Take the lead

21 December 2023

Committee Secretariat
Senate Standing Committees on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

By Email: economics.sen@aph.gov.au

Dear Committee Members

Senate Inquiry into the Government's proposed amendments to Schedule 2 of Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill [Provisions] 2023 (the Senate Inquiry)
Submission by SW Accountants & Advisors

SW Accountants & Advisors Pty Ltd (**SW**) welcomes and appreciates the opportunity to make a further submission to the Economics Legislation Committee (**Committee**) in relation to the proposed amendments (the **Proposed Amendments**) to amend Schedule 2 of the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill [Provisions] 2023* (the **Bill**).

The focus of this submission is a particular issue that presents a significant, and we consider, unfairly adverse outcome for an ASX-listed real estate investment trust (**REIT**) client, although the issue is far from unique and would have broader implications throughout the property sector.

In this submission, we will outline our concern in relation to foreign currency hedging arrangements and the conduit financer rules that are common throughout the property sector and provide the Committee with a proposed solution to the issue.

Should you have any questions in relation to the submission please feel free to contact us.

Yours sincerely

Stephen O'Flynn
Director
SW Accountants & Advisors Pty Ltd

1. Background

The Bill includes a specific targeted concession relating to conduit financiers. Whilst the third party debt test is only generally available to taxpayers that borrow directly from an unrelated/external party, the proposed rules also appropriately seek to cater for circumstances where one entity in a group borrows externally and on-lends to other entities in the group.

Under proposed section 820-427C, as currently drafted, the conduit financier rules will only be available where a number of strict conditions are met. The essential thrust of these conditions is that the terms of a loan from the conduit financier are required to be the same as the terms of the loan to the conduit financier entity from the external lender.

The current wording of the proposed rules in section 820-427C permit the conduit borrower to recover:

- '*reasonable administrative costs that relate to the ultimate debt interest*' (being the loan to the conduit financier from the external lender), and [1]
- a cost that is a '*debt deduction*' that is treated as being attributable to the ultimate debt interest (under subsection 820-427A(2)) because it is '*directly associated with hedging or managing the interest rate risk in respect of the ultimate debt interest*'.[2]

However, the proposed rules do not permit a conduit financer to pass through the costs associated with managing foreign currency risk pertaining to the ultimate debt interest (the external loan) on behalf of the group. The way in which the proposed rules are currently drafted, the passing on of such costs would mean that a conduit financier would not be able to satisfy the third party debt test. It is submitted that there are two problems with the current drafting which lead to this result or (in the case of the second) arguably lead to this result:

- the cost of hedging foreign currency risk relating to a foreign currency denominated debt does not fall within the meaning of 'debt deduction', and
- it is unclear whether the term '*hedging or managing the interest rate risk*' is a composite phrase or 'hedging' and 'managing interest rate risk' are separate exclusions. This wording creates uncertainty as to whether the hedging of foreign currency risks relating to debt would be able to be recovered by a conduit financier without breaching the conduit financier conditions.

We have set out below some brief commentary on common commercial practice in relation to hedging of foreign currency risk (see 2, below), followed by a more detailed explanation of the two technical concerns referred to above (see 3 and 4, below). We have also set out (at 5 below) proposed amendments to rectify the issue identified.

2. Hedging foreign currency

The hedging of foreign currency risk is a commercial necessity in relation to circumstances where Australian entities are required to import debt capital into Australia where the third party lender is only willing to lend in foreign currency. From a policy perspective, it is submitted that an entity that hedges foreign currency risk associated with a third party loan, should not be precluded from eligibility for the third party debt. It is submitted that the hedging of this risk should be viewed in exactly the same way as arrangements to hedge interest rate risk. Neither the hedging of interest rate risk nor foreign currency risk associated with a debt interest gives rise to base erosion or shifting of profits at which the new thin capitalisation rules seek to target.

