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The logo for Ashurst, featuring the word "ashurst" in a lowercase, bold, sans-serif font.

Dear Corporate and International Tax Division

## 1. INTRODUCTION

Thank you for the opportunity to provide comments on the exposure draft legislation *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation and interest limitation (Exposure Draft)*.

Ashurst is a leading global law firm and in Australia (formerly known as Blake Dawson) is one of Australia's largest law firms. The Ashurst tax practice is one of the largest tax practices among the law firms. Ashurst advises clients across all industry sectors, including ASX-listed companies, large multinationals, private companies, funds, financial institutions, and governments.

This letter sets out our submissions on the Exposure Draft, and is organised into two sections:

1. Key policy issues identified in relation to the Exposure Draft, with a particular focus on the external third party debt test; and
2. Technical drafting issues in the Exposure Draft, providing comments on what we have assumed are technical issues with the proposed drafting (rather than being intentional policy decisions).

Notwithstanding that the second section relates to technical drafting issues, many of the identified drafting issues have a material impact and require amendment.

Section references below are to the *Income Tax Assessment Act 1997 (ITAA 1997)* or to the Exposure Draft. We have also referred to the OECD report on *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update (OECD Report)*.

We would like the opportunity to discuss our submission points further with Treasury once you have had the opportunity to review.

## 1. PART 1: KEY POLICY ISSUES

### General comments

We note that the proposed change from the current safe harbour debt amount to the fixed ratio rule (**FRR**) is likely to materially impact the financial profile of many existing projects and investments. In addition, the third party debt rule (**TPDR**), as currently drafted, is not likely to provide a genuine choice to many taxpayers to ensure debt deductions on their third party debt arrangements are allowable as deductions, in the light of both the eligibility requirements, and the relevant third party debt conditions (which do not reflect extremely common third party lending arrangements). Further, the group ratio rule (**GRR**), as currently drafted, will not be available to a significant number of taxpayers and, in any case, will often apply to deny debt deductions where the level of gearing of Australian entities is lower than their global average, due to the nature of calculations.

Accordingly, the proposed rules will negatively impact many existing projects and investments, as well as the capacity for Australia to continue to attract foreign capital (as a net capital importing country). Many of these investments and projects are in areas of national and community significance, such as infrastructure, energy (including renewables), healthcare and the real estate sector, among others. Existing investment decisions, including financing arrangements in many significant projects, have been based on modelling and assumptions regarding the application of Australia's taxation rules, including the availability of interest deductions and the application of the thin capitalisation regime. In most instances, investments in these sectors are made with an intention of holding the asset for the long term, and on the basis of the modelling undertaken at the time of acquisition.

Many taxpayers have relied on the Government announcements with respect to the proposed reforms; announcements that are not reflected in the Exposure Draft. In particular, for example, many taxpayers have relied on the announcement in Budget 2022-23 that the Government would *"retain an arm's length debt test as a substitute test which will apply only to an entity's external (third party) debt, disallowing deductions for related party debt under this test."* In reality, and based on the Exposure Draft, taxpayers will not be able to be certain they have made a valid election to apply the TPDR and, in any case, we are not aware of any taxpayer whose third party debt arrangements would in fact satisfy the conditions in the TPDR. We have provided extensive commentary on these problems in section 1 below.

However, and given the expected impact of the reforms, we consider that certain long term projects (such as certain infrastructure and similar projects) should be subject to grandfathering or a reasonable period of transition.

With respect to a process to transition, taxpayers should be given the option to opt in to the revised rules from 1 July 2023, but taxpayers should also be able to continue applying the current rules until at least 1 July 2024 (to give them time to make decisions around their capital structure). Taxpayers who will be adversely impacted by the measure should have at least a reasonable period of time to consider the impact of the measures, and (if they choose to) seek to renegotiate or secure alternative funding.

We further note that certain taxpayers may seek to refinance in order to fall within the revised thin capitalisation regime, but these taxpayers are likely to face potentially material break costs (as well as likely higher interest costs, given they are refinancing in an environment of higher interest rates). These taxpayers may also face certain integrity hurdles in seeking to refinance – including, for example, the potential application of Australia's general anti-avoidance rule.

Accordingly, we consider that the ATO should formally announce that they will not seek to apply anti-avoidance provisions to restructures to financing arrangements where the purpose of the restructure is to address changes made by the revised thin capitalisation regime to achieve a comparable commercial outcome. We note that this is similar to certain announcements made by the ATO in the context of the hybrid mismatch rules – see, for example, Practical Compliance Guideline PCG 2018/7.

Examples of such restructures may include (this list is not exhaustive):

1. Restructuring the level at which debt is obtained, noting that the Exposure Draft would (generally speaking) give rise to a higher level of allowable debt deductions under the fixed ratio test at a downstream level (where depreciation is claimed).
2. Replacing related party debt with third party debt or equity.
3. Renegotiating security arrangements in order for arrangements to qualify for the external third party debt test.

### **Debt deductions and net debt deductions**

The Exposure Draft amends the definition of "debt deductions" in a manner that results in a lack of clarity as to which expenses are to be classified as debt deductions. In addition, the definition of "net debt deductions" is non-symmetrical, meaning that amounts may be treated as "debt deductions" (where they are expenses), but not subtracted in determining "net debt deductions"

(where comparable amounts are income). Examples of items affected by these two issues include fees in relation to a debt interest, lease payments, swap/derivative payments, etc..

In the debt deduction definition in section 820-40, the removal of the words "in relation to a debt interest issued by the entity" in subsection 820-40(1) is the root of the issue and suggests that debt deductions can now arise in respect of other arrangements. The Explanatory Memorandum suggests this is the intended effect, and refers to the OECD's proposed approach. The OECD Report suggest that interest expense should apply to, among other items, payments under profit participating loans, Islamic finance, the finance cost elements of finance lease payments, notional interest amounts under derivative contracts, foreign exchange losses on borrowings, and guarantee fees.<sup>1</sup>

There is a lack of clarity around the impact of the proposed change to subsection 820-40(1) for two reasons – first, because of the retention of subsection 820-40(3), and second, because there is (in effect) an otherwise deductible requirement that the cost has to be an allowable deduction (paragraph 820-40(1)(b)).

First, subsection 820-40(3) has the effect of deeming certain amounts to not be debt deductions where they arise "in relation to a debt interest issued by the entity" (being the words now deleted in subsection 820-40(1)). However, as the "in relation to a debt interest issued by the entity" words in subsection 820-40(1) have been removed, subsection 820-40(3) no longer removes all such items from debt deductions but only those that are "in relation to a debt interest issued by the entity". It is not clear to us why subsection 820-40(3) is so restricted. That list of items includes losses or outgoings associated with hedging or managing the financial risk in respect of the debt interest, foreign exchange losses, and rental expenses for a lease.

The proposed amendments make it unclear if payments under an interest rate swap are debt deductions (or whether there is a distinction between one type of interest rate swap (which is not covered by subsection 820-40(3)) and another kind that is associated with hedging or managing the financial risk in respect of a debt interest (and so is covered by subsection 820-40(3)). Similarly, it is unclear whether foreign exchange losses are debt deductions. It is also unclear whether payments under a lease that are deemed (for accounting purposes) to have a financial element and which are not debt interests for tax purposes are debt deductions even though the lease is an operating lease and not a finance lease under the old pre-IFRS classification, noting that the IFRS accounting standards now impute a financing element even to traditional operating leases (for the lessee).

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<sup>1</sup> OECD Report, paragraph 36.

It is also unclear how broad the concept of "any other amount that is calculated by reference to the time value of money" is, in a context where the amount does not need to relate to a debt interest. For example, it is not clear whether that now includes a late payment penalty or an early payment discount (even if the arrangement is not a debt interest on the basis of its short term nature – see subsection 974-25(1)). Another example is a performance fee that is calculated by reference to the internal rate of return of an investment – is the performance fee now a debt deduction (and, potentially, an amount subtracted in determining net debt deductions, where it is income) on the basis that it is calculated by reference to the internal rate of return of an investment in a fund?

If the Government intends to change the definition of debt deduction, any such changes should be clear and consistent. We would strongly recommend that consideration should be given to the operation of subsection 820-40(3). The removal of the words "in relation to a debt interest issued by the entity" in subsection 820-40(1) expands the concept too broadly - those words should be reinstated, and the legislation should include specific items that are not in relation to a debt interest that are now intended to be included in the debt deduction concept.

Second, the Explanatory Memorandum states (at paragraph 1.116) that the intention of the change to the definition of "debt deductions" is to align the meaning to reflect the OECD's recommended approach as set out in the OECD Report. Merely referring to the OECD Report in this regard is unhelpful, as it does not reflect other elements of the definition of debt deduction, or other Australian rules that relate to deductibility (such as the debt/equity classification rules). One particular element that is not referred to is the otherwise deductible requirement, which means that a number of payments referred to in the OECD Report may not in fact be debt deductions for Australian tax purposes – payments under profit participating loans, for example, may be non-deductible as the loan may be characterised as an equity interest; similarly, payments under Islamic finance arrangements may also be non-deductible. We strongly recommend that the Explanatory Memorandum be updated to refer specifically to the types of payments that are now considered to be included in the definition of "debt deductions", rather than merely referring to the OECD Report.

