



13 April 2023

International Tax Unit
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600
Attn: David Hawkins

Via Email: MNETaxintegrity@treasury.gov.au

SUBMISSION TO THE TREASURY ON THE MULTINATIONAL TAX INTEGRITY – STRENGTHENING AUSTRALIA’S INTEREST LIMITATION (THIN CAPITALISATION) RULES EXPOSURE DRAFT

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 30 March 2023 discussing the proposed changes to Australia’s thin capitalisation rules (as announced in the March 2023 Exposure Draft legislation).

Please find a submission attached, developed by Infrastructure Partnerships Australia’s Tax Policy Taskforce.

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 Treasury in this matter. 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
Chief Executive Officer
Infrastructure Partnerships Australia

Attachment

Introduction

- The Tax Policy Taskforce respectfully provides the following submission to the Federal Treasury on the Multinational Tax Integrity – Strengthening Australia’s Interest Limitation (Thin Capitalisation) Rules Exposure Draft:
 - We are supportive of integrity measures to prevent base erosion and profit shifting and welcome the opportunity to provide feedback.
 - Infrastructure investments are generally highly geared (with the debt provided by third party lenders) due to their relatively certain cashflows. Greenfield infrastructure projects can take many years to build and the costs are generally recouped over many decades. There is a large pipeline of privately financed infrastructure in the country, especially in respect of the energy transition (both poles and wires and renewable generation).
 - We have identified a number of issues in the proposed legislation. Unless these issues are addressed we expect that there will be a denial of debt deductions for existing and new projects.
 - This will result in an increased cost to governments or end users of the infrastructure (for example through higher power prices).
 - Given that infrastructure projects are naturally highly geared, we do not believe that this is the intended outcome from the proposed changes.
- We very much appreciate the opportunity to provide this submission and would be happy to discuss it further should you wish.

Issues – External Third-Party Debt Test (ETPDT)

- 1) One in, all in election for 10 per cent associate entities
- 2) Conduit financier and recourse of external third-party lenders – Bank Security
- 3) More than a single conduit financier not permitted
- 4) On-loan has the same terms
- 5) “Recourse” – direct / indirect lender recourse
- 6) External third-party debt conditions (non conduit financier)
- 7) All or nothing approach re ETPDT and debt deductions
- 7A) ETPDT conditions – “wholly to fund” requirement

Issue 1 – One in, all in election for 10 per cent associate entities

Issue:

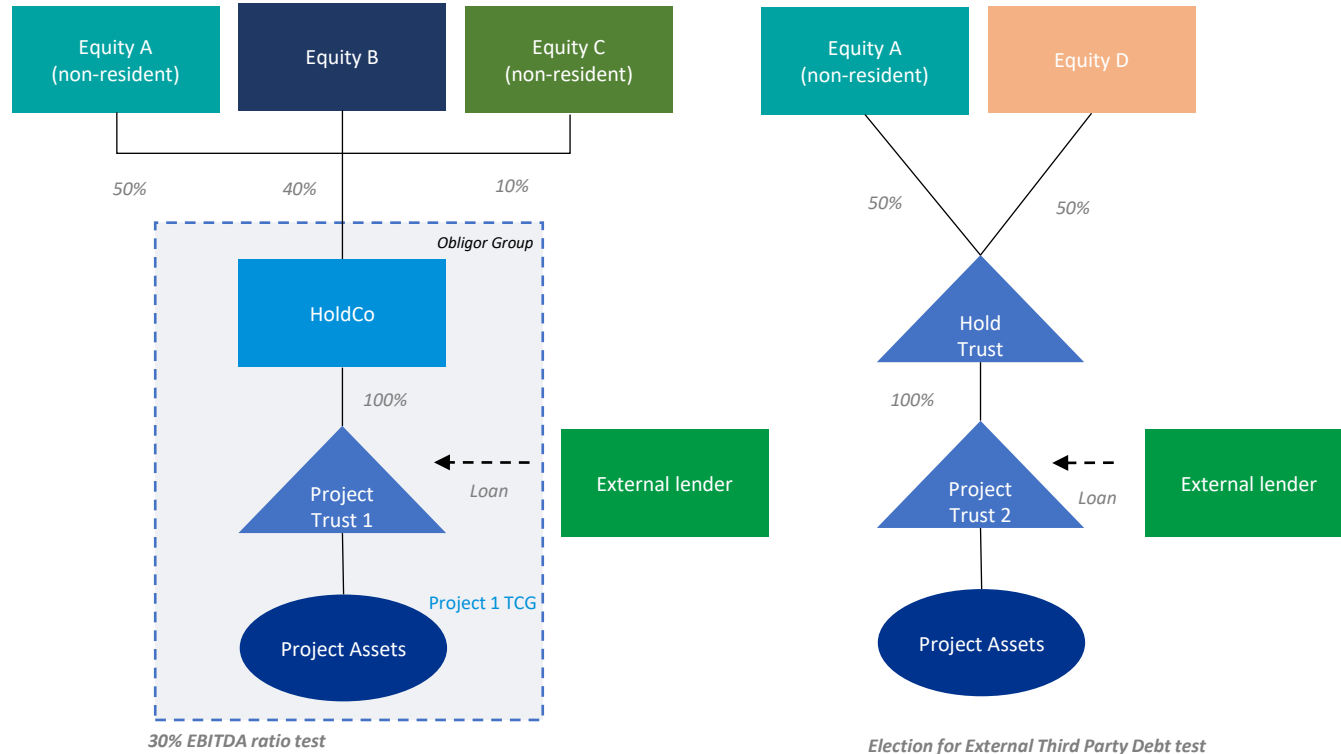
- All general class investors that are associate entities (other than exempt entities) must elect to apply the external third- party debt test (ETPDT) for any single borrower to use the test. The associate entity definition has been modified to include an associate that has a 10 per cent or greater TC control interest. We believe this wide definition means that a taxpayer is likely to have many unrelated associate entities. Furthermore, with such a low threshold there will be practical issues for a taxpayer trying to obtain sufficient information about whether elections have been made, or being in a position to ensure that all associate entities make the election (each year) before lodgement of the relevant tax returns (which could have differing year ends). See Figure 1 which shows an example of how a common investor in two projects makes all investors and entities in each project associate entities.
- Making all 10 per cent associate entities elect the ETPDT will preclude many project entities from being able to claim even \$1 of bank debt interest. This is particularly relevant for greenfield construction projects (for example renewable energy projects or public private partnerships) that have no Earnings before Interest, Taxes, Depreciation and Amortisation (EBITDA) during construction and hence cannot use the Group Ratio or Fixed Ratio tests. Further these entities often cannot use excess Fixed Ratio credits during operations phase when they derive EBITDA ,as the high level of third-party gearing makes this a permanent loss of debt deductions.
- We acknowledge that there are integrity concerns that led to this approach being adopted, but the one in all in approach, effectively denies all external third-party debt deductions to a downstream entity that is a trust or partnership, where the upstream investor doesn't choose ETPDT. This is in contrast to the current thin capitalisation rules that address this integrity issue by denying debt deductions to the upstream investor. See Figure 2 for an example and more detailed explanation.
- We do not believe that increasing the associate entity percentage above 10 per cent, even to 50 per cent, would alleviate our concerns. That is because even at 50 per cent irrelevant associates may have to make an election (see Figure 1 for an example).

