22 December 2023

Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

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

Dear Committee Secretary

Submission to Senate Standing Committees on Economics

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

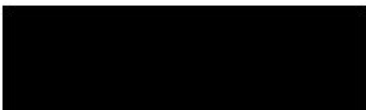
QIC Limited (**QIC**) is pleased to provide this submission to the Senate Economics Legislation Committee (**SELC**) in in relation to the proposed amendments (**Senate Amendments**), based on the earlier exposure draft legislation (**October 2023 ED**), in respect of the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023* (**Bill**) and the Senate supplementary explanatory memorandum to the Bill (**Supplementary EM**).

QIC is one of Australia's largest institutional fund managers with approximately AUD $100 billion in funds under management for over 115 local and international institutional clients. QIC is wholly owned by the Queensland Government and operates as an independent and fully commercial entity under the *Queensland Investment Corporation Act 1991* (Qld). QIC has a diverse range of investment capabilities with infrastructure included as one of its specialisations (in addition to real estate, private capital and debt and liquid market solutions).

QIC is pleased to provide this submission to the SELC.

Please note the views expressed in this submission represent the views of QIC as an independent, fully commercial entity and not the views of the Queensland Government.

Yours sincerely



Peter Nearhos
General Manager, Tax
QIC

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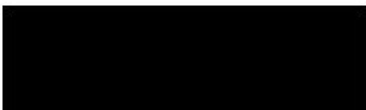

Peter Nearhos
General Manager, Tax
QIC

Introduction and summary of submissions

Given QIC's role as a fund manager and significant investor, we consider that it is vital that the proposed changes strike the right balance between protecting Australia's tax base and ensuring that Australia's ability to attract foreign capital is not disproportionately affected.

For the reasons set out in more detail further below, we provide the following recommendations which we consider appropriately strike such a balance.

At the outset, we consider that the proposed revised drafting of the Bill in the Senate Amendments is a significant improvement on the previous draft and the October 2023 ED. However, there are still a number of issues for QIC and the funds industry more generally with the Senate Amendments. In particular:

- the start date for all of the changes (not just the debt deduction creation rule (**DDCR**)) should be deferred until 1 July 2024 (and the DDCR start date moved to 1 July 2025), to afford taxpayers an appropriate amount of time to prepare for what are significant changes in the law;
- the DDCR continues to operate more broadly than the stated policy intention; and
- the trust excess capacity sharing mechanisms under the fixed ratio test (**FRT**) still produce asymmetrical, arbitrary and inconsistent outcomes such as where amounts are excluded from Tax EBITDA but are not available for capacity sharing.

Legislative references are to the Income Tax Assessment Act 1997 (**1997 Act**), the Income Tax Assessment Act 1936 (1936 Act) and the Taxation Administration Act 1953 (**TAA**), as appropriate.

Prior submissions

QIC previously made a submission **(Prior Submission)**[1] to the SELC (**First Senate Inquiry**) in relation to the SELC review and the ED changes to the Bill as set out in the October 2023 ED and accompanying exposure draft supplementary explanatory memorandum (**ED Supplementary EM**) (**included as Annexure 1**).

Recommendations

We respectfully recommend the following:

TOPIC	RECOMMENDATION
Error! Reference source not found. **Debt deduction creation rules**	We welcome the changes to the DDCR in the Senate Amendments. However, we submit that that breadth of the DDCR is still much broader than is required to satisfy their policy objective which will lead to uncertainty and increased compliance costs for taxpayers in circumstances where there is no risk to the revenue. **1.1** We recommend that purely domestic arrangements should not be covered by the rules at all as any debt creation would be expected to give rise to corresponding assessable income for the lender as well as a deduction available to the borrower. Additionally: • an overarching purpose test should be included to limit the DDCR to situations or transactions the predominant purpose of which is to increase debt deductions in Australia or to reduce assessable interest income in Australia; and • a safe-harbour rule whereby transactions not reasonably expected to result in a material net increase in debt deductions in Australia or a net reduction in

[1] QIC Submission to the SELD, 4 August 2023.

	assessable interest income in Australia should be included to provide certainty to taxpayers. **1.2** We recommend that the 90% Australian asset exemption in section 820-37 be extended to cover the DDCR to appropriately carve out entities and groups with overwhelmingly domestic operations, presenting a minimal risk to revenue. **1.3** We recommend that the DDCR should not apply to arrangements existing prior to 1 July 2024. Additionally, start date for the DDCR be extended to 1 July 2025 to allow taxpayers time to prepare for the DDCR.
2 Excess capacity sharing	**2.1** The excess capacity sharing rule in section 820-60 should be aligned with the 10% ownership trigger for the loss of Tax EBITDA (rather than the currently proposed 50%) to avoid asymmetrical outcomes and the creation of further complexity in the funds industry.
3 Amounts economically equivalent to interest	**3.1** The concept of an '*amount that is economically equivalent to interest*' should be clarified by examples of what is and what is not covered.
4 Third party debt test (TPDT)	**4.1** The concept of '*minor or insignificant*' in relation to the exception to the 'Australian asset only' requirement in the third-party debt conditions (subsection 820-427A(3)(c)) should be clarified. We recommend an objective test, for example by reference to the value of the ineligible asset as a proportion (such as 10%) of the security pool when the relevant debt is created, to provide certainty to taxpayers. **4.2** The requirement that the borrower does not use amounts borrowed to fund overseas operations (subsection 820-427A(3)(d)) should only be breached where the purpose of the funding includes the purpose of directly funding overseas operations. **4.3** An exclusion should be added for groups/entities that breach the credit support limitation in section 820-427A(5)(a)(ii) solely because of a parental guarantee from an Australian entity where there is no direct recourse to non-Australian assets. This will ensure Australian outward groups are not disadvantaged (versus non-Australian parented groups) and discouraged from foreign investment.
5 Timing	**5.1** We recommend that the start date for the Bill should be moved to 1 July 2024 to: • ensure taxpayers can operate with more certainty in relation currently proposed transactions; • allow time for more careful consideration of the drafting and policy objectives of the changes; and • allow taxpayers time to review their current arrangements.
6 Review mechanism	**6.1** We recommend that Senator David Pocock's proposal to include a requirement for a review of the new rules to occur no later than 1 February 2026 be adopted.

Submissions

1. Debt deduction creation rules

We welcome the changes to the DDCR in the Senate Amendments. However, we submit that that the breadth of the DDCR still exceeds that required to satisfy the policy objective of the rules and will lead to uncertainty and increased compliance costs for taxpayers in circumstances where there is no risk to the revenue.

We reiterate our comments in the Prior Submissions,[2] that the purpose of the DDCR is articulated in the explanatory memorandum to the Bill (**EM**) to the Bill as addressing the risks identified in paragraphs 173-174 of Chapter 9 of the BEPS Action 4 Report[3] (the Supplementary EM does not provide any further context as to the DDCR's purpose). The risks identified by the OECD relate to situations where debt creation results in a net increase in deductions (or tax-exempt income) or a decrease in interest income. This position is reflected in the many submissions to the First Senate Inquiry, as noted in the report from that inquiry (**Report**). For example:

The American Chamber of Commerce in Australia submitted that:[4]

> *'...the proposed Debt Deduction Creation rules...do not align with OECD norms and will result in Australia becoming a global outlier with overly restrictive debt limitation rules compared to our peers.'*

The Property Council of Australia submitted:[5]

> *'...with respect to the debt creation rules, in our view they should be deferred until proper consultation can be undertaken to determine an appropriate scope to those rules. To be honest, they apply to very common restructure and refinancing arrangements in circumstances where there appears to be no mischief that is actually being targeted. So, to take a very straightforward example, those debt creation rules can apply where there's actually no net debt created at all. If you move an asset between two vehicles and you gear it at the same level, those rules will apply to deny your debt deductions. There's no discernible logic as to why the rules operate in that manner.'*

Perpetual Limited submitted:[6]

> *'These provisions go much further than that and actually attack domestic transactions which have no impact on Australian revenue whatsoever.'*

The proposed changes in the Senate Amendments (in particular, the exception for certain CGT assets in section 820-423AA) do improve the situation by ensuring the rules are more targeted. However, the drafting of the provisions is still very broad and will capture many transactions where there is no mischief. For example, in relation to financial arrangement debt (which the new exceptions do not cover), and the continued capture of many purely domestic arrangements where there would be no net loss to revenue. The new exceptions also add yet another layer of complexity to already very complicated rules.

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2 QIC Submission to the Senate Economics Legislation Committee, part 2 and QIC Submission on the October 2023 ED, part 1.

3 EM, [2.144]-[2.147].

4 American Chamber of Commerce in Australia, Submission 21, p. 5.

5 Mr Stephen Whittington, Member, Capital Markets Committee, Property Council of Australia, *Committee Hansard*, 15 August 2023, pp. 39.

6 Mr John Kirkness, Head of Tax, Group Finance, Perpetual Limited, Committee Hansard, 15 August 2023, p. 25.

In relation to the risks identified by BEPS Action 4 Report, we consider that these are adequately addressed under existing rules (including transfer pricing and Pt IVA) in concert with the proposed thin cap changes under the Bill more generally. Even if this were not the case, we consider that the breadth of the rules (as amended by the proposed Senate Amendments) still goes further than what is required to protect Australia's revenue base.

We consider that the policy basis for the rules should go no further than situations where debt creation results in a net increase in Australian deductions (or tax-exempt income) or a decrease in Australian assessable interest income (including via reduced rates of withholding taxes), in line with the BEPS Action 4 Report recommendation.

The current drafting of the DDCR as amended will still require consideration in many vanilla and uncontroversial transactions, which will increase uncertainty and compliance costs for taxpayers and investors. In this respect, we note that the DDCR will cover many more taxpayers, including groups with primarily domestic operations that should not present any mischief to the revenue. This is because, for example:

- the $2m *de minimis* exception is less and less relevant in light of the current interest rate environment and that it has not been updated for many years; and
- the DDCR will apply even where the entity is covered by the general exclusion for Australian entities with 90% Australian assets (which many primarily domestic groups rely on).

We note that the DDCR will have retrospective effect and require taxpayers to reconsider arrangements that were entered into long ago. This will create a significant compliance burden. It is likely that in many cases, the evidence that would be required to assess to application of the DDCR to existing arrangements would not be available (because at the time it was not expected that it would be). Accordingly, existing arrangements should be grandfathered. Additionally, the start date for the DDCR should be extended to 1 July 2025 (to align with the recommended new start date of 1 July 2024 for the rules more broadly).

Recommendation

1.1 We recommend that purely domestic arrangements should not be covered by the rules at all as any debt creation would be expected to give rise to corresponding assessable income for the lender as well as a deduction available to the borrower. Additionally:

    - an overarching purpose test should be included to limit the DDCR to situations or transactions the predominant purpose of which is to increase debt deductions in Australia or to reduce assessable interest income in Australia; and
    - a safe-harbour rule whereby transactions not reasonably expected to result in a material net increase in debt deductions in Australia or a net reduction in assessable interest income in Australia should be included to provide certainty to taxpayers.

1.2 We recommend that the 90% Australian asset exemption in section 820-37 be extended to cover the DDCR to appropriately carve out entities and groups with overwhelmingly domestic operations, presenting a minimal risk to revenue.

