

Submission to the
consultation on the
exposure draft for
strengthening
Australia's interest
limitation (thin
capitalisation) rules

BCA Submission

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1. Overview

The Business Council welcomes the opportunity to provide a submission to the consultation on proposed changes to deliver on the government's election commitments on strengthening Australia's interest limitation (thin capitalisation) rules.

All companies must meet their tax obligations and where arrangements do not keep pace with community norms, they should be reviewed. Robust tax integrity and transparency measures are an integral complement to more competitive business tax arrangements.

Australia has some of the strongest tax integrity rules in the world, and they have been strengthened over time.¹ Existing integrity measures, institutions and enforcement all contribute towards and complement a high level of compliance with our tax system. The Australian Taxation Office (ATO) is a strong, capable, active and well-resourced administrator, with extensive powers and a strict interest and penalty regime. The ATO workforce focused on large companies is "larger and more skilled than it has ever been", and it has one-to-one engagement with large companies for assurance over approximately two-thirds of all corporate tax (around \$60 billion).²

The BCA supports the notion that measures be balanced against "the need to attract and retain foreign capital and investment in Australia, limit potential additional compliance cost considerations for business, and continue to support genuine commercial activity."³ A consultation process that follows best practice principles is critical.⁴

The tax system must ensure that the Australian economy, which is heavily reliant on trade and foreign investment, remains strong and continues to grow. Productivity growth is the key driver of living standards but the past decade was the worst decade for productivity growth in the past 60 years. Investment is critical for driving productivity and has accounted for two-thirds of labour productivity growth the past 40 years. This includes through procurement of state-of-the-art machinery and equipment and the development and adoption of cutting-edge technologies.

2. Key recommendations

1. Any proposed changes should be subject to a comprehensive assessment that follows best practice principles. This includes the problem to be solved must be well understood, new regulation is subject to cost-benefit analysis, adequate time for consultation and regulation must achieve objectives at least cost.
2. Do not proceed with the proposed repeal of sections 25-90 and 230-15 of the *Income Tax Assessment Act 1997*. To the extent there are concerns to be addressed, they should be dealt with through a separate consultation process.
3. The proposed changes to the above-mentioned sections, if they are to proceed, should apply prospectively and not to debt already committed to by taxpayers. And, as an absolute minimum, should not apply earlier than the first income year commencing from 1 July 2024.
4. The BCA endorses the Corporate Tax Association submission lodged in response to the draft legislation.

¹ Commonwealth of Australia, Treasury, 2018, *The Digital Economy and Australia's Corporate Tax System*, Treasury Discussion Paper, October.

² <https://www.ato.gov.au/General/Tax-and-Corporate-Australia/We-are-an-active-and-capable-administrator/>
<https://www.ato.gov.au/about-ato/research-and-statistics/in-detail/tax-gap/large-corporate-groups-income-tax-gap/>

³ The Australian Government the Treasury, 2022, *Government election commitments: Multinational tax integrity and enhanced tax transparency*, Consultation paper, August.

⁴ Commonwealth of Australia, Department of the Prime Minister and Cabinet, *The Australian Government Guide to Regulatory Impact Analysis*

3. Additional information

Australia's thin capitalisation regime is an integrity measure designed to ensure that multinationals do not allocate an excessive amount of debt to their Australian operations. They limit the extent to which a company may claim deductions for interest paid on debt.

Some business models require companies to fund operations with larger amounts of debt, in which case an arm's length debt test applies, to ensure they are not disadvantaged. There are many examples of businesses with significant upfront investments that take time to recoup and rely on high levels of debt. They include mines, oil and gas projects, infrastructure, power plants, aircraft and office buildings.

The investment environment has already been made more challenging, particularly for capital intensive projects with long lead times. Recent years have seen governments abruptly change the rules of the game, increasing risk premiums for future projects. There also has been a long line of 'one-offs' and measures that give broad scope and power for unnecessary and excessive interventions in business practices such as recent energy market intervention, the introduction of energy divestiture laws, critical infrastructure laws and the adjustment of the relative bargaining positions of firms (e.g. the News Media Bargaining Code). Businesses with the largest balance sheets have also been the target of ad hoc tax increases (e.g. royalty and payroll tax hikes), additional compliance measures, increased reporting, and additional/higher penalties. There has been excessive government reliance on ministerial discretion and less predictable, ad hoc decision making.

Repeal of sections 25-90 and 230-15

The draft legislation proposes to repeal sections 25-90 (and the related provision section 230-15) of the *Income Tax Assessment Act 1997*. This goes beyond the proposed scope of changes to Australia's thin capitalisation rules outlined as part of the government's election commitment or the recent Budget announcement.⁵

Section 25-90 was introduced over 20 years ago following the *Review of Business Taxation*.⁶ This provision relates to interest deductions on debt used for offshore investments. Its introduction reflected that interest was deductible in the past provided the debt could be "traced" to onshore investments. This could generally be achieved by taxpayers but having to track, monitor and trace the flow of debt funds was a costly compliance exercise for taxpayers and administratively costly for the ATO to audit. The introduction of section 25-90 reduced compliance costs while achieving the same outcomes in practice by virtue of a tightening of the thin capitalisation rules at the time.

