Corporate Tax Association

Level 11, 455 Bourke Street
Melbourne, 3000

Tel: (03) 96004411
admin@corptax.com.au

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Mr Marty Robinson
First Assistant Secretary
International Tax Unit
Corporate and International Tax Division
Treasury
Langton Crescent
PARKES ACT 2600

By email: MNETaxIntegrity@treasury.gov.au

Dear Mr Robinson,

Strengthening Australia's interest limitation (thin capitalisation) rules

The Corporate Tax Association (**CTA**) welcomes the opportunity to make a submission to Treasury on the *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation* Exposure Draft (**ED**) and the accompanying Explanatory Memorandum (**EM**).

The CTA is the key representative body representing over 150 of the major companies in Australia on tax issues impacting the large corporate sector. The majority of the CTA membership is large Australian listed entities. A list of CTA members and further information about the CTA can be found on our website at www.corptax.com.au.

We appreciate Treasury's willingness to consult on the measure prior to the lodgement of this submission. We note that the CTA has never received as many member comments on a legislative proposal than on what is proposed in this ED.

The ED in its current form is an overengineered integrity rule

While we recognise the rules are in essence an integrity measure, if the proposed regime is implemented as set out in the ED, Australia will have one of the most restrictive interest limitation regimes in the world. Add this to Australia's high headline corporate tax rate, overengineered integrity rules and the proposed effective repeal of sec 25-90 and subsection 230-15(3)[1] and you have a system that will place Australian groups at a competitive disadvantage (particularly those with offshore activities and desires for future offshore expansion) while giving the distinct impression that Australia is not 'open for business'.

[1] For simplicity, future references in this submission will only be to sec 25-90 but the same reasons noted herein equally apply to subsection 230-15(3).

The proposed section 25-90 amendments are bad policy and need reconsideration

To say the proposed changes to sec 25-90 came as a surprise is an understatement. At no stage of the consultation process (either in the MNE Consultation Paper or the October 2022 Budget announcement) were the proposed changes flagged, nor (with respect) does the rationale for its repeal as outlined in the EM consider the fundamental policy difference between outbound and inbound groups.

Furthermore, the sec 25-90 changes are intended to come into effect from 1 July 2023 and have not taken into consideration previous rules operative from 2013 that removed the need for tracing of the use of funds. It is submitted the EBITDA tests referencing Australian earnings plus the overarching transfer pricing rules provide the necessary limitation on debt deductions. At the very least, the proposed changes to sec 25-90 should only apply to debt deductions on new arrangements and be subject to a separate consultation process from the proposed changes to Division 820 and 815.

Detailed Comments

We have included in Appendix 1 some commentary on the priority concerns our members have raised. In summary, these issues include:

1. The ED does not reflect the original policy intent, particularly with the substitution of the arm's length debt test with the new External Third Party Debt Test and the surprise repeal of sec 25-90.

2. Separate consultation on sec 25-90 is required as a minimum to thoroughly consider the implications of its proposed repeal. The integrity concerns underpinning its proposed repeal have not been communicated – these need to be unpacked so a more targeted rule may be introduced if required.

3. The interaction of the proposed rules with the transfer pricing provisions will lead to enormous compliance costs if detailed guidance on their interaction on the price and quantum of debt is not provided. It is possible that these new rules could impact Australian taxpayers investing overseas more than foreign multinationals.

4. There are significant concerns with the tax EBITDA calculation and its use of the taxable income definition in the calculation and only adjusting for Subdivision 40-B and Division 43 capital allowances in arriving at tax EBITDA.

5. The Group Ratio and External Third Party Debt tests are unworkable alternative tests, particularly as there is no access to the 15 year carry forward of denied deductions, unlike in most other jurisdictions, including the UK.

6. Other issues with the External Third Party Debt Test (ETPDT) making it practically unworkable including:

    a. the 10% associate threshold;
    b. the requirement that all "associate entities" must choose to apply the test;

c. providing security only over the assets of a borrowing trust and not the units of the trust;
d. the test not being available to stapled structures; and
e. issues for conduit financers.

7. The broad nature of the amendment to the 'financial entity' definition and the lack of clarity around what integrity concerns the proposed amendment is targeting.

8. Other technical anomalies arising in relation to:

   a. proposed amendments to the definition of debt deduction in sec 820-40 may inadvertently bring arrangements that are not ordinarily considered 'debt interests' into the regime, for example operating leases under the new leasing standard AASB 16;
   b. the exclusion in relation to the 90% Australian asset threshold test;
   c. the exclusion of special purpose entities;
   d. the exclusion of a head company of an outbound tax consolidated group that is not a financial entity; and
   e. the proposed carry forward loss rules that lack consistency with the current loss testing rules.

9. Particular concerns with general insurers and the regulatory impact of the rules.

We have also included for completeness Appendix 2 which contains our finalised paper on the history and context of sec 25-90. Nothing of substance has changed from the draft of this paper previously provided to you.

Appendix 3 contains diagrammatical examples outlining some issues with the 'Associate entity' definition and 'all in' rule.

The CTA and its members look forward to working with Treasury on any revised version of the ED.

Should you have any questions, please do not hesitate to contact Michelle de Niese on 0402 471 973 or Paul Suppree on 0408 185 050.

Yours sincerely,

Michelle de Niese
Executive Director

Paul Suppree
Assistant Director

CC: Ms Diane Brown, Deputy Secretary, Revenue, Small Business and Housing Group
Ms Kathryn Davy, Assistant Secretary, International Tax Branch

Appendix 1 – Priority Concerns

1 The ED may not reflect the original policy intent

Australia is a capital-importing nation that relies on debt capital for business investment both in and outside of Australia. As such, business investment in Australia, including attracting foreign investment into Australia, is sensitive to the rules in Australia that impact the cost of capital.

The original policy intent for the new interest limitation measure announced in the October 2022-23 Federal Budget[2] was:

- To strengthen Australia's thin capitalisation rules to address risks to the corporate tax base arising from the use of excessive debt deductions.
- To replace the safe harbour and worldwide gearing tests with earnings-based tests to limit debt deductions in line with an entity's activities (profits).
- This would be done by making changes to:
    - "limit an entity's debt-related deductions to 30 per cent of profits (using EBITDA —earnings before interest, taxes, depreciation, and amortisation – as the measure of profit). This new earnings-based test will replace the safe harbour test;
    - allow deductions denied under the entity-level EBITDA test (interest expense amounts exceeding the 30 per cent EBITDA ratio) to be carried forward and claimed in a subsequent income year (up to 15 years);
    - allow an entity in a group to claim debt-related deductions up to the level of the worldwide group's net interest expense as a share of earnings (which may exceed the 30 per cent EBITDA ratio). This new earnings-based group ratio will replace the worldwide gearing ratio;
    - retain an arm's length debt test as a substitute test which will apply only to an entity's external (third party) debt, disallowing deductions for related party debt under this test."

In our view, the proposed provisions do not align with what was expressed in the Budget announcement, particularly in relation to the new External Third Party Debt Test and the limitations imposed on Division 40 allowances. Also, the surprise inclusion of amendments to sec 25-90 was not mentioned in the Budget announcement.

While we recognise the ED by its nature is more detailed than any budget announcement could be, the overwhelming view expressed by members is the ED represents significant integrity creep, with almost every potential decision point deferring to revenue collection, not ease of compliance or OECD best practice.

