INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

21 July 2023

Committee Secretary
Senate Standing Committee on Economics
PO Box 6100 Parliament House
Canberra ACT 2000

Via Email: economics.sen@aph.gov.au

Dear Committee Secretary,

SUBMISSION ON TREASURY LAWS AMENDMENT (MEASURES FOR FUTURE BILLS) BILL 2023: THIN CAPITALISATION INTEREST LIMITATION

1. Introduction

Infrastructure Partnerships Australia is an independent think tank and executive member network, providing research focused on excellence in social and economic infrastructure. We exist to shape public debate and drive reform for the national interest. As the national voice for infrastructure in Australia, our membership reflects a diverse range of public and private sector entities, including infrastructure owners, operators, financiers, advisers, technology providers and policy makers.

Infrastructure Partnerships Australia draws together the public and private sectors in a genuine partnership to debate the policies and priority projects that will build Australia for the opportunities and challenges ahead.

We are pleased to make this submission to the Senate Economics Legislation Committee on the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023 (Cth)* (referred to as "**the Bill**") introduced into Parliament on 22 June 2023.

The measures outlined in the Bill will have material consequences for infrastructure investment in Australia. Our submission seeks to highlight the importance of:

1. retaining the third-party debt test as set out in the Bill, subject to further technical refinements to ensure the rules are consistent with the policy intent
2. ensuring appropriate carve outs or transitional rules for infrastructure projects, noting the proposed Canadian carve out and the critical nature and unique contribution of the infrastructure sector to the Australian economy
3. concerns on the potential broad application, timing and limited consultation on the proposed new debt creation rules, and
4. providing restructuring relief for entities wishing to restructure to comply with the new rules.

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For a more comprehensive understanding of our input into the design of the policy package, and the subsequent drafting of the Bill, we refer the Committee to our previous submissions to Treasury, including:

- Submission to Treasury on the Government Election Commitments: Multinational Tax Integrity and Enhanced Tax Transparency, dated 2 September 2022
- Submission to Treasury on the Multinational Tax Integrity Package – Amending Australia's Interest Limitation (Thin capitalisation) Rules, dated 9 January 2023, and
- Submission to Treasury on the Multinational Tax Integrity– Strengthening Australia's Interest Limitation (Thin capitalisation) Rules 2023 Exposure Draft, dated 13 April 2023.

2. Background and context

Over the past 20 years, Australia has attracted and retained capital by enabling investors to competitively price infrastructure assets, based on confidence in the regulatory and legislative environments. This has been particularly evident by the participation of foreign investment in Australia's infrastructure transactions, including social and economic Public Private Partnerships (**PPPs**), telecommunications, energy and renewables.

These projects are able to justify a higher level of debt as the cash flows from the project are typically relatively secure over the long term, enduring beyond one or more economic cycles. Thus, these Australian infrastructure entities are able to raise debt from third party arm's length lenders at a level which is in excess of the current safe harbour debt amount and the proposed 30 per cent fixed ratio rule. The tax deductibility of the interest on such debt is an important factor in pricing investors' cash flows and in achieving an appropriate after-tax rate of return on their equity.

It is widely recognised and acknowledged as Australia emerges from a rising interest rate and high-inflationary environment, that new and existing infrastructure assets will play a central role in developing and expanding our economy. Australia has an enviable record in delivering infrastructure assets and projects efficiently via PPPs, including most particularly economic infrastructure (including toll roads and energy infrastructure), social infrastructure (including social housing, hospitals and schools) and other projects for the broader benefit of the Australian community.

Third party debt test

We welcome the retention of the third-party debt test in the Bill, however, note there are still various technical drafting amendments required to ensure the legislation operates as intended by allowing interest on debt from bona fide third-party debt providers to be deductible. We continue to engage with Treasury on these technical amendments.

The third-party debt test is critical to the delivery of major infrastructure projects and the facilitation and encouragement of foreign investment. Any intention to abandon or reduce its use as an alternative thin capitalisation test would have a serious negative impact on the costs for all levels of government to access private sector capital (for example, through PPPs) to deliver Australia's critical social and economic (including renewable

energy) infrastructure. The infrastructure sector contributes significantly to Australia's economic activity by enhancing productivity across the nation and enabling the nationally planned transition to net zero emissions.

