KPMG

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

KPMG submission

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Executive summary

As a leading professional services firm, KPMG Australia (**KPMG**) is committed to meeting the requirements of all our stakeholders – not only the organisations we audit and advise, but also employees, governments, regulators and the wider community. We welcome the opportunity to provide a submission on the exposure draft parliamentary amendments (**the ED**) to *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023* (**the Bill**) released by Treasury on 18 October 2023.

Good progress has been made on the latest exposure draft to incorporate points raised in previous submissions, however there remain some changes required to ensure that the new interest limitation rules operate as intended.

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

While we welcome the changes made to the debt deduction creation rule, this rule remains overly broad in its application when compared to the policy intention as set out in the Explanatory Memorandum. Without a further narrowing of these rules, many related party funding arrangements used in the ordinary course of business, and which are genuine and commercially justifiable, will be adversely impacted. In addition, the debt deduction creation rule should be updated to grandfather existing arrangements.

Our submission also makes a number of other recommendations in relation to the new interest limitation tests, in order to ensure that taxpayers are not precluded from reasonable debt deductions.

Yours sincerely,

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Background

About KPMG

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

KPMG International Tax practice

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

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

KPMG has also contributed to and adopted the *Australian Tax advisory firm governance, best practice principles* which aim to enhance public understanding of the large advisory firms and further build community confidence and trust in the taxation system. The principles have been developed in consultation with the Australian Tax Office, the Tax Practitioners Board and the largest tax advisory firms.

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Section 1: KPMG recommendations

RECOMMENDATION 1:

Debt arrangements in place before 22 June 2023 should be grandfathered under the debt deduction creation rules (**DDCR**), given these arrangements were put in place at a time before this measure was announced. There will be a high compliance burden and cost associated with undertaking the tracing and apportionment required in respect of existing debt, with limited information potentially available, and the 12 month deferral will therefore be inadequate to address this for many groups.

Further, given that there are a number of policy and technical issues with the DDCR which still need to be worked through, we recommend the DDCR provisions are removed from the current Bill and introduced in a separate Bill. This could provide more time for consultation on the DDCR, without holding up the rest of the interest limitation rules.

RECOMMENDATION 2:

Fully domestic transactions remain within the scope of the DDCR. That is, funding from an Australian parent to a non-tax consolidated Australian subsidiary/joint venture will be within scope even where the debt deductions are not referable to funding involving a foreign related party and the relevant transactions are purely domestic (e.g. interest income assessable). Such transactions present no BEPS risk and should be excluded from the operation of the rules.

RECOMMENDATION 3:

A principal purpose test should be included in the DDCR to align with the policy rationale outlined in the explanatory memorandum of the rules only seeking to disallow debt deduction to the extent they are incurred in schemes that "*lack genuine commercial justification*".

RECOMMENDATION 4:

If no purpose test is included, there are likely to be a range of circumstances where the DDCR has unintended application. To provide a pathway for taxpayers to obtain relief where the application of these rules results in an unreasonable outcome, the Commissioner of Taxation should be provided with the ability to exercise discretion to determine that debt deductions are not denied under the DDCR.

RECOMMENDATION 5:

The trust excess tax EBITDA amount mechanism should be extended to all entities. As such, the rule should be extended to companies and partnerships, including circumstances where the holding entity and controlled entities are different types of entities.

The threshold to determine "control" of an entity (50 percent or more) should be reduced to align with the threshold for excluding associate entity distributions (10 percent or more).

The trust excess tax EBITDA amount mechanism should also be extended to apply to the calculation of tax EBITDA in the group ratio test in the same way that it applies to the fixed ratio test.

RECOMMENDATION 6:

The phrase "Australian assets" in the third party debt test is a critical concept and hence should be defined in the legislation (rather than the explanatory memorandum). In doing so, the definition should be expanded to confirm that an entity's debt and equity interests (e.g., shares) in its foreign subsidiaries should be Australian assets of the entity.

