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30 October 2023

Dear Sir/Madam

Exposure draft law: Multinational Tax Integrity – strengthening Australia's interest limitation (thin capitalisation) rules (amendments)

PwC welcomes the opportunity to make this submission in relation to the proposed amendments to *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023* (the Bill) released for consultation on 18 October 2023.

We welcome the proposed amendments which address many of the issues raised by stakeholders during the recent Senate Economics Legislation Committee inquiry into the provisions of the Bill. In our submission we have focused on key issues where we believe significant uncertainty remains, and technical issues which may prevent the operation of the provisions in the manner intended. These are outlined in the following Appendices:

Appendix A: Debt deduction creation rules

Appendix B: Third party debt test

Appendix C: Fixed ratio test

Appendix D: Other issues

In line with our previous submissions, we recommend that a post-implementation review be undertaken within a few years of implementation of the proposals to understand the practical consequences and issues which have emerged since their introduction. Such a review should include a consideration of the impact that the measures have had on global investment into Australia and compliance costs.

We welcome the opportunity to discuss our submission with you. If you have any questions or wish to make arrangements for a further discussion, please contact me on +61 418 496 220.

Yours sincerely

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APPENDIX A: Debt deduction creation rules

Clarification of the application date and transitional provision

We consider that further clarification is required in relation to the application date for the proposed debt deduction creation rules. A proposed transitional rule included in the draft amendments seeks to provide a one-year transitional period such that Subdivision 820-EAA apply as follows:

- for financial arrangements entered into on or after 22 June 2023, to income years commencing on or after 1 July 2023; and
- for financial arrangements entered into prior to 22 June 2023, to income years commencing on or after 1 July 2024.

The proposed transitional rule in section 820-50 of the *Income Tax (Transitional Provisions) Act 1997* (the Transitional Provisions Act) also states that, in relation to financial arrangements entered into before 22 June 2023, the amendments will apply "*regardless of when the financial arrangement to which the debt deduction related was entered into*". As such, it appears intended that the rules can apply to any financial arrangement and in respect of any transaction that has been entered into historically, for which debt deductions still arise.

We welcome the inclusion of a transitional period to give taxpayers time to assess the impacts of these rules. However, this does not alleviate the compliance burden associated with the retrospective application of these rules which requires taxpayers to consider historical transactions that may have occurred many years ago, in some cases well beyond the current general tax record keeping requirement period, and may pre-date the current ownership and existence of records.

For example, assume a taxpayer issued a debt interest to a related party in 2010 to acquire a CGT asset from an associate in connection with the completion of a global merger. The relevant asset was sold in 2020, but the debt remained on foot. The company used the proceeds from the sale of the asset to fund third party costs in relation to a large capex project. In 2022, the loan was refinanced for working capital and to support completion of the large capex project with the same associate lender. To determine if this loan is potentially subject to the debt deduction creation rule from 1 July 2024, paragraph 820 423A(2)(d) demands an inquiry into whether the debt deduction for 2025 income year "is, wholly or partly, in relation to ..(i) the acquisition [of the CGT asset or] … (ii) the acquirer's holding of the CGT asset". In this example, the acquirer no longer holds the CGT asset, so paragraph (ii) is not applicable. The question therefore to be answered is whether any part of the loan remaining on foot relates to the acquisition of the CGT asset almost 15 years ago. This is a simple example, in many instances the fungible use of the funding over the period of time when the related party debt was first introduced means accurate tracing will be practically prohibitive.

It is impractical for taxpayers to go back an indefinite period to determine whether the conditions may have been met when a financial arrangement was originally entered into, particularly given that both tests only require "some" or "part" of the proceeds of the debt be used to fund the relevant acquisition or payment. In effect, these rules appear to require taxpayers to have tracked the source and use of all money borrowed from associates in the past, when the rules did not yet exist. This information is unlikely to be available and will materially add to the compliance burden of certain taxpayers to determine if these rules apply. Taxpayers may not even be able to do so with any accuracy if data is not available, and therefore will be unable to determine with any certainty if the debt deduction creation rules apply to existing related party debt. As such, we recommend that the rules be amended to apply prospectively only (unless it is the broader intention that related party debt (including where entered into for a commercial purposes), should be non-deductible for Australian tax purposes).

If it is intended that these rules apply retrospectively to transactions that occurred prior to the relevant start date, and this is to be retained in the final law, we note that the words in the main operative provision, section 820-432A, may not currently achieve this intention. This section provides that:

> "*This subsection disallows all or part of a debt deduction of an entity for an income year* ***if, for that year*** *… subsection (2) or (5) applies.*" [emphasis added]

Subsection (2) then provides that the subsection applies if:

> "*an entity* ***acquires*** *a CGT asset (other than a CGT asset covered by section 820-423AA), or a legal or equitable obligation, either directly, or indirectly through one or more interposed entities, from one or more other entities (each of which is a disposer)*". [emphasis added]

These two subsections together may be interpreted to limit the operation of the debt deduction creation rule to the year in which the relevant CGT asset or legal or equitable obligation is actually acquired.

Subsection (5) applies if:

> "*an entity (the payer)* ***obtains*** *proceeds from entering into or having a financial arrangement with another entity*".

This could similarly be interpreted to limit the operation of the debt deduction creation rule to the year in which the financial arrangement is entered into. We do not believe this is intended, especially with regards to transactions that occurred in income years commencing on or after 1 July 2023, as this would limit the effective operation of the rules to one year in respect of each relevant transaction.

