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Committee Secretary
Senate Standing Committee on Economics (Legislation)
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Committee Secretary,

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

The Corporate Tax Association (**CTA**) welcomes the opportunity to make a submission on the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023* (**Bill**).

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 are 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.

In what follows we have made observations in relation to:

1. the disclosure of residency status;
2. the thin capitalisation changes;
3. the breadth of the proposed debt creation rules; and
4. tax policy formulation.

1. Disclosure of Tax Residency Status

The only observation we make on the proposed disclosure of tax residency status measure is the proposal relies upon taxpayers being able to determine the tax residency of their subsidiaries with certainty. At present, due to the ATO's interpretation of the *Bywater* case, the corporate tax residency rules do not necessarily make it a simple task to determine residency. In order for listed groups to be able to comply with this proposed measure, the Australian Taxation Office (**ATO**) needs to develop simple, practical rules for listed groups to follow.

The ATO is currently seeking feedback on its Practical Compliance Guideline on corporate residency, and we have suggested a simple no-risk "white zone" for public groups with active businesses in foreign jurisdictions not operating in a tax haven.[1] Unless this occurs,

[1] See PCG 2018/9DC1 | Legal database (ato.gov.au)

we suggest the Parliament pursue the 2020-21 Budget announcement and legislate the corporate tax residency law changes as recommended by the Board of Taxation.[2]

2. Thin Capitalisation Rules

We commend the Government for addressing some of the concerns expressed with the initial Exposure Draft (**ED**) on the thin capitalisation changes, particularly the announcement to deal with the potential removal of section 25-90 via a separate consultation process.

Having said that, there are still issues with the Bill as drafted.

We have attached as Appendix 1 our detailed comments on the wider thin capitalisation changes which include comments and recommendations on:

a) the calculation of Tax EBITDA,
b) the operation of the third party debt test; and
c) the interaction of the proposed rules with transfer pricing rules.

3. Breadth of the Debt Creation Rules

The most concerning aspect of the Bill is the proposed introduction of revised debt creation (**DC**) rules in Sub-Division 820-EAA and the anti-avoidance rule in section 820-423D.

These provisions came as a surprise and their breadth is even more surprising.[3]

There was no indication prior to the Bill being tabled that the proposed DC rules were to be introduced. As far as we are aware, there was no confidential taxpayer or adviser consultation on the measure, but we suspect there may have been some consultation only with the ATO. This apparent lack of consultation on the proposed DC rules is reflected in their broad impact on legitimate business transactions that do not create increased net debt levels in Australia.

The multiple and overlapping issues with the current drafting of the proposed DC rules also suggest the following:

- That Treasury may not have the requisite level of expertise and commercial understanding to effectively manage such an historically complex tax issue.

- That the ATO, if it was consulted prior to the insertion of the proposed rules into the Bill, has not provided fulsome and transparent advice to Treasury.

- That the revenue risk underpinning the introduction of the proposed DC rules is not fully understood by either Treasury or the ATO. That is, it is unclear whether the

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[2] See Corporate Tax Residency Review | Board of Taxation (taxboard.gov.au)

[3] In consultation with Treasury on the original ED, the CTA (and others) suggested the reintroduction of Division 16G may be a means to address the integrity concerns that may exist with debt creation. This suggestion was predicated on the assumption that the scope of, and exemptions to, the old Division 16G were replicated in any new proposal and as an alternative to the removal of section 25-90.

proposed DC rules are in fact aimed at addressing (unarticulated) concerns around domestic transfer pricing or 'debt dumping', rather than debt **creation**. Needless to say, these are all complex concepts that should have been unpacked and analysed prior to attempting to draft legislation.

While we acknowledge the fraught environment (around consultation and confidentiality) in which these measures are being contemplated, it is exactly these types of complex issues that benefit most from early engagement with impacted taxpayers. Attempts to draft anti -avoidance provisions in such contexts also require a clear articulation of the problem the proposed law is aimed at addressing. This articulation – given it is related to a revenue risk – must necessarily first come from the ATO, which then allows Treasury to craft a solution to the problem. A lack of adherence to these necessary steps will inevitably lead to policy failure.

The CTA understands that some of the obstacles Treasury has faced throughout the MNE consultation process have been outside its control, and we very much appreciate the genuine willingness of Treasury staff to work through these obstacles as best they can, given resourcing and expertise constraints. However, with respect, of all the obstacles that have arisen during the MNE consultation process[4], the proposed DC rule is the largest in terms of potential 'policy failure'[5].

The reasons for this potential policy failure are relatively simple:

- The proposed DC rules apply to resident associates, even though there cannot be net debt creation from an Australian perspective.

- The proposed DC rules do not include the equivalent of the sec 159GZZF exemptions in the old Division 16G. These exclusions ensured the old debt creation rules were directed to transactions not in the ordinary course of business that **created** increased net debt levels in Australia.

- There is no linking of the proposed DC rules to the consultation process to be undertaken surrounding section 25-90, despite their obvious overlap.

We have provided a detailed paper in Appendix 2 which outlines the breadth of the rules as drafted and how they impact many ordinary commercial undertakings. This includes, for example, the debt funding of the purchase of trading stock, plant and equipment and new businesses with any related party debt. We have suggested the rules need a recalibration and that any proposed rules form part of the consultation process surrounding section 25-90 before they are finalised.

4. Consultation in Tax Policy Formulation

Some CTA members have advised us they are placing halts on business-as-usual transactions that cannot proceed until there is certainty on the breadth of the proposed DC

[4] These include the proposed removal of sec 25-90, the inappropriate scope of the proposed intangibles measure, and the inclusion of four additional disclosures in the proposed public Country-by-Country Reporting regime.

[5] The unintended consequences that would accompany the introduction of the proposed DC rules in their current form will unquestionably constitute a policy failure.

rules. This reality, combined with the lack of clarity around the interaction between this consultation process and that for section 25-90, points to either a breakdown in governance around consultation and tax policy formulation or a lack of adherence to it.

While it is absolutely understood that we are in challenging economic times in terms of the longer-term Budget outlook and our susceptibility to further budget shocks, impacting legitimate business activity via poorly drafted legislation will bring that susceptibility to life much faster than addressing a perceived revenue leak that is not even significant enough to warrant its own costing. A strong governance framework around tax policy formulation – and adherence to that framework – is the most effective way to mitigate such outcomes.

We must ensure Australia maintains an approach to tax policy formulation that encompasses early, transparent, constructive engagement with taxpayer stakeholders, not just with the ATO. Otherwise, attempts to raise relatively insignificant amounts of revenue will result in far greater losses in current and future revenue.

The failure to engage early with impacted taxpayers on the proposed DC rules is evidenced by the fact that no one from Treasury or the ATO has, at this stage, been able to explain to the CTA or its members when we discussed the content in Appendix 2 with them why the exemptions in the old Division 16G were not replicated (or were ignored) in the proposed DC rules, why the proposed rules apply to resident associates, or whether the anti-avoidance rule in section 820-423D is trying to deal with the tracing of funds. Furthermore, no one has been able to explain why the proposed DC rules are in fact broader in many respects than the removal of section 25-90, which, as noted above, is apparently going to be subject to further consultation[6].

While we remain committed to engaging with both Treasury and the ATO on this matter, we should all take this opportunity to pause and reflect on the fact that the large-scale uncertainty this proposed measure has created for corporates engaging in legitimate business transactions could have been avoided if consultation was sought prior to the measure being introduced in the Bill.

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

[6] Section 25-90 effectively allows a debt deduction incurred in the generation of certain exempt non-portfolio dividends. The proposed DC rules as drafted would also fully deny debt deductions on arm's length related party borrowings used to acquire new sources of assessable income from an unrelated party such as new shares, new businesses (say a greenfield investment in energy transition assets), trading stock and plant and equipment.

Appendix 1 - Thin Capitalisation Changes

The following Appendix provides comments on the wider thin capitalisation rules contained in the Bill notably around:

1. the calculation of tax EBITDA
2. the operation of the third party debt test; and
3. the interaction of the proposed rules with the transfer pricing rules.

Detailed comments on the debt creation rules and the anti-avoidance debt creation rule are provided in Appendix 2.

1 Calculation of EBITDA requires amendment to account for the income of Joint Venture Companies, Partnerships and Trusts

Australian businesses undertake substantial business activities through joint venture (JV) companies, trusts and partnerships (common in the property development, engineering and construction industries). These arrangements will be significantly impacted by not including their appropriate share of the company, trust or partnership net income in their respective tax EBITDA. It is not uncommon for JV partners (used as a collective term for those with an interest in the underlying company, trust or partnership) to debt fund a portion of their equity interest in the JV, with limited or no debt within the JV entity. There are numerous commercial (non tax) reasons why the debt may be sourced by the JV partner and not the JV, including:

- JV partners have different gearing requirements/policies
- Individual JV partners may have access to cheaper funding as part of broader group facilities
- Mitigation against risk of default by the other partner if each JV partner is only responsible for their own debt financing.

