



Thursday, 13 April 2023

Mr Marty Robinson
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Treasury
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By email: MNETaxIntegrity@treasury.gov.au

Dear Marty

Thin capitalisation interest limitation – Exposure draft legislation

Chartered Accountants Australia and New Zealand (CA ANZ) welcomes the opportunity to provide feedback on Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation exposure draft legislation (ED) and explanatory materials (EM).

CA ANZ represents more than 128,000 financial professionals, supporting them to build value and make a difference to the businesses, organisations and communities in which they work and live. Around the world, Chartered Accountants (CAs) are known for their integrity, financial skills, adaptability and the rigour of their professional education and training.

We welcome the release of the ED and EM.

However, in view of the 1 July 2023 commencement date for the new rules, the ED should have included a transitional period to exclude interest on certain loans from the application of the new rules. The OECD best practice approach to implementation of the new fixed ratio rule recognised that a new rule to limit tax deductions for an entity's interest expense could involve a significant cost for some entities and "it was expected that a country introducing a fixed ratio rule and group ratio rule would give entities *reasonable time to restructure existing financing arrangements* before the rules come into effect."¹ [Emphasis added]

In the current environment of increasing interest rates, Treasury should consider at least providing a transitional period so that entities can restructure their existing financing arrangements to fit within the new rules.

CA ANZ also suggests that a post-implementation review be scheduled of the new thin capitalisation rules to check whether:

- the new law is serving its intended purpose (or whether there are unintended outcomes)
- compliance costs can be ameliorated, and
- there has been any impact on foreign investment into Australia and economic growth.

Our submission and offer to host a consultative forum

CA ANZ has sought out feedback on the ED and EM from our membership. We have set out the comments received as well as feedback on priority issues for the ATO's administrative approach and public advice and guidance, in the attached Appendix.

¹ *OECD/G20 Base Erosion and Profit Shifting Project: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update, Page 83*

As discussed with you, CA ANZ would be happy to host consultative forums with CAs who specialise in international tax (whether they be working in public practice or in-house tax groups).

If you have any queries, please contact Karen Liew at karen.liew@charteredaccountantsanz.com in the first instance.

Yours sincerely

A handwritten signature in black ink, appearing to read "Michael Croker".

Michael Croker
Tax Leader - Australia

Comments on the ED

Application of the external third-party debt test

An entity that is a general class investor may make a choice under subsection 820-43(4) of the *Income Tax Assessment Act 1997* (ITAA 97) to apply the external third-party debt test instead of applying the fixed ratio test. However, to apply the external third-party debt test, an entity and ALL of its associate entities must make a mutual choice to do so (subsection 820-43(5)). For these purposes, associate entities are those in which there is a 10%+ interest. Refer to paragraphs 1.32 to 1.35 of the EM.

The requirement for an entity and all of its 10%+ associate entities to choose to apply the external third-party debt test is overly restrictive and will give rise to practical issues, such as:

- *Conflicts of interest.* To illustrate, if an investor who holds a greater than 10% interest in a trust wishes to adopt the external third-party debt test for another investment, the trust would also have to apply the external third party debt test (this may not be the optimal choice).
- *Practicality.* It would be impractical in most group structures given the number of potential associate entities. For example, it would include the (dormant) corporate trustee of every trust that is not even required to lodge tax returns. It would also include foreign subsidiaries that have no presence in Australia whatsoever and requiring these entities to make a choice would be going too far.
 - Where there is any joint venture entity then it becomes almost impossible. For example, you might have Group A invest into a JV company or unit trust with another group (Group B), holding 50% each. That JV entity could account for less than 1% of the Group A's overall business. However, the JV entity is an associate entity of Group A and must also make the choice to use the external third-party debt test. While it could be agreed to with Group B that they will allow the JV entity to make the election, that is not enough. In order for the JV entity to make the election its associate entities need to all make the election, this includes the entities comprising Group B. So the mere presence of a JV entity in any group means not only does the JV also have to make the election but all the (10%+) owners of the JV have to make the election. If this were a JV with five 20% owners, then all five groups need to make the mutual choice. One of those groups could be in a wholly separate JV with five others and for it to make the election then every entity in those five groups also need to make the election.
- *Differing accounting periods.* A group may have entities with different accounting periods and the requirement to make an election before lodgment date of the tax return may be difficult where one is required to lodge six months later, effectively bringing forward the date for an entity to make an election to be the earliest lodgment date for any of their associate entities.