[2] Budget Paper No. 2, October 2022-23 Federal Budget

2 Separate consultation on the amendment to sec 25-90 is required as a minimum

The proposed amendment to sec 25-90 was not contemplated by the original policy announcement. As such, many stakeholders have been caught by surprise at the resurfacing of the 2013 proposal to effectively repeal sec 25-90, which will have a significant cost impact for taxpayers who have not traced borrowed funds to the level which will be required to support an ATO review. In our view, a thorough consideration of the proposal to amend sec 25-90 is needed, alongside an understanding of the integrity concerns associated with this provision.

Appendix 2 to this submission provides important historical and policy context as to why sec 25-90 was not repealed in 2013 including previous detailed and very considered Treasury analysis. In our view, the policy and practical reasons for the retention of sec 25-90 equally apply in 2023 under an earnings-based approach as they did to the current asset-based rules back in 2013. In our view, the rationale in the EM for an earnings-based approach being somehow a differentiating feature from the current asset-based approach is flawed logic.

While it is understood there is potential for revenue leakage under sec 25-90, it is unclear from a policy perspective what the integrity concern is with outbound groups borrowing to fund offshore expansions, particularly if the funding is raised domestically, where interest income would be assessable. Appendix 2 provides more detail.

Australian outbounds may suffer a double cost under sec 25-90, impacting offshore expansions. In our view, it is incumbent upon those advocating the effective repeal of sec 25-90 to articulate any mischief they are seeing to demonstrate why sec 25-90 should be amended, why previous reasons for its non-repeal are somehow different in 2023 than they were in 2013, and why the range of existing integrity measures are insufficient to address such mischief. Targeted integrity rules would be more appropriate if the mischief is clearly articulated.

We also note the amendment of sec 25-90 is quite punitive to outbound general insurance groups. Insurers need to raise Tier 2 regulated debt in Australia at the holding company level for APRA and rating agency capital purposes. Such insurers don't have the option of raising Tier 2 capital overseas to help fund an overseas acquisition as insurers do not get Group capital credit.

A prospective targeted integrity rule aimed at the mischief the ATO may be aware of would be a workable solution rather than the proposed blanket amendment to sec 25-90.

If, after further consultation, it is still regarded that sec 25-90 should be amended, any changes should apply prospectively and only to funding arrangements entered into from the point in time those consultations are concluded. Grandfathering of the existing rules for existing debt funding arrangements must be provided as a minimum and ATO guidance around the consequential restructuring of debt facilities (understanding such restructuring cannot happen overnight) would need to be provided as a priority.

Guidance on the tracing requirements and any apportionment of debt deductions where borrowing may have more than one purpose would also be required as well as guidance for where debt is used to partly fund acquisitions is also needed (i.e. where an acquisition or offshore expansion is funded partly by borrowings and partly by existing funds).

3 Interaction with Transfer Pricing Provisions

The consequential amendments to Division 815 require the transfer pricing rules to apply before the new interest limitation rules apply.

Under the current rules, the thin capitalisation rules determine a taxpayer's maximum allowable amount of debt. Many taxpayers that will become "General class investors" under the proposed rules have existing related party debt arrangements that were entered into having regard to the safe harbour debt amount because the modification in current sec 815-140 meant there was no need to determine an arm's length amount of debt for those arrangements. In effect, the reference to arm's length conditions (as discussed in the EM at paras 1.124 to 1.127) resurrects the need to undertake a transfer pricing analysis on both the amount and price of debt before the Fixed Ratio Test applies.

Thus the current EBITDA proposal operates as a cap on arm's length outcomes. This change is very significant and should be thoughtfully considered, particularly as the External Third Party Debt Test is practically useless as a means to resurrect arm's length outcomes.

The bifurcation of the 'amount' of debt deduction under the current rules into an analysis of the quantum of debt (under Div 820) and the price of debt (under Div 815), while not a sophisticated arm's length analysis, was workable and understood. By contrast, transfer pricing the <u>amount</u> of debt deductions (that is interest rate multiplied by the quantum of debt in simple terms) is an imprecise science. Such a process can be highly fact-driven, sometimes subjective, will unquestionably create uncertainty about the cost of debt and will be a compliance overkill, even for relatively lowly-geared taxpayers. It is also unclear when the quantum of debt is to be determined for the purpose of calculating the amount of debt deductions permitted (e.g. is it at the outset of the loan, annually, each time the terms of the loan are varied, or can a taxpayer rely on the terms of the particular loan to make this determination themselves etc).

Determining arm's length terms and conditions for financing arrangements is very difficult, as each individual factor, term or condition affects the others (e.g., assumed credit rating affects interest rate, which in turn affects quantum). There is no formal limit on the amount of debt a party can take on. Each incremental amount is often more expensive and/or subordinated relative to existing debt, but there is no firm line. Accordingly, there is no single answer as to what is an 'appropriate' amount of debt under arm's length conditions but rather a range of acceptable outcomes in the circumstances.

There has been no commentary or guidance provided by Treasury on how it anticipates taxpayers with existing related party loans should now substantiate the arm's length amount of their debt. In the absence of certainty on this, in practice project economics may be modelled on the basis that debt funding costs are non-deductible. This can add significantly to the forecast cost of current and potential activities, especially in a higher interest rate environment, permanently impacting business investment.

If, after further consideration of the basis upon which this change is being made, it is found that the change is warranted, a transitional rule / quasi-grandfathering provision must be made available to taxpayers who have relied on the current rules for debt arrangements.

Ordinarily, it would be expected that the arm's length terms and conditions of the loan are to be established at the commencement of the arrangement, and the taxpayer would subsequently have the opportunity to refinance the loan if more favourable borrowing terms become available. However, with a proposed commencement date of 1 July 2023, there is insufficient time for taxpayers to undertake analysis and consider options for refinancing their existing related party arrangements if the results indicate their actual quantum of debt exceeds the arm's length amount. The result of these measures will only increase Australian investment uncertainty and impose the added compliance burden on taxpayers and the ATO seeking external expert opinion. Practical flags on the transfer pricing beach are needed for both taxpayers and the ATO to ensure this does not happen.

We suggest either the consequential adjustments be removed, or if they proceed, a transitional rule be included to provide taxpayers with a choice to determine the arm's length quantum of debt that a taxpayer would be able to borrow at the beginning of the first income year to which the new rules apply (rather than retrospectively determine this as at the commencement of the loan).

4 Tax EBITDA

Tax EBITDA makes adjustments to a relevant taxpayer's taxable income for net debt deductions, Subdivision 40-B (only) and Division 43 allowances and carry forward tax losses to the extent they have been deducted in the current year.

We note the term 'taxable income' is used as a proxy for Australian earnings. However taxable income has certain nuances for certain statutory income such as:

- foreign CFC attributed income that does not relate to Australian earnings; and
- the gross-up for franking credits associated with receiving franked dividends.

While CFC attributed income is assessable and interest deductions should not be restricted beyond 30% in principle (even though they are not Australian earnings), the policy rationale for giving debt deduction 'headroom' for the tax gross-up for franking credits, but not for all Division 40 allowances, is unclear.

It is also unclear why, other than a presumed revenue collection imperative, adjustments (add-backs) are only made for Subdivision 40-B capital allowances and Division 43.

In essence, the draft rules adopt a hybrid EBITDA/EBIT test by excluding some capital allowances. While this is arguably in accordance with BEPS Action 4, it does appear unduly restrictive and arbitrary. The underlying policy behind an EBITDA-based test is fundamentally a cash flow basis of interest restriction. By only including Subdivision 40-B and Division 43 deductions as add-backs, it appears more restrictive to capital-intensive industries than others. The only inference to draw is the underlying policy is not to allow partial debt financing of certain capital-intensive industries. In an environment where increasing labour productivity is a key government priority, and where capital investment is key to increasing real wages, we question why, unlike all other countries that have adopted an EBITDA test, Australia wants to implicitly restrict capital deepening by having a unique Australian revenue driven spin on what is a globally accepted definition of EBITDA.

