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Dear Sir/Madam

Exposure draft law: Multinational Tax Integrity – strengthening Australia’s interest limitation (thin capitalisation) rules

PwC welcomes the opportunity to make this submission in relation to the Treasury Consultation Paper “Multinational Tax Integrity – strengthening Australia’s interest limitation (thin capitalisation) rules” released for consultation on 16 March 2023.

Our comments in this submission focus on our understanding of the policy objectives of the Government, considering compliance obligations for taxpayers and ensuring that the proposed new rules are consistent with commercial transactions in Australia. To this end, we consider that the external third party debt test is a critical issue and have recommended changes to the rules as drafted to ensure that taxpayers with genuine arm’s length debt financing are not penalised by rules that are not aligned with commercial borrowing practices. In addition, we do not support the proposed amendments to deny interest deductions for borrowings to fund foreign subsidiaries that produce non-assessable non-exempt (NANE) income.

Our specific comments on the draft materials are considered in the attached Appendices:

- Appendix 1 - External third party debt test
- Appendix 2 - Fixed ratio and group ratio tests
- Appendix 3 - Issues for financial services sector
- Appendix 4 - Interest limitation rules - interactions and other issues
- Appendix 5 - Removing the interest deduction for section 768-5 NANE income

All references in this submission are to the *Income Tax Assessment Act 1997*, unless specified. References to the ITAA 1936 are to the *Income Tax Assessment Act 1936*.

Previously unannounced measures

The exposure draft law includes a number of significant measures which were not previously announced by the Government. This has left taxpayers with little time to assess the potential impact, particularly for those June balancing taxpayers where the start date is 1 July 2023. We submit that given the significance in relation to the following previously unannounced measures, if these measures are to proceed, there needs to be a deferred start date or at least transitional relief for those taxpayers who already have arrangements in place that would be subject to these new rules:

- the change to the definition of financial entity;
- the amendments to the transfer pricing provision (section 815-140) which require general class investors to apply the transfer pricing provisions to support their quantum of debt, in addition to satisfying one of the new thin capitalisation limitation tests; and
- although we do not support this measure, in the event that it does proceed, the denial of deductions for interest costs incurred by the entity in deriving income from a foreign source that is NANE income under section 768-5.

These issues are discussed further in our attached Appendices.

Additional guidance needed

We also suggest that if the measures proceed as proposed, the Australian Taxation Office (ATO) should issue, as soon as practicable, public advice and guidance, in line with the policy intention of these measures, on the following key aspects which arise from the proposed new rules:

- Practical compliance guideline indicating ATO's views on risks of restructures or refinancing undertaken in response to the new law;
- Law Companion Rulings or other guidance on the group ratio rule, specifically addressing the concept of group ratio, GR group, GR group parent, GR group member and entity EBITDA;
- Law Companion Rulings or other guidance on the proposed new definition of debt deduction in section 820-40 and net debt deduction in proposed section 820-45(3), particularly in relation to the treatment of hedge gains and losses; and



- Practical compliance guideline in relation to apportionment and allocation of relevant debt deductions that are subject to denial due to amendments to section 25-90(b) and 230-15(3)(c) in relation to the derivation of foreign equity distributions as NANE income.

In addition, we would welcome clarification in the Explanatory Memorandum on the general anti avoidance provisions regarding restructures undertaken by taxpayers, as a result of the introduction of these measures.

Post-implementation review

We also recommend that a post-implementation review be undertaken within a few years of implementation of the proposals to understand the practical consequences and issues which have emerged since their introduction. Such a review should include a consideration of the impact that the measures have had on global investment into Australia and compliance costs.

Conclusion

We believe the new measures are very significant and that some aspects of our submission, particularly around the external third party debt test, might benefit from a discussion. In this respect we welcome the opportunity to discuss our submission with you and to engage in further consultation as the specific measures are designed and refined. If you have any questions or wish to make arrangements for a meeting, please contact [James Nickless](#) (+61 411 135 363) or [Jillian Gardner](#) (+61 429 514 341).

Yours sincerely

A handwritten signature in blue ink that reads 'CMorris'.

Chris Morris
Australian Tax Leader

External Third Party Debt Test

The introduction of a provision allowing interest expenses on third party debt (the external third party debt test or ETPDT), despite being restricted to third party debt only, is welcome and key to ensure that taxpayers whose capital structures are arm's length and satisfy the existing anti-avoidance and transfer pricing provisions, are not penalised by the interest limitation rules which may not align with borrowing practices in certain circumstances or industries.

The current proposed drafting of the ETPDT, however, means that many taxpayers, albeit with genuine third party capital structures, will not be eligible for the test. Our two key concerns are with respect to the definition of "external third party debt conditions" and the "all in" election for associate entities. The ETPDT in its current form is binary; you meet the conditions and qualify, or you don't. If you don't, the test is not available in its entirety; there are no adjustments to the extent any of the conditions are not met, irrespective of whether these impact the quantum of third party debt raised or give rise to Base Erosion and Profit Shifting (BEPS) risks.

We have included below our comments on the ETPDT and our recommendations on how this test could be improved without jeopardising the broader objectives of the thin capitalisation reform.

Definition of "external third party debt conditions"

The definition of 'external third party debt conditions' requires:

1. The holder of the debt interest having recourse to payment of the debt only from assets of the entity; and
2. The entity uses the proceeds of issuing the debt interests wholly to fund its investments that are attributable to its Australian operations, Australian permanent establishments (PEs), and for the purpose of deriving assessable income.

The above two conditions are similar to the existing arm's length debt test provisions which require a series of "factual assumptions" to be made in working out the notional amount of arm's length debt. In particular, the current test provides at section 820-215(2) for inward investing entities:

- any guarantee, security or other form of credit support provided to the entity in relation to the Australian business during that year from its associates is taken not to have been received; and
- the entity's only assets and liabilities during the year were those that are attributable to the Australian business.

Common commercial practice will involve borrowers and lenders negotiating debt structures to balance pricing, risk and flexibility (e.g. by way of covenants and other forms of recourse). The manner in which these debt structures are often agreed means that the above two conditions (recourse from assets which are not those of the entity and use of funds wholly for its Australian operations) cannot be met. This is despite standard commercial practice. We have set out below some examples to highlight this point.

- A central treasury function will often access the debt markets on behalf of the worldwide group. For an Australian group who looks to raise debt in the domestic banking market, it will be very common, for example, for that group to have a number of foreign subsidiaries (e.g. New Zealand). Lenders will naturally seek to have the foreign subsidiary's assets included in the security net, despite being comfortable the debt will be entirely serviced and supported from the Australian cash flows and balance sheet. Despite the foreign assets not increasing the debt quantum raised in instances such as this, these debt arrangements would fail the external third party debt conditions.
- The domestic debt markets in Australia have grown over the past decade. The new rules, arguably, encourage foreign owned multinationals to raise their external debt domestically, rather than at the global treasury level and on-lend to Australia¹. However, certain groups who choose to raise debt domestically may seek to have the parent provide an explicit parent guarantee. This would have the effect of reducing the borrowing cost associated with the debt, however not necessarily alter the actual quantum of debt (we understand lenders will still require the Australian borrower to have adequate cash flows to service the debt on a stand alone basis as they do not lend with an expectation of seeking recourse from guarantees). Again, this type of arrangement, despite being attractive for the Australian domestic debt markets, would fail the external third party debt conditions.
- It is very common for an Australian group to have a general corporate debt facility and from time to time advance some of these funds to a foreign subsidiary for working capital needs. Where this amount is advanced in the form of capital or a short-term interest free loan, the third party debt conditions would be failed. This

¹ Note, many global multinationals will not be able to raise domestically due to the preference for managing all funding centrally, global banking relationships, and restrictions under existing third party arrangements

would be in addition to the debt deductions otherwise being denied if the proposed amendments to section 25-90 and subsection 230-15(3) occur.

