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

Uploaded via Senate Standing Committees on Economics Inquiry Website

03 January 2024

Dear Sir or Madam

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

We thank you for the opportunity to provide a submission in respect of the Government's proposed amendments (the **November Amendments**) to Schedule 2 of the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023* (the **Interest Limitation Bill** or **the Bill**), which were submitted to the Senate on 28 November 2023, and referred to the Senate Economics Legislation committee on 5 December 2023.

This submission is made jointly by:

- Public Sector Pension Investment Board (**PSPIB**), a Canadian Crown corporation that invests amounts transferred to it by the Government of Canada for the pension plans of the Canadian Public Service, the Canadian Forces, the Royal Canadian Mounted Police and the Reserve Force. PSPIB has C$243.7 billion of net assets under management as at 31 March 2023 and invests globally in a variety of asset classes, including natural resources, public markets, private equity, real estate, infrastructure and credit investments.
- The New Zealand Superannuation Fund (**NZSF**) is a long-term, growth-oriented, global investment fund that is funded by the New Zealand Government. NZSF exists to help provide for the future funding of retirement benefits paid by the New Zealand Government which are guaranteed to all New Zealanders aged 65 and older. NZSF had NZ$65 billion of assets under management as at 30 June 2023 and invests in diversified assets throughout the world, including Australia.

  together (the **Foreign Funds**).

We recognise the Government's overarching policy objective to align Australia's thin capitalisation rules with the latest Organisation for Economic Cooperation and Development (**OECD**) best practice recommendations in order to protect Australia's tax base and deliver on a Labor Party election commitment. We value the opportunity to make this submission in relation to the November Amendments to the Interest Limitation Bill and the accompanying Supplementary Explanatory Memorandum (**SEM**).

We, the Foreign Funds, have previously made joint submissions to:

- The Department of Treasury in response to the public consultation on the *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation* (the **Exposure Draft Legislation**) which was released on 16 March 2023. Our submission is dated 11 April 2023 and is available on the Treasury webpage.[1]

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[1] https://treasury.gov.au/consultation/c2023-370776

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[1] https://treasury.gov.au/consultation/c2023-370776

- The Senate Economics Legislation Committee in relation to the Interest Limitation Bill. Our submission is dated 21 July 2023 and is available on the Senate Standing Committees on Economics (the **Senate Committee**) webpage.[2]

- The Department of Treasury in response to the public consultation on the Government's proposed amendments to the Interest Limitation Bill which was released on 18 October 2023 (the **October Amendments**). Our submission is dated 30 October and is available on the Treasury webpage.[3]

We wish to acknowledge that some of the changes suggested in our previous submissions have been reflected in the Interest Limitation Bill. The adoption of these changes and in particular the updated approach to trust structures has been well received by the Foreign Funds.

We are writing to you to share our key concerns in respect of the November Amendments and provide suggested changes which we consider to be both constructive and within the policy objectives of the proposed changes to Australia's thin capitalisation rules. We have limited our submission to aspects of the Bill where we believe the proposed rules materially depart from the desired policy objective. Our principal concerns relate to the following aspects of the November Amendments.

Effective Start Date of Interest Limitation Rules

Submission 1: The Interest Limitation Rules should only apply from income years starting on or after 1 July 2024

The November Amendments were referred to the Senate Economics Legislation Committee on 5 December 2023. We understand that the Senate Economics Legislation Committee will review the November Amendments, and relevant submissions, and report to the Senate by 5 February 2024. Taxpayers will therefore not have visibility over the final amendments to the thin capitalisation rules until February or March 2024.

As a result, taxpayers will have limited time remaining in the proposed first year of application (being from 1 July 2023 for the year ending 30 June 2024) to properly assess the full impact of the rules on existing investment portfolios and also undertake commercial restructuring of debt arrangements if required (e.g. restructuring third party borrowings to remove guarantees or refinance existing debt facilities to comply with the new rules). Restructuring of such debt arrangements can be a complex undertaking and taxpayers will require time to seek professional tax advice in relation to the final form of the amended legislation to ensure new debt facilities are compliant.

To mitigate the retrospective effect of the rules and adverse impacts on existing arrangements, we submit that the start date for the Interest Limitation Rules should be updated to 1 July 2024, as opposed to 1 July 2023 to allow taxpayers adequate time to consider the impacts of the final legislation and undertake appropriate restructuring.

Submission: The reference to "1 July 2023" in Paragraphs 144(1) and (2) of Part 2 of Schedule 2 of the Bill should be replaced with a reference to "1 July 2024".

