FSC FINANCIAL SERVICES COUNCIL

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

FSC Submission to Treasury on Proposed Amendments

October 2023

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1 About the Financial Services Council

The FSC is a peak body which sets mandatory standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our full members represent Australia's retail and wholesale funds management businesses, superannuation funds, investment platforms and financial advice licensees. Our supporting members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing more than $3 trillion on behalf of over 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is one of the largest pool of managed funds in the world.

The FSC's mission is to assist our members achieve the following outcomes for Australians:

- to increase their financial security and wellbeing;
- to protect their livelihoods;
- to provide them with a comfortable retirement;
- to champion integrity, ethics and social responsibility in financial services; and
- to advocate for financial literacy and inclusion.

2 Introduction

The FSC thanks Treasury for the opportunity to provide a submission on proposed amendments to the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023* (**the Bill**) currently before the Senate.

The FSC thanks the Government for its engagement on the proposals and for proposing further refinements to improve Schedule 2 of the Bill (interest limitation or thin capitalisation rules) identified during previous rounds of consultation and the Senate Economics Legislation Committee inquiry (**the inquiry**), to which the FSC has previously made submissions.[1]

The FSC's submission to Treasury provides additional comment on the proposed exposure draft amendments and explanatory memorandum.

3 Schedule 2 – Interest limitation (thin capitalisation) rules

3.1 Debt deduction creation rules

The FSC previously identified a number of concerns with the proposed debt deduction creation rules that were included in the Bill without prior consultation. While our recommendation to remove the provisions subject to a full and comprehensive consultation process was not adopted, we note that the amendments will make some improvements to the Bill and address a number of the concerns identified in our submission to the Senate Committee.

While the aim of the Bill was to disallow debt deductions in relation to debt creation schemes that lack genuine commercial justification, it was observed by the FSC and other submissions to the inquiry that the drafting of proposed Subsection 820-EAA was much more extensive in scope than required to capture these types of transaction.

There was a concern that the rules as drafted were likely to have unintended consequences, including denying debt deductions for many common and simple commercial transactions. Safeguards and exclusions found in the former debt creation rules the provisions purport to replace, which would have prevented these transactions from being captured, were not included in the Bill.

The amendments address this by ensuring that not all debt financing transactions by related parties fall within scope of the rules. Assets can be acquired by related parties without triggering the debt deduction creation rules. The amendments introduce specific exemptions to the limitation rule, including an exception for related party lending.

The introduction of a related party debt deduction condition, where an associated unit trust holds a debt deduction referable to a related entity, improves targeting of the measure. This change allows financial arrangements involving related party debt, such as where a group structure finances or facilitates borrowing for a related unit trust.

These changes are important to ensure that related party transactions do not all need to be equity funded and allow for genuine debt funding by corporate groups as a means of financing activities such as business expansion and acquiring assets without having to raise capital on an individual entity basis.

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[1] Relevant FSC submissions are available from the FSC website: https://fsc.org.au/resources/submissions

Our submission to the inquiry also raised concerns with the retrospectivity of the debt deduction creation rules. We note that the amendments have introduced a one-year grace period for the application of the rules (applying to financial arrangements entered into before 22 June 2023), which take effect for all arrangements relating to debt deductions claimed from 1 July 2024 onwards.

These changes partly address the FSC's concerns. While still difficult to trace back borrowings for debt deductions applying in income years beyond 1 July 2024 where these arrangements were made prior to introduction of the Bill, the transition period will allow for a partial solution in many instances.

However, there is still scope for retrospective application by not applying the treatment to all arrangements made before 22 June 2023, regardless of the income year in which they are applied.

Despite this, the amendments improve the proposed retrospective effect of the Bill to allow a means of claiming debt deductions where the required information may not have been collected prior to introduction of the legislation to Parliament.

Irrespective of the amendments made, we reiterate that issues remain in terms of the complexity and breadth of the rules. The proposed amendment will still cover many purely domestic arrangements where there is no overall net increase in interest deductions or no net loss to revenue. For example, where assets are transferred between members of a group of Australian trusts (e.g., as part of portfolio rebalancing) and the consideration is in the form of a debt, the debt deduction creation rules could apply to deny deductions for the interest on the outstanding debt, even though there is no net loss to revenue from the transaction because interest on the debt should be assessable to the transferor.

