Corporate
Tax Association

Level 11, 455 Bourke Street
Melbourne, 3000

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

1 November 2023

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

By email: MNETaxIntegrity@treasury.gov.au

Dear Mr Robinson,

Thin Capitalisation and Debt Deduction Creation Bill and Parliamentary Amendments

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

Consistent with paragraph 2.146 of the original Explanatory Memorandum to the Bill, the debt deduction creation rules (rules) were put in place to *"disallow debt deductions to the extent that they are incurred in relation to **debt creation schemes that lack genuine commercial justification**"*. Whilst the CTA agrees with this statement, we observe that the current drafting of the rules does not achieve this stated intent.

This is because the Bill is drafted in a way that results in virtually all related party transactions being caught if they are funded directly or indirectly with related party borrowings, with limited exclusions then being provided. The result is that genuine commercial transactions are inadvertently captured by the rules, and this should not be the case.

We recommend that the Bill instead be drafted by specifically defining only those transactions that the Government considers lack commercial justification – which we understand is limited to the use of related party debt in the funding of distributions such as dividends, capital returns, and in related party mergers and acquisition (M&A) transactions. We also note that the Bill retrospectively applies to debt that was put in place many years ago, if it was used to undertake such transactions in the past, even though such transactions met all of the tests of tax deductibility that existed at the time the transactions were undertaken. Such retrospectivity needs to be removed.

Addressing these matters through our recommendations is critically important. The ability to raise and use debt is central to Australia's economic growth and development. Australia is heavily reliant on foreign direct investment due to our small domestic market. It is common for companies to have equity, raise debt to fund operations and return profits to shareholders

in the form of dividends. However, the current draft rules are so broad that all related party debt is likely to become non-deductible over time even if it was put in place for genuine commercial purposes. In particular, the proposed rules will adversely impact the basic refinancing of related party debts that were put in place for genuine commercial purposes.

Further, the rules are also so broad that all dividend-paying companies will cease to get tax deductions for related party debt even where that debt is used to fund ordinary commercial transactions. The impact of these rules as drafted is to effectively force inbound groups to equity fund (a 0% EBITDA rule). The rules also have significantly costly and distortionary effects on Australian-headquartered groups with foreign investments. This must be rectified as it goes wholly against the government's election commitment and international norms and is completely inconsistent with the actual stated intent of the rules.

We note that the consultation period for the Bill and associated parliamentary amendments has been less than 14 days. That is after the original iteration was tabled in the House of Representatives without consultation. It has made it difficult to fully examine the rules and their impacts to the best of our ability given the wide-ranging ramifications of the rules. That said, we have endeavoured to provide Treasury with recommendations that will address the issues identified by our membership during the short consultation period.

Our recommendations are set out below. The length of this list - as supported by the content in our submission contained in **Attachment A** to this letter - reflects the extent and magnitude of the issues identified by our membership. It is highly probable there are other issues not yet identified and examined. Accordingly, notwithstanding the fixes we have proposed in this letter, we strongly recommend that implementation of the legislation is deferred with proper consultation undertaken shortly thereafter.

Structural amendments

1. The rules should only apply from 1 July 2023 to new transactions entered into after that date. Existing transactions that occurred prior to the commencement of the Bill should be grandfathered if they were compliant with the law at that time.

2. A 12-month amnesty from the date of Royal Assent should be provided to ensure taxpayers are not unfairly penalised and can restructure related party debt arrangements as required to not inadvertently fall within the scope of subdivision 820-EAA where there is no anti-avoidance purpose.

3. Subsections 820-423A(2) and (5) should be so that they specifically only target the direct related party funding of dividends, capital returns and related party mergers and acquisitions, rather than ordinary business payments.

Drafting refinements

4. Insert "or a *foreign entity" in paragraph 820-423A(5B)(a) so that foreign related party debt meets the exclusion subject to the application of section 820-423D. This change would ensure that the refinancing of 'good' related party debt with new related party debt continues to be outside the scope of the rules.

5. In paragraph 820-423A(5B)(b) add the words "or interest" after the word "principal". This change will ensure that the refinancing exception will still apply even if the principal and any accrued but unpaid interest on the existing related party facility is refinanced.

6. Remove subparagraphs (ii) and (iii) from paragraph 820-423A(5)(b) and remove subparagraph 820-423A(6)(a)(ii) so the provisions achieve the stated policy intent. This change will ensure that only direct borrowings to pay dividends are caught by the rules. Any activities by taxpayers to attempt to structure around the direct nexus test would be caught by the integrity rule in section 820-423D.

7. A new subsection 820-423A(5C) be inserted into the Bill to expressly exclude global cash pooling arrangements from the application of Subdivision 820-EAA.

8. Exclude any related party borrowings to pay for deductible expenditures from the operation of sub-sections 820-423A(2) and (5).

9. Replace the principal purpose test in section 820-423D with a dominant purpose test that aligns with the policy intent of what subdivision 820-EAA is designed to achieve.

10. Insert a provision with the intent of the former subsection 159GZZF(5) into subdivision 820-EAA to ensure the rules do not apply where there is no increase to the net indebtedness of the impacted group, nor was it used in directly funding distributions as defined in section 26BC.

11. Insert a new subsection (4) in section 820-423AA to exclude the acquisition of trading stock from the application of subdivision 820-EAA.

12. Clarify the exclusion in subsection 820-423AA(1) to ensure capital contributions that are new contributions of equity, but not new membership interests are excluded from the rules. This is necessary because it is common in some jurisdictions (e.g. USA) for capital to be contributed without a new membership interest.

13. Exclude the wording of "legal or equitable obligation" in section 820-423A(2) as it is so broad that it could cover the "acquisition" of a related party service (insurance, royalty payment, swap payment, service agreement), as well as debts and financial arrangements that are subject to subsection 820-423A(5). Alternatively, an exclusion for these acquisitions is needed in section 820-423AA.

14. Clarify that the exceptions in section 820-423AA apply to both subsections 820-423A(2) and 820-423A(5).

15. Clarify the operation of paragraphs 820-423A(2)(e) and 820-423A(5)(f) so that they do not apply to pass-through payments, being payments made initially to a related party, but ultimately paid to third parties on the same terms.

16. Changes to the excess tax EBITDA rules in sec 820-60 so that they equally apply to any type of entity (company, trust and partnership), and not just eligible trusts and sub-trusts. Also, reduce the threshold from 50% to 10% to align with the requirement to disregard distributions from these entities in the tax EBITDA calculation.

We note that we continue to have members contact us with additional concerns about the scope of the proposed debt deduction creation rules. Accordingly, we may look to provide a supplementary submission to cover any additional recommendations as the need arises.

Should you have any questions, please do not hesitate to contact me on 0403 152 157 or at sstaples@corptax.com.au.

Yours sincerely,

Simon Staples
Assistant Director

Submission:

Thin Capitalisation and Debt Deduction Creation Bill & Parliamentary Amendments

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Background

The Corporate Tax Association (CTA) generally accepts the intent of the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023* (Bill) and the associate parliamentary amendments.

In making this submission we note that the majority of the commentary and recommendations seek to address what we see as an oversight in design that will have extensive unintended consequences or distort economic investment decisions. All recommendations deal with the application of subdivision 820-EAA unless otherwise stated.

All examples contained in this document involved Australian tax consolidated groups and are sanitised depictions of real past, current or contemplated transactions that the current drafting of the rules will impact.

Summary of recommendations

Structural amendments

1. The rules should only apply from 1 July 2023 to new transactions entered into after that date. Existing transactions that occurred prior to the commencement of the Bill should be grandfathered if they were compliant with the law at that time.

2. A 12-month amnesty from the date of Royal Assent should be provided to ensure taxpayers are not unfairly penalised and can restructure related party debt arrangements as required to not inadvertently fall within the scope of subdivision 820-EAA where there is no anti-avoidance purpose.

3. Subsections 820-423A(2) and (5) should be drafted so that they specifically only target the direct related party funding of dividends, capital returns and related party mergers and acquisitions, rather than ordinary business payments.

Drafting refinements

4. Insert "or a *foreign entity" in paragraph 820-423A(5B)(a) so that foreign related party debt meets the exclusion subject to the application of section 820-423D. This change would ensure that the refinancing of 'good' related party debt with new related party debt continues to be outside the scope of the rules.

5. In paragraph 820-423A(5B)(b) add the words "or interest" after the word "principal". This change will ensure that the refinancing exception will still apply even if the principal and any accrued but unpaid interest on the existing related party facility is refinanced.

6. Remove subparagraphs (ii) and (iii) from paragraph 820-423A(5)(b), and remove subparagraph 820-423A(6)(a)(ii) so the provisions achieve the stated policy intent. This change will ensure that only direct borrowings to pay dividends are caught by the rules. Any activities by taxpayers to attempt to structure around the direct nexus test would be caught by the integrity rule in section 820-423D.

7. A new subsection 820-423A(5C) be inserted into the Bill to expressly exclude global cash pooling arrangements from the application of Subdivision 820-EAA.

