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11 April 2023

Dear Sir or Madam

Multinational Tax Integrity – Australia's interest limitation rules
Submission by Foreign Funds

We thank you for the opportunity to provide a submission in respect of the Exposure Draft Legislation and Explanatory Memorandum (EM) for the proposed changes to Australia's interest limitation (**thin capitalisation rules**) which were released for consultation on 16 March 2023.

This submission is made jointly by:

- Public Sector Pension Investment Board (Canadian Pension Fund)
- Guardians of New Zealand Superannuation Fund (New Zealand Superannuation Fund) together (the **Foreign Funds**).

We recognise the Government's overarching policy objective to align Australia's thin capitalisation rules with the latest Organisation for Economic Cooperation and Development (**OECD**) best practice recommendations[1] to protect Australia's tax base and also deliver on a Labor Party commitment from the 2022 Federal election. We value the opportunity to participate in the Government's public consultation process in relation to the proposed reforms and to provide our views on the Exposure Draft legislation and accompanying explanatory material.

We also acknowledge the Government's decision to include the "external third party debt test" (**ETPDT**) to ensure taxpayers can claim a tax deduction for genuine third party borrowings in respect of Australian assets. This is a critical feature of the new rules for the Foreign Funds. We wish to ensure that third party borrowings are not adversely affected and that the effective tax rate on investments does not exceed the 30% corporate tax rate as a result of the proposed changes.

We are writing to you to share our key concerns in respect of the Exposure Draft legislation. We have limited our submission to aspects where we believe the drafting could be amended in a manner that aligns with the desired policy intent while maintaining an overall effective tax rate of up to 30% on investments. We have also sought to highlight the potential adverse and unintended impacts on commercial investment arrangements and practices in the Australian market.

Our principal concerns relate to the following aspects of the draft legislation:

- The requirement for "associate entities" to make a mutual choice to access the ETPDT;
- The application of the Fixed Ratio Test (**FRT**) to trust structures;
- The exclusion of certain capital allowance deductions from the "tax EBITDA" calculation; and
- Application of the "associate entity" definition to Foreign Funds.

Our submissions on these specific items are outlined below. We would be pleased to have further discussions with you in respect of the matters raised herein at your convenience.

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[1] Final report on Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016
Report accessible online: *https://www.oecd.org/tax/beps/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2016-update-9789264268333-en.htm*

Global investor perspectives

As outlined above, we generally support the Government's decision to implement the OECD's Base Erosion and Profit Shifting framework, including the interest deductibility limitation measures as part of the proposed changes to thin capitalisation.

Our experience has been that Governments in other countries (such as the UK and US) have adopted the change to their equivalent of Australia's thin capitalisation rules in conjunction with a reduction in the corporate tax rate. For example, the Tax Cuts and Jobs Act (**TCJA**)[2], which modified the thin capitalisation provisions contained within the United States' Internal Revenue Code of 1986 to introduce an EBITDA cap, also included a reduction of the corporate tax rate from 35% to 21%.

In contrast, the Australian Government is proposing to legislate the change as a multinational integrity measure without any reduction in the 30% corporate tax rate. The proposed changes are therefore expected to increase the overall effective tax rate for foreign investors in Australia to potentially above the 30% corporate tax rate where debt deductions on third party debt becomes non-deductible.

As global investors, we see Australia's corporate tax rate as a key factor for encouraging future investment in nationally significant infrastructure and other key areas of reform (such as energy transition towards net zero). It is therefore important that the effective tax rate on both existing and prospective investments does not exceed the 30% corporate tax rate as a result of the proposed thin capitalisation rules.

Whilst there are a number of policy matters that we would like to raise with Treasury regarding the proposed changes to Australia's thin capitalisation regime, we have focused our submission on the critical aspects of the Exposure Draft legislation that have the potential to result in tax deductions for genuine costs being denied by the proposed rules. We intend to separately make a submission regarding the broader policy considerations.

