Building a better
working world

Ernst & Young
200 George Street
Sydney NSW 2000 Australia
GPO Box 2646 Sydney NSW 2001

Tel: +61 2 9248 5555
Fax: +61 2 9248 5959
ey.com/au

International Tax Unit
Corporate and International Tax Division
Treasury
Langton Cres
Parkes ACT 2600

30 October 2023

By email: MNETaxIntegrity@treasury.gov.au

EY Submission

ED Amendments to Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023

Dear Mr Hawkins

Ernst & Young (EY) welcomes the opportunity to comment on the Exposure Draft (ED) released on 18 October 2023 of proposed amendments to the thin capitalisation and debt deduction creation measures in Schedule 1 of *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023* (the Bill).

We welcome the further proposed incremental and technical amendments to the thin capitalisation measures and the adjustments to the scope of the debt deduction creation measures in the ED.

The proposed thin capitalisaton law is very complex and includes for example many mismatches of approaches in dealing with non-consolidated groups for thin capitalisation purposes. The policy reasons for these approaches are not articulated in the explanatory materials. Taxpayers will be required to undertake extensive detailed work and to obtain advice on many matters to be able to comply with the provisions.

The debt deduction creation rules are drafted in extremely broad terms and will cause uncertainty for both existing debt and any newly introduced debt into an inbound group unless a very limited number of specific exceptions apply.

The drafting of the provisions and these particular issues will mean that taxpayers will need to seriously contemplate seeking binding private rulings from the Australian Taxation Office before entering into even simple commercial arrangements to seek to resolve uncertainties, which will increase costs of compliance and costs of doing business.

Further substantive changes are therefore needed to the proposals in line with submissions of EY and others to address significant continuing issues that we submit will result in uncertainty and unexpected outcomes which would inadvertently hinder businesses from accessing legitimate debt deductions that arise in their ordinary business operations or as part of businesses expanding their operations.

Please refer to the Appendix for our detailed comments and recommendations in relation to:

- ► Fixed Ratio Test tax EBITDA calculation issues including:
  - ► Tax losses - the original ED law adjustment to add back in the calculation of tax EBITDA carry forward tax losses used by an entity to reduce their taxable income should be reinstated.

    Alternatively, subsection 820-52(1A) should be repealed. This proposed amendment to deem that the maximum amount of carried forward tax losses have been applied in

calculating an entity's tax EBITDA is inappropriate. Taxpayers that choose not to use their carried forward losses should not be penalised by having their debt deductions limited on a notional calculation basis. Further, taxpayers who are limited in the use of their carried forward tax losses (e.g. tax consolidated groups that have an available fraction on certain tax losses) would be unfairly penalised by this proposed amendment.

- An entity should not be required to exclude from its tax EBITDA dividends including franking credits, its share of the net income of a trust in which it is a beneficiary and / or its share of the net income of a partnership in which it is a partner. That is, subsections 820-52(2), (3), (6) and (8) should be repealed.

  In the alternative (if these changes are not made):

  - The usual 50% associate test should apply to the proposed exclusions;
  - The trust distributions excluded in this context should be limited to only distributions of net income and should exclude tax deferred distributions; and
  - There should be a sharing of excess tax EBITDA capacity for all entities as exists within the current thin capitalisation rules for the "associate entity excess amount". There is no valid reason for limiting the sharing of excess tax EBITDA only between unit trusts and managed investment trusts as proposed in section 820-60. As currently drafted, the Bill and proposed amendments in the ED, unfairly disadvantage non-consolidated groups and partnership structures.
    Further any trust distributions excluded should exclude tax deferred distributions.

- Trust excess tax EBITDA amounts – section 820-60 should be amended to include indirect control interests in determining eligible entities.

- Trust calculation of tax EBITDA - should exclude the 50% CGT discount and the carry forward of disallowed deductions rules should allow trusts to rely on the business continuity rule.

- Third party debt test conduit financing concession issues:
  - Strict requirements for costs incurred in paragraph 820-427C(1)(e) should be relaxed to provide that "costs" are required to be "substantially similar" and to specifically address issues for private company groups to deem that the requirement is met if the loan to the borrower is at or more than the Division 7A ITAA 1936 benchmark interest rate for the year.
  - The paragraph 820-427A(3)(c) requirement that the only assets that a secured borrower can look to for the third party debt test to be available are Australian assets should be removed.

- Definition of net debt deductions issues:
  - Paragraph 820-50(3)(b)(ii) should be amended to expand the debt interest condition to apply to a broader range of financing arrangements.
  - Paragraph 820-50(3)(b) should also be amended to address timing mismatch issues between the assessable income of the entity and amounts incurred by another entity.

- Debt deduction creation rules issues including:
  - Entities that are excluded from the thin capitalisation rules under section 820-37 (90% Australian asset test) should also be excluded from the debt creation rules. This would be consistent with the exclusion provided for entities that are excluded from the thin

capitalisation under the de minimis test (section 820-35) and certain special purpose entities (section 820-39).

