PSP Investissements Investments

NZSUPERFUND Te Kaitiaki Tahua Penihana Kaumātua o Aotearoa

Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Uploaded via Senate Standing Committees on Economics Inquiry Website

21 July 2023

Dear Sir or Madam

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

We thank you for the opportunity to provide a submission in respect of the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023* (**the Interest Limitation Bill** or **the Bill**) which was introduced into the House of Representatives on 22 June 2023 and proposes changes to Australia's thin capitalisation and transfer pricing rules.

This submission is made jointly by:

- Public Sector Pension Investment Board (**PSPIB**), a Canadian Crown corporation that invests amounts transferred to it by the Government of Canada for the pension plans of the Canadian Public Service, the Canadian Forces, the Royal Canadian Mounted Police and the Reserve Force. PSPIB has C$243.7 billion of net assets under management as at 31 March 2023 and invests globally in a variety of asset classes, including natural resources, public markets, private equity, real estate, infrastructure and credit investments.

- The New Zealand Superannuation Fund (**NZSF**) is a long-term, growth-oriented, global investment fund that is funded by the New Zealand Government. NZSF exists to help provide for the future funding of retirement benefits paid by the New Zealand Government which are guaranteed to all New Zealanders aged 65 and older. NZSF had circa NZ$64 billion of assets under management as at 30 June 2023 and invests in diversified assets throughout the world, including Australia.

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 in order to protect Australia's tax base and deliver on a Labor Party election commitment. We value the opportunity to make a submission to the Senate Committee in relation to the proposed Interest Limitation Bill and accompanying explanatory material.

We, the Foreign Funds, have previously made a joint submission to the Department of Treasury in response to the public consultation on the *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation* (the **Exposure Draft Legislation**) which was released on 16 March 2023. Our submission dated 11 April 2023 is available on the Treasury webpage[1].

At the outset, we wish to acknowledge that some of the changes suggested in our previous submission on the Exposure Draft Legislation have been reflected in the Interest Limitation Bill[2]. The adoption of these changes has been well received by the Foreign Funds. However, there are elements of the revised Bill that have not reflected the concerns raised in our previous submission or give rise to additional concerns due to the nature of various amendments or inclusion of the new rules, including the "Debt Deduction Creation Rule" and certain modifications to the Fixed Ratio Test (**FRT**) for trusts.

[1] https://treasury.gov.au/consultation/c2023-370776
[2] https://treasury.gov.au/sites/default/files/2023-06/410898-mne-sum-oc.pdf

We are writing to you to share our key concerns in respect of the Interest Limitation Bill and provide suggested changes which we consider to be both constructive and within the policy objectives of the proposed changes to Australia's thin capitalisation rules. We have limited our submission to aspects of the Bill where we believe the proposed rules materially depart from the desired policy objective and if legislated, could have a significant impact on foreign investment in Australia.

Key messages for the Senate Committee

In light of our approach above, our principal concerns relate to the following aspects of the Bill:

1. Interest Limitation Rules

The proposed Interest Limitation Rules **discriminate** between company and trust structures as:

- The Third Party Debt Test (**TPDT**) is not available to trusts due to the specific "residency" requirement in the "third party debt conditions"[3] (whereas companies are taken to satisfy this requirement and therefore have access the TPDT to determine the maximum allowable debt deductions); and

- The FRT does not permit any form of 'grouping' between trust entities to ensure that surplus debt capacity in one trust can be utilised by another trust with a portfolio that this under common ownership (whereas company structures can benefit from such grouping through Australia's tax consolidation rules).

We consider the above outcomes to have a disproportionate impact on foreign institutional investors, such as the Foreign Funds, as we commonly invest in Australia through trust entities. Importantly for us, the use of trust structures in Australia has been encouraged by the Australian Government through the Managed Investment Trust regime[4] (particularly for real estate and infrastructure investments) and we believe it is important that there is fairness and equity for taxpayers that have invested through trust structures (vis-a-vis a company).

