21 July 2023

Committee Secretary
Senate Economics Legislation Committee
The Senate
Parliament House
CAPITAL HILL ACT 2600

Email: Economics.Sen@aph.gov.au

Dear Secretary

Submission to the Inquiry into *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023*

The Australian Investment Council (**the Council**) welcomes the opportunity to consult with the Senate Economics Legislation Committee on the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill* 2023 (**the Bill**).

The Council is the peak body for private capital in Australia and our members collectively manage over A$57 billion for investment into the establishment and growth of Australian businesses. Our members comprise the leading domestic and international private capital firms operating in Australia, and span private equity, venture capital, private credit, family offices, superannuation, and sovereign wealth funds.

Private capital funds serve an important purpose by pooling capital from a variety of sources to finance economic activity and jobs in Australia. Capital is invested by individuals, Australian superannuation funds, sovereign wealth funds (including the Future Fund), foreign persons as well as life insurance companies, endowments, and charities.

There are three specific issues in the Bill that form the basis of our Submission:
1. The inclusion of a New Debt Creation Rule in the Bill;
2. The breadth of the proposed Third-Party Debt Test; and
3. The application of the Fixed Ratio Test to unfranked dividends.

To assist the Committee, we have listed recommendations in a box at the end of each section.

If you have any questions about this submission, please do not hesitate to contact me or our policy team via email at policy@investmentcouncil.com.au.

Yours sincerely

Navleen Prasad
Chief Executive Officer
Australian Investment Council

Australian Investment Council Submission

The Council's submission focuses on the Bill's proposed amendments in **Schedule 2**, which amends the *Income Tax Assessment Act* 1936, the *Income Tax Assessment Act* 1997, and the *Taxation Administration Act* 1953 to strengthen Australia's thin capitalisation rules. In making recommendations, we have been informed by the policy intent of the proposed Bill.

1. New Debt Creation Rule

Under the new debt deduction creation rule (proposed Subdivision 820-EAA), debt deductions are disallowed to the extent that they are incurred in relation to debt creation schemes that lack commercial justification. These rules are intended to restrict debt deductions for:

- Any debt (from an unrelated external third party or an associate entity) relating to an acquisition of an asset (or an obligation) from an associate entity (s820-423A (2)); or
- Debt from an associate entity to fund a distribution or payment to that, or another, associate entity (s820-423A (5)).

We acknowledge that these provisions have intentionally been drafted broadly to help ensure they can apply to debt creation schemes of varying complexity. The Explanatory Memorandum (**EM**) states that proposed Subdivision 820-EAA is intended to apply to 'debt creation schemes that lack genuine commercial justification'.

However, and because there has been no public consultation on these provisions, there has been no proper opportunity for stakeholders to examine the practical application of the policy and therefore, whether there are any unintended and perverse consequences. For example, the provisions have the capacity to capture arrangements that have genuine commercial justifications such as the transfer of shares or assets between members of a group for various reasons (eg: asset protection or to facilitate a sale).

The inclusion of Subdivision 820-EAA in the Bill that was presented to Parliament was a surprise to taxpayers, advisors, and industry. Other provisions in the Bill have undergone a more rigorous public policy development process, including public consultation in September 2022.

Another measure that did not have the benefit of proper public consultation, the proposed repeal of section 25-90, has been deferred. This measure was contained in the March 2023 draft legislation and was similarly unexpected by taxpayers. We welcome government's decision to listen to stakeholder feedback and defer the measure so that proper public consultation can be conducted. We strongly suggest that the proposed new debt creation rule also be removed from the Bill and a separate consultation process be conducted.

Grandfathering

Another reason for deferring proposed Subdivision 820-EAA is the commencement date: 1 July 2023, which is only six business days after the Bill was introduced into Parliament. There does not appear to be any grandfathering for existing arrangements.

It is practically unfeasible for taxpayers to review and comprehend the impact of the provisions on their operations, and then try to implement them. For example, many taxpayers will not have sufficient historical records to go back and trace to what extent its debt deductions are caught by this measure, particularly where such transactions have occurred many years ago and personnel have left the business.