Issue 1 – One in, all in election for 10 per cent associate entities (cont.)

Proposed amendment:

- The ‘one in, all in’ rule in 820-43 is removed from the proposed rules.
- An election by an entity to apply the ETPDT for an income year is not valid unless each member of the “Obligor Group” for that external debt/ultimate debt interest that is required to lodge an Australian income tax return for that income year has also made an election for that income year. Obligor Group refers to the group of entities that provides security to senior secured lenders (such as banks, bond or note holders and swap counterparties) in relation to external third-party debt that finances the group’s activities. The security provided will generally include all of the assets of the conduit financier and other members of the Obligor Group, including security over the shares/units in the ultimate borrower entities held by SPV holding entity(s).
- The time for making the election should be by the earlier of the due date for lodgement or actual date of lodgement of the income tax return for the members of the Obligor group. That is, if the due date for lodgement or actual date of lodgement for a member of the Obligor Group is later than others in the group it is that later date by which all members of the Obligor Group must have made the election. This is a practical measure to allow members of the Obligor Group to meet the requirement.
- The rules are consequently amended such that tax EBITDA of an entity (relevant for the Group Ratio Test and Fixed Ratio Test) is reduced to the extent it is attributable to any direct or indirect taxable distribution received from a member of the Obligor Group that is a trust or partnership and that has made an ETPDT election. This should mitigate integrity concerns about associate entities making different choices that result in double gearing benefits for the upstream investor. Taking into account tax attributes flowing from downstream investors is already a feature of the current thin capitalisation rules and similar to the tracing approach of NCMi required for managed investment trusts.

Figure 1: Thin cap -10 per cent associates



In order for Project Trust 2 to elect to use the ETPDT, all 10 per cent associate entities must also elect to use this test. This would include:

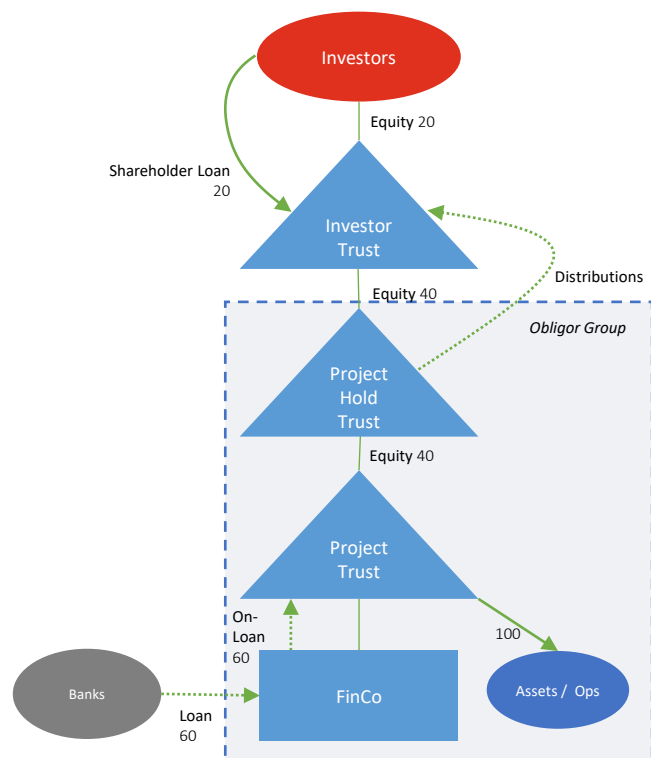
- Equity A
- Equity B
- Equity C (if an associate)
- Equity D
- Hold Trust, and
- Project 1 tax consolidated group (TCG).

Plus: Any other 10 per cent associate entity of the above entities.

If any single one of the above entities does not make the election then none can.

Please note that even if the associate entity threshold was set at 50 per cent, then this would reduce the associate entities (i.e. Equity B and C) may cease being associate entities but this would not otherwise solve the issues with irrelevant associate entities in different projects.

Figure 2: ETPDT Elections



- Under the current thin capitalisation rules, Investor Trust would not be able to claim deductions for interest on the Shareholder Loan under the Safe Harbour rule. This is because the debt of its associate entity Project Trust would mean that Investor Trust did not effectively satisfy the Safe Harbour Test. This is the current way to effectively eliminate "double gearing" deductions.
- Under the Exposure Draft rules, Investor Trust would also have to make the ETPDT election for FinCo/Project Trust to use the conduit financier rule and hence for Project Trust to be able to claim debt deductions. This would mean Investor Trust would not be able to claim any debt deductions on the Shareholder Loan as it is not an external third party debt. If Investor Trust or any other associate entity did use the Fixed Ratio Test, then Project Trust would instead be denied all debt deductions. This is effectively punishing the downstream entity for the actions of the upstream entity and unlike the present thin capitalisation approach of denying deductions to the upstream entity (which is the level at which any potential "double gearing" may occur).
- Under the amendment suggested above to Issue 1, all of Project Trust, Project Hold Trust and FinCo would be required to make the ETPDT election in order for the election by Project Trust and FinCo to be valid. Therefore Investor Trust would not be able to claim any debt deductions under either the Group Ratio Test or the Fixed Ratio Test (ignoring unrelated income), because its tax EBITDA would not include any amount from the distributions it receives from Project Hold Trust or indirectly from Project Trust. Therefore, even though Investor Trust is permitted to make the Group Ratio Test election or use the Fixed Ratio Test it would not be able to claim any debt deductions on the Shareholder Loan.

Issue 2 – Conduit financier and recourse of external third-party lenders – Bank Security

Issue:

The conduit financier rules as drafted will be likely difficult to satisfy (820-61(5)). The rules provide that the ultimate lender (the third party) can only have recourse for payment of the ultimate debt interest (the loan) against (one) the assets of the ultimate borrower(s), and (two) each asset of the conduit financier that is a relevant debt interest (the on-loan to the ultimate borrower(s)).

