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By email: MNETaxIntegrity@treasury.gov.au

Treasury Exposure Draft Legislation - Strengthening Australia's Interest Limitation (Thin Capitalisation) Rules

Dear Mr Robinson

Ernst & Young (EY) welcomes the opportunity to respond to Treasury's exposure draft legislation on Strengthening Australia's interest limitation (Thin Capitalisation) rules (*Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation*) (ED Bill) issued on 16 March 2023.

Our submission with our recommendations is set out in the attached Appendices:

- ▶ Appendix A – Thin capitalisation amendments
- ▶ Appendix B – Sections 25-90 and 230-15 amendments removing interest deductions related to section 768-5 NANE income.

An issue of great concern in our submission is the proposed amendments to section 25-90 (and related section 230-15). This proposed change is a complete surprise to the business community at such a late stage of legislative development and will lead to harsh and unreasonable consequences for affected taxpayers.

We therefore suggest this measure be deleted from the proposed Bill and be subject to proper community consultation ahead of any legislative proposal. Moreover, we see no real justification for the measure for a number of reasons set out below. If such a measure was to be proceeded with then in any event it should apply only prospectively to debts incurred after the commencement date of the legislation.

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Should you have any questions in relation to the above or wish to discuss these matters in further detail, please do not hesitate to contact Alf Capito (02 8295 6473, alf.capito@au.ey.com) or Tony Merlo (03 8575 6412, tony.merlo@au.ey.com) in our Tax Policy Centre.

Yours sincerely

Ernst & Young

Appendix A – Thin capitalisation amendments

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A1. Amendments to transfer pricing – interaction with thin capitalisation

It is proposed to amend the Division 815 transfer pricing rules to remove the exclusion from applying the arm's length conditions in relation to the quantum of the debt interest, which occurs in the current thin capitalisation rules application to determine maximum allowable debt, for "general class investors". Where the modification contained in section 815-140 no longer applies, section 815-115 applies to determine the quantum of debt, such that the ATO could substitute a hypothetical 'arm's length' amount of debt in place of the 'actual amount' of debt.

These amendments to the transfer pricing rules are a significant and retrograde departure from the current law, which was enacted to codify the administrative practice set out in Taxation Ruling TR 2010/7. The sensible purpose of section 815-140, as described in the Explanatory Memorandum to *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* (Cth), remains equally applicable today:

3.144 The rule [in section 815-140] preserves the role of Division 820 in respect of its application to an entity's amount of debt.

This measure will create uncertainty over the tax deductibility of debt as it will require an annual assessment, typically by professional advisers, of what a hypothetical amount of debt would be loaned to a taxpayer group. This naturally will place a costly and complex burden on taxpayers and advisers respectively for realistically little benefit to the revenue given the many other exiting provisions in the tax law that guard against excessive interest deductions, including the proposed thin capitalisation rules, the existing transfer pricing rules, the interest hybrid rules, Part IVA, the CFC rules, various provisions in Australia's Tax Treaties and the soon to be introduced Pillar Two rules.

As a result, we recommend the proposed amendment should not proceed.

If the change is to be proceeded with, as a minimum the impact of this change should be elevated in the explanatory memorandum (EM) to be referenced in the discussion of the new thin capitalisation tests and not just included as a "consequential amendment". The EM should also provide guidance or examples as to how the arm's length debt amount should be determined.

Some examples of how the thin capitalisation provisions interact with the transfer pricing provisions should be included in the EM.

A2. Application of exceptions

As currently drafted, the exception contained in sections 820-35, 820-37 and 820-39 do not exclude the operation of the new Subdivision 820-AA where one of the exceptions applies. Based on the comments contained in paragraph 1.113 of the Explanatory Memorandum (EM), we understand that it is intended that these exceptions should continue to apply to outward investing general class investors and that the omission of Subdivision 820-AA is an advertent drafting error.

We recommend that sections 820-35, 820-37 and 820-39 be updated to exclude the operation of Subdivision 820-AA where the relevant section applies.

A3. Fixed ratio test (30% of tax EBITDA)

Tax EBITDA add back for depreciation expenses

The depreciation add back component of the proposed paragraph 820-49(c) tax EBITDA calculation is limited to certain depreciation provisions only – being Subdivision 40B (core provisions) and Division 43 (deductions for capital works)¹.

Other depreciation and capital works provisions, including Subdivision 40-D balancing adjustments and certain software, primary production, exploration/mining deductions and project pools (Subdivisions 40-E to 40-I), are not included, despite these provisions giving rise to capital allowances (i.e. tax depreciation).

There is no clear policy rationale for excluding the full range of allowable depreciation and capital allowance provisions. In particular, we are concerned that their exclusion will disadvantage certain capital intensive taxpayers and industries which have significant tax deductions in accordance with those rules.

The BEPS Action 4 2015 Final Report best practice does not prescribe that the depreciation and amortisation add-back component should be limited to only a sub-set of relevant tax deduction provisions.²

We recommend that the depreciation add-back should include all allowable depreciation and capital amortisation deductions calculated under Division 40 and Division 43.

15 year carry forward of denied deductions

Loss of carry forward amounts

A deduction is to be allowed for debt deductions previously disallowed under the fixed ratio test (FRT disallowed amount) over the previous 15 years in a subsequent year where debt deductions are less than the fixed ratio test cap in that year, only if the taxpayer does not elect to use the group ratio test or the third-party debt test in any intervening year.

A taxpayer should not be precluded from utilising its FRT disallowed amount if it has used one of the elective methods in a year. The need for this rule to address year-on-year earnings volatility concerns for businesses, which are limited in their ability to claim debt deductions depending on their economic situation, is equally valid whichever method is used.

However, if the restriction is to discourage the use of the group ratio test or the third-party debt test in a year then this should not impact the availability of deductions in any subsequent year in which the (default) fixed ratio test is used. This rule undermines the purpose of the alternative methods.