In short, the current choice requirements need to be reconsidered.

At the very least there should not be a requirement to make a choice for an entity if it has no debt deductions for the year. Paragraph 1.32 of the EM says that only associate entities that are not exempt from thin capitalisation need to make the choice. However, a dormant entity or a corporate

trustee of a trust is not exempt from thin capitalisation just because it does not have any income or expenses. This is because the \$2 million de minimis is determined on an associate entity inclusive basis and not a standalone basis. So, if those dormant entities or foreign entities with no Australian presence belong to a group that has over \$2 million of debt deductions then they are subject to thin capitalisation despite having \$0 of debt deductions themselves.

Additionally, we recommend that subsection 820-43(6) be removed such that a 50% interest be required to bring in another entity as having to make the choice. In fact, this should be a greater than 50% interest (rather than 50% or greater) to avoid problems for an entity jointly owned, equally between two groups, making it difficult for the entity to make the choice where the two groups have different choices.

CA ANZ recommends that requiring all the associate entities to make the same choice to apply the external third-party debt test be modified so that it is clear that associate entities that are dormant or have no debt deductions are not required to make a choice.

CA ANZ also recommends that the associate entity interest be set at greater than 50% rather than 10%. Setting the interest from 10% makes it practically difficult for an entity and its associate entities to make the same choice.

Meaning of external third-party conditions

From a practical perspective, the external third-party debt conditions in subsection 820-61(2) are almost impossible to satisfy for group borrowings not within a tax consolidated group.

Typically, there are cross guarantee arrangements involving most members of the group, so the recourse requirement in paragraph (c) would not be met. Also, the tracing requirement in paragraph (d) would in most cases be impossible to establish, i.e. the entity uses the proceeds of issuing the debt interest to *wholly* fund Australian investments and operations.

CA ANZ recommends that the external third-party requirements in paragraphs 820-61(2)(c) and (d) be amended to allow some flexibility for what happens in normal commercial practice.

Fixed ratio and group ratio test

CA ANZ welcomes the adoption of a tax EBITDA which is calculated according to concepts from Australia's income tax system which should reduce compliance costs when applying the fixed ratio test. However, we submit that consideration be given to making the following additional adjustments in working out tax EBITDA:

- Adjustment for discount capital gains (particularly relevant to trust entities subject to the rules) or concessional capital gains
- Adjustment for capital allowance deductions for capital expenditure on software development pools (Subdivision 40-E), exploration or prospecting, rehabilitation of mining or quarrying sites and environmental protection activities (Subdivision 40-H), and for primary producers and other landholders (Subdivision 40-H). The concessions provided under the existing income tax law

seem to be disadvantaging taxpayers who have access to these rules for claiming capital allowance deductions in place of any decline in value deduction claimed under Subdivision 40-B

- Adjustment for balancing adjustment deductions allowed under Division 40 need to be added to increase the EBITDA amount.

While we welcome the ability to enable the ‘fixed ratio test disallowed amount’ (FRT disallowed amounts) to be carried forward and utilised in later income years, we raise the following issues:

- It is unclear why a company only has recourse to the modified version of the continuity of ownership test (COT) but not to the business continuity test (BCT). A company’s access to the special deduction for the FRT disallowed amount should be subject to the modified COT or BCT (including when seeking to transfer the amount to the head company of a tax consolidated group on joining).
- There is no choice to cancel the transfer of FRT disallowed amounts to the head company of a consolidated group as there is with losses of an entity that joins a tax consolidated group (under existing section 707-145).
- It is unclear why there is no ability to carry forward any disallowed amount under the group ratio test (the carry forward mechanism is only available under the fixed ratio test). Group earnings can be impacted by year-on-year volatility in the same way as an entity’s tax EBITDA. To mitigate any revenue concerns for years where entities have extraordinarily high group ratios (i.e. where the Group EBITDA is a relatively small positive amount), a carry forward rule could contain a cap on the amount of excess current year capacity (e.g. 100% of tax EBITDA).

