2022–2023

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

SENATE

TREASURY LAWS AMENDMENT (MAKING MULTINATIONALS PAY THEIR FAIR SHARE—INTEGRITY AND TRANSPARENCY) BILL 2023

EXPOSURE DRAFT

SUPPLEMENTARY EXPLANATORY MEMORANDUM

Glossary

This Supplementary Explanatory Memorandum uses the following abbreviations and acronyms.

Abbreviation	***Definition***
AMIT	Attribution managed investment trust
Bill	Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*

General outline and financial impact

Thin capitalisation – Parliamentary amendments

Outline

The Parliamentary amendments amend Schedule 2 to the Bill to ensure the new thin capitalisation rules are appropriately targeted.

Date of effect

The Parliamentary amendments commence at the start of the first quarter following Royal Assent and apply to assessments for income years beginning on or after 1 July 2023.

Proposal announced

Together with Schedule 2 to the Bill, the Parliamentary amendments implement the MNE interest limitation rules from the Government election commitment on multinational tax integrity, included as the 'Multinational Tax Integrity Package – amending Australia's interest limitation (thin capitalisation) rules' measure from the October 2022-23 Budget.

Compliance cost impact

The Impact Analysis relating to the amendments in Schedule 2 to the Bill is at Attachment 2 to the Explanatory Memorandum for the Bill.

Chapter 1: Thin capitalisation

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Outline of chapter

1.1 The Parliamentary amendments amend Schedule 2 to the Bill to ensure the new thin capitalisation rules are appropriately targeted. The amendments relate to the following matters:

- Choices under Subdivision 820-AA.
- The meaning of 'obligor group'.
- The meaning of 'tax EBITDA'.
- The third party debt test.
- The debt deduction creation rules.
- Other matters.

1.2 All legislative references are to the ITAA 1997 unless otherwise indicated.

Context of amendments

1.3 The Bill was introduced into the House of Representatives on 22 June 2023. Schedule 2 to the Bill contains the new thin capitalisation rules.

1.4 On 22 June 2023, the Government referred the provisions of the Bill to the Senate Economics Legislation Committee (the Committee). The Committee published its report on 22 September 2023 and recommended that Schedule 2 to the Bill be passed subject to technical amendments.

1.5 The Parliamentary amendments represent these technical amendments.

Detailed explanation of amendments

1.6 The Parliamentary amendments amend Schedule 2 to the Bill to ensure the new thin capitalisation rules are appropriately targeted.

Choices under Subdivision 820-AA

1.7 New subsection 820-47(4A) clarifies the ordering between a deemed choice under subsection 820-46(5) (third party debt test choice) and a choice under subsection 820-46(3) (group ratio test choice). In relation to a single income year, if a choice under subsection 820-46(5) is taken to have been made by the entity, the entity cannot subsequently make a choice under subsection 820-46(3) and any choice previously made under subsection 820-46(3) by the entity is revoked and taken never to have been made.
[Amendment 13, subsection 820-47(4A)]

1.8 The conditions for revoking certain choices under Subdivision 820-AA have been simplified. Revoking a choice no longer requires the particular entity that made the choice to always satisfy certain conditions. However, the Commissioner must still be satisfied that it is fair and reasonable, having regard to matters the Commissioner considers relevant, to allow the entity to revoke the choice. Such matters may include whether the entity made the choice on a reasonable and genuine basis, and not as a part of aggressive tax planning.
[Amendment 15, subsection 820-47(6)]

1.9 An entity must apply to revoke a choice in relation to an income year within four years after they lodge their income tax return for the income year (or are required to lodge their income tax return for the income year if that date is earlier). This time limit provides administrative certainty and ensures that entities have a reasonable amount of time to revoke choices.
[Amendment 16, paragraph 820-47(6)(c)]

Obligor group

1.10 An amendment clarifies that a creditor does not need to have recourse to all the assets of an entity for that entity to be an "obligor entity". It is sufficient for recourse to be had to one or more assets of the entity.
[Amendment 21, paragraph 820-49(1)(b)]

1.11 Where a creditor only has recourse to the assets of an entity that are membership interests in the borrower, then that entity will not be an obligor entity. Lenders often have recourse to the membership interests in the entity they lend to. An amendment ensures that entities which merely hold membership interests in the borrower do not become obligor entities.
[Amendment 22, subsection 820-49(3)]

