments to these provisions, the ABA strongly recommends appropriate grandfathering rules be developed for existing relevant overseas investments, which have been based on investment decisions undertaken under longstanding tax rules. The precise manner in which such grandfathering should take place could be co-designed by the ABA and Treasury.

Further, should the government move forward with the Proposed Changes, the ABA submits that the amendments should not commence until 1 July 2024 to allow for extensive and detailed consultations between Treasury, the Australian Taxation Office and the Banking sector over the intervening 15 months.

In support of this proposal, the ABA draws Treasury's attention to the OECD's view that, "...that any rule to limit tax deductions for an entity's interest expense could involve a significant cost for some entities"<sup>13</sup>. The OECD also states that "...a country may also apply transitional rules which exclude interest on certain existing loans from the scope of the rules, either for a fixed period or indefinitely..."<sup>14</sup>.

The ABA also notes precedent for transitional arrangements. On 14 May 2013 Treasury released a 'Proposals Paper' that contained a proposal to repeal section 25-90 of the ITAA, this repeal was planned to have effect from 1 July 2014 so as "to provide time for taxpayers to rearrange their financing arrangements"<sup>15</sup>. The ABA encourages Treasury to provide a similar timeline of no less than 15 months for implementation of the Proposed Changes. The ABA believes that this would allow for the necessary amount of consultation and that the additional time assist all parties through the transition, including regulators.

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<sup>13</sup>Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update, pg 83, p 194.

<sup>14</sup> Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update, pg. 83, p. 195.

<sup>15</sup> Addressing profit shifting through the artificial loading of debt in Australia, Proposal Paper; [https://treasury.gov.au/sites/default/files/2019-03/Proposals\\_Paper\\_Profit\\_shifting.pdf](https://treasury.gov.au/sites/default/files/2019-03/Proposals_Paper_Profit_shifting.pdf)