In relation to the application of the group ratio test, the current definition of GR group parent (in proposed section 820-51) refers to the existing definition of a worldwide parent entity in subsection 820-935(6). This will limit access to the test for some groups where the immediate parent is “controlled” by another entity, but not fully consolidated into the ultimate parent’s financial statements due, for example, to the application of the investment entity exception applicable under recognised overseas accounting standards. There should be some mechanism to enable such affected groups (or at least sub-groups which can be determined from the immediate “parent” entity that is controlled by an investment entity) to access the group ratio test.

Further, the group ratio test provides no benefits to taxpayers should the group ratio be less than the 30% fixed ratio. Some taxpayers may elect to use the group ratio on the understanding that the group ratio is greater than 30%. If this is miscalculated or amended following an audit such that the group ratio is less than 30% then the taxpayer should be allowed to revert back to the 30% fixed ratio test. This could be achieved by making it a condition of making a group ratio test election that the entity’s group ratio for the year is greater than 30%.

There are also many practical difficulties in applying the group ratio test, including:

- adjustments for payments made to or by associates, using the low threshold of a “TC control test” of 10% or more,
- identifying and adjusting for negative EBITDA (and whether this should be on a stand-alone basis or its negative contribution to the group EBITDA after consolidation adjustments).

In relation to the FRT, there should be allowance for excess tax EBITDA capacity to be shared / grouped between associate Australian taxpayers (e.g. parent and subsidiary taxpayers). The current safe harbour test includes such a mechanism in the form of the associate entity excess amount

(section 820-920 of the ITAA 97) and provides for equitable outcomes for those groups who have Australian entities that are not members of a tax consolidated group.

CA ANZ recommends:

- consideration be given to including additional adjustments in working out the tax EBITDA for discount capital gains or concessional capital gains, other capital allowance deductions mentioned above and balancing adjustment deductions
- allow the group ratio test to be accessed where the immediate parent is “controlled” by another entity, but not fully consolidated into the ultimate parent’s financial statements
- that the low threshold TC control test of 10% or more be increased due to the practical difficulty in applying the group ratio test
- further clarification be provided in identifying and adjusting for negative EBITDA in a group
- in relation to the FRT, there should be allowance for excess tax EBITDA capacity to be shared / grouped between associate Australian taxpayers.

What happens when an entity becomes a general class investor during the year?

Further clarification is required as to what happens when an entity becomes a general class investor during the year, i.e. the part-year period provisions have not been amended to deal with the case where for example, an Australian purely domestic entity becomes an outward entity or is acquired by a foreign entity to become an inward entity.

Removal of deductions for foreign equity distributions

Section 25-90 and 230-15 of the ITAA 1997 currently provides that interest expenses incurred to derive certain non-assessable non-exempt (NANE) income including foreign equity distributions under s768-5 are deductible. Although this is contrary to the general rule in Australia’s income tax law (which provides that expenses incurred in deriving NANE income are non-deductible), there was a policy reason why the decision was made to allow deductions for interest expenses against foreign equity distributions.

Section 25-90 was introduced in 2001, together with the new thin capitalisation rules in Division 820 of the ITAA 1997. The EM introducing the section states:

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

1.100 The relevant debt deductions are those incurred in earning foreign income that is exempt income under sections 23AI, 23AJ and 23AK of the ITAA 1936.

Therefore, by enabling interest expenses to be deductible under section 25-90, the thin capitalisation rules would be the sole determinant of interest deductibility. Section 25-90 also reflected a compliance saving policy objective in that it removed the requirement for taxpayers to trace interest expense deductions to the funds borrowed. Prior to the introduction of section 25-90, it was acknowledged that the general rule in section 8-1 for denying deductions for exempt income was easy to circumvent by establishing a use of funds that ensured deductibility and tracing the use of funds.

In May 2013, the then Labor Government announced the proposal to tighten the thin capitalisation rules and repeal section 25-90. According to the [14 May 2013 Proposals Paper](#),² there was evidence that a debt loading structure was being used to exploit the then thin capitalisation rules, the loophole in the exemption for foreign non-portfolio dividends (i.e. the exemption applying to redeemable preference shares that was considered ‘debt’) and the ‘compliance cost saver’ provision (i.e. the deduction for interest expenses incurred in deriving certain exempt foreign income). The combined effect was to wipe out the Australian taxable income of a mature Australian company.