Furthermore, the proposed definition of "net debt deductions" does not provide symmetry with respect to outgoings on the one hand (i.e., debt deductions) and income on the other (being amounts subtracted in determining net debt deductions). In particular, the "net debt deductions" definition in subsection 820-45(3) only reflects (on the income side) the equivalent of subparagraph 820-40(1)(a)(i) – there is no inclusion of, for example, the difference between financial benefits provided and received under the arrangement (see subparagraph 820-40(1)(a)(ii)), any amount received in providing or maintaining the financial benefits provided (see subparagraph 820-40(1)(a)(iii)). Accordingly, this means that an entity may (in economic substance) have no net debt deductions, but the proposed drafting may result in there being net

debt deductions. This does not appear to be intended, and we strongly recommend that the relevant definitions are symmetrical.

### **The Fixed Ratio Rule**

Our key submissions in respect of the FRR are as follows:

1. The FRR, as drafted, results in adverse implications for upstream gearing in a non-consolidated structure (e.g., at a holding level) compared to downstream gearing in a non-consolidated structure (e.g., at an asset level), with no policy rationale for the adverse treatment;
2. A number of the calculations required to apply the FRR simply cannot be performed, including (in certain circumstances) determining tax EBITDA, as well as determining the amount available to obtain the special deduction for previously FRT disallowed amounts; and
3. Companies should be able to apply the continuity of business test in determining the FRT disallowed amount.

We have elaborated on these points below.

#### *Adverse impacts on upstream gearing*

Groups of entities may choose to obtain debt financing at different levels of their structure – a group may (for example) choose to obtain debt finance at a downstream level, where the debt is borrowed to fund a particular asset (e.g., a particular property held in a special purpose trust). Alternatively, a group may choose to obtain debt finance at an upstream level, where debt is borrowed against a portfolio of assets, or alternatively where debt is borrowed to finance the acquisition of an entity or group of entities.

The preference for downstream debt financing or upstream debt financing will generally be driven by commercial factors, such as the terms of the borrowing, noting that the rate of interest for debt borrowed against a portfolio of assets will often be lower than debt borrowed against each specific asset. Generally speaking, Australia's thin capitalisation rules do not presently distinguish in any meaningful way between downstream debt and upstream debt in the context of a non-consolidated structure.

The FRR discriminates in its effect between structures where debt is provided at an upstream level compared to how it applies to structures where debt is provided at a downstream level. Taking an example of a holding entity that only holds equity in downstream entities, the principal cause of this discrimination is that upstream holding entities do not claim depreciation (as they hold no

depreciable assets), whereas downstream entities may hold depreciable assets. Therefore, the tax EBITDA of a downstream entity (or of the downstream entities collectively) will be higher than the tax EBITDA of the upstream entity (assuming it operates purely as a holding entity).

We explained this in our submission on the Consultation Paper using the following straightforward example:

- Assume a wholly-owned trust (or company) invests in real estate or other depreciable assets, and derives \$50 of assessable income (e.g., in the form of rent), and claims depreciation for tax purposes of \$25, leaving it with net (or taxable) income of \$25. On a tax EBITDA basis, it has EBITDA of \$50.
- Assume further that the parent entity is presently entitled to the income of the wholly-owned trust or is paid a fully franked dividend. The parent entity, in this scenario, has tax EBITDA of \$25. As a consequence, gearing at the parent entity level would result in much lower thin capitalisation capacity.

We note that this adverse impact does not apply to tax consolidated groups. In other words, the proposed rules adversely impact a number of valid and permissible structures, including (for example) non-wholly-owned structures, non-consolidated structures, and trust groups (which are not generally able to form a tax consolidated group), and in so doing, create a tax preference for tax consolidated structures.

There is no policy rationale for a lower level of gearing being permissible at an upstream level compared to a downstream level. The debt is able to be supported by the same underlying assets, and the serviceability of the debt is driven by the income streams derived by reference to the same underlying assets. Indeed, as noted above, the rate of interest on upstream debt will often be lower than on downstream debt, given that the holding entity may hold a number of different entities and assets that may be used to service the debt. Perversely, therefore, the proposed rules – which are intended to limit the level of permissible debt deductions – may encourage taxpayers to incur higher interest costs (i.e., at a downstream level), on the basis that, on an after tax basis, the overall cost is lower (due to the reduced level of debt deduction denial). Furthermore, and as noted above, the current thin capitalisation rules contain associate entity rules which are intended to operate so that excess thin capitalisation capacity flows to upstream associate entities (i.e., as the attributable safe harbour excess amount), precisely in order to avoid the thin capitalisation rules preferencing a particular level at which debt should be obtained.

We strongly recommend that the rules should be indifferent between upstream gearing and downstream gearing. This could be achieved by allowing upstream entities access to their share of downstream depreciation where it has not been used to shelter net debt deductions downstream.

To illustrate how this would work, consider a downstream trust which has aggregate tax EBITDA of \$200, which includes an amount of depreciation of \$100 and net debt deductions of \$30. Considering that the tax EBITDA excluding depreciation of \$100 is sufficient to shelter the net debt deductions (i.e., as \$100 at 30% = \$30 allowable debt deductions, being equal to the net debt deductions), the depreciation contribution to the tax EBITDA is not being used to shelter any part of the relevant net debt deductions. In this scenario, the upstream unitholder should be entitled to include in its tax EBITDA its share of the depreciation (e.g., if it holds 50% of the units in the trust, it would include \$50 in its tax EBITDA).

This position can be contrasted with an alternative example where some part of the downstream depreciation is used to shelter net debt deduction. Consider, for example, a downstream trust which also has tax EBITDA of \$200, again including depreciation of \$100 but in this scenario with net debt deductions of \$50. In this scenario, some part of the depreciation is being used to shelter net debt deductions at the downstream level, as the tax EBITDA (excluding depreciation) provides an allowable debt deduction of only \$30. Accordingly, \$20 out of the \$50 debt deductions is being sheltered by the depreciation, which (grossed up by the application of 30% element of the FRR) means \$66.6 of the depreciation is being used to shelter this \$20 of net debt deductions. As a consequence, the upstream unitholders should only be able to include the excess depreciation amount (being the \$34.4 of the depreciation shelter which is unused) in their tax EBITDA.

Note that the unitholders' share of the depreciation deductions may change throughout the year (e.g., if there are unitholder changes). The FRR (in contrast to the safe harbour debt amount) operates by reference to flow and not stock, while unitholdings in a trust are typically measured at a particular time. We consider the only simple way to provide for including an amount in the upstream entity's tax EBITDA is for the upstream unitholders to include their share of excess depreciation by reference to the share of income of the trust to which the unitholder is presently entitled in respect of the income year (which may not reflect precisely their status as a unitholder throughout a period). Note that the above relates to a non-AMIT trust scenario, but similar adjustments will be required for non-consolidated corporate groups, as well as for AMITs.

*Certain calculations cannot be performed in certain circumstances*

In certain circumstances, it is not possible to calculate an entity's tax EBITDA as presently drafted.

To take an example, assume that an entity has carried forward tax losses of \$200, taxable income (for that income year disregarding the operation of Division 820) of \$0 (i.e., because it used some amount of those tax losses), net debt deductions of \$40, and depreciation of \$30. Further assume that the entity has assessable income of \$100. If the net debt deductions are allowed, then the entity will have used tax losses of \$30. In this case, the tax EBITDA of the entity would be \$100 (i.e., no taxable income, plus \$40 of net debt deductions, plus \$30 of depreciation, plus \$30 of tax

losses utilised), meaning net debt deductions of \$10 would be denied. However, if \$10 of net debt deductions are denied, then the entity will (in fact) use \$40 of losses. The use of \$40 of losses will increase its tax EBITDA (to \$110), which means that only \$7 is denied. In other words, because the extent of tax loss utilisation affects (in certain circumstances) an entity's tax EBITDA, which in turn determines the debt deduction denial, which in turn determines the tax loss utilisation, the calculation of tax EBITDA can become circular. The most obvious solution to this problem would be for tax EBITDA to include tax losses that would be utilised, disregarding the operation of Division 820 (i.e., assuming, in effect, there is no debt deduction denial).

A similar problem arises with respect to the special deduction for previously disallowed FRT amounts in section 820-57. Assume an entity has carried forward tax losses of \$200, taxable income (for that income year) of \$0 (i.e., because it uses some amounts of those tax losses), net debt deductions of \$20, and no depreciation. Further assume that the entity has assessable income of \$100. Prima facie, the entity will have tax EBITDA of \$100 (i.e., net debt deductions of \$20, plus tax losses utilised of \$80). Accordingly, its fixed ratio amount will be \$30, permitting \$10 of carried forward FRT deductions to be used. However, in using the carried forward amount of \$10, the tax losses utilised reduces, which (in turn) reduces the excess capacity. Again, the calculations are circular. Note, for completeness, that the carried forward FRT amounts are not debt deductions in the year the FRT amounts are claimed, given paragraph 820-40(1)(b) which requires that the amounts are deductible "apart from this Division". As the special deduction is provided for in the Division, the special deduction for FRT disallowed amounts should not give rise to debt deductions.

