MinterEllison.

21 July 2023

Senate Economics Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Senators

We welcome the opportunity to make a submission to the Senate Economics Legislation Committee (**Committee**) on the provisions in *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency)* Bill 2023 (**Bill**).

We regularly act for a number of large corporate clients, particularly in the infrastructure, energy and natural resources and property sectors, and with that background and experience we have some concerns in relation to certain aspects of the Bill. We set out below a summary of these concerns. The below is limited to only certain key issues that we consider require addressing and which we submit would require amendments to the Bill to address, noting that we consider them to be unintended consequences of the current drafting of the Bill.

Dividends and distributions from investee entities

Section 820-52 of the Bill:

(a) excludes *any* assessable dividends and the gross up for franking credits from forming part of the *tax EBITDA*;

(b) excludes a partner's share of the net income of a partnership in determining the partner's *tax EBITDA* where a partner has a *TC control interest of 10% or more* in the partnership (i.e. is an *associate entity* of the partnership); and

(c) excludes a beneficiary's share of the net income of a trust (or a capital gain to which the beneficiary is specifically entitled) in determining the beneficiary's *tax EBITDA* where a beneficiary has a *TC control interest of 10% or more* in the trust (i.e. is an *associate entity* of the trust).

The Explanatory Memorandum to the Bill (**EM**) explains the purpose of these amendments as being to prevent *double counting* of thin capitalisation capacity.[1]

While we acknowledge that there is a genuine issue associated with a potential for *double counting* of capacity, we submit that the approach in the Bill reaches beyond this stated policy objective. We expect that this is unintended and respectfully submit that it requires rectification.

As drafted, the Bill adversely applies to the following "plain vanilla" commercial structures where the investee entities are subject to the thin capitalisation rules:

(a) borrowing to subscribe for equity in a domestic company or in a foreign resident company, where the borrower holds less than 10% of the voting power in the foreign resident company; or

(b) borrowing to invest equity capital in any partnership or trust where the borrower holds an interest of at least 10% in the relevant partnership or trust.

In each of the above scenarios, the investee entity is an *associate entity* of the borrower under the Bill.

Where the investee entity has significant thin capitalisation "headroom", for example, its *tax EBITDA* under the *fixed ratio test* (**FRT**) is significantly greater than its *net debt deductions*, the current Bill would deny the ability of the investor (the borrower) to utilise any of that excess "headroom".

[1] EM paragraph 2.69 provides that '*[t]hese adjustments aim to ensure that these adjustments only count towards tax EBITDA of partnerships and trusts, and not also the tax EBITDA of the entities…to which such amounts may ultimately be assessed*'.

This approach goes beyond merely preventing double counting of thin capitalisation capacity to adversely impact groups that gear through a holding vehicle, even though the amount of net debt deductions at a group level is the same.

We submit that the appropriate policy setting is to ensure that unused thin capitalisation capacity in an investee entity should be available to an investor in a similar way to the *attributable safe harbour excess amount* concept within the *associate entity excess amount* under the current thin capitalisation rules in section 820-920 of the *Income Tax Assessment Act 1997*. By way of example, if a partner held 50% of a partnership, they should be entitled to 50% of any "headroom" attributable to that partnership.

This suggested approach would meet the stated policy aim of preventing double counting, while ensuring that the unintended consequences illustrated above should not arise.

This issue is a major concern for both the infrastructure and property sectors, where trusts and partnerships are used extensively to achieve commercial objectives and the debt is not always capable of being issued by the asset owning entity.

Availability of third party debt test inappropriately impacted by guarantees and credit support

While it is acknowledged that the Bill relaxes some elements of the *third party debt test* (**TPDT**), we submit that there remain some significant anomalies, particularly where the lender has recourse under a guarantee or other form of credit support.

We illustrate the point below with reference to a guarantee, but the point should equally apply to other forms of credit support from other entities.

As drafted, where a guarantee is provided in favour of the lender, the relevant debt cannot satisfy the TPDT in proposed section 820-427A unless the underlying activity relates wholly to property development (see in particular proposed paragraph 820-427A(3)(c)(ii) and proposed subsection 820-427A(4)).

