Law Council
OF AUSTRALIA
Business Law Section

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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

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 supplementary explanatory memorandum (**Supplementary EM**) on proposed changes to Australia's thin capitalisation rules in Division 820 of the *Income Tax Assessment Act 1997*.[1]

The Committee makes the comments on the following aspects of the Exposure Draft and Supplementary EM:

1. extreme retrospectivity;
2. uncertainty;
3. commencement date;
4. definition of Australian entity in relation to partnerships;
5. inconsistent treatment of ownership interests;
6. debt deduction creation rules;
7. definition of debt deduction; and
8. form of amendments.

Detailed comments—policy issues

Extreme retrospectivity

The 'debt deduction creation rules' will apply to all debts, whenever they were entered into.

This extreme retrospectivity is already causing concern among taxpayers who are trying to trace the origins of debt entered into many years ago in reliance upon the tax laws that were place at the time the debts were entered into.

[1] Unless otherwise noted, all references to legislation are to the *Income Tax Assessment Act 1997*

The following are some simple examples of how the retrospective operation of the law gives rise to inappropriate results for taxpayers:

> ***Example 1:***
>
> *An Australian resident entity borrowed from a related Australian resident finance company in 2010 in order to acquire a building from a third related Australian resident entity.*
>
> *The Australian resident borrower does not have sufficient available cash to repay the loan before 30 June 2024.*
>
> *There is no net loss to revenue from the arrangement because the borrowing gives rise to both interest deductions and assessable interest income in Australia.*
>
> *The debt creation rules will apply to deny interest deductions claimed by the borrower in respect of the outstanding loan from 1 July 2024.*
>
> *This will also be the case if the ownership of the Australian resident borrower has changed such that the lender is no longer a related party of the borrower.*
>
> ***Example 2:***
>
> *Non-resident parent lends funds to an Australian resident subsidiary to be used as part of the subsidiary's general working capital (**'good' debt**) in 2010.*
>
> *The global group grows and is able to obtain global financing at cheaper rates and refinances its loans to all global subsidiaries in 2015 with the effect of reducing interest payable by the Australian borrower to the non-resident parent.*
>
> *The simple act of refinancing in 2015 turned 'good' debt into 'bad' debt under section 820–423A(5B). Had the loan terms been amended instead, the debt would still be 'good' debt.*
>
> *There can be no policy reason for why simple refinancing turns 'good' debt into 'bad' debt. However, because the group made the decision to refinance, rather than amend the terms, with the effect of reducing interest payable by the Australian borrower, the debt deduction creation rules will apply to deny deductions on the debt owed by the Australian subsidiary.*

In addition, taxpayers may not have business records to reconstruct what happened when loan agreements were entered into. It is not clear what the Australian Taxation Office (**ATO**) intends to do in circumstances where taxpayers have not kept relevant records because they did not know they had to keep such records at the time.

The retrospective effect of the legislation is contrary to Treasury's own express policy.[2]

In the interests of taxpayers having faith that they can undertake their business activities in compliance with the current tax laws without future penalty, and minimising their burgeoning compliance costs in trying to trace and analysing old debts, the debt creation rules should only apply to debts entered into, or existing debts the terms of which are materially amended, from 1 July 2024.

Uncertainty

The third-party debt test which applies from 1 July 2023 is intended to replace the arm's length debt test for both general class investors and financial entities. Authorised deposit-taking institutions (**ADIs**) can still access the existing arm's length debt test.

Borrowers that currently rely on the arm's length debt test for existing debts may not comply with the third-party debt test. Such borrowers may need to, for example, negotiate with lenders to change security arrangements to comply with the third-party debt test. It is

[2] Treasury, Report on Aspects of Income Tax Self Assessment (August 2004)

not clear whether the ATO would apply the general anti-avoidance provisions in such circumstances.

We understand that the ATO may issue a Practical Compliance Guideline explaining which types of restructuring the ATO considers low risk in a similar vein to Practical Compliance Guideline PCG 2018/7 (Part IVA of the *Income Tax Assessment Act 1936* and restructures of hybrid mismatch arrangements). We submit that it is not appropriate for the new thin capitalisation rules to take effect prior to such guidance being provided by the Commissioner because, in the absence of such guidance, taxpayers are hamstrung in what they can do.

