

Multinational Tax Integrity – strengthening Australia's interest limitation (thin capitalisation) rules

KPMG submission

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Executive summary

As a leading professional services firm, KPMG Australia (**KPMG**) is committed to meeting the requirements of all our stakeholders – not only the organisations we audit and advise, but also employees, governments, regulators and the wider community. We welcome the opportunity to provide a submission on the exposure draft *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation (the Draft Bill)* released by Treasury on 16 March 2023.

Changes to the proposed new thin capitalisation tests are needed in order to ensure they operate in a fair and balanced manner. In addition, amendments to section 25-90 should be abandoned.

We acknowledge the Federal Government's commitment to maintaining the integrity of Australia's tax base arising from the use of excessive debt deductions and its intention to bring Australia's thin capitalisation rules more in line with OECD's best practice guidelines. In moving to implementation of the proposed rules, it is important these objectives are balanced with the need to attract and retain foreign capital and investment in Australia.

It is therefore critical that a number of design features across all three proposed thin capitalisation tests be moderated, in order to ensure that taxpayers are not precluded from reasonable debt deductions. It is worth noting that adverse impacts are likely to be compounded by the increased interest rate environment which is expected to persist for the foreseeable future.

In addition, we strongly recommend retaining section 25-90 as a compliance saving measure, consistent with the original intention when legislating this provision. In the alternate, the Draft Bill should be updated to grandfather existing arrangements.

KPMG looks forward to continued engagement with the Federal Government as it implements these rules.

Yours sincerely,

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Background

About KPMG

KPMG is a global organisation of independent professional firms, providing a full range of services to organisations across a wide range of industries, governments and not-for-profit sectors. We operate in 146 countries and territories and have more than 227,000 people working in member firms around the world. In Australia, KPMG has a long tradition of professionalism and integrity combined with our dynamic approach to advising clients in a digital-driven world.

KPMG International Tax practice

KPMG's International Tax practice works with multinational organisations to provide commercially focused advice on cross-border tax matters. We help companies manage the complexities of meeting their tax obligations relating to multiple tax systems and supranational regulation around the world.

We partner with our clients to advise on and manage the tax implications relating to their cross-border arrangements, structures and transactions. We also help businesses manage the tax impact and drive efficiency relating to complex events, including cross-border mergers and acquisitions, divestments, international expansion, cross-border financing, and business change. By drawing not only on our network of tax professionals around the world, but also on our specialists in other areas of taxation, we provide a complete, multi-disciplined perspective to any tax challenge.

Section 1:

KPMG recommendations

RECOMMENDATION 1:

We strongly recommend retaining section 25-90 in its current form. Section 25-90 is an important compliance saving measure, consistent with the government's original intention when legislating this provision. The existing legislative framework provides sufficient ability to target and address BEPS activities in the context of debt funding of outbound groups, and the proposed measure risks disparate outcomes for Australian headquartered outbound groups.

If the above recommendation is not accepted, existing arrangements should be grandfathered given these arrangements were put in place when the policy setting was such that the source of funds for foreign investments was not relevant for tax purposes, and as such, most taxpayers will not have the records needed to trace the use of debt over the past 20 plus years.

RECOMMENDATION 2:

The current thin capitalisation safe harbour rules include well-designed mechanisms to prevent duplication of capacity and allow the sharing of excess gearing capacity between associates. This produces the right economic result to align the treatment of groups that are not tax consolidated with that of tax consolidated groups, as well as dealing with potential integrity concerns preventing duplication of gearing capacity (by excluding investments in associates from the asset base that supports debt). The fixed ratio test (**FRT**) should include equivalent mechanisms to share excess capacity and eliminate the duplication of capacity created by distributions from associates.

RECOMMENDATION 3:

The number of adjustments required under group ratio test should be simplified. As currently drafted, it will be difficult for taxpayers who should otherwise be eligible to use this test, due to the unnecessary complexity and compliance costs associated with the determination of the group ratio earnings limit. In particular, for the adjustment for payments made to or by associates, which uses a 'TC control test' of 10 percent or more, at a minimum a 20 percent or more threshold should instead be adopted, as 20 percent is broadly aligned existing accounting concepts.