Adopting a unique EBITDA approach will also result in companies within the same industry potentially having different outcomes depending on where they may be in the investment cycle. For example, the exclusion of add-backs for early capital expenditure used in R&D,

exploration and prospecting, project pools, primary production, environmental deductions, rehabilitation expenditure, low value and software development pools[3] is presumably driven by perceived revenue collection not equitable or efficient tax policy. It should be noted these could in effect lead to permanent differences in outcomes, as the carry-forward rules are not relevant to the calculation of the tax EBITDA denominator.

If the rationale for excluding all Division 40 capital allowances and other fixed asset-related deductions (eg capitalised repairs) other than Subdivision 40-B is directed against industries where previous policy decisions have been made to apply a different rate of capital allowances, this should be made clear and the policy rationale stated in the EM.

In our view, draft sec 820-49(c) should include an add-back for all Division 40 allowances and other fixed asset-related deductions to be in accordance with best practice and eliminate industry and life cycle biases.

We also note other items excluded from the tax EBITDA calculation include items such as balancing adjustments from the disposal of depreciated assets (particularly an issue if the asset was disposed of for nominal value) and costs involved in assets in a project pool not owned by a taxpayer.

5 Group Ratio and External Third Party Debt tests are unworkable alternative tests

The effect of the election process to adopt the new Group Ratio Test (**GRT**) and the External Third Party Debt Test (**ETPDT**) make these tests practically unworkable as alternative tests to the Fixed Ratio Test (**FRT**). This is a departure from the workability of the three existing thin capitalisation tests (which operate sequentially) to determine the highest maximum allowable debt amount. We also note that the limitation of the availability of the 15 year carry-forward of disallowed deductions under the FRT if an election is made to apply the GRT or ETPDT significantly dilutes their utility as options.

These features place Australia at odds with countries such as the UK, where the tests are sequential and have the ability to carry forward denied deductions under the equivalent of the GRT. The UK rules preference the higher of the results under the tests to determine the amount of interest deductions to which a taxpayer is entitled (similar to Australia's current rules); the new rules in Australia preference the lower of the results under the tests to determine the amount of interest deductions to which a taxpayer is entitled.

6 Group Ratio Test

Other than making the GRT practically unworkable, it is unclear why the GRT while calculated using accounting EBITDA, then applies this ratio to Australian tax EBITDA.

While we acknowledge GRT must only rely on statutory accounts (and effectively an accounting EBITDA), to apply the ratio to an Australian tax EBITDA (with the exclusions for non-Subdivision 40-B allowances) illustrates an integrity bias in the rule design. Some companies are required to recognise large non-cash impairment expenses in their Profit

[3] For example, in the tech industry, there will be vastly different outcomes for two taxpayers that incur expenditure on developing in-house software where one has depreciated the software under Subdivision 40-B (included in tax EBITDA) and the other depreciated the software under Subdivision 40-E in a software development pool (excluded from tax EBITDA).

and Loss statement (P&L). Sometimes this impacts EBITDA, other times it is an extraordinary expense for accounting purposes. This is determined by accounting standards. Given this cost is uncontrollable by taxpayers (both in terms of when it is incurred, and where in the P&L it is recognised) and can be significantly large for many businesses, it would seem inappropriate such non-cash expenses should limit a company's ability to deduct interest.

As mentioned in Section 4 above, having a tax EBITDA that allows add-backs for all Division 40 and 43 allowances is more consistent with OECD best practice or alternatively applying the GRT ratio to Australian accounting EBITDA.

Moreover, losses under the GRT should be carried forward if the GRT is adopted rather than the FRT.

7 'Associate entity' definition and 'all in' rule

The proposed ETPDT effectively disallows an entity's debt deductions to the extent that they exceed the entity's debt deductions attributable to external third party debt (and which satisfy certain other conditions). As the legislation is currently drafted, all of an entity's "associate entities" which are subject to the thin capitalisation rules must also choose to apply this test. In our view, a 10% threshold is unduly restrictive, capturing entities that are not economically controlled. This reinforces the obsession with the design of the draft rules to pay lip service to tests other than the FRT. In our view, the current 50% or more associate entity test should remain.

We also note the definition of "associate entity" doesn't deal with the specific problem of the redefinition of associate entity whereby the reference in paragraph 820-905(1)(a) to an "associate interest of 50% or more" should instead be a reference to a "TC control interest of 10% or more".

The examples in Appendix 3 provide an overview of issues in respect of the application of the proposed ETPDT, being the requirement in sec 820-43(5) that all associate entities (using the amended definition of associate entity because of sec 820-43(6)) subject to the thin capitalisation rules must make an election to apply the ETPDT (i.e. essentially a 'one-in-all-in' requirement). This requirement is problematic in our view as the definition of associate entities is unduly broad, as highlighted in the examples. While the main examples in Appendix 3 relate to trusts, they are equally applicable to incorporated joint ventures. This means that entities that are practically unrelated cannot apply the ETPDT unless other entities choose to apply that test. It also means that practically unrelated entities need to be cognisant of the elections made by others, not only at the time that the entities become associate entities of one another, but also over time.

As a consequence, this test is likely to be unworkable and unavailable to a significant proportion of affected taxpayers.

If it is decided that the 'all in' rule should remain (and we consider it should not), a possible alternative could be to require any upstream entity to calculate its tax EBITDA on a modified basis excluding taxable income referable to their share of the earnings of the downstream entity from its tax EBITDA calculation where a downstream entity that is not part of the tax consolidated group has made an election to apply the ETPDT. This should address any integrity concerns with 'double gearing' the same income stream.

8 External Third Party Debt Test

Some of the key issues with the ETPDT include:

- It is only available where the security encompasses only the assets of the borrower (per sec 820-61(2)(c)). It is relatively standard for security to be provided over not only the assets of a trust but also the units in that trust. There does not seem to be a policy reason for the ETPDT to not apply in these circumstances.

- In respect of credit support generally, tax consolidated groups are treated as a single entity and therefore, any 'credit support' provided by their subsidiary companies is disregarded for the purposes of applying the ETPDT. In contrast, credit support would result in the ETPDT not being available in a stapled structure, a holding structure with subsidiary trusts or a structure where security is provided over the units in the borrower trust (as described above). Such credit support should be permissible where they correspond to ordinary commercial dealings and do not represent an integrity concern.

- While the proposed rules attempt to accommodate certain conduit financer arrangements, the rules require the terms of each debt interest issued to the conduit financer to be "the same as the terms of the ultimate debt interest" issued to the ultimate lender by the conduit financer (apart from terms as to the amount of debt). This will be problematic where (as is typical) the terms of the related party loan would provide a lesser security to that which is granted to the third party lender or if the pricing of the related party loan reflects a small margin to cover the costs of the entity that has borrowed externally and on-lent to a related party. This is a common occurrence.

- There are adverse consequences for project financing arrangements. Guarantees from a parent entity are ordinarily required to secure unrelated third party debt for infrastructure projects during the construction phase. A taxpayer is unlikely to have sufficient equity funding for any large infrastructure project. Accordingly, they are unlikely to secure third party debt in the absence of guarantees being given for the debt. As currently proposed, the ETPDT is effectively inoperable for new infrastructure projects,[4]

9 Financial entity definition

The EM is unclear regarding the rationale supporting the repeal of paragraph (a) 'a registered corporation under the *Financial Sector (Collection of Data) Act 2001*' in the definition of 'financial entity' in subsection 995-1 of the 1997 Act.

