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 International Tax Unit  
Corporate and International Tax Division  
The Treasury  
Langton Cres  
PARKES ACT 2600

*By Email: [MNETaxIntegrity@treasury.gov.au](mailto:MNETaxIntegrity@treasury.gov.au)*

Dear Sir/Madam

**MULTINATIONAL TAX INTEGRITY – STRENGTHENING AUSTRALIA’S INTEREST  
LIMITATION (THIN CAPITALISATION) RULES**

1. Thank you for the opportunity to provide comments to Treasury in relation to the exposure draft legislation (“**ED**”) and explanatory memorandum (“**EM**”) relating to the proposed new thin capitalisation rules to apply from 1 July 2023.
2. Pitcher Partners specialises in advising taxpayers in what is commonly referred to as the middle market. Many of these groups have offshore investments and/or offshore investors and also invest alongside other taxpayers with inbound investors or outbound investments. Accordingly, we service many clients that may be impacted by changes to the thin capitalisation rules.
3. We understand that the Government is committed to the policy of implementing an interest limitation rule in accordance with the OECD’s BEPS Action 4 Report (“**OECD Report**”). Accordingly, our submission is not directed towards this policy choice.
4. However, we highlight that there are a number of technical and practical deficiencies contained in the current design of the rules. We believe that many of these critically need to be addressed before legislation is introduced.
5. In particular, the external third party debt test (“**ETPDT**”) as contained in the ED is extremely limited and impractical in its current format and requires significant refinement for it to be a workable replacement for the current arm’s length debt test.
6. Additionally, while the fixed ratio test (“**FRT**”) in the ED is likely to be a straightforward rule to apply, we believe it will provide a significant number of inappropriate outcomes particularly for non-corporate taxpayers.
7. Our review of the key issues and technical problems with the ED has resulted in an attachment containing over 25 pages of (what we consider to be) deficiencies in the current ED. We are significantly concerned that this legislation is being rushed in with

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an application date of 1 July 2023, without appropriate time for Treasury to properly understand the concerns raised, let alone being able to address such concerns.

#### **Delay the start date**

8. We strongly recommend that the start date of the new rules is deferred by 12 months to income years commencing on after 1 July 2024. The new thin capitalisation rules are a radical departure from the existing rules and significantly impact existing structures. While grandfathering or transitional rules may be difficult to implement and design, a 12-month deferred start date may be appropriate given the ED was only released in March 2023 with any final legislation unlikely to be passed prior to 1 July 2023.
9. This would allow taxpayers a fair chance to consider the rules and their impacts on existing arrangements after considering any guidance that the ATO will need time to develop before the rules become operative. In particular, taxpayers should be able to understand the ATO's view on the application of Part IVA to any restructuring of financing arrangements in response to the new rules. A 1 July 2023 start date would not allow taxpayers sufficient time to understand what kind of restructuring would be considered low risk by the ATO. Accordingly, we believe that this is an extremely unfair position to place taxpayers in. Taxpayers should be given some degree of certainty on the operation of the new rules and whether they are able to arrange their affairs to meet the requirements of such rules.
10. Additionally, we believe Treasury should commit to a post-implementation review within 2-3 years so that any major issues arising out of a new thin capitalisation regime be addressed.

#### **Adjust the *de minimis* rule for small and medium enterprises (“SMEs”)**

11. We are significantly concerned about the impact that the proposed changes will have on the middle market. In particular, we do not believe that the middle market exclusions are sufficient to balance the consequences of the proposed legislative amendments.
12. Firstly, we highlight that the \$2 million *de minimis* has not changed since 2014. With rising interest rates, this threshold is likely to be breached by many SME groups. We believe that this threshold no longer reflects an appropriate exclusion for smaller entities for which the compliance costs of the thin capitalisation rules are most disproportionately felt. We therefore suggest increasing this *de minimis* to \$4 million and/or determining this on a net debt deduction basis instead of the current gross basis. We also recommend that this threshold be CPI indexed.
13. Furthermore, the use of a ‘central banking entity’ in a non-tax consolidated SME group has the effect of doubling the ‘debt deductions’ counted under the \$2 million *de minimis* test. This is because the debt deductions are counted on an associate-inclusive gross basis. Accordingly, the internal group lender counts its debt deductions to the external party, while its associate entities count their debt deductions paid to the internal group lender. Given the move to a ‘net debt deduction’ concept, we strongly urge Treasury to update the *de minimis* rule so that it is consistently applied on a ‘net’ basis.

#### **Amendments to make the provisions fair for middle market taxpayers**

14. There are a number of key aspects of the legislation that do not work appropriately and provide anomalous outcomes for middle market structures. We strongly recommend

that the following key areas of the ED should be amended in any finalised Bill that is tabled in Parliament.

- 14.1. Revise the ETPDT to reduce the number of entities required to make a mutual choice.
  - 14.2. Relax the limited recourse requirement under the ETPDT.
  - 14.3. Allow for the conduit financier rule to cater for current commercial financing structures in the market as well as a blend of financing in addition to changes to the “same terms” requirement.
  - 14.4. Provide for excess interest capacity to be utilised by related entities under the FRT.
  - 14.5. Expand the exclusions from the definition of associate entity for certain managed investment schemes.
  - 14.6. Allow for the business continuity test (“**BCT**”) to be considered in respect of the carry forward of FRT disallowed amounts.
15. The following provides some further detail to the above key points. In addition, the Attachment contains a more comprehensive list of technical and other issues and identified in the ED.

***Mutual choice requirement under the ETPDT***

16. The current “mutual choice” requirement for all associate entities that are general class investors having to make an ETPDT for an income year in order for any one of them to make the election is unworkable in its current form for almost all groups. This is particularly so given associate entities for these purposes are those in which a 10% or greater interest is held.
17. The rules need to be modified to properly limit the mutual choice requirement. As a bare minimum, entities that do not have material debt deductions and those that are not required to lodge income tax returns should be excluded from this requirement.
18. Additionally, Treasury should seek to limit this further to ensure the mutual choice requirement is properly targeted to only those entities that are either funded by, or provide funding to, the entity electing to use the ETPDT. Alternatively, Treasury may seek to allow for entities to make elections on a standalone basis and include a more targeted integrity rule to address any mischief arising out of some entities in a group using the ETPDT and other entities using the FRT or group ratio test.

***Limited recourse requirement under the ETPDT***

19. The requirement that a lender only have recourse to the assets of the borrower would result in most genuine third-party loans not satisfying the external third party debt conditions contained in the ED.
20. It is very common for banks to take guarantees over parent entities or underlying assets in subsidiary entities. Further, property development entities commonly take security over the assets of landowning entities. This makes the limited recourse condition particularly difficult to satisfy for non-consolidated groups. Additionally,

trustees of trusts and partners of partnerships may be personally liable for trust and partnership debts respectively, making the condition potentially impossible to satisfy for non-corporate taxpayers.

21. We recommend that the limited recourse rule be expanded so that the lender may have recourse to the assets of the borrower as well as any associate entity of the borrower, provided that associate entity also elects to use the ETPDT that income year. This is not too dissimilar from the conduit financier rule allowing the ultimate lender to have recourse to the assets of multiple entities. The underlying entity will not be able to provide its assets as security more than once under genuine third party financing such that the principle of genuine third party financing would not be undermined by our proposed change to the limited recourse requirement.

#### ***Conduit financier rule under the ETPDT***

22. We suggest that the following features of the conduit financier rule should be modified to allow genuine commercial arrangements funded by third party debt to have access to the ETPDT.

#### ***Same terms requirement***

23. The on-lending on the same terms requirement in the ED is too restrictive and inherently uncertain given the breadth of terms in commercial lending contracts.
24. The requirement should be relaxed to cover on-lending on substantially similar terms. In particular, it should be clear that the conduit financier is able to make a margin from the on-lending of amounts. The inability to do so may jeopardise its own deductions under section 8-1<sup>1</sup> for lacking sufficient nexus to assessable income.
25. Further, the legislation should state what kinds of terms should be considered in order to satisfy this requirement. Terms which do not materially affect commercial outcomes should not have to be considered. We have provided additional comments in our detailed Attachment.

#### ***Blending of financing sources by the conduit financier***

26. The conduit financier rule should be flexible enough to allow for the conduit financier to lend to borrowers with funds obtained from multiple sources including:
- 26.1. Multiple third-party ultimate lenders which each satisfy the external third party debt conditions;
- 26.2. Associate entity lenders of the conduit financier, which would satisfy the external third party debt conditions but for the associate entity condition, where the lender is not an associate entity of the ultimate borrower;
- 26.3. Equity from entities that are not associate entities of the borrower/s, regardless of whether or not they are associate entities of the conduit financier. For example, it should not matter whether an ultimate lender lends directly or via a subsidiary, so long as the ultimate lender is not an associate entity of the ultimate borrower/s.