The only exception to this is where the *conduit financing conditions* in proposed section 820-427C are satisfied (see proposed paragraph 820-427B(4)(b)), as this permits the lender to have recourse to the Australian assets of Australian resident members of the borrower's *obligor group*.

We submit that this approach will result in two different tax outcomes for the same economic position.

Under the first alternative, a parent may borrow from an external lender and on-lend to an asset owning subsidiary under the conduit financing rules. The asset owning subsidiary will provide a guarantee to the lender. The TPDT is capable of applying to this alternative.

Under the second alternative, the asset owner borrows and the parent provides a guarantee to the lender. As there is no *on-lending* under this alternative, the provision of a guarantee (even if it is by an Australian entity and solely in respect of Australian assets) will result in the debt, which is clearly economically a third party debt, being outside the TPDT.

We submit this is clearly not the intention of the test and amendments should be made to clarify the operation of the TPDT in the context of the provision of guarantees and credit support.

Debt deduction creation rules

Subdivision 820-EAA of the Bill includes proposed "targeted" *debt deduction creation rules* (**DDCR**), which broadly seek to mitigate the perceived base erosion arising from excessive debt deductions created in connection with acquisitions of assets from *associates,* or certain associate debt-funded payments to associates. The DDCR seek to do this by fully denying debt deductions in certain circumstances, independently and in addition to, the operation of the FRT, *group ratio test* or *third party debt test* (proposed section 820-423C).

The stated aim of the DDCR in the EM is to disallow debt deductions to the extent that they are incurred in relation to a *debt creation scheme* that *lacks genuine commercial justification*.[2] This is not reflected in the draft legislation.

[2] See in particular EM at paragraph 2.146.

We submit that the operation of the DDCR goes beyond this stated policy objective and adversely affects "plain vanilla" commercial transactions, including:

(a) ordinary *refinancing* transactions where the overall indebtedness of the group is not increased. Such transactions could previously have been excluded from former Division 16G under former subsection 159GZZF(5) of the *Income Tax Assessment Act 1936*;

(b) any transactions even where the interest is assessable in Australia (and therefore there should not be any *base erosion*);

(c) borrowing at arm's length from a third party (as opposed to an *associate*) to acquire assets from an *associate pair*; and

(d) borrowing to acquire assets from a trust in which the borrower holds a nominal interest.[3]

Additionally, in our view, the drafting of paragraph 820-423A(5)(c) should be amended to clarify the meaning of threshold terms such as *predominantly* and *increase the ability of any entity*, each of which could apply in very broad circumstances that are typical commercial transactions lacking in any tax avoidance purpose.

Given that these terms are critical to the breadth and application of the DDCR, we submit that they should be clear in their application and restricted to schemes which, in the language of the EM, *lack genuine commercial justification.*

Further, the DDCR rules apply to entities that are exempt from thin capitalisation under the 90% Australian asset threshold test.[4] Given that this exemption is not available to *foreign controlled entities* (i.e. inward investors), the debt to which the DDCR apply for such entities is likely to be held by an Australian entity. In these circumstances, the interest should be assessable to the Australian tax base. Consequently, from a policy perspective, we would submit that entities exempt from the thin capitalisation rules under the 90% Australian asset threshold test should also be exempt from the DDCR. Failing that, there should be a *switch off* of the DDCR where the interest is otherwise assessable in Australia.

Finally, the most significant concern with the DDCR is that they arguably apply to debt deductions in respect of debt that was issued prior to the issue of the Bill. There is no exception to the anti-avoidance rule in section 820-423D or transitional measure to permit restructuring in a manner which ensures that the DDCR do not apply to pre-existing debt interests. This can have significant adverse implications for a group which entered into bona fide commercial transactions at a time when there was no announcement of the DDCR.

We submit that the appropriate policy setting is to exclude any debt deductions attributable to debt issued prior to the start of the Bill.

Please contact Adrian Varrasso if you have any questions in relation to this submission.

Yours sincerely

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[3] We note that under section 318 of the *Income Tax Assessment Act 1936,* a unitholder may be an *associate* of a trust where it holds a nominal interest in the capital of the trust (e.g. one unit) without any material influence. In these circumstances, the unitholder and the trust would be an *associate pair* under the Bill.
[4] Section 820-37 of the *Income Tax Assessment Act 1997* (Cth).