21 July 2023

Committee Secretary
Senate Economics Legislation Committee
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600
economics.sen@aph.gov.au; seniorclerk.committees.sen@aph.gov.au

RE: *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share- Integrity and Transparency) Bill 2023*

Dear Senate Economics Legislation Committee

Introduction

We are writing in respect of the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share- Integrity and Transparency) Bill 2023* (**Bill**) which has been referred by the Senate to the Economics Legislation Committee for inquiry.

This joint submission is made by the Ontario Municipal Employees' Retirement System (**OMERS**), Caisse de dépôt et placement du Québec (**CDPQ**), British Columbia Investment Management Corporation (**BCI**), and the Ontario Teachers' Pension Plan (**OTPP**) (together, the **Canadian Investors**) with assistance from Ashurst.

As a group, the Canadian Investors represent a significant portion (by value) of Canadian public pension funds and are major capital investors into Australian infrastructure and real estate assets. Further details of each investor are as follows:

- OMERS is one of Canada's largest public pension plans, with 541,000 members and over 1,000 employers. OMERS invests C$121 billion in net assets to generate an investment return that, in turn, is used to pay pensions of Ontario police officers, fire fighters, school board employees, municipal employees and more. OMERS' investments are diversified across different asset classes and geographies.

- CDPQ is an institutional investor that manages funds primarily for Quebec's public and para public sector pension and insurance plans. CDPQ's portfolio includes high-quality assets of all classes, reflecting a strategy to create long-term value for CDPQ's Depositors. CDPQ is one of the largest institutional fund managers in North America, with net assets of C$402 billion as at 31 December 2022.

- BCI is one of Canada's largest institutional investors, with C$211.1 billion of assets under management. BCI's clients include public sector pension plans representing over 715,000 plan members, insurance funds providing more than 3 million Autoplan insurance policies annually, benefits coverage to more than 2 million workers and 225,000 companies, and a special purpose fund within British Columbia's public sector. BCI invests globally in all major asset classes, including infrastructure and renewable resources and in real estate through QuadReal, BCI's real estate investment manager.

- OTPP is Canada's largest single-profession pension plan with C$247.2 billion in net assets under management as at December 31, 2022. OTPP invests in more than 50 countries in a broad array of assets across a range of sectors and industries to deliver retirement income for 336,000 active, former and retired teachers in the Canadian province of Ontario. OTPP is a long-term investor in Australia through a diversified portfolio of infrastructure, agricultural and equity investments.

We have invested extensively in critical Australian real property and infrastructure assets, with combined Australian assets under management of over A$35 billion. The assets that we have invested in include Port of Melbourne, Port of Brisbane, Transgrid, Westconnex, Equis (renewables), Sydney Desalination Plant, Pacific National, Endeavour Energy, Spark Infrastructure, FRV Australia, Waveconn, Melbourne Convention Centre, a number of hospitals (such as Footscray Hospital), and Build to Rent properties.

Key concerns with the Bill

We are seriously concerned that if the Bill is enacted in its current form, it will have a material impact on Australia's attractiveness as a destination for the investment of capital, including our capital. In particular, and while we understand concerns associated with base erosion and profit shifting, the measures, if implemented in their current form, will result in material debt deduction denials on third party debt arrangements that are entirely commercially driven. Given the significance of these measures, and the material amendments that are required to ensure they are fit for purpose, we strongly recommend that the application date of the measures be deferred to income years commencing on or after 1 July 2024, to ensure that there is sufficient time to remedy the legislative defects.

We continue to support the implementation of the OECD's Base Erosion and Profit Shifting (**BEPS**) Framework, but there are fundamental issues with the Bill. We note that a number of jurisdictions have implemented the OECD's recommendations under the BEPS Framework, but they have done so without creating the material adverse impacts that the Australian rules would have. For example, both the United Kingdom and the United States have provided regimes that apply to certain real estate and infrastructure projects, and ensure availability of debt deductions arising in respect of genuine third party arrangements. Accordingly, we respectfully request that certain elements of the Bill are revised to make the rules workable so that it does not act as a deterrent to further investment in Australian real estate and infrastructure for foreign investors like this group, or result

in increased costs being passed on to Australian consumers and other stakeholders. We respectfully submit that these results would not be aligned with the intention of the BEPS Framework.

Ensuring that the measures are implemented to permit commercial debt financing arrangements based on the unique constraints of the infrastructure and real estate sectors is important for Australia to maintain the country's competitiveness for capital relative to other jurisdictions.

We have set out below our more detailed submissions in respect of the fixed ratio test, third party debt test, and group ratio test, along with submissions on the proposed debt creation rules. At a more general level, we submit that the relevant elements of the measures should be designed consistently with the following principles:

General

- Continuity of tax policy within a stable regulatory framework is critical in encouraging continued capital investment. Changes in tax policy and retrospective application of law change creates uncertainty which can have a detrimental effect on Australia's competitive standing as a preferred destination of capital, and raises sovereign risk concerns. We note that by the time this Bill passes through both Houses of Parliament (if, indeed, it does), a significant proportion of the income year will have passed without any certainty as to the operation of the thin capitalisation rules. Stability and certainty is particularly important for long term investments such as infrastructure and real estate projects which support Government policy.

- The thin capitalisation rules are intended to address risks associated with the erosion of the tax base, and are not intended to prevent ordinary business or commercial practices which do not have the effect of profit shifting (e.g., by way of related party debt) or base erosion.

