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Corporate and International Tax Division
Treasury
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13 April 2023

Dear Sir or Madam

Multinational Tax Integrity – Australia’s interest limitation rules Submission by Foreign Funds

We thank you for the opportunity to provide a submission in respect of the Exposure Draft Legislation and Explanatory Memorandum (**EM**) for the proposed changes to Australia’s interest limitation (**thin capitalisation rules**) which were released for consultation on 16 March 2023.

This submission is made by Serenitas Management Pty Limited, an owner and operator of residential land lease communities throughout Australia and has been prepared with assistance from our tax advisor, PricewaterhouseCoopers.

We recognise the Government’s overarching policy objective to align Australia’s thin capitalisation rules with the latest Organisation for Economic Cooperation and Development (**OECD**) best practice recommendations¹ to protect Australia’s tax base and also deliver on a Labor Party commitment from the 2022 Federal election. We value the opportunity to participate in the Government’s public consultation process in relation to the proposed reforms and to provide our views on the Exposure Draft legislation and accompanying explanatory material.

We also acknowledge the Government’s decision to include the “external third party debt test” (**ETPDT**) to ensure taxpayers can claim a tax deduction for genuine third party borrowings in respect of Australian assets. This is a critical feature of the new rules for us. We wish to ensure that third party borrowings are not adversely affected and that the effective tax rate on investments does not exceed the 30% corporate tax rate as a result of the proposed changes.

We are writing to you to share our key concerns in respect of the Exposure Draft legislation. We have limited our submission to aspects where we believe the drafting could be amended in a manner that aligns with the desired policy intent.

Our principal concerns relate to the following aspects of the draft legislation:

- Submission 1: The requirement for “associate entities” to make a mutual choice to apply the ETPDT;
- Submission 2: The application of the Fixed Ratio Test (**FRT**) to trusts.

Our submissions on these specific items are outlined below. We would be pleased to have further discussions with you in respect of the matters raised herein at your convenience.

¹ Final report on Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016
Report accessible online: <https://www.oecd.org/tax/beps/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2016-update-9789264268333-en.htm>

Submission 1: The mutual choice for “associate entities” to access the ETPDT

As interest on third party debt can exceed 30% of an entity's EBITDA in certain cases, the inclusion of the ETPDT in the proposed thin capitalisation rules is a welcomed policy initiative to ensure such interest on third party borrowings can be deducted against the returns from the underlying investment.

However, the proposed drafting of the eligibility requirements for the ETPDT has raised concerns, as our impression is that it will be difficult for some entities to confirm their eligibility to apply the ETPDT (in its current form) due to the requirement for “associate entities” to make a “mutual choice”.

Our concern specifically relates to the scope of the proposed subsection 820-43(5) which prevents an entity from making an election to apply the ETPDT where one or more “associate entities” do not make a choice to apply the ETPDT in relation to an income year (e.g., one or more associate entities apply the FRT or the Group Ratio Rule (**GRR**) in relation to an income year).

The draft EM states that the policy for this ‘one-in, all-in’ rule is to:

“...ensure that general class investors and their associates are not able to structure their affairs in a way that allows them to artificially maximise their tax benefits by applying a combination of different thin capitalisation tests. The restriction effectively requires a general class investor and all of its associate entities to make a mutual choice to use the third party debt test, if any more of those entities wishes to use that test”.

We consider the policy objective of this integrity provision to be reasonable and appropriate in the context of entities in a direct ownership chain that invest into a particular asset or portfolio of assets. However, as a result of the proposed amendment to the ‘associate entity’ definition to refer to a 10% ‘TC control interest’ (as defined in section 995-1 of the Income Tax Assessment Act 1997 (*Cth*)), two or more unrelated entities could be considered “associate entities” of each other and the same investment entity could be an “associate entity” of multiple upstream investors in a consortium or club-style of investment.

Accordingly, we are concerned that the drafting of the proposed legislation would apply to more than the entities in the direct or indirect ownership chain and could result in an aggregation of completely unrelated investments, including across a range of different asset classes, for the purpose of the rule. This is principally because:

- the ownership threshold for “associate entities” is effectively lowered to a 10% direct and indirect interest for the purpose of the proposed subsection 820-43(5), and
- the definition of “associate entity” in section 820-905 includes the associate entities of a third entity under subsection 820-905(3A) and (3B).

We believe this application of the Exposure Draft legislation is unintended as the outcome is significantly beyond the policy objective set out in the EM which is to prevent general class investors from “artificially maximising tax benefits by applying a combination of different thin capitalisation rules”.