1.3 Finally, we recommend that the DDCR should not apply to arrangements existing prior to 1 July 2024. Additionally, the start date for the DDCR be extended to 1 July 2025 to allow taxpayers time to prepare for the DDCR.

2 Excess capacity sharing

We welcome the inclusion of the trust excess capacity sharing rule in section 820-60 covering new entities. However, it remains unclear what the basis is for limiting the rule to TC control interests of 50% or more, where the trigger for the exclusion of distributions from tax EBITDA is a TC control interest of 10% or more. This means a holding entity which holds a TC control interest of between 10% and 50% in a subsidiary entity is unable to include either the distribution income received (as the TC control interest is 10% or more) or excess tax capacity from the subsidiary entity (as the TC control interest is less than 50%) in calculating its tax EBITDA amount.

Recommendation

2.2 The excess capacity sharing rule in section 820-60 should be aligned with the 10% ownership trigger for the loss of Tax EBITDA to avoid asymmetrical outcomes and the creation of further complexity in the funds industry.

3 Amounts economically equivalent to interest

As noted in our Prior Submission,[7] there remains uncertainty as to 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). Although it is apparent from the EM that swaps would be covered by the new wording the scope of the words is unclear as many arrangements could be said to be economically equivalent to interest but may not in fact correctly characterised as such. Examples include:

a. It is not clear that lease payments under accounting finance leases which are not hire purchase agreements for income tax purposes would be captured as debt deductions, given the broad drafting of subparagraphs 820-40(1)(a)(i) and 820-50(3)(b)(ii).

b. Many contractual payment obligations incorporate net present value, internal rate of return, inflation/CPI and similar formulas, such as a lease payment clause including yearly increases for CPI. Such arrangements are generally common commercial terms and should not be treated as if they were legal form interest.

c. Many contractual arrangements involve the sale of assets, such as receivables, at a discount (e.g., debt factoring). The form of these arrangements is varied (whether it is in substance a sale of an asset or a form of financing), but the concept of what constitutes a debt deduction or net deduction should provide sufficient guidance on what the parameters are. Similar arrangements involving sale and repurchase agreement (e.g., 'repos') would be subject to similar uncertainty under the existing vague concept.

Recommendation

3.2 The concept of an 'amount that is economically equivalent to interest' should be clarified by examples of what is and what is not covered.

4 TPDT

The purpose of the TPDT is to allow genuinely highly geared groups to fund Australian operations at a higher level than the fixed ratio test would allow.[8] While changes are proposed in the Senate Amendments, the rules remain too narrow and as such are unlikely to be utilised in the context of anything but the simplest of scenarios, particularly by groups with offshore operations.

The TPDT conditions require that the third-party lender only has recourse to particular Australian assets. That requirement has been modified to:

- cover Australian assets that are held by the issuer, membership interests in the issuer, or held by an *'Australian entity'* that is a member of the relevant *'obligor group'*; and
- ignore *'minor or insignificant assets'* that would otherwise be ineligible.

The Supplementary EM explains that the allowance for '*minor or insignificant assets*' '*is intended to prevent [the TPDT conditions] being contravened for inadvertent and superficial reasons. Determining whether recourse to ineligible assets is minor and insignificant will generally require a consideration of the ineligible assets to which recourse for payment of the debt can be had and whether those ineligible assets are of a minor and insignificant nature.*'[9]

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[7] QIC Submission to the Senate Economics Legislation Committee, [3.3]; QIC Submission to Treasury in respect of the October ED, part 3.
[8] EM, [2.12].
[9] Supplementary EM, [1.30].

These changes are welcome, although there is some uncertainty as to what may be considered *'minor or insignificant'*.

However, many entities/groups with international operations will still struggle to apply the rules practically and will thus be excluded from rules that, in line with the stated policy of making allowances for genuinely highly geared groups, should allow them to rely on the TPDT. Two requirements in particular will present practical difficulties for such entities/groups:

- Section 820-427A(3)(d) requires that:

  'the entity uses all, or substantially all, of the proceeds of issuing the debt interest to fund its commercial activities in connection with Australia that do not include:

  *(i) any *business carried on by the entity at or through its *overseas permanent establishments; and*

  *(ii) the holding by the entity of any *associate entity debt, *controlled foreign entity debt or *controlled foreign entity equity;'*

  Accordingly, where there are offshore operations that the relevant debt may indirectly fund solely by virtue of comingling working capital, the TPDT requirements may be failed. This presents a significant compliance burden for such entities who propose to rely on the TPDT as complicated tracing and segregation would be required. The associated risk of this (e.g., failing the TPDT completely because of accounting errors) will deter many who should be entitled to rely on the TPDT from a policy perspective and make reliance on the rules administratively burdensome. From a policy perspective, section 820-427A(3)(d) should only be breached where the purpose of the funding includes the purpose of directly funding overseas operations.

- Section 820-427A(3)(c) (together with subsections (4) and (5), excludes arrangements that involve credit support that includes (section 820-427A(5)(a)(ii)):

  'a right that provides recourse, directly or indirectly, only to one or more Australian assets covered by subsection (4) that are not rights covered by this subsection;'

  The exclusion of indirect recourse to foreign assets makes the rules unworkable in practice, particularly for outward Australian groups who would find it difficult, if not impossible, to effectively exclude such foreign assets because **any** indirect interest (via shares/units in Australian subsidiaries or a chain of subsidiaries) would breach the rules. This will disadvantage Australian groups over non-Australian parented groups, who would be expected to find it easier to exclude non-Australian assets from the security pool. An exclusion for groups/entities that breach section 820-427A(5)(a)(ii) solely because of a parental guarantee from an Australian entity where there is no direct recourse to non-Australian assets would address this issue.

Recommendation

4.2 The concept of 'minor or insignificant' in relation to the exception to the 'Australian asset only' requirement in the third-party debt conditions (subsection 820-427A(3)(c)) should be clarified. We recommend an objective test, for example by reference to the value of the ineligible asset as a proportion (such as [10%]) of the security pool when the relevant debt is created, to provide certainty to taxpayers.

4.3 The requirement that the borrower does not use amounts borrowed to fund overseas operations (subsection 820-427A(3)(d)) should only be breached where the purpose of the funding includes the purpose of directly funding overseas operations.

An exclusion should be added for groups/entities that breach the credit support limitation in section 820-427A(5)(a)(ii) solely because of a parental guarantee from an Australian entity where there is no direct recourse to non-Australian assets. This will ensure Australian outward groups are not disadvantaged (versus non-Australian parented groups) and discouraged from foreign investment.

5 Timing

The significant thin capitalisation changes are set to apply from 1 July 2023. Following the previous SELC report handed down in September 2023, the Bill was not considered by the Senate again until it was referred to the SELC again on 5 December 2023. Given that the SELC is due to provide its report on 5 February 2024, it may be May or June before the Bill is finalised. This does not provide taxpayers with sufficient time to prepare for the changes.

Recommendation

5.2 We recommend that the start date for the Bill should be moved to 1 July 2024 to:

- ensure taxpayers can operate with more certainty in relation currently proposed transactions;
- allow time for more careful consideration of the drafting and policy objectives of the changes; and
- allow taxpayers time to review their current arrangements.

6 Review

Senator David Pocock has proposed[10] the inclusion of a requirement for a review of the new rules to occur no later than 1 February 2026. We consider this to be a sensible proposal which will represent an opportunity to review the law to ensure that it is operating appropriately and address technical issues. Without such a mechanism, it is likely that many issues (including those identified in the various submissions on the new law but also many that we expect will become apparent once the law is operative) will remain unresolved for a long time (if they are indeed ever resolved).

Any such review should also address the impact of the new rules on foreign direct investment.

Recommendation

6.2 We recommend that Senator David Pocock's proposal to include a requirement for a review of the new rules to occur no later than 1 February 2026 be adopted.

[10] CW - Independent [sheet 2294].

Annexure 1 – Prior Submissions

International Tax Unit
Corporate and International Tax Division
Treasury
Langton Cres
Parkes ACT 2600

MNETaxIntegrity@treasury.gov.au

30 October 2023

Dear Committee Secretary

Submission to Treasury

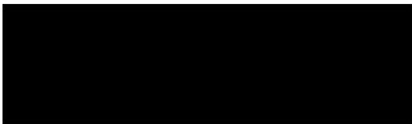
Multinational Tax Integrity – strengthening Australia's interest limitation (thin capitalisation) rules

QIC Limited (**QIC**) is pleased to provide this submission in respect of the proposed amendments to the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share — Integrity and Transparency) Bill 2023* (**Bill**) as set out in the Exposure Draft Legislation (**ED**) and accompanying supplementary explanatory memorandum (**Supplementary EM**) released for consultation on 18 October 2023.

QIC is one of Australia's largest institutional fund managers with approximately AUD $100 billion in funds under management for over 115 local and international institutional clients. QIC is wholly owned by the Queensland Government and operates as an independent and fully commercial entity under the *Queensland Investment Corporation Act 1991* (Qld). QIC has a diverse range of investment capabilities with infrastructure included as one of its specialisations (in addition to real estate, private capital, debt and liquid market solutions).

Please note the views expressed in this submission represent the views of QIC as an independent, fully commercial entity and not the views of the Queensland Government.

Yours sincerely



Peter Nearhos
General Manager, Tax
QIC

Introduction and summary of submissions

Given QIC's role as a fund manager and significant investor, we consider that it is vital that the proposed changes strike the right balance between protecting Australia's tax base and ensuring that Australia's ability to attract foreign capital is not disproportionately affected.

For the reasons set out in more detail further below, we provide the following recommendations which we consider appropriately strike such a balance.

At the outset, we consider that the revised drafting of the Bill is a significant improvement on the previous draft; however, there are still a number of issues for QIC and the funds industry more generally with the revised draft. In particular:

- we note that the debt deduction creation rule (**DDCR**) continues to operate more broadly than the stated policy intention; and
- the trust excess capacity sharing mechanisms under the fixed ratio test (**FRT**) still produce asymmetrical, arbitrary and inconsistent outcomes such as where amounts are excluded from Tax EBITDA but are not available for capacity sharing.

Legislative references are to the *Income Tax Assessment Act 1997* (**1997 Act**), the *Income Tax Assessment Act 1936* (**1936 Act**), and the *Taxation Administration Act 1953* (**TAA**), as appropriate.

Prior submissions

QIC previously made a submission (**Prior Submission**)[1] to the Senate Economics Legislative Committee in relation to the Senate Economics Legislation Committee review (included as **Annexure 1**).

Recommendations

We respectfully recommend the following:

TOPIC	RECOMMENDATION
1. Debt deduction creation rules	We welcome the changes to the DDCR in the ED. However, we submit that that breadth of the DDCR is still much broader than is required to satisfy their policy objective which will lead to uncertainty and increased compliance costs for taxpayers in circumstances where there is no risk to the revenue. **1.1** We recommend that purely domestic arrangements should not be covered by the rules at all as any debt creation would be expected to give rise to assessable income for the lender as well as the deductions available for the borrower. Additionally: • an overarching purpose test should be included to limit the DDCR to situations or transactions the predominant purpose of which is to increase debt deductions in Australia or to reduce assessable interest income in Australia; and • a safe-harbour rule whereby transactions not reasonably expected to result in a material net increase in debt deductions in Australia or a net reduction in assessable interest income in Australia should be included to provide certainty to taxpayers. **1.2** We recommend that there is a complete grandfathering of arrangements entered in before 22 June 2023, as opposed to only a 'grace period' given the significant compliance costs and challenges taxpayers will have in identifying and potentially restructuring existing arrangements. **1.3** Notwithstanding our preference for grandfathering, we would alternatively recommend that the grace period in the ED should be extended to 1 July 2025 to allow taxpayers time to prepare for the DDCR, which will require review of historic arrangements (given that taxpayers will currently only have a little over six months to prepare for the changes once the legislation has been finalised).