- Where the thin capitalisation rules apply to deny debt deductions, they increase the cost of debt finance for business, which is a necessary capital component for business. Such debt deduction denials decrease the incentive and the appetite of foreign investors to invest further in Australia. Accordingly, the thin capitalisation measures need to be appropriately targeted to reduce base erosion risks without increasing the cost of capital for ordinary business and genuine commercial arrangements.

- The thin capitalisation rules should be drafted such that the legal arrangement put in place should not result in a denial of interest that would have been permitted under a different legal structure (e.g., "substance over form" should prevail, such that the level of a structure at which debt is borrowed, or the legal form of the entity borrowing the debt, should not determine whether amounts are deductible). Tax laws should be drafted carefully so that they do not create ambiguity, since long term investors like this group measure and make investments by reference to their risk adjusted returns, and this will ultimately affect the cost of capital for Australians.

Fixed ratio test

- The fixed ratio test should not differentiate between obtaining debt at an upstream entity level or downstream entity level, so long as the income of the relevant group is not supporting greater than 30% debt deductions. This will ensure that debt can be sourced at the commercially preferred level.

Third party debt test

- The third party debt test should be available to all taxpayers that are subject to the thin capitalisation rules (including trusts and partnerships).

- Standard third party lending arrangements, including standard security arrangements, should typically satisfy the relevant third party debt conditions. In particular, third party lending arrangements where recourse is limited predominantly to Australian assets should satisfy the relevant third party debt conditions.

- For construction finance, third party lenders require some form of credit support from an entity of economic substance (such as a parent guarantee or other form of credit support), given that the development asset is not income earning, and its value is subject to completion of the development. To facilitate foreign capital investing in development assets (given the significance of these assets to the Australian economy, including Australian jobs), foreign parent guarantees or other forms of credit support should be permissible under the third party debt conditions from commencement of development of a material asset up until stabilisation of the relevant asset.

- Intragroup arrangements directed towards managing cash requirements and payment mechanisms within a group of entities should be permitted to co-exist with third party debt, provided that the lending is not sourced from external debt or, if it is, that the on-lending occurs on substantially similar terms with respect to costs as the third party debt.

- It is common for taxpayers to enter into commercial arrangements, such as swap arrangements, that hedge or otherwise manage their exposure to economic variables, such as variable interest rates or currency exchange rates. In considering these arrangements, taxpayers will ordinarily consider the all-in cost of the arrangements (e.g., borrowing at a variable rate, and hedging some or all of the exposure into a fixed rate via an interest rate swap). The form of these commercial arrangements, and by which entity they are entered into, should not be prescribed by tax law. Tax law should not bias or interfere with standard commercial tools for managing these risks (to avoid increasing costs on taxpayers).

Group ratio test

- The group ratio test should be available to taxpayers within the same control group, regardless of whether accounting rules permit those entities not to prepare consolidated financial statements. In this scenario, and consistent with the OECD's recommendations, controlled entities of investment entities should be eligible to form a group for the purposes of the group ratio test where they prepare consolidated financial statements.

Debt creation rules

- The debt creation rules should target contrived and artificial arrangements that lack commercial purpose and business substance. They should not target genuine financing arrangements with third parties, or commercially motivated restructures, and should only be applicable prospectively to avoid creating uncertainty in existing arrangements.

Please refer to our detailed comments below.

1. Fixed Ratio Test (FRT)

There are fundamental issues with the application of the FRT for entities in non-tax consolidated structures, particularly where borrowing occurs at a level above the asset holding entity. In addition, there is uncertainty in respect of how the FRT applies to attribution managed investment trusts (**AMITs**), which appears to be unintended. This adversely impacts a large number of trusts in which the Canadian Investors hold interests.

1.1 Upstream gearing

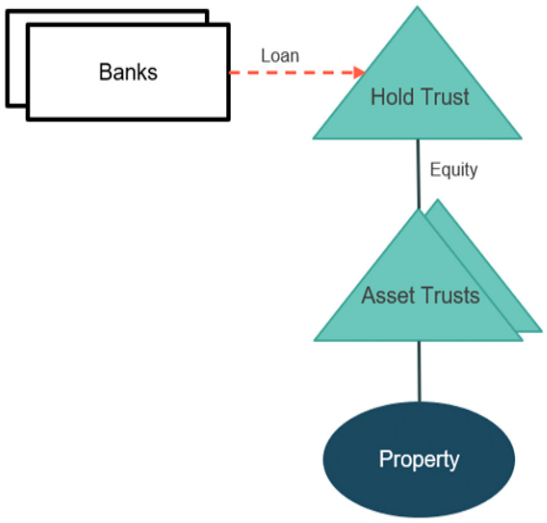
The FRT operates by reference to tax EBITDA, being (in effect) taxable income, plus net debt deductions, plus certain (but not all) depreciation deductions for tax purposes. One of the key changes that was made to the exposure draft legislation was to exclude from taxable income amounts arising from downstream entities that are associate entities.

This change has a material impact on any investment structure where there is upstream gearing. It is very common to have debt at an upstream level. Often debt will be sourced at an upstream entity level (as depicted below) because third party finance will have been sought on a portfolio basis (and assets in the real estate and infrastructure sectors are typically held in separate special purpose vehicles), or because third party debt was obtained at this level to finance an entity acquisition (e.g., acquire an entity that holds an asset). Portfolio debt is often commercially preferred because:

- it can be obtained more cheaply (i.e., at a lower interest rate), as the debt is secured by reference to the underlying pool of assets, rather than debt being sourced in respect of each asset; and

- it enables financial covenants, such as interest coverage ratios or loan to value ratios, to be measured on a portfolio basis, lowering the risk of default if a particular asset underperforms.

