14 April 2023

International Tax Unit
Corporate & International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Via email: MNETaxintegrity@treasury.gov.au

Dear Treasury

Multinational Tax Integrity – Strengthening Australia's Interest Limitation (Thin Capitalisation) Rules

The Australian Financial Markets Association (**AFMA**) represents the interests of over 125 participants in Australia's financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. They are the major providers of wholesale banking and financial market services to Australian businesses and investors.

We are pleased to lodge a submission on the Exposure Draft and draft Explanatory Memorandum to amend Australia's thin capitalisation rules.

Executive Summary

AFMA recommends that:

- The Government does not proceed with the proposed amendments to Section 25-90 and Section 230-15, particularly in relation to Approved Deposit-Taking Institutions (**ADIs**) and financial entities;
- The Government clearly articulate the integrity concerns that are used to justify the proposed amendment to the definition of "financial entity" to allow for a more targeted amendment that retains the objectivity in the current definition;
- The final legislation ensures that insolvency remote special purpose entities that are within the scope of Section 820-39 are not subject to the interest limitation rules in Subdivision 820-AA;
- The Government provide confirmation that restructures to funding arrangements to mitigate the extend of non-deductible interest cannot be challenged under Part IVA;

- The Government confirm that any break costs incurred by taxpayers restructuring their affairs to address the new provisions are deductible; and
- Any amendments apply to income years starting on or after 1 July 2024.

Introductory Comments

The vast majority of AFMA members are either classified as ADIs or financial entities for the purposes of Division 820. As such, the proposed modifications to the Australian thin capitalisation rules for general class investors contained in the Exposure Draft have limited application to AFMA's members and AFMA makes no comment in relation to these proposed amendments.

Amendments to Section 25-90/230-15

It is noted that the Exposure Draft seeks to amend Sections 25-90 and 230-15 such that they do not apply in relation to a foreign equity distribution that is non-assessable, non-exempt income under Section 768-5. The effect of this proposed amendment is, in substance, that Australian corporate tax entities (including ADIs and financial entities) will need to trace their debt funding to determine the extent to which this funding was deployed to capitalise an entity that, in turn, has made or will make equity distributions that are non-assessable, non-exempt income. In essence, Sections 25-90/230-15 are being repealed insofar as they relate to foreign equity distributions.

The proposal to substantively repeal Sections 25-90/230-15 is not new. In response to a Treasury Discussion Paper in 2013, AFMA stated:

> "AFMA is concerned about the effect that the repeal of Section 25-90 will have on the market for finance, and financial services, from Australia. It is AFMA's view that Section 25-90 is an integral part of a finely tuned framework of Australia's international taxation regime and its repeal will have a significantly detrimental impact on the competitiveness of Australian businesses operating overseas. "

The basis for this view is that through requiring entities that have offshore subsidiaries to trace funding to ensure continued deductibility for funding costs was a significant disincentive to using Australia as a headquartering jurisdiction and hindered overseas expansion.

For all entities subject to which the thin capitalisation rules apply, the immediate practical effect of the proposed amendments to Sections 25-90/230-15 will be to exacerbate compliance costs significantly for entities with offshore subsidiaries, without any material increase to Government revenue. These compliance costs relate both to the tracing requirements that will need to be undertaken going forward and, given the proposed lack of grandfathering of existing funding arrangements, the requirement for entities with offshore subsidiaries to restructure funding arrangements purely for the purpose of allowing tracing in the future.

The proposed amendments for Sections 25-90/230-15 are even more punitive for ADIs due to the calculation of "adjusted average equity capital" in Division 820. In calculating their adjusted average equity capital amounts, ADIs are required to subtract the capital referable to offshore subsidiaries, referred to in the Division as "controlled foreign entity equity." Accordingly, for

ADIs, investments in offshore subsidiaries either cause the ADI to hold a greater amount of equity capital onshore or risk a higher proportion of debt deductions being denied. In this circumstance, there is no policy rationale for the proposed amendments to Sections 25-90/230-15 for ADIs.

The rationale for the proposed amendments to Section 25-90/230-15 in the draft Explanatory Memorandum relates solely to the earnings-based tests that apply to general class entities. Accordingly, our recommendation is that, to the extent that the Government proceeds with the proposed amendments to Section 25-90/230-15, then these amendments apply only to general class entities and both Section 25-90 and 230-15 continue to operate as they do currently for ADIs and financial entities. We further recommend that there is grandfathering for existing financing arrangements given the inability to trace funding retrospectively when the funding was deployed at a time where there was no tracing requirement.