We recommend that subsections 820-59(2) and (3) be deleted such that FRT disallowed amounts should be able to be used in any year where a choice is not made to use one of the other two methods (subject to satisfaction of the integrity rules if a company).

¹ Legislative references are to *Income Tax Assessment Act 1997* (Cth) (ITAA 1997).

² OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report, <https://www.oecd.org/ctp/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report-9789264241176-en.htm>.

Testing should include business continuity tests

If the entity is a company, it must pass a modified version of the continuity of ownership test (COT) in relation to each of its FRT disallowed amounts.

We recommend that FRT disallowed amounts should also be available for deduction under this rule applying the business continuity tests (i.e. same or similar business test). Absent a business continuity test, these deductions will be lost in most significant acquisition scenarios. This, in turn, increases the cost of transacting (as compared to not transacting) and reduces capital market efficiency.

The inclusion of the business continuity tests will align the carry forward treatment with that of income tax losses.

Tax consolidation issues

The carry forward FRT disallowed deduction may be transferred to the head company of a tax consolidated group on joining or formation by applying a modified COT as a transfer test. The deduction stays with the consolidated group if that entity leaves.

We recommend that transfer of FRT disallowed amounts to a tax consolidated group should also be allowed where the business continuity test is applied as a transfer test. This would again align the treatment of FRT disallowed deductions with that of income tax losses. Absent the business continuity test being applied as a transfer test, it would seem that FRT disallowed amounts could not be transferred into a tax consolidated group in circumstances where the joining entity would fail the modified COT at the joining time (which is often the case in an acquisition).

An adjustment is made to reduce the joining entity's allocable cost amount (ACA) for the FRT disallowed amount transferred (at the corporate tax rate). There is no option to cancel the transfer of the FRT disallowed amount to avoid this adjustment.

There will be many circumstances where the head company of a tax consolidated group will not value the transfer of FRT disallowed amounts to the group from a joining entity including where the characteristics of the group mean that the disallowed amounts are unlikely to be utilised by the group in the short, medium or long term. Such groups will be adversely impacted by the decrease in the ACA of the joining entity as they will not receive any practical advantage from the FRT disallowed amount transferred.

We recommend that an option should be included to allow the head company of a tax consolidated group to cancel the transfer of FRT disallowed amounts from a joining entity so there is no corresponding ACA adjustment. The choice to cancel the transfer could be made irrevocable. This will again align the treatment of FRT disallowed deductions with income tax losses.

Calculation of tax EBITDA for trusts

The calculation of tax EBITDA contained in section 820-49 refers to "taxable income". The section does not appropriately address partnerships or trusts which are not required to make a calculation of taxable income. We recommend that section 820-49 is amended to make clear that, in respect of partnerships or trusts, the calculation should reflect the net income, partnership loss or tax loss of the partnership or trust as defined in Divisions 5 and 6 of Part III of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) or, in respect of AMITs, the AMIT's trust components of a character of assessable income as calculated under Division 276 of the ITAA 1997 (subject to our comments below).

The calculation of tax EBITDA does not address the application of the capital gains tax (CGT) discount to trusts. Non-resident investors in trusts are not entitled to benefit from the CGT discount which may be applied in calculating a trust's net income. Accordingly, non-resident investors in trusts will be inappropriately disadvantaged where tax EBITDA is reduced by the amount of any CGT discount because they will suffer additional disallowed interest deductions while not actually benefitting from the CGT discount.

We recommend that the CGT discount is ignored for the purposes of calculating the tax EBITDA of trusts.

The calculation of tax EBITDA currently only allows for certain depreciation deductions of "the entity" under Division 40 and 43 of the ITAA 1997 to be taken into account. It does not permit the depreciation deductions to be taken into account for an entity (the top entity) with an interest in the entity with the deductions (the subsidiary entity). This approach results in anomalous outcomes because different thin capitalisation outcomes arise depending on which entity has incurred the debt. For example, where the top entity has borrowed funds to acquire all of the interests in the subsidiary entity which holds real estate, the top entity would not benefit from the addition of depreciation deductions when calculating the tax EBITDA of the borrower (i.e. the top entity). However, where the subsidiary entity borrows directly, the tax depreciation of the subsidiary entity will be added when calculating the tax EBITDA of the borrower (i.e. the subsidiary entity). This outcome is inequitable because the top entity's economic position is the same as if it had held the real estate directly, but its thin capitalisation outcomes are markedly different.

We recommend that trusts be allowed to include the net debt deductions, capital allowances and tax losses of subsidiary trusts in the calculation of the trust's tax EBITDA.

A4. Irrevocable election to use the alternative tests

Both the group ratio test and third-party debt test may only be used in a year where an irrevocable election is made to use the particular test. This rule departs from the current thin capitalisation rules which allows a taxpayer to use the method in a year which provides the maximum allowable debt amount.

Under the proposals, where a taxpayer elects to use one of the alternative tests in a year but this limit amount subsequently changes whether as a result of taxpayer corrections or following an ATO review, the taxpayer will then not have recourse to the fixed ratio test should that now provide a greater deduction limit. This significantly detracts from the usability of the alternative tests.

The draft EM does not explain why the election to use the alternative tests must be irrevocable.

We recommend that the election to use either alternative test should not be irrevocable such that subsequent amendments can be made by a taxpayer to use another test in substitution where that provides a greater deduction limit, in line with the current thin capitalisation approach.

A5. Group ratio test

The group ratio test relies on the consolidated financial statements of the group ratio (GR) group, which may include a large number of entities worldwide and may change year-on-year. The test, as drafted, will be near impossible to apply in practice due to the complexity of adjusting the consolidated financial statements for:

- ▶ Entities with negative EBITDA
- ▶ Payments to and from associate entities (applying a 10% TC control interest threshold) who are not GR group members.