Purpose of the transitional period

The proposed transitional provision in section 820-50 of the Transitional Provisions Act will be welcomed by taxpayers as it provides additional time to review existing arrangements in light of the ongoing uncertainties with these provisions. However, we consider that additional guidance should be provided as to the intended operation of this transitional provision. It would be helpful to clarify if this provision is intended to provide taxpayers with an opportunity to not only review their existing arrangements, but also refinance or restructure existing arrangements to prevent the application of the debt deduction creation rule.

Some taxpayers will look to replace existing related party debt with third party debt during this transitional period. There is uncertainty as to whether this may attract the operation of the proposed anti-avoidance rule in section 820-423D, as any new third party debt will immediately fall within the scope of Subdivision 820-EAA as it would be entered into after 22 June 2023. It is also uncertain whether other existing anti-avoidance provisions could apply to any refinancing or restructures that seek to replace existing related party debt (for which deductions will be denied under Subdivision 820-EAA) with third party debt which would not attract the operation of Subdivision 820-EAA (disregarding the specific anti-avoidance rule in section 820-423D).

Further clarity on these points would be welcome.

Related party debt and conduit financing

There are a number of potential issues with the debt deduction creation rules that would appear to conflict with the underlying proposition that conduit financing and related party borrowings more generally are permissible under the broader scheme of the proposed new thin capitalisation rules (and other existing areas of the tax law).

Related party debt plays a critical role in providing capital for businesses to invest and expand in Australia. In our view, related party debt should be permissible where it is created for genuine commercial purposes, and is on an arm’s length basis, consistent with existing transfer pricing and anti-avoidance provisions. The current version of the debt deduction creation rules - which still lacks any kind of purpose rule to limit its application - has the potential to apply to most, if not all, related party financing transactions.

We have highlighted below some specific technical issues with the debt deduction creation rules, as they apply to related party transactions. However, we strongly recommend consideration be given to including a purpose test within these rules to ensure they are appropriately targeted. Alternatively, if the rules are to be retained as currently drafted, additional guidance and examples are required to assist taxpayers in applying these rules, including examples involving tracing the use of funds and available approaches where direct tracing is not appropriate.

Acquires a legal or equitable obligation

Clarification is sought as to the meaning of the concept in subsection 820-423A(2) of acquiring a legal or equitable obligation. This concept is not defined in the proposed legislation, nor are there currently any examples of its intended meaning in the explanatory materials.

It is possible that issuing a debt interest (which is a legal obligation to repay the debt) could fall within the meaning of acquiring a legal obligation. If so, this could result in the application of the debt deduction creation rule to all related party debt. This would appear to be unintended given the inclusion of the conduit financing rules in the third party debt test and other exceptions included in the rules that appear to cater for on-lending arrangements (see further discussion below).

Refinancing with an offshore related party lender

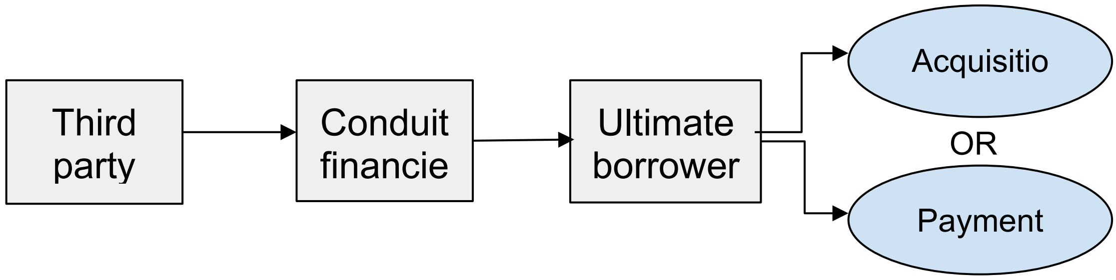
Proposed subsection 820-423A(5B) provides an exception to the debt deduction creation rule in subsection 820-423A(5) regarding debt issued to an associate where the proceeds of issuing the debt are used to fund payments or distributions to an associate. This exception disregards a payment that is entirely referable to the repayment of principal under a debt interest, presumably to allow debts to be refinanced without triggering application of the debt deduction creation rule.

However, this exception as currently proposed is limited to situations where the recipient of the payment is an Australian entity. As such, any refinancing of existing offshore related party debt would fall within the scope of subsection 820-423A(5), resulting in the denial of debt deductions in the future, even in situations where the original debt was not the result of a debt deduction creation scheme that would otherwise be captured under the proposed new rules. This seems like an unintended outcome. For example, new offshore related party debt to finance the acquisition of assets from a third party will give rise to deductible interest, however refinancing existing offshore related party debt where the original debt financed the acquisition of assets from a third party would not give rise to deductible interest.

Conduit financing within the context of the debt deduction creation rules

We welcome the inclusion of a new related party debt condition in Subdivision 820-EAA to limit the application of these provisions to circumstances involving related party debt. However, we are concerned that the lack of an equivalent to the third party debt test conduit financing concession may result in unintended consequences.

It appears that the proposed amendments have attempted to carve out some on-lending arrangements. For example, proposed section 820-423AA includes a new exemption from subsection 820-423A(2) for acquisitions of certain debt interests, which is described in the draft explanatory memorandum as intended to "*ensure that mere related party lending is not caught by the rules*". However, this amendment only ensures that the conduit financier is not subject to a denial of deductions under subsection 820-423A(2), it does not extend to the ultimate borrower. If the ultimate borrower is using the debt to fund the acquisition of a CGT asset from an associate, this would fall within the scope of subsection 820-423A(2) notwithstanding that it is indirectly sourced from third-party debt.



