The Tax Institute

21 July 2023

Tas Larnach
Committee Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

By electronic upload

Dear Mr Larnach,

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

The Tax Institute welcomes the opportunity to make a submission to the Senate Economics Legislation Committee (**Committee**) in respect of its inquiry and report on the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023 (**Bill**) and accompanying explanatory memorandum (**EM**).

In the development of this submission, we have closely consulted with our National Large Business and International Technical Committee to prepare a considered response that represents the views of the broader membership of The Tax Institute.

Schedule 1 of the Bill proposes to introduce additional disclosure requirements regarding the subsidiaries of Australian public companies. We consider that Schedule 1 of the Bill would benefit from further consultation on specific reporting aspects and a deferred application date. This will allow for the identification of opportunities to streamline the reporting of the additional disclosure requirements, reducing the compliance costs for impacted taxpayers. We also consider that further clarification is required in certain regards, to ensure that taxpayers and tax practitioners can better understand, and affected taxpayers can meet, their new disclosure obligations.

Schedule 2 of the Bill propose to introduce a new framework and regime for Australia's thin capitalisation rules. The new thin capitalisation framework is a significant change for all impacted taxpayers, as it fundamentally alters the application of the existing rules. Schedule 2 of the Bill is currently proposed to apply to income years commencing from 1 July 2023. In practice, the Bill requires taxpayers to retrospectively comply with a new framework as the start date has now passed and legislation has not yet been enacted. The Tax Institute is of the view that Schedule 2 of the Bill should be deferred by a period of at least 12 months from the proposed start date to provide taxpayers with sufficient time to understand their obligations.

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The new thin capitalisation framework is also likely to have a broader application than intended by the policy in relation to common commercial transactions involving trust groups. We consider that amendments are required to better align the outcomes between companies and trust groups, ensuring that there are more proportionate and consistent outcomes across corporate structures.

Schedule 2 to the Bill also proposes to introduce a new Subdivision 820-EAA to the Income Tax Assessment Act 1997 (**ITAA 1997**). This new subdivision was not part of the exposure draft legislation and would benefit from public consultation to ensure its practical impact is proportionate to the intended policy outcome. As current drafted, there are concerns that the rules may unintentionally and unfairly apply to common and low-risk arrangements. We consider that these rules require a dominant purpose threshold requirement to ensure that they only target arrangements of concern. There are also concerns that proposed Subdivision 820-EAA of the ITAA 1997 may have a retrospective impact. We consider that it would be an inappropriate outcome for these rules to apply retrospectively to pre-existing arrangements that are compliant with the current thin capitalisation regime.

Further, we recommend that consideration be given to certain other aspects of Schedule 2 of the Bill to ensure that it does not encourage market distortions and appropriately accounts for existing tax concepts.

Our detailed response is contained in **Appendix A**. We have provided at **Appendix B** an example of an inappropriate outcome that results from the application of the proposed new thin capitalisation rules to a trust group.

We would be pleased to work with the Committee to ensure that the Bill best achieves its policy intent without resulting in inequitable outcomes for taxpayers.

The Tax Institute is committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all. Please refer to **Appendix C** for more information about The Tax Institute.

If you would like to discuss any of the above, please contact our Senior Tax Counsel, Julie Abdalla, on (02) 8223 0058.

Yours faithfully,

Jerome Tse

Council Member

APPENDIX A

We have set out below our detailed comments and observations for your consideration.

Schedule 1 – Multinational tax transparency — disclosure of subsidiaries

Commencement date

The Government has announced that the application date for the proposed changes to the public country-by-country (**CbC**) reporting regime in Australia will be deferred by 12 months to 1 July 2024. This is partly to allow time for further stakeholder consultation on certain issues including disaggregated reporting. We consider that the consultation process for the amended CbC reporting regime should also provide an opportunity to consider whether the additional disclosure requirements under Schedule 1 of the Bill may be suitable to be included as part of the proposed changes to the CbC reporting regime. The commencement date of Schedule 1 of the Bill would also benefit from being deferred by 12 months to allow for further consultation.

