

13 April 2023

International Tax Unit
Corporate and International Tax Division
Treasury
Langton Crescent
Parkes ACT 2600

By email: MNETaxIntegrity@treasury.gov.au

Dear Sir/Madam,

Multinational Tax Integrity—strengthening Australia’s interest limitation (thin capitalisation) rules

1. The Taxation Committee of the Business Law Section of the Law Council of Australia (the **Committee**) welcomes the opportunity to comment on Treasury’s exposure draft legislation (**Exposure Draft**) and explanatory memorandum (**Draft EM**) on proposed changes to Australia’s thin capitalisation rules in Division 820 of the *Income Tax Assessment Act 1997*.¹
2. In addition, in the Schedule to this submission we have we have included extracts from the publication, *ATTA Doctoral Series: Volume 7: Preventing tax base erosion through reform* (Oxford University Press, 2019) by Associate Professor Ann Kayis-Kumar, a member of the Committee. These extracts focus on a critique of the thin capitalisation rules in the context of good tax design.
3. The Committee comments on the following aspects of the Exposure Draft and Draft EM:
 - exemptions to the thin capitalisation rules in sections 820-35 and 820-37;
 - commencement date;
 - the nature of choices:
 - irrevocable choices; and
 - 10 per cent associates and the need for one-in-all-in;
 - interaction with the transfer pricing rules;
 - changes to sections 25-90 and 230-15;
 - definition of financial entity;
 - special purpose vehicle exemption; and
 - conduit financier concession.

¹ Unless otherwise noted, all references to legislation are to the *Income Tax Assessment Act 1997*.
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Detailed comments

Exemptions to the thin capitalisation rules

4. The Committee commends Treasury for leaving (largely) unchanged the exemptions from the thin capitalisation rules in sections 820-35 and 820-37. However, with respect to section 820-35, as the *de minimis* threshold last changed in 2014, the Committee recommends that Treasury consider raising, or indexing, the \$2 million threshold.

Commencement date

5. The Exposure Draft, if passed in its current form, will apply to income years beginning on or after 1 July 2023. There is no grandfathering for existing debt and no transitional period. Given the extensive nature of the proposed changes to the current thin capitalisation rules contained in the Exposure Draft, the Committee submits that 10 weeks is not enough time for taxpayers to adapt to those proposed changes, for the following reasons:
 - The proposed commencement date provides taxpayers with insufficient time to change their systems to monitor and forecast earnings before interest, taxes, depreciation and amortisation (**EBITDA**) in relation to debt levels (system changes will be more costly in relative terms for smaller businesses);
 - Where taxpayers may need to pay down debt to fall within the default 'Fixed Ratio Test', the proposed commencement date provides insufficient time for such taxpayers to raise replacement capital on favourable terms;
 - While interest rates remain relatively high, the effect of the provisions will be skewed against taxpayers that are at a point in their business cycle where debt is falling due and is required to be replaced with new debt with higher debt deductions—a longer lead time for the commencement of the provisions may provide such taxpayers with at least some opportunity to level the playing field;
 - The proposed provisions removing deductions for interest expenses incurred in deriving certain foreign equity distributions (see below) were not foreshadowed in the October 2022–23 Federal Budget announcement about amending Australia's interest limitation rules, nor in Treasury's Consultation Paper released in August 2022.² Many taxpayers will have analysed and entered into offshore investments on the basis that such deductions are available. The amendments will effectively create three levels of tax—offshore, via the denial of interest deductions in Australia, and upon distribution of the non-assessable non-exempt (**NANE**) income to Australian shareholders. The Committee suggests that, in the first instance, whether these amendments do in fact give rise to a 'double benefit' as discussed in the Draft EM³ should be reconsidered. If these amendments are enacted as set out in the Exposure Draft, it is submitted that taxpayers will need significantly more than 10 weeks to address these measures, including potentially disposing of or winding up offshore investments and/or replacing funds borrowed in Australia with funds borrowed offshore. At the very least, the Committee submits that the enactment of these amendments should be deferred until the Australian Taxation Office (**ATO**) has

² Treasury, Consultation Paper, *Government election commitments: Multinational tax integrity and enhanced tax transparency*, August 2022.

³ Draft EM, at paragraphs [1.119] and [1.120].

provided detailed guidance, which has been subject to taxpayer consultation, as to how taxpayers are to 'allocate' homogenous debt to offshore investments and assurances that the ATO will not seek to penalise Australian taxpayers who move onshore debt offshore as a consequence of the amendments.

Unlike the changes to Division 820, as these changes were not foreshadowed, the Committee submits that Treasury should excise these from the Exposure Draft and place them into a separate process to allow Treasury time to make a proper evaluation of the impacts of the proposal, which is a major reversal of longstanding policy.

- The proposed change to paragraph 815-140(1)(a) (see below) which introduces an additional transfer pricing-based limit on debt, and which was also not previously announced, if enacted in its current form, will require certain taxpayers to undertake further, potentially complex, transfer pricing analyses. Again, 10 weeks is unlikely to be sufficient time for activities such as the commissioning and preparation of detailed transfer pricing reports, particularly where there is generally increased demand for such reports.
6. As mentioned, the provisions set out in the Exposure Draft do not contemplate the grandfathering of existing debt. The absence of transitional rules or grandfathering rules could have significant negative consequences for long dated investments made on the basis of law existing at the time of investment, noting in particular that tax is an economic factor that goes to the value of an investment and would have been considered at the time of the investment based on existing laws. The Committee recommends that consideration be given to transitional rules, particularly in relation to long term debt.

The nature of choices (a)—irrevocable choices

7. The Committee commends Treasury for providing two alternative tests for taxpayers in addition to the default Fixed Ratio Test. However, the Committee is not aware of any policy reason for the choices to be 'irrevocable', as proposed in the Exposure Draft.
8. As presently drafted, paragraph 820-43(8) regarding the Group Ratio Test and External Third-Party Debt Test, and paragraph 820-61(8) regarding conduit financiers, are specified to be irrevocable.
9. The Committee notes that only a relatively small number of the many elections or choices contained in the ITAA 1997 are specified to be irrevocable. These are generally where:
- the changes result in significant administrative changes to the instance of taxation upon the taxpayer; and/or
 - a taxpayer could otherwise 'game' the system by making a choice in an earlier year which they could, in the absence of the choice being irrevocable, revoke in a future year with the benefit of hindsight.
10. For example, consider the choice to form a tax consolidated group.⁴ It would be administratively undesirable for taxpayers to be able to elect to form consolidated groups and subsequently revoke such an election within the statutory amendment period having regard to the significant upheaval of the formation of a tax consolidated group.