- Another example would be Australian groups who raise an acquisition facility from its Australian cash flows and balance sheet in connection with a foreign acquisition. Despite the Australian group servicing the entirety of this debt from its Australian cash flows (and the lenders genuinely sizing the debt by reference to the Australian operations), the use of \$1 of this debt to subscribe for equity in a foreign subsidiary would fail the external third party debt conditions. This would put Australian groups at a disadvantage compared to their foreign competitors.
- In many arm's length credit arrangements, the obligations of the borrower may be guaranteed by one or more external parties (e.g. letters of credit, forms of insurance), commonly a financial institution. In addition, lenders may have recourse to other parties where their loan receivables are externally insured or are the subject of credit default swaps. Again, despite these arrangements being critical to the commercial arrangement between lenders and borrowers (and in some instances co-equity investors), they would fail the third party debt conditions.
- The financing of many Australian projects, typically in the real estate and infrastructure sectors, will see external lenders seeking guarantees and security from all entities within the project's Australian holding structure. Despite the importance of these projects to the national economy, and the well established project finance lending arrangements which are designed to minimise the cost of funding while providing the lenders maximum avenues for recourse in the event of default, they would fail the external third party debt conditions.
- It is typical for the holder of the debt interest (e.g. financial institution) to have recourse for payment of the debt to *the shares or units of the borrowing entity*. In commercial third party debt transactions, it is not uncommon for the terms of the financing to include security over all of the assets of the borrowing entity as well as security over the shares or units in the borrowing entity. Although the inclusion of shares or units in the borrowing entity do not increase the value of the total assets pledged as security, those shares or units are legally the assets of the borrowing entity's parent and not the borrowing entity itself. Security over these shares and units would fail the third party debt conditions.

Accordingly, we would recommend the following considerations to address the above:

1. Maintain the current arm's length debt test provisions, however limiting to external debt only (subject to our comments later in this submission with respect to related party debt); or

2. Amending the current definition of external third party debt conditions in proposed paragraphs 820-61(2)(c) and (d). This could be done along the lines of:
 - a. Moving these two subparagraphs into a new subsection "adjustments to external third party debt amount".
 - b. Have that subsection operate to adjust the quantum of debt deductions attributable to a debt interest issued by the entity which satisfies the "external third party debt conditions" (i.e. 820-61(2)(a) and (b)).
 - c. The adjustment could be equal "to the extent" the external third party debt quantum is greater than it would be if the conditions as presently drafted in 820-61(2)(c) had been met.
 - d. Include certain clarification points to assist with determining the extent of the adjustments, such as:
 - i. The fact the debt would not be raised at all absent the existence of these recourse arrangements required by the lenders does not mean the quantum is nil;
 - ii. The quantum should be determined by disregarding any assets or cash flows attributable to foreign operations;
 - iii. For project finance arrangements (project finance could be defined), allow security provided it is from an Australian resident and it can be demonstrated it does not increase the actual quantum of debt or if it is provided by entities within the security net of the particular project;
 - iv. No adjustment is required for the shares or units in the borrowing entity itself; and
 - v. Regulations to be added further from time to time as new issues are encountered that conflict with policy intent.
 - e. Remove the requirement under section 820-61(2)(d) that the funds are used to wholly fund the investments covered by subsection 820-61(3) and its Australian operations. Through the proposed amendments to section 25-90, as well as determining the quantum of debt by reference to only the Australian assets and cash flows, it should not be relevant how the funds are applied.
 - f. Provide the Commissioner of Taxation with the same powers as applicable under subsections 820-105(4) and 820-215(4) that allows him to substitute another amount that he considers better reflects the extent the above features impact the overall quantum of debt. The Commissioner's discretion should work both ways - i.e. to permit all or part of the debt deductions to be allowed where the requirements have been substantially met / reductions if he considers the impact of the above conditions have not been appropriately reflected.

Conduit financing

It is common commercial practice for companies to have a central financing entity or for trust structures to have a financing company that coordinates the debt for the structure/group.

As drafted, the rules in subsection 820-61(5) are difficult to satisfy. This is for a number of reasons:

- The rules provide that the ultimate lender (the third party) can only have recourse for payment of the ultimate debt interest (the loan) against the assets of the ultimate borrower(s) and each asset of the conduit financier that is a relevant debt interest (ie the on-loan to the ultimate borrower(s)). This means that the rule cannot be satisfied when the ultimate lender takes security over the shares or units in the ultimate borrower(s) or where there is indirect recourse through the provision of letters of credit, construction bonds or even equity commitments.
- The terms of the on-loan must be the same as the ultimate debt interest. This would seem to indicate that where there are ancillary arrangements to keep the borrower whole for swap costs etc that this would not meet this test.
- Additionally there is no provision for a second conduit which is not uncommon. These arrangements will need to be restructured.

The use of letters of credit, construction bonds and equity commitment deeds are common in the development of greenfield assets. They may also be utilised in circumstances where the industry may be an emerging one where the risk profile is not yet defined. The breadth of the word "recourse" in paragraph 820-261(5)(g) means that the existence of these instruments is likely to mean that the test is failed.

As such, we recommend that subsection 820-61(5) be expanded to:

- allow an external third-party lender providing project finance to a conduit entity to have recourse to the assets of this entity and all borrowers from this entity and to include all the assets of the obligors in a project finance bank security group,
- ignore indirect recourse (e.g. letters of credit, equity commitment deeds, construction bonds) (i.e. that indirect recourse to these types of arrangements is not a recourse to which this provision has regard),
- ensure that the pricing of the on-loan needs to be on substantially the same terms (other than regarding quantum) as the pricing of the third-party debt interest but allowing for adjustments regarding the on-charging of other expenses such as hedging and swaps related to the debt (i.e. such that the conduit financier is kept tax neutral), and
- permit multiple conduit financiers.

Requirement for all 10% associates to make the same choice

In order for a general class investor to elect to apply the external third party debt test, subsections 820-43(4) and (5) require that all associate entities that are subject to the thin capitalisation provisions make the same choice. As a result of the associate entity definition being modified to include an associate that has a 10% or greater TC control interest, it is likely that taxpayers will have multiple largely unrelated associate entities.

The requirement that all 10% associate entities must elect the ETPDT will preclude many entities from being able to claim a deduction for their external bank debt given each unrelated associate will make its own independent choice based on its facts and circumstances (and based on the particular investment, which could be entirely unrelated). This associate requirement is far reaching and would require entities that have no business relationship to be making the same choices - which in our view is not workable. For example, an investor in a joint venture (JV) that holds 50% in the JV, would mean that the investor and all its subsidiaries (that have no connection with the JV) would have to make the same choice as the JV.

In addition, as this class of investor will often have depressed (in the case of companies acquired by private equity) or no EBITDA (in the case of greenfield projects in the real estate and infrastructure industries), these entities will be materially penalised despite having genuine debt structures and an absence of any BEPS risk.

Furthermore, applying this test at such a low threshold will often mean a taxpayer may not be able to (nor have the means to be able to) comprehensively identify all entities that may be associate entities that are general class investors and not exempt from the thin capitalisation rules.

In order to mitigate broad-reaching and (we submit) arguably unintended adverse outcomes and disproportionate compliance burden across the funds investment cohort, we would strongly recommend this requirement be refined to target the specific risks which the Government is seeking to address. One consideration could be limiting the choice to the 10% associate entities within the same Division 832 control group or project group (which would need to be defined) so that the choices of unrelated 10% associate entities do not unfairly impact a particular taxpayer. Alternatively, the rules could be amended such that tax EBITDA of an entity (relevant for the Group Ratio Test and Fixed Ratio Test) is reduced to the extent it is attributable to any direct or indirect distribution received from an associate entity that is a trust or partnership and that has made an ETPDT election (if there are integrity concerns around double gearing benefits).

There are also some practical issues regarding the operation of this “all in” associate rule which, if retained, should be clarified. This includes:

- the operation of paragraph 820-4(5)(a)(ii) which appears to refer to associate entities that *are* eligible for an exemption under sections 820-35, 820-37 or 820-39 rather than entities that *are not* eligible for an exemption
- whether financial entities, which have an option to choose the ETPDT under proposed amendments to section 820-85 and section 820-185, must also make the choice to use this test under the “all in” principal if any of its 10% associate entities also make the choice, and
- whether a relevant 10% associate entity with no net debt deductions is still required to make a choice to use the ETPDT to ensure that another entity’s choice to use ETPDT is valid.

In addition, we note there may be practical issues in determining whether an entity is an associate entity using the 10% or greater TC control interest, as the definition of TC control interest includes an interest held by associate entities, resulting in a circular definition.

Limiting the ETPDT to only third party debt

We acknowledge BEPS concerns with respect to related party debt, however we also acknowledge that many capital structures adopted by groups reflect arm’s length behaviours that commonly exist between independent parties.

Many taxpayers have made investments prior to the proposed measures based on genuine commercial considerations, including the deductibility of their debt financing associated with the investment, and certain capital structures have been put in place with related party debt to achieve key commercial objectives (e.g. onlending of upstream external debt raised by a global parent to facilitate interest payments, protect rights on a wind-up, investing short to medium term surplus cash to derive debt returns, cash flow waterfalls between investors, etc). In some cases the use of arm’s length debt in the investment structure may have led to increased acquisition values on day 1 and associated tax collections.