RECOMMENDATION 4:

The external third party debt test should be expanded to allow debt deductions from genuine third party debt to be tax deductible, without restrictions as to the purpose of the funds, the recourse for payment of the debt and the choices made by associates. These features will preclude many taxpayers from claiming debt deductions in circumstances where there is little risk of BEPS practices.

The conduit financier exception should also be moderated, particularly because in practice it is rare for conduit financing to be provided on exactly the same terms as the ultimate loan. The rule should allow recourse to the assets of FinCo, all borrowers from FinCo and all the assets of obligors in the Obligor Group. Further, multiple conduit financiers should be allowed within the same Obligor Group.

RECOMMENDATION 5:

The rules relating to the transfer of the FRT disallowed amount to a head company when joining or forming a consolidated group should be modified. The definition of trial year should be updated to ensure a transfer can occur to a head company, notwithstanding the (typical) change of ownership that often occurs at a joining time. The choice to cancel the FRT disallowed amount should also be available to the head company, as a 'double benefit' does not always arise.

RECOMMENDATION 6:

We consider that the amendments to the debt deduction definition do not achieve the intention of bringing the definition in line with OECD best practice guidance. In particular, the debt deduction definition should use the phrase 'amounts economically equivalent to interest' (i.e. aligning with the wording of the OECD guidance) rather than the current drafting which uses 'any other amount that is calculated by reference to time value of money'.

The specific inclusions and exclusions from the definition of debt deduction in the later subsections need to be reviewed to ensure they properly reflect the intended scope of the new definition. Further guidance should be included in the Explanatory Memorandum on the types of common arrangements that may be caught within the definition.

In addition, from a policy perspective, there should an alignment between the definition of 'debt deduction' and the interest income amounts that offset to create an entity's 'net debt deduction'.

RECOMMENDATION 7:

The complying superannuation fund exemption should be extended as there continues to be a risk that investment holding entities which are wholly owned by superannuation funds are 'associate entities', which brings the investment holding entities into the thin capitalisation regime.

Section 2:

KPMG insights

Response to consultation

Changes to section 25-90

We disagree with the proposal to amend section 25-90 of the *Income Tax Assessment Act 1997* (**ITAA 97**) and recommend it be kept in its current form on the basis of the following:

- The existing legislative framework provides the Commissioner with sufficient ability to target and address any BEPS activities in the context of debt funding of outbound groups. The thin capitalisation rules together with transfer pricing rules (given the proposed amendments to section 815-140) restrict both overall debt levels and debt pricing. Hence, it should not be necessary to deny deductions because of the purpose of funds, except where there is a tax avoidance purpose, whereby domestic anti-avoidance rules would apply. This is consistent with the original intention when introducing this provision (at the same time as the thin capitalisation rules) to have the quantum of debt be limited by the thin capitalisation maximum allowable debt.
- We consider the rationale outlined in the explanatory memorandum (**EM**) at 1.119 – 1.120 to be misleading. The description that section 25-90 provides taxpayers with a 'double benefit' (being the non-assessable non-exempt (**NANE**) treatment of the foreign dividends and the interest deduction for funds incurred in earning those dividends) disregards the operation of the thin capitalisation rules, both under current law and proposed amendments. For example, an Australian holding company that borrows to invest in a foreign subsidiary and has no other Australian business could not claim interest deductions under the existing rules (because controlled foreign entity equity is not counted as an asset for thin capitalisation safe harbour purposes) nor would the company be able to deduct interest expense under the new fixed ratio test (**FRT**) (because the dividends from the foreign subsidiary would be NANE income and hence not included in tax EBITDA).
- This measure now creates an uneven playing field for Australian headquartered multinationals with offshore operations compared with foreign headquartered inbounds, where both have the same debt

levels, depending on the decisions made with regards to the funding of those offshore investments.

- It may also be the case that the Australian group earns taxable income from the offshore operations (e.g., by way of royalties or sales of goods or services, or even controlled foreign company attributable income). In these cases, there may be an argument that interest on funds borrowed to fund the investment in the offshore operations has sufficient nexus with this assessable income (i.e. a deduction for the interest may be allowable).
- The proposed change will necessitate complex tracing and apportionment exercises, both in relation to existing arrangements (absent any grandfathering) and future arrangements. Complying with (and administering) the law will be quite challenging for a number of groups, and it is likely those with complex funding arrangements will need to rely on some proxy in ATO guidance, which is likely to be favourable to the Revenue and not give an accurate outcome.
- For example, in a situation where a taxpayer originally borrowed to fund its offshore investment say 10 years ago, and in the interim has refinanced the debt several times, we expect it would be necessary to consider multiple factors such as relative size of offshore as compared to onshore operations, history of profitability and dividends by offshore operations, other sources of funding during the period, etc. This complexity is likely to be exacerbated by limited record-keeping given it has not been necessary for taxpayers to track and retain this information.