⁴ Section 703-50.

11. Contrary to the example noted above, the Committee is not aware of any policy reason such that a single-year election to adopt either of the two alternative thin capitalisation tests should be irrevocable. In the absence of any such policy reason, it is considered preferable to allow taxpayers the benefit of the usual statutory amendment period to change any choice made if new facts come to light: for example an error is identified in taxable income of the taxpayer such that they have negative EBITDA. In such a circumstance, consistent with the self-assessment taxation regime, it is submitted that a taxpayer should appropriately be entitled to choose to apply one of the alternative tests if they are otherwise able to do so.
12. We note that this is consistent with what Treasury recorded in its 2010 Consultation Paper on the *Review of Elections in the Income Tax Law*:

Proposed guideline 4: Variation

Future elections should allow taxpayers to revoke or vary their choice prospectively within the usual amendment periods applicable to their income tax assessments. Alternatively, where necessary, an election should allow taxpayers to revoke or vary their choice retrospectively.

However, there may be certain circumstances where it is inappropriate for the choice made to be revocable or variable. In such a case, where it is justifiable, the law should clearly identify the choice as being irrevocable. Explanatory Memoranda should explain why the election needs to be irrevocable.

The nature of choices (b)—10% associates and the need for one-in-all-in

13. The Committee notes that, pursuant to proposed subsection 820-43(5), a taxpayer cannot choose to apply the External Third Party Debt Test in relation to an income year if any of its 'associates' with a thin capitalisation (TC) control interest of greater than 10% has not also chosen to apply the External Third Party Debt Test in relation to that income year. We note there appears to be an error in the current drafting in that subparagraph 820-43(5)(a)(ii) does not reflect the explanation of the rule as outlined in the Draft EM.⁵ The balance of comments in this section of our submission provides commentary on what the Committee understands to be the intended position.
14. The Committee notes the explanation of the one-in-all-in approach in the Draft EM:⁶
- The restriction on this choice ensures that general class investors and their associates are not able to structure their affairs in a way that allows them to artificially maximise their tax benefits by applying a combination of different thin capitalisation tests. The restriction effectively requires a general class investor and all of its associate entities to make a mutual choice to use the third party debt test, if any one of those entities wishes to use that test.
15. The Committee has given detailed consideration to the above explanation. However, given the various other mechanisms built into the Exposure Draft, it cannot see how entities could 'structure their affairs to artificially maximise their tax benefits by applying a combination of different thin capitalisation tests'. This is because the External Third Party Debt Test is a deliberately 'narrow'⁷ test, which is only available for an entity that meets the following criteria:
- no debt interest is issued to or held at any time in the income year by an entity that is an associate entity of the entity;

⁵ We note there appears to be an error in the current drafting of the Exposure Draft in that subparagraph 820-43(5)(a)(ii) appears to have the result that subsection 820-43(5) would only have effect where a taxpayer has at least one associate that is a general class investor **that is exempted from the thin capitalisation rules**, which does not appear consistent with the approach outlined in the Draft EM.

⁶ Draft EM, at paragraph [1.33].

⁷ Draft EM, at paragraph [1.71].

- the (external third party) holder of the debt interest has recourse for payment of the debt **only to the assets of the entity**; and
 - the entity uses the proceeds of issuing the debt interest wholly to fund its Australian operations.
16. Given that these criteria need to be met by any taxpayer that looks to rely on the External Third Party Debt Test, the Committee submits that there is no policy need to consider the actions of any associate of that taxpayer. This is because, to apply the External Third Party Debt test, a taxpayer cannot rely on the cashflows of any related party, nor the support of any parent or other associate entity, as the debt must be genuine third party debt with recourse only to the assets of that entity. Given these requirements, it does not appear that any group of related entities, however structured, could 'artificially' optimise their position through a combination of thin capitalisation tests.
17. To illustrate, consider the following scenario. Taxpayer A and B are associates by virtue of sharing a common majority parent entity.
- Taxpayer A is an Australian tax consolidated group with significant investment in real estate with (wholly external) debt deductions approximately 35% of EBITDA. Absent a consideration of the choices of its associates, it otherwise meets the requirements of the External Third Party Debt Test.
 - Taxpayer B is an Australian tax consolidated group which is the head of a regional manufacturing business with 20% of its operations outside of Australia. Its debt deductions approximate 15% of EBITDA.
18. In this scenario, as currently drafted neither entity could choose to apply the External Third Party Debt Test because Taxpayer B could not make the choice given its overseas operations (notwithstanding its very low interest expense). In such a scenario it is submitted there would be nothing artificial about the group applying a combination of thin capitalisation tests such that Taxpayer A applies the External Third Party Debt Test and Taxpayer B applies the Fixed Ratio Test. Indeed, it appears the above two taxpayers would be within the policy intent of the thin capitalisation provisions to do so.
19. The Committee notes that the above example also glosses over the very difficult and often subjective test of who is an associate, resulting in a high degree of uncertainty. The Committee is concerned this will lead to unnecessary disputes in joint venture type scenarios where Taxpayers risk being considered the associate of another entity where there is no visibility of that entity's choices. The Taxpayer and ATO would at times be placed in difficult positions given the secrecy obligations on the Commissioner—could the Commissioner tell a taxpayer what choice another taxpayer has made where he considers those two entities to be associates? The proposed reduction of the TC control interest from 50% to 10% compounds this challenge, and given the vagaries of who can be argued on rational grounds to be an associate of whom. This creates the risk that entities with no visibility over each other who happen to share a minority investor finding themselves in a dispute with the Commissioner about whether they are eligible to apply the External Third Party Debt Test. The Committee believes this is unnecessary and punitive, as there are already sufficient safeguards on the External Third Party Debt Test to ensure the choice is only available to entities appropriately able to make the choice.

