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Assistant Secretary
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The Treasury
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Submitted by email: MNETaxIntegrity@treasury.gov.au

Insurance Australia Group Limited (**IAG**) is pleased to respond to the Government's Exposure Draft legislation: *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation (Draft Legislation)*. In preparing this submission, we have also considered the *Explanatory Memorandum* released with the draft legislation (**EM**). Our comments largely echo our previous submission made to the Treasury on 22 September 2022 in relation to the *Government election commitments: Multinational Tax Integrity and Enhanced Tax Transparency (Consultation Paper)* issued in August 2022.

IAG is the parent company of a general insurance group with controlled operations in Australia and New Zealand. Our businesses underwrite almost \$12 billion of premium per annum, selling insurance under many leading brands, including: NRMA Insurance, CGU, SGIO, SGIC and WFI (in Australia); and NZI, State, AMI, and Lumley Insurance (in New Zealand). With more than 8.5 million customers and information on the majority of domestic residences in our markets, we use our leadership position to understand and provide world-leading customer experiences, making communities safer and more resilient for the future.

Our purpose is to make your world a safer place and we authorise that our role extends beyond transferring risk and paying claims. Our purpose drives our business to work collaboratively with the community to understand, reduce and avoid risk, and to build resilience and preparedness. This results in better outcomes for the community and means fewer claims and lower costs for our business.

We work collaboratively with government, industry bodies and Australian and international organisations on a range of topics and issues that relate to our customers, our people and the community including safety on the road.

Our response

A. Multinationals interest limitation rules

IAG supports the objectives announced by the Government to address tax avoidance practices of multinational entities (**MNE**) including amending Australia's existing thin capitalisation rules to limit interest deductions for MNEs. We note the Government's objectives are in line with the Organisation for Economic Cooperation and Development's (**OECD**) recommended approach under Action 4 of the Base Erosion and Profit Shifting Project (**BEPS**) as outlined in the Consultation Paper (the **Action 4 Report**). IAG's response is in accordance with the recommended approach for insurers set out in the Action 4 Report.

B. New thin capitalisation rules – fixed, group and external third-party debt tests

While IAG is supportive of the proposed measures relating to thin capitalisation, consistent with the language in the Consultation Paper and the Action 4 Report, we strongly recommend that an exemption from the new thin capitalisation rules be provided to APRA-regulated insurers.¹ This can be achieved by including regulated insurers in the definition 'financial entity' for thin capitalisation purposes (i.e. so as an insurer, akin to a bank, is not a 'general class investor').²

We note that relief was proposed for those entities which were classified as a 'financial entity' under subsection 995-1(1) of the Income Tax Assessment Act 1997 (**ITAA 97**) in the Consultation Paper. The policy intent behind not including regulated insurers within the definition of 'financial entity' in the Draft Legislation is inconsistent with the recommendations in the Action 4 Report, which suggests a carve-out from interest limitation rules for both banks *and* insurers.

Further, the Consultation Paper acknowledged that the fixed ratio (which applies to most general class investors) and the group ratio are inappropriate for financial entities and authorised deposit-taking institutions (**ADIs**) because the entities are net lenders and are subject to strict regulatory capital rules.³ This clearly relates to insurers as well and by way of example, IAG is a key provider of debt finance to the Australian economy as an investor in corporate bonds.

In our view, the new thin capitalisation rules as outlined in the Draft Legislation is inappropriate for insurers for the following key reasons (with further detail provided in Appendix One of our submission):

1. **The fixed ratio is not in line with the Action 4 Report recommendations** – Specifically, the OECD acknowledges that insurance companies derive interest income in a "*fundamentally different way*" than most other businesses because interest income is intrinsically linked to the treasury function of managing a group debt. The OECD suggests that the fixed ratio test and group ratio test are considered "*unlikely to be effective*" in addressing BEPS risks.⁴
2. **The group ratio test and external third-party debt test are unworkable as alternative tests** – The Draft Legislation makes the two alternative tests practically redundant due to limitation of the 15-year carry forward of disallowed debt deductions to only the fixed ratio test and loss of any carry forward

¹ Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2016 Update, 22 December 2016 (**the Action 4 Report**)

² EM, paragraph 1.18

³ Part 1 of the Consultation Paper.

⁴ The Action 4 Report, paragraph 188.

amount on changing the ratio applied in an income year. These features are a significant departure from how the existing thin capitalisation rules work in Australia and, by way of comparison, the United Kingdom where the tests operate sequentially to allow taxpayers to determine the highest maximum allowable debt.