Australia’s existing legislative framework has a robust set of provisions which prevent BEPS through non-arm’s length capital structures. In addition to the amendment to section 815-140 as part of the current proposals, taxpayers must satisfy the general anti-avoidance provisions, the transfer pricing provisions in Subdivision 815-B (which includes strong reconstruction powers), and the diverted profits tax. These mechanisms mean that taxpayers should not be able to introduce debt into their structure which is not reflective of the most commercially realistic option.

We would encourage Treasury to consult further on the impact of related party debt being excluded from the new arm's length debt test, particularly given no grandfathering is available for existing structures, the extent of powers available to protect the revenue base under existing legislation, and the inequitable outcome for non-resident investors relative to domestic investors who are not subject to the thin capitalisation rules. Inclusion of related party debt would also make the rules more consistent with Australia's double tax agreements (DTAs).

We also submit that the 10% associate test is too broad a test for determining if debt is third party debt. Common structures involving an equity fund borrowing from an ostensibly unrelated credit fund may, we submit, unintentionally be prohibited from using the ETPDT. One consideration could be limiting the definition for third party debt to 10% associate entities within the same Division 832 control group, as suggested above.

The fourth external third party debt condition (820-61(2)(d) - Wholly to fund Australian investments and Australian operations

Separate to the comments above in relation to the fourth external third party debt condition (that "the entity uses the proceeds of issuing the debt interest wholly to fund its investments covered by subsection (3) and its Australian operations"), a plain reading of this fourth condition suggests that the condition will be met only if the debt proceeds are used to fund both Australian operations and the assets covered by subsection (3). Therefore, the condition would not be met in a circumstance where the proceeds were used wholly to fund Australian operations but not applied to fund any assets. As we do not expect that it is the Government's intent for the fourth condition to operate in this manner, we recommend that the condition will be clarified to be an "and / or" test.

Choice of tests - interaction between subsections 820-43(5) and (8)

We seek clarification on the impact to an entity that has made a choice in the approved form to apply the ETPDT for an income year, and subsequently discovers that it was not able to make that choice due to the choice of an associate entity to apply a different test for that income year.

The proposed subsection 820-43(8) provides that a choice to apply the ETPDT cannot be revoked once it is made. However, subsection 820-43(5) provides that an entity cannot make the choice to apply the ETPDT if an associate entity that is a general class investor and not exempt from the thin capitalisation rules has chosen to apply a different test for the same income year.

We consider the words of these subsections to indicate that the entity mentioned in the first paragraph above is taken not to have made a valid choice to apply the ETPDT, and therefore would be able to apply a different test (noting that in most cases, the time for making a choice to use the group ratio will have passed, and therefore the entity will rely on the fixed ratio test).

An alternative construction of the subsections might be that the entity is taken to have made a choice to apply the ETPDT in these circumstances and cannot choose to apply another test. For completeness, our view is that the adoption of this alternative construction would be inconsistent with the plain language of the subsections and have the consequence of unnecessarily deterring taxpayers from choosing the ETPDT. As noted earlier, a taxpayer may not be able to (nor have the means to be able to) comprehensively identify all entities that may be associate entities that are general class investors and not exempt from the thin capitalisation rules. Large and diversified groups commonly manage their operations based on business line rather than geography, and therefore the tax compliance processes for all entities in Australia may not be centrally managed. This will be made even more difficult given that the modified definition of 'associate entity' will apply for the purposes of the subsection 820-43(5) restriction.

For the above reasons, we would appreciate further clarity on the interaction of these two subsections.

Fixed ratio and group ratio tests

The exposure draft law proposes to replace the existing asset-backed safe harbour debt test for all general class investors with the “fixed ratio test” that limits an entity’s net debt deductions to 30% of its taxable income adjusted for interest, depreciation, and amortisation (tax EBITDA), with the ability to carry forward denied deductions for up to 15 years. As an alternative to the fixed ratio test, the group ratio test disallows debt deductions to the extent that the entity’s net debt deductions exceed the group ratio earnings limit for the income year and will replace the existing worldwide gearing debt test for all general class investors.

In summary, our key issues are as follows:

- We support the adoption of a tax EBITDA which is calculated according to concepts from Australia’s income tax system which should reduce compliance costs as compared with adopting earnings based on financial accounting reports. However, certain aspects of it seem inappropriate and may apply to adversely affect certain important industries and investment structures.
- There are significant issues relating to the use of the fixed ratio test where trust structures are common (for example, in the property and infrastructure sectors). There is no ability to access an associate entity’s excess amount. This particularly affects debt-funded Australian entities investing in other Australian companies that do not pay dividends. This will also be an issue for trust groups that do not have access to the tax consolidation regime (especially where debt is at the head trust level and depreciation is claimed in the sub-trusts). Other jurisdictions have rules that allow sharing of associate entity capacity.
- A company’s access to the special deduction for the FRT disallowed amount should be subject to the business continuity test in addition to the modified continuity of ownership test. There does not appear to be any basis to exclude the business continuity test other than an indirect mechanism to reduce interest deductions to below 30% of EBITDA. Furthermore, FRT disallowed amounts should not be forfeited due to a change of choice between the fixed ratio test, group ratio test and the ETPDT, particularly when driven by new external events or circumstances.
- The “group ratio earnings limit” is highly complex and subject to volatility. There are also significant limitations on the ability to access the group ratio test for groups which are controlled, but for which the accounting rules prevent the consolidation of investment entities.

Tax EBITDA

An entity's 'tax EBITDA' is worked out according to the steps in proposed section 820-49.

We have identified a number of elements that would seem to be problematic in its calculation.

Capital gains tax concessions

In the case of a trust, as currently proposed, the tax EBITDA calculation will mean that any capital gains tax (CGT) discount which is applied when working out the trust's net income will arbitrarily reduce the amount. This seems inappropriate given that the trust has made an actual economic capital gain which is not discounted. Furthermore, it is worth noting that the final discount is actually applied at the beneficiary level (section 115-215(3)).

It is also inequitable that economic capital gains that are subject to a small business CGT concession under Division 152 reduce tax EBITDA.

We submit that tax EBITDA should be calculated by reference to the capital gain before applying any applicable CGT discount or other small business CGT concessions, i.e. an adjustment should be made to add back the applicable CGT discount or small business CGT concessional amount to work out the tax EBITDA amount.

It is also unclear why there is no adjustment for capital losses which have the effect of reducing any resulting assessable capital gain, given that tax losses are adjusted as part of the ascertainment of tax EBITDA.

Capital allowances

It is appropriate to adjust for the sum of the entity's decline in value (Subdivision 40-B) and capital works (Division 43) deductions (if any) for the income year, but we submit that capital allowance deductions allowed for the following also be taken into account at paragraph (c) of proposed section 820-49, i.e. to increase the amount of the tax EBITDA. There does not seem to be a policy reason for their exclusion:

- Software development pools (Subdivision 40-E) - note that deductions are allowed under section 40-555 not under Subdivision 40-B. Taxpayers who have used this method for working out their capital allowance entitlement are disadvantaged compared to those who chose not to allocate to a pool (and have no choice to

discontinue the method). This also is not supportive of Australia's use of software and technology to foster innovation and productivity.

- Capital expenditure of primary producers and other landholders (Subdivision 40-G) - note that deductions are allowed under sections 40-630 and 40-645 and not under Subdivision 40-B.
- Capital expenditure on exploration or prospecting, rehabilitation of mining or quarrying sites and environmental protection activities that are immediately deductible (Subdivision 40-H). The exclusion of these amounts from the calculation of EBITDA places the extractive industries sector at a disadvantage to other sectors due to the deductions provided under Subdivision 40-H which reduce the tax EBITDA.
- Capital expenditure on carbon sequestration (Subdivision 40-J) and deductions allowed under section 70-120 for the capital cost of acquiring trees.
- Balancing adjustment losses which arise in respect of a depreciating asset whose decline in value is worked out under Subdivision 40-B (Subdivision 40-D). Such amounts represent the unclaimed decline in value deduction that would have otherwise arisen over future periods had the asset continued to be held.
- In addition, the following adjustments should also be considered: project pool deductions and black hole expenditure (Subdivision 40-I).

It would also be useful for the Explanatory Memorandum to clarify that deductions allowed for the decline in value of depreciating assets in a low-value pool under Subdivision 40-E (section 40-440) are included in the "Step 3: Add the sum of the entity's decline in value and capital works deductions (if any) for the income year" amount (i.e. these amounts would seem to be distinguished from software development pools dealt with later in this Subdivision).