8. Exclude related party borrowings to pay for deductible expenditures from the operation of sub-sections 820-423A(2) and (5).

9. Replace the principal purpose test in section 820-423D with a dominant purpose test that aligns with the policy intent of what subdivision 820-EAA is designed to achieve.

10. Insert a provision with the intent of the former subsection 159GZZF(5) into subdivision 820-EAA to ensure the rules do not apply where there is no increase to the net indebtedness of the impacted group, nor was it used in directly funding distributions as defined in section 26BC.

11. Insert a new subsection (4) in section 820-423AA to exclude the acquisition of trading stock from the application of subdivision 820-EAA.

12. Clarify the exclusion in subsection 820-423AA(1) to ensure capital contributions that are new contributions of equity, but not new membership interests are excluded from the rules. This is necessary because it is common in some jurisdictions (e.g. USA) for capital to be contributed without a new membership interest.

13. Exclude the wording of “legal or equitable obligation” in section 820-423A(2) as it is so broad that it could cover the “acquisition” of a related party service (insurance, royalty payment, swap payment, service agreement), as well as debts and financial arrangements that are subject to subsection 820-423A(5). Alternatively, an exclusion for these acquisitions is needed in section 820-423AA.

14. Clarify that the exceptions in section 820-423AA apply to both subsections 820-423A(2) and 820-423A(5).

15. Clarify the operation of paragraphs 820-423A(2)(e) and 820-423A(5)(f) so that they do not apply to pass-through payments, being payments made initially to a related party, but ultimately paid third parties on the same terms.

16. Changes to the excess tax EBITDA rules in sec 820-60 so that they equally apply to any type of entity (company, trust and partnership), and not just eligible trusts and sub-trusts. Also, reduce the threshold from 50% to 10% to align with the requirement to disregard distributions from these entities in the tax EBITDA calculation.

General observations about the policy intent and design of the rules

Before providing commentary and recommendations in relation to the Bill and associated parliamentary amendments, it is important that we set out the broader contextual impacts of the rules. Australia is a country that is heavily reliant on foreign direct investment (FDI) due to our small domestic market. Australia's tax laws have been designed in a manner to facilitate FDI so that Australia can compete on a global scale.

It is common for companies to have equity, raise debt to fund operations and return profits to shareholders in the form of dividends all at the same time. Most multinationals use centralised treasury operations, often in the location of their head office. These centralised treasury operations will typically borrow on the bank and bond market, and on-lend to operating subsidiaries using 'shareholder loans'. These treasury operations will also "borrow" from operating subsidiaries through global cash management systems (i.e., cash pooling) whereby operating subsidiaries deposit excess cash with the treasury function which it then invests and deploys those funds to their highest and best use throughout a group. These structures are considered to be a necessary part of ordinary commercial practices, and these shareholder loans make up a large proportion of Australia's FDI.

We agree that should a company deliberately enter into a transaction that lacks genuine commercial justification that would see the shifting of profits out of Australia, then that transaction should be disallowed and any interest deduction denied. However, such a rule should include a purpose test, and should not retrospectively apply to transactions that occurred prior to the commencement of the rules.

We accept that from a policy perspective, the government does not want companies to borrow from a related party to directly fund the payment of a dividend or to purchase a business from a related party and increase debt in Australia as a consequence.

However, if the notion is that companies are required to repay related party debt before a distribution is made or that companies are prevented from paying a dividend due to the existence of related party debt, then the rules will severely distort commercial activity. Moreover, this is not consistent with the stated policy intent of the rules, which is to *"disallow debt deductions to the extent that they are incurred in relation to debt creation schemes that lack genuine commercial justification"*. It would also be at odds with section 254T of the *Corporations Act 2001* which recognises distributions to shareholders can be made provided the company's assets exceed liabilities at the time of payment, the distribution is fair and reasonable, and it does not materially prejudice the company's ability to pay its creditors.

The current drafting also suggests that there is no scope for related party debt in Australia. That is despite the Australian tax legislation already having well-understood mechanisms such as the transfer pricing rules which operate to ensure that related party loans are priced appropriately, and the level of debt is at arm's length. It is also important to remember that the thin capitalisation rules are designed to complement transfer pricing and allow an Australian subsidiary to fund using a proportion of tax-deductible debt. If all related party debt becomes non-deductible over time – which will occur under the current drafting when such

debts are refinanced upon maturity, or where companies in the ordinary course of their activities borrow to finance expansion but continue to pay dividends – the cost of capital for investing in Australia will increase.

We do not see this as the policy intent of Subdivision 820-EAA. Not allowing access to related party debt or arm's length debt deductions will ultimately drive up the cost of doing business in Australia by companies being forced into sourcing far more expensive third-party debt capital. This would also be the case where surplus funds are deposited with Australian headquartered treasury functions.

Over time, this could also decrease Australia's FDI, as a company's cost of capital for Australian operations increases.

This submission contains several examples that illustrate the unintended outcomes that arise from the current drafting of the debt deduction creation rules. We have included suggested drafting to rectify these unintended consequences.

Remove retrospectivity and provide a 12-month amnesty

RECOMMENDATIONS:

The Bill retrospectively applies to debt that was put in place many years ago, if it was used to undertake certain transactions in the past, even though such transactions met all of the tests of tax deductibility that existed at the time they were undertaken. Such retrospectivity needs to be removed.

The rules should only apply from 1 July 2023 to transactions entered into after that date. Existing transactions that occurred prior to the commencement of the Bill should be grandfathered if they were compliant with the law at that time.

Furthermore, a 12-month amnesty should be provided from the date of Royal Assent to ensure taxpayers are not unfairly penalised and can restructure related party debt arrangements as required to not inadvertently fall within the scope of these provisions, where there is no anti-avoidance purpose.

More appropriately defining debt creation in subdivision 820-EAA

RECOMMENDATION:

We recommend that subsections 820-423A(2) and (5) be drafted to specifically define only those transactions that the Government considers lack commercial justification – which we understand is limited to the use of related party debt in the funding of distributions such as dividends and capital returns, and in related party mergers and acquisition (M&A) transactions.

Consistent with paragraphs 2.146 of the original Explanatory Memorandum to the Bill, the debt deduction creation rules (rules) were put in place to *"disallow debt deductions to the extent that they are incurred in relation to debt creation schemes that lack genuine commercial justification"*. The CTA agrees with this stated intent of the rules.

We observe that the current draft rules do not achieve the stated intent. This is because they are drafted in a way that results in virtually all related party transactions being caught if they are funded with related party borrowings, with limited exclusions then being provided. The result is that genuine commercial transactions are inadvertently captured by the rules. The drafting should be amended to specifically target only those transactions that lack a genuine commercial justification.

Refinancing with foreign related party debt with new foreign related party debt

RECOMMENDATIONS:

An amendment is required to paragraph 820-423A(5B)(a) to insert "or a *foreign entity" after "*Australian entity" to ensure that related party debt can be refinanced with related party debt from a foreign entity provided that section 820-423D is not triggered.

It is also recommended that in paragraph 820-423A(5B)(b) the words "or interest" are inserted after the word "principal". This change would ensure that the refinancing exception would still apply even if the principal and any accrued but unpaid interest on the existing related party facility is refinanced.

This is replicated below:

(5B) For the purposes of paragraph (5)(b), this subsection covers a payment or distribution if:

> *(a) the recipient is an *Australian entity or a *foreign entity; and*
>
> *(b) the payment or distribution is entirely referable to the repayment of principal or interest under a debt interest issued by the payer;*

Alternatively, paragraph 820-423A(5B)(a) can be removed in conjunction with the amendment to paragraph 820-423A(5B)(b).

As expanded on below, we consider that any limitation of the refinancing exclusion to Australian related party debt would unfairly prejudice multinational groups and potentially fall foul of non-discrimination articles of Australia's double tax agreements.

From a policy perspective, we see no reason to require that only Australian related party debt be the subject of the refinancing exclusion. Foreign related party debt should be able to meet the exclusion in s820-423(5B), subject to the existing debt not having been put in place for debt creation purposes. This could be further supported through the inclusion of the former subsection 159GZZF(5) which provided the Commissioner with factors to consider such as the original loan was not subject to debt creation or that the new loan is no larger (see later in this document).

