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Senate Standing Committees on Economics
PO Box 6100
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By email: economics.sen@aph.gov.au

Dear Secretariat,

Submission to the Senate Economics Legislation Committee

Inquiry into Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023

Perpetual Limited ("Perpetual") appreciates the opportunity to make a submission to the Senate Economics Legislation Committee inquiry into Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023 ("the Bill").

The primary focus of this Submission relates to **Schedule 2** of the Bill which amends the *Income Tax Assessment Act 1936 ("ITAA 1936"),* the *Income Tax Assessment Act 1997* ("ITAA 1997") and the *Taxation Administration Act 1953* in order to strengthen Australia's thin capitalisation rules.

1 About Perpetual

Perpetual is an ASX listed global financial services firm operating a multi-boutique asset management business, as well as wealth management and trustee services businesses.

Perpetual owns leading asset management brands including Perpetual, Pendal, Barrow Hanley, J O Hambro, Regnan, Trillium and Thompson, Siegel and Walmsley (TSW). Perpetual's private wealth business services high-net worth clients, not for profits, and small businesses through brands such as Perpetual Private, Jacaranda Financial Planning and Fordham. Perpetual's corporate trust division provides services to managed funds, the debt market and includes a growing digital business, encompassing Laminar Capital.

Headquartered in Sydney, Perpetual services its global client base from offices across Australia as well as internationally from Asia, Europe, the United Kingdom and the United States.

2 Deferral of previously Proposed Amendments to Section 25-90 and 230-15

We welcome the Government's decision to remove from the Bill the proposed amendments to section 25-90 and 230-15 of the ITAA 1997 which sought to disallow interest deductions incurred in deriving non assessable non-exempt (NANE) income.

We note that on page 92 of the Explanatory Memorandum to the Bill that the proposed amendment has been "deferred", to be considered via a separate process to the current Bill. In accordance with our submission to the Exposure Draft Legislation "Treasury Laws Amendment (Measures For Future Bills) Bill 2023; Thin Capitalisation Interest Limitation", we consider that future amendment to sections 25-90 and 230-15 of the kind proposed in the Exposure Draft legislation remains inappropriate for the following reasons:

- Any amendment of section 25-90 and 230-15 of the kind proposed in the Exposure Draft legislation would represent a significant modification to the policy approach underpinning Australia's outbound international income tax rules which have applied for the last 25 years. These rules were designed, inter alia, to improve the competitiveness of Australian companies with offshore operations, to encourage the establishment in Australia of regional headquarters for foreign groups and improve Australia's attractiveness as a continuing base for existing multinational companies.

- A critical element in pursuing this objective to encourage Australia as a regional holding company jurisdiction is the ability to deduct financing costs. Attempts to position Australia as a jurisdiction from which to establish holding companies (either domestic or foreign owned) which then acquire foreign companies will be frustrated if the holding company cannot borrow to fund its acquisitions. Any future modifications to sections 25-90 and 230-15 will increase the average cost of capital and make Australia less competitive in the global market. Any change to sections 25-90 and 230-15 may mean that Australian based multinationals will be forced to raise equity finance, which is more expensive than debt, or else borrow in the foreign jurisdiction where debt margins may well be higher for foreign owned borrowers.

- Most other OECD countries allow a deduction for interest incurred to derive dividends from foreign subsidiaries, subject to earnings-based interest limitation rules. Any future amendment to sections 25-90 and 230-15 will put Australia out-of-step with other major developed economies in the OECD, including the UK, Germany, Canada, the US, France, Spain and, as a result, Australia will become uncompetitive as a holding company jurisdiction and Australian multinationals will be disadvantaged relative to foreign multinationals. As an example, Australian multinationals may be unable to compete with foreign multinationals in acquiring new foreign assets (this is discussed in more detail in Appendix 1).

- The thin capitalisation rules will prevent the artificial loading of debt into Australian entities and remain the appropriate means to prevent such outcomes without the need to amend sections 25-90 and 230-15. The thin capitalisation tests require sufficient Australian income earning assets and assessable income to support interest deductions.

3 Debt Deduction Creation Rules

Subdivision 820-EAA of the Bill has unexpectedly introduced new "debt deduction creation rules". These rules were not included in the Exposure Draft legislation, nor have they been the subject of any previous Government announcement or mentioned in any consultation process.

The new rules are acknowledged on page 34 of the Explanatory Memorandum to the Bill as being a "modernised version" of the former debt creation provisions previously contained in Division 16G of the ITAA 1936. However, the proposed "debt deduction creation rules" are far broader than those previously contained in Division 16G of the ITAA 1936 and as such, may give rise to a number of inadvertent consequences.

The proposed "debt deduction creation rules" seek to mitigate the base erosion arising from excessive debt deductions created in connection with acquisitions of assets from associates or payments to associates by denying debt deductions in certain circumstances. The stated aim of the "debt deduction creation rules" is to disallow debt deductions to the extent that they are incurred in relation to debt creation schemes that lack "genuine commercial justification". However, the Bill does not seem to give effect to this stated intention. Instead, new Subdivision 820-EAA operates very broadly where the

transaction comes within a set of prohibitions, whether or not the transaction is domestic or cross border.

The new rules are intended to deny debt deductions in income years commencing on or after 1 July 2023 in circumstances where:

- Interest bearing debt (whether related party or third party) is used to acquire an asset (or an obligation) from an associate.