The diagram below illustrates a common structure in the real estate and infrastructure sector, involving a holding trust (**Hold Trust**) obtaining debt financing.



Under the proposed FRT, because assessable income amounts arising from holding interests in associate entities are disregarded in calculating tax EBITDA, upstream entities will often have no

debt deduction capacity under the FRT. In such scenario, Hold Trust's tax EBITDA would be negative, **meaning that all of its debt deductions will be denied under the fixed ratio earnings limit**. Note that this should not impact the position for tax consolidated groups, but as trusts are not (generally) eligible to form a tax consolidated group , this results in trust structures, which are commonly used in real estate and infrastructure investments, being disproportionately (and unfairly) impacted by the measures.

While we understand the integrity concerns where debt is obtained at both an asset trust and holding trust level, it would be straightforward to permit upstream entities (in this scenario, Hold Trust) to include in its tax EBITDA its share of the downstream entity's excess fixed ratio earnings limit. This ensures integrity, while not adversely impacting structures where debt is sourced at an upstream level for commercial reasons.

This approach is consistent with the operation of the current thin capitalisation rules (where excess thin capitalisation capacity flows upstream), and reflects an appropriate policy approach which permits gearing by reference to the underlying income streams and assets. As drafted, the measures expressly prefer downstream entity debt, notwithstanding the commercial impact of downstream debt in certain structures (higher interest costs (i.e., more debt deductions), and greater risks of default).

For completeness, we note that it may not be possible to simply move the gearing down to the downstream entity to access its tax EBITDA – this would be costly to implement (as it would involve a refinancing), may result in higher interest rates, and also is likely to result in the application of the debt creation rules (notwithstanding that no net debt may, in fact, be created).

In order to remedy this issue, **the FRT should be amended to allow upstream entities to utilise excess thin capitalisation capacity of downstream entities**, in line with the existing thin capitalisation rules. We have previously provided a proposal to Treasury as to how this could conceptually be drafted, without giving rise to integrity concerns.

Note that the above also impacts the operation of the group ratio test (**GRT**), which applies the relevant group ratio to tax EBITDA. Incorporating downstream entities' excess thin capitalisation capacity in an upstream entity's tax EBITDA would be the most straightforward way to remedy this issue.

1.2 Exclusion of AMITs from applying the fixed ratio test

Under the measures, a trust is required to calculate its tax EBITDA by reference to its "net income", which is a concept appliable to most trusts. However, there is uncertainty around how the relevant provisions apply to AMITs. The AMIT regime was introduced in 2016, with the purposes of encouraging the growth of the Australian fund management sector, as well as increasing investor certainty when investing in trust vehicles. Accordingly, it would be perverse if AMITs were not treated comparably to other trust vehicles.

To elaborate, AMITs are specifically excluded from the operation of Division 6 of the ITAA 1936, and so the "net income" concept in this Division, as well as other adjustments that are prescribed in determining net income, is not necessarily appropriate in the context of AMITs.[1] This means that the FRT and the GRT is not necessarily able to be applied by AMITs in a comparable way. There is no

[1] Per section 95AAD of the *Income Tax Assessment Act 1936*.

evident logic from a policy perspective to treat AMITs in a non-comparable fashion to other trusts in applying the FRT and the GRT.

In order to remedy this issue, **the definition of tax EBITDA should be amended to allow AMITs to calculate their tax EBITDA by reference to their aggregate determined trust components** (being the equivalent of net income for AMITs).

2. Third party debt test (TPDT)

As investors, the basic expectation is that debt capital sourced from genuine third party financiers should give rise to interest costs that are deductible. This is generally consistent with the tax results obtained in most other jurisdictions. The purpose of using third party debt capital is not tax driven, and measures designed to target base erosion and profit shifting should not apply in this context. The purpose of using third party debt capital is to operate efficiently for our ultimate members by using debt capital where appropriate, as debt capital is cheaper than equity capital.

The Labor Party's election manifesto included a commitment to "maintain the arm's length test" in the current thin capitalisation rules.[2] In addition, the Government committed as part of October Budget 2022-23 to "retain an arm's length debt test as a substitute test which will apply only to an entity's external (third party) debt". The proposed TPDT will, if implemented in its current form, apply to very few (if any) genuine third party debt arrangements in the infrastructure or real estate sectors since it does not accommodate standard elements of third party financing arrangements, and also because it is an "all or nothing" test whereby one would need to meet all of the conditions to be able to choose this methodology. Accordingly, the TPDT would be totally ineffective in permitting third party arrangements if the conditions are not carefully drafted. We have detailed below the particular problems with the proposed TPDT that require further rectification.

For completeness, a fall back to the FRT (or GRT) is not sufficient to maintain deductions for current third party debt arrangements – that is, the FRT (and GRT) is not sufficient to permit debt deductions if the TPDT is not amended appropriately. In particular, the application of the FRT and GRT is particularly harsh in the context of large infrastructure and real estate greenfield projects, where there are long lead times and often no taxable income generated for a number of years. Accordingly, if the issues with respect to the TPDT set out below are not remedied, it will materially adversely affect investment returns of existing investment projects or result in increased costs being passed on to consumers. It will also affect the returns on future investments, and consequently will result in foreign investors allocating their scarce capital to other foreign markets .