Application of the fixed ratio test to trust structures

As highlighted in our submission dated 2 September 2022, the commercial realities of project financing involved in trust or certain corporate structures means that debt is likely to be sitting at a different level from the operational business (i.e. which will typically have the tax EBITDA). This problem is significant in commonly used multi-tiered trust structures but can also apply to companies that are not part of a tax consolidated group. As a result of the way the financing and security nets are constructed, the debt is typically at a higher tier than the operating business and therefore the tax EBITDA is lower because there are no adjustment add-backs at the relevant levels.

This issue can be seen clearly in an example for greenfield and brownfield infrastructure assets. A greenfield project will typically have debt (even on a back to back basis) coming

into the entity that is developing the asset (that will generate the tax EBITDA in the future) and a brownfield project where debt comes into the entity that is buying the asset (typically units in a trust and a layer above the entity generating the tax EBITDA).

A group approach may be required to resolve this issue (see further comments below regarding a group-based test).

In a chain of trusts, each trust would be able to deduct interest expense against the same underlying pool of earnings if trust distributions are treated as earnings by the upstream trust. We recommend specific integrity measures to ensure that income flowing through these vehicles does not create additional interest deductions via a multiplier effect. Conversely, an ability for an upstream trust to utilise excess capacity of the downstream entity should be introduced.

Special 15-year carry-forward deduction for the fixed ratio test

Although we support a mechanism to enable FRT disallowed amounts to be carried forward and utilised in later income years, we raise the following issues:

- It is unclear why a company only has recourse to the modified version of the continuity of ownership test (COT) but not to the business continuity test (BCT). If there were no disallowed deductions under this test, it is possible that the company would have otherwise had a tax loss for which the BCT would have been available. There does not seem to be a policy argument for not including a BCT together with the modified continuity of ownership test. We would submit that the two tests are linked and provide for a known regime to manage the carry forward amounts. A company's access to the special deduction for the FRT disallowed amount should be subject to the modified COT or BCT.
- We submit that consideration should be given as to the appropriateness of the 15 year limitation, having regard to practical outcomes, in particular for critical infrastructure and manufacturing investments in Australia. If this time period cannot be adjusted in the current context, the practical consequences should at least be subject to a post-implementation review undertaken within the first three years of the new rules applying.
- It is unclear, from a policy perspective, why FRT disallowed amounts are forfeited where a taxpayer chooses to switch from the fixed ratio test to either the group ratio test or the external third party debt test. The amendments to section 815-140 mean that taxpayers are still required to demonstrate that their capital structure is arm's length under all three tests, and therefore it does not seem appropriate to



permanently deny interest deductions where taxpayers make a different choice due to a change of circumstances (e.g. a new acquisition or divestment, external market conditions (e.g. COVID-19, etc) or compliance simplicity).

Group ratio test

Group Ratio Earnings Limit

Under the group ratio test, the amount of an entity's debt deductions for an income year that are disallowed is the amount by which the entity's net debt deductions exceed the entity's "group ratio earnings limit" for the income year. The calculation of the "group ratio earnings limit" is complex.

While we support the approach that has been adopted to broadly utilise the group's consolidated financial statements as the basis for determining the group ratio as these provide the most reliable source of financial information on a worldwide group and reduce compliance costs, we are concerned that the inclusion of accounting revaluations (particularly for investment entities that hold many of their assets at fair value through profit or loss) may impact an entity's ability to rely on this test. This may be due to, for example:

- year on year variability of EBITDA caused by fair value movements
- devaluations resulting in negative EBITDA, such that the test cannot be applied, or certain entities in the group are excluded from group EBITDA.

We also note that the requirement to eliminate negative EBITDA entities is not practical for multinational companies which will often have hundreds of entities globally and many which will not have underlying financial accounts which are prepared in accordance with recognised accounting standards or for which the information will be readily available.

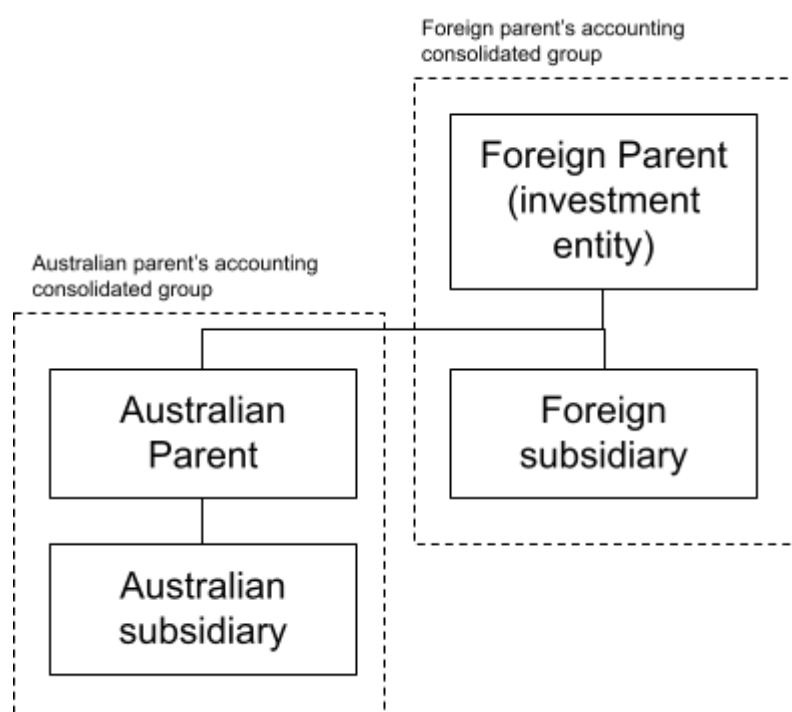
Accordingly, we recommend that fair value gains and losses be excluded from the determination of group EBITDA and entity EBITDA. This would also better align the calculation of the group ratio with the fixed ratio test, that seeks to limit interest deductions based on taxable economic activity. We also recommend that where there is an ultimate listed entity that it is not necessary to eliminate all negative EBITDA entities to remove the onerous compliance burden.

Accessing the test - a GR group parent is critical

We note that the current definition of GR group parent, which refers to the existing definition of a worldwide parent entity in subsection 820-935(6), may limit access to the test for some

groups where the immediate parent is “controlled” by another entity, but not fully consolidated into the ultimate parent’s financial statements due, for example, to the application of the investment entity exception.

This is illustrated in the diagram below, where the Australian sub-group, although it is controlled by Foreign parent, is not consolidated into the Foreign Parent’s financial statements due to the application of the investment entity exception applicable under recognised international accounting standards.



We consider that in these circumstances, sub-groups such as the group headed by the Australian parent above, should have access to the group ratio test, in line with the OECD’s recommendations². This will be particularly harsh where there are other controlled entities that are not in the tax consolidated group but would be included in the consolidated financial statements of the Australian parent.

Guidance needed on GR group ratio concepts

² OECD (2017), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update, Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. Paragraphs 268 to 270 <https://doi.org/10.1787/9789264268333-en>

In addition, we recommend that there be additional guidance provided in the Explanatory Memorandum or by the ATO explaining and illustrating the key components in the application and calculation of the group ratio earnings limit:

1. Determination of the GR group, the GR group parent and a GR group member.
2. Calculation of GR group net third party interest expense, including, for example, how interest amounts that are capitalised in the balance sheet of the consolidated financial statements for the GR group parent are included, and whether notional interest amounts such as those recognised under IFRS 16 *Leases* are included.

We also note that it appears that, due to the current drafting, the GR group net third party interest expense (which is the numerator in determining the group ratio), and the GR group's adjusted net third party interest expense, which forms part of GR group EBITDA (which is the denominator in determining the group ratio) could be different amounts as the adjustment in section 820-53(1) to include amounts in the nature of interest or calculated by reference to the time value of money in GR group net third party interest expense is not replicated in adjusted net third party interest expense.

3. Calculation of entity EBITDA (which appears to only be relevant if it is less than zero) and in particular:
 - How is entity EBITDA determined? We assume this is to be determined having regard to recognised accounting standards or principles, however this is not specified in the draft law.
 - Is entity EBITDA worked out on a standalone basis, or are intra-group transactions disregarded?
4. Calculation of group EBITDA, including examples and practical guidance regarding how group EBITDA is to be adjusted where an entity has negative entity EBITDA (particularly if entity EBITDA is calculated on a standalone basis and therefore includes intra-group transactions).
5. Examples of components of "depreciation and amortisation expenses" (for example, would this include any impairment charges?)
6. Calculation of adjusted net third party interest expenses. Similar to the comments above regarding entity EBITDA, we note that the draft law does not specify the basis on which this is to be determined.