Paragraph 1.26 of the EM refers to 'integrity concerns' about entities that fall into this subparagraph but does not articulate what the integrity concerns are, other than perhaps

[4] This by default means project-financed arrangements with parental guarantees used in infrastructure (such as large green technology projects) only have access to the FRT test, given the GRT doesn't allow carry forward of losses despite the debt being wholly unrelated. While losses can be carried forward under the FRT, it adds to project funding costs. It is not apparent there is any policy reason for deduction denial where such parental guarantee is given over third party debt.

to question whether they should be considered financial entities and entitled to the same tax treatment ADIs have under current rules.

A number of regulated industries will be adversely impacted by this change, including non-bank lenders, genuine asset financers, buy-now pay-later financial providers, and general insurers. BEPS Action 4 contemplated a carve-out from interest limitation rules for banks and insurance companies. The proposed change is inconsistent with this position.

It would be useful to understand the integrity concerns being addressed with this proposed amendment and whether a targeted rule to address any perceived mischief may be more appropriate.

10 Other technical anomalies

a) Amendments to the definition of 'debt deduction' in sec 820-40

Although the proposed changes to the definition of debt deductions build off the existing definition, there is uncertainty as to whether some items which are not in the nature of interest are captured, including for example operating lease payments or amounts accounted for as interest under AASB 16.

The removal of the words "in relation to a debt interest issued by the entity" in the modified sec 820-40(1) definition of debt deduction could technically bring in items such as interest on leases recognised under AASB 16 or a discount for early payment under a commercial contract where the amount of the discount is calculated based on the time value of money. The current definition of debt deduction in sec 820-40(1) would not pick up lease 'interest' as such interest does not arise "in relation to a debt interest issued by the entity" but the removal of these words for the purpose of the proposed rules arguably takes away this protection and could require such interest to be included and, because of the mechanics of how the FRT is calculated, could cause an entity to be in breach of the 30% EBITDA requirement (even though the lease 'interest' is never deductible for tax).

We suggest the words "in relation to a debt interest issued by the entity" be retained and the definition of 'debt deduction' be expanded to specifically include amounts that are intended to be captured per the OECD best practice guidance (referred to in para 1.116 of the EM). This will remove any uncertainty.

b) 90% assets threshold test

There appears to be a drafting error in the amendment to sec 820-37. While the EM confirms at paragraph 1.113 that sec 820-37 has been amended to ensure it continues to apply to the new 'general class investor' concept in new Subdivision 820-AA, the concept of 'general class investor' has only been referenced in new subparagraph 820-37(1)(a)(i) which refers to outward investing entities (ADI and non-ADI) that are not general class investors. The EM is clear that sec 820-37 "now applies to general class investors who, assuming those general class investors were financial entities, would be an outward investing financial entity (non-ADI)".

Therefore, the proposed amendment sec 820-37(1)(a) should be amended to also refer to the concept of 'general class investor' in subparagraph 820-37(1)(a)(ii) which refers to financial entities to line up with paragraph 1.113 of the EM. A reference to Subdivision 820-AA should also be inserted at the beginning of sec 820-37(1) similar to the proposed amendment to sec 820-35.

For consistency, a note should be included in new Subdivision 820-AA to confirm that Subdivision 820-AA does not apply if section 820-37 applies. A note following new sec 820-43(1) could be a suitable place for this amendment.

c) Exclusion of special purpose entities test

There appears to be a drafting error whereby sec 820-39 has not been amended to exempt special purpose entities from the new Subdivision 820-AA, while new sec 820-43(5)(a)(ii) contemplates that sec 820-39 may apply within Subdivision 820-AA. We suggest a reference to Subdivision 820-AA be inserted at the beginning of subsections 820-39(1) and (2) respectively to resolve this.

d) Head company of an outbound group with a financial entity member

There appears to be a drafting error in the new amendments to sec 820-583, whereby the head company of an outbound tax consolidated group with a group member that is a financial entity (where the head company is not itself a financial entity) is now removed from the thin capitalisation rules as it is excluded from all categories.

The proposed amendment to sec 820-583(3)(a) requires the head company itself to satisfy the requirements in new Items 2 and 4 being inserted into sec 820-85(2). Both items require the head company to also be a financial entity. The EM provides at para 1.132 "[c]onsequential amendments are made to paragraph 820-583(3)(a) to reflect the updated table items in subsection 820-85(2). Similarly, paragraph 820-583(3)(b) is now redundant given that the head company needs to be a financial entity throughout the period." We note no item has been included in the ED to repeal section 820-583(3)(b).

Under the current rules, so long as there is a member of the group that is a financial entity, the head company will be regarded as a financial entity.

Clarification is needed as to whether the intended outcome is that unless a head company is a financial entity in its own right, the outbound tax consolidated group is removed from the thin capitalisation rules, or there is a drafting oversight and, consistent with the current rules, outbound tax consolidated groups that have a group member that is a financial entity and the head company is not are still subject to the thin capitalisation rules.

If it is a drafting oversight, this could be rectified by changing 'and' at the end of existing sec 820-583(3)(a) to 'or' and retaining sec 583(3)(b).

e) Similar Business Test should also apply to carry-forward interest deductions disallowed under the FRT

The Similar Business Test should also be included in the 15 year carry-forward test for disallowed amounts under the FRT, in addition to the modified continuity of ownership test, so that it is consistent with the principle behind the loss testing rules.

Again, a preoccupation with loss trafficking and tax integrity is permeating the proposed rules. Capital injections from unrelated third parties or transfers of ownership during the lifecycle of long lead-time projects are not uncommon. To potentially deny an economic loss in such cases is not good tax policy.

11 General Insurers

The ED adversely impacts insurers who should be granted a similar carve out from the new thin capitalisation measures which have been provided to ADIs. This is consistent with the OECD recommendations on the introduction of interest limitation rules to banks and insurance companies as outlined in the *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2016 Update, 22 December 2016* (the 'Action 4 Paper'). Some specific points to note (which are all within the Action 4 paper) are:

- Insurers operate fundamentally in a different way to other businesses (like ADIs).

- Insurers are already subject to strict capital regulations by APRA which act as a de facto debt limitation rule.

- Insurers invest through unit trusts in debt assets. Where a unit trust is in losses, gross interest income from the unit trust does not get distributed to the insurer. It is therefore recommended the ED at least allow gross interest income from underlying unit trusts to be included in 'tax EBITDA' / 'EBITDA' / 'net debt deduction' calculations relevant to the FRT and GRT.

- Insurers are generally in a net interest income position and the Revenue will not be disadvantaged if insurers are carved out of the proposed rules.

Despite there being an ability to carry forward interest deductions denied as tax losses, there is an increased cost of capital to insurers as Deferred Tax Assets (which are booked for carry-forward losses in financial accounts) are subtracted from the regulatory capital base of insurance companies.

12 Requirement for ATO Guidance

In our view, it is essential that the ATO issue practical guidance at the same time any of the proposed changes become law. The proposals represent a significant change to the existing thin capitalisation landscape. As such, thorough, practical guidance from the ATO on how they intend to administer the draft rules must be prepared as a matter of priority. A Practical Compliance Guideline is particularly relevant in this case.

