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Dear Mr Robinson

Exposure Draft: Multinational Tax Integrity – strengthening Australia’s interest limitation (Thin Capitalisation) rules

We refer to Treasury’s Exposure Draft *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation* (“ED”) and accompanying Explanatory Memorandum (“EM”).

We thank you for the opportunity to provide our submissions on the ED and EM and we set out our summary of submissions below and detailed submissions in the attached Appendix.

We are supportive of the policy intent to combat multinational tax avoidance. We recognise these measures are broadly consistent with Australia’s international obligations under the OECD BEPS Action 4 Limitation on Interest Deductions recommendations of which Australia is a signatory.

As with any measure, the method and timing of implementation is critical. Therefore, we have provided our submissions from our perspective as a leading accounting and tax advisor to multinationals and as a valued partner of the Australian Taxation Office (ATO) through its Key Agent Program. Our overriding intent is to seek a balance between effective revenue raising, ease of compliance and encouraging investment in Australia.

Summary of submissions

1. Removal of interest deductions for Non-Assessable Non-Exempt (NANE) income
2. Transitional provisions for NANE income
3. Alignment of Allocable Cost Amount (ACA) Step 6A Adjustment with tax loss provisions
4. Inclusion of a modified Same Business Test/Similar Business Test – previously disallowed FRT amounts
5. Definition of adjustments to entity EBITDA and Group Ratio EBITDA

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6. Interaction between previously Financial Ratio Test (FRT) disallowed amounts and the de minimis threshold/general class investor rules
7. Interaction between previously FRT disallowed amounts and the GRT and ETPDT
8. Reinstating the ability to share associate entity excess fixed ratio amounts
9. Group Ratio Test (GRT) exclusion of negative EBITDA entities
10. External Third-Party Debt Test (ETPDT) expanded definition of “associate entity”
11. Irrevocability of the GRT and ETPDT
12. ETPDT conduit financier arrangements – same terms and asset recourse requirements
13. Transitional provisions – Thin Capitalisation
14. FRT tax EBITDA – adjustment for prior year net capital losses

We thank you in advance for your consideration of our submissions.

Please contact Yan Wong (yan.wong@au.gt.com or 08 8372 6609) if you wish to discuss this matter further.

Yours sincerely



Sandie Boswell

National Managing Partner - Taxation, Grant Thornton Australia Limited

Appendix

Submission 1: Removal of interest deductions for NANE income

We refer to proposed Items 1 and 2 in the ED which operate to remove references to section 768-5 ITAA 1997 in sections 25-90 and 230-15 ITAA 1997.

These proposed items have the effect of disallowing long-standing interest deductions for non-assessable non-exempt (NANE) income from foreign subsidiaries. The current section 768-5 deems certain foreign equity distributions as NANE income of an entity, including foreign equity distributions from non-portfolio equity interests (such as dividends from foreign subsidiaries). At the same time, Section 25-90 and Section 230-15 provide that interest expenses incurred in deriving this type of NANE income are specifically deductible.

This concessionary treatment was a welcome introduction accompanying the current thin capitalisation rules in 2001. It has been a longstanding feature of the Australian tax law to encourage businesses to expand offshore, and following public consultation in 2012, it was clear that this provision should remain despite Government proposals then to repeal the measure. The submissions at the time clearly indicated strong policy and commercial reasons to do so and we would submit that Treasury revisit the various submissions made on this matter.

Since 2012, Australian businesses operating overseas find themselves facing increasing debt costs, global competition and foreign State erected trade barriers. If these measures were critical in 2012, they remain ever more so now. If measure is implemented, we anticipate an increase in compliance costs and loss of competitiveness through loss of interest deductions, thereby unnecessarily increasing the cost of Australian businesses expanding overseas.

On the basis of previous consultations and in light of the fact that taxpayers have taken out long term investments based on government assurances at the time, we submit that the Government not proceed with these amendments.

Submission 2: Transitional Provisions for NANE income

If the Government chooses to proceed with Items 1 and 2 of the ED, we submit in the alternative that it would be appropriate to introduce transitional rules to reflect the reality that debt funded foreign equity investments require time to unwind as they often reflect strategic long-term investments.