Similar issues may arise with the rule in subsection 820-423A(5). As noted above, a new exclusion has been proposed under subsection 820-423A(5A) for a payment that is referable to mere on-lending to an Australian associate where, broadly, the on-lending is on the same terms. However, again this new exemption only protects the conduit financier from the application of the debt deduction creation rule, it does not apply to the ultimate borrower in circumstances where they use the debt from the conduit financier to make payments or distributions to an associate. We further note that if subsection 820-423A(5A) is to be amended to provide a workable conduit-financing exemption, subsection 820-423A(5B) should also be amended to ensure that it does not prevent refinancing of such debt with new conduit debt (as the current paragraph 820-423A(5B)(c) disregards the operation of 820-423A(5A)).

Clarification of the related party condition

We note that the related party conditions in paragraph 820-423A(2)(e) and (5)(f) refer to a debt deduction that is "*referable to an amount paid or payable, either directly or indirectly, to …an associate*". There are two possible interpretations of this condition:

- The amount paid or payable refers to the actual debt deduction (e.g. interest) on the relevant loan or financial arrangement; or
- The amount paid or payable refers to other payments to associates (for example, the consideration for acquisition of the CGT asset or the "payment or distribution").

The draft explanatory materials clarify that the amount paid or payable in this context is referring to the debt deduction (e.g. interest) on the relevant loan or financial arrangement, which is consistent with the apparent intention of the related party conditions to limit the application of the debt deduction creation rules to related party debt. We recommend that these provisions be amended to clarify that the amount paid or payable is referring to the debt deduction itself, as noted in the explanatory materials, and not to other payments to associates.

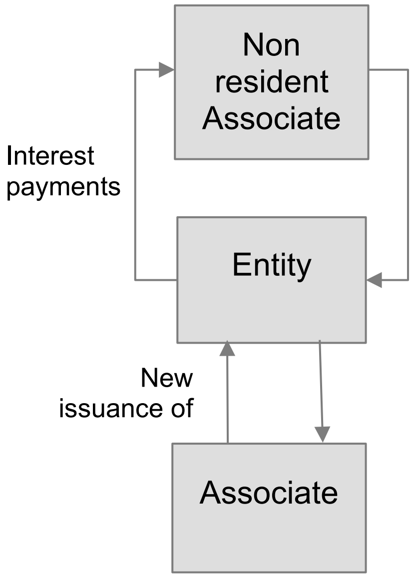
Breadth of subsection 820-423A(5)

Clarification is sought on the intended breadth of section 820-423A. It is noted that subsection 820-423A(1) operates to disallow “all or part of a debt deduction”. However, the current drafting of subsection 820-423A(5), through use of the words “some or all of the proceeds”, appears to suggest that where only a small proportion of the total debt funding is used to fund, facilitate the funding of, or increase the ability of any entity to make a relevant payment or distribution, debt deductions relating to the full amount of the borrowings will be denied. The original drafting of subsection 820-423A(5) required that the debt funding is used “predominantly” to fund, facilitate the funding of, or increase the ability of any entity to make a relevant payment or distribution. The current drafting seems to operate more broadly than perhaps intended.

Exemptions in subsection 820-423A(2) and interaction with subsection 820-423A(5)

We welcome the inclusion of new exemptions from subsection 820-423A(2) relating to acquisitions of CGT assets from associates. However, we are concerned that these exemptions may be rendered ineffective due to the application of subsection 820-423A(5) to each of these circumstances as an acquisition from an associate in most cases requires a payment to be made from the relevant entity to its associate. The broad scope of subsection 820-423A(5) to apply to any debt, some or all of which is used to fund a “payment or distribution” to an associate, would capture almost every scenario where a CGT asset is acquired from an associate.

For example, an entity obtains a loan from a non-resident associate to fund the acquisition of new shares in a company that is also its associate. Under the proposed amendments, this would be carved out of subsection 820-423A(2) as a result of the exemption for newly issued membership interests in subsection 820-423AA(1). However, subsection 820-423A(5) would apply as the entity has used the proceeds of a loan from an associate to make a payment (consideration for the new share) to an associate, resulting in the interest payments being non-deductible.



Indeed, it is difficult to foresee any example of an acquisition which is permitted by subsection 820-423A(2), via the exceptions in section 820-423AA, not being denied by subsection 820-423A(5) by virtue of any acquisition necessitating the making of a “payment”.

Accordingly, we consider that the scope of subsection 820-423A(5) should be narrowed by either removing the word “payment” from paragraph 820-423A(5)(b) or extending the exclusions to cover any payment relating to an acquisition of a CGT asset covered by section 820-423AA.

In addition, we consider that an exemption from subsection 820-423A(2) should be provided for the acquisition of a CGT asset that is trading stock of the acquirer. This will allow bulk purchasing of trading stock on behalf of associates, in a similar manner to the proposed exclusion for new depreciating assets.

Additional exemptions

In our view the following additional exemptions from the operation of the debt deduction creation rules should be considered:

- Entities that satisfy the requirements of section 820-37 (the 90% Australian asset exemption) should be excluded from the operation of the debt deduction creation rule. Not only will this simplify the legislation by aligning this exemption with the exemptions in sections 820-35 and 820-39, it also carves out groups where the risk of base erosion and profit shifting through debt creation schemes is limited.