This should include as priorities:

- Guidance on the application of the general anti-avoidance rules in Part IVA to taxpayers who restructure existing debt arrangements to comply with the new provisions, particularly if sec 25-90 is amended.

- Guidance on the quantum (both interest rate and quantum) of debt if the proposed revision of Division 815 proceeds.

Appendix 2 – CTA Paper on the History of Section 25-90

Appendix 2 -
History and context

Appendix 3 – Examples with the ‘Associate entity’ definition and ‘all in’ rule

Appendix 3 -
Examples with the '

History and context of the thin cap rules and section 25-90

Background

As a matter of law, the deductibility of interest on debt is determined by the use to which the funds are put.[1] This effectively requires the "tracing" of where borrowed funds are used. Thus if borrowings are traced to funding assessable income, the interest on the funds borrowed would generally be deductible. Conversely, if the funds are traced to funding the derivation of exempt income, the interest on the funds borrowed would not be deductible.

Prior to the introduction of the current thin cap rules in 2001, interest was not deductible on the derivation of exempt income under section 8-1 of the Income Tax Assessment Act 1997 (ITAA97).[2] As a matter of policy, this denial had existed well before the adoption of Australia's participation exemption regime and then existing thin capitalisation rules.

The 2001 changes

As part of the Ralph review, it was concluded that Australia's existing thin cap rules contained in Division 16F (supplemented with Division 16G – dealing with debt creation) of the Income Tax Assessment Act 1936 (ITAA36) needed modernising.

In 2001, the thin cap rules in Division 820 and section 25-90 of ITAA97 were introduced with the thin cap rules contained in Divisions 16F and 16G of the Income Tax Assessment Act 1936 (ITAA36) repealed.

As was noted at para 1.9 in the EM that introduced the 2001 changes, the general rule in section 8-1 of ITAA97 denying deductions for exempt income was easy to circumvent via tracing the use to which the borrowed funds were put.

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

For example, Company A is considering investing $100 offshore. It has $1,000 of Australian assets, with a debt-to-asset ratio of 50% ($500 debt to $1000 in Australian assets). If it borrowed $100 at a 10% interest rate to fund the purchase of 100% of an offshore entity, the $10 interest on the funds borrowed would not be deductible under section 8-1 of ITAA97. However, if Company A used $100 of its working capital to fund the offshore acquisition and $100 was then borrowed to replace working capital, the $10 interest would be deductible as the debt to Australian asset ratio does not exceed 60% ($1,000 Australian assets and $600 debt). Economically it could be said the extra $10 deduction has funded the derivation of exempt income but is still deductible.

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[1] Steele's case. See [Legal database - View: Cases: Judgment by Gleeson CJ, Gaudron and Gummow JJ (ato.gov.au)]

[2] See [Legal database - View: Extrinsic Materials: New Business Tax System (Thin Capitalisation) Act 2001 - Explanatory Memorandum - REPS]

In essence, the introduction of section 25-90 of ITAA97 recognised "tracing" was a reality and not requiring tracing would be a compliance saving for both taxpayers and the ATO. In effect, the rules recognised that by limiting debt deductions based on the level of Australian assets, no tracing of borrowing would be required.[3]

This was recognised at para 1.99 and 1.100 of the EM to the 2001 Bill which said:

> *1.99 Debt deductions will, in certain instances, no longer be denied to taxpayers because they were incurred in earning exempt foreign income. These debt deductions, provided they are otherwise allowable under the general deduction provisions, will come within the scope of the thin capitalisation regime when determining the amount to be allowed.*
>
> *1.100 The relevant debt deductions are those incurred in earning foreign income that is exempt income under sections 23AI, 23AJ and 23AK of the ITAA 1936.*

We note in passing that when Div 820 and section 25-90 of ITAA97 were introduced, the law repealed both Div 16F (the thin cap rules) and **Division 16G** of ITAA36 (the debt creation rules).

The repeal of the debt creation rules

The debt creation rules in Division 16G of ITAA36 were aimed at preventing the debt-funded acquisition of <u>certain foreign assets from non-resident controllers</u>. That is, they were aimed at preventing a foreign-controlled Australian group from acquiring certain foreign assets with debt and having interest on such debt offsetting other assessable income.[4]

Presumably, the repeal of Division 16G was due to a view the new Div 820 and the general anti-avoidance rule in Part IVA could apply to deal with egregious debt creation arrangements.

The 2014 Amendments[5]

In May 2013, the then Labor government introduced a proposal paper[6] to tighten the thin cap rules. Paragraph 10 of the paper says:

> *10. This package of measures is intended to:*
>
> - *Tighten the safe harbour settings in the thin capitalisation rules while still ensuring taxpayers have access to other tests where they have higher borrowings at commercially independent levels;*

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[3] Thus the thin cap rules were seen as acting as a code over the quantum of debt limiting the quantum by reference to the value of Australian assets (and thus indirectly the quantum of Australian earnings) with the transfer pricing rules in Division 815 of the ITAA97 determining the rate of interest on that debt.

[4] We have reproduced Division 16G of ITAA36 as an Appendix 1.

[5] [Tax and superannuation Laws Amendment (2014 Measures No.#) Bill 2014 - Explanatory Memorandum (treasury.gov.au)]

[6] The 2013 proposal paper is attached as Appendix 2.

- *Implement the 2009-10 Budget announcement to reform the exemption for foreign non-portfolio dividends (section 23AJ of the Income Assessment Act 1936}; and*

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

The result of the consultation and parliamentary process on this proposal led (amongst other things) to Division 820 being amended to reduce the debt-to-asset ratios to 60% for non-ADIs and the amendment (but not repeal) of section 25-90 to deal with specific compliance issues with section 23AJ. The specific reform to section 25-90 was to deny a tax deduction for the cost of funding the purchase of redeemable preference shares which were not impacted by the thin capitalisation rules.

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

Despite the known example outlined in the 2013 proposal paper of tax planning <u>with inbound groups potentially abusing sec 25-90</u> by gearing up to the thin cap limit, it appears to have been recognised that the repeal of section 25-90 would not solve the problem, but rather reintroduce "tracing" as a means to circumvent any repeal of the section.

As was recorded in Hansard in an exchange between Senator Milne and the Deputy Secretary of Treasury Rob Heferen, in 2014 in relation to the decision not to repeal sec 25-90:[7]

> *Senator MILNE: That is a long way of saying that Treasury changed its mind in terms of its recommendation in relation to repealing these provisions. Why wouldn't we have just repealed the provisions and addressed the other side of the argument? The only reason you would keep something like that is that it did not prevent people carrying out legitimate business, which is what you have just said. Why did we not just address that separately, rather than leave this in here? It is increasingly costing the taxpayer. What is it actually costing us? What is your projection on what it will cost by keeping it?*
>
> ***Mr Heferen :*** *Very little. In the unfortunate world of public policy and public policy advising, we do it in reasonably constrained environments; but you learn a lot of things when you go through consultation. Originally the government, back in November 2013, announced that there were a range of things that the previous government had on the books and also that the Howard government had on the books as far as tax goes that it would not proceed with, some it would proceed with and some it would change. The 25-90 one was one that would change. What it said was, 'What we will do is not proceed, but we will explore a targeted anti-avoidance provision.'*
>
> *We then worked it through with the Tax Office. On the ones that we were actually worried about, there were seven or eight identified. As was worked through quite closely, what we then found was that actually all of those ones that we were worried about would have the facility to restructure and still claim whatever deduction they could. They were large enough and sophisticated enough to have sufficient debt to fund their Australian operations and sufficient equity to fund their foreign operations. They would have to do some tracing of the funds. So there were some extra compliance costs, but for these large corporations it was probably not much.*

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[7] ParlInfo - Economics References Committee : 09/04/2015 : Corporate tax avoidance (aph.gov.au)

As it turned out, the revenue that we at one stage thought would be obtained from that was a mistake. Really, there was no upside with proceeding. The measure would have only had downsides, because what it would have done was prevent legitimate activity taking place. It was one of those very salutary lessons for people like me and people who work with me in our jobs. We realised what seemed like a good idea at the time turned out to be not what we thought, largely because of the capacity of the firms—which we thought the arrangements were targeting—to be able to get around what was being provided.