Submission 1: The mutual choice for "associate entities" to access the ETPDT

As part of maintaining a balanced and diversified investment portfolio we, the Foreign Funds, invest in a range of "real assets" such as infrastructure, real estate and agriculture, around the globe and in Australia. These real asset classes often comprise critical infrastructure or national building assets that provide long term inflation-linked returns for our funds. The risk-return profile of the assets also means they have a high capital value which requires substantial third-party borrowings to fund the investment in both greenfield and brownfield assets.

As interest on third party debt can exceed 30% of an entity's EBITDA in certain cases, the inclusion of the ETPDT in the proposed thin capitalisation rules is a welcomed policy initiative to ensure such interest on third party borrowings can be deducted against the returns from the underlying investment.

However, the proposed drafting of the eligibility requirements for the ETPDT has raised concerns, as our impression is that the ETPDT (in its current form) could be unavailable to our Australian investments due to the requirement for "associate entities" to make a "mutual choice".

Our concern specifically relates to the scope of the proposed subsection 820-43(5) which prevents an entity from making an election to apply the ETPDT where one or more "associate entities" do not make a choice to apply the ETPDT in relation to an income year (e.g., one or more associate entities apply the FRT or the Group Ratio Rule (**GRR**) in relation to an income year).

The draft EM states that the policy for this 'one-in, all-in' rule is to:

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[2] *H.R.1 - An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018* – became law on 22 December 2017
Legislation accessible online: ***https://www.congress.gov/bill/115th-congress/house-bill/1/text***

"...ensure that general class investors and their associates are not able to structure their affairs in a way that allows them to artificially maximise their tax benefits by applying a combination of different thin capitalisation tests. The restriction effectively requires a general class investor and all of its associate entities to make a mutual choice to use the third party debt test, if any more of those entities wishes to use that test".

We consider the policy objective of this integrity provision to be reasonable and appropriate in the context of **a chain of entities** that invest into a particular asset or portfolio of assets. However, as Foreign Funds, we deploy patient long-term capital in Australia in a range of different ways, including: principal investments, participation in consortia, and minority stakes in listed and unlisted entities.

Accordingly, we are concerned that the drafting of the proposed legislation would apply to more than the entities in the direct or indirect ownership chain and potentially aggregate multiple investments, across a range of different asset classes, for the purpose of the rule. This is principally because:

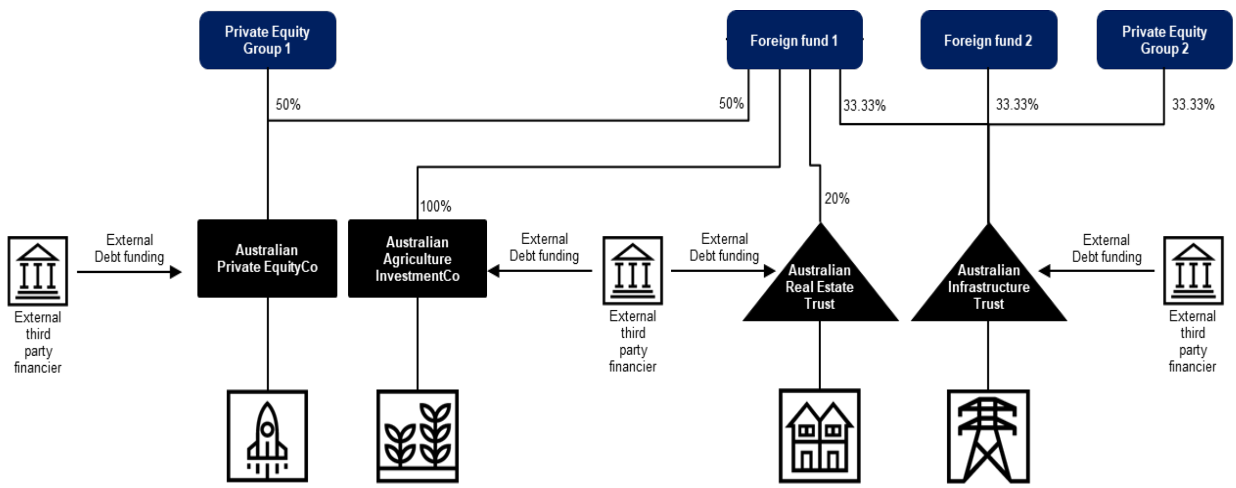
- the ownership threshold for "associate entities" is effectively lowered to a 10% or more interest for the purpose of the proposed subsection 820-43(5), and
- the definition of "associate entity" in section 820-905 includes the associate entities of a third entity under subsection 820-905(3A) and (3B).