As global investors we also assess the efficacy of Australia's tax laws with other comparable jurisdictions. In the context of the changes to Australia's thin capitalisation regime, we have observed the design and implementation of the OECD Action 4 across a number of jurisdictions. Importantly, these jurisdictions (including for example the US and Canada), have implemented grouping rules for tax transparent entities which are the equivalent of Australia's trusts and partnership entities. The proposed design of Australia's FRT rule for trusts and partnerships is therefore **out of step** with comparable jurisdictions. This proposed approach also has material implications for commercial arrangements that exist in the market where assets are held in a portfolio of trusts or through joint venture arrangements with Australian operators or co-investors.

We encourage the Senate Committee to examine the appropriateness of these outcomes for trusts under the proposed Interest Limitation Bill as it will have a disproportionate impact on institutional investors, particularly in areas of intended long term investment such as Australian Build to Rent residential projects and nationally significant infrastructure to support Australia's energy transition.

2. Debt Deduction Creation Rule

The inclusion of a Debt Deduction Creation Rule was a surprise to the Foreign Funds as it was not part of the previous announcements by the Government or Exposure Draft Legislation, nor is it contemplated by the OCED's Action 4. This submission is therefore our first opportunity to comment on the proposed Debt Deduction Creation Rule.

Our assessment is that the effect of the Debt Deduction Creation Rule extends significantly beyond the policy objective and as currently drafted, potentially applies to transactions which occurred before 1 July 2023 – if true, effectively giving the rule a **retrospective** application. This is in contrast to the last time debt creation rules were introduced whereby the introduction of the Division 16G rules were presaged by announcement several months in advance of the introduction and where the rules were explicitly limited to transactions arising after their introduction. Moreover, we have identified a number

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[3] Proposed subsection 820-427A(3) of the Bill.

[4] Division 275 of the Income Tax Assessment Act 1997 and Subdivision 12-H of Schedule 1 in the Taxation Administration Act 1953.

of common commercial arrangements across our existing portfolios where the proposed rule will have an adverse and we expect unintended impact (for example, where an investment borrows from third party lenders through a conduit financing entity within the group, often referred to as the “Finance Co”).

We encourage the Senate Committee to exclude the proposed Debt Deduction Creation Rule from the Bill and refer the proposed rule to the Board of Taxation for proper consideration and consultation with industry stakeholders. Such a process will provide the taxpayer community and investors with confidence that the proposed integrity rule is implemented in a manner that appropriately addresses the relevant mischief or concerns. It should also be made explicitly clear that the Debt Deduction Creation Rule applies on a prospective basis.

Our detailed submissions on the proposed Interest Limitation Bill are outlined below for your consideration.

Global investor perspective

As outlined above, we generally support the Government's decision to implement the OECD’s Base Erosion and Profit Shifting (**BEPS**) 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 of 2017* (**TCJA**)[5], which modified the thin capitalisation provisions contained within the United States’ Internal Revenue Code of 1986 to introduce an EBITDA cap (with EBITDA applied from 2022 onward), 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 meaning the proposed changes will increase the effective tax rate for foreign investors in Australia with effect from 1 July 2023.

As global institutional investors, we assess a country's sovereign risk as part of making new investments and managing our global portfolio. A country’s sovereign risk is generally increased where, among other things the taxation laws are amended in a way that results in:

- the effective tax rate on profits for foreign investment entities being greater than the general corporate tax rate for domestic entities - given this essentially discriminates between domestic and foreign owned businesses; and
- increased tax liabilities arising on transactions that occurred before such amendments were proposed or announced to the public - particularly where there is no transitional relief or grandparenting available to existing arrangements.

There are aspects of the proposed Interest Limitation Bill that, if legislated as currently drafted, could create unexpected sovereign risk in Australia. This is because the proposed changes to the thin capitalisation rules:

- preclude trust and partnership investment entities (which are commonly used to invest in Australian real estate and infrastructure through Managed Investment Trusts in accordance with Australia’s policy settings) from accessing the TPDT - the outcome being that foreign equity investors in such an entity could have an effective tax rate of greater than 30% in Australia; and
- include a previously unannounced “Debt Deduction Creation Rule” which effectively has a retrospective application given that the rule applies to transactions that occurred prior to 1 July 2023 (or even announcement of the rules in 2022).