Opportunities may exist to streamline reporting obligations, thereby reducing associated compliance costs for impacted taxpayers. For example, companies could potentially disclose the residency status of their subsidiaries through proposed additional CbC reporting requirements. Alternatively, if the CbC reporting framework does not apply to an organisation (e.g. because its annual global income is less than AUD$1 billion), the tax residency of subsidiaries may instead be disclosed through other statements that form part of the tax return process or tax transparency report. We also consider that the Government should consult further on whether any additional disclosures under this measure should be limited to Australian public companies. This consultation should also seek stakeholder input on the potential disincentive for foreign investors that may arise from the increased cost of compliance under Schedule 1 of the Bill.

'True and correct'

The Bill proposes to insert paragraph 295(4)(da) to the *Corporations Act 2021* (Cth) (**Corporations Act**) which would require directors to declare:

> whether, in the directors' opinion, the consolidated entity disclosure statement required by subsection (3A) is **true and correct**; …
>
> [emphasis added]

We consider that the use of the term 'correct' imposes an inconsistent and unreasonable obligation on directors and should instead be replaced with a requirement that the relevant declaration is 'true and fair' or 'made on reasonable grounds'. The term 'correct' is not used in other regulatory reporting requirements. For example, the Australian Auditing Standards (**ASA**) uses the term 'true and fair', and other areas of the Corporations Act use the term 'true and fair view'. In certain circumstances, directors' declarations under the Corporations Act use the expression 'reasonable grounds to believe' when referring to the obligations of a director in relation to the accuracy of the obligation.[1]

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[1] For example, see paragraph 295(4)(c) of the Corporations Act.

We consider that it is unreasonable to impose a requirement on a director's judgement to be 'correct'. The determination of tax residency is often difficult to assess, and can be open to interpretation or challenge. We also note the relevant announced but unenacted measure regarding corporate tax residency that could fundamentally change the rules for corporates, trusts and corporate limited partnerships. This ongoing uncertainty, combined with the practical challenges under the current rules, makes it difficult for directors to provide with confidence a 'correct' view on the residency status of a corporate.

If the requirement for a 'correct' disclosure is not replaced, targeted consultation with stakeholders including the Auditing and Assurance Standards Board (**AUASB**) and industry bodies should be undertaken regarding the impact of this requirement on audit reports. Auditors will need to consider what type of audit report they can provide if the new and higher requirement of 'correct' is introduced by the Bill. Given the complexities associated with the determination of corporate residency, an auditor may not practically be able to provide a 'correct' opinion. Guidance will be required on how these reporting obligations can be met. Without further guidance, there is likely to be an increase in complexity around financial statements and the responsibilities of an auditor reporting on them and greater room for error.

Public companies

We consider that further clarification is required about the entities to which Schedule 1 of the Bill applies. Schedule 1 of the Bill is currently proposed to apply to a 'public company'. Under the Corporations Act, a public company is broadly a company other than a proprietary company or a corporate collective investment vehicle (**CCIV**). It is unclear whether Schedule 1 of the Bill will apply to:

- companies limited by guarantee;
- no liability companies; and
- registered foreign companies.

If the intention is for the legislation to apply to these entities, we consider that this should be clearly stated. Further consideration and guidance in the EM may also be required regarding how the rules apply regarding branches given that some branches may not be considered to be 'subsidiaries' under the ASA.

Alternatives to current disclosure requirements

Broadly, Schedule 1 of the Bill requires that the relevant information concerning subsidiaries 'must' be presented in financial statements. We consider that further consultation should be undertaken regarding the extent to which the proposed disclosures can be made under AASB 1054 Australian Additional Disclosures (**AASB 1054**), instead of requiring that the disclosures be made under the Corporations Act. AASB 1054 currently contains other Australian-specific disclosure requirements, such as franking credit information. It may be possible to streamline reporting obligations and reduce compliance costs by incorporating the additional disclosures under pre-existing frameworks.

Part of consolidated entity

Proposed paragraph 295(3A)(a) of Schedule 1 of the Bill requires a:

> …a statement that includes the following information for **each entity that was, at the end of the financial year, part of the consolidated entity**…

[emphasis added]

We consider that the meaning of phrase ‘each entity that was, at the end of the financial year, part of the consolidated entity’ is unclear and would benefit from further clarification and guidance in the EM. For example, it is uncertain whether the phrase could include subsidiaries as defined under AASB 10 Consolidated Financial Statements. Further, neither the Corporations Act nor ASA define ‘part of’, resulting in uncertainty around whether an associate entity (such as an interest in a joint operation), or an interest in an entity that is accounted at fair value[2] is included within the scope of the ‘consolidated entity’.