We would recommend that the utilisation of tax losses should be determined disregarding the operation of Division 820 (i.e., assuming, in effect, that no previous FRT disallowed amounts would be available as a deduction).

*Companies should be able to apply the continuity of business tests in determining the FRT disallowed amounts*

A modified version of the continuity of ownership test (or **COT**) applies to FRT disallowed amounts. The COT applies in the context of company tax or capital losses. The Explanatory Memorandum draws a number of comparisons between FRT disallowed amounts and losses, including referring to the "policy objective" of the COT, and seeking to apply that policy objective in the context of FRT disallowed amounts.

Of course, for actual losses, companies that fail the COT are also entitled to apply one of two continuity of business tests from the date of failure of the COT to the end of the year in which the relevant losses are to be utilised. It is entirely unclear why a similarly modified continuity of business test would not apply in respect of FRT disallowed amounts. We submit that, in the

absence of any clear policy rationale for drawing this distinction, a modified continuity of business test should be included for companies.

We note that this issue is particularly significant for taxpayers undertaking projects that take a long period to earn income. Start-ups, for example, often take a significant period to become profitable (if, indeed, they do become profitable), and during this period it may be expected that they would be seeking to raise capital from investors (thereby impacting their ability to satisfy the COT). The Exposure Draft unfairly penalises these taxpayers (in contrast to the position with respect to losses).

### **The Group Ratio Rule**

Our key submissions in respect of the GRR are as follows:

1. The GRR, as drafted, and in conflict with the OECD Report, is not available to a large number of taxpayers. In particular, it is not available to taxpayers whose global parent is an investment entity. As a consequence, a rule that is intended to operate as a genuine alternative to the FRR in order to specifically allow groups that are highly geared with genuine third party debt to claim an appropriate level of debt deductions, is not available to these taxpayers.
2. The GRR, as drafted, does not appear to be available to global parents that are Australian entities (or, at the very least, is unclear in this regard). No policy rationale is given for this result, and the outcome is inconsistent with the current treatment of Australian parent entities under the current worldwide group debt amount.
3. Some of the adjustments that are made in calculating the group ratio, particularly the exclusion of entities with negative EBITDA, are unfair or illogical in their operation.

We have elaborated on these points below.

#### *The GRR is not available for investment entities*

The Explanatory Memorandum explains that the GRR is meant to alleviate the level of debt deduction denial expected under the FRR for heavily geared groups, stating (at paragraph 1.15):

*The group ratio test can be used as an alternative to the fixed ratio test for more highly leveraged groups. **The group ratio test allows an entity in a highly leveraged group to deduct net debt deductions in excess of the amount permitted under the fixed ratio rule, based on a relevant financial ratio of the worldwide group.***

[Emphasis added]

This approach is consistent with the recommended approach in the OECD Report:<sup>2</sup>

*Recognising that some groups are highly leveraged with third party debt for non-tax reasons, **the recommended approach proposes a group ratio rule alongside the fixed ratio rule.** This would allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group. Countries may also apply an uplift of up to 10% to the group's net third party interest expense to prevent double taxation.*

[Emphasis added]

The OECD Report goes on to explain that it is precisely the safety valve of the GRR that enables a relatively low FRR (which is effective in combatting base erosion and profit shifting), as follows:<sup>3</sup>

*...a fixed ratio rule does not take into account the fact that groups in different sectors may be leveraged differently and, even without a sector bias, some groups are simply more highly leveraged. **Therefore, if a fixed ratio rule is introduced in isolation, groups which have a net third party interest/EBITDA ratio above the benchmark fixed ratio would be unable to deduct all of their net third party interest expense.** To reduce the impact on more highly leveraged groups, it is recommended that countries consider combining a fixed ratio rule as described in Chapter 6, with a group ratio rule. This would allow an entity in a highly leveraged group to deduct net interest expense in excess of the amount permitted under the fixed ratio rule, based on a relevant financial ratio of the worldwide group. **This means that the benchmark fixed ratio can be kept low,** in particular for entities in large multinational groups, making sure the fixed ratio rule is effective in combating base erosion and profit shifting, while the group ratio rule compensates for the blunt operation of such a rule.*

[Emphasis added]

It is worth highlighting one other point from the above excerpt. The OECD Report refers to groups which have a high "net **third party** interest/EBITDA ratio". The reason why they refer to "third party" interest is because the operation of the GRR (when designed well) determines the group ratio by reference to genuine third party debt (as intragroup interest payments, and interest payments to related entities, are not included in determining the relevant ratio). As this ratio is then applied to each entity's EBITDA, it would be expected that debt deductions on related party debt would be highly likely to be adversely impacted. In other words, a well-designed GRR should operate as a safety valve for groups that are highly geared with third party debt on a worldwide basis – it cannot be used to achieve debt loading into Australia, nor can it be used by groups which excessively finance via related party debt.

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<sup>2</sup> OECD Report, page 13.

<sup>3</sup> OECD Report, paragraph 115.

Unfortunately, for many taxpayers, the GRR will not (as drafted) be an available alternative, because the GRR requires that the global parent entity prepares consolidated financial statements on a line-by-line basis. A large number of taxpayers are controlled by entities that are classified as "investment entities" for accounting purposes, and investment entities are not required to prepare consolidated financial statements on a line-by-line basis; rather, they typically equity account for their controlled entities. Accordingly, for taxpayers who operate in highly geared sectors (such as infrastructure and real estate, among others), but which are controlled by an investment entity, the GRR – an alternative that was meant to be available for these taxpayers – will not be able to be accessed. A significant number of institutional investors may be classified as investment entities, including (for example) superannuation funds and sovereign wealth funds. These institutional investors, whether Australian or foreign, are important sources of capital for Australia.

Further, we note that the eligibility requirements set out in the Exposure Draft are not consistent with the OECD's recommended approach. In particular, in these circumstances, the OECD Report the following recommendation:<sup>4</sup>

*A group does not include entities which are included in the consolidated financial statements but are not fully consolidated on a line-by-line basis. In other words, it does not include entities which are included using equity accounting, proportionate consolidation or at fair value. In limited situations, an entity may be controlled by a company but not consolidated in that company's consolidated financial statements. **This may arise for example where the company is an investment entity which makes investments for the purposes of capital appreciation and/or investment income, and may account for these investments at fair value. In these situations, even though the controlled entity is not the top level company in the holding structure, it may be the parent of a separate group (including itself and any entities that it includes in its consolidated financial statements).** Illustrations of how this definition would apply to groups in different scenarios are included as Example 7 in Annex I.D.*

[Emphasis added]

One of the examples provided by the OECD is especially illustrative in the context of investment entities. Example 7e is as follows:<sup>5</sup>

*In Figure I.D.6, Parent A is a company which is an investment entity, and which directly controls three companies. Parent A is the top level company in the structure.*

*Subsidiary A provides services connected with Parent A's investment activities, and is consolidated into Parent A's consolidated financial statements.*

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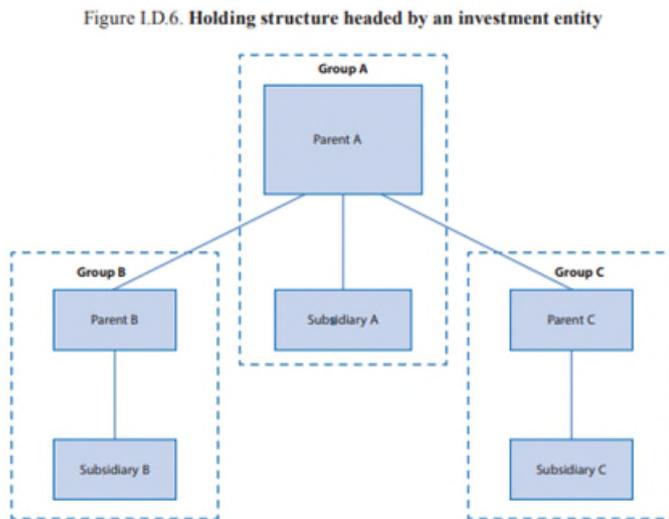
<sup>4</sup> OECD Report, paragraph 126.

<sup>5</sup> OECD Report, paragraphs 276 to 279.

*Parent B and Parent C are held by Parent A for the purposes of capital appreciation and investment income. As such, they are recognised in Parent A's consolidated financial statements as investments and carried at fair value.*

*Parent A and Subsidiary A form a group (Group A) for the purposes of applying the group ratio rule. Parent B and Parent C are not members of Group A. Instead, each of these companies forms a separate group with their respective subsidiaries (Group B and Group C).*

Diagrammatically, the OECD shows the relevant groups for the purposes of the group ratio as follows:<sup>6</sup>



It is clear, therefore, that the OECD recommends that entities controlled by an investment entity should be able to access the GRR, and that the relevant group in that regard is the controlled entity (e.g., Parent B) and its controlled entities. That entity would then be entitled to apply the GRR where it prepared consolidated financial statements on a line-by-line basis.