Disallowed amounts under the group ratio

It is unclear why there is no ability to carry forward any disallowed amount under the group ratio test. Allowing an entity's disallowed amount after having applied the group ratio would reduce the impact of volatility in group earnings on an entity's ability to deduct net interest expense, and is consistent with the principle of allowing a group to deduct an amount equivalent to its net third party interest expense. Such an amount could be subject to the same conditions for future deductibility as currently proposed for allowing the special deduction for the FRT disallowed amount. The OECD paper³ does not reject the ability for a country to enable the carry forward of such amounts.

³ OECD (2017), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update, Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. Paragraphs 159 to 167 <https://doi.org/10.1787/9789264268333-en>

Issues for financial services sector

At the outset we welcome the approach of ensuring that the financial entity thin capitalisation provisions remain in place for those entities that continue to meet the relevant definitions. However there are a number of unexpected changes that may have material impacts for the financial services sector as a result of key definitional changes, in particular to the definition of “financial entity” which were not previously announced.

Our key issues are as follows:

- The change to the definition of financial entity may have material impacts with limited notice to a number of non-bank lending entities. This change was not previously announced and appears to be in conflict with the comments in the Treasury's consultation paper from August 2022⁴ which indicated that there would be no change to the financial entity provisions. We recommend a deferral of the change to allow appropriate time for those entities to consider the impact, and changes to address the integrity concerns raised in the draft Explanatory Memorandum.
- Entities subject to the authorised deposit-taking thin capitalisation provisions currently have a reduction in their thin capitalisation capacity in relation to foreign equity investments. Accordingly, the proposed amendments to section 25-90 in conjunction with the adverse thin capitalisation outcome may result in enhanced denials.
- The draft legislation does not provide an exclusion from the general class investor for insurance companies. We observe that the OECD's BEPS Action 4⁵ report notes that a country should exclude insurance groups from the scope of the fixed ratio and group ratio rule where no specific BEPS risks are identified.

'Financial entity' definition

Entities that are not authorised deposit-taking institutions (ADIs) that currently are considered a financial entity subject to the special thin capitalisation rules in Subdivisions 820-D and 820-E have been affected by the tightening of the definition of 'financial entity' in subsection 995-1(1). This amendment was not previously announced (and appears to be

⁴ Treasury (August 2022), Government election commitments: Multinational tax integrity and enhanced tax transparency, Consultation Paper, <https://treasury.gov.au/consultation/c2022-297736>

⁵ OECD (2017), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update, Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. Part III, <https://doi.org/10.1787/9789264268333-en>

contrary to Treasury's consultation in August 2022 which indicated that '[F]inancial entities and authorised deposit-taking institutions would, in the interim, continue to be subject to the existing thin capitalisation rules'⁶.

With this amendment applying from as early as 1 July 2023, there is little time for an affected entity to consider the impact of being categorised as a general class investor which is subject to the new fixed ratio, group ratio or ETPDT.

Although this change is identified as an integrity measure, it is not clear why entities that are appropriately registered under the *Financial Sector (Collection of Data) Act 2001* and that carry on a business of providing finance should no longer qualify to apply these provisions. Paragraph 1.26 of the draft Explanatory Memorandum provides that:

This has given rise to integrity concerns that entities which satisfy this broad definition should genuinely be considered financial entities, with access to the generally more favourable taxation treatment. The repeal of paragraph (a) is an integrity measure to ensure the thin capitalisation rules are fit for purpose and that the amendments to introduce the new earnings-based rules are not undermined.

It is important to note that an entity that meets the registration requirements is *required* to register under the *Financial Sector (Collection of Data) Act 2001* - it is not a voluntary code. As such, any integrity concerns should be addressed not by reference to the registration but by reference to actual business activities.

Of those entities impacted by this change, due to the new concept of 'net debt deductions' it is likely that those that are predominantly in the business of lending money may not be materially impacted on the expectation that their activities should result in a positive net interest margin (or put differently, have no net debt deduction). This should be true in normal economic conditions, however in periods of economic stress this may not always be the result.

For other entities that are required to register under the *Financial Sector (Collection of Data) Act 2001*, including leasing companies, who derive income other than interest income, the change in thin capitalisation classification could have a material impact.

⁶ Treasury (August 2022), Government election commitments: Multinational tax integrity and enhanced tax transparency, Consultation Paper, page 6, <https://treasury.gov.au/consultation/c2022-297736>. The Consultation paper further states that "the OECD acknowledges that the fixed ratio rule is unlikely to be effective for these types of entities – partly because they are net lenders and are subject to regulatory capital rules. As such, they can be excluded from the fixed ratio rule."

In order to address integrity concerns, we submit that registered corporations under the *Financial Sector (Collection of Data) Act 2001* that predominantly carry on a business of providing finance should have the choice to continue to qualify as financial entities under the thin capitalisation provisions. The addition of a requirement to perform a minimum level of financial activity should address integrity concerns. This would result in a similar outcome for those entities that may still qualify as a 'financial entity' where they have the required Australian financial services licence (AFSL) and 'carry on a business' relevant to that AFSL.⁷

Finally, due to the unexpected and unannounced change, entities that are currently classified as a financial entity under the current rules as at the immediately prior to the application of the proposed new law should have additional time (ideally no less than one year) before being subject to the new interest limitation rules for general class investors, other than where they choose to adopt the rules from the generally applicable start date. It is important that these entities have the appropriate time to reflect on the changes and consider their profile given the unexpected and unannounced change.

Application of section 820-942 - securitisation vehicles

The amendment to paragraph (a) of the definition of "financial entity" removes some non-bank lenders from the existing financial entity thin capitalisation rules. However, lenders with a securitisation vehicle that meets the criteria in section 820-942 may remain within the ambit of the financial rules.

This test has had limited historical application because most securitisation vehicles qualify for the exemption under section 820-39. The definition in section 820-942 may be capable of being satisfied by non-insolvency remote securitisation vehicles, however, certain aspects of the test are difficult to meet in practice. For example, the requirement that all arrangements with associates are on arm's length terms may be difficult to meet because the originator, who is usually an associate, retains deeply subordinated notes and the risk/reward associated with residual units. However, given that these entities continue to meet the financial entity definition, additional guidance or clarification may be needed on how these

⁷ For example, the definition of a 'financial entity' includes at (c) an entity that:

- (i) is a financial services licensee within the meaning of the Corporations Act 2001 whose licence covers dealings in at least one of the financial products mentioned in paragraphs 764A(1)(a), (b) and (j) of that Act; or
- (ii) under paragraph 911A(2)(h) or (l) of the Corporations Act 2001, is exempt from the requirement to hold an Australian financial services licence for dealings in at least one of those financial products; and carries on a *business of dealing in securities, but not predominantly for the purposes of dealing in securities with, or on behalf of, the entity's * associates.



rules are intended to apply in the absence of any detailed guidance in the Explanatory Memorandum at the time the provisions were implemented.

Further, in our view some confusion could result from leaving section 820-942 “securitisation vehicles” within the existing thin capitalisation rules while removing section 820-39 vehicles. For example:

- Whether an entity is a financial or general entity may end up relying solely on the ability to demonstrate whether a securitisation vehicle is insolvency remote; and
- The choice of funding structure for a non-bank lender could impact its thin cap classification - e.g. a non-bank lender that uses securitisation vehicles may end up having different thin capitalisation constraints to a non-bank lender that has a different structure in place.

Given the importance of this distinction in the new provisions it should be clarified in the existing legislation whether an entity can be *both* a securitisation vehicle under section 820-39 and section 820-942 (although Note 2 to subsection 820-39(3) implies that this is not the case). If it is intended that there is a distinction between these two concepts, this should be clarified in the legislation so that there is no uncertainty for taxpayers going forward.

We recommend that Treasury consider whether there is a genuine intention to differentiate between the treatment of securitisation vehicles for these purposes, and whether it is the intent of the law that the existence of a non-insolvency remote securitisation vehicle drives the classification of an entity as within or outside the financial entity rules.

