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International Tax Unit
Corporate and International Tax Division
Treasury
Langton Cres
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By email: MNETaxIntegrity@treasury.gov.au

Dear Sir / Madam

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

We acknowledge and appreciate the opportunity to provide feedback on the Exposure Draft legislation to amend Australia’s interest limitation (thin capitalisation) rules which Treasury released on 16 March 2023 (the ***Exposure Draft***).

Allens is an independent, Australian-headquartered law firm that is part of an integrated alliance with global law firm Linklaters. In this submission we address a small number of issues which are of particular concern to our clients. All legislative references are to the draft Exposure Draft or the *Income Tax Assessment Act 1997* (Cth) (the **1997 Act**).

1 Transitional rules are necessary

Given the wholesale nature of the proposed amendments, and the likelihood that the final form of the legislation will not be known until May/June 2023, taxpayers should be given a choice of either:

- (a) opting into the new rules from 1 July 2023, for those taxpayers who may have already incorporated the new rules into their modelling and funding arrangements based on the Exposure Draft; or
- (b) continuing to apply the current thin capitalisation rules until at least 30 June 2024, for those taxpayers in need of additional time to consider the effect of the new measures.

2 The external third-party debt test should be amended

The Exposure Draft proposes a new external third-party debt test (***TPDT***) which generally disallows an entity’s debt deductions to the extent that they exceed the debt deductions which are attributable to third party debt.

We recommend that the proposed TPDT be modified to reduce its complexity and improve its effectiveness, and to ensure that genuine external third-party debt is deductible. With this in mind, we make the following specific comments.

13.4.2023

2.1 Requirement for all 'associate entities' to choose to apply the TPDT is not workable

- (a) The explanatory materials indicate that an entity will not be permitted to apply the TPDT if it has 'associate entities' that are subject to the thin capitalisation rules that have not elected to also apply this test.¹ There would appear to be a tension between this ostensibly rational proposition, and the drafting of proposed section 820-43(5)(a)(ii). We recommend that Treasury review the drafting of proposed section 820-43(5)(a)(ii) to ensure that the intended outcome is achieved.
- (b) Further, we recommend Treasury:
 - (i) review why, under the current Exposure Draft, it is proposed that section 820-35 be amended to provide that Subdivision 820-AA does not apply, but there is no equivalent drafting for the exemption in section 820-37; and
 - (ii) include explanatory commentary to clarify the relationship between Subdivision 820-AA and the insolvency remote vehicle exemption in section 820-39.
- (c) The Exposure Draft proposes to alter the definition of 'associate entity' to lower the associate entity test for most entities from 50 per cent or more to 10 per cent or more. This can be expected to have significant implications for joint ventures involving minority holdings. While we recognise the policy objective of addressing the use of so-called 'double gearing structures',² we recommend more targeted drafting. Under the current drafting, a 10% tracing requirement will capture minority investors who, having regard to their own particular circumstances and other investments, may or may not choose to apply the TPDT (or may simply fail to make a choice by the required deadline), leading to significant repercussions for another entity.

2.2 The conduit finance rule needs to take into consideration market practice

The Exposure Draft includes a conduit finance rule as an exception to the TPDT, which allows one entity in a group to raise funds and on-lend to other entities in the group.

Treasury recognises that conduit financing arrangements 'can streamline and simplify borrowing processes for [a] group'.³ However, the proposed conduit finance rule is narrow in its application and is unlikely to be able to apply to common commercial arrangements which involve a 'finco'.

The proposed conduit finance rule is contained in section 820-61(5) of the Exposure Draft. Proposed sections 820-61(5)(a) to (e) require that:

- (a) an entity (the conduit financier) issued a *debt interest (the **ultimate debt interest**) to another entity (the ultimate lender); and
 - (b) one or more other entities (the **borrowers**) are *associate entities of each other; and
 - (c) each borrower issued a debt interest (a **relevant debt interest**) to the conduit financier; and
 - (d) the conduit financier **financed the amount** loaned under each relevant debt interest only with proceeds from the ultimate debt interest; and
 - (e) the terms of each relevant debt interest are **the same as the terms of the ultimate debt interest** (other than terms as to the amount of the debt); and ...
- (Our emphasis.)

We make the following comments in relation to the conduit finance rule.

¹ Explanatory Memorandum to the Exposure Draft, paragraph 1.32.

² *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Act 2019* (Cth), Schedule 2.

³ Explanatory Memorandum to the Exposure Draft, paragraph 1.78.

On-lending requirements

- (a) The operation of the requirement that the conduit financier 'financed the amount' loaned to the borrowers from the ultimate debt interest would not seem to create practical difficulties in circumstances where, after 1 July 2023, a new conduit financier arrangement is being established. The new finco would use the funds raised from issuing the ultimate debt interest to finance the amounts loaned to the borrowers, and would maintain satisfactory documentation to demonstrate that flow of funds.

The difficulty arises where there is a conduit financier arrangement in place as at 1 July 2023, but the existing arrangement needs to be restructured to some extent so as to comply with sections 820-61(5). It will not be practical, or even feasible, for the finco to redeem and reissue the pre-existing ultimate debt interest, because this pre-existing debt interest will be held by third party lenders. As such, it is not clear how the finco can:

- (i) lend new amounts to borrowers, to comply with paragraph (c) of section 820-61(5); and
- (ii) demonstrate that the new lending has been financed only with the funds raised from the ultimate debt interest, to comply with paragraph (d) of section 820-61(5).

There needs to be an express acknowledgment that such amounts will be taken to be 'financed' by the original external debt interest which may have been previously on-lent. Without this amendment, taxpayers will only be able to apply the conduit finance rule for external debt that comes into existence after 1 July 2023, which does not appear to be the intended purpose of the provision.

