INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

9 January 2023

Assistant Secretary
Corporate & International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600
Attn: David Hawkins

Via Email: MNETaxintegrity@treasury.gov.au

SUBMISSION TO THE TREASURY ON MULTINATIONAL TAX INTEGRITY PACKAGE – AMENDING AUSTRALIA'S INTEREST LIMITATION (THIN CAPITALISATION) RULES

Infrastructure Partnerships Australia is an independent think tank and executive member network, providing research focused on excellence in social and economic infrastructure. We exist to shape public debate and drive reform for the national interest. As the national voice for infrastructure in Australia, our membership reflects a diverse range of public and private sector entities, including infrastructure owners, operators, financiers, advisers, technology providers and policy makers.

Infrastructure Partnerships Australia draws together the public and private sectors in a genuine partnership to debate the policies and priority projects that will build Australia for the opportunities and challenges ahead.

Background and Content

Infrastructure Partnerships Australia would like to thank your time spent on the 8 November 2022 discussing the proposed changes to Australia's thin capitalisation rules (as announced in the October 2022 Federal Budget). As part of that meeting, we committed to sending you our further comments in relation to implementation considerations.

To that end we have compiled a list of topics which we consider are high priority areas for consideration. These are as follows:

1) Retainment of the ability to transfer Associate Entity Excess Amounts

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2) The ability for the Arm's Length Debt Test (ALDT) to take account of external debt being passed through interposed parties such as Fin Co's

3) Application of the ALDT where there is mixed internal and external funding

4) Retaining the 90 per cent assets threshold exemption for outward investing entities

5) Introduction of the proposed earnings-based group ratio / removal of the worldwide gearing ratio, and

6) The potential for concessions to be given in relation to restructuring activities undertaken to comply with the new rules.

Further detail on each of the above areas is provided below.

1. Retainment of the ability to transfer Associate Entity Excess Amounts

Based on our conversation on the 8 November 2022, we understand that the Treasury is currently planning for the new earning based 30 per cent earnings before interest, taxes, depreciation, and amortisation (EBITDA) test to be applied on an individual entity by entity basis rather than a group basis. We also understand that the Treasury is not currently considering including a mechanism in the new rules to allow entities to transfer capacity to each other in a similar way to the way that the Associate Entity Excess Amounts can be transferred under the existing rules.

We consider it critical to allow for a mechanism for the transfer of capacity in appropriate cases. Without such a mechanism, a structure which has debt coming in at a different level to where the income of the business is being derived, may be inappropriately impacted when compared with a structure that has debt coming in at the same level at which the income is derived.

We have set out in Appendix 1 a comparison of two simple scenarios to highlight the expected differences in interest deductibility arising from debt coming in at two different levels in a common structure using trusts based on our current high-level understanding of how the new thin capitalisation are intended to work. For completeness, we note that although the scenarios in Appendix 1 use a trust structure, a very similar analysis would be applicable if companies were used in place of trusts.

As you will see from Appendix 1, in a scenario where debt comes into the structure at a "higher" level than where the income of the businesses is derived (Scenario 2), this results in significantly less interest expense

being treated as deductible when compared with the situation where debt comes into the structure at the same level of where the income is derived (Scenario 1). In this case, the disparity seems like a perverse outcome given that the economic effect of the two structures is identical. It is for this reason that we believe some form of "capacity transfer" mechanism is necessary. In these types of situations, the level of debt in a structure which is capable of being treated as deductible should be agnostic of where the debt comes into structure.

2. The ability for the ALDT to take account of external debt being passed through interposed parties such as Fin Co's

We understand that the Treasury has not yet decided the criteria for what debt will be "related party" debt for the purposes of the ALDT. We consider it essential that when determining whether debt is treated as related party debt or not, that provisions are made in the rules to "look though" interposing entities under common ownership to determine the actual "source" of the debt (i.e., whether it originates from an external third-party source or not).

For example, as you are likely aware the infrastructure sector makes extensive use of separate nominally capitalised Finance Companies to source external third-part debt. These special purpose Finance Companies borrow from third party lenders and pass the sourced debt on to the project vehicle typically on back-to-back terms.