Given the 10% 'TC control interest' (as defined in section 995-1 of the Income Tax Assessment Act 1997 (*Cth*)) threshold applied for the associate entity rule, two or more unrelated entities that are "associate entities"' of a Foreign Fund because of its investment in the entities, could be associate entities of each other.

In many of these cases the Foreign Fund may not have meaningful (or any) control over the entities in which they invest or the ability to exert any influence in respect of debt quantum and/or the terms of elections (such as those proposed under the amended thin capitalisation rules). In this circumstance, there is a high likelihood of two or more entirely unrelated entities being required to make a "mutual choice" for the purposes of the thin capitalisation rules - despite investing in diverse asset classes with different leverage ratios and profiles. Additionally, the same investment entity could be an "associate entity" of multiple upstream investors in a consortium or club-style of investment where the parties may have different preferences across their broader portfolio of Australian investments with respect to the interest limitation methods (i.e., they may choose to apply the FRT, GRR or ETPDT).

It follows that where one or more of such "associate entities" elect either the FRT or the GRR, the ETPDT would practically be unavailable to all other associate entities. We have illustrated this potential impact in Figure 1 below.

Figure 1: *Illustration of potential "associate entity" groups*



As outlined in the diagram above, investments in different industries often have different gearing ratios. The table below outlines the indicative loan-to-value ratios across the different real asset asset classes, as well as the interest limitation method that may be preferred by taxpayers in these sectors.

Investment class / sector	Indicative loan-to-value ratio	Indicative limitation method
Infrastructure	75%	ETPDT
Real estate	55%	ETPDT
Agriculture	30%	FRT
Private equity	60%	FRT

We believe this application of the Exposure Draft legislation is unintended as the outcome is significantly beyond the policy objective set out in the EM which is to prevent general class investors from "*artificially maximising tax benefits by applying a combination of different thin capitalisation rules*".

We believe each underlying investment of the Foreign Funds should be entitled to apply one of the three interest limitation methods (FRT, GRR or ETPDT) depending on their particular facts and circumstances and that such an outcome would not give rise to any "artificiality" in respect of the application of the rules (rather it would reflect the commercial realities of each underlying investment). We therefore submit that the draft legislation should be amended to limit the "mutual choice" to associate entities within the same direct and indirect ownership chain.

Submission:

Subsection 820-43(6) should be amended to exclude the application of subsection 820-905(3A) and subsection 820-905(3B) from the "associate entity" definition for the purpose of the mutual choice rule in subsection 820-43(5) to ensure that only entities that hold a 10% or more interest in the same ownership chain are required to elect the same test for the purpose of the thin capitalisation rules.

Submission 2: Application of the Fixed Ratio Test to trust groups

We, the Foreign Funds, commonly invest in passive assets situated in Australia for the purpose of deriving long term rental income, such as commercial, industrial, retail and residential property. The typical ownership structure for these assets is a trust structure, including Managed Investment Trusts.

It is also commonplace for the Foreign Funds to invest in trust structures where the borrowings are structurally separated from the underlying income producing asset for commercial and financial reasons. Examples of such commercial arrangements include:

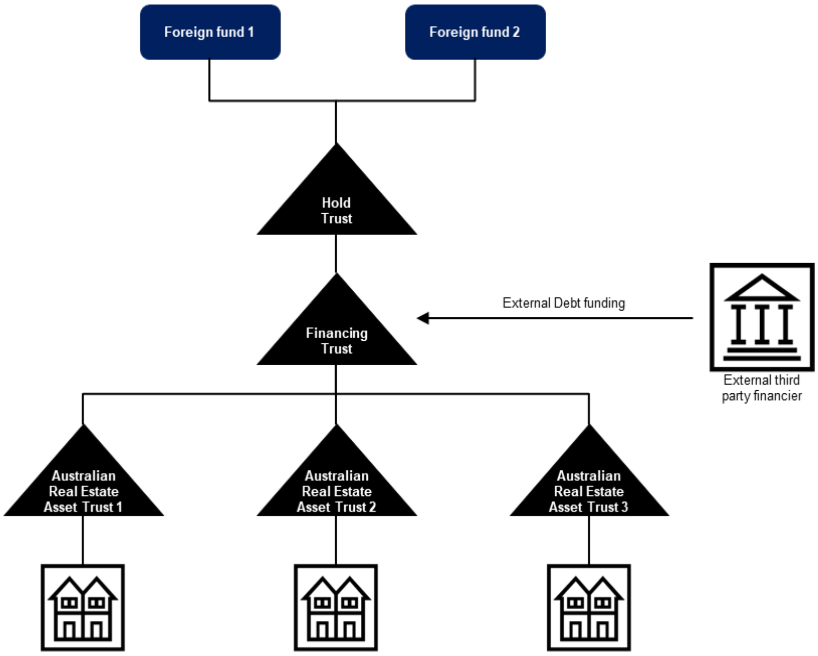
- Co-investment arrangements where each investor separately arranges their debt and equity capital for an investment. This can be due to a range of commercial factors such as differences in risk profiles, financing terms or each investor's respective cost of capital, or

- Portfolios of assets where a "portfolio" or "corporate level" debt is arranged to cover all assets (rather than a series of borrowings for each special purpose entity in the structure), as this can provide the best terms and ultimately the lowest cost of capital for the portfolio.

We have provided an illustration of the portfolio level debt that is commonly obtained by a holding trust for assets within a particular real estate sub-class at Figure 2 below.

Importantly, the current thin capitalisation rules accommodate these commercial arrangements without any adverse impacts or distortions. The current rules effectively achieve this by grouping trusts that have a total participation interest of 10% or more and allowing associate entities to utilise the excess debt capacity of another entity (referred to as the "associate entity excess amount"). It is important that these features of the thin capitalisation rules are preserved under the proposed rules such that any excess debt capacity of an associate entity under the FRT can be attributed to another entity in the ownership chain. We believe such a feature would ensure the policy intent to limit debt deductions to the 30% fixed ratio is achieved without adversely impacting appropriate commercial structures.

Figure 2: *Illustration of portfolio level borrowings*



It is also noted that the ETPDT may not be available to support the third-party debt in Figure 2 in all circumstances. For example, this may be because the holding structure includes foreign assets to which the financier has recourse, or a recourse is extended through a parental guarantee, in which case the trust group would need to apply the FRT.

Putting aside the proposed thin capitalisation rules, the structural separation of borrowings from the underlying asset is generally efficient due to the flow-through nature of the trust entities which allows the debt deductions at the Financing Trust level to be applied against the net income to which the finance or holding trust is presently entitled for an income year from an underlying property trust(s).

However, under the draft legislation, such a trust group would be materially disadvantaged under the FRT. This is because the "tax EBITDA" of the Finance Trust in Figure 2 would be determined based on the net taxable income from the underlying property trusts which would be **after deductions for depreciation and tax losses**. The "tax EBITDA" would therefore reflect a profit before tax basis of calculation, rather than an EBITDA measure. We have set out at Appendix A a simple numerical example that illustrates this issue in practice and the material impacts for holding trusts.

We consider this outcome to be inappropriate in the context of the policy objective of the proposed changes to the thin capitalisation rules. We submit that the trust group should be entitled to utilise the surplus capacity of other entities within the ownership chain to ensure that the 30% fixed ratio is applied to the tax EBITDA of the trust group as a whole. Applying the FRT to trusts in this manner would also ensure that the outcome for trusts is consistent with the outcome for tax consolidated groups (e.g., where the Head Entity is liable for the tax and the EBITDA is determined on a group basis).