2.1 Australian residence requirement

The Bill limits the application of the TPDT to "Australian residents" – the base TPDT requires a debt interest to be issued by an Australian resident, and the conduit financer rules require the conduit financer and borrower to be Australian residents. The definition of "Australian resident" only applies to companies and individuals. Accordingly, trusts and partnerships, which are subject to the thin capitalisation rules, are not able to apply the TPDT. As trusts (and partnerships) are common investment vehicles in the infrastructure and real estate sectors, many investment vehicles in these sectors are currently ineligible to apply the TPDT.

[2] *Statement on Labor's Economic Plan and Budget Strategy*, page 10.

We expect that this is a drafting error, as there is no logic from a policy perspective to disadvantage trusts and partnerships by excluding them from the TPDT. In any case, we submit that the TPDT should be amended to accommodate trusts and partnerships. The most straightforward way to effect this outcome would be to replace the reference to "Australian resident" with a reference to "Australian entity" as defined in section 336 of the *Income Tax Assessment Act 1936*. This definition accommodates companies, trusts, and partnerships.

2.2 Recourse requirements

The base TPDT, which applies in circumstances not involving a conduit financer, prescribes requirements that do not accommodate standard security arrangements negotiated with third party lenders. In particular, the base TPDT requires that the holder of the debt interest (i.e., the third party financier) has recourse for payment of the debt "only to the assets of the entity" that has borrowed the amount, being the issuer of the debt interest.

In commercially accepted lending arrangements involving infrastructure and real property trusts, the bank will take security not only over the assets of the borrower trust, but also over the units in the borrower trust (i.e., security granted by the holding entity). The rationale for this is not to provide credit support to the lender, but rather because the lender, if it needs to enforce its security, will typically do so by taking a transfer of the units in the borrower trust, rather than an assignment of all of the underlying property of the borrower trust. Taking an assignment of all of the underlying property of the borrower trust would be more complex and would involve the assignment of a large number of assets, typically including assets involving third parties for which consent may be required. Accordingly, the lender will require recourse over the units in the borrower trust, not as a way to obtain credit support, but rather to assist it with enforcement of its security. These standard arrangements would not be permitted under the base TPDT, notwithstanding that the entities that have granted security over the units would be subject to a deemed election to apply the TPDT where the borrower so elects.

In addition, in commercially accepted lending arrangements where a bank is lending to a holding trust (i.e., against a portfolio of assets held indirectly by the holding entity), the bank will take security over the assets of the holding entity, the assets of the downstream asset entities, and the units in the holding entity. Again, this is to provide the bank with options over where to exercise security. These standard arrangements would not be permitted under the base TPDT, notwithstanding that the entities that have granted security would be subject to a deemed election to apply the TPDT where the borrower so elects.

In commercially accepted lending arrangements where a bank is lending to a stapled entity, it is common for security to be provided across both sides of the staple. Again, these common security arrangements do not fall within the permitted recourse arrangements under the TPDT, notwithstanding that the stapled entity may be subject to a deemed election to apply the TPDT.

As drafted, the base TPDT would result in a failure of the relevant conditions for all of these standard arrangements, notwithstanding that all of the relevant entities would have been deemed to have elected to apply the TPDT where the borrower makes such an election. In addition, the failure of the base TPDT conditions will occur where the entities which are providing security to the external lender are Australian entities, that (directly or indirectly) hold Australian assets. Accordingly, and from an integrity perspective, there is no concern that (for example) the credit rating of a parent entity, or explicit credit support by that parent entity, is being used in order to gear Australian

entities at a level that is not supportable by the Australian assets. Therefore, there should be no concern with these commercially accepted lending arrangements from a tax integrity perspective.

Further, we note that these standard security arrangements would not be problematic where the entities were all members of a tax consolidated group. Accordingly, if these issues are not remedied, tax consolidated groups will be treated preferentially to other valid and permitted structures. This is particularly relevant for the infrastructure and real estate sectors where trusts are often the commercially/legally preferred structure for investment purposes.

Presently, this issue is largely resolved where the conduit financing conditions are satisfied, via a modification of the TPDT that applies in the context of the conduit financing requirement. This modification permits recourse against entities that are members of the "obligor group" (as defined in the legislation), which (as noted above) are also deemed to have elected to apply the TPDT where the borrower makes such an election. There is no policy reason why the position should be different in a circumstance where an entity chooses to borrow directly from a financier, rather than via a conduit vehicle.

Accordingly, **the base TPDT test should permit the widened recourse requirements applicable in the context of the conduit financing provisions**.

In addition, we submit that the requirement that all of the assets over which a lender has recourse are Australian assets is overly restrictive – a single foreign asset (such as a foreign bank account) would result in a complete failure of the TPDT, with a consequent denial of all debt deductions. Accordingly, **the provisions should permit that recourse is against assets that are, or substantially are, Australian assets**. This will ensure the integrity requirements are satisfied (i.e., debt secured substantially by Australian assets), without operating in an onerous manner.

2.3 Guarantees, security and credit support

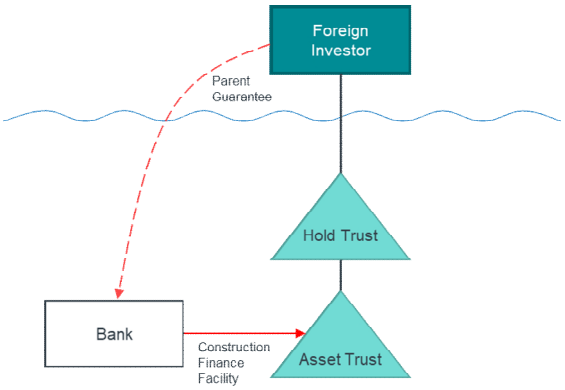
As currently drafted, the TPDT conditions generally do not permit recourse to rights under or in relation to guarantees, securities, or other forms of credit support, regardless of who has provided those rights. The Explanatory Memorandum (at paragraph 2.99) explains that this is to avoid multinational enterprises having an unfettered ability to fund their Australian operations with third party debt.