If the imposition of a Finance Company would have the impact of making the project vehicle view the debt as related party debt under the ALDT, this would have a devasting impact on the infrastructure sector and would likely have a significant adverse impact on the costs of all levels of Government to access private sector capital (for example, through Public Private Partnerships (PPPs)) to deliver Australia's critical social and economic infrastructure.

We also consider that the provisions should be drafted such that they cover debt being passed through multiple entities in a chain. For example, a Finance Company passing debt into a stapled structure.

We do not consider our suggestions to be open to abuse as the debt in these structures is legitimately externally sourced, it just happens to pass through an interposed company prior to coming into the accounts of the project vehicle. The most common reason for the use of Finance Companies is to aggregate the external financing requirements of the group in a single entity to achieve a more efficient financing structure.

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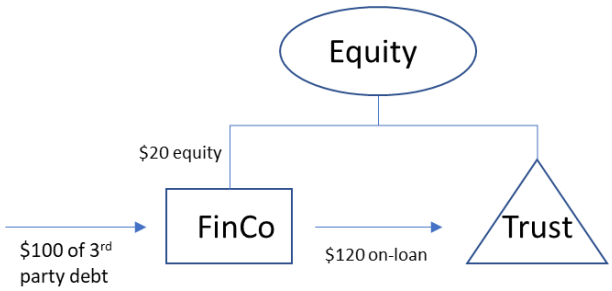
3. Application of the ALDT where there is mixed internal and external funding

We understand that Treasury intends to modify the ALDT such that it will only apply to external third-party debt and not related party debt. While we understand the rationale for this, we believe it is critical that the ALDT should be capable of being applied to entities that are funded by a mix of related party and external third-party debt. We consider that this is consistent with the Federal Government's announcement which states that the intention is to "*retain an arm's length debt test as a substitute test which will apply only to an entity's external (third party) debt, disallowing deductions for related party debt under this test*".

Our strong opinion is that where any entity has a mixture of related party and external third-party debt, the ALDT should be capable of being applied to fully allow a deduction for interest expenses arising from the external third-party debt, while disallowing a deduction for the interest expenses that arise from the related party debt. We do not believe that the mere presence of related party debt should prevent an entity from being able to access the ALDT and apply it to its external third-party debt, as this would produce some significant adverse disparities for entities funded by mixed debt if it were not the case.

Further to our submission in respect of section 2 above, the ability to "look though" interposing entities under common ownership to determine the actual "source" of the debt should also be considered in the context of entities that are funded by a mix of related party and external third-party debt. For example, a common very simple structure (created solely for illustrative purchase) could entail a Finance Company funded by $20 of equity, that sources $100 of debt from an external third-party lender. This Finance Company would then lend $120 to Project Trust on similar terms to the external third-party lender. The Finance Company and the Project Trust would typically be under common ownership.



In the above example, it will be critical for at least $100 of the full $120 amount lent to Project Trust, to meet the definition of external third-party debt under the newly modified ALDT rules. We do not consider that treating the full $120 amount as related party debt reflects the commercial funding arrangement given that $100 has been sourced from unrelated third party lenders by Finance Company. From the third party

lenders' perspective, Project Trust is part of the security net and lenders would assess Project Trust's credit worthiness as part of their condition to lend the $100.

In the PPP context, this structure has previously been referred to as an "Equity securitised licence PPP" by the ATO and distinguished from a "Vanilla securitised licence PPP". In both structures, Finance Company is a special purpose vehicle that has been established to procure project finance for the project and manage the risks associated with this role. It is established to perform this role throughout the concession period. The key difference is that the $20 equity in the "Vanilla securitised licence PPP" is contributed to the Project Trust and not to the Finance Company. By treating the $100 of the on-loan to Project Trust as unrelated arm's length debt, this would produce a consistent outcome between the Vanilla securitised licence PPP structure and the Equity securitised licence PPP structures in the market.

In addition to the above, given that the proposed changes to ALDT, we submit that consideration should be given to simplifying the compliance requirements associated with it. The fact that it will now just apply to external third-party debt in our view means that any integrity measures associated with it from a compliance perspective should be able to be relaxed.

4. Retaining the 90 per cent assets threshold exemption for outward investing entities

We understand Treasury is giving consideration as to whether the 90 per cent assets threshold exemption for outward investing entities (that are not also inward investing entities) set out in section 820-37 of the ITAA 1997 should be retained.