[1] QIC Submission to the Senate Economics Legislation Committee, 4 August 2023.

TOPIC	RECOMMENDATION
2. Excess capacity sharing	**2.1** We consider that the trust excess capacity sharing rule in s 820-60 should be aligned with the 10% ownership trigger for the loss of Tax EBITDA to avoid asymmetrical and arbitrary outcomes and the creation of further complexity. **2.2** Excess capacity sharing should also be allowed in relation to partnerships, in order that common partnership structures in the property and infrastructure sector are not arbitrarily disadvantaged where arrangements are structured as partnership as opposed to trusts (a commercial decision). **2.3** More broadly, we submit that the appropriate policy should be that where income is excluded from Tax EBITDA, excess capacity sharing is made available, regardless of the entity type. Therefore, capacity sharing should not be limited to partnerships and trusts.
3. Amounts economically equivalent to interest	3.1 The concept of an "amount that is economically equivalent to interest" should be clarified by examples of what is and what is not covered.

Submissions

1. Debt deduction creation rules

We welcome the changes to the DDCR in the ED. However, we submit that that the breadth of the DDCR still exceeds that required to satisfy the policy objective of the rules and will lead to uncertainty and increased compliance costs for taxpayers in circumstances where there is no risk to the revenue.

As noted in our Prior Submission,[2] the purpose of the DDCR is articulated in the EM to the Bill as addressing the risks identified in paragraphs 173-174 of Chapter 9 of the BEPS Action 4 Report[3] (the Supplementary EM does not provide any further context as to the DDCR's purpose). The risks identified by the OECD are situations where debt creation results in a net increase in deductions (or tax-exempt income) or a decrease in interest income.

In relation to the risks identified by BEPS Action 4 Report, we consider that these are adequately addressed under existing rules (including transfer pricing and Pt IVA) in concert with the proposed thin cap changes under the Bill more generally. Even if this were not the case, we consider that the breadth of the rules (as amended by the ED) still goes further than what would be required to protect Australia's revenue base.

We consider that the policy basis for the rules should go no further than situations where debt creation results in a net increase in Australian deductions (or tax-exempt income) or a decrease in Australian assessable interest income (including via reduced rates of withholding taxes); in line with the BEPS Action 4 Report recommendation.

The current drafting of the DDCR as amended will still require consideration in many vanilla and uncontroversial transactions, which will increase uncertainty and compliance costs for taxpayers and investors. For example, where assets are transferred between related (common management or sister) Australian trusts, the transfer is often funded by inter-entity debt. Such a transaction would likely fall foul of the DDCR in circumstances where there is no mischief (that is, the borrower will have new deductions, but the lender would have new income) and the asset has in fact been transferred to where it can be most efficiently used within the group, likely resulting in a net economic benefit.

Finally, and consistent with our Prior Submissions in relation to grandfathering,[4] we note that tax is an economic factor that goes to the value of an investment and would have been considered at the time of the investment based on existing laws. Therefore, it is appropriate to grandfather existing investments and/or provide for transitional rules. This is particularly relevant given that based on the existing drafting it will in many cases not be possible to restructure arrangements (as explained in Prior Submissions)[5] to fit within the new regime – resulting in lost deductions for investments made in good faith based on the laws in force at the time investment decisions were made. In addition, information to determine if a historical transaction did in fact cause a breach of the debt creation rules may not exist today as such information may not have been required to be retained and therefore have been destroyed or not properly documented.

Recommendation

1.1 We recommend that purely domestic arrangements should not be covered by the rules at all as any debt creation would be expected to give rise to corresponding assessable income for the lender as well as the deduction available to the borrower. Additionally:

- an overarching purpose test should be included to limit the DDCR to situations or transactions the predominant purpose of which is to increase debt deductions in Australia or to reduce assessable interest income in Australia; and
- a safe-harbour rule whereby transactions not reasonably expected to result in a material net increase in debt deductions in Australia or a net reduction in assessable interest income in Australia should be included to provide certainty to taxpayers.

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[2] QIC Submission to the Senate Economics Legislation Committee, part 2.
[3] EM, [2.144]-[2.147].
[4] QIC Submission to the Senate Economics Legislation Committee, recommendation 1.3.
[5] QIC Submission to the Senate Economics Legislation Committee, recommendation 1.2.

1.2 We recommend that grandfathering of existing arrangements, as opposed to only a 'grace period' should be allowed given the significant compliance costs and challenges taxpayers will have in identifying and potentially restructuring existing arrangements.

1.3 Notwithstanding our strong preference for grandfathering, we would alternatively recommend that the grace period in the ED should be extended to 1 July 2025 to allow taxpayers time to prepare for the DDCR, which will require review of historic arrangements (given that taxpayers will currently only have a little over six months to prepare for the changes once the legislation has been finalised).

2. Excess capacity sharing

We welcome the inclusion of the trust excess capacity sharing rule in s 820-60. However, it is unclear what the basis for limiting the rule to TC control interests of 50% or more where the trigger for the exclusion of distributions from Trust EBITDA is a TC control interest of 10% or more.

It is very common for investment trusts (e.g., in typical joint venture arrangements) to hold less than a 50% interest in downstream trusts and it appears arbitrary to limit the excess capacity rule in such a way. For example, many trusts will hold passive interests in other investment trusts which may exceed 10%, producing an odd outcome where such passive investment results in a net detriment as compared to more active investment (at 50% or more). As it stands, the limited excess capacity sharing rule will inappropriately influence decision making and deter investments in other trusts where the interest would be between 10% and 50%. This further complicates the Australian funds environment, where the existing MIT and public trading trust rules already require a delicate balancing of membership interests.

Partnerships and other entities

Section 820-52(9) provides that when considering an associate entity for the purposes of subsections (3), (6), (6B) and (8) in applying 820-905 you must disregard whether they are in fact an associate and treat the reference to a 50% interest as being to a 10% interest (as well as a couple of other expansions).

Subsections (3), (6), (6B) and (8) deal with shareholders of companies, beneficiaries of trusts (other than AMITs), AMITs, and partners respectively. Accordingly, the same issue of reduced Tax EBITDA on account of distributions arises for partnerships and other entities.

In relation to the property and infrastructure sector in particular, many assets are held in partnerships as part of joint venture arrangements (or otherwise) and debt would not typically be held by the partnership (for commercially reasons, such as joint and several liability), particularly as such partnerships would not commonly be general law partnerships. Therefore, any debt would be borrowed at the partner level. Joint venture partnerships are a common structure choice in the property and infrastructure space and may be chosen instead of a special purpose vehicle (such as a trust) for many commercial reasons (such as control and isolation of risk). The exclusion of partnerships from excess capacity sharing will inappropriately influence decision making in relation to joint ventures where debt is used (which would be practically all such ventures in the property and infrastructure space). This produces an anomalous outcome whereby a joint venture partnership cannot be leveraged but a joint venture special purpose vehicle (such as a trust) can be.

Accordingly, excess capacity sharing should be allowed in relation to interests of trusts in partnerships.

More generally, given that the same issue of reduced Tax EBITDA on account of distributions arises for entities other than trusts, it is incongruent from a policy perspective to limit excess capacity sharing to only trusts.

Recommendation

2.1 We consider that the trust excess capacity sharing rule in s 820-60 should be aligned with the 10% ownership trigger for the loss of Tax EBITDA to avoid asymmetrical outcomes and the creation of further complexity in the funds industry.

2.2 Excess capacity sharing should also be allowed in relation to partnerships, in order that common partnership structures in the property and infrastructure sector are not arbitrarily disadvantaged where arrangements are structured as partnership as opposed to trusts (a commercial decision).

2.3 More broadly, we submit that the appropriate policy should be that where income is excluded from Tax EBITDA, excess capacity sharing is made available, regardless of the entity type. Therefore, capacity sharing should not be limited to trusts, but include partnership (per above) and companies.

3. Amounts economically equivalent to interest

As noted in our Prior Submission,[6] there remains uncertainty as to 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). Although it is apparent from the EM that swaps would be covered by the new wording the scope of the words is unclear as many arrangements could be said to be economically equivalent to interest but are not in fact correctly characterised as such.

An example of uncertainty that may arise is that it is not clear that lease payments under accounting finance leases which are not hire purchase agreements for income tax purposes would be captured as debt deductions given the broad drafting of subparagraphs 820-40(1)(a)(i) and 820-50(3)(b)(ii).

Recommendation

3.1 The concept of an "*amount that is economically equivalent to interest*" should be clarified by examples of what is and what is not covered.

[6] QIC Submission to the Senate Economics Legislation Committee, [3.3].

Annexure 1 Prior Submissions

Committee Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600
seniorclerk.committees.sen@aph.gov.au

4 August 2023

Dear Committee Secretary

Submission to Senate Standing Committees on Economics

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

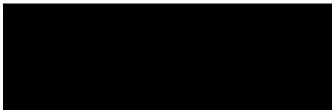
QIC Limited (**QIC**) is pleased to provide this submission to the Senate Standing Committees on Economics in respect of the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023* (**Bill**) and accompanying explanatory memorandum (**EM**). QIC's submission relates to Schedule 2 of the Bill (the interest limitation or thin capitalisation rules).

QIC is one of Australia's largest institutional fund managers with approximately AUD $100 billion in funds under management for over 115 local and international institutional clients. QIC is wholly owned by the Queensland Government and operates as an independent and fully commercial entity under the *Queensland Investment Corporation Act 1991* (Qld). QIC has a diverse range of investment capabilities with infrastructure included as one of its specialisations (in addition to real estate, private equity, debt and liquid market solutions).

Please note the views expressed in this submission represent the views of QIC as an independent, fully commercial entity and not the views of the Queensland Government.

Please contact me if you would like to discuss.

Yours sincerely



Peter Nearhos

General Manager, Tax

QIC

QIC respectfully acknowledges the Traditional Owners and Custodians of Country throughout Australia and recognises their continuing connection to land, water and community. We pay our respects to Elders past, present and emerging.

Introduction and summary of recommendations

Given QIC's role as a fund manager and significant investor, we consider that it is vital that the proposed changes strike the right balance between protecting Australia's tax base and ensuring that Australia's ability to attract foreign capital is not disproportionately affected.

For the reasons set out in more detail below, we provide the following recommendations which we consider appropriately strike such a balance.

At the outset, we express our concern that current drafting of the Bill raises significant concerns for QIC and the funds industry more generally. The primary concern is that the rules do not work appropriately in the context of funds and in particular trusts. . For example, based on the current drafting of the Bill, a typical property or infrastructure trust group with only third party debt would potentially be subject to a 100% denial on their third party interest deductions.

Some of these issues can be resolved with simple drafting changes but others are more fundamental. By way of observation, these issues would benefit from further consideration and consultation (see the table in Part 1.1 below).