Schedule 2 – Thin Capitalisation

Deferral of start date

Schedule 2 of the Bill is proposed to take effect for income years commencing on or after 1 July 2023. This effectively requires taxpayers with financial years that end on 30 June to comply with a new and complex thin capitalisation framework without guidance and before the legislation is enacted. Noting that the Committee’s report is currently scheduled to be completed by 31 August 2023, and may lead to changes to the Bill, we will be at least two months into the new financial year, if not more, before affected taxpayers will have any certainty about their obligations under the new framework.

We consider that the start date of Schedule 2 of the Bill should be deferred by at least 12 months and apply to income years commencing on or after 1 July 2024 (or later). Further, we consider that taxpayers should be provided a reasonable transitional period to provide them reasonable opportunity to review existing arrangements and undertake any relevant structural or reporting steps to meet the requirements of the new thin capitalisation framework.

A deferred start date and/or transitional period may also assist with the associated compliance costs for taxpayers and will put tax practitioners in a better position to provide timely and accurate advice.

We note that Paragraph 85 of the EM states:

> ‘…the amendments are estimated to increase the compliance burden on taxpayers in the initial year they come into effect, in the form of one-off costs. As businesses adjust to the new rules, they will likely seek updated tax advice responding to the changed rules for the first applicable income year. Once this initial advice is received, nil ongoing regulatory costs are estimated, as these costs are expected to fall under the business-as-usual costs of the company that they already incur as part of their annual tax management arrangements.’

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[2] See IFRS 9 Financial Instruments, available at https://www.ifrs.org/issued-standards/list-of-standards/ifrs-9-financial-instruments/.

Feedback from our members raises concerns that compliance costs associated with the amendments contained in Schedule 2 of the Bill are likely to be significantly greater in practice than stated in the EM. The cost of adopting new systems and reporting frameworks for a new and as yet unenacted system are likely to be substantial in the first few years, not just the initial year in which they come into effect. Further, the need for guidance and costs associated with addressing unintended outcomes over the course of the coming years are likely to result in compliance costs remaining high for the short to medium term. This will be exacerbated if the issues identified with Schedule 2 of the Bill are not resolved before it is enacted. Deferring the commencement of the new framework and/or providing a transitional period, can allow taxpayers to better manage compliance costs.

Definition of 'tax EBITDA'

Section 820-52 of the Bill proposes to introduce a definition for the term 'tax EBITDA'. The proposed definition excludes NANE income, with no policy rationale for this exclusion provided in the draft EM.

We consider that NANE income should be included in definition of 'tax EBITDA' to the extent that financing costs incurred in deriving the relevant NANE income would be deductible (disregarding the debt limitation rule). If this NANE income is not included, the financing costs incurred in relation to NANE income would be included in the same test as financing costs incurred in relation to taxable income, however, the available limit would be determined by reference to 30% of taxable income only. This outcome would arbitrarily impair the deductions otherwise available in respect of the financing costs incurred in relation to NANE income.

For example, financing costs incurred in deriving income under section 23AI (**s 23AI income**) of the *Income tax Assessment Act 1936* (**ITAA 1936**) are deductible under section 25-90 of the ITAA 1997. If an entity had s 23AI income in a given year, but no taxable income, its deduction under section 25-90 of the ITAA 1997 would be wholly denied, even if the relevant financing costs were less than 30% of the s 23AI income.

Impact on trust groups

We consider that the proposed thin capitalisation framework results in disproportionate and unfair outcomes for many common structures involving trust groups. The proposed rules have a relatively low threshold for application for public trusts, requiring these trusts to meet existing residency requirements. Broadly, a trust will have interest deductions limited or denied if it is not an Australian tax resident. Impacted trust groups will be non-residents unless more than 50% of the beneficial interest in the trust's income or property is held by Australian residents (even if there are no foreign controllers of the trust). Feedback from our members indicates that the scope of these rules may impact many withholding managed investment trusts (**MITs**) and attribution managed investment trusts (**AMITs**), potentially impacting a large number of listed and widely held wholesale Australian trusts.