RECOMMENDATION 7:

The exceptions in the conduit financier rule to allow certain costs to be recovered by the conduit financier should be extended to payments the conduit financier makes to the borrower where a swap is in the money. We therefore recommend the rules disregard terms that provide for the passing on of benefits directly associated with hedging or managing the interest rate risk in respect of the ultimate debt interest.

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RECOMMENDATION 8:

In relation to the definitions of "debt deduction" and "net debt deduction", the treatment of foreign exchange gains and losses should be clarified, particularly given the OECD's best practice guidelines generally include these amounts in the interest limitation rules.

There is also an existing drafting error in the debt deduction definition with respect to leases that should be corrected as it creates uncertainty and complexity in relation to the treatment of leases

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Section 2: KPMG insights

Response to consultation

Debt deduction creation rule (DDCR)

We welcome the changes made to the DDCR, and in particular the limitation of the rule to related party debt and the exclusion of ADIs and securitisation entities. However, the rule remains overly broad in its application when compared to the policy intention as set out in the Explanatory Memorandum to the Bill (**EM**). Our comments are outlined below.

Transitional period and start date

The one-year deferral of the commencement of the DDCR for arrangements entered into prior to 22 June 2023 is welcomed and will provide some 'breathing room' to taxpayers in respect of pre-existing arrangements. However, given the rules continue to apply retrospectively irrespective of when the arrangement that gave rise to the debt deductions was entered into, the DDCR still presents great complexity and uncertainty for many taxpayers.

The complicated tracing and apportionment exercises highlighted in our prior submission regarding the previously proposed changes to section 25-90 equally apply here. The DDCR will require a tracing of the use to which existing debt was put in order to identify whether the rule has application, potentially back over a substantial period of time when there was no awareness of the rules, increasing the compliance burden and costs for taxpayers. The exercise may also be ineffective if information is unavailable, including where taxpayers have not needed to maintain records for this purpose.

It is worth noting that this measure impacts many smaller taxpayers who present relatively lower levels of risk, given the policy decision not to increase the $2 million de minimis threshold which has been in place since 2014 (particularly given the current interest rate environment).

As a balanced and reasonable approach, we recommend the DDCR apply on a prospective basis only to new arrangements entered into from 22 June 2023.

Whether prospective or retrospective, complying with the law will be quite challenging for many groups (and we expect that administering this rule will present similar difficulties). Hence, the ATO should provide comprehensive guidance as a priority as to how to practically undertake this exercise.

Given that there are a number of policy and technical issues with the DDCR which still need to be worked through, we recommend the DDCR provisions are removed from the current Bill and introduced in a separate Bill. This could provide more time for consultation on the DDCR, without holding up the rest of the interest limitation rules, given taxpayers are already four months into the start of the new rules without final legislation.

Genuine commercial justification test

The EM states that the DDCR seeks to disallow debt deductions to the extent they are incurred in schemes that "*lack genuine commercial justification*".

However, the breadth of the DDCR together with the restricted exceptions available means that many arrangements with no base erosion and profit shifting (**BEPS**) motive, which are not artificial, are nevertheless caught by these rules.

In order to better align with the policy rationale in the EM, the DDCR should be updated so arrangements that are not carried out for a principal purpose of enabling a tax benefit are not subject to the DDCR. The risks arising under these arrangements are already adequately addressed by the other interest limitation rules (including transfer pricing).

Commissioner's discretion

If no purpose test is included, there are likely to be a range of scenarios in which the DDCR has unintended application that cannot be addressed via minor amendments to the exceptions.

Accordingly, the Commissioner of Taxation (**Commissioner**) should be provided with the ability to exercise discretion to determine that

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there is no denial of deductions under the DDCR. This would provide a pathway for taxpayers to obtain relief where the application of the DDCR would result in an unreasonable outcome.

The ATO should also prioritise the publication of guidance on how this discretion should be exercised.