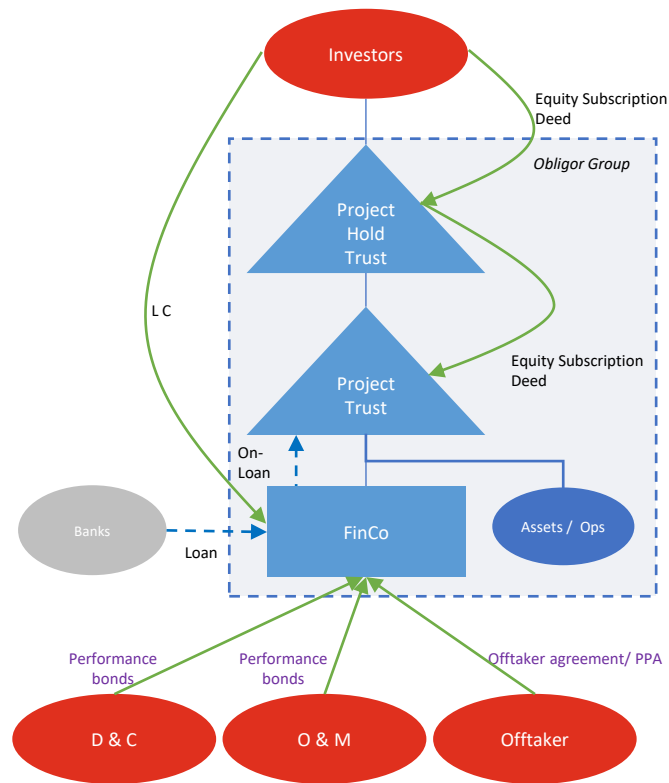
- In most conventional project finance settings, these strict requirements cannot be satisfied. Third-party financiers will generally take broad security over the Obligor Group. Please note that the expression Obligor Group is used throughout this submission to refer to the group that provides security to senior secured lenders. The third-party lenders may include more than banks, for example, bond or note holders and swap counterparties. This will include security over all assets of the conduit financier and other members of the Obligor Group including security over the shares/units in the ultimate borrower entities held by SPV holding entity(s). These issues are demonstrated in far more detail in Figures 3 and 4.
- The current arms length debt test (ALDT) provides for the calculation of a quantum of arms length debt by testing factors that disregard credit support provided by associates. This was an effective integrity rule to prevent inflated debt levels based upon recourse of financiers to non project assets such as parent guarantees, but allowed borrowers to claim debt deductions based on a lower level of debt. Disallowing all debt deductions under the new rules is not commercial.

Issue 2 – Conduit financier and recourse of external third-party lenders – Bank Security (cont.)

Proposed amendment:

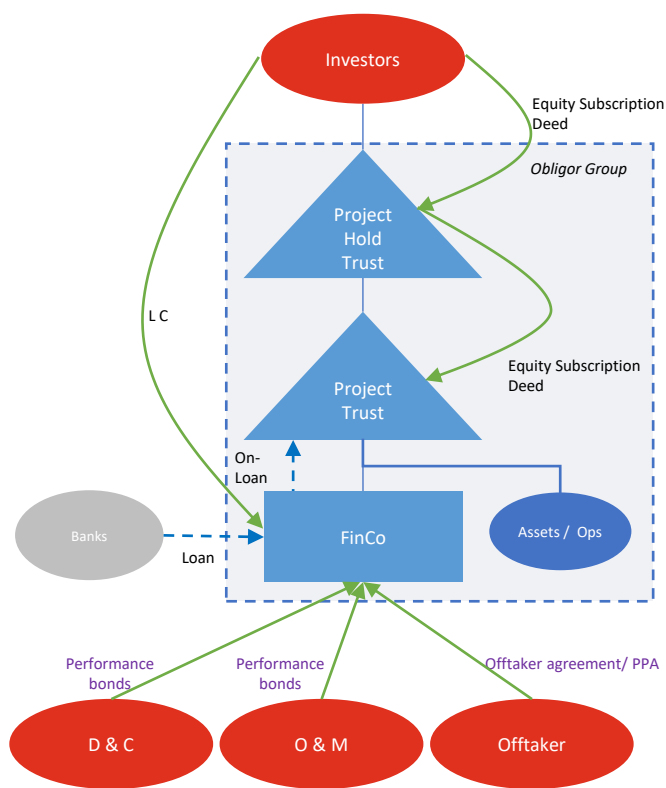
- We believe that it would be beneficial if section 820-61(5) is expanded to permit an external third-party lender providing project finance to a conduit entity (FinCo) to have recourse to the assets of FinCo, all borrowers from FinCo, but also to include all the assets of obligors in an Obligor Group. Consistent with our submission on Issue 1, every entity in the Obligor Group is required to make the ETPDT election and therefore would not be able to make a Group Ratio Election or use the Fixed Ratio rule in order to apply this approach. This ensures integrity and importantly aligns with the commercial reality and the basis upon which the external third party lender has made the decision to lend.

Figure 3: Greenfield Renewable Project Example



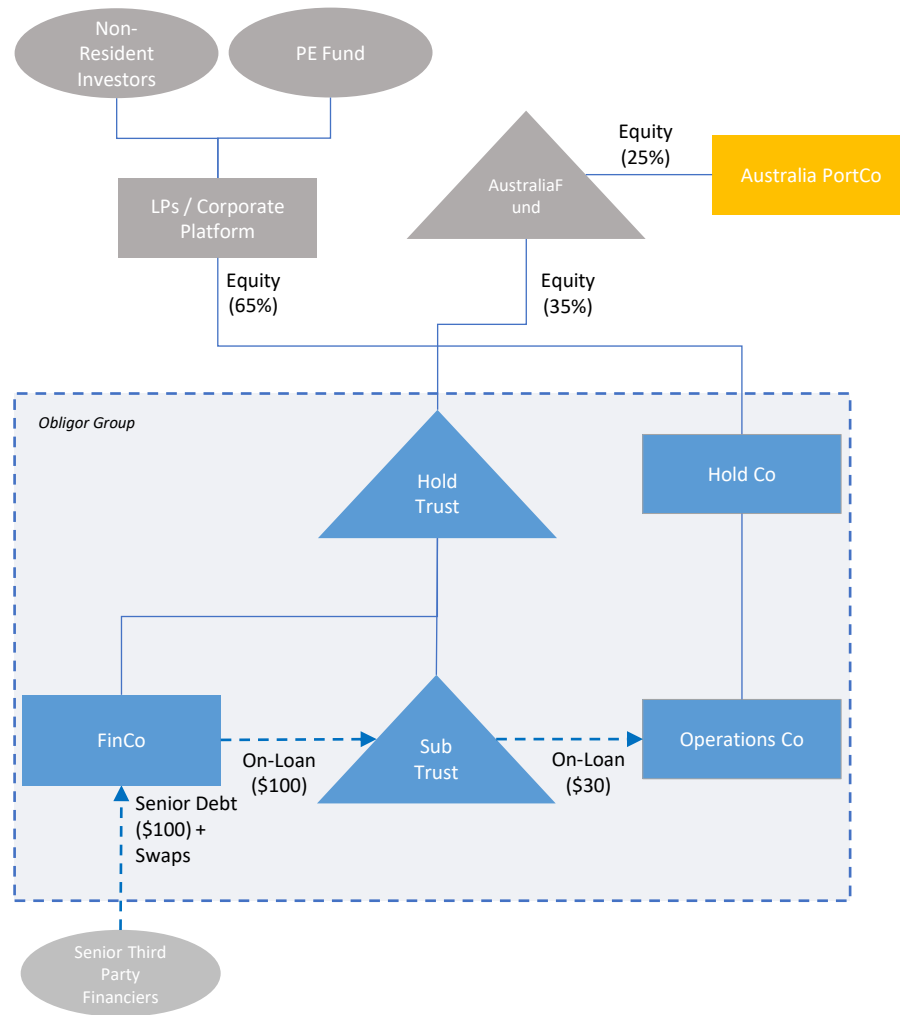
1. The example below is a typical special purpose project financing structure for a single stand-alone renewable energy project. There are no assets of any project entities other than project assets, all located in Australia.
2. Banks enter into a loan facility (Loan) with FinCo pursuant to which banks will lend 60 per cent of the total project funds to FinCo. This will be progressively drawn down over the construction period. Banks will also enter into interest rate swap agreements with FinCo to manage interest rate risk.
3. FinCo enters into an On-Loan on back-to-back terms to provide the borrowed funds to Project Trust. FinCo also enters into a back-to-back interest rate swap agreement to match the terms of the bank swaps.