We submit that this is the approach that Australia should adopt in respect of the application of the GRR in this context. In particular, where an entity is controlled by an investment entity, and where that entity prepares consolidated financial statements on a line-by-line basis, it should be eligible to apply the GRR.

<sup>6</sup> Ibid, Figure I.D.6, page 109.

*The GRR does not appear to be available for Australian worldwide parents*

Where the worldwide parent is an Australian entity, it appears that it is not possible for entities controlled by that worldwide parent to apply the GRR. In particular:

1. Only entities that are a "GR group member" of a "GR group" may elect to apply the GRR (see paragraph 820-43(3)(b));
2. A "GR group" is defined as the group that comprises a "worldwide parent entity ... whose financial statements ... are \*audited consolidated financial statements", and each other entity that is fully consolidated on a line-by-line basis in those statements (see subsection 820-51(2));
3. "Audited consolidated financial statements" are defined in section 820-935, and require, among other things, that:
  - a. the statements have been prepared in accordance with standards covered by subsection (3) and (4), the former of which refers to foreign standards, and the latter of which refers to IFRS;
  - b. the statements have been audited in accordance with the requirement in the law of a foreign jurisdiction mentioned in subsection (3) or another jurisdiction that has adopted the standards mentioned in subsection (4) (i.e., IFRS).

We understand (from accounting experts) that most Australian entities would prepare their financial statements in accordance with AASB. We further understand that there is some uncertainty about whether, even if the financial statements were prepared in accordance with IFRS, they would be considered to have been audited "in accordance with the requirement in the law of [Australia] that had adopted [IFRS]". Based on our understanding of the relevant accounting rules, we submit that there is (at least) a lack of clarity around whether an Australian worldwide parent entity would meet these requirements. We recommend that the Exposure Draft should be amended to clarify that consolidated statements prepared in accordance with accounting standards (as defined in the ITAA 1997), which includes Australian Accounting Standards, also qualify.

We also note that the eligibility requirements appear to require that there is a worldwide parent entity and at least one other entity (per the "audited consolidated financial statements" requirement – see paragraph 820-935(2)(a)). It is possible that a single entity may constitute a worldwide parent entity, and be subject to the thin capitalisation rules (e.g., if it is an Australian

entity that operates via foreign branches, or a foreign entity that operates via an Australian branch). We consider that such an entity should be eligible to access the GRR.<sup>7</sup>

#### *Adjustments made in calculating GRR*

The Exposure Draft requires that, in calculating the GR group's GR group EBITDA, any GR group member's EBITDA is disregarded if its entity EBITDA is less than zero (subsection 820-55(3)).

The operation of this adjustment is unfair for three reasons. First, when an external third party lender lends to a group (e.g., and takes security over assets held by the group entities), it will typically consider financial elements across the group, including if a particular entity is making losses. These amounts would be captured, for example, in typical debt covenants such as the interest coverage ratio. In disregarding that entity's entity EBITDA, the rules unfairly reduce the group ratio.

Second, there is no logic as to why this loss should be excluded, compared to a situation where the loss was made but in another entity which had sufficient income to shelter. For example, assume there are three companies in a group – one with EBITDA of \$500, one with EBITDA of \$200, and the final with EBITDA of -\$100. In this case, the group EBITDA would be \$700. If instead a decision had been made for the activities of the third company to be carried on by the second company, it would have group EBITDA of \$600. There is no logic for there being such different outcomes depending on whether a group choose to carry on activities in different subsidiaries compared to (for example) one operating entity.

Third, the calculation of entity EBITDA may show an EBITDA of less than zero as a consequence of intragroup arrangements – arrangements that are excluded in determining the GR group's EBITDA. To take an example, assume there are three companies, being Company A (an offshore global parent entity), which holds 100% of the shares in two Australian companies, Company B and Company C. Company B operates a start-up business, and it makes payments to Company C in order to use some of its intellectual property. Assume that the GR Group's EBITDA (disregarding subsection 820-55(3)) is \$100, and it has GR group net third party interest expense of \$50. Note that the GR Group's EBITDA is entirely sourced from outside the group.

Further assume that Company B, as a start-up, has limited income (say, \$20) and royalty payments to Company C of \$30. As a consequence, it has entity EBITDA of -\$10. This entity EBITDA will be "disregarded" in calculating the group EBITDA, but the group EBITDA did not include the payments made from Company B to Company C (i.e., because they were payments

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<sup>7</sup> We further note that the application of the GRR to a single entity would not mean that there would necessarily be no debt deduction denials, as the group ratio is applied to tax EBITDA, and it is possible that this amount is lower than the actual debt deductions.

within the group). Accordingly, if Company B's EBITDA is disregarded, the group's EBITDA will be \$90, notwithstanding that the \$100 was entirely sourced outside the group. This outcome is not sensible, and in determining an entity's EBITDA, we recommend that adjustments are made for intragroup arrangements.

### **The External Third Party Debt Test and Limit**

Our key submissions in respect of the TPDR are as follows:

1. The eligibility requirements relating to the TPDR, specifically the requirement that all associate entities (determined on an adjusted basis) have also made the election, are unworkable for taxpayers, and will result in conflicts between taxpayers. The associate entity election requirements need to be removed, and the relevant integrity concerns can be addressed by modifying the calculation of tax EBITDA where an entity's assessable income includes amounts derived (directly or indirectly) from an entity that has made the election to apply the TPDR.
2. The TPDR only permits debt deductions attributable to debt interests, but the (unclear) expansion of debt deductions to include certain items that arise other than on debt interests would mean all of these types of debt deduction would be denied. The TPDR needs to cover these arrangements as well.
3. The operation of the TPDR is unclear in circumstances where a debt interest satisfies the relevant requirements for part but not all of an income year or, alternatively, where a debt interest satisfies the relevant requirements for all of an income year, but did not meet the relevant requirements in earlier income years. It should be clarified that debt deductions in respect of any period where the debt interest satisfies the relevant requirements are available.
4. The requirement that external lenders only have recourse for payment from the issuer of the debt interest does not reflect standard security arrangements, and would mean that few, if any, taxpayers would satisfy the relevant requirements. Provided that the external lenders have recourse against Australian assets, no integrity concerns should be considered to arise. Similar issues arise with respect to the conduit financier provisions.
5. The conduit financier rule that requires the on-lending to be on the "same terms" as the external debt interests will be impossible to satisfy, meaning that no (or very few) taxpayers would satisfy the relevant requirements. From an integrity perspective, the relevant concern is if the on-lending was at a significant margin; provided the interest rate is the same or substantially similar, that should be sufficient.

6. The conduit financier provisions, as drafted, do not actually apply to the debt interests issued by the conduit financier. These debt interests need to be incorporated.
7. Even with the changes above, issues will remain for construction finance debt (e.g., for large scale investments, such as infrastructure developments), where external lenders typically seek forms of support (such as guarantees or other arrangements) from parent entities, which may be foreign parents. To ensure construction finance remains available for large scale and significant developments, construction finance for large development projects that has been issued to a third party should satisfy the TPDR.

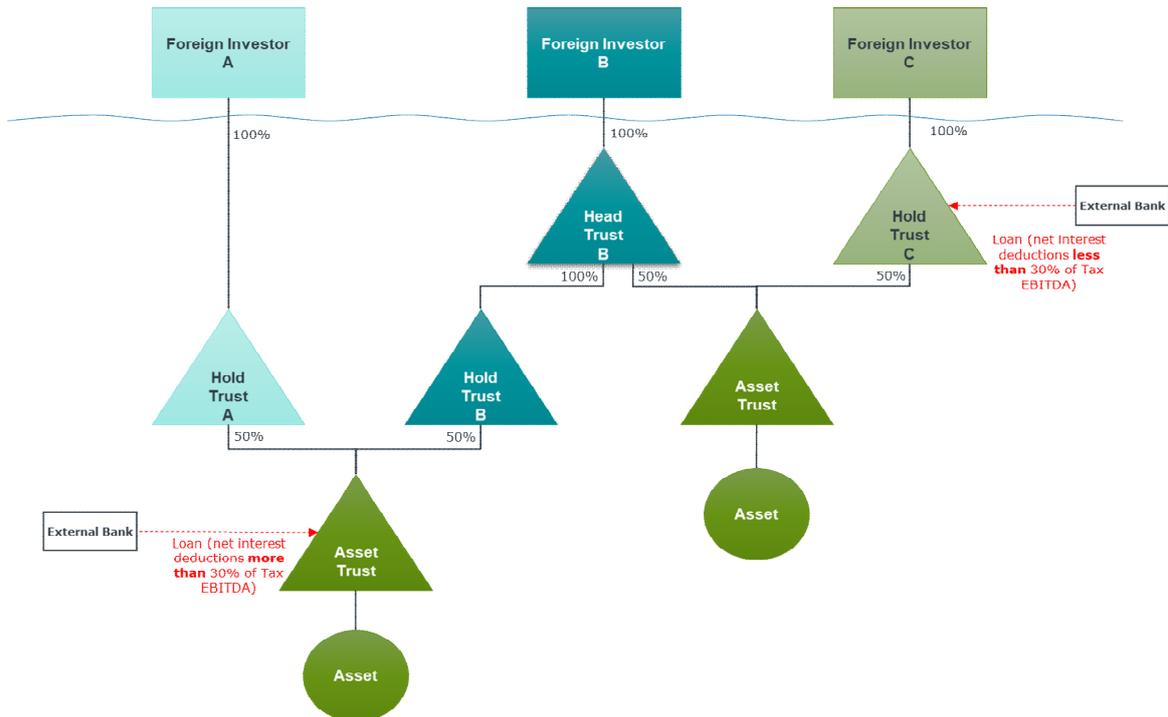
We have elaborated on these points below

#### *Eligibility requirements*

In order for an entity to make an election to apply the TPDR, the Exposure Draft requires that all general class investors, which are associate entities (determined using a modified associate entity test which considers TC control interests of 10% or more), have also made an election to apply the TPDR.

