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## Multinational tax integrity – strengthening Australia’s interest limitation (thin capitalisation) rules

Dear Assistant Secretary

The Australian Investment Council (**the Council**) welcomes the opportunity to consult with The Treasury on the Exposure Draft for the *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation*.

The Council is the peak body for private capital in Australia and our members collectively manage over A\$57 billion for investment into the establishment and growth of Australian businesses. Our members comprise the leading domestic and international private capital firms operating in Australia, and span private equity, venture capital, private credit, family offices, superannuation, and sovereign wealth funds.

Private capital funds serve an important purpose by pooling capital from a variety of sources to finance economic activity and jobs in Australia. Capital is invested by individuals, Australian superannuation funds, sovereign wealth funds (including the Future Fund), foreign persons as well as life insurance companies, endowments, and charities.

Debt financing plays a key role in enabling private capital funds, in particular private equity funds, to effectively deploy capital to drive economic growth and job creation. The Council acknowledges that the thin capitalisation rules have a role to play in ensuring that Australia’s tax base is not eroded by excessive debt deductions, however this submission will highlight a number of unintended consequences arising from the Exposure Draft, and how this is likely to adversely impact investment by private capital funds in Australian businesses.

Of great concern is the short timeframe for implementation of the proposed changes (i.e. effective 1 July 2023). There are steps that a prudent investment manager will need to take in preparation for the legislative changes which will not be practically feasible in a period of roughly 10 weeks, particularly given the current challenging economic and global financial markets environment. We further outline these concerns in this submission.

**Further information**

If you have any questions about specific points made in this submission, please do not hesitate to contact me or our policy team via email at [policy@investmentcouncil.com.au](mailto:policy@investmentcouncil.com.au).

Yours sincerely

Navleen Prasad

Chief Executive Officer

**Australian Investment Council**



## Australian Investment Council Submission

The Council has identified five key issues arising from the Exposure Draft that may undermine the viability of the private capital industry in Australia. These, and our recommendations as to how the Exposure Draft should be amended to mitigate any unintended consequences, are summarised below. In making recommendations, we have been informed by the policy intent of the proposed legislative amendments.

### 1. External Third-Party Debt Test (ETPDT)

The ETPDT is intended to replace the existing 'arm's length debt test' and, according to the Exposure Draft Explanatory Memorandum, has been specifically designed to be narrow so that it only accommodates genuine commercial arrangements relating only to Australian operations and investments.

Unfortunately, the proposed drafting of the ETPDT is so narrow that it is likely to exclude genuine third-party debt used by taxpayers across all industries (for example, a vanilla loan from an unrelated financial institution such as a bank), including private capital funds, to fund the acquisition of portfolio companies or to fund Australian business operations of those companies.

Further, the revised definition of 'associate entity' is so broad that it potentially captures otherwise independent entities that are linked only by virtue of minority interests held by private capital funds in those entities. From a practical perspective, the application of the new rules is impractical and unworkable, and we would query whether the outcome is intended.

The key issues with applying the ETPDT to portfolio companies owned by private capital funds are highlighted below.

#### Wholly funding Australian operations or investments

The ETPDT is only available where:

- the debt is used to wholly fund a taxpayer's Australian operations or investments held for the purposes of producing assessable income (proposed paragraph 820-61(d) and subsection 820-61(3)); and
- where the lender only has recourse to the assets of the taxpayer (proposed paragraph 820-61(c)).

With respect to current debt commitments, this will mean that where debt was partially used to fund offshore operations/assets and/or where the lender has recourse to those offshore assets, all the interest deductions may be denied even where the offshore operations may be a minor part of the group.

In this regard, the changes, as currently drafted, create a structural impediment to growth that will penalise Australian businesses in the early stages of international expansion. Businesses that are early in their international growth typically struggle to separately raise debt in foreign jurisdictions and

are reliant on their Australian operations and lenders. From an overall economic and productivity standpoint, flow-on effects include:

- diluting the willingness of Australian businesses to expand into international markets and contribute to trade balances;
- discouraging Australian businesses from attempting international expansion in a way that is particularly punitive for small to medium-sized organisations; and
- limiting the potential for Australian businesses to achieve scale through international expansion, thus reducing their scope for longer-term economic contribution.