20. For completeness, we note that the Organisation for Economic Cooperation and Development (**OECD**) adopts a 25% common ownership approach when considering who is a related party.⁸ As noted above, there does not appear to be a pressing policy need to require even entities with a common 25% owner to make the same choice (considering the common example above). Notwithstanding this, to the extent that it is considered desirable to do so, the Committee recommends a test based on 25% common ownership to avoid unnecessary disputes.

Interaction with the transfer pricing rules: proposed amendment to paragraph 815-140(1)(a)

21. As noted above, the Committee commends Treasury for the inclusion of a fixed 30% EBITDA test, in the form of the Fixed Ratio Test, which of itself should ensure the compliance burden for taxpayers is kept to a minimum. Equally, the removal of the former Arm's Length Debt Test, while disadvantaging taxpayers in certain industries such as infrastructure and real estate, of itself will also streamline documentation required and reduce the risk of subsequent disputes about the appropriate amount of debt issued by a taxpayer.⁹
22. In this vein, the Committee has concerns that the proposed change to paragraph 815-140(1)(a), which had not been previously announced, will have the effect of re-introducing significant uncertainty for taxpayers as to the permitted level of debt. In particular, it has the effect of rendering the Fixed Ratio Test a 'cap' rather than a 'safe harbour' leading to the real potential for unnecessary and undesirable transfer pricing disputes regarding debt deductions, notwithstanding those deductions fall below the fixed ratio. This concern is amplified in the context of the challenges for multinational groups' ability to apply the Group Ratio or External Third Party Debt tests.
23. The Committee notes the relevant paragraphs from the Draft EM, which appear to indicate a need for this change:
- 1.126 As debt deductions are disallowed on a quantum of debt basis in existing Division 820, it was not necessary for the arm's length conditions in Division 815 to also seek to do this. Section 815-140 effectively disapplied the arm's length conditions in relation to the quantum of the debt interest.
- 1.127 However, as the new thin capitalisation tests deny debt deductions on an earnings basis, the arm's length conditions should not be disapplied for entities using the new earnings-based tests. Consequential amendments are made to ensure this outcome.
24. Contrary to the above, the Committee understood from the budget papers—and this is reinforced in the 'Context' section of the Draft EM¹⁰—that the earnings-based limit to debt deductions was intended to **replace** the existing asset-based test, and not provide an additional test, consistent with OECD best practice guidance. In this regard, the Committee notes that the definition of EBITDA adopted in the Fixed Ratio Test only includes income subject to Australian taxation and therefore appears to appropriately limit debt deductions without the need for an additional transfer-pricing based test.

⁸ OECD report on Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update, [176]

⁹ Consistent with the comments at paragraph [1.70] of the Draft EM.

¹⁰ See, for example, paragraph [1.8] of the Draft EM "*aligning interest deductions with taxable economic activity is a more robust approach to address base erosion and profit shifting*" and paragraph [1.12] of the Draft EM "*The fixed ratio test... ensures that a portion of an entity's profits remains subject to tax in Australia and cannot be eroded by excessive debt deductions.*".

25. The OECD report on BEPS action 4¹¹ refers to the interaction of debt limitation rules and transfer pricing rules only in the context of limiting “*the amount of interest payable to group companies lacking appropriate substance to no more than a risk-free return on the funding provided...*” That is, the arm’s length **quantum** of debt should be determined under the thin capitalisation rules, but the arm’s length **rate** is determined by transfer pricing rules.
26. For the reasons noted above, it is submitted that the introduction of an additional transfer pricing-based limit on debt will introduce significant uncertainty without furthering the aims of the proposed change.

Changes to sections 25-90 and 230-15

27. For the reasons set out below, the Committee submits that the changes to tax law reflected in Items 1 and 2 of the Exposure Draft should be addressed as follows:
- Items 1 and 2 should be excised from the Exposure Draft;
 - decisions about this measure should be the subject of a short period of specific consultations;
 - if, after consultation, a measure is to be enacted, whether in the original form or revised form, it should start no earlier than 1 July 2024; and
 - as part of the consultations, appropriate transitional arrangements need to be considered for interest on debt on foot as at 1 July 2024 which might be affected by the measure, including the grandfathering of existing debt, or an extended period before any new regime would apply.

The current law and policy settings

28. In the Committee’s view, the current law, specifically section 25-90 (or subsection 230-15(3)), section 768-5 and the thin capitalisation regime, is part of a comprehensive regime for the taxation of international arrangements, which is both principled and practical. These rules have been part of Australia’s tax landscape for over 20 years, and taxpayers have structured their affairs in good faith that this combination was settled policy.
29. The Draft EM says the rules are defective, but in our submission the outcome they produce does not reveal a structural flaw. That is because the decision to treat dividends from foreign subsidiaries as NANE (rather than assessable with a credit for foreign taxes) was made for pragmatic reasons of administrative convenience: “*the effect of the [foreign tax credit system] for companies ... broadly equivalent to providing an exemption for the dividends, but it imposes greater compliance costs than would an exemption.*”¹² Since the current NANE treatment of the dividend is not the result of any underlying tax policy, it does not represent a compelling policy basis for determining the appropriate tax treatment of the interest. Rather, the treatment of the interest expense should be based on the view that the dividend is assessable (but for reasons of convenience is being handled another way).
30. Further, section 25-90 is in line with the objectives of the *Review of International Taxation Arrangements*¹³ as well as the objectives of the thin capitalisation regime, which were to handle the capacity to deduct interest costs incurred in producing exempt income in the form of section 768-5 dividends through the limitations of the thin capitalisation regime applicable to outward investors, and not through constraints arising from section 8-1. The Explanatory Memorandum to the *New Business Tax*

¹¹ OECD report on Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update.

¹² Explanatory Memorandum to the *Taxation Laws Amendment (Foreign Income) Act 1990*.

¹³ Commonwealth Department of Treasury, 2002.