In light of these issues and other more general issues, our view is that in order to:

- ensure taxpayers can operate with more certainty in relation to existing and currently proposed transactions;
- address various technical and policy issues; and
- allow time to prepare for the changes,

the start date for the thin cap amendments in Sch 2 of the Bill be deferred until *at least* 1 July 2024 and the proposed debt creation rules should be removed from the Bill and subject to a further consultation process.

Legislative references are to the *Income Tax Assessment Act 1997* (**1997 Act**), *Income Tax Assessment Act 1936* (**1936 Act**), and the *Taxation Administration Act 1953* (**TAA**), as appropriate.

Recommendations

We respectfully make the following recommendations.

<table>
<tr><th>TOPIC</th><th>RECOMMENDATION</th></tr>
<tr><td rowspan="3">1 Timing Grandfathering / transitional rules</td><td>1.1 Timing
The start date for thin cap amendments in Sch 2 of the Bill should be moved to at least 1 July 2024.</td></tr>
<tr><td>1.2 Certainty for restructuring
We also recommend that the provisions should allow for appropriate restructuring of existing arrangements to meet the new legislative requirements (without the risk of avoidance rules applying). In this respect, the rules should confirm that anti-avoidance rules will not apply to any restructuring that occurs ahead of the implementation or because of the new rules. We envisage such rules would include an election mechanism to provide certainty to taxpayers.</td></tr>
<tr><td>1.3 Grandfathering / transitional rules
The proposed changes are significant and will have a broad impact on existing arrangements. We recommend providing for grandfathering / transitional rules or in the alternative delaying the start date for the rules. The absence of transitional rules or grandfathering rules will have significant negative consequences for existing structures (many of which are long dated investments made based on law existing at the time of investment).
Tax is an economic factor that goes to the value of an investment and would have been considered at the time of the investment based on existing laws. Therefore, it is appropriate to grandfather existing investments and/or provide for transitional rules. This is particularly relevant given that based on the existing drafting it will in many cases not be possible to restructure arrangements (as explained variously below) to fit within the new regime – resulting in lost deductions for investments made in good faith based on the laws in force at the time investment decisions were made.</td></tr>
<tr><td>2 Debt deduction creation rules</td><td>The debt deduction creation rules should be removed from the Bill and subject to further consultation.
The specific mischief(s) to which the debt deduction creation rules are intended to cover should be articulated and specifically covered. The current drafting represents a broad 'catch-all' which based on the current drafting:
has a much broader scope than the BEPS Action 4 Report and stated objectives in the EM (in particular there is no purpose test to ensure the measure is appropriately targeted and it applies to purely domestic arrangements notwithstanding it purports to address cross border structures);
will result in the denial of interest deductions from standard commercial dealings and transactions and will likely represent a significant impediment to takeover transactions and fund-raising activities; and
prevents restructuring to validly fall within the scope of the new thin cap regime – this is particularly relevant given the changes to the way the rules will operate for trusts and partnerships (impacting a significant number of existing structures).
We submit that Pt IVA of the 1936 Act, coupled with transfer pricing, provides sufficient protection against contrived arrangements to circumvent the new thin cap regime. As</td></tr>
</table>

TOPIC	RECOMMENDATION
	noted in Recommendation 1.2 and in Recommendation 3.1, restructuring to comply with the new rules should be allowed.
3 Tax EBITDA calculation	**3.1 Application to trusts and partnerships** The changes to the Exposure Draft legislation in the Bill to address trusts and partnerships in the Fixed Ratio Test (**FRT**) are problematic. They would result in the inappropriate loss of debt deductions for a very large number of groups in the Australian economy which would significantly damage the funds industry, particularly where the debt deduction creation rules are not removed from the Bill. We recommend that: • Trusts (and partnerships) be entitled/required to recognise their proportionate share of any subsidiary trust and partnership EBITDA and net interest expense. This approach provides an economically consistent outcome under the EBITDA test and overcomes the wholesale loss of deductions simply because of common, commercial structuring and financing arrangements. • Alternatively, there must be provision which allows for a subsidiary trust or partnership's excess capacity to be flowed up to its holding trusts. • In addition, the provisions should allow for appropriate restructuring of existing arrangements to meet the new legislative requirements (as noted more broadly in Recommendation 1.2). We note that the same issues arise for groups that include partnerships, and we make the same recommendation as for trusts.
	3.2 Technical issue with AMITs The current drafting in subsections 820-52(4)-(6) do not cover 'attribution managed investment trusts' (**AMIT**). We do not consider this is intended and recommend changes in Part 3.2 to address AMITs.
	3.3 Debt deduction definition Technical amendments to the definitions of *debt deduction* in subparagraph 820-40(1)(a)(i) and *net debt deduction* in subparagraph 820-50(3)(b)(ii) should be made to provide certainty to taxpayers by: • removing the amorphous concept of 'amounts economically equivalent to interest' and reinstating '*the time value of money*' wording; and • specifically identifying amounts that are intended to be included (or excluded) from the scope of the provision. We further recommend the exclusion of foreign exchange swaps from the scope of debt deductions as we do not consider they are akin to interest.
	3.4 Balancing adjustment losses It should be clarified whether balancing adjustment losses are intended to be added back in the calculation of tax EBITDA.
4 Group ratio test	The GRT will not work for funds due to the exclusions of investment entities from the relevant accounting standards for consolidation. We recommend amendments are made to appropriately address this.
	5.1 Application to trusts and partnerships

TOPIC	RECOMMENDATION
5 Third party debt test	References to 'Australian residents' in the third party debt test (**TPDT**) should be replaced with 'Australian entity' to appropriately cover trusts and partnerships.
	5.2 Rules too narrow We recommend: • Instead of identifying specific terms to be disregarded (which will still create significant uncertainty and compliance burdens), the 'same terms' requirement in the conduit financier rules should be amended to identify the core terms that must be the same, which should cover the interest rate, repayment dates, and maturity date only. • The expansion of subsection 820-427A(3)(c) to allow for security from the 'obligor group'.
6 Associate test	The associate test exemption for superannuation funds should be expanded to cover investment funds such as MITs on the basis that the same rationale for the superannuation funds rule apply to MITs. Further, in our view the 10% threshold is too low and will operate extremely broadly in the context of trusts given that anyone who is a beneficiary of a trust will be an associate of the trustee.

Detailed submissions

1 Timing and grandfathering

1.1 Timing

The key dates in relation to the proposed thin capitalisation changes can be summarised as follows.

EVENT	DATE
Treasury consultation paper released entitled *Government election commitments: Multinational tax integrity and enhanced tax transparency* (**Consultation Paper**). The Consultation Paper requested input in respect of the broad policy settings for the proposed thin cap changes based on OECD recommendations in the BEPS Action 4 review paper, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, Action 4 - 2016 Update (**Action 4 Report**).	5 August 2022
Consultation period for the Consultation Paper closes.	2 September 2022
Treasury exposure draft legislation released for consultation *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation* (**Exposure Draft**) (and accompanying explanatory memorandum (**ED EM**)). The Exposure Draft legislation provides the framework for Treasury's preferred model.	16 March 2023
Consultation period for the Exposure Draft closes.	13 April 2023
The Bill is introduced into Parliament.	22 June 2023
The Senate referred the provisions of the Bill to the Economics Legislation Committee (**ELC**) for inquiry and report by 31 August 2023.	22 June 2023
START DATE for the Sch 2 to the Bill	1 July 2023
Closing date for the committee receiving submissions on the Bill.	21 July 2023
Due date for the ELC report.	31 August 2023

We make the following observations in relation to the above timeline:

- The Initial Consultation Paper and process dealt with threshold policy design issues based on the OECD recommendations in the Action 4 Report.
- It was not until the release of the Exposure Draft that the scope and broad framework of the rules become apparent to taxpayers. This is in relation to rules slated to start from 1 July 2023 (just over three months after the Exposure Draft was released). The Exposure Draft also included previously unannounced peripheral changes to sections 25-90 and 230-15(3)(c), which taxpayers had to consider (and which have now been deferred).

- Just over two months after the Exposure Draft consultation process ended, the Bill was introduced eight days before the end of the financial year and the start date for the changes. The Bill also includes significant previously unannounced measures in the form of the debt deduction creation rules in addition to significant amendments to the way the rules operate in respect of trusts and partnerships. Furthermore (as outlined in this paper) the current draft of the law does not operate appropriately and would result in many typical property and infrastructure trust groups having a 100% denial on their third party interest deductions.

It is submitted that the accelerated process to introduce Action 4 measures by the Government has resulted in the inclusion of measures and various technical issues in the draft legislation and now the Bill which require further consultation and consideration (as noted variously in this submission).

A particular concern with the timing for the measures is that the debt deduction creation rules and changes to the tax EBITDA rule for trusts a-nd partnership (see below), announced eight days before their start date, mean that many taxpayers cannot appropriately restructure to ensure the thin cap changes apply to them in an appropriate way and not in a way that results in taxpayers obtaining no debt deductions at all (despite only having third party debt) .

The debt creation rules as drafted also apply to a debt creation event that occurred at any time in the past to the extent debt related/attributable to the debt creation event remains today. We submit that it would take significant time to understand historical transactions to determine if the debt creation rules apply, and records relating to such debt creation event may no longer be available as they may not have been required to be kept under law to date.

Recommendation

We recommend that the start date for the Bill should be moved to 1 July 2024 to:

- ensure taxpayers can operate with more certainty in relation currently proposed transactions;
- allow time for more careful consideration of the drafting and policy objectives of the changes; and
- allow taxpayers time to review their current arrangements,

and the start date for the proposed debt deduction creation rules should be removed from the Bill and subject to a further consultation process.

1.2 Certainty for restructuring

We recommend that the provisions should allow for appropriate restructuring of existing arrangements to meet the new legislative requirements (without the risk of avoidance rules applying).

In this respect, the rules should confirm that anti-avoidance rules will not apply to any restructuring that occurs ahead of the implementation or because of the new rules. It is envisaged that an election could be made similar to that in the stapled structure rules. Alternatively, the Commissioner should provide detailed and binding guidance on the potential application of anti-avoidance rules to comply with the new measures at the same time the legislation receives Royal Assent.

1.3 Grandfathering / transitional rules

We re-iterate our view that grandfathering or transitional rules should be provided. An overview of our recommendations is set out in the Summary.

2 Debt deduction creation rules

Subdivision 820-EAA of the Bill establishes a very broad set of debt deduction creation rules that were not previously subject to public consultation (as noted above).

These rules will have significant negative consequences for taxpayers, and we consider many of these consequences are unintended. Coupled with the lack of grandfathering or transitional rules, these rules mean that in many cases it would not be possible to restructure arrangements (as explained variously below) to fit within the new regime – resulting in lost deductions for investments made in good faith based on the laws in force at the time investment decisions were made.