Current thin capitalisation rules allow the excess debt capacity in the underlying entity to be effectively transferred to the JV partners, so as to mirror the economic outcomes that would occur should the relevant debt funding be at the underlying entity level (see 820-920 of the *Income Tax Assessment Act 1997)*. These excess capacity rules are not replicated in the proposed rules.

a) <u>Companies and the dividend exclusion</u>

The calculation of tax EBITDA excludes amounts referrable to the franked component of a dividend received (Division 207 of the *Income Tax Assessment Act 1997*) but also the underlying dividend (section 44 of *Income Tax Assessment Act 1936*) and distributions from trusts and partnerships under proposed sections 820-52(3), (6) and (8).

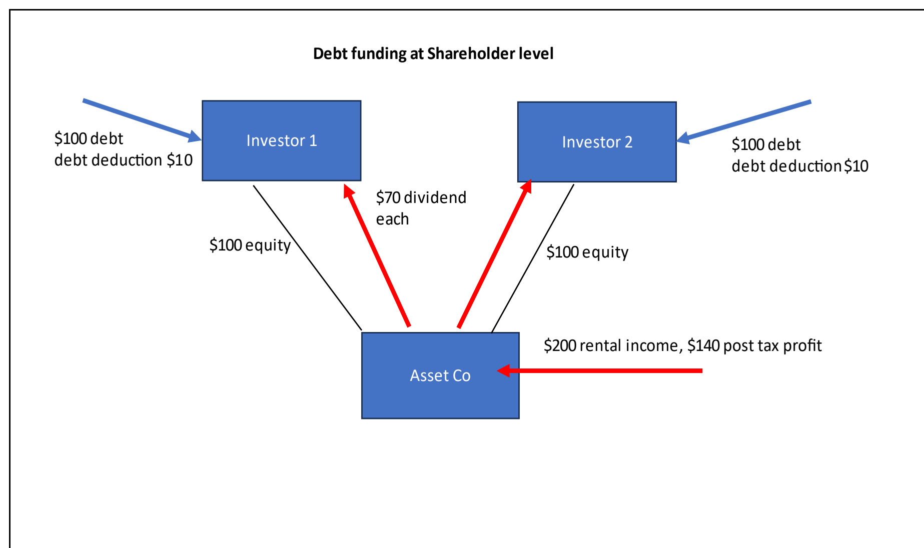
The rationale for the dividend exclusion from tax EBITDA is provided at paragraph 2.61 of the EM, which acknowledges the franked component under Division 207 should be excluded. We consider this is appropriate given this is a notional amount of assessable income, being the franking credit component of the underlying dividend.

The policy rationale for excluding the underlying dividend is less clear. The EM notes at paragraph 2.61 that:

> "...[D]ividends that are included in an entity's assessable income under section 44 of the ITAA 1936 are excluded from the entity's tax EBITDA. This avoids double counting income as the dividend represents profits which have already been taxed at the company level and are referrable to the company's tax EBITDA."

The inference here is that the subsidiary company will apply the tax EBITDA tests in its own right and this will determine if a debt deduction is allowable or otherwise by reference to its underlying EBITDA. Whilst superficially correct, this is not always the case. Problems arise where the underlying company may not be funded in part by any debt and thus not have any debt deductions. However, at the holding entity (or shareholder) level, debt deductions are incurred. This is common in many property structures where debt funding is at the shareholder level via joint venture companies, rather than the operating entity level, or where an investor holds a non-portfolio interest in shares. This is not a structure driven by tax, but by commercial reasons discussed further below.

For example, assume Investors 1 and 2 each borrow $100 incurring debt deductions of $10. They have no other source of income. The borrowed funds are used to equity fund Asset Co with $200 which it uses to fund the construction of a commercial property for $200. Assume Asset Co generates $200 rental income and pays $60 tax, leaving $140 after tax profit which it distributes to Investor Co 1 and 2 ($70 each).



As the law is drafted, the tax EBITDA for Asset Co is $200, but it has no debt deductions. By contrast, Investors 1 and 2 have tax EBITDA of $10 (being their debt deductions, only as the dividend received from Asset Co is currently excluded under sections 820-52(2) and (3)). This would result in only $3 of interest being deductible to Investors 1 and 2 ($3 being 30% of their $10 EBITDA), with $7 carry forward deductions.

By contrast, if Asset Co was debt funded by $200, it would incur debt deductions of $20, and have a tax EBITDA of $200 (taxable income of $180 plus debt deductions of $20). It would be able to fully deduct its interest expense of $20, as this is below the 30% Fixed Ratio (30% of $200 is $60).

In both scenarios, Investors 1 and 2 have beneficial and economic ownership of Asset Co's rental income (less tax) and economic exposure to $100 of debt. However, in the case where debt is at the shareholder level, interest deductions are denied, whereas not in the latter case.

Allowing Investors 1 and 2 to include the dividend received (but not the franking credit) from Asset Co would give the same economic outcome. Alternatively, giving each Investor its share of Asset Co's debt capacity provides the appropriate economic outcome.

It is recommended the law is amended to either include the sec 44 dividend, or excess capacity is transferred to the associate. The latter happens under existing thin capitalisation rules.

b) <u>Partnership and Trust Exclusion</u>

Similarly, tax EBITDA also excludes any income derived from interests in trusts and partnerships under sections 820-52 (6) and (8). Again, the rationale employed here is that this ensures no double counting at the partner or beneficiary level (see paragraph 2.69 of the EM).

Based on the current drafting, JV partners will not be able to include any tax EBITDA of the JV entity in their thin capitalisation calculations, resulting in the denial of interest deductions under the FRT at the shareholder, partner or beneficiary level.

The proposed section 820-52(6)(b) also excludes distributions from trusts where the beneficiary is an associate of the trust. This means that a head trust that borrows and invests entirely through one or more subsidiary trusts would have to omit all income from the subsidiary trusts from the calculation of EBITDA – as a result, the head trust would not be able to use the EBITDA test.

There is also an exemption from the associate test for super funds, and wholly owned subsidiaries of super funds, but this exemption does not apply to widely held investment funds (MITs, AMITs and CCIVs). As a result, this will disadvantage widely held funds, including infrastructure funds.

c) <u>Attributed Managed Investment Trusts (AMITs)</u>

The EBITDA test uses the concept of taxable income, which is corrected to net income for trusts under section 820-52(4). However, this adjustment doesn't work for AMITs. As a result, the EBITDA test doesn't work for AMITs and should be amended to reflect the same.

d) <u>Recommendations</u>

i. The current rules need amendment to allow an entity to include any excess tax EBITDA capacity from associate entities similar to the existing associate entity excess rules in section 820-920 of the *Income Tax Assessment Act 1997*.

We note at page 86 of Attachment 2 to the Bill the following comment as to why the current rules do not include excess capacity rules:

"Additionally, some groups of trusts and other non-consolidated groups may opt to simplify their operating structures in absence of *specific excess capacity rules*, such as by limiting the number of interposed trusts in their structure. This response could arise by restructuring the trust's debt financing to align the debt with the income earning asset (rather than structuring whereby debt is on-lent through a chain of trusts) to support their debt deductions under the fixed ratio (earnings-based) test, which would also help to increase the transparency of trust structures." (our emphasis).

Whilst this may be the case in theory, it is far from what would be the expected behavioural response. In fact, this assumes that the excess capacity rules are in fact some sort of concession, when in fact all they are trying to achieve is to have the tax outcome mirror the economic substance of the arrangement.

With respect, to assume it is a simple matter to restructure financing arrangements with third party banks is naïve and assumes there are no break costs.

We note the existence of excess capacity rules is critical, particularly given the breadth of the proposed anti-avoidance rule in section 820-423D (discussed in detail in Appendix 2). As drafted, these anti-avoidance rules would deny a taxpayer a debt deduction where the principal purpose of restructuring the debt was to counter the impact of the debt creation rules. Thus rules would negate any benefit from the suggested restructure outlined in the EM.

We also note at page 93 of the EM, the use of the excess capacity rules was not pursued for "simplicity and integrity reasons". There is no indication of what the simplicity and integrity concerns are. As mentioned, the excess capacity rules are critical to ensure the correct economic taxation of underlying profits. To have tax rules that introduce a distortion due to the choice of a commercial (non tax) structure is bad tax policy, particularly given anti-avoidance rules prevent reorganisations.

ii. The draft rules also need to be adjusted to accommodate AMITs and other collective investment vehicles.

2. Third Party Debt Test (TPDT)

a) Based on current drafting, trusts and partnerships do not qualify for the TPDT and thus will only have access to the Fixed Ratio Test or Group Ratio Test. To qualify for the TPDT, the borrower must be an 'Australian resident'. Trusts are technically not 'Australian residents' and therefore do not qualify as the test in sec 820-427A (3) only applies to Australian residents.

b) Under the current draft rules, the lender can only have recourse for payment to the Australian assets of the borrowing entity. This appears to work for consolidated groups under the single entity rule but not the property funds sector where it is

common for lenders to have recourse to the assets of the broader trust group (i.e. obligor group).

Typically, a bank would not only have recourse to the borrower but would also have recourse to membership interests in the borrowing entity and assets of sub-trusts. This will disqualify a large number of trust groups.

