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RE: Exposure Draft Legislation - "Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitations "

Dear Treasury

Introduction

We are writing in response to the Government's Exposure Draft Legislation *Treasury Laws Amendments (Measures for Future Bills 2023) Bill 2023: Thin capitalisation interest limitation (Exposure Draft)*. This joint submission is made by the Ontario Municipal Employees' Retirement System (**OMERS**), Caisse de dépôt et placement du Québec (**CDPQ**), British Columbia Investment Management Corporation (**BCI**), and the Ontario Teachers' Pension Plan (**OTPP**) (together, the **Interested Canadian Investors**) with assistance from Ashurst.

As a group, the Interested Canadian Investors represent the majority (by value) of Canadian public pension funds and are major capital investors into Australian infrastructure and real estate assets.

Further details of each investor are as follows:

- OMERS is one of Canada's largest public pension plans, with 541,000 members and over 1,000 employers. OMERS invests C\$121 billion in net assets to generate an investment return that, in turn, is used to pay pensions of Ontario police officers, fire fighters, school board employees, municipal employees and more. OMERS' investments are diversified across different asset classes and geographies.
- CDPQ is an institutional investor that manages funds primarily for Quebec's public and para public sector pension and insurance plans. CDPQ's portfolio includes high-quality assets of all

classes, reflecting a strategy to create long-term value for CDPQ's Depositors. CDPQ is one of the largest institutional fund managers in North America, with net assets of C\$402 billion as at 31 December 2022.

- BCI is one of Canada's largest institutional investors, with C\$211.1 billion of assets under management. BCI's clients include public sector pension plans representing over 715,000 plan members, insurance funds providing more than 3 million Autoplan insurance policies annually, benefits coverage to more than 2 million workers and 225,000 companies, and a special purpose fund within British Columbia's public sector. BCI invests globally in all major asset classes, including infrastructure and renewable resources and in real estate through QuadReal, BCI's real estate investment manager.
- OTPP is Canada's largest single-profession pension plan with C\$247.2 billion in net assets under management as at December 31, 2022. OTPP invests in more than 50 countries in a broad array of assets across a range of sectors and industries to deliver retirement income for 336,000 active, former and retired teachers in the Canadian province of Ontario. OTPP is a long-term investor in Australia through a diversified portfolio of infrastructure, agricultural and equity investments.

The Interested Canadian Investors have invested extensively in critical Australian real property and infrastructure assets, with combined Australian AUM of over A\$35 billion. The assets that they have invested in include Port of Melbourne, Port of Brisbane, Transgrid, Westconnex, Equis (renewables), Sydney Desalination Plant, Pacific National, Endeavour Energy, Spark Infrastructure, Melbourne Convention Centre, FRV Australia, Waveconn, and a number of hospitals (such as Footscray Hospital) and build-to-rent properties. These investee companies continue to invest in the Australian economy by building new assets, employing thousands of workers and providing an increasing number of critical services to the Australian economy in line with the Government's priorities in sectors such as housing, trade, digital services and the energy transition.

Key concerns with Exposure Draft

We are writing to provide our comments on our key concerns regarding the Exposure Draft, with a particular focus on the external third party debt test (the **TPDT**). We have also made submissions on the fixed ratio test (the **FRT**) and the group ratio test (the **GRT**).

While we continue to support the implementation of the OECD's Base Erosion and Profit Shifting (**BEPS**) Framework, there are fundamental issues with the Exposure Draft. We respectfully request that Treasury revise certain elements of the Exposure Draft to make the rules workable for international investors so that it does not act as a deterrent to further investment in Australian real estate and infrastructure for investors like this group or result in increased costs being passed on to Australian consumers and other stakeholders. We respectfully submit that these results would not be aligned with the intention of the BEPS Framework.

Ensuring that the measures are implemented to permit commercial debt financing arrangements based on the unique constraints of the infrastructure and real estate industries is important for Australia to maintain the country's competitiveness for capital relative to other jurisdictions.

(i) External third party debt test does not permit debt deductions in respect of our common external debt financing structures

The TPDT as drafted will not apply to the most common external financing structures used in the infrastructure and real estate sectors, cannot be used in respect of the Interested Canadian Investors' existing Australian external third party debt, and will create impediments for future investments and potentially delay planned capital expenditures. This is primarily because the security arrangements required by external lenders will not satisfy the proposed technical legislative requirements.

Without changes being made to the Exposure Draft, most interest deductions arising in respect of genuine third party debt, and all debt deductions arising on other financial arrangements (such as interest rate swaps) would be denied under the TPDT. We have set out in greater detail our concerns with the TPDT in section 1.

In this regard, we note that a fall back to the 30% FRT is not sufficient to maintain deductions for current third party external debt arrangements, and will materially adversely affect investment returns of existing investment projects or result in increased costs being passed on to consumers. The application of the 30% FRT is particularly harsh in the context of large infrastructure and real estate greenfield projects, where there are long lead times and no taxable income for a number of years. This creates an unexpected sovereign risk that has not been previously flagged in Australia's implementation of the OECD measures as it was expected that arm's length debt arrangements would not be adversely affected under any implementation of Action Item 4.

(ii) No access to group ratio test for our investments

The group ratio test is not available for our Australian investments because our respective global parent/holding entities are investment entities for accounting purposes, and investment entities are not required to (and do not) prepare line-by-line consolidated financial statements. In order for the group ratio test to remain available for the Interested Canadian Investors and many other similar institutional investors, an alternative option should be included where the global parent entity is an investment entity. We have set out in greater detail our concerns on the group ratio test in section 2.

(iii) Fixed ratio test applies adversely for portfolio level debt

The fixed ratio test disadvantages trust structures where there is upstream gearing compared to downstream gearing. Upstream gearing is common in trust structures where investors seek portfolio-level debt (i.e., debt secured against and borrowed to invest in a portfolio of assets). It is also common where the assets are part of a pool acquired by way of an entity acquisition rather than an asset acquisition. Trust structures, which are commercially/legally beneficial and commonly used in real estate and infrastructure investments, do not have access to Australia's tax consolidation regime and are structurally disadvantaged under the Exposure Draft. We have set out in greater detail our concerns on the application of the FRT to portfolio level debt in section 3.

(iv) Exposure Draft less favourable than comparable rules in other jurisdictions

If the Exposure Draft were to be implemented without appropriate amendments being made, Australia would have more onerous thin capitalisation provisions than other comparable jurisdictions which have also implemented or are implementing the OECD's recommendations.

For example, the United Kingdom has implemented measures consistent with Action Item 4, and their regime contains a "public benefits" exemption (which is included as a supplemental option in the OECD's Action Item 4 Report).¹ The public benefits exemption is broader than an exemption for traditional infrastructure assets – qualifying investments include traditional infrastructure, but also include certain real estate assets. In particular, a building qualifies as a public infrastructure asset if the entity carries on a UK property business, the building is to be let on a short term basis to non-related parties, the building has an economic life of at least ten years, and the building meets the group balance sheet test (which effectively requires that the building is recognised on the balance sheet of the relevant company). Where the exemption applies, interest on all third party debt is deductible. Accordingly, and even though the United Kingdom has introduced similar measures, it has sought to allow higher levels of third party gearing for certain asset classes, including both infrastructure and real estate (in recognition of the traditionally higher levels of third party debt in these sectors).