- (b) Further, proposed section 820(5)(e) requires the finco to directly on-lend the ultimate debt interest on 'the same terms' as the terms of the ultimate debt interest (other than quantum). It is not clear whether this captures terms such as security (which would be impossible to replicate for on-lending) or whether it is limited to only the essential terms relating to interest, payment and duration. In our view, this should be limited to only the terms which constitute and create the debt interest, as defined in the legislation, and this should be expressly provided for in the legislation. We would also recommend the clause be updated to allow for on-lending through a chain of entities (rather than only directly from the conduit financier).
- (c) As presently drafted, section 820-61(5)(b) and 820-61(5)(c) could be read to require that a finco must on-lend to an entity and each of its associate entities (per the definition of 'borrowers' in section 820-61(5)(b)). We assume that this is not intended and would recommend this section be updated to address this concern.

Security net

- (d) One of the general requirements for an entity to apply the TPDT is that the holder of the debt interest can only have recourse for payment of the debt to the assets of the 'entity' that has issued the debt interest (proposed section 820-61(2)(c)). We would recommend that a note in the legislation be included to confirm that the reference to the 'entity' in proposed section 820-61(2)(c) captures all entities in a tax consolidated group that may provide security.⁴

If the holder has recourse to another entity's assets, it is necessary to consider whether the debt is eligible for the conduit finance rule. To apply the conduit finance rule, section 820-61(5)(g) requires:

the ultimate lender has recourse for payment of the ultimate debt interest only to:

⁴ Division 820 generally applies to the head company of a tax consolidated group in accordance with the single entity rule. This should also be confirmed for the equivalent requirements in proposed section 820-61(4)(b) and 820-61(5)(g).

- (i) the assets of each borrower; and
- (ii) each asset of the conduit financier that is a relevant debt interest; ...

The result of this is that the finco must on-lend to each entity in the group that provides security for the ultimate debt interest. This is impractical for many groups, particularly those which have holding entities or trustee companies which fall within the security net (but do not otherwise have any commercial operations). Provided that these entities make a choice to apply the conduit finance rule, in our view, these entities should not be required to also be borrowers under the conduit finance rule for the other entities in the group to satisfy the conduit finance rule.

- (e) Further, the position for limited security providers, and entities that provide support but do not provide security over their own assets, should be clarified. It is not clear whether an ultimate lender would have 'recourse' to the assets of the limited security providers. For the same reason as above, in our view, these entities should not be required to be borrowers under the conduit finance rule.
- (f) In addition, it is not clear whether the reference to 'a' relevant debt interest in proposed section 820-61(5)(g)(ii) includes all on-lending arrangements or only those on-lending arrangements which are related to the specific 'ultimate debt interest' which is being tested. We recommend this section be amended to allow the conduit financier to provide general security over all its assets to a lender (as is the case with proposed section 820-61(5)(g)(i)). This would be consistent with market practice and would avoid the need for the security nets to be renegotiated with external lenders in order to comply with this rule.

2.3 Inclusion of worked examples

We would recommend Treasury include examples to demonstrate how the conduit finance rule is intended to operate, including details about the terms of the on-lending which are required to comply with proposed section 820-61(5)(e).

3 Calculation of 'Tax EBITDA'

The amendments will introduce a fixed ratio test, allowing an entity to claim net debt deductions up to 30% of its 'Tax EBITDA'. Under proposed section 820-49, 'Tax EBITDA' is calculated as an entity's taxable income or tax loss adding back certain amounts including the entity's total deductions under Subdivision 40-B.

Division 40 allows taxpayers to claim amounts which are referable to the decline in value of certain depreciating assets held by that taxpayer, generally measured with reference to the effective life of the relevant asset. Subdivision 40-B contains the core deduction provisions but there are also deduction provisions in other subdivisions of Division 40.

Subdivision 40-B does not apply to expenditure which is allocated to a software development pool in accordance with Subdivision 40-E, or which has been deducted under Subdivisions 40-F, 40-G or 40-J.⁵ However, this carve out from Subdivision 40-B does not apply to expenditure which has been allocated to a low value asset pool under Subdivision 40-E (as this remains subject to Subdivision 40-B).⁶

As expenditure which is dealt with under other subdivisions in Division 40 is not added back to calculate an entity's 'Tax EBITDA' under proposed section 820-49, this results in a disparity between taxpayers. Using in-house software as an example, generally a taxpayer has a choice to allocate its

⁵ See section 40-50 of the 1997 Act.

⁶ See section 40-25 of the 1997 Act and 40-50(2) (which does not apply to low value asset pools) of the 1997 Act.

expenditure on developing in-house software to a 'software development pool' under Subdivision 40-E. If a taxpayer makes this choice, then the core provisions in Subdivision 40-B cease to apply.⁷ This means that two otherwise identical taxpayers that invest in in-house software but apply Division 40 differently in relation to that expenditure will have different 'Tax EBITDA'.

The explanatory materials do not address this disparity, and we see no reason why this disparity should exist. We would recommend that Treasury expand section 820-49(c) and update the explanatory materials to clarify the operation of this section.

Further, we consider that taxpayers would be assisted if the Explanatory Memorandum provided commentary to specifically address the treatment of expenditure allocated to a low value pool in the calculation of 'Tax EBITDA'.

We once again thank Treasury for the opportunity to comment on the Exposure Draft. We believe that these recommendations, if adopted, would help ensure that the legislation is fair and effective in achieving its objectives.

If you require any further information or wish to discuss any aspect of this submission, please do not hesitate to contact us.

Yours sincerely



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⁷ See section 40-50(2) of the 1997 Act.