3. Interaction with Transfer Pricing Rules

A key change to the thin capitalisation architecture in the Bill is the consequential amendments in relation to the operation of the transfer pricing rules.

The effect of these amendments is that the proposed thin capitalisation rules effectively act as a limitation or cap on the arm's length outcome under the existing transfer pricing rules in Division 815 of the *Income Tax Assessment Act 1997*. Previously, the thin capitalisation rules in Division 820 determined the allowable quantum of debt by reference to the value of assets by reference to 1 of 3 tests (the 60%, worldwide gearing or arm's length debt test) and Division 815 (or the transfer pricing rules) effectively determined the arm's length value of the debt deduction (or interest rate) applying to that quantum of debt.

As a practical matter, the quantum of debt under current rules is quite mechanical (at least for the 60% test and worldwide gearing test) whilst the rate of interest requires some degree of transfer pricing analysis.

As a practical matter, the ATO provided some degree of practical guidance on determining the rate of interest in its Practical Compliance Guideline PCG 2017/4.

The technical impact of the current proposal is a taxpayer will need to determine the transfer pricing outcome for both the quantum of debt and the rate of interest (that is the amount of debt deduction) as a first step and then apply the EBITDA tests to determine if they limit the outcome applying arm's length conditions.

Inevitably this will involve taxpayers seeking expert opinion on the arm's length quantum of debt and the interest rate. In our experience, the cost of obtaining expert opinions is significantly higher than the initial $30,000 start-up costs referenced in Attachment 2 to the Bill and definitely more than zero on an ongoing basis[7] as a transfer pricing analysis is most likely required each year as a minimum. These are costs that would not otherwise arise.

In our view, as a matter of priority, the ATO needs to provide clear and simple practical guidance to assist taxpayers, advisers and ATO staff to help determine the arm's length conditions and thus outcome under Division 815, so as to avoid lengthy and costly disputes in the future.

[7] See page 85 of the EM to the Bill which provide estimated compliance costs of businesses subject to the amended rules.

Appendix 2 - Debt Creation Rules

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This Appendix explores the operation of the proposed new debt creation rules contained in Subdivision 820-EAA (the proposed rules).

For ease of reference, we have attached:

- Attachment 1 which includes the proposed wording of the debt creation rules in Subdivision 820-EAA. Appendix 1 also includes the Explanatory Materials (EM) that accompanied the Bill on the debt creation provisions.

- Attachment 2 which includes the wording of the old Division 16G of the *Income Tax Assessment Act 1936* – the old debt creation rules.

- Attachment 3 which includes clause 50 of the EM to *Tax Laws Amendment Bill (No.4) 1988* which introduced the debt creation rules (pages 83-97).

- Attachment 4 which includes the full text of Chapter 9 of the BEPS Action 4 Final Report.

- Attachment 5 which includes the definition of "distribution" from the *Income Tax Assessment Act 1936.*

Summary Observations

1. Like the proposed removal of sec 25-90 of the *Income Tax Assessment Act* 1997, the proposed introduction of new debt creation rules came as a surprise, and its breadth of scope even more surprising. The rules need to be targeted to the apparent mischief.[8]

2. Fundamentally, the proposed rules as drafted would appear to completely deny debt deductions for any arrangements that involve an associate, whether it is an asset purchased from an associate or a debt instrument issued to an associate. The inference is that all related party transactions should be equity funded. This is bad policy impacting plain vanilla commercial arrangements such as the purchase of trading stock even for wholly domestic to domestic transactions.

3. A new foreign investor would not get any debt deduction in Australia for a new Australian investment if is funded in whole or part with related party debt such as a new greenfield investment in renewables. This effectively creates a permanent 0% EBITDA fixed ratio. This further adds to perceptions Australia is not open for business, and impacts wider Government objective such as green energy transition.

4. The rules appear to apply to transactions entered into before 1 July 2023 that may incur debt deductions from 1 July 2023 despite the quantum of debt and interest rate meeting arm's length conditions. The proposed sec 820-423D would appear also to deny debt deductions, if a taxpayer restructured an old transaction with unrelated party debt.

5. In our view, it would have been more appropriate to have considered the introduction of any new debt creation rules in conjunction with any consultation surrounding the potential repeal of section 25-90, particularly as there appears overlap.

6. As a minimum the proposed rules need to completely mirror Division 16G and only apply to non-resident associates <u>and</u> have certain asset acquisitions excluded from their operation as was the case with the old Division 16G.

Background

Whilst the old Division 16G of the Income Tax Assessment Act 1936 could be used as a template for the development of a modernised targeted debt creation rule, the breadth of the current proposal extends well beyond the ambit of the old Division 16G.

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[8] We understand this might be linked to current Federal Court cases involving non-resident associates, but are not aware of any cases involving resident associates creating increase debt levels, and thus increased debt deductions.

In our view this is bad policy as currently drafted because:

- It applies to domestic associates; and
- Certain asset types are not excluded from the operation of the new rules. Certain exclusions existed in Division 16G by virtue of section 159GZZF which are not replicated in the proposed rules.[9]

Whilst we acknowledge the comments at paragraph 4.153 in the EM that the rules are broadly drafted "to help ensure they are capable of applying to debt creation schemes of varying complexity" we dispute this "approach is necessary given the ability of multinational groups to enter into complex debt creation arrangements." A more targeted approach is necessary.

As a result of their broad remit and the lack of exclusions, the proposed rules apply to many straightforward ordinary commercial arrangements that have no tax minimisation purpose or effect and impact arrangements that do not create additional debt deductions. This seems at odds with the intent of the rules articulated in the EM.

In relation to the intent with the rules, the EM notes at paragraph 2.145 – to 2.147 that:

The strengthened thin capitalisation rules will play an important role in limiting excessive debt deductions. However, they do not address the risk of excessive debt deductions for **debt created in connection with an acquisition from an associate entity or distributions or payments to an associate entity**. Such debt deductions may only ever indirectly, and at most, be partially limited by the thin capitalisation rules.

2.145 New Subdivision 820-EAA seeks to directly address this risk by disallowing debt deductions to the extent that they are incurred in relation to **debt creation schemes that lack genuine commercial justification**.

2.146 Subdivision 820-EAA represents a **modernised version of the debt creation rules** in former Division 16G of the ITAA 1936. Subdivision 820-EAA is consistent with Chapter 9 of the OECD's BEPS Action 4 Report (specifically paragraphs 173 and 174 of that report) which recognises the need for supplementary rules to prevent **debt deduction creation**. (emphasis added)

We note:

1. that references in the EM are to **debt creation**, not debt replacement, debt refinancing, debt reduction, or simple debt financing activities.
2. the EM refers to the rules as a "modernised version" of the old Division 16G rules. With respect, the new rules go much further than modernising the old rules and impact some very plain vanilla activities, such as the purchase of trading stock or capital assets in the ordinary course of business that were specifically excluded from the old rules. The proposed rules as drafted are both a modernisation and

[9] See Appendices 2 and 3

extension of Division 16G, and are not restricted to debt creation at all, but appear to apply to any transaction with an associate involving debt funding.

3. the question of whether there is to be a removal of section 25-90 is still subject to further consultation. As the proposed rules are drafted, they are wide in operation covering part of the operation of section 25-90 but also extending well beyond denying debt deductions incurred in deriving certain NANE income. They appear to deny debt deductions in cases where they are directly incurred in deriving assessable income or carrying on a business for that purpose.

Detailed Comments

What is different with the proposed rules and Div 16G.

It is acknowledged the old Division 16G rules were targeted at the acquisition of assets from non-resident controllers and this was consistent with the operation of the old thin capitalisation rules in Division 16F that only applied to foreign debt from a non-resident controller.[10]

By contrast, the current thin capitalisation and proposed EBITDA rules apply to all debt and to all taxpayers.

Whilst it may seem logical to therefore extend the equivalent of the Division 16G debt creation rules to acquisition of assets by domestic associates (as the thin capitalisation rules apply to foreign and domestic controlled groups), this is not quite right.

Why Division 16G did not apply to assets acquired by an Australian controller from an Australia associate

It is implicit in the operation of Division 16G that debt funding an acquisition of an **existing** asset from an Australian resident controller would not be problematic debt **creation** as it didn't increase the net level of debt of the associate group. This is because the cash (debt funding) used by the acquirer would go to the seller. The proceeds from the sale (the amount borrowed) would be received by a resident disposer. There was no mischief from a system perspective from a debt-funded acquisition from one resident associate to another resident associate as the debt funding received by the purchaser would equal the cash given to the seller.