We strongly recommend retaining section 25-90, and consider that the original policy basis for legislating this rule continues to be sound. At that time, it was acknowledged that the existing legislation was 'deficient'. The EM to the *New Business Tax System Thin Capitalisation Bill 2001* states the following at 1.9:

"The current provisions that regulate the deductibility of interest expenses for outward investors are also deficient. These rules rely on tracing the use of borrowed funds. It is relatively

easy to circumvent their operation by establishing a use of funds that ensures deductibility.”

There is a real risk this circumvention would reappear following the proposed changes to section 25-90.

In relation to the compliance burden, the EM to the *New Business Tax System Thin Capitalisation Bill 2001* states the following at 11.16:

“Compared with the current arrangements...the removal of interest expenses from the general rule of denying deductions for expenses incurred in earning exempt foreign income and from the foreign loss quarantining provisions, in most cases, will decrease compliance costs.”

If the above recommendation is not accepted, the proposed rules should be updated to grandfather existing arrangements. Grandfathering of existing arrangements would be appropriate given these arrangements were put in place when the policy setting was such that the source of funds for foreign investments was not relevant for tax purposes. As such, most taxpayers will not have the records needed to trace the use of debt over the past 20 plus years.

At the very least, given the lack of prior announcement and the short consultation period on such a significant change, these amendments should be decoupled from the thin capitalisation rule amendments and considered as a separate measure that will not apply from 1 July 2023, to give sufficient time for more fulsome consultation.

Fixed ratio test (FRT)

‘Fixed ratio earnings limit’ – grouping and duplication

It is fair and reasonable to allow excess tax EBITDA capacity to be shared / grouped between associate Australian taxpayers (e.g. parent and subsidiary taxpayers). The current safe harbour test includes such a mechanism in the form of the associate entity excess amount (section 820-920 ITAA 97) and provides for equitable outcomes for those groups who have Australian entities that are not members of a tax consolidated group. This includes unconsolidated corporate groups as well as trust structures (i.e., holding trusts with external

lending with downstream trusts holding real estate assets, where the holding trusts cannot include the downstream depreciation in their tax EBITDA computations). This position should be considered together with the following comments.

For groups of Australian associate taxpayers, the new rules should include a mechanism to address the duplication of tax EBITDA capacity that can result where distributions are made between associates. As an illustration, where a taxpayer company pays a fully franked dividend to its taxpayer parent company, both the subsidiary company and parent company would have an interest limit derived from the same profits – noting too that the tax EBITDA of the parent would also include the franking credit gross-up.

In order to ensure appropriate economic outcomes under the FRT, both from an equity perspective and an integrity perspective, we recommend additional steps are included in section 820-49 to:

- Remove from tax EBITDA distributions (dividends, trust distributions, partnership distributions) from associates; and
- Include any excess capacity from associates based on the relevant ownership interest.

Trusts and partnerships and tax EBITDA

Section 820-49 should be updated to confirm that trusts (including attributable managed investment trusts (**AMITs**)) and partnerships can use the FRT. Trusts and partnerships generally have net income rather than taxable income¹, and hence under the current drafting of the rules, it is not clear that section 820-49(a) can be satisfied. We suggest the legislative drafting in section 701-65 ITAA 97 could be used to update Subdivision 820-AA.

Tax losses adjustment

Subsection 820-49 should be updated to confirm that multiple iterations of the tax EBITDA calculation are not required. Given that a FRT denial can increase an entity's tax loss deduction (i.e., prior year tax losses recouped in a current year), the adjustment at subsection 820-49(d) should disregard any FRT denial.

¹ For example, section 701-65 ITAA 97 was introduced to ensure that trusts and partnerships are subject to the single entity rule and the rules for working out an entity's tax position for non-membership periods, even though

those provisions use the ‘taxable income’ concept that is not be applicable to trusts and partnerships.