- We recommend that genuine non-ADI financing companies should also be excluded from the rules in respect of their financing business.
- An exclusion for borrowings from an associate to fund the acquisition of trading stock and existing equity interests should be included. This would be consistent with the exclusions provided in former Division 16G of the ITAA 1936.
- There should be a purpose requirement in subdivision 820-EAA so that it is only where the obtaining of a tax benefit is the predominant or principal purpose for the restructure that these interest deduction denial rules will apply, to reflect the policy intent of the measure as stated in the EM that the provisions are intended to disallow debt deductions to the extent that they are incurred in relation to debt creation schemes that "lack genuine commercial justification".
- Exceptions for the acquisition of certain CGT assets in section 820-423AA timing requirement should be clarified.
- Subsection 820-423A(5) should be limited to shareholder equity distributions such as dividends and returns of capital. Subsection (5) should not apply to payments more generally. Subsection (5) is very broadly drafted and will capture a range of normal business scenarios that are not schemes that are within the spirit of what the debt creation rules are intended to capture (i.e.. they are not schemes that lack genuine commercial justification).
- Refinancing of an existing loan from a foreign associate should be excluded from the debt creation rules where that loan had originally been used for a purpose that would not be within the scope of the debt creation rules (e.g. a loan from a foreign resident associate to fund the acquisition of an asset from a third party). This would be akin to the exclusion provided in former Division 16G where there is no increase in net indebtedness of the Australian entity.
- We recommend an exception should be included where there is no increase in net indebtedness as was the case in former Division 16G.
- We also recommend a carve out for any related party refinancing of previously deductible debt (i.e. outside parameters of debt creation rules).
- We recommend the removal of sub paras (ii) and (iii) from subsection 820 – 423A(5) (ie "facilitate the funding of' and "increase the ability of..") since the specific anti avoidance provision of section 820-423D can already safeguard the revenue from arrangements which have a principle purpose of gaming the system.
- *Retrospective application of the rules* - Notwithstanding the proposed ED change to the debt deduction creation application provisions to provide a one year "grace period" in respect of certain pre-existing debt, the provisions will still have a substantial retrospective effect, which is in our view inappropriate and should be remedied by grandfathering existing structures or transactions without any sunsetting date.

* * * * *

We would be pleased to discuss these matters in further detail with Treasury.

Should you have any questions in relation to our comments and suggestions, please do not hesitate to contact Alf Capito (02 8295 6473, alf.capito@au.ey.com), Tony Merlo (03 8575 6412, tony.merlo@au.ey.com) or Brian Lane (03 8650 7250, brian.lane@au.ey.com) in our Tax Policy Centre.

Yours sincerely

Ernst & Young

Appendix

A1. Fixed ratio test – Tax EBITDA calculation issues

The proposed calculation for the fixed ratio test of an entity's tax EBITDA (section 820-52) may give rise to inappropriate outcomes which we submit should be adjusted as below.

A1.1 Adjustment for the use of carry forward tax losses by an entity in reducing their taxable income

The fixed ratio test should apply to the actual tax EBITDA of an entity referable to activities undertaken in that income year.

The March 2023 ED recognised this and included in the calculation of tax EBITDA a step to add the sum of each entity's tax losses for earlier income years to the extent they are deducted under Division 36 from its assessable income for the income year. In the Bill this step is now absent.

We submit that omitting this adjustment distorts the entities' tax EBITDA and penalises entities that legitimately seek to reduce their tax payable through the utilisation of tax losses referable to activities undertaken in prior years.

We recommend the adjustment outlined in paragraph 820-49(d) of the March 2023 ED that "next, add the sum of each of the entity's tax losses for earlier income years, to the extent that they are deducted under Division 36 from its assessable income for the income year;" be again reincorporated into the tax EBITDA calculation.

The ED proposed rule in subsection 820-52(1A) to deem that the maximum amount of carry forward losses have been applied in calculating tax EBITDA is also inappropriate. Taxpayers that choose not to use their carry forward losses should not be penalised by having their debt deductions limited on a notional calculation basis.

A further example of where the proposed ED amendment in subsection 820-52(1A) would have a disproportionate impact on the calculation of tax EBITDA is where a tax consolidated group has a bundle of tax losses with an available fraction. The available fraction limits the amount of tax losses that can be utilised in a particular income year; however, subsection 820-52(1A) would deem the entire amount of the tax losses to have been utilised in calculating the tax EBITDA for the tax consolidated group. This will be a particularly harsh outcome where a bundle of tax losses has a low available fraction.

If the loss add-back is not included in the Bill then we recommend this provision should be removed.

A1.2 Dividend income exclusion

Notwithstanding the proposed ED exclusion for interests in companies which are not associates under the modified 10% TC control interest definition used for the provision, the remaining subsection 820-52(3) exclusion of dividend income and franking credits from tax EBITDA will still result in inappropriate and inequitable thin capitalisation outcomes for impacted entities.