For example, assume Australian Controller owns an Australian TargetCo and sells it to AcquireCo. AcquireCo borrows $100 from a bank and uses the cash to buy TargetCo from Controller. The $100 borrowed is given to Controller for the sale. The debt amount in AcquireCo of $100 equals the cash in Controller of $100. Net debt for the group remains at zero in Australia.[11]

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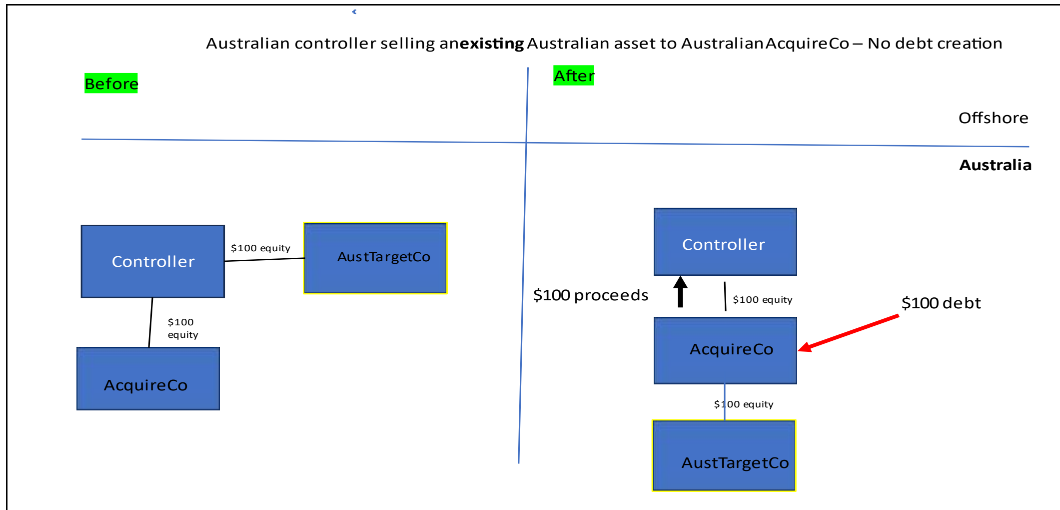
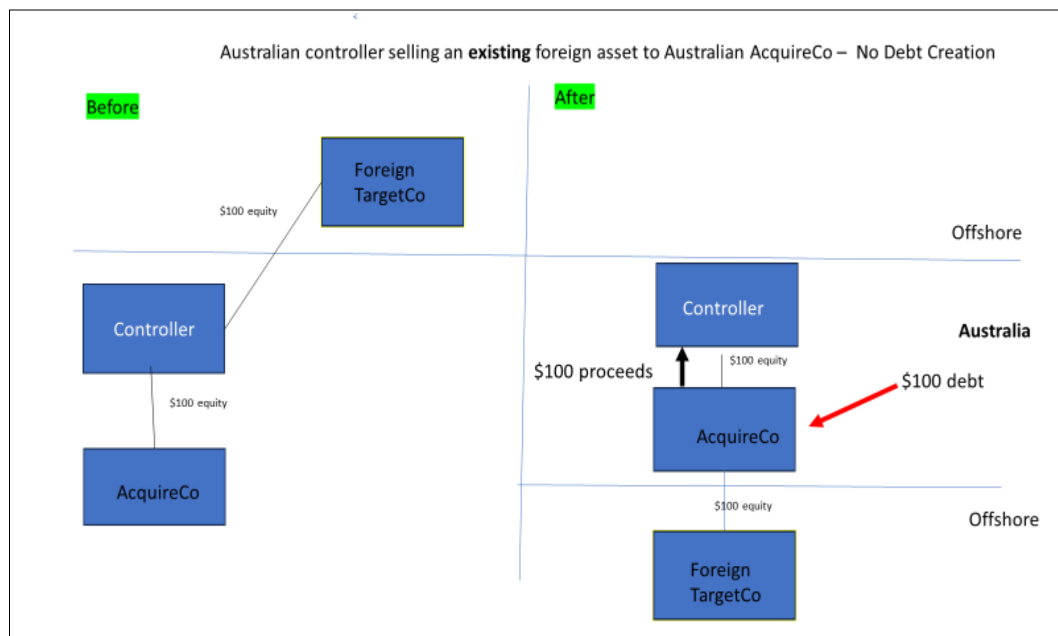
[10] Similarly, Division 16F (the old thin cap rules) only applied to foreign debt deductions. See [Income Tax Assessment Act 1936 (legislation.gov.au)]

[11] This assumes no tax on the sale by Controller.

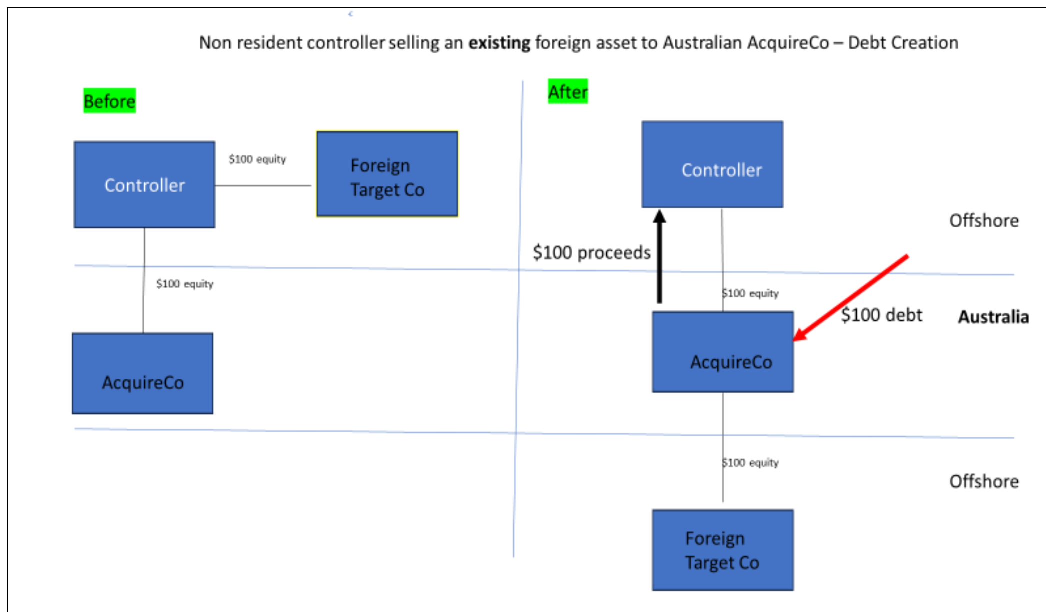


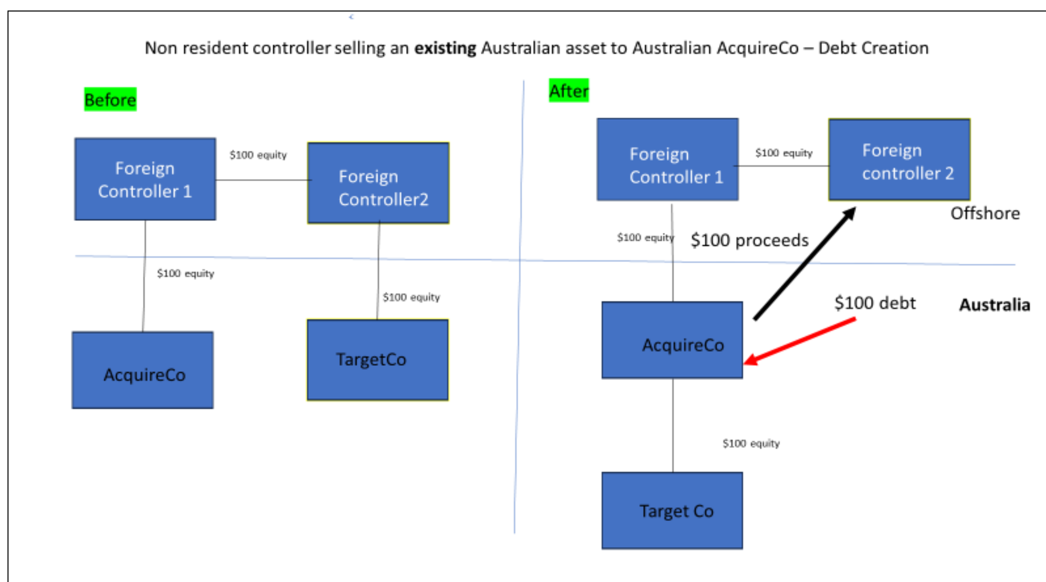
Similarly, a sale of an existing foreign asset (Foreign TargetCo) from an Australian Controller would not lead to increased net debt in Australia for the same reason. The cash borrowed from AcquireCo would equal the amount given to the seller, Controller.



By contrast, where a foreign controller sells a foreign **or** domestic asset to a domestic AcquireCo, there is debt **creation** in Australia as the sale proceeds received by the seller leave Australia, but the debt remains in Australia.

For example, the $100 borrowed by Australian AcquireCo to acquire TargetCo is given to Foreign Controller. So, although there is no net debt created for the group, there is net debt created in Australia (in AcquireCo), and net cash is offshore (Controller).





The critical thing with these examples is they demonstrate there is no net debt created in Australia if the associate acquirer and the disposer are both in Australia. That is, no debt creation for **existing** assets ever occurs if both associates (the seller and acquirer) are in Australia.

The exclusions in sec 159GZZF were a critical design feature

In addition to the fact Division 16G only applied to acquisitions from a non-resident controller, a further critical design feature of Division 16G was that debt funded acquisitions of certain asset types from a non-resident controller were also excluded from rules.