Group classification - income tax consolidated groups

We also note that changes to the classification rules for tax consolidated groups may result in unexpected outcomes as currently drafted. It is not clear whether a tax consolidated group with one member that meets the definition of a financial entity (including a securitisation vehicle under section 820-942) would continue to be classified as a “financial entity”. Noting the proposed changes to section 820-583, it appears that an outward investing tax consolidated group would not be classified as a financial entity for thin capitalisation purposes unless the head company itself meets the definition of a financial entity.⁸

⁸ At paragraph 1.132 the Explanatory Memorandum states that “[C]onsequential amendments are made to paragraph 820-583(3)(a) to reflect the updated table items in subsection 820-85(2). Similarly, paragraph 820-583(3)(b) is now redundant given that the head company needs to be a financial entity throughout the period.

As amended, section 820-583(3) requires that there be at least one group member who is a financial entity. However, amendments to section 820-583(3)(a) also require the head company to satisfy the condition in the second column of *items 2 or 4* of section 820-85(2). Column 2 of items 2 and 4 of the table in new subsection 820-85(2) each state, "the relevant entity is a *financial entity throughout that period". As drafted, it appears that a head company must *also* itself be a financial entity under the proposed new rules⁹.

Read this way, a tax consolidated group with a subsidiary member that is a financial entity would not be a financial entity for thin capitalisation purposes unless the head company was also a financial entity. This outcome does not arise for inward investing financial entities due to there being no change to the previous classification criteria as set out at subsection 820-583(6). As such there may be a difference in entity classification depending on whether the group is an inward or outward investor which should not be an intended outcome of the changes. We request clarification on the intended changes and amendments as required if the rules are intended to operate as they did previously, in that the requirement was merely for at least one member of the group to be a financial entity.

ADI thin capitalisation provisions

In addition to our comments regarding the proposed changes to section 25-90 (and the equivalent TOFA provision in section 230-15) set out in Appendix 5, we make the following specific comments in relation to ADIs.

ADIs remain subject to the existing thin capitalisation provisions (which are linked to the amount of capital that they are required to hold for prudential regulatory purposes). When the thin capitalisation provisions were introduced in 2001, it was made clear that section 25-90 would permit deductions for interest expenses incurred to fund foreign equity investments as the thin capitalisation rules would deal with this issue. It was for this reason that section 25-90 was introduced.

This logic was clearly reflected in the 2001 explanatory memorandum to the Act that introduced the thin capitalisation rules and section 25-90. Relevantly, the explanatory memorandum stated:

"Debt deductions will, in certain instances, no longer be denied to taxpayers because they were incurred in earning exempt foreign income. These debt deductions, provided they are otherwise allowable under the general deduction provisions, will

⁹ Existing section 820-583(3)(a) requires the head company to satisfy the condition in the second column of item 1 and 3 in the table in subsection 820-85(2). This condition, broadly, states that the relevant entity is *not* a financial entity, *nor* an ADI, at anytime during that period.

come within the scope of the thin capitalisation regime when determining the amount to be allowed.¹⁰ (our emphasis added)

The logic behind this remains exactly the same today as it was in 2001 and has been for the last 20 years.

As such, the proposed amendments to section 25-90 and section 230-15, if they proceed, should not apply to ADIs, as they are still subject to the existing thin capitalisation rules which already deal with the issue.

If ADIs were not carved out of the change to section 25-90 and section 230-15 then they would suffer a double detriment as they would:

- be denied the debt deduction (under section 25-90/section 230-15), and
- have their thin capitalisation capacity reduced by reference to their investments in overseas entities (which occurs through the reduction in thin capitalisation capacity for investments in 'controlled foreign entity equity').

There is no logical or policy reason why this should be the case - and it would run contrary to the policy of the thin capitalisation provisions that were introduced in 2001 (and which ADIs will remain subject to).

Insurance entities

The amended definition of "financial entity" in the current draft legislation does not automatically include APRA regulated insurers. In practice, insurers are subject to regulatory capital requirements which impose minimum amounts of equity and restrict the use of debt funding, and so these APRA rules effectively act as a restriction on the ability of insurance companies to claim tax deductions for debt.

A decision to exclude insurers from the proposed new earnings-based tests would be consistent with the OECD's comments on BEPS Action 4 that a fixed ratio rule is unlikely to be effective for insurers because:

- Insurance companies typically invest premium income in stable income producing assets such as debt securities, to generate income and ensure sufficient liquidity to pay out claims. As such, insurers typically have significant net interest income. The fixed rate ratio would only apply to limit net interest expenses.

¹⁰ Paragraph 1.99 of the *New Business Tax System (Thin Capitalisation) Bill 2001*



- Interest income is usually a major part of an insurer's revenue which implies that EBITDA would not be a suitable measure for economic activity across a group in the insurance sector. As such, there is a fundamental difference in the nature and role of interest in the insurance sector as compared to other businesses.

Given the prudential regulations that already address the risk of excessive interest deductions by insurers, the additional complexity would only create a significant compliance burden on insurers for no significant revenue gain. As such, we recommend that insurers continue to be subject to the existing asset-based tests for general (non-financial, non-ADI) entities.

Interest limitation rules - interactions and other issues

This part of our submission considers issues relating to the interaction or association of concepts relating to the new provisions within Division 820 and also with other aspects of the income tax law.

In summary:

- The proposed amendments to the definition of debt deduction need further clarification in order to provide certainty to taxpayers.
- There is a mismatch between amounts included in debt deduction and on the income side of net debt deduction which may result in unintended consequences.
- Clarification is required regarding the application of the proposed new Subdivision 820-AA to part year periods.
- There needs to be further amendments to ensure that the FRT disallowed amount of an entity that joins a consolidated group is suitably dealt with.
- Consideration needs to be given to other income tax law interactions, specifically tax consolidation and hybrid mismatch rules.
- We welcome the continued application of the de minimis exemption (section 820-35), the Australian asset based exemption for outward investing entities (section 820-37) and the exemption for insolvency-remote special purpose entities (section 820-39). However, we recommend some adjustments be made to the de minimis threshold and also note some drafting issues which may prevent the application of these exemptions where the new tests in Subdivision 820-AA apply.

Debt deductions

The definition of debt deduction in section 820-40 is proposed to be amended with the intention to capture interest and amounts economically equivalent to interest, in line with the OECD best practice guidance. This has been achieved by removing the reference in subsection 820-40(1) to the cost being in relation to a debt interest issued by the entity. The draft Explanatory Memorandum¹¹ explains that this change means that amounts which are economically equivalent to interest, but which may not necessarily be incurred in relation to a debt interest issued by the entity, fall within the definition of debt deductions. No examples are provided in the draft Explanatory Memorandum.

¹¹ Paragraph 1.117

The OECD¹² has provided useful guidance material on the concept of interest and payments economically equivalent to interest. However, this needs to be tailored in the context of Australia's income tax system and made clear for Australian taxpayers. For example, this should consider the interplay with Australia's debt-equity rules (Division 974), treatment of lease payments (including Division 242) and arrangements treated as a sale and loan ((Division 240).

It would appear that the OECD guidance would capture losses from derivative instruments or hedging arrangements related to an entity's borrowings (e.g. interest rate swap), but not foreign exchange losses on instruments to hedge currency exposure connected with the raising of finance. Subsection 820-40(3) has not been amended and would seem to continue to apply to exclude losses and outgoings directly associated with hedging or managing the financial risk in respect of a debt interest. We recommend that it be made very clear what is intended in relation to the treatment of hedging arrangements.

Furthermore, the concept of net debt deduction (proposed subsection 820-45(3)) which is relevant to the fixed ratio test and group ratio test, would include amounts of assessable income that are interest, in the nature of interest, or any other amount that is calculated by reference to the time value of money. This may result in the inclusion of gains from certain derivative instruments or hedging arrangements. It is unclear whether this is intended, and we note that this would give rise to a mismatch with the section 820-40 definition of debt deductions due to the exclusion for losses and outgoings related to hedging in subsection 820-40(3).

We note that there are other scenarios where a mismatch arises between amounts included in debt deduction and in the income side of net debt deduction which may result in unintended consequences. For example, the definition of debt deduction is sufficiently broad to capture a range of fees and costs associated with borrowing such as borrowing costs. The income side of the net debt deduction definition, however, is limited to interest, amounts in the nature of interest, and amounts calculated by reference to the time value of money. This means that a financing entity that merely borrows and on-lends may have net debt deductions as it typically passes on borrowing costs to the ultimate borrower, and the income generated from this would not be captured in net debt deductions.

