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By email: MNETaxIntegrity@treasury.gov.au

Dear Sir,

**Exposure Draft Legislation
Treasury Laws Amendment (Measures For Future Bills) Bill 2023; Thin Capitalisation Interest Limitation**

Perpetual Limited ("Perpetual") welcomes the opportunity to make a submission in relation to the Exposure Draft legislation and materials released on 16 March 2023 entitled "Treasury Laws Amendment (Measures For Future Bills) Bill 2023; Thin Capitalisation Interest Limitation".

The primary focus of this Submission is on the proposed amendment to sections 25-90 and 230-15 of the Income Tax Assessment Act 1997 (the Act) (hereafter collectively referred to as section 25-90) to deny a deduction for interest costs connected with the derivation of "non-assessable non-exempt" (NANE) dividend income from foreign subsidiaries (per section 768-5 of the Act).

Perpetual submits that the proposed amendments to section 25-90 are inconsistent with the policy that Australia has pursued over the past two decades of promoting Australia as a suitable jurisdiction to establish holding companies for multinational investment and are prejudicial to investments undertaken under the existing laws.

If, notwithstanding our submission, section 25-90 is amended, then taxpayers with committed funding who are currently entitled to deduct interest on those funds should not be affected by the measure for so long as the funding and underlying investment in respect of which the funds were used remains in place.

The Exposure Draft legislation follows consultation undertaken in 2022 in response to Treasury's Consultation Paper dated August 2022 entitled "Government Election Commitments; Multinational tax integrity and enhance tax transparency". Perpetual is surprised and disappointed that the proposed amendments to section 25-90 were **not** foreshadowed in the Treasury Consultation Paper of August 2022, nor in any announcements made by the Government's as part of their election commitment platforms which forms the basis of the Consultation Paper, nor in any of the consultation undertaken by Treasury in relation to the policy issues and implementation issues associated with these commitments. Rather, the proposed amendments to section 25-90 have been secreted in the Exposure Draft legislation with two brief paragraphs in the Explanatory Memorandum which do not provide any clear indication of the policy intent of the measures, nor with any previous consultation opportunity.

1. Policy Background and Rationale for Section 25-90

The proposed amendments to section 25-90 represent a significant modification to the policy approach underpinning Australia's outbound international income tax rules which were set around 25 years ago by the Review of Business Taxation (the Ralph Review), were continued through the Reform of International Taxation (RITA) process and which remain in place today.

The Ralph Review delivered its final report "A New Tax System Redesigned" in July 1999. In his press release of 11 November 1999, Treasurer Peter Costello adopted a number of international tax recommendations of the Ralph Review - under the heading "Responding to Globalisation" he stated:

"Steps will be taken to ensure that Australia receives a fairer share of tax paid by multinational enterprises. In addition, measures will be introduced so that Australian businesses are not hindered from expanding overseas and that Australia becomes a more attractive investment destination.

The Ralph Review had recommended a substantial overhaul of the thin capitalisation rules - one aspect of which was extending the rules to Australian based multinational investors. The Ralph Review recommended the repeal of the quarantining rules then in force, which restricted deductibility of interest to foreign income, together with the suggested expansion of the thin capitalisation rules. The thin capitalisation rules were to provide the mechanism for regulating interest borrowed to invest in controlled foreign entities. Section 25-90 went hand in hand with the expansion of the thin capitalisation rules to outbound investors.

In February 2003 the Board of Taxation delivered its report to the Treasurer containing its recommendations for the reform of international taxation. The then Treasurer Peter Costello released the report and outlined a legislative program which was designed to improve the competitiveness of Australian companies with offshore operations. He stated:

"The reforms will encourage the establishment in Australia of regional headquarters for foreign groups and improve Australia's attractiveness as a continuing base for our multinational companies."

In the *2013-14 Budget*, the Government announced that it would be "removing the provision allowing a tax deduction for interest expenses incurred in deriving certain exempt foreign income" (i.e section 25-90) as part of a suite of measures to "address profit shifting by multinationals through the disproportionate allocation of debt to Australia." No legislation was enacted and in November 2013, it was announced that 25-90 would not be repealed but that the Government would instead introduce a targeted anti-avoidance provision after detailed consultation with stakeholders. It was also recognised at this time that any repeal of 25-90 would impose unreasonable compliance costs on Australian businesses.