Given the breadth of the modified associate entity definition, each taxpayer is likely to have a large number of associate entities. In addition, each of those associate entities are likely to have a large number of different associate entities. Once the taxpayer and each of its associate entities make the election, the associate entities of each of the associate entities need to make the election (in order for the election to be valid). This process continues. If one of the associate entities fails to make a valid election (e.g., whether of the associate entities of the original taxpayer, or the associate entities of the associate entities, or of those associate entities' associate entities (and so on)), the relevant elections will become invalid, and cascade back to the original taxpayer. It will be impossible, in the circumstances, for the original taxpayer to make an election with any confidence.

To illustrate the problem, consider the structure diagram below:



In this structure, if the Asset Trust with the third party debt wanted to make an election to apply the TPDR, each other entity shown would also need to make a valid election. To expand:

1. Each of Hold Trust A, Foreign Investor A, Hold Trust B, Head Trust B, and Foreign Investor B would need to make the election, as they (directly or indirectly) hold TC control interests of 10% or more in Asset Trust;
2. As a consequence of each of those entities making an election, the Asset Trust which has no debt would need to make the election (due to the reversal of the associate entity status under subsection 820-905(3B)). This is the case even though that Asset Trust is not in any way related to the first Asset Trust, and holds no direct or indirect interest in the first Asset Trust;
3. As a consequence of the second Asset Trust making an election, Hold Trust C and Foreign Investor C would need to make the election. This is the case even though these entities are entirely unrelated from the original Asset Trust which wanted to make the election, and also in circumstances where their debt does not exceed the amount permitted under the FRR. In some ways, the result would be even more perverse if related party debt were provided to Hold Trust C, as all debt deductions arising on this debt would then be denied (even if it was within the FRR).

The relationships between structures similar to the above are common – and, likely more expansive. Foreign Investor A, B, and C may each have different investments, and some of those may be investments into fund entities with other investors. Investment groups, for example, often have a number of portfolio companies with different assets, investment profiles, investors, and financing requirements. If there is one common investor holding 10% or more across those portfolio companies, all of them would need to make the election.

On a practical level, Foreign Investor A, in order to make the election, needs to know whether Foreign Investor C has made a valid election. But there is no reason why Foreign Investor A would even know who Foreign Investor C is. Similarly, Foreign Investor C, which has no debt, may not even consider making the election (even though it would not be adverse). There is simply no rationale for this election requirement to apply in these circumstances.

In our view, this problem is not solved merely by increasing the percentage threshold (unless, for example, the percentage were increased to greater than 50%). In particular, even at a percentage of less than 50%, material conflicts between investors (and between investors and fund managers) will arise. Assume, for example, that Asset Trust has \$1 million of debt deductions (and no tax EBITDA), but Head Trust B has related party debt and has \$600,000 of debt deductions. Head Trust B will not make the election (as it would lose \$600,000 of deductions), but as a consequence of not making the election, Asset Trust will lose the entire \$1 million of deductions (potentially to be utilised on a carried forward basis). Head Trust B will indirectly lose its share of those deductions (\$500,000), but will be better off overall. But taxpayers will collectively be worse off (\$1 million of deductions lost for \$600,000 of deductions saved). This creates conflicts between investors, and also between investors and fund managers. It is simply not a workable solution to certain integrity concerns.

The integrity concern identified in the Explanatory Memorandum (at paragraph 1.33) is as follows:

*The restriction on this choice ensures that general class investors and their associates are not able to structure their affairs in a way that allows them to artificially maximise their tax benefits by applying a combination of different thin capitalisation tests. The restriction effectively requires a general class investor and all of its associate entities to make a mutual choice to use the third party debt test, if any one of those entities wishes to use that test.*

We assume that the reference to structuring their affairs would be to, for example, have the Asset Trust (above) make the election, while the upstream unitholders would not make the election, thereby permitting access to the FRR which could (for example) be used for related party debt (although, conceptually, also for third party debt).

There is a much more straightforward way to address this integrity concern than to require a continuing series on elections (which is unworkable), and it reflects the way the current thin

capitalisation rules operate. In the current thin capitalisation rules, where an entity relies on the arm's length debt amount, any excess capacity arising under the arm's length debt amount does not flow upstream. In addition, taxpayers are only likely to apply the arm's length debt amount where the safe harbour debt amount has been breached (much like we expect taxpayers will act under the revised rules – entities will only elect to apply the TPDR where the FRR and GRR do not provide sufficient thin capitalisation capacity). In calculating the upstream entity's thin capitalisation capacity, the value of associate entity equity (and debt) is subtracted, and in its place the associate entity excess amount is included (reflecting, as one part, any excess thin capitalisation capacity of downstream entities calculated by reference to the safe harbour debt amount).

In other words, if an entity has elected to apply the arm's length debt amount, meaning that it has likely exceeded the safe harbour debt amount, **no excess thin capitalisation capacity flows upstream, thereby preventing gearing the same underlying asset at multiple levels.**

In order to replicate this result in the Exposure Draft, an entity which holds an associate interest (as currently defined in the legislation), directly or indirectly, of 10% or more should be required to exclude from their tax EBITDA the taxable income that arises from the holding of that (direct or indirect) associate interest.

To take an example, assume a Holding Trust holds 100% of units in Asset Trust A and Asset Trust B. Asset Trust A has taxable income of \$100, and Asset Trust B has taxable income of \$200. Asset Trust A has made the TPDR election, but no other entities have. Holding Trust, in addition to having assessable income of \$300 (i.e., from its holding of units in Asset Trust A and Asset Trust B), has general expenses of \$60 (for a taxable income of \$240). The relative contributions to its taxable income is \$80 from Asset Trust A (i.e.,  $\$100/\$300 \times \$240$ ), while the relative contribution to its taxable income is \$160 from Asset Trust B (i.e.,  $\$200/\$300 \times \$240$ ). Accordingly, the first step of Holding Trust's tax EBITDA, applying the integrity rule suggested above, is \$160, reflecting only the taxable income contributed by the entity that has not made the TPDR election.

We submit this is a much more workable solution than the current proposed eligibility requirements. In addition, the information required to undertake this calculation should (generally) be in the hands of the person who needs to perform the calculation. This is in contrast to the current thin capitalisation rules, where upstream holders may not be aware of and may be unable to access information in respect of the excess thin capitalisation capacity of downstream funds.

*TPDR only permits debt deductions attributable to debt interests*

As noted above, the definition of "debt deduction" has been amended to remove the words "in relation to a debt interest", leaving it uncertain (in our view) as to whether debt deductions may

now arise in respect of other types of financial arrangements (such as interest rate swaps).

Assuming that that is the intention of the amendment (consistent with OECD Report), then the TPDR is particularly problematic, because it only permits debt deductions that are "attributable to debt interests", per subsection 820-61(1). This is reinforced in subsection 820-61 (2), which refers only to a debt interest (and not other arrangements) satisfying the external third party debt conditions.

In other words, if debt deductions now includes amounts incurred in respect of other financial arrangements (such as interest rate swaps), electing to apply the TPDR would appear to deny debt deductions in respect of those financial arrangements, even where those financial arrangements are with third parties. In addition, those deductions would be permanently lost (in contrast to the position under the FRR).

We submit this is a perverse outcome for a rule that is intended to facilitate the deductibility of payments made on genuine third party arrangements. Accordingly, we strongly recommend that the TPDR be expanded to cover other financial arrangements entered into with third parties. The TPDR needs to work in the light of the expanded definition of debt deduction to ensure that all debt deductions on third party arrangements are covered. One way to do this would be to define "debt deductions" by reference to amounts arising in relation to a debt interest (but making it clear that items such as interest rate swaps which hedge the interest rate exposure on a debt interest arise "in relation" to the debt interest), and then adopting similar language in the TPDR.

*Application to part year periods or to arrangements that failed the requirements in previous years*

The TPDR, as drafted, has unclear application in circumstances where a debt interest satisfies the TPDR for a period that is part of an income year, as well as in circumstances where a debt interest satisfies the TPDR for the entire income year, but did not satisfy the requirements in prior years.

To elaborate, subsection 820-61(1) refers to a debt interest that satisfies the external third party debt conditions "in relation to the income year". This implies that a debt interest needs to satisfy each of the conditions in relation to the entire income year (and not some part of a year).