The EM explains the policy basis for the new rules as follows (emphasis added):[1]

> *2.144 Excessive debt deductions pose a significant risk to Australia's domestic tax base.*
>
> *2.145 The strengthened thin capitalisation rules will play an important role in limiting excessive debt deductions.* ***However, they do not 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****. Such debt deductions may only ever indirectly, and at most, be partially limited by the thin capitalisation rules.*
>
> *2.146 New Subdivision 820-EAA seeks to directly address this risk by disallowing debt deductions to the extent that they are incurred in relation to debt creation schemes that* ***lack genuine commercial justification.***
>
> *2.147 Subdivision 820 EAA represents a modernised version of the debt creation rules in former Division 16G of the ITAA 1936. Subdivision 820 EAA is consistent with Chapter 9 of the OECD's BEPS Action 4 Report (specifically paragraphs 173 and 174 of that report) which recognises the need for supplementary rules to prevent debt deduction creation.*

Paragraphs 173-174 of the Chapter 9 of the BEPS Action 4 Report provide (emphasis added):

> *173. The fixed ratio rule and group ratio rule described in this report provide an effective solution to tackle most base erosion and profit shifting involving interest and payments economically equivalent to interest. However, as set out in Chapter 3, in certain situations, a country may restrict application of the fixed ratio rule and group ratio* ***rule to entities in multinational groups****. Therefore, targeted rules* ***may be required*** *to address base erosion and profit shifting risks posed by entities which are not subject to the general interest limitation rules. Even where the fixed ratio rule and group ratio rule apply, a number of specific base erosion and profit shifting risks remain. Therefore, it is recommended that countries* ***consider*** *introducing rules to address the risks listed below:*
>
>> *An entity which would otherwise have net interest income enters into an arrangement which involves the payment of interest to a group entity outside the country or a related party* ***to reduce the level of interest income subject to tax in the country****. An entity makes a payment of interest on an "artificial loan", where no new funding is raised by the entity or its group. An entity makes a payment of interest to a third party under a structured arrangement, for instance under a back-to-back arrangement. An entity makes a payment of interest to a related party, which is excessive or is used to finance the production of tax exempt income. An entity makes a payment of interest to a related party, which is subject to no or low taxation on the corresponding interest income.*
>
> *174. Rules to address the risks above should ideally be applicable to all entities, irrespective of whether they are also subject to the fixed ratio rule and group ratio rule. However, these*

[1] From [2.144].

> *rules are particularly important where an entity is not subject to a fixed ratio rule as described in Chapter 6.*

We submit that it would be appropriate to remove these measures from the Bill and subject them to further detailed consultation.

As noted, the EM highlights a concern regarding debt deductions related to acquisitions from or payments to associate entities and therefore it is appropriate to address this risk by disallowing debt deductions for debt creation schemes lacking genuine commercial justification.

However, we submit that the current drafting of the rules is much broader in scope than necessary to capture only those debt creations lacking genuine commercial justification in the international context envisaged in the Action 4 Report:

- The rules lack a purpose test or other safeguards to ensure that they target only such appropriate transactions (i.e., those that '*reduce the level of interest income subject to tax in the country*' as identified in the BEPs Action 4 Report).
- Consequently, the current draft rules are likely to deny debt deductions for many common and non-controversial commercial transactions with no threat to revenue.
- The rules would operate very broadly in the context of trusts give the definition of associate is incredibly broad for a trust (anyone that benefits directly or indirectly under the trust).[2] For example, if a trust buys an asset on commercial terms using borrowed funds from another party, and that other party own 0.000001% of the trust (directly or via a chain of trusts), the debt creation rules would apply to deny interest deductions.
- The broad drafting of the rules introduces significant uncertainty and as to application. For example, if debt is borrowed for multiple purposes and one purpose is debt creation, it might result in interest on the whole loan being denied.
- Although the rules purport to update or modernise the old debt creation rules in Division 16G of the 1936 Act, they go much further. In particular, they lack the significant safeguards and exclusions present in the previous Division 16G.
- The rules are clearly intended to capture cross-border transactions, but there is no such limitation in the current drafting. Therefore, purely domestic arrangements that are no threat to the revenue would be caught and will increase compliance burdens for groups looking to undertake very vanilla transactions.
- The debt deduction creation rules do not differentiate between the artificial creation of additional debt and genuine debt financing for expanding an entity's business capacity through the acquisition of assets such as trading stock, shares, capital assets, or debt. As currently drafted, the rules are likely to require all related party transactions to be funded with equity, disregarding the important role debt plays in funding and capital management. This equity funding requirement would impede economic activity in Australia.

An example of the unintended operation of the rules would be if an Australian entity borrows funds (regardless of whether it is from related or unrelated parties and on arm's length terms) to finance its associate (domestic or foreign) on arm's length terms, the entity would be denied debt deductions on that borrowing. Consequently, the Australian entity would be taxed on gross interest income. This would compel corporate groups to raise finance on an entity-by-entity basis which is often economically less efficient, potentially leading to increases in the cost of funds.

[2] See 1936 Act, s 318.

Furthermore, the rules have retrospective effect, applying to debt deductions after July 1, 2023, but with respect to transactions that occurred before that date. Moreover, once the provision is triggered it is not possible to cure the denial through refinancing or otherwise.

We also submit that it will be particularly challenging for taxpayers to retroactively trace borrowings, sometimes spanning significant periods, in order to comply with the rules.

Finally, we submit that there is no need for a specific anti-avoidance rule where it would be expected than any arrangement designed to achieve a tax benefit by inappropriately circumventing the new thin cap rules would in any case be covered by Pt IVA of the 1936 Act, coupled with the transfer pricing rules. As noted in Recommendation 1.2 and in Recommendation 3.1, restructuring to comply with the new rules should be allowed.

Considering the points above, we submit that the rules extend beyond their stated policy intention.

Recommendation

The debt deduction creation rules should be removed from the bill and subjected to separate extended consultation.

3 Tax EBITDA calculation

It is apparent that the FRT is intended to be default test under the new rules and the test that would be applied by most taxpayers. Therefore, it should be simple to apply and should apply to all taxpayers regardless of capital or ownership structure. It should not be overly complicated and result in taxpayers being excluded by technicalities in the law such that the alternative tests (i.e. the TPDT) must be relied upon, which as noted further below has its own challenges.

We set out below our submissions on the FRT, particularly in relation to the concept of 'tax EBITDA' as defined in subsection 820-52 of the Bill.

3.1 Application to trusts and partnerships

Subsection 820-52(1) provides to starting point for the 'tax EBITDA' definition and is modified by subsections (4)-(6) where the relevant entity is a trust and (7)-(8) where the entity is a partnership. These modifications are stated to provide for:[3]

> *certain adjustments are made to ensure correct outcomes are achieved. Notably, the adjustments account for the fact that partnerships and trusts have 'net income' rather than 'taxable income'.*

The effect of these changes is that borrowing arrangements that are typical within many groups of trusts would now result in the loss of (most likely) all debt deductions. This is because:

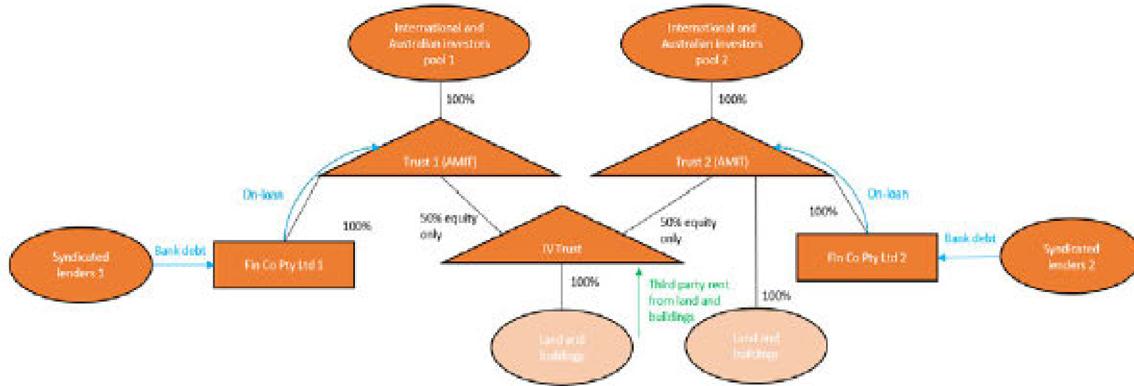
- Section 820-52(6)(b) excludes distributions from trusts when calculating taxable income for trust beneficiaries associated with the trust, leading to potential loss of deductions.
- Income from subsidiary trusts, is therefore omitted from tax EBITDA calculations, rendering the 'head trust' and interposed trusts unable to utilise the EBITDA test and potentially facing significant debt deduction denials.

[3] EM, [2.68].

Trust groups

Trust groups in Australia are typically structures such that investors invest in a head trust (**Head Trust**), which then invests in sub-trusts (sometimes via a mid-trust) that operate the relevant investment business of the group (such as holding property to derive rent) (**Op Trusts**). In this type of structure, it is extremely rare that third party debt would be borrowed at the Op Trust level. It would typically be borrowed by the Head Trust (or another member of the group that is a group borrower entity (**Fin Co**)), with the cash then directed where it is required within the group (typically via loan to the Head Trust and subsequent equity contribution(s) by Head Trust to Sub Trusts). These are normal commercial dealings that are not driven by tax but the need to sensibly allocate capital within a group of trust entities.

This type of structure may then be replicated in the context of a joint ventures where there is a joint venture trust (**JV Trust**). An example of a typical joint venture arrangement is illustrated below:



As set out above, third party debt enters each joint venturer group through a special purpose Fin Co subsidiary and is then on-lent to Head Trust and invested as equity in the JV Trust.

Under the proposed changes in the Bill:

- Assuming no other activities, and symmetrical back-to-back lending terms, it would be expected that Fin Co has no net debt deductions (and also no taxable income), which is the appropriate outcome.
- However, Trust 1 (assuming its only income is distributions) would have no taxable income for the purposes of calculating tax EBITDA. Therefore, it would be denied 100% of its interest deductions (assuming the Head Trust had no other income) in respect of interest on amounts borrowed from Fin Co. The same outcome would arise if Head Trust borrowed directly.
- The JV Trust has no debt, so its net income would not be reduced by any debt deductions, resulting in higher net income which is assessable to Trust 1's members.
- The above is replicated on the Trust 2 side of the joint venture.

The net result of the above, is that third-party debt deductions are denied to the group in circumstances where there is no mischief. For example, the structure above reflects the different borrowing profiles of the different joint venturer head trusts.

The impact analysis in the EM (at page 86) alludes to the challenges for trusts and partnerships as highlighted above (emphasis added):

Additionally, some groups of trusts and other non-consolidated groups ***may opt to simplify their operating structures*** *in absence of specific excess capacity rules,* ***such as by limiting the number of interposed trusts in their structure****. This response could arise by* ***restructuring the trust's debt financing to align the debt with the income earning asset*** *(rather than structuring whereby debt is on-lent through a chain of trusts) to support their debt deductions under the fixed ratio (earnings-based) test, which would also help to increase the transparency of trust structures.*

Ultimately, the final design parameters seek to balance tax integrity considerations with non-tax considerations, ***such as continuing to attract and retain foreign capital and investment in Australia, limiting investment distortions, minimising unnecessary compliance costs for business, and continuing to support genuine commercial activity.*** *This includes consideration of broader policy objectives on infrastructure investment, the renewable energy transition, and fostering start-ups/ innovation (see consultation section below).*

Therefore, the solutions proposed in the EM to address concerns are to remove interposed trusts and refinance debt, so it arises at the level of asset owning trusts. This indicates a view that interposed trusts in a trust group serve no purpose and can be simply removed, and that refinancing debt is a simple proposition. We disagree with this view. There are various reasons why borrowing within a treasury entity and/or at a level above operational entities (via interposed trusts), including:

- this allows lenders to deal with one borrower entity;
- this simplifies security arrangements;
- this allows cash to be transferred quickly and efficiently to where it is needed within the group without asset owning entities needing to deal with lenders directly every time cash is required; and
- in the context of joint venture arrangements, borrowing at the level of the asset (i.e., in the JV Trust) requires participation of the joint venturers to negotiate with lenders and potentially provide security and guarantees which, for many commercial reasons, is inappropriate.