We believe each investment or portfolio of assets should be entitled to apply one of the three interest limitation methods (FRT, GRR or ETPDT) depending on their particular facts and circumstances and that such an outcome would not give rise to any “artificiality” in respect of the application of the rules (rather it would reflect the commercial realities of each underlying investment). We therefore submit that the draft legislation should be amended to limit the “mutual choice” to associate entities within the same direct and indirect ownership chain.

Submission:

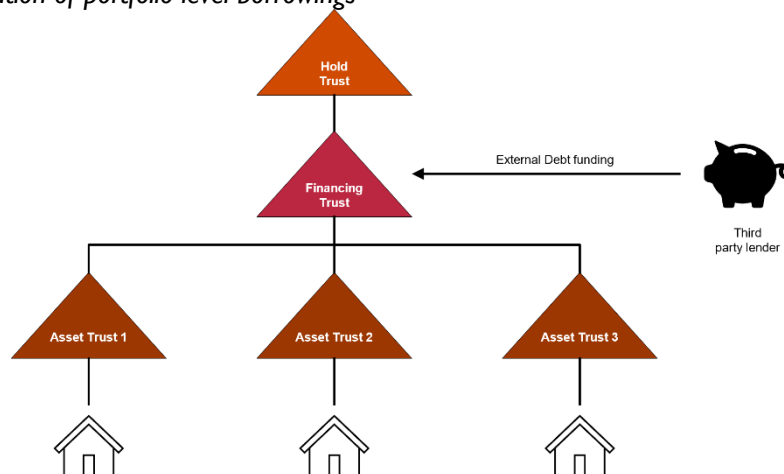
Subsection 820-43(6) should be amended to exclude the application of subsection 820-905(3A) and subsection 820-905(3B) from the “associate entity” definition for the purpose of the mutual choice rule in subsection 820-43(5) to ensure that only entities that hold a 10% or more interest in **the same ownership chain** are required to elect the same test for the purpose of the thin capitalisation rules.

Submission 2: Application of the Fixed Ratio Test to trust groups

It is commonplace for investment into Australian property to be made in trust structures where the borrowings are structurally separated from the underlying income producing asset for commercial and financial reasons. Examples of such commercial arrangements include portfolios of assets where a “portfolio” or “corporate level” debt is arranged to cover all assets (rather than a series of borrowings for each special purpose entity in the structure), as this can provide the best terms and ultimately the lowest cost of capital for the portfolio.

We have provided an illustration of the portfolio level debt that is commonly obtained by a holding trust for assets within a particular real estate sub-class at Figure 1 below.

Figure 1: Illustration of portfolio level borrowings



Importantly, the current thin capitalisation rules accommodate these commercial arrangements without any adverse impacts or distortions. The current rules effectively achieve this by allowing associate entities to utilise the excess debt capacity of another entity (i.e the “associate entity excess amount”). It is important that this feature of the thin capitalisation rules is preserved under the proposed rules such that any excess debt capacity of an associate entity under the FRT can be attributed to another entity in the ownership chain. We believe such a feature would also be important to uphold the policy intent to limit debt deductions to the 30% fixed ratio.

Putting aside the proposed thin capitalisation rules, the structural separation of borrowings from the underlying asset is generally efficient due to the flow-through nature of the trust entities which allows the debt deductions at the Financing Trust level to be applied against the net income to which the finance or holding trust is presently entitled for an income year from an underlying property trust(s).

However, under the draft legislation, such a trust group would be materially disadvantaged under the FRT because the “tax EBITDA” of the Finance Trust in Figure 1 would be determined based on the net taxable income from the underlying property trusts which would be after deductions for depreciation and tax losses. The “tax EBITDA” would therefore reflect a profit before tax basis of calculation, rather than an EBITDA measure.

We submit that the trust group should be entitled to utilise the surplus capacity of other entities within the ownership chain to ensure that the 30% fixed ratio is applied to the tax EBITDA of the trust group as a whole. Applying the FRT to trusts in this manner would also ensure that the outcome for trusts is consistent with the outcome for tax consolidated groups (e.g., where the Head Entity is liable for the tax and the EBITDA is determined on a group basis).

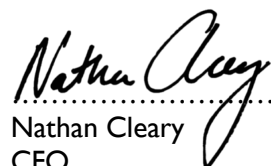
Submission:

The Fixed Ratio Test in the draft legislation should be amended to allow surplus debt capacity of a trust to be attributed to another trust in the direct or indirect ownership chain where there is a TC control interest of 10% or more to ensure the test applies with the commercial arrangements existing in the market.

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We trust that the submissions included above will be of use to you as part of finalising the proposed legislation and explanatory memorandum. We value and appreciate the ability to provide our views through the consultation process and would welcome the opportunity for further discussions with you.

Yours sincerely



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Nathan Cleary
CFO