The availability of the group ratio test for companies that are a part of an investment group or partially or entirely owned by an institutional investor may be restricted. The group ratio test requires a 'worldwide parent entity' who prepares consolidated accounts. A worldwide parent entity cannot be controlled by another entity (in accordance with accounting standards).

Where an institutional investor or fund holds a majority ownership interest in an Australian company, the group ratio test may not be available to that Australian company where the Institutional Investor or Fund does not prepare consolidated accounts (under AASB 10 Consolidated Financial Statements). The proposed drafting would put groups owned by entities applying such accounting treatment at a disadvantage compared to other groups in Australia.

Entities with negative EBITDA

OECD best practice is to place an upper limit on the group ratio, described as follows:

151. This risk could be dealt with in part by a general principle that places an upper limit on the interest capacity of any entity applying the group ratio rule, equal to the net third party interest expense of the entire group. This upper limit should not mean that an entity's net interest deductions are lower than they would have been under the group ratio rule if group EBITDA had not been reduced by losses. This approach does not remove the risk that the total net interest deductions of all group entities could exceed the group's actual net third party interest expense. *However, it should prevent an individual entity receiving a very high level of interest capacity that could be used for base erosion and profit shifting purposes (emphasis added).*³

While the OECD recognises the potential to exclude entities with negative EBITDA the group ratio calculation, it cautions:

153. An alternative approach would be to exclude loss-making entities from the calculation of a group's EBITDA. This would remove the risk that any entity would receive an excessive amount of interest capacity. However, in general it would not be possible to obtain information on loss-making entities within a group from the consolidated financial statements. It may be possible for an entity to provide this information directly to a country's tax authority, but it may be very difficult for the tax authority to confirm the accuracy of this information and ensure that all loss-making entities in a group have been identified and excluded.⁴

Therefore, it appears that Treasury is proposing to adopt the more complex option, despite little or no evidence that this complexity is necessary to address the supposed mischief.

We recommend that an upper limit on the group ratio of 80% should be included, and the adjustment for entities with negative EBITDA should be deleted.

³ Ibid, p 69.

⁴ Ibid.

Payments to and from associate entities

The proposal to adjust for payments to and from associate entities (applying a 10% TC control interest threshold) goes well beyond the OECD's suggested targeted integrity measure. Specifically, the OECD recommends addressing related party payments by including entities in the GR group where there is common control.

The calculation of group EBITDA and net third party interest expense, in contrast, should be based on the financial reporting figures with as few adjustments as possible:

138. The calculation of net third party interest [expense] should be based on figures taken from a group's consolidated financial statements. While the use of unadjusted figures is currently considered an acceptable approach, there are risks that net third party interest expense could be overstated or understated and it is likely that most countries will wish to make some adjustments to these figures, *although in the interests of simplicity these adjustments should be kept to a minimum* (emphasis added).⁵

In the interests of having a workable test, *we recommend*:

- ▶ Deleting the requirement to adjust net third party interest expense for payments to and from associate entities, or
- ▶ Deleting paragraph 820-53(5), which reduces the associate entity threshold to a 10% TC control interest.

Differences between accounting EBITDA and tax EBITDA

The group ratio is based on accounting EBITDA, which is then applied to tax EBITDA and net debt deductions. The differences between the two concepts means that even a single entity may inadvertently breach the group ratio, for example as a result of an amount that is deductible in a different year than it is expensed for accounting purposes.

This can be seen as follows, where \$46 is deductible for tax purposes but has or will be expensed in a different year for accounting purposes (shows year of later deduction for tax):

	Accounting	Tax
EBITDA	100	54
Interest expense	35	35
Group ratio	35%	-
Group ratio earnings limit	-	19
Debt deductions denied	-	16

This result is unreasonably prejudicial to the taxpayer, particularly since any debt deductions denied cannot be carried forward and utilised (for example, when a tax adjustment unwinds in a future income year).

To mitigate this outcome, *we recommend*:

- ▶ The 10% uplift to the group ratio, as suggested by the OECD, be adopted
- ▶ Any debt deductions denied be permitted to be carried forward, the same as FRT disallowed amounts.

⁵ Ibid, p 66.

Alternatively, *we recommend* that a group of Australian taxpayers should be permitted to use tax EBITDA (for the group) rather than accounting EBITDA.

A6. External third-party debt test

Choice requirements to use the test are prohibitive

Requirements for the choice to use the third-party debt test in a year to be made by all associate entities (subsection 820-43(5)) will be practically impossible to satisfy for a large number of taxpayers given the new very low “associate entity” threshold. This has any of the following effects:

- ▶ The test may have limited or no operation in practice, making the enactment of the provisions pointless
- ▶ Investors with existing portfolio assets that rely on the third-party debt test may be reluctant to acquire a taxpayer who relies on the fixed ratio rule, or vice versa, due to the contagious impact of this condition, creating capital allocation inefficiencies
- ▶ Taxpayers genuinely financed by external third-party debt may not be able to rely on the test, increasing the cost of third-party debt finance (as a result of denied debt deductions) for those entities.

It will be impractical to meet this requirement in many groups which may have many potential associates. The new proposed very low 10% associate entity threshold will exponentially increase the number of associates that must make an election. Current subsections 820-905(3A) and (3B) will effectively link together any 10% relationship between entities, and also link all 10% associates of associates and so on. We are aware of examples of parallel investment or co-investment and minority investments where the proposed changes are likely to make it impractical or impossible for taxpayers to identify associate entities and to obtain sufficient information on how those entities are applying the thin capitalisation rules.

Joint venture (JV) company or unit trust arrangements may subject unrelated entities to the associate rule. For example, if independent Group A and independent Group B enter into a 50/50 JV arrangement not only would they both need to elect to use the test for the other to be eligible, but all associates of both groups may also be required to elect.