Accordingly, we currently have an income tax regime in place which seeks to encourage Australia as a regional holding company jurisdiction, which in addition to section 25-90 includes:

- conduit foreign income rules which allow Australian companies to pass income earned abroad such as dividends, royalties and interest to foreign owners without paying either Australian corporate level tax or withholding taxes;
- a participation exemption which exempts Australian companies from paying capital gains tax on sales of shares in foreign companies which conduct active business; and
- various simplifications to the CFC rules along with the repeal of the foreign investment fund (FIF) regime and the announced enactment of a simplified anti roll up or foreign accumulation fund (FAF) rule.

The amendments proposed in the ED Legislation released on 16 March 2023 represented a significant policy shift from this position. The international income tax rules focus on ensuring that Australian resident entities paid either Australian tax or a comparable rate of tax offshore. So, for example, dividends received from comparable tax jurisdictions benefitted from tax exemption whilst those from lowly taxed jurisdictions did not - shareholder relief being limited to a credit for foreign taxes paid.

The policy settings were expressly revised in 2003 so that non-portfolio dividends from any country were exempted from income tax. The intent behind this was that Australian owned businesses should not be subject to higher income tax than their commercial competitors. There was an important proviso however - that the benefits were only available in situations where they operated active businesses. More mobile passive income, such as dividends, interest and royalties were outside the regime - being subject to income tax on an accruals basis through the CFC and former FIF regimes.

Clearly, a critical element in pursuing this objective to encourage Australia as a regional holding company jurisdiction is the ability to deduct financing costs. There was certainly a compliance cost reduction aspect to the original recommendation which led to section 25-90 being introduced, as it was acknowledged that taxpayers were using a tracing of funds approach so foreign investments were equity funded and domestic income producing assets were to the extent possible debt funded. Nevertheless, it can be seen as a complimentary measure in the context of the overall reform of Australia's outbound income taxation rules.

Attempts to position Australia as a jurisdiction from which to establish holding companies (either domestic or foreign owned) which then acquire foreign companies will be frustrated if the holding company cannot borrow to fund its acquisitions. Without this, in many cases the presence of the abovementioned facilitative provisions such as conduit foreign income rules or the participation exemption will largely be academic.

Using debt to fund such acquisitions is to be expected. Generally, debt reduces a company's average cost of capital. There is no question of tax avoidance here. Companies have been doing exactly what the government had encouraged them to do. Notwithstanding this, repealing section 25-90 will increase the average cost of capital and make Australia less competitive in the global market. The amendment of section 25-90 would mean that Australian based multinationals will be forced to raise equity finance, which is more expensive than debt, or else borrow in the foreign jurisdiction - where debt margins may well be higher for foreign owned borrowers.

Most other OECD countries allow a deduction for interest incurred to derive dividends from foreign subsidiaries, subject to earnings-based interest limitation rules. The repeal of section 25-90 will put Australia out-of-step with other major developed economies in the OECD, including the UK, Germany, Canada, the US, France, Spain, and Japan.

As a result, Australia will become uncompetitive as a holding company jurisdiction and Australian multinationals will be disadvantaged relative to foreign multinationals. As an example, Australian multinationals may be unable to compete with foreign multinationals in a bidding war for new foreign assets.

It is clear that section 25-90 was introduced in order to reduce complexity and uncertainty associated with having to trace the use of funds to determine whether interest expense was deductible. At the same time, the severe tightening of the thin capitalisation regime in 2001 (discussed further in section 3 below) ensured that integrity of the interest deductibility regime was not compromised. The further strengthening of the interest deductibility rules to adopt earnings based rules makes the retention of section 25-90 even more appropriate today.

2. The impacts of Amending Section 25-90

The proposed removal of income tax deductibility resulting from the amendments to sections 25-90 will have a significant detrimental impact on Australian outbound investors, of which Perpetual is one. The increased cost of any shift from debt funding to equity funding going forward has been noted above.

However, in addition it is also important to recognise that Perpetual, like many other outbound investors, has already made investment decisions based on the existing legislative framework. Perpetual has recently completed the acquisition of Pendal Limited (effective 23 January 2023), a major acquisition which involved a significant degree of debt funding. In determining our debt funding versus equity funding for this transaction, we considered not only the existing legislative provisions, but also the implications of thin capitalisation changes enunciated via the Treasury Consultation Paper of August 2022 and announcements made by the Government's as part of their election commitment platforms. It

is inappropriate that the proposed amendments to section 25-90 which were not previously foreshadowed and whose impact is so significant, should be introduced without warning and with a start date which gives taxpayers no opportunity to plan for and implement alternatives.

