

19 April 2023

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

Via email: MNETaxIntegrity@treasury.gov.au

Dear Ms Davy,

**Re: EXPOSURE DRAFT TREASURY LAWS AMENDMENT (MEASURES FOR FUTURE BILLS) BILL 2023:
THIN CAPITALISATION INTEREST LIMITATION**

The Council of Australian Life Insurers (CALI) was recently formed to support the Australian life insurance industry and its members, through dedicated representation, engagement and advocacy, to drive positive outcomes for customers, insurers and their partners. CALI represents the Australian life insurance industry. Its members comprise life insurance companies and reinsurance companies representing 99% of the life insurance market and 100% of the reinsurance industry in Australia.

CALI and the life insurance industry thank Treasury for the opportunity to provide a submission on the Exposure Draft *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation* (the ED Bill).

In the attached submission we put forward the case for the importance of recognising:

- (i) Life insurers should be subject to the existing thin capitalisation rules and should not be subject to the new rules for “general class investors”. This is consistent with OECD guidance.
- (ii) It should be made clear in the law that interest and equivalent income derived through interests in trusts and Attribution Managed Investment Trusts (AMITs) is included in the calculation of “net debt deductions” in new proposed subsection 820-45(3)(b) of the *Income Tax Assessment Act 1997* (ITAA 97).

The life insurance industry is a global market, maintaining an approach consistent with the OECD guidance is appropriate in the context of Australia’s strict regulation of life insurers, and allows Australia to align with requirements in other jurisdictions.

Further, taking into account interest income derived through a trust or AMIT that is included in assessable income in arriving at an entity's net deductions amount is consistent with core principles of Australian tax law.

Thank you for the opportunity to contribute to this consultation. I look forward to continued engagement as the Government progresses this important reform. I can be contacted at christine.cupitt@cali.org.au and 0402857401.

Yours sincerely,

Christine Cupitt
Chief Executive Officer

COUNCIL OF AUSTRALIAN LIFE INSURERS

EXPOSURE DRAFT TREASURY LAWS AMENDMENT (MEASURES FOR FUTURE BILLS) BILL 2023: THIN CAPITALISATION INTEREST LIMITATION

DETAILED SUBMISSIONS

Life insurers should be defined as “financial entities”

The stated purpose of the ED Bill is to strengthen Australia’s thin capitalisation rules in line with those recommended in the OECD best practice guidance. The ED Explanatory Memorandum (ED EM) states:

“Financial entities and ADIs will otherwise continue to be subject to their existing asset-based thin capitalisation safe harbour and worldwide gearing tests. This is because the OECD recognises that the earnings-based tests are unlikely to be effective for these types of entities, partly as they are net lenders and subject to regulatory capital rules.” [para 1.17]

The reasoning of the OECD for “financial entities and ADIs” applies equally to life insurers. Life insurers are subject to rigorous regulatory capital rules and are net lenders.

Life insurers are required to hold minimum levels of capital by APRA to ensure they can meet obligations to policy owners at all times. They are subject to strict regulations which impose restrictions on their capital structure. These include minimum required amounts of equity and restrictions on debt. Therefore, they are already subject to restrictions on gearing which mean they pose little risk of excessive debt deductions eroding Australia’s tax base. In this context, there is no need for an additional restriction on debt deductions for life insurance groups when the APRA rules achieve this outcome already.

Life insurers are generally net lenders. That is, the interest income they derive, including indirectly from investments in trusts and AMITs that are external to their tax consolidated groups, exceeds any debt deductions. This is because of the capital they are required to hold and because investment income is a critical part of life insurers’ business. Investment in interest-bearing securities is usually a necessary and significant part of their portfolios.

Therefore, for the reasons set out by the OECD, life insurers should be excluded from the earnings-based thin capitalisation tests and instead the existing asset-based thin capitalisation tests should continue to apply.

The current and proposed definition of “financial entity” does not expressly include entities registered to carry on a life insurance business in Australia. Similar to ADIs, obtaining and maintaining registration to carry on life insurance business in Australia requires approval by APRA (under section 21 of the *Life Insurance Act 1995*) and adherence to APRA’s prudential standards. A person who is not registered is prohibited under the *Life Insurance Act 1995* from issuing life policies or undertaking life policy liabilities. These are high thresholds and barriers to entry and it is not a simple undertaking to become registered. For completeness, life insurance entities are generally not registered corporations

under the *Financial Sector (Collection of Data) Act 2001* and are therefore not the subject of the proposed amendment addressing that existing category of “financial entity”.

For the reasons set out by the OECD life insurers should be subject to the existing, asset-based thin capitalisation rules and not the proposed new earnings-based rules. One way that may be considered to achieve this could be to amend the tax law definition of “financial entity” in section 995-1 of the ITAA 97 to include a registered life insurance company for the purposes of the thin capitalisation rules, provided there are no other unintended consequences.

Interest income should expressly include interest income earned through trusts and AMITs

The ED Bill proposes, amongst other things, two new thin capitalisation safe harbour tests for “general class investors” being the Fixed Ratio Test and Group Ratio Test. Under these tests, an entity’s “net debt deductions” amount for an income year is tested against the ratios.

Under proposed subsection 820-45(3) of the ITAA 97, an entity’s net debt deductions amount for an income year is worked out as follows:

- (a) first, work out the sum of the entity’s *debt deductions for the income year;
- (b) next, work out the sum of each amount included in the entity’s assessable income for that year that is:
 - (i) interest; or
 - (ii) an amount in the nature of interest; or
 - (iii) any other amount that is calculated by reference to the time value of money;
- (c) next, subtract the result of paragraph (b) from the result of paragraph (a).

Net debt deductions are intended to be debt deductions less amounts of interest or amounts in the nature of, or economically equivalent to, interest, that are included in assessable income.

Many life insurance companies invest in trusts and AMITs to derive income from underlying investments in interest-bearing securities to support their life insurance businesses and policy liabilities. As noted above, investment income is a critical part of life insurers’ business and investment in interest-bearing securities is usually a necessary and significant part of their portfolios.

Many of the trusts and AMITs that life insurers invest in are not wholly owned or included in the tax consolidated group of which the life insurer is a member. The income derived from the trusts and attributed by the AMITs is included in the assessable income of the life insurer (except where it is derived from segregated exempt assets in which case it is non-assessable non-exempt income). It is a principle of Australian tax law that income derived through a trust or AMIT retains its character in the hands of the beneficiary or investor. Consistent with this, the interest income derived through the trusts and AMITs is reported as “interest income” on the distribution statements and AMIT Member Annual Statement (AMMA) issued to the investor. Therefore, the assessable amounts of interest income derived through the trust or AMIT are clear.

Subsection 820-45(3) should make it clear that interest, amounts in the nature of interest or amounts calculated by reference to the time value of money, include such amounts derived through a trust or

AMIT. There is no reason in principle why interest income derived through a trust or AMIT that is included in assessable income should not be taken into account in arriving at an entity's net deductions amount.

The law should also clearly state that if the amount of "net debt deductions" is negative (i.e. the result of paragraph (c) is negative because the result of paragraph (b) exceeds the amount of paragraph (a)), then it is zero or nil.