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

Email: economics.sen@aph.gov.au

22 December 2023

Dear Sir/Madam,

Government Amendments to 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 Government Amendments (Sheet **RU100**) to **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 summary comments and key points for your consideration:

- The 30 per cent tax EBITDA interest rate cap will reduce deductible debt. Limiting the debt deductions companies can claim will make Australia a less attractive place to invest, adversely impacting jobs and the economy.
- Despite the narrowing of its scope, the debt deduction creation anti-avoidance rules without a tax purpose test will have the unintended consequence of adversely impacting genuine commercial transactions, resulting in the denial of their commercially valid interest deductions.
- The third party debt test needs to include a tax purpose test instead of a general prohibition on recourse to assets that are credit support rights.
- Entities that hold between 10 per cent and just below 50 per cent in an investment entity will not be able to benefit from the transfer of excess tax EBITDA. This could curtail property joint ventures and consortiums investing in Australian housing developments.
- Change the $2 million *de minimis* threshold from a gross basis to a net basis to prevent amounts being duplicated within a group and being counted twice.
- The new thin capitalisation rules should not have a retrospective application. They have been developed in haste, poorly conceived and still have significant issues that if not addressed, will drive investment offshore to jurisdictions with more favourable and simpler thin capitalisation rules.

If these sub-optimal thin capitalisation rules are legislated, we submit they will seriously hurt investment, the economy and jobs in Australia.

Please refer to the Appendix for our detailed discussions. If you have any queries, contact Bill Leung, Tax Technical Advisor on (03) 9606 9779 or bill.leung@cpaaustralia.com.au.

Yours sincerely,

Ram Subramanian
Interim Head of Policy and Advocacy

Appendix

Detailed discussion

1. Summary

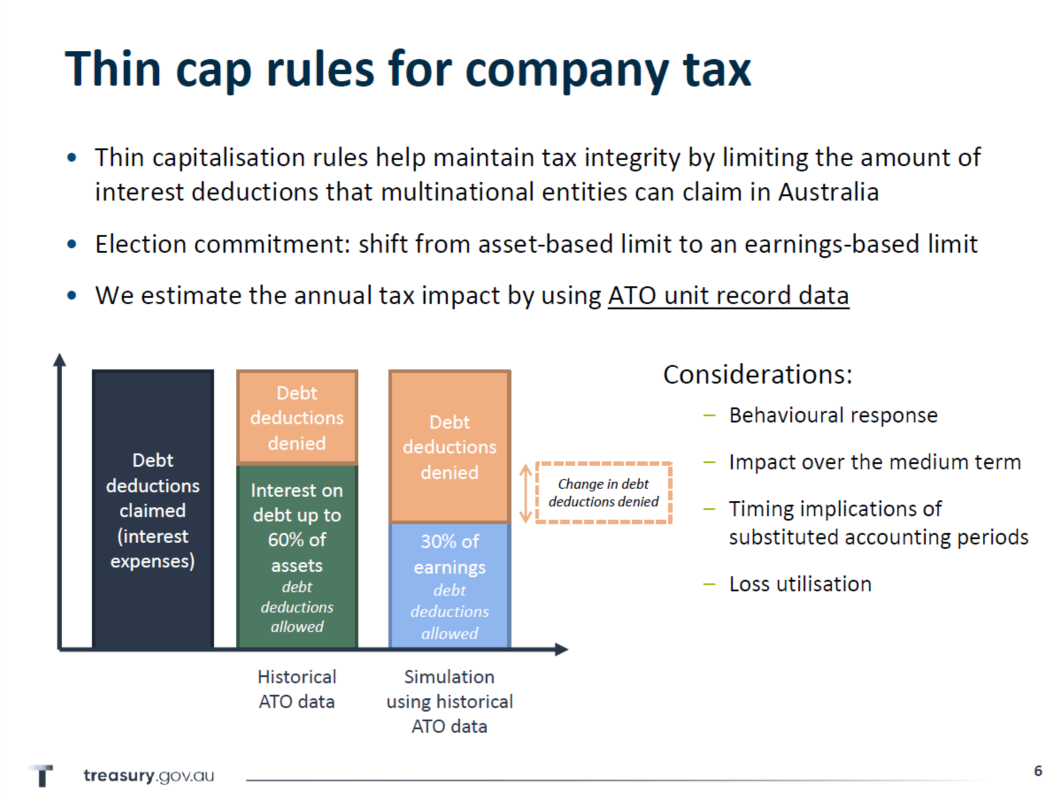
We stress that passage of this Bill as is has the potential to damage our economy and jobs. Capital is mobile and investors have choices. They seek opportunities with the best return on investment and this Bill will impact that return. Jurisdictions with thin capitalisation rules that are more favourable and less complicated, will look more attractive to investors than Australia.