A further and much simpler option for trust groups, would be to restructure current lending arrangements internally by refinancing equity contributions to subsidiary trusts or joint venture trusts such that amounts attributable to third party debt are on-lent within the group to the asset owning (and income generating) member.

However, the debt creation rules (addressed above) would not allow this approach. Further, this approach is not possible in the case of JV trusts.

Therefore, the only option to avoid the risk of significant debt deductions is to embark on refinancing of debt lent to one entity in the group to multiple single borrowers. This is impractical as an option and will place unexpected tax and compliance burdens on groups of trusts. In particular:

- It is unrealistic to assume that this is possible in anything but the simplest scenarios.
- In the context of JV Trusts, as noted it is impractical and unlikely to be commercially possible for JV Trusts to borrow directly. Head Trust investors into a JV will have their own assets and risks profiles which require a different approach to borrowing.
- The restructuring proposed by the EM would result in significant and prohibitive duty and other transactions costs in any real asset structure. The proposed solutions in the EM are incompatible with standard market practice structures and security arrangements.

- Assuming that restructuring as suggested in the EM is possible, the timing required, particularly where significant numbers of taxpayers are attempting this at the same time, would likely take many months. In the meantime, debt deductions would be lost.
- It is important to note that the possibility of debt creation was not known until eight days before the start date for the rules. Further, it will not be until September or later (after the ELC report) that there will be certainty as to the form of the rules.
- Further, we note that the approach proposed is inconsistent with the approach undertaken throughout the OECD..

Additionally, the requirement to disregard distributions from trust and partnerships does not differentiate between wholly owned subsidiaries, or even joint venture arrangements, and portfolio interests. It applies broadly. Therefore, the tax EBITDA of an entity owning multiple portfolio interests in Australian funds but no other investments would have no debt capacity under the FRT.

Recommendation

We recommend that:

- Trusts (and partnerships) be entitled/required to recognise their proportionate share of any subsidiary trust and partnership EBITDA and net interest expense. This information can be provided by the subsidiary trusts and partnerships to their investors in their yearly tax distribution statements. This approach provides an economically consistent outcome under the EBITDA test (i.e., there should be no inappropriate duplication of interest deduction capacity or inappropriate denial of interest deductions regardless of holding structure and level of gearing). Further this approach is consistent with the OECD approach to thin capitalisation (this is because countries in Europe, the UK and US use limited partnerships (rather than trusts) as investment fund vehicles which necessarily recognise the gross income and expenses of their subsidiary limited partnerships).
- Alternatively, there should be provision which allows for a subsidiary trust or partnership's excess capacity to be flowed up to its holding trusts.
- In addition, the provisions should allow for appropriate restructuring of existing arrangements to meet the new legislative requirements. In this respect, we re-iterate that the rules should confirm that anti-avoidance rules will not apply to any restructuring that occurs ahead of the implementation or as a consequence of the new rules.

We note that the same issues arise for groups that include partnerships, and we make the same recommendation as for trusts.

3.2 Technical issue with AMITs

The changes in the EM to deal with trusts in subsections 820-52(4)-(6) only deal with the scenario where the trust is a Division 6 trust and not an AMIT (including a sub-funds within a corporate collective investment vehicle (**CCIV**) that are deemed trusts and may be AMITs).[4] Subsection 820-52(4) refers to net income, which is a concept in Division 6 of Part III of the 1936 Act,[5] which does not apply to a trust estate that is an AMIT.[6]

4 1997 Act, s 195–115 and Subdivision 195-C more generally.
5 1936 Act, s 95.
6 1936 Act, s 95AAD.

Therefore, the Bill as currently drafted will place a substantial tax penalty on AMITs. It is very common for AMITs to having borrowing, particularly in the context of infrastructure and property investment sector.

Based on the purpose of the changes stated above, we assume that this is an oversight in the drafting and expect that it is not intended that AMITs would not be able to calculate an amount of tax EBITDA.

Recommendation

We recommend the following changes to ensure AMITs are covered:

(4) If the entity is a trust or an entity that is otherwise an AMIT:

(a) treat the reference in subsection (1) to the entity's taxable income as being a reference to:

*(i) the *net income of the entity; or*

*(ii) if the entity is an AMIT in respect of the income year, the *determined trust components of the entity; and*

*(b) treat the reference in subsection (1) to the entity's *net debt deductions as being a reference to the entity's net debt deductions taken into account in working out that net income or *determined trust components; and*

*(c) treat the reference in subsection (1) to the entity's deductions as being a reference to the entity's deductions taken into account in working out that net income or *determined trust components; and*

*(d) treat the references in subsection (1) to the entity's assessable income as being a reference to the entity's assessable income taken into account in working out that net income or *determined trust components.*

(5) To avoid doubt, for the purposes of references in subsection (4) to net income, do not make the assumption in subsection 102UX(3) of the Income Tax Assessment Act 1936.

Subsection (6) should also be modified in line with the above drafting changes, noting our broader recommendation that the inclusion of net income from subsidiary trusts or partnerships should be included in the tax EBITDA calculations – so the requirement to disregard such distributions should be excluded (e.g., paragraph 6(b)) should be removed.

3.3 Debt deduction definition

The Bill would amend the debt deduction definition to subparagraph 820-40(1)(a)(i) to:

*Omit "in relation to a *debt interest issued by the entity,".*

Omit "or any other amount that is calculated by reference to the time value of money", substitute "or any other amount that is economically equivalent to interest".

The new 820-50(3)(b)(ii) (within the definition of net debt deduction) includes the equivalent wording.

The EM confirms that this definition is:[7]

… intended that interest related costs under swaps, such as interest rate swaps, are included in the widened definition of debt deduction.

[7] EM, [2.159]-[2.160].

> *In particular, the definition is amended to ensure that a cost incurred by an entity does not need to be incurred in relation to a debt interest issued by the entity for that cost to be a debt deduction. This and other changes mean that amounts which are economically equivalent to interest, but which may not necessarily be incurred in relation to a debt interest issued by the entity, fall within the definition of debt deductions.*

Recommendation

We make the following recommendations in relation to these changes:

- We consider that introducing a new concept of amounts that are 'economically equivalent to interest' introduces uncertainty as to the meaning of economically equivalent to interest, particularly where an instrument includes various aspects so it is necessary to unpick the instrument to determined 'the extent' (as required by s 820-40(1)) to which part of it may be *economically equivalent to interest*. An example of uncertainty that may arise is that it is not clear that lease payments under accounting finance leases which are not hire purchase agreements for income tax purposes, for example, would be captured as debt deductions given the broad drafting of the amended section 820-40.

  If the intention is to cover swaps (as noted in the EM) then a clearer solution would be to specifically cover swaps and retain the original wording in s 820-40(1)(b) and make the equivalent change to 820-50(3)(b)(ii). Such an approach would provide a bright line for taxpayers to apply and would be consistent with the approach elsewhere in the tax acts to specifically identify amounts that are intended to be captured (such as in section 128A of the 1936 Act).

- In relation to swaps, we do not consider that foreign exchange swaps in relation to debt interests should be treated the same as other interest amounts on the basis that the outcomes from such swaps are akin to interest. Rather they represent a gain or loss on a derivative subject to any splitting of components (for which guidance should be provided) in the case of combined interest rate and currency swaps.

3.4 Balancing adjustment losses

In calculating tax EBITDA, subparagraph 820-52(1)(c) requires the add back of depreciation deductions as follows (emphasis added):

> *next, add the sum of the entity's deductions (if any) under Divisions 40 and 43 for the income year from its assessable income for the* income year (**other than deductions for the entire amount of an expense incurred by the entity**);

As currently drafted, the above calculation requires an add back for losses as a result of a balancing adjustments (i.e. under Subdivision 40-D), being deductions that arise under Division 40. The Exposure Draft previously only covered deductions pursuant to Subdivision 40-B (about declines in value) so this may be an unintended drafting change.

4 Group ratio test

The GRT requires that audited consolidated financial statements for the period have been prepared the 'GR Group' (subsections 820-53(2)-(5)).

However, the consolidated financial statement requirement does not work for funds because 'Investment Entities' (as defined in the accounting standards)[8] do not account for subsidiaries through consolidation.[9] We recommend that the Group Ratio test is modified for Investment Entities. Careful consideration should be given to how this may be achieved in a way that adequately addresses the unique nature of funds.

In addition the above, a grouping rule for funds under the FRT should be included as noted above.

5 Third party debt test

5.1 Application to trusts and partnerships

Section 820-427A defines 'third party earnings limit' and 'third party debt conditions', setting the limit for debt deductions under the TPDT.

The third party debt conditions require, among other things, that the borrower is an 'Australian resident' (paragraph 820-427A(3)(e)). The 'Australian resident' concept is also a requirement under the conduit financing conditions (subparagraph 820-427B(4)(b)(ii) and paragraph 820-427C(1)(g)).

Australian resident is defined in section 995-1 of the 1997 Act to mean a 'person' who is a resident for the purposes of the 1936 Act. This however excludes partnerships and trusts from satisfying this condition because they are not 'persons' for the purposes of the definition. We do not consider that it is intended that trusts and partnerships be excluded from the TPDT and conduit financing conditions. As currently drafted, this means trust groups with conduit third party borrowings will be subject to 100% denial on interest deductions.

Recommendation

References to 'Australian residents' in the TPDT should be replaced with 'Australian entity' to appropriately cover trusts and partnerships. 'Australian entity' is a broader concept – it is defined in section 995-1 of the 1997 Act, by reference to the definition in Pt X of the 1936 Act, which covers resident partnerships, trusts and companies.

5.2 Rules too narrow

The purpose of the TPDT is to allow genuinely highly geared groups to fund Australian operations at a higher level than the fixed ratio test would allow.[10] However, the rules remain too narrow and as such are unlikely to be utilised in the context of anything but the most simple of scenarios.

Although the rules have been widened since the Exposure Draft, there remain gaps and technical issues that make it practically difficult to comply with the TPDT. These include:

- Under the conduit financier rules, the terms of debt on-lent to group members must be on the same terms as the ultimate debt (paragraph 820-427C(1)(e)), which is modified to disregard the specific terms in subsection (2). It is submitted that this still required many key terms that would be unnecessary for intercompany debt to be imported and create significant uncertainty. Taxpayers would need to go through a detailed exercise of company third party terms with intercompany terms for each loan.

8 See *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27).*
9 See *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27).*
10 EM, [2.12].

We recommend that a simpler approach would be to identify the core terms that must be the same, which should cover the interest rate, repayment dates, and maturity date only.

- Pursuant to subsection 820-427A(3)(c) security for debt must be limited to the assets of the borrower, except where the section 820-427C (conduit financier rules) applies (subsection 820-427B(4)). This is too limiting – it should be the case that security may be provided by the borrower or other members of the 'obligor group'.