Decline in value addback

We consider that all Division 40 deductions (such as section 40-880 costs) should be added back in the tax EBITA computation, given the reason for adopting an earnings limit approach is that it is a proxy for debt serviceability. That is, by excluding major non-cash costs, EBITDA is a guide to the ability of an entity to meet its obligations to pay interest.²

The limitation in section 820-49(c) to deductions under Subdivision 40-B gives rise to an increase in complexity and create unnecessary compliance, as there are decline in value deductions for depreciating assets which operate outside Subdivision 40-B. For example, in Subdivisions 40-E, low-value pools are depreciated under Subdivision 40-B, so would be included in the addback, whereas software development pools are deducted under Subdivision 40-E, so would not be included in the addback. There are therefore mismatches between the treatment of Division 40 depreciating assets, and so taxpayers will need to undertake a detailed review of their tax depreciation claims in order to determine the correct addback for section 820-49(c) purposes.

Temporary depreciation incentives – future considerations

Temporary depreciation incentives (e.g. accelerated depreciation, instant write-offs) introduced in the future may result in volatility in what is included or excluded from section 820-49(c). These types of measures are commonly introduced to stimulate investment in times of economic downturn. However, in these times, the EBIT component of corporate earnings is typically depressed, and hence the exclusion of temporary depreciation amounts may disincentivise the very investment the measure is trying to stimulate.

For example, the Instant Asset Write-Off, Backing Business Investment and Temporary Full Expensing rules rely on section 40-25 ITAA 97 as the operative provision for decline in value (while transitional provisions calculate the decline the value), and the depreciation under these incentives would hypothetically be included in the section 820-49(c) addback. As such, it will be necessary for the government to consider the deduction mechanism(s) in any future similar concessions to ensure such rules operate as intended.

Group ratio test (GRT)

We agree that the FRT does not account for the fact that groups in different sectors may have relatively higher levels of gearing for genuine commercial reasons and so a GRT should be allowable as a thin capitalisation test for taxpayers in these groups.

However, we consider the GRT in its current form to be practically unworkable for many large multinational corporate groups given the complexity associated with the adjustments. We recommend only minimal adjustments to the starting points in the consolidated financial statements, and in particular the following adjustments should be revised:

- Section 820-53(1) – adjustments for amounts in nature of interest and any other amount calculated by reference to the time value of money. We suggest further guidance is provided in the EM to allow taxpayers to obtain accurate data from the global group to reasonably compute this amount. This should be consistent with the additional guidance in relation the same test in subsection 820-45(3)(b) (net debt deductions), discussed further below.
- Section 820-53(3) – adjustments for payments made to or by associates, using the 'TC control test' of 10 percent or more. With such a low threshold, it will be practically very difficult for taxpayers to both identify relevant entities and to obtain the information in relation to relevant payments. We consider a TC control test of 20 percent or more to be reasonable. For example, a 20 percent threshold would broadly align with the threshold in the 'significant influence' condition in [IAS 28 Investments in Associates and Joint Ventures](#). Further comments in relation to the associate entity changes are discussed below.
- Section 820-55(3) – adjustment for an entity's negative EBITDA. The EM should be updated to confirm how this adjustment should be computed (i.e., whether the adjustment is equal to the entity's negative EBITDA on a stand-alone basis or its negative contribution to the group EBITDA after consolidation adjustments).

In addition, the proposed GR group parent definition should extend to include an entity that is not controlled by another entity that consolidates the results of the entity into its financial statements on a line-by-line basis. This

² This is consistent with the OECD's best practice guidelines at pp. 78 (Action 4 2015 Final Report). The OECD notes that it is also a measure of earnings which is often

used by lenders in deciding how much interest an entity can reasonably afford to bear.

is required as many groups will be unable to use the GRT as currently drafted because of their worldwide parent entity applying the investment exemption from consolidation. Entities that typically use this exemption include those held by pension funds and sovereign wealth funds (amongst others).

External third party debt test

We acknowledge the guidance in the EM at 1.70 – 1.73 in relation to the specific considered design of the external third party debt test. However, we strongly recommend the conditions of the test be revisited, as the current drafting will overwhelmingly prohibit many taxpayers with genuine commercial third party debt arrangements and no BEPS motive from accessing this test, with the result of a real risk of decline in foreign investment. We expect this will be acute in the infrastructure and real property sectors.