Dividend income that is assessable under section 44 of the *Income Tax Assessment Act 1936* (ITAA 1936) should be included in tax EBITDA regardless of whether these amounts have been franked and the percentage ownership held. Similarly, ignoring Division 207 denies the incorporation of the amount of a gross up in establishing the total amount of dividend income received where the dividend is a franked dividend. We are of the view that this amount should also be included in tax EBITDA.

We can see no fundamental mischief where an entity has borrowed to invest in another entity which warrants a denial of deductions in respect of costs of that borrowing.

Where a significant portion of a company's earnings are dividends (franked or otherwise), their ability to claim any interest expenses incurred in generating this income will be significantly reduced under

the proposed changes. For holding/investment companies and finance entities that are not consolidated for tax purposes, the impact on tax payable could detrimentally impact the ability for these non-consolidated businesses to benefit from this additional investment.

This could distort investment decisions, especially when financing acquisitions of less than a 100% interest in Australian companies and may have a negative impact, particularly on Australian companies that have a history of paying dividends to investors (franked or otherwise).

It also seems an inconsistent outcome that a head entity of a tax consolidated group will include the income of all members in the consolidated group in the tax EBITDA calculation notwithstanding where the debt financing sits in the group (i.e. whether debt deductions are in the head entity or in a group member) while a group that is not consolidated or which has less than 100% owned controlled entities (e.g. a 90% controlled entity) cannot include that part of the non-consolidated entities' income which has been paid up to the controlling entity as dividends.

There are times for commercial reasons (for example to give employees equity in an entity) that head companies might only own say 80% or 90% of a subsidiary. Where the head entity had borrowed to buy or fund the subsidiary, it cannot be a good policy outcome that the head entity receives no deduction for its interest since the only income it has is dividends from the subsidiary

We recommend subsections 820-52(2) and 820-52(3) be removed from the Bill.

A1.3 Excess tax EBITDA amounts

While, subject to our specific comments for trusts below, we welcome the inclusion of the ability to add excess tax EBITDA from certain controlled unit trusts and / or managed investment trusts (MITs) to an entity's own tax EBITDA as proposed in section 820-60, we can see no policy reason why this approach should be limited to unit trusts investments in other unit trusts.

The ability to transfer excess tax EBITDA capacity amounts should be extended to apply to all entities irrespective of the nature of the entity.

Concerns that this could result in "double dipping" of EBITDA capacity are unfounded as there would only be a sharing of the excess tax EBITDA capacity. Further, as the fixed ratio test and group ratio test (which both rely on the calculation of tax EBITDA) are "earnings based" tests, it is appropriate that there be a sharing of excess tax EBITDA capacity as the income is ultimately subject to tax at the investor level.

Even if a policy intent of denying entities' access excess tax EBITDA amounts of associate entities (other than certain unit trusts) was to require debt to be borrowed by the entity which generates the relevant earnings, such policy intent ignores the commercial reality that groups typically have one entity which manages its financial arrangements with third party financiers and on-lends amounts throughout its group as required. Further, the new debt deduction creation rules would then appear to penalize groups which follow the policy intent by denying debt deductions for such on-lent amounts (see examples discussed further below). This can be further exacerbated where an Australian non-tax consolidated group simply utilizes an Australian cash pool which results in no overall net Australian indebtedness, resulting in entities with taxable interest income but entities which are potentially denied debt deductions. Such outcomes disproportionately penalize inbound and outbound groups which have simple and benign financing arrangements as compared to taxpayers with Australia-only operations which are not subject to the thin capitalization regime.

Companies with interests in other companies and unit trusts (and partners with partnership income) and unit trusts with interests in companies should also be entitled to access this excess tax EBITDA mechanism to balance the exclusion of dividend and trust and partnership income from the tax EBITDA calculation. Notably under the current thin capitalisation rules the add-back for "associate entity excess amounts" is not restricted to any particular entity or entity relationship.

Building a better working world

Alternatively, if the deletion of subsections 820-52(2) and 820-52(3) is not proceeded with then:

- *We recommend that the exclusion of dividend income from tax EBITDA be limited to dividends which are received from associate entities applying a 50% or more associate test – that is, applying the current associate entity test without any further modification (i.e. not applying any modifications such as in subsection 820-52(9)).*
- *Further, we recommend that the rules include a mechanism for excess tax EBITDA from the relevant associate company, trust or partnership to be reflected in the interest holder's tax EBITDA calculation in a similar manner as the existing associate entity excess rules operate. This should apply at a minimum in respect of any entity which is not excluded from the amended dividend adjustment rule above.*

A1.4 Fixed ratio test for trusts and partnerships other issues

Amendments are required so that the fixed ratio test operates more appropriately for trusts and in particular for property trusts:

A1.4.1 Exclusion of trust and partnership income

- The reduction in tax EBITDA by disregarding trust and AMIT income and partnership income rules in subsections 820-52(6), (6B) and (8) should be removed.
  - If the rules are not removed then they should apply only in respect of associate interests *applying a 50% or more associate test – that is, applying the current associate entity test without any further modification (i.e. not applying any modifications such as in subsection 820-52(9)).*
- Further the trust distributions excluded in this context should be limited to only distributions of net income and should exclude tax deferred distributions.
- In addition, an appropriate transfer of excess tax EBITDA amounts for partners in partnerships which are associates should be included (for the reasons noted above).