Subsection 820-61(2) similarly refers to "in relation to an income year", but paragraph 820-61(2)(a) requires testing the satisfaction of a condition at the time of issuance (which may have been in that income year or in an earlier income year), paragraph 820-61(2)(b) refers to a debt interest not being held by an associate "at any time in an income year", and paragraph 820-61(2)(c) does not refer to any time – it simply states that the holder of the debt interest has recourse for payment of the debt only to the assets of the entity.

We consider that the TPDR should permit debt deductions arising on a debt interest in respect of any period where the debt interest satisfies the relevant conditions. Further, it should be clarified that the recourse arrangements in particular only require consideration in respect of a period. To take an example, assume that a taxpayer has currently issued a debt interest that provides recourse for payment against itself, and also its parent entity (which, as discussed below, is extraordinarily common). Assume that the terms of the debt interest are then amended, to remove the security interest granted by the parent entity (likely with an impact on pricing). As drafted, it is not clear whether the debt interest will always fail to meet the conditions (because, at one time, it provided recourse against a person other than the issuer), or if it will meet the conditions during the period that recourse for payment was limited to the issuer. Clearly, it would be logical for the regime to look at the period during which the conditions were satisfied. Similar points arise in respect of the conduit financier provisions.

We further note that the testing of a debt interest at the time of issuance in respect of it being held by an associate entity, as well as in respect of during the income year, appears to be punitive. We are aware of certain situations where a taxpayer has negotiated a debt interest with an external lender, but due to unexpected events in credit markets, the external lender has not advanced the relevant funds. In some cases, these taxpayers have issued the debt interest to an associate entity as the funds were need for a time critical matter (such as an acquisition), and the associate entity has subsequently transferred the debt interest to an external lender once the credit market turbulence has subsided. In our view, while the debt interest is held by the external lender, this is clearly a third party arrangement. There is no rationale for continuing to treat the debt interest as not satisfying the external third party debt conditions during the period it is held by the external lender. Given the relevant integrity concern is adequately covered by paragraph 820-61(2)(b), we submit that paragraph 820-61(2)(a) should be removed in its entirety.

We also note, for completeness, that the condition in paragraph 820-61(2)(d) is unnecessarily strict, in that it requires the use of the proceeds is "wholly" to fund certain investments (identified in subsection 820-61(3)) and Australian operations. Accordingly, if a single dollar were used on assets that did not meet the requirement, or on foreign operations, or (arguably) a single dollar was simply not used (e.g., it was drawn and then not deployed in any way), the relevant conditions would be failed. Additional issues arise where a debt interest is issued, and the funds are used to repay previously borrowed debt (i.e., as taxpayers may then be required to consider what those previously borrowed funds were used for, and so on for each refinancing – records that may no longer be available). We submit that a more reasonable approach is to require apportionment between those uses currently identified in the legislation, and other uses (with the proportion deployed to those other uses giving rise to debt deductions that are not allowable deductions under the TPDR). The permitted uses should also be extended to refinancings.

*The recourse requirement*

The TPDR requires that the holder of the debt interest "has recourse for payment of the debt only to the assets of the entity", being the entity that issued the debt interest. The conduit financier TPDR requires that the holder of the ultimate debt interest (the ultimate lender) has recourse for payment of the ultimate debt interest only to the assets of the borrower(s) (being the entity or entities to which the conduit financier has on-lent), as well as to each asset of the conduit financier that is a relevant debt interest.

We are not aware of any taxpayer's third party debt interests would meet these requirements. The reason for this is that external lenders will typically take security over a wider range of assets than the assets of the issuer, such that recourse for payment will arise in respect of other entities. We would see the following as the typical recourse arrangements in genuine third party debt scenarios:

1. Where a third party lender makes a loan to an asset-level entity (e.g., a downstream entity), the third party lender will take security over the units in that asset-level entity (providing recourse against the holder of the equity). The external lender will typically do this because it is straightforward to exercise security over equity, in contrast to underlying assets (depending on the precise nature of the underlying assets).
2. Where a third party lender make a loan to a holding entity that holds multiple subsidiaries, the third party lender will take security over all the assets of the issuer, all of the assets of the subsidiaries, as well as over the equity in the issuer (i.e., recourse against the holder of the equity).
3. Where a third party lender makes a loan to a conduit financier, it will prescribe the entity or entities to which that conduit financier can on-lend (which is often referred to as the obligor group). If the conduit financier can on-lend to its parent, the third party lender will take all asset security over the conduit financier (not just its assets consisting of on-lending arrangements), all of the assets of its parent, all of the assets of any subsidiary of the parent, as well as over security over the equity in the parent. More generally, it will take all asset security of each entity of the obligor group.
4. Further, it is possible that the conduit financier may be permitted to lend to multiple entities but, in fact, only lends to some of those entities. In this scenario, the external lender will still take all asset security of any entity which can be on-lent funds (i.e., the obligor group).

If the banks were not to take this security, we understand it would impact their willingness to lend, as well as potentially the relevant financial covenants, and the interest rate. Again, it would be perverse if rules designed to deny excessive debt deductions resulted in an increase in the

permitted debt deductions, because changes required to comply with the relevant TPDR requirements resulted in higher interest costs (but lower after tax costs compared to leaving existing security arrangements in place).

The security arrangements outlined above should not give rise to an integrity concern, provided that the relevant entities are Australian entities which hold predominantly Australian assets. In this case, the third party debt is supportable by the Australian assets – parental guarantees and the like are not being used to debt load into Australia.

Accordingly, provided recourse for payment is only against Australian entities holding predominantly Australian assets, we submit the recourse arrangements should be permitted under the TPDR. This could be defined by reference to the recourse being granted by entities the interests in which were taxable Australian property, or whose assets (by value) were situated in Australia.

#### *Conduit financier on-lending requirements*

In order to access the conduit financier provisions, the terms of each relevant debt interest (being the debt interests issued to the conduit financier) must be "the same" as the terms of the ultimate debt interest (being the debt interest issued to the external lender).

Again, we are not aware of any taxpayer that would meet these requirements. There are a number of extraordinarily common differences between the terms of the external debt and the terms of the on-lending, some of which we have set out in the table below:

<b>Typical terms in an external debt arrangement</b>	<b>Whether term included in on-lending arrangement</b>	<b>Rationale for difference</b>
The external lender will take security over the assets of the conduit financier, as well as over the assets of the entity to which it on-lends (among others – see above).	The arrangement is unsecured.	<p>The conduit financier will not grant security as it is the holder of the debt interest (not the issuer).</p> <p>The conduit financier will lend on an unsecured basis, and security has already been granted to the external lender. They will not seek a second ranking security (and,</p>

		even if they did, the terms would not be the "same").
In a syndicated facility agreement, the banks will appoint an agent.	The conduit financier will not appoint an agent.	The conduit financier is the single on-lender; it does not need to appoint an agent.
In a syndicated facility agreement, certain things may need to be consented to by all banks, while other things may need to be consented to only by a majority of the lenders.	Typically the conduit financier will not have broad consent rights but, if it does, it will not include unanimous and majority lender matters.	The conduit financier is the single on-lender; it does not need to distinguish between unanimous and majority matters.
The external lender may need to approve certain transactions, such as the payment of distributions or asset disposals, where they do not fall within prescribed definitions for permitted distributions and permitted disposals.	The conduit financier will not have to consent to these things.	The external lender would not accept a situation where the bank consented but the conduit financier did not; the external lender wants sole control.
The external lender will require certain financial covenants (such as an interest coverage ratio) to be measured (typically on a group basis), with a report or compliance certificate in respect of the satisfaction of the covenant to be submitted.	The conduit financier will not include financial covenants, or require reports or certificates to be submitted.	The conduit financier is part of the group; it does not need to mandate these tests or reports – it will be aware of them in any case.
The external lender will require various representations and	The conduit financier will not include representations and	The parties to the on-lending arrangements are related parties, and it would be unusual to seek

warranties (e.g., regarding status, authority, etc.).	warranties (or will require a more limited set).	comprehensive representations and warranties.
The external lender will not have a right to charge the conduit financier for general administration costs.	The conduit financier will have certain administration costs, such as audit costs or tax return preparation, among others. It will have a right to recover these from the entities to which it on-lends (or may charge a small margin to finance these costs).	The conduit financier will typically have no source of income other than interest or fees on the on-lending arrangements. To meet its costs, it will need to on-charge them, or charge a margin to finance them.

Many external financing documents run into the hundreds of pages. It would be onerous (and, indeed, impossible) for all of those terms to be reflected in the on-lending arrangement(s).

The rationale provided for "the same" requirement in the Explanatory Memorandum (at paragraph 1.81) is as follows:

*The requirement for the terms of the relevant debt interest to be on the same terms as the terms of the ultimate debt interest is intended to ensure that conduit finance arrangements that satisfy these criteria, are afforded the same tax treatment as if the finance had been provided directly to the ultimate borrowers.*

The identified terms above are not modified in order to achieve some kind of tax advantage. However, we can understand if there were concerns that a conduit financier may seek to on-lend at a significant margin, while claiming that the on-lending qualified as external debt (in effect) under the conduit financier provisions. To address this risk, there should be a requirement that the debt deductions arising in respect of the on-lending arrangements are not materially different to the debt deductions arising on the external lending arrangements. Debt deductions (as presently defined) should cover interest and other relevant costs (e.g., commitment fees, etc.). This alternative approach would actually be able to be satisfied in genuine conduit financier arrangements. The reference to "not materially different" is to cover the point made above about the on-charging of administration costs (which, when incurred by the conduit financier, are not debt deductions), or the scenario where there is a small margin charged (to finance those administration costs).