While we understand the integrity concerns associated with related party guarantees or credit support (subject to the comments below about these arrangements in the context of development assets), the current drafting prohibits third party guarantees, securities, or other forms of credit support, such as (for example) third party bank guarantees or lessee bonds. There is no policy rationale for prohibiting the granting of recourse against assets that are third party assets. For example, it is common to require contractors to provide a bank guarantee to secure performance under construction contracts. As noted above, in commercially accepted lending arrangements involving infrastructure and real estate trusts, banks will take security over all the assets of the borrower, which will include any such third party arrangements.

It would not be in line with legislative intention to preclude the existence of external credit support such as the above from enabling an entity to apply the TPDT. Accordingly, **the prohibition on "security, guarantee, or other forms of credit support" needs to draw a distinction between third party arrangements, and related party arrangements**. The preferred way for this to occur is for the TPDT conditions to be amended to only prohibit guarantees, security, and credit support provided by associate entities (not third parties), subject to the submission below regarding development assets.

2.4 Development assets

As acknowledged in the Explanatory Memorandum to the Bill, it is common for wider recourse arrangements to be required by third party financiers where they are financing development assets (i.e., construction financing). In particular, as the value and income serviceability of development projects are not presently reflected in the underlying assets but are only realised after construction completes, third party financiers will require some form of credit support from an entity of economic substance before they are willing to provide finance to undertake material developments. For example, no third party financier will lend to a material renewable energy development, or a build-to-rent development, without some form of credit support. A common form of such an arrangement is set out below.



The Bill seemingly caters for the unique profile of development assets, broadly by allowing the TPDT conditions to be satisfied where a lender has recourse over assets that are guarantees, securities, or other forms of credit support in this context. However, this concession does not apply where such rights are provided by foreign entities that are associate entities of the borrower, meaning common development structures where the equity is sourced from foreign investors will not be permitted to apply the TPDT. In other words, the rules expressly discriminate against foreign institutional investors (such as this Canadian Investor Group) compared to domestic investors.

The implications of this approach will be material, and will have the following economic impacts:

- The cost of capital for development projects in Australia will rise, decreasing the incentive to invest in infrastructure and real estate developments that are significant to the Australian economy and the Government's agenda – including (for example) energy transition[3] and the Housing Accord. Infrastructure Australia identified in 2022 that the five year pipeline of major infrastructure projects was valued at $237 billion,[4] and the Government has a critical pipeline of energy transition projects under the Australian Energy Market Operator's Integrated System Plan. The cost of all of these projects will increase.

- For certain asset classes, such as build-to-rent, these assets have predominantly (to date) been financed by foreign investors, because foreign investors are more familiar with asset class through investments in foreign markets where this has been a more long-standing asset

---

4 *Infrastructure Market Capacity: 2022 Report* (December 2022), Infrastructure Australia, page 12.

class (such as in the United States). The reduced investment by foreign investors in these sectors will deprive Australian fund managers of this international expertise and perspective. This expertise and experience is one of the reasons why Australian investors also often seek to invest alongside foreign capital, potentially further decreasing investment in this sector.

- These impacts will flow through other sectors of the Australian economy, including the construction sector (which employs hundreds of thousands of Australians), and the funds management sector. We note, in this regard, that the underlying structures will typically be managed by an Australian fund manager, with Australian entities acting as developer vehicles.

- For projects that do nonetheless proceed, and where those projects are equity funded by a number of investors (including Australian investors), the Australian investors will indirectly be adversely affected by the prohibition on foreign parent entity credit support – their share of project-level debt deductions will also be denied as a consequence of the participation of the foreign entity.

In addition, the measure is targeted at investment in real property. There are a number of critical infrastructure assets where its classification as real property for these purposes is either not clear, or (alternatively) where it is clear that they are not real property. Given Australia's significant capital requirements with respect to infrastructure, ensuring the concession is expanded to cover these infrastructure assets is material.

Accordingly, the measures, as drafted, adversely impact Australia's capacity to attract foreign capital to finance developments in key sectors (e.g., infrastructure and build-to-rent, noting that build-to-rent assets are a new asset class in Australia, such that almost all investments in this space represent investments in development assets). Note, in this regard, that there are a large number of announced (but not yet commenced) projects that are likely to be impacted by these changes.

Given the significance of attracting foreign capital to these sectors, including the significant pipeline of infrastructure assets (such as renewable energy assets) and the Government's Housing Accord (which aims to have 1 million new dwellings built over the 5 years from 2024), **the development assets concession should be expanded to facilitate foreign capital investing in these types of assets**. Moreover, **the relevant concession should expressly be expanded to include infrastructure assets (not all of which may be real property)** – we note, in this regard, that the concept of "economic infrastructure facility" as defined in subsection 12-439(5) of Schedule 1 to the *Taxation Administration Act 1953* could be used as the basis for such an expansion.

Accordingly, **the TPDT should be amended in order to allow foreign associate entities to provide credit support to Australian entities undertaking development activities**. This permissible recourse should extend beyond the timeframe of the physical development of the asset, as the banks will require these arrangements to be in place typically until the point of stabilisation of the relevant asset (which, for many build-to-rent assets, is often 18-24 months following the completion of the development).