Neither of these outcomes is consistent with OECD Action Item 4 – *Limitation on Interest Deductions* so we did not expect these to be the outcomes of Australia implementing the changes to its thin capitalisation rules.

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[5] SEC. 13301 of the TCJA: https://www.congress.gov/115/plaws/publ97/PLAW-115publ97.pdf

As global investors, we see Australia's corporate tax rate as a key factor for determining the relative attractiveness of future investment in nationally significant infrastructure and other key areas (such as the energy transition towards net zero carbon emissions). It is therefore important that the effective tax rate on both existing and prospective investments does not exceed the 30% corporate tax rate and appropriate transitional rules are established where a new "Debt Deduction Creation Rule" is legislated as part of this package.

Furthermore, we would expect the perspectives outlined in our submission to be shared by other institutional investors. The publication of submissions lodged in April 2023 in response to Treasury's public consultation process on the Exposure Draft Legislation to change Australia's thin capitalisation rules highlights the significant level of interest from both foreign and domestic institutional investors. In this regard, Treasury has disclosed that it received a total of 55 submissions with a number of those coming from leading Australian superannuation funds, Canadian pension funds and other foreign institutional investors.[6] The volume and nature of submissions that global institutional investors have felt compelled to make on these proposed laws highlights both the level of attention they are receiving, and the level of concern investors have with the proposed rules.

Submission 1: Trusts and partnerships should have access to the TPDT

Based on the current drafting of the legislation, we understand that the TPDT is **not** available to trusts or partnerships. As we commonly invest in trust structures to hold Australian real estate and infrastructure assets (consistent with the policy settings for the Managed Investment Trust regime), we have significant concerns regarding the application of the TPDT as provided for in the proposed Bill.

We understand trusts and partnerships are not eligible for the TPDT on the basis that the "third party debt conditions" in the proposed subsection 820-427A(3) include a requirement that the entity is an Australian resident. In this regard, the term "Australian resident" is defined in section 995-1 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**) to mean "a person who is a resident of Australia for the purposes of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**). Section 6(1) of the ITAA 1936 defines a "resident or resident of Australia" to effectively include **only** a person or a company.

Based on the definition of "resident" in section 6(1) of the ITAA 1936, **only** individuals or companies can qualify to meet the "third party debt conditions" in the proposed subsection 820-427A(3). As a result, other entities, such as trusts and partnerships, do not meet the conditions to apply the TPDT, meaning the interest deductions for trusts and partnership entities is limited to the FRT or Group Ratio Test ("**GRT**"). In respect of the GRT and FRT, we note that:

- the GRT is not expected to be available to the Foreign Funds due to the requirement for the assets and liabilities of an entity to be proportionately consolidated in the financial statements[7] of the Foreign Fund (which is typically not the case for institutional fund investors who apply the accounting exemption from consolidation that is available to investment entities); and

- the interest limitation under the FRT (which is capped at 30% of tax EBITDA) is not sufficient to maintain deductions for third party external debt arrangements on typical real estate and infrastructure investments owned through trust structures. It will therefore have a material adverse impact on the investment returns for the Foreign Funds as equity holders.

The potential outcome for institutional investors, such as the Foreign Funds, is that some or all of the debt deductions for genuine third party debt will not be deductible in working out the net taxable income of a trust entity which will increase the effective tax rate on affected investments, potentially above the 30% corporate tax rate in Australia. This is essentially because the equity investors' net taxable income would be greater than its economic profits or gains from the relevant investment.

