CPA Australia Ltd
ABN 64 008 392 452

Level 20, 28 Freshwater Place
Southbank VIC 3006 Australia

GPO Box 2820 Melbourne
VIC 3001 Australia

P 1300 737 373
Outside Aust +613 9606 9677

cpaaustralia.com.au

Committee Secretary
Economics Legislation Committee
Department of the Senate
Parliament House
CANBERRA ACT 2600

Email: seniorclerk.committees.sen@aph.gov.au

21 July 2023

Dear Sir/Madam,

Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023

CPA Australia is Australia's leading professional accounting body and one of the largest in the world. We represent the diverse interests of more than 173,000 members in over 100 countries and regions. We make this submission in response to the **Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023** (Bill) on behalf of our members and in the broader public interest.

We make the following comments and key points for your consideration which we believe would further improve the efficacy of the proposed new thin capitalisation legislation (Schedule 2 to the Bill).

1. Start date

The Government should defer the commencement date of the legislation until at least after Royal Assent. Many areas require further clarity and resolution and the retrospective application is unfair to taxpayers.

2. De minimis threshold

The Government should consider changing the $2 million de minimis threshold from a gross basis to a net basis given the introduction of a "net debt deduction" concept. This would prevent taxpayers being caught where amounts are duplicated within a group and being counted twice. As an example, an amount borrowed and on-lent to a related party resulting in $1 million of interest on each leg of the back-to-back loan would result in $2 million total debt deductions in the group. Under a net debt deduction test there would more appropriately be $1 million of net debt deductions as the interest income derived by the interposed entity would reduce the $2 million gross amount to a $1 million net amount.

3. Adoption of an associate entity excess rule with respect to excess capacity

The adoption of an associate entity excess rule with respect to excess capacity would properly complement the removal of trust distributions and dividends from an entity's tax earnings before interest, taxes, depreciation, and amortisation (tax EBITDA). In a non-consolidated structure, such as a head trust or a sub-trust, where the debt is incurred at the head entity level to fund equity in the subsidiary, the proposed rules effectively deny all material debt deductions. This is because the parent entity's tax EBITDA is likely to be minimal or nil if it only consists of distributions from the subsidiary entity. The subsidiary entity may have no debt at all and may have large excess capacity, for example, large profits but no debt deductions. While the removal of distributions from tax EBITDA prevents "double counting" of benefits, it also unfairly attacks structures where there is no double counting, but debt is merely at the wrong level, that is, at the parent entity level.

Allowing the parent entity to pick up the excess capacity of the subsidiary entity, based on its percentage held in the subsidiary, would achieve alignment between consolidated groups and non-consolidated group and would be neutral as to what level of the structure that debt is held at. The Explanatory Memorandum (EM) suggests that the reason for the no associate excess rule is for "simplicity" and "integrity". However, such a rule should exist side-by-side with the exclusion of distributions from tax EBITDA, in particular to avoid targeting commercial structures entered into in good faith under the existing rules which allow the use of the excess safe harbour amounts of subsidiary entities.

The EM also hints at potential restructuring to avoid such outcomes, for example "pushing debt down" but this appears to ignore commercial realities that existing arrangements cannot always be changed. This also seems to involve the new debt creation rules being triggered. As an example, a subsidiary entity may borrow in order to return capital to the parent entity, which uses those funds to pay down debt. This effectively pushes the debt down from the parent entity to a subsidiary entity. However, if the borrowing is from an associate, the use of those funds to return capital to another associate is caught by the debt creation rules and potentially Part IVA of the general anti-avoidance rules, subject to any ATO guidance. The combination of the lack of associate entity rules and the new debt creation rules has the effect of trapping entity groups in certain structures and denying debt deductions even when the overall level of debt deductions for an entity group is not excessive.

4. Removal of debt creation rules (new Subdivision 820-EAA) until proper public consultation undertaken

The debt creation rules were added to the Bill and were not included in the Exposure Draft. As such, they were developed without consultation. The proposed rules are extremely broad and go far beyond the stated purpose of attacking debt creation schemes that lack commercial justification. For example, they will apply to deny debt deductions where an entity borrows, including from a bank, to purchase trading stock from a related entity or simply to establish a subsidiary entity.