Trust groups may be left in a position where they cannot claim an interest deduction for what are widely accepted as commercial and common arrangements. This includes instances where a trust group holds debt in the head trust and the assets are held in special purpose vehicle (**SPV**) trusts. Our understanding is that these arrangements are common for market transactions, are often highly leveraged, and usually do not source external debt. A detailed example demonstrating the outcomes of the proposed rules in respect of a trust group is outlined in **Appendix B**.

The denial of interest deductions for these trusts will result in a disproportionate increase in the taxable income of both non-resident and domestic investors in the affected funds. Impacted taxpayers may include many Australian superannuation funds.

Attachment 2 to the EM notes that 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. However, this approach does not appropriately recognise the significant tax and commercial costs associated with restructuring existing arrangements nor the commercial rationale for their existence. This approach also does not appropriately recognise that investors (who may be Australian resident investors) in such structures may themselves need to borrow funds to make the required equity investment to give effect to such a restructure. The exclusion of trust distributions and dividends from the investor's tax EBITDA under the fixed ratio test (**FRT**) exacerbates the issue.

We consider that the proposed thin capitalisation framework should apply to trust groups under the same principles as apply to consolidated corporate groups. This may be achieved by amending Schedule 2 of the Bill for MITs and AMITs such that:

- the FRT/group ratio test allows an allocation rule based on a one-time group wide election to either calculate tax EBITDA at the level of a nominated holding trust or the SPV trusts (if a holding trust is nominated, only the holding trust would be able to apply the FRT, reducing the ability for trust groups to blend outcomes and reach unintended outcomes. We note that further consideration would need to be given to certain arrangements, such as joint ventures and other non-wholly owned SPV trusts);
- the scope of the residency requirements in the third-party debt test (**TPDT**) is broadened to make it clear that trusts and partnerships that are not foreign controlled are able to access the TPDT; and
- the start date is deferred and/or a transitional period is provided, allowing trust groups to restructure their debt arrangements to be compliant with the requirements of the new thin capitalisation framework.

Debt deduction creation rules

Application of debt deduction creation rules

Schedule 2 of the Bill proposes to introduce a new Subdivision 820-EAA to the ITAA 1997. Broadly, these rules will disallow debt deductions to the extent that they are incurred in relation to debt creation schemes.

We consider that further clarification is required regarding the timing of the application of the debt creation rules. In its current form, there are concerns that the debt creation rules may apply to arrangements that were in place before 1 July 2023, and therefore apply before the commencement of the new thin capitalisation framework.

Subsection 820-423A(2) provides that the relevant rules will apply if the CGT asset is acquired under the relevant conditions, potentially applying to assets acquired before 1 July 2023. Similarly, the rules could apply in the future if an entity becomes subject to Division 820 of the ITAA 1997 and the trigger event occurred before the start date for the relevant entity. This approach would impose a significant compliance burden on taxpayers who may need to retrospectively ascertain whether there was a relevant acquisition of an asset from an associate that involved borrowings in relation to the asset, or if it had borrowed from an associate to fund payments to it or another associate. Such an outcome is, in our view, disproportionate to the intended purpose of the rules.

Purpose of debt deduction creation rules

Paragraph 2.146 of the EM states that:

> 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.

Further, paragraph 2.53 of the EM provides that the ‘provisions are drafted broadly to help ensure they are capable of applying to debt creation schemes of varying complexity.’ However, we consider that this stated scope is too broad and will unfairly impact low-risk arrangements.

Feedback from our members suggests that the debt deduction creation rules could potentially apply to simple and commercially accepted transactions involving associates that result in borrowings with potential debt deductions. Examples of such arrangements that may be impacted include:

- borrowing funds to subscribe for shares or units in an associate;
- borrowing under a working capital or cash pooling facility to fund the acquisition of trading stock from an associate; or
- obtaining or refinancing debt lent from a special purpose finance company for a group.

We consider that proposed Subdivision 820-EAA of the ITAA 1997 should contain a dominant purpose requirement so the rules better target arrangements of concern.