We consider this exemption is critical for taxpayers that are predominately Australian, with only relatively small offshore investments (specifically, less than 10 per cent of total assets values). This exemption allows for the thin capitalisation rules to operate as intended, targeting foreign taxpayers or taxpayers with significant offshore operations to limit their gearing.

If this exemption were to be removed as part of the broader changes to the thin capitalisation rules, this would unduly adversely impact outward investors to apply the thin capitalisation rules with disproportionate outcomes. It is expected that there would be an erosion of the competitiveness of Australian businesses, with an increase in the compliance burden of Australian groups and no additional tax base gained from other jurisdictions.

As the exemption itself is already targeted in nature to only apply to outward investors that are not also inward investors (as a result of a recent law change), and the threshold is sufficiently high at 90 per cent, we consider the removal of such an exemption would be a draconian measure.

5. Introduction of the proposed earnings-based group ratio / removal of worldwide gearing ratio

We understand that a group ratio test will be introduced to mitigate the impact of the 30 per cent EBITDA test for groups that operate in industries where the leverage ratios are higher than that permitted under the 30 per cent EBITDA test.

We understand that the policy intent underpinning the group ratio rule is to provide flexibility for highly leveraged groups (i.e., those with a net third party interest/ EBITDA ratio above the 30 per cent benchmark fixed ratio) to choose to deduct a higher net interest expense than what would be permitted under the fixed ratio rule.

Further to our earlier submissions, groups that operate in the infrastructure sector are typically highly leveraged and therefore would benefit from the group ratio test. We strongly the support the introduction of the group ratio test, but note the following observations:

- The definition of 'group' must be carefully considered. With the different types of entities in Australia and different attendant treatment, including flowthrough entities and corporate tax entities (including public trading trusts), together with a dividend imputation system, the treatment of entities which are not grouped but for which the group holds an interest will need to be carefully considered. We support the OECD position that the prima facie definition of group should be based on accounting concepts; that is, the definition of a group is one that is based on a consolidated group for financial accounting purposes. We submit that such a definition is both simple and workable in the context of worldwide groups.
- As the group ratio will vary year-on-year (as it is computed based on a worldwide group's actual EBITDA and actual group interest expense), the ability to choose the group ratio test in lieu of the 30 per cent to EBITDA test must be available to an entity on a year-by-year basis.
- The choice of using the group ratio or fixed ratio test should not impact on the ability to carry forward denied interest expenses.

- In its consultation paper, *Government election commitments: Multinational tax integrity and enhanced tax transparency* (August 2022), Treasury canvassed the option of providing a 10 per cent uplift to the group's net third party interest expense. The rationale underpinning the 10 per cent uplift is to reduce the risk that all of a group's actual net third party interest expense is not taken into account and reduce the impact of constraints which mean that a group may not be able to precisely align its net interest expense and EBITDA. Under the group ratio rule, the actual interest deductions allowed to the group will likely always be less than the EBITDA of the group multiplied by the ratio. This is because it is highly unlikely that the debt of the group is spread proportionally to the allocation of the EBITDA on a member by member basis.

6. The potential for concessions to be given in relation to restructuring activities undertaken to comply with the new rules

As you will appreciate, many groups have structured their existing debt arrangements to be compliant with the existing thin capitalisation rules. Prior to the new thin capitalisation rules coming into force as of 1 July 2023, we expect that many groups will look to re-structure their debt arrangements to be compliant with the new rules (particularly because we understand based on our conversation on the 8 November 2022 that you are not intending to introduce any transitional rules or grandfathering provisions alongside the new rules).

We would expect that these debt restructuring activities may result in some entities either having their debt capitalised (i.e., converted into equity) or potentially even forgiven. Given that these re-structuring activities will be carried out in response to a change in law we consider that it would be appropriate to include concessions within the rules to not overly punish groups which are just trying to re-structure their debt to comply with the new rules.

One area where consider concessions may be required is in relation the capital injection test in paragraph 707-325(4)(a) of the ITAA 1997. Without concessions in this area any capitalisation of debt required to comply with the new rules may have the unintended consequence of restricting the use any carried forward tax losses where the entity in question sits with a tax consolidated group.