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<sup>1</sup> All legislative references are to the *Income Tax Assessment Act 1997* unless otherwise specified.

27. For completeness, we highlight that even if the conduit financier raised finance from an ultimate lender that is an associate entity of the borrower/s, this need not result in the entire loan made to the borrower/s as failing the conduit financing rule. Instead, an apportionment rule could apply to deem part of the loan to satisfy the rule to the extent it was ultimately funded from third party sources with the remainder of the loan resulting in debt deductions that would be disallowed to the borrower/s under the ETPDT.
28. Consistent with paragraph 1.78 of the EM, a group entity that raises funds on behalf of other entities in the group would generally raise such funds from multiple sources. The ED currently only allows loans to related borrowers to be sourced from funds raised under a single loan obtain from a single lender.
29. The conduit financier rules should allow multiple sources of finance to be pooled together and lent out to associate entity borrowers. Any interest incurred by the conduit financier in relation to related-party loans would be denied under the ETPDT in any case. Further, there is no evident tax mischief if a lending entity is widely held (e.g. a debt (managed) fund) uses equity to make the loans to associate entities.
30. Further, the use of syndicated debt vehicles using third party investors that acquire units in unit trusts is a common financing structure in the market that would not satisfy the current requirement for the conduit financier to issue a "debt interest".
31. Therefore, we suggest a relaxation of the conduit financing rule to allow for a blend of funding sources. Such an amendment should be considered in conjunction with the "same terms" requirement to ensure the conduit financier lends to the associate entity borrowers on appropriate terms.

#### ***Allocation of excess interest capacity under the FRT***

32. The ED does not currently provide for an ability for entities within an Australian group to utilise excess interest capacity of their related entities. In particular, this results in non-consolidated groups of taxpayers being at a disadvantage as the excess interest capacity of one entity does not automatically offset the excessive debt deductions of another group entity in the same way as a tax consolidated group.
33. Consistently with the OECD Report's recommendations, interest capacity within a local group of entities should be allocated between those entities under rules developed by the relevant country.
34. We recommend that the FRT be modified to provide for this which could be achieved using the existing associate entity excess mechanism in section 820-920. Further, we recommend an extension to allow certain entities within Schedule 2F<sup>2</sup> family groups to surrender any excess interest capacity to other group members to provide for appropriate outcomes to groups with discretionary trusts subject to the thin capitalisation rules.

#### ***Associate entity definition for managed investment schemes***

35. We refer to item 45 of the ED, which seeks to limit the scope of the associate entity rules to certain complying superannuation entities to prevent them from being

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<sup>2</sup> *Income Tax Assessment Act 1936.*

inappropriately subject to the thin capitalisation rules despite not exercising any meaningful control over its associate entities.

36. We recommend a similar amendment be considered to limit the scope of the associate entity concept in section 820-905 for certain managed investment schemes. In particular, many wholesale schemes are subject to the thin capitalisation rules due to the responsible entity being a foreign controlled Australian entity. However, the nature of the managed investment scheme is such that it commercially operates in Australia on standalone basis with no scope for the allocation of excessive debt from foreign associate entities to the Australian managed investment scheme entity (e.g. an Australian unit trust). The responsible entity is regulated and would not have the capacity to allocate excessive debt to a particular scheme. Doing so would also be a breach of its fiduciary obligations to investors as excessive interest costs would significantly reduce their returns or create excessive financial risk.
37. Currently, subsection 820-905(2A) only applies to registered schemes, which are not used in the middle market due to their high compliance costs. This current limitation will unfairly discriminate against middle market business operators and place them at a major competitive disadvantage under the proposed thin capitalisation amendments, as entities that simply register their schemes obtain a more beneficial outcome.
38. We therefore strongly recommend that subsection 820-905(2A) be modified so that it extends to all managed investment schemes, not merely registered schemes. This would ensure that trusts which are majority-owned by non-residents are still subject to the thin capitalisation rules,<sup>3</sup> but not merely because a responsible entity is related to a non-resident.

***Business continuity test for the carry forward of disallowed FRT amounts***

39. We recommend that the carry forward of FRT disallowed amounts for companies not be limited to continuity of ownership testing (“COT”) only. There is no clear rationale why a company that fails COT but continues to carry on the same or similar business should be required to forfeit these amounts.
40. We therefore suggest that utilisation of prior year FRT disallowed amounts also be subject to the BCT if COT is not satisfied. This maintains a consistent approach with tax losses and net capital losses and also provides for more appropriate interactions with the tax consolidation regime for when FRT disallowed amounts are transferred to the head company of a tax consolidated group.

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If you would like to discuss any aspect of this submission, please contact either Leo Gouzenfiter on (03) 8612 9674 or Alexis Kokkinos on (03) 8610 5170 or Brian Farrelly on (03) 8612 9204.

Yours sincerely



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<sup>3</sup> As foreign controlled Australian trusts under s 820-790(1)(c).

Attachment – List of issues in current Exposure Draft

ED Item	ITAA 1997 Provision	Issue	Type	Rating
3-5	705-60 705-112	<p>The ED does not allow a head company to cancel a transferrable FRT disallowed amount such that the step 6A amount would be nil resulting in a higher allocable cost amount (ACA).</p> <p>FRT disallowed amounts are automatically transferred to the head company if the modified COT in section 820-62 is satisfied.</p> <p>The ED should be updated to include an option to cancel the transfer similar to current section 707-145.</p> <p>For example, the FRT disallowed amounts may have been made 14 years ago with little prospect of utilisation by the head company as they will be expiring. Additionally, the head company may be utilising one of the two elective methods and may not have use for FRT disallowed amounts.</p>	Technical legislation	Medium
	705-60 705-112	<p>The ED should include a step 3 adjustment to reverse the effect of step 6A where FRT disallowed amounts have reduced the undistributed profits accruing to the joined group. Without such an adjustment, the FRT disallowed amount will reduce ACA twice. Example 1 demonstrates this issue. It is noted that all other adjustment provisions (Step 3, Step 5, Step 7, etc) contain an ‘anti-duplication’ provision to ensure that this does not occur. Accordingly, 705-112 is currently inconsistent with the current provisions. Example 1 in Appendix A demonstrates this.</p> <p>We recommend that Treasury include a rule similar to s 705-90(2B) to allow the effect of the FRT disallowed amount to not be taken into account in working out undistributed profits of an entity.</p>	Technical legislation	High
	705-112	<p>As highlighted below, we believe that the FRT provisions should contain a business continuity test. To the extent that this is the case, the tax consolidation provisions need to deal with a transferred FRT as either being an “owned case” or an “acquired case”. This is what occurs for all other items (e.g. Step 5 owned losses and Step 6 acquired losses). At the moment, all amounts are being treated as “acquired” FRT amounts, which technically is inconsistent with how tax consolidation is intended to operate.</p>	Technical legislation	Low
43	820-62	<p>Policy is not clearly articulated as to whether FRT amounts can be transferred in a 100% (or &gt;50%) takeover scenario. Given that the trial year ends just <u>after</u> the joining time, any &gt;50% takeover by a consolidated group would cause a failure of the modified COT.</p> <p>If this is the intended outcome, then the EM should state this more clearly (i.e. amounts are only transferred in a formation or stepped acquisition scenario where the ultimate beneficial owners of the head company held over 50% when the FRT disallowed amounts were first made).</p>	Additional EM information	Low

ED Item	ITAA 1997 Provision	Issue	Type	Rating
43	820-62	<p>There should be an ability to transfer FRT disallowed amounts if the Business Continuity Test is satisfied.</p> <p>An entity may forecast start-up losses (including interest expenses) that are recouped many years later. If additional equity is injected in at a later time, or a takeover occurs, it is not clear why those FRT disallowed amounts should be permanently lost if the company's underlying activities remain unchanged. A lack of a BCT may affect the viability of longer-term projects.</p>	Policy	Critical
43	820-62	<p>More clarity is required around whether FRT disallowed amounts are "refreshed".</p> <p>Section 820-62(3) states that the head company has the FRT disallowed amount for the income year mentioned in 820-60(1)(b), being the income year for the disallowed amount. This suggests the 15-year time limit is not refreshed.</p> <p>Section 820-62(7) says for the purposes of s 820-59(7) treat the head company as having the disallowed FRT amount for the income year in which joining time occurs.</p> <p>Paragraph 1.105 of the EM states EM states that this is a similar provision to section 707-140 to ensure "modified COT is not automatically failed for income years occurring after consolidation".</p> <p>Some further EM commentary should clarify that this is not a refresh of the 15-year utilisation period. However, it is not clear if the beneficial ownership is intended to be refreshed, similar to section 707-140. It should be clear that the transferring in of FRT disallowed amounts is not a "COT transfer" that requires future year utilisation to occur in a manner similar to section 707-210. We have provided Example 2 in Appendix A which outlines this issue in further detail.</p>	Technical legislation or Additional EM information	Medium
43	820-62	<p>This item (Item 43) is being inserted at the end of Subdivision 820-FA (which ends at section 820-589). Is it supposed to be section 820-590 – 820-594? Not clear what Subdivision this is supposed to be inserted into.</p> <p>Furthermore, it is unclear why a tax consolidation provision such as this is being drafted into Division 820 (where other similar provisions are drafted within Part 3-90).</p> <p>We recommend you consider placing the provision should be moved into the tax consolidation rules in Part 3-90. For example, within Division 707 or within Division 715.</p>	Technical legislation	Low
43	820-62	<p>Cross referencing errors in s 820-62(4):</p> <ul style="list-style-type: none"> <li>– 820-62(2): "subsection (3)" should be "subsection (4)"</li> <li>– 820-62(4): "subsection (4)" should be "subsection (5)"</li> </ul>	Potential drafting error	Low