System (Thin Capitalisation) Act 2001 was clear that “*debt deductions ... will come within the scope of the thin capitalisation regime when determining the amount to be allowed*”¹⁴ reflecting a conscious decision that thin capitalisation, when applied to outbound investors, was appropriate and adequate to prevent the Australian operations from carrying excessive levels of debt. It reflected a view that “*the current provisions that regulate the deductibility of interest expenses for outward investors [section 8-1] are also deficient. These rules rely on tracing the use of borrowed funds.*”¹⁵ The decision to switch off section 8-1 by enacting section 25-90 was conscious and considered.

An improvement to the current policy settings?

31. This has been settled tax policy in Australia for 20 years, so one would expect to see a clear case for the change. The explanations in the Draft EM for making the change are unconvincing.

32. The first argument is that the change is needed because of the move from a balance sheet thin capitalisation test to a test based on cash flow:

... the policy intent of the new earnings-based tests is to limit the amount of deductible interest expense by reference to earnings—that is, an entity is only able to increase its net interest deductions in Australia by increasing earnings in Australia.¹⁶

33. The Committee can see no logic to this argument. There is a change to the thin capitalisation computation but it is entirely a matter of mechanics; computing how much debt can be borrowed in this way rather than that way, has no bearing on the question. It is also factually incomplete: there is no change to the safe harbour calculation for financial entities or for ADIs. Even if the move to a 30% EBITDA Fixed Ratio Test was an appropriate rationale for amending ss 25-90 and 230-15, it does not explain why financial institutions, which remain subject to the debt:asset gearing safe harbour, are being affected by this change.

34. The Draft EM also indicates that absent any change:

The rules ... go against the policy underlying the new rules as it gives rise to a double benefit; the benefit of the income being NANE income and the benefit of a deduction for the interest expenses incurred to derive such NANE income.¹⁷

35. Putting to one side that there is no “double benefit” (see below), the above explanation does not explain why that outcome was considered acceptable tax policy for the last 20 years. The “double benefit” reflected part of a considered package: the decision about the level of debt which could be borrowed to fund the Australian operations and foreign operations, was made alongside a decision to allow the deduction of interest in both cases. Switching off the ability to deduct interest on money borrowed to fund foreign operations is tantamount to resetting that debt level down to zero.

36. Given that the effect of this change will be to return Australian tax law to the position pre-2001, one would have expected the Draft EM to explain why that world is superior. But the Draft EM says nothing about what the new (that is, old) world will look like. Repealing section 25-90 will force companies to separate their funding sources so that debt used to fund offshore entities will be funded directly to those entities rather than through an Australian treasury function. One reason for the 2001 amendments introducing Division 820 was to get rid of the compliance nuisance that “*the debts of an outbound investor are traced to an end use to determine the treatment of the*

¹⁴ Explanatory Memorandum to the *New Business Tax System (Thin Capitalisation) Act 2001*, at [1.99].

¹⁵ Explanatory Memorandum to the *New Business Tax System (Thin Capitalisation) Act 2001*, at [1.9].

¹⁶ Draft EM, [1.119].

¹⁷ Draft EM, [1.119].

interest expense.”¹⁸ In short, the Draft EM does not address the adverse impacts of the repeal of section 25-90 and the increased compliance costs as a consequence of the changes to funding and investment practices in order to satisfy the practical imperative to trace the use of borrowed funds.

37. The Committee submits that the thin capitalisation rules (and not section 8-1) continue to be the most appropriate tool by which to restrict the deductibility of interest in Australia, because:

- the thin capitalisation rules apply in respect of the **Australian** assets of the multinational group. As such, the percentage of Australian income on which the tax payable can be eliminated is already in effect limited via the thin capitalisation rules, albeit via the use of Australian assets as a proxy for Australian income—there is no double benefit;
- the application of the principle that interest should only be deductible if incurred in the production of assessable income (that is, a matching principle) is not appropriate in the context of the principles underpinning the *Review of International Taxation Arrangements*; and
- the thin capitalisation rules are already supported by the general anti-avoidance rules in Part IVA (in extreme cases) and the revised transfer pricing rules in Division 815.

Unscrambling the egg

38. The consequences of the change will not be trivial and will require taxpayers to unwind financial structures put in place over many years.

39. The amendment means there will need to be a restructuring of existing transnational debt to ensure that interest continues to be deductible on a go-forward basis (including potential for realising foreign exchange gains and losses and an increased tax risk from the potential applicability of the general anti-avoidance rules to such restructuring).

40. There is also the potentially high cost of restructuring such debt, including in the form of break fees with respect to existing debt, and the potential need to raise equity at a time when the cost of capital is high.

41. There is also a strong likelihood of capricious outcomes on a transitional basis for those taxpayers that have reasonably relied on section 25-90 since its introduction, including the denial of debt deductions for taxpayers that have comparatively modest levels of debt and have not engaged in any behaviour that could be classified as “aggressive”. The consequences of the repeal of section 25-90 will be borne most heavily by taxpayers that are not able to restructure their long-term debt at all. Such outcomes arbitrarily punish taxpayers for legitimately taken commercial decisions.

42. The Committee submits that the original policy arguments remain valid and the case for change has not been made out. Consequently, Items 1 and 2 should be excised from the Exposure Draft and decisions about this measure should be the subject of specific consultations over the next few months.

¹⁸ Explanatory Memorandum to the *New Business Tax System (Thin Capitalisation) Act 2001*, at [1.15].