Are there any other policy reasons for repealing sec 25-90?

As the above illustrates, the repeal of sec 25-90 would lead to the re-establishment of the tracing of funds behaviour. The final view was repeal was unnecessary and in fact counterproductive.

It is acknowledged that there can be potential revenue leakage under sec 25-90 where a foreign-controlled inbound group increases debt levels up to 60% of Australian asset values by debt funding the acquisition of existing foreign assets that generate exempt income.

The 2013 proposal paper provides an example of such "debt loading" activities. The example shows a non-resident essentially dropping foreign assets into Australia, funded by debt, with the interest on such debt offsetting taxable income on profitable businesses already in Australia. Presumably, a view was taken that Part IVA could not be enlivened in such cases.

We note there is no example in the 2013 proposal paper of an Australian-controlled outbound group investing offshore and generating exempt income as being problematic or against the wider tax policy settings underpinning Australia's participation exemption regime.[8]

The reason arrangements involving Australian-controlled outbound firms may not be considered objectionable is probably due, in part, to the fact any debt-funded foreign investment by such a firm should lead to dividends being received in Australia. Whilst such dividends are initially exempt from Australian tax, they result in unfranked retained profits in the investor firm. When these unfranked retained profits are distributed, Australian tax is paid at the marginal tax rate of the shareholder (or subject to dividend withholding tax to the extent unfranked). To deny a section 25-90 deduction would effectively amount to double tax in Australia.[9]

By contrast, a foreign-controlled outbound firm could invest in a controlled or uncontrolled foreign group, but the dividend income received flows through to its shareholders as conduit foreign income that is not taxed in Australia.[10] Thus in such cases, deductions can be incurred in Australia up to the debt cap, but there is no assessable income either directly or indirectly taxed in Australia.

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[8] See for example comments in the EM at New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004 (legislation.gov.au)

[9] In fact, more like triple tax globally as: 1 - profits are taxed in the foreign country, 2- dividends are taxed in Australia at shareholder marginal rates when distributed, and 3 - an interest denial for funding the investment under any repeal of 25-90.

[10] See INCOME TAX ASSESSMENT ACT 1997 - SECT 802.5 What this Subdivision is about (austlii.edu.au)

Is the proposed move to an EBITDA-based test any different for sec 25-90 outcomes?

We note the EM introducing the proposed EBITDA rules at paragraphs 1.118 to 1.120 states:

> *1.118 Section 768-5 of the ITAA 1997 deems certain foreign equity distributions as non-assessable non-exempt (NANE) income of an entity. At the same time, sections 25-90 and 230-15 of the ITAA 1997 provide that interest expenses incurred to derive this NANE income are deductible. This is contrary to the general rule in Australia's tax system which provides that expenses incurred in deriving NANE income are non-deductible.*
>
> *1.119 Additionally, the policy intent of the new earnings-based tests is to limit the amount of deductible interest expense by reference to earnings – that is, an entity is only able to increase its net interest deductions in Australia by increasing earnings in Australia. The rules described in the paragraph above go against the policy underlying the new rules as it gives rise to a double benefit; the benefit of the income being NANE income and the benefit of a deduction for the interest expenses incurred to derive such NANE income.*
>
> *1.120 To address this double benefit and ensure the effectiveness of the thin capitalisation rules, sections 25-90 and 230-15 are amended so that they do not allow a deduction for interest expenses incurred to derive the NANE income under section 768-5.*

Firstly, we note re-prosecuting the case for repealing sections 25-90 and 230-15, in conjunction with the current EBITDA proposal, will not change the fact that inbound and outbound firms will still be able to trace funds and retain debt deductions, and hence only be limited by EBITDA ratios rather than by current debt-to-asset ratios.

Secondly, the current rules limit interest deductions by reference to Australian assets which are used in deriving Australian earnings. Thus, the additional policy rationale mentioned in paragraph 1.119 is not really an additional reason for abolishing sec 25-90. Whilst current rules reference debt to Australian asset ratios, these are of course assets that are used to generate Australian earnings. In essence, current rules are a 'balance sheet approach' rather than an earnings-based approach to essentially arrive at a similar outcome of limiting debt deductions.

Possible solutions

Bearing in mind the wider tax policy of encouraging Australian-owned firms to invest offshore under the participation exemption regime, rather than repealing sec 25-90 and effectively reintroducing tracing, in our view any potential mischief of debt creation could be addressed by better-targeted rules if it was felt sec 25-90 requires change.

At the very least, if amendments to sec 25-90 are to proceed, they should only apply to prospective borrowings and not for debt deductions on earlier borrowings from 1 July 2023 given the difficulties in tracing and the fact the law did not require tracing from at least 2013.

Appendix 1

Division 16G—Debt creation involving non-residents[11]

Subdivision A—Interpretation

159GZY Interpretation

In this Division, unless the contrary intention appears:

asset means any form of property and includes:

(a) an option, a debt, a chose in action, any other right, goodwill and any other form of incorporeal property; and

(b) any form of property created or constructed.

associate has the same meaning as in Division 16F, except that the references in section 159GZC to 15% shall be read as references to 50%.

capital entitlement factor has the meaning given by section 159GZZ.

foreign controller has the meaning given by section 159GZZA.

interest means interest within the meaning of subsection 128A(1AB).

scheme has the same meaning as in Division 16F.

159GZZ Capital entitlement factor

(1) For the purposes of this Division, the capital entitlement factor of a person in respect of a company at a particular time is the percentage that the person (together with any associates of the person who are non-residents) would be beneficially entitled to receive, directly or indirectly, of any distribution of capital that is, or may be, made by the company at that time.

(2) For the purposes of subsection (1):

(a) a person shall be taken to be beneficially entitled to receive indirectly a particular percentage of a distribution of capital of a company; or

(b) 2 or more persons shall be taken together to be beneficially entitled to receive indirectly a particular percentage of a distribution of capital of a company;

if, in the event of a distribution of capital of the company, the person or persons would (otherwise than as a shareholder or shareholders in the company or as a trustee or trustees) receive or have received that percentage of that distribution of capital, on the assumption that there had been successive distributions of the relative parts of that distribution of capital to and by each of any companies, partnerships or trustees interposed between the company making the distribution of capital and that person or those persons.

159GZZA Foreign controller

For the purposes of this Division, a person is a foreign controller of a company if:

(a) the person is a non-resident or a prescribed dual resident; and

[11] Income Tax Assessment Act 1936 (legislation.gov.au)

(b) the capital entitlement factor of the person in respect of the company is at least 50%.

