5 January 2024

The Committee Secretary
Senate Standing Committee on Economics
(Economics Legislation Committee)
PO Box 6100
Parliament House
CANBERRA ACT 2600

Email: economics.sen@aph.gov.au

Dear Committee Secretary

Government Amendments to Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023

Chartered Accountants Australia and New Zealand and The Tax Institute (**together the Joint Bodies**) write to you as the peak professional accounting and tax practitioner bodies in Australia representing the tax profession.

The Joint Bodies welcome the opportunity to provide feedback to the Senate Economics Legislation Committee (**the Senate Committee**) inquiry into the Government Amendments on sheet RU100 (the **Government Amendments**) to Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023 (**the Bill**).

Schedule 2 to the Bill contains changes to the thin capitalisation rules to limit an entity's debt deductions to 30 per cent of its tax EBITDA (the fixed ratio test (**FRT)**) and provide two alternative thin capitalisation tests, the group ratio test and the third party debt test (**TPDT)**. It also introduces the new debt deduction creation rules (**DDCR**) that seek 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.

The Government Amendments seek to amend Schedule 2 to the Bill in response to the Senate Committee report on the inquiry into the Bill that recommended that the Bill be passed subject to technical amendments.

Government Amendments

The Joint Bodies are pleased that the Government Amendments have addressed some of the concerns raised in our respective submissions to Treasury on the exposure draft Parliamentary Amendments to the Bill. These amendments include:

- allowing an entity to access excess tax EBITDA in other legal entities and not just eligible unit trusts and managed investment trusts, as this ensures that common controlling investment structures can continue to be funded by investor debt;
- when applying the TPDT, a debt holder can have recourse to minor and insignificant ineligible assets such as a non-Australian asset;

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- deferring the application date for the new DDCR to income years starting on or after 1 July 2024; and
- further narrowing of the scope of the DDCR by ensuring that the rules apply in relation to a defined list of payments or distributions rather than payments or distributions generally.

Nevertheless, we have ongoing concerns regarding the Bill and the Government Amendments which are, broadly:

- the application date of the thin capitalisation changes (being from 1 July 2023) (other than the DDCR) means that entities have been and will continue to be subject to the new rules for at least eight months without enacted legislation;
- at a minimum, prior year tax losses as of 1 July 2023 (i.e. the application date) should be excluded from the tax EBITDA calculation as these losses would have been calculated under the existing thin capitalisation asset-based regime;
- where a company chooses not to utilise the tax losses in a year under the FRT (for example, in cases involving stapled structures), there could potentially be a double counting of losses;
- the impact on the tax EBITDA calculation for entities that receive dividends or distributions from 10% to up to 50% controlled entities and as such cannot utilise the proposed excess tax EBIDTA;
- the removal of the DDCR from the Bill for comprehensive consultation process remains preferred;
- the DDCR still needs clear exceptions for related party debt funding for acquisitions of trading stock from an associate pair, Australian domestic debt between associate pairs, and entities that have 90%+ assets in Australia (i.e. an exclusion along the lines of the thin capitalisation exclusion under section 820-37 of the *Income Tax Assessment Act 1997* (**ITAA 1997**));
- the TPDT does not include definitions or scope of key terms such as ‘minor or insignificant assets’ and ‘Australian assets’; and
- modifying the thin capitalisation changes to accommodate private groups (that commonly operate in the middle market).

Additionally, given the significant impact of the proposed amendments, the Joint Bodies consider that it is crucial that the Government commits to a post-implementation review. Stakeholders have been engaged in providing timely feedback since the proposed changes were first announced. However, we recognise that the Bill once enacted may require clarifications and other technical amendments based on its operation in practice and as tax advisers start to apply the law. It would be preferable that such a post-implementation review be conducted in real time and in any case, within a year or two of the commencement of the new rules.

We have set out our submissions in more detail in the attached Appendix. If you have any queries regarding this submission, please contact at first instance Chartered Accountants Australia & New Zealand's Senior Advocate, Karen Liew, on [redacted] or by email at [redacted], or The Tax Institute's Senior Counsel – Tax & Legal, Julie Abdalla, on [redacted], or by email at [redacted]

Yours sincerely,

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Appendix

Comments on Government Amendments

Retrospective commencement of new thin capitalisation provisions with no enacted legislation

With the Government Amendments now subject to inquiry and report by the Senate Committee, the Bill will not be considered further until Parliament sittings commence from 6 February 2024. This means that by the time the Bill receives Royal Assent, at least eight months will have passed since 1 July 2023, the start date for the thin capitalisation changes (other than the DDCR).

To provide certainty to taxpayers and to uphold a properly functioning legislative process, the Joint Bodies are of the strong view that the application date should be deferred to income years commencing on or after 1 July 2024.