ED Item	ITAA 1997 Provision	Issue	Type	Rating
7	820-35	<p>The current de minimis rule is determined on an associate entity inclusive basis and considers whether the gross debt deductions of all such entities are \$2 million or less. No double counting rule exists where the debt deductions are incurred in relation to related entities (and including in the assessable income of related entities).</p> <p>The current ED introduces the concept of net debt deductions into Division 820. The de minimis should be amended accordingly so that it applies where the total <u>net</u> debt deductions of the entity and all its associate entities for the year are \$2 million or less.</p> <p>For example, a group may consist of only two entities, with one entity borrowing from a bank (the central borrower) and on lends to an associate entity. The first entity may pay \$1 million of interest to the bank and the associate entity may pay \$1.05m of interest to the first entity. It is clearly inappropriate that this results in the de minimis being breached even though the related parties only effectively incur \$1 million of net debt deductions.</p> <p>With the introduction of the concept of 'net debt deductions', it is critical that section 820-35 be amended for consistency with this definition.</p>	Technical legislation	Critical
7, 8	820-35 820-37 820-39	<p>The amendment in item 7, which inserts a reference to Subdivision 820-AA into the section 820-35 exemption should be replicated for sections 820-37 and 820-39. This would be consistent with the stated policy in paragraphs 1.113-1.114 of the EM. Further, it would be coherent with s 820-43(5)(a)(ii) which infers that sections 820-37 and 820-39 may prevent Subdivision 820-AA from applying to entities that are general class investors.</p>	Technical legislation	Low
8	820-37(1)(b)	<p>Drafting error – new concept of “outward investing financial entity (non-ADI)” replaces “outward investing entity (non-ADI)”, but (1)(b) keeps the existing reference to “inward investing entity (non-ADI)” when this has been replaced with “inward investing financial entity (non-ADI)” under items 26 and 52 of the ED.</p> <p>References in s 820-37(1)(b) need to be updated to reflect this.</p>	Potential drafting error	Medium
8	820-37(1)(a)	<p>We request Treasury clarify what the following additional words “(and is not a general class investor for the year)”. Are these additional words to avoid doubt? By definition a general class investor cannot be an outward investing financial entity or an outward investing entity (ADI) under 820-43(2)(a).</p> <p>Accordingly, does this cover a situation where an entity is an outward investing financial entity for part of the year because such entities may still be a general class investor for the year (i.e. section 820-43(2) is not satisfied only if the entity is not a financial entity for <u>all</u> of the income year)? We request further information be provided on this.</p>	Additional EM information	Low

ED Item	ITAA 1997 Provision	Issue	Type	Rating
9-11	820-40	<p>Is there a need to remove a reference to <u>the</u> debt interest in s 820-40(2)(c) consistent with the removal from s 820-40(1)(a)(i)?</p> <p>There may need to be a reference to <u>a</u> debt interest or, alternatively <u>the</u> debt interest mentioned in subparagraphs (1)(a)(ii) or (iii).</p>	Potential drafting error	Low
9-11	820-40	<p>With the removal of “debt interests”, we believe that the term “any other amount that is calculated by reference to the time value of money” in s 820-40(1)(a)(i) will be too broad and will be difficult to comply with. We request Treasury to consider additional exclusions once the debt interest requirement is removed. The following is a list of items that we believe should be excluded (as a minimum).</p> <p>GIC/SIC are specific deductions under s 25-5(1)(c) covering tax-related expenses but do not arise out of financing arrangements.</p> <p>Section 974-25 provides an exception from the debt test for short-term schemes (i.e. those with a term of 100 days or less). To reduce compliance costs any interest arising out of such short-term schemes should also be excluded from the scope of debt deduction.</p> <p>Vendors may offer a discount for prompt payment for goods/services. Should the customer not pay the discounted price it is arguable that the difference represents the time value of money. If so, having to determine these kinds of amounts would add significant compliance costs. Consider providing an exclusion for amounts that are not incurred in respect of “financing arrangements” as defined in section 974-130. Such an exclusion should also cover GIC and SIC.</p>	Technical legislation	High
9-11	820-40	<p>The meaning of debt deduction is expanded but the external third party earnings limit in subsection 820-61(1) limits this to debt deductions that are attributable to a debt interest issued by the entity.</p> <p>This creates an asymmetry as any debt deductions under the expanded meanings (i.e. those not incurred in relation to a debt interest) would be denied in full for any entity that uses the external third party debt test.</p> <p>By way of example, subordinated debt provided by a third party may not technically satisfy the ENCO test contained in section 974-135 (i.e. for the purposes of section 974-20, due to the subordination) but may not be contingent on economic performance (for the purposes of section 974-75). Such instruments may still be a loan and thus be subject to section 820-40 (as proposed to be amended).</p> <p>The rules should be amended so that arrangements that aren’t debt interest but that nevertheless give rise to debt deductions can be covered by the external third party debt test if the arrangements under which they are incurred satisfy a third party test.</p>	Technical legislation	High

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-41	Typo in the box as “820B” should be “820-B”	Potential drafting error	Low
12	820-43(1)(b)	Not clear if there is any utility of this paragraph as it appears to always be satisfied. That is, a general class investor will either have not made a choice or will have made a choice.	Technical legislation	Low
12	820-43(3)(b) 820-51(1)	<p>It is unclear what it means to be a period to “correspond” to an income year where the period for accounting purpose does not align to the income year? Where there is a six-month overlap (e.g. 31 December period but 30 June income year) it is not clear which period corresponds (e.g. the period where the first half falls within the income year or where the second half falls within the income year).</p> <p>Please consider drafting a rule to avoid any doubt. For example, s 832-105(1)(b) talks about whether a payment is subject to tax in the same foreign tax period as the income year and contains a timing rule:</p> <p><i>a * foreign tax period that starts no later than 12 months after the end of the income year</i></p>	Technical legislation	Medium
12	820-43(7)	<p>The EM at para 1.38 refers to ability of Commissioner to defer the time under s 388-55 of Sch 1 to the TAA. However, this provision only gives you more time to give the form to the Commissioner (or another entity). That section does not permit more time to <u>make</u> the choice. Section 388-55 is only applicable where the approved form is required to be given to someone as per s 388-50(1)(d). The choices, as drafted in the ED, do not require the approved forms to be given to anyone such that s 388-55 would not be applicable.</p> <p><b>We note that the extent of this power has already been considered in the case of Full Federal Court decision of <i>M W McIntosh Pty Limited v FCT</i> [2009] FCAFC 88 where it was made clear that this power did not allow an extension of time.</b></p> <p>It is therefore critical that the provision should include an ability to seek an extension of time to <u>make</u> the choice. For example, a taxpayer may lodge a ruling request in respect of the application of Division 820. The ATO may not be able to respond to the ruling by the due date. In such a case, the Commissioner should be able to extend the due time to make a choice. Also, a taxpayer may seek an extension to lodge a tax return. Sometimes, these extensions change the due date for lodgement, while other times the ATO only grant a payment extension. In the latter case, a choice would not be available at the time of lodging the tax return (unless the provisions allow for this).</p> <p>We note that election provisions generally provide “or a later time as allowed by the Commissioner”. See for example the rule contained in section 275-115.</p>	Technical legislation	Critical