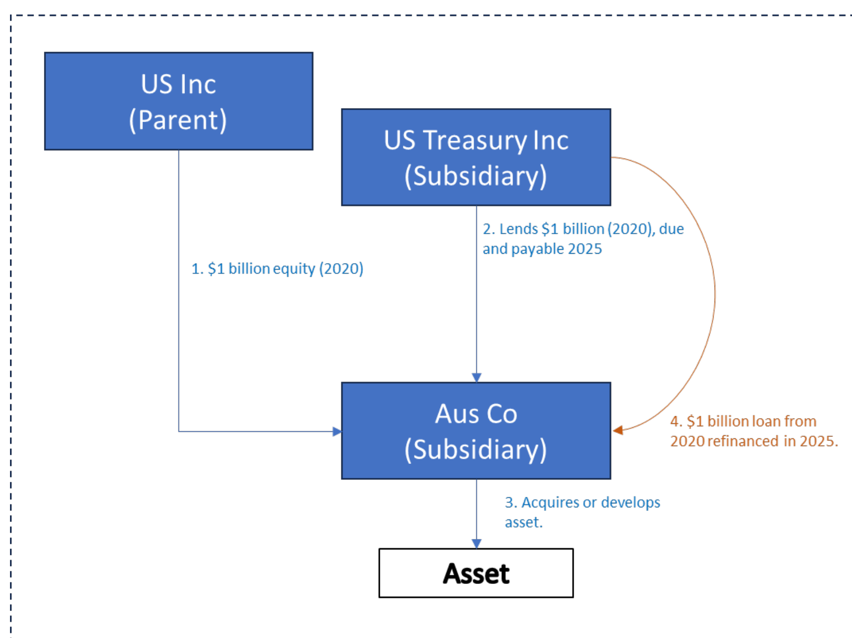
This adjustment is important as over time, as all foreign related party debt owed by Australian subsidiaries of foreign parents mature, and they are refinanced with new foreign related party debt, they will automatically fail the debt creation test. This is even the case if the original financing was not caught by the debt creation rules – say because it was raised to fund an M&A transaction or to build a capital project.

As currently written, the only way to ensure that a refinancing of an existing foreign related party loan is not subject to the debt creation rules is to replace the related party debt with

external debt. However, we are concerned that this may be caught by the anti-avoidance rule in section 820-423D. Moreover, as noted above, most multinational groups fund their operations using centralised treasury operations, typically in the location of their parent companies. It may not be practical or cost-effective for such groups to have to use external debt to directly fund their Australian subsidiaries. It is also noted that the use of external debt is likely to decrease the interest withholding tax revenue the Australian government currently collects on all related party debts. If Australian subsidiaries all finance themselves with bonds and international syndicated facilities, it is highly likely such debt will be exempt from interest withholding tax under section 128F. Furthermore, such facilities are usually provided by foreign investors, so the interest income will not be taxable in Australia.

Example 1 below demonstrates why it is inappropriate for the refinancing exclusion to exclude borrowings from foreign related parties.

Example 1 – Refinancing foreign related party debt



In this example, Aus Co is a wholly owned subsidiary of a listed US multinational (US Inc) that built a $ 2 billion copper mine in Australia in 2020, which it funded with 50% shareholder loans and 50% shareholder equity.

US Inc has a centralized Treasury organization based in the US (US Treasury Inc). It centralizes the raising of debt for its global operations in the bank and bond market. It helps finance US Inc's global operations by lending to the foreign subsidiaries of US Co on arm's length terms.

AUS Co's $1b of debt was in the form of a 'shareholder loan' from US Treasury Inc. It is for 5 years, and the interest rate complies with the transfer pricing rules in Australia and the US. This was confirmed by a bilateral advanced pricing agreement from both tax authorities.

In 2025 the $1b shareholder loan matures, and the parties intend to refinance it with a new 5-year shareholder loan from US Treasury Inc on similar terms. Aus Co has asked if that new loan will be tax deductible in Australia, given that it is not increasing its overall debt position. It is merely refinancing the existing $1b debt.

Conclusion:

The recent Exposure Draft introduced a limited carve-out in s820-423(5B) to exclude from the application of the rules the refinancing of an existing debt, as long as the new debt is no larger. However, the exclusion only applies if the original borrowing is from an Australian entity. This is because of the requirement in paragraph (a) that the 'recipient' is an Australian entity.

'Recipient' is defined in paragraph s820-423A(5)(b) to be the recipient of the loan repayment. In this example, the recipient is US Treasury Inc, a US company, as it receives the repayment of the original $1b principal upon refinancing of the loan. Accordingly, the refinancing exclusion would not apply and pursuant to section 820-423A(5) the new debt will be subject to the debt creation rules, even though it replaced a financing that was put in place to build a copper mine.

It is also recommended that in paragraph 820-423A(5B)(b) the words "or interest" are added after the word "principal". This change would ensure that the refinancing exception would still apply even if the principal and any accrued but unpaid interest on the existing related party facility is refinanced.

Funding operations with debt whilst continuing to pay dividends

RECOMMENDATIONS:

An amendment is required to paragraph 820-423A(5)(b) to remove subparagraphs (ii) and (iii) to ensure that where related party debt is used for a purpose other than to directly fund a distribution (or to the extent), the debt deductions are not denied in full as a result of subparagraphs (ii) and (iii).

This is replicated below:

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

*(a) an entity (the payer) obtains proceeds from entering into or having a *financial arrangement with another entity;*

(b) the payer uses some or all of the proceeds to fund:

~~*(i) fund; or*~~

~~*(ii) facilitate the funding of; or*~~

~~*(iii) increase the ability of any entity (including the payer) to make;*~~

one or more payments or distributions (within the meaning of section 26BC of the Income Tax Assessment Act 1936), other than distributions covered by subsection (5A) or (5B) of this section, that it makes to one or more other entities (each of which is a recipient);

As a consequential adjustment removal of subparagraph 820-423A(6)(a)(ii) would also be required:

~~*(ii)before, at or after the time the payer enters into or has the *financial arrangement mentioned in paragraph …*~~

It is submitted that subparagraph 820-423A(6)(a)(ii) has no work to do in the absence of subparagraphs 820-423A(5)(b)(ii) and (iii). In this respect, we submit that where a related party borrowing is used directly to fund a distribution partially or fully, then the interest deduction would be disallowed in part or full by the application of section 820-423B.

As expanded on below, we consider the inclusion of subparagraphs 820-423A(5)(b)(ii) and (iii) would unfairly prejudice multinational groups and potentially fall foul of non-discrimination articles of Australia’s double tax agreements.

There is a real risk that Australian subsidiaries of foreign multinationals will never be able to have related party debt if they are also paying dividends to their parent out of cashflows. The current test is drafted so widely, due to the inclusion of paragraphs 820-423A(5)(b) (ii) and (iii), that this would be the unintended outcome.

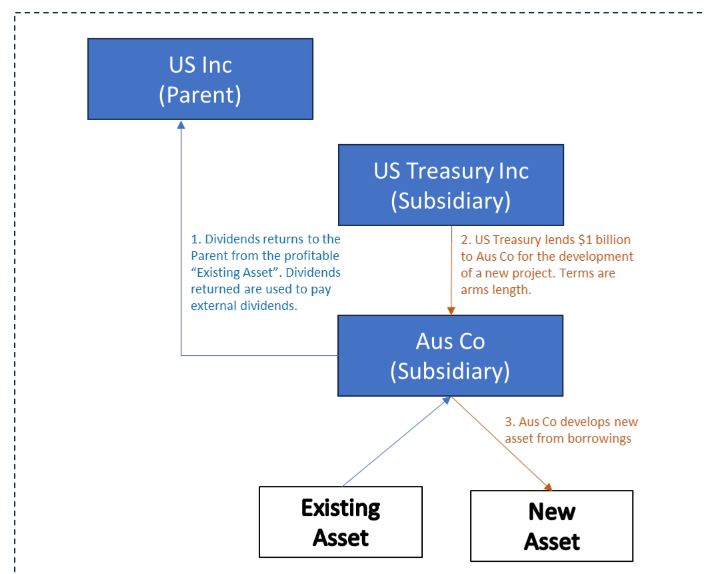
Australia is a capital importing nation, and this rule could eliminate the tax deductibility of a large portion of funding provided into Australia where the operations are profitable and dividend paying. Practically this is putting such operations at a competitive disadvantage to Australian based multinationals and subsidiaries of foreign multinationals that can borrow externally. There does not appear to be a policy rationale for that given that the transfer pricing rules already operate to ensure that related party loans are priced appropriately, and the level of debt is at arm's length.

As such, we recommend that the language in 820-423A(5)(b)(ii) and (iii) is removed. That is, remove the reference to 'facilitate the funding of' and 'increase the ability of any entity (including the payer) to make'.

Accordingly, the provision should only apply where an entity directly borrows to pay a distribution to a foreign associate. We accept that where a related party borrowing is used directly to partially or fully fund a dividend, then the interest deduction would be disallowed in part or full by the application of section 820-423B. Where a taxpayer structures its affairs with the principal purpose of 'indirectly' borrowing to pay dividends, we believe that section 820-423D would apply. Accordingly, the language in paragraph 820-423A(5)(b)(ii) and (iii) is unnecessary and if not removed will have material adverse implications for all profitable Australian operations that are also dividend paying.

This is a more reasonable approach as the existing language simply utilises a mathematical approach to determine if the borrowing increased the ability of the entity to make the dividend payment. Example 2 below demonstrates this.

<u>Example 2 – funding capital expenditure with debt whilst continuing to pay dividends</u>



In this example, Aus Co is a wholly owned subsidiary of a listed US multinational (US Inc) which is operating an oil and gas project that it developed many years ago. It is quite profitable and has been regularly paying dividends to US Inc from its oil and gas profits.