Figure 3: Greenfield Renewable Project Example (cont.)



4. Investors, D & C Contractors, O & M providers and offtakers may enter into commitments regarding the performance of their respective obligations in delivering, operating, purchasing outputs and equity funding in respect of the project. In this regard:
 - D & C Contractors may issue performance bonds to Project Trust in support of their obligation to design and construct the project.
 - O & M Contractors may issue performance bonds in support of their obligation to operate and maintain the project.
 - An Offtaker may enter into a power purchase agreement (PPA) in respect of purchasing the electricity generated by the project.
 - Investors may enter into an Equity Subscription Deed with Project Hold Trust to provide the equity funding of 40 per cent. Equity will be drawn down progressively during the construction period. Project Hold Trust has, in turn, entered into an Equity Subscription Deed with Project Trust to provide equity funding.
 - Investors may procure LC Banks to provide a letter of credit to FinCo/banks that can be drawn down in the event that Investors/Project Hold Trust fail to meet their obligations under the Equity Subscription Deeds.
5. Investors have procured LC Banks to provide a letter of credit to FinCo/banks that can be drawn down in the event that Investors/Project Hold Trust fail to meet their obligations under the Equity Subscription Deeds.
6. Project Hold Trust and Project Trust are obligors in respect of the performance by FinCo under the banking documents. The security trustee for the Banks will have the benefit of security over FinCo's assets, Project Trust's assets, security over the assets of Project Hold Trust including a mortgage over the units in Project Trust and its trustee, and a mortgage over the shares in FinCo.

Figure 4: External Third Party Debt Test



Issues

- Senior Third Party Financiers have security over all of the assets of FinCo, Sub Trust, Hold Trust, Operations Co and Hold Co. This does not appear to be permissible as 820-61(5) plus 820-61(2) (as modified by 820-61(4)) only allows security over the Sub Trust/Operations Co and the asset FinCo holds in relation to the debt interest (being the On-Loan of \$100). As such, there cannot be any security over Hold Trust, Hold Co and all of the assets of FinCo.
- The terms of the On-Loan of \$100 may have incorporated a blended rate/an indemnity payment in addition to interest on the loan such that Sub Trust makes FinCo whole for any FinCo exposure on FinCo's Swaps with the Senior Third Party Financiers. This does not appear to be permissible as 820-61(5)(e) states that the terms must be the same (other than terms as to the amount of the debt).
- Using the proceeds of the Senior Debt of \$100, FinCo has on-lent the \$100 through the On-Loan to Sub Trust. Sub Trust has then on-lent \$30 of that \$100 through a separate On-Loan to Operations Co. This does not appear allowable as 820-61(5)(a-c) contemplates that the ultimate borrower (i.e. Sub Trust) must issue a debt interest to a conduit financier (i.e. FinCo). That is, there cannot be a second 'conduit' (like Sub Trust).
- Disregarding the issues identified above, even if FinCo, Sub Trust and Operations Co could apply the ETPDT, Australia Fund would also have to make an election to apply the ETPDT (by virtue of 820-43(4-5)). In addition, if Australia Fund is to make an election to apply the ETPDT, it is likely that Australia PortCo will also be required to apply the ETPDT. If Australia PortCo has related party debt that is within its FRT or GRT, then despite it being allowable under those tests, it is still subject to a denial given that it has to elect to apply the ETPDT.

Issue 3 – More than a single conduit financier not permitted

Issue:

- No more than a single conduit financier is permitted by the rules. The rules require that a single conduit financier loans money to one or more borrowers. A FinCo may, alternatively, use the proceeds it raises from third party lenders to on-lend all the borrowed funds to Sub Trust. The Sub Trust may then on-lend a portion of those funds through a separate on-loan to an Operations Co. (See Figure 4 for an example).
- This is not permitted by s.820-61(5), which contemplates that the ultimate borrower must issue a debt interest to a conduit financier (i.e. FinCo). That is, there cannot be a second conduit like Project Trust.
- There does not appear to be any tax benefit that is obtained by having two or more conduit financiers lending funds on back-to-back terms to ultimate borrowers within the Obligor Group rather than FinCo lending directly to separate borrowers. There are many existing arrangements, particularly within stapled groups, where the 'single conduit financier' approach prescribed by the rules has not been followed.

Proposed amendment:

- We respectfully submit that the rules could be amended to permit multiple conduit financiers in a project finance context. We submit that the following requirements should be sufficient to address any integrity concerns:
 - Multiple conduits are only permitted where each on-loan loan meet the "same terms" test (modified per issue 4).
 - Multiple conduits must be members of the same Obligor Group
 - Consistent with our recommended amendment for Issue 1, all conduit financiers, borrowers in the Obligor Group would have to elect into the ETPDT.

Issue 4 – On-loan has the same terms

Issue:

- For on-lending through a conduit financier, (e.g. a group FinCo), the rule is only satisfied if the terms of the on-lent debt are “the same” as the terms of the ultimate debt, other than the value of the principal. This is difficult to apply as terms of on-lent debt may often incorporate other financing costs (including swap costs and borrowing costs) as noted in Figure 4. The terms of a bank facility agreement may be much more complicated than the drafting of a more vanilla on-loan agreement.
- The on-loans will also by necessity be unsecured or at least subordinated to the ultimate debt.
- Noting that the on-loans are all made to members of the same Obligor Group, we believe that the key tax integrity issue is the pricing of the debt, which needs to be the same as the interest paid to third-party lenders after adjusting for on-charges such as swap costs and borrowing costs and fees. Other terms should be substantially the same but acknowledging that the key focus is on the debt pricing.