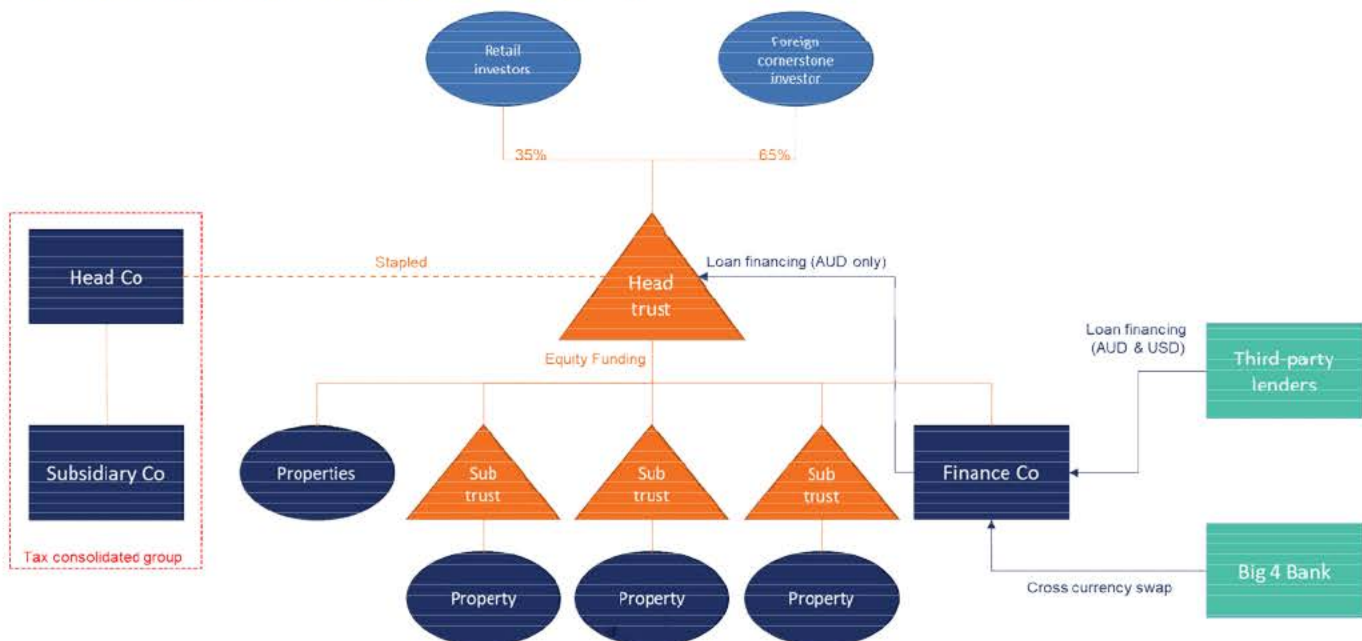
We have a client that is a major ASX-listed REIT, that has the following structure:

- Finance Co borrows USD from third parties (being banks and other financial institutions in the United States).

[1] Proposed paragraph 820-427C(2)(b).
[2] Proposed paragraph 820-427C(2)(d).

- Finance Co enters into hedging arrangements with the big 4 banks in Australia.
- Finance Co lends money in AUD to the Head Trust that is listed on the ASX.
- The Head Trust uses the AUD loans to invest directly and indirectly in Australian real estate assets.

We have set out this structure diagrammatically below.



The purpose of having Finance Co in the above structure is to have a single entity raise funds for the group. As noted in the Explanatory Memorandum commentary on the conduit financier rules, this borrowing structure is commonly implemented by large groups to streamline and simplify the borrowing process.

Our client has entered into cross currency swap arrangements with the big 4 banks in order to manage the foreign currency exposure on foreign currency denominated debt. This approach is standard industry practice within the property funds sector and is important to provide capital security and reduce volatility of earnings for retail investors.

Whilst it has been investigated, we note that it is not commercially possible for each separate property owning trust in the group to enter into separate foreign currency hedging arrangements. Therefore, the only debt structure acceptable to the third party lenders of the group and the big 4 banks with which the hedging arrangements have been entered into, is the structure adopted above, as it allows for the streamlining and simplification of the ongoing lending process.