In 2025 it is looking to build a new project but wishes to continue to pay dividends to US Inc from its operating cash flows, as US Inc relies on these profits to pay its external dividends. Accordingly, Aus Co intends to borrow $1b from the US treasury subsidiary of US Inc (US Treasury Inc) to develop the oil and gas project. The interest rate is set on arm's length terms, and Aus Co is otherwise well within its thin capitalisation ratio.

On current drafting, either paragraphs 820-423A(5)(b)(ii) or (iii) would apply to disallow interest deductions where a related party borrowing is used directly for wholly commercial purposes, if at the same time the company uses its other cashflows to fund a payment to an associate, including dividends. The language is extremely broad and can apply where the borrowing is not directly related to the payment of a dividend. The mere existence of a dividend will result in the deductions being disallowed despite Aus Co borrowing from a related party to directly fund its capital expenditure. As there is no purpose test associated with these rules, this outcome will apply as a matter of course.

It is important to note that the CTA believes that both paragraphs 820-423A(5)(b)(ii) or (iii) would apply in the example above to disallow the interest deductions on the borrowings to build the oil and gas project. They are both extremely broad and we submit to achieve the same result. They both need to be removed to reinstate the intended policy intent of only disallowing borrowings used to pay dividends.

A consequential adjustment to remove subgraph 820-423A(6)(a)(ii) would also be required. It is submitted that subparagraph 820-423A(6)(a)(ii) has no work to do in the absence of subparagraphs 820-423A(5)(b)(ii) and (iii).

Global cash management systems and payments to associates

RECOMMENDATION:

A new subsection 820-423A(5C) be inserted into the Bill to expressly exclude global cash management systems from the application of Subdivision 820-EAA.

An example of the proposed new subsection 820-423A(5C) is below:

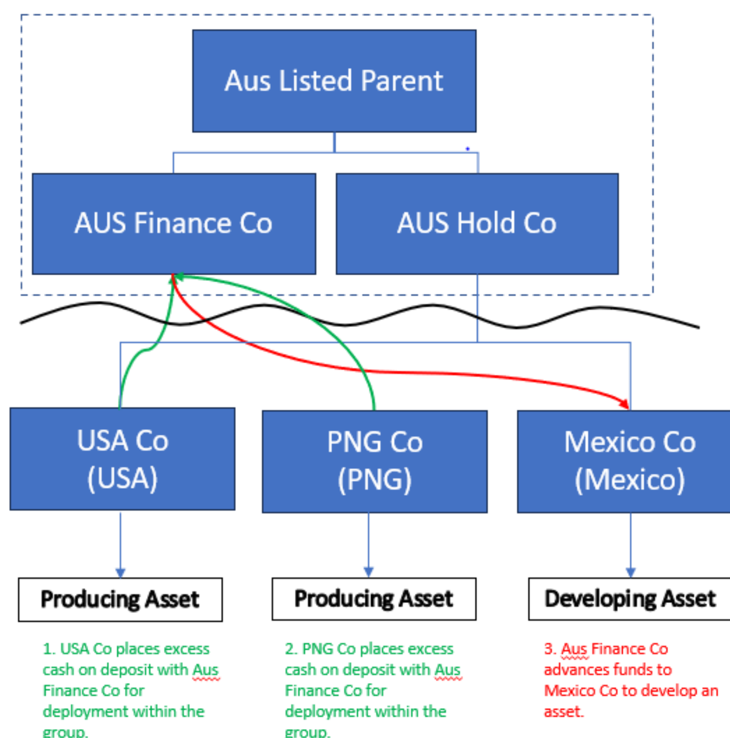
(5C) For the purposes of paragraph (5)(b), this subsection covers a payment or distribution if:

> *(a) the recipient is an *Australian entity or a *foreign entity; and*
>
> *(b) the payment or distribution is referrable to a centralised *cash pooling arrangement.*
>
> …

The term *cash pooling arrangement will need to be subsequently defined in section 995-1 of the ITAA 1997. This will need to be subject to further discussion.

Examples 3.1 and 3.2 further demonstrate how payments to associates are impacted by a centralized cash pooling arrangement operating across a global group of entities (GCPA).

Example 3.1 – Outbounds using cash pooling to make a payment to an associate



In this example, Aus Finance Co is a wholly owned subsidiary of the Aus Listed Parent, an Australian headquartered group. Aus Listed parent, Aus Finance Co and Aus Hold Co form an Australian tax consolidated group (the TCG). Aus Hold Co holds the TCG's investments in producing and developing mine assets around the world (i.e. in USA Co, PNG Co and Mexico Co).

The TCG has a centralised Treasury organisation based in Australia. Aus Finance Co raises debt capital for the global group and operates a centralised GCPA whereby all the group's subsidiaries have individual cash balances 'swept' into a centralised account daily. This GCPA is facilitated by an arrangement with a third-party bank. Cash pooling is an efficient means of optimising the liquidity of a global group.

USA Co and PNG Co are cashflow positive, and their excess cash balances are swept to Aus Finance Co on interest bearing terms. Aus Finance Co, in turn, places funds on deposit with Australian banks or makes interest bearing advances under a development loan to Mexico Co. Loan and deposit rates on the GCPA are benchmarked against arm's length rates.

Aus Finance Co's interest deductions are disallowed. This is because the broad language of section 820-423A(5) applies where excess cash deposited with Aus Finance Co (say, by USA Co) has facilitated the funding of, or increased the ability of Aus Finance Co, to make a distribution (as defined in section 26BC – being "interest" in this case) to a foreign related party (i.e. PNG Co).

It does appear at odds with policy intent to disallow the interest deductions of an Australian taxpayer (the TCG) where the nexus of these costs is so closely linked with the interest income earned by that taxpayer.

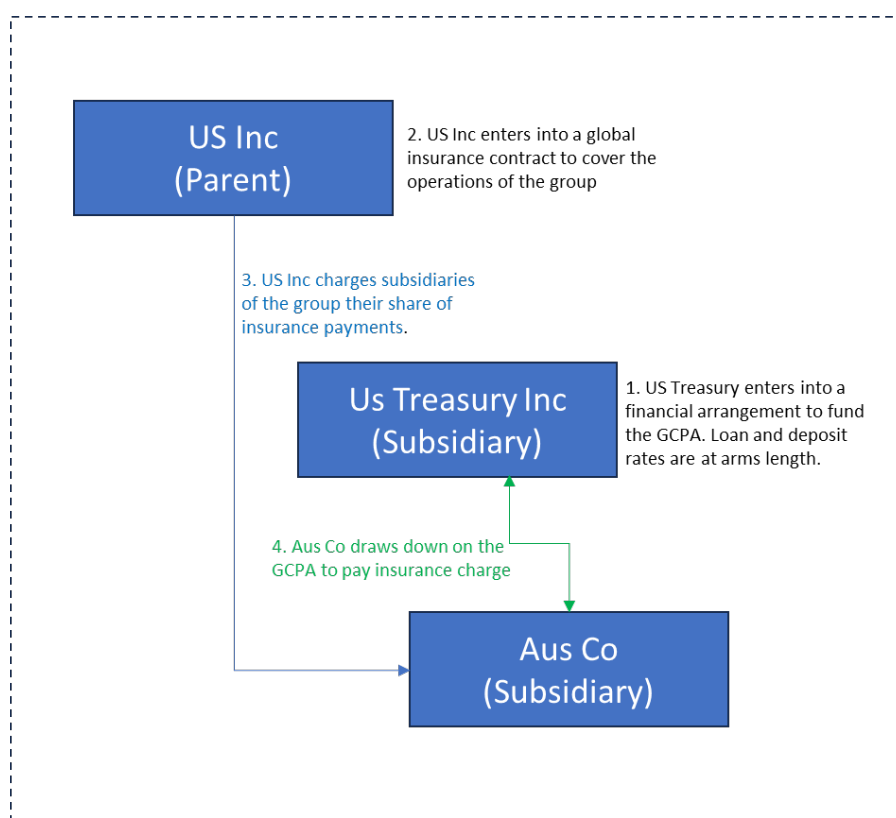
Double taxation may also arise where section 820-423A(5) is allowed to operate in tandem with the controlled foreign company rules. In this regard, if the interest income of PNG Co were to be attributed to TCG under the tainted income rules, then:

1. The TCG would be denied a deduction for interest paid to PNG Co under section 820-23A(5) – effectively increasing its taxable income by the amount so denied; but

2. The TCG would be required to include an amount equal to that same interest under Part X of the *Income Tax Assessment Act 1936* – increasing its taxable income by the same amount again.

These likely unintended outcomes would appear to be punitive to Australian headquartered groups legitimately optimizing their liquidity.

Example 3.2 – Inbounds using cash pooling to make a payment to an associate



In this example, Aus Co is a wholly owned subsidiary of a listed US multinational (US Inc) that owns an interest in a producing LNG plant in Australia. US Inc has a centralised Treasury organisation based in the US (US Treasury Inc). US Treasury Inc is responsible for the raising of debt capital for the global group and optimising day-to-day operating cashflows.