Proposed amendment:

- We respectfully submit that the pricing of an on-loan needs to be the same pricing in terms of the third-party debt interest, but allowing adjustments for the on-charging of other expenses such as swap costs and borrowing costs relating to the debt. The balance of the terms excluding the amount of principal should be on substantially the same terms taking into account the circumstances of the on-loan (e.g. generally on-loan agreements are much more simplified documents than debt arrangements with external third-party financiers).

Issue 5 – “Recourse” – direct / indirect lender recourse (Equity Commitments, LCs, Construction Bonds)

Issue:

- As demonstrated above in Figure 3, external third-party lenders will have direct or indirect recourse to project assets / contractual rights that may extend beyond the security provided by obligors in the Obligor Group. For the reasons outlined below, it is submitted that any indirect recourse provided to external lenders/ultimate lenders should be disregarded when applying the ETPDT. Therefore, it should only be direct recourse provided by entities outside the Obligor Group that may breach the requirements in section 820-61(2)(c) or section 820-61(5)(g) respectively.
- A practical dividing line between an arrangement that constitutes indirect recourse (that should be disregarded) and an arrangement that constitutes direct recourse (that should be taken into account) should turn on the purpose of the arrangement which is intended to serve in the context of the project or business being financed by the external third party debt. In this regard:
 - A direct recourse arrangement is one that directly relates to the repayment of the lender/ultimate lender in the event of a default under the terms of the debt interest/ultimate debt interest. This would include the provision of guarantees by entities and security over assets that only relate to facilitating repayment of the debt interest/ultimate debt interest in the event of a default under the terms of debt interest.
 - An indirect recourse arrangement is one that instead relates to the performance of an obligation related to the carrying on of a project or business (notwithstanding that a failure to perform the obligation may indirectly result in an event of default under the debt interest/ultimate debt interest). This would include arrangements such as D & C Contractor performance bonds, O&M Contractor performance bonds, offtaker agreements and deferred equity commitments by Investors supported by letters of credit. In a project finance context, these arrangements are entered into in respect of delivery, operation, sale of outputs and equity funding of the project or business.

Issue 5 – “Recourse” – direct / indirect lender recourse (Equity Commitments, LCs, Construction Bonds) (cont.)

Issue:

- We respectfully submit that the distinction drawn above between direct and indirect recourse has a parallel in the existing ALDT regarding the proper interpretation of the term “any guarantee, security or other form of credit support”. A literal interpretation of the term credit support may potentially include the arrangements considered as indirect recourse outlined above. In considering whether such arrangements may constitute credit support under the current ALDT, the Commissioner states at paragraph 69 of PCG 2020/7:

69. The existence of a commercial arrangement undertaken at arm's length between the notional Australian business and an associate should not necessarily be taken to indicate the existence of credit support. This will turn on the precise facts but an example that is considered unlikely to constitute credit support is an offtake agreement for the sale of a commodity. In contrast, an arrangement entered into for the purpose of facilitating lending from a third-party lender, such as a commitment to deferred equity by a shareholder, is likely to have a sufficient nexus to the provision of financing to constitute credit support.

- In making these comments, the Commissioner was necessarily constrained by the fact that ‘credit support’ in the ALDT legislation has, based on its ordinary meaning, an extremely wide scope and could refer to anything to which supports (directly or indirectly) the lending decision of the external lender.
- The issue of what constitutes credit support under the existing arms length test has been a source of considerable uncertainty in the application of the ALDT. It is submitted that the replacement of the ALDT with the ETPDT provides a much needed opportunity to remove this uncertainty and ensure that it is not replicated in the new regime.

Issue 5 – “Recourse” – direct / indirect lender recourse (Equity Commitments, LCs, Construction Bonds) (cont.)

Proposed amendment:

- We respectfully submit that in determining whether the holder of the debt interest has recourse for payment of the debt only to assets of the entity for the purposes of section 820-61(2)(c) and its equivalent in section 820-61(5)(g) in respect of a conduit finance arrangement, any indirect recourse should be disregarded.
- To give effect to this, the following drafting could be included at new section 820-61(2A) and section 820-61(5A):

Section 820-61(2A)

- For the purposes of paragraph (2)(c), disregard recourse to any commercial arrangement entered into by the entity on arms length terms (whether or not with an associate entity of the entity) unless the sole purpose of that arrangement is to facilitate the repayment of the debt interest in an event of default occurring under the terms of that debt interest.

Note: Examples of recourse that may be disregarded for these purposes include recourse to performance bonds, offtake agreements, equity subscription rights, letters of credit supporting equity subscription rights or other project-related contractual rights. This on the basis that these arrangements are intended to secure the performance of obligations related to the carrying on of a project or business rather than solely the repayment of the debt interest.

Section 820-61(5A)

- For the purposes of paragraph (5)(g), disregard recourse to any commercial arrangement entered into by an entity (within the Obligor Group) on arms length terms (whether or not with an associate entity of the entity) unless the sole purpose of that arrangement is to facilitate the repayment of the ultimate debt interest in an event of default under the terms of that debt interest.

Note: Refer to the note provided for section 820-61(2A) for examples of recourse that may be disregarded for these purposes.

Issue 6 – External third-party debt conditions (non-conduit financier)

Issue:

- To meet the external third-party debt conditions, the holder of a debt interest can only have recourse to assets of the borrower. We have highlighted the issues with the conduit financier rule because infrastructure vehicles are typically structured as one or more unit trusts that borrow via a special-purpose FinCo. Importantly, all of the above issues are also relevant to a direct borrower (company, unit trust or partnership) who borrows from a non-associate.

Proposed amendment:

- We respectfully request that the amendments proposed in respect of issues 1, 2 and 5 above, apply equally to a direct borrower needing to satisfy the external third-party debt conditions. Those recommendations in summary include:
 1. amendments be made to the all or nothing election rule such that tax EBITDA of an associate entity is reduced for distributions received directly or indirectly from a trust or partnership entity that has made an ETPDT election
 2. extension of assets of the borrower to include assets of obligors of the Obligor Group, and
 3. indirect recourse be allowed for LCs / Equity Contribution Deeds and other third party contractual rights.

