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Senate Standing Committees on Economics

PO Box 6100

Parliament House

Canberra ACT 2600

Via email [redacted]

AMENDING AUSTRALIA'S INTEREST LIMITATION (THIN CAPITALISATION) RULES

SUBMISSION ON PROPOSED AMENDMENTS

Dear Sir / Madam,

We, the Nufarm Limited Group (**Nufarm**), are writing to provide our submission with respect to the reform of the interest limitation (thin capitalisation) rules in Division 820 of the *Income Tax Assessment Act 1997* (Cth) as contemplated in *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023* (the **Bill**).

As an Australian headquartered multinational group (**Australian MNE Group**), we have been working through the potential impacts and are concerned with the reform in its current draft state and the potentially highly adverse impact it may have on Australian MNE Groups. In particular, we note that in our view:

- The introduction of the third-party debt conditions creates an impractical and seemingly unfair outcome for Australian MNE Groups in comparison to foreign headquartered multinational groups (**Foreign MNE Groups**) operating in Australia through a local subsidiary; and

- The current treatment in the Bill of tax losses in the Tax earnings before interest, taxes, depreciation, and amortisation (**EBITDA**) computation is flawed from a policy perspective and is punitive for Australian MNE Groups that have their risk taking and entrepreneurial activities in Australia compared to Foreign MNE Groups with far more limited risk operations with respect to their Australian presence.

We have outlined in the attached **Annexure** our background, further details regarding the above areas of concern (taking into consideration the most recent amendments released), and our submission.

If you would like to discuss any aspect of this submission, please contact me on [redacted]

Yours sincerely,

[redacted]

Damian Morrin

Global Tax Manager

Nufarm Limited

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Annexure

1) Our Background

Nufarm is a global crop protection and seed technology company that has developed and manufactured its products in Australia for over 60 years. Headquartered in Australia, Nufarm has 2 domestic manufacturing sites, employs 500+ Australians, and is the only local manufacturer of active ingredients for crop protection products.

Our crop protection business develops, manufactures, and sells solutions such as herbicides, insecticides and fungicides to help growers protect crops against weeds, pests and disease.

Our seed technology business creates products that provide protection and treatment for damage caused by insects, fungus and disease, and our Nuseed division develops unique plant output traits with specific customer and consumer benefits such as the world's first source of plant-based long-chain omega-3, a project developed in partnership with CSIRO.

For us, "agricultural sustainability" means the ability of the agricultural value chain to reliably and securely produce affordable food, fees and fuel in ways that regenerate the environment and protect the ongoing needs of future generations. We strive to enable this by engaging with our customers to understand their needs and bring innovative solutions to market.

Nufarm's commitment to its Australian heritage and the Australian agriculture sector has supported regional Australia's recovery in recent years, and Nufarm has been a trusted and quality solution provider maintaining supply of critical inputs to Australia's farmers.

In recent years, Nufarm's commitment to regional Australia has unfortunately played a significant part in the generation of significant carried forward tax losses. In the years to 2020 when Australia experienced prolonged droughts, the worst in 120 years, local sales reduced significantly, and Nufarm was forced to scale back manufacturing operations. It was not until 2020 when the drought broke that a strong demand for crop protection products returned (a primary driver of revenue growth for Nufarm). Furthermore, underlying operating costs increased in the same period partly due to the currency impact of a weaker Australian dollar.

In 2020 when the COVID-19 virus hit Australia, Australian supply of critical crop protection products was under threat, demonstrating how the sector has become increasingly dependent on imports which come primarily from China. Nufarm continued to stay true to its Australian roots and remained the only onshore manufacturer of the active ingredients needed for certain crop protection products.

Given our earnings from year-to-year can be heavily impacted by the Australian climate, it is evident that there can be volatility in Nufarm's earnings. Whilst we are accepting of the impact of such volatility under an earnings-based interest limitation rule, we advocate for an appropriate design of such rules (i.e., the computation of Tax EBITDA).

For completeness, we note that Nufarm has historically had gearing levels within Australia's prescribed safe harbour debt limit in accordance with the existing thin capitalisation rules in Division 820, with no disallowance of debt deductions resulting.