Operating cash requirements are managed through a centralised GCPA whereby all the group's foreign subsidiaries (i.e. not only Aus Co) have individual cash balances 'swept' into a centralised account daily, facilitated by an arrangement with a third-party bank. Cash pooling is an efficient means of optimising the cash positions of a global group.

Aus Co is in a net cash deficit position because cash was drawn down from the GCPA to fund capital expenditure requirements during the year. As sales receipts are received from product sales the cash is swept to reduce the amount owing by Aus Co on the GCPA. As a consequence, on a first-in-first-out (FIFO) basis, the net cash deficit is repaid and refinanced on a regular basis. That is, most borrowings are repaid quickly, but then replaced with new borrowings as Aus Co draws down to pay expenditure. Loan and deposit rates on the GCPA are benchmarked against arm's length rates.

US Inc takes out a global insurance policy with a third party insurer to provide insurance for Aus Co's business operations as well as the group's other foreign operations. US Inc recharges the Australian proportion of the insurance charge to Aus Co at cost (no markup). Aus Co makes

payment to US Inc for the insurance recharge. Given all of Aus Co's cash is automatically swept up into the GCPA, Aus Co's draws down on its bank account (in the GCPA) to pay the recharge.

*As a result of the payment, s*ection 820-423A(2) and/or (5) disallows interest deductions on that drawdown. This is because the language is extremely broad and can apply where there is no actual borrowing to make the payment but where the funds were sourced from a drawdown under centralised GCPA.

For Australian taxpayers it will be a very large compliance process to analyse each and every transaction that goes through a GCPA to identify those charges that are from related parties, determine when applying a FIFO principle that advance was repaid via the deposit of product sales receipts, and calculate the interest expense for that (typically short) period. Each related party payment will have a different quantum, loan period and interest charge.

It is submitted that borrowings for such expenditures through a GCPA should not be the subject of the debt deduction creation rules and should be the subject of a specific exclusion.

Funding operations with debt whilst paying arm's length related party expenses

RECOMMENDATION:

The term 'payment' in section 820-423A(5) results in a broad consideration of all related party transactions. It is recommended that deductible expenditure be excluded from the remit of 820-423A(5).We recommend - noting subsection 823-423(5C) proposal in this submission with respect to global cash pooling arrangements -creating a new subsection 820-423A(5D) such as:

> *(5D) For the purposes of paragraph (5)(b), this subsection covers a payment or distribution if it is a deductible expenditure.*

Section 820-423A(5)(b) provides that *"the payer uses some or all of the proceeds to (i) fund; or (ii) facilitate the funding of; or (iii) increase the ability of any entity (including the payer) to make; one or more payments or distributions (within the meaning of section 26BC of the Income Tax Assessment Act 1936), other than a payment or distribution covered by subsection (5A) or (5B) of this section, that it makes to one or more other entities (each of which is a recipient)."*

Unlike the term 'distribution', the term 'payment' is undefined in section 26BC, and can be interpreted as not being refined simply to financing or lending arrangements (i.e. interest, dividend or share/unit type expenditure).

The current framing of the provisions poses the risk that to the extent an entity has international related party debt, interest deductions will be proportionately denied to the extent they have any related party expenditure incurred for ordinary commercial operational purposes – this will include such expenditure as: insurance arrangements, shared services arrangements, royalties, trading stock etc. Such costs are incurred in the ordinary operation of the business and are required to be priced on arm's length terms. There does not appear to be an established policy rationale for interest denial in relation to these operational expenditures.

The language of the provision is considered extremely broad resulting in the mere existence of a related party payment, despite the pricing of the transaction being in accordance with arm's length Transfer Pricing rules, resulting in denial of interest deductions. As such, we recommend that deductible expenditure is excluded from the remit of 820-423A(5) by creating a new subsection 820-423A(5D)[1].

Please note that the above proposal to exclude operating expenses from the remit of subsection 820-423A(5) is in furtherance to our recommendation seeking an exclusion of such charges from section 820-423A(2).

[1] Noting subsection 823-423(5C) proposal in this submission with respect to global cash pooling arrangements.

Ensuring that the anti-avoidance rules in section 820-423D are appropriate in scope

RECOMMENDATION:

Replace the principal purpose test in section 820-423D with a dominant purpose test that aligns with the policy intent – to disallow debt deductions to the extent that they are incurred in relation to debt creation schemes that lack genuine commercial justification.

The current drafting uses the words "reasonable to conclude" and "principal purpose" which will likely capture transactions not intended.

This can be achieved as follows:

820-423D Schemes relating to this Subdivision

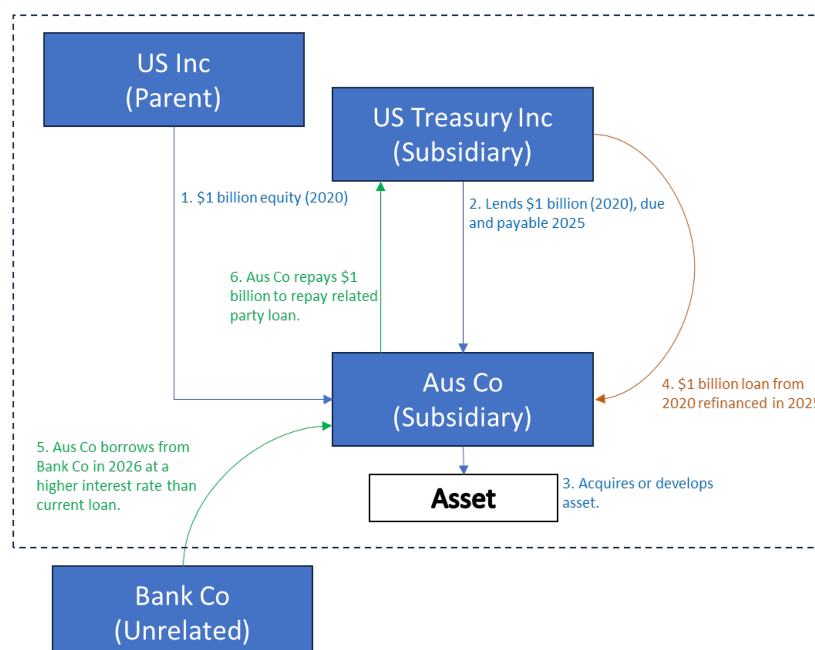
(1) Subsection (2) applies if the Commissioner is satisfied that:

*(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~~ dominant purpose of~~, or for more than one principal purpose that included the purpose of,~~ achieving any of the following results:*

…

Consideration should also be given to inserting the former subsection 159GZZF(5) into Subdivision 820-EAA to provide conditions for the Commissioner to be satisfied the rules do not apply such as where the original loan was not subject to debt creation, is not larger, nor was it used in directly funding distributions as defined in section 26BC.

<u>Example 4 - replacing related party debt with external debt</u>



Assuming the same facts as example 1, the insertion of the rules means that Aus Co is looking to borrow from Bank Co (unrelated) to repay its loan to US Treasury Inc. On our reading of the current drafting, the broadness of section 820-423D would result in deductions associated with the external debt being disallowed as the low threshold of the words “reasonable” and “principal purpose” would likely see this transaction as being used to avoid the otherwise application of the debt creation rules at the time of the refinancing.

We are of the view that the rules should not apply to restructuring where overall equity and debt remain unchanged on a commercially driven project and therefore exemptions should be made to ensure the rules are in fact, appropriately targeted. This would be consistent with para 1.39 in the EM where Amendment 54 seeks to ensure that the debt deduction creation rules are appropriately targeted, also noting that EM accompanying the original bill in para 2.146 explains that the new Subdivision seeks to disallow debt deductions to the extent they are incurred in relation to debt creation schemes that lack genuine commercial justification.