There are critical policy reasons for the exclusions. In short, if a taxpayer was denied a debt deduction for the debt funded acquisition of an asset from a non-resident controller, debt

deductions would be denied for many normal commercial activities associated with carrying on a business or in deriving assessable income in Australia.

As is noted at page 83 of the EM to introduction of Division 16G[12]:

> "On June 1988 a draft of the main operative provisions of this proposed Division was released for public comment. Submissions on the draft were received from professional bodies and industry. Suggestions contained in these submissions have been adopted in the Bill, particularly those in relation to the need for specific exemptions for certain assets to ensure that the operation of the Division does not unnecessarily intrude into normal trading activities of foreign controlled companies."

Further at page 93 in relation to the exclusion in section 159GZZF:

> "The purpose of this section is to exclude from the application of this Division those transactions not normally regarded as corporate restructures."

The exclusions in sec 159GZZF were as follows:

1. *Cash (and the acquisition was not part of the acquisition of a business or part of a business).*

   This was to allow the taxpayer to debt fund working capital and other loans from a non-resident controller and to also to ensure transactions such as external borrowings by a company for the purpose of on lending to a related company are not subject to the Division[13]. It also ensured a subsidiary putting excess cash on deposit with a domestic parent did not result in an interest denial to the parent paying interest to a subsidiary.[14]

2. *Trading stock (and the acquisition was not part of the acquisition of a business or part of a business).*

   This was to allow the taxpayer to debt fund the purchase of trading stock from a non-resident controller. See the Example in paragraph 3 on page 94 of the Division 16G EM[15].

3. *Shares not previously issued*.

   This was to allow the debt funded acquisition of new share issues – these could be new shares in a domestic or foreign company. By contrast, the purchase of existing shares would be caught as debt creation (see the examples above). See the last paragraph at page 94 of the Division 16G EM.

4. *Acquisition of an asset not previously held or applied for the purpose of gaining or producing income or carrying on a business*.

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[12] See Appendix 3

[13] See Example on page 93 to the Division 16G EM

[14] If the subsidiary put excess cash on deposit with a bank, no such interest deduction is denied to the bank.

[15] See Appendix 3

This was to allow the debt funded acquisition of new capital assets (plant and equipment). It's worth noting subsection (4A) says subsection (4) does not apply if the asset was a share in a resident company. Again, see the examples at page 4 above as to why.

5. *The debt denial does not apply to the acquisition of an asset if the Commissioner is satisfied the acquisition has not increased the overall indebtedness of the group or increase the ability of the group to pay an amount that is not an assessable dividend or dividend subject to withholding tax.*

   This is effectively to stop the debt funded payment of a non-assessable dividend (or a dividend not subject to withholding tax) to a foreign controller or a capital reduction or share buyback. We note in passing the wording in the proposed sec 820-423A(5) is very similar, albeit wider in operation.

We note in passing the reason for the exclusions related to the acquisition of a business or part of a business, is the same as to why a taxpayer cannot get a deduction for the debt funded acquisition of an existing share from a non- resident controller. This is because the business would be an **existing** business and allowing a taxpayer to acquire it with debt would **increase** debt levels and debt deductions in Australia for transactions not in the ordinary course of business.

Section 820-423(A)(2) – Asset or obligation acquisition

It is clear from the draft provisions that any debt-funded or partially debt funded acquisition of any CGT asset or obligation from a foreign or domestic associate will have interest denied under the provision, including transaction in the ordinary course of business.

It doesn't matter that the debt funding is from an associate or not, or whether the source of the funding is domestic or foreign.

It would also appear the rules would apply to historic funding arrangements, but which would currently generate debt deductions.

This would therefore appear to deny debt deductions for many non-controversial debts funded asset acquisitions from foreign and domestic associates. The following table summarises some impact of the rules.

Sec 820-423A(2) - Asset/Obligation acquisition from a domestic or foreign associate

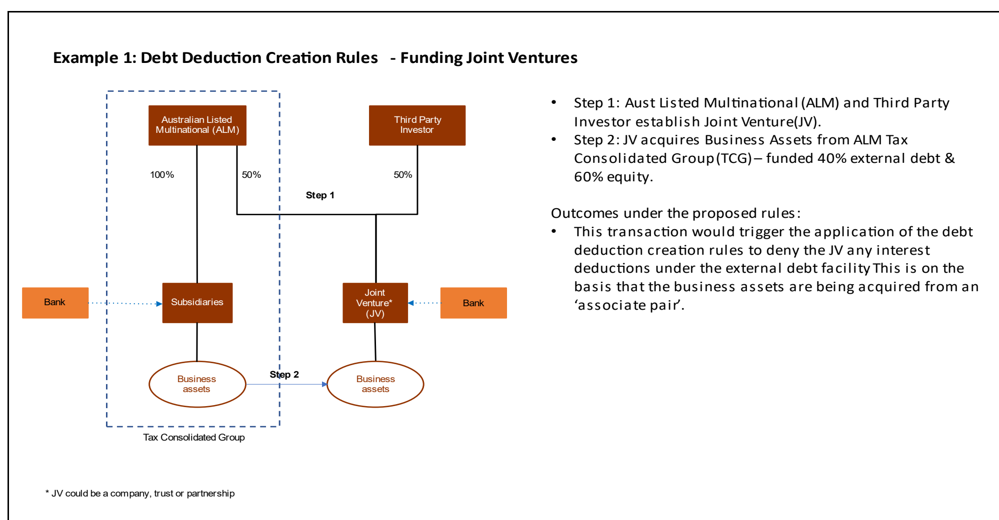
	Asset/Obligation acquired from a domestic or foreign associate	Acquisition of asset (or obligation) funded by domestic or foreign		Effect
		Associate	Non Associate	
1	Foreign business	No deduction	No deduction	No change
2	Trading stock	No deduction	No deduction	Change
3	Capital asset	No deduction	No deduction	Change
4	Domestic business	No deduction	No deduction	Change
5	Domestic shares	No deduction	No deduction	Change
6	Existing foreign shares (non portfolio)	No deduction	No deduction	Change
7	Existing foreign shares (portfolio)	No deduction	No deduction	Change
8	New Issuance of foreign shares	No deduction	No deduction	Change
9	New Issuance of domestic shares	No deduction	No deduction	Change
10	Cash (to repay existing debt, working capital or placing excess cash on deposit)	No deduction	No deduction	Change
11	Management/Service Fees	No deduction	No deduction	Change

Why a debt-funded acquisition of trading stock, a capital asset, a domestic share from a domestic associate should not be deductible is difficult to understand from a policy perspective. The rules would allow debt funding if the purchase of trading stock, capital asset or share was from a non-associate. It would for example, deny debt deductions for the debt funding of any distributor type arrangements, cash for working capital, etc.

Similarly, as per item 12 in the above table, if in the ordinary course of business a domestic financier borrows from external parties (say at 5%) and on lends to a related domestic or foreign operating or finance subsidiary (not in the same tax consolidated group) at 7%, the financier has acquired an asset from an associate (the receivable from the operating or finance subsidiary returning 7%) funded with debt (costing 5%), but is arguably denied a full deduction on the 5% interest cost. This is the case even though the financing transaction is creating a positive interest margin (taxable income) to the financier of 2%. Additionally, the operating company has acquired cash (a CGT asset) from the associate financier, funded by debt (the borrowing from the financier). It would also be denied a deduction on the 7% interest cost.

Such transactions were excluded under the exemptions in the old Div 16G.

Debt funded acquisition Joint Venture – associate pair example



Section 820-423(A)(5) – Debt instrument issued to an associate

This section is also widely drafted impacting the issuance of debt instruments to associates used to fund, facilitate the funding of, or increasing the ability to make payments or distributions[16] to associates.

The following table summarises some the impact of the rules:

[16] See Appendix 5 for the definition of distribution.

Sec 820-423A(5) - Debt Issuance to domestic or foreign associate				
	Funds used to predominantly fund, facilitate funding or increase the ability to make payments or distributions to a foreign or domestic associate for	Issuing debt interest to		Effect
		Domestic associate	Foreign associate	
1	Dividends	No deduction	No deduction	No change
2	Share buyback	No deduction	No deduction	No change
3	Capital reduction	No deduction	No deduction	No change
4	Purchase of foreign business	No deduction	No deduction	No change
5	Interest	No deduction	No deduction	Change
6	Repayment of debt or part of debt	No deduction	No deduction	Change
7	Funding working capital	No deduction	No deduction	Change
8	Purchase capital assets	No deduction	No deduction	Change
9	Purchase of domestic shares	No deduction	No deduction	Change
10	Purchase of foreign shares	No deduction	No deduction	Change
11	Purchase of domestic business	No deduction	No deduction	Change

It is not clear what, for example, is the policy rationale for denying debt deductions for the refinancing all or part of an **existing** related party debt. There is no "creation" of incremental debt levels on a balance sheet. .

