Monday, 30 October 2023

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Dear David

Treasury Laws (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023 – draft Parliamentary amendments

Chartered Accountants Australia and New Zealand (CA ANZ) appreciates the opportunity to comment on the draft Parliamentary amendments to Treasury Laws (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023 (the Bill) and the draft supplementary Explanatory Memorandum (EM).

CA ANZ represents more than 128,000 financial professionals, supporting them to build value and make a difference to the businesses, organisations and communities in which they work and live. Around the world, Chartered Accountants (CAs) are known for their integrity, financial skills, adaptability and the rigour of their professional education and training.

Consultation period is too short for such complex provisions

We acknowledge that the Government is committed to addressing multinational tax integrity and the announced changes to the thin capitalisation rules to implement a 30% EBITDA ratio test commencing from 1 July 2023. We commend the Government's decision to allow public consultation on the draft Parliamentary amendments to the Bill before the amendments are proposed in the Senate.

The exposure draft legislation is seeking to amend very complex provisions in the Income Tax Assessment Acts. The 8 working day consultation period is not enough time for stakeholders to be able to digest the proposed amendments and test the draft provisions to see if the stated outcome is achieved by the draft provisions. Our members have expressed deep concern that many issues, particularly those concerned with debt deduction creation rules, will not be able to be identified during this consultation process.

It is noted that the Senate resumes Parliamentary sittings on 6 November 2023, and there are only four sitting weeks remaining to pass the Bill. If the amendments are to be introduced when the Senate resumes sittings, then Treasury and the Office of Parliamentary Counsel will only have effectively four business days to consider stakeholders' feedback on the draft provisions. We are concerned that this is not enough time for Treasury and the Office of Parliamentary Counsel to properly address stakeholders' concerns with the provisions in the final version of the amendments to the Bill.

Thin capitalisation changes

CA ANZ is pleased that numerous amendments have addressed issues raised by stakeholders in relation to the proposed thin capitalisation provisions. During this extremely short consultation period, several further issues have been identified – such as:

- needing to align the thin capitalisation (TC) direct control interest tests for accessing trust excess tax EBITDA and disregarding trust distributions from Tax EBITDA
- the different treatment between trusts and other legal entities when allowing excess tax EBITDA to be shared
- the appropriateness of requiring tax losses to be utilised, and
- various adjustments to the third-party debt test.

Comments on these issues are contained in the Appendix to this letter.

Debt deduction creation rules

In contrast, our members have advised us that there are still substantial drafting issues with Subdivision EAA, containing the debt deduction creation provisions, even though the scope of the Subdivision has narrowed to related party arrangements.

There are also great concerns about the retrospective nature of the proposed changes. CA ANZ is particularly concerned that the specific anti-avoidance provisions will still capture entities that are trying to restructure their existing financing arrangements during the transitional period to ensure that they do not fall within the debt deduction creation rules. There are also concerns that provisions are inadvertently capturing arrangements that should not be within scope.

CA ANZ recommends that Subdivision EAA of the *Income Tax Assessment Act 1997* (ITAA 1997) containing the new debt deduction creation rules be excluded from the Bill. This will allow Treasury to immediately prioritise addressing stakeholders' concerns with the drafting of the amendments to the thin capitalisation rules for general class investors in Subdivision 820-AA for introduction in the Senate. Thereafter, Treasury can focus on fixing the drafting of Subdivision EAA. The debt deduction rules can then be introduced in a later Bill.

Our comments on the Parliamentary amendments

Our comments on the draft Parliamentary amendments are attached in Appendix. Speaking to our members and other stakeholders, we understand that there are significant concerns with the drafting of the provisions and they have outlined their concerns in detail in their submissions. CA ANZ has provided only high level comments on the issues.

Should you wish to discuss this submission, please contact Karen Liew on 02 80785483 or at karen.liew@charteredaccountantsanz.com in the first instance.

Yours faithfully

Simon Grant FCA
Group Executive – Advocacy and International Development

Appendix A

Thin capitalisation comments

Tax EBITDA

Trust excess tax EBITDA

CA ANZ welcomes the amendments made to the tax EBITDA calculation which better accommodates funding of economic activity where there is a multi-level group structure.