The rationale for change is unclear

The rationale for the proposed repeal of section 25-90 is unclear and unnecessary for achieving the broader policy intent of the proposed changes. Companies will be able to continue to claim interest deductions if they can "trace" funds and demonstrate a link between the debt and how it is used. This will lead to:

- a significant increase in compliance costs – which 25-90 was introduced to deal with
- may impede genuine commercial activity in the form of offshore investments
- raise limited – if any – revenue on an ongoing basis.

On that basis, the justification for repealing section 25-90 is unclear.

Treasury previously consulted on the repeal of section 25-90 and came to a similar conclusion. This was explained in detail by Treasury's Rob Heferen (Executive Director, Revenue Group) at the time. The conclusions Treasury drew from this consultation were:

⁵ <https://web.archive.org/web/20221004191508/https://www.alp.org.au/policies/labors-plan-to-ensure-multinationals-pay-their-fair-share-of-tax>

⁶ Ralph, John, Robert Joss, and Richard Allert. 1999. *Ralph Review: Review of Business Taxation*.

- *"I think it is fair to say that, through public consultation on that, it became apparent that the proposal that stood would not be a sensible proposal to proceed on"*⁷
- *"As it turned out, the revenue that we at one stage thought would be obtained from that was a mistake. Really, there was no upside with proceeding. The measure would have only had downsides, because what it would have done was prevent legitimate activity taking place."*⁸

Issues with repealing section 25-90

There are several issues to consider regarding the proposal to repeal section 25-90. Any repeal will:

- **Discourage offshore investment** by reducing after-tax returns through potentially denied deductions, higher compliance costs, and a higher cost of capital due to the need for alternative (and more expensive) debt or equity funding. At the same time, Australian companies looking to invest offshore will be competing with overseas companies which do not face these same barriers.
- Lead to **higher compliance costs** due to the need for increased documentation to "trace" funds as well as the practical steps to demonstrate compliance such as quarantining funds to separate bank accounts.
- Be a **retrospective change to tax law** due to the inability to "grandfather" existing arrangements. This would come with potentially significant costs for taxpayers through a mix of:
 - potentially denied deductions, for example due to an inability to restructure debt arrangements or insufficient records to demonstrate "tracing" (e.g. because standard commercial practices involve centralised cash management), or
 - through the costs of restructuring debt, which can be an expensive and lengthy process.

What is an alternative approach?

As noted above, Treasury previously advised *against* the repeal of section 25-90. The federal government must clearly articulate why it now proposes *for* the repeal of section 25-90. This should include a clear articulation of the problem to be solved for, how facts and circumstances may have changed relative to 2014, and a demonstration of how this proposal is the best approach to achieving the policy intent at least cost to the economy (for example, compared with better targeted rules to target any perceived problem).

The federal government should not proceed with the repeal of section 25-90. To the extent there is a problem to be addressed, this should be dealt with as a separate measure and through a separate consultation process.

Further consultation is required

The proposed changes to the thin capitalisation rules include the introduction of a "general class investor" definition and three new tests in the form of a fixed ratio test, group ratio test and external third-party debt test. The Explanatory Memorandum notes this approach will simplify elements of the thin capitalisation regime.

Other elements of the proposed changes will increase complexity, increase compliance costs and make it more difficult to attract and retain foreign investment in Australia – including through the permanent denial of interest deductions. When combined with Australia's relatively high 30 per cent corporate tax rate, an approach that permanently denies interest deductions may adversely impact investment. Capital intensive projects with long lead times (e.g. resources and infrastructure), start-ups and projects with volatile earnings may be particularly adversely affected. Other issues raised by BCA member companies include:

- The 15-year carry forward of denied interest deductions is only available under the fixed ratio test but may be lost due to changes in company ownership or if the fixed ratio test is not applied each year.

⁷ Commonwealth of Australia, 2014, *Senate Economics Legislation Committee: Estimates*, 5 June.

⁸ Commonwealth of Australia, 2015, *Senate Economics References Committee: Corporate tax avoidance*, 9 April.

- The procedure for choosing a test in a particular year is strict and irrevocable.
- Further clarity and consultation to understand the implications of changes to the 'debt deduction' definition.

It is critical that consultation allows sufficient time to understand the potential impact of any proposed changes, and ensures proposals meet the policy intent in a way that minimises compliance costs and avoids unintended consequences. The BCA strongly supports the government's previous commitment to "consult further on exposure draft legislation prior to introducing any legislation into Parliament."⁹

In light of these and other issues raised, the proposed changes should apply prospectively and not to debt already committed to by taxpayers, and as an absolute minimum, should not apply earlier than the first income year commencing from 1 July 2024. This reflects the complexity and outstanding issues with the existing proposal, including its retrospectivity and therefore unreasonable effect on existing debt commitments, and the need to allow time to update existing systems and processes – for both companies and the ATO.

⁹ The Australian Government the Treasury, 2022, *Government election commitments: Multinational tax integrity and enhanced tax transparency, Consultation paper*, August.

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