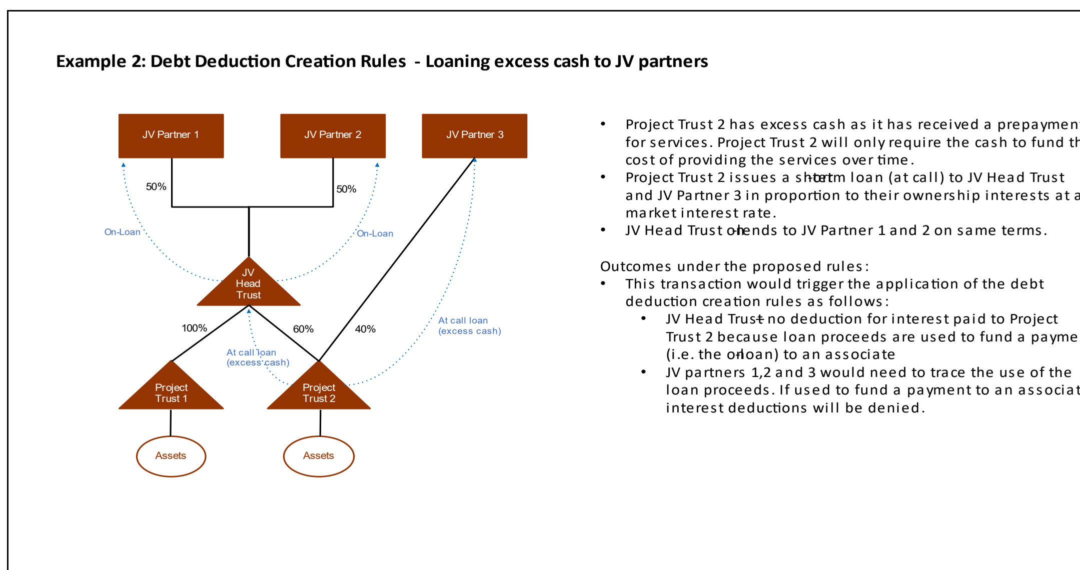
Similarly, a bank which issues a debt instrument to a domestic or foreign associate and uses the funds to on lend to a non-associate could have interest denied.

Furthermore, issuing a debt instrument to an associate with the funds raised to the purchase of a business from an unrelated party, could be seen as "increasing the ability to make payments" to an associate.

It is noted section 159GZZF(5) – which seems to be the equivalent provision to 820-423A(5) - notes the transaction needs, in the Commissioners' opinion, to **increase** the indebtedness of the taxpayer.

In fact, it is implicit in the Div 16G rules that they are not directed denying deductions that increased debt levels associated with the derivation of new income streams or from new business activities.

As summarised at item 12 in the above table, the proposed rule would also appear to impact the on lending of excess cash around an associate group, even though there is no net increase in indebtedness.



Comparison Table - The Proposed Rules and Division 16G

The following table shows the pertinent differences between the proposal and the old Division 16G. The critical differences lie with how the proposed rules apply to resident and non-resident associates and do not have certain assets excluded from their operation.

It is worth emphasising in our view the proposed rules are not targeted to the type of transactions where debt is created in circumstances that are not in the ordinary course of carrying on a business.

	Feature	Subdivision 820- EAA	Division 16G
1	Covers acquisitions of	Assets and obligations	Assets
2	Disposer	Resident and Non residents associates	Non resident controllers (associates) only
3	CGT assets excluded	None	1. Cash 2. Assets not being the acquisition of a business or part of a business (trading stock, capital equipment) 3. shares in a company that were not previously issued 4. assets have not previously been used to produce assessable income and the eligible seller was a non resident 5. shares in a resident company issued before the acquisition See sec 159GZZF(1) to (4)
4	Issuance of debt interest to associate	Included	6. where the Commissioner is satisfied there is no increase in the overall indebtedness; or ability to pay an amount that is a non assessable dividend or dividend not subject to WHT. See 159GZZF(5).
5	Specific anti-avoidance rule to debt creation rule	Principal purposes test of avoiding the debt creation rules.	None

Section 820- 423D

Given the breadth of the current drafting of the proposed rules, under the proposed section 820-423D, schemes undertaken with the principal purpose of not having a debt deduction denied also has a similarly wide application by default.

For example:

- If the asset acquisition rules in sec 820-423A(2) prevent a debt deduction for the debt funded purchase of trading stock from an associate, presumably the decision to change the supplier of trading stock to a non-associate would result in a denial of debt deductions on the new supply arrangement.

- If the debt issuance rule in sec 820-423(5) denied a debt deduction for refinancing a $100 of related party debt with a new $100 debt related party debt facility, a

decision to refinance the $100 debt with non-associate debt would not prevent the denial of the debt deduction.

- If the associate excess capacity rules mentioned in Appendix 1 are not introduced, suggestions in the EM that a trust could restructure to have debt at the operating entity level, rather than the shareholder, trust level would still deny a debt deduction.[17]

- Actions undertaken to trace funds (or pool funds) may be caught. For example:

  - if an entity was denied a debt deduction for purchasing trading stock from an associate but decided to use cash reserves to pay for trading stock and borrowed from a non-associate to replenish cash reserves.

  - Using excess cash to fund a dividend to an associate and borrowing from an associate to replenish working capital.

Treasury views on tracing and the impact of sec 820-423D in this regard would be welcomed.

What would be the impact of the rules

Fundamentally, the proposed rules as drafted would appear to completely deny debt deductions for any arrangements that involve an associate, whether it is an asset purchased from an associate or a debt instrument issued to an associate, rather than having the wider EBITDA rules operate to limit interest deductions. The inference is that all related party transactions should be equity funded.

Whilst the intent of the rules is to "address the risk of excessive debt deductions for debt created in connection with an acquisition from an associate entity or distributions or payments to an associate entity", as drafted the rules are bad policy and ignores the critical role debt plays in funding and capital management and the related party acquisition of trading stock and other assets in the ordinary course of business.

As drafted it fundamentally results in a 0% EBITDA ratio for related party transactions, and a maximum 30% EBITDA for unrelated party transactions. The rules also appear to apply to arrangements entered into before 1 July 2023 that may generate debt deductions on or after 1 July 2023.

Section 820-423C

Sec 820-423C indicates nothing in the debt creation Subdivision impacts the operation of the full gamut of the new Div 820. This could mean even though debt deductions could be denied under the debt creation rules, the denied debt deduction may still be used in the calculation of the relevant fixed and group EBITDA ratios.

[17] See page 86 of the EM to the Bill.

If this is the case, there is potential double debt deduction denial for unrelated party debt funding, and an effectively lower EBITDA fixed ratio rule than 30%.

We do not suspect this is the intent of the rules as drafted, but we would wish to understand Treasury's views.

Recommendation

Given:

- the potential interaction and overlap with these rules and the potential removal of sec 25-90,
- the fact the new debt creation rules extend well beyond the old debt creation rules by covering domestic associates, and
- there are no exemptions for certain asset categories, notably asset acquisitions and financing from associates in the ordinary course of business and that are not a restructure, like those that existed in Division 16G by virtue of sec 159GZZF.

we would recommend the introduction of any debt creation rule is delayed and subject to further consultation in combination with the consultation processes that are to occur in relation to the potential removal of sec 25-90.

Attachment 1 – Draft Rules and Explanatory Materials

Subdivision 820-EAA—Debt deduction limitation rules for debt deduction creation (all relevant entities)

Guide to Subdivision 820-EAA

820-423 What this Subdivision is about

This Subdivision sets out debt deduction limitation rules that apply to entities that are dealt with in rules set out in Subdivisions 820-AA, 820-B, 820-C, 820-D or 820-E. These rules deal with:

(a) debt deductions in relation to the acquisition of CGT assets, or legal or equitable obligations, from associate pairs of the acquirer; and

(b) debt deductions in relation to a debt interest that is issued predominantly to fund (etc.) payments or distributions to associate pairs of the issuer, or of the entity to which the relevant debt interest was issued.

Table of sections

Operative provisions

820-423A Debt deduction limitation rule for debt deduction creation (all relevant entities)
820-423B Amount of debt deduction disallowed
820-423C This Subdivision does not limit reduction of debt deductions other provisions
820-423D Schemes relating to this Subdivision

Operative provisions

820-423A Debt deduction limitation rule for debt deduction creation (all relevant entities)

Debt deduction limitation rule

(1) This subsection disallows all or part of a *debt deduction of an entity for an income year if, for that year:

(a) the entity is any of the following for that year:

(i) a *general class investor;

(ii) an *outward investing financial entity (non-ADI);

(iii) an *inward investing financial entity (non-ADI);

(iv) an *outward investing entity (ADI);

(v) an *inward investing entity (ADI); and

(b) subsection (2) or (5) applies.

Note 1: This Subdivision does not apply if the total debt deductions of that entity and all its associate entities for that year are $2 million or less, see section 820-35.

Note 2: To work out the amount to be disallowed, see section 820-423B.