We submit that the breadth of the debt deduction rules should be further limited as follows:

- The introduction of a simple overarching purpose test (i.e. transactions where the predominant purpose is to increase debt deductions in Australia or reduce assessable interest income in Australia). Such a test would assist in ensuring that commercially justifiable transactions are excluded from the debt deduction creation rules and provide more certainty for taxpayers. This would also more closely align with what the OECD envisaged in the BEPS Action 4 Report.
- Whilst the exclusory amendments proposed mirror those exemptions provided under the old Division 16G of the Income Tax Assessment Act, a number of exclusions have not been reiterated, including an exclusion for the acquisition of trading stock. This exclusion was included in Division 16G to recognize that debt (via inter-company balances) is commonly used as working capital to fund the acquisition of trading stock from other group members. We consider that such an exemption should be included to the debt deduction creation rules in order to ensure the exclusion of commercially justifiable transactions.
- An exemption should be provided for short-term loans or financial arrangements arising in the ordinary course of business on commercial terms. Proposed section 820-423(5) operates to deny debt deductions where an entity enters into a financial arrangement with an associated entity and uses "some or all" of the proceeds to

"facilitate the funding" or "increase the ability of the entity" to make a "payment" to an associate recipient. It is arguable that inter-company balances are a financial arrangement with the resultant potential for the denial of interest deductibility. Interest may be chargeable on such balances to satisfy transfer pricing requirements. It seems an incongruous and inequitable outcome that inter-company commercial arrangements on which interest is charged in order to satisfy transfer pricing requirements may result in the denial of interest deductions in Australia. If this exemption for short-term financial arrangements is not included, then detailed tracing of the use of fungible working capital would be required. Such tracing is onerous and subject to interpretation and manipulation, and is something that previous iterations of the thin capitalisation rules were designed to avoid.

The FSC **recommends** extension of the exemption from application of the debt deduction creation rules to all arrangements made before 22 June 2023, regardless of the income year to which it relates.

The FSC **recommends** that the debt reduction rules should be further limited through

- An overarching purpose test.
- An exclusion for the acquisition of trading stock.
- An exemption for short term loans or financial arrangements arising in the ordinary course of business on commercial terms.

3.2 Third-party debt test – application to partnerships and trusts

The FSC had concerns that the proposed third party debt test in the Bill would not apply to trusts and partnerships and, assuming this was not a deliberate policy decision, recommended amendment to ensure application to these structures.

This recommendation has been adopted by the proposed amendments, which now use the defined term 'Australian entity' to ensure the third party debt test is available to trusts and partnerships.

The FSC **supports** the amendments as proposed.

3.3 Application of rules to Attribution Managed Investment Trusts

The FSC submission to the Senate Committee inquiry raised concerns specific to Attribution Managed Investment Trusts (AMITs) being excluded from accessing interest deductions under the tax EBITDA test in a way that did not apply for any other form of trust.

We note that proposed section 820-52 now contains new provisions modifying the calculation of tax EBITDA to apply for AMITs that incur an interest expense. This will ensure that the EBITDA test is accessible to AMITs that borrow in the same way as other types of trust.

The FSC **supports** the amendments as proposed.

3.4 Distributions from trusts

The amendments allow for excess tax EBITDA amounts to be transferred between unit trusts and are intended to allow for application of the test to more financial arrangements using subsidiary trusts. Criteria that must be satisfied include an element of direct control between the entity and transferring trust and both not having elected to apply an approach other than the fixed ratio test.

Proposed changes address concerns with the inability for a trust beneficiary to use the income from its subsidiaries to calculate its EBITDA for tax purposes, as subsidiary trusts can allocate excess tax EBITDA to the head trust based on the proportion of the year in which a majority direct control interest was held.

The FSC **supports** the amendments as proposed.

3.5 Associate entity test exemption

While the FSC welcomes exempting superannuation funds from the 'associate entity' test, we restate our recommendation to extend this exemption to include both superannuation funds and other widely held investment funds such as AMITs, Managed Investment Trusts (MITs), and Corporate Collective Investment Vehicles (CCIVs) as part of these proposed amendments.

Due to the similarity between the essential characteristics of investment and superannuation funds, the FSC stresses that the reasons provided for the test being not fit for purpose and justifying an exemption apply equally to these other entities. Specifically:

- Investment funds, just like superannuation funds, collectively have significant investments in different assets.
- Investment funds, just like superannuation funds, are important sources of capital investment for Australian assets, particularly infrastructure assets.
- Under current interest limitation rules, some investment funds may have a relatively large number of associate entities, which would bring their investments into scope of the thin capitalisation rules.
- Investment funds, just like superannuation funds, are subject to a strong regulatory regime.
- Investment funds, just like superannuation funds, generally do not exercise any meaningful control over associate entities.

Given these points, the FSC submits the exemption should apply similarly to investment funds as well as superannuation funds.

The competitive non-neutrality identified in our earlier submission to the Senate inquiry still exists where an investment fund is wholly owned by a superannuation fund, an inequity that should also be resolved through amendments to the Bill before its passage by Parliament. This could create a disincentive for investment funds that are not owned by superannuation

funds but subject to the interest limitation rules from investing in assets requiring significant gearing such as housing and renewable energy projects.

The FSC **recommends** the amendments extend the proposed exemption from the associate entity test for superannuation funds to also apply to other investment funds that satisfy the existing 'widely held' test (MITs, AMITs and CCIVs).