159GZZB Acquisition of asset not previously in existence

For the purposes of this Division, where a person or persons have acquired an asset (other than a debt) that did not previously exist:

(a) the asset shall be taken to have existed immediately before the acquisition and to have been acquired from the person or persons who created the asset; and

(b) if the asset is taken to have been acquired from more than one person—the respective interests of those persons in the asset immediately before the acquisition shall be taken to have been:

(i) if consideration was payable to those persons in respect of the acquisition and subparagraph (ii) does not apply—proportional to their entitlements to that consideration;

(ii) if consideration was payable to those persons in respect of the acquisition but the Commissioner considers that it is not appropriate for subparagraph (i) to apply—in such proportions as the Commissioner considers reasonable in the circumstances; or

(iii) in any other case—in such proportions as the Commissioner considers reasonable in the circumstances.

159GZZC Acquisition of asset through interposed persons

Where, under a scheme, an asset is acquired by a person or persons (in this section called the ***final buyer***), indirectly through one or more interposed persons, from another person or persons (in this section called the ***original seller***), the Commissioner may, for the purposes of this Division, treat the acquisition of the asset as if it had been directly by the final buyer from the original seller.

Subdivision B—Application of Division

159GZZD Application of Division

This Division applies to interest incurred in respect of an amount owing in connection with the acquisition of an asset if:

(a) the interest was incurred on or after 1 July 1987; and

(b) the acquisition occurred on or after 1 July 1987 (otherwise than under a contract entered into before that date).

Subdivision C—Reduction of interest deductions

159GZZE Reduction or extinction of interest deduction in case of certain created debt

(1) Where:

(a) apart from this Division and Division 16F, an amount of interest is allowable as a deduction from the assessable income of a taxpayer that:

(i) is a company; and

(ii) is not a taxpayer in the capacity of trustee;

(b) the interest is in respect of an amount owing in connection with the acquisition of an asset by the taxpayer, either alone or together with another person or persons, from another company (in this section called the ***eligible seller***), either alone or together with another person or persons; and

(c) any of the following subparagraphs applies in relation to the acquisition:

(i) the eligible seller:

(A) was a foreign controller of the taxpayer immediately after the acquisition; or

(B) later became a foreign controller of the taxpayer under a scheme of which the acquisition was a part;

(ii) the taxpayer:

(A) was a foreign controller of the eligible seller immediately before the acquisition; or

(B) earlier ceased to be a foreign controller of the eligible seller under a scheme of which the acquisition was a part;

(iii) in a case to which neither subparagraph (i) nor (ii) applies—the following conditions are satisfied in relation to a person (in this section called the ***common foreign controller***):

(A) the person was a foreign controller of the eligible seller immediately before the acquisition, or earlier ceased to be a foreign controller of the eligible seller under a scheme of which the acquisition was a part;

(B) the person was a foreign controller of the taxpayer immediately after the acquisition, or later became a foreign controller of the taxpayer under a scheme of which the acquisition was a part;

the deduction so allowable shall be reduced in accordance with this section.

(2) If there are 2 or more eligible sellers in relation to the acquisition of the asset by the taxpayer, subsection (1) applies successively to each combination of the taxpayer and each of those eligible sellers.

(3) Where:

(a) subsection (1) applies, because of subparagraph (1)(c)(iii), in relation to the taxpayer and a particular eligible seller; and

(b) there are 2 or more common foreign controllers in connection with that application of subsection (1);

the amount calculated for the purposes of that application of subsection (1) shall be the aggregate of the amounts that would be calculated in relation to each of those common foreign controllers.

(4) In respect of each application of subsection (1) in relation to the same acquisition of an asset, the deduction shall be reduced by the amount calculated in accordance with the formula:

Deduction ´ Asset ownership factor ´ Capital entitlement factor

where:

Deduction is the amount of the deduction that would be allowable apart from this Division and Division 16F.

Asset ownership factor is the eligible seller's interest in the asset immediately before the acquisition, expressed as a proportion of the total interests in the asset.

Capital entitlement factor is:

(a) where subparagraph (1)(c)(i) applies—the capital entitlement factor of the eligible seller in respect of the taxpayer:

(i) if sub-subparagraph (1)(c)(i)(A) applies—immediately after the acquisition; or

(ii) if sub-subparagraph (1)(c)(i)(B) applies—immediately after the eligible seller became a foreign controller of the taxpayer;

(b) where subparagraph (1)(c)(ii) applies—the capital entitlement factor of the taxpayer in respect of the eligible seller:

(i) if sub-subparagraph (1)(c)(ii)(A) applies—immediately before the acquisition; or

(ii) if sub-subparagraph (1)(c)(ii)(B) applies—immediately before the taxpayer ceased to be a foreign controller of the eligible seller; or

(c) where subparagraph (1)(c)(iii) applies—the smaller of the following percentages:

(i) the capital entitlement factor of the common foreign controller in respect of the eligible seller:

(A) if the common foreign controller was a foreign controller of the eligible seller immediately before the acquisition—immediately before the acquisition; or

(B) if the common foreign controller earlier ceased to be a foreign controller of the eligible seller as mentioned in sub-subparagraph (1)(c)(iii)(A)—immediately before that occurred;

(ii) the capital entitlement factor of the common foreign controller in respect of the taxpayer:

(A) if the common foreign controller was a foreign controller of the taxpayer immediately after the acquisition—immediately after the acquisition; or

(B) if the common foreign controller later became a foreign controller of the taxpayer as mentioned in sub-subparagraph (1)(c)(iii)(B)—immediately after that occurred.

(5) Where the interest is only partly in respect of the amount owing as mentioned in paragraph (1)(b), this section applies to the deduction to a corresponding extent.

(6) In the application of this section to the acquisition of an asset, an entitlement to receive, directly or indirectly, a particular percentage of a distribution of capital of a company shall not be counted to the extent to which that entitlement has previously been counted in the application of this section to that acquisition.

159GZZF Section 159GZZE not to apply in certain cases

(1) Section 159GZZE does not apply to the acquisition of an asset if:

(a) the asset is cash; and

(b) the acquisition was not, and was not part of, the acquisition of a business or of part of a business.

(2) Section 159GZZE does not apply to the acquisition of an asset if:

(a) immediately before the acquisition, the asset was trading stock of the eligible seller (or of all of the eligible sellers, as the case requires); and

(b) the acquisition was not, and was not part of, the acquisition of a business or of part of a business.

(3) Section 159GZZE does not apply to the acquisition of an asset if the asset is a share in a company and had not previously been issued.

(4) Section 159GZZE does not apply to the acquisition of an asset if:

(a) before the acquisition, the asset had not previously been used, held or applied by any person:

(i) for the purpose of gaining or producing assessable income; or

(ii) in carrying on a business for the purpose of gaining or producing assessable income; and

(b) the eligible seller (or each of the eligible sellers, as case requires) was a non-resident immediately before the acquisition.

(4A) Subsection (4) does not apply to the acquisition of an asset if the asset is a share in a company that was a resident immediately before the acquisition.

(5) Section 159GZZE does not apply to the acquisition of an asset if the Commissioner is satisfied that the acquisition has not, and will not, result directly or indirectly in:

(a) an increase in the overall indebtedness of the group constituted by:

(i) each affected taxpayer; and

(ii) the eligible seller (or each of the eligible sellers, as the case requires); or

(b) an increase in the ability of:

(i) the eligible seller (or any of the eligible sellers, as the case requires); or

(ii) any associate of the eligible seller (or of any of the eligible sellers, as the case requires);

to pay an amount (other than an amount assessable under section 44 or liable to tax under subsection 128B(4)) to:

(iii) a foreign controller of the eligible seller (or of any of the eligible sellers, as the case requires); or

(iv) an associate of a foreign controller of the eligible seller (or of any of the eligible sellers, as the case requires).