Further, proposed Subdivision 820-EAA of the ITAA 1997 will apply to entities otherwise exempt under section 820-39 of the ITAA 1997, adversely impacting any non-consolidated securitisation vehicles that acquire receivables from associate originator entities. We consider that the EM should clarify whether the entities noted in section 820-39 of the ITAA 1997 are intended to be exempt from proposed Subdivision 820-EAA of the ITAA 1997.

Consider extending exclusion for superannuation funds to managed funds

Subsection 820-905(1A) of the Bill proposes to exclude complying superannuation funds and wholly owned subsidiaries of complying superannuation funds from the interest limitation rules. Paragraph 2.162 of the EM sets out the rationale for this exclusion. We recommend that further consideration on whether this exemption should also apply to MITs, AMITs and CCIVs should be undertaken given the rationale provided regarding superannuation funds in the EM could seemingly apply to managed funds.

APPENDIX B

Example – Thin capitalisation rules and trust groups

A trust group for a large property group contains third party debt at the head trust level, with assets in SPV trusts. This structure often reflects the decision of the property group to seek to finance its investments on a whole of portfolio basis rather than a project-by-project basis. This structure provides a wide range of commercial benefits, including:

- better management of the loan to value ratio, interest coverage ratio variability, and existing loan covenants;
- flexible overall cashflow management;
- providing the ability to enter into common terms deeds, allowing multiple lenders on same terms with pricing benefits;
- removing issues associated with differential lending on various assets;
- robust debt management;
- reduction in the financial statement audit footprint, potentially only requiring full financial statement audit at the head trust level; and
- the ability to scale the business and access a better credit rating and future borrowing terms.

The trust group will fall within the scope of proposed thin capitalisation framework if more than 50% of its investors are non-residents. As a result, the trust group would be subject to the following outcomes under the various tests:

- Fixed ratio test – the trust group cannot apply the FRT because (unlike in a corporate case) the rules operate to deny the consolidation of the EBITDA on which the operation of this rule depends. Broadly, the SPVs have EBITDA but no debt. Meanwhile, the head trust has no (or limited) EBITDA (as distributions from sub-trusts are excluded) and all the debt. Calculating a ratio on the EBITDA of the head trust means no (or low) interest deductions are available.
- Group ratio test – is also not available for the trust group to use as it is based on the allocation of EBITDA.
- TPDT – is not available for the trust group to use the trusts are not Australian residents for the purposes of the provisions. Further, the rules require that recourse is limited to the Australian assets of the borrowing entity. This will be a concern where the debt is situated in the head trust and the assets are held in SPV trusts. While this concern has been addressed in the conduit financing rules, allowance of security over the assets of the Obligor Group is not replicated in the TPDT rules.
- Conduit financing conditions – the availability of the conduit financier rules depend on the circumstances of each case.

As a result, the interest will be denied or significantly limited for all entities in the trust group. If interest deductions allowed under the FRT, the amount allowed would be significantly lower than the outcome for an equivalent corporate group. We consider that there should not be a difference in outcomes between trust groups and corporate groups.

APPENDIX C

About The Tax Institute

The Tax Institute is the leading forum for the tax community in Australia. We are committed to representing our members, shaping the future of the tax profession and continuous improvement of the tax system for the benefit of all, through the advancement of knowledge, member support and advocacy.

Our membership of more than 11,000 includes tax professionals from commerce and industry, academia, government and public practice throughout Australia. Our tax community reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate knowledge and learning.

We are committed to propelling members onto the global stage, with over 7,000 of our members holding the Chartered Tax Adviser designation which represents the internationally recognised mark of expertise.

The Tax Institute was established in 1943 with the aim of improving the position of tax agents, tax law and administration. More than seven decades later, our values, friendships and members' unselfish desire to learn from each other are central to our success.

Australia's tax system has evolved, and The Tax Institute has become increasingly respected, dynamic and responsive, having contributed to shaping the changes that benefit our members and taxpayers today. We are known for our committed volunteers and the altruistic sharing of knowledge. Members are actively involved, ensuring that the technical products and services on offer meet the varied needs of Australia's tax professionals.