- A *de minimis* exemption for entities with aggregate cross-border loans of less than $50m million (aligned with the transfer pricing safe harbour for low-level inbound loans in PCG 2017/2). Similar to the proposed carve out above, this would remove the significant additional compliance burden from groups with low risk of base erosion and profit shifting through debt creation schemes.
- The exclusion for ADIs and securitisation vehicles should be extended to all financial entities as they have similar commercial operations and low risk of profit shifting through debt creation schemes

In these cases, we consider that any residual risk could be dealt with under existing anti-avoidance and transfer pricing provisions.

Other matters

Modified meaning of associate pair for unit trusts

Proposed section 820-423E provides a modified meaning of associate pair for certain unit trusts for the purposes of the debt deduction creation rule, intended to “narrow the ordinary operation of ‘associate’ in section 318 of ITAA 1936”.

Clarification is required as to the intended purpose of the modifications to the sufficient influence test in subsections (4) and (5). It is unclear when a breach to the terms of a debt interest would have occurred “only to protect the interests of secured creditors” as required by the current provision.

We believe that this modification may have been intended to ensure that any limited rights provided to secured creditors in the event of a breach in the terms of a debt interest do not result in sufficient influence, and therefore an associate relationship, between the creditors and the relevant trust. However, it is not clear how this situation fits within the current wording of this modification, and why this modification is limited to certain unit trusts only.

Test time for associate pairs

Clarification is required as to the test time for an associate pair under the proposed debt deduction creation rules. For example, paragraph 820-423A(2)(b) will be satisfied where “*one or more of the disposers (each of which is an associate disposer) is an *associate pair of the acquirer*”, with no time specified for when this limb of the test must be satisfied. Similarly, paragraph 820-423A(5)(c) will be satisfied where “one or more of the recipients (each of which is an associate recipient) is an associate pair of the payer”, again with no test time specified

In our view, these tests should be applied at the time of the relevant acquisition with respect to subsection 820-423A(2), and at the time of the relevant payment or distribution with respect to subsection 820-423A(5). This should be clarified in the legislation to ensure that these rules cannot apply where the disposer or recipient, as relevant, later becomes an associate of the acquirer or payer, and the relevant debt is still on foot.

APPENDIX B: Third party debt test

Conduit financing: Modification of the third-party debt conditions

The proposed subsections 820-427B(4) to (6) contain 'special rules' that modify the third party debt conditions when applied to conduit financing arrangements. However, as explained below, the current drafting of the conduit financing test appears to require the unmodified third party debt conditions to be met before the modified conditions have effect, which results in a conduit financing test that can never practically be applied.

'Special rules' to modify the third party debt conditions for conduit financing are necessary given that, without such modification, a relevant debt interest or ultimate debt interest are unable to satisfy the third party debt conditions (for example, the proceeds of the ultimate debt interest are used by the conduit financer to fund associate entity debt which is not permissible under the third party debt conditions). However, subsection 820-427B(1) provides that these 'special rules' will have effect *only if subsection 820-427C(1) is met*, and one of the requirements of subsection 820-427C(1) is that the ultimate debt interest must satisfy the third party debt conditions. In other words, the ultimate debt interest cannot satisfy the third party debt conditions without these 'special rules', but the 'special rules' will not have effect if the ultimate debt interest is unable to meet the unmodified third party debt conditions.

As this issue appears to cause the conduit financing test to be ineffective, we expect that it is unintended and hope that it will be addressed through appropriate revisions to sections 820-427B or 820-427C.

Meaning of 'Australian assets'

There is ambiguity and uncertainty as to what may constitute an 'Australian asset' for the purposes of the third party debt test. Therefore, taxpayers will benefit from either a statutory definition or more detailed guidance presented in an Explanatory Memorandum.

'Australian assets' is not a defined term in the current tax law nor in the Bill and its proposed amendments, resulting in ambiguity as to its meaning. The term 'Australian assets' for the purposes of the third party debt test does not appear to be directly linked to a similarly named term "average Australian assets", which is found in section 820-37.

Paragraph 2.98 of the Explanatory Memorandum to the Bill contains the following comments, which as explained further below are unclear.

‘Australian assets’ is intended to capture assets that are substantially connected to Australia. The following assets are not intended to be Australian assets:

- *Assets that are attributable to the entity’s overseas permanent establishments.*
- *Assets that are otherwise attributable to the offshore commercial activities of an entity.*

Notably, ‘Australian assets’ appears to be more narrow than the ‘assets’ relevant for the current thin capitalisation safe harbour test, which refers to “assets (other than assets attributable to its overseas permanent establishments)”. However, in addition to not being attributable to an overseas permanent establishment, an ‘Australian asset’ must also be “substantially connected to Australia” and are not “otherwise attributable to the offshore commercial activities of an entity”. These additional terms are also undefined and appear to require a degree of subjective judgement.

As the term ‘Australian assets’ is undefined, appears to involve a degree of subjectivity and may be more narrow than the ‘assets’ as currently used for safe harbour calculations, taxpayers will benefit from further clarity as to its intended meaning.