Against this backdrop, the Council considers that the external third-party earnings limit should not be affected by any recourse of a lender to foreign assets until such time as foreign resident entities are able to independently raise local debt in their jurisdictions of residence.

The process of re-negotiating financing (for example, to exclude foreign assets from the lenders' recourse) in the current market is at best highly complex and at worst, unworkable, meaning that the rules as currently drafted will result in adverse outcomes for groups seeking to rely on ETPDT or are required to do so due to the broad application of the associate entity rules.

Even if it is possible to re-negotiate financing to limit a lender's security to assets of the taxpayer, there will still be a denial of interest deductions to the extent that the debt was not used to wholly fund Australian operations or investments held for the purposes of producing assessable income.

#### **Example 1**

Consider a private equity fund which acquires a group of companies carrying on a business almost entirely in Australia with comparatively insignificant operations carried on by a foreign subsidiary in a foreign jurisdiction such as New Zealand, which is not uncommon for Australian headquartered companies. The private equity fund incorporates an Australian company to make the acquisition and the company borrows some external debt to fund the acquisition.

Under the proposed drafting, if the lender has recourse to the assets of the entire group of companies (including the foreign subsidiary) it appears that the ETPDT could not apply at all.

There will be a range of these investments which already exist, solely funded by genuine third-party debt. Practically, it would likely be unfeasible to arrange timely refinancing of the external group debt across the entire capital market in an orderly way prior to 1 July 2023.

The Council further notes that in determining the arm's length debt amount under the current thin capitalisation rules, one of the assumptions that must be made is that no guarantee, security, or other form of credit support is provided to the entity by its associates. However, a critical difference with the ETPDT is that this is a gating requirement which, if not satisfied, will prevent the ability to rely on the ETPDT to begin with. Given that financial institutions lending to a taxpayer which is part of a group will typically seek security over the assets of other members of that group (whether those are Australian or foreign assets), this new requirement will mean many taxpayers are unable to rely on

the ETPDT, regardless of whether the security provided by associates is immaterial or has no meaningful impact on the level of debt obtained, which seems excessively punitive.

## **Recommendation 1**

### **A. Recourse to foreign assets**

The Council recommends that the proposed requirement in paragraph 820-61(2)(d) that a lender must only have recourse to the assets of the taxpayer should be removed.

Instead, if a lender does have recourse to foreign assets, the Council recommends that the calculation of the 'external third-party earnings limit' under proposed section 820-61 should take this into account. For example, the external third-party earnings limit could be calculated by reference to the proportion of earnings or assets of the Australian entities in the group as a proportion of the total earnings or assets of the group.

### **B. Wholly to fund Australian operations or investments used to derive assessable income**

The Council recommends that taxpayers should still be able to choose the ETPDT if the proceeds of any financing are used 'principally' (rather than 'wholly') for those same purposes. Furthermore, the calculation of the external third-party earnings limit should be modified to permit deductions for interest to the extent that the financing has been used to fund Australian operations and investments held for the purpose of producing assessable income.

## **Associate entities**

The proposed definition of 'associate entity' would be so broad that it will be practically difficult (and, in some cases, impossible) for independently operated businesses to apply the thin capitalisation rules with any level of confidence.

As the Council has sought to highlight below, these commercially independent businesses, which may only be related for the purposes of the ETPDT by virtue of a common shareholder with an interest of greater than 10 per cent but less than 50 per cent (referred to hereafter as a 'minority interest'), will be faced with":

- a significant compliance burden in determining if they are eligible to use the ETPDT; and
- a likely residual uncertainty associated with the position which they ultimately adopt.

This will mean that the ETPDT is not a viable option for many businesses in which private capital funds invest.

The Exposure Draft provides that before the ETPDT can be elected by a taxpayer, associate entities are required to also adopt the ETPDT, or must have already adopted it (see proposed subsection 820-43(5)). For these purposes, it is proposed to amend the definition of an 'associate entity' such that only a thin capitalisation (TC) 'TC control interest of 10 per cent' is required (rather than an 'associate interest of 50 per cent') which will widen the population of entities who will be associate entities of a

taxpayer. The issues that this proposed change may create for private capital funds are highlighted in the two examples below.