Acquisition of CGT asset, or legal or equitable obligation

(2) This subsection applies if all of the following conditions are satisfied:

(a) an entity (the ***acquirer***) *acquires a *CGT asset, or a legal or equitable obligation, either directly, or indirectly through one or more interposed entities, from one or more other entities (each of which is a ***disposer***);

(b) one or more of the disposers (each of which is an ***associate disposer***) is an *associate pair of the acquirer;

(c) the entity mentioned in subsection (1) (the ***relevant entity***) is:

(i) the acquirer; or

(ii) an *associate pair of the acquirer; or

(iii) an associate pair of an associate disposer;

(d) the relevant entity's *debt deduction mentioned in subsection (1) is, wholly or partly, in relation to any of the following:

(i) the acquisition mentioned in paragraph (a) of this subsection;

(ii) the acquirer's holding of the CGT asset, or legal or equitable obligation.

(3) To avoid doubt, subsection (2) may apply more than once in relation to the *acquisition of a *CGT asset, or a legal or equitable obligation.

(4) For the purposes of paragraph (2)(a) and subsection (3), disregard paragraph (b) of the definition of "acquire" in subsection 995-1(1).

Issue of debt interest to associate pair

(5) This subsection applies if all of the following conditions are satisfied:

(a) an entity (the ***first associate***) is an *associate pair of another entity (the ***second associate***);

(b) the first associate issues a *debt interest to the second associate;

(c) the first associate uses the proceeds of issuing the debt interest predominantly to:

(i) fund; or

(ii) facilitate the funding of; or

(iii) increase the ability of any entity (including the first associate) to make;

one or more payments or distributions (within the meaning of section 26BC of the *Income Tax Assessment Act 1936*) that it makes to one or more other entities (each of which is a ***recipient***);

(d) one or more of the recipients (each of which is an ***associate recipient***) is an associate pair of any of the following:

(i) the first associate;

(ii) the second associate;

(e) the entity mentioned in subsection (1) (the ***relevant entity***) is any of the following:

(i) the first associate;

(ii) the second associate;

(iii) an associate pair of the first associate;

(iv) an associate pair of the second associate;

(f) the relevant entity's *debt deduction mentioned in subsection (1) was in relation to the debt interest.

(6) For the purposes of paragraph (5)(c):

(a) the payments or distributions mentioned in that paragraph may be made:

(i) directly, or indirectly through one or more interposed entities (see subsection (4)); and

(ii) before, at or after the time the first associate issues the *debt interest; and

(b) a recipient may be the second associate or another entity.

(7) For the purposes of subparagraph (6)(a)(i), in determining whether a payment or distribution is made indirectly through one or more interposed entities:

(a) it is sufficient if payments exist between each interposed entity; and

(b) it is not necessary to demonstrate that each payment in a series of payments funds the next payment, or is made after the previous payment.

820-423B Amount of debt deduction disallowed

Acquisition of CGT asset, or legal or equitable obligation

(1) If the condition in subsection 820-423A(2) is met, the amount of the *debt deduction disallowed under subsection 820-423A(1) is the amount of the debt deduction, to the extent that the relevant entity mentioned in subsection 820-423A(2) incurred it in relation to any of the following:

(a) the acquisition mentioned in subparagraph 820-423A(2)(d)(i);

(b) the holding mentioned in subparagraph 820-423A(2)(d)(ii).

Issue of debt interest to associate pair

(2) If the condition in subsection 820-423A(5) is met, the amount of the *debt deduction disallowed under subsection 820-423A(1) is the amount of the debt deduction, to the extent that the relevant entity mentioned in subsection 820-423A(5) incurred it in relation to the *debt interest mentioned in paragraph 820-423A(5)(b).

820-423C This Subdivision does not limit reduction of debt deductions other provisions

Nothing in this Subdivision limits other provisions of this Division in their application to reduce, or further reduce, *debt deductions of an entity.

820-423D Schemes relating to this Subdivision

(1) Subsection (2) applies if the Commissioner is satisfied that:

(a) it is reasonable to conclude that one or more entities (each of which is a ***participant***) entered into or carried out a *scheme for the principal purpose of, or for more than one principal purpose that included the purpose of, achieving any of the following results:

(i) subsection 820-423A(2) does not apply in relation to a *debt deduction;

(ii) subsection 820-423A(5) does not apply in relation to a debt deduction;

(whether or not the debt deduction is a debt deduction of any of the participants and whether or not any of them carried out the scheme or any part of the scheme); and

(b) the scheme has achieved, or apart from this section would achieve, that purpose.

(2) The Commissioner may determine that this Act has, and is taken always to have had, effect as if:

(a) subsection 820-423A(2) applies in relation to the *debt deduction; or

(b) subsection 820-423A(5) applies in relation to the debt deduction.

(3) A determination under subsection (2) has effect accordingly.

(4) This section applies whether or not the scheme has been or is entered into or carried out in Australia or outside Australia, or partly in Australia and partly outside Australia.

(5) A determination under subsection (2) is not a legislative instrument.

(6) An entity who is dissatisfied with a determination under subsection (2) made in relation to the entity may object against the determination in the manner set out in Part IVC of the *Taxation Administration Act 1953*.

Explanatory Materials

Debt deduction creation rules

Excessive debt deductions pose a significant risk to Australia's domestic tax base.

4.144 The strengthened thin capitalisation rules will play an important role in limiting excessive debt deductions. However, they do not address the risk of excessive debt deductions for debt created in connection with an acquisition from an associate entity or distributions or payments to an associate entity. Such debt deductions may only ever indirectly, and at most, be partially limited by the thin capitalisation rules.

4.145 New Subdivision 820-EAA seeks to directly address this risk by disallowing debt deductions to the extent that they are incurred in relation to debt creation schemes that lack genuine commercial justification.

4.146 Subdivision 820-EAA represents a modernised version of the debt creation rules in former Division 16G of the ITAA 1936. Subdivision 820-EAA is consistent with Chapter 9 of the OECD's BEPS Action 4 Report (specifically paragraphs 173 and 174 of that report) which recognises the need for supplementary rules to prevent debt deduction creation.

4.147 Subdivision 820EAA only applies to entities that are subject to the thin capitalisation rules and are not exempt from those rules under 820-35. Broadly, this means that the rules only apply to entities that are part of a multinational enterprise and have total debt deductions of over $2 million for the income year.
[Schedule 2, item 78, section 820-423A]

4.148 Subdivision 820-EAA disallows debt deductions in two cases. These cases represent integral parts of schemes where artificial interest-bearing debt is created within a multinational group. Over time, this interest-bearing debt effectively allows for profits to be shifted out of Australia in the form of tax-deductible interest payments.

4.149 The first case broadly involves an entity acquiring an asset (or an obligation) from its associate. The entity, or one of its associates, will then incur debt deductions in relation to the acquisition of that asset. The debt deductions are disallowed to the extent that they are incurred in relation to the acquisition, or subsequent holding, of the asset. For example, debt deductions arising from debt created by an entity would generally be disallowed if the debt created funded the acquisition of:

- shares in a foreign subsidiary from a foreign associate; or
- business assets from foreign and domestic associates in an internal reorganisation after a global merger.

[Schedule 2, item 78, subsections 820-423A(2) and 820-423B(1)]

4.150 The second case broadly involves an entity borrowing from its associate to fund a payment to that, or another, associate. The entity will then incur debt deductions in relation to the borrowing. The debt deductions are disallowed to the extent that they are incurred in relation to the borrowing. For example, debt deductions arising from related party debt created by an entity to fund or increase the ability of the entity to make payments to a foreign associate as

part of an entirely internal restructure would generally be disallowed.
[Schedule 2, items 78 and 1220, subsections 820-423A(3), (3A) and 995-1(1)]

4.151 The payments or distributions referred to in the second case take the same meaning as in section 26BC of the ITAA 1936 and includes any amount credited, reinvested, applied to the benefit of another entity, settled on a net basis or on a non-cash basis, and the forgiveness of a debt. Payments or distributions may also include amounts of capital, such as returns of capital and repayments of principal under a debt interest.
[Schedule 2, item 78, subsections 820-423A(4) and 820-423B(2)]

4.152 The provisions are drafted broadly to help ensure they are capable of applying to debt creation schemes of varying complexity. This approach is necessary given the ability of multinational groups to enter into complex debt creation arrangements.

Anti-avoidance

4.153 An anti-avoidance rule ensures the debt deduction creation rules cannot be readily avoided. Broadly, if the Commissioner is satisfied that a principal purpose of a scheme was to avoid the application of the rules in relation to a debt deduction, then the Commissioner may determine that the rules apply to that debt deduction.
[Schedule 2, item 78, subsection 820-423D(1)-(4)]

4.154 A determination by the Commissioner under subsection (2) is not a legislative instrument under the *Legislation Act 2003*. Subsection 820-423D(5) merely confirms this result.
[Schedule 2, item 78, subsection 820-423D(5)]

4.155 Where an entity is dissatisfied with a determination that the Commissioner made in relation to the entity, the determination is reviewable under Part IVC of the TAA 1953.
[Schedule 2, item 78, subsection 820-423D(6)]

4.156 Limiting objections to determinations made under the debt creation rules is included to provide that an entity cannot object to part of the determination which relates to a matter already dealt with in an objection previously made. Where there has been a taxation objection against a determination under 820-423D(2), then the right to object under Part IVC of the TAA 1953 to an assessment is limited to objecting on the grounds that neither were, nor could have been, grounds for the taxation objection against the determination. This is an appropriate amendment as it has the effect of ensuring that an entity can only make an objection on new grounds that does not relate to a previous objection.
[Schedule 2, item 145, paragraph 14ZVA(a)]

Attachment 2 – Division 16G

Division 16G—Debt creation involving non-residents[18]

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

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[18] 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.