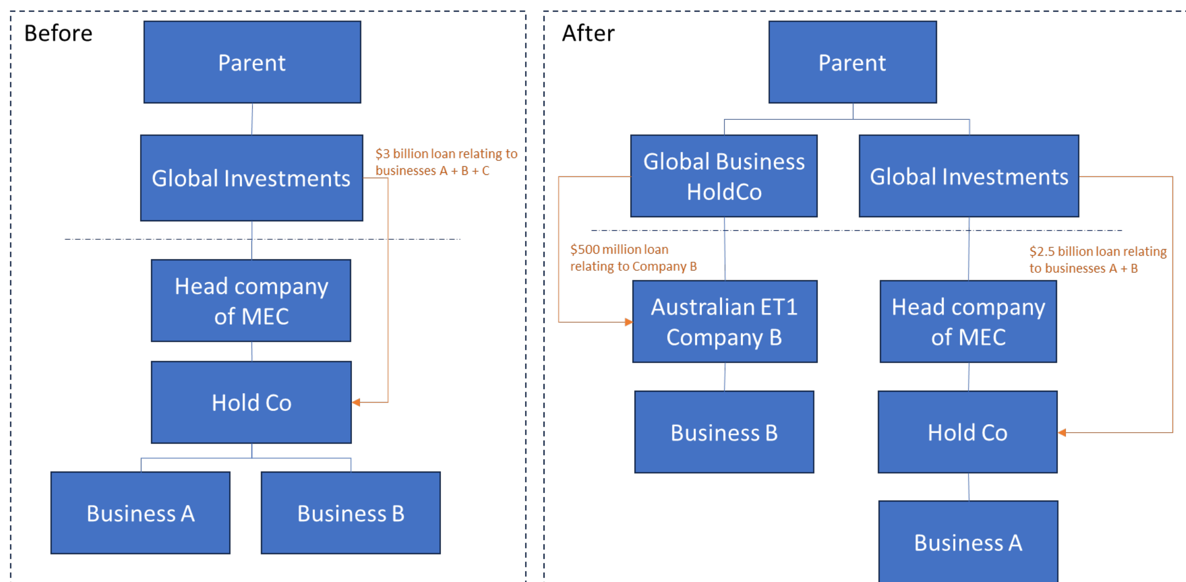
Inserting provisions that deal with circumstances where there was no increase to net debt

RECOMMENDATION:

The former subsection 159GZZF(5) of the *Income Tax Assessment Act 1936* should be inserted into Subdivision 820-EAA to provide conditions for the Commissioner to be satisfied the rules do not apply such as where the original loan was not subject to debt creation, is not larger, nor was it used in directly funding distributions as defined in section 26BC.

The need for the former subsection 159GZZF(5) is illustrated in Example 5 below.

Example 5 – FIRB approved corporate reorganisation



A global organisation has been verticalizing their holding structures to align with its global commercial businesses. FIRB approval was obtained, so in 2021, the Australian part of the global organization verticalized one of their businesses by establishing a new Eligible Tier One company (ET1 company B).

Equity and debt were issued by the ET1 Company B to offshore related parties which in turn acquired Business B from HoldCo. The terms and conditions of the debt interests mirrored the T&Cs of existing debt. HoldCo then paid down its level of debt relating to Business B. Noting that overall net debt to the MEC group has not changed, nor have the terms and conditions changed, but commercially, $500m of debt relating to business B is appropriately placed with the assets of business B.

Under the current draft of section 820-423A(2), the interest relating to the debt interests of the 2021 restructure would be disallowed despite there being no increase in net debt arising from the restructure.

That is why further consideration should be given to replicating the former subsection 159GZZF(5) in Subdivision 820-EAA that provides conditions for the Commissioner to be satisfied the rules do not apply such as the original loan was not subject to debt creation, is not larger, nor was it used in directly funding distributions as defined in section 26BC.

Trading stock should be treated the same as depreciating assets

RECOMMENDATION:

A new subsection 820-423AA(4) should be inserted to exclude the acquisition of trading stock from the application of subdivision 820-423EAA.

This can be achieved as follows:

Acquisition of trading stock

*(4) For the purposes of paragraph 820-423A(2)(a), the acquisition of a *trading stock.*

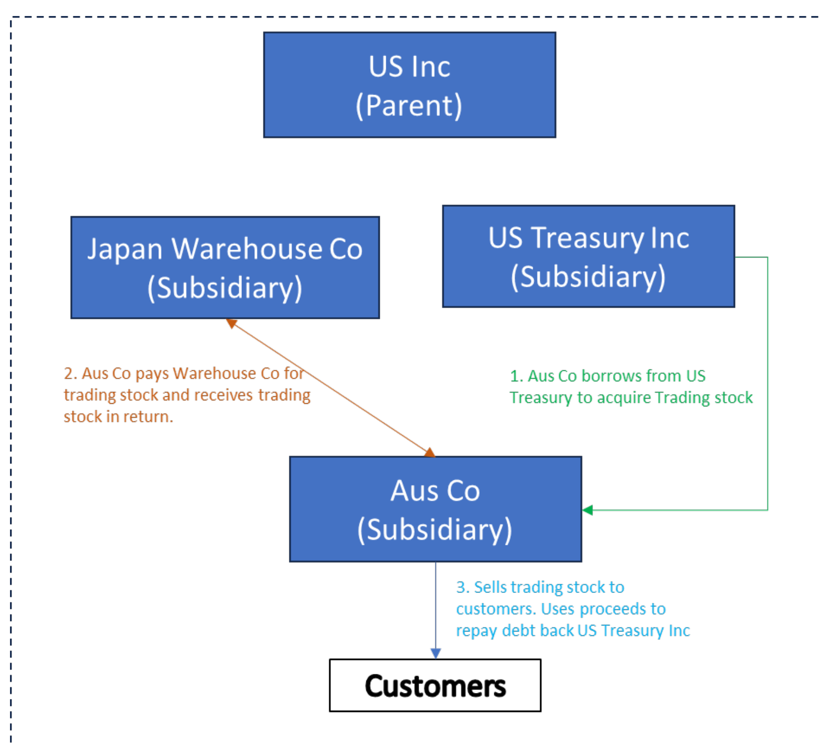
As trading stock is defined term in section 995-1 of the *Income Tax Assessment Act 1997*, no further conditions are required.

We struggle to understand the policy position that acquiring a depreciating asset from a related party would be excluded from the rules but trading stock is not.

If the concern is structuring to avoid the paying of tax, then we submit that Part IVA should be considered by the ATO given there would appear to be a scheme that had a dominant purpose.

This is illustrated in Example 6 below.

Example 6 - acquiring trading stock using related party debt (including a cash pool)



In this example, Aus Co is a wholly owned subsidiary of a listed US multinational (US Inc) that sells trading stock to customers in Australia and New Zealand. US Inc has a centralised Treasury organisation based in the US (US Treasury Inc) which is responsible for managing the global financial operations of the group.

US Inc also has a centralised warehouse (Japan Warehouse Co) which acts as a distributor of widgets to the different jurisdictions in which it operates. Aus Co borrows $2 million from US Treasury Inc and uses those funds to acquire trading stock from Japan Warehouse Co. Aus Co sells trading stock to its customers with the net proceeds used to repay the loan to US Treasury Inc and where applicable, returns excess profits to US Inc which is then paid to external shareholders.

The current drafting of subsection 820-423A(2) would disallow debt deductions as the drawdown was used to make a payment to a foreign related party and trading stock is not subject to an exclusion in section 820-423AA. Further, where Aus Co was to pay a dividend to US Inc, subparagraphs 820-423A(5)(b) (ii) & (iii) will apply to deny any deductions due to the broad language of the provision.

Broaden the scope of new membership interest exclusion

RECOMMENDATION:

The exclusion in subsection 820-423AA(1) should be amended to clarify that the exclusion also applies to the increase in contributed equity in relation to existing membership interests in the circumstances described in the provision.

This can be achieved as follows:

*(1) For the purposes of paragraph 820-423A(2)(a), the acquisition of a *CGT asset is covered by this section if:*

*(a) the CGT asset is a *membership interest in or is an increase to equity of an existing membership interest of:*

*(i) an *Australian entity; or*

*(ii) a *foreign entity that is a company; and*

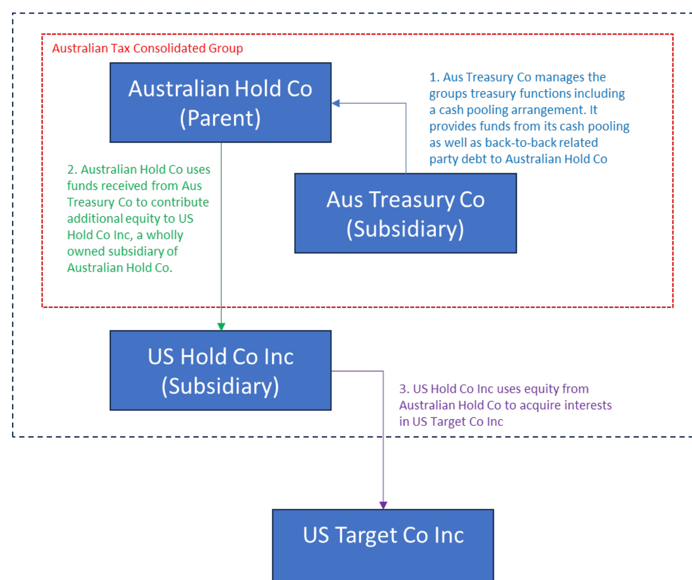
(b) the membership interest or increase to existing membership interest has not previously been held by ~~any~~ an associate.

As currently drafted, paragraph 820-423AA(1)(b) says that a membership interest must not have been "previously held by **any entity**". This therefore indicates a need for new membership interests to be brought into existence that were not previously held by a related party.

It is our understanding that this exclusion in paragraph 820-423AA(1)(b) is intended to also apply where new membership interests are acquired in entities you already own to provide requisite funds for those entities to purchase or subscribe for new interests outside the group. In this context, it is noted that, in some countries (including Australia and the US), equity can be subscribed without the need for new equity interests to be issued. Rather, equity is contributed to an existing membership interest to increase the capital base of the shareholder and member. The current drafting would not capture this situation and therefore unnecessarily limit the operation of the exclusion where "new membership interests" in the literal sense are not acquired.