Choice conditions

The mutual choice requirement in subsection 820-43(5) is unreasonable in its current form and it appears (putting aside our comments in relation to the associate entity changes discussed below) that the rules propose a unanimous choice by potentially many entities particularly in arrangements where there are multiple investors such as joint ventures (**JV**).

For example, where there is a JV trust, the ATO view³ is that unitholders that have veto rights over certain key decisions (such as changes to the distribution policy for the JV trust) should be considered to have control over that JV trust. The broad class of investors that may constitute associates of the JV trust will present practical difficulties in relation to the determination as to whether all relevant entities have made the appropriate election.

Given the impracticality of the proposed drafting, we recommend section 820-43(6) be removed (i.e., a reversion to the associate interest of 50 percent or more test) or ideally increased to greater than 50 percent.

The EM should also be updated to clarify that where an entity makes an election that is ultimately invalid (e.g. because an associate did not make the same choice), the entity remains able to use the FRT.

Subsection 820-43(5)(a)(ii)

Subsection 820-43(5)(a)(ii) should be updated as it does not reflect the intention per the EM at

1.32. We understand 1.32 to mean that a taxpayer cannot make the choice to use the external third party debt test, where it has associate entities that are general class investors and who have not made a choice to (also) use this test, provided these associate entities 'are not exempt from the thin capitalisation rules'. That is, when examining the associate entities that are general class investors, the entities that are exempt from the thin capitalisation rules can be disregarded.

Subsection 820-43(5)(a)(ii) should therefore read as follows: 'Sections 820-35, 820-37 or 820-39 do not apply to the associate entity for the income year'.

A further limitation should also be applied to exclude associate entities that do not have debt deductions (noting these entities may be subject to the thin capitalisation rules despite not having debt deductions because the \$2 million de minimis applies on an associate inclusive threshold).

External third party debt conditions

The conditions in subsections 820-61(2)(c) and 820-61(2)(d) are too restrictive with the result that many taxpayers with genuine third party debt cannot rely on this test. In particular, the external third party debt test restricts the use of guarantee arrangements. This includes both traditional guarantees as well as performance guarantees which are commonly seen in large infrastructure projects. This restriction will increase the cost of capital for significant national projects which may have an impact on foreign investment.

Examples of adversely impacted taxpayers that should be accommodated under this test include the following:

- Multinational groups – in multinational groups it is common for there to be recourse to the group's global assets (rather than merely the assets of the borrower) and for foreign parent guarantees to be provided.
- Taxpayers creating or constructing assets – a taxpayer may be creating / constructing an asset when a loan is secured, so subsection 820-61(2)(c) cannot be satisfied. Performance guarantees are often provided during the construction period, hence subsection 820-61(2)(d) cannot be satisfied either.
- Groups (not tax consolidated) where assets are owned by one entity and the related debt is held by a holding entity – it is

³ ATO ID 2011/11.

common for infrastructure and real property investors to borrow at a holding trust and for the debt to be secured against real estate assets held by subsidiary unit trusts. The external third party debt conditions should be amended to allow debt in this scenario to qualify for the test.

- Stapled structures – given both sides of the staple will typically be included within the lender's securing arrangement.
- Taxpayers with outbound operations or investments – as the funds must be 'wholly' used to fund Australian business operations. While the proposed changes to section 25-90 may result in a partial denial of deductions, this condition goes beyond that by fully denying deductions under this test even where the debt is genuine third-party debt.

Conduit financing exception

We support that a conduit financing exception has been included in the external third party debt test, however the current drafting is overly restrictive and will have limited practical application. We suggest the rule is broadened as follows:

- In our experience, it is very rare for on-lending to be on exactly the same terms. For example, an external financier will have security terms which may not be required between related entities, the conduit financier will charge a margin in consideration for the financing services provided, or the conduit financier will enter into swap or other hedging arrangements (subsection 820-61(5)(e)).
- The rule should allow recourse to the assets of FinCo, all borrowers from FinCo and all the assets of obligors in the Obligor Group.
- Subsection 820-62(5)(f) requires the conduit financier to satisfy the external third party debt conditions, which in turn means subsection 820-61(2)(d) must be satisfied. The result here is that the conduit financier must effectively be an Australian tax resident (or an Australian permanent establishment). It is common for inbound multinational groups to use a foreign group entity as a conduit financier – under the existing rules, these arrangements do not appear to qualify. We suggest subsection 820-61(2)(d) be disregarded when applying subsection 820-61(5)(f).
- The rules should be updated to allow for more than a single conduit financier within the same Obligor Group.