Importantly, this application of the Interest Limitation Bill is inconsistent with the Government's policy objective set out in the Federal Budget 2022-23, where the Government stated that it would "*retain an arm's length debt test as a substitute test which will apply only to an entity's external (third party) debt, disallowing deductions for related party debt under this test*." and also at various paragraphs in the Explanatory Memorandum (**EM**) which describe the aim of the "third party debt conditions" as being "*to ensure the third party debt test only captures genuine third party debt which is used to fund Australian*

[6] https://treasury.gov.au/consultation/c2023-370776
[7] Per the proposed section 820-53(2) of the *Income Tax Assessment Act 1997* (Cth).

business operations."[8] Furthermore, there is nothing in the EM that indicates the TPDT is intended to be limited to Australian companies and individuals and specifically exclude trust or partnership entities.

We also note that there are a number of technical corrections to the third party debt test and the conduit debt rules so that they may have application. These changes are particularly relevant for trusts and partnerships. As set out at the end of this submission, we have not highlighted these changes individually and will leave that to other technical based submissions by interested parties.

The Foreign Funds have continued to invest in Australia on the basis that all forms of entities would be able to claim a debt deduction for genuine third party debt and request the Senate Committee to review the deficiencies in the drafting of the Bill which would prevent this outcome should the Bill be legislated in its current form.

Submission:

The references to "Australian resident" in the proposed subsection 820-427A(3)(e) (and elsewhere in the Bill such as the proposed subsection 820-427B(4)(b)(ii)) should be amended to ensure that entities, including trusts and partnerships, can access the TPDT to claim a debt deduction for costs relating to genuine third party debt where the other relevant conditions are satisfied.

Submission 2: Trust grouping rules to allow sharing of surplus tax EBITDA

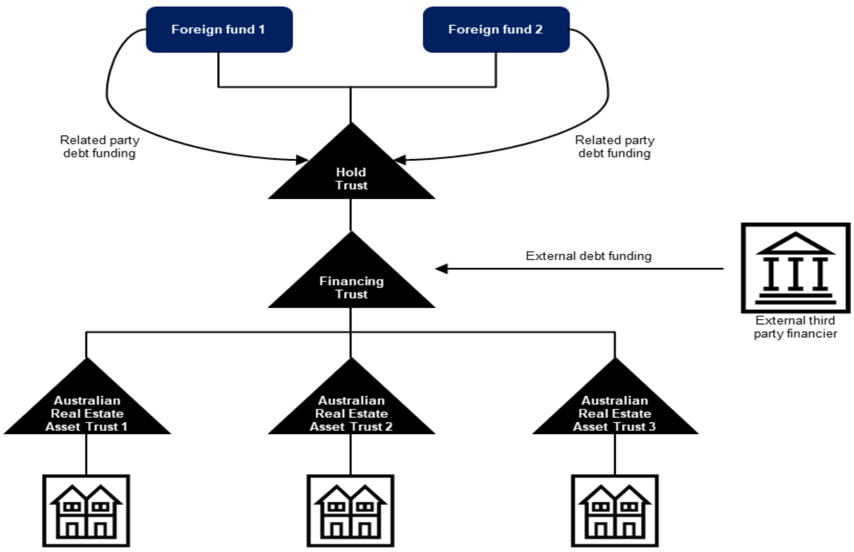
We commonly invest in passive assets situated in Australia and elsewhere for the purpose of deriving long term rental income, such as commercial, industrial, retail and residential property. In Australia, these assets are typically owned through a trust structure. It is also commonplace for the borrowings to be 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 asset class at Figure 1 below.

Figure 1: *Illustration of portfolio level borrowings*



[8] Refer to Paragraphs 2.92, 2.93 and 2.97 of the Explanatory Memorandum to the Bill.

The current thin capitalisation rules accommodate these commercial arrangements without any adverse impacts or distortions by allowing trust groups to utilise the **excess** debt capacity of another entity (referred to as the "associate entity excess amount"[9]). The operation of the "attributable safe harbour excess amount" is particularly relevant to the effective sharing of surplus debt capacity.

However, the design of the FRT under the proposed Interest Limitation Bill **does not** facilitate the sharing of any excess debt capacity between relevant associates. This is because the proposed subsection 820-52(9) modifies the calculation of an entity's "tax EBITDA" where it is a beneficiary of another associate trust to exclude the share of net income from the trust or distributions from the trust in calculating the tax EBITDA.