Submission:
The Fixed Ratio Test in the draft legislation should be amended to allow surplus debt capacity of a trust to be attributed to another trust in the direct or indirect ownership chain where there is a TC control interest of 10% or more to ensure the test applies with the commercial arrangements existing in the market.

Submission 3: The exclusion of certain capital allowance deductions from the “tax EBITDA” calculation

The proposed FRT has been drafted using a ‘tax EBITDA’ concept as opposed to an accounting EBITDA concept. The adoption of tax EBITDA as the benchmark is a welcome policy initiative as it provides a common set of rules for all taxpayers, whereas accounting outcomes can be impacted by accounting policy choices. Additionally, accounting EBITDA would commonly include items such as unrealised gains and losses (e.g., revaluations and impairments) which could distort outcomes, particularly in the real asset sectors.

However, one particular area of concern is the specific adjustments that are made under the “tax EBITDA” calculation in the proposed section 820-49. The draft rules propose that an entity’s tax EBITDA for an income year is calculated by taking the entity’s taxable income, and adding:

- net debt deductions;
- tax losses deducted in that income year; and
- **certain** capital allowances and capital works deductions

Relevantly, only the entity’s deductions under Subdivision 40-B and Division 43 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**) are added back in the calculation of tax EBITDA. As a result, the following capital allowances deductions are **not** added back in the calculation of tax EBITDA:

- Balancing adjustments (subdivision 40-D)
- Software development pools (subdivision 40-E)
- Primary production depreciating assets (subdivision 40-F)
- Capital expenditure of primary producers and other landholders (subdivision 40-G)
- Certain immediately deductible capital expenditure (subdivision 40-H)
- Project pool deductions (subdivision 40-I)
- Blackhole expenditure (section 40-880)
- Capital expenditure for the establishment of trees in carbon sink forests (subdivision 40-J)
- Deductions in relation to farm-in farm-out arrangements (subdivision 40-K)

There is no discernible policy basis for differentiating between capital allowances deductions of this nature. To the extent the test is designed to mirror an entity’s ‘EBITDA’, deductions under any of these subdivisions would generally be depreciated or amortised as the economic benefits associated with the asset flow and the asset is ultimately consumed or exhausted. All of these deductions are included within the scope of Division 40 – Capital Allowances.

The proposed narrowing of the definition of depreciation and amortisation within the meaning of ‘tax EBITDA’ is of particular concern to the Foreign Funds. As noted above, we invest in a range of “real assets” such as infrastructure, real estate and agriculture in Australia. These asset classes typically have significant capital expenditure for which a deduction can be claimed under the capital allowance rules in Part 2-10 of the ITAA 1997. Our experience is that the calculation of taxable income for our real asset investments can include deductions such as:

- Low-value and software development pools (subdivision 40-E)
- Primary production depreciating assets (subdivision 40-F)
- Capital expenditure of primary producers and other landholders (subdivision 40-G)
- Certain immediately deductible capital expenditure (subdivision 40-H)
- Project pool deductions (subdivision 40-I)
- Blackhole expenditure (section 40-880)

We are concerned that the drafting of the proposed legislation to exclude such categories of capital allowances would be particularly detrimental to investments made in real assets where deductions for capital expenditure can be prominent (such as the agriculture and infrastructure, including the energy transition sectors).

Importantly, such capital expenditure is commonly financed by way of **debt and equity** capital provided to the taxpayer which is commonly capitalised to the balance sheet for accounting purposes. As a result, the taxpayers' debt deductions could be directly attributable to the capital expenditure on such costs.

Furthermore, taxpayers **do not** have the choice to calculate capital allowances deductions under subdivision 40-B (as opposed to 40-F, 40-I etc). Rather, capital expenditure that falls into specific subdivisions outside of subdivision 40-B must be deducted under those provisions.

By way of example:

- subsection 40-50(1) prevents a decline in value deduction under Subdivision 40-B for depreciating assets where an amount can be deducted by the taxpayer (or a former holder) under subdivision 40-F, subdivision 40-G or subdivision 40-J.