We understand the intention is for the borrowers to be associate entities of the conduit financier (EM at 1.79 – 1.80). However, it is not readily apparent from the proposed drafting that this requirement is achieved – while subsection 820-61(4)(a) switches off the restrictions in subsections 820-61(2)(a) and (b) that the debt be external, there does not appear to be any explicit legislative requirement that the ultimate borrowers are the conduit financier's associates.

Choice procedures

The requirement to make a choice in the 'approved form' in subsections 820-43(3) and 820-43(4) adds an unnecessary level of compliance and should instead be a written choice merely retained by the taxpayer (e.g. consistent with the tax consolidation choices) or evidenced by the way the taxpayer prepares its tax return (e.g. capital gains tax choices, per section 103-25 ITAA 97).

Further, the time limit to the 'earlier of' the day of tax return lodgement and tax return due date is strict. In this regard, significant global entities are subject to significant penalties for late tax return filings, and in our experience typically lodge on time, except where they are granted a due date deferral by the ATO which broadly requires exceptional or unforeseen circumstances. In these instances, it is fair to allow the taxpayer the additional time to finalise all aspects of their tax return which should include the making of choices in relation to the thin capitalisation rules.

FRT disallowed amount and the special deduction

The rule in subsection 820-57(1)(a) to require taxpayers to make no choices to use the GRT or external third party debt test in order to claim the special deduction is too narrow and the policy reasoning for this limitation is not apparent from the EM.

In light of the overarching rationale to provide the special deduction to address earnings volatility concerns and accommodate entities with initial periods of high upfront capital investment, and given that access to the alternate tests is only available in certain circumstances, these taxpayers should be free to make year-on-year assessments as to which test provides optimal debt deductions without forsaking a FRT disallowed amount from a previous year. The special deduction should be available if and when there is a reversion to the FRT during the 15 year carry forward period.

This rule is even more restrictive in the context of groups where associate entities wish to rely on the external third party debt test in some years and are required to make a mutual choice. We make further comments on this condition above.

Modified continuity of ownership test (COT)

We acknowledge the limitation applied to the carry forward of FRT disallowed amounts in the form of satisfaction of modified COT, with no allowance for the business continuity test (BCT).

However, we see no policy rationale for why the BCT should not be allowed, consistent with carry forward of losses and tax offsets. In particular, despite not having any changes in ownership, it can be difficult for certain taxpayers to obtain the beneficial ownership information necessary to establish that COT is satisfied (e.g. private equity ownership, minority foreign shareholders, etc). Hence, section 165-13 allows the BCT where it is not practicable to show that the taxpayer meets all of the conditions of the continuity of ownership test in section 165-12. A similar allowance should be provided in section 820-59.

Trusts

The EM should be updated to make it explicit that the result of subsection 820-59(5) is that the COT does not apply to non-company entities.

Tax consolidation

The rules currently require the modified COT to be satisfied in order to transfer a FRT disallowed amount to a head company (section 820-62). For loss transfers, the trial year ends immediately after the joining time which is (typically) after the change of ownership that occurs at the joining time and therefore forces the joining entity to use the BCT for the trial year. As such, under the current drafting, an FRT disallowed amount will only be transferable in very limited instances, for example, certain formations of a tax consolidated group or 'staggered' acquisitions.

In the absence of the BCT being available for the carry forward of the FRT disallowed amount, the trial year (for this purpose) should end immediately before the joining time, so that the rules would continue to require that modified COT is satisfied.

We suggest the following amendments:

Section 820-62(4) ...an income year (the **trial year**) consisting of the period described in subsection (4 5) if:

Section 820-62(5) For the purposes of subsection (4), the period trial year is the period...

(b) ending just ~~after~~ before the joining time.