It would be useful to clarify whether assessable trust or partnership income needs to be analysed to determine the extent to which the amount includes interest - specifically,

¹² OECD (2017), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update, Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. Chapter 2 <https://doi.org/10.1787/9789264268333-en>

whether components of distributions from trusts and partnership that comprise interest income are taken into account in determining the net debt deductions of the recipient entity. In our view, it is appropriate to allow taxpayers to recognise that part of any distribution that is in the nature of interest as an amount of income within Step 2 of the 'net debt deductions' calculation, although we note that this will create an additional compliance burden for affected taxpayers.

We note also that the existing definition of debt deduction which makes reference to a debt interest ensures that interest payable on short term trade payables is not subject to the existing thin capitalisation rules. The proposed change in the definition will now mean that interest payable on such ordinary trade dealings will now be subject to potential denial. We submit that consideration be given to excluding from the definition of debt deduction amounts that would otherwise meet the short term debt exception in subsection 974-25(1).

The broadening of the definition of debt deduction may also result in other types of interest, such as General Interest Charge (GIC) and Shortfall Interest Charge (SIC) imposed by the ATO, being included in the scope of debt deductions, potentially leading to denied deductions for some or all of these amounts. We recommend that such amounts be excluded from the definition of debt deductions potentially subject to the new interest limitation rules, as these amounts do not give rise to BEPS risks.

It would be useful for the Explanatory Memorandum to provide examples of which amounts the amendment to the definition of debt deduction and the new definition of net debt deduction are expected to capture and if not, for the ATO would issue guidance on the extent of these important new concepts.

Application to part-year periods

It is currently unclear how the proposed new tests in Subdivision 820-AA are to be applied where there is an outward or inward investor for only part of an income year. Whilst the proposed amendments to sections 820-85 and 820-185 outline when an entity will be an outward investing financial entity (non-ADI) or an inward investing financial entity (non-ADI) *for a period that is all or part of an income year*, it is not clear whether an entity that is either of these for part of an income year only meets the definition of a general class investor in subsection 820-43(2), which requires the entity to be an outward investing financial entity (non-ADI) or an inward investing financial entity (non-ADI) *for the income year*.

It would also be useful to provide examples of the application of Subdivision 820-AA to part year periods in the Explanatory Memorandum. In our view, the application of the proposed new rules should be limited to periods in the income year where the entity is an outward or

inward investor, in line with the current provisions, although we note that this would add complexity to the calculations required.

The special deduction and consolidated groups

We support the ability for FRT disallowed amounts of an entity that joins a tax consolidated group to be able to be transferred to and utilised by the head company of the group. As noted in the draft Explanatory Memorandum¹³, this is to align with the treatment for the transfer of tax losses into a tax consolidated group. We raise the following issues which in our view are not aligned with the treatment of losses of a joining entity:

- There is no choice to cancel the transfer of FRT disallowed amounts as there is with losses (under section 707-145). We submit that such a choice should be provided.
- As noted in Appendix 2 in this submission, we submit that the BCT should be provided in addition to the modified COT to companies with available FRT disallowed amounts and that this should equally apply when testing for the transfer of the amount to the joined group.

We note also there appears to be an error in drafting of proposed section 820-62(4) - the reference in the last line should be to subsection (5).

Other interaction issues

We also raise the following issues which should be addressed when considering the interaction of the new rules with other aspects of the tax law:

- Interaction of choices with the entry history or exit history rule when an entity joins or leaves a tax consolidated group (i.e. whether modifications are needed under Subdivisions 715-J and 715-K).
- Application of the FRT disallowed amount in the context of the hybrid mismatch provisions (Division 832).

Exemptions

As noted above, we welcome the continued application of the existing exemptions applicable to Division 820. However, as we raised in our submission of 2 September 2022 in response to the Treasury Consultation Paper “Government election commitments: Multinational tax integrity and enhanced tax transparency”, we submit that the de minimis threshold (section

¹³ Paragraph 1.98

820-35) should be periodically adjusted to ensure it remains suitable for the current economic conditions, particularly since debt deductions are constantly influenced by interest rate movements (see also OECD recommendations¹⁴).

In respect of the Australian asset based exemption for outward investing entities (section 820-37), there would appear to be a drafting error in that existing paragraph (1)(b) makes reference to “inward investing entity (non-ADI)”. We think that this should be to an “inward investing financial entity (non-ADI)” given the amendments to section 820-185.

With regards to the exemptions in sections 820-37 (asset threshold) and 820-39 (special purpose entities), there do not appear to be any proposed amendments to ensure that entities that qualify for these exemptions are actually exempt from the application of proposed new Subdivision 820-AA (the thin capitalisation rules for general class investors). As currently drafted, these exemptions will continue to only prevent Subdivision 820-B, 820-C, 820-D and 820-E from applying. We note that the draft Explanatory Memorandum¹⁵ clearly states that amendments are made to section 820-37 to ensure it continues to apply to outward investing entities that are now general class investors, but this has not been reflected in the same way as the amendments were made to the de minimis exemption. In our view, both of these exemptions are essential and should be updated to apply to general class investors subject to the new tests in Subdivision 820-AA.

¹⁴ OECD (2017), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update, Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. Paragraph 56 <https://doi.org/10.1787/9789264268333-en>

¹⁵ Paragraph 1.113

Removing the interest deduction for section 768-5 NANE income

In this section we have provided comments in relation to the proposed amendments to section 25-90 and subsection 230-15(3) (collectively referred in this submission as section 25-90), being provisions originally and deliberately designed to ensure Australian companies can claim tax deductions for financing costs incurred in deriving non-assessable non-exempt (NANE) foreign dividends. As these proposed amendments were not previously announced by the Government, this is our first opportunity to provide our view on these proposals.

We consider the proposed amendments to section 25-90 to be ill-founded and unnecessary. We strongly encourage the Government to retain section 25-90 as currently enacted.

Given the lack of consultation prior to the release of this Exposure Draft, at the very least, the Government should announce an indefinite deferral of the proposed amendments while it is referred to the Board of Taxation to undertake a comprehensive review of the proposal with the benefit of input from interested parties. We appreciate that there may be integrity concerns particularly where a taxpayer may have higher earnings limits under the new interest limitation rules, but there are existing provisions in the tax law which can be used to address this including the hybrid mismatch rules and the general anti-avoidance provisions.

The current proposal comes nearly ten years after the previous abandoned plan to repeal section 25-90, which was announced on 14 May 2013¹⁶. Many of the arguments in favour of retaining section 25-90 in its current form are the same as those included in the submission PwC made to the Treasury in response to the public consultation undertaken, dated 19 July 2013.

As Australia moves from a balance sheet thin capitalisation regime to an earnings-based interest limitation regime, there are now further, and equally compelling, arguments.

In our view, the concerns of the Government in implementing OECD Action 4 are more than adequately addressed without the proposed amendments to section 25-90. The exclusion of NANE dividends from foreign subsidiaries in the calculation of 'tax EBITDA' under the fixed ratio and group ratio tests already appropriately reflects the policy position that Australian taxpayers should not be able to increase the capacity for interest deductions through the production of exempt or tax deferred income.

¹⁶ The then Hon David Bradbury MP, Assistant Treasurer, Minister Assisting for Financial Services & Superannuation and Minister for Competition Policy & Consumer Affairs, 14 May 2013, *Protecting the corporate tax base*, Media Release

Australian headquartered businesses will be unfairly disadvantaged in the following ways if the Government proceeds with this proposal:

- By increasing the funding costs of Australian companies seeking to expand offshore, Australian multinationals will no longer be on a level playing field with their foreign competitors when it comes to making strategic investments offshore.
- Australian companies will be subjected to significant commercial and compliance costs associated with restructuring existing arrangements in addition to needing to apply onerous 'tracing' principles to determine interest deductibility going forward. This may include having to look back and trace the purpose and use of funds that were borrowed in the last 22 years.

As an economy competing for global capital, Australia will become uncompetitive as we will be moving out-of-step with other major economies. Most other OECD countries allow a deduction for interest incurred to derive dividends from foreign subsidiaries, subject to earnings-based interest limitation rules.

BEPS concerns adequately addressed by implementing OECD Action 4

The OECD's BEPS Action 4 called for recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense. The OECD's recommended approach is a fixed ratio test which limits an entity's net deductions for interest and payments equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA).

The introduction of a new earnings-based test for general class investors in Australia is a direct response by the Australian Government to align Australia's interest limitation rules with the OECD best practice guidance.

The amendments to Division 820, if enacted, would subject all interest costs, whether deductible under section 8-1 or the current section 25-90, to the earnings-based fixed ratio test and group ratio test, or the ETPDT.