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-43(5)	<p><u>Mutual choice</u></p> <p>Requiring a mutual choice for the ETPDT method (as contained in proposed section 820-43(5)), will be difficult, if not impossible, to satisfy in most cases.</p> <p>As a starting point, a requirement for all parties to make the choice to use the ETPDT by the lodgment day presents significant challenges, especially given the requirement for all associate entities to make a mutual choice. For example, some associate entities have different lodgment dates than others, particularly if some have substituted accounting periods. The rule therefore requires every entity to make a choice by the earliest lodgment day for all associate entities.</p> <p>The presence of a single joint venture entity in an associate entity group is likely make the other JV party (and all of their associates) associate entities of the unrelated group (due to the 10% threshold). Further, all beneficiaries of a trust and all partners in a partnership are associates of the trust or partnership (as provided by section 318). Having a 10% threshold as the basis for determining an associate entity rule (as proposed by section 820-43(6)) will therefore significantly expand the scope of those entities covered by this provision.</p> <p>Likewise, every foreign entity is an “inward investor” under item 4 of s 820-185(2) regardless of whether they have any Australian presence. If a foreign entity owns only 10% in a trust or a partnership, the whole of that foreign group could be covered by proposed section 820-43(5).</p> <p>Accordingly, the associate entity test proposed by section 820-43(6) is significantly broad and would be extremely difficult to determine. Requiring all parties to make an election in such a case will be almost impossible to satisfy in most cases.</p> <p>As a minimum, we request Treasury amend section 820-43(5) to exclude entities that have no debt deductions for the year from having to make the choice to use the external third party debt test in order for their associate entities to make that election. We also request Treasury amend the provision to exclude entities that do not have a “funding” relationship with the entity making the choice.</p> <p>While these suggested amendments will remove a number of the entities, it still will not exclude the complex requirement of ensuring all parties make the election by the requisite time. Accordingly, we request Treasury consider an alternative to the “mutual choice” requirement of section 820-43(5)</p>	Technical legislation	Critical
12	820-43(5)(a)(ii)	<p>We do not think the legislation achieves what the EM is intending. A literal reading of the provision may be one that suggests the subparagraph is satisfied if the thin cap rules do not apply because one the three listed exceptions actually applies (e.g. the thin cap rules do not apply because the entity satisfies the \$2 million de minimis in section 820-35). If the comma were removed (i.e. after “income year”) then the provision would appear to achieve the intended outcome such that it is satisfied if the thin cap rules are not turned off because of one of the three exceptions.</p>	Potential drafting error	Low

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-43(8)	<p><u>Irrevocable choices</u></p> <p>Given the choices to use one of the two elective tests are for an income year only and temporary in nature, it is not clear why this need be irrevocable in comparison to choices that are expected to have long-lasting duration such as choices to from a tax consolidated group, become an AMIT, make a family trust election, etc.</p> <p>A taxpayer may make a choice to use the external third party debt test and have a dispute with the Commissioner as to whether a minor technical item is otherwise satisfied (e.g., on the security offered under the facility). In such a case, if the Commissioner were to win the argument, this could render 100% of deductions being denied with no fall back to the FRT method where the election is irrevocable. This would clearly be an inappropriate outcome. We submit it is absolutely critical that a taxpayer be allowed to change their choice during the amendment period contained in section 170 (i.e. similar to section 160-16).</p>	Technical legislation	Critical
12	820-43(3)	<p>In relation to the group ratio test, consider including an additional condition such that the election in s 820-43(3) can only be made if the group ratio is greater than 30% for the income year. The only effect of choosing the group ratio (other than the inability to carry forward disallowed amounts) is to substitute a different ratio to the fixed 30% ratio in determining the annual limit on an entity's net debt deductions. The group ratio is applied to the same tax EBITDA as the fixed ratio. Therefore, no taxpayer would sensibly knowingly choose a lower ratio than the 30% available under the FRT, particularly with the loss of carry forward of denied amounts. It may be that a taxpayer miscalculates the group ratio (e.g. thought to be 45%, but it turns out to be 15%). However, this should not be a reason to lock the taxpayer into that as some kind of penalty as a fair outcome would be to have the legislation automatically invalidate that choice such that the FRT applies instead. As there is no mutual choice requirement under the group ratio, a modification of this kind is simple and has no effect on related parties.</p>	Technical legislation	Low

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-45(3) 820-49(b) 820-57(1)(b)	<p>It is not clear whether the provisions intend that net debt deductions for an income year can be a negative.</p> <p>While this is not relevant for the current year tax calculation<sup>1</sup>, it is critical to clarify that net debt deductions can be negative amounts for the purposes of the carry forward of FRT disallowed amounts rule. In our view the legislation supports a negative amount for the purposes of calculating the quantum of the FRT disallowed amount, which we believe is the appropriate outcome.</p> <p>It is therefore important to clarify that: (a) net debt deductions (s 820-45(3)) can be a negative amount; (b) clarify that in working out tax EBITDA that “adding” the net debt deductions under s 820-49(b) for the year results in a <u>subtraction</u> of an amount when net debt deductions are negative; and (c) clarify that in applying s 820-57(1)(b), a negative net debt deduction can result in an increased “excess” of the entity’s current year FRT earnings limit such that the “excess” can be greater than the FRT earnings limit</p> <p>The outcome is demonstrated by Example 3 in Appendix A, which show the proposed clarifications result in a robust operation of the rules.</p>	Additional EM information	Medium
12	820-45(3)(b)	<p>The amounts listed as kinds of interest income are somewhat limited.</p> <p>Consider adopting the section 128A(1AB) ITAA1936 definition of “interest” which is more comprehensive.</p> <p>Further, for consistency with both the income side and the deduction side consider adopting the concepts in the meaning of debt deduction under section 820-40. For example, any fee income derived by an entity that meets the definition in s 820-40(2)(c) (e.g. line fee in respect of a debt interest) should result in a reduction of an entity’s net debt deductions for the year. For example, an intermediary lender that charges a loan establishing fee, which is then passed on to the ultimate lender will not be able to net the “fees” under the proposed definitions (i.e. the expense would be regarded as a debt deduction covered by section 820-40, while the income would not be included in net debt deductions). Clearly this would be an inappropriate outcome.</p>	Technical legislation	High
12	820-45(2)(a) 820-45(3)(a)	<p>Potential drafting error as both paragraphs refer to the same concept, being the total debt deductions for the year but do not use the same term.</p> <p>(2)(a) refers to “the debt deductions of the entity for the income year”</p> <p>(3)(a) refers to “the sum of the entity’s debt deductions for the income year”</p>	Potential drafting error	Low

<sup>1</sup> This is because, even if the amount is deemed to be nil, the ultimate result is that no deductions are disallowed as nil cannot exceed the fixed ratio or group ratio earnings limits which themselves cannot be negative as tax EBITDA is currently deemed to be zero if the result of section 820-40 is negative.

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-49(a)	<p>The starting point of tax EBITDA is taxable income. This would not cover 'net income' of a partnership or trust.</p> <p>Paragraph 820-49(a) should therefore be expanded to cater for partnerships and trusts to state that:</p> <ul style="list-style-type: none"> <li>• The reference to taxable income should instead be to the entity's *net income (for which an existing definition is already included in s 995-1 covering both trusts and partnerships).</li> <li>• For partnerships in particular, that a tax loss should instead be a *partnership loss (for which an existing definition is already included in s 995-1)</li> </ul> <p>A provision that is the modelled on sections 815-305 and 815-310 would achieve this purpose as these provisions expressly cater for the fact that these entities do not have taxable income and that partnerships do not make tax losses.</p>	Potential drafting error	High
12	820-49(c)	<p>The depreciation add-back is severely limited and does not cover other capital allowances in Division 40 (e.g. for primary producers, project pools, software development pools, etc.)</p> <p>Further it excludes small business entities entirely for which tax depreciation is provided for under Subdivision 328-D. Note that these general small business pools still continue to operate in later years even if the entity stops being a small business entity (see subsection 328-220(1)).</p> <p>Section 820-49(c) should be amended to cover all capital allowances (as defined in s 995-1) with an adjustment to exclude balancing adjustment deductions under Subdivision 40-D if necessary.</p>	Technical legislation	High

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12		<p><u>Balancing adjustments</u></p> <p>It is not clear why these should not be added back as part of tax EBITDA. For example, where an entity has under-depreciated an asset (and disposes of the asset for less than its adjustable value) it will have a reduced tax EBITDA by the amount of the deductible balancing adjustment. Conversely, where an entity has over-depreciated (and disposes of the asset for more than its adjustable value) it will have increased its tax EBITDA by the amount of the assessable balancing adjustment.</p> <p>However, it should be the case that both scenarios should result in the same outcome, namely that the tax depreciation should have no bearing on tax EBITDA at all with the decline in value and subsequent balancing adjustment (in either direction) being backed out in calculating tax EBITDA. This may require a clarification that assessable balancing adjustments are subtracted in calculating tax EBITDA.</p> <p>We note that under the current ED, balancing deductions under section 43-40 (as calculated under Subdivision 43-H) for the destruction of capital works would qualify as “deductions under Division 43 for the income year”. There does not appear to be a coherent policy reason why these balancing deductions are added back but Subdivision 40-D balancing adjustment deductions are not.</p> <p>Paragraph 357 of the OECD's BEPS Action 4 report suggests that gains and losses on the disposal of fixed assets should be included in the relevant depreciation and amortisation figure should be treated consistently with the depreciation charges and therefore removed from earnings in calculating EBITDA. As such, this best practice approach would suggest that balancing adjustments are also covered by the adjustment to tax EBITDA in paragraph 820-49(c).</p>	Technical legislation	Medium