Similarly, the United States has implemented an exemption for a real property trade or business, which includes both infrastructure and real estate investments, in their equivalent EBIT rules.

The Exposure Draft in its current form will make Australia significantly less attractive as a destination for international institutional capital. The Exposure Draft would increase the cost of financing Australian assets, and as other jurisdictions provide more favourable treatment for infrastructure and real estate assets, it is highly likely that capital that would have otherwise been deployed in Australia (in the absence of the Exposure Draft) would now be deployed in other jurisdictions.

This is most likely to affect those sectors where the investment returns are already low, including regulated assets (such as infrastructure) and certain real estate asset classes, such as Built to Rent (**BTR**). These include ports and transport corridors, electricity transmission networks, hospitals and water assets, which are not only economically significant, but are fundamental key utilities for Australia. Further, the Interested Canadian Investors have collectively invested a significant amount in a number of BTR funds or assets, which will increase the quantity and quality of Australia's housing stock.

We note that these are sectors where the Australian Government is seeking to encourage investment. For example, Infrastructure Australia identified in 2022 that the five year pipeline of major infrastructure projects was valued at \$237 billion,² and the Government has a critical pipeline of energy transition projects under the Australian Energy Market Operator's (**AEMO**) Integrated System Plan.

These key Government priorities will require hundreds of billions of capital investment, and the Government has recognised it will need to implement reforms to encourage this investment. Much of this investment is funded by foreign institutional investors who invest in Australian infrastructure assets for the long term, as is evidenced by the investments made in the infrastructure sector (including the renewable energy sector and associated transmission networks) by the Interested Canadian Investors. The Exposure Draft represents a major impediment to attracting foreign capital for these important infrastructure investments.

¹ *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments: Action 4 – 2016 Update* (December 2016), OECD, paragraphs 64 to 70.

² *Infrastructure Market Capacity: 2022 Report* (December 2022), Infrastructure Australia, page 12.

Similarly, the Government's National Housing Accord has set a target for one million new homes to be built over a 5 year period from 2024.³ One element of the Accord is to review barriers to institutional investments in the housing market, including in particular Build to Rent.⁴ We consider that the Exposure Draft, if enacted in its current form, would represent a new barrier to further institutional investment in the Build to Rent sector.

1. The external third party debt test

As institutional investors, the basic expectation is that debt capital sourced from genuine third party financiers should give rise to interest costs that are deductible. The purpose of using third party debt capital is not tax driven, and measures designed to target base erosion and profit shifting should not apply in this context. The purpose of using third party debt capital is to operate efficiently for our ultimate members by sourcing debt capital where appropriate, noting that debt capital is cheaper than equity capital.

Institutional investors have followed the Australian Labor Party's and the Government's announcements in this regard closely, and reassurance was taken from the intention to retain the arm's length debt amount as an option for determining the maximum allowable debt. In particular, the Labor Party announced (prior to the Federal Election in 2022) that it intended to retain the arm's length debt amount, while introducing the FRT to replace the safe harbour debt amount. Similarly, in Budget 2022-23, the Government stated that it 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.*" Institutional investors, including the Interested Canadian Investors, have continued to invest in Australia on the basis of these reassurances.

However, the proposed TPDT will, if implemented in its current form, apply to very few (if any) genuine third party debt arrangements. Accordingly, the proposed TPDT is not consistent with the Government's announced policy to retain an equivalent of the arm's length debt amount. We have detailed the particular problems with the proposed TPDT below that require rectification.

1.1 The one-in all-in election requirement

Where one general class investor elects to apply the TPDT, the Exposure Draft requires all associate entities that are general class investors to elect to apply the TPDT, with associate entities determined by reference to a "TC control interest" of 10% or more. The definition of "TC control interest" is very broad, and requires consideration both of direct and indirect interests held by an entity, but also direct and indirect interests held by associate entities.

The implication of the breadth of this definition is that an election to apply the TPDT will need to be made by sister vehicles which do not hold any direct or indirect interest in the relevant entity and by non-controlled investee entities by virtue of the 10% TC control interest.

This is particularly problematic in both the infrastructure and real estate sectors where it is common for a consortium of investors to invest in project entities, given the substantial value of the underlying assets. It is not possible for a consortium member to dictate the elections of the project entities. Neither is it possible for a project entity to dictate the elections of its consortium members and their associate entities. The one-in all-in election requirement has the effect that all consortium members and their associate entities, plus the associate entities of those associate entities (which are likely entirely different groups), will have to make the TPDT election. In practice, no entity will

³ *Budget 2022-23: Improving Housing Supply and Affordability*, page 2.

⁴ *Ibid*, page 3.

ever be able to make the election or, even if an election were made, no entity would have confidence that the election has been effective (i.e., that each entity that can possibly be an associate entity through another associate entity has validly made the election).

To take an example, assume there is a consortium of five investors that have each invested in an infrastructure project. The project entities have borrowed from banks to finance the project. In order for the project entities to make the TPDT election, each of the five investors are required to make the TPDT election. In order for those five investors to make a valid election, each of their associate entities are required to make the election – which may include upstream holding entities as well as associate entities which hold no direct or indirect interests in the project-entities. Some of those associate entities may have invested alongside other investors into (for example) another infrastructure project or a property fund. As a consequence, the other infrastructure project, property fund and their 10%+ investors will be required to make the election. In order for those investors to make the election, the process of tracing and associate identification, and the requirement to make elections, continues and so on. This becomes an impossible task – to both identify and ensure that "all" the relevant entities make the TPDT election. If any one of these entities fails to make the election, it invalidates the elections made by "all" the other entities.

This is an impossible and unrealistic requirement. In practice, it will simply not be possible to verify that all relevant entities have made valid elections. The fundamental problem in the Exposure Draft is not remedied merely by increasing the percentage threshold, unless that percentage gives relevant control over the associate, as conflicts may arise between investors, eventuating in no election being possible.

From a policy perspective, we submit that there is no rationale to require this. From a tax integrity perspective, we understand the concern with associate entities not making a TPDT election is the risk of upstream/downstream gearing of the same underlying income stream/assets. The one-in all-in election requirement reaches too far and is unnecessary to defend against this integrity risk.

The Interested Canadian Investors submit that the one-in all-in requirement should be removed. In order to ensure the integrity concerns are addressed, modifications to the FRT and GRT calculations should be made where there is a downstream entity which has made the TPDT election.