A1.4.2 Proposed s820-60

While we welcome the proposed inclusion of the trust excess tax EBITDA amount provision in the ED (section 820-60 and paragraph 820-52(1)(ca)) we recommend an adjustment is required to the subsection 820-60(2) controlled trust 50% or more interests held condition to include TC indirect control interests as well as TC direct control interests in this calculation.

A1.4.3 Calculation of tax EBITDA for trusts – CGT discount provisions

Where the CGT discount provisions are not disregarded for the purpose of calculating the tax EBITDA of a trust, this will give rise to anomalies for unitholders:

- For example, in the context of a managed investment trust, the tax EBITDA will be calculated based on the net income of the trust (including the net capital gain at a 50% discount), capping the debt deductions to 50% of the capital gain. However, a distribution from the trust to non-resident unitholders will be calculated based on the fund payment amount (which ignores the CGT discount). The MIT withholding tax is a final withholding tax. These unitholders pay tax on the full capital gain but do not get the benefit of the full debt deduction (capped at 30% EBITDA) against the grossed-up capital gain.
- Similar issues arise with the calculation of the excess tax EBITDA as this calculation is based on the same tax EBITDA.
- Despite holding a 50% or more interest in a trust, corporate beneficiaries do not benefit from any debt deduction in the trust as corporate beneficiaries are excluded from the excess tax EBITDA.

- *We recommend amendments should be made to exclude the 50% CGT discount in calculating net income and determined trust components.*

A1.5 Carry forward of disallowed debt deductions under fixed ratio test

- Subsection 820-59(5) requires that trusts seeking to carry forward disallowed debt deductions satisfy the rules in Schedule 2F ITAA 1936 as though the disallowed amounts were tax losses. While we acknowledge the need to place limits on the carry forward of the amounts to prevent trafficking of disallowed amounts, we submit that it is inequitable that most trusts will be restricted to applying the 50% stake test without access to the business continuity test.
- We submit that there is no policy reason that a trust (which is commonly used in the commercial funds management industry) which is ultimately held by a number of investors who may turn over on a regular basis (such as an open-ended fund) should be treated differently from a company in the same circumstances.

Accordingly, we submit that the rules should be amended to permit trusts to rely on the business continuity rule where the 50% stake test is not satisfied.

A2. Third party debt test conduit financing concession

Whilst we welcome the carve out for conduit financing arrangements and adjustments made in the Bill and the ED proposals, the rule remains restrictive in nature and still may not be accessible in practice to many third party financing arrangements.

A2.1 Costs incurred

Paragraph 820-427C(1)(e) requires that that the terms of each relevant debt interest are the same as the terms of the ultimate debt interest to the extent those terms relate to a cost incurred in relation to the debt (with some specific exceptions in subsection 820-427C(2)).

These requirements are unduly restrictive and do not reflect the common usage of group financing entities. Typically:

- The terms of internal loans are generally much briefer to suit the commercial needs of the group (whereas external loans are often governed by terms several hundred pages long).
- 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.
- *Private company groups*

  A further issue arises for private company groups where conduit financing needs to be subject to the Division 7A Income Tax Assessment Act 1936 provisions where the conduit financing is to an entity other than a company.

  These provisions broadly require loan arrangements to associates to be put on complying Division 7A terms to avoid the operation of the rules, which would deem a dividend to have been paid. The loan must be either for 7 years or 25 years with security and requires minimum repayments each year applying a "benchmark interest rate" which resets each year. The Division 7A rules are a legislated arm's length structure for related party loans within private groups.

  It would be unlikely that the terms of the conduit financier's loan from the ultimate lender would match the terms required under the Division 7A complying loan rules. In particular the benchmark interest rate (currently 8.27% for the 2023-24 income year and adjusted annually) would not align to commercial third party terms for a loan. This will typically result in a private company not being able to access the conduit rules, notwithstanding the conduit financier has borrowed from a third party and on-lent the funds on terms which the legislature has

prescribed as arm's length terms. We see no good policy reason why private company groups should be disadvantaged in this manner.

We recommend that:

- *The condition in paragraph (e) is amended such that "costs" are required to be "substantially similar" (we note that the word "substantially" is included in paragraph 2.106 of the EM in relation to what generally is a conduit financier arrangement)*
- *For private companies the cost condition for the amended paragraph (e) should be taken to be met if the loan to the borrower is at the benchmark interest rate for the year.*

A2.2 Non-Australian assets

There is a requirement in paragraph 820-427A(3)(c) that the only assets that a secured borrower can look to, for the third party debt test to be available, are Australian assets but the definition of this is nebulous and could exclude a foreign debt owing to an exporter of goods or services from Australia.

Accordingly if all that an Australian borrower has is purely an Australian operation but one which exports overseas, any customer receivable owing to the company to which a secured lender can look to for security, could have the effect of denying the entity use of the third party debt test.