The proposed amendments to section 25-90 go beyond the OECD's recommendations. The harmful tax practises targeted by Action 4 are adequately dealt with by the introduction of the fixed ratio test and group ratio test, which establish an 'absolute cap' on net debt deductions. The exclusion of NANE dividends from foreign subsidiaries in the calculation of 'Tax EBITDA' under the fixed ratio and group ratio tests already appropriately reflects the

policy position that Australian taxpayers should not be able to increase the capacity for interest deductions through the production of exempt or tax deferred income.

This drafting is consistent with the OECD's observations¹⁷ in the context of banks and insurance companies that may use interest to fund non-taxable income but equally applicable to other general class taxpayers:

496. The BEPS Action Plan identifies cases where groups use interest to fund non-taxable or deferred income as a key risk to be addressed under Action 4. The common approach in Part I of this report reduces this risk by linking an entity's net interest deductions to a percentage of its EBITDA, which is calculated so as to exclude non-taxable income such as dividend income and the profits of a foreign permanent establishment which benefit from a participation exemption.

In other words, the definition of 'tax EBITDA' appropriately reduces the risk of taxpayers using interest to fund NANE income because, regardless of what purpose borrowings are put to, capacity for interest deductions can only be increased by increasing taxable income. For example, an Australian company that borrows to fund a single asset, being shares in a foreign subsidiary, would have all debt deductions denied under the fixed ratio test and group ratio test, even where it derives dividends from its foreign subsidiary.

In relation to the proposed amendments to section 25-90, the draft Explanatory Memorandum¹⁸:

Additionally, the policy intent of 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. The rules described in the paragraph above [being sections 25-90 and 230-15(3)] go against the policy 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.

Whilst the description of the policy statement is correct, what follows is misleading and ill-founded as it fails to appreciate that the earnings against which net interest may be claimed *exclude* NANE income. The earnings-based interest limitation rules already give effect to the policy intent. There is no double benefit because taxpayers cannot increase

¹⁷ OECD (2017), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update, Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. Paragraph 496 <https://doi.org/10.1787/9789264268333-en>

¹⁸ Paragraph 1.119

their earnings in Australia through the derivation of NANE dividends. To amend section 25-90 as proposed is therefore unnecessary to achieve the desired policy outcome.

In addition, as discussed in more detail at Appendix 1 in relation to the ETPDT, the proposed drafting includes a limitation in section 820-61(2)(d) that requires the proceeds of relevant third-party borrowings be used *wholly* to fund assets that are used within an Australian permanent establishment or assets held for the purposes of producing assessable income. With the proposed amendments to section 25-90, taxpayers can expect to be both denied a deduction and excluded from the ETPDT despite having an arm's length external borrowing if \$1 of debt is provided to a foreign subsidiary by way of equity.

Tracing the use of funds presents significant compliance challenges

The statement in paragraph 1.119 of the draft Explanatory Memorandum also presupposes that interest expenses can be readily traced to the derivation of NANE income. The proposed amendments to section 25-90 will expose taxpayers to significant uncertainty when attempting to determine whether interest expense has a sufficient nexus to assessable income to be deductible. Australian headquartered taxpayers will be forced to apply general principles outlined in case law and ATO administrative practice to determine whether there is sufficient nexus between interest expense and assessable income.

While these principles, which include 'tracing' the uses of cash over time, can be applied in simple situations of taxpayers borrowing to fund an acquisition at a particular point in time, they are more difficult to apply to modern businesses where money is fungible. This difficulty will be compounded if the amendments apply to existing debt arrangements because taxpayers will be required to trace the purpose and use of funds that were borrowed in the last 22 years, a period when there was no strict requirement for taxpayers to maintain records sufficient to do that tracing and apportionment.¹⁹

It is a question of fact as to whether an apportionment of interest expense is fair and reasonable. Unfortunately, case law does not provide any clear guidance on how interest expense should be apportioned where it is not possible to trace the purpose and use of funds. This lack of guidance provides additional uncertainty and compliance costs for taxpayers seeking to claim deductions for interest expense, through interest expense tracing, matching and quarantining.

The deductibility of interest expense incurred in relation to offshore investment was considered by the Review of Business Taxation (RBT) in its discussion paper entitled A

¹⁹ Other than for the purpose of completing a disclosure in the International Dealings Schedule lodged with the ATO.

Platform for Consultation, released in February 1999 and discussed in its Final Report, *A Tax System Redesigned*. The RBT recommended²⁰ that interest incurred in deriving exempt foreign source income not be quarantined, i.e it remains deductible. The RBT was of the view that the thin capitalisation provisions should be 'the only restriction on the deductibility of interest where Australian taxpayers borrow for investment in controlled foreign entities.' The RBT recognised that '[c]ompliance costs will be reduced by removing interest expenses from the operation of the current quarantining provisions.'

The recommendations of the RBT were reflected in the introduction of *New Business Tax System (Thin Capitalisation) Act 2001* (Cth), which included section 25-90 and the then new thin capitalisation rules. Section 25-90 was clearly introduced in order to reduce complexity and uncertainty associated with having to trace the use of funds to determine whether interest expense was deductible, whilst the severe tightening of the thin capitalisation regime ensured that integrity of the interest deductibility regime was not compromised.

The same logic exists for the retention of section 25-90 as currently enacted in 2023.

In our view, the complexity and uncertainty associated with establishing sufficient nexus between interest expense and assessable income has only increased over the last 22 years. With a further tightening of the thin capitalisation / interest-limitation regime, it is difficult to see how there is any benefit in amending section 25-90 as proposed.

Over time the proposed amendments are also unlikely to further reduce interest deductions that would not otherwise be achieved by the proposed introduction of the new earnings-based rules. The return to 'tracing' is likely to see Australian companies use debt funding for their Australian operations and 'cost-free' funding (profits or other forms of equity) to fund their overseas operations. As a result, Australian companies should be able to claim interest deductions up to the 30% tax EBITDA ratio. Of course, as noted above, this is the very reason for the 2001 reforms which recognised the shortcomings in a system that requires tracing.

Australian multinationals will not be on a level playing field with foreign competitors

By increasing the funding costs of Australian companies seeking to expand offshore, Australian multinationals will no longer be on a level playing field with their foreign competitors when it comes to making strategic investments offshore.

²⁰ Review of Business Taxation (July 1999), *A Tax System Redesigned* More certain, equitable and durable - Report, Recommendation 22.6

Australian companies with existing arrangements that were entered into in good faith in compliance with section 25-90 will likely restructure or face significant non-deductible interest costs. This will introduce substantial additional costs, including:

- break costs in repaying existing debt and unwinding existing swaps;
- the triggering of foreign exchange gains and losses arising from repaying existing foreign currency denominated debt;
- time and money involved in negotiating new debt facilities including the possibility of higher funding costs;
- time and money involved in briefing analysts, investors and the market; and
- negative perceptions by the market caused by the fact that the taxpayer has restructured its existing debt facilities.

Financial decisions will be distorted as there will be a bias toward funding Australian operations with debt. Australian businesses will need to explore the possibility of moving debt offshore by borrowing in their foreign subsidiaries. This presents significant commercial challenges, including:

- where an Australian company sets up a foreign company in a foreign jurisdiction and the foreign company borrows to establish a business in that foreign jurisdiction, the foreign company may not generate sufficient income in the early years to be able to pay interest on the borrowing or to pay for any parental support provided by the Australian company to facilitate the borrowing;
- Australian companies may not have relationships with any banks operating in the foreign country from which it could raise debt funding;
- the cost of funding off the balance sheet of the foreign company may exceed a debt raising supported by the balance sheet of the Australian parent;
- the imposition of foreign withholding taxes on cross-border loans;
- an Australian company's existing loan relationships may prevent it from borrowing through a subsidiary in a foreign jurisdiction because of debt subordination clauses or the potential adverse effects on the group's overall credit rating.

Relevantly, the inability to raise funds offshore was one of the commercial considerations originally identified by the RBT as explaining why debt is commonly raised in Australia.

Australia will be out-of step with other major economies

Most other OECD countries allow a deduction for interest incurred to derive dividends from foreign subsidiaries, subject to earnings-based interest limitation rules. The proposed amendments to section 25-90 will put Australia out-of-step with other major developed



economies in the OECD, including the UK, Germany, Canada, the US, France, Spain, and Japan.

As a result, Australia will become uncompetitive as a holding company jurisdiction and Australian multinationals will be disadvantaged relative to foreign multinationals. As an example, Australian multinationals may be unable to compete with foreign multinationals in a bidding war for new foreign assets, or Australian groups with foreign assets.