Tax EBITDA

1.12 Paragraph 820-52(1)(c) requires entities to add the value of some of their deductions to their tax EBITDA calculation. Two new deductions are now included under this paragraph. Firstly, general deductions under section 8-1 that relate to forestry establishment and preparation costs. Secondly, deductions under section 70-120 (capital costs of acquiring trees). These changes enable plantation forestry entities to better apply the fixed ratio test, given their sector's unique harvesting timelines that results in long lead-times for earnings.
[Amendment 25, paragraph 820-52(1)(c)]

1.13 A corporate tax entity may choose the amount of its tax losses that it deducts in an income year. To account for this choice, amendments clarify how corporate tax entities calculate their tax EBITDA. Broadly, in working out the taxable income or tax loss of a corporate tax entity for the purposes of subsection 820-52(1), it is assumed that the entity chooses to deduct, under subsection 36-17(2) or (3), all the entity's tax losses and subsection 36-17(5) does not apply to that choice.
[Amendment 28, subsection 820-52(1A)]

1.14 In line with the treatment of trusts and partnerships, dividends are now only disregarded for tax EBITDA purposes where the entity receiving the dividend is an associate entity of the company paying the dividend. The modified associate entity test provided by subsection 820-52(9) applies for these purposes.
[Amendment 29, subsection 820-52(3)]

1.15 New provisions in section 820-52 specifically cater for AMITs. Subsections 820-52(6A) and (6B) make modifications to the calculation of tax EBITDA for AMITs and members of AMITs, respectively.
[Amendment 34, subsection 820-52(6A)]

1.16 Notional deductions of R&D entities are now required to be subtracted from tax EBITDA. Division 355 provides R&D entities a tax offset in respect of their notional deductions. Absent the amendments, R&D entities applying the fixed ratio test would receive a double benefit of the tax offset and disregarding their notional deductions for tax EBITDA purposes.
[Amendment 37, subsection 820-52(10)]

1.17 Amendments are made to the tax EBITDA calculation to allow eligible unit trusts to transfer their excess tax EBITDA amounts to other eligible unit trusts. The amendments allow the tax EBITDA calculation to facilitate a greater variety of lending arrangements involving eligible unit trusts.
[Amendments 26 and 40, paragraph 820-52(1)(ca) and section 820-60]

1.18 Broadly, the amendments only apply in relation to unit trusts and managed investment trusts which satisfy the following conditions:

- The unit trust is a resident trust for CGT purposes. In the case of a managed investment trust, the residency requirement in subsection 275-10(3) applies.
- The trust is general class investor and is using the fixed ratio test for the income year.
- The transferee trust has a direct control interest of 50% or more in the transferor trust at any time in the income year.

[Amendment 40, section 820-60]

1.19 Excess tax EBITDA amounts are transferred according to the transferee trust's average direct control interest in the transferor trust for the income year. This requires a consideration of the direct control interest for each day of the income year. For a day to count towards the calculation of the average direct control interest, the direct control interest for that day must be 50% or greater.
[Amendment 40, section 820-60]

1.20 An excess amount transferred to an eligible trust is taken into account when considering whether that trust has an excess amount itself, which it can, in turn, transfer to another eligible trust.

Third party debt test

1.21 Amendments are made to Subdivision 820-EAB (third party debt test). The following paragraphs explain the broad effect of the amendments.

1.22 An interest rate swap cost that relates to multiple debt interests is generally now deductible under the third party debt test, to the extent subsection 820-427A(2) is satisfied in relation to the cost.
[Amendment 68, subsection 820-427A(2)]

1.23 In conduit financer cases, an interest rate swap cost incurred by a borrower is generally now deductible under the third party debt test, to the extent subsection 820-427A(2) is satisfied in relation to the cost. Additionally, borrowers can recover these costs from other borrowers further down the 'borrowing chain'.
[Amendments 77 and 89, section 820-427B and paragraph 820-427C(2)(e)]

1.24 The holder of the debt interest being tested under the third party debt test (the 'tested debt interest') can now have recourse to the following kinds of assets:

- Australian assets held by the entity.

  In conduit financer cases, this condition is modified to instead refer to the Australian assets of the conduit financer and borrowers.