There will also be complex conflict of interest issues as entities may be associates of a number of groups, in particular in trust structures.

This requirement will be very difficult to meet for associates upstream in the entity's ownership chain including due to difficulties in obtaining information on such associates and whether they are subject to Australia's thin capitalisation rules such that the choice condition must be met.

The associate entity rule will be difficult for offshore funds managers of multiple different funds to meet, for example where the manager potentially has “significant influence” over the funds as owner of the general partners.

As mentioned in the draft EM, the restriction on making the third-party debt test choice is intended to ensure that associates are not artificially maximising tax benefits by applying a combination of different thin capitalisation tests. The perceived mischief targeted by this measure should not arise where the other entities are operated wholly independently and without transacting with one another.

Non-operating or dormant entities which may technically be general class investors may still be caught and it may be both difficult to identify such entities and to ensure an election is made.

Finally, it is unclear how a taxpayer who relies on the external third-party debt test would be able to positively assert that it knows who all of its associate entities are, and what test they have chosen to apply, in the event of an ATO review. Even the ATO is likely to struggle to identify all the relevant information, but the burden of proof remains with the taxpayer.

We recommend that this condition be deleted.

Alternatively, *we recommend* that:

- ▶ The associate entity interest be set at more than 50% rather than 10% (paragraph 820-905(1)(a))
- ▶ Entities which are associate entities of each other merely by virtue of being “sufficiently influenced” by the same third entity (i.e. in the absence of holding, directly or indirectly, a majority beneficial ownership interest) should not be required to elect into the third-party debt test
- ▶ This condition should only apply in respect of downstream associates in which the general investor has direct or indirect ownership interests
- ▶ Treasury should clarify in the EM how the associate test now works for the rule, including to confirm that the linking rules in subsections 820-905(3A) and (3B) are turned off for determining associates for this requirement where there is a foreign entity (applying current Division 820 provisions)
- ▶ The requirement should not apply if the associate does not have any debt deductions in the income year (modify paragraph 820-43(5)(a)).

Conditions to use the test are prohibitive

Paragraph (c) of the subsection 820-61(2) external third-party debt conditions requires that “the holder has recourse for payment of the debt only to the assets of the entity”. This condition will make the external third-party debt test inaccessible to many entities in a manner which we do not consider is consistent with the policy objective of this test. This is because third party lenders generally require a package of security which extends beyond the assets of the borrower itself. Common examples of security package inclusions are:

- ▶ Specific security over the shares or units of the borrower
- ▶ Guarantees by other Australian group entities.

Additionally, where the borrower is borrowing funds to finance the acquisition of an asset, where the asset is held by an entity being acquired, specific security will commonly be given by the asset-owing entity. If left unamended, the external third-party debt test will not provide a real alternative to the fixed ratio test due the restrictive nature of this condition and its inconsistency with standard commercial practice for third party debt finance arrangements.

We recommend that the condition is replaced with a condition that the lender must only have recourse to assets situated in Australia. This should address any integrity concerns regarding the leveraging of Australian entities supported by assets which are outside the Australian tax net.

Conduit financing concession

Whilst we welcome the carve out for conduit financing arrangements, the rule is very restrictive in nature and may not be accessible in practice.

The requirements in paragraphs (d) and (e) of subsection 820-61(5) require that the conduit financier finance each relevant debt interest *only* with proceeds from the ultimate debt interest and that the terms of each relevant debt interest are *the same* as the terms of the ultimate debt interest (other than terms as to the amount of debt). These requirements are unduly restrictive and do not reflect the common usage of group financing entities. Typically:

- ▶ Group financing entities are used to pool funds from a range of external sources and advance those funds within the group, or
- ▶ Group financing entities are used to achieve advantageous debt funding terms and pricing (e.g. by leveraging the collective assets of the group, economies of scale, etc) and advances those funds to various entities within the group on varying terms as each entity may have varying purposes or uses for the funding, or a different risk profile.

At present, the draft requirements in paragraphs (d) and (e) would preclude the above typical circumstances from applying the conduit financing concession.

Apart from the reasons above, it is also typical for internal loans not to perfectly match the terms of a corresponding external loan for the following reasons:

- ▶ The terms of internal loans are generally much briefer in order to suit the commercial needs of the group (whereas external loans are often governed by terms of several hundred pages long)
- ▶ Internal loans will necessarily be secured by different assets (e.g. an external loan made to the group financing entity may be secured over a large pool of assets whereas an internal loan may only be secured by the assets of the relevant borrower or be made on an unsecured basis)
- ▶ The funding needs of group entities may vary over time and the purpose of a group financing entity is generally to manage the funding needs as efficiently as possible. This may mean that funds originally advanced to a particular group entity may later be redirected to a different group entity as the need requires
- ▶ Different entities within a group may have different risk profiles, meaning that a value shift arises if a different, arm's length interest rate cannot be charged.

We recommend that:

- ▶ The condition in paragraph (d) is amended such that the relevant debt interest must be reasonably attributable to the ultimate debt interest
- ▶ The condition in paragraph (e) is amended such that the following specific terms are required to be substantially similar:
 - Interest, fees and costs
 - Tenor
 - Currency.

This approach should continue to require sufficient nexus between the debt interests; however, it should provide taxpayers with appropriate flexibility to manage their group financing entities according to usual commercial practice.

A safe harbour interest margin could be considered (e.g. 300 basis points (BPS) under the non-arm's length income rules or 150bps under the TOFA cap) which should address ATO concerns in relation to re-characterisation of other income into interest income while leaving sufficient margin to cover financing company expenses.

Multiple conduits

Further, the conduit financing rule should specifically allow for the external third-party debt to be passed through more than one conduit entity, rather than a single conduit financier. This is required to reflect common financing arrangements across groups.