This is best demonstrated in Example 7 below.

Example 7 – increasing equity in relation to existing membership interests



In this example, Australian Hold Co is the head of an Australian multinational group. Aus Treasury Co is a wholly owned subsidiary that manages the treasury function on behalf of the worldwide consolidated group.

Aus Treasury Co uses a combination of related party borrowings and funds sourced from its global cash management system and lends this to Australian Hold Co, which uses the cash to contribute capital into its existing wholly owned US Hold Co parent entity.

US Hold Co Inc then uses the additional capital received to fund the acquisition by US Hold Co parent of US Target Co, which is wholly unrelated to the group. That subscription is in addition to existing contributed capital in US Hold Co as it does not involve the issue of new membership interests per se.

The current drafting would disallow the deduction for interest to Australian Hold Co in this situation as US Hold Co has not issued it with new shares. This fact pattern is however aligned to the policy intent and therefore drafting as proposed above could be introduced to ensure the deduction remains available.

Another example would involve Australia Hold Co utilising related party borrowings to contribute additional equity into an Australian joint venture unit trust. Instead of issuing new units in the joint venture trust, Australia Hold Co contributes equity to the existing units that it holds in the trust. The current drafting would disallow the deduction for interest in this situation also.

Exceptions in section 820-423AA should apply to both subsections 820-423A(2) and 820-423A(5)

RECOMMENDATION:

That all of the exclusions in section 820-423AA should apply to subsection 820-423A(2) and subsection 820-423A(5).

Currently, subsection 820-423A(2) and subsection 820-423A(5) operate independently and sequentially. It is possible for a transaction to pass the test in subsection 820-423A(2) due to the exceptions in section 820-423AA, but then fail the test in subsection 820-423A(5) resulting in the denial of debt deductions. This is because subsection 820-423A(5) is broadly drafted and the exceptions in section 820-423AA do not apply.

For example, an entity borrows from a related party to fund the acquisition of a 50% interest (a new membership interest) in an Australian entity. Subsection 820-423A(2) would not apply due to the exception in 820-423AA(1). Subsection 820-423A(5) would however apply to the transaction because the entity has used the proceeds from the related party borrowing to fund a payment to an associate pair of the entity. The exception in 820-423AA(1) does not apply when assessing the application of subsection 820-423A(5).

We recommend that all of the exceptions in 820-423AA should apply to subsection 820-423A(5).

Clarification of the purpose of the wording of "legal or equitable obligation" in subsection 820-423A(2)

RECOMMENDATIONS:

The term 'legal or equitable obligation' in subsection 820-423A(2) results in the inclusion of multiple operation arrangements within the scope of the debt deduction creation rules, such as acquisition of services or insurance from a related party under a contract.

Subsection 820-423A(2) also extends to many arrangements that are dealt with under subsection 820-423A(5), providing uncertainty in the order of application of the provisions, given the overlap. Moreover, the overlap can mean that the policy-based carve-outs applying to subsection 820-423A(5) are ultimately ineffective (as arrangements sought to be excluded under subsection 820-423A(5) are still inadvertently captured under subsection 820-423A(2)).

Recommendations are:

1. Clarification of the intended 'legal or equitable obligation' to be caught under subsection (2), such that obligations under related party services at arm's length are not intended to be caught under these rules.

2. A new subsection 820-423AA(5) should be inserted to exclude the acquisition of a CGT asset or legal or equitable obligation from subsection 820-423A(2), where that CGT asset or legal or equitable obligation is part of a financial arrangement, on the basis that these situations are dealt with in subsection 820-423A(5).

This can be achieved as follows:

Acquisition of financial arrangements

*820-423AA(5) For the purposes of paragraph 820-423A(2)(a), the acquisition of a *CGT asset, or legal or equitable obligation, is covered by this section of all the following conditions are satisfied:*

*(a) The CGT asset, or legal or equitable obligation, is a *financial arrangement or is part of a financial arrangement;*

*(b) An entity (the acquirer) begins to have the *financial arrangement immediately after its creation;*

Paragraph 820-423A(2)(a) provides that "*an entity (the acquirer) acquires a CGT asset (other than a CGT asset covered by section 820-423AA), 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)*". Unlike the term 'CGT asset', the term 'legal or equitable obligation' is not defined in the Act. In addition, a CGT asset covered by section 820-423AA is excluded from subsection (2), while there is no comparable exclusions for legal or equitable obligations.

The term 'legal or equitable obligation' in section 820-423A(2) is extremely broad and can encompass:

- the 'acquisition' of related party services, or the obligation that naturally arises to pay for such services; and
- financial arrangements intended to be captured by section 820-423A(5).

There has been no legislative clarification or EM guidance to confirm the intended scope or application of the term 'legal or equitable obligation'. The breadth of this concept results in a lack of clarity on the scope and limits of application of subdivision 820-EAA.

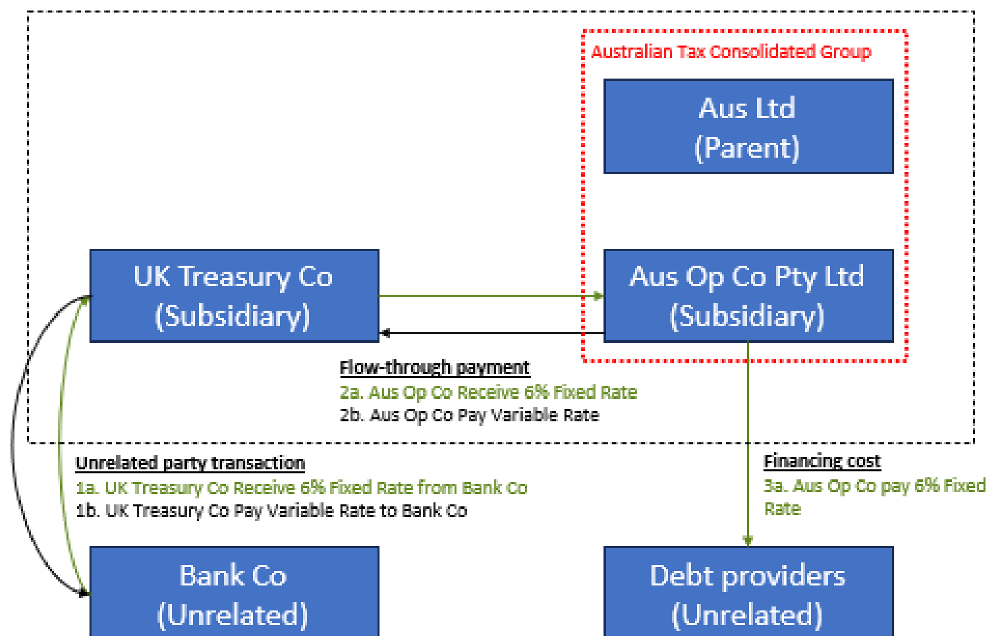
From a structural perspective, financial arrangements are clearly intended to be captured under section 820-423A(5), provided that they have the required features under the debt deduction creation rules (that is, they fund certain kinds of distributions, etc). However, these arrangements can, at the same time, be captured under section 820-423A(2) given the broad definition of both 'CGT asset' and 'legal or equitable obligation'. Moreover, because subsection 820-423A(2) does not include a requirement for a certain kind of distribution to be made (such as 820-423A(5)(b)), the mere entry into the financial arrangement can be enough to attract the adverse application of the subdivision.

As an example, while the acquisition of a debt interest as a CGT asset is excluded from subsection 820-423A(2) for the *lender* by operation of subsection 820-423AA(3), the legal or equitable obligation acquired by the *borrower* when entering into the same debt interest is not explicitly excluded. Consequently, where an entity borrowing from a related party can have interest deductions denied under 820-423A(2), even when the borrowed funds are used for a purpose that is neutral under the regime (e.g. payment of salary costs).

In addition, the acquisition of a 'legal or equitable obligation' can be interpreted to encompass derivative arrangements associated with hedging or managing financial risk, such as interest rate swaps or cross-currency interest rate swaps. When a taxpayer enters into a swap, it will acquire a right to receive future payments and come under a legal or equitable obligation to make payments under the arrangement. Where that swap is with a related party, payments under the swap (being 'debt deductions' under the extended definition) stand to be denied under 820-423A(2). This is the case even if the debt that is being hedged by the swap has been used for a neutral purpose or is even third party debt.

The example below illustrates this:

Example 8.1 – arrangements satisfying both subsection 820-423(2) and subsection 820-423A(5)



In this example, the Australian-based global group has decided to centralise certain treasury functions in the UK to promote efficiency, process standardisation, etc. The UK treasury function, through UK Treasury Co (which maintains relationships with financial intermediaries) assists the global group to meet a number of financial requirements including acquisition of interest rate swaps and cross currency interest rate swaps which are needed by the group's subsidiaries to hedge the financial risk associated with external borrowings.

