BCA
Business Council of Australia

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

BCA Submission

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1. Overview

The Business Council welcomes the opportunity to provide a submission to the Senate Inquiry Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023. The proposed changes seek to deliver on the government's election commitments on multinational tax and transparency, particularly strengthening Australia's interest limitation (thin capitalisation) rules.

All companies must meet their tax obligations and where arrangements do not keep pace with community norms, they should be reviewed. Robust tax integrity and transparency measures are an integral complement to more competitive business tax arrangements.

Australia has some of the strongest tax integrity rules in the world, and they have been strengthened over time.[1] Existing integrity measures, institutions and enforcement all contribute towards and complement a high level of compliance with our tax system. The Australian Taxation Office (ATO) is a strong, capable, active and well-resourced administrator, with extensive powers and a strict interest and penalty regime. The ATO workforce focused on large companies is "larger and more skilled than it has ever been",- and it has one-to-one engagement with large companies for assurance over approximately two-thirds of all corporate tax (over $60 billion).[2] The ATO has measured the net tax gap in 2019-20 for individuals not in business to be $9.0 billion (or 5.6 per cent), for small business to be $11.9 billion (or 11.6 per cent), and for large companies to be $2.6 billion (or 4.2 per cent).[3]

The BCA supports the notion that measures be balanced against "the need to attract and retain foreign capital and investment in Australia, limit potential additional compliance cost considerations for business, and continue to support genuine commercial activity."[4] A consultation process that follows best practice principles is critical.[5]

The tax system must ensure that the Australian economy, which is heavily reliant on trade and foreign investment, remains strong and continues to grow. Productivity growth is the key driver of living standards, but the past decade was the worst decade for productivity growth in the past 60 years. Investment is critical for driving productivity and has accounted for two-thirds of labour productivity growth the past 40 years. This includes through procurement of state-of-the-art machinery and equipment and the development and adoption of cutting-edge technologies.

2. Key recommendations

1. The overhaul of the thin capitalisation regime should be accompanied by a legislated requirement for a formal review process, to be conducted within three years.
2. Remove the debt deduction creation rules from the Bill and consider them as part of a broader consultation process into section 25-90 of the of the *Income Tax Assessment Act 1997*. If the rules are not removed, it should be clarified that they apply only if a scheme was entered into for the sole or dominant purpose of generating excess debt deductions and reducing tax payable in Australia.

[1] Commonwealth of Australia, Treasury, *The Digital Economy and Australia's Corporate Tax System*, Treasury Discussion Paper, October 2018.
[2] https://www.ato.gov.au/General/Tax-and-Corporate-Australia/We-are-an-active-and-capable-administrator/
[3] https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Australian-tax-gaps-overview/?page=3#Annual_tax_gap_findings
[4] The Australian Government the Treasury, 2022, *Government election commitments: Multinational tax integrity and enhanced tax transparency, Consultation paper*, August.
[5] Commonwealth of Australia, Department of the Prime Minister and Cabinet, *The Australian Government Guide to Regulatory Impact Analysis*

3. Additional information

Australia's thin capitalisation regime is an integrity measure designed to ensure that multinationals do not allocate an excessive amount of debt to their Australian operations. It limits the extent to which a company may claim deductions for interest paid on debt.

The proposed changes to the thin capitalisation rules include the introduction of a 'general class investor' definition and three new tests in the form of a fixed ratio test (to replace the safe harbour test), group ratio test (to replace the worldwide gearing test) and a third-party debt test (to replace the arm's length debt test). They also include the introduction of new debt deduction creation rules.

It is critical the proposed changes do not unnecessarily increase complexity and compliance costs or make it more difficult to attract and retain investment in Australia – including through the permanent denial of interest deductions. When combined with Australia's relatively high 30 per cent corporate tax rate, an approach that permanently denies interest deductions could have an adverse impact on investment.

Some business models require companies to fund operations with larger amounts of debt, in which case the existing arm's length debt test applies, to ensure they are not disadvantaged. There are many examples of businesses with significant upfront investments that take time to recoup, and these businesses often rely on high levels of debt. They include mines, oil and gas projects, renewable energy projects, infrastructure, power plants, aircraft and office buildings. The intention of the proposed third-party debt test is that these projects are still not disadvantaged.

The investment environment has already been made more challenging, particularly for capital-intensive projects with long lead times. Recent years have seen governments abruptly change the rules of the game, increasing risk premiums for future projects. There also has been a long line of 'one-offs' and measures that give broad scope and power for unnecessary and excessive interventions in business practices such as recent energy market intervention, the introduction of energy divestiture laws and critical infrastructure laws. Businesses with the largest balance sheets have been the target of ad hoc tax increases (e.g. royalty and payroll tax hikes), additional compliance measures, increased reporting, and additional/higher penalties. There has been excessive government reliance on ministerial discretion and less predictable, ad hoc decision making.