Obligor group definition and recourse to assets

The definition of "obligor group" is drafted so broadly that it would include, for example:

1. a third party financial intermediary that as part of the operation of its ordinary financial services business provides a letter of credit/guarantee to support equity commitments of an obligor entity; or
2. where support is provided for contractual obligations of third-party service providers such as construction bonds provided by construction contractors, letters of credit/security provided by third party offtakers under power purchase agreements.

We believe that it is not intended that such parties should be part of the obligor group. Therefore, we suggest that an amendment be made to section 820-49 such as:

"(4) For the purposes of (1)(b) disregard an entity that is not an associate entity of the borrower."*

There also needs to be a corresponding amendment to subsection 820-427A(3)(c) so that a lender's recourse to assets (Australian or foreign) provided by such third parties are permitted under the third party debt conditions. We believe that if the amendment is made to exclude such non-associate entities as members of the obligor group at new 820-49(4) as suggested above, then the following amendment (possibly new 820-427A(3)(cb) should be sufficient to achieve this.

"(cb) For the purposes of subsection 820-427A(3)(c), disregard recourse to assets (other than assets that are membership interests in the entity, conduit financer or each borrower mentioned in subsection 820-427C) that is provided by entities that are not members of the obligor group."

Prohibition on rights in relation to a guarantee, security or other form of credit support

Paragraph 820-427A(3)(c) operates to specify the group of Australian assets to which the third party holder of a debt interest is permitted to have recourse. This relevantly includes the Australian assets of the borrower entity, Australian assets of each member of the obligor group and Australian assets that are membership interests in the borrowing entity. Section 820-427A(3)(ca) then excludes assets from that group that "are rights under or in relation to a guarantee, security or other form of credit support".

Under the predecessor arm's length debt test, a factual assumption upon which the quantum of arm's length debt was assessed required that any guarantee, security or other form of credit support provided to the entity in relation to the Australian business during that year by its associates is taken not to have been received by the entity. The determination of the arm's length debt amount was then made on the basis that no guarantee, security or other form of credit support is provided to the entity. In contrast, rather than merely reducing the deductible debt quantum, any credit support, security or guarantee under the proposed revised rules completely negates the ability to satisfy the third party debt test conditions. Because it is an "all or nothing rule", it is imperative that there are clear bright line boundaries.

We recommend that the following amendments be made to paragraph 820-427A(3)(ca) so as to ensure that the assets treated as being provided under or in relation to credit support:

i) are only those regarded as being provided by "external credit support" and not "internal credit support". Internal credit support would consist of assets provided by members of the obligor group and include the provision of security over membership interests in the entity;

ii) should be limited to credit support that is provided by an associate entity of the borrowing entity/member of the obligor group; and

iii) should specifically exclude implicit credit support.

(i) Internal credit support/security/guarantee excluded

This amendment is designed to remove any doubt that assets related to the relevant guarantee/security/credit support permitted in paragraph 820-427A(3)(c) (which we have termed "internal credit support") are not effectively then removed by paragraph 820-427A(3)(ca). Without amendment the conduit test could not be satisfied and the obligor group concept would be meaningless.

(ii) External credit support limited to associate entities

Credit support provided should only be captured where that support is provided by entities that are themselves associate entities of either the borrowing entity, or any member of the obligor group. This would remove concerns where, for example, letters of credit/guarantees are provided by non-associated counterparties (e.g. a third party bank where a bank guarantee is obtained) or to support contractual obligations of service providers (e.g. construction bonds provided by unrelated construction contractors, letters of credit/security provided by third party offtakers under power purchase agreements). The provision would still operate as intended to apply to arrangements where an external guarantee is provided to the borrower entity/obligor group member by an associate entity.

(iii) Implicit credit support is not regarded as credit support

This deals with the distinction of implicit credit support.

We refer to Chapter 5 of the Board of Taxation *Review of the Thin Capitalisation Arm's Length Debt Test* (December 2014) which clearly highlights the difficulties with defining/identifying what constitutes credit support. A recommendation was made that "implicit credit support" should be specifically carved out from the concept of credit support which should therefore apply only to "explicit credit support". We believe that implicit credit support should be specifically excluded. This could be done by way of note (e.g. Implicit credit support is not to be regarded as credit support for the purposes of this subsection).

Modified paragraph 820-427A(3)(ca)

This section incorporating amendments (i),(ii) and (iii) could now read:

> *"none of the assets covered by paragraph (c) are rights under or in relation to a guarantee, security or other form of credit support that is*
>
> *i) provided directly or indirectly by an entity that is an associate entity of either the entity or a member of the obligor group; and*

ii) provided by an entity other than a member of the obligor group; and

iii) does not constitute a membership interest in the entity covered by section 820-427A(3)(c)(ii).

Note: Implicit credit support is not to be regarded as credit support for the purposes of this subsection."

New subsection 820-427B(5A) incorporating amendments (i), (ii) and (iii) for conduit financing

Corresponding amendments to (i), (ii) and (iii), as suggested below, are also required to section 820-427B to ensure that the modifications to section 820-427A are reflected in the conduit finance arrangements. The logic for the amendments necessary for the conduit finance arrangements in section 820-427B is the same as outlined above.

"In applying subsection 820-427A(3) in relation to the income year, for an interest that is a relevant debt interest or the ultimate debt interest mentioned in subsection 820-427C(1), treat the reference in sub-paragraph 820-427A(3)(ca) to the modified version as follows:

none of the assets covered by paragraph (c) are rights under or in relation to a guarantee, security or other form of credit support that is:

i) provided directly or indirectly by an entity that is an associate entity of either the conduit financer, a borrower mentioned in subsection 820-427C(1) or a member of the obligor group; and

ii) provided by an entity other than the conduit financer, a borrower mentioned in subsection 820-427C(1) or a member of the obligor group; and

iii) does not constitute a membership interest in the conduit financer or each borrower covered by section 820-427A(3)(c)(ii).