It is worth noting that the rules apply differently to companies and trusts. Our comments and examples below and throughout this submission relate to investments made by private capital funds in companies.

### **Example 2 – Parallel investments**

Assume a limited partnership fund has non-controlling stakes in two Australian companies (Company A and Company B) which are both subject to the thin capitalisation rules (i.e. they are 'general investors'). With the exception of the fund being a common (minority) shareholder, Company A and Company B are independent businesses and have no other common shareholders.

Under the proposed change to the definition of associate entity, Company A and Company B could be considered to be associate entities of each other. Where they are associate entities of each other, Company A and Company B would need to consult with each other before choosing the ETPDT. If Company A makes a choice to apply the fixed ratio test (FRT) (and not the ETPDT), Company B would be unable to choose the ETPDT (and vice versa).

The amendments as currently drafted, place an unreasonable compliance burden and risk on both Company A and Company B as, in many instances, these companies may not even be aware that they share a common (minority) investor. "These minority investors are generally passive and/or foreign investors. These passive and/or foreign investors are likely to hold a minority interest in a large number of investments and would need to undertake a process each income year to:

- determine whether it is an "associate entity" of each one of its investments for that income year;
- determine whether each one of its investments is subject to the thin capitalisation rules for that income year; and
- determine what elections have been made by that investment for that income year.

These foreign and/or passive investors are unlikely to have the power to request this level of information or the capacity to undertake such a process. This process would also be practically difficult where its investments have different year-ends and have not yet undertaken the assessment as to whether it is subject to the thin capitalisation rules and what elections it will make for that income year.

### **Example 3 – Co-investment**

Funds often acquire businesses alongside other investors (co-investors). Assume a private capital fund invests in a portfolio company (Company A) together with a co-investor who acquires a minority interest in Company A. The co-investor has a minority interest in another company (Company B).

Under the proposed amendments, Company A and Company B may be associate entities such that Company A would need to obtain confirmation from the co-investor about the thin capitalisation method chosen by Company B in order to determine whether it can choose the ETPDT.

Aside from the unreasonable compliance burden and risk raised in Example 2, the co-investor, depending on the level of its interest in Company B, may not have any rights to request the information which Company A requires.

The Exposure Draft Explanatory Memorandum states that the requirement for associate entities of a taxpayer to also choose the ETPDT ‘ensures 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.’

However, it is evident from these examples that completely independent and unrelated businesses with entirely separate debt facilities and security nets will be forced to comply with this requirement even though they will have no visibility on each other’s tax affairs. Commercially, these independent businesses would not jointly structure their affairs to maximise tax outcomes under the thin capitalisation rules.

Furthermore, each of these examples highlights the impracticality and uncertainty which private capital funds and their portfolio companies may encounter in attempting to determine how the thin capitalisation rules apply. As mentioned above, there are likely to be practical difficulties in obtaining information to make this assessment such that an entity may never have full visibility of who its associate entities are, whether they are subject to the thin capitalisation rules or not and, if so, what method they have chosen to apply to calculate their maximum allowable debt. Requiring businesses to operate with this level of tax uncertainty and risk is clearly unacceptable.

The Council also notes that the proposed changes to the definition of ‘associate entity’ may inappropriately prevent public or private companies from relying on the ETPDT as a consequence of the thin capitalisation positions of completely independent and unrelated entities and/or as a result of matters outside the control of those companies or the shareholders in those companies.

This may be particularly prevalent at the intersection between institutional investors in public and private markets:

- For example, any public and private companies in which a private fund or exchange traded fund has a minority interest are potentially associate entities of each other under the proposed changes. This technically means that all those companies would be required to apply the ETPDT for any of them to be able to rely on this test, which the Council believes is a perverse and unintended outcome.
- Further, if an investor currently holds a minority interest in companies which do not use the ETPDT, this may preclude any future companies in which the investor invests from ever using the ETPDT.

Consider an investor with investments in entities that use the ETPDT that subsequently acquires a minority interest in a public company on-market (i.e. an event that is clearly outside the public company's control). This would technically mean that the public company must use the ETPDT (or that those entities already held by the investor must cease to use the ETPDT).