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-49(a)	<p><u>Capital gains - trusts</u></p> <p>The current treatment of capital gains under tax EBITDA results in inappropriate outcome for trusts and partnerships.</p> <p>For trusts, where capital gains are eligible for the CGT discount, only 50% of the capital gains made by trusts will form part of the assessable net capital gain and tax EBITDA. This is despite it not being clear whether the beneficiary who is attributed the capital gain under Subdivision 115-C would be eligible for the 50% discount (e.g. they may be a foreign resident or a company). Under s 115-215(3)(b), the beneficiary of the trust is generally required to include an extra capital gain equal to twice the amount mentioned in subsection 115-225(1) (i.e. effectively requires the discounted gain to be grossed-up back to the gross capital gain).</p> <p>Accordingly, the capital gain may not be subject to a discount but may still reduce tax EBIDTA by 50%.</p> <p>To avoid this unfair outcome for trusts that are subject to thin capitalisation, the tax EBITDA should be adjusted such that net capital gain under section 102-5 is adjusted to be the amount remaining after step 2 of the method statement in that section (i.e. before the application of CGT concessions, but after the application of capital losses).</p> <p>We note that this issue is absolutely critical for property funds. In such cases, the FRT method may permanently deny deductions over the life of the asset (due to a lower tax EBITDA). If the ultimate disposal results in a capital gain (some years later), the carry forward amount may not be fully utilised where only half of the gain is included in tax EBITDA.</p>	Technical legislation	Critical
12	820-49(a)	<p><u>Capital gains – Partnerships</u></p> <p>Partnerships do not make capital gains in relation to their CGT assets. Instead the partners of the partnership make the capital gain as per section 106-5. However, a partnership entity may be subject to thin capitalisation where debt deductions are incurred at the partnership level. The misalignment between the level at which the debt deductions are incurred to where the capital gains affect tax EBITDA creates adverse outcomes for partnerships. To achieve a fair outcome and adjustment may be required for the purposes of the definition of tax EBITDA to allow a partnership to increase its tax EBITDA by the total capital gains made by the partners in relation to the CGT assets of the partnership in accordance with section 106-5. To avoid double counting, the partners should have to reduce their tax EBITDA by their proportion of these capital gains made in relation to the partnership assets.</p>	Technical legislation	Critical

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-49(a)	<p><u>Trusts and NANE amounts for withholding</u></p> <p>Income that is subject to non-resident withholding tax may be considered non-assessable non-exempt (NANE) of a Division 6 trust (under section 128D ITAA1936) or a Managed Investment Trust (under section 840-815). For example, interest income derived by a trust that is then distributed to a non-resident investor.</p> <p>The ATO has taken the view that certain categories of income derived by a trust are treated as NANE income of not only the beneficiary, but also the trust, where the beneficiary is liable for non-resident withholding tax (e.g. on interest, dividend and royalty income).</p> <p>Refer to <a href="#">ATO ID 2002/93</a> (regarding interest income) and <a href="#">ATO ID 2002/94 (Withdrawn)</a> (regarding unfranked dividend income).</p> <p>If this view is correct, this would significantly reduce the amounts that could form part of the tax EBITDA of trusts where there are material interests held by non-resident beneficiaries.</p> <p>Further, for managed investment trusts, the NANE treatment also extends to amounts subject to MIT withholding (e.g. rental income, capital gains from taxable Australian property) such that effectively no amounts contribute to the tax EBITDA of a MIT to the extent of its non-resident ownership.</p> <p>Additionally, for interest income derived by a trust that is subject to non-resident withholding tax where it flows through to a non-resident beneficiary, such amounts may not reduce the net debt deductions under s 820-45(3)(b) as they may not be included in assessable income.</p> <p>The ATO view also has the potential to make interest incurred in deriving such NANE amounts as non-deductible at the trust level under ordinary principles (i.e. under s 8-1(2)(c)) such that the thin cap rules may not even have scope to operate if the amounts are already non-deductible.</p> <p>To deal with these issues, it is suggested that a modification be included for trusts (other than public trading trusts and superannuation entities) that requires them to disregard the operation of Divisions 11A of Part III of the ITAA1936 and Division 840 of the ITAA1997 in calculating their tax EBITDA and their net debt deductions for an income year.</p>	Technical legislation	Critical
12	820-49(d)	<p>There is potential circularity in the tax loss adjustment to tax EBITDA. To avoid doubt, paragraph 820-49(d) should state that the tax losses deducted are those that are deducted “disregarding the operation of this Division” similar to the words used in paragraph 820-49(a). Presently, there is some confusion as to whether the application of Division 820 results in the denial of a deduction and the consequent use of additional prior year tax losses resulting in a further application of the FRT with a new adjustment for tax losses required.</p> <p>Refer to Example 4 in Appendix A which demonstrates this.</p>	Potential drafting error	Medium

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-49(d)	<p>An additional interaction may be required under section 36-17 for corporate tax entities. The amount of tax losses deducted by a corporate tax entity is the amount it chooses to deduct, with a limit to prevent deducting tax losses in a way that would result in excess franking offsets for the year. This may present a difficulty where the denial of deductions under the FRT method then allows the corporate tax entity to deduct further tax losses. Essentially the company would need to remake its choice, and this may not be currently provided for in the legislation.</p> <p>However, section 820-49(a) may use an amount that is (prima facie) the choice amount, which then (through the application of section 820-49) may result in a breach of the requirements of section 36-17.</p> <p>To solve this issue, the rules should contain a further amendment to section 36-17 allowing a choice to be remade in the circumstances where the FRT method results in a denial of debt deductions or state that the corporate tax entity can make a hypothetical interim choice for the purposes of determining its taxable income under section 820-49(a).</p> <p>Example 4 in Appendix A also considers this.</p>	Technical legislation	Medium
12	820-49(d)	<p>Consider simplifying drafting in paragraphs 820-49(c) and (d) by removing “from its assessable income”.</p> <p>These additional words may be redundant as it is sufficient to refer to the sum of the relevant deductions for the income year.</p> <p>The term deduction is defined in section 995-1 by reference to sections 8-1 and 8-5 (and does not need to be asterisked as per 2-15). Sections 8-1 and 8-5 both mention that entities can deduct amounts “from your assessable income” such that it is unnecessary to repeat this phrase in other provisions referring to deductions.</p>	Technical legislation	Low
12	820-51(1)	<p>The provision refers to an entity being “a GR group member for a period of a GR group for the period”.</p> <p>Consider simplifying to “a GR group member for a period” to avoid confusion.</p>	Potential drafting error	Low
12	820-51(2)	<p>It is unclear whether a GR Group can be a group of entities that comprise a single tax consolidated group even though the group prepares audited consolidated financial statements. This is where the worldwide parent entity is the head of the tax consolidated group and the only members of the accounting group are the members of the tax consolidated group.</p> <p>That is, the single entity rule may apply in such a way that the head company is the only “entity” such that the requirement in s 820-935(2)(a) is not satisfied. We recommend a clarification that the single entity rule does not operate to prevent a tax consolidated group comprising a GR Group.</p>	Technical legislation	Low

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-51(2)	<p>Additional clarity is required (e.g. in the EM) in relation to the term “fully consolidated on a line-by-line basis”.</p> <p>Does this suggest that entities that are 99% owned by a group would not be fully consolidated if the consolidated financial statements only consolidates 99% of the entity’s income and expenses?</p>	Additional EM information	Low
12	820-53(1)	<p>On the current drafting the ED could be read as paragraphs 820-53(1)(a) and (b) overriding what is actually disclosed in the financial statements as interest by creating a hypothetical net interest expense (i.e. what <u>would</u> be the net interest expense if it consisted of amounts under (a) and (b)) which would essentially exclude all amounts that actually are interest expenses under the ordinary meaning. If such a view were to occur, this would be very difficult in practice (i.e. to unpick the amounts out of the financial statements).</p> <p>Consider a change to the first paragraph such that it is modified to “on the basis that the following <u>were also</u> treated as interest” to clarify that these are extensions and are not intended to override the financial statements.</p>	Potential drafting error	Medium
12	820-53(2)	<p>It is not clear why the words “third party” are used in reference to interest expenses and interest income. That is, the only defined term is “adjusted net third party interest expense” in section 820-53(4). However, this concept of “third party interest expense” is undefined.</p> <p>The consolidated financial statements should already ignore intra-group amounts and will instead, simply disclosure interest income or expenses (i.e. being payments to entities outside of the group).</p> <p>A court may be required to give meaning to the words “third party” and if they are not strictly needed it is suggested that these are removed. We believe that the section operates as intended after removing these words.</p>	Technical legislation	Medium
12	820-53(3)	<p>It is unclear why you need such a complex rule to determine the amounts covered by subsection (3). We believe that the subsection could simply cover a payment if “the payment is made by an entity to an associate entity where only one of the two entities is a GR group member”.</p>	Technical legislation	Low
12	820-53(4)(a) and (b)	<p>The word “is” appears to be mistakenly included. Alternatively the word “that” should be included before “is”. The provisions should read:</p> <ul style="list-style-type: none"> <li>• a payment <del>is</del> made by the entity... OR a payment <b>that</b> is made by the entity</li> <li>• a payment <del>is</del> made by an associate entity... OR a payment <b>that</b> is made by an associate entity</li> </ul>	Potential drafting error	Low