Issue 7 – All or nothing approach re ETPDT and debt deductions

Issue:

- The rules are currently drafted such that all debt deductions are denied if the external third-party debt conditions are not wholly satisfied (e.g. if the lender has recourse to \$1 of assets outside the borrower or \$1 of assets in a foreign jurisdiction), creating a 'cliff face' approach so that all debt deductions are denied if the external third party debt conditions are not wholly satisfied.
- The current ALDT provides for the calculation of a quantum of arms length debt by disregarding credit support provided by associates. This was an effective integrity rule to prevent inflated debt levels based upon recourse of financiers to non project assets such as parent guarantees. We acknowledge a level of administration was created by the ALDT rules and that the new rules are trying to create a much simpler bright line test. We have previously discussed this in Issue 5 concerning the issues around LCs, Equity Contribution Deeds, construction bonds, etc.

Proposed amendment:

- We respectfully propose that an alternate way of addressing this 'cliff face' denial of debt deductions is for the rule to provide for a Commissioner's discretion to permit all, or part, of the debt deductions to be allowed where the requirements have been substantially met. Criteria could be set against this to determine the exercise of that discretion and allow taxpayers an effective avenue of appeal if there is disagreement with the level of debt deductions omitted.
- In the event the above proposal is not accepted, the rules could instead allow for the election to use the ETPDT to be revoked such that the group ratio test or fixed ratio test could be used.

Issue 7A – ETPDT conditions – “wholly to fund” requirement

Issue:

- The *external third party debt conditions* can only be satisfied by debt issuances where the proceeds from the debt issuance are used **wholly** to fund certain investments (in particular, assets that the entity holds for the purposes of producing assessable income or assets that are attributable to an entity’s permanent establishments) - paragraph 820-61(2)(d).
- This may preclude an entity from satisfying the external third party debt conditions where some or all of the proceeds from the debt issuance is used to:
 - Re-gear an asset (i.e. where the proceeds replace equity). For example, for an infrastructure asset in a greenfield stage, the shareholders may choose to fund the construction of the assets by way of equity which may subsequently be replaced with bank debt upon the asset becoming income producing;
 - To fund the payment of expenses (for example, Bank Fees) or liabilities; or
 - To fund non-income producing assets. Infrastructure projects typically involve the construction of both income producing assets and non-income producing assets, such as community infrastructure associated with the project. For example, a toll-road project may involve the construction of a toll road (which is income producing) and an associated bus lane (which is not income producing).

Proposed amendment:

- We respectfully submit that given that a debt deduction would be required to satisfy ordinary principles (s 8-1 / s 230-15) in addition to thin capitalisation, it appears unclear what this condition seeks to achieve.
- If the integrity concern is to ensure that funds are not used offshore, we propose that section 820-61(2)(d) can be drafted in the negative – i.e., the entity does not use the proceeds to fund, to any extent, its non-Australian operations or to derive non-assessable non-exempt income.

Issues – Group Ratio Test

- 8) Interest expenses in the construction phase are typically capitalised for accounting purposes
- 9) Use of accounting EBITDA in Group Ratio Test is unclear and may give rise to unexpected outcomes
- 10) Definition of GR Group will not apply to entities that apply the investment exemption from consolidation

Issue 8 – Interest expenses in the construction phase are typically capitalised for accounting purposes

Issue:

- Interest expenses incurred in relation to the construction phase of a project are typically capitalised for accounting purposes such that no interest expense will be shown in the profit & loss account of the audited financial statements of the worldwide parent entity.
- Given that the numerator of the “group ratio” is calculated by reference to the “financial statement net third party interest expense” this will result in no debt deduction capacity being generated under the group ratio rule despite the fact that genuine third party debt payments are being made.
- The cause of this is the difference in the accounting and tax treatment of interest expenses incurred in relation to the construction phase of the asset. For accounting purposes the debt is capitalised and depreciated over the life of the asset but for tax purposes it is treated as immediately deductible.

Proposed amendment:

- We respectfully request that the “financial statement net third party interest expense” definition is adjusted to allow an upward adjustment in relation to interest expenses that have been capitalised for accounting purposes. If this amendment is adopted, a corresponding downward adjustment will also be required to remove interest expenses unwinding over the life of the asset to avoid double counting.

Issue 9 – Use of accounting EBITDA in Group Ratio Test is unclear and may give rise to unexpected outcomes

Issue:

- The denominator of the “group ratio” is calculated by reference to “GR group EBITDA” which is the group’s accounting “net profit” after adjusting for net third party interest expenses, depreciation and amortisation. Adjustments are also made to remove entities which have a negative “entity EBITDA” which is an entities net profit after similar adjustments.
- The use of accounting net profits means that movements in unrealised valuations will be captured which may give some odd or unexpected outcomes which are very difficult to model or predict. For example, upward asset revaluations would result in a lower group ratio figure and downward asset revaluations would result in a greater group ratio figure.
- The requirement to remove entities which have negative entity EBITDA when calculating the “group ratio” is also quite unclear as currently drafted. Specifically, how is the “entity EBITDA” calculated if that entity has income and expenses which are received or paid to other members of the GR Group? Is the adjustment equal to the entity’s negative EBITDA on a stand-alone basis or its negative contribution to the group EBITDA after consolidation adjustments?
- It also appears unclear what is being disregarded, whether it is:
 - that entities’ contribution to net profit, adjusted third party interest expense and depreciation and amortisation; or
 - a manual removal of EBITDA from the sum of the GR Group EBITDA.
- It also appears unclear what integrity concern is driving the need for this adjustment. Given that there is a requirement for the financial statements to be audited we would not expect it to be possible to manipulate the group EBITDA.

Issue 9 – Use of accounting EBITDA in Group Ratio Test is unclear and may give rise to unexpected outcomes (cont.)

Proposed amendment:

- We respectfully submit that:
 - the “GR group EBITDA” and “entity EBITDA” definitions are amended to remove unrealised valuation movements.
 - The Rules clarify if “entity EBITDA” is calculated on a stand-alone basis or after consolidation adjustments. You may wish to consider removing this adjustment to simplify the calculation, which currently may present challenges in practical application.

Issue 10 – Definition of GR Group will not apply to entities that apply the investment exemption from consolidation

Issue:

- The Group Ratio Test requires an entity to be in a “GR Group” which consists of a worldwide parent entity and each other entity that is fully consolidated on a line-by-line basis in its audited financial statements.
- Many investors do not consolidate externally managed fund investments in their financial statements even where they have a controlling interest in them (due to the investment exemption from consolidation).
- Example entities that commonly apply the investment exemption from consolidation include pension funds and sovereign wealth funds (amongst others).
- As currently drafted the rules do not allow for these investors to elect to use the Group Ratio Test.

Proposed amendment:

- We respectfully submit that the “worldwide parent entity” definition could be amended to be an entity that is not controlled by another entity that consolidates the results of the entity into its financial statements on a line-by-line basis.