This must be an oversight and should be corrected in the draft law.

A3 *Definition of net debt deductions*

- 820-50(3)(b)(ii) – this paragraph includes amounts which are received "under a scheme giving rise to a debt interest". Finance companies may provide finance through arrangements which are not debt interests. For example, finance leases, bailment or other arrangements which are hire purchase arrangements under Division 240. Fees paid under these arrangements are economically equivalent to fees paid under debt interests and taxpayers should benefit from the same reduction in the net debt deductions amount.

  Accordingly, we recommend that this subparagraph is amended to expand the debt interest condition to apply to a broader range of financing arrangements (e.g. Division 240). This is consistent with the role of finance companies being mere financial intermediaries.

- 820-50(3)(b)(ii) and (iii) – each of these subparagraphs refer to an amount which is "incurred" by another entity. If the use of this expression takes its meaning from the expression as it is used in section 8-1, this may inadvertently exclude amounts because they are incurred by another entity in a different income year from which they are included in the assessable income of the taxpayer applying Division 820. This timing mismatch could be acute where the taxpayer receiving the payment is required to include the amount in their assessable income pursuant to the accruals method under the Taxation of Financial Arrangements rules in Division 230. It is unclear why the inclusion of assessable income is linked with an expense incurred by another entity.

  We suggest amending Section 820-50(3)(b) by omitting the existing subparagraphs (ii) and (iii) and replacing them with:

  > *"(ii) any financial benefits received, or to be received, by the other entity under a scheme giving rise to a *debt interest or similar financial arrangement (including Division 240 arrangements); or*
  >
  > *(iii) any other financial benefits received that is specified in the regulations made for the purposes of this subparagraph."*

A.4 Debt deduction creation rules

The Bill introduces new Subdivision 820-EAA debt deduction limitation rules for debt creation.

We welcome the ED amendments to appropriately reduce the potential scope of the debt deduction creation rules to apply only to related party debt and for the other modifications proposed.

However the rules as they stand remain extremely problematical and will result in significant uncertainty. We anticipate that it will be difficult for tax advisors to give comfort to any inbound client (or Australian groups that fall into the rules due to the 90% asset test exclusion not applicable for these rules) that debt deductions on their related party debt, both current or future, is deductible.

Paragraph 2.146 of the EM dealing with the debt deduction creation rules notes the following:

> "New subdivision 820 – EAA directly addresses this risk by disallowing debt deductions to the extent that they are incurred in relation to debt creation schemes that lack genuine commercial justification".

We submit that the debt deduction creation rules as currently drafted have significant unintended consequences which go well beyond capturing "schemes that lack genuine commercial justification" or transactions or arrangements which create (as per paragraph 2.149 of the EM) "artificial interest bearing debt within a multinational group."

Specific examples of where the draft rules apply which we believe are inconsistent with this intent include:

- ► Funding transactions undertaken, completed or executed before 1 July 2023 (albeit with debt deductions claimable in income years after that date)
- ► Transactions that result in no net increase in interest bearing debt/debt deductions in Australia. That is, the borrower and lender are both Australian residents or where an Australian resident entity refinances an existing loan with a foreign resident associate (particularly where that loan was originally provided for a purpose that would not have been within the scope of the debt creation rules (e.g. to fund the acquisition of an asset from a third party)).
- ► Transactions which whilst resulting in additional debt, simultaneously increase the Australian taxable income producing capacity of the Australian taxpayer.

A4.1 Related party acquisitions

Under subsection 820-423A(2) the rules apply to deny deductions for related party debt, where that debt is used to effectively acquire an asset from a related party unless a limited range of exceptions now proposed in the ED apply.

We welcome the ED inclusion of three exceptions for the acquisition rule however exceptions should also be included in line with carve outs in the former debt creation rules in Division 16G of the 1936 Income tax Assessment Act (Div 16G) for:

- ► *The acquisition of trading stock*
- ► *The acquisition of existing equity interests, unless part of an avoidance scheme.*

Moreover, there are many instances where businesses restructure themselves to achieve commercial efficiencies, or in anticipation of a demerger or potential business divestment. Such restructures often involve borrowings to acquire related party assets.

In such cases, the commercial driver is not the interest deduction tax benefit, but rather the various commercial imperatives that drive the decision to restructure.

In such cases, where it is clear that the restructure or transaction does not "lack genuine commercial justification", it would seem harsh that the rules would apply to deny interest deductibility.

- *For this reason, we recommend that provision make it clear that it is only where the obtaining of a tax benefit is the predominant or principal purpose for the restructure, that these interest deduction denial rules will apply.* Any such recognition of purpose would also align the broader rule with the specific anti-avoidance rules contained in section 820-423D.

We believe there should be more guidance on what is meant by "holding of the CGT asset" contained in s820-423A(2)(d)(ii). For example, if an entity acquires a CGT asset from an associate which is not funded from debt but debt is later obtained to develop the CGT asset (e.g. a building), presumably this is not debt that is in relation to the holding of the CGT asset but has been incurred for another purpose. However, the use of the word "holding" is ambiguous and therefore greater clarity in the EM should be provided.