3. **Highly regulated operations** – Insurers in Australia are already subject to stringent regulatory capital rules which limit their ability to excessively gear their operations by requiring insurers to hold minimum amounts of equity set at unquestionably strong levels by APRA. This acts as a de-facto debt limitation rule for the insurance sector.
4. **Net interest expense** – As investors of premiums collected from customers, insurance companies, prima facie, have net interest income and the Government will not be disadvantaged if insurers are exempted from applying the new thin capitalisation measures. There may be instances under the fixed ratio and group ratio tests where insurers are unfairly disadvantaged because they are in a net interest expense position as a result of investments held through unit trusts in debt assets. Where a unit trust is in losses (as a result of sales of interest bearing securities at a loss), net interest income would not be included in the ‘net debt deduction’ of unitholders. We recommend amendment to the Draft Legislation to allow for net interest income from underlying investment trusts to be included in the ‘net debt deduction’ calculations, notwithstanding other deductions that may result in the trust being in a tax loss position (because interest income derived in a investment trust retains its character where the trust is in a loss akin to how the rules operate where the trust is in a net income position).
5. **Increased compliance cost** – Insurers typically experience substantial volatility in profitability due to the nature of insurance and fluctuating interest rates. This will often produce obscure outcomes to tax EBTIDA / ‘net debt deduction’ calculations. Coupled with the arbitrary and restrictive capital works and decline in value add-back in the tax ‘EBITDA’ calculations, this increases the likelihood of insurers having debt denials. Despite the ability to carry forward potential denied deductions as a carry forward loss, insurers may seek to alternatively apply the group ratio or external third-party debt test which will be a costly exercise.

C. Interest limitation rules – Repeal of section 25-90 and section 230-15 of the ITAA 97

The proposed Draft Legislation amends sections 25-90 and 230-15 of the ITAA 97 to disallow interest expenses incurred in deriving non-assessable non-exempt (**NANE**) income under section 768-5 of the ITAA 97. Whilst we can understand the Government’s intention to limit interest deductions by reference to earnings in Australia, this proposed change is punitive to outbound insurers and the policy intent behind this repeal is unclear.

In particular, the rationale outlined in the EM at paragraph 1.119 – 1.120 is misleading. The description that section 25-90 provides taxpayers with a ‘double benefit’ (being the NANE treatment of the foreign dividends and the interest deduction for funds incurred in earning those dividends) disregards the operation of the thin capitalisation rules, both under current law and proposed amendments. For example, an Australian holding company that borrows to invest in a foreign subsidiary and has no other Australian business could not claim interest deductions under the existing rules (because controlled foreign company equity is not counted as an asset for thin capitalisation safe harbour purposes) nor would the company be able to deduct interest expense under the new fixed ratio test (because the dividends from the foreign subsidiary would be NANE income and hence not included in tax EBITDA).

This measure now creates an uneven playing field for Australian headquartered multinationals with offshore operations compared with foreign headquartered inbounds, where both have the same debt levels.

Insurers have broad funding sources for capital regulation purposes and therefore lack a direct line of sight over allocation of funds to identify what portion of debt deductions may be attributed to foreign investments. If insurers are not carved out of this rule, the Government should consider including grandfathering provisions to enable insurers to manage debt allocation on foreign investments on a go-forward basis. This is also consistent with OECD's recommendations for countries to fairly implement targeted interest deduction limitation rules without disrupting existing capital regulations.⁵

Regardless of whether the grandfathering provisions are included in the enacted legislation or an updated Draft Legislation, we recommend a separate consultation be conducted by the Treasury at the earliest opportunity on the repeal of section 25-90 and 230-15 of the ITAA 97 as the implications of this proposed change are far-reaching and not something that was anticipated by affected stakeholders.

In summary, we submit that the Government consider amending the Draft Legislation to fairly accommodate insurers by:

1. Including regulated insurers in the definition of 'financial entity' for thin capitalisation purposes;
2. Amending the Draft Legislation to allow for net interest income from underlying investment vehicles to be included in the 'net debt deduction' calculation; and
3. Including grandfathering provisions in relation to the repeal of sections 25-90 and 230-15 of the ITAA 97 and providing further consultation on this measure at the earliest opportunity.

The Consultation Process

We thank the Treasury for initiating this consultation process.

Should the Government decide as a matter of policy to introduce the abovementioned thin capitalisation and interest limitation rules to insurance companies such as IAG, we would appreciate a meeting with the Treasury prior to the release of the bill to discuss any options to ensure there are no unintended tax consequences arising for insurance companies such as IAG.

We look forward to working closely with the Government and the Treasury on this proposed reform and future consultations.

If you have any questions or require any further information, please do not hesitate to contact Sarah Pang on 0401 683 705 or Shifa Javed on 0433 457 868.

Yours sincerely



Sarah Pang
Head of Tax

⁵ The Action 4 Report, paragraph 539.