Having regard to the above, the Council reiterates an earlier point that there is likely to be a practical roadblock to obtain sufficient information to determine when entities are associate entities and how those entities are applying the thin capitalisation rules. Even after a taxpayer has used its best efforts to obtain this information, the ability of a taxpayer to rely on the ETPDT may still be uncertain.

Further, if a taxpayer wishes to rely upon the ETPDT, the determination of whether associate entities are relying upon the ETPDT must be performed for each income year, imposing a substantial ongoing compliance burden. In summary, the proposed 10 per cent interest threshold for the purposes of the definition of an associate entity may essentially default a significant portion of the Australian public capital markets, into the FRT, making the ETPDT unavailable (or practically unavailable due to the obstacles to obtaining sufficient information to accurately assess its availability).

## **Recommendation 2**

To address the issues highlighted above, the Council recommends amending the proposed definition of associate entity in the following manner:

- (a) Remove the proposed amendment from the Exposure Draft to adjust the definition of associate entity in paragraph 820-905(1)(a);
- (b) In the alternative, increase the threshold from 10 per cent to 40 per cent and remove the application of subsections 820-905(3A) and 820-905(3B) when applying section subsection 820-905(1) for the purposes of determining when a choice for the ETPDT can be made. A 40 per cent threshold aligns with other areas of the tax law that seek to group otherwise unrelated entities – such as the connected entity rules in paragraph 328-125(1)(b). For similar carveouts already drafted into Division 820, please refer to section 820-820 of the *Income Tax Assessment Act 1997*; and



(c) Alternatively, the relevant grouping test could instead be based on the concept of a 'Division 832 control group' (refer section 832-205). This is an existing and understood concept, which is also used in an integrity provision in circumstances where it is necessary for there to be a level of understanding of the relevant circumstances of the various in scope entities.

Alternatively, the election to use the ETPDT should be made by each taxpayer independently. The Council has sought to demonstrate that the proposed changes are likely to make it impractical or impossible for taxpayers to identify associate entities and to obtain sufficient information on how those entities are applying the thin capitalisation rules.

## 2. Fixed Ratio Test – 30 per cent EBITDA Test

### Carry forward of disallowed interest deductions

While interest deductions disallowed under the 30 per cent Tax EBITDA / FRT in an income year can be carried forward for up to 15 years, the excess interest deductions may only be used where:

- the FRT method has been applied continuously during this period; and
- the modified continuity of ownership rules are satisfied.

There are several issues with the proposed carry forward approach under the revised rules and the Council highlights some of the key issues below.

#### Continuity of ownership test

Firstly, the Council submits that there is no policy support for restricting this tax attribute to where there is a failure of a modified Continuity of Ownership Test (**COT**) but there would be satisfaction of Business Continuity Test (**BCT**). This would place excess interest deductions on the same footing as tax losses and non-refundable Research and Development (**R&D**) tax offsets.

In the context of carried forward tax losses, the availability of a BCT in addition to the COT provides some relief where taxpayers are not able to readily trace ultimate beneficial ownership or there is a lack of certainty around satisfaction of the COT. These tracing issues and other administrative impediments would also still be present in the context of excess interest deductions. The Council submits that there is no policy support for a BCT not to be available for excess interest deductions.

Secondly, these requirements are impractical to satisfy by a group that has private capital investors. There is a clear purpose for the concession of allowing taxpayers to carry forward excess interest deductions which is to overcome the earnings volatility that may arise for some businesses. This concern was widely raised by taxpayers in the consultation process in August 2022. Introducing the additional requirement of having to satisfy the COT without a fallback position in the form of the BCT will adversely affect the availability of the concession and will mean that many businesses experiencing earnings volatility will be unable to benefit from it.

### **Requirement to consistently apply the FRT**

Consistent with the policy intent of having alternative thin capitalisation tests available to taxpayers, excess interest deductions should be capable of being carried forward from a year in which FRT is applied to another year in which FRT is applied notwithstanding elections made in intervening years to use alternative tests.