Note: Implicit credit support is not regarded as credit support for the purposes of this subsection."

Taxpayers that indirectly hold foreign assets

It is currently unclear whether the ownership of shares in a foreign entity would be considered to be an

‘Australian asset’ (see our commentary above regarding the need for a legislative definition). In addition, it is unclear whether foreign assets held by the foreign entity, which are in turn indirectly held by the Australian entity, might be considered to be assets that the lender has recourse to.

It is common for a lender to require an Australian entity that holds an interest in a foreign entity to provide security over the membership interests in that foreign entity. While these foreign subsidiaries may not increase the borrowing capacity of the Australian entity, this is a common practice taken in security arrangements by lenders. This is the case even if the proceeds of the debt will only be used to fund Australian commercial activities.

We do not consider it to be appropriate for debt interests issued by these Australian entities to be ineligible for the third party debt test as these debt interests would be genuine third party debt if they satisfied all other third party debt conditions. We further note that any potential tax integrity issue would be limited given that the third party debt conditions also require that substantially all of the proceeds of the debt are used to fund the Australian entity’s Australian commercial activities, which excludes the holding of controlled foreign entity equity.

Taxpayers with insignificant foreign assets

As currently drafted, it is unclear whether the third party debt test can be available for Australian taxpayers that directly or indirectly hold an insignificant amount of foreign assets. Given that the holding of insignificant foreign assets by an Australian entity would not be expected to allow the Australian entity to receive a higher amount of external debt or receive more favourable funding terms, we consider it is reasonable for such entities to be able to access the third party debt test.

This may be the case, for example, where an Australian entity only operates in Australia, but has opened and continues to maintain a small balance of funds in a foreign bank account. A holder of debt issued by that Australian entity may have recourse to all assets of that entity and therefore would have recourse to assets that are not ‘Australian assets’[1]. However, the lender is unlikely to have had regard to the presence of the small amount of foreign funds when determining the terms of funding to the Australian entity.

To alleviate this issue, a *de minimis* rule should be implemented. This rule could disregard recourse to non-Australian assets of an entity if they comprise less than 10% of the total assets held by that entity (this would align to the existing 90% Australian asset threshold exemption in section 820-37, however would be available to both inward and outward investors). This will help to ensure that the third party

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[1] For the purposes of this example, we have assumed that the funds in the foreign bank account are not ‘Australian assets’ for the purposes of the third party debt test. See our commentary above regarding the need for a legislative definition for ‘Australian assets’.

debt test is available to Australian entities that receive genuine third party debt and do not pose a tax integrity risk.

Real property/movable property carve-out requires clarification

Section 820-427A(4) provides a carve-out from the credit support prohibition contained in paragraph 820-427A(3)(ca) which relates to Australian assets provided under or in relation to credit support in relation to the development of CGT assets that are Australian land/real property but now also including certain moveable property situated thereon.

The intention made clear by the original Explanatory Memorandum to the Bill is that recourse of a third party lender to assets such as letters of credit/equity commitments to support the progressive contribution of equity during the construction period, required for an eligible development project, should not disqualify the third party debt from meeting the third party debt conditions.

In particular, paragraph 2.102 of the Explanatory Memorandum to *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023*: "*A credit support right only relates wholly to the creation or development of real property where the right arises under an arrangement the borrowing entity enters into wholly in the course of creating or developing real property. For example, an arrangement under which the borrowing entity has the right to a commitment from investors to provide equity capital on a fixed and capped investment timeline wholly in relation to creating or developing real property*."

It is important to clarify whether an equity commitment which is "an arrangement under which the borrowing entity has the right to a commitment from investors to provide equity capital on a fixed and capped investment timeline" is excluded from the definition of 'credit support', regardless of whether the investment relates wholly to the creation or development of real property. Such commitments are critical to the growth of Australia's strategic priorities, such as affordable housing, to encourage investment in those areas. This type of credit support is regularly provided where investors may provide equity commitment letters to funds that are in fundraising stages, to enable investments to be made, but those capital commitments are not fully drawn until the fund has not been fully invested. As such it would be helpful to clarity if such commitments (whether or not in relation to the creation or development of real property) will be excluded from the definition of 'credit support.

The kind of moveable property that is permitted is now defined in subsection 820-427A(6) as follows:

> *"For the purposes of sub-paragraph 4(a)(ii), moveable property situated on land is of a kind covered by the subsection if the property is, or is reasonably expected to be:*
>
> *(a) incidental to and relevant to the ownership and use of the land and*
>
> *(b) situated on the land for the majority of its useful life."*

The terminology used in paragraph (a) seems loosely based on section 102MB(1) of the *Income Tax Assessment Act 1936* (ITAA 1936). In that section, the terms are used to articulate when moveable property (items that would not otherwise be regarded as an interest in land) will be treated as investments in land for the purpose of deriving rent.

It is unclear from the revised Explanatory Memorandum accompanying the Exposure Draft as to when or what types of moveable property are contemplated. A number of submissions to the Senate Economics Legislation Committee Inquiry requested that the exception be expanded to include projects such as infrastructure construction projects where a large portion of the development expenditure may relate to items that may not constitute fixtures at common law or be subject to a form of statutory severance meaning they are not land, an interest in land or real property.