We therefore submit the Government should as a grandfathering provision continue to allow interest deductions in respect of section 768-5 ITAA 1997 distributions received from foreign equity investments that were acquired prior to the start date of the items 1 and 2 amendments. We also submit that affected taxpayers be given an extra year to transition into this specific measure by delaying the effective date to income years commencing on or after 1 July 2024.

Submission 3: Alignment of ACA Step 6A Adjustment with tax loss provisions

We refer to item 3 which inserts into the table in section 705-60 ITAA 1997 a step 6A requiring an Allocable Cost Amount (ACA) adjustment in accordance with section 705-112, where previously FRT disallowed amounts are transferred to a tax consolidated group head company under section 820-62 ITAA 1997.

These are similar to provisions that exist for tax losses in Step 6 of section 705-60. However, the existing tax loss measures are complemented by the ability for the head company to cancel the transfer of losses under section 707-145 ITAA 1997.

We submit that, consistent with how the ACA rules operate with tax losses, the head company be given the same choice of cancelling transferred FRT disallowed amounts and thus not incur a step 6A adjustment.

Submission 4: Inclusion of a modified Same Business Test/Similar Business Test – previously FRT disallowed amounts

We refer to proposed subsections 820-59(4)-(8) which outline the modified Continuity of Ownership Test (COT) for companies utilising the carried forward FRT disallowed amounts per divisions 165, 166 and 167 of the ITAA 1997.

To keep this concession consistent with the general tax loss rules, we submit that a modified Same Business Test /Similar Business Test be included as an alternative in the event of failure of this modified COT. This would ensure consistency of policy between tax losses and previously FRT disallowed amounts.

Submission 5: Definition of adjustments to entity EBITDA and Group Ratio EBITDA

We refer to proposed subsections 820-55(1)(c) and (2)(c) ITAA 1997, which sets out the definitions of entity EBITDA and GR group EBITDA including various adjustments to these items.

In subsection 820-55(2), the items specified in respect of the GR group EBITDA are clearly stated to be “as disclosed in the *audited consolidated financial statements for the period”.

To avoid ambiguity, and in the interest of consistency, we submit that this expression be incorporated (with some amendments) into subsection 820-55(1) to clarify that the entity’s items (1)(a)-(c) adjustments to stand-alone EBITDA take their accounting meaning, as follows: “as **included** in the *audited consolidated financial statements for the period”. The insertion of “included” instead of “disclosed” simply reflects the fact that a subsidiary entity’s stand-alone accounting numbers may not be disclosed in the consolidated accounts but would be included in the disclosures of said consolidated accounts.

Submission 6: Interaction between previously FRT disallowed amounts and the de minimis threshold/general class investor rules

We refer to proposed section 820-57 ITAA 1997 which permits a special deduction for previously FRT disallowed amount in future years if there is an excess of the entity’s fixed ratio earnings limit over the sum of the entity’s net debt deductions for an income year (per paragraph 820-57(1)(b)).

As it is currently drafted, the provisions and supporting EM do not indicate whether a taxpayer that is not subject to the Thin Capitalisation rules in a future income year (for instance, where the taxpayer’s debt deductions fall below the \$2m de minimis threshold or is no longer a general class investor) is entitled to claim this special deduction if they otherwise satisfy the FRT in that year.

We submit that, as a matter of policy, the EM and ED should be amended to specifically state that a taxpayer may apply the section 820-57 special deduction for previously FRT disallowed amounts under the FRT even if the taxpayer is below the de minimis threshold or is otherwise no longer subject to the Thin Capitalisation rules because it is no longer a general class investor so long as the taxpayer satisfies the excess FRT cap and other elements of section 820-57. This will ensure that an entity will not permanently lose previously FRT disallowed amounts just because they are no longer being subject to the Thin Capitalisation rules. If the FRT rules policy is to allow recoupment of these amounts when an entity has an excess cap in future years, then this should be allowed whether or not they continue to be subject to the Thin Capitalisation rules.

Submission 7: Interaction between previously FRT disallowed amounts and the GRT and ETPDT

We refer to proposed subsections 820-59(2) and (3) ITAA 1997 which operate to disallow a special deduction for previously FRT disallowed amounts from one income year in future income years where either the GRT or ETPDT has been utilised in a prior intervening income year.