A4.1.1 Acquisition of CGT assets exceptions

None of the exceptions for the acquisition of certain CGT assets in section 820-423AA include a timing requirement in respect of when the disposing entity is an associate pair of the acquirer. Accordingly, entirely separate arrangements and transactions may have the ability to unintentionally bring a debt within the scope of the rules.

For example: if an Australian subsidiary (part of a multinational group) acquired shares in another entity from an unrelated third party (vendor) using related party debt, the debt creation rules would appear not to apply to the related party debt. However, if subsequently as part of a completely separate transaction (and potentially years later), the broader multinational group underwent another acquisition which included a direct or indirect acquisition of the vendor, any debt deductions incurred by the Australian subsidiary post- acquisition of the vendor would appear to become non-deductible (because 820-423A(2)(b) is not limited to whether the disposer was an associate pair at the time of the acquisition).

We recommend this requirement is clarified in order to provide certainty to taxpayers by requiring the disposer to be an associate pair of the acquirer at the time of acquisition (or within a limited period before/after).

A4.2 Related party distributions

Subsection 820–423A(5) denies debt deductions on borrowings between related parties where the money borrowed is used to make distributions or other payments to one or more related parties. Presumably this would cover distributions in the nature of dividends, capital or simple loan repayments.

Subsection 820-423A(5) is very broadly drafted and will capture a range of normal business operation scenarios that are not schemes that are within the spirit of what the debt creation rules are intended to capture (i.e. they are not schemes that lack genuine commercial justification) and which should not be subject to the rules.

The ED amendment to the subsection removes the previous limitation to the "predominant" use of funds for the stated purposes which further expands the potential application of the provision. The proposed ED exceptions in subsections 820-423A(5A) and (5B) apply narrowly.

A borrowing by a parent to inject equity into a non-consolidated or partly owned (i.e. joint venture) entity to enable that entity to make a dividend or capital distribution to all of its shareholders, both related and unrelated, would be caught by these provisions. As would a simple loan to the non-consolidated or partly owned (i.e., joint venture) entity in similar circumstances, rather than an equity injection.

Or if the subsidiary was simply to repay a loan back to the parent or any other related party, this would also be caught. Indeed the entire loan borrowed by the parent company would be caught as being non-deductible, even though only part of the distributions made by the subsidiary were made to a related party.

Moreover, in the case of the loan repayment, all that has happened, is that an interest-bearing deductible loan that resided with the subsidiary has been replaced by equity in the subsidiary, and the loan has effectively been transferred to the parent, with no additional debt created in the parent/subsidiary structure.

As there is no increase in debt, it seems anomalous that the debt creation rules would apply to such circumstances, which are not uncommon.

We recommend subsection 820-423A(5) should only apply to shareholder equity "distributions" – e.g. dividends and returns of capital and it should not apply to "payments" more broadly as this can capture payments of ordinary business operating expenses to related parties (e.g. purchase of trading stock, management fees etc.). It will become very difficult (if not impossible) for an entity to try and trace funds where it may have a working capital facility with a related party (e.g. cash pooling arrangement) that is used to fund its business operations.

Our comments in section A4.2.1 below raise additional issues in relation to the terminology used in this provision.

We would again recommend that the new provisions have a safeguarding rule, requiring that there be an intended purpose of creating an Australian tax benefit (ie increasing prima facie debt deductions in Australia) as the predominant/principal motivator behind any transaction or arrangement before the rules should operate.

A further safeguard that would deal with this anomaly would be to make it a precondition to the operation of the rules that the aggregate deductible debt amount that the parties to the transaction are entitled to in Australia must have increased in order for the rules to apply. Notably, in the former Div 16G rules, there was a carve out from the rules for transactions that did not give rise to any increased overall related party indebtedness (subsection 159GZZF(5))(discussed further below).

Other examples of what we believe are unintended consequences requiring adjustment to the draft rules:

<u>Acquisition transaction</u>

It is not uncommon in commercially driven acquisition transactions for a target entity to be acquired by an acquiring company and, as part of the acquisition, the acquiring company will facilitate loans to the target in order to enable the target to repay existing loans to its previous parent, other related parties or third party debt, being the loans which existed preacquisition.

In these cases, it is typical for the acquirer to provide loan funding to the target to enable the target to repay its pre-acquisition loans as part of the acquisition settlement process. This of itself may trigger the rules.

Moreover, often the acquiring parent then re-finances those intermediary loans made to the target at the time of acquisition with more efficient funding. This refinancing may also trigger the rules.

We recommend a predominant/principal purpose test as a precondition to the operation of the rules would be one way of dealing with such unintended consequences.

<u>Any related party refinancing of previous clean/deductible related party debt is caught</u>

If an Australian subsidiary borrows from an overseas parent to refinance an existing "clean" debt, i.e. a debt not currently in debt creation proposals but owed to a non-resident related party (e.g. the debt has been used to acquire an asset from a third party), then refinanced debt is in the new rules because

the borrowing refinanced will not be in the exclusion in subsection 820-423A(5B) as the lender (recipient) is a foreign resident.