For completeness, any amendments also need to facilitate elements of conduit financing relating to interest rate swaps and other arrangements. In some conduit financing arrangements, the ultimate borrower will enter into hedges. In other conduit financing arrangements, the conduit financier will enter into hedges, and then enter into bank-to-back hedges with the entities to which it on-lends. In still other conduit financier arrangements, the conduit financier will hedge its interest rate risk, and then on-lend on the basis of the hedged exposure. All of these arrangements need to be permissible.

*The conduit financier provisions do not apply to the ultimate debt interest*

The conduit financier provisions apply only to the on-lending arrangements, and not to the debt interests issued by the conduit financier. To elaborate, subsection 820-61(4) modifies the TPDR, but only in respect of the "relevant debt interest". The "relevant debt interest", in turn, is defined as the debt interest issued by each borrower to the conduit financier (paragraph 820-61(5)(c)). The conduit financier provisions require (in paragraph 820-61(5)(f)) that the ultimate debt interest (i.e., issued by the conduit financier) either satisfies the external third party debt conditions, or would satisfy the external third party debt conditions on the basis of certain modifications. In most instances, the conduit financier will only be able to satisfy those modified conditions. However, once those modified conditions are satisfied, the provisions do not then provide that the external third party debt conditions are satisfied in respect of the ultimate debt interest.

Rather, as presently drafted, the conduit financier would in fact fail the third party debt conditions, resulting in a denial of all of its debt deductions (noting that it has to elect into the TPDR in order for the entities to which it has on-lent to access the TPDR).

We sincerely hope that this is a drafting error, and that there is no intention to deny all debt deductions of the conduit financier.

Note that there are a number of other drafting errors, some of which are identified in Part 2.

*Construction finance facilities*

The TPDR, even with the changes proposed above, is not appropriate for dealing with the typical terms required for construction finance facilities. Construction finance facilities are put in place in order to fund major developments, such as material infrastructure projects or real estate assets (among others). These construction finance facilities have unique elements which relate to the fact that the underlying assets are being developed, and are not income producing. However, construction finance is also critically important to ensure that investors have access to debt financing (which is cheaper than equity financing) in pursuing these projects.

For construction finance facilities, the external lender will typically require recourse arrangements to go beyond those set out above, given the value and income serviceability of the project is not at that

time reflected in the underlying assets. Typically, therefore, an external lender would seek some form of guarantee or protection from an entity of economic substance – which, in the context of inbound investors, will ordinarily be an offshore parent entity. This protection may take the form of a guarantee (as mentioned), an equity commitment (being a requirement to subscribe for equity in the borrower to meet certain costs), or a requirement to procure third party guarantee arrangements (e.g., a bank guarantee or a letter of credit), potentially among others.

It is important that these construction financing facilities can be put in place, while allowing this form of external debt to qualify for the TPDR, lest these developments become prohibitively expensive and are not pursued in Australia by offshore institutional investors. Accordingly, we consider a limited exception should be included from the recourse arrangements referred to above in circumstances where the arrangement is a construction facility, being used to finance a material development. The threshold for a material development could be developed further, but could (for example) be defined by those projects which require expected aggregate capital expenditure of over \$25 million.

*Amendments to paragraphs 25-90(b) and 230-15(3)(c)*

The Exposure Draft amends paragraphs 25-90(b) and 230-15(3)(c) to remove the reference to section 768-5. The impact of this change is that certain costs arising in respect of a debt interest are no longer allowable as deductions where the amount is incurred in deriving non-assessable non-exempt income arising from foreign equity distributions paid on non-portfolio interests. We note that this amendment was not previously announced.

Section 25-90 was in fact introduced at the time that the current thin capitalisation rules were introduced, in the *New Business Tax System (Thin Capitalisation) Act 2001* (Cth). At that time, the rationale for the section was explained in the Explanatory Memorandum (at paragraph 1.99) as follows:

*Debt deductions will, in certain instances, no longer be denied to taxpayers because they were incurred in earning exempt foreign income. These debt deductions, provided they are otherwise allowable under the general deduction provisions, will come within the scope of the thin capitalisation regime when determining the amount to be allowed.*

The rationale behind the section is that the thin capitalisation rules prescribed the level of debt that was permissible (in order for debt deductions to be available), and those rules excluded controlled foreign debt and equity in determining the maximum allowable debt. Accordingly, if the debt was within the maximum allowable debt amount, which was determined only by reference to Australian assets, that was permissible. That was the case even where the debt was borrowed to finance investment in foreign equity. This change would make Australia more attractive as a hub for investment activity. In addition, requiring the tracing of funds and their use generally operated as

a tax on those who were poorly advised. As money is fungible, taxpayers (prior to the introduction of section 25-90) were free to organise their affairs so that they borrowed to invest in assets that generated assessable income, while using other funds to invest in foreign equity. Accordingly, only those who were poorly advised tended to face difficulties in demonstrating that the interest on borrowed funds were deductible.

Further, with the other changes being made to the thin capitalisation rules, there is likely to be significantly less thin capitalisation capacity for most general class investors. In particular, the FRR will in most instances lower taxpayers' permissible debt deductions, particularly in capital intensive sectors. As the FRR is based on tax EBITDA, which excludes non-assessable non-exempt income, no thin capitalisation capacity arises from investments in non-portfolio foreign equity. In other words, the thin capitalisation rules themselves provide the relevant integrity regime. If a taxpayer who has debt deduction capacity under the FRR borrows to fund an investment in Australia, or an investment offshore, but in both cases they have sufficient capacity for the debt deductions, it is unclear why they should not be entitled to deduct the relevant amounts (noting that money is fungible).

The Explanatory Memorandum provides (at paragraph 1.119) the following rationale for the amendment:

*the policy intent of the new earnings-based tests is to limit the amount of deductible interest expense by reference to earnings – that is, an entity is only able to increase its net interest deductions in Australia by increasing earnings in Australia.*

The statement above is correct, and the existence of section 25-90 does not change that. The only way to increase allowable debt deduction capacity is to increase earnings. Borrowing to invest in non-portfolio foreign equity does not increase allowable debt deductions, as it generates non-assessable non-exempt income.

Accordingly, we strongly recommend that the amendments proposed to section 25-90 and 230-15 are not implemented.

We also note that if those amendments are made, a number of significant problems will arise. First, for debt interests which are on issue (i.e., not new arrangements), the provision will require considering the use that was made of the funds at the time of issuance. This may have been a number of years ago, noting that it is not uncommon for financial arrangements in certain sectors to be issued for long tenors (e.g., over 5 years). For these taxpayers, they may no longer have the relevant records in order to identify where the entity incurred the amount in deriving income from a foreign source. Those taxpayers will be left in a position where they are unable to substantiate their tax positions.

The problem is even more pernicious for those taxpayers who have refinanced facilities. This could require tracing the use of funds through multiple refinancings to the original financing, potentially going back decades. These taxpayers will be highly unlikely to undertake this kind of exercise. The problem with historical tracing is further exacerbated by tax consolidation which commenced after the introduction of section 25-90. Most corporate groups have now formed tax consolidated groups, and documents showing intragroup tracing of funds are not likely to be maintained since tax consolidation, and would be difficult to establish retrospectively. We also note that this proposed policy position is not one adopted by a number of comparable jurisdictions.

Accordingly, and if the amendments must be made, they should only apply to prospective arrangements. In addition, for new refinancings of previously issued debt, a safe harbour alternative needs to be included for those who are unable to trace the use of funds. The safe harbour could operate by reference to the proportion of assessable income and non-assessable non-exempt income in respect of any year (e.g., if a taxpayer was unable to trace the use of funds, and 20% of their total income was non-assessable non-exempt income from non-portfolio foreign equity), they would be entitled to deduct 80% of their debt deductions (subject to the thin capitalisation and other regimes).

#### *Change to the definition of financial entity*

The Exposure Draft amends the definition of "financial entity" to remove paragraph (a), being a registered corporation under the *Financial Sector (Collection of Data) Act 2001* (Cth). This change to the definition of financial entity was not previously announced; in fact, Budget 2022-23 specifically stated that "[f]inancial entities will continue to be subject to the existing thin capitalisation rules."

The rationale advanced for the amendment in the Explanatory Memorandum (at paragraph 1.24) is as follows:

*This has given rise to integrity concerns that entities which satisfy this broad definition should genuinely be considered financial entities, with access to the generally more favourable taxation treatment. The repeal of paragraph (a) is an integrity measure to ensure the thin capitalisation rules are fit for purpose and that the amendments to introduce the new earnings-based rules are not undermined.*

With respect to whether registered corporations under the *Financial Sector (Collection of Data) Act 2001* (Cth) are "genuinely financial entities", we note that that Act defines a "registrable corporation" by reference to certain corporations where "the corporation engages in the provision of finance in the course of carrying on business in Australia." It is not clear why an entity, which engages in the provision of finance as part of its Australian business activities, would not be regarded as a financial entity.