  Under the typical Hold Trust, Obligor Trust and Security Trust structure, Obligor Trust has the debt, Security Trust has the assets and security is provided over the assets and the units in Security Trust. However, where the Obligor Trust is not a conduit entity (i.e. where the debt is on-lent to the Security Trust), the relevant lender security for the purposes of the test appears that is must be limited to the assets of the borrower only (i.e. Obligor Trust). Thus, it seems this structure cannot apply to an Obligor Trust where the amount is used to hold units in Security Trust and the security is extended to the assets of the Security Trust.

  Therefore, we recommend expansion of subsection 820-427A(3)(c) to allow for security from the 'obligor group'.

- Furthermore it is unclear from the drafting whether the recourse for payment referred to in section 820-427A(3)(c) would capture arrangements entered into by a lender with persons other than the borrower i.e. if the lender were to enter into a credit default swap with a third party, this should not be considered to be recourse for the purposes of these requirements. Such arrangements are extremely common and to prohibit them would be a significant limitation, notwithstanding that in many cases a borrower would not be aware of any such arrangements.

6 Associate test

We consider that the 10% threshold for the associate entity test is too low and will operate extremely broadly in the context of trusts. For anything other than the simplest group of entities, it will inappropriately bring too many entities within the scope of 'associate entity' and will be one of the factors that makes the third-party debt test unfeasible for many taxpayers particularly in the funds industry.

We support the exemption in the Bill for superannuation funds and their wholly owned entities from the 'associate entity' test (subsection 820-905(1) and (2B)) for the reasons noted in the EM (emphasis added):[11]

> *Under the current rules, these investments may cause superannuation funds to have a relatively large number of associate entities, which would bring their investments into scope of the thin capitalisation rules. However,* ***superannuation funds are subject to a relatively strong regulatory regime and generally do not exercise any meaningful control over their associate entities****. On this basis, the associate entity definition (to the extent it relates to the thin capitalisation rules) is no longer fit-for-purpose for Australian superannuation funds.*

However, we consider that the same rationale for the above exclusion applies to other investment funds such as MITs, AMITs:

- Investment funds, like superannuation funds, hold significant investments across various assets and therefore are likely to have significant associates for the purposes of the thin cap rules as modified.

[11] EM, [2.162].

- Investment funds, like superannuation funds, are subject to a strong regulatory regime under the *Corporations Act 2001*.
- In order to qualify as a MIT (which is a requirement to be an AMIT), the trustee must not carry on or control a trading business, necessarily meaning that its activities are limited to passive activities or activities that are otherwise eligible investment activities (as defined in section 102M of the 1936 Act).
- Current interest limitation rules may subject some investment funds to thin capitalisation rules due to their associate entities.

Additionally, the extension of the exemption to MITs and AMITs is consistent with other broader policy objectives:

- Investment funds play a vital role in providing capital for Australian assets, particularly infrastructure.
- Investment funds are actively investing in asset classes aligned with important government priorities.

Therefore, we consider the associate entity exemption should be extended to MITs and AMITs.

Introduction and summary of submissions

Given QIC's role as a fund manager and significant investor, we consider that it is vital that the proposed changes strike the right balance between protecting Australia's tax base and ensuring that Australia's ability to attract foreign capital is not disproportionately affected.

For the reasons set out in more detail further below, we provide the following recommendations which we consider appropriately strike such a balance.

At the outset, we consider that the proposed revised drafting of the Bill in the Senate Amendments is a significant improvement on the previous draft and the October 2023 ED. However, there are still a number of issues for QIC and the funds industry more generally with the Senate Amendments. In particular:

- the start date for all of the changes (not just the debt deduction creation rule (**DDCR**)) should be deferred until 1 July 2024 (and the DDCR start date moved to 1 July 2025), to afford taxpayers an appropriate amount of time to prepare for what are significant changes in the law;
- the DDCR continues to operate more broadly than the stated policy intention; and
- the trust excess capacity sharing mechanisms under the fixed ratio test (**FRT**) still produce asymmetrical, arbitrary and inconsistent outcomes such as where amounts are excluded from Tax EBITDA but are not available for capacity sharing.

Legislative references are to the Income Tax Assessment Act 1997 (**1997 Act**), the Income Tax Assessment Act 1936 (1936 Act) and the Taxation Administration Act 1953 (**TAA**), as appropriate.

Prior submissions

QIC previously made a submission **(Prior Submission)**[1] to the SELC (**First Senate Inquiry**) in relation to the SELC review and the ED changes to the Bill as set out in the October 2023 ED and accompanying exposure draft supplementary explanatory memorandum (**ED Supplementary EM**) (**included as Annexure 1**).

Recommendations

We respectfully recommend the following:

TOPIC	RECOMMENDATION
Error! Reference source not found. **Debt deduction creation rules**	We welcome the changes to the DDCR in the Senate Amendments. However, we submit that that breadth of the DDCR is still much broader than is required to satisfy their policy objective which will lead to uncertainty and increased compliance costs for taxpayers in circumstances where there is no risk to the revenue. **1.1** We recommend that purely domestic arrangements should not be covered by the rules at all as any debt creation would be expected to give rise to corresponding assessable income for the lender as well as a deduction available to the borrower. Additionally: • an overarching purpose test should be included to limit the DDCR to situations or transactions the predominant purpose of which is to increase debt deductions in Australia or to reduce assessable interest income in Australia; and • a safe-harbour rule whereby transactions not reasonably expected to result in a material net increase in debt deductions in Australia or a net reduction in

[1] QIC Submission to the SELD, 4 August 2023.

QIC

	assessable interest income in Australia should be included to provide certainty to taxpayers. **1.2** We recommend that the 90% Australian asset exemption in section 820-37 be extended to cover the DDCR to appropriately carve out entities and groups with overwhelmingly domestic operations, presenting a minimal risk to revenue. **1.3** We recommend that the DDCR should not apply to arrangements existing prior to 1 July 2024. Additionally, start date for the DDCR be extended to 1 July 2025 to allow taxpayers time to prepare for the DDCR.
2 Excess capacity sharing	**2.1** The excess capacity sharing rule in section 820-60 should be aligned with the 10% ownership trigger for the loss of Tax EBITDA (rather than the currently proposed 50%) to avoid asymmetrical outcomes and the creation of further complexity in the funds industry.
3 Amounts economically equivalent to interest	**3.1** The concept of an '*amount that is economically equivalent to interest*' should be clarified by examples of what is and what is not covered.
4 Third party debt test (TPDT)	**4.1** The concept of '*minor or insignificant*' in relation to the exception to the 'Australian asset only' requirement in the third-party debt conditions (subsection 820-427A(3)(c)) should be clarified. We recommend an objective test, for example by reference to the value of the ineligible asset as a proportion (such as 10%) of the security pool when the relevant debt is created, to provide certainty to taxpayers. **4.2** The requirement that the borrower does not use amounts borrowed to fund overseas operations (subsection 820-427A(3)(d)) should only be breached where the purpose of the funding includes the purpose of directly funding overseas operations. **4.3** An exclusion should be added for groups/entities that breach the credit support limitation in section 820-427A(5)(a)(ii) solely because of a parental guarantee from an Australian entity where there is no direct recourse to non-Australian assets. This will ensure Australian outward groups are not disadvantaged (versus non-Australian parented groups) and discouraged from foreign investment.
5 Timing	**5.1** We recommend that the start date for the Bill should be moved to 1 July 2024 to: • ensure taxpayers can operate with more certainty in relation currently proposed transactions; • allow time for more careful consideration of the drafting and policy objectives of the changes; and • allow taxpayers time to review their current arrangements.
6 Review mechanism	**6.1** We recommend that Senator David Pocock's proposal to include a requirement for a review of the new rules to occur no later than 1 February 2026 be adopted.

Submissions

1. Debt deduction creation rules

We welcome the changes to the DDCR in the Senate Amendments. However, we submit that that the breadth of the DDCR still exceeds that required to satisfy the policy objective of the rules and will lead to uncertainty and increased compliance costs for taxpayers in circumstances where there is no risk to the revenue.

We reiterate our comments in the Prior Submissions,[2] that the purpose of the DDCR is articulated in the explanatory memorandum to the Bill (**EM**) to the Bill as addressing the risks identified in paragraphs 173-174 of Chapter 9 of the BEPS Action 4 Report[3] (the Supplementary EM does not provide any further context as to the DDCR's purpose). The risks identified by the OECD relate to situations where debt creation results in a net increase in deductions (or tax-exempt income) or a decrease in interest income. This position is reflected in the many submissions to the First Senate Inquiry, as noted in the report from that inquiry (**Report**). For example:

The American Chamber of Commerce in Australia submitted that:[4]

> *'...the proposed Debt Deduction Creation rules...do not align with OECD norms and will result in Australia becoming a global outlier with overly restrictive debt limitation rules compared to our peers.'*

The Property Council of Australia submitted:[5]

> *'...with respect to the debt creation rules, in our view they should be deferred until proper consultation can be undertaken to determine an appropriate scope to those rules. To be honest, they apply to very common restructure and refinancing arrangements in circumstances where there appears to be no mischief that is actually being targeted. So, to take a very straightforward example, those debt creation rules can apply where there's actually no net debt created at all. If you move an asset between two vehicles and you gear it at the same level, those rules will apply to deny your debt deductions. There's no discernible logic as to why the rules operate in that manner.'*

Perpetual Limited submitted:[6]

> *'These provisions go much further than that and actually attack domestic transactions which have no impact on Australian revenue whatsoever.'*

The proposed changes in the Senate Amendments (in particular, the exception for certain CGT assets in section 820-423AA) do improve the situation by ensuring the rules are more targeted. However, the drafting of the provisions is still very broad and will capture many transactions where there is no mischief. For example, in relation to financial arrangement debt (which the new exceptions do not cover), and the continued capture of many purely domestic arrangements where there would be no net loss to revenue. The new exceptions also add yet another layer of complexity to already very complicated rules.

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2 QIC Submission to the Senate Economics Legislation Committee, part 2 and QIC Submission on the October 2023 ED, part 1.

3 EM, [2.144]-[2.147].

4 American Chamber of Commerce in Australia, Submission 21, p. 5.

5 Mr Stephen Whittington, Member, Capital Markets Committee, Property Council of Australia, *Committee Hansard*, 15 August 2023, pp. 39.

6 Mr John Kirkness, Head of Tax, Group Finance, Perpetual Limited, Committee Hansard, 15 August 2023, p. 25.

In relation to the risks identified by BEPS Action 4 Report, we consider that these are adequately addressed under existing rules (including transfer pricing and Pt IVA) in concert with the proposed thin cap changes under the Bill more generally. Even if this were not the case, we consider that the breadth of the rules (as amended by the proposed Senate Amendments) still goes further than what is required to protect Australia's revenue base.

We consider that the policy basis for the rules should go no further than situations where debt creation results in a net increase in Australian deductions (or tax-exempt income) or a decrease in Australian assessable interest income (including via reduced rates of withholding taxes), in line with the BEPS Action 4 Report recommendation.

The current drafting of the DDCR as amended will still require consideration in many vanilla and uncontroversial transactions, which will increase uncertainty and compliance costs for taxpayers and investors. In this respect, we note that the DDCR will cover many more taxpayers, including groups with primarily domestic operations that should not present any mischief to the revenue. This is because, for example:

- the $2m *de minimis* exception is less and less relevant in light of the current interest rate environment and that it has not been updated for many years; and
- the DDCR will apply even where the entity is covered by the general exclusion for Australian entities with 90% Australian assets (which many primarily domestic groups rely on).