The use of the word “incidental” seems to indicate that the value of the moveable property cannot be substantial as compared to the total value of the land and real property on that land. However, in our view, if this were and remains the intention, then the concepts could be better expressed.

If the provisions are intended to apply to infrastructure assets such as wind farm turbines, solar panels, batteries or storage assets, where the value of the moveable property substantially exceeds the value of the balance of land and real property, then the wording of the subsection will need to accommodate this, and it would be useful to clarify this in the revised Explanatory Memorandum. If this is the intention, then the wording of paragraphs 820-427(6)(a) and (b) could be amended as indicated below.

If these kinds of infrastructure projects are not intended to benefit, based on the proportion/relative value of moveable property (as indicated by the use of the references to incidental/ownership) we think the provision could be better expressed. It is difficult to understand in a context different from section 102MB not involving the renting of land, where moveable property situated on land would be regarded as incidental to the land and how that has any relationship to the ownership of the land. Therefore paragraph 820-427A(6)(c) could be included and possibly be reworded as follows (proposed new text in blue):

> *“For the purposes of sub-paragraph 4(a)(ii), moveable property situated on land is of a kind covered by the subsection if the property is, or is reasonably expected to be:*
>
> *(a) ~~incidental to and~~ relevant to the ~~ownership and~~ use of the land; and*
>
> *(b) situated on the land for the majority of its useful life; and*
>
> *(c) such that the value of moveable property [does not exceed the value of land/real property].”*

Access for ‘non’ Australian entities

Under the current proposed amendments, the third party debt test conditions can only be satisfied by entities that are ‘Australian entities’. Whilst we welcome the amendments to ensure that this allows partnerships and trusts to access the third party debt debt, we note that the proposed rules exclude foreign entities with Australian permanent establishments and partnerships that are majority-owned by non-resident entities from being able to satisfy the TPDT conditions.

We acknowledge the stated policy intention of these proposed changes, to ensure that only those entities with a “strong connection to Australia” are able to access the test which does not allow “avoidance behaviour”. However, where these entities solely or predominantly hold Australian assets, it seems that this restriction penalises these entities by preventing access to the third party debt test in situations where these entities have genuine third party debt.

In these cases, the relevant entity may need to fall back on the fixed ratio or group ratio test, which may not be suitable to their circumstances if they operate in a capital intensive industry that generally has higher gearing ratios. Where the entity is part of an obligor group of another entity that chooses to apply the third party debt test, these entities may also be deemed to have chosen to apply the third party debt test, resulting in a third party earnings limit of nil.

We also note that limiting access to the third party debt test in this manner, particularly with respect to partnerships, creates a bias towards certain investment vehicles over others. As currently drafted, an Australia unit trust or Australian incorporated company which is 49% held by an Australia resident and 51% held by a foreign resident is able to access the third party debt test. In contrast, a partnership held in the same proportions will not be able to access this test. In our view, the rules should apply in the same way to all vehicle types.

APPENDIX C: Fixed ratio and group ratio tests

Excess tax EBITDA

We welcome the proposed amendments which will permit certain the inclusion of excess tax EBITDA amounts from downstream trusts in an entity's tax EBITDA where it broadly has at least a 50% direct interest in the downstream trust.

Following the amendments, beneficiaries of trusts that broadly hold an interest of less than 10% will be able to include their share of the taxable income of the trust in the calculation of tax EBITDA. The proposed amendments will permit certain beneficiary trusts to include the excess tax EBITDA of a trust where the beneficiary trust has at least a 50% direct control interest.

However, we raise the following additional points for consideration:

1. It is unclear why this relief has been provided to unitholders that are trusts but has not been extended to other unitholder entity types.

2. There is also an imbalance in the outcomes for investors that hold between 10% - 49.99% in a trust, because these entities are not able to include their share of net income of the trust or the trust's excess tax EBITDA in the calculation of their tax EBITDA. For example, where two investors hold interests of 49% and 51% in a unit trust through a series of trust, the investor that holds 49% will have no ability to recognise income generated by the downstream trust in its tax EBITDA. In contrast, the investor who holds 50% or more would be able to get the benefit of the excess tax EBITDA amount. The rationale for providing no excess tax EBITDA (or inclusion of that beneficiary's share of taxable income) to beneficiaries of trusts which hold interests of 10 - 49.99% is unclear.

3. Similarly, it is unclear why the excess tax EBITDA amount has been provided for trusts, and not any other type of entity. In our view, the rules should apply in the same way to all vehicle types, and should not create a bias towards a particular type of investment vehicle for investors (whether it be upstream or downstream). We see many investment structures that use a combination of trusts, partnerships and companies that will be unable to use excess tax EBITDA amounts.

   The impact is particularly acute for existing structures that utilise unincorporated or incorporated joint venture vehicles. In such joint ventures, it is common for any debt to be held by the investors, and not necessarily within the joint venture vehicle. The inability of the investors to include dividends from the joint venture company or a share of the net income or loss from an unincorporated joint venture that is treated as a tax law partnership in their tax

EBITDA, or to utilise excess tax EBITDA of the joint venture vehicle, will significantly restrict the ability of the investors to fund their investment with debt.