The Interested Canadian Investors suggests that a solution to the integrity concerns can be addressed by, where a downstream entity has made an election to apply the TPDT:

1. an upstream entity holding 10% or more of the direct or indirect interests in that entity being required to exclude from the calculation of their tax EBITDA the taxable income that is referable to that direct or indirect interest in applying the FRT or the GRT. This would ensure that multiple gearing of the same income stream in excess of the third party debt levels at different levels of the structure could not occur; and
2. if there must be a requirement for a group to all make the election, that group should be limited to the group referable to the project. We consider that a common interest of 80% should be adopted in determining the group that should be required to make the election, similar to the identification of stapled entities in section 12-436 of Schedule 1 to the *Taxation Administration Act 1953* (Cth). This would operate in concert with the proposal above in paragraph 1 regarding modifications to the FRT and the GRT (i.e., for upstream entities).

The benefits of adopting this approach is that it is broadly similar to the current thin capitalisation regime (in terms of how it treats upstream gearing), while allowing the TPDT to be accessed. It also appropriately addresses the relevant integrity concerns.

We further note that it is conceptually similar to the way in which comparable rules operate in other jurisdictions. For example, the United Kingdom rules apply in a similar manner where a downstream vehicle avails itself of the infrastructure exemption – in that case, the taxable income of that vehicle is treated as being nil in determining how the fixed ratio test applies to upstream vehicles.

Note that our description of the relevant integrity concerns are based on the general comments in the Explanatory Memorandum. If there are further specific integrity concerns that are not addressed from the above proposal, we would like to discuss these further with you, in order to find an alternative workable way to address those integrity concerns without compromising access to the TPDT.

1.2 Recourse requirements

Both the base TPDT (i.e., applying in circumstances not involving a conduit financier) and the conduit financier TPDT prescribe limitations that would not accommodate the standard finance security arrangements negotiated with third party banks/lenders. In particular:

1. The base TPDT requires that the holder of the debt interest has recourse for payment of the debt "only to the assets of the entity", being the issuer of the debt interest (paragraph 820-61(2)(c)); and
2. The conduit financier TPDT requires that the ultimate lender (e.g., a bank) has recourse for payment of the ultimate debt interest only to the assets of each borrower (being the entities to which the conduit financier has on-lent) and the assets of the conduit financier that are the relevant debt interests (i.e., the on-lending arrangements) (paragraph 820-61(5)(g)).

The problem with the above recourse limitations is that they do not reflect commercially accepted arrangements with third party lenders. Therefore, no commercially accepted lending arrangements will qualify under the TPDT, again rendering the TPDT meaningless for infrastructure and real estate investments.

In commercially accepted lending arrangements involving infrastructure and real property trusts, the bank will take security not only over the assets of the asset trust, but also security over the units in the asset trust (i.e., security granted by the holding entity). The rationale for this is not to provide credit support, but rather because the bank, if it needs to enforce its security, will typically do so by taking a transfer of the units in the asset trust, rather than an assignment of all of the underlying property of the asset trust (i.e., which may be more complex and involve the assignment of a large number of assets, assets involving third parties for which consent may be required).

Also, in commercially accepted lending arrangements where a bank is lending to a holding trust (i.e., against a portfolio of assets held indirectly by the holding entity), the bank will take security over the assets of the holding entity, the assets of the downstream asset holding entities, as well as security over the units in the holding entity. Again, this is to provide the bank with options over where to exercise security.

Similar security arrangements would be used in the case of a conduit financier – the conduit financier would borrow from the bank, and on-lend, and the bank would take security over all of the assets of the conduit financier (not just their assets which are on-lending debt interests), all of the assets of

the entities to which the conduit financier has on-lent, all of the assets of the group of entities that are allowed by the bank to be on-lent to (the "obligor" group, even if there is no immediate on-lending), and also over the units or shares in those entities.

In stapled structures, it is common for security to be provided across both sides of the staple (in a stapled structure context, the corresponding arrangement to the commercially accepted lending arrangements described above).

We also highlight that in commercially accepted lending arrangements for infrastructure and real estate assets, the entities which are providing security to the external lender are Australian entities, that (directly or indirectly) hold Australian assets. That is, the lending is secured over certain Australian assets. Accordingly, and from an integrity perspective, there is no concern that (for example) the credit rating of a parent entity, or explicit credit support by that parent entity, is being used in order to gear Australian entities at a level that is not supportable by the Australian assets. Therefore, there should be no concern with these commercially accepted lending arrangements from a tax integrity perspective.

We note that these standard security arrangements would not be problematic where the entities were all members of a tax consolidated group. Accordingly, if these issues are not remedied, tax consolidated groups will be treated preferentially to other valid and permitted structures. This is particularly relevant for infrastructure and real estate sectors where trusts are the commercially/legally preferred structure.

Accordingly, the Interested Canadian Investors submit that the TPDT should be amended in order to permit these standard arrangements. This can be done by permitting recourse given in respect of the assets held by, and the equity in:

- Australian entities holding predominantly Australian assets (by value); and
- Obligors that are party to the third party lending arrangements.

The above would align the TPDT with commercially accepted lending arrangements (particular, the standard security arrangements) and will make this aspect of the TPDT workable for these arrangements.

If the TPDT is not amended, then in reality the TPDT will not apply to commercially accepted lending arrangements. In other words, the announced Government policy of enabling interest deductions on genuine third party debt will not be implemented.

If there are concerns that the borrowed funds may be deployed offshore, this is separately addressed by other elements of the TPDT (e.g., see subsection 820-61(2)(d)). To assist in your consideration of this issue, we have shown the most common types of security arrangements in Appendix B, and included suggested drafting changes to the TPDT in Appendix A. Note that the security arrangements depicted in Appendix B are not (and are not intended to be) exhaustive; they are provided merely to assist in your consideration of this issue.

Note that the above does not address a particular issue unique to development assets, which we consider requires a separate, more limited application of the TPDT (discussed below).

1.3 Development assets

There is a particular issue with development assets as such assets have unique third party funding arrangements suitable to the asset's circumstances. Third party development debt is critical to the

investment decision making criteria in order for investors like us to proceed to develop material assets (e.g., such as a major infrastructure asset or a major real estate development).

For development projects, it is common for the recourse arrangements to go beyond those set out above, given the value and income serviceability of the project is not presently reflected in the underlying assets but is only realised after construction completes. In particular, it is common for the external bank to seek a guarantee from a vehicle of economic substance, or alternatively to seek some other form of comfort, often in the form of a parental guarantee, an "equity commitment letter", or a Bank Guarantee. Because of the use of special purpose vehicles (at both the asset level and the holding level) for these projects, it is common that this support will be provided by a parent entity of substance.

These development projects are important for the Australian economy, supporting many thousands of Australian jobs and the creation of physical assets which provide community value and amenity. Accordingly, these projects are worthy of support and differentiation.

Accordingly, to facilitate job creation and to meet Australia's infrastructure and other needs (such as continuing to grow the housing stock and facilitate energy transition), the Interested Canadian Investors implore the Australian Government to allow these parental support arrangements so that construction finance and developments can be funded. We would therefore propose a limited exception for development assets that provide recourse outside the project group, where:

1. The development is significant – involving, for example, planned capital expenditure of \$50 million or more (to target significant, economy building developments); and
2. The relevant period during which support is required by lenders by non-project parent entities of substance is limited. We note that it is common in construction facilities to limit this period by reference to the period tied with the development or other regulatory approval, e.g. up to the point of stabilisation of the asset (e.g. for real estate, generally, when 75% of the net lettable area of the asset is leased). After this period, the construction facility is either converted into a more standard arrangement (with more common security arrangements set out in section 1.2 above) or is refinanced with such an arrangement.