Requiring taxpayers to choose the FRT to utilise excess interest deductions in an income year is reasonable. However, the requirement for taxpayers to continuously choose the FRT to carry forward excess interest deductions will mean that in many cases, taxpayers will effectively be forced into using the FRT. This would seem to contradict the spirit of the rules which is to allow taxpayers the choice of method that provides the highest maximum allowable debt amount.

Moreover, the requirement to continuously apply the FTR effectively negates the point of having other options, without forfeiting potentially material excess interest deductions over 15 years. If a company's circumstances change it should have the flexibility to change its choice.

The Council also believes that there should be no forfeiture of excess interest deductions solely because there is either a temporary change in the thin capitalisation status of a taxpayer or there is a temporary non-application of the thin capitalisation rules to the taxpayer in an intervening year. As the thin capitalisation rules are an annual test, a taxpayer may be subject to the thin capitalisation rules for 14 out of 15 consecutive income years, but would not be able to carry forward any accumulated FRT denied amounts following the one intervening period it was not subject to the thin capitalisation rules.

This does not appear to be in line with the purpose of this concession of allowing taxpayers the ability to overcome the impact of earnings volatility in income years it is subject to the thin capitalisation rules.

The Council believes that there should be no forfeiture of excess interest deductions solely because there is either a temporary change in the thin capitalisation status of a taxpayer or there is a temporary non-application of the thin capitalisation rules to the taxpayer in an intervening year.

### **Calculation of Tax EBITDA and capital allowance deductions**

The current draft provisions provide that in calculating Tax EBITDA, an entity's deductions under Subdivision 40-B and Division 43 are added back. As a result the following capital allowances deductions would not be added back in the calculation of Tax EBITDA:

- Balancing adjustments (subdivision 40-D);
- Software development pools (subdivision 40-E);
- Primary production depreciating assets (subdivision 40-F);
- Capital expenditure of primary producers and other landholders (subdivision 40-G);
- Certain immediately deductible capital expenditure (subdivision 40-H);

- Project pool deductions (subdivision 40-I);
- Blackhole expenditure (section 40-880);
- Capital expenditure for the establishment of trees in carbon sink forests (subdivision 40-J); and
- Deductions in relation to farm-in farm-out arrangements (subdivision 40-K).

The Council is unable to discern the policy basis for excluding these types of capital allowances deductions. Taxpayers do not have the choice to calculate capital allowances deductions under subdivision 40-B (as opposed to other subdivisions).

The Council is concerned that the drafting of the proposed legislation to exclude such categories of capital allowances would be detrimental to investments made in the real assets and infrastructure sectors where capital expenditure is more significant. Another example would be a business which incurs significant costs in relation to a material restructure or merger and acquisition activity. Such costs may result in deductions under section 40-880, in respect of which the proposed drafting would reduce the ability to deduct debt costs which would otherwise have been allowable under ordinary business conditions.

## **Excess capacity**

Further to the earnings volatility concern mentioned above, and as highlighted in our submission of September 2022, the Council reiterates that consideration should be given to the ability to carry forward excess capacity (i.e., where debt deductions for an income year fall below the deductibility cap under the FRT). Such a rule would be consistent with the policy underpinning the ability to carry forward interest deductions denied under the FRT for up to 15 years, which is to address earnings volatility concerns.

An ability to carry forward excess capacity would also be consistent with OECD guidance and has been adopted by other jurisdictions which have introduced an FRT. For example, Germany, which also has a FRT based on 30 per cent of EBITDA, allows unused capacity to be carried forward for up to five years. The Council also notes Canada is currently considering changes to its thin capitalisation rules which will permit a three-year carry forward of excess capacity.

### Recommendation 3

The Council recommends:

- (a) A test like the BCT contained in the loss utilisation rules should be available to determine if excess interest deductions can be carried forward.
- (b) The requirement to apply the FRT continuously to carry forward excess interest deductions should be removed so that those excess interest deductions can be claimed in a future income year where the FRT is chosen (provided it is within the 15-year timeframe).
- (c) It should be clarified that excess interest deductions can be available in a later year notwithstanding:
  - i. In an intervening year, the total net debt deductions of the taxpayer is below A\$2 million;
  - ii. In an intervening year, a taxpayer ceases to have relevant control of a foreign entity; and
  - iii. In an intervening year, there has been a less than majority change in the beneficial ownership of the taxpayer, but the change has resulted in the taxpayer temporarily ceasing to be foreign controlled such that the thin capitalisation rules do not apply.
- (d) Amending the definition of Tax EBITDA to capture add-backs for all provisions in Division 40, not just Subdivision 40-B.