Unseemly haste

43. The combination section 25-90 (or subsection 230-15(3)), section 768-5 and the thin capitalisation regime has been settled tax policy in Australia. To reconfigure this suite of policies with only 10 weeks' notice is draconian.
44. Given the magnitude of the changes, one would have expected to see a plausible time frame in which to get to grips with the new world before it operates. We note that a similar proposal was announced by Treasurer Wayne Swan in the *Budget 2013–14*, and elaborated by Treasury in the Discussion Paper, *Addressing profit shifting through the artificial loading of debt in Australia*.¹⁹ The Budget announcement said the repeal of section 25-90 would come into effect, “for income years commencing on or after 1 July 2014.” In 2013, 14 months' notice was afforded before the new rules would operate; a similar time frame should apply here.
45. If, after consultation, the Exposure Draft is to be enacted, whether in the original form or revised form, the Committee suggests that it should start no earlier than 1 July 2024.
46. Finally, there is no analysis in the Draft EM about the transition to the new world, meaning the new rules will apply to interest incurred after the start date without any grace period or grandfathering of existing debt. This will penalise taxpayers who have relied on the current position as settled law.
47. Again, given the magnitude of the changes, one would have expected to see a serious discussion about how the unannounced change will accommodate long-term financing structures and structural investments offshore put in place in reliance on settled law and which cannot be unwound without penalty—investments which should not have to be abandoned simply because of a tax change.
48. The proposed “hard” start date of 1 July 2023 is inconsistent with the way changes with similar ramifications have been handled in the past.
49. For example, when the debt-equity rules were legislated in 2001, an optional 3-year transition was allowed: transitional rules allowed the issuers of an interest, that would change character as a result of the new rules, to elect to have the instrument treated under the existing law until 1 July 2004. The election to retain the existing treatment was buttressed by suitable integrity measures: there needed to be an explicit election, it had to be in writing, it was irrevocable and it would apply to all interests of the same class issued by the company. The Explanatory Memorandum to the *New Business Tax System (Debt and Equity) Bill 2001* said this transitional rule, “provides for continuity in private sector decision-making and allows issuers sufficient time to redeem issued instruments in an orderly manner.”²⁰ The same justification applies here.
50. When Division 230 was enacted in 2010,²¹ the transition was even more generous; it was handled by grandfathering existing instruments. The rules would only apply to financial arrangements issued or acquired on or after 1 July 2010 (with an option to “ungrandfather” existing instruments for taxpayers who were ready and able to apply Division 230 and did not want to run parallel systems for old and new instruments).
51. Accordingly, the Committee submits that, as part of the consultations on this measure, appropriate transitional arrangements need to be considered for interest on debt on

¹⁹ Commonwealth Department of Treasury, *Addressing profit shifting through the artificial loading of debt in Australia*, May 2013.

²⁰ Explanatory Memorandum to the *New Business Tax System (Debt and Equity) Bill 2001*, at [2.212].

²¹ *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009*.

foot as at 1 July 2024 which might be affected by the measure, including the grandfathering of existing debt, or an extended period before any new regime would apply.

Definition of ‘financial entity’

52. The narrowing of the definition of “financial entity” in subsection 995-1(1), by deleting paragraph (a) of that definition which refers to a registered corporation under the *Financial Sector (Collection of Data) Act 2001* (Cth), will reclassify a number of non-bank lending businesses that do not have Australian Financial Service Licences as ‘general class investors’, thereby removing them from the scope of the existing thin capitalisation rules and the more favourable debt/equity ratios that apply to ADIs and financial entities in acknowledgment of the nature of their borrowing and lending business activities.
53. The amendments will have the effect that a number of genuine, non-bank lending businesses which hold Australian credit licences will be subject to the new provisions. It has been argued that the ‘net debt deduction’ concept should apply to such lenders to ensure that they are not unfairly denied debt deductions. However, in circumstances where there are a number of defaults by borrowers and resultant poor profits, the new rules could have the effect of denying such entities debt deductions. This would appear to be an inadvertently inappropriate outcome of the proposed amendment.
54. The Draft EM explains that the amendment is an integrity measure in response to ‘an increasing number of entities now purporting (for tax purposes) to be financial entities’. The Committee suggests that some further work should be done to differentiate genuine lending businesses from the entities referred to in the Draft EM that have given rise to this concern and to develop an amendment that does not disadvantage genuine, non-bank lending businesses. It is suggested that the concept of a ‘non-bank lender’ that is a ‘financial entity’ may be appropriate in this context.

Special purpose vehicle exemption

55. The original exemption from the thin capitalisation rules for ‘securitisation vehicles’ as defined in subsection 820-942(2) was too narrow to encompass a large cohort of securitisations in the market. This led to the introduction of the exemption in section 820-39 for certain special purpose vehicles (**SPVs**). The Explanatory Memorandum to the *Taxation Laws Amendment Bill (No. 5) 2003* explained the reasons for this as follows:

1.4 The zero capital amount provides a carve out of certain assets from the thin capitalisation regime and as a consequence allows full debt funding of those qualifying assets. Assets held by a securitisation vehicle are included in the zero capital amount provided that the definition of securitised asset and securitisation vehicle as set out in section 820-942 are satisfied.

1.5 This treatment reflects that securitisation vehicles are tax neutral entities established to pool assets and are generally funded entirely through the issue of debt interests without the need to hold equity.

1.6 The securitisation industry is complex and dynamic. Many securitisation programs are not able to avail themselves of the benefits of the zero capital treatment provided under the current thin capitalisation legislation. In particular, the current definitions do not contemplate origination, warehousing, two-tiered securitisation or synthetic securitisation. Nor do the current rules allow any residual equity holding in a securitisation vehicle. As a consequence, many bona fide securitisation vehicles will inappropriately have a proportion of their interest deductions denied under the thin capitalisation rules.

1.7 To address this, amendments will exclude special purpose entities from the thin capitalisation rules for all or part of the income year provided that the following conditions are met ...

56. The exemption for insolvency-remote SPVs in section 820-39 remains unaffected by the amendments. However, the exemption has not been extended to proposed new Subdivision 820-AA which will apply to the new category of 'general class investors'.
57. It is not clear why the exemption for insolvency-remote SPVs in section 820-39 has not been extended to general class investors in the same way as the *de minimis* exemption in section 820-35. It would be an incongruous result for 'securitisation vehicles', as defined in subsection 820-942(2), to remain carved-out from the new thin capitalisation rules²², but not insolvency-remote SPVs, when it has previously been acknowledged that the subsection 820-942(2) definition of 'securitisation vehicle' is inadequate for the securitisation industry. Having regard to other proposed changes in the Exposure Draft which appear to contemplate that the section 820-39 exemption will remain in place,²³ this appears to be an oversight which should be remedied by a simple amendment to the Exposure Draft.
58. In this context, it has been argued that the 'net debt deduction' concept could apply to securitisation vehicles to ensure that they are not denied debt deductions under the new rules. However, as discussed above, this may not be the case where, for example, there are defaults in respect of securitised loans such that debt deductions exceed interest income in a particular income year.