We are happy to discuss the nature of these arrangements with the Government to ensure the rules adequately address any integrity concerns. We have included potential drafting for this limited exception in Appendix A.

1.4 Conduit financing arrangements – on-lending requirements

One of the specific requirements in the conduit financier provisions is that the on-lending from the conduit financier occurs on "*the same terms*" as the ultimate debt interest. In practice, having regard to commercially accepted lending arrangements, it will be impossible for the precise terms to be exactly the same, and it will also be common for other terms to be different where they are not applicable. For example (this is not an exhaustive list but only to illustrate the point):

1. The external lender will take security over all of the assets of the entity to which the conduit financier on-lends or can on-lend (i.e., entities within the obligor group), so it can enforce the security directly (and not through the conduit financier). Accordingly, the conduit financier cannot take security over those assets (or, could take security, but such security would need to be negotiated with and consented to by the external lender, could only be second ranking (if allowed), and would only be done to meet this tax requirement rather than a commercial

requirement). Accordingly, recourse arrangements will not satisfy the same terms requirement.

2. The external lender may be required to consent to certain things, such as the disposal of a material asset, or the payment of a distribution outside the obligor group. The external lender would not want the conduit financier to also have to consent to these things – the bank will require sole consent rights on these matters. Accordingly, these rights will not be included in the on-lending.
3. The conduit financier may hedge aspects of its borrowing – for example, it may swap a floating interest rate into a fixed rate under an interest rate swap. The conduit financier may then on-lend at the fixed rate (i.e., reflecting the all-in cost of these arrangements collectively). Clearly, in this circumstance the on-lending will not be on the same terms as the external finance.
4. In a syndicated facility agreement, the external banks will typically nominate a bank to act as their agent (commonly referred to as agency provisions), and there may be particular provisions relating to the majority lender. Because the conduit financier is the sole lender, these agency and majority lending provisions would not be included in the on-lending.
5. Similarly, the external lender will typically include debt covenants, such as loan-to-value ratios, or interest coverage ratios. These will typically be tested on a group basis. However, the on-lending arrangement will not include these terms, as they are already measured on a group basis, and there is no need to separately report this information to a related entity.

At the most general level, the external finance documents may run to hundreds of pages, whereas it is not necessary for the on-lending agreements to have the same complexity and will typically be much shorter documents (e.g., 20 pages).

We understand integrity concerns may arise where the on-lending occurs on different terms, such as charging a materially different interest rate, or with different payment terms (which may allow income and expenses to be recognised over different periods). We submit that the TPDT should be changed to address these concerns only and not require "the same terms". The changes we submit should be made are either:

1. Substantially the same terms with respect to the rate of interest, taking into account other debt related arrangements (such as swap arrangements, borrowing costs) in determining the all-in cost of interest. We also have referred to "substantially the same" and not "the same", as in some structures it is common to charge a small margin (e.g., 50 basis points). This margin may be used to meet administration costs (such as the cost of tax return preparation and audit fees) for the conduit financier. In addition, the ATO has at times adopted a position that a margin should be charged in order for the on-lending to qualify as "associate entity debt" under the existing thin capitalisation rules. Accordingly, a safe harbour margin should be included. We suggest permitting an up to 50 basis point margin - the ATO has in other contexts considered a 50 basis point margin over referable debt a low risk/"green zone" (see, for example, PCG 2017/4).
2. Alternatively, the rule could require that the amount of debt deductions claimed by the conduit financier in respect of and related to the debt arrangements (that is, including swaps

and on-lending) is not substantially different to the assessable income included by the conduit financier in respect of these debt arrangements. This would permit some small differences (e.g., if interest income derived under the on-lending arrangements is used to satisfy certain routine administration costs). We note that the Taxation of Financial Arrangements rules contain a number of provisions that has a similar concept relating to whether elections would result in substantial changes to the recognition of income and expenses (from a timing perspective) to address integrity concerns – see, for example, paragraph 230-410(1)(f)).

As above, we are happy to discuss with the Government any other types of terms that are considered to give rise to integrity risks, to ensure that the conduit financier provisions can operate to cover standard on-lending arrangements.

1.5 Conduit financier provisions to cover external arrangement

At present, the Exposure Draft conduit financier provisions apply only to the debt interests issued by the entities to which the conduit financier has on-lent, and not the debt interests issued by the conduit financier itself. In particular, subsection 820-61(4), which is the key provision modifying the base TPDT to conduit financing arrangements, makes it clear that it modifies the rules in respect of a "relevant debt interest". A "relevant debt interest" is defined in paragraph 820-61(5)(c) as the debt interest issued by each borrower to the conduit financier. Accordingly, where the conduit financier provisions apply, they permit debt deductions on the on-lending arrangements, but not the debt interests issued by the conduit financier to the third party lenders.

We expect that this is a drafting error, but we have brought it to your attention given its significance. Please let us know if this is intended, as (if so) we will make more submissions on why the regime needs to be extended to the external debt issued by the conduit financier.

1.6 Coverage of debt deductions arising on interests other than debt interests

As a consequence of the changes to the definition of "debt deduction", it is possible (although it is not clear) that debt deductions arise not only in relation to a debt interest, and may now arise in respect of other financial arrangements, such as interest rate swaps (among others). We note that paragraph 820-40(3)(a) does not exclude this, given the changes made to subsection 820-40(1), item 9 of the Exposure Draft. Notwithstanding this broadening, the TPDT only allows debt deductions that are "attributable to debt interests" (see subsection 820-61(1) and also (2), which refers to "debt interests" satisfying certain conditions). In other words, if entities were to elect into the TPDT, then all debt deductions on arrangements that were not attributable to debt interests (noting that interest rate swaps may not be attributable to the debt interests given the way hedges are undertaken) would be denied.

We expect that this is a drafting error. The TPDT needs to cover all arrangements with third parties that *relate* to the debt interests. For clarity, the legislation should include examples of arrangements that relate to debt interests, which should include swaps or other hedging arrangements.

2. Group ratio test – eligibility

The GRT is intended to operate as an alternative means to support debt deductions in those sectors which are traditionally heavily geared for commercial reasons. In particular, the OECD recognises that third party debt, sourced for non-tax reasons, does not give rise to base erosion and profit shifting risks. In particular, the OECD states:⁵

*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's rationale is consistent with the rationale set out in the draft Explanatory Memorandum. In particular, and as the Explanatory Memorandum identifies, the FRT is not appropriate for groups in sectors that may be leveraged more highly for genuine commercial reasons, and so the GRT is intended to alleviate the adverse impact of the FRT on these sectors. Both the infrastructure sector and the real estate sector are typically highly geared. However, as drafted, it is not possible for the Interested Canadian Investors, among other investors, to meet the eligibility requirements associated with the GRT.