If these arrangements are not permitted, it will simply not be feasible for foreign institutional investors to continue to invest in large scale development projects, as foreign investors will not be able to source appropriate third party debt arrangements that give rise to deductible debt deductions. This will materially decrease post-tax returns, incentivising them to invest their capital elsewhere.

2.5 On-lending by conduit financers

The Explanatory Memorandum to the Bill outlines that the TPDT conduit financing conditions have been included in recognition of the fact that one entity may raise funds on behalf of a wider group, in order to streamline and simplify borrowing processes (paragraph 2.105). We agree that this is a common structure, and should be facilitated under the measures. However, as drafted, there are a range of issues with respect to the conduit financing regime.

The first is that the conduit financer itself must satisfy the base TPDT in order to claim debt deductions in respect of its own borrowings, and the TPDT does not allow an entity to use "all, or substantially all" of its own borrowings to fund the holding of "associate entity debt" (which would be the case in most typical group lending arrangements, including that of this group as Canadian institutional Investors). "Associate entity debt" is defined as debt that is lent to an associate entity on arm's length terms. That is, notwithstanding that the purpose of the conduit financer provisions is to permit on-lending to associates, the provisions (as drafted) actually explicitly prohibit it.

We expect that this is a drafting error. If not amended, the above prohibition will prevent all uses of standard conduit financing arrangements, which is inconsistent with the legislative intention.

Therefore, **the use of proceeds provision should be amended to permit a borrower using the funds to hold "associate entity debt" where the conduit financer provisions apply**.

2.6 Conduit financing conditions should be limited in their application to on-lent amounts sourced out of external debt

The conduit financer provisions, as currently drafted, require:

- that all lending between associate entities satisfies the conduit financing conditions, even where that debt is not sourced out of amounts borrowed from a third party; and

- that all such lending satisfies the conduit financing conditions; such that a failure of one debt interest results in all debt interests failing.

To take an example, if an entity within a group of entities relying on the conduit financing provisions lends an amount to another group entity on an interest free basis, sourced from excess cash, that debt interest will fail the conduit financing provisions. As a consequence, all interests will fail the conduit financing conditions, and no debt deductions will be available (even where the amounts on-lent are sourced from the third party debt do satisfy the relevant requirements).

We submit that:

- **the conduit financer requirements should apply only to amounts on-lent within the group where it is sourced from the external debt**. That addresses the relevant integrity risk as we understand it as expressed by Treasury – i.e., a concern with entities on-lending at a margin over the external debt to increase debt deductions; and

- **the conduit financer requirements should apply on an interest-by-interest basis**, so that if one debt interest qualifies and another debt interest fails the requirements, only the debt deductions associated with the interest that fails should be denied.

2.7 Swaps

One of the key changes of the measures is to bring within the definition of "debt deductions" deductions arising in respect of certain swaps. However, there are technical deficiencies with how the TPDT deals with swaps, such that many standard swap arrangements will result in the denial of debt deductions.

We note that swap arrangements are extremely common. Borrowers who are exposed to variable interest rates will often seek to swap their obligations into a fixed interest rate, in order to hedge against fluctuations in market interest rates. This is particularly the case where the income received by the entity is not referable to prevailing interest rates – such as investments in infrastructure where returns may be regulated.

Paragraph 2.95 of the Explanatory Memorandum to the Bill indicates an intention for deductions referable to conventional interest rate swap arrangements between unrelated parties to be deductible under the TPDT. However:

- If a borrower enters into interest rate swaps that hedges its exposure to a number of debt interests, none of the swap deductions will be available (as the debt deductions are only available if they directly hedge the interest rate exposure in respect of a particular debt interest).

- If a borrower enters into a swap with a third party in respect of a loan borrowed via a conduit financer, swap amounts will not be deductible, as the rule that deems directly related swap costs to be attributable to a debt interest does not apply in a conduit financing scenario.

- If the conduit financer enters into a qualifying swap arrangement, and then enters into a back-to-back arrangement with the entity to which it has on-lent the borrowed funds, the debt deductions on the back-to-back arrangement will also not be available, as they are paid to an associate entity (notwithstanding there is a back-to-back arrangement with a third party).

- If a borrower enters into a cross-currency interest rate swap, because (for example) they have borrowed in offshore markets (to achieve a lower financing cost on the debt, which is common), the debt deductions in respect of the cross-currency interest rate swap will not be available, limiting taxpayers' access to offshore debt markets.

All of the above arrangements are common commercial arrangements. We understand that the relevant integrity concern primarily relates to related party swaps, rather than the above mentioned arrangements (which are genuine third party arrangements). Given this, we would propose the following straightforward approach:

- Debt deductions associated with hedging or managing interest rate risk (and other similar risks for that matter) in respect of one or more debt interests are deductible, provided that the debt deduction is not referrable to an amount paid:

    - directly to an associate entity, unless the amount is paid indirectly to an entity that is not an associate entity; and

    - indirectly to an associate entity.

3. Group ratio test

In addition to the issues set out above in the discussion of the FRT (which similarly impact the GRT), a key deficiency of the GRT is its eligibility criteria, which means that many institutional investors will be unable to apply the test.