Conduit financier concession

59. Subsection 820-61(5) of the Exposure Draft provides a concession for the common practice of using an internal finance company to raise funds and have it on-lend to other members of the (non-consolidated) group. The rules allow the on-lending of externally-raised debt to associates of the borrower by relaxing some of the conditions that would ordinarily prohibit this (the associate tests and the recourse test), but the conditions which must be met are very tight, in essence requiring a back-to-back loan arrangement of the borrowed funds (only) on the same terms with those of the ultimate debt interest, with the exception of the debt amount.²⁴
60. There are a number of practical challenges with the real-world practices of conduit financing arrangements that this stipulation may cause. The following are examples of potential issues and impracticalities arising from this condition:
- When a conduit financier offers security to the ultimate lender based on an asset of the borrower being financed (such as for purchasing or constructing real property), the borrower may not be able to provide identical security to the conduit financier. In such cases, the borrower might offer alternative security over the same asset, like a second lien or mortgage. However, this security would differ from that provided by the conduit financier to the ultimate lender.
 - If the parent company of a multinational enterprise (**MNE**) group guarantees the ultimate lender to encourage them to finance the conduit financier associated with the ultimate debt interest, it is unlikely that the MNE group's parent company would also guarantee the conduit financier to finance the borrower associated with the relevant debt interest.

²² Included in the definition of "financial entity" in section 995-1(1).

²³ Paragraph 1.32 of the EM.

²⁴ Paragraph 820-61(5)(e).

- United States Private Placement (**USPP**) arrangements often include unique terms and conditions that may not be present in more conventional financing agreements, reflecting specific market requirements for USPP debts. Requiring conformity with USPP arrangements could severely hinder commercial transactions and negotiations.
- The internal loan may be of a different tenure, i.e. at call, to reflect the capacity and needs to reuse the funds within the group.
- A small margin would generally be imposed on the funds to enable the Finance Company to meet its costs.

61. In each of these instances, the ‘same terms’ requirement is unattainable for purely commercial reasons unrelated to tax avoidance.

62. Paragraph 820-61(5)(g) requires that the ultimate lender only have recourse to the assets of each borrower and the loans owed to the conduit financier. If the ultimate lender requires security over the group, then the conduit financier would need to make loans to each entity within that group, regardless of need, in order to satisfy this requirement.

63. We propose that subsection 820-61(5) of the Exposure Draft be revised to better align with commercial practices and realities. This could be achieved by amending the requirement to stipulate that the rate on the debt interests is similar and that the requirement in paragraph 820-61(5)(g) be removed.

64. Finally, we note that the requirement that the loan arrangements only be between “associate entities” may also cause problems for stapled structures, and that such structures should be able to access the conduit financier concession without the need to have conduit financiers on both sides of the stapled group.

Conclusion and further contact

65. The Committee would be pleased to discuss any aspect of this submission. Please contact the Chair of the Committee Justin Byrne at justin.byrne@qldbar.asn.au or Committee Member Chris Atkinson, on (03) 9671 7382 if you would like to do so.

Yours faithfully



Philip Argy
Chairman
Business Law Section

SCHEDULE

The below paragraphs are extracted from *ATTA Doctoral Series: Volume 7: Preventing tax base erosion through reform*, Associate Professor Ann Kayis-Kumar (Oxford University Press, 2019).

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As observed in the OECD's BEPS Final Report on Action 4 ('Action 4 Report'), there is currently a trend away from applying fixed debt-to-equity ratios to instead applying fixed net interest-to-EBITDA ratios. This approach is thought to supply a better instrument to combat base erosion and profit shifting, and its emerging popularity is illustrated in the below Figure 1.²⁵ However, commentators such as Burnett posit that a worldwide leverage ratio limit is preferable to a worldwide interest-to-earnings ratio limit because the latter is more prone to fluctuations caused by factors beyond the MNE's control.²⁶

Figure 1—Convergence towards fixed interest-to-earnings ratios

Fixed interest to earnings (EBITDA) ratios in selected countries	
Finland:	25 per cent of EBITD calculated based on the taxable profit and loss account. The calculation is made by entity and adjusted by taking into account group contributions received or made.
Germany:	30 per cent of taxable EBITDA.
Greece:	30 per cent of EBITDA. Phased-in system according to which the percentage will reduce from 60 per cent in 2014 to 30 per cent in 2017.
Italy:	30 per cent of EBITDA, adjusted by adding rental payments under finance lease transactions.
Norway:	30 per cent of taxable EBITDA.
Portugal:	30 per cent of EBITDA, adjusted by excluding certain items such as income resulting from shares eligible for the participation exemption or attributable to a permanent establishment outside Portugal to which the option for exemption is applied. Phased-in system according to which the percentage will reduce from 70 per cent in 2013 to 30 per cent in 2017.
Spain:	30 per cent of operating profits adjusted by adding certain items such as depreciation and amortisation and financial income from equity investments.
United States:	50 per cent of adjusted taxable income, ie. EBITDA plus specific deductions taken into account when calculating the taxable income.

Source: OECD (2014)

Good tax design

Given the difficulty of delineating and testing exactly what constitutes 'excessive' deductions, policymakers have typically utilised artificial caps and ratios—including 'safe harbour' debt/equity tests, leverage ratios and arm's length rules—to restrict interest relief.

These artificial caps and ratios reflect a pragmatic policy focus, which prioritises administrative ease and taxpayer certainty. This existing policy focus of thin capitalisation rules' debt/equity test was similarly articulated by the Action 4 Report, which observed that the ability of the debt/equity test to deliver administrative ease and taxpayer certainty was its main advantage.²⁷

However, it is important to note that guiding principles used to instruct tax design are often in conflict, as emphasised in the above section **Error! Reference source not found..** In

²⁵ OECD, 'BEPS Action 4: Interest Deductions and Other Financial Payments' (Public Discussion Draft, 18 December 2014) 49 <<http://www.oecd.org/ctp/aggressive/discussion-draft-action-4-interest-deductions.pdf>>.