We therefore recommend that paragraph (c), (d) and (e) are amended as follows:

- (c) each borrower issued a debt interest (a relevant debt interest) to:
 - (i) the conduit financier; or
 - (ii) another borrower (the other borrower); and
- (d) the conduit financier or other borrower financed the amount loaned under each relevant debt interest with amounts reasonably attributable to the ~~only with~~ proceeds from the ultimate debt interest; and
- (e) the following terms of each relevant debt interest are substantially similar ~~the same~~ as the terms of the ultimate debt interest ~~(other than terms as to the amount of the debt)~~:
 - (i) interest, fees and costs;
 - (ii) tenor; and
 - (ii) currency; and

A7. Debt deduction definition

Asymmetry of "debt deduction" between methods

The fixed ratio and group ratio rules apply to the "net debt deductions" of a taxpayer. The net debt deduction (proposed subsection 820-45(3)) is total debt deductions (defined in section 820-40) less "interest income" (proposed subsection 820-45(3)(b)). However, the two concepts do not align, with the income side being a relatively narrow list and the deduction side being a very expansive list:

Item	Calc.	Definition
Net debt deduction	A – B	Section 820-45
Debt deduction	A	Section 820-40 (i) interest, an amount in the nature of interest, or any other amount that is calculated by reference to the time value of money; or (ii) the difference between the financial benefits received, or to be received, by the entity under a scheme giving rise to a debt interest and the financial benefits provided, or to be provided, under that scheme; or (iii) any amount directly incurred in obtaining or maintaining the financial benefits received, or to be received, by the entity under a scheme giving rise to a debt interest.
Interest income	B	Section 820-45(3) (i) interest; or (ii) an amount in the nature of interest; or (iii) any other amount that is calculated by reference to the time value of money.

This approach may produce anomalous outcomes, particularly for entities conducting lending businesses (refer to the comments below). For example, this means that a taxpayer who borrows and on-lends on the same terms and has no economic gain or loss may still have a “net debt deduction” as a result of an item that is a “debt deduction” outgoing, but is not “interest income” when received.

Further, taxpayers are subject to tax on notional interest arising under Division 240 (hire purchase agreements) and Division 250 (assets put to a tax preferred use). Such amounts are interest for tax purposes and therefore should be regarded as interest income for the purposes of calculating the net debt deduction. It is unclear whether this is achieved under the current drafting.

In addition to the items already included in paragraph 820-45(3)(b), we recommend that the definition of net debt deductions permit a reduction for all amounts related to debt interests held by the entity which are included in the entity's assessable income. This approach should mitigate the potential inequities in taxpayers engaged in lending, but it should also address the asymmetry in the net debt deduction definition more generally.

We recommend paragraph 820-45(3)(b) should be amended to read as follows:

- (b) *next, work out the sum of each amount included in the entity's assessable income for that year that is:*
- (i) *interest, an amount in the nature of interest, or any other amount that is calculated by reference to the time value of money; or*
 - (ii) *the difference between the financial benefits provided, or to be provided, by the entity under a scheme giving rise to a debt interest and the financial benefits received, or to be received, under that scheme; or*
 - (iii) *any amount directly earned in obtaining or maintaining the financial benefits provided, or to be provided, by the entity under a scheme giving rise to a debt interest; or*
 - (iv) *any notional interest Division 240 of the Income Tax Assessment Act 1997 applies; or*
 - (v) *any gain on a financial arrangement to which Subdivision 250-E of the Income Tax Assessment Act 1997 applies.*

Further, we note that the guidance issued by the ATO in relation to the definition of debt deduction under the existing rules has caused some concerns.

In order to provide clarity to taxpayers, we recommend that the EM contain detailed guidance on the scope of net debt deductions, including what is intended or not intended to be captured by "any other amount that is calculated by reference to the time value of money" as this is very broad, with examples where relevant.

We would also welcome the opportunity for Treasury to clarify elements of what are "debt deductions" including whether this should extend to legal and other costs incurred in relation to the financial arrangement as per TD 2019/12.

Debt deduction in relation to a debt interest

Proposed subsection 820-40(1) removes the current requirement that a "debt deduction" needs to be in relation to a debt interest. Existing subsection 820-40(2) now takes on additional importance as it specifically includes within the definition amounts such as interest on leases and repurchase agreements, even though the underlying arrangements are not typically considered to be debt interests. The policy intention underpinning the broadening of the definition is likely to be an acknowledgement that commercial and common forms of third-party financing may not fit within the debt interest definition, but still give rise to tax deductions economically equivalent to interest that should be also subject to thin capitalisation limits.

It is perplexing therefore that the external third-party earnings limit in proposed subsection 820-61(1) only includes debt deductions in relation to debt interests. The practical effect of this is that any actual debt deductions in relation to arrangements that do not satisfy the definition of debt interests can never be deductible if the external third-party debt test is elected. It is not clear why this would be an intended outcome given arrangements such as leases and repurchase arrangements are genuine and accepted forms of third-party financing.

We recommend that proposed subsection 820-61(1) and (2) be amended such that the debt deduction does not need to be in relation to a debt interest. This would provide symmetry and still achieve the intended desire to only allow deductions in relation to genuine third-party financing.

A8. Definition of "financial entity"

The proposed repeal of paragraph (a) of the definition of financial entity will result in many entities which are engaged in lending activities being required to apply the thin capitalisation rules for general class investors. This change may result in inequitable outcomes for entities engaged in the lending activities.

While some entities engaged in lending businesses may not have positive net debt deduction amount because they earn a net interest margin, where an entity earns its returns on amounts lent through fees charged to customers which do not comprise amounts calculated by reference to the time value of money, these taxpayers may be placed at a competitive disadvantage. For example, a consumer finance business may derive a significant proportion of its income from establishment fees, account keeping fees and late fees, none of which may be considered to reflect the time value of money.