Further, we note that as a consequence of the deletion of paragraph (a) from the definition of financial entity, it is difficult to see how non-bank lenders will be classified as financial entities. The alternative paths to classification as a financial entity would be for a securitisation vehicle (which would not cover non-bank lenders, although may cover certain entities within the non-bank lender sector), a financial services licensee whose licence meets certain requirements and who carries on a business of dealing in securities (which will not cover non-bank lenders who do not deal in the loans they make), or a financial services licensee whose licence meets certain requirements and who carries on a business of dealing in derivatives (again, which will not cover non-bank lenders who do not deal in derivatives, even if they (for example) enter into derivatives).

If there are particular concerns regarding the current definition, such as (for example) a concern that entities are registering where they are not carrying on a genuine business of providing finance (notwithstanding the requirements in the Act itself), the better approach would be to supplement the existing definition with a substantive activities based requirement. This could, for example, be that the assets of the registered corporation need to consist predominantly (by value) of "moneylending debts", being a defined term in the ITAA 1997. If the integrity element is pursued by removing paragraph (a) in its entirety, a number of genuine financial entities will be adversely impacted, such that a more targeted approach is preferable.

## 2. PART 2: TECHNICAL DRAFTING ISSUES WITH THE EXPOSURE DRAFT

This section details what we have assumed are technical drafting errors, although many of these are material items. For simplicity, we have included our comments on the relevant sections of the Exposure Draft in a table, with corresponding comments on the drafting issues we have identified

Exposure Draft Section Reference	Technical Issue	Proposed Solution
705-60	The adjustment to the ACA amount for transferred FRT disallowed amounts should be subject to whether a taxpayer elects to have those FRT disallowed amounts cancelled (i.e., there should be a general right to have them cancelled).	This would operate in a similar manner to losses.
820-40(1) –	The removal of the words "in relation to a debt interest issued by the entity" causes issues with the breadth of debt deductions set out on page 3.	Reverse omission made by item 9 of the Exposure Draft.
820-43(3) and (4)	It is not clear whether a taxpayer can make an election under both subsections (3) and (4) in respect of the same year.	Taxpayers may wish to make an election to apply both the GRR and the TPDR, to provide a back up option in circumstances where (for example) the ATO successfully challenges one of the positions. This should be permitted, and it should be made clear that where two elections are made the election that gives rise to the higher level of allowable debt deductions applies.
820-43(5)	The subsection appears to prohibit a taxpayer from making a TPDR election if an associate entity that is a general class investor is exempt from the thin capitalisation regime (i.e., per the wording, an entity cannot make choice if the entity has one or more associate entities where the Subdivision does not apply ... because of section 820-35, 820-37 or 820-39).	The legislative drafting is inconsistent with the Explanatory Memorandum, and what we understand is the policy rationale. Removing the requirement for all associate entities to elect into the regime will address this issue, but if that proposal does not proceed, the drafting needs to be amended to be consistent with the policy.
820-43(7)	N/A.	The Commissioner should be provided with a discretion to allow elections to be made within a further period, to avoid the timing requirement to operative in an unduly harsh manner. Note that this applies for all election timing requirements.

		Similarly, if an election is made and the ATO successfully challenges the position (e.g., that the debt interest satisfies the third party conditions), it should be possible for taxpayers to fall back on the FRR.
820-45(2)	<p>The process to determine which debt deductions were disallowed does not seem consistent with the relevant elections.</p> <p>To take an example, assume that a taxpayer has borrowed external debt and related party debt. Because of the formulaic approach to determining which debt deduction is denied, some of the debt deductions on the third party arrangement will be denied.</p>	It is not generally clear why there needs to be a determination of which debt deductions have been denied. We further note that the Explanatory Memorandum refers to this formulaic approach as applying only to the FRR, but that is not consistent with the legislative drafting.
820-45(3)	Items of assessable income included in the calculation of net debt deductions is not symmetrical, issue as set out above on page 4.	Assessable income equivalents of section 820-40(1)(a)(ii), (iii) and (iv) should be taken into account in determining net debt deductions.
820-49	<p>The definition of tax EBITDA as drafted does not appear to apply to trusts (including AMITs), as it refers to taxable income.</p> <p>The definition does not reverse out the CGT discount in determining net income, which creates an advantage for companies over trusts with respect to the FRR.</p> <p>The depreciation which is added back should include all depreciable items for tax purposes.</p> <p>The last item results in tax losses that are utilised being added back, but there is no equivalent provision for capital losses.</p>	<p>The definition needs to be amended to apply to trusts (i.e., net income not taxable income), as well as AMITs.</p> <p>Entities that are eligible for the CGT discount (such as trusts) should gross up their capital gains (to reflect the position for corporate vehicles).</p> <p>All forms of depreciation should be included, such that the reference should simply be to Division 40. Other items, such as section 25-110 deductions, should also be included (effectively, treated equivalently as blockhole expenditure).</p> <p>Finally, if capital losses are used to shelter capital gains, those capital losses should also be added back (i.e., treated similarly to tax losses).</p>
820-53(1)	The section requires adjustments to be made for amounts in the nature of interest, as well as any other amount that is calculate by reference to the time value of money.	The relevant intended items for inclusion should be specifically identified, so that the relevant information can be obtained.

	As noted above, this is potentially very broad, and it is not clear what this actually captures. Given its potential breadth, actually obtaining this information in the context of a large multinational group is likely to be problematic.	In our view, it may be prudent merely to rely on the accounting standards, which typically have a broader concept of interest than the Australian tax concept in any case.
820-53(4)	"Net interest expense" is not defined.	This should be defined.
820-55(2)	Paragraph (2)(b) refers to the GR group's adjusted net third party interest expense, but it is not clear how this is calculated in the context of the GR group (subsection 820-53(4) only defined it by reference to an entity and not the group).	This should be defined.
820-59(7)	There are a number of complex integrity rules that are relevant for losses but not FRT disallowed amounts. This is particularly the case for the measures dealing with loss duplication, such as section 165-165. Loss duplication does not arise in respect of FRT disallowed amounts; these should just normal business expenses that loss duplication rules do not apply to.	Paragraph 820-59(7)(d) should also exclude the following provisions (and equivalent Division 166 provisions): <ul style="list-style-type: none"> <li>• Section 165-165</li> <li>• Subdivision 165-B</li> <li>• Subdivision 165-CD</li> </ul>
820-61(5)(b) and (c)	Paragraph 820-61(5)(b) defines the "borrowers" as associate entities of each other, and paragraph 820-61(5)(c) requires those associate entities have issued debt interests to the conduit financier.  Read literally, any two associate entities of each other are defined as borrowers, and then these two associate entities are required to issue debt interests to the conduit financier. That is, the provision effectively requires all taxpayers to have issued debt interests to the conduit financier.	The paragraphs should effectively be reversed – i.e., that a borrower is defined by reference to the issuing of a debt interest, and then that person should be required to be an associate of the conduit financier.  Note that whether all of the borrowers are associate entities of each other should be irrelevant – in certain stapled structures, they may not be associate entities or each other (but, generally, they will be associate entities of the conduit financier, noting the current rules for debt interests to qualify as associate entity debt).
820-61(5)(b) and (d)	The provision is (d) requires that the conduit financier financed the amount loaned under a relevant debt interest only from the proceeds from the ultimate debt interest, but it is possible that they have financed it from multiple ultimate debt interests.	In circumstances where the conduit financier issued multiple ultimate debt interests, they may on-lend the aggregate borrowed under one debt interest. Accordingly, this should be accommodated.

820-905(1A)	<p>The intended effect of this new subsection is not clear. In particular, it is not clear how it is intended to alleviate the position for complying superannuation entities (e.g., whether it is intended to mean that investee entities are not associate entities and so are not required to all make an election to apply the TPDR if one of the investee entities makes such an election.</p> <p>Assuming that is the intention, the drafting is deficient because it appears only to operate where the complying superannuation entity is the "first entity" (as that is the entity to which the section applies). The complying superannuation entity may still be "another entity".</p>	<p>If the intended effect is as described, the subsection should be updated to refer to a complying superannuation entity being neither a "first entity" or "another entity".</p> <p>In addition, if it is considered necessary to amend how the associate entity definition applies to complying superannuation entities because they holds a large number of non-controlling stakes in investee entities, consideration should be given to other similar entities that also typically hold a large number of non-controlling stakes in investee entities. Examples would include foreign superannuation funds with 50 or more members, or sovereign wealth funds. The same logic should apply to these types of investors, such that the subsection should be amended to also encompass these types of entities.</p>
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If you have any queries on any of our comments above, please contact Steve Whittington on 02 9258 6547.

Yours faithfully,

Ashurst

The logo for Ashurst, consisting of the word "ashurst" in a lowercase, bold, sans-serif font.