- Australian assets that are membership interests in the entity, unless the entity has a legal or equitable interest, directly or indirectly, in an asset that is not an Australian asset. The proviso ensures that membership interests cannot be representative of non-Australian assets.

  In conduit financer cases, this condition is modified to instead refer to Australian assets that are membership interests in the conduit financer and borrowers. The proviso continues to apply in these cases.

- Australian assets held by an Australian entity that is a member of the obligor group in relation to the tested debt interest.

  [Amendments 71 and 78, paragraph 820-427A(3)(c) and subsections 820-427B(4) and (5)]

1.25 The updated recourse conditions account for a greater variety of lending arrangements.

1.26 The general prohibition on recourse to credit support rights is maintained. The prohibition ensures that multinational groups do not have an unfettered ability to 'debt dump' third party debt in Australia that is recoverable against the global group.
[Amendment 71, paragraph 820-427A(3)(ca)]

1.27 The allowance for recourse to credit support rights that wholly relate to the creation or development of land or other real property situated in Australia has been updated. This allowance now extends to the creation and development of certain moveable property situated on the land. The extension is intended to cater for property that is not part of the land but has a close economic connection to the land.
[Amendments 74 and 75, paragraph 820-427A(4)(a)]

1.28 Moveable property situated on the land is captured by the allowance if the property is, or is reasonably expected to be:

- incidental to and relevant to the ownership and use of the land; and

- situated on the land for the majority of its useful life.

[Amendment 75, subsection 820-427A(6)]

1.29 For conduit financer cases, a targeted modification is made to subparagraph 820-427A(3)(d)(ii) to ensure that the conduit financer and borrowers can on-lend borrowed amounts.
[Amendment 78, subsection 820-427B(6)]

1.30 For conduit financer cases, minor amendments clarify that the conduit financing conditions do not require every associate entity of a conduit financer to be a 'borrower' and therefore subject to certain conditions. Additionally, minor amendments clarify that not every debt interest that a borrower issues is a 'relevant debt interest' and therefore subject to certain conditions.
[Amendments 79 to 85, subsection 820-427C(1)]

1.31 The 'Australian entity' term is now used in Subdivision 820-EAB to ensure trusts and partnerships can access the third party debt test. The meaning of this term is modified in relation to partnerships to ensure the term reflects partnerships with a strong connection to Australia and does not allow avoidance behaviour. A partnership will be an Australian entity where Australia residents together hold at least a 50% direct participation interest in the partnership.
[Amendments 71, 88 and 93, section 820-427E]

Debt deduction creation rules

1.32 New section 820-31 clarifies the ordering between Subdivision 820-EAA (debt deduction creation rules) and all other provisions in Division 820. An entity first works out if their debt deductions are disallowed under the debt deduction creation rules. To the extent their debt deductions are disallowed under those rules, the disallowed debt deductions are disregarded for the purposes of applying all other provisions in Division 820. The other provisions in Division 820 may further disallow the entity's debt deductions.
[Amendment 10, section 820-31]

1.33 The exemption of certain special purpose entities from the thin capitalisation rules is extended to the debt deduction creation rules.
[Amendments 11 and 12, section 820-39]

1.34 ADIs and securitisation vehicles are now also excluded from the debt deduction creation rules.
[Amendments 47 and 48, subsection 820-423A(1)]

1.35 There are now three exceptions to the condition provided by paragraph 820-423A(2)(a) (about the acquisition of an asset from an associate pair):

- The acquisition of a new membership interest in an Australian entity is disregarded. Additionally, the acquisition of a new membership interest in a foreign entity that is a company is disregarded.
- The acquisition of certain new tangible depreciating assets is disregarded. This exception is broadly intended to allow an entity to bulk-acquire tangible depreciating assets on behalf of its associate pairs.
- The acquisition of certain debt interests is disregarded. This is a technical exception which ensures that mere related party lending is not caught by the rules. This exception only relates to 820-423A(2) and *not* 820-423A(5).

[Amendment 60, section 820-423AA]

1.36 Provisions make clear that subsection 820-423A(2) may apply in relation to the indirect acquisition by an entity of a CGT asset through an interposed entity, even if the indirect acquisition happens because of the direct acquisition by the first entity of a CGT asset covered by one of the three exceptions.
[Amendment 53, subsection 820-423A(3A)]

1.37 Australian currency is not a CGT asset when it is used as legal tender. Accordingly, the acquisition of Australian currency is generally not expected to be caught by paragraph 820-423A(2)(a).