[2] https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/TLABMultinationalTax/Submissions
[3] https://treasury.gov.au/consultation/c2023-454217

Fixed Ratio Test

The November Amendments included a mechanism to share excess tax EBITDA within both a chain of trusts, and also with corporate and partnership structures. This change is consistent with the Foreign Funds submission to Treasury on the October Amendments and is welcomed by the Foreign Funds. However, further improvements could be made to align the Interest Limitation Bill with existing policies and other parts of Australia's tax laws.

Submission 2: Adopting a 10% ownership threshold for the sharing of excess tax EBITDA

Based on the current drafting of the November Amendments and the Bill, an entity that holds 50% or more of another entity will be able to include the excess tax EBITDA of this other entity in the calculation of tax EBITDA. Additionally, an entity that holds less than 10% of a lower tier entity can include the distributions received from that entity in the calculation of its tax EBITDA. However, an entity that holds between 10% and less than 50% in a lower tier entity is **not** eligible to include the excess tax EBITDA of a lower tier entity in its calculation of tax EBITDA.

Setting the ownership threshold at 50% or more creates a disadvantage for investors holding between 10% and 50% in an Australian entity – particularly a trust entity as the investor is required to pay tax on the income from the trust. It is common for foreign pension funds and sovereign funds to hold an ownership interest of between 10% and 50% of a consortium vehicle as a means of co-investment and pooling capital on large infrastructure assets or real estate investments. The existence of such commercial arrangements was specifically acknowledged by the Australian Government in previous amendments to the thin capitalisation rules for trust entities where the Revised Explanatory Memorandum to the *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2019* states:

> *"It is common in some sectors for consortiums to provide funding through a combination of equity and debt. These investors typically have controlling interests of 20 per cent to 40 per cent and therefore fall below the 50 per cent threshold."*[4]

The previous amendments were specifically designed to align the application of the thin capitalisation rules to trust structures where investors have an interest of less than 50%, which is common in certain sectors (such as real estate and infrastructure). The policy behind the proposed departure from the 2019 amendment approach for trusts is unclear and inconsistent. It also creates an issue for investors such as the Foreign Funds that have made investments in consortium arrangements since 2019 based on the ability to attribute surplus "safe harbour debt amounts" between trusts where a 10% or more interest is held..

We submit that the threshold for sharing excess tax EBITDA between trust structures should be aligned with the current approach in Australia's safe harbour debt rules (reflected by the 2019 amendments) and that the threshold for sharing excess tax EBITDA in the Amendments to the Bill should be lowered to 10% or more.

Submission: The reference to a "TC direct control interest of 50% or more" in paragraph 820-60(2)(a) should be replaced with a reference to a "TC direct control interest of 10% or more in the case of a trust or partnership".

[4] Revised Explanatory Memorandum to the *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2019*: https://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r6192_ems_a6c5b4f5-5ca8-462c-abcc-2aee5836873d/upload_pdf/698715_Revised%20Explanatory%20Memorandum.pdf;fileType=application%2Fpdf

Submission 3: The Excess Tax EBITDA calculation should account for the effect of discounted capital gains

The current drafting of sections 820-52 (Meaning of tax EBITDA) and section 820-60 (Excess tax EBITDA amount) do not appropriately accommodate tiered trust structures and the operation of the capital gains tax (**CGT**) discount rules.

In a scenario where a trust (the **underlying trust**) disposes of property and distributes a net capital gain to another Australian trust (the **holding trust**), the calculation of the tax EBITDA for both the underlying trust and the holding trust would be based on the discounted capital gain (rather than the gross capital gain). This effectively results in the tax EBITDA being determined based on 50% of the gross capital gain realised by the underlying trust. Where the net income of the trust is ultimately assessable to foreign investors and subject to MIT withholding tax (or other taxpayers that do not qualify for the CGT discount, such as companies), an anomaly arises because the investors are liable to pay tax on the gross capital gain (excluding the CGT discount), but the debt deduction for interest is capped at 30% of the discounted capital gain. This could effectively result in a taxpayers "fixed ratio earning limit" being reduced by up to 50% of the intended amount.

The above outcome for trusts can be contrasted to a scenario where an underlying company disposes of property. In this case, the excess tax EBITDA calculation would be determined based on 100% of the gross capital gain. This effectively allows the company's debt deductions to be determined based on the full capital gain and thereby increase both the "tax EBITDA" and "excess tax EBITDA amount" for the company (as compared to a trust).

We submit that taxpayers that are ineligible for the CGT discount (such as foreign investors) should be permitted to include the gross capital gain when determining the "tax EBITDA" under section 820-52 and "excess tax EBITDA amount" under section 820-60. This would remove the current anomaly in the proposed rules and allow an equitable calculation of the "fixed ratio earnings limit" for taxpayers that invest in trusts.