<u>Uncertainty created with new debt with subsequent distribution funded by cash reserves</u>

Any new debt which is used for "clean" purposes could "facilitate the funding of" or "increase the ability of any entity (including the payer)" to make a payment (e.g. loan repayment) or distribution (e.g. Dividend) to an overseas related party (subsection 820-423A(5) as amended by the ED)

For example, if a subsidiary borrowed from its parent to fund operating expenses, but later in the year, or next year, used pooled cash to pay a dividend to its parent, the fact that the first borrowing increased the capacity of the sub (or related entity or group) to pay the dividend is problematic.

This creates enormous uncertainty as to how a company can manage its financing even when the company is being careful not to fall foul of the rules. Since funding is a fungible concept, the use of concepts such as "facilitate the funding of" or "increase the ability of" makes navigating these rules without risk almost impossible without seeking an ATO ruling on a regular basis. Surely this cannot be the objective of good law design.

In this regard we point out that the Revenue is already well protected from arrangements designed to "game the system" by virtue not only of the generally anti avoidance rule in Part IVA but also from that newly introduced specific anti avoidance rule in 820-423D.

We recommend an exception should be included where there is no increase in net indebtedness as was the case in the former Division 16G.

We also recommend a carve out for any related party refinancing of previously deductible debt (i.e., outside parameters of debt creation rules).

We recommend the removal of sub paras (ii) and (iii) from subsection 820 – 423A(5) (i.e. "facilitate the funding of' and "increase the ability of..") since the specific anti avoidance provision of section 820-423D can already safeguard the revenue from arrangements which have a principle purpose of gaming the system.

A4.2.1 Meaning of 'payments or distributions'

The use of the phrase "payments or distributions (within the meaning of section 26BC of the ITAA 1936)" in paragraph 820-423A(5)(b) appears unclear.

Section 26BC of the ITAA 1936 relates to securities lending arrangements. It includes a definition of 'distributions' and makes reference to certain 'payments', but it does not refer to the concept of 'payments or distributions':

- A 'distribution' is defined to include:
  - Interest
  - Dividends
  - A share issued by a company to a shareholder in the company where the share is issued as a bonus share or in the circumstances mentioned in subsection 6BA(1) (i.e. where the shares are issued in respect of the original shares)
  - An amount credited by the trustee of a unit trust to a unit holder as a unit holder
  - A unit issued by the trustee of a unit trust to which section 130-20 of the ITAA 1997 applies (i.e., bonus unit issuances)
- References to a 'payment' include:
  - The making or payment of a distribution (in respect of a borrowed security)

- A payment (a compensatory payment) equal to the value to the lender of the distribution (in respect of a borrowed security)
- A payment equal to the value of the right or option (in the context of the issue of a right or option in respect of a borrowed security)
- A payment equal to the value of the shares, units, bonds, debentures or financial instruments that resulted from or would have resulted from exercising the right or option (in the context of a borrowed security being a right or option)

Accordingly, if the meaning of "payment or distribution" was strictly limited to the meaning per section 26BC, we would not expect the meaning to extend to a repayment of capital, repayment of loan principal, ordinary trading arrangements (i.e., acquisition of trading stock, payment of management fees etc.). However, the comments in the EM appear to go beyond the meaning in section 26BC by stating that the term "includes any amounts credited, reinvested, applied to the benefit of another entity, settled on a net basis or a non-cash basis, and the forgiveness of a debt …, amounts of capital, such as returns of capital and repayments of principal under a debt interest."

If the clause should be interpreted broadly consistent with the guidance in the EM, i.e., as "… one or more payments, or distributions (within the meaning of section 26BC of the ITAA 1936),…", the clause appears to significantly extend beyond the desired policy impact and may impact any ordinary related party commercial arrangements (including cash pool arrangements used by many large multinational groups) such as the acquisition of trading stock from a related party, payment of management fees to a related party (both of which relate to amounts credited / applied to the benefit of another entity).

We recommend the extent of this clause is clarified – either through specific EM commentary or via drafting amendments.

For example: If an Australian subsidiary borrowed from its foreign or Australian parent to fund operating expenses, which included any related party transaction (i.e., an acquisition of trading stock / payment of management fees, etc.) with an Australian or foreign related party, such transactions would appear to fall within the ordinary meaning of 'payment' or alternatively within the extended meaning per the EM of amounts credited or applied to the benefit of the entity and therefore the debt deduction creation rules would appear to deny a debt deduction. Further, with respect to payments made to Australian related parties, neither exception would appear to apply since the payment would not be 'entirely referable to the proceeds of the issue of the debt interest' where the funds are used as part of ordinary working capital, and the payment is not referable to the repayment of principal.

A4.2.2 Exceptions in 820-423(5A) and (5B)

In addition to the comments above regarding non-tax consolidated corporate groups, we consider the drafting of the two exceptions to subsection 820-423A(5) to be too narrow.