Issues – Fixed Ratio Test

- 11) No replacement for “associate entity excess” rules
- 12) Decline in value addback only applies to s.40-B
- 12a) Notional loan and non financial debt arrangements

Issue 11 – No replacement for “associate entity excess” rules

Issue:

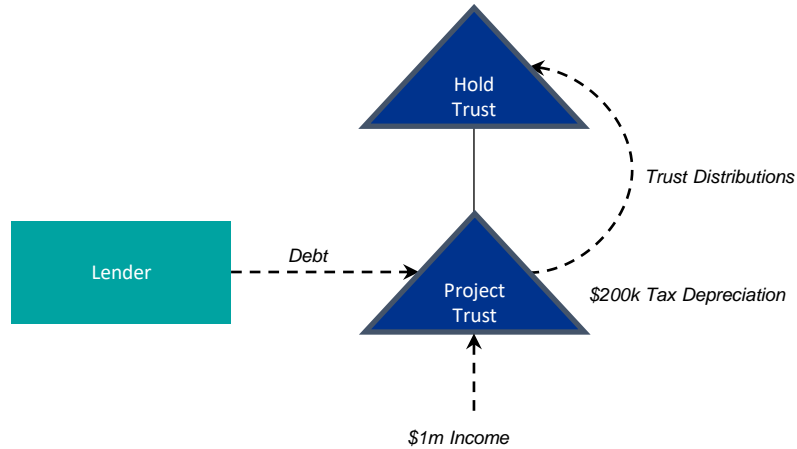
- Unlike the current safe harbour thin capitalisation provisions, the calculation of the “fixed ratio earnings limit” does not include any excess thin capitalisation capacity from an underlying subsidiary.
- This means that the limit for deductibility of debt deductions at a holding trust level may be significantly less than if the borrowings were in an asset owning trust (because its tax EBITDA will reflect 30 per cent of assessable net income after taking account of tax depreciation and capital allowances).
- Given that it is common for investors to borrow at a holding trust and secure this debt against assets held by subsidiary unit trusts, this could materially impact the net debt deductions available under the fixed ratio test where investors have this structure.
- Figure 5 shows 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. In this example, the disparity seems like a perverse outcome given that the economic effect of the two structures is identical.

Proposed amendment:

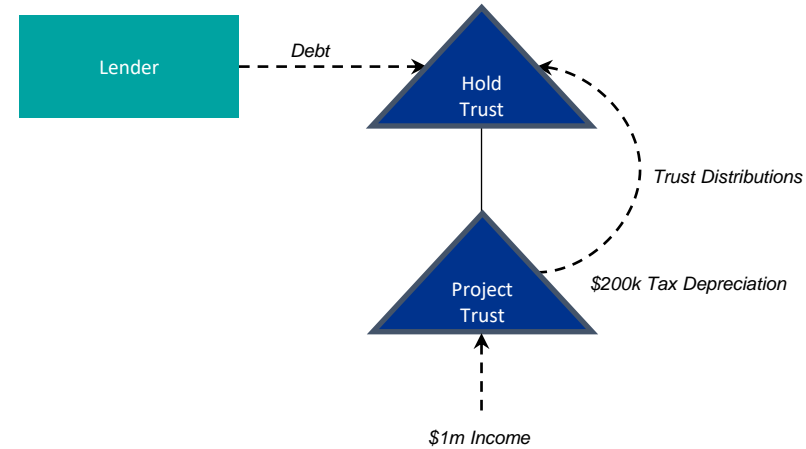
- We respectfully submit that the Rules incorporate some form of replacement for the “associate entity excess” rules for structures that cannot consolidate (i.e. trusts). This could be as simple as allowing the taxable income element of trust distributions to be broken down to show depreciation and amortisation amounts which can then be added back when calculating the Tax EBITDA of the holding entity.

Figure 5: No associate entity excess rules

Scenario 1



Scenario 2



	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	\$800,000
Hold Trust Deductible Interest Expense	\$0 (N/A – no interest expense)	(\$240,000) (30% x \$800,000)

Issue 12 – Decline in value addback only applies to s.40-B

Issue:

- Given the reason for adopting an earnings limit approach is that it is a proxy for debt serviceability, it is unclear why only specific depreciation/amortisation amounts are adjusted for when calculating tax EBITDA.
- For example, as currently drafted, items such as balancing adjustments as well as project pool and blackhole amortisation do not seem to be added back when calculating tax EBITDA.
- Given that these amounts do not have cash payments associated with them in the year they are amortised, it appears odd to not add them back because they should not impact debt serviceability.
- There are also unexpected mismatches in the rules which will add significant and unnecessary complexity which taxpayers will need to navigate. For example, in Subdivision 40-E, low-value pools are depreciated under Subdivision 40-B, so would be included in the addback, whereas software development pools are deducted under Subdivision 40-E, so would not be included in the addback.

Proposed amendment:

- We respectfully submit that all Division 40 deductions are added back in the calculation of tax EBITDA computation.

Issue 12a – Notional loan and non financial debt arrangements

Issue:

- The Exposure Draft does not appear to give consideration to the treatment of arrangements that are subject to notional loan treatment under Division 250/ Division 240 or are otherwise treated as non debt financial arrangements and other arrangements that are recognised on a profit emerging basis.
- For example, payments received in respect of the tax preferred use of that asset that is subject to an application of Division 250 are bifurcated into deemed payments of notional interest and repayments of notional loan principal calculated in accordance with section 250-255.
- However, the notional interest is not taken into account in the calculation of net interest deductions that are tested against the Fixed Ratio. Therefore, an entity that finances an asset that is subject to Division 250 will have net interest deductions equal to the gross interest deductions arising on that financing.
- Equally, the effective amortisation of the asset represented by payments taken to be the receipt of notional repayments of the notional loan principal are not added back to taxable income under the ITDA of the calculation. This is notwithstanding that the effective amortisation of the asset is economically and in-substance equivalent to non cash depreciation/amortisation arising under Division 40 and Division 43 for depreciating assets and capital works that are not subject to Division 250.
- This results in an anomalous and adverse tax outcome for a taxpayer attempting to finance assets affected by an application of Division 250 with deductible gearing. Similar concerns apply to hire purchase arrangements that are subject to Division 240 and other non debt arrangements where not all payments received are included in the assessable income of the entity as a result of a notional non cash amortisation deduction that is not added back under the ITDA part of the Fixed Ratio test.

Issue 12a – Notional loan and non financial debt arrangements (cont.)

Proposed amendment:

- We respectfully submit that the above arrangements should be accommodated in the Fixed Ratio test so that either:
 - The notional interest deemed to arise under the notional loan arrangement/or profit emerged is deemed to be interest for the purposes of calculating the net interest deductions; or
 - The notional amortisation of the asset deemed to be repayments of notional loan principal is added back to taxable income under the ITDA part of the Fixed Ratio calculation.