We also welcome the decision to allow eligible unit trusts and managed investment trusts (MITs) to transfer their excess tax EBITDA amounts to other eligible unit trusts and MITs. However, we are concerned with the level of control the transferee trust (head trust) must hold in the transferor trust (subsidiary trust) to be eligible to include the trust's excess tax EBITDA. The head trust is required to hold a TC direct control interest of 50% or more in the subsidiary trust to be eligible (section 820-60(2)(a) of the ITAA 1997). Thus, a high level of control is required for excess tax EBITDA of a subsidiary trust to be utilised by a head trust.

In contrast, the minimum percentage of TC control interest is 10% or more in a subsidiary trust for the purpose of having the trust distribution being disregarded from tax EBITDA calculation of the head trust. This means that there is a much lower control threshold for the head trust to disregard a trust distribution from the subsidiary trust in the tax EBITDA calculation of the head trust, thus making it harder to access debt deduction deductions.

To be more equitable, members have suggested that the TC control interest thresholds be aligned. This could be achieved by changing section 820-60(2)(a) from 50% to 10% and allowing the ownership percentage of the excess tax EBITDA to be utilised.

CA ANZ also queries why only trust structures can share their excess Tax EBITDA. The ability to share excess capacity should be indifferent to the type of legal structure that is used.

Prior year revenue and capital losses in the calculation of taxable income

Broadly, section 820-52(1A) provides that in working out the taxable income or tax loss of a corporate tax entity for an income year for the purposes of section 820-52(1), it is assumed that the entity chooses to deduct all entity's prior years' tax losses. CA ANZ queries whether it is appropriate to deduct prior year losses in the Tax EBITDA calculation.

The objective of the amendments is to implement the OECD's best practice guidance[1] so that an entity's debt deductions are limited to a percentage of the entity's EBITDA for an income year. The OECD best practice approach "ensures that an entity's interest deductions are directly linked to the taxable income generated by its economic activities"[2] which is a more robust approach to address base erosion and profit shifting.

However, the inclusion of prior year losses in the Tax EBITDA calculation deviates from the objective as the prior year losses have been incurred in a different time period that is not reflective of the taxable income derived from an entity's economic activity for that income year. There is also a potential circularity as the prior year's tax loss utilised by an entity can be impacted by the denial of the debt deduction under the fixed ratio test.

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[1] OECD/G20 Base Erosion and Profit Shifting Project: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update
[2] Ibid, page 14

Third party debt test

Prohibition on recourse to guarantee, security and credit support rights

We understand from our members that the exclusion of recourse to assets that are rights under a guarantee, security or other credit support remains a practical problem for entities to be able to access the third party debt test (section 820-427A(3)(ca)) as it makes no distinction between an Australian provider or foreign provider of the guarantee, security or credit support. We recommend that the prohibition of a right under a guarantee, security or other credit support be limited to foreign providers.

From a practical perspective, we recommend that the recourse to only Australian assets should include a de minimis for non-Australian assets. We understand from our members that Australian multinational groups may have difficulty accessing the third party debt test. If one of their entities has granted security over all of its assets, if the entity has limited foreign assets (e.g., a foreign bank account which has been set up to deal with foreign suppliers), the group may be precluded from accessing the third party debt test. Accordingly, a de minimis for foreign assets will ensure entities are not adversely impacted by nominal assets that may arise from time-to-time.

The prohibition of guarantees, security and other credit support is also a condition to access the conduit financing exception to the third party debt test conditions. Accordingly, practical access to the conduit financing exception is also impacted by the prohibition.

Issue with cross-stapled arrangements

We also understand from members that property developers may not be able to apply the third-party debt test due to the deeming of cross-stapled entities as associate entities. There is also a concern that the definition of cross-staple arrangement may capture privately owned group arrangements.

Debt deduction limitation rules for debt deduction creation

Application date and retrospectivity

CA ANZ welcomes the introduction of transitional rules (item 142) which provide entities a one-year grace period for the debt deductions that relate to financial arrangements entered into before 22 June 2023.