Transfer of FRT disallowed amounts by trusts

Section 820-62 and the EM should be updated clarify that FRT disallowed amounts of a trust can be transferred to the head company of a joined group. Given we understand trusts are able to carry forward and deduct FRT disallowed amounts without satisfying COT, subsection 820-62(4) should be disregarded in this situation.

Step 6A of allocable cost amount (ACA) calculation

We understand the intention of this new step is to stop the joined group obtaining a double benefit, in the form of a higher ACA amount and a FRT disallowed amount.

There will be many instances in practice where the joined group either cannot use the FRT disallowed amount (e.g. it appears that if the head company has made an election to use the GRT or external third party debt test, it cannot claim a special deduction in respect of a transferred FRT disallowed amount) or the joined group does not expect to be able to use the FRT disallowed amount (e.g. head company has large amounts of carry forward tax losses).

This mismatch should be addressed by the inclusion of a choice by the head company to cancel the FRT disallowed amount which would result in a nil amount for Step 6A, i.e., an equivalent of the choice to cancel tax losses in subsection 705-110(2)(d) ITAA 97.

Definition of 'debt deduction'

The EM states at 1.116 that the amendment to the definition of debt deduction is designed with the intention to capture 'interest and amounts economically equivalent to interest', in line with the OECD best practice guidance'. In our view, this has not been achieved by the proposed drafting for a number of reasons:

- The reference in subsection 820-40(1)(a)(i) to 'any other amount that is calculated by reference to time value of money' is very broad and is currently constrained under existing rules by being only in respect of a 'debt interest'. Without this constraint, the phrase is too wide, and suggest it is preferable to use the phrase 'amounts economically equivalent to interest' (i.e., aligning with the wording of the OECD guidance).

- Certain inclusions within the scope of debt deductions by subsection 820-40(1)(a)(ii) – (iii) are not amounts economically equivalent to interest (e.g. establishment fees) and these inclusions remain subject to the debt interest limitation.
- Although the proposed amendment to subsection 820-40(1) expands what can be a debt deduction, subsection 820-40(3) contains a number of exclusions for amounts that would, under the OECD guidance, be considered economically equivalent to interest.

In addition to revising the section 820-40 drafting as outlined above, the EM should be updated at 1.116 - 1.117 to give examples of the amounts that are included and excluded from the new debt deduction definition. This should include the following:

- Notional interest expense recognised for accounting purposes under AASB 16. It is reasonably clear that such amounts should not be classed as debt deductions as they are not costs that can be deducted from assessable income. However, the EM should make this explicit, noting these amounts can be very large for many taxpayers.
- Costs from interest rate hedging / swap arrangements.

Net debt deduction

From a policy perspective, there should be an alignment between the definition of debt deduction (section 820-40) and the interest income amounts that offset to create an entity's net debt deduction in subsection 820-45(3)(b).

As currently drafted, the amounts that qualify as debt deductions are broader than the amounts that qualify as interest income under subsection 820-45(3)(b). We consider the articulation of the 'interest income' in proposed section 820-45(3)(b) should mirror the amended definition of debt deduction subsection 820-40. This should also include the non-exhaustive examples of inclusions and exclusions set out in subsections 820-40(2) and 820-40(3).

To provide further certainty, the EM should be updated at 1.48 - 1.49 to give additional examples of the amounts that are included and excluded from the subsection 820-45(3)(b).

The treatment of the following amounts should be specifically confirmed:

- Interest income indirectly derived by a taxpayer through a trust. This is relevant where a taxpayer such as an insurer earns

investment income from its investments in trusts (including AMITs), which invest in debt securities and earn interest. We consider that the underlying character of the investment income should be retained, such that these amounts qualify as 'amounts in the nature of interest'.

- Income from interest rate hedging / swap arrangements.
- Amounts deemed to be interest under hire purchase arrangements.
- The interest component of rents billed for finance leases and novated finance leases, as these are financing arrangements.
- The interest component of rents billed for operating leases and novated operating leases, as these are financing arrangements albeit with the lessor taking asset risk.
- Bailment fees.
- Incidental fees and charges, such as establishment fees, early termination fees, variation fees etc.

'Associate entity'

The definition of associate entity is proposed to be changed for certain aspects of the thin capitalisation rules by treating the reference in section 820-905(1)(a) to 'an associate interest of 50 percent or more' with a 'TC control interest of 10 percent or more' (subsections 820-43(6), 820-53(5) and 820-61(9)). The EM states at 1.35 that the modified definition strengthens the existing definition.