Other issues

- 13) Definition of 'debt deductions'
- 14) Interaction of transfer pricing rules with thin capitalisation rules
- 15) Repeal of s.25-90 and associated amendments
- 16) Transitional rules – including for Part IVA
- 17) Infrastructure carve out

Issue 13 – Definition of ‘debt deductions’

Issue:

- The Exposure Draft Legislation proposes the insertion of a broader concept of ‘debt deduction’ covering a ‘scheme giving rise to a debt interest’. As defined, this concept is potentially significantly wide and may give rise to considerable uncertainty in terms of practical application.
- The Draft Explanatory Memorandum suggests that the intention of the proposed amendment is to capture amounts ‘economically equivalent to interest’, in line with the OECD Best Practice Guidance. Similarly, the concept of amounts ‘economically equivalent to interest’ is unclear/uncertain. For example, would this include interest rate swaps and if so, would swaps and on-charges be netted in the debt deduction calculation?

Proposed amendment:

- We recommend that additional clarity be provided as to the practical application of the broader concept of ‘debt deduction’ and amounts ‘economically equivalent to interest’, including by for example, specific excluding amounts which represent a return on an equity interest as provided (for example) in s.128A(1AB) of the 1936 Tax Act.

Issue 14 – Interaction of Transfer Pricing Rules with Thin Capitalisation Rules

Issue:

- s.815-140 contains a special rule which modifies the way an entity works out its taxable income or loss and the way the Thin Capitalisation Rules apply effecting debt deductions for the entity for a particular income tax year. Effectively taxpayers are directed to apply Sub division 815-B prior to applying Division 820 in determining the appropriate, amongst other things, debt deductions available to the taxpayer.
- Pursuant to the proposed amendments and as supported by the Draft Explanatory Memorandum, it would appear that the proposed amendments to section 815-140 would now apply the arm's length conditions in relation to the quantum of the debt interest under the Transfer Pricing Rules, i.e. in determining the arm's length rate of interest, regard should be given to the amount of debt that might reasonably be expected to be made available between independent parties acting on arm's length terms.
- Importantly, we note that it is not a requirement for entities to be associated or related in order for the cross-border test or the Transfer Pricing Rules to apply – refer s.815-120. Accordingly, under the proposed amendments, it would appear that the practical application of the proposed amendments is ambiguous and/or uncertain and could result in external third party cross-border debt being subject to the additional transfer pricing, economic analysis and related documentation requirements under the Transfer Pricing Rules (ie. separate to the thin capitalisation requirements).
- In addition to the prescribed documentation requirements in the Transfer Pricing Rules, legitimate external third party cross-border debt and relevant taxpayers would be exposed to the more severe penalties (reasonably arguable position/documentation) under the Transfer Pricing Regime – as well as duplication of analysis.

Proposed amendment:

- Given the extensive additional documentation/broader compliance requirements, duplication and unfair penalty exposure, we respectfully request that these proposed amendments be withdrawn or restricted to genuine related party cross-border debt arrangements.

Issue 15 – Repeal of section 25-90 and associated amendments

Issue:

- The proposed repeal of s.25-90 and related amendments may unfairly impact on foreign equity investments by Australian-based multinationals, i.e. place them in an international competitive disadvantage, particularly in the current tightening credit and rising interest rate environment.

Proposed Amendment:

- We respectfully request that these proposed amendments be withdrawn.

Issue 16 – Transitional Rules – including for Part IVA

Issue:

- Given the changes proposed to the Thin Capitalisation Regime contained in the Exposure Draft Legislation (and accompanying Draft Explanatory Memorandum) dated 16 March, 2023, it is anticipated that many multinational groups may need to restructure and prepare for the proposed introduction of the new regime (including the fixed ratio test, group ratio test and external third party debt test) effective from 1 July, 2023. The timeframe to prepare for the new regime may cause difficulties for many multinational taxpayers to properly plan and restructure at this time without being mindful of appropriate and broader taxation consequences.

Proposed amendment:

- Given the potential issues outlined regarding the possible impact of the proposed changes to the Thin Capitalisation Regime in July, we respectfully suggest that the Government make it clear in any amending Legislation and the related Explanatory Memorandum (and related materials) that the general anti-avoidance provision, Part IVA and any associated integrity rules (e.g. debt forgiveness), not be applicable to restructures undertaken by multinational groups in responding to the legitimate impacts of the proposed new Thin Capitalisation Rules. Specific wording to this effect could for example be included in the Explanatory Memorandum that accompanies the proposed Thin Capitalisation Legislation, as well as the Minister's Second Reading Speech.

Issue 17 – Unavailability of infrastructure exemption

Issue:

- The nature of infrastructure investments as large scale long term projects are typically capital intensive and usually involve Public Private Partnerships (PPP) between the Government and private investors. Investment in infrastructure assets are supported by concessions which are often held in the private sector for many decades before potentially reverting back to the Government.
- Funding of private sector infrastructure investment lends itself to higher gearing (through predictable cash flows) which in turn decreases the weighted average cost of capital. This in turn enables private sector bidders for infrastructure to maximise the sale price obtained by Government (in the case of privatisations) or to reduce the charges to government / the public (in the case of greenfield projects). The beneficiaries of this funding mix are the Government and the Australian public through direct and indirect investment in vehicles.
- Integrity measures designed to prevent base erosion and profit shifting are supported by us, however, a lack of carve-out for the infrastructure industry within the draft legislation may inadvertently impact the genuine financing of infrastructure projects and deter future investment in domestic infrastructure projects.
- We respectfully suggest that Treasury could draw on approaches adopted by comparable international jurisdictions such as Canada, the United Kingdom and the United States, each of which have provided some form of infrastructure exemptions as follows:
 - **Canada:** Relief is provided to certain Canadian PPP infrastructure projects by excluding third-party interest and financing expenses incurred for the construction of real or immovable property when applying the fixed ratio or group ratio rule.
 - **United Kingdom:** Projects which satisfy the “public benefit test” allows a qualifying company to deduct all third-party interest expense without limitation and is excluded from the fixed ratio and group ratio rules.
 - **United States:** Infrastructure projects and other “real property trade or business” are exempt, or can opt-out of, the Sec 163(j) rules (US equivalent interest deduction limitation rules).

Issue 17 – Unavailability of infrastructure exemption (cont.)

Proposed Amendment:

- The similarity in approach between Australia's proposed thin capitalisation rules and those adopted by comparable international jurisdictions supports the introduction of an infrastructure exemption.
- If a full exemption is not palatable, the existing thin capitalisation rules should be grandfathered to continue to apply to relevant entities for the duration of the infrastructure assets' life, recognising that the decision to invest and set the debt/equity funding mix were a function of the known tax outcomes at that time and a change in law following such decisions (being sovereign risk) can have adverse and unjust outcomes on infrastructure investment in general.