We recommend this proposed amendment be reconsidered including whether a targeted integrity measure to address the perceived integrity concerns could be included instead for consultation.

A9. Superannuation funds

The amendment to exclude complying superannuation funds from the definition of associate entity is a welcomed recognition of the regulatory landscape in which complying superannuation funds operate.

However, complying superannuation funds often use wholly owned investment entities (for example, Australian unit trusts) to hold multiple investments. These investment entities may still be associate entities of the underlying investments, which can inadvertently bring both investment holding entities and investments into the thin capitalisation regime.

We recommend that this inadvertent limitation should be addressed by extending the carve-out in subsection 820-905(1A) so that it reads:

Subsection (1) does not apply to:

- (a) a trustee of a *complying superannuation entity (other than a *self-managed superannuation fund); and*
- (b) an entity that is wholly owned (directly or indirectly) by one or more trustees of a *complying superannuation entity (other than a *self-managed superannuation fund).*

A10. Compliance with new rules

The proposed rules are a significant departure from existing law and will affect long-term financial arrangements entered into long before any changes were flagged.

The lack of any quarantining or transitional provisions means that taxpayers may be required to rearrange their affairs to comply, in good faith, with the new rules. However, there is a risk that a taxpayer who seeks to comply with the new rules could, by virtue of steps undertaken, inadvertently trigger taxable gains or deductible losses or become subject to the general anti-avoidance rules in Part IVA of the ITAA 1936.

To provide certainty for taxpayers and to encourage compliance with the new rules, *we recommend* that any steps taken to re-arrange existing financial arrangements to align with the new rules:

- ▶ Qualify for rollover relief under Division 230 and Part 3-1, and
- ▶ Be specifically excluded from the operation of Part IVA.

Appendix B – Section 25-90 and 230-15 amendments removing the deduction for interest incurred to derive section 768-5 NANE income

The proposed denial of tax deductibility for interest incurred on borrowings to invest in non-portfolio investments, has caught EY and our clients by complete surprise.

The proposal was not foreshadowed in the previous Treasury discussion papers that had been issued in respect of the proposed thin capitalisation changes and was not in any of the pre-election or post-election manifestos of the Labor Government.

In our view, for the reasons discussed below, *we recommend* that this change should not proceed.

The proposal will:

- ▶ Have an adverse financial impact on a large number of Australian enterprises including small and medium size businesses, that have structured their existing arrangements and business ventures in reliance on existing laws that were well-settled and understood
- ▶ Reduce the attractiveness of Australia for investment by foreign multinationals
- ▶ Impair the competitiveness of Australian groups that have expanded and/or are expanding offshore.

However, if the change is to proceed, then *we recommend*:

- ▶ The amendment to sections 25-90 and 230-15 (for convenience we subsequently refer to section 25-90 in the submission to cover both sections) should apply only on a prospective basis to debts incurred after the commencement date of the rules
- ▶ Failing this, the application date must be deferred to be no earlier than years commencing on or after 1 July 2024 to allow taxpayers a period to properly consider and adjust to the final law which may result in significant impacts on the economics of their business and require changes to their operations
- ▶ Transitional rules for arrangements in place as at the date of the announcement (16 March 2023) must be included to exempt arm's length third party borrowings which have been made legitimately based on the Australian tax law
- ▶ The law should specifically allow, in the absence of a taxpayer tracing borrowed funds to ultimate use, for a reasonable apportionment to be made by taxpayers in determining what amount of debt relates to section 768-5 ITAA 1997 income
- ▶ A \$2 million interest deduction de minimis should apply for the application of the section 25-90 rule change to limit compliance costs (matches de minimis for thin capitalisation rules)
- ▶ Interest withholding tax should not apply to non-deductible interest payments made by the Australian taxpayer to a non-resident.

Change to existing policy is misconceived

The proposed changes are being justified purportedly on the basis that since the non-portfolio dividends received from foreign subsidiaries are exempt (under section 768-5), it therefore follows that the interest incurred on borrowings to fund such investments should equally be treated as non-deductible. This, however, does not do justice to the original policy rationale concerning section 25-90.

In 2001, the thin cap rules in Division 820 and section 25-90 were introduced.⁶

As was noted at paragraph 1.9 in the Explanatory Memorandum to the Bill which introduced the 2001 changes (2001 Bill), the general rule in section 8-1 denying deductions for exempt income was easy to circumvent via tracing the use to which the borrowed funds were put.

1.9 The current provisions that regulate the deductibility of interest expenses for outward investors are also deficient. These rules rely on tracing the use of borrowed funds. It is relatively easy to circumvent their operation by establishing a use of funds that ensures deductibility. Another problem with the rules is that they apply only on a single entity basis, and it is possible to circumvent them by using interposed entities to separate foreign income from the expenditure.⁷

In essence, the introduction of section 25-90 recognised “tracing” was a reality and not requiring tracing would be a compliance saving for both taxpayers and the ATO. In effect, the rules recognised that by limiting debt deductions based on the level of Australian assets, no tracing of borrowings would be required.⁸

This was recognised at paragraph 1.99 of the Explanatory Memorandum to the 2001 Bill which said:

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.

The 2014 Amendments⁹

In May 2013, the then Labor government introduced a proposal paper¹⁰ to tighten the thin cap rules, including:

- *Repeal the special rule that allows tax deductibility for interest expenses incurred in deriving exempt foreign income (section 25-90 of the Income Assessment Act 1997) (emphasis added).*

The result of the consultation and parliamentary process on this proposal led (amongst other things) to Division 820 being amended to reduce the debt-to-asset ratios to 60% for non-ADIs and the amendment (but not repeal) of section 25-90.

⁶ *New Business Tax System (Thin Capitalisation) Act 2001* (Cth).

⁷ *New Business Tax System (Thin Capitalisation) Bill 2001* (Cth), https://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r1345_ems_2767efc2-f458-440b-ab42-df5724e392ba/upload_pdf/41348.pdf;fileType=application%2Fpdf.