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Recommendations

1. We recommend that this measure is removed from the Bill so that it can have a proper consultation process.

2. In the alternative, we request that the Bill is updated to introduce a purpose requirement, ie: that the measure only applies if one of the principal purposes is not genuinely commercial.

3. The EM should also be updated to provide some examples of the types of transactions that do not lack genuine commercial justification and would not be caught by this measure, for example:
   - Certain internal restructures within 12 months of a third-party acquisition, where the anti-churning measures contained within s716-440 do not apply.
   - The carve out of certain assets to a new entity in preparation for sale, where the new entity funds that acquisition with debt from an unrelated external third party.

2. Third-Party Debt Test

The EM suggests the policy intent of the proposed amendments in the Bill is to strengthen Australia's thin capitalisation rules to combat multinational profit shifting and tax avoidance by ensuring that debt (interest) deductions are linked to an entity's economic activity and taxable income in Australia. We understand that with this backdrop, the proposed rules have been written with multinational companies in mind.

Private capital investments funds, and their portfolio companies, can be Australian residents but be brought into the thin capitalisation rules as an outward investing entity due to holding a foreign (eg: New Zealand) subsidiary. Consequently, we consider there are some unintended consequences for private capital funds which we have set out below.

Under the External Third-Party Debt Test (ETPDT), a debt interest issued by an entity only satisfies the '*third party debt conditions*' in relation to an income year if the following conditions (amongst others) are met (proposed paragraph s820-427A (3)):

> c) the holder of the debt interest (eg: the lender) has recourse for payment of the debt ***only to Australian assets held by the entity.*** However rights under or in relation to a guarantee, security or other form of credit support are prohibited, unless specified circumstances apply; and
> d) the entity uses ***all, or substantially all***, of the proceeds of issuing the debt interest to ***fund its commercial activities in connection with Australia***.

The EM (at paragraph 2.30) confirms that these additional requirements are an integrity measure to ensure the thin capitalisation rules are fit for purpose and that the amendments to introduce the new earnings-based rules are not undermined. We consider there are unintended consequences with this proposed drafting that could be overcome with some minor tweaks to the drafting without compromising the policy intent.

Recourse only to Australian assets
In relation to the recourse of the holder in section 820-427A(3)(c), the proposed drafting creates a 'cliff' where 100 per cent of the interest deductions on the debt from an unrelated third-party bank can be treated as non-deductible under the third-party debt test where the unrelated third-party bank has recourse to any non-Australian assets. This is the case even where the foreign assets represent a relatively immaterial (eg: 11 per cent) of the total assets that the holder has recourse.

Going forward, taxpayers may be able to negotiate with the lender such that the lender does not have recourse to any foreign assets to ensure that this condition is met. However, as these rules are intended to apply from 1 July 2023 and there is no grandfathering for existing debt interests, there will be many instances where existing debt from an unrelated third-party bank that would otherwise satisfy the third-party debt conditions, but for the lender having recourse to an immaterial amount of foreign assets, will be impacted by this requirement.

Those taxpayers could explore whether it is possible to refinance the existing bank debt to remove the non-Australian assets from the security net, however this may not be commercially realistic (due to the economic situation), can take months to implement and can be expensive for taxpayers (due to bank fees and specialist advice costs).

Rather than creating a 'cliff', the policy intent could be met by restricting a percentage of interest deductions. The percentage should be equal to the portion of non-Australian assets relative to total assets that the lender has recourse. This would be a more proportionate way of meeting the policy intent without excessively penalising taxpayers who are seeking to grow their businesses.

All, or substantially all, of the proceeds are used to fund commercial activities in Australia
The term "substantially all" is not defined in the legislation. The EM (at paragraph 2.30) confirms that the term 'all, or substantially all' is intended to cover circumstances where all of the proceeds are used for the relevant activities but accommodates a minor or incidental use of the proceeds for other activities.