However, we acknowledge that the Government is committed to the currently proposed application date for the thin capitalisation changes from 1 July 2023 and the forecasted revenue from these changes may have already been allocated.

Should the application date for the thin capitalisation changes be maintained as 1 July 2023, the Joint Bodies' key concern is the transitional period. Our members have expressed deep concern that taxpayers have had to *anticipate* the law during the past six months from 1 July 2023 and continue to do so until the enactment of the Bill. Entities that have applied the law as enacted in managing their tax affairs may find themselves in a historically non-compliant position once the Bill is enacted. Furthermore, and due to the ongoing amendments to the Bill, entities that have sought to comply with the proposed changes in planning and forecasting the expected tax outcomes on new or existing financing arrangements, may equally find themselves in a historically non-compliant position. This is costly and difficult for taxpayers to rectify and causes an undue burden on the administrator. In this regard, the funds management industry is acutely impacted as managed funds have had to use their best endeavours to anticipate the changes to the thin capitalisation rules in making interim trust distributions relied upon by investors.

Accordingly, it will be crucial for the Australian Taxation Office to work pragmatically with taxpayers that have incorrectly anticipated the law during this prolonged period of uncertainty.

Tax EBIDTA – prior year losses

Broadly, subsection 820-52(1A) of the ITAA 1997 provides that in working out the taxable income or tax loss of a corporate tax entity for an income year for the purposes of working out an entity's tax EBITDA, it is assumed that the entity chooses to deduct all the entity's prior years' tax losses.

While we submit that it seems inappropriate that tax losses that are deducted or available impact the tax EBIDTA (noting that prior year losses do not affect an entity's capacity to fund current year debt costs), the Joint Bodies submit that at a minimum the prior year tax losses of an entity as at 1 July 2023 (assuming the commencement date is 1 July 2023) should be excluded from the tax EBITDA calculation. This is because the prior year losses have been incurred in a time period where the thin capitalisation rules have been based on an asset-based calculation.

Additionally, in relation to the FRT, there is a broader concern that in the case of stapled structures, there may be an issue of double counting of losses where a company chooses not to apply losses in a particular year, i.e. the FRT assumes maximum utilisation of losses in the year in which the loss is not applied, and then also recognises the loss in the year applied.

Tax EBITDA – investment holdings between 10% and 50%

The Joint Bodies are concerned about the impact of the thin capitalisation changes in calculating the tax EBITDA for investors who hold interests in investments in the range of 10% up to 50%.

The Government Amendments propose that investors with a TC control interest of 50% or more can access excess tax EBIDTA of a lower tier entity (section 820-60 of the ITAA 1997) in calculating their fixed ratio earnings limit (i.e. 30% of EBITDA) under the FRT. We fully support the need to enable investors to access excess tax EBITDA of lower tier investments whether they be companies, trusts or partnerships.

For investors with a TC control interest of less than 10%, dividends or distributions received are not disregarded in working out their taxable income/loss for the purposes of calculating their fixed ratio earnings limit.

However, investors such as joint ventures and consortiums with a TC control interest in the range of 10% up to 50% are subject to a more restrictive fixed ratio earnings limit - they do not have the benefit of being able to access excess tax EBITDA of a lower tier entity and they are required to disregard any dividend or distribution received from their investment in lower tier entities. In the absence of other investment activity, this means there is no debt deduction available to these investors. This outcome will likely mean that these investments become unviable for those that need to debt fund the investment, and as such these investors may seek to move or direct their investment interests outside of Australia. There is no clear policy rationale for this gap and disparate treatment which is not present under the equivalent associate entity excess amount rules.

Should this 'dead zone' remain in the final legislation, we strongly recommend that this be taken into account in the post-implementation review of Schedule 2 that we have recommended, to assess the impact on foreign investment into Australia, outbound investment and economic growth.

Third party debt test

While the Joint Bodies welcome the substitution of the third party debt condition in paragraph 832-427A(3)(c) to disregard recourse to minor and insignificant ineligible assets such as assets which are not Australian assets, we have the following concerns:

- There is no practical guidance either in the explanatory memorandum or in the Bill on the 'minor or insignificant asset' carve out. The scope of the term is uncertain in practice. For example, it is unclear whether foreign assets comprising more or less than 5% or 10% secured assets are to be considered minor or insignificant.
- The meaning of the key term 'Australian assets' is not defined in the Bill. It is uncertain whether it requires active business to be conducted in Australia or whether passive investments are recognised. The explanatory memorandum to the Bill in paragraph 2.98 provides limited guidance on the term that, '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.