Submission:
The definition of tax EBITDA in section 820-52 (for trusts) and excess tax EBITDA amount in section 820-60 should include a specific adjustment to ensure that gross capital gains are *included* in the calculation of excess tax EBITDA..

Third Party Debt Test

Submission 4: Exception to the TPDT for certain foreign entity support

Based on the current drafting of the Third Party Debt Test (**TPDT**) in the November Amendments and the Bill, certain types of credit support are now permissible (e.g., credit support, equity commitment letters, or guarantees that relate wholly to development of CGT assets that are land in Australia). However, where such credit support allows recourse to a foreign entity that is an associate, the arrangement is not permissible under the current drafting of section 820-427A(5)(b) and therefore the Australian borrower cannot access the TPDT to claim debt deductions in respect of the third party loans.

We acknowledge Treasury's comments in the SEM that this general prohibition ensures that multinational groups do not have an unfettered ability to leverage their Australian entities with debt that is recoverable against the global group. However, an exception is available in specific circumstances in order to allow third party debt to be supported by guarantee, security or other form of credit support. One such circumstance includes the development of CGT assets that are land in Australia (which ultimately increases the taxable value of the land in Australia through the improvements constructed).

In the context of long term development projects, it is customary for foreign institutional investors, such as the Foreign Funds, to progressively provide equity to fund the development expenditure over time (rather than a lump sum upfront which is unapplied for a number of years). These arrangements involve equity commitment letters which are relevant to the third party lending to the project. The Foreign Funds have recent examples of such 'equity commitment letters' in relation to 'Build to Rent' accommodation developments in Australia.

From a policy perspective, the use of such equity commitments from foreign associates on long term development projects does not create issues with 'debt dumping' in Australia and therefore the proposed amendments to Australia's tax laws should not preclude the Australian entity from claiming a tax deduction for third party debt where such arrangements exist. Where these types of credit support cannot be provided by the foreign associate, it could give rise to broader policy considerations. For example, a lack of foreign entity credit support may result in third party debt may not being available for certain greenfield development projects or alternatively increase the cost of debt funding for such projects, thereby reducing the viability of construction projects in Australia.

The Australian Government and Treasury are currently engaging with potential investors (such as foreign pension funds) to achieve other policy initiatives such as increasing the supply of housing through 'Build to Rent' incentives[5], and transitioning towards a de-carbonised economy.[6] Investments in the 'Build to Rent' and renewable energy sectors require significant upfront capital to develop the necessary infrastructure. These investments involve significant third party debt funding and may require specific credit support from a foreign entity before an asset has reached stabilisation (typically one to two years post construction).

We submit that consideration should be given to the broader policy spectrum of the Federal Government and, at a minimum, allowing for equity commitment letters to be provided by foreign entities that are associates of Australian borrowers as part of the specific list of circumstances in subsection 820-427(5)(a)).

Submissions:
Further consideration should be given to the expansion of subsection to 820-427(5)(b) to permit equity commitment letters from foreign associates in relation to the list of activities covered by subsection 820-427A(5)(a) and thereby support Government's ability to meet other policy objectives – particularly relating to housing and renewable energy.

Debt Deduction Creation Rule

Submission 5: Debt Deduction Creation Rule

The proposed Debt Deduction Creation Rule is extremely broad based, and we can see the potential for it to have a range of adverse and unintended consequences across commercial arrangements in the Australian market. Consistent with our previous submissions, we encourage the Government to defer any legislative action with respect to the proposed rule and refer the policy to the Board of Taxation to undertake a comprehensive review of the proposal with the benefit of input from interested parties.

The Board of Taxation could, among other things, consider:

1) the necessity for such a broad-based integrity rule for debt deductions in the context of Australia's general anti-avoidance provisions (which have repeatedly been strengthened), transfer pricing rules (which are expanded by the proposed Interest Limitation Rule) and other integrity measures (such as diverted profits tax and hybrid mismatch rules); and

[5] https://www.ato.gov.au/about-ato/new-legislation/in-detail/businesses/incentives-to-increase-the-supply-of-housing.
[6] https://www.globalaustralia.gov.au/industries/net-zero

2) the design of the proposed legislation and whether there is appropriate alignment between the policy objectives and the expected practical application of the rule to genuine commercial arrangements.

We encourage the Senate Committee to exclude the proposed Debt Deduction Creation Rule from the Bill and refer the proposed rule to the Board of Taxation for proper consideration and consultation with industry stakeholders. Such a process would provide the taxpayer community and investors with confidence that the proposed integrity rule is implemented in a manner that appropriately addresses the relevant mischief or concerns.