- for taxpayers that have made an election into subdivision 40-E in respect of software development pools prior to the introduction of the proposed rules, the taxpayer is required to deduct certain costs through the pools rather than under subdivision 40-B. The policy intention of subdivision 40-E is to alleviate the compliance burden of calculating capital allowances deductions for each underlying asset and therefore should not result in a detrimental outcome for thin capitalisation purposes.

- Subdivision 40-I provides a deduction for capital expenditure associated with certain projects carried on by the taxpayer (which can include expenditure on *community infrastructure* for a community associated with a project).

We do not understand the policy rationale for excluding such capital allowance deductions from the calculation of an entity's "tax EBITDA" and therefore effectively reducing the maximum allowable debt deductions under the thin capitalisation rules - particularly in the case where the taxpayer is specifically prevented from claiming a decline in value deduction under Subdivision 40-B because of an anti-overlap rule which gives priority to another subdivision in the capital allowances regime.

Taxpayers commonly invest in capital expenditure to generate earnings. These earnings would be included in the calculation of tax EBITDA. However, the tax EBITDA would not be adjusted to exclude capital allowances deductions to the extent that these deductions are required to be calculated under another subdivision (other than subdivision 40-B or Division 43) as noted above.

In addition to the comments above, it is also important to note that the other subdivisions in Division 40 often just change the timing of when deductions are claimed for tax purposes (e.g., immediately, or over specified periods - such as low value pool deductions). The result of this is that any differences between the timing of a deduction under subdivision 40-B and the other subdivisions should unwind over the effective life of the asset. This means that there would be no mischief in the calculation of tax EBITDA by including all categories of capital allowances (if the draft legislation was amended). Any timing differences in the calculation of tax EBITDA should unwind over the effective life of the asset. We have set out at Appendix B a simple numerical example that illustrates this issue.

We submit that the calculation of "tax EBITDA" should include all categories of capital allowances on the basis that, commercially, such capital expenditure is financed through a combination of debt and equity capital (in the same manner as depreciating assets and capital works under Subdivision 40-B and Division 43 respectively).

Submission

The proposed subsection 820-49(c) should be amended to include all categories of capital allowances deductions under Division 40, as opposed to just deductions under subdivision 40-B. This provision could be amended to read: *"next, add the sum of the entity's deductions (if any) under Division 40 or Division 43 for the income year from its assessable income for the income year."*

Submission 4: Application of “associate entity” definition to Foreign Funds

Finally, it is noted that the Exposure Draft legislation includes a carve out for Australian superannuation funds from the relevant associate entity provisions. The rationale for this modification in respect of superannuation funds as explained in the EM is that:

> ‘*superannuation funds have grown to have significant investments in a variety of different assets and are now an important source of capital investment for Australian assets, particularly infrastructure assets. Under the current rules, these investments may cause superannuation funds to have a relatively large number of associate entities, which would bring their investments into scope of the thin capitalisation rules. However, superannuation funds are subject to a relatively strong regulatory regime and generally do not exercise any meaningful control over their associate entities. On this basis, the associate entity definition (to the extent it relates to the thin capitalisation rules) is no longer fit-for-purpose for Australian superannuation funds.’*

As a result, the aggregation of unrelated entities identified in Submission 1 (above) would not apply where the membership interests are owned by Australian superannuation funds. This could potentially result in entities that would be associate entities through an Australian superannuation fund being allowed to utilise the ETPDT on an investment-by-investment basis, but those owned by Foreign Funds being prevented from accessing the ETPDT in practice and therefore being denied debt deductions for genuine third-party borrowings.

The rationale for the modification of the treatment of Australian superannuation funds – i.e., that they are an important source of capital, have a strong regulatory regime, and generally do not exercise meaningful control – applies equally to the Foreign Funds. The Foreign Funds are highly regulated entities that invest money for a passive financial return (i.e., the funds do not undertake active trade through the provision of goods or services) and generally do not exercise meaningful control over the entities in which they invest (particularly those where the Foreign Funds hold a less than 50% ownership interest).