Further, in general, the TPDT is drafted as an 'all or nothing' test. To the extent the conditions are partially satisfied, it is unclear why the law should not allow the debt to satisfy the TPDT (i.e., to the extent to which conditions are satisfied). The Joint Bodies are of the view that such an approach would still be in line with the policy objectives and better align with approaches taken globally.

Debt deduction creation rules

The Joint Bodies prefer that the DDCR be removed from the Bill so that it can be subject to a comprehensive consultation process.

However, the Joint Bodies acknowledge that the commencement of the DDCR has been deferred to commence for income years starting on or after 1 July 2024 under the Government Amendments. This provides entities with some more time to examine their existing related party funding arrangements and restructure their affairs if necessary to be compliant with the new DDCR.

There remains, however, an ongoing compliance burden for taxpayers to review historical transactions for any debt arrangements that remain in existence at the commencement of the new rules to ascertain whether or not the initial funding was associated with the acquisition of a relevant asset from an associate pair or with funding the targeted payments or distributions to associate pairs. This is effectively a retrospective application of the law. For many groups, it will be extremely difficult to positively determine that the funds were not put to such uses, particularly where the debt has been in place for significant periods of time.

Debt deduction creation rules – exclusions

Exclusion for related party funding for the acquisition of trading stock from an associate pair

The Joint Bodies previously submitted in their respective submissions on the exposure draft of the Government Amendments that the exclusions do not go far enough to exclude common and commercial related party transactions from being captured. Although the scope of the DDCR has been narrowed under the Government Amendments, a clear exclusion for related party funding for the acquisition of trading stock remains absent and is still required.

Exclusion for entities satisfying the 90% Australian assets test under the exclusion from thin capitalisation.

An exclusion should be available from the DDCR for entities not subject to thin capitalisation under section 820-37 (those groups with 90%+ Australian assets). It is not clear why only the section 820-35 and 820-39 exclusions have been adopted but not section 820-37.

Exclusion for domestic debt

We recommend that the DDCR should not apply to any debt deductions relating to domestic debt, i.e. between Australian resident associate pairs. There is no apparent mischief for profit shifting since the interest expense deducted is assessable interest income to the lender.

Exclusion for entities that have chosen the third party debt test.

There are exclusions in the rules for entities that have made a choice to apply the TPDT but these only reference choices made under subsection 820-46(4). This would only apply to general class investors. Financial entities can make choices to apply the TPDT under subsection 820-85(2C) (for outward entities) and section 820-185(2C) (for inward entities). The exclusions should cover general class investors and financial entities.

Thin capitalisation changes – private groups

Excess tax EBITDA

Private groups usually include controlling individuals and their respective trusts. We query whether the ability to access a lower tier entity's excess tax EBITDA should be available to individuals and discretionary trusts so as to accommodate middle market structures. While a discretionary trust should not be able to attribute amounts to its beneficiaries, where an Australian discretionary trust holds shares/units in a lower tier entity it should be eligible to be a 'controlling entity' under section 820-60.

Third party debt test – deemed choice made for entities in a cross staple arrangement.

There is also concern that the deemed choice of applying the TPDT in subsection 820-48(3) that covers cross staple arrangements will have unintended reach. Many private groups (e.g. a property trust and operating company owned by the same family trust) could be considered 'cross staple arrangements' under the current definition of 'cross staple arrangements'. All that is required for a cross staple arrangement is an asset entity and operating entity with 80%+ common ownership. No legal stapling is required. We suggest that the Government Amendments include clarification that the deemed choice for cross staple arrangements does not include entities in a private group where there is no legal stapling.

Other Matters

Consistent with our previous submissions regarding the draft Bill, the explanatory memorandum to the Bill would benefit from further guidance, explanation, and examples regarding the following:

- the costs taken into account under the term 'debt deductions' as used in paragraph 820-50(3)(a) and for the purposes of determining amounts included in an entity's assessable income for the purposes of paragraph 820-50(3)(b);
- the scope of the reference to an 'amount that is economically equivalent to interest' in subparagraphs 820-40(1)(a)(i) and 820-50(3)(b)(ii) (e.g., is this intended to capture arrangements such as finance leases or other contractual obligations determined by reference to net present value or internal rate of return calculations?);
- the revised definition of 'financial entity', particularly in relation to what 'indirectly...on behalf of' means (e.g., is this limited to agency relationships, or can it apply where a subsidiary lends money as part of an offshore parent's business (as opposed to its own?));
- guidance that illustrates what would be considered an appropriate 'use of the proceeds of issuing the debt interest' by an entity to wholly fund its investments that relate only to assets:
  - that are attributable to the entity's Australian permanent establishment;
  - the entity holds for the purpose of producing assessable income; and
  - its Australian operations.