²⁶ Burnett C, 'Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach' (2014) 6(1) *World Tax Journal* 40, 45.

²⁷ OECD, 'BEPS Action 4: Interest Deductions and other Financial Payments' (Final Report, 5 October 2015), 21. However, determining the level of certainty is largely dependent on the actual rules in place domestically.

relation to the policy focus of thin capitalisation rules, commentators such as Webber²⁸ and policymakers such as the OECD²⁹ have observed that prioritising administrative ease and taxpayer certainty has come at the expense of economic efficiency.

This is problematic because such non-neutralities create tax-induced distortions which provide the principal building blocks for tax planners.³⁰

Utilising economic efficiency as one of the guiding tax policy criteria in the design of these rules would be consistent with a more principled approach—particularly since thin capitalisation rules are generally conceptualised as forming part of the anti-avoidance framework.

Similarly, it remains unclear whether these rules address the underlying tax-induced distortion which causes the behavioural response of thinly capitalising entities in higher-taxing jurisdictions. Conceptualised in this way, limiting the deductibility of interest expenses may be misplaced in that such a limitation does not address the tax-induced cross-border funding bias by equalising the tax treatment of economically equivalent financing alternatives.

Under thin capitalisation rules the amount of debt deductions are capped ($r^D = r^{\text{capped}}\%$). On the other hand, equity deductions are effectively denied ($r^E = 0\%$). However, what is not supported by the empirical evidence is the logical extension that, in turn, these rules definitively protect the tax revenue base. Rather, it remains unclear whether these limits have the effect of directing base erosion techniques of MNEs into other deductible payments that are not so constrained.

Interest limitation rules prioritise simplicity at the expense of economic efficiency, and by focussing on debt only are too narrow in scope to attain neutrality. On the other hand, if funding neutrality were to be addressed, the resulting neutrality would in theory make these rules redundant.³¹

Of course, in the absence of international tax coordination, full tax neutrality cannot be obtained, as tax rates and systems will still differ. However, it is still possible to encourage neutrality where practicable as a second-best solution.

Legal design weaknesses

There are five key legal design weaknesses inherent in existing thin capitalisation rules: first, their development is ad hoc; second, they create an unnecessary compliance burden for the majority of MNEs which do not fall within the target group of tax-aggressive MNEs; third, MNEs operating at the legal limits of these interest limitation rules can potentially respond to regulatory tightening by changing their funding mix; fourth, these rules give rise to tax arbitrage opportunities; and fifth, the framework for these rules is exceedingly complicated.

Ad hoc development

Thin capitalisation rules are typically developed in an ad hoc manner. No two countries have identical interest limitation rules. Further, these regimes appear to be rather unstable—most countries have rewritten theirs at least once. Despite the variability, most countries' rules sit somewhere along a spectrum which has at one end a stand-alone

²⁸ Webber S, 'Thin Capitalization and Interest Deduction Rules: A Worldwide Survey' (2010) 60(9) *Tax Notes International* Special Report 683, 703.

²⁹ OECD, 'BEPS Action 4: Interest Deductions and other Financial Payments' (Final Report, 5 October 2015), 21.

³⁰ Australian Government, Department of the Treasury, *Taxation Reforms: Problems and Aims* (Treasury Taxation Paper No 1, 1974) 5–6.

³¹ Massimi F and Petroni C, 'Real-World ACE Reforms and the Italian Experience: Towards a General Trend?' (2012) 40(11) *Intertax* 632.

entity approach, and at the other end a worldwide ratio approach. Burnett questions the appropriateness of a single arm's length leverage ratio or interest rate for a given subsidiary, or even a workable range of ratios and rates.³² Even though empirical evidence supports the proposition that thin capitalisation rules technically restrict internal borrowing by MNEs,³³ it is relatively simple for MNEs to circumvent these rules. For example, entities falling outside the threshold levels are openly advised to reassess their thin capitalisation positions by either reducing debt, revaluing assets or recapitalising to prevent the denial of interest expenditure.³⁴ Accordingly, thin capitalisation rules are reactionary provisions that fail to effectively target many avoidance-related transactions.³⁵

Unnecessary compliance burden

Ruf and Schindler posit that the empirical evidence supports the proposition that, for the average MNE, there is no need to implement thin capitalisation rules.³⁶ If this is the case then the applicability of these complex rules to non-tax-aggressive MNEs constitutes an unnecessarily onerous administrative burden.

Further, Ruf and Schindler observe that the mismatch between empirical evidence and anecdotal evidence provided by tax consultants and auditors is attributable to the fact that only a few large MNEs engage in aggressive tax planning.³⁷ This evidence remains anecdotal, with other commentators such as Vann observing that new FDI in Australia is often financed at or around the legal limits and that internal debt is often not recorded in FDI statistics, suggesting that what is currently regarded as portfolio debt in Australia is probably disguised FDI.³⁸ This highlights a research gap relating to the proposition that it is common for new FDI in Australia to be financed at or around the debt-to-equity ratio limit.

Tax arbitrage opportunities

Thin capitalisation rules may be avoided by MNEs that can exploit tax arbitrage opportunities by using hybrid financial instruments and international differences in definitions of debt and equity.³⁹ Despite the literature acknowledging these issues,⁴⁰ very few empirical papers examine this aspect.⁴¹ Burnett suggests that intercompany debt and

³² Burnett C, 'Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach' (2014) 6(1) *World Tax Journal* 40.

³³ Overesch M and Wamser G, 'Bilateral Internal Debt Financing and Tax Planning of Multinational Firms' (2014) 42(2) *Review of Quantitative Finance and Accounting* 191; Buettner T et al, 'The Impact of Thin-Capitalization Rules on the Capital Structure of Multinational Firms' (2012) 96 *Journal of Public Economics* 930; Ruf M and Schindler D, 'Debt Shifting and Thin-Capitalization Rules: German Experience and Alternative Approaches' (2015) 1 *Nordic Tax Journal* 17.

³⁴ PwC, 'Tighter Thin Capitalisation Regime to Limit Australian Debt Deductions' (26 September 2013) <<http://www.pwc.com.au/tax/federal-budget/2013/thin-capitalisation.htm>>.