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-53	<p>The Treatment of capitalised interest expenses is unclear. Paragraph 134 of the OECD's BEPS Action 4 report states that capitalised interest is to be specifically adjusted for in the net third party interest expense and may be recognised "in the period where the interest is incurred, or as it is amortised over the life of the related asset".</p> <p>It is unclear if the current modifications in s 820-53(1) are intended to specifically include capitalised interest in the year they are incurred as "amounts calculated by reference to time value of money" despite the amounts not being recognised as expenses in the year they are incurred.</p> <p>If amounts of capitalised interest are not included in full in the year they are incurred they would not appear to be captured in later years as they would not be disclosed as interest expenses in those years. Rather, they may be treated as amortisation expenses and instead added back to increase the group EBITDA (denominator) and this reducing the group ratio without ever being including group's net third party interest expense (the numerator).</p> <p>For example, \$100 of capitalised interest expense in year 1 should result in \$100 in the numerator and \$100 added back to group EBITDA in denominator. When the \$100 is amortised over its life it should NOT be added back to group EBITDA as this would unfairly reduce the ratio.</p> <p>Therefore, it should be clarified that net third party interest expenses should include amounts of capitalised interest incurred during the period. Further, the definition of amortisation expenses should thus be amended to specifically exclude amounts of amortisation of capitalised interest expenses.</p>	Technical legislation	High
12	820-55(1)(a) 820-55(2)(a)	<p>The starting point to calculate EBITDA is net profit. This should include net profit or loss with a loss treated as a negative amount consistently with the concept of tax EBITDA in section 820-49(a).</p> <p>This would ensure that group EBITDA is not overstated for groups that have an accounting loss for the year.</p> <p>Further, if the starting amount of entity EBITDA is nil (rather than negative) where the entity has made a loss for the year, then subsection 820-55(3) may have little scope to operate as entity EBITDA is unlikely to ever be a negative if calculated by adding amounts to a nil starting amount.</p>	Technical legislation	Low
12	820-55(1)(b) 820-55(2)(b)	<p>Both paragraphs use the concept of "adjusted net third party interest expenses".</p> <p>Paragraph (1)(b) has a clear reference to s 820-55(4) but paragraph (2)(b) is not clearly defined. This is because section 820-55(4) refers to an "entity's" net third party interest expenses, whereas a GR Group may not be an entity as that term is used in the ITAA1997.</p> <p>Suggest that a definition of "GR group net third party interest expense" be defined to be the amount in s 820-55(1). This amount works in conjunction with subsections (2) and (3) encompassing the relevant adjustments required.</p>	Technical legislation	Low

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-55(3)	<p>It is not clear what the effect of the single entity rule is in disregarding specific entities with negative EBITDAs. For example, a foreign parent may own two separate tax consolidated groups, which are consolidated in a foreign parent's financial statements. The single entity rule does not extend to looking at another tax consolidated group and therefore the SER may be limited when applied in the context of applying this formula.</p> <p>To avoid groups having to consider specific entities with a tax consolidated group, we believe it should be clarified that the single entity rule applies such that the members comprising a tax consolidated group (with the broader accounting consolidated group) are taken to be one entity for these purposes. Similar provisions are contained in Division 715 (which extend the SER to make provisions work properly). See for example section 715-875.</p>	Technical legislation	Low
12	820-51 820-43	<p>Currently section 820-43(3)(c) prevents an entity from choosing to use the group ratio test where the group EBITDA is negative. However, section 820-51 contemplates that the group ratio could be negative and deems the amount to be nil.</p> <p>Presumably this could be the case where the numerator (i.e. group net third party interest expense) is negative but the denominator (i.e. group EBITDA is positive). If the rules contemplate that the third party interest expense can be negative then this should be stated to avoid doubt and clarified that adding such a negative amount results in a subtraction.</p>	Technical legislation	Low
44	820-985	<p>The provision states that records need to be prepared by the time the tax return is due. Consider extending this to the time the entity actually lodges the return in case it is lodged late. Existing failure to lodge penalties deal with late lodgment with potential SGE penalties of 500 times. There should not be a further penalty for late lodgment if the group ratio records are prepared between the due date and the actual lodgment date.</p>	Technical legislation	Low
12	820-57	<p>For entities that use prior year tax losses, clarify that where prior year FRT disallowed amounts are deducted in later years (under section 820-57), that this results in a reduction of the amount of tax losses deducted for the income year. That is, it is important to clarify the order of priority of the provisions. See Example 5 in Appendix A that demonstrates this issue.</p>	Technical legislation	Low

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-57 820-59	<p>The carry forward of FRT disallowed amounts is not appropriate for partnerships. Instead, the partners should have the FRT disallowed amount.</p> <p>Allowing a partnership to carry forward such amounts presents an integrity risk as there is no existing continuity of ownership type rule for partnerships. Instead, the taxation of partnerships involves the flow through of partnership losses to partners (as deductions) with continuity of ownership testing occurring at the level of the partners if they are companies or trustees.</p> <p>This lack of any such testing could allow new investors to subscribe for partnership capital and potentially inappropriately access the benefit of these deductions in later years. Furthermore, as investors would otherwise obtain the benefit of a tax loss in a partnership, they should also benefit from the carry forward FRT amount.</p> <p>Accordingly, the ED should be amended to allocate any disallowed FRT amount for an income year to the partners of a partnership based on their respective shares of the net income or partnership loss for the income year.</p> <p>Further, in income years where amounts are not disallowed, any excess interest capacity of the partnership (under s 820-57(1)(b)) should similarly be allocated to the partners on the same proportionate basis. This ensures that the partners receive an appropriate share of the partnership's tax EBITDA for the year rather than merely its share of the partnership's net income, being an amount reduced by net debt deductions and capital allowances at the partnership level and not added back at the partner level.</p> <p>We highlight that various provisions in the tax law make special provisions for partnerships in such ways allowing for the flow-through of tax attributes. For example, see Subdivision 245-F containing special rules relating to partnerships that have net forgiven amounts under the commercial debt forgiveness rules. Those rules operate to allocate certain amounts to the partners based on their respective shares in the partnership.</p>	Technical legislation	High
12	820-59(4)	There is a superfluous "the" in the sentence (" <u>the</u> an amount").	Potential drafting error	Low
12	820-59(7)	Unclear why subsection 165-12(1) needs to be disregarded as s 820-59(7)(c) makes the relevant modifications to the meaning of the ownership test period. If section 165-12(1) were disregarded in its entirety, then how does one apply section 820-59(6) which states that an entity must satisfy that provision?	Technical amendment	Medium

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-61	<p>In the middle market, it is not uncommon for debt to be provided by a managed investment fund. The middle market provides a substantial amount of debt funding through, what is referred to as, non-bank lending vehicles. Many of these entities are “registrable” entities for APRA purposes.</p> <p>The non-bank lender may constitute a managed fund and may be owned 100% by unrelated parties. However, as the trustee of the managed fund may be an associate of the ultimate borrowers, the managed fund may not be an entity that is regarded as a third party. This is because there is a different associate entity test for wholesale managed funds (used in the middle market) and retail managed funds (used in the “big end of town”). This distinction is contained in the current section 820-905(2A) which only applies for retail schemes, whereby a wholesale scheme is always caught within the associate entity rules as it is required to apply section 820-905(1)(b).</p> <p>This means that most managed funds in the wholesale space will likely fail the requirement of section 820-61(2)(a) where debt is issued provided to a party associated with the trustee.</p> <p>There are non-bank lending managed funds in the middle market with loan portfolios typically ranging between \$100 million to \$2 billion. These funds are managed investment scheme (MIS) entities and are subject to stringent AFSL licencing requirements, appropriate widely-held and closely-held rules and are subject to acting in the best interests of investors.</p> <p>If section 820-905(2A) remains as is, this will place managed funds in the middle market at a competitive disadvantage as compared to retail schemes in the big end of town (even though the two funds may be equivalent in substance), as such funds may not be able to access the third party debt test (especially where the Fund is used to provide debt to a “conduit entity” that then lends to an ultimate borrower).</p> <p>Given the heavy focus on distinguishing between related party and third party debt, we request that Treasury consider an amendment be made to section 820-905(2A) that extends the provision to all managed funds that are MIS arrangements (and not just registered managed funds). This outcome replicates what would occur if the lenders lent directly to the ultimate borrower (and did not provide funding through a collective investment vehicle).</p>	Technical amendment	Critical