In scope debt deductions

As noted above, the limitation of the DDCR to related party debt is welcomed. However, fully domestic transactions remain within scope based on the current drafting. That is, funding from an Australian parent to a non-tax consolidated Australian subsidiary/joint venture will be within scope of the DDCR even though the debt deductions are not referable to funding involving a foreign related party and the relevant transactions are purely domestic (e.g. interest income assessable). Such transactions present no BEPS risk and should be excluded from the operation of the rules.

The DDCR would seem to have unintended consequences in relation to cash pooling and other 'revolving' working capital arrangements. For example, a taxpayer that has a cash pooling arrangement in place that is usually in a positive position such that interest income is received, will potentially be denied interest deductions under the DDCR whenever that balance is negative. This is notwithstanding that over the course of the income year the interest income exceeds the interest expense and indeed the taxpayer does not have a net debt deduction position. It would seem inappropriate for such arrangements to be within scope and as such the DDCR should only apply to cash pooling and other revolving arrangements where they result in a net debt deduction for the income year. In such cases the application of the DDCR should be limited to the net debt deduction amount.

The DDCR would also seem to capture arrangements where related party funding has been provided by factoring (acquisition of customer receivables), where the disposer of the receivable claims a deduction for the discount on the receivable.

Acquisition of assets (first limb test)

We acknowledge the need to draft the DDCR with sufficient breadth to prevent the artificial creation of new debt without commercial justification. However, we recommend that further appropriate carve-outs be incorporated to ensure genuine ordinary business activity involving the use of debt is not unfairly restricted.

In relation to first limb, the following commercially driven transactions and restructures should be allowable (also broadly consistent with the former Division 16G exclusions):

- The acquisition of assets from associates that occur in the ordinary course of business. The exemption would ensure that asset acquisitions are not caught provided they are within the ordinary course of a business – the level of gearing in these cases should just be subject to the normal interest limitation rules.
- As an alternative to the above exception, the acquisition of trading stock from an associate (e.g., acquisitions of stock by an Australian limited risk distributor from a related party foreign manufacturer). It is not apparent from the Exposure Draft Supplementary Explanatory Memorandum (**Supplementary EM**) why a distinction is made between the acquisition of certain depreciable assets and trading stock.
- Acquisition of assets from an associate as part of a restructure, where the restructure does not result in an increase in the overall indebtedness of the Australian associate inclusive group. If is intended that these arrangements are subject to the DDCR, the Supplementary EM should be updated to explain the mischief that the rules address.

The drafting of the depreciating asset exception should be clarified. The heading of the subsection and the Supplementary EM state that the asset must be "*new*". Where a depreciating asset has not previously had any tax nexus with Australia, the acquisition of the asset should satisfy this exception. This is consistent with the scope of the exception in the former Division 16G. The drafting of subsection 820-423AA(2)(d) is not clear on this point, and hence we suggest it reads as follows: "*the CGT asset has not been *installed ready for use, or previously used, for a taxable purpose*…", with consequential changes to the heading and Supplementary EM.

Payments or distributions (second limb test)

The drafting of the second limb remains very broad. While we understand this is intentional, it

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is still not evident what arrangements this test is specifically intending to target. In particular:

- It is unclear from the drafting of the amendments and the EM whether it is intended that the second limb applies to payments generally, or only those within the meaning of section 26BC. The EM states that "*The payments or distributions referred to in the second case take the same meaning as in section 26BC of the ITAA 1936…*" which suggests "*payments*" is to take its meaning from section 26BC. However, section 26BC defines distributions but does not explicitly define payments. Whether this is an error in the EM, or the definition of payments should in fact be limited by section 26BC, should be clarified.

- The section 26BC definition of distribution includes interest. Hence, where i) a borrower makes an interest payment to the lender using a portion of the loan proceeds or ii) interest capitalises on the loan, debt deductions will be denied. This means that this test effectively captures all loans between associates. Again, the policy intention here is not clear – for example, this appears to be somewhat inconsistent with the exception provided for the repayment of principal to Australian lenders. In addition, the Supplementary EM states in relation to a first limb exception that "*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)".* The basis for excluding mere related party lending from the first limb but not the second limb should be reconciled.