- Interest bearing debt (related party debt only) is used to fund any payment to an associate, including a dividend, return of capital or repayments of principal on a debt interest, and payments made in the ordinary course of business (such as acquiring trading stock and plant and equipment).

The way in which the provisions are drafted, including the lack of any purpose test, means the rules appear to have wide application to a broad range of transactions including those that have a genuine commercial justification. For example, an injection of additional equity by a holding company into either an offshore subsidiary, or a domestic subsidiary of a non-consolidated group in return for shares, could result in interest disallowance if the holding company borrowed to make the injection. By way of illustration, Perpetual currently seeds overseas investment strategies and products via corporate entities in the jurisdiction of the product – the capital for the overseas corporate to provide seeding is currently provided by Perpetual Ltd in Australia as an equity injection. Under the broad current drafting of the "debt deduction creation rules", any borrowing related to that injection could result in interest disallowance despite the transaction being a common and commercial practice. Additionally, given the fungibility of money and where an entity is operating on a pool of funds basis, taxpayers such as Perpetual will be forced to return to the practice of tracing to determine whether any equity injections discussed above have been directly or indirectly funded by borrowings. Of course, the practicalities of "tracing" are open to interpretation and disagreement and will impose an additional compliance burden on taxpayers that the thin capitalisation rules were in part designed to avoid.

The previous debt creation rules contained in Division 16G of the ITAA 1936 only applied to Australian entities controlled by a foreign controller. The previous rules excluded various types of transactions, whereas the current rules have a broader application and propose no exclusions. There are many aspects of the proposed rules which require refinement or clarification.

We also note that, as there are no transitional arrangements associated with the provisions, the "debt deduction creation rules" will apply to deny interest deductions for arrangements that were in place before 1 July 2023. Given that there has been no previous consultation on this rule, it is inequitable to deny taxpayers deductions for pre-1 July 2023 arrangements. We note that many outbound investors (including Perpetual) have made recent investment decisions based not only on the existing legislative provisions, but also the implications of thin capitalisation changes included in the Treasury Consultation Paper of August 2022, and other Government announcements.

We therefore believe it is inappropriate that the proposed "debt deduction creation rules", which were not previously foreshadowed, should be introduced without warning and with a start date which gives taxpayers no opportunity to plan for and implement alternatives.

4 Submission

Perpetual submits that:

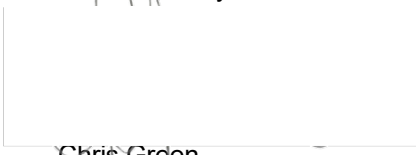
- Section 25-90 and 230-15 should be retained in their current form and that deductions should continue to be allowed indefinitely for interest costs connected with the derivation of NANE dividend income from foreign subsidiaries (per section 768-5 of the Act). Any concerns in relation debt loading in Australia are appropriately addressed by the thin capitalisation measures.

- The Government should remove the "debt deduction creation rules" from the Bill, and those rules and the concerns that they are aimed at should be subject to a comprehensive review and consultation process.

- If it is determined that the amendments will go ahead with effect from 1 July 2023, then grandfathering of existing arrangements is necessary.

Thank you for the opportunity to make this submission. If you require any further information, please do not hesitate to contact John Kirkness (Head of Tax) at .

Yours faithfully,



Chris Green
Chief Financial Officer
Perpetual Limited

APPENDIX 1
THIN CAPITALISATION – FUTURE AMENDMENTS TO SECTION 25-90 AND 230-15
REDUCED COMPETITIVENESS GLOBALLY / OECD COMPARISON

The Australian tax law identifies seven countries (which are also OECD members) whose tax systems are considered closely comparable to the Australian system ("listed countries"):

- United States
- United Kingdom
- Germany
- France
- Canada
- Japan
- New Zealand

[Source: Para 3.4 of the EM of *Taxation Laws Amendment (Foreign Income Measures) Bill 1997* and para 4.40 of the Board of Tax review of 2007 entitled *Review of Foreign Source Income Anti-Tax Deferral Regimes*].

All listed countries above:

- Allow a tax exemption for dividends from foreign subsidiaries;
- apply or will shortly apply an earnings-based interest deduction limit of the kind recommended in OECD's BEPS Action 4 report (except for NZ which continues to apply an assets-based outward thin capitalisation rule similar to Australia's current rules); and
- allow deductions for interest relating to exempt foreign dividends, but subject to the earnings-based limit.

Accordingly, the proposed amendment of section 25-90 would make Australia an outlier relative to its comparable jurisdictions and trading partners as summarised in the table below:

	US	UK	Germany	France	Canada	Japan	NZ	Aust Current	Aust Proposed
Foreign Dividend Exemption	Y	Y	Y	Y	Y	Y	Y	Y	Y
Earnings-based interest deduction limitation	Y	Y	Y	Y	Y	Y	N (Assets Based)	N (Assets Based)	Y
General denial of deduction for interest referable to exempt divs	N	N	N	N	N	N	N	N	Y

Australian headquartered multinationals that are unable to trace to domestic assessable income use would face an increase in their effective cost of borrowing which would disadvantage them relative to global competitors and negatively impact future growth prospects. The position adopted by the listed countries (and reflected in the current Australian position) recognises that multinational groups may prefer to borrow in their headquartered countries due to existing banking relationships, lower funding costs, and access to cashflows from mature businesses.

To amend sec 25-90 and 230-15 in the manner contemplated in the Exposure Draft Legislation places Australian headquartered multinationals in an adverse position relative to their global competitors.