We submit that subsections (2) and (3) should be removed and the EM updated to allow the special deduction for the previously FRT disallowed amount in a future income year if the taxpayer has reverted to applying the FRT in that income year subsequent to applying the GRT or ETPDT.

This is on the basis that taxpayers should not be permanently disadvantaged by losing the special deduction just because it may have chosen to apply an alternative test and revert to the FRT. We believe that extending this concession in this instance would not detract from the overall policy intent of these measures because the taxpayer would still be subject to the FRT in that future year.

Submission 8: Ability to share associate entity excess under FRT

We refer to proposed section 820-59 ITAA 1997 which contains the meaning of the FRT disallowed amounts.

This provision represents a major departure from its predecessor safe harbour method currently contained in Division 820 because the FRT disallowed amount is calculated on a stand-alone basis and does not allow any “excess” FRT amounts of associate entities to be shared with a taxpayer even though those associates are included for various other purposes (eg for de minimis testing purposes). This policy change penalises non-consolidated associate entity structures with debt deductions in one entity related to earnings in another entity.

These provisions differentiate between corporate tax consolidated groups (which are treated as a single entity) and alternative investment structures that invest through unit trusts for example. In particular, issues will arise for those entities borrowing at a holding trust level that are secured against properties held by the subsidiary unit trust, thus severely impacting net debt deductions available under the FRT.

As such, there are likely to be significant restrictions on interest deductibility for holding trusts going forward, even where all debt is third party debt. We therefore submit that the Government reinstate the ability to share excess interest deduction capacity between associates.

Submission 9: GRT exclusion of negative EBITDA entities

We refer to proposed subsection 820-51(1) ITAA 1997 which operates to exclude those entities within a group from the calculation of an entity's GR where their EBITDA is negative.

The OECD considered this issue in its “inclusive framework for Action 4”, and pointed out the practical disadvantage to this approach:

“380. There are downsides to this approach. Where an entity with negative EBITDA is located in the country where the group ratio rule is being applied, it should be relatively easy for entities in the country to make the necessary adjustments to the calculation of group EBITDA and for these to be audited by the tax authority. However, where the entity with negative EBITDA is in a different country, this would be more difficult. In effect, this approach could oblige a multinational group to have systems in place to calculate entity EBITDA each year for every entity in the worldwide group, including those in countries which do not apply the group ratio rule, in order to ensure that any with negative EBITDA can be identified. This could impose a significant additional burden on groups. From the perspective of a tax authority, it would also be very difficult for tax auditors to confirm whether a group has any such entities and to ensure that losses have been correctly removed from group EBITDA. This information is not typically contained in a group's consolidated financial statements, and so tax auditors would need to rely on information provided by the entity applying the rule or obtained from foreign tax authorities. In addition, although this approach should be effective in addressing the impact of entities with negative EBITDA on the operation of the group ratio rule, it would not deal with the impact of entities with a very low positive EBITDA, which could also potentially inflate a group's ratio to very high levels. A country should carefully consider these issues before adopting this approach”.

We submit that this exclusion should be removed to reflect this clearly recognised practical burden of compliance and to recognise that there are a variety of business models which may incur high interest with low accounting income globally, but which are not partaking in specifically thinly capitalising their Australian operations. This

exclusion will mean that the presence of multiple negative EBITDA entities in a worldwide group may render the GRT unworkable, which is not an appropriate practical or policy outcome.

Submission 10: ETPDT expanded definition of “associate entity”

We refer to proposed subsection 820-53(5) which seeks to include entities with a “TC control interest of 10% or more” in the modified definition of ‘associate’. We have received feedback from industry that this amendment will create practical burdens in the identification of all relevant associate entities, as well as preventing a taxpayer from using the ETPDT where not all associated entities (as expanded) wish to adopt the test.

We see this as being particularly problematic for private equity structures where different earnings profiles exist in different groups within a portfolio where there is no central control or management because of the diverse ownership structures.

It is our submission therefore that the definition of “associate” under the current Thin Capitalisation rules in Section 820-905 ITAA 1997 not be amended as proposed under section 820-53(5).