The rules also apply to wholly domestic schemes that do not involve payments being transferred offshore despite the EM referring to profit-shifting arrangements. The former Division 16G of *the Income Tax Assessment Act 1936* (ITAA 1936), which these rules are stated to be modelled on, had sensible exclusions for these exact kinds of ordinary transactions. The current proposed rules have no exclusions at all and have no tax purpose test.

They also appear to attack non-consolidated structures common in small and medium enterprises (SME) groups. For example, a group could have an operating entity, a finance entity and a service entity. If the operating entity borrows from the finance entity for working capital and also pays service/management fees to the service entity, these would now appear to result in denied deductions. By contrast if this was in a tax consolidated group then this would not result in any denials because of the single entity rule. The rules also do not have the "90 per cent Australian asset" exclusion under s 820-37 of the *Income Tax Assessment Act 1997* so that groups with a minimal foreign presence (e.g., a dormant foreign subsidiary with $100 in it) will be caught by the rules even though there is no risk of profit-shifting (assuming over $2 million Australian debt deductions within the group as this exclusion still applies).

The rules also have no grandfathering such that it could apply in relation to post-1 July 2023 debt deductions that relate to pre-1 July 2023 asset acquisitions. For example, it could be an asset transferred to an associate entity in 1995 that is still held by the associate entity. This requires significant compliance costs to consider how every single asset held post 1 July 2023 was historically acquired. The old Division 16G had a sensible rule such that it only applied to assets acquired after the start date of the rules, i.e. 1 July 1987.

We recommend that the debt creation rules be removed from the Bill and a proper public consultation process is undertaken.

5. Issues with the third party debt test requiring correction

There are currently major deficiencies in the third party debt conditions in s 820-427A(3). In particular, the limited recourse rule in s 820-427A(3)(c), which only allows the external lender to have recourse to the assets of the borrowing entity. Very few third party lenders will lend having recourse to the assets of the borrowing entity only, instead they will require assets of related entities as security and guarantees. In its present form, most third party lenders will not satisfy the third party debt test.

Furthermore, the test also does not make sense considering the concept of obligor group in s 820-48, which result in entities also being deemed to make a third party debt test choice where they provide a guarantee or security in relation to a debt incurred by an entity that made a Third party debt test (TPDT) election. This deemed choice only makes sense if a lender can have recourse to the assets of entities other than the borrower in the first place. However, where this borrowing is done via a related "conduit" that satisfies the conduit financing conditions in s 820-427C, the rules appear to allow the lender to now have recourse to the assets of entities that are members of the obligor group (refer to s 820-427B(4)(b)(i)). This is the appropriate outcome and the treatment of borrowing via a related conduit borrowing from an external lender directly should be treated similarly.

Another issue is the requirement of the conduit financer on-lending only on the same arm's length terms (refer to s 820-427C1(e)). This means where the conduit financer on-lends third party borrowing on non-arm's length terms, the recipient entity, which could be related group entities, will be denied its debt deductions.

The other main issue with the third party debt test is that the conditions can only be satisfied by an "Australian resident" as per s 820-427A(3)(e). This term links back to the definition in s 6(1) of the ITAA 1936, which only covers individuals and companies. This means that trusts and partnerships are effectively excluded entirely from accessing this third party debt test. Therefore, trust and partnerships will need to use the group or fixed ratio tests instead. We believe this is a drafting error. Correction should be made by replacing "Australian resident" with "Australian entity", which is defined in section 336 of the ITAA 1936 to include Australian trusts and Australian partnerships and is a term commonly used in the thin capitalisation rules.

If you have any queries, contact Bill Leung, Tax technical Advisor on (03) 9606 9779 or **bill.leung@cpaaustralia.com.au**.

Yours sincerely,

Elinor Kasapidis
Head of Policy and Advocacy