We believe the starkly different outcome seems inconsistent with the policy objectives and discriminates between entities owned by Australian superannuation funds and foreign pension or superannuation or sovereign wealth funds. It also potentially brings into question the application of the Non-discrimination clause such as that under the Australia-New Zealand Double Tax Agreement.[3]

Submission: The proposed new subsection 820-905(1A) contained in Item 45 of the Exposure Draft should be modified so that the exclusion also applies to superannuation funds for foreign residents as already defined.

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[3] Article 24 of the Australia-New Zealand Double Taxation Agreement
Double Taxation Agreement accessible online: *https://www.austlii.edu.au/au/other/dfat/treaties/2010/10.html*

We trust that the submissions included above will be of use to you as part of finalising the proposed legislation and explanatory memorandum. We value and appreciate the ability to provide our views through the consultation process and would welcome the opportunity for further discussions with you.

Yours sincerely

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Appendix A: Numerical example of application of the Fixed Ratio Test to trust groups

Lending pooled at the financing trust level

Entity	Asset Trust 1	Asset Trust 2	Asset Trust 3	Financing Trust	Total
Trading income	2,000,000	2,000,000	2,000,000	-	6,000,000
Depreciation	500,000	500,000	500,000	-	1,500,000
Interest expense	-	-	-	1,500,000	1,500,000
Taxable income*	1,500,000	1,500,000	1,500,000	3,000,000	
Tax EBITDA	2,000,000	2,000,000	2,000,000	4,500,000	
FRT Limit	600,000	600,000	600,000	1,350,000	
Interest Denials	-	-	-	150,000	150,000

* Assuming no debt deduction denials

Lending at the asset trust level

Entity	Asset Trust 1	Asset Trust 2	Asset Trust 3	Financing Trust	Total
Trading income	2,000,000	2,000,000	2,000,000	-	6,000,000
Depreciation	500,000	500,000	500,000	-	1,500,000
Interest expense	500,000	500,000	500,000	-	1,500,000
Taxable income*	1,000,000	1,000,000	1,000,000	3,000,000	
Tax EBITDA	2,000,000	2,000,000	2,000,000	3,000,000	
FRT Limit	600,000	600,000	600,000	900,000	
Interest Denials	-	-	-	-	-

* Assuming no debt deduction denials

The above examples demonstrate that trust structures with identical trading income, tax depreciation and interest expense can have different outcomes under the proposed Fixed Ratio Test depending on the location of the borrowings within the trust structure.

Appendix B: Numerical example of the exclusion of certain capital allowance deductions from the "tax EBITDA" calculation

Deductions over time under subdivision 40-B

Entity	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Trading income	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000	25,000,000
Subdivision 40-B deductions	500,000	500,000	500,000	500,000	500,000	2,500,000
Interest expense	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	5,000,000
Taxable income *	3,500,000	3,500,000	3,500,000	3,500,000	3,500,000	17,500,000
Tax EBITDA	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000	
FRT Limit	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	
Interest Denials	-	-	-	-	-	-

* Assuming no debt deduction denials

Immediate deduction under subdivision 40-F

Entity	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Trading income	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000	25,000,000
Subdivision 40-F deductions	2,500,000	-	-	-	-	2,500,000
Interest expense	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	5,000,000
Taxable income *	1,500,000	3,500,000	3,500,000	3,500,000	3,500,000	17,500,000
Tax EBITDA	2,500,000	5,000,000	5,000,000	5,000,000	5,000,000	
FRT Limit	750,000	1,500,000	1,500,000	1,500,000	1,500,000	
Interest Denials	250,000	-	-	-	-	250,000

* Assuming no debt deduction denials

The above examples demonstrate that whilst the total capital allowances deductions are the same in both scenarios (either over time or immediately), the requirement to not capture deductions under subdivision 40-F in the calculation of tax EBITDA results in a partial denial of interest deductions, as compared to the scenario where deductions are claimed under subdivision 40-B (where there are no denial of interest deductions).