- The phrase "*increase the ability of any entity…to make…payments or distributions*" is vague, and hence we recommend that the connection between the loan and the payment/distribution be more precise. Each of the following propositions is equally arguable:

  - All additional funds received under a loan arrangement will increase the ability of the taxpayer to make a distribution because they provide an additional cash balance (either directly or indirectly) from which the distribution can be made.

  - Additional funds received under a loan arrangement do not increase a taxpayer's capacity to make a distribution because the additional funds come with a liability to repay those funds and therefore capacity is not increased.

    For example, where a taxpayer obtains related party funding and uses the proceeds to pay (third party) working capital expenses, the taxpayer has effectively 'freed-up' its revenues which can accumulate and ultimately be used to fund dividends to an associate. Is the policy intention for this arrangement to be caught by the second limb test?

- The broadness of this phrase also opens up questions with regards to timing. For example, if related party funding was received many years ago, does this funding need to be considered when making all future distributions because it theoretically may have "freed-up" revenues for distributions to be made in much later years. If so, many groups will likely face significant difficulty in applying these rules as documentation in relation to historic funding may not have been kept as there was no requirement to do so.

- While the EM states that a payment or distribution includes a return of capital, a return of capital is not explicitly included in section 26BC definition of distribution. We suggest the legislation is updated to clarify this.

- Where a taxpayer makes payments or distributions to multiple recipients that are not all associate pairs of the taxpayer, but the other elements of subsection 820-423A(5) are otherwise satisfied, the amount of debt deductions denied should be limited to the amount of borrowings that are used to fund the payment or distribution to the associate pair(s). However, it is unclear whether this is the outcome under subsections 820-423A(5) and 820-423B(2).

  For example, where A Co borrows $100 from an associate pair, and A Co uses the funds to return capital to its shareholders as follows: Shareholder 1: $51 (an associate pair); Shareholder 2: $9; Shareholder 3: $10; Shareholder 4: $10; Shareholder 5: $10; Shareholder 6: $10 (Shareholders 2 – 6 are not associate pairs). All the conditions in subsection 820-423A(5) are satisfied in relation to the payment or distribution to Shareholder 1, but it is unclear whether all the conditions in subsection 820-423A(5) are satisfied in relation to the payment or

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distribution to Shareholders 2 – 6 . The ambiguity appears to result primarily from paragraph 820-423A(5)(c) in particular – that is, it is unclear whether:

- $100 of the loan proceeds may be said to meet the condition because, when examining all the distributions made by A Co to its shareholders, *one or more* recipient is an associate pair; or
- $51 of the loan proceeds may be said to meet the condition because, only one recipient in this example is an *associate recipient*.

Subsection 820-423B(2) then deals with the amount of the debt deduction disallowed, which appears to link this to the $100 loan proceeds or use of the proceeds, which is not constrained by whether the recipient is an associate pair or not. In conjunction with a reading of subsection 820-423A(5) which does not apportion loan borrowings to the extent of payments to associate recipients, the total amount of debt deductions referable to the $100 loan would be denied, despite only $51 being a payment to an associate pair.

In addition, consistent with our comments regarding the first limb, the second limb should include a carve-out for arrangements involving the purchase of assets (or as an alternative, this exception could be limited to depreciable assets and trading stock) and services from associates that occur in the ordinary course of business. The exemptions would ensure these transactions are not caught provided they are within the ordinary course of a business – the level of gearing in these cases should just be subject to the normal interest limitation rules.