The efficient deployment of debt capital translates directly into lower community costs for both social and economic infrastructure than would apply if additional equity capital was required, given that equity investors typically require higher rates of return than debt financiers.

3. Infrastructure carve out for Australian PPP infrastructure projects

Similarly to Australia, Canada is proposing new Interest Limitation Rules consistent with the recommendations in the report under Action Four of the G20/OECD Base Erosion and Profit Shifting Project (BEPS Action Four Report). These proposed new rules are the subject of draft Legislation and accompanying Explanatory Notes, the core Rules for which are known as the new Excessive Interest and Financing Expenses Limitation (**EIFEL**) Regime. The EIFEL Regime is also intended to align with the OECD Best Practice Guidance and would be operative for income tax years beginning on or after 1 October 2023.

The Explanatory Notes accompanying the draft Legislation state that the objective of the EIFEL Regime Is to address BEPs issues arising from taxpayers deducting for income tax purposes excessive interest and other financing costs, principally in the context of multinational enterprises and cross-border investments.

In general terms, the EIFEL Rules limit interest deductions to 30 per cent of earnings before interest, tax, depreciation and amortisation (EBITDA). However, the EIFEL Rules do not apply to limit the deductibility of interest and financing expenses that are incurred in respect of many Canadian PPP infrastructure projects. For example, an exception is provided for "exempt interest and financing expenses" (as defined in draft Section 18.2(1)) – see extract below.

> "*exempt interest and financing expenses*"
>
> *of a taxpayer for a taxation year means the total of all amounts, each of which would, if the description of A in the definition "interest and financing expenses" were read without reference to "exempt interest and financing expenses", be included in interest and financing expenses of the taxpayer for that year, and that is incurred in respect of a borrowing or other financing (referred to in this definition as the "borrowing") of the taxpayer or a partnership of which the taxpayer is a member (referred to in this definition as the "borrower"), if*
> *(a) the borrower entered into an agreement with* ***a public sector authority to design, build and finance, or to design, build, finance, maintain and operate, real or immovable property owned by a public sector authority****;*
> *(b) the borrowing was entered into by the borrower in respect of the agreement;*
> *(c) it can reasonably be considered that all or substantially all of the amount is directly or indirectly borne by the public sector authority; and*
> *(d) the amount was paid or payable to persons that deal at arm's length with the borrower (other than any person or partnership that is, or does not deal at arm's length with, a person or partnership that has a direct or indirect equity interest (within the meaning of subsection 18.21(1)) in the borrower).*

Generally, the exception will apply to third party interest and financing expenses that are incurred in respect of a borrowing or other financing that was entered into in respect of an agreement with a Canadian public sector authority to, amongst other things, design, build, finance, operate and maintain real or immovable property effectively owned by a public sector authority, where those interest and financing expenses are economically borne by the Canadian public sector authority. Further guidance, rationale and explanations are provided in the Explanatory Notes accompanying the draft Legislation which include that these 'Exempt Interest and Financing Expenses', as defined, do not pose significant base erosion and profit shifting risks targeted by the new rules.

We submit the Committee gives due consideration to a similar carve out or exception for Australian PPP infrastructure projects, including the emergence of Renewable Energy Zone PPPs as seen in NSW.

4. Commencement date and transitional rules

In the absence of a carve out for certain infrastructure projects, the commencement date of any proposed changes needs to be carefully considered. The current Bill provides that the measures will apply retrospectively from 1 July 2023 with no provision for transitional relief, notwithstanding there are still a number of drafting issues in the Bill. A start date of 1 July 2023 does not give any time for stakeholders to consider and prepare for the new law, noting that taxpayers currently require further information to be able to assess the impact of the measures and to understand the consequences for existing and proposed investment activities. This includes consideration of the new Debt Creation rules, which were not foreshadowed during the consultation period (refer to discussion of these rules below).

Further, the Explanatory Memorandum accompanying the Bill states at paragraph 2.183 that Schedule 2 (Thin Capitalisation) would only commence on the first 1 January, 1 April, 1 July or 1 October (effectively first quarter) after the Bill receives Royal Assent. As Thin Capitalisation is an annual test, this should mean that for example, for entities with a 30 June year end, these measures would be applicable only from income years starting on 1 July, 2024 – given that the Thin Capitalisation reforms and rules are likely not to receive Royal Assent before September or October 2023, at the earliest.