Nor is restructuring a particularly attractive course of action in these circumstances. Restructuring may lead to major additional business costs being incurred. For example, long-term borrowings are likely to involve substantial break costs if debt is to be repaid early or restructured. Any refinancing also involves significant time and the cost of management, the board, legal and other advisors. It is incongruous to require taxpayers to incur such additional costs when their original arrangements were completely in line with the law and clearly stated policy at that time. Further, we would submit that guidance is necessary (either in the legislation itself or at least in the EM) providing sufficient direction and comfort that anti avoidance rules would not be triggered by restructuring to address these proposed amendments.

3. The thin capitalisation rules are the appropriate mechanism to prevent “debt loading”

The thin capitalisation rules will prevent the artificial loading of debt into Australian entities. It is this regime that is relevant for the restriction of such behaviour. As noted, the extension of the thin capitalisation rules to outbound investors went hand in hand with the introduction of section 25-90. It is not appropriate to amend section 25-90 while retaining thin capitalisation rules as they currently stand and after the introduction of the other proposed amendments - particularly in relation to outward investing entities (as discussed further below).

It is not clear from a policy perspective why a deduction would be denied in relation to debt that is used in the business and is not in excess of the accepted debt norms as determined by the operation of the appropriate thin capitalisation provisions.

It is noted that the thin capitalisation provisions only consider a taxpayer's Australian assets when calculating the safe harbour debt amount (e.g. see the method statement in subsection 820-100(2), which will remain in place following the changes) which deducts controlled foreign entity equity amounts from total assets).

In relation to the proposed changes to the safe harbour provisions, the exclusion of NANE dividends from foreign subsidiaries in the calculation of 'Tax EBITDA' under the Fixed Ratio Test and Group Ratio Test already appropriately reflects the policy position that Australian taxpayers should not be able to increase the capacity for interest deductions through the production of exempt or tax deferred income.

The definition of External Third Party Earnings Limit also includes a limitation in section 820-61(2)(d) that requires the proceeds relevant third-party borrowings to be used *wholly* to fund assets that are used within an Australian permanent establishment or assets held for the purposes of producing assessable income. As this section already requires establishing a nexus between a borrowing and the production of assessable income, the repeal of section 25-90 is not necessary.

We see no reason why amendments to section 25-90 are required as this provision was implemented to achieve (and continues to achieve) clear policy objectives to address concerns regarding artificiality in gearing. This should simply be achieved by the rules specifically aimed at this matter, namely the thin capitalisation provisions.

Further, taxpayers will be forced to apply general principles outlined in case law and ATO administrative practice to determine whether there is sufficient nexus between interest expense and assessable income. While it may be possible to apply this principle in simple situations, it is more difficult to apply it to modern businesses where money is fungible. The return to 'tracing' is likely to see Australian companies use debt funding for their Australian operations and 'cost-free' funding (profits or other forms of equity) to fund their overseas operations. Further, whilst this may be possible for new investments, it will be problematic for existing investments such as those recently undertaken by Perpetual where the source of funds has already been directed. As such, the enactment of the proposed amendments will give rise to a competitive disadvantage for existing investments relative to future investments. This seems particularly prejudicial when those existing investments have been undertaken having regard to existing legislation and foreshadowed changes to that legislation, but which are then severely impacted

by previously unannounced changes which have significantly detrimental effects and would be applied within an unreasonably short space of time.

4. Submission

Perpetual submits that:

- Section 25-90 should be retained in its current form and deductions should continue to be allowed for interest costs connected with the derivation of NANE dividend income from foreign subsidiaries (per section 768-5 of the Act). Any concerns in relation debt loading in Australia are appropriately addressed by the thin capitalisation measures.
- If there are specific integrity issues that the Government is seeking to address, these issues should be clearly enunciated, consulted on, and a targeted solution developed that continues to support genuine commercial activity and the promotion of Australia as an investment destination.
- If it is determined that the amendments will go ahead with effect from 1 July 2023, then grandfathering of existing arrangements is necessary. Many taxpayers, including Perpetual very recently, will have borrowed to acquire foreign investments in full compliance with, and reliance upon, existing legislation and explicit Government policy - it is inappropriate that a financial penalty should be suffered by those taxpayers where that policy is subsequently altered. In such a case, Perpetual submit that it is imperative that interest on facilities entered into prior to the enactment of the legislation should continue to be deductible for the life of the facility.
- At the very least, the Government should announce an indefinite deferral of the repeal of section 25-90 while it is referred to the Board of Taxation to undertake a comprehensive review of the proposal with the benefit of input from interested parties.

We would welcome the opportunity to discuss our submission in person. To arrange such a meeting, or if you have any questions in relation to this submission, please do not hesitate to contact John Kirkness (Head of Tax) at john.kirkness@perpetual.com.au.

Yours faithfully,



Chris Green
Chief Financial Officer
Perpetual Limited