To elaborate, in order to be eligible to apply the group ratio test, it is necessary that there is a global parent entity, and for that global parent entity to prepare line-by-line consolidated financial statements. However, many entities are eligible to not line-by-line consolidate their controlled entities, including "investment entities". Investment entity status is generally conferred on superannuation funds. This includes this group of Interested Canadian Investors and some of their respective holding entities.

Accordingly, the Interested Canadian Investors will not be entitled to access the group ratio test as currently proposed. This is not how the group ratio test is being implemented in other OECD countries (including the United Kingdom) and in our view, the eligibility criteria should be amended to allow the group ratio test to apply in these circumstances on a modified basis.

This amendment would be consistent with the recommended approach of the OECD. The OECD notes that investment entities will prima facie be unable to access the GRT where the parent entity is an investment entity, and in these circumstances it recommends that the controlled entity that is not a parent entity may form a group (where that controlled entity does prepare consolidated financial statements on a line-by-line basis).⁶ The OECD goes on to provide examples of how a group should be determined for the purposes of the GRT (in Annex I.D), and Figure I.D.3 (relating to companies held by a limited partnership via fund vehicles) and Figure I.D.6 (relating to a structure headed by an investment entity) are illustrative. In particular, these examples demonstrate that the OECD recommends that separate groups should be able to be formed by subsidiary vehicles of the investment entity for the purposes of applying the GRT.

⁵ *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments: Action 4 – 2016 Update* (December 2016), page 13.

⁶ *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments: Action 4 – 2016 Update* (December 2016), paragraph 126.

Accordingly, our submission is that:

1. Where the global parent entity is an investment entity; and
 2. A subsidiary of the global parent entity does prepare line-by-line consolidated financial statements; and
 3. The Australian entity or entities are consolidated on a line-by-line basis by that subsidiary;
- it should be possible to make an election to apply the group ratio test on a modified basis by reference to the consolidated financial statements of that subsidiary.⁷

The above proposal will ensure that global institutional investors which are classified as investment entities will still be able to access the rule which is intended to apply relief where the investors operate in highly geared sectors on a worldwide basis. It will also ensure the Australian rules are consistent with the OECD's recommended approach, as well as the approach adopted by other jurisdictions (such as the United Kingdom).

3. Fixed ratio test – modification for upstream gearing

The fixed ratio test operates by reference to Tax EBITDA, being (in effect) taxable income, plus net debt deductions, plus certain (but not all) depreciation expense for tax purposes, plus tax losses utilised in the relevant income year.

It is very common in the real estate and infrastructure sectors to have debt at an upstream level – i.e., above the asset trust level. Often debt will be upstream because the external finance will have been sought on a portfolio level (and assets are typically held in separate special purpose vehicles), or because debt was obtained at this level to finance an entity acquisition (e.g., acquire a trust that holds an asset). Because tax depreciation is claimed at the asset trust level and not the holding trust level, the holding trust's Tax EBITDA is limited to their share of the downstream trust's net (i.e., taxable) income and (effectively) after downstream depreciation.

This will have a material impact on the operation of the fixed ratio rule depending on the level where debt is situated, and there is no logic from a policy perspective for there being a different outcome depending on which level of the structure has gearing (upstream level compared to a downstream level). It is fundamentally the same income stream and underlying assets, and so the level of permissible debt deductions should be equivalent.

It may not be possible (and in any event costly to implement) to simply move the gearing down the levels in order to access the depreciation amount in calculating tax EBITDA – leaving aside technical issues like whether the interest is deductible if this is undertaken (and noting the ATO's views in Taxation Ruling 2005/12), as well as integrity issues around the application of anti-avoidance regimes. Further, the pricing of debt at an asset level may well be different (i.e., more expensive as compared to portfolio debt).

In order to remedy this, we submit that in calculating Tax EBITDA, upstream entities should be able to include their share of downstream depreciation, which has not otherwise been used to shelter downstream debt deductions, to achieve an equivalent outcome as downstream gearing. To take an

⁷ We note that the existing integrity provisions would apply to this smaller group – i.e., interest payments made to the investment entity by entities within the group would already be excluded in determining the GRT (see subsection 820-53(3)).

example, assume that a downstream trust has Tax EBITDA of \$150, which includes depreciation of \$50 and debt deductions of \$15. As the Tax EBITDA (excluding depreciation) itself would permit the debt deductions of \$15 being available (as \$100 at 30% = \$30 thin capitalisation limit), no part of the depreciation (\$50) is being used to shelter debt deductions. Accordingly, the upstream unitholder should be entitled to include in its Tax EBITDA its share of the depreciation (e.g., if it wholly-owned the downstream trust, it would include \$50). In contrast, if the downstream trust has Tax EBITDA of \$150, which includes depreciation of \$50 and debt deductions of \$40, some part of the depreciation is being used to shelter debt deductions at the downstream level (\$10 out of the \$40 debt deductions sheltered, meaning \$33.33 of the depreciation is so utilised to shelter the \$10). This means \$16.67 of the depreciation shelter is unused, and the upstream unitholder should be entitled to include its share of this amount in its Tax EBITDA (e.g., if it wholly-owned the downstream trust, it would include \$16.67).

4. Other observations

Addressing the above issues is material to ensuring that Australia adopts a commercially realistic and internationally comparable regime to other jurisdictions, particularly with regard to the real estate sector and the infrastructure sector.

In our view, and given the importance of designing the rules in a logical manner that addresses relevant integrity concerns, and the number of issues with the Exposure Draft (only some of which are covered in this submission), we consider that the Government should defer the application of the proposed rules for at least a year (i.e., to commence for income years commencing on or after 1 July 2024).

Alternatively, given that the rules (as drafted) are likely to seriously impact certain sectors and particularly non-consolidated group structures, which may require debt restructuring, consideration should be given to implementing the new rules on an elective basis for a number of years, until all of the identified issues can be rectified. This would also allow taxpayers to undertake renegotiation and potential restructuring of their external third party debt arrangements.

At a general level, we note that where interest payments are made to either Australian tax resident lenders or Australian permanent establishments of foreign incorporated lenders, the interest is included in the Australian tax base. Accordingly, consideration should be given to a complete exclusion of debt deductions arising as a consequence of payments made to Australian tax resident entities or Australian permanent establishments.

As set out above, the Exposure Draft is not well designed for trust structures. If a significant proportion of debt deductions are denied for trusts (which is likely to be the case if the above identified issues are not rectified), there will be a range of provisions that will become problematic for trusts, including non-symmetrical cost base treatment for non-AMIT trusts. Accordingly, ensuring the regime operates effectively for trusts is important to preventing contagion risks in respect of other elements of Australia's taxation regime.

Finally, we note that item 45 of the Exposure Draft provides (or at least intends to provide) concessional treatment for institutional complying superannuation entities. The Explanatory Memorandum notes, for example, that the definition of "associate entity" is too broad in the context of complying superannuation entities. At paragraph 1.122, the Explanatory Memorandum notes that superannuation funds have grown to have significant investments in a variety of different assets, are an important source of capital investment for Australian assets (particularly infrastructure

assets), and the thin capitalisation rules would treat them as having a large number of associate entities.