Where Aus Op Co needs to enter into an interest rate swap to convert a $100m fixed rate loan to variable rate, UK Treasury Co enters into a $100m fixed-for-floating interest rate swap on market and provides a $100m fixed-for-floating interest rate swap to Aus Op Co on back-to-back terms (i.e. immediately and at cost).

The interest rate swap between Aus Op Co and UK Treasury Co is both a financial arrangement with an associate pair for the purposes of subsection 820-423A(2) and also a legal or equitable obligation to an associate pair for the purposes of subsection 820-423A(5). Because amounts received under the swap are paid away to debt providers, 820-423A(5) has no adverse application to the swap: 820-423A(5)(b) and 820-423A(5)(c). Nonetheless, 820-423A(2) appears to still apply, inappropriately, to deny all deductions under the swap.

It is submitted that an amendment is necessary to ensure that financial arrangements, which are specifically addressed by section 820-423A(5) are beyond the scope of operation of section 820-423A(2).

Clarify the operation of paragraphs 820-423A(2)(e) and 820-423A(5)(f) so that they do not apply to pass-through payments

RECOMMENDATIONS:

Clarify paragraphs 820-423A(2)(e) and 820-423A(5)(f) to ensure that they do not inappropriately capture payments that merely flow through a related entity, without being retained by any related entity.

This can be achieved as follows:

820-423A(2)(f) the relevant entity's debt deduction mentioned in subsection (1) is not referable to an amount that is initially paid or payable by the entity to any of the following

(i) an associate pair of the relevant entity

(ii) an associate pair of the acquirer

(iii) an associate pair of an associate disposer

where the amount is ultimately paid or payable to an entity that is not an associate entity on the same terms.

820-423A(5)(g) the relevant entity's debt deduction is not referable to an amount that is initially paid or payable by the entity to any of the following:

(i) an associate pair of the relevant entity

(ii) an associate pair of the payer

(iii) an associate pair of an associate recipient

where the amount is ultimately paid or payable to an entity that is not an associate entity on the same terms.

Paragraphs 820-423A(2)(e) and 820-423A(5)(f) are focussed on the debt deduction claimed by an Australian entity and whether the debt deduction is referrable to an amount paid or payable, directly or indirectly to a related entity (viz. an associate pair of the entity, an associate pair of the acquirer, an associate pair of an associate disposer/recipient).

This approach risks inappropriately prohibiting debt deductions for amounts which merely flow through a related entity as an intermediate step in a transaction, before flowing on to a third party.

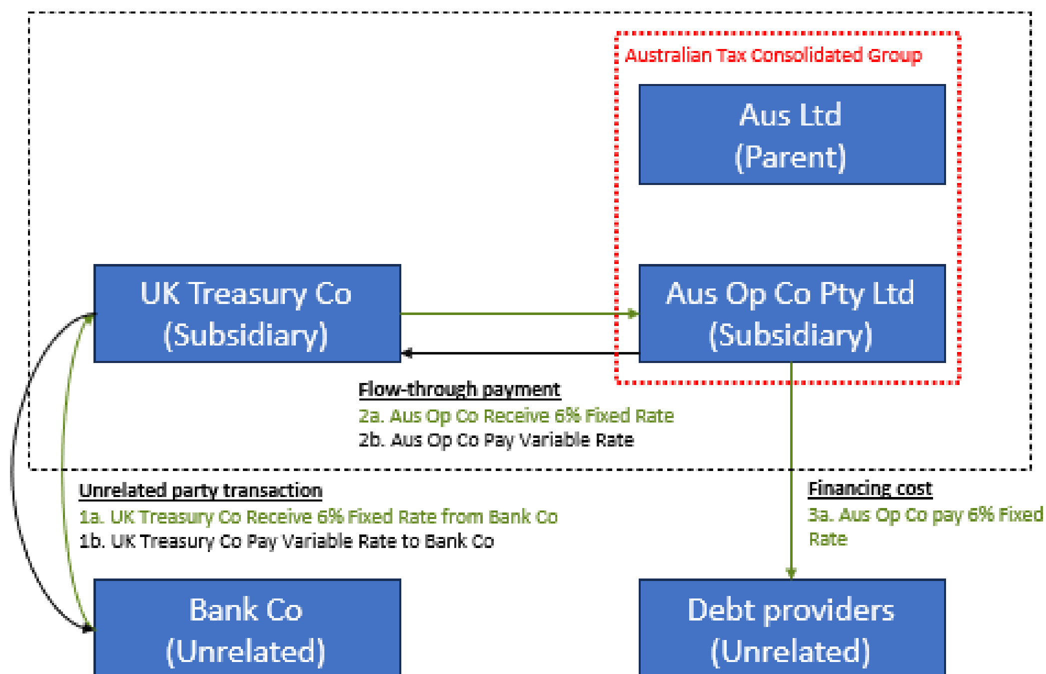
Transactions may be structured in this flow-through manner to achieve administrative convenience, efficiency and oversight/governance benefits via functional centralisation and so the structure does have genuine commercial purpose. At the level of cash cost, however, both the Australian entity claiming the deduction for the payment and the broader group to which it belongs are entirely indifferent as to whether:

- The payment flows through the related party; or
- The payment is made directly by the Australian entity to the non-related party.

It is submitted that the tax treatment of a direct payment to a third party and a payment that flows to a third party via a related party should be identical under Subdivision 820-EAA, but it is not clear that this outcome results, as paragraphs 820-423A(2)(e) and 820-423A(5)(f) are wide enough to capture the first leg of the payment (to the related party) while ignoring the second leg (to the third party).

This situation is illustrated by the fact pattern used in Example 8.1 above.

Example 8.2 – pass through payments



Because the interest rate swap will involve swap payments from Aus Op Co to UK Treasury Co (which is an associate pair), the transaction is caught by both:

- 820-423A(5) – because there is a financial arrangement under which Aus Op Co receives proceeds; and
- 820-423A(2) – because the entry into the interest rate swap is the acquisition of a CGT asset (contract) or an assumption of an obligation from an associate entity

Subsection 820-423A(5) does not ultimately have an adverse application because in this example Aus Op Co uses all amounts received under the swap to pay its obligations under the external debt (and does not use any funds to make payments to related parties, as described by 820-423A(5)(b)).

However, subsection 820-423A(2) operates to deny deductions for the swap payments made by Aus Op Co merely because they are made to UK Treasury Co, which is an associate. This is notwithstanding that UK Treasury Co operates on a pure flow-through basis and that back-to-back swaps are a commonly used transaction structure and are explicitly rated as low risk by the ATO in PCG 2017/4 (provided that the swaps are genuine, i.e. are held to maturity and involve regular cashflows). If Aus Op Co had entered into the interest rate swap directly with Bank Co, there would be no application of subsection 820-423A(2).

Extend the trust excess tax EBITDA amount in sec 820-60 to other structures

RECOMMENDATION:

Section 820-60 should be expanded to apply to any type of entity (company, trust and partnership) in relation to investments in any type of entity to ensure equitable outcomes arise for different entity types. The threshold should also be reduced from 50% to 10% to align with the requirement to disregard distributions from these entities in the tax EBITDA calculation.

Under the proposed Fixed Ratio Test, when calculating tax EBITDA for an income year:

(a) An entity must disregard distributions from companies, trusts and partnerships where it holds a 10% or greater interest in the entity; and

(b) If the entity is a trust, section 820-60 allows the trust to include any excess tax EBITDA from sub-trusts (where it holds 50% or greater interest) in its tax EBITDA calculation.

It is not equitable to allow only trusts to include excess tax EBITDA from sub-trusts in their tax EBITDA calculations. This rule should equally apply to any type of entity (company, trust and partnership) in relation to investments in any type of entity.

For example, an Australian listed company borrows funds from a bank to set up a 50/50 joint venture unit trust with an unrelated Australian listed trust. The joint venture trust undertakes property development and investment activities. The joint venture partners agree to fund the joint venture trust using 100% equity. Each partner separately sources bank debt to partially fund (approx. 30%) their equity contributions.

Both joint venture partners apply the Fixed Ratio Test when undertaking their thin capitalisation calculations. The Australian listed trust is able to include the trust excess tax EBITDA amount in its tax EBITDA calculation in accordance with section 820-60, however, the Australian listed company is not eligible. This results in the denial of interest deductions in relation to the bank debt for an Australian listed company, but not for the Australian listed trust. The post tax returns for each joint venture partner are significantly different because the proposed law favours trusts over companies.

We recommend section 820-60 should be expanded to apply to any type of entity (company, trust and partnership) in relation to investments in any type of entity to ensure equitable outcomes arise for different entity types.

We also recommend that the threshold in section 820-60 be reduced from 50% to 10% to align with the requirement to disregard distributions from these entities in the tax EBITDA calculation. Without this change, entities that hold a joint venture interest of between 10% and 50% will be unfairly disadvantaged as they will not be able to include in their tax EBITDA

calculation any distributions from the joint venture or their share of any excess tax EBITDA capacity from the joint venture.