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-61(2)(c)	<p><u>Limited recourse rule does not properly consider trusts and partnerships</u></p> <p>Trustees are personally liable such that all their assets are at risk. Normally a creditor would only have rights to be subrogated to trustee's right of indemnity such that they would only have recourse to assets forming the trust estate where there is no breach of trust. Any other trust estates with the same trustee would not have their assets exposed.</p> <p>However, the creditor would still have recourse to the trustee's <u>personal</u> assets. For a \$2 corporate trustee this would include those \$2. As such there would be a technical failure of the limited recourse rule unless specific clauses in the loan contract limit the recourse to assets belonging to the trusts.</p> <p>For partnerships the same issue arises as partners are jointly and severally liable. Even for limited partnerships (which is deemed to be a company) technically there should be one general partner whose own assets are at risk and such assets do not belong to the entity that is the limited partnership (or deemed company).</p> <p>The limited recourse rule should be adjusted for trusts and partnership to disregard the effect of the general law on the liability of trustees and former trustees of a trust and for partners of a partnership or limited partnership.</p>	Technical amendment	Critical
12	820-61(2)	<p>The provisions current require recourse be had "only to the assets of the entity". In the middle market, this condition would rarely be satisfied. If the parent entity owns 100% of the shares in a subsidiary, it would be rare that the financier would not have recourse to both the "equity" in the subsidiary and its assets. Generally speaking, such security would be the same and does not provide the lender entity with additional security. This would be the same for a JV participant in a joint venture arrangement (who seeks funding at the JV partner level).</p> <p>Furthermore, parent company guarantees, personal guarantees and director guarantees are also predominant in almost all financing arrangements and would also appear to breach this condition.</p> <p>From a practical perspective, Treasury need to consider relaxing this condition to ensure that it is capable of being complied with in practice.</p>	Technical amendment	Critical

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-61(5)	<p>We recommend a number of modifications are required to clarify the operation of the conduit financier provision.</p> <ul style="list-style-type: none"> <li>Clarify that <u>not all</u> associate entities have to borrow amounts from the conduit financier. On the current drafting, it may suggest that all entities that are associate entities of each other are borrowers (under paragraph (b)) such that each must issue a debt interest to the conduit financier.</li> <li>Clarify that one borrower is sufficient. Paragraph (b) seems to suggest there only needs to be one ultimate borrower by referring to "<u>one</u> or more other entities" but it is not clear how one entity can be an associate entity of itself.</li> <li>The restriction in paragraph (d) is too limited. There may be mixture of borrowings funding the conduit loan. This could be a mixture of different third party debt. While the conduit financier could lend out to associates via two or more separate loans and trace these back to each separate ultimate lender but not clear why this is strictly necessary. A group treasury entity would generally raise finance from various sources and lend these amounts out to other group entities from a pool of funding. If there is such strict tracing required such that the conduit financier is essentially a pass-through entity that simply obtains a loan and on-lends those specific amounts to a related party on the same terms (rather than lending from a mixed pool of funds) then there is little to no scope for the rule to operate. In such cases, the ultimate borrower would probably seek to borrow directly from the external third party debt provider if it wished to access the external third party debt test.</li> <li>It should be clarified that the conduit financier rule can operate where there are two or more conduit financiers between the ultimate lender and the ultimate borrower. An amendment can be included to clarify that the successive application of the rules could result in the first conduit financier becoming the "ultimate lender" for the purpose of the next application of the rules. For example, the first application of the rules could result in a loan between the first conduit financier and the second conduit financier to satisfy the external third party debt conditions. This would mean that paragraph (f) is satisfied so that the loan from the second conduit financier to the ultimate borrower can satisfy the conduit financier rule.</li> <li>It is unclear how a conduit financier can still satisfy the conditions in subsection (2) in relation to the loan it obtained from a third party where it is seeking to on-lend this amount to ultimate borrowers under the conduit financier rule. The requirement in paragraph (2)(c) (about limited recourse) would appear to not be satisfied if the ultimate has recourse to assets of other entities (i.e. the ultimate borrowers). The conduit financier rule facilitates the ultimate lender having recourse to the assets of each of the ultimate borrowers, as per s 820-61(4)(b)(ii), but in doing so would cause the conduit financier to fail the external third party debt conditions. Currently, subsection (4) only affects the references to paragraph (2)(c) in relation to the relevant debt interest mentioned in subsection (5). It should also affect the references to the debt interest mentioned in (2) so that the conduit rule not only assists with the on-lending by the conduit financier but also operates such that the initial loan to the conduit financier can still satisfy subsection (2).</li> </ul>	Technical amendment	Critical

ED Item	ITAA 1997 Provision	Issue	Type	Rating
12	820-61(5)(e)	<p>It will generally not be possible to replicate the “same terms” through a conduit financing entity. For example:</p> <ul style="list-style-type: none"> <li>• Where a third party financier has provided debt financing secured over real property by way of a first mortgage, it is not possible to replicate that security interest through the intermediary loan. We are unsure why this rule is required. We believe the risk is the “net interest margin” charged by the conduit entity.</li> <li>• A conduit entity may take a first secured mortgage on a loan to an ultimate borrower, which is funded by external financiers through the loans to the conduit entity. The loans from the external financiers may take security over the loan agreement to the ultimate borrower (and essentially, they can assume the overall arrangement and the first secured mortgage by stepping in the shoes of the lender). The terms of a limited recourse arrangement (such as this) would not be the same terms, but essentially this is a form of back-to-back arrangement.</li> </ul> <p>Due to the significant difficulties in trying to create a rule on “same terms”, we instead believe that Treasury should only be concerned about interest rate margin for the conduit. That is, Treasury should consider a “safe harbour” for section 820-61(5)(e) where the “margin” made by the conduit is no greater than 300 basis points (which is the general margin derived by conduit financing entities in the middle market). We note that this is higher than in the public market, due to the higher cost structure and lower volume of transactions.</p>	Technical amendment	Critical
12	820-61(6)	<p>The rationale as to why another choice is required under subsection (6) is unclear.</p> <p>All such borrowers and the conduit financier having to make a choice to use the external third party debt test for the year under the mutual choice rule.</p> <p>It should be sufficient for these entities to then self-assess whether their borrowings satisfy the conduit financier rule without having to make another election that year.</p> <p>While a conduit financier may be exempt from thin cap or may be a financial entity using the balance sheet safe-harbour method, such that they do not choose to use the external third party debt test, there still appears to be no obvious reason while the ultimate borrowers effectively have to make two choices.</p> <p>The additional choice does not prevent the ultimate borrower of issuing further debt interests directly to an external lender that meets the external third party debt conditions under s 820-61(2). It would be implicit in any choice to use the external third party debt test that an ultimate borrower would be seeking to apply to the conduit financier rule to any related-party debt that meets the requirements in subsection (5).</p> <p>If these is merely for information purposes, then this could simply be done by way of a disclosure in a tax return without adding an additional legal threshold to the use the conduit financier rule.</p>	Technical amendment	Critical

ED Item	ITAA 1997 Provision	Issue	Type	Rating
13, 26	820-85(2A), 820-185(2A)	<p>Financial entities can make external third party debt test elections or use the balance sheet safe harbour.</p> <p>We submit that financial entities (non-ADIs) should also have access to the fixed ratio test if they so choose.</p> <p>Currently, these entities are at a disadvantage as a general class investor appropriately can assess their position using the net debt deduction concept (i.e. no denial under the FRT if interest income exceeds interest deductions).</p> <p>Financial entities should be able to obtain the same outcome rather than being subject to the balance sheet test which considers gross debt deductions. Being able to elect into the FRT would simplify compliance for many financial entities as a simple tax calculation could confirm no denial of debt deductions (if net debt deductions are nil or negative) instead of requiring a complete balance sheet calculation to be undertaken.</p> <p>If financial entities can elect into the FRT, they would have to elect into FRT every subsequent year in order to utilise any carry forward FRT disallowed amounts.</p>	Technical amendment	Medium

## Appendix A – Examples

### Example 1 – Operation of section 705-60 and 705-112

Head Co establishes a subsidiary (Sub Co) with \$1,000 of share capital. Sub Co uses the \$1,000 in addition to borrowing \$15,000 to fund working capital in its business.

Sub Co makes \$10,000 in net operating income from carrying on its business and incurs \$4,000 of interest expenses. Sub Co repays the working capital loan in full.

Under the FRT method, Sub Co is denied \$1,000 of deductions in relation to its interest expenses (i.e. tax EBITDA is \$10,000, the FRT limit is \$3,000 with \$1,000 of the \$4,000 of interest incurred disallowed as deductions). Sub Co has \$7,000 of taxable income and a tax liability of \$2,100.