(6) In this section:

affected taxpayer, in relation to the acquisition of an asset, means a taxpayer to whom section 159GZZE would apply (apart from this section) in relation to the acquisition.

eligible seller, in relation to the acquisition of an asset, means a person who is an eligible seller for the purposes of section 159GZZE in relation to that acquisition.

Appendix 2 – 2013 Proposal Paper

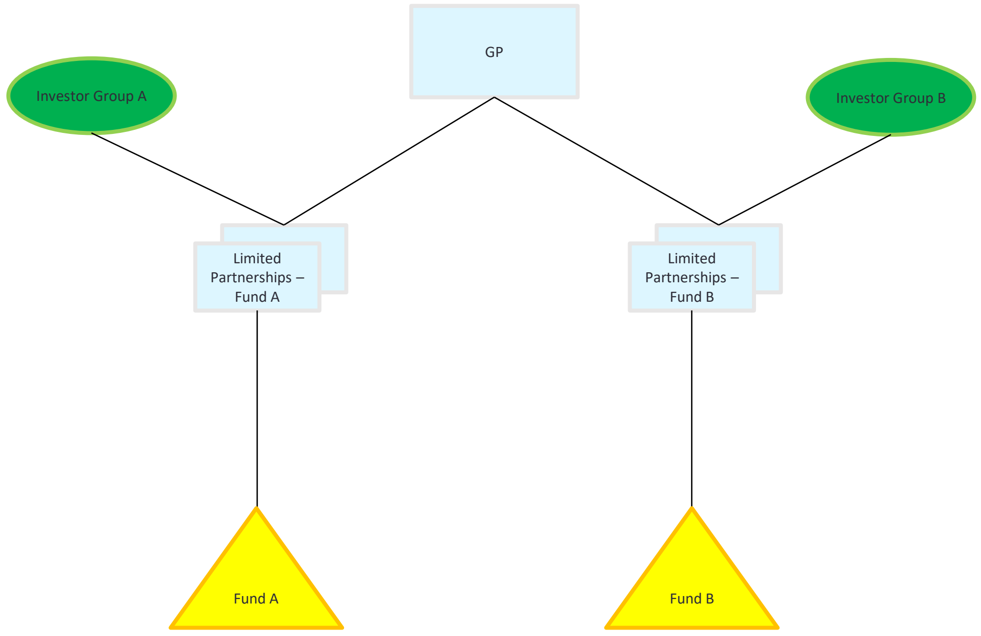
proposal paper.pdf

Thin cap example – foreign limited partnership fund structure

Inbound investments into Australia are often structured by aggregating investors into limited partnerships. The GP of the limited partnerships is commonly controlled by the foreign parent of the investment fund which is managing the investment. The GP may commonly have only a small proportionate interest in the respective limited partnerships (to align the interests of the GP with the investors)

The structure chart oppose shows two funds that have different underlying investors, with both funds subject to the thin capitalisation rules. As the funds may be considered to be controlled by the GP and therefore the foreign investment fund's parent, Fund A and Fund B may be associate entities of each other. Therefore, under the proposed thin capitalisation amendments, Trust B cannot choose to apply the external third party debt test unless Trust A chooses to apply the test

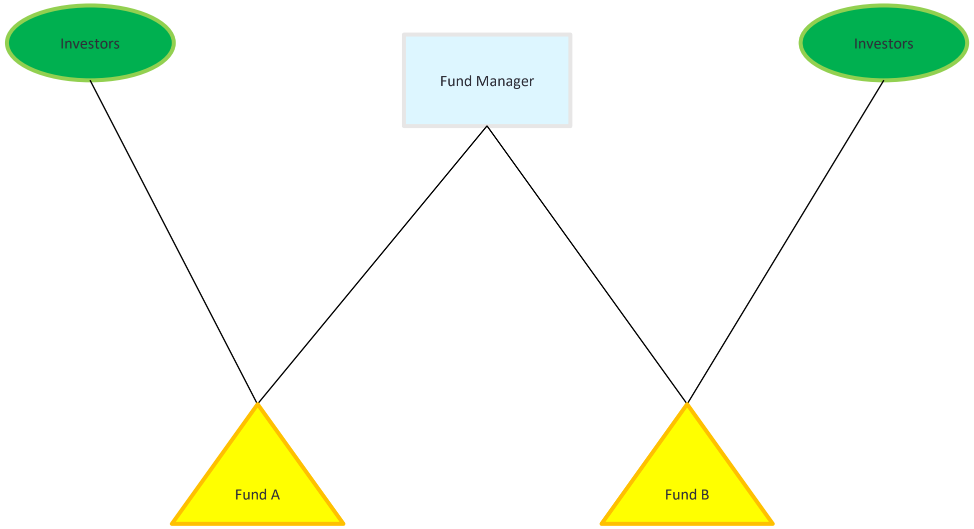
There can be no policy reason for requiring the funds to apply consistent elections in respect of the external third party debt test. This requirement places the GP in conflict, as elections made in respect of one fund (to apply the fixed ratio test) may have adverse consequences for the other (cannot apply external third party debt test)



Thin cap example – common Australian fund manager

Similar issues to the preceding slide also arise where there is a common fund manager and the fund manager has capital invested into the separate fund vehicles – commonly this capital invested will be more than 10% and is generally demanded by investors to ensure that there is alignment between the investors and the fund manager

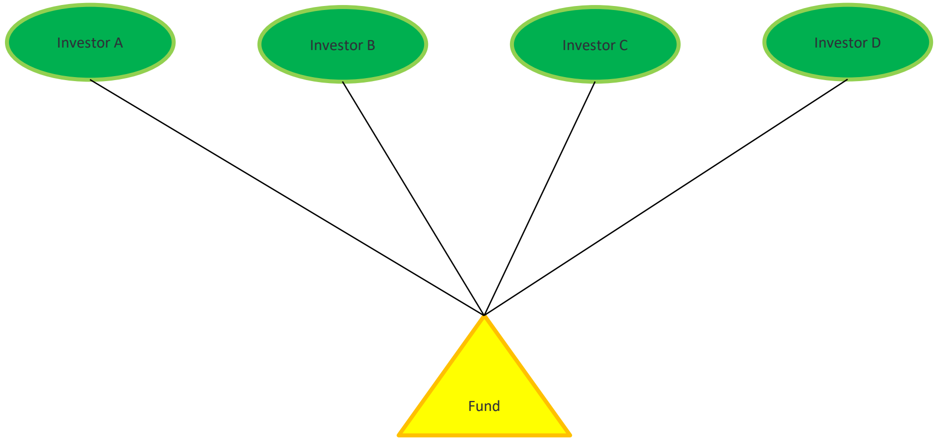
In the example opposite, Fund A and Fund B are associate entities under the proposed new rules (and cannot therefore make inconsistent elections as regards the external third party debt test) even though there is no relationship between the vehicles apart from the common fund manager



Thin cap example – club investors

Four unrelated investors invest 25% each into a jointly owned unit trust to acquire real property

Because of the 25% unitholding, each investor will be an associate of the Fund, and would also be associate entities of each other. This would mean that Fund A could not adopt the external third party debt test unless **all** of the investors have adopted this test. Furthermore, if an associate entity of (for example) Investor A has not adopted the external third party debt test, this means that none of Investors B to D **nor any of their associate entities** can adopt the external third party debt test.



Thin cap example – Australian IJV

In this scenario, the Australian IJV would need the same thin cap choice as the Australian TCG and Australian company (the latter are each subject to thin cap rules due to the outbound and inbound ownership respectively) if it wanted to access the third party test.