Another area where we consider concessions may be required is relation to application of the Commercial Debt Forgiveness rules (Division 245 of the ITAA 1997). Without concessions in this area any debt which is required to be forgiven to comply with the new rules may have the unintended consequence of reducing the carry forward tax losses, tax written value of depreciating assets or cost bases of CGT assets held by the entity in question.

In addition to the above, concessions could also be considered in relation to the limited debt provisions (Division 243 of the ITA 1997), the direct value shift rules (Division 725 of the ITA 1997) and the distributions to entities connected with a private company riles (Division 7A of the ITA 1936).

Conclusion and further contact

We very much appreciate the opportunity to provide this submission and would be happy to discuss it further should you wish.

Infrastructure Partnerships Australia looks forward to further assisting the Independent Review. If you require additional detail or information please do not hesitate to contact Jamie Harrison, Senior Policy Adviser on 02 9152 6000 or Jamie.harrison@infrastructure.org.au.

Yours sincerely

Adrian Dwyer
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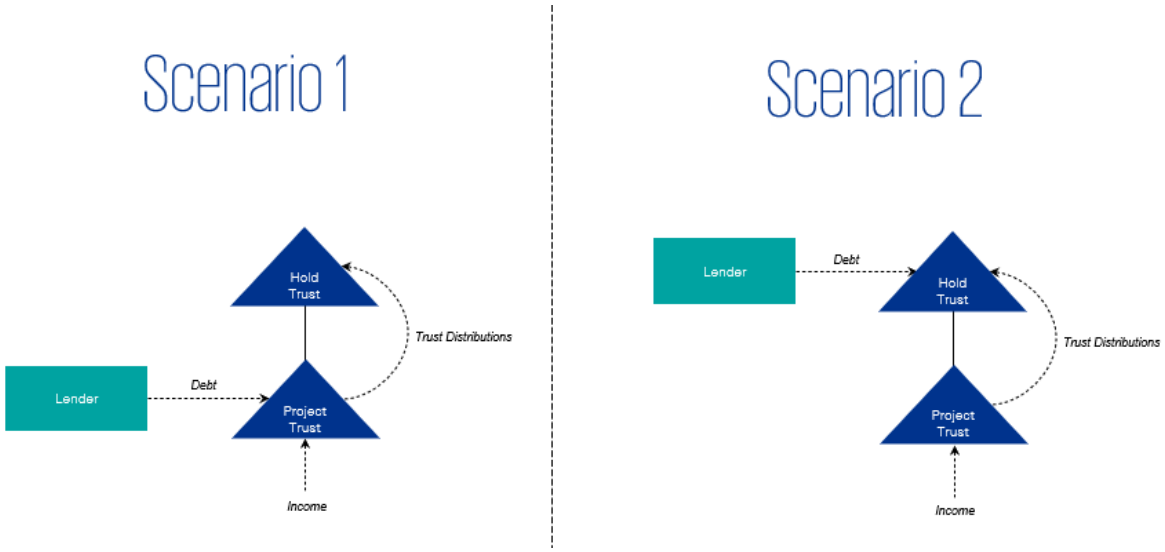
Infrastructure Partnerships Australia

Appendix

Appendix 1 – Comparison of Debt Entering Structure at Different Levels



Under both scenarios we have made the following simple assumptions purely for illustrative purposes:

- Assessable income derived by Project Trust is $1,000,000 per annum and is equal to its tax-EBITDA (i.e. no other expenses in Project Trust beyond interest expenses and depreciation)
- Interest expense arising on the debt is $500,000 per annum
- Tax depreciation on the assets of Project Trust is $200,000 per annum
- All taxable income of the Project Trust is distributed each year to Hold Trust

	Scenario 1	Scenario 2
Assessable Income of Project Trust (Tax EBITDA)	$1,000,000	$1,000,000
Project Trust Deductible Interest Expense	($300,000) *(30% x $1,000,000)*	$0 *(N/A – no interest expense)*
Tax Depreciation in Project Trust	($200,000)	($200,000)
Taxable Income of Project Trust / Assessable Income of Hold Trust	$500,000	$700,000
Hold Trust Deductible Interest Expense	$0 *(N/A – no interest expense)*	($210,000) *(30% x $700,000)*