³⁵ Cottarelli C (eds), IMF Fiscal Affairs Department, 'Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy' (International Monetary Fund Study, 12 June 2009), 13.

³⁶ Ruf M and Schindler D, 'Debt Shifting and Thin-Capitalization Rules: German Experience and Alternative Approaches' (2015) 1 *Nordic Tax Journal* 17, 24.

³⁷ Ruf M and Schindler D, 'Debt Shifting and Thin-Capitalization Rules: German Experience and Alternative Approaches' (2015) 1 *Nordic Tax Journal* 17, 24–8.

³⁸ Vann R J, 'Corporate Tax Reform in Australia: Lucky Escape for Lucky Country?' [2013] 1 *British Tax Review* 59, 71.

³⁹ By way of background, the difference between debt and equity stems from the legal, finance and accounting realms, rather than being grounded in tax or economic principles. Unlike finance, neither tax nor economics is concerned with the function of debt as a safeguard for third party liabilities. Accordingly, the non-neutrality in the tax treatment between debt and equity finance (in other words, the tax-induced debt bias) is distortive from a tax perspective, creates complexity, encourages avoidance and adds unnecessary administrative and compliance costs for both MNEs and governments. These issues are exacerbated in the context of cross-border hybrids: OECD, Public Discussion Draft, *BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)*, 19 March 2014 – 2 May 2014 <<http://www.oecd.org/ctp/aggressive/hybrid-mismatch-arrangements-discussion-draft-domestic-laws-recommendations-march-2014.pdf>>.

⁴⁰ De Mooij R A and Keen M J, 'Debt, Taxes and Banks' (IMF Working Paper 12/48, February 2012).

⁴¹ The only detailed discussion of the treatment of hybrid finance under thin capitalisation rules appears to be in Klostermann M, 'The Consequences of Hybrid Finance in Thin Capitalization Situations: An Analysis of the Substantive Scope of National Thin Capitalization Rules with Special Emphasis on Hybrid Financial

third-party debt are substitutable.⁴² However, research in this area lacks surveys or interviews with accounting and law firm partners, and private equity firm managers. This could be the subject of future research.

Instead, the literature analysing thin capitalisation rules focusses on their impact on intercompany loans, and is generally limited to datasets from the United States ('US')⁴³ and the EU.⁴⁴ Further, the finance literature often identifies the tax deductibility of debt as the most significant factor governing the choice between third-party debt and equity finance. However, from an economic substance perspective, the reasons put forward to distinguish third-party debt from equity generally do not hold in intercompany situations.⁴⁵

Exceedingly complicated framework

There is also a strong consensus that the existing thin capitalisation framework is highly technical and complicated. There is a wider international tax framework including but not limited to complex debt and equity rules; dividend imputation and corporate shareholder taxation issues;⁴⁶ withholding taxes;⁴⁷ other jurisdictions' interest limitation rules; bilateral tax treaties; interactions with the OECD Model Tax Convention, including arts 9(1) and 24(4); OECD Guidelines; and other OECD materials.

For instance, Australia's existing thin capitalisation regime contained in Division 820 of the *ITAA97* currently spans over 150 pages of legislation, with highly technical rules requiring complicated calculations. This calls into question whether these rules (and other associated rules) achieve simplicity and transparency. It is also arguable that the existing legal design of these rules conflicts with the effectiveness and fairness principles.⁴⁸ Further, as observed in the above section 2.4.2, a thorough examination of this regime is currently a research gap. Accordingly, the following section 2.4.4 presents a longitudinal legal analysis of Australia's past and present thin capitalisation regimes.

Instruments' (Discussion Papers SFB International Tax Coordination No 22, WU Vienna University of Economics and Business, July 2007).

⁴² Burnett C, 'Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach' (2014) 6(1) *World Tax Journal* 40, and studies cited therein.

⁴³ Data was used from the US Bureau of Economic Analysis: Desai M A, Foley C F and Hines J R, 'The Costs of Shared Ownership: Evidence from International Joint Ventures' (2004) 73(2) *Journal of Financial Economics* 323.

⁴⁴ A large micro-level panel dataset of virtually all German MNEs compiled by Deutsche Bundesbank, which included information about the actual amount of internal debt used by foreign affiliates, distinguished into loans from the parent and loans received from other foreign affiliates: Buettner T and Wamser G, 'Internal Debt and Multinational Profit Shifting: Empirical Evidence from Firm-Level Panel Data' (2013) 66(1) *National Tax Journal* 63, 69.

⁴⁵ Burnett C, 'Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach' (2014) 6(1) *World Tax Journal* 40, 57–62. Burnett's 'Proposition 1', that "*Intra-group debt is a close or perfect substitute for equity, pre-tax*", is widely accepted among both tax lawyers and economists.

⁴⁶ See further, Taylor C J, 'Approximating Capital-Export Neutrality in Imputation Systems: Proposal for a Limited Exemption Approach' (2003) 57 *Bulletin for International Taxation* 135; Taylor C J, 'Development of and Prospects for Corporate-Shareholder Taxation in Australia' (2003) 57 *Bulletin for International Taxation* 346.

⁴⁷ Importantly, the Henry Review criticised Australia's current treatment of foreign debt as complex and distortionary, recommending a reduction in the interest withholding tax rate to zero among tax treaty partners. With an effective interest withholding tax rate of 3.5%, liability for withholding tax would likely not outweigh the advantages of interest deductibility given comparative levels of corporate tax. While the literature has recognised the debt bias as prevalent in the foreign debt context, policymakers have called for the reduction of interest withholding tax to 0% provided appropriate safeguards exist to limit tax avoidance: "*Recommendation 34: Consideration should be given to negotiating, in future tax treaties or amendments to treaties, a reduction in interest withholding tax to zero so long as there are appropriate safeguards to limit tax avoidance*": Australian Government, Department of the Treasury, 'Australia's Future Tax System: A Report to the Treasurer', December 2009 ('Henry Review'), Part 1, 87.

⁴⁸ Webber S, 'Thin Capitalization and Interest Deduction Rules: A Worldwide Survey' (2010) 60(9) *Tax Notes International Special Report* 683.