- The exception in (5A) only permits related party debt to be on-lent to Australian related parties. This is not conducive to Australia being used as a holding jurisdiction which provides financing to international related parties.
- As set out above, the exception in (5B) permits related party debt to be used to refinance pre-existing related party debts owing to Australian entities. However, due to the wording of paragraph (c), this exception appears only to apply to an initial refinancing, since any subsequent refinancing would be in respect of an amount which meets the requirements of paragraphs (5)(a), (b) and (c).

A4.3 Specific exclusions

It is notable that the former Division 16G rules were limited in their application to transactions between companies which had a foreign controller, and any interest deduction denial was based on a capital entitlement factor (restricting any interest denial essentially to the foreign controller's

ownership interest). The rules contained exceptions for the acquisition of trading stock, the acquisition of newly issued shares in a company, acquisition of existing shares in an Australian resident company and where the transaction resulted in no increase in the overall indebtedness of the group.

Subdivision 820-EAA only excludes a taxpayer with associate inclusive debt deductions of $2m or less, or that is an insolvency remote special purpose entity, securitisation vehicle or ADI as proposed by the ED, and therefore the rules have broad application.

We submit that taxpayers that are excluded from the thin capitalisation rules by section 820-37 (ie. the 90% Australian asset threshold test) should also be excluded from the debt creation rules in subdivision 820-EAA. These entities are predominantly Australian parented groups that have limited foreign operations. For example, certain Australian groups may only have a very small single offshore entity which would bring them within these rules and cause significant compliance burden on trying to comply with such rules given the difficulties noted above (even though there is symmetry between the expense and income with any related party on-lending). The perceived concerns that the debt creation rules are intended to capture do not apply to such taxpayers. Such an exclusion would also be consistent with the exclusions referred to above.

We therefore also recommend that a number of further specific exclusions should be introduced:

- ► *For any taxpayer who satisfies the asset threshold rules in section 820-37 and is not otherwise subject to the thin capitalisation rules*
- ► *Where there is no increase in the net indebtedness of the associate pair*
- ► *Where debt deductions are paid to an Australian resident lender (whether related party or not) unless, having regard to the purpose test, there is back-to-back funding with a non-resident.*

A4.3.1 Exclusions for financiers

We welcome the inclusion in the ED of sensible exclusions from the provisions for ADIs and securitization vehicles.

There are lots of other financing entities operating credit businesses which have some level of APRA regulation which are not ADIs that are all still in the rules.

A good example of this is finance companies used by large groups such as the motor vehicle manufacturers or by leasing companies.

The finance company provides loans, chattel mortgages, leases to third party customers to purchase the relevant asset – e.g. car. The finance company needs funds to buy the car from the distributor (whether related party or not). Typically these finance companies operate with significant debt funding and they source the cheapest debt they can because this impacts the pricing to the customer. This may be related party debt or third party debt or a combination of both. The profile/quantum of the debt may change over time, and the challenge with an exclusion for no overall increase in net indebtedness is the level of debt will depend upon whether their loan portfolio is increasing or decreasing. In some instances, the financier could be rolling related party debt every 30 days. Whilst the funds are being lent to external customers (i.e. "clean" debt), if they roll related party debt, this is going to result in the refinanced debt being caught by the "payment" issues outlined above.

From a policy perspective, there is no logic to refinancing of the debt used to fund an external loan book being subject to these rules as the financiers are net lenders and their net debt deduction will be positive assessable income.

EY
Building a better working world

We recommend that genuine non-ADI financing companies should also be excluded from the rules in respect of their financing business.

A4.4 Sufficient influence exception

We welcome the sufficient influence debt default exception included in proposed s820-423E(4)&(5) however we query why is this exception is only limited to trusts. *We recommend that this debt default exception should equally apply to companies in default of their debt.*

A4.5 Retrospective application of the rules

Notwithstanding the proposed ED change to the debt deduction creation application provisions in respect of certain pre-existing financial arrangements, the new provisions will still have a substantial retrospective effect, which is in our view inappropriate and should be remedied by grandfathering existing structures or transactions without any sunsetting date.

While the proposed "grace period" application change may defer the application of the rules for financial arrangement entered into before 22 June 2023, the provisions will still apply to such debt arrangements which are still on foot as at 1 July 2024, from that date.

It is unclear from the ED change and draft explanatory material to the ED what is permissible under the extension to restructure arrangements out of the proposed provisions before 1 July 2024.

In particular we are concerned whether any attempt to restructure the arrangements to avoid the unexpected adverse impact of the new rules, would potentially be contrary to the widely drafted anti avoidance rules forming part of the new changes in Section 820-423D.

In addition, taxpayers will be required to identify all impacted arrangements and take steps to restructure them in a very short period of time from the eventual enactment of the law to 30 June 2024.

As a simple solution to this we recommend that the debt deduction creation deduction rules only apply in respect of debt deductions <u>*on debts that are created after a specific date (eg 1 July 2023).*</u>