3.1 Eligibility

The GRT is intended to operate as an alternative means to support debt deductions in those sectors which are traditionally heavily geared for commercial reasons. In particular, the OECD recognises that third party debt, sourced for non-tax reasons, does not give rise to base erosion and profit shifting risks. In particular, the OECD states:[5]

> *Recognising that some groups are highly leveraged with third party debt for non-tax reasons,* ***the recommended approach proposes a group ratio rule alongside the fixed ratio rule****. This would allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group. Countries may also apply an uplift of up to 10% to the group's net third party interest expense to prevent double taxation.*
>
> [Emphasis added]

However, under the Bill, and in order to be eligible to apply the group ratio test, it is necessary that there is a global parent entity, and for that global parent entity to prepare line-by-line consolidated financial statements. Many entities do not line-by-line consolidate their controlled entities, as they are "investment entities". Investment entity status is generally conferred on superannuation funds. This includes this group of Canadian Institutional Investors and some of our holding entities.

Accordingly, many investors will not be entitled to access the GRT as currently proposed. This is not how the GRT has been implemented in other OECD countries (including the United Kingdom). Accordingly, **the eligibility criteria should be amended to allow the GRT to apply in these circumstances on a modified basis**.

Moreover, we note that Australia's approach (per the Bill) is not consistent with the recommended approach of the OECD. The OECD notes that investment entities will prima facie be unable to access the GRT where the parent entity is an investment entity, and in these circumstances **it recommends that the controlled entity that is not a parent entity may form a group (where that controlled entity does prepare consolidated financial statements on a line-by-line basis)**.[6] The OECD goes on to provide examples of how a group should be determined for the purposes of the GRT (in Annex I.D), and Figure I.D.3 (relating to companies held by a limited partnership via fund vehicles) and Figure I.D.6 (relating to a structure headed by an investment entity) are illustrative. In particular, these examples demonstrate that the OECD recommends that separate groups should be able to be formed by subsidiary vehicles of the investment entity for the purposes of applying the GRT.

Accordingly, we submit that:

- where the global parent entity is an investment entity; and

---

5 *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments: Action 4 – 2016 Update* (December 2016), page 13.

6 *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments: Action 4 – 2016 Update* (December 2016), paragraph 126.

- a subsidiary of the global parent entity does prepare line-by-line consolidated financial statements; and

- the Australian entity or entities are consolidated on a line-by-line basis by that subsidiary;

it should be possible to make an election to apply the group ratio test on a modified basis by reference to the consolidated financial statements of that subsidiary.

The above proposal will ensure that global institutional investors which are classified as investment entities are able to access the GRT, which is intended to apply relief where the investors operate in highly geared sectors on a worldwide basis. It will also ensure the Australian rules are consistent with the OECD's recommended approach, as well as the approach adopted by other jurisdictions (such as the United Kingdom).

4. Debt creation rules

The debt creation rules were included in the introduced Bill, but were not included in the Exposure Draft legislation published by Treasury. Nor were they considered in the Treasury Discussion Paper. Accordingly, **the debt creation rules have not been subject to public consultation at all**, and represent an entirely unexpected element of the Bill. Given that they effectively apply on a retrospective basis (as explained below), this lack of public consultation on an element of the Bill that applies retrospectively is totally inappropriate from a tax policy perspective.

Moreover, and as outlined in further detail below, the proposed debt creation rules are incredibly broad, and would appear to capture a wide variety of arrangements, including many which are not "debt creation schemes". For this reason, it is submitted that the rules should be narrowed, to avoid unintended impacts on arrangements where there is no policy reason to limit debt deductions. We further note that the debt creation rules were not included in the exposure draft legislation, and so broad consultation on the measures has not taken place. Given the breadth of these proposed measures, we consider that this element of the measures should be deferred for a year until consultation can be undertaken, consistent with appropriate tax law design.

4.1 De facto retrospective application

The debt creation rules have been drafted in such a manner that while the rules only apply to income years commencing on or after 1 July 2023, deductions arising in relation to debt interests that were issued before this time are subject to the rules. This means, in effect, that taxpayers who undertook transactions in prior years in circumstances where the transaction was entirely permissible may now find themselves subject to debt deduction denials on debt interests issued in prior years.

We note, in this regard, that the Department of the Prime Minister and Cabinet's *Legislation Handbook* (at [5.19 and 5.20]) advises against the use of retrospective legislation except in exceptional circumstances, as follows:

> *Provisions that have a retrospective operation adversely affecting rights or imposing liabilities are to be included only in exceptional circumstances and on explicit policy authority….*
>
> *Departments need to be aware that the Senate Standing Committee for the Scrutiny of Bills and the Parliamentary Joint Committee on Human Rights, which scrutinise all bills, expect that an explanation and justification for any retrospective provisions will be included in the explanatory memorandum and statement of compatibility with human rights….*

The Explanatory Memorandum to the Bill does not indicate that the debt creation rules are intended to apply to historical arrangements, and provide no justification for such an approach. This is extremely concerning.

Furthermore, taxpayers are likely to find themselves unable to determine whether the debt creation rules could apply to certain transactions entered into prior to 1 July 2023. To elaborate, taxpayers are generally only required to maintain records for a period of five years from the date of lodgement of a tax return. Accordingly, taxpayers may not have the relevant information available to determine whether and, if so, how the debt creation rules may apply to their debt interests. This is simply not an acceptable position for taxpayers to find themselves in, and we strongly recommend that the debt creation rules only apply to debt interests issued on or after 1 July 2023.