It is submitted that this funding arrangement which is driven purely by commercial factors and is by no means unique to our client should not be denied eligibility for the conduit financier concession. In our view, it is quite contrary to intended objectives of the proposed amendments and OECD guidance for the Head Trust to be denied debt deductions merely because Finance Co passes through the foreign currency hedging costs to the Head Trust in order to recoup the full costs of the external borrowing arrangement. It seems anomalous that the recovery of costs associated with hedging foreign currency risk on external debt should preclude access to the third party debt test. It is strongly submitted that such arrangements should be treated in the same way as arrangements to manage interest rate risk.

3. Debt deduction

The concession in the conduit financer provisions, regarding passing through costs associated with 'hedging or managing interest rate risks' provided in section 820-427C(2)(e), relates solely to amounts that are 'debt deductions'. The definition of a debt deduction will be amended to include amounts where:

> *The cost is interest, an amount in the nature of interest, or any other amount that is economically equivalent to interest.*

We note that there is no statutory definition or guidance regarding what constitutes an 'amount that is economically equivalent to interest'. It is considered clear that payments under an interest swap arrangement (commonly used to hedge against the risk of an increase in variable interest rates on debt) would fall within the definition of debt deduction. However, in relation to foreign currency hedging, in the '*Action 4: 2015 Report: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*', the OECD makes the following comment:

> *It is recognised that foreign exchange gains and losses on instruments to hedge or take on a currency exposure connected with the raising of finance are not generally economically equivalent to interest.* ***A country may however wish to treat some or all foreign exchange gains and losses on these instruments as economically equivalent to interest, in line with local tax rules and to reflect the economics of the currency exposure.*** [emphasis added]

The proposed amendments below would align with OECD guidance to treat foreign currency hedges as an amount which could be passed through a conduit financer. It is considered that this would be also entirely consistent with the policy intent of the new changes and would not present any integrity risks.

4. Hedging or managing interest rate risks

In our view it is unclear whether the term used in the existing draft conduit financier rules '*hedging or managing the interest rate risk*' is a composite phrase or whether each is a separate alternative - expressed in other words, whether the term is only referring to arrangements relating to interest rate risk or whether the term 'hedging' should be read as contemplating not only the hedging of interest rate risk, but also foreign currency risks.

We would strongly recommend that this is clarified in the final form of the legislation. The proposed amendment below includes a new subsection in 820-427C(2) to specifically address foreign currency hedging arrangements to clarify this matter.

5. Proposed amendments to the Bill

We have included below, in bold, the minor technical amendments that we propose be implemented to rectify the anomaly in the legislation referred to above.

> Section 820-427C(2)
>
> *For the purposes of paragraph (1)(d):*
>
> …
>
> *(e) disregard the terms (if any) of a relevant debt interest, to the extent that those terms have the effect of allowing (whether directly, or indirectly through one or more interposed borrowers) the recovery of costs of a borrower that:*
>
> > *i. are a debt deduction for the income year of the borrower; and*
> >
> > *ii. are a debt deduction that is treated as being attributable to another debt interest under subsection 820-427A(2) because it is directly associated with hedging or managing the interest rate risk in respect of that other debt interest.*

(f) disregard the terms (if any) of a relevant debt interest, to the extent that those terms have the effect of allowing (whether directly, or indirectly through one or more interposed borrowers) the recovery of costs of a borrower that:

- **i. are directly associated with hedging or managing foreign currency risk in respect of the ultimate debt interest ; and**
- **ii. are not referrable to an amount paid or payable, directly or indirectly, to an * associate entity of the conduit financer, the borrowers and each conduit borrower.**

6. Conclusion

Internationally, there is growing interest in the investment and growth of the Australian property sector. Any changes to the thin capitalisation regime should be balanced, measured, and cognisant of the commercial realities and impact on property trusts, a key stakeholder contributing to Australia's economy and housing supply.

Any reform of the thin capitalisation regime must take due account of international competition for global capital and the policy objectives intended. As discussed above, the purpose of the Bill is to address risks to Australia's domestic tax base arising from excessive use of interest expenses or debt deductions, which amount to base erosion or profit shifting arrangements.

We believe the proposed amendments above support the general policy intent to permit debt deductions where there are genuine third-party arrangements, whilst also protecting Australia's revenue base.

SW fully supports, and will continue contributing to, the ongoing reform of Australia's current tax laws, particularly in dealing with tax issues affecting the Australia property sector, to ensure the future success of Australia.