The exception in subsection 820-423(5A) needs refinement. In this regard:

- Should subsection 820-423(5A)(a) read as follows: *"the ~~recipient~~ payer has issued a debt interest to the ~~payer~~ recipient;*"?
- It is not clear whether this exception is only for on-lending / back-to-back loans or applies more broadly. The Supplementary EM indicates the former (at para. 1.42). However, the drafting of subsection 820-423(5A) can be read to suggest the exception may be met by only satisfying the conditions in (a), (b) and (c) of that provision (i.e. not (d)), which would mean that lending from an Australian entity is acceptable.
- Assuming the intention is to limit this exception to on-lending, it is reasonable to update subsection 820-423(5A)(d) so that there is a mirroring with the on-lending conditions in the conduit financier rules (i.e. subsection 820-427C(2)). This would allow the conduit financier arrangements to remain effective.

Similarly, the second exception needs refinement. In subsection 820-423(5B). there is a requirement that subsections 820-423A(5)(a), (b) and (c) do not apply. However, it appears that all related party loans could satisfy these conditions, and so it is not clear how this exception could apply in practice. We recommend that the drafting of this section be reconsidered.

90 percent Australian assets exception

The DDCR now excludes entities that satisfy sections 820-35 (de minimis) and 820-39 (certain special purpose entities). However, this exclusion has not been extended to entities which are excluded from the thin capitalisation rules because they satisfy the 90 percent Australian assets exception in section 820-37. We see no policy basis for this difference in treatment, and hence recommend that subsection 820-37(1) be updated to include Subdivision 820-EAA.

DDCR anti-avoidance rule

It is expected that taxpayers will seek to restructure existing debt during the transitional period. Clarification should be provided to allow taxpayers to undertake refinancing in certain circumstances where there should be no application of section 820-423D.

In addition, the ATO should prioritise guidance in relation to section 820-423D. This should take the form of a practical compliance guidance which provides examples of schemes which the Commissioner would consider to be 'low risk' and to which the Commissioner would not seek to apply section 820-423D.[1]

[1] A relevant example is PCG 2018/7 which relates to the application of Part IVA to restructures of hybrid mismatch arrangements.

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Fixed ratio test (FRT)

Trust excess tax EBITDA amount

We welcome the inclusion of an excess capacity rule for trusts. Our previous submissions have highlighted the need for the ability to pass capacity between non-tax consolidated taxpayers. The ability to share capacity in similar circumstances should be extended to companies and partnerships, including circumstances where the holding entity and controlled entities are different types of entities (e.g. holding company with controlled trust).

Where the excess tax EBITDA rule is limited to trusts as currently drafted, it should be extended to allow all non-trust unitholders/beneficiaries to access a trust's excess tax EBITDA amount. This would mean a holding company of a controlled trust can access the excess tax EBITDA amount of the trust.

The threshold of the "*TC direct control interest of 50 percent or more*" test should be reduced given the modified definition of associate entity in the context of the treatment of distributions under the tax EBITDA calculation. As currently drafted, where an interest is between 10 percent and 50 percent, any distributions must be excluded but no excess capacity is available which gives rise to an inconsistent outcome. We consider that the threshold for excluding associate entity distributions should align with the threshold to include excess capacity. Hence, the threshold should be 10 percent or more.

The transfer is based on the number of days a 50 percent or greater interest was held (step 2 of method statement in subsection 820-60(3). A proportion based on the share of net income of the trust (or determined trust components of an AMIT) is more reflective of an earnings based model.

Tax losses

Where a taxpayer has carried forward tax losses, we understand the intention in working out the taxable income or tax loss is that it should be assumed that the maximum possible amount of tax losses is deducted.

However, subsection 820-52(1A) (and the Supplementary EM) is somewhat ambiguous as it references a choice to deduct "*<u>all of the entity's tax losses</u> for loss years occurring before the income year*" [emphasis added]. For clarity, this should be updated to confirm that the relevant amount is the maximum amount of carried forward tax losses that could be deducted in the current year (rather than the total carried forward amount). We understand this to be consistent with the intended outcome.