To the extent that the proposed amendments to Section 25-90/230-15 do proceed, AFMA recommends:

- That the Government provide confirmation and, if necessary, legislative amendment that provides the necessary assurance to taxpayers that restructures to funding arrangements to mitigate the extend of non-deductible interest cannot be challenged by the ATO under Part IVA of the 1936 Act; and
- That the Government confirm that any break costs incurred by taxpayers restructuring their affairs to address the new provisions are deductible under Section 8-1 of the 1997 Act.

Definition of "financial entity"

AFMA notes the proposal in the Exposure Draft that the definition of "financial entity" in Section 995-1 of the 1997 Act by removing the bright-line test that an entity is registered under the *Financial Sector (Collection of Data) Act* 2001. As a result, in order to establish that they are financial entities, taxpayers that are not securitisation vehicles that hold an appropriate AFSL will need to show that they carry on a business of dealing in securities, but not for the purposes of dealing with associates. This is a subjective test that exposes taxpayers to the risk of differing interpretations by the ATO and, accordingly, reduces certainty and increases the likelihood of challenge.

The draft Explanatory Memorandum states that the rationale for this proposed amendment is that "non-ADI corporations can register under that Act for reasons unrelated to income tax. As a result, an increasing number of entities are now purporting (for tax purposes) to be financial entities." The proposed amendment is perceived as being "an integrity measure to ensure the thin capitalisation rules are fit for purpose."

Notwithstanding the pejorative language in the draft Explanatory Memorandum, there is no articulation from Government as to the types of entities that are required to be registered under the *Financial Sector (Collection of Data) Act* 2001 that are considered as not "financial" for thin capitalisation purposes. That is, the Government has not provided any example that justify the stated integrity concerns.

The *Financial Sector (Collection of Data) Act* 2001 specifies that a corporation will be registrable where it engages in the provision of finance in the course of carrying on business in Australia or

is a corporation or within a class of corporation specified under a determination made by APRA. AFMA understands that APRA has made a determination that entities that guaranteed lending to small and medium enterprises during the pandemic qualified as registrable corporations. The Act specifies the meaning of "provision of finance" and there are a number of exemptions, including:

- ADIs;
- Private health insurers;
- Life insurers;
- General insurers; and
- Entities with less than $50 million of debts outstanding.

AFMA is unable to identify a class of corporation that is required to be registered under the *Financial Sector (Collection of Data) Act* 2001 that should not be considered "financial" for thin capitalisation purposes.

AFMA's preference would be the retention of an objective test in the definition of "financial" for thin capitalisation purposes, ideally one that leverages other regulatory requirements such as registration under the *Financial Sector (Collection of Data) Act* 2001. Given the absence of clarity as to the integrity concerns that are underpinning the proposed amendment in the Exposure Draft it is difficult for AFMA to suggest an alternative objective test that both ensures that the thin capitalisation classification is fit for purpose and also provides taxpayers with requisite certainty through not relying on a subjective test. Accordingly, it is our recommendation that the Government articulate the integrity concerns in a manner that allows for a targeted amendment to address these concerns while retaining an objective test.

Ensuring insolvency remote special purpose entities remain unaffected

AFMA notes that, on a technical reading of the provisions in the Exposure Draft, insolvency remote special purpose vehicles that are currently exempt from denial of debt deductions due to the operation of the thin capitalisation rules, may not be exempt from the application of new Subdivision 820-AA. AFMA recommends that appropriate amendments be made to ensure that this is not the outcome in the final legislation.

Commencement

As noted above, in 2013 Treasury consulted on a number of changes to the thin capitalisation rules and related amendments, including the proposed repeal of Section 25-90. It was agreed at the time that there be a significant lead time between the enactment of the proposed amendments and their commencement, in the order of twelve months. This would facilitate both the formation of a specialist working group comprising personnel from Treasury, the ATO and industry to agree guidance as to how the proposed amendments would apply and also allow taxpayers sufficient time to rearrange financing arrangements in light of the proposed amendments.

To the extent that the Government proceeds with any proposed amendments in the Exposure Draft, then AFMA's view is that a similar transition period is appropriate and recommends that any amendments apply to income years starting on or after 1 July 2024.

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Thank you for the opportunity to provide a submission in relation to the Exposure Draft. Please contact me on (02) 9776 7996 or at rcolquhoun@afma.com.au to discuss any of the matters that we have raised in this submission.

Yours sincerely,

Rob Colquhoun
Director, Policy