2. 30 per cent tax EBITDA cap

The OECD's 2015 **Action 4 report**[1] on *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* established rules that linked an entity's net interest deductions to its level of economic activity within the jurisdiction, shifted the measurement from asset-based limit to using taxable earnings before interest income and expense, depreciation and amortisation (tax EBITDA).

From the commencement of 2019, all European Union (EU) Member States apply an interest cap that restricts a taxpayer's deductible borrowing costs to generally 30 per cent of the taxpayer's earnings before tax EBITDA. The Government's new thin capitalisation rules also propose to adopt the 30 per cent tax EBITDA interest cap.

It is important to recognise that the adoption of interest limitation rules is not prevalent around the world. The latest edition of OECD's **Corporate Tax Statistics**[2] published in November 2023 shows that of the 134 Inclusive Framework jurisdictions, 67 (or 50 per cent) had interest limitation rules in place in 2023, and this is unchanged from what was **published**[3] in July 2020. Out of the 67, only 23 of them have a 30 per cent tax EBITDA interest cap in place. This means jurisdictions such as Canada and China with asset-based limits and who are competing with Australia for investment will have a more favourable and simpler thin capitalisation regime.



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1 OECD (2015), **Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report**, 5 October 2015

2 OECD (2023), **Corporate tax Statistics 2023**, 21 November 2023

3 OECD (2020), **Action 4 Limitation on Interest Deductions**, July 2020

The above graph from the Treasury's costing slide[4] compares deductible debt under the existing thin capitalisation rules with the proposed 30 per cent tax EBITDA interest cap. It provides evidence that the proposed thin capitalisation rules will significantly reduce deductible debt from 60 per cent to 30 per cent in Australia, i.e. halving interest deductions.

Therefore, given only half of the Inclusive Framework jurisdictions have some form of interest limitation rules in place and of that only 23 out of the 67 jurisdictions (or 34 per cent) have a 30 per cent tax EBITDA interest cap, we submit it is not in Australia's best interest to be an earlier adopter of the 30 per cent tax EBITDA interest cap. Furthermore, the halving of deductible debt from 60 per cent to 30 per cent tax EBITDA will significantly reduce investments in Australia as investors can achieve a better return on investment in more favourable thin capitalisation jurisdictions. This will have a detrimental impact on Australian jobs and the economy.

3. Debt deduction creation rules

We submit it is necessary to insert a tax purpose test into the debt deduction creation rules.

While the amendments propose to narrow the scope of the debt deduction creation rules, the lack of a tax purpose test means genuine commercial transactions could still be caught by these anti-avoidance rules. For example, there is still no exemption for purchases of trading stock, meaning that debt deductions will likely be denied where an entity uses related party debt to fund the acquisition of trading stock from an associate. This is likely to capture situations where intercompany payables on stock purchases are left outstanding and begin to accrue interest.

The general Part IVA anti-avoidance rules have a tax purposes test to ensure genuine commercial transactions would not be caught. We **reiterate** our significant concern that given the priority in the application of the debt deduction creation rules over the three primary thin capitalisation tests, there would still be genuine commercial transactions falling outside the exclusion from the application of the debt deduction creation rules. This unintended application to genuine commercial transactions will further discourage investments into Australia. Investors need certainty – they are hesitant to invest in jurisdictions where tax anti-avoidance rules could apply to a genuine commercial transaction.

We previously **submitted** that there is also no grandfathering of any pre-existing arrangements with the debt deduction creation rules and this is still the case with the latest amendments. As such, an exercise will still be required to assess the application of the debt deduction creation rules to transactions that may have occurred before the commencement of the rules to determine whether the debt deductions will be allowable once the rules commence. There will still, however, be a need for a complex tracing exercise to determine the original use of any existing and new related party debts, including where these debts have been refinanced multiple times.