Dividends

Subsection 820-52(3) now disregards certain dividends or non-share dividends. However, we consider there to be a drafting error as the subsection references the "shareholder" of a company, and the recipient of a non-share dividend is not a shareholder. This should be updated to reference the entity holding an equity interest in the company.

Group ratio test (GRT)

It is reasonable for the excess tax EBITDA rule in the FRT (section 820-60) to be mirrored in the GRT, such that a taxpayer can access a controlled entity's excess group ratio earnings limit. The rationale for the sharing of excess capacity in the FRT is equally applicable to the GRT.

Third party debt test (TPDT)

Recourse to assets

Consistent with our prior submission, we consider the recourse conditions to be too restrictive such that many taxpayers with genuine third party debt cannot rely on this test. Noting the policy intention to limit recourse to Australian assets and generally prohibit credit support rights, we provide the recommendations below.

<u>Australian assets</u>

The phrase "*Australian assets*" in subsection 820-427A(3)(c) is a critical concept and hence should be defined in the legislation (rather than the EM).

The definition should also be expanded to clarify whether debt and equity interests (e.g., shares) in foreign subsidiaries can be Australian assets of an entity. In this regard, where the holder of the debt interest has recourse to an Australian borrower's assets which include the shares of the borrower's foreign subsidiary, this should not cause a failure of the TPDT. The EM states that assets attributable to the offshore commercial activities of an entity are not Australian assets

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(at para. 2.98) but we consider this should not include debt and equity interests in an entity.

We also recommend that the recourse to only Australian assets include a de minimis for non-Australian assets. This would allow certain Australian outbound groups to access the TPDT without being adversely impacted by nominal foreign assets (e.g. foreign bank account).

Credit support rights

We recommend the exclusion of a right under a guarantee, security or other credit support be limited to foreign providers, so that credit support from an Australian provider is allowable under the TPDT conditions (e.g. cross collateralisation arrangements provided within the Australian obligor group).

In addition, the allowance in subsection 820-427A(4)(d) for recourse to credit support rights that wholly relate to the creation or development of land or other real property should be considered in the context of build-to-rent (**BTR**) projects, given the Federal Government is seeking to encourage BTR investment including through the proposed introduction of incentive measures. Banks can require credit support to continue during the lease-up period, however the EM states that the exception does not apply to credit support rights that support business activities beyond the creation or development of the relevant real property.

Use of proceeds of debt

Subsection 820-427A(3)(d) requires that the entity uses all, or substantially all, of the proceeds of issuing the debt interest to fund its commercial activities in connection with Australia. This is a challenging condition for taxpayers with outbound operations or investments, and hence further examples should be provided in the EM. A simple example is using the proceeds of third-party debt to repay debt from a foreign associate. In this scenario it would be helpful to clarify that the “use” of the proceeds in subsection 820-427A(3)(d) takes its character from any existing debt that is refinanced (i.e. where proceeds from the existing foreign-associate debt was used to fund commercial activities in connection with Australia).

The ATO should also prioritise guidance to assist outbound groups determine when debt is used to fund Australian commercial activities.

There is an exclusion to subsection 820-427A(3)(d) whereby the condition cannot be satisfied where the proceeds fund the holding of any associate entity debt (subsection 820-427A(3)(d)(ii)). This restricts the ability for a borrower to satisfy the TPDT merely because it on-lends borrowed funds to a related Australian entity. It is not apparent from the EM why the holding of a loan with an Australian associate does not form part of the entity's commercial activities in connection in Australia.

Cross-stapled entities

Entities that are part of a cross-staple arrangement are deemed to be associate entities (section 820427D). This can create practical difficulties for cross-stapled entities in the property sector to access the TDPT. For example, where there is a cross-stapled loan, and one side of the staple obtains bank financing, it cannot access this test as the cross-stapled loan does not satisfy the TDPT / conduit financing exception. To address this, the deemed choice for entities that have entered into cross-staple arrangements should be removed unless the entities are members of an obligor group.