Each of the points in support of treating complying superannuation funds differently also apply with respect to foreign superannuation funds. Accordingly, to the extent that problems have been identified with respect to the associate entity definitions in the context of complying superannuation entities, we submit equivalent changes should also be made for foreign superannuation funds which have at least 50 members.⁸ We also submit that the policy rationale for the superannuation fund exception equally applies to sovereign entities and their wealth funds, and the same changes should be made in this regard.⁹

If item 45 is not extended to foreign superannuation funds and sovereign wealth funds, the benefits of breaking any associate links created by the complying superannuation fund's interests in other entities is highly likely to be unwound by the other consortium members. This is because it is very common for complying superannuation funds to invest as part of a consortium, typically including other institutional investors (such as foreign superannuation funds and sovereign wealth funds). The interests held by these foreign superannuation funds or sovereign wealth funds will therefore create the relevant associate entity links between project entities. Accordingly, if item 45 is not extended, one possible impact is that complying superannuation funds may be reticent to participate in consortia with similar foreign residents. This, in turn, may impact the competitiveness of bidders in and pricing of infrastructure projects.

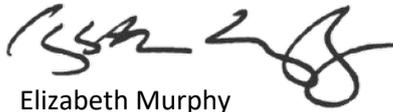
⁸ We note that foreign superannuation funds which have 50 members are often treated in a comparable way to complying superannuation entities – see, for example, paragraphs 275-20(4)(c) and (g)). For completeness, we also note that the impact of item 45 (the proposed changes for complying superannuation entities) is not clear. The primary change is to provide that subsection 820-905(1) does not apply to a trustee of a complying superannuation entity. Read in context, it means the trustee of a complying superannuation fund is not a "first entity" under that provision. However, the associate entity issues discussed in the Explanatory Memorandum are not the result of the complying superannuation entity being the "first entity" referred to in that subsection, but rather where it is "another entity" referred to in that subsection. Accordingly, item 45 of the Exposure Draft should make clear that it applies so that an associate relationship is not created when the trustee of the superannuation fund is either the "first entity" or "another entity".

⁹ The definition of sovereign wealth fund could reflect paragraph 275-20(4)(h).

Conclusion

Thank you for the opportunity to participate in the consultation process regarding these important tax changes.

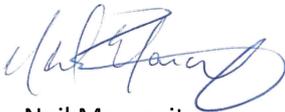
Sincerely,



Elizabeth Murphy
OMERS Global Head of Tax



Steve Bossé
VP Finance & Tax – CDPQ



Neil Marcovitz
VP Tax – BCI



Hersh Joshi
Managing Director, Taxation – OTTP

APPENDIX A – Suggested Legislative Drafting for the TPDT

Operative Provisions

820-61 **Meaning of *external third party earnings limit* and *external third-party debt conditions***

- (1) An entity's ***external third party earnings limit*** for an income year is the sum of each *debt deduction of the entity for the income year that ~~is attributable~~ relates to a *debt interest issued by the entity to the extent that it satisfies the *external third-party debt conditions for a period in ~~relation to~~ the income year.

[Drafting note 1: "Attributable" has been replaced by "relates", to encompass debt deductions that arise in respect of other arrangements (such as interest rate swaps) but is related to the debt interest (e.g., in the sense that they hedge or manage risks related to that debt interest). See also proposed subsection (1A) below to make clear that swaps are included.]

Drafting note 2: The wording "to the extent" and "for a period" has been inserted to allow part-year qualifying external third party debt arrangements to benefit from the TPDT - the current Exposure Draft wording is unclear as to how the section is applied where the requirements are satisfied with respect to part of the year but not all of the year.]

(1A) To avoid doubt, the following amounts are amounts that relate to a debt interest in subsection (1):

- (a) losses or outgoings associated with hedging or managing the financial risk in respect of a debt interest;
- (b) an expense specified in the regulations made for the purposes of this paragraph.

[See Drafting note 1 above.]

- (2) A *debt interest issued by an entity satisfies the ***external third-party debt conditions*** in relation to an income year if the following conditions are satisfied:
- ~~(a) the entity issued the debt interest to an entity that is not an *associate entity (see subsection (9)) of the entity; and~~
 - ~~(ba)~~ the debt interest is not held at any time in the income year by an entity that is an *associate entity (see subsection (10)) of the entity;
 - ~~(eb)~~ the holder of the debt interest has recourse for payment of the debt only to any of the following:
 - (i) the assets of the entity and the *equity interests in the entity; and
 - (ii) assets set out in subsection (3);
 - ~~(ec)~~ the entity uses the proceeds of issuing the debt interest ~~wholly~~ to fund its investments covered by subsection (3) and its Australian operations.

[Drafting note 3: Paragraph (a) has been deleted, as it should be sufficient to rely on paragraph (b) (now paragraph (a)). In particular, if debt markets were to dry up at the time of completion of a deal, a related party may acquire some of the debt interest (on third party terms) then transfer them to a third party. In this case, the TPDT should be able to be satisfied with respect to the period that it was held by a third party, rather than its initial issuance forever preventing it from doing so.]

Drafting note 4: Renumbered paragraph (b) has been amended to broaden the recourse to reflect commercially accepted security arrangements – i.e., that the external lender will at a minimum seek security over the equity interests in the issuer, as well as potentially other assets held in the Australian group.

Drafting note 5: Renumbered paragraph (c) has been amended to no longer require the funds are used "wholly" to fund relevant investments or Australian operations. In the absence of this change, debt deductions would not be available at any time on a debt interest if some part (even if some very small part) were used to fund foreign operations. The rule should more sensibly require apportionment.]

- (3) This subsection covers investments that relate only to:
- (a) assets that are attributable to ~~the entity's~~ *Australian permanent establishments; or
 - (b) assets that ~~are held the entity holds~~ for the purposes of producing assessable income.

[Drafting note 6: The changes to paragraphs (a) and (b) reflect that security may be granted by other entities, consequential change as a result of the suggested wording to renumbered paragraph 820-61(2)(b) and drafting note 4 above.]

- (4) A debt interest on issue by an entity during a *development period also satisfies the **external third-party debt conditions** in relation to an income year if the following conditions are satisfied:
- (a) the debt interest is not held at any time in the income year by an entity that is an associate entity (see subsection (10)) of the entity;
 - (b) the debt interest is issued to fund a *development project; and
 - (c) all of part of the *development period falls in the income year.

[Drafting note 7: This new subsection has been inserted to address the development asset/construction finance facility concerns set out in section 1.3 of our submission.]