Appendix One

A. OECD's Action 4 Report commentary

The commentary in the Action 4 Report expands on why the fixed ratio and group ratio rule is not appropriate for banking and insurance entities as follows:

- *“Although banks and insurance companies are engaged in very different businesses, in both cases third-party interest income is vitally important to ensure a group’s profitability and liquidity. For insurance companies, interest income is a major form of investment income used to meet insurance liabilities as they fall due. In both cases, the nature of interest is fundamentally different to that for most other businesses, where interest income is linked to the treasury function of managing a group’s net debt.*
- *Banks and insurance companies are subject to regulatory capital rules and commercial constraints (e.g. from credit rating agencies) which require them to hold minimum amounts of equity and restrict their ability to place an excessive level of debt in particular entities or to use debt to fund equity investments in subsidiaries.*
- *Banks and insurance companies are key providers of debt finance to groups in other sectors, either as lenders or as investors in corporate bonds. As such, entities engaged in banking or insurance business will typically have net interest income rather than net interest expense.”*⁶

We would also draw your attention to the OECD’s acknowledgement in the Action 4 Report, that “significant regulatory and commercial considerations reduce the risks posed by banking and insurance groups”⁷ and that excessive interest deductions are claimed such that “it is not expected that [a] country should introduce new rules to deal with a risk that does not exist or is already addressed”⁸. Instead, the OECD suggests “[i]n this case, a country may reasonably exempt banking and/or insurance groups from the fixed ratio rule and group ratio rule without the need for additional tax rules”.⁹

The Draft Legislation does not take into account the OECD’s acknowledgement on issues the fixed ratio and group ratio pose to APRA-regulated insurers and also does not comply with the recommendation set out by the OECD that insurance companies should be exempt from the fixed ratio and group ratio.

B. APRA regulation of the insurance industry

Insurers play a unique role in the economy, protecting individuals and businesses from financial loss arising from risks ranging from natural catastrophes, workplace injuries and the inability to work because of illness or injury. The essence of insurance is the transfer of risk between the insured party and the insurance company in exchange for the payment of premium. It is for this reason that regulated insurance companies, such as IAG, are subject to strict regulatory capital rules which limit the ability to excessively gear their operations by requiring them to hold minimum amounts of equity. This ensures that insurance companies will be able to pay

⁶ The Action 4 Report, paragraph 487.

⁷ The Action 4 Report, Executive Summary, pg 14 - 15.

⁸ The Action 4 Report, paragraph 484.

⁹ Ibid.

any claims that arise beyond those expected and ultimately that policyholders are protected.

The OECD acknowledge that “[i]n most cases it is expected that regulatory capital rules will be effective in protecting countries from excessive interest deductions in a solo-regulated bank or insurance company.”¹⁰ Specifically, the regulatory capital rules should be effective at reducing excessive interest deductions if APRA ensures that an “...insurance company is capitalised with an appropriate level of equity, where the definition of equity for tax and regulatory purposes is consistent, these rules may also provide protection against excessive leverage for tax purposes”.¹¹

The effect of this is that APRA regulation acts like an effective interest limitation rule for insurance companies and given the greater proportion of equity capital in relation to debt for insurance companies when compared to other industries, we believe that APRA’s regulatory capital rules will be effective in protecting Australia from excessive interest deductions from general insurers i.e. insurance companies would pose little BEPS risk in relation to Action 4.

As highlighted in the Draft Legislation, the new thin capitalisation rules (with majority of taxpayers implementing the fixed ratio test) will target ‘general class investors’ as defined under the Draft Legislation. Financial entities (under the proposed narrower definition) and ADIs are effectively exempted and can continue to be subject to the existing thin capitalisation rules. Given banking companies will either be ADIs or financial entities and are subject to similar APRA regulatory capital rules applicable to insurance companies, we strongly believe that it would be reasonable to also exempt insurers from the new thin capitalisation rules.

C. Net interest expense

General insurers typically have net interest income (by virtue of investing premium income received into debt finance products issued by corporates and the Government). In this scenario, the fixed ratio and group ratio are unlikely to provide protection against the risks of excessive interest deductions such that there would be no loss to the Government if general insurance companies were excluded from the measure (noting the role APRA regulation plays in ensuring excessive interest deductions cannot also be claimed – refer above).

Per the Draft Legislation, there may be instances where a general insurer would experience net interest expense rather than net interest income by virtue of the way in which debt assets are held. It is not uncommon for general insurers to invest into a unit trust which holds debt assets (**Investment Trust**). The general insurer would bring to account the net income of the Investment Trust which includes gains and losses from the sale of debt assets as well as the interest income derived.