2) The Bill – Areas of Concern

As noted above, as currently stands, it is submitted that the proposed amendments in their current form may well have a higher adverse impact on Australian MNE Groups compared to local subsidiaries of Foreign MNE Groups. In our view, the unfair outcome that would result from the reform is heightened for those Australian MNE Groups who have previously derived tax losses locally due to their ongoing local presence (such as our continuous entrepreneurial endeavours and risk-taking activities noted above).

It is suggested that entities that have historically been compliant with the Australian thin capitalisation rules before are unfairly disadvantaged being subject to the thin capitalisation rules based on the design of the external third party debt test and treatment of carried forward tax losses in the definition of 'Tax EBITDA' (for the purposes of both the fixed ratio test and group ratio test). The proposed amendments to Division 820 (in particular the definition of Tax EBITDA in section 820-52 of the Bill) will result in prior year tax losses being inappropriately accelerated (and 'burnt out') along with other tax attributes (e.g., foreign income tax offsets (**FITO**), research and development (**R&D**) non-refundable tax credits, etc.).

We have noted below our reasoning for why we consider the amendments as currently drafted (including the most recent amendments released in November 2023) result in a comparative and actual disadvantage to Australian MNE Groups. In summary, we consider this to be a result of:

- The eligibility criteria contained in the Third-Party Debt conditions (particularly proposed paragraphs (c) and (d) of subsection 820-427A(3) of the Bill); and

- The treatment of tax losses in computing tax EBITDA in proposed section 820-52; that is, pursuant to subsections 820-52(1) and (1A) of the Bill, the 'deemed' notional use of available carry forward tax losses under subsection 36-17(2) or (3) in computing Tax EBITDA for an income year.

Third-Party Debt Conditions

Pursuant to proposed paragraph (d) of subsection 820-427A(3) of the Bill, it is a requirement under the third-party debt conditions that the entity (i.e., taxpayer applying Division 820) must use all (or substantially all of) the proceeds of its issued debt interests (to non-associates) to fund its commercial activities in connection with Australia. This must not include any overseas PE business and / or the holding of any associate entity debt (**AED**), controlled foreign entity debt (**CFED**) or controlled foreign entity equity (**CFEE**). Further, paragraph (c) of subsection 820-427A(3) of the Bill also imposes the requirement that a debt interest issued by an entity will only satisfy the third party debt conditions if, disregarding recourse to minor or insignificant assets, the holder of the debt interest has recourse for payment of the debt to which the debt interest relates *only to* certain Australian assets.

Setting aside the commercial practical difficulties that will arise in the tracing of proceeds, it is our expectation that the requirement in paragraph (d) of subsection 820-427A(3) of the Bill is likely to effectively prevent large Australian 'outbound investing' MNE Groups from accessing the Third-Party Debt Test (**TPDT**). Further, Australian MNE Groups in practice often provide credit support, including their foreign subsidiaries assets and shares, as collateral or security to their third-party financiers (as we would expect to be common market practice to ensure favourable financing terms). Again, this will negate the ability to access the TPDT. Australian MNE Groups that are ineligible for the TPDT (which provides for deduction entitlement on qualifying debt issuance to unrelated parties) will instead need to compute their interest deductibility by reference to the new concept of 'tax EBITDA' as defined in the Bill (per section 820-52), for the purpose of the Fixed Ratio Test in or the Group Ratio Test in Subdivision 820-AA of the Bill.

It is worth noting that in contrast, an Australian subsidiary of a foreign MNE Group is generally likely to satisfy the TPDT conditions where debt and equity interests in foreign group members are not structured as being held by the Australian entity (as a holding company) but rather under a foreign group entity, as 'sister' subsidiaries to their Australian operations. The inability for Australian MNE Groups to restructure their holding of foreign company equity and debt interests (CFED and CFE) in such a way to qualify for the TPDT is inequitable and unfair, and places Australian MNE Groups at a competitive disadvantage to their foreign counterparts.