⁸ Thus, the thin capitalisation rules were seen as acting as a code over the quantum of debt limiting the quantum by reference to the value of Australian assets (and thus indirectly the quantum of Australian earnings) with the transfer pricing rules in Division 815 ITAA 1997 determining the rate of interest on that debt.

⁹ *Tax and Superannuation Laws Amendment (2014 Measures NO. #) Bill 2014* (Cth), https://treasury.gov.au/sites/default/files/2019-03/C2014-022_EM-Thin-Capitalisation.pdf.

¹⁰ The Treasury, *Addressing profit shifting through the artificial loading of debt in Australia*, https://treasury.gov.au/sites/default/files/2019-03/Proposals_Paper_Profit_shifting.pdf.

Why section 25-90 was amended but not repealed back in 2014

As was recorded in Hansard in an exchange between Senator Milne and the Deputy Secretary of Treasury Rob Heferen in 2014 in relation to the decision not to repeal section 25-90:¹¹

Senator MILNE: That is a long way of saying that Treasury changed its mind in terms of its recommendation in relation to repealing these provisions. Why wouldn't we have just repealed the provisions and addressed the other side of the argument? The only reason you would keep something like that is that it did not prevent people carrying out legitimate business, which is what you have just said. Why did we not just address that separately, rather than leave this in here? It is increasingly costing the taxpayer. What is it actually costing us? What is your projection on what it will cost by keeping it?

Mr Heferen : Very little. In the unfortunate world of public policy and public policy advising, we do it in reasonably constrained environments; but you learn a lot of things when you go through consultation. Originally the government, back in November 2013, announced that there were a range of things that the previous government had on the books and also that the Howard government had on the books as far as tax goes that it would not proceed with, some it would proceed with and some it would change. The 25-90 one was one that would change. What it said was, 'What we will do is not proceed, but we will explore a targeted anti-avoidance provision.'

We then worked it through with the Tax Office. On the ones that we were actually worried about, there were seven or eight identified. As was worked through quite closely, what we then found was that actually all of those ones that we were worried about would have the facility to restructure and still claim whatever deduction they could. They were large enough and sophisticated enough to have sufficient debt to fund their Australian operations and sufficient equity to fund their foreign operations. They would have to do some tracing of the funds. So there were some extra compliance costs, but for these large corporations it was probably not much.

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. It was one of those very salutary lessons for people like me and people who work with me in our jobs. We realised what seemed like a good idea at the time turned out to be not what we thought, largely because of the capacity of the firms—which we thought the arrangements were targeting—to be able to get around what was being provided.

We therefore ask the question, what has changed since then? If there was no upside then, why is there upside now?

The simple rationale now being put forward that the interest should be non-deductible simply because the non-portfolio dividends are exempt, does not do justice to the policy intent behind the configuration of the existing law.

Moreover, such an important change should have been the subject of advanced warning and proper consultation, prior to the law taking effect being from 1 July 2023. This is poor policymaking.

¹¹ Parliament of Australia, Economics References Committee meeting dated 9 April 2015, <https://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;db=COMMITTEES;id=committees%2Fcommsen%2Faa68d895-38dc-4165-bce7-2082c796519b%2F0003;query=Id%3A%22committees%2Fcommsen%2Faa68d895-38dc-4165-bce7-2082c796519b%2F0000%22>

Many companies have borrowed from third parties in order to invest in their offshore operations and have done so on the basis that the economics are such that it would be preferable to borrow from third parties in Australia, as opposed to raising equity, or alternatively, as opposed to borrowing in the foreign country to fund those foreign operations. Now at the last minute, the economics are being fundamentally changed by denying a deduction for the interest in circumstances where many of these third-party borrowings are locked in to medium and long-term arrangements. This is clearly unfair.

An additional concern is that since the law has been stable for some 10 years or more, many companies have not been tracing the use of borrowed funds and so are not in a position to be able to prove that interest incurred on borrowings that exist as of as of 1 July 2023 relate wholly to funds used for Australian operations. As a result, and since the onus of proof is on the taxpayer rather than on the Commissioner, they will find it very difficult to convince either their auditors for financial reporting purposes or the Australian Tax Office (ATO), that such untraceable borrowings are deductible. Again this is totally unfair.

Another concern that taxpayers have is that if they now embark on restructuring to improve the tax efficiency of such borrowings, such restructuring will be challenged by the ATO on the basis of Australia's anti avoidance rules with the risk of significant penalties. We recommend that flexibility to restructure debt arrangements should be included in the law changes should no or only limited grandfathering be allowed. This is consistent with the approach taken with the introduction of the anti-hybrid rules.

And finally, the new regime will lead to a behavioural response that means that companies will now need to start tracing the use of funds in their companies in corporate groups, which is something that is impractical, if not, in some cases impossible. Rules to provide for a reasonable apportionment of interest expenses between deductible and non-deductible purposes should be included in the law.

As noted earlier, some taxpayers may be able to change their approach to funding future investments in foreign entities so as to use debt to fund their Australian operations and to use equity or cash reserves to fund their foreign operations. Again we note that when changes to the provision were previously considered in 2013 and which were subsequently discontinued, Treasury were of the view that because of the potential for such a change in behaviour the measures would therefore be ineffective for large companies and rather *"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."* (Deputy Secretary of Treasury Rob Heferen in an exchange with Senator Milne¹²)

Interaction with OECD earnings-based approach

The draft EM to the ED Bill includes (at paragraph 1.119):

Additionally, the policy intent of the new earnings-based tests is to limit the amount of deductible interest expense by reference to earnings – that is, an entity is only able to increase its net interest deductions in Australia by increasing earnings in Australia. The rules described in the paragraph above go against the policy underlying the new rules as it gives rise to a double benefit; the benefit of the income being NANE income and the benefit of a deduction for the interest expenses incurred to derive such NANE income.