Submission 11: Irrevocability of GRT and ETPDT

We refer to proposed subsection 820-43(8) ITAA 1997 which states that a choice to utilise either the GRT or ETPDT for an income year cannot be revoked. This restriction significantly reduces the flexibility to amend the choice if subsequent to lodging a tax return (but prior to expiry of the amendment period for that return), the taxpayer identifies extraneous or uncontrollable facts and circumstances (for example, changes in GRT relevant EBITDA in overseas group entities or identification of changes to borrowing terms) that causes the taxpayer to be unable to satisfy the conditions for either GRT or ETPDT.

In this case, the taxpayer would be denied debt deductions without being able to amend the tax return to choose to revert to the FRT.

Furthermore, a choice to apply either GRT or ETPDT in circumstances where that choice turns out to be unavailable will cause any previously FRT disallowed amounts to be lost permanently (unless our previous submission on this issue is accepted), thus further increasing the negative consequences of making and not being able to amend that choice.

We submit that a fairer outcome and one more consistent with the general concessional tax law policy approach around choice is to allow a taxpayer to amend its choice within the statutory tax return amendment period and with appropriate notice being given to the ATO.

Submission 12: ETPDT conduit financier arrangements – same terms and asset recourse requirements

We refer to proposed subsection 820-61(5) ITAA 1997 which allows for on-lending via conduit financier arrangements to satisfy the ETPDT subject to various conditions, specifically the “same conditions” test in paragraph (e) and also the asset recourse requirements in proposed paragraphs 820-61(2)(c) and (5)(g).

We have received preliminary informal comments from taxpayer groups and legal advisers that this requirement in paragraph (e) that “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)” would render this ETPDT practically unworkable for most corporate groups. This is especially given the context of how Courts would likely seek to strictly interpret the requirement of the terms being “the same” (for example, as has been the case for the tax loss Same Business Test).

Whilst we recognise the need for some measures to prevent manipulation of the ETPDT, we would submit that this paragraph (e) requirement be modified to reflect a “similar” rather than “same” condition with examples provided in the EM and with appropriate public guidance from the ATO to focus on key terms such as interest

rates, term, security etc and in doing so, that Government consult widely with a range of stakeholders in industry and banking/finance on this particular aspect.

Further, our feedback from those taxpayer groups and legal advisors is that it is also common practice for debt to be secured by recourse to assets not just held by the borrower or conduit financier, but also other entities within the consolidated or commonly controlled group. Therefore, we submit that the asset recourse requirements in subsections 820-61(2)(c) and (5)(g) should be broadened to permit satisfaction of the ETPDT and the conduit financier requirements where a debt is subject to recourse against other members of the borrower's/conduit financier's "associate" entities (ie based on the existing 50%+ threshold). This reflects commercial reality and does not in any way impair the integrity of the ETPDT.

Submission 13: Transitional Provisions – Thin Capitalisation

These measures require a substantial change in the way affected taxpayers will approach compliance to the Thin Capitalisation rules. This includes not just examining a taxpayer's own accounting, financing and tax circumstances, but also, in the case of the GRT and ETPDT, those of global group entities and associates.

We submit the proposed start date of 1 July 2023 (which is less than 4 months after release of the ED) is too soon to enable a sensible and considered transition for taxpayers.

We therefore submit a deferral to the start date to 1 July 2024 to allow impacted groups more time to review their funding arrangements to enable compliance.

We further submit that Treasury liaise with the ATO to examine the appropriateness of providing public administrative concessions to not apply the Australian general anti avoidance Part IVA ITAA 1936 measures to taxpayers who seek to restructure, refinance or otherwise pay down their existing debt to comply with the new rules for a period from now of up to say 2 years after commencement date. Such relief would apply only to arrangements where the tax benefit identified for Part IVA purposes would arise due to the proposed Thin Capitalisation rules.

This is in no way a submission for the ATO to permit tax avoidance but simply a request for a public statement of assurance to taxpayers who are legitimately seeking commercial solutions to a substantial change of law.

Submission 14: FRT tax EBITDA – adjustment for prior year net capital losses

Proposed section 820-49 sets out the adjustments to tax EBITDA in determining the FRT and, at paragraph (d) includes an adjustment for tax losses deducted under Division 36 ITAA 1936. In order to achieve policy consistency, because net capital gains are included in tax EBITDA, it is our submission that a new paragraph (e) be included to allow tax EBITDA to be increased by adding prior year net capital losses that have been applied in determining net capital gains for the income year.

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