Treatment of Tax Losses in Tax EBITDA Computation

The above outcome, although contended as being inequitable for Australian MNE Groups, could potentially be viewed as reasonable and appropriate if the alternative interest limitation tests in Subdivision 820-AA of the Bill (i.e., the fixed ratio test and group ratio test) operated in such a way that suitably accommodated for Australian MNE Groups. In particular, we note Australian MNE Groups whose functions are not risk-limited as commonly is the case for local subsidiaries (e.g., distributors) of foreign MNE Groups. Unfortunately, the current drafting of 'tax EBITDA', specifically the treatment of losses, has the opposite effect and operates to further penalise such Australian MNE Groups.

The October and November 2023 amendments to the interest limitation reform Bill contemplate utilisation of full amounts of available losses of a taxpayer in calculating their tax EBITDA for an income year. This is a stark comparison to the Original Bill released in June 2023 where the tax EBITDA concept required an 'add-back' for tax losses. The retention of entrepreneurial activity in Australian (and potential profit 'up-side' as a result) is something that has been a key aspect of the ATO's compliance activities with respect to MNE Groups in recent years (for example, see the ATO's guidance on cross border intangible arrangements in PCG 2023/D2 and the comments contained within on migration of intangible assets). For Australian MNE Groups that have retained valuable intangible property and functions in Australia, and have unfortunately made losses due to economic and market conditions, it is disappointing that the latest draft amendments with respect to the definition of 'tax EBITDA' in proposed subsections 820-52(1) and (1A) of the Bill contemplate the deemed notional use of all available losses.

It is submitted that this issue (i.e., treatment of tax losses) is potentially of lesser relevance and impact for many foreign MNE Groups and their Australian subsidiaries, particularly those with limited risk functions where annual profitability is expected to be more fixed (see for example the ATO Guidance on expected profit margins for inbound distributors in PCG 2019/1).

Furthermore, it is submitted that the deemed notional use of all available losses can also result in inappropriate outcomes in other cases. Considering a scenario whereby a taxpayer has a negative tax EBITDA in one year and not the next, it can present a risk of 'double counting' of the reduction to tax EBITDA (through deemed notional use of the full available carried forward tax losses in following years) and also present at odds with the concept of 'EBITDA' more generally.

Moreover, it is contended that it is essentially an unfair and inappropriate outcome for a loss relating to a prior income year (that has previously been subject to the interest limitation rules at the time) to impact a taxpayer's taxable income / loss position in a future income year under a new reformed thin capitalisation regime.

It is also observed that the computation of tax EBITDA post-deduction for prior year tax losses appears 'out of step' with many foreign jurisdictions with respect to design of interest limitation rules. For example, it is our understanding that the interest limitation rule in the United States contained in section 163(j) of the Inland Revenue Code, determines 'adjusted taxable income' (a concept equivalent to tax EBITDA) with an add-back for deductions for Net Operation Losses. This difference in treatment of losses can also indirectly impact the competitiveness of Australian MNE Groups.

3) Our Submission

In order to remove the expected disadvantaging effect that Division 820 reform may have on Australian MNE Groups compared to foreign MNE Groups, we submit that Tax EBITDA should be a year-by-year concept (such that taxpayers impacted by the thin capitalisation rules previously should not be disadvantaged twice) and either:

- The amendments should reflect the original bill in contemplating an 'add-back' for tax losses utilised in computing taxable income (absent the operation of Division 820). We contend this approach is preferable as EBITDA (excluded deductions for prior year tax losses) can be viewed as more appropriately reflecting the economic performance of a taxpayer for a given income year; or

- Carried forward tax losses relating to income years pre-implementation of the proposed amendments in the Bill should be 'grandfathered' without reduction for tax EBITDA for income years post effective date of the amendment.

Furthermore, we submit that:

- The third-party debt condition in paragraph (d) of subsection 820-427A(3) of the Bill be deleted in its entirety. In this regard, we note that it may still take a potentially lengthy period of time for Australian MNE Groups to arrange their affairs such that their financing arrangements fall within eligibility for the TBDT, noting the requirement in paragraph (c) regarding the limited types of assets that lender recourse can relate. As such, we view the suggested tax EBITDA correction as critically important for Australian MNE Groups for the immediate period of transition post implementation of the proposed amendments in the Bill.