Based on a comment in Attachment 2 (Impact Analysis for Schedule 2) of the EM in relation to trust grouping rules, this appears to be a deliberate decision taken by Treasury:

> ***Trust grouping rules (and general neutrality with tax consolidated groups)****: stakeholders noted the draft legislation seemed to be weighted towards accommodating corporate structures and that further consideration was required for trusts and partnerships. This included facilitating excess interest capacity for trust 'groups', to reflect the existing arrangements possible under current law, noting this aligns with the 'natural capacity' of corporate groups.*
>
> *In response to these issues, a number of technical changes were adopted to better accommodate trusts and non-consolidated groups, for example by amending the tax EBITDA calculation.* ***Feedback was considered on the inclusion of an ability to share excess interest capacity within trust groups, but ultimately decided against including this for simplicity and integrity reasons.*** [Emphasis Added]

As institutional investors in Australia, the shortcut taken by Treasury is concerning to the Foreign Funds as it consciously:

- disregards the principles of fairness and creates inequity in tax outcomes between taxpayers - for example, a corporate group can consolidate to effectively share any surplus tax EBITDA between the entities for the purpose of determining the taxpayer's maximum allowable debt, whereas the taxpayer in a trust structure is not eligible to share any surplus; and
- ignores the genuine commercial arrangements that exist in Australian markets.

Treasury's approach is also disappointing given the concerns raised by stakeholders through the Exposure Draft Legislation consultation process and the fact that such a grouping rule currently exists in Australia's thin capitalisation rules through the "attributable safe harbour excess amount". Moreover, Treasury has based this decision on "*simplicity and integrity reasons*" despite what are already significantly complex proposed thin capitalisation rules and the inclusion of a Debt Deduction Creation Rule as a new integrity rule.

We would welcome the opportunity for Treasury to explain the simplicity and integrity reasons in further detail so we can engage constructively in relation to the law design and provide insights on the approach adopted by comparable jurisdictions (including the US and Canada) which implemented the equivalent of trust grouping rules for tax transparent entities in their jurisdictions (such as limited partnerships and limited liability companies) – see further details below.

We believe the principle of allowing the "tax EBITDA" to be utilised <u>**once in totality**</u> by trust groups is a fair and equitable outcome for taxpayers and is consistent with the policy objectives of the thin capitalisation rules. This outcome could be achieved by allowing the surplus debt capacity of a trust or partnership entity to be utilised by a direct owner of the entity on an attribution basis. Such a rule could operate in a similar manner to the existing "attributable safe harbour excess amount" in subsection 820-920(4) of the ITAA 1997.

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[9] Refer to section 820-920 of the *Income Tax Assessment Act 1997* (Cth).

Importantly, the principle of allowing the tax EBITDA to be used once in totality would be consistent with trust/partnership net income being counted towards tax EBITDA **once**[10], and would ensure the rules applicable to trusts operate in effectively the same manner as they do to tax consolidated groups.[11] Furthermore, it would align Australia's FRT rules with the approach adopted by comparable jurisdictions on the implementation of a 30% EBITDA interest limitation rule in accordance with the OECD Action 4 recommendation, including for example:

- *United States*: which has implemented an interest limitation rule in Section 163(j) of the Regulations which is similar to the proposed FRT. Partnerships are a commonly used tax transparent entity in the United States by institutional investors. Under the US regulations, any "excess taxable income" can flow up to the partner of the partnership to be utilised against other "business expense income" of the partner.[12]

- *Canada*: which has implemented an excessive interest and financing expenses limitation (**EIFEL**) rule similar to the proposed FRT. Similar to the US, partnerships are a common investment vehicle in Canada. Under the Canadian laws, partnerships are not subject to the EIFEL provisions, but are required to complete the relevant calculations to ensure that the interest and financing expenses (and any denials) are included in the partner's EIFEL calculations.[13]

To illustrate the difference between Australia and other jurisdictions, we have included a simple example at **Appendix A** to compare the outcomes for investors in a trust structure under Australia's proposed FRT with:

- a partnership structure under US Section 163(j) regulation, and
- a company structure under Australia's proposed FRT.