Allowing the carry forward of excess capacity under the FRT for a period of time.

## 3. Debt used to fund offshore expansion

The proposed repeal of section 25-90 seems to be at odds with broader policy intent to encourage Australian businesses to successfully expand internationally so that they may make a greater economic contribution to the nation.

This intent is clearly stated in Explanatory Memorandum to the *Tax and Superannuation Laws Amendment (2014 Measures No. 4) Bill 2014* (at paragraph 2.4):

*The intention of this exemption is to make non-portfolio returns on equity to Australian resident companies exempt of Australian income tax, to remove the Australian tax burden from active business income earned by a foreign subsidiary of an Australian owned company. **This helps ensure that the foreign subsidiaries are able to compete on an equal footing with other businesses located in that foreign country.** [emphasis added]*

It is further reflected in the Board of Taxation's discussion paper on its Review of the Debt and Equity Tax rules in 2014 at paragraph 8.85:

*The policy to exempt dividends received by an Australian company, sourced from a non-portfolio investment in a foreign company, **is intended to ensure that the tax system does not discourage the expansion of Australian companies overseas.** [emphasis added]*

Section 25-90 was clearly introduced to encourage the establishment of regional headquarters in Australia for foreign groups, and to improve Australia's attractiveness as a base for multinational groups. In doing so, the administrative burden of tracking and tracing use of debt proceeds within a corporate group would be removed. A more comprehensive thin capitalisation regime was introduced at the same time as section 25-90 thereby ameliorating any concerns that Australia would be disproportionately burdened with the debt of a multinational group.

Fundamentally, there has been insufficient consultation on the proposed repeal of section 25-90. It was not tabled as part of the consultation process on the reforms in August/September 2022 and its inclusion in the draft legislation was completely unexpected by taxpayers and their advisers.

The Council understands concerns about section 25-90 are highlighted at paragraph 1.119 of the Exposure Draft Explanatory Memorandum. The Council respectfully disagrees; our view is that retaining section 25-90, together with the redrafted Division 820, would not create a so-called 'double benefit'. The Council notes that the ability to fund an overseas investment or an investment that generates non-assessable non-exempt income would still be impacted by Division 820, in particular:

- reducing the Tax EBITDA under the FRT; and
- a potential inability to rely on the ETPDT.

At the very least, separate consultation on the proposed repeal of section 25-90 would allow for proper examination of the benefits of repeal relative to the cost, notably encouraging Australian businesses to be internationally competitive and enabling them to be greater economic contributors.

The Council notes that a repeal of section 25-90 was proposed in the 2013-14 Federal Budget but, for the policy reasons given above, the Government decided not to proceed with the repeal.

Finally, the Council highlights that removal of section 25-90 will substantially increase the compliance burden of taxpayers with foreign operations. As mentioned earlier, one of the policy reasons behind the introduction of the provision was to reduce the administrative burden of tracking and tracing use of debt proceeds within a corporate group. In addition to the compliance burden, where this rule applies retrospectively (as currently proposed in the Exposure Draft), many taxpayers may practically be unable to determine with any degree of certainty the appropriate percentage of interest deductions to deny as they are unlikely to have records with the required level of detail from the time the debt was drawn down.

#### **Recommendation 4**

- A. The Council strongly recommends that Treasury reconsider the repeal of section 25-90 given the policy underpinning this provision, which is to encourage Australian businesses to expand offshore and to ensure that they can compete on an equal footing with foreign businesses. The competitiveness of Australian-headquartered businesses is even more critical given the current highly uncertain global economic outlook, with the Federal Government noting that there are significant risks to Australia's economic outlook should there be 'a more severe economic global downturn.'<sup>1</sup>
- B. At the very least, if the Government is now seeking to revisit whether section 25-90 should be retained, the Council recommends that any potential change be quarantined from the Exposure Draft and separately considered through a comprehensive consultation process, particularly given that its potential repeal has not been previously tabled.