Using the same example as above, where a debt is borrowed from an unrelated third-party bank by an Australian acquisition company to fund the acquisition of an Australian target company that has a New Zealand subsidiary, it is not clear from the proposed drafting whether the Australian acquisition company has used all of the proceeds to funds its commercial activities in connection with Australia, as the Australian target company will have operations in both Australia and (indirectly via its subsidiaries) in NZ.

Where the Australian acquisition company is not considered to have used all of the proceeds to fund its commercial activities in connection with Australia, the proposed drafting of this section creates a 'cliff' where 100 per cent of the interest deductions on the debt from an unrelated third party bank can be treated as non-deductible under the third party debt test, if the portion of funding that corresponds to the value of the New Zealand subsidiary did not represent a minor or incidental part of the funding.

When considering this in combination with the proposed repeal of s25-90, we consider that only interest deductions in relation to the portion of debt that relates to funding of the New Zealand subsidiary should be restricted under this provision. Given the potential overlap between these two rules, where the proportionate method is adopted, we recommend there is clarity provided on the interaction between the ETPDT and any future repeal of s25-90 to confirm that these provisions deny the same proportion of debt deductions. For example, using the above example for illustrative purposes, the ETPDT and any future repeal of s25-90 would apply to restrict the same 11 per cent of interest deductions.

We acknowledge that the drafting will need to ensure that taxpayers allocate the value between Australian and non-Australian entities on a fair and reasonable basis.

Recommendations

1. We suggest that paragraph 2.98 of the EM be updated to confirm that "Australian assets" is intended to capture shares in foreign subsidiaries / interests in other foreign entities.

2. We recommend that new subsections are inserted as follows:

   s820-427A(6): *Where a debt interest that would otherwise meet the conditions in s820-427A(3) but fails the condition in s820-427A(3)(c) due to the holder of the debt interest having recourse for payment of the debt to which the debt interest relates to both Australian and non-Australian assets, the following percentage of the debt interest will be treated as satisfying the third party debt conditions in s820-427A(3).*

   Value of Australian assets / Value of Australian and non-Australian assets
   s820-427A(7): *Where a debt interest that would otherwise meet the conditions in s820-427A(3) but fails the condition in s820-427A(3)(d) due to the proceeds from the debt interest being used to fund the direct or indirect acquisition of a foreign entity that was not a minor or incidental use, the following percentage of the debt interest will be treated as satisfying the third party debt conditions in s820-427A(3).*

   Value of Australian entities / Value of Australian and non-Australian entities
   s820-427A (8): *For the purposes of s820-427A (6) and s820-427A (7), the value of the assets or entities should be determined as follows:*

   i. Their value in the most recent audited financial statements for that entity for a period ending no earlier than 18 months prior to the debt interest is issued; or

   ii. Their value as determined by an independent market valuation using a commercially accepted valuation methodology.

3. Fixed Ratio Test and dividends

In calculating tax EBITDA, subsections 820-52(2) and (3) of the Bill proposes to exclude dividends and franking credits. The EM states that this avoids double counting income as the dividend represents profits which have already been taxed at the company level and are referable to the company's tax EBITDA.

However, this fails to recognise that some profits may not have been subject to corporate tax and may be distributed as unfranked dividends. For example, a company may have received a dividend from a foreign subsidiary which is non-assessable non-exempt income, or it may have disposed of a foreign subsidiary carrying on an active business. As set out in list of provisions in section 11-55 of the *Income Tax Assessment Act 1997*, there are a range of other scenarios in which amounts derived by a company may not be subject to corporate tax.

In these circumstances, we suggest that it is inappropriate to exclude dividends from tax EBITDA of the upstream entity receiving the dividend as there would be no double counting of amounts in tax EBITDA.

Recommendation

1. We note that it may be impractical to determine the extent to which a company has paid tax on its profits. To address difficulties with tracing the source of profits and whether corporate tax has been paid on those profits, our recommendation is, that unfranked dividends should not be excluded from tax EBITDA.