Furthermore, the debt deduction creation rules will still need to be considered where an entity has conduit financing arrangements that satisfy the conditions of the third party debt test but the entity has not chosen the third party debt test. This is because the entity also has related party debt or if it does not want to forfeit its ability to carry forward disallowed amounts under the fixed ratio test.

4. Third party debt test

We **previously** submitted that the third party debt test is problematic in the draft Bill, i.e. a third party lender does not have recourse to a guarantee, security or other forms of credit support. The general prohibition on recourse to assets that are credit support rights is still maintained, although the proposed government amendments seek to broaden the so-called 'greenfield exception' (which will broadly allow rights in relation to a guarantee, security or credit support in certain circumstances) to include the creation of and development of certain moveable property situated on Australian land (in addition to the development of Australian land as per the original Bill).

However, the concession is not available where a foreign entity that is an associate entity provides a guarantee or other form of credit support. This requirement creates an unlevel playing field for development assets, where Australian entities that hold 50 per cent or more are permitted to provide a guarantee (even where the assets of the Australian entity are foreign assets), while non-residents are not permitted to provide a guarantee in these circumstances (even if their assets are Australian assets).

[4] The Treasury (2023), Treasury Revenue Costing Process, 231207 – TAD Costing Role slides, page 6

We submit our concerns that the third party debt test is not reflective of how third party lenders operate. Standard lending arrangements would see the lender also having (as a minimum) security over the equity in the borrower, as well as associate entities. The fact remains that very few third party lenders will lend having recourse to the assets of the borrowing entity only. They will require assets of related entities as security and guarantees instead. As it stands, some third party lenders will still not satisfy the third party debt test recourse requirements. As such, in its current form, the third party debt test is still limited in utility.

To address the government's concern, we recommend that the test should insert a purpose test that limits its scope to disallowing debt deductions where a 'debt dump' of third party debt in Australia that is recoverable against the global group occurs. This was the specific concern highlighted in the **Explanatory Memorandum**[5] to the draft Bill. We should not pursue a general prohibition on recourse to assets that are credit support rights.

5. Fixed ratio test and excess tax EBITDA

As recommended in our previous **submission**, the amendment in the Exposure Draft allows trust distributions to form an entity's tax EBITDA for entities holding less than ten per cent and eligible unit trusts that hold more than fifty per cent to benefit from the excess tax EBITDA amendment. However, entities that hold between ten and just below fifty per cent, such as joint ventures and consortium investments, are excluded from benefitting from the amendment. The change to allow eligible unit trusts to transfer their excess tax EBITDA amounts to other eligible unit trusts is welcome, however it is still very narrow in scope as most non-consolidated entities and trusts will not be able to benefit.

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.

Entities that hold between ten per cent and just below fifty per cent in an investment entity will not be able to benefit. This would have wide ranging negative implications for joint ventures and consortium investments in Australia. One such consequence is that property development joint ventures and consortiums would shift their investments from Australia to other jurisdictions with a more favourable tax regime. This is at a time when Australia needs significant investment into new housing developments. Australia is not the only jurisdiction that needs investment into housing development.

6. *De minimis* threshold

We also raised in our previous **submission** that the Government needs to change 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 from being caught where amounts are duplicated within a group and counted twice and 'lose' their *de minimis* threshold. 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.

7. Retrospective application of the new thin capitalisation rules

Given the issues we raised above and that eight months would have elapsed since the 1 July 2023 start date by the time the Senate Economic Committee's report is delivered on 5 February 2024, we submit any new thin capitalisation rules should not commence on 1 July 2023.

The new thin capitalisation rules should not have a retrospective application in any circumstance. Our premise is that the new thin capitalisation rules should only commence when they are ready and we submit the current amended Bill is still flawed and significant issues remain.

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[5] The Parliament of The Commonwealth Of Australia (2023), **Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023: Explanatory Memorandum**, p 26

If the Parliament legislates these sub-optimal thin capitalisation rules in haste, they will seriously hurt investment into Australia, and therefore the economy and jobs. We submit that we should continue with the existing thin capitalisation rules until we have a properly designed replacement thin capitalisation legislation.