Attachment 3 – Division 16G Explanatory Memorandum

Division 16G EM.pdf

Attachment 4 - Chapter 9 BEPS Action 4

Chapter 9

Targeted rules

Aim of targeted rules

168. Targeted interest limitation rules include any provisions which apply to restrict interest deductions on payments made under specific transactions or arrangements. These may be contrasted with general interest limitation rules, such as the fixed ratio rule and group ratio rule, which impose an overall limit on an entity's interest deductions. A number of countries do not currently apply any general interest limitation rule and rely solely on targeted rules. One benefit of such an approach is that it reduces the risk that a rule could negatively impact on entities which are already appropriately capitalised and also avoids any incentive for groups to increase the level of net interest expense of local entities up to the level allowed under a fixed ratio rule. The use of targeted rules also allows countries to address specific areas of concern, potentially minimising compliance costs for entities, in particular those which do not engage in base erosion or profit shifting. However, such an approach has drawbacks. Most importantly, to some extent targeted rules will always be a reactive response, requiring countries to be aware of specific base erosion and profit shifting risks as they emerge. There is a risk that some groups may consider all arrangements not covered by targeted rules to be acceptable, meaning that over time new targeted rules may be required. Targeted rules also require active application, meaning the tax administration must be able to recognise situations where a rule could apply, often as part of a complex transaction, and then engage with a group to determine the correct result. Overall, an approach based entirely on targeted rules may result in a large number of rules which will increase complexity, as well as increasing compliance and administrative
costs. If the rules are not comprehensive then they are unlikely to deal with all base erosion and profit shifting risks. On the other hand, an approach which uses a general rule supplemented by targeted rules in key areas should provide countries with the comfort that
the main risks posed by base erosion and profit shifting are addressed, while ensuring that groups are able to obtain relief for their real net third party interest expense.

169. While the best practice approach in this report recommends general interest limitation
rules, it is recognised that targeted rules can also provide an effective solution to some base erosion and profit shifting risk. This chapter sets out a number of specific risks that may not be addressed by the fixed ratio rule and group ratio rule, where targeted rules may
be required. Countries may also continue to apply existing targeted and general interest limitation rules, where these address specific risks. For example, a country may apply a thin capitalisation rule based on a fixed debt/equity ratio to disallow interest on excessive debt in addition to the fixed ratio rule and this could apply to disallow interest even where an entity does not exceed the level of net interest expense permitted under the fixed ratio rule.

170. The impact of a targeted rule applying to an arrangement will vary depending upon the nature of the arrangement and the risk the rule is intended to address. In some cases it may be appropriate for a rule to deny a deduction for a gross interest payment under

a transaction. In other cases it may be more appropriate for a rule to apply to part of a payment, or to net interest payments after taking into account income under the same transaction. Where the result of a transaction is to increase the level of net third party interest expense under a group ratio rule, a rule may simply operate to disregard this increase, with no specific disallowance.

Targeted rules to prevent avoidance of the general rules

171. A best practice approach should be robust against attempts to avoid the effect of a rule. A fixed ratio rule (and group ratio rule where applied) should therefore be supported by targeted rules to counteract planning undertaken by groups to reduce the impact of these rules. To achieve this, it is recommended that countries also introduce targeted rules
to address the following risks:

- An entity with net interest expense enters into an arrangement to reduce the net interest expense subject to the fixed ratio rule (e.g. by converting interest expense into a different form of deductible expense, or by converting other taxable income into a form which is economically equivalent to interest).
- An entity which is part of a group enters into an arrangement with a related party or third party in order to increase the level of net third party interest expense under the group ratio rule (e.g. by making a payment to a related party or to a third party under a structured arrangement, or by converting interest income into a different form).
- A group is restructured to place an unincorporated holding entity at the top of the structure, to create two groups. This may be to prevent a fixed ratio rule applying (e.g. in a country where the rule does not apply to standalone entities) or to separate the original group into two parts for group ratio rule purposes.

172. The above risks may be addressed by standalone rules, specific provisions within the fixed ratio rule and group ratio rule, or by other tax rules (such as, for example, a country's general anti-avoidance rule). These rules should be applicable to all entities which are subject to the fixed ratio rule, and group ratio rule where this applies. The terms "related party" and "structured arrangement" are defined below.

Targeted rules to address other base erosion and profit shifting risks

173. The fixed ratio rule and group ratio rule described in this report provide an effective solution to tackle most base erosion and profit shifting involving interest and payments economically equivalent to interest. However, as set out in Chapter 3, in certain situations, a country may restrict application of the fixed ratio rule and group ratio rule to entities in multinational groups. Therefore, targeted rules may be required to address base erosion and profit shifting risks posed by entities which are not subject to the general interest limitation rules. Even where the fixed ratio rule and group ratio rule apply, a number of specific base erosion and profit shifting risks remain. Therefore, it is recommended that countries consider introducing rules to address the risks listed below:

• An entity which would otherwise have net interest income enters into an arrangement which involves the payment of interest to a group entity outside the country or a related party to reduce the level of interest income subject to tax in the country.
• An entity makes a payment of interest on an "artificial loan", where no new funding
is raised by the entity or its group.
• An entity makes a payment of interest to a third party under a structured arrangement, for instance under a back-to-back arrangement.
• An entity makes a payment of interest to a related party, which is excessive or is
used to finance the production of tax exempt income.
• An entity makes a payment of interest to a related party, which is subject to no or
low taxation on the corresponding interest income.

174. Rules to address the risks above should ideally be applicable to all entities, irrespective of whether they are also subject to the fixed ratio rule and group ratio rule.
However, these rules are particularly important where an entity is not subject to a fixed
ratio rule as described in Chapter 6.

Definition of "related parties" and "structured arrangements"

175. A number of the specific risks listed above refer to transactions with or payments made to a related party or to a third party under a structured arrangement.

Related parties

176. An entity which is part of a group may also be related to individuals or entities which are not part of the group, but where a significant relationship exists. For the purposes of this report, two persons (including individuals and entities) are related if they are not in the same group but they meet any of the following conditions:
• The first person has an investment that provides that person with effective control of the second person or there is a third person that holds investments which provide that person with effective control over both persons.
• The first person has a 25% or greater investment in the second person or there is a third person that holds a 25% or greater investment in both.
• They can be regarded as associated enterprises under Article 9.

177. A person will be treated as holding a percentage investment in another person if that person holds directly or indirectly through an investment in other persons, a percentage of
the voting rights of that person or of the value of any equity interests of that person.

178. For the purposes of this related party definition, a person who acts together with another person in respect of the ownership or control of any voting rights or equity interests
will be treated as owning or controlling all of those voting rights and equity instruments.

179. Two persons will be treated as acting together in respect of ownership or control of

any voting rights or equity interests if they meet any of the following conditions:
• They are members of the same family.
• One person regularly acts in accordance with the wishes of the other person in respect of ownership or control of such rights or interests.
• They have entered into an arrangement that has material impact on the value or control of any such rights or interests.
• They each directly or indirectly hold debt in the entity in proportion to their voting rights or equity interests.
• The ownership or control of any such rights or interests is managed by the same person or group of persons. In respect of any taxpayer that is a collective investment vehicle (CIV), if the investment manager can establish to the satisfaction of the tax authority from the terms of the investment mandate and the circumstances in which the investment was made that two funds were not acting together in respect of the investment, then the interests held by those funds should not be aggregated under this part of the "acting together" test.

180. For these purposes a CIV is any vehicle which is widely held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established. It is left to countries to determine the types of vehicle which would meet this definition. For example, countries may consider certain types of CIVs to be widely-held if their shares or units are listed for quotation on a stock exchange or can be readily purchased or sold by the public (i.e. the purchase or sale of shares or units is not implicitly or explicitly restricted to a limited group of investors). However, a country may apply a different test to determine whether a CIV is widely held.

Structured arrangements

181. Targeted rules may also apply where an entity makes a payment of interest to a third party under a structured arrangement. A structured arrangement is any arrangement where
the entity, its group and its related parties, taken together, do not bear the entire cost of the
interest payment.

182. An example of a structured arrangement would be a "back-to-back" arrangement whereby an entity makes a payment of interest to a third party in circumstances where the
third party also makes a payment to the entity, a member of the entity's group or a related party of the entity. This second payment may be in a form other than interest

Attachment 5 - Distribution definition

Section 26BC ITAA 1936

distribution includes:

(a) interest; or

(b) a dividend; or

(c) a share issued by a company to a shareholder in the company where the share is issued:

(i) as a bonus share; or

(ii) in the circumstances mentioned in subsection 6BA(1); or

(d) an amount credited by the trustee of a unit trust to a unit holder as a unit holder; or

(e) a unit issued by the trustee of a unit trust to which section 130-20 of the *Income Tax Assessment Act 1997* applies (apart from subsection (4) of that section).