Conduit financing exception

The changes in subsection 820-427C(2) to allow certain costs to be recovered by the conduit financier when assessing whether conduit financing is on the same terms are helpful. It is reasonable to extend this to payments the conduit financier makes to the borrower where a swap is in the money. As such, we recommend that the rules disregard terms that provide for the passing on of benefits directly associated with hedging or managing the interest rate risk in respect of the ultimate debt interest.

Definition of obligor group

Subsection 820-49(3) should be extended to disregard assets that are membership interests of any member of the obligor group. Lenders can take security over membership interests in entities other than the direct borrower, and so the rule should operate to disregard all entities which merely hold membership interests in any member of the obligor group.

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Definition of 'debt deduction'

Foreign exchange (FX) losses

The treatment of FX gains and losses in the debt deduction and net debt deduction definitions should be clarified. In this regard, the OECD[2] states that the best practice rule should apply to amounts which include "*certain foreign exchange gains and losses on borrowings and instruments connected with raising finance".* As such, whether or not the Australian position aligns with the OECD best practice approach should be made explicit, including in the EM.

In relation to FX losses, the debt deduction exclusion in 820-40(3)(b) only relates to the part of the definition in subsection 820-40(1)(a)(ii). This means that if an FX loss could also be covered by the other parts of the debt deduction definition in subsections 820-40(1)(a)(i) (because it is an amount economically equivalent to interest) or 820-40(1)(a)(iii) (because it is incurred in obtaining or maintain the financial benefits received under a debt interest) then the exclusion would not apply.

A relevant example of where an FX loss could potentially be equivalent to interest is a borrowing in a low interest rate foreign currency. In theory, the cost of borrowing in a relatively lower interest rate foreign currency together with the cost of the associated FX exposure on repayment in foreign currency should be equivalent to the cost of borrowing in AUD (with a relatively higher interest rate).

Leases

There is an existing drafting error in section 820-40 with respect to leases that should be corrected. The costs associated with arrangements treated as notional loans for tax purposes are expressly brought within the scope of subsection 820-40(1)(a) by subsection 820-40(2)(d). At the same time, subsection 820-40(3) contains the following exclusion:

> "*(3) To avoid doubt, the following amounts that are incurred by an entity <u>in relation to a * debt interest</u> issued by the entity are not covered by paragraph (1)(a):*
>
> *…*
>
> *(d) rental expenses for a lease if the lease <u>is not a debt interest</u>;*" [emphasis added]

It is not clear how rental expenses for a lease that is not a debt interest can be costs incurred in relation to a debt interest. The original purpose of the "*not a debt interest*" requirement in the exclusion is not apparent, given there was (until now) a threshold requirement that the arrangement be a debt interest in order for there to be a debt deduction.

Given the threshold requirement that the arrangement be a debt interest is now removed (in subsection 820-40(1)), there is uncertainty and complexity in relation to the treatment of leases which depends on whether they satisfy the debt test. As such, we recommend the debt deduction definition be updated to reflect the following treatment:

- Arrangements that are treated as notional loans for income tax purposes (e.g. hire purchase arrangements) should result in debt deductions; and
- Other rental or lease arrangements that are not treated as notional loans for income tax purposes (e.g. ordinary real property leases) should not give rise to debt deductions.

Choices

The ATO should provide guidance in relation to the matters that will be taken into account in determining whether a choice revocation is "*fair and reasonable*", noting limited guidance has been provided in the EM / Supplementary EM.

Minor drafting errors

For completeness, we suggest the following minor edits:

- To make it easier for the reader to follow, we suggest consistency in drafting in relation to the exceptions to both limbs of the DDCR test. Exceptions to subsection 820-423A(2) are separately included in section 820-423AA, whereas the exceptions to subsection 820-423A(5) and included in

[2] OECD (2017), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris

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subsections 820-423A(5A) and 820-423A(5B).

- Subsection 705-112(3) is now a duplication of subsection 705-102(3) and should be removed.

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