1.38 For subsections 820-423A(2) and (5) to apply to a debt deduction, a new related party debt deduction condition must now be satisfied. Broadly, the condition will be satisfied where the relevant entity's debt deduction is paid or payable, directly or indirectly, to an associate pair of the entity.
[Amendments 52 and 54, paragraphs 820-423A(2)(e) and (5)(f)]

1.39 The related party debt deduction condition ensures the debt deduction creation rules are appropriately targeted. Where a group finances a related party transaction with related party debt, there may be little to no real economic cost borne by the group in relation to the transaction and debt.

1.40 Schemes that seek to exploit the related party debt deduction condition to artificially locate or 'debt-dump' third-party debt in Australia will be subject to the anti-avoidance rules in section 820-423D and Part IVA of the ITAA 1936. These anti-avoidance rules may also apply to any avoidance schemes relating to the debt deduction creation rules.

1.41 Subsection 820-423A(5) now applies in relation to financial arrangements rather than debt interests. This aligns with the new definition of 'debt deduction' in section 820-40, under which debt deductions may be incurred in relation to various financial arrangements.
[Amendment 54, subsection 820-423A(5)]

1.42 There are now two exceptions to the condition provided by paragraph 820-423A(5)(b) (about a payment or distribution to an associate pair):

- Broadly, a payment that is entirely referable to mere on-lending to an Australian associate is disregarded, where the on-lending is on the same terms (to the extent those terms relate to costs).
- Broadly, a payment that is entirely referable to the repayment of principal under a debt interest is disregarded. However, this exception does not apply where paragraphs 820-423A(5)(a), (b) and (c) would otherwise apply in relation to the debt interest. This ensures that entities cannot use the exception as a means of refinancing otherwise captured arrangements to avoid the application of the debt deduction creation rules.

[Amendment 54, subsections 820-423A(5A) and (5B)]

1.43 Debt deductions which subsection 820-423A(5) applies to are now disallowed on a proportionate basis. This provides a more appropriate and clearer basis for the disallowance of debt deductions. If the conditions in subsection 820-423A(5) are met, the amount of the debt deduction disallowed under subsection 820-423A(1) is the amount of the debt deduction, to the extent that the relevant entity mentioned in subsection 820-423A(5) incurred it in relation to proceeds, or use of those proceeds, mentioned in paragraph 820-423A(5)(b).
[Amendment 63, 820-423B(2)]

1.44 A modified definition of 'associate pair' applies in relation to unit trusts for the purposes of the debt deduction creation rules. This modified definition is intended to narrow the ordinary operation of 'associate' in section 318 of the ITAA 1936.
[Amendment 64, 820-423E]

1.45 The modified definition of 'Australian entity' applies for the purposes of the debt deduction creation rules (see paragraph 1.31 above).
[Amendment 64, 820-423F]

Other matters

1.46 A modified definition of 'associate entity' is used throughout the new thin capitalisation rules. Minor amendments are made to this modified definition to ensure the related definition of 'associate' in section 318 of the ITAA 1936 does not conflict with the modifications to the definition of 'associate entity'.
[Amendments 20, 36, 38 and 91, subsections 820-48(2), 820-52(9), 820-54(5), 820-427D(1)]

1.47 Amendments ensure that FRT disallowed amounts are appropriately dealt with under the allocable cost amount provisions in Division 705.
[Amendments 1 to 7, sections 705-60, 705-65, 705-75, 705-102, 705-105, 705-160 and 705-235]

Commencement, application, and transitional provisions

1.48 The Parliamentary amendments commence at the start of the first quarter following Royal Assent and apply to assessments for income years beginning on or after 1 July 2023.

1.49 Debt deductions that relate to financial arrangements entered into before 22 June 2023 are subject to a one-year grace period in relation to the debt deduction creation rules. The debt deduction creation rules apply in relation to all debt deductions for income years beginning on or after 1 July 2024, regardless of when the financial arrangements to which the debt deductions relate were entered into.
[Amendment 97, section 820-50 of the Income Tax (Transitional Provisions) Act 1997]