We understand that there are concerns that if the debt creation rules only apply to debt interests issued on or after 1 July 2023, that taxpayers may seek to (for example) amend existing financial arrangements, in order to avoid issuing a new debt interest (and thereby being subject to the debt creation rules). If this is the relevant integrity concern, we note that there are more appropriate ways to address this issue than applying the rules on a retrospective basis. For example, certain provisions in the Income Tax Assessment Acts require taxpayers to consider the character of financing arrangements following material changes to their terms. The debt creation rules could be designed to apply to debt interests issued on or after 1 July 2023, or any interest that is subject to a material change in the form of an amendment to its terms where that amendment occurs on or after 1 July 2023.

4.2 Safe harbour – permitted transactions

The debt creation rules are explained in the Explanatory Memorandum to the Bill as a measure designed to address the risk of "excessive debt deductions for debt created in connection with an acquisition from an associate entity or distributions or payments to an associate entity" (paragraph 2.145). They are also explained as seeking to disallow debt deductions to the extent they relate to schemes "**lacking genuine commercial justification**" (paragraph 2.146).

However, and unfortunately, the debt creation rules have been drafted without any legislative requirements associated with the purpose of the arrangement, and are so broad that they easily capture situations where:

- an arrangement does not in fact increase the level of debt within a group of entities (i.e., where there is no net debt creation); and/or

- debt interests are issued for genuine non-tax reasons.

Moreover, elements of the rules require that the transactions are between "associate pairs". However, the definition of associate that is used for these purposes is particularly broad when applied to trusts and partnerships. To take a simple example, where a natural person directly or indirectly benefits under the terms of a trust, those two trusts are associates of each other. Accordingly, many listed real estate investment trusts will be associates of each other, and transactions between those listed vehicles will potentially be subject to the debt creation rules.

The policy reason for disallowing deductions in these situations is unclear, and the application of the debt creation rules in these cases would disincentivise genuine commercial arrangements. Examples of common commercial scenarios that could trigger the application of the debt creation rules include:

- refinancing at a downstream level, and using the proceeds to repatriate funds to retire debt. In this case, there is no net debt created taking into account the debt that is repaid, although the debt creation rules would apply to it.

- transferring an asset to an associate entity as part of a restructure, and partially financing the acquisition with debt. The proceeds from the transfer of the asset are used to retire the existing debt – again, there is no net debt created taking into account the debt that is repaid.

We note that Australia's former debt creation rules, which were repealed, contained a number of exclusions that would also be appropriate in the current context, including an exclusion for arrangements where there was no net debt created as a consequence of the overall arrangement.

For these reasons, **the debt creation rule should incorporate a safe harbour, which limits the rules from applying where there is no net debt creation, or debt is created under a scheme where there is no dominant purpose of obtaining a tax benefit** (or, alternatively, where the scheme is not designed with the purpose of increasing the level of gearing). In addition, **the threshold for testing associate status needs to be increased**.

4.3 Breadth of provisions

At a more general level, there is a concerning trend towards new and proposed integrity rules being drafted incredibly broadly, in a manner where they apply to common and standard commercial arrangements. This is a concerning trend for taxpayers, as the application of these broad integrity regimes ultimately becomes a matter for the discretion of the revenue authority. In our view, integrity concerns need to be clearly identified, with the integrity regime then targeting only artificial arrangement that would attract integrity concerns .

To take an example of the breadth of the measures, the debt creation rules also seek to address situations where an entity borrows from an associate to fund a payment to that, or another, associate. However, the rules have been drafted in such a manner that all borrowings from an associate that "facilitates the funding of" or "increases the ability of any entity to make" a payment or distribution to an associate is captured. This is extremely broad – on one view, any borrowing increases the ability of an entity to make a payment or a distribution to an associate.

The breadth of the provisions represents significant overreach with respect to what we understand is the integrity concern – contrived or artificial arrangements designed to increase the level of gearing of Australian entities. However, we further note that part of the integrity concern related to the Government not progressing (at this time) the proposed repeal to section 25-90 of the *Income Tax Assessment Act 1997*. Given that the Government has stated it will undertake further consultation on the repeal of section 25-90, such that the need for an interim integrity measure may ultimately fall away, we would strongly recommend that the debt creation rules should be considered as part of that consultation, to ensure that integrity measures are subject to appropriate consultation. In particular, proceeding with the proposed debt creation rules without adequate consultation (noting no exposure draft of these measures was publicly released) risks capturing a number of common commercial arrangements that do not give rise to integrity concerns.

Conclusion

We consider that substantial changes are required to the legislation to ensure that common commercial arrangements which are not motivated by base erosion or profit shifting are not inadvertently caught by the revised thin capitalisation measures. In particular, and to deliver on the

Government's commitment to ensuring debt deductions on genuine third party arrangements remain available, material redrafting of the TPDT is required. Given the number of changes identified above that are required to be made, we strongly urge the Committee to recommend deferring the application of these measures to income years commencing on or after 1 July 2024, to ensure there is sufficient time and consultation to adopt appropriate measures.

If the above identified issues are not remedied, the legislation will have a significant impact on Australia as a destination for offshore capital. Given the significance of this source of capital to developing Australia's material infrastructure and real estate assets – including its transition to renewable energy, the development of residential houses to address housing affordability, as well as its other infrastructure needs – these measures will have a material impact on Australians' wellbeing and its competitiveness compared to other countries. Accordingly, we urge the Senate Economics Legislation Committee to recommend the identified proposed changes, and to defer the application to income years commencing on or after 1 July 2024.

We have consulted with Treasury in respect of some of these concerns mentioned above , and we are willing to continue working with both Treasury and the Senate Economics Legislation Committee to ensure that the revised thin capitalisation measures are fit for all purposes.