- (45) If the condition in subsection (56) is met in relation to the income year, in applying subsection (2) or subsection (4) in relation to a ~~relevant~~ debt interest mentioned in subsection (56):
- (a) treat the conditions in paragraphs (2)(a) ~~and (b)~~ or subsection (4)(a) as being satisfied; and
 - (b) treat the reference in paragraph (2)(~~be~~) to the assets of the entity as being a reference to any of the following:
 - (i) the assets of the entity and the *equity interests in the entity; and
 - (ii) the assets of each other borrower mentioned in subsection (56) and the equity interests in each other borrower; and
 - (iii) any assets set out in subsection (3).

[Drafting note 8: The deletion of "relevant" ensures that it covers not only debt interests issued by the borrowers (i.e., the entities to which the conduit financier on-lends), but also to the debt interests issued to third parties by the conduit financier. The other changes reflect the changes discussed in the drafting notes above.]

- (56) This subsection applies in relation to an income year (the **relevant year**) if:
- (a) an entity (the **conduit financier**) issued a *debt interest (the **ultimate debt interest**) to another entity (the **ultimate lender**); and

- (b) one or more other entities (the ***borrowers***) issued a debt interest (a ***relevant debt interest***), or are permitted under the ultimate debt interest to issue a debt interest, to the conduit financier ~~are~~ ^{*}~~associate entities of each other~~; and
- (c) each borrower ~~issued a debt interest (a ***relevant debt interest***) to the conduit financier and the conduit financier are~~ ^{*}~~associate entities of each other~~; and
- (d) the conduit financier financed the amount loaned under each relevant debt interest only with proceeds from the ultimate debt interest; and
- (e) the difference between the following amounts would reasonably be expected not to be substantial:
 - (i) the assessable income of the conduit financier in relation to the debt interests mentioned in this subsection; and
 - (ii) the allowable deductions of the conduit financier in relation to debt interests mentioned in this subsection; and terms of each relevant debt interest are the same as the terms of the ultimate debt interest (other than terms as to the amount of the debt); and
- (f) the ultimate debt interest:
 - (i) satisfies the ^{*}external third-party debt conditions in relation to any income year; or
 - (ii) would satisfy the external third-party debt conditions in relation to any income year if paragraph (2)(c) were disregarded; and
- (g) the ultimate lender has recourse for payment of the ultimate debt interest only to any of the following:
 - (i) the assets of each borrower and the ^{*}equity interests in each borrower; and
 - (ii) ~~each~~ the assets of the conduit financier ~~that is a relevant debt interest and~~ the equity interests in the conduit financier; and
 - (iii) any assets set out in subsection (3); and
- (h) a choice under subsection (67) for the relevant year has been made within the time specified in subsection (8) by:
 - (i) the conduit financier; and
 - (ii) each borrower.

[Drafting note 9: The changes to paragraph (b) are to correct an error in the previous drafting, which required that each associate entity had issued a debt interest to the conduit financier. The further changes to this paragraph are to refer to on-lending to entities which are typically defined in the external lending agreement as the "obligor group", over which the external lender ordinarily takes security (i.e., in respect of their assets, and the equity in those entities).

Drafting note 10: The changes to paragraph (c) as part of the first change noted in drafting note 9.

Drafting note 11: The changes to paragraph (e) reflect our substantive submissions in section 1.4, noting that the on-lending will not be on the same terms (but are intended to reflect that the arrangements are, in totality, substantially on back to back terms). The wording used is borrowed from similar wording in paragraph 230-410(1)(f).

Drafting note 12: The changes to paragraph (g) reflect the changes above.]

- (67) An entity may make a choice under this subsection for an income year for the purposes of this section.

- (78) A choice under subsection (67) must be:
- (a) made in the *approved form; and
 - (b) made on or before the earlier of the following days:
 - (i) the day the entity lodges its *income tax return for the income year;
 - (ii) the day the entity is required to lodge its income tax return for the income year.
- (89) A choice under subsection (67) cannot be revoked.
- (910) For the purposes of this section, in determining whether an entity is an **associate entity** of another entity, treat the reference in paragraph 820-905(1)(a) to “an *associate interest of 50% or more” as instead being a reference to “a *TC control interest of 10% or more”.

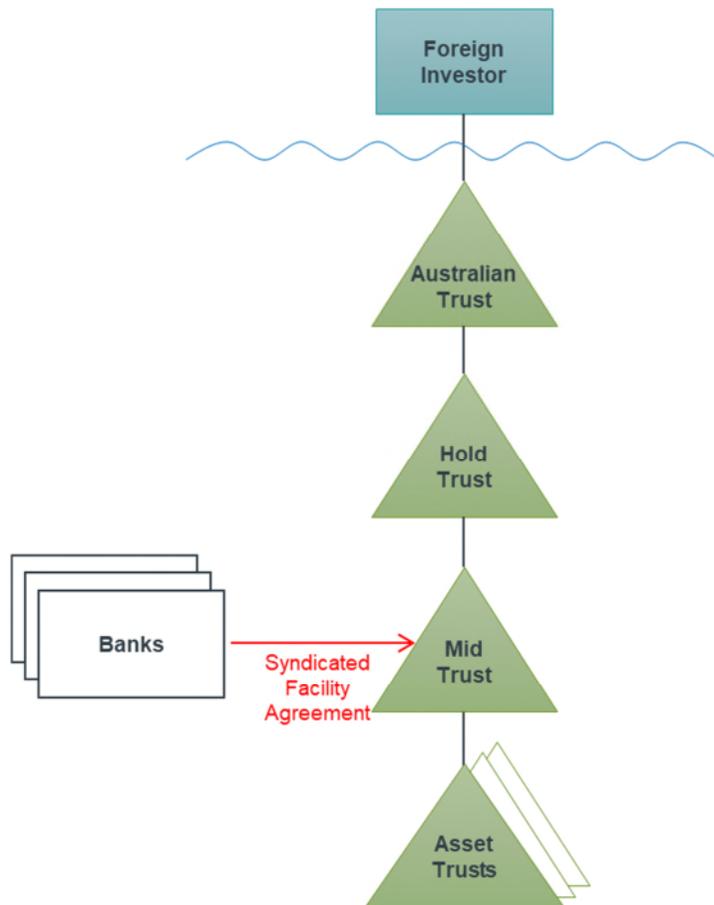
New definitions (for subsection 995-1(1) of the *Income Tax Assessment Act 1997* (Cth))

Development project means a project in respect of which expenditure is incurred in relation to the construction or installation of a building, improvement or facility where the aggregate expenditure in respect of the construction and installation is expected to be \$50 million or more.

Development period in relation to a debt interest issued by an entity to fund a *development project means the period referable to the construction or installation of the building, improvement or facility under the terms of the debt interest.