Where the Investment Trust disposes of underlying debt assets for a loss that is in excess of the interest income derived, those losses will not be distributed to the general insurer. This has occurred in the past and may happen in the future. As a result, the net interest income derived is also **not** distributed to the general insurer. Where this occurs, the fixed ratio test or group ratio test would likely yield a net interest expense position giving rise to interest denial after the application of the fixed ratio test.

To ensure that general insurers that invest a significant amount of premium income through Investment Trusts are not disadvantaged compared to those entities who invest directly into debt assets, the calculation of gross income for the fixed ratio test should include the net interest from the underlying Investment Trusts.

¹⁰ The Action 4 Report, paragraph 481.

¹¹ The Action 4 Report, paragraph 491.

To continue to support the financing of businesses and the Government, we reinforce that regulated insurers should be excluded from the new thin capitalisation rules.

D. Interest denial and increased compliance costs may increase the cost of insurance

Given the fixed ratio test is based on 'tax EBITDA' and the group ratio test is based on 'EBITDA' (albeit the methodology for EBITDA under both tests is ultimately a hybrid of EBIT/EBITDA), insurers who typically experience substantial volatility in profitability due to the nature of insurance may result in interest denial or may look to explore and incur significant costs in applying one of the alternative tests (such as the group ratio test or external third-party debt test).

In addition, the methodology for 'tax EBITDA' per the Draft Legislation effectively allows only an add-back for Subdivision 40-B and Division 43 (of the ITAA 97) deductions claimed in an income year. The policy intent behind why not all Division 40 allowances are added-back in the 'tax EBITDA' calculation is unclear and appears quite restrictive. For insurers who are already subject to volatility, this exclusion will result in an increased likelihood of debt deductions being denied.

By way of example – applying the fixed ratio test to the IAG tax consolidated group for the year ended 30 June 2021 – IAG would have all of its interest expense (more than \$50 million) denied as it was in a nil EBITDA position given the material taxable loss for the year.

Even if the Government introduces the carry forward of disallowed interest under the fixed ratio test to be utilised in future years per the Draft Legislation, this is likely to increase the cost of capital to insurers as Deferred Tax Assets (**DTAs**) are subtracted from the regulatory capital base of insurance companies (notwithstanding that the differences are temporary in nature).

The scenarios noted above may result in additional costs for IAG that would be passed onto policyholders by way of an increase in insurance premiums.

E. Section 25-90 and section 230-15 repeal

The unexpected repeal of sections 25-90 and 230-15 of the ITAA 97 will pose a significant burden to insurers who will need to undertake complex tracing and / or interest income apportionment calculations to determine what, if any, debt deduction is disallowed. This rule appears contrary to OECD's comments in respect of interest limitation rules to "*not conflict with or reduce the effectiveness of capital regulation intended to reduce the risk of a future financial crisis*".¹²

Regulatory and commercial imperatives drive an insurer's funding structure and the location in which the debt is raised, rather than consideration around tax benefits. Insurers need to raise Tier 2 regulated debt in Australia at the holding company level for APRA and rating agency capital purposes.

In addition, excessive leverage in the banking or insurance sector is generally not a risk in majority of cases (as discussed in the Action 4 Report, Chapter 16) because insurers are generally in a net interest income position. A carve out for insurers in respect of this rule should not have an impact to the Government. If insurers are not exempted from applying this new rule, then we recommend grandfathering provisions be put in place under *different targeted integrity rules* to allow sufficient time for regulated entities to manage their

¹² The Action 4 Report, paragraph 190.

investment portfolios which are funded by debt. This is also in line with OECD's recommendations for targeted rules for the banking and insurance sectors, an extract of which has been provided below:

“As set out in Chapter 11, a country may exclude interest on existing loans from the scope of rules, either for a fixed period or indefinitely. This may be particularly relevant for third-party loans which form part of a group's regulatory capital, as these loans are often long-dated and there may be substantial penalties if they are repaid early. In any case, these “grandfathering” rules should only apply to loans entered into before interest limitation rules are announced, and should cease to apply if a loan is subsequently re-financed or if the terms of the loan are significantly modified, to the extent this results in an increase to the tenor of the loan, the principal of the loan or to the rate of interest that applies”.¹³

The implementation of grandfathering provisions would enable insurers to attribute interest income on a go-forward basis for new financing arrangements. This should not have an impact on the Government as insurance companies are required to hold sufficient capital which is stress tested by APRA to cover underwriting risk, market risk, credit risk and operational risk. As a result, insurers are generally not highly geared and do not have excessive interest deductions.

Regardless of whether grandfathering is accepted or not in the enacted Legislation or updated Draft Legislation, we recommend a separate consultation be conducted by the Treasury for the repeal of sections 25-90 and 230-15 of the ITAA 97 at the earliest opportunity as the implications of this proposed change are far-reaching and not something that was anticipated by affected stakeholders.

¹³ The Action 4 Report, paragraph 539.