## **4. Timing of 1 July 2023**

Due to the short timeframe between the Exposure Draft's release and the legislation's projected commencement, it is unlikely that taxpayers will have final legislation, and therefore certainty of what the new rules will be, prior to the proposed start date of 1 July 2023.

Even if taxpayers assume the final legislation will be similar to the draft legislation, a proposed start date of 1 July 2023 does not provide taxpayers with sufficient time to re-negotiate the terms of their existing debt to ensure they are not inadvertently non-compliant or have their interest deductions denied. The Council also note that some taxpayers may incur significant costs should they be required to restructure their debt before 1 July 2023. For example, some long-term borrowings may be subject to significant break fees if debt is repaid before maturity.

The suddenness of the changes will adversely impact existing private capital funds' investor relations (with regards to information and education about the impact of the changes, including negative economic outcomes) and impose a significant burden for new capital raisings by private capital funds where outcomes are uncertain and impractical. The absence of a transitional period for such significant changes is highly unusual, and the Council strongly recommends that transitional arrangements are introduced.

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<sup>1</sup> Federal Government, Budget Paper No. 1, October 2022.

## Recommendation 5

Where the start date of 1 July 2023 is not able to be delayed, The Council recommends that taxpayers are provided with some form of transitional relief as outlined below:

- (a) Where a taxpayer can renegotiate the terms of its debt by 30 June 2024, such that the debt meets the requirements of the ETPDT by 30 June 2024, then it will be deemed to have met the requirements for the entire income year ending 30 June 2024.
- (b) Taxpayers are afforded a transitional period to be allowed to restructure or refinance existing debt arrangements without the application of Part IVA or integrity measures which would otherwise potentially apply. This is a similar approach that was adopted in respect to the implementation of the diverted profits tax and other BEPS-related measures.
- (c) Given the removal of the arm's length debt test and its replacement with the ETDPT, the proposed requirements around electing ETDPT to be restricted to where all associate entities have so elected should be deferred until 1 July 2024. This is subject to the Council's earlier recommendations in relation to the ETDPT (see recommendation 2). This would allow more time to ascertain associate entities and for such entities to engage in a discussion around what tests can and will be applied.
- (d) Where a taxpayer elects to apply the ETPDT in an income year and later discovers that it was ineligible to do so, under the current drafting it is not able to apply the FRT for that income year. This irrevocable choice seems overly punitive – particularly in instances where the taxpayer has associate entities with different year ends and the associate entities have not yet concluded which method they will apply for that income year at the time the taxpayer needs to file its return. The Council recommends that the choice is irrevocable for all taxpayers. Where the choice is not irrevocable, the Council recommends that as a minimum, for the year ending 30 June 2024, the method chosen under the thin capitalisation rules should be revocable for that year given there is high probability that further guidance and clarity around interpretation may be released after an election is made by a taxpayer.

## 5. Application of Group Ratio Test to private capital owned groups

The current drafting of the Group Ratio Test (**GRT**) has the potential to not be available to groups which are owned by private capital funds. This is due to the test only being available to groups which have a 'worldwide parent entity' who prepares consolidated accounts. Importantly, a worldwide parent entity (as defined in subsection 820-935(6)) cannot include an entity which is controlled by another entity (in accordance with accounting standards).

Where a private capital fund holds a controlling interest in a portfolio company, that portfolio company would be precluded from applying the GRT because the fund would not prepare consolidated accounts due to the exemption for investment entities (see, for example, paragraph 31 of AASB 10



*Consolidated Financial Statements*). Our concern is that this drafting would put groups owned by private capital funds at a disadvantage compared to other groups in Australia.

### **Recommendation 6**

The Council recommends that the definition of worldwide parent entity is amended to exclude entities that are controlled by another entity, other than in situations where that other entity does not consolidate the portfolio group due to applying the investment entity exemption in the accounting standards. This would allow groups owned by private capital funds to apply this test subject to the other relevant conditions.