APPENDIX B – Examples of Security Arrangements

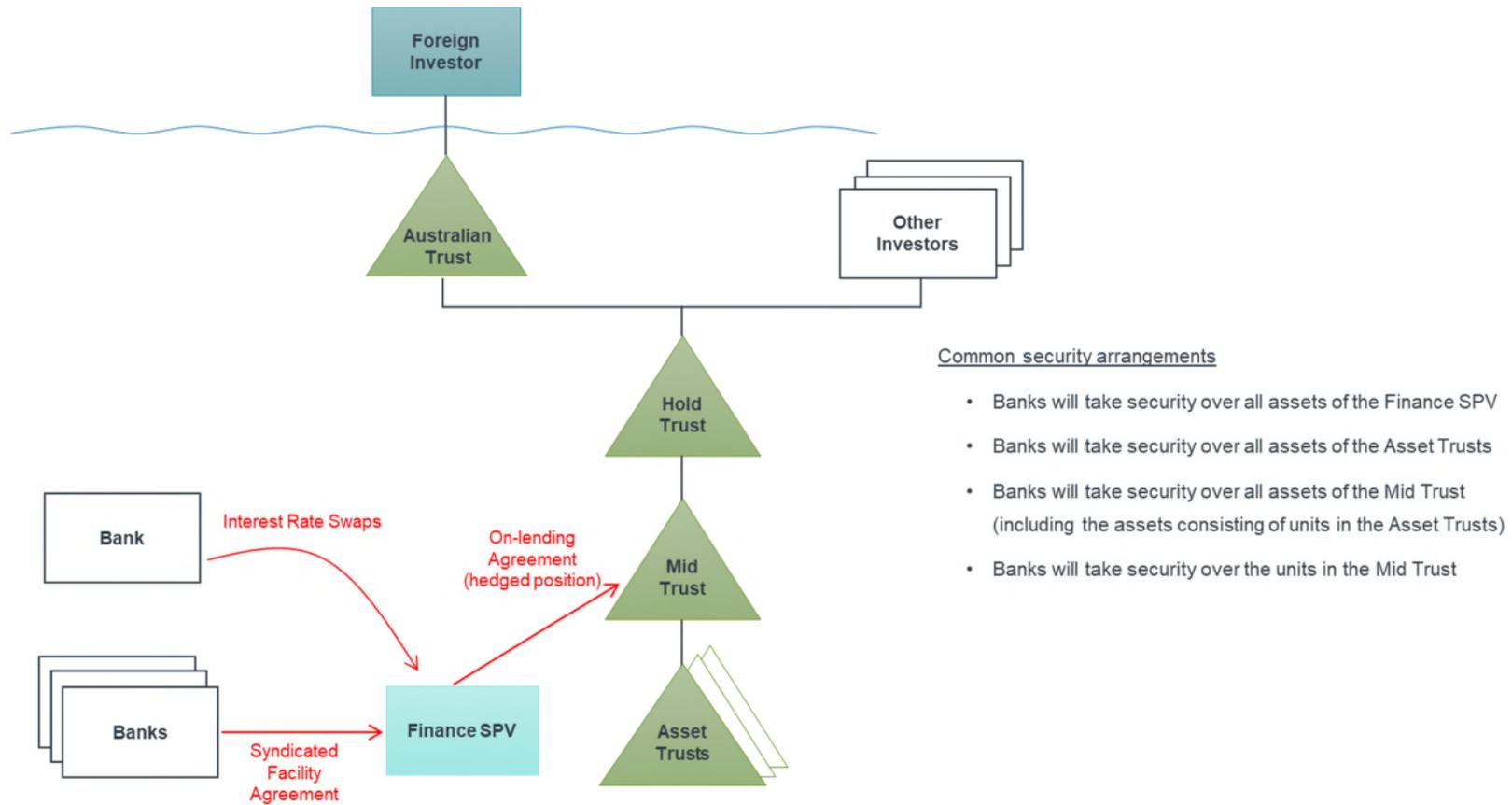
Portfolio Debt – No Conduit Financer



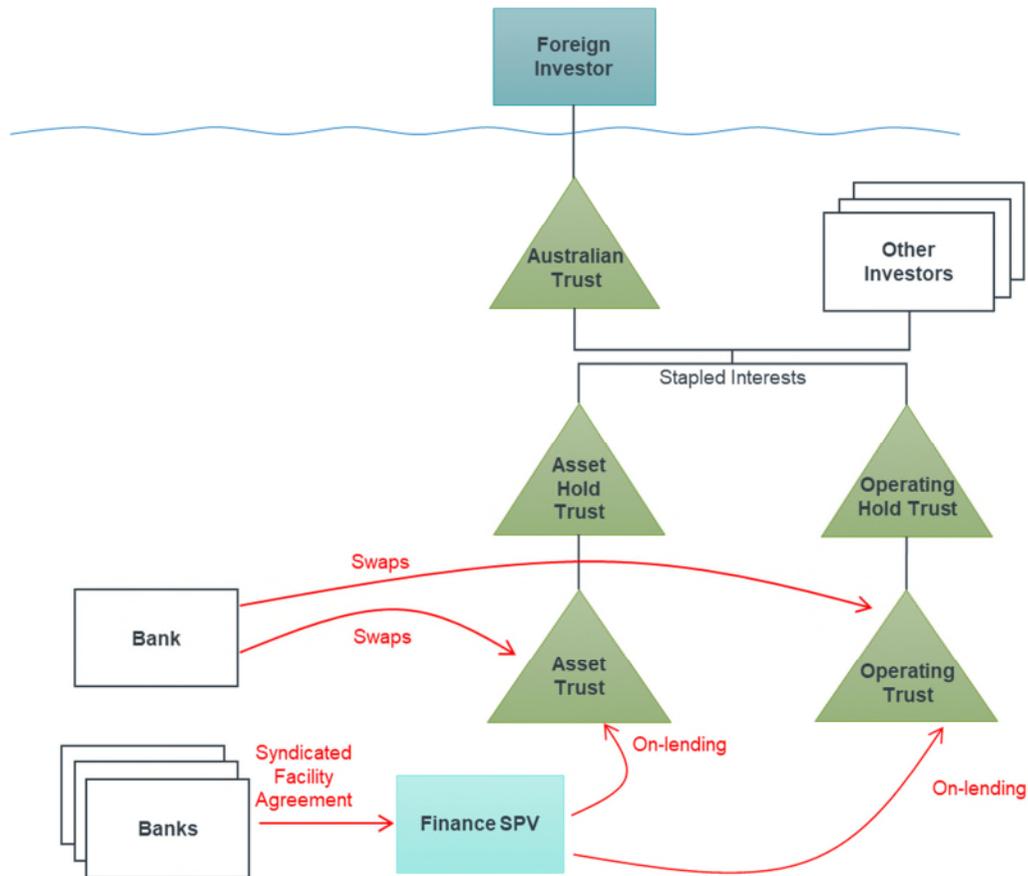
Common security arrangements

- Banks will take security over all assets of the Asset Trusts
- Banks will take security over all assets of the Mid Trust (including the assets consisting of units in the Asset Trusts)
- Banks will take security over the units in the Mid Trust

Portfolio Debt – Conduit Financer with hedging at the conduit financier level



Infrastructure Staple – Conduit Financer with hedging by ultimate borrower



Common security arrangements

- Banks will take security over all assets of the Finance SPV
- Banks will take security over all assets of the Asset Trust
- Banks will take security over all assets of the Operating Trust
- Banks will take security over the units in the Asset Trust
- Banks will take security over the units in the Operating Trust