Any proposed changes to the thin capitalisation rules should only apply prospectively, following careful consideration of challenging transitional and financing issues (for example, breach of debt covenants caused by the denial of debt deductions under the fixed ratio rule).

We submit that the earliest start date for the measures should be for income years starting on 1 July 2024. Having the measures apply prospectively from the commencement of a new tax year will make it easier for taxpayers to manage, apply and comply with the new rules for the full income year.

Given the OECD/G20 guidance and comments on targeted anti-abuse/integrity rules, we query and reference alternative methods of pursuing excessive interest deductions under existing anti-avoidance/integrity rules, including Part IVA, transfer pricing rules and diverted profits tax.

Transitional rules and relief

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Given the third-party debt test is critical to the delivery of major infrastructure projects and the facilitation and encouragement of foreign investment, we submit that a transitional timeframe of three years be made available for existing infrastructure projects to comply with the new rules.

By way of comparison, the Canadian draft Legislation mentioned above includes a "pre-regime election" to allow taxpayers to carry forward excess debt capacity generated in the three years before the proposed EIFEL rules take effect.

While these Canadian Transitional Rules are not necessarily directly helpful or relevant in the Australian context, they do reinforce the need for some level of recognition and concessions whilst taxpayers adjust and convert to the proposed new interest limitation rules, particularly exacerbated by long term and complex debt arrangements for infrastructure projects in Australia.

5. Debt creation rules

Concerns regarding lack of consultation

The proposed debt creation rules contained within the Bill are drafted in very broad terms and have the potential to adversely affect many commercial transactions and therefore go beyond the policy intent of the thin capitalisation rules. Moreover, the debt creation rules were not foreshadowed in earlier Treasury consultations, nor were those rules outlined in the Exposure Draft of 16 March 2023. As a result, industry has not had an opportunity to provide proper and meaningful input on the design of these rules.

We note in particular that the Explanatory Memorandum observes that there were debt creation rules contained within the former Division 16G of the Income Tax Assessment Act 1936. However, the debt creation rules were repealed by the New Business Tax System (Thin Capitalisation) Act 2001 in response to the *Review of Business Taxation*. The *Review of Business Taxation* in 1999, after extensive consultations and consideration, specifically recommended the repeal of the debt creation rules (amongst various other thin capitalisation reforms). It is therefore surprising that the Bill now proposes to reintroduce debt creation rules that are very broadly drafted, without consultation and which go beyond the policy intent of the thin capitalisation regime.

Furthermore, and as discussed below, there are already a number of existing integrity rules outside of the thin capitalisation rules that address BEPS concerns that might not otherwise be addressed by the earnings based thin capitalisation regime.

Given this, consultation on the debt creation rules has been inadequate and that the case for the debt creation rules has not been properly articulated. For the reasons set out below, we submit that the debt creation rules in the Bill should be removed and that a further round of consultation should be undertaken to ensure that any proposed integrity rules are better targeted.

In addition to the above concerns, we set out below our specific comments on the current drafting of the debt creation rules.

Breadth of application and absence of any purpose test

The Explanatory Memorandum states that the purpose of the debt creation rules is to disallow debt deductions in relation to arrangements that "lack genuine commercial justification" or involve the creation of "artificial interest-bearing debt." However, the drafting of the Bill does not make any reference to these concepts, nor are there any purpose-based tests (other than in the related anti-avoidance rule) in the Bill to reflect these apparent aims.

The lack of any purpose-based tests in the Bill, combined with the broad drafting of the debt creation rules, will adversely affect many ordinary commercial transactions that do not give rise to inappropriate BEPS outcomes. Indeed, the debt creation rules in the Bill do not distinguish between genuine commercial transactions or transactions undertaken wholly within an Australian domestic group, as opposed to transactions that are undertaken for a base eroding purpose.

For example, an Australian company borrowing funds from an unrelated domestic bank to fund the acquisition of an asset on arm's length terms from a shareholder (holding an equity interest of greater than 50 per cent) would potentially give rise to the debt deductions being denied in respect of that borrowing, notwithstanding that there would clearly be no "artificial interest-bearing debt" having been created within the taxpayer's group, and notwithstanding also that the asset would have been acquired from an Australian counterparty, subject to Australian income tax and in a context where there is no loss to the revenue.