From a broader policy perspective, it should not be the case that taxpayers have to rely on non-binding guidance from the ATO to try to understand whether they are likely to be treated as having complied with the tax laws. It would be preferrable to rely on transitional rules that exempt certain restructures from the application of anti-avoidance rules.

It is noted that the hybrid mismatch rules were enacted with a deferred commencement date, which was intended to allow taxpayers time to review their existing hybrid arrangements and to unwind or restructure out of such arrangements in advance of the introduction of the new rules if they chose to do so.

A deferred start date would be even more appropriate for the thin capitalisation rules where taxpayers are likely to be seeking to simply change from compliance with the old arm's length debt test to compliance with the new third-party debt test: i.e. unlike the hybrid mismatch rules, there is no policy mischief to be remedied in such cases.

Commencement date

The Bill,[3] if passed in its current form, will apply to income years beginning on or after 1 July 2023. As mentioned, the application would be retrospective and there is no grandfathering for existing debt and no transitional period. Given the extensive nature of the changes to the current thin capitalisation rules contained in the Bill, including changes from the Exposure Draft, the Committee submits that the commencement date should be changed.

The absence of transitional rules or grandfathering rules could have significant negative consequences for long dated investments made on the basis of the law existing at the time of investment. The Committee also recommends that, in addition to changing the commencement date, consideration be given to transitional rules, particularly in relation to long-term debt.

Detailed comments—technical issues

Definition of Australian entity in relation to partnerships

The Committee commends Treasury on expanding the range of entities that qualify for the 'third party debt test' and the 'conduit financier exemption'. However, the Committee is not aware of any policy reason including the 'Australian entity' requirement in either test.

While we note the comments in paragraph 1.31 of the Supplementary EM that the Australian entity definition was modified "*to ensure it captures partnerships with a strong connection to Australia and does not allow anti-avoidance behaviour*", the Committee

[3] Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023 (**Bill**).

submits that this is already achieved through the requirements in the third-party debt conditions that:

1. the holder of the debt interest has recourse only to Australian assets (that are held by the entity, membership interests in the entity or held by a member of the obligor group in relation to the debt interest); and

2. the entity uses all, or substantially all, of the proceeds of issuing the debt interest to fund its commercial activities in connection with Australia, that do not include any business carried on by the entity at or through its overseas permanent establishments and the holding by the entity of any associate entity debt, controlled foreign entity debt or controlled foreign entity equity.

As such, the Committee is not aware of any need for an additional requirement that the (necessarily) Australian assets be held by an Australian entity.

If, contrary to the above, there is a need for the inclusion of an additional requirement that the Australian assets be held by an Australian entity, this requirement should be consistent between partnerships and trusts. That is, a partnership should satisfy the Australian entity definition if at least one partner is an Australian resident trust or Part X Australian resident in the same way that a trust satisfies the Australian entity definition if any trustee is a Part X Australian resident.

Absent the above change, the Committee is concerned that existing genuine debt in partnerships, relating to Australian business operations using Australian assets, may not meet the third-party debt conditions. This is inconsistent with the policy intent as set out at paragraph 2.92 of the explanatory memorandum[4] to design the third-party debt test to accommodate genuine commercial debt arrangements relating to Australian businesses.

Inconsistent treatment of ownership interests

The Committee commends the Treasury on its efforts to enhance the application of the new law to trusts, which was an area of significant concern for the property and infrastructure sectors. However, there is currently an inconsistency in the treatment of the distributions received from trusts depending on the ownership vehicle and the percentage ownership interest.

As presently drafted, entities that hold less than a 10 per cent interest in a trust are able to include distributions received in respect of those interests in the calculation of their tax EBITDA. Additionally, new section 820-60 allows unit trusts and MITs holding a direct control interest of 50 per cent or greater in other trusts to have transferred to them any ‘excess’ tax EBITDA.

While the above is a welcome addition in the context of trust structures, we make the following observations:

1. The 50 per cent threshold for excess capacity sharing for trusts should be aligned with the 10 per cent threshold for the exclusion of distributions from Tax EBITDA, otherwise the excess capacity sharing changes only partially address the issues raised in previous submissions. We do not consider there to be any policy basis to exclude distributions from Tax EBITDA in relation to trust interests between 10 and 50 per cent, or entities that may hold more than 50 per cent via direct and indirect interests.

[4] Explanatory Memorandum to the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023 (**Explanatory Memorandum**).