We note that the DDCR will have retrospective effect and require taxpayers to reconsider arrangements that were entered into long ago. This will create a significant compliance burden. It is likely that in many cases, the evidence that would be required to assess to application of the DDCR to existing arrangements would not be available (because at the time it was not expected that it would be). Accordingly, existing arrangements should be grandfathered. Additionally, the start date for the DDCR should be extended to 1 July 2025 (to align with the recommended new start date of 1 July 2024 for the rules more broadly).

Recommendation

1.1 We recommend that purely domestic arrangements should not be covered by the rules at all as any debt creation would be expected to give rise to corresponding assessable income for the lender as well as a deduction available to the borrower. Additionally:
   - an overarching purpose test should be included to limit the DDCR to situations or transactions the predominant purpose of which is to increase debt deductions in Australia or to reduce assessable interest income in Australia; and
   - a safe-harbour rule whereby transactions not reasonably expected to result in a material net increase in debt deductions in Australia or a net reduction in assessable interest income in Australia should be included to provide certainty to taxpayers.

1.2 We recommend that the 90% Australian asset exemption in section 820-37 be extended to cover the DDCR to appropriately carve out entities and groups with overwhelmingly domestic operations, presenting a minimal risk to revenue.

1.3 Finally, we recommend that the DDCR should not apply to arrangements existing prior to 1 July 2024. Additionally, the start date for the DDCR be extended to 1 July 2025 to allow taxpayers time to prepare for the DDCR.

2 Excess capacity sharing

We welcome the inclusion of the trust excess capacity sharing rule in section 820-60 covering new entities. However, it remains unclear what the basis is for limiting the rule to TC control interests of 50% or more, where the trigger for the exclusion of distributions from tax EBITDA is a TC control interest of 10% or more. This means a holding entity which holds a TC control interest of between 10% and 50% in a subsidiary entity is unable to include either the distribution income received (as the TC control interest is 10% or more) or excess tax capacity from the subsidiary entity (as the TC control interest is less than 50%) in calculating its tax EBITDA amount.

Recommendation

2.2 The excess capacity sharing rule in section 820-60 should be aligned with the 10% ownership trigger for the loss of Tax EBITDA to avoid asymmetrical outcomes and the creation of further complexity in the funds industry.

3 Amounts economically equivalent to interest

As noted in our Prior Submission,[7] there remains uncertainty as to 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). Although it is apparent from the EM that swaps would be covered by the new wording the scope of the words is unclear as many arrangements could be said to be economically equivalent to interest but may not in fact correctly characterised as such. Examples include:

a. It is not clear that lease payments under accounting finance leases which are not hire purchase agreements for income tax purposes would be captured as debt deductions, given the broad drafting of subparagraphs 820-40(1)(a)(i) and 820-50(3)(b)(ii).

b. Many contractual payment obligations incorporate net present value, internal rate of return, inflation/CPI and similar formulas, such as a lease payment clause including yearly increases for CPI. Such arrangements are generally common commercial terms and should not be treated as if they were legal form interest.

c. Many contractual arrangements involve the sale of assets, such as receivables, at a discount (e.g., debt factoring). The form of these arrangements is varied (whether it is in substance a sale of an asset or a form of financing), but the concept of what constitutes a debt deduction or net deduction should provide sufficient guidance on what the parameters are. Similar arrangements involving sale and repurchase agreement (e.g., 'repos') would be subject to similar uncertainty under the existing vague concept.

Recommendation

3.2 The concept of an 'amount that is economically equivalent to interest' should be clarified by examples of what is and what is not covered.

4 TPDT

The purpose of the TPDT is to allow genuinely highly geared groups to fund Australian operations at a higher level than the fixed ratio test would allow.[8] While changes are proposed in the Senate Amendments, the rules remain too narrow and as such are unlikely to be utilised in the context of anything but the simplest of scenarios, particularly by groups with offshore operations.

The TPDT conditions require that the third-party lender only has recourse to particular Australian assets. That requirement has been modified to:

- cover Australian assets that are held by the issuer, membership interests in the issuer, or held by an '*Australian entity*' that is a member of the relevant '*obligor group*'; and
- ignore '*minor or insignificant assets*' that would otherwise be ineligible.

The Supplementary EM explains that the allowance for '*minor or insignificant assets*' '*is intended to prevent [the TPDT conditions] being contravened for inadvertent and superficial reasons. Determining whether recourse to ineligible assets is minor and insignificant will generally require a consideration of the ineligible assets to which recourse for payment of the debt can be had and whether those ineligible assets are of a minor and insignificant nature*.'[9]

[7] QIC Submission to the Senate Economics Legislation Committee, [3.3]; QIC Submission to Treasury in respect of the October ED, part 3.
[8] EM, [2.12].
[9] Supplementary EM, [1.30].

These changes are welcome, although there is some uncertainty as to what may be considered *'minor or insignificant'*.

However, many entities/groups with international operations will still struggle to apply the rules practically and will thus be excluded from rules that, in line with the stated policy of making allowances for genuinely highly geared groups, should allow them to rely on the TPDT. Two requirements in particular will present practical difficulties for such entities/groups:

- Section 820-427A(3)(d) requires that:

  'the entity uses all, or substantially all, of the proceeds of issuing the debt interest to fund its commercial activities in connection with Australia that do not include:

  *(i) any *business carried on by the entity at or through its *overseas permanent establishments; and*

  *(ii) the holding by the entity of any *associate entity debt, *controlled foreign entity debt or *controlled foreign entity equity;'*

  Accordingly, where there are offshore operations that the relevant debt may indirectly fund solely by virtue of comingling working capital, the TPDT requirements may be failed. This presents a significant compliance burden for such entities who propose to rely on the TPDT as complicated tracing and segregation would be required. The associated risk of this (e.g., failing the TPDT completely because of accounting errors) will deter many who should be entitled to rely on the TPDT from a policy perspective and make reliance on the rules administratively burdensome. From a policy perspective, section 820-427A(3)(d) should only be breached where the purpose of the funding includes the purpose of directly funding overseas operations.

- Section 820-427A(3)(c) (together with subsections (4) and (5), excludes arrangements that involve credit support that includes (section 820-427A(5)(a)(ii)):

  'a right that provides recourse, directly or indirectly, only to one or more Australian assets covered by subsection (4) that are not rights covered by this subsection;'

  The exclusion of indirect recourse to foreign assets makes the rules unworkable in practice, particularly for outward Australian groups who would find it difficult, if not impossible, to effectively exclude such foreign assets because **any** indirect interest (via shares/units in Australian subsidiaries or a chain of subsidiaries) would breach the rules. This will disadvantage Australian groups over non-Australian parented groups, who would be expected to find it easier to exclude non-Australian assets from the security pool. An exclusion for groups/entities that breach section 820-427A(5)(a)(ii) solely because of a parental guarantee from an Australian entity where there is no direct recourse to non-Australian assets would address this issue.

Recommendation

4.2 The concept of 'minor or insignificant' in relation to the exception to the 'Australian asset only' requirement in the third-party debt conditions (subsection 820-427A(3)(c)) should be clarified. We recommend an objective test, for example by reference to the value of the ineligible asset as a proportion (such as [10%]) of the security pool when the relevant debt is created, to provide certainty to taxpayers.

4.3 The requirement that the borrower does not use amounts borrowed to fund overseas operations (subsection 820-427A(3)(d)) should only be breached where the purpose of the funding includes the purpose of directly funding overseas operations.

An exclusion should be added for groups/entities that breach the credit support limitation in section 820-427A(5)(a)(ii) solely because of a parental guarantee from an Australian entity where there is no direct recourse to non-Australian assets. This will ensure Australian outward groups are not disadvantaged (versus non-Australian parented groups) and discouraged from foreign investment.

5 Timing

The significant thin capitalisation changes are set to apply from 1 July 2023. Following the previous SELC report handed down in September 2023, the Bill was not considered by the Senate again until it was referred to the SELC again on 5 December 2023. Given that the SELC is due to provide its report on 5 February 2024, it may be May or June before the Bill is finalised. This does not provide taxpayers with sufficient time to prepare for the changes.

Recommendation

5.2 We recommend that the start date for the Bill should be moved to 1 July 2024 to:

- ensure taxpayers can operate with more certainty in relation currently proposed transactions;
- allow time for more careful consideration of the drafting and policy objectives of the changes; and
- allow taxpayers time to review their current arrangements.

6 Review

Senator David Pocock has proposed[10] the inclusion of a requirement for a review of the new rules to occur no later than 1 February 2026. We consider this to be a sensible proposal which will represent an opportunity to review the law to ensure that it is operating appropriately and address technical issues. Without such a mechanism, it is likely that many issues (including those identified in the various submissions on the new law but also many that we expect will become apparent once the law is operative) will remain unresolved for a long time (if they are indeed ever resolved).

Any such review should also address the impact of the new rules on foreign direct investment.

Recommendation

6.2 We recommend that Senator David Pocock's proposal to include a requirement for a review of the new rules to occur no later than 1 February 2026 be adopted.

[10] CW - Independent [sheet 2294].

Annexure 1 – Prior Submissions

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30 October 2023

Dear Committee Secretary

Submission to Treasury

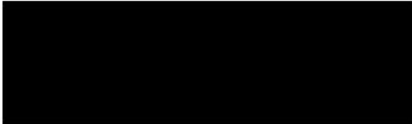
Multinational Tax Integrity – strengthening Australia's interest limitation (thin capitalisation) rules

QIC Limited (**QIC**) is pleased to provide this submission in respect of the proposed amendments to the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share — Integrity and Transparency) Bill 2023* (**Bill**) as set out in the Exposure Draft Legislation (**ED**) and accompanying supplementary explanatory memorandum (**Supplementary EM**) released for consultation on 18 October 2023.

QIC is one of Australia's largest institutional fund managers with approximately AUD $100 billion in funds under management for over 115 local and international institutional clients. QIC is wholly owned by the Queensland Government and operates as an independent and fully commercial entity under the *Queensland Investment Corporation Act 1991* (Qld). QIC has a diverse range of investment capabilities with infrastructure included as one of its specialisations (in addition to real estate, private capital, debt and liquid market solutions).

Please note the views expressed in this submission represent the views of QIC as an independent, fully commercial entity and not the views of the Queensland Government.

Yours sincerely



Peter Nearhos
General Manager, Tax
QIC

Committee Secretary
Senate Standing Committees on Economics
PO Box 6100
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Canberra ACT 2600
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4 August 2023

Dear Committee Secretary

Submission to Senate Standing Committees on Economics

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

QIC Limited (**QIC**) is pleased to provide this submission to the Senate Standing Committees on Economics in respect of the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023* (**Bill**) and accompanying explanatory memorandum (**EM**). QIC's submission relates to Schedule 2 of the Bill (the interest limitation or thin capitalisation rules).

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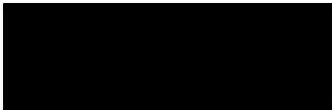
Please note the views expressed in this submission represent the views of QIC as an independent, fully commercial entity and not the views of the Queensland Government.

Please contact me if you would like to discuss.

Yours sincerely



Peter Nearhos

General Manager, Tax

QIC

QIC respectfully acknowledges the Traditional Owners and Custodians of Country
throughout Australia and recognises their continuing connection to land, water and community.
We pay our respects to Elders past, present and emerging.