However, the associate entity test in section 820-905(1) continues to start with a requirement that there be an 'associate' as defined by section 318 of the *Income Tax Assessment Act 1936*. For companies, the associate test is a majority voting interest test or sufficient influence test.

As such, with the reduction of the 'TC control interest' threshold to 10 percent, the requirement for the entity to be a section 318 associate under the proposed drafting becomes a "gatekeeper". To illustrate, it is likely that an entity in which the taxpayer holds a 10 percent interest would not be an associate entity, because although the TC control interest is 10 percent, the entity would not be an associate under section 318 given the taxpayer's minority interest. This appears to be inconsistent with the intention per the EM.

Complying superannuation fund exemption

We agree the associate entity definition in section 820-905 can operate too broadly for superannuation funds and hence the carve-out proposed in section 820-905(1A) is helpful for directly held investments of a super fund.

Under the proposed rules, there continues to be a risk that investment holding entities that are wholly owned by superannuation funds (e.g. Australian unit trusts) are associate entities, which brings the investment holding entities into the thin capitalisation regime.

We recommend this is addressed by extending the carve-out in section 820-905(1A) so that it reads: 'Subsection (1) does not apply to a trustee of a *complying superannuation entity (other than a *self managed superannuation fund) and investment entities that are wholly owned by complying superannuation entities.' This extension would carve-out both an investment entity that is wholly owned by a superannuation fund, and an investment entity that is wholly held by more than one superannuation fund.

In addition, the carve-out should be extended to exempt institutions that are eligible for a refund (within the meaning of the ITAA 97). These entities encounter similar thin capitalisation issues as complying superannuation funds.

Definition of 'financial entity'

The purpose of the *Financial Sector (Collection of Data) Act 2001 (Act)* is to enable APRA to collect information of multiple purposes, including to assist the Minister to formulate financial policy and to enable APRA to publish information given by financial sector entities. To increase regulation and transparency in the non-bank lender sector, the Act was amended several years ago to widen the class of entities which must be registered.

This sector has expanded in recent times to meet the growing financing needs of customers who are seeking sources of funding outside traditional banks. As such, we disagree with the statement in the EM at 1.24 that an 'increasing number of entities are now purporting (for tax purposes) to be financial entities'. Rather, we consider that an increasing number of entities are financial entities under current tax law because the sector has genuinely flourished and is more regulated. These entities are providing financial services under ordinary concepts and hence should continue to be subject to the financial entity thin capitalisation rules.

Notwithstanding the above, the entities that will be impacted by the change to the definition have very little time to prepare prior to 1 July 2023, given this measure was not previously announced. To minimise unintended consequences, we recommend this definition change be delayed by 6 - 12 months.

Exemptions to the thin capitalisation rules

Australian assets exception

We suggest there is a drafting error in relation to section 820-37, such that subsection 820-37(1) should omit 'Subdivision 820-B' and substitute 'Subdivision 820-AA, 820-B'. This is consistent with the proposed amendments to section 820-35 (de minimis exception) and would align the operation of the provision with the intention articulated in 1.113 – 1.114 of the EM.

Securitisation vehicles exception

This exception should continue to be available. As such, subsections 820-39(1) and 820-39(2) should be amended to include a reference to the new Subdivision 820-AA (i.e., consistent with the proposed amendments to section 820-35).

For entities that are members of a tax consolidated group, under current law section 820-584 ITAA 97 treats the securitisation vehicle as not being a member of a tax consolidated group, and section 820-39 exempts the entity from the thin capitalisation rules.

If the policy intent is for the exception to no longer be available, the proposed drafting creates a number of practical difficulties in these circumstances. Section 820-584 will continue to apply, but the entity will now be subject to the general class investor rules for thin capitalisation purposes. It is not clear how the FRT would then operate given the entity is part of a tax consolidated group (e.g. whether a denial of deductions would impact the head company). Although many securitisation vehicles will have net interest income, there are circumstances in which the thing securitised does not give rise to interest income (e.g., where the securitised asset is lease receivables or factored receivables) and hence these securitisation vehicles would have net debt deductions.



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