However, the debt deduction creation rules will still be retrospective as these financial arrangements will be caught by the debt deduction creation rules from 1 July 2024. Maintaining the retrospectivity of these rules will impose a significant compliance burden on entities to review their historical transactions to see what may be caught by the new rules. Some transactions may be so old there are no longer any records in existence and some transactions may pre-date the current owners of the entity.

Should the retrospectivity of the rules be maintained, to ease the compliance burden of first applying these rules, we recommend that Subdivision EAA only apply to financial arrangements entered into from 22 June or 1 July 2018. That is, entities should only go far back as the record keeping retention rules require for tax purposes.

Nonetheless, during the Senate inquiry hearing into the Bill,[3] Treasury and ATO explained the rationale for introducing the debt deduction creation rules was essentially to prevent taxpayers exploiting the variance in tax EBITDA to gear up with related party debt. As this risk is a prospective risk, we recommend that the debt deduction creation rules apply prospectively only.

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[3] Public hearing on 15 August 2023 for the Senate Economics Legislation Committee inquiry into the Bill

Exclusion of certain entities

Subdivision EAA should have a similar carveout for predominately Australian groups as section 820-37 under the thin capitalisation provisions. For example, where a wholly Australian group decides to expand offshore and establishes a new company offshore which is dormant for a while, it seems overly burdensome that the Australian group is required to apply Subdivision EAA without some de minimis rule.

Exclusions for the acquisition of certain CGT assets

CA ANZ welcomes the exclusions for the acquisition of certain CGT assets:

- Newly issued membership interests in an Australian entity or foreign company
- "New" depreciating assets (other than intangibles)
- On-lending arrangements.

However, the exclusions do not go far enough to exclude normal related party commercial transactions from being captured and we recommend that the additional exclusions under former Division 16G (former 159ZZF) be included. That is:

- Trading stock
- New assets other than tangible depreciating assets
- The Commissioner's power to exclude the acquisition of assets which do not result in:
    - an increase in the debt owed by the group constituted by the affected taxpayer and the seller; or
    - An increase in the ability of the seller or their associates to make payments which are not dividends that were assessable income or liable to dividend withholding tax to a foreign controller of the seller (or associate of the foreign controller).

Exception for certain payments or distributions

On-lending exception

Broadly, section 820-423A(5A) provides an exception for a payment that is entirely referable to mere on-lending to Australian associate where the on-lending is on the same terms to the extent those terms relate to costs, i.e. back-to-back. We recommend that back-to-back requirement be removed or modified on the basis it is impractical for all on-lending arrangements down the chain to be on the exact same terms in relation to costs.

There are a number of modifications in respect of the "same terms" requirements in the conduit financing rules (i.e. s820-427C(2)). These modifications should be mirrored in any 'back to back' requirement in the debt deduction creation rules otherwise the modifications to the "same terms" requirement for conduit financing will be pointless from a practical perspective.

Exception for repayment of principal

Broadly, section 820-423(5B) provides an exception for the repayment of principal under a debt interest as long as the repayment of principal is not a means of refinancing a financial arrangement to avoid the application of the debt deduction creation rules.

To address the refinancing of captured arrangements, section 820-423(5B) contains the requirement that paragraphs (5)(a), (b) and (c) are not satisfied in relation to the debt interest (disregarding subsection (5A) (on-lending exception)). However, it appears that all related party loans could satisfy these paragraphs rendering this exception redundant. We recommend that the drafting of this section be reconsidered.

Restructures during the transitional period and the anti-avoidance rule

The new section 820-423D is the specific anti-avoidance rule to ensure that debt deduction creation rules cannot be avoided. If the Commissioner is satisfied that a principal purpose of a scheme was to avoid the application of the rules in relation to a debt deduction, then the Commissioner may determine that the rules apply to that debt deduction.

During the transitional period, some entities with existing debt arrangements would want to restructure their debt arrangements to comply with the new debt deduction creation rules. However, it appears that any refinanced debt arrangement could fall foul of the section 820-423D anti-avoidance rule as it is a new financial arrangement entered into after 22 June 2023 and section 820-423D captures a scheme where the principal purpose was to avoid the application of the debt deduction creation rules.

Further clarification is required in the legislation to confirm that any refinancing arrangements during the transitional period should not be captured by section 820-423D.