The estimated revenue gain implies the new tests will be harder for some entities and transactions to satisfy. However, to that extent, the deterrent to new investment will also be larger, pointing to dynamic risks to future capital-intensive investments and any associated revenue that could offset any static revenue gain.

A post-implementation review will be critical

The proposed changes are due to take effect from 1 July 2023, with the Bill being introduced to the Parliament a little over a week prior to that date. This Senate Inquiry into the Bill will help inform the Parliamentary debate around the potential impact of any proposed changes. This includes ensuring that they meet the policy intent in a way that continues to attract and retain foreign capital and investment, minimises compliance costs, continues to support genuine commercial activity and avoids unintended consequences.

It should be recognised that the final details of the proposed changes are not yet legislated or confirmed. Without change, they will apply retrospectively, including to debt already committed to by taxpayers. Both taxpayers and the ATO will have limited time to update existing systems and processes to comply with a highly complex and technical set of changes. At the same time, the proposed changes represent a significant overhaul of Australia's thin capitalisation regime with new tests, new definitions, and new concepts.

Taken together, these factors outline a strong case for a formal post-implementation review following the proposed overhaul of the thin capitalisation regime. The proposed immediate application of these highly complex changes in particular mean it is almost inevitable that unintended consequences will arise. While Treasury and the ATO will monitor the application of the changes as standard practice, a formal review process

would provide taxpayers with greater certainty and clarity with a formal mechanism for raising and addressing any potential issues. The Board of Taxation may be well placed to conduct such a review.

Recommendation 1

The overhaul of the thin capitalisation regime should be accompanied by a legislated requirement for a formal review process, to be conducted within three years.

Debt deduction creation rules

The newly proposed debt deduction creation rules seek to deny debt deductions "to the extent that they are incurred in relation to debt creation schemes that lack genuine commercial justification".[6] While this is mentioned in the Explanatory Memorandum, the rules as currently drafted do not support this intention.

The debt deduction creation rules have been introduced in place of the previously proposed repeal of section 25-90 of the *Income Tax Assessment Act 1997*. This repeal would have led to a significant increase in compliance costs, impeded genuine commercial activity in the form of offshore investment, and raised limited – if any – revenue on an ongoing basis.[7] Its deferral in the form of a separate consultation process is welcome.

The proposed debt deduction creation rules have been deliberately "drafted broadly to help ensure they are capable of applying to debt creation schemes of varying complexity".[8] However, this broad application means the proposed rules will likely impact genuine commercial transactions and existing arrangements used to fund past transactions as there is no substance or purpose-based carve out contained in the rules. Debt deductions may be denied for routine transactions between associates for which there are no integrity concerns. For example, where an Australian taxpayer had an interest-bearing line of credit from a related company to buy trading stock from a third-party supplier. The net result will be the distortion of debt and equity financing across companies.

This is compounded by the similarly broad anti-avoidance measure that will potentially capture any attempt to structure a transaction in response to the debt creation rule.[9] A more targeted approach is required, for example greater specificity around transactions of concern and/or exclusions for certain transactions. At a minimum, the draft legislation should clarify that the proposed rules are meant to apply only when the sole or dominant purpose of using debt was to generate excess interest deductions and therefore reduce Australian tax payable. This will also ensure the rules align with the broader policy intent of the Bill.

The Impact Analysis notes these debt deduction creation rules are "targeted",[10] but the analysis does not clearly outline how they are the best approach of achieving the policy intent at least cost to the economy (for example, compared with better targeted rules to target the problem).

The broad application of the debt deduction creation rules, highly technical nature, potential impact on genuine commercial transactions and high risk of unintended consequences, means further consultation is warranted. Their connection to the proposed repeal of section 25-90 suggests the forthcoming consultation process into this measure should consider both changes together.

Recommendation 2

Remove the debt deduction creation rules from the Bill and consider them as part of a broader consultation process into section 25-90 of the of the *Income Tax Assessment Act 1997*. If the rules are not removed, it should be clarified that they apply only if a scheme was entered into for the sole or dominant purpose of generating excess debt deductions and reducing tax payable in Australia.

[6] Explanatory Memorandum, paragraph 2.146
[7] https://www.bca.com.au/submission_to_the_consultation_on_the_exposure_draft_for_strengthening_limitation_thin_capitalisation_rules
[8] Explanatory Memorandum, Paragraph 2.153
[9] Explanatory Memorandum, Paragraph 2.154
[10] Explanatory Memorandum, Page 92.

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GPO Box 1472, Melbourne 3001 T 03 8664 2664 F 03 8664 2666 www.bca.com.au

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