However, the OECD final report on *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* includes that best practice under the earnings-based approach is that "non-taxable

¹² Ibid, quoting Deputy Secretary of Treasury Rob Heferen in an exchange with Senator Milne.

income such as branch profits or dividend income that benefit from a participation exemption should not be included in the calculation of earnings."¹³ The Australian definition of tax EBITDA meets this criteria, as the starting point is taxable income which does not include amounts that are NANE applying subdivision 768-A.

Denying interest deductions in respect of the non-portfolio dividends NANE income therefore goes beyond the best practice of the OECD.

The interest deductible under section 25-90 would also be included as part of debt deductions for thin capitalisation purposes and may therefore already either be limited or denied applying these provisions. The change to an earnings-based approach means that there is a greater likelihood that such interest may be restricted or denied under thin capitalisation as a result of the non-portfolio dividend NANE income exclusion from the calculation of tax EBITDA.

International comparisons

The proposed measure will make the Australian tax regime less competitive internationally with more restrictive rules (and with greater compliance costs) which are out of step with comparable foreign jurisdictions.

Disallowance of all interest to fund foreign investments is not the approach in all or even most of the OECD or G20 countries which have adopted an earnings based or EBTDA approach. It is not the approach of comparable tax jurisdictions such as the US, UK, France, Germany, Japan, Canada and New Zealand, all of which allow a deduction for outbound financing costs borrowed locally while at the same time limiting the allowable leverage cap to either in-country earnings or in-country assets.

Transitional rules required

Grandfathering of exiting arm's length third party debts or prospective application only

The current rule has been in the legislation since 2001. As outlined above, many taxpayers have existing funding arrangements entered into for commercial ventures and investments in circumstances where the anticipated economic return (and overall investment viability) was based on critical and reasonable assumptions around debt levels and the availability of interest deductibility.

The repeal of the section will cause some projects that were otherwise viable to become uneconomical. We submit that this would deliver an outcome that is manifestly unfair to taxpayers who have priced their existing business ventures on the basis of a stable rule that has operated for over 20 years.

Much debt will be economically 'locked in' and not capable of simply being repaid or restructured.

We recommend that, at a minimum, some type of grandfathering of existing arrangements is needed, especially in respect of third-party arm's length debt.

An even better approach would be to apply the rules, if they are in any event contrary to our recommendation and to nonetheless proceed, on a prospective basis to debt incurred after the commencement date of the rules.

¹³ OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report, <https://www.oecd.org/ctp/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report-9789264241176-en.htm>, paragraph 78.

Flexibility to restructure debt arrangements

If the amendments proceed with no transitional rules, *we recommend* the law must recognise that groups should have an opportunity to restructure their debt arrangements to the extent commercially possible.

Groups which might easily have traced their funds used for overseas acquisitions, and which did not do so because Australia's tax laws were changed expressly to make such tracing unnecessary, must not be denied the opportunity to appropriately restructure their debt.

Therefore, Australian companies will consider, at its simplest level, using free operating cash flow to repay existing debt which has been borrowed expressly to finance shareholding in foreign associated companies, and raising new debt funding which relates to its Australian business or for payment of dividends and the interest for which is deductible.

This type of structuring should not be subject to Part IVA risk. Groups (absent transitional rules) need to have the opportunity to structure their debt arrangements so as to comply with the new legislative environment. This is consistent with the approach taken with the introduction of the interest hybrid rules some years ago.

Reasonable allocation rules must be legislated

Reasonable allocation rules require legislative action.

The amendments to section 25-90 will mean that many affected groups need to determine a basis upon which interest expenses can be allocated between Australian income producing purposes (deductible under section 8-1) and the making of investments in foreign branches or subsidiaries that yield exempt income (non-deductible).

Where Australian entities can specifically direct (trace) the use of funds to a purpose for which interest is deductible, the ability to specifically undertake such tracing must be preserved.

Affected groups must be provided with a reasonable degree of flexibility to choose how to allocate the funding arrangements (borrowing for one purpose, using cash for another) rather than being subject to the risk of being challenged by the ATO on allocation issues or from a Part IVA perspective.

It should not be open to the ATO to deny a deduction to a taxpayer for interest expenses that can be specifically traced to the use of debt for an allowable (Australian) purpose.

Where tracing is not possible, then there needs to be reasonable and codified basis upon which companies with debt (not otherwise subject to transitional rules) can apportion interest between deductible and non-deductible components. *We recommend* the basis upon which apportionment may be undertaken should be prescribed in legislation or regulation as being a reasonable basis rather than being subject to ATO discretion.

The interrelationship with Part IVA is of significant concern. It should be open to groups to choose how to allocate their funding arrangements (borrowing for one purpose, using cash for another) rather than being subject to the risk of being challenged by the ATO from a Part IVA perspective. *We recommend* this should be specifically addressed at least as part of the explanatory memorandum to the Bill.

De minimis is required to protect small firms

The proposed changes will result in unnecessary compliance burdens on all companies with offshore investments in relation to their debt financing, including medium and small businesses. In particular medium and small business will typically not have the flexibility of larger businesses in how to structure their foreign operations in order to reduce or avoid requirements for tracing of the use of the borrowed funds.

We recommend that a \$2 million de minimis exemption be included in the section 25-90 proposal (i.e. retain section 25-90 for all companies with debt deductions that do not exceed \$2 million) in line with the de minimis for thin capitalisation purposes.

Interest withholding tax

It would be unfair and inappropriate for withholding tax to be applied to interest payments made by an Australian taxpayer to a non-resident in circumstances where the interest deduction is not available by virtue of the section 25-90 amendment.

We recommend that a consequential amendment should be made to these provisions in order to prevent these inappropriate outcomes.