Similarly, borrowing to fund distributions to shareholders or investors or to refinance existing related party funding arrangements are common commercial transactions. In our view, the current rules are drafted so broadly that they would inadvertently capture the vast bulk of third-party external borrowing used to fund distributions to shareholders[1].

We respectfully submit that any debt creation rule (or any other integrity rule proposed to be introduced to address to residual BEPS concerns) should be drafted to include a clearly worded purpose test to ensure its application is appropriately targeted.

Residual BEPS concerns are already addressed by targeted integrity measures

The Explanatory Memorandum suggests that paragraphs 173 and 174 of Chapter Nine of the OECD's BEPS Action Four Report provide support for the need for the debt creation rules.

However, we point out that those paragraphs of the OECD BEPS Action Four Report specify that any further integrity rules should be specifically targeted to address a limited number of specific BEPS concerns (for example transactional) that are not otherwise addressed by the fixed ratio and group ratio rules. The OECD BEPS Action Four

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[1] Under the proposed debt creation rules, where an entity borrows from a non-associate and uses those borrowings to fund a distribution to an associate, the debt creation rule would not apply (as is clearly intended by the Bill). However, where an associate (such as an internal finance entity) borrows from an unrelated related third-party and on-lends that debt to fund the distribution, the debt creation rule would apply, notwithstanding that the relevant borrowings are obtained from a non-associate. As a result, borrowings from associated conduit financier entities (where all of the relevant underlying debt is sourced from third-party lenders) would be inappropriately affected by the debt creation rule in section 820-423A(5).

Report does not recommend a rule that operates as broadly as the proposed debt creation rules contained within the Bill.

Further, the specific Anti-avoidance rule (Section 820-423D) provided in the proposed Debt Creation Rules is too broad and unnecessary, including for the following reasons.

In fact, any such residual BEPS concerns that are not addressed by earnings based thin capitalisation rules should be adequately addressed by various existing integrity rules, including the transfer pricing regime, Part IVA, the targeted integrity rule in Division 832 of the ITAA 1997, the diverted profits tax and the forthcoming implementation of the OECD's Pillar Two project.

We therefore submit that significant further comprehensive consultation and redrafting of the debt creation rules is required to ensure that they are better targeted to achieve their intended outcomes.

Compensating adjustments

Where the debt creation rules operate to deny deductions for interest expenses incurred to associates of the taxpayer, we submit that the rules should provide for a compensating adjustment to exclude that interest from the assessable income of the recipient. This would be consistent with the compensating adjustment rules contained within the general anti-avoidance rule in Part IVA.

Need for clarification of transitional application

Under the Bill, it appears that the debt creation rules may potentially apply retrospectively to deny debt deductions incurred on or after 1 July 2023 (which is the current proposed start date of the Bill) in respect of borrowings and trigger events that occurred well before that date.

In addition to our comments above regarding the need for more appropriate transitional periods for affected taxpayers, we respectfully submit that the start date for the application of the debt creation rules should be clarified such that those rules would apply only to debt deductions incurred in relation to debts and trigger events occurring on or after the intended start date of the legislation (which we submit should be 1 July 2024). Legislative clarity is also required for situations where the debt and trigger event happen when an entity is not subject to the thin capitalisation rules, but becomes subject to the thin capitalisation rules in a later income year.

6. Concessions for restructuring activities undertaken to comply with the new rules

Many infrastructure projects have structured their existing debt arrangements to be compliant with the existing thin capitalisation rules. Prior to the new thin capitalisation rules coming into force, we expect that many groups will look to re-structure their debt arrangements to be compliant with the new rules.

We would expect that these debt restructuring activities may result in some entities either having their debt capitalised (i.e., converted into equity) or potentially even forgiven, which may have adverse tax outcomes. Given that these re-structuring activities would be carried out in order to comply with a change in law we consider that it would be appropriate to include concessions within the rules to not punish groups that re-structure their debt

simply to comply with the new rules. The current Bill does not contain any concessions for taxpayers wishing to restructure simply to comply with these new rules.

7. Conclusion and further contact

We very much appreciate the opportunity to provide this submission on the Federal Government's important multinational tax integrity and enhanced transparency proposals. Infrastructure Partnerships Australia looks forward to further assisting the Independent Review.

If you require additional detail or information, please contact Jamie Harrison, Senior Policy Adviser at

Yours sincerely

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Infrastructure Partnerships Australia