2. The same issue that was raised in submissions regarding trusts, which the excess capacity rule is intended to address, arise in relation to distributions from companies and partnerships. Excess capacity sharing should be available where amounts are excluded from Tax EBITDA, regardless of entity type.

4. Specifically in relation to partnerships, we note that joint venture arrangements are commonplace in the funds industry, particularly the property and infrastructure sector. The exclusion of partnerships from the excess capacity sharing provisions is likely to make such arrangements effectively unviable.

The Committee recommends that a consistent approach be adopted in respect of all entities with interests in trusts.

Debt deduction creation rules

Financial institutions/ADIs

It is not clear what the policy reason is for excluding ADIs, but not other financial institutions that have similar businesses to ADIs, from the operation of the debt deduction creation rules.

This will create a competitive disadvantage for small- to medium-sized non-bank lenders and other financial institutions which are a funding source for small- to medium-sized Australian businesses.

It is submitted that the exemption should be fairly extended to other money-lending businesses.

Debt creation rules still cover a number of ordinary transactions

As demonstrated from the example above, the debt creation rules continue to apply to a number of ordinary commercial transactions that do not give rise to any loss to revenue.

> ***Example 3:***
>
> *A fund manager procures the transfer of assets between related Australian resident funds to balance their respective portfolios and an outstanding receivable (loan to the transferor) is left in place as consideration for the transfer.*
>
> *The debt deduction creation rules will operate to deny interest deductions claimed by the purchaser trust in respect of the outstanding loan from 1 July 2024.*
>
> *This is an ordinary commercial transaction that happens all the time in the fund management industry.*

As mentioned above, the simple act of refinancing 'good' debt will turn it into 'bad' debt for the purposes of the debt deduction creation rules (unless the lender being repaid is an Australian resident third party). The Committee cannot see any policy basis for this.

The Committee recommends that a simple purpose test be inserted. That is, a requirement that the rules apply to transactions where the predominant purpose is to increase debt deductions in Australia or reduce assessable interest income in Australia would address many of these issues and provide more certainty for taxpayers. Such a test would also more closely align with what the OECD envisaged in BEPS Action 4 Report.

Definition of ‘debt deduction’

The phrase “*amount that is economically equivalent to interest*” in the definition of ‘debt deduction’ is likely to give rise to uncertainty for taxpayers.

Contrary to statement in paragraph 2.159 of the Explanatory Memorandum to the Bill that *“[i]t is intended that interest related costs under swaps, such as interest rate swaps, are included in the widened definition of debt deduction*”, payments under ordinary interest rate swaps are not ‘economically equivalent to interest’.

Swaps are essentially contracts for differences which hedge risk, and net payments made under swaps represent the differences between two different amounts at particular times. While interest rate swaps are calculated by reference to interest rates (for example, fixed and floating), they operate no differently from swaps that are calculated by reference to movements in capital indexes, or prices of commodities, etc. Net payments under interest rate swaps do not fall within any common law description of ‘interest’ in that they do not represent a payment for the use of money over time or a payment for being kept out of the use of money. It is not, therefore, clear what the policy intent is behind the drafting of the definition and the comments in both the Explanatory Memorandum to the Bill mentioned above and paragraphs 1.22 and 1.23 of the Supplementary EM.

The Committee suggests returning to the original definition of ‘debt deduction’ being an “*amount that is calculated by reference to the time value of money*” which reflects the common law definition of interest. Alternatively, an update to the final explanatory memorandum to the updated Bill to make it clear that the debt deduction creation rules do not apply to genuine interest rate swaps which hedge risk would at least allow for the definition to be interpreted consistently with the common law definitions of interest.

Form of amendments

The Committee is disapproving of these amendments being released as a separate bill to amend a bill that has not yet been enacted. This structure made it extremely difficult for advisors and taxpayers to understand the context of the proposed amendments, particularly given the very limited period for comment on these changes.

Clearly these difficulties may have affected the drafting process as there are numbering problems when the provisions in both bills are put together—for example:

- there is now no section 820-47(5)(b)—rather, the provisions simply jump from section 820-47(5)(a) to section 820-47(5)(c); and
- similarly, there is now no section 820-427B(2).

Given sections 820-47 and 820-427B are new provisions, this seems indicative of drafting done in haste.

The Committee recommends that, in future circumstances where provisions are subject to consultation, a mark-up of the changes and a conformed copy of the entire bill be released at the same time.

Conclusion and further contact

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

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