However, after the consultation process it was recognised that this structure was more effectively dealt with by amending section 25-90 and reforming section 23AJ (i.e. replace it with subdivision 786-A), rather than repealing section 25-90. During the consultation process, Treasury heard from Australian based companies who stated that, if they wanted to expand offshore they would only be able to fund that from equity funding and not from debt funding if section 25-90 was repealed. This would put them on a weaker footing compared with the offshore local businesses. Treasury then worked with the ATO and recognised that the entities which had structures that they were concerned about were large enough and sophisticated enough to have sufficient debt to fund their Australian operations and sufficient equity to fund their foreign operations. To ensure deductibility for their interest expenses, all they had to do was trace their funds which would just involve extra compliance costs.³ As such, repealing section 25-90 would not result in much upside but would prevent legitimate, economically beneficial activity taking place.

The current proposal to remove the deduction for section 768-5 NANE income would raise similar concerns as those raised in the earlier consultation process on the repeal of section 25-90. Changing the thin capitalisation rules to an earnings-based test does not change the fact that section 25-90 is still required to ensure that the thin capitalisation regime is the sole determinant of interest deductibility and continues to be a compliance saving measure.

Furthermore, the rationale for the proposed change (refer EM at paragraphs 1.119 – 1.120) is that section 25-90 provides taxpayers with a ‘double benefit’ (being the NANE treatment of the foreign dividends and the interest deduction for funds incurred in earning those dividends). Such a statement disregards the operation of the thin capitalisation rules, both under current law and proposed amendments.

For example, an Australian holding company that borrows to invest in a foreign subsidiary and has no other Australian business could not claim interest deductions under the existing rules (because controlled foreign company equity is not counted as an asset for thin capitalisation safe harbour

² *Addressing profit shifting through the artificial debt loading in Australia*, [Treasury Proposals Paper 14 May 2013](#)

³ [Hansard, Senate Economics References Committee inquiry into corporate tax avoidance, 9 April 2015](#), page 21-23

purposes), and nor would the company be able to deduct interest expense under the new fixed ratio test (because the dividends from the foreign subsidiary would be NANE income and hence not included in tax EBITDA).

If there was concern with the external third-party debt test, other adjustments could be included in the test to take into account the debt funding of foreign investment rather than removing deductions for foreign equity distributions under sections 25-90 and 230-15(3)(c).

CA ANZ recommends that the proposal to deny deductions for interest expenses incurred in deriving foreign equity distributions be abandoned.

Minor typos

We note the following typos and drafting errors:

- In proposed subsection 820-59(4), 4th line “....out of the an amount of a deduction...”
- Item 43 “At the end of Subdivision 820-FA

Add:

section 820-62” – check section numbering.

- In proposed subsection 820-62(4) - the reference in the last line should be to subsection (5).
- For the Australian assets exception in subsection 820-37(1): this should omit ‘Subdivision 820-B’ and substitute ‘Subdivision 820-AA, 820-B’. This is consistent with the proposed amendments to section 820-35 (de minimis exception) and would align the operation of the provision with the intention articulated in paragraphs 1.113 – 1.114 of the EM.

Priority issues for ATO administration and public advice and guidance

We suggest that the following issues need ATO guidance:

- ATO’s views on risks on restructuring or refinancing arrangements undertaken in response to the new law.
- The group ratio rule, specifically addressing the concepts of group ratio, GR group, GR group parent and GR group member, GR group net third party interest expense and financial statement net third party interest expense, entity EBITDA (the source of working out the components of this), and the practical issues associated with excluding from GR group EBITDA an entity that might have negative EBITDA (a difficult task for very large multinationals). These issues are complex and there is no guidance in the EM.
- The proposed new definition of debt deduction in section 820-40 and net debt deduction in proposed subsection 820-45(3), particularly in relation to the treatment of hedge gains and losses.
- Apportionment and allocation of relevant debt deductions that are subject to denial due to amendments to sections 25-90(b) and 230-15(3)(c) in relation to the derivation of foreign equity distributions as non-assessable non-exempt (NANE) income (if this measure is to proceed).

ATO engagement with the tax profession and impacted businesses needs to occur quickly and effectively.