> **Submission:**
> The Government should refer the policy and legislative design of the Debt Deduction Creation Rule to the Board of Taxation to undertake a comprehensive review of the proposal with the benefit of input from interested parties.

Submission 6: Include a rule to permit post-acquisition group restructures

The proposed Debt Deduction Creation Rule does not include any accommodation for genuine group restructuring – particularly in the period following a commercial transaction. It is common practice for institutional investors to acquire third party assets or businesses and subsequently restructure the group to facilitate integration with existing businesses or to separate the business based on its functional use. This type of post-acquisition restructuring is particularly common in transactions with ASX listed groups where the transaction is commonly governed by a Scheme of Arrangement that does not facilitate restructuring prior to the acquisition. The proposed Debt Deduction Creation Rule means that any subsequent restructuring of a group that involves related party debt funding would be adversely impacted. This is despite the related party debt funding for the original acquisition being permitted and outside the scope of the proposed Debt Deduction Creation Rule.

We recommend amending the Debt Deduction Creation Rule to allow a deduction where a restructure occurs within a 12-month period of an original acquisition from a third party. This application of the rules would be consistent with a similar integrity rule concerning the resetting of an asset's tax base in accordance with section 716-440 of the *Income Tax Assessment Act 1997* (Cth) (the **Anti-Churn Rule**). The purpose of the anti-churning rules was to prevent foreign resident taxpayers from undertaking group restructures to obtain unintended tax benefits[7]. Relevantly, the anti-churning rule includes relief for post-acquisition restructures that occur within 12 months of the original acquisition of the entity – thereby facilitating the ability for genuine commercial group restructuring to occur[8].

The inclusion of a similar 12-month rule in the Debt Deduction Creation Rules would ensure that genuine commercial restructuring can continue to occur, whilst also achieving the policy outcomes of preventing debt deduction creation schemes that are not commercially justifiable.

> **Submission:**
> The Debt Deduction Creation Rule in Subdivision 820-EAA should be amended to apply to assets acquired outside an initial 12-month period post-acquisition to ensure that genuine commercial restructuring can occur without the arrangements being adversely impacted.

Submission 7: The Debt Deduction Creation Rule should not have retrospective application

These rules as drafted would apply to any arrangements established prior to 1 July 2024 that are still in operation post-1 July 2024. We submit that the Debt Deduction Creation Rule should be amended to only apply to transactions occurring on or after 1 July 2024 that would otherwise trigger the application of the rules.

[7] Paragraph 1.257 of the EM to *Treasury Laws Amendment (Income Tax Consolidation Integrity) Bill 2018*.
[8] Paragraph 1.173 of the EM to *Treasury Laws Amendment (Income Tax Consolidation Integrity) Bill 2018 and paragraph 5.40 of the* Board of Taxation's June 2012 Report.

The proposed application of the rules to arrangements that were entered into before 1 July 2024 but still in place as at this date creates adverse implications for current investments and significant complexity in tracing historical transactions. This is further complicated where tracing is required beyond the statutory amendment periods for Australian tax returns (4 years) and normal commercial data retention periods (commonly 7 years) where the need to retain sufficient information for this purpose was not a part of the law.

Where Treasury or the ATO is concerned with debt arrangements claimed as a consequence of initiated transactions occurring before 1 July 2024 these should be dealt with under the existing integrity rules in Australia's taxation laws at the time the transaction occurred, including for example the General Anti-Avoidance Rule in Part IVA of the *Income Tax Assessment Act 1936* (Cth) and Transfer Pricing Rules in Division 815 of the *Income Tax Assessment Act 1997* (Cth) (noting that Treasury has separately proposed amendments to the transfer pricing rules to increase the potential application of these rules to related party debts[9]).

Submission:
Where the Government proceeds with the Debt Deduction Creation Rule, Subdivision 820-EAA should be amended to clarify that the provisions do not apply to debt arrangements of an entity in an income year starting on or after 1 July 2024 that relate to:

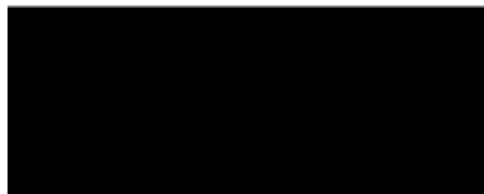
- the acquisition of a CGT asset, or legal or equitable obligation; or
- the issuance of a debt interest to an associate pair.

that occurred prior to 1 July 2024.

* * * * *

The Foreign Funds value and appreciate the ability to provide our views through the consultation process.

Yours sincerely



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[9] Per the proposed addition to subsection 815-140(1)(a) of the *Income Tax Assessment Act 1997* (Cth).