Method statement for trust excess tax EBITDA amount

In step 1 of the method statement to calculate a trust excess tax EBITDA amount, a taxpayer is required to determine the amount by which the controlled trust's fixed ratio earnings limit exceeds net debt deductions and any FRT disallowed amounts for the 15 income years immediately before the current income year.

We note that the adjustment for FRT disallowed amounts in step 1 of the trust excess tax EBITDA calculation does not appear to take into account FRT disallowed amounts that are "lost" due to a subsequent change in choice of tests or change in ownership arising under sections 820-58 and 820-59 respectively, as these provisions only apply for purposes of 820-56.

To clarify that any such forgone amounts should be excluded from the step 1(b) amount, (b) could be amended as follows:

*the total of the controlled trust's *FRT disallowed amounts for the 15 income years ending immediately before the income year (to the extent those amounts have not been applied under paragraph 820-56(2)(b)* *<u>or treated as nil as a result of the application of section 820-58 or section 820-59</u>*).*

Treatment of prior year losses

The current approach to calculating tax EBITDA includes deductions for prior year losses for all entity types, with an assumption for corporate tax entities that they will choose to use the maximum amount of losses available.

This approach is inconsistent with the policy of adding back certain current year deductions in the calculation of tax EBITDA (such as depreciation and debt deductions) to the extent the losses are generated by those types of deductions. This effectively penalises entities that have generated overall losses rather than being in a taxable position.

Including prior year losses in the calculation of tax EBITDA is also inconsistent with a broader policy position that tax EBITDA is a reflection of an entity's capacity to pay its borrowing costs. If an entity has current year earnings, its tax EBITDA should not be reduced by prior year losses. Accordingly, we recommend that the calculation of tax EBITDA be adjusted to add back deductions for prior year losses (consistent with the exposure draft law released for consultation on 16 March 2023).

If the current approach is to be retained, we recommend that deductions for prior year losses that predate the introduction of these rules be excluded from the calculation of tax EBITDA.

APPENDIX D: Other issues

Modifications to the definition of associate entity

The proposed amendments include new modifications to the definition of associate entity which apply for various purposes within the fixed ratio test, the group ratio test and the third party debt test. The modifications disregard the requirement in subsections 820-905(1) and (2A) that the entity is an associate (as defined in section 318 of the ITAA 1936) of the other entity.

The removal of the "associate" condition significantly broadens the definition of associate entity, particularly in conjunction with control thresholds of only 10% or 20%. In these cases, an investor entity may have very little effective control over an entity in which it holds a 10% or 20% interest (and therefore, little ability to use debt to engage in profit shifting activities), and little ability to obtain information about the financial and tax position of the other entity. As such, this modification imposes a significant administrative burden on both entities to obtain information about potential associate entities for the purposes of these rules. In addition, given the modifications to introduce the "TC control interest" concept to the associate entity definition throughout the proposed rules already significantly expand the application of the rules, we consider the retention of the requirement to satisfy the 'associate' condition to be important to appropriately limit the application of the rules.

Definition of general class investor

The proposed definition of "general class investor" includes an entity that, assuming it were a financial entity, would be an outward investing financial entity (non-ADI). Under Item 2 of the table in subsection 820-85 (as per the proposed amendments), an outward investing financial entity (non-ADI) includes:

(a) an entity (the relevant entity) that is an Australian entity throughout a period that is all or part of an income year; and

(b) throughout that period, the relevant entity is an associate entity of another Australian entity; and

(c) that other Australian entity is an outward investing financial entity (non-ADI) or an outward investing entity (ADI) for that period,

where the relevant entity is a financial entity throughout that period.

The proposed wording of these provisions appears to indicate that the "relevant entity" would only be a general class investor where the "other Australian entity" is actually a financial entity or ADI. This is because the financial entity assumption in the definition of general class investor only extends to the "relevant entity" - it does not also encompass the "other Australian entity". Therefore, where the relevant entity is an associate entity of an outward investing entity that is neither a financial entity nor an ADI, it is not currently within the definition of general class investor, and hence not subject to the proposed new thin capitalisation provisions. Such an entity would, however, be subject to the existing thin capitalisation provisions as an outward investor (general) under Item 3 of the table in existing subsection 820-85(2). We recommend clarifying whether this is an intended outcome under the proposed new rules.

Definition of a Financial Entity

The proposed definition of financial entity continues to include an entity that is a registered corporation under the *Financial Sector (Collection of Data) Act 2001* but also requires that the entity:

- carry on a business of providing finance but not predominantly for the purposes of providing finance directly or indirectly to or on behalf of the entity's associates, and

- derives all, or ***substantially all***, of its ***profits*** from that business in the relevant income year.

The term "provision of finance" is not currently a defined term under the law and therefore presents uncertainties for certain taxpayers (such as leasing enterprises). We recommend a reasonable approach to clarifying this uncertainty would be to make the definition inclusive of items listed within the section 32 of the *Financial Sector Collection of Data Act 2001* (defining the provision of finance for the purpose of that Act).

Further, the concepts of "substantially all" and "profits" which are both undefined terms present ambiguity for taxpayers. In particular, the following issues are noted:

- With respect to the term "substantially all", what is unclear is the threshold level that should be applied for the purposes of satisfying the requirement of "substantially all".

- With respect to the term "profits", it is unclear whether the intention is for the term to be interpreted as "accounting profits" or "taxable income". Further, it is unclear what the intended outcome is if a taxpayer does not have any accounting profits or taxable income in a given income year.

We recommend that guidance is provided as to the interpretation of these terms.