Sub Co's assets consist of \$4,900 of cash. This is the \$1,000 of cash funded by share capital and a further \$3,900 of retained earnings being:

\$10,000 of net operating income *less*

\$4,000 interest expense *less*

\$2,100 income tax paid.

**\$3,900 total retained earnings**

Head Co chooses to form a tax consolidated group with Sub Co, resulting in the transfer in of \$1,000 of FRT disallowed amounts.

Head Co's ACA in Sub Co will be:

\$1,000 cost base in Sub Co's shares (step 1)

\$3,900 taxed profits accruing to the joined group (step 3)

(\$300) FRT disallowed amount x corporate tax rate (step 6A)

**\$4,600 Total**

Under the tax cost setting rules, \$4,900 is allocated to retained cost base assets result in a \$300 capital gain under CGT event L3 as a result of the tax cost setting amount for retained cost base assets exceeding the ACA of Sub Co.

Effectively, this results in Sub Co being taxed twice on the \$1,000 of disallowed debt deductions and is inconsistent with the object of the tax cost setting rules as set out in section 705-10 as the cost of acquiring the \$4,900 of underlying cash should be \$4,900 rather than \$4,600. An appropriate outcome would occur if the Step 3 amount is not reduced by expenses that are otherwise taken into account under another step. In this case, this is the \$300 additional income tax expense (that reduces retained earnings) in respect of the \$1,000 FRT disallowed amounts. An anti-duplication rule is required to remove this double counting.

### Example 2 – Operation of section 820-62

Test Co has always been owned by Individual X (49%) and Consol Head Co (51%). Consol Head Co has always been wholly-owned by Individual Y. Test Co has FRT disallowed amounts for the 2024 income year.

Consol Head Co acquires the 49% interest of Individual X in the 2026 year such that Test Co joins the Consol Head Co tax consolidated group (and transfers in the FRT disallowed amounts).

Is it the case that the beneficial ownership is “refreshed” for later year utilisation of the FRT disallowed amount such that Individual Y is taken to own 100% at the start of the ownership test period? Would a 1% transfer of shares by Individual Y in Consol Head Co to Individual Z cause a subsequent failure in respect of utilising the disallowed FRT amount (i.e. because COT testing is done based on beneficial ownership back to the start of the FRT disallowed amount year) or would a 50% transfer be required to Individual Z to cause such a failure (i.e. because the beneficial ownership of Test Co is refreshed to the ownership as at joining time)?

These answers to these questions require clarification in the EM.

### Example 3 – Negative net debt deductions

As a starting premise, an entity has \$300 of interest deductions and \$300 of interest income for the year. Its net debt deductions are nil and its tax EBITDA is nil. The expenses are deductible in full and the result is no taxable income or loss for the year.

If however, these facts are modified such that the \$300 interest income is derived over two income years:

Year 1  
\$300 Interest expenses  
\$200 Interest income

Year 2  
\$100 Interest income

The overall outcome should still be that the \$300 of interest expenses are deductible in full over those two years with \$200 deductible in year 1 (as the nil tax EBITDA results in \$100 disallowed in year 1) and \$100 deductible in year 2 under section 820-57 as a carry forward amount (assuming COT is satisfied).

Importantly, to use the denied FRT amounts in year 2, the entity should only need \$100 of interest income in year 2 rather than \$333 of other income (e.g. sales income).

To obtain the right outcome there needs to be a \$100 “excess” under s 820-57(1)(b).

In order to conclude that there is such an excess:

- the fixed ratio earnings limit for year 2 should be nil;
- the net debt deductions for year 2 should be negative \$100;
- the excess of nil over negative \$100 should be \$100

For the fixed ratio earnings limit in year 2 to be nil, the tax EBITDA needs to be nil. The way to achieve a nil tax EBITDA in year 2 is to reduce the \$100 of taxable income by \$100 of net debt deductions (i.e. by treating net debt deductions in year 2 as negative \$100 and subtracting an amount under s 820-49(b)). That is, it needs to be confirmed that “adding” negative net debt deductions results in a subtraction.

To have a \$100 excess in s 820-57(1)(b) it should be confirmed that when comparing the fixed ratio earnings to the net debt deductions for the year, where the latter is a negative amount, that the excess over a negative amount is essentially the adding of the negative amount to the fixed ration earnings limit.

If the example is changed to also have \$100 of sales income in year 2, the tax EBITDA will be \$100 with a \$30 FRT limit. The “excess” should now be \$130 (being \$30 less -\$100 net debt deductions). This allows prior year FRT amounts to be deducted in full resulting in \$100 taxable income. Effectively this would result in the use the prior FRT amounts on a 1:1 basis against interest income and leaving the other \$100 sales taxable as per normal (i.e. at 30% corporate rate).

If the example is further changed to have \$50 sales and \$50 interest income in year 2 then tax EBITDA becomes \$50 with a \$15 FRT limit and a \$65 excess (i.e. \$15 limit less -\$50 net debt deductions). Using \$65 of the prior year \$100 FRT amount results in taxable income of \$35. Effectively \$50 of the denied FRT amount is used against \$50 of the next year interest income (on a 1:1 basis) and \$15 is used against the \$50 other taxable income (on a 3:10 basis).

By way of contrast, a current reading of the rules could be one under which net debt deductions cannot be negative. While we do not think this is the better view, inappropriate outcomes would occur. The main example above would result in \$100 of tax EBITDA in year 2 (as the \$100 of taxable income is not reduced by any amount) and an FRT limit of \$30 for the year. Under section 820-57 the excess of the FRT limit over the net debt deductions for the year would only be \$30 such that the entity can deduct only \$30 (of the prior year disallowed amount) against the current year interest income rather than the full \$100. This would not result in a sensible outcome.

#### Example 4 – Circularity of the calculation of tax losses

ABC Pty Ltd has \$1,000 of sales income, \$400 of debt deductions for the year with \$10,000 of prior year carry forward losses it may utilise.

ABC Pty Ltd calculates its tax EBITDA as \$1,000 on the basis of its starting taxable income being nil after choosing to utilise \$600 of prior year tax losses. The \$400 of debt deductions and \$600 of tax losses utilised are added to result in a tax EBITDA of \$1,000 and \$300 FRT limit.

ABC Pty Ltd is denied \$100 of debt deductions, increasing its taxable income to \$100. ABC Pty Ltd wishes to use an additional \$100 of prior year tax losses to reduce its taxable income to nil.

It should be made clear that ABC Pty Ltd can actually then deduct this additional \$100 of tax losses (i.e. \$700 in total) and that this does not then result in a reapplication of the FRT by requiring a different add back under s 820-49(d) due to the amount of tax losses deducted having changed.

#### *Example continued... considerations for corporate tax entities*

Further to the above, ABC Pty Ltd may be considered to have already chosen to deduct only \$600 of tax losses under s 36-17(2) which limits the choice to the excess of total assessable income less total deductions (except tax losses) for the year.

Subsections 36-17(10)-(13) provide for the changing of choices following the recalculation of amounts after an entity has lodged its income tax return. These provisions would not appear to apply to this example as the changing of the choice is not due to a recalculation after lodging and income tax return. Rather it is a recalculation is as a result of applying Division 820.

It may be argued that ABC Pty Ltd only makes one choice, being to deduct \$700 of prior year tax losses after the application of Division 820 and that it is only making a hypothetical choice for the purposes of determining its tax EBITDA. However, this is not free from doubt.

#### Example 5 – Order of provisions

XYZ Pty Ltd has \$100 of sales income for the year with \$100 of prior year tax losses and \$30 of prior year FRT disallowed amounts.

XYZ Pty Ltd's tax EBITDA is \$100, being its taxable income of nil with the \$100 of tax losses deducted being added back. Its FRT limit is therefore \$30 and has a \$30 excess for the year as it has no debt deductions. XYZ Pty Ltd utilises the \$30 carry forward deduction under section 820-57.

This should result in only \$70 of tax losses being deducted (instead of \$100) in order for it to reduce its taxable income to nil (i.e. it uses \$30 of the prior year FRT disallowed amount and \$70 of prior year tax losses and carries forward \$30 of those tax losses to later years).

An alternative view is that XYZ Pty Ltd deducts both the \$100 tax loss and the \$30 prior year FRT disallowed amount under s 820-57 such that the result for the year is a \$30 tax loss. This would effectively result in the prior year \$30 tax loss being refreshed to a later year \$30 tax loss and should not be the preferable view.

This raises similar issues to those referred to above in relation to s 820-49(d). If it is clarified that the tax losses deducted are calculated "disregarding the operation of this Division" this should also have the effect of ensuring section 820-57 works appropriately. An EM example may also be added.

Also refer above to the potential interaction issue with section 36-17 and the remaking of choices by corporate tax entities. The suggestions made regarding section 36-17 should also effectively deal with the issue raised in this example.