These examples highlight the disproportionate impact for investors in Australian trusts compared to both Australian company structures and also tax transparent entities in jurisdictions that have implemented OECD Action 4.

Given the nature of our investments in trust structures and the broad use of these structures across the Australian market, it is important to us (and no doubt other foreign institutional investors) that the proposed Bill is amended to include a rule that allows trust groups to share surplus debt capacity. Such a rule would prevent material adverse impacts for structures where debt is borrowed by a trust that is higher in a structure than the asset owner.

Submission:
The Fixed Ratio Test in the Bill, in particular the proposed subsection 820-52(9) 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.

Submission 3: Debt Deduction Creation Rule

The Debt Deduction Creation Rule was not previously announced by the Government, nor was it included in the Exposure Draft Legislation. As such, this is our first opportunity to comment on this proposed rule.

We consider the proposed Debt Deduction Creation Rule to be extremely broad based and we can see the potential for it to have a range of adverse and unintended consequences across our commercial arrangements in the Australian market.

As an overarching submission, we encourage the Government to defer any legislative action with respect to the proposed rule and refer the policy to the Board of Taxation to undertake a comprehensive review of the proposal with the benefit of input from interested parties.

[10] Consistent with the policy intent set out in paragraph 2.69 of the Explanatory Memorandum to the Bill.
[11] Consistent with the policy intent set out in paragraph 2.68 of the Explanatory Memorandum to the Bill.
[12] IRC §163(j).
[13] Sections 18.2 and subsection 12(1)(l.2) of the *Income Tax Act*.

The Board of Taxation could, among other things, consider:

1) the necessity for such a broad based integrity rule for debt deductions in the context of Australia's general anti-avoidance provisions (which have repeatedly been strengthened), transfer pricing rules (which are expanded by the proposed Interest Limitation Rule) and other integrity measures (such as diverted profits tax and hybrid mismatch rules), and

2) the design of the proposed legislation and whether there is appropriate alignment between the policy objectives and the expected practical application of the rule to genuine commercial arrangements (we have endeavoured to highlight a number of these below).

In addition to this, it is noted throughout the EM (and in prior announcements[14]) that Australia is seeking to amend its existing thin capitalisation rules to limit debt deductions for MNEs in line with the OECD's recommended approach under Action 4 of the BEPS program.[15] The proposed Debt Deduction Creation Rule is not consistent with the recommended approach under Action 4.

> **Submission**
> The Government should defer any legislative action with respect to the proposed Debt Deduction Creation rule and refer the policy to the Board of Taxation to undertake a comprehensive review of the proposal with the benefit of input from interested parties.

Against these overarching comments, we make the following specific submissions in respect of particular aspects of the Debt Deduction Creation Rule in the proposed Bill that we recommend are addressed by the Government in the event that the matter is not referred to the Board of Taxation and such a rule is legislated by the Australian Parliament.

Item 1: The Debt Deduction Creation Rule should not have retrospective application

Subdivision 820-EAA applies to disallow all or part of a debt deduction for an income year where a relevant entity has such a debt deduction arising in connection with:

- the acquisition of a CGT asset, or legal or equitable obligation; or
- the issuance of a debt interest to an associate pair.

The Debt Deduction Creation Rule therefore applies to disallow debt deductions from transactions that occurred before 1 July 2023 where such a deduction is claimed in an income year after 1 July 2023. The inclusion of a new integrity rule in Australia's taxation law that applies, over and above the thin capitalisation rules, to transactions occurring prior to 1 July 2023 is concerning for the Foreign Funds. The effective retrospective application of this rule potentially increases Australia's sovereign risk among institutional investors - particularly given the breadth of the proposed rule and application to genuine commercial transactions (as outlined in Item 2 and 3 below).

We submit that the Debt Deduction Creation Rule should be amended to have application only to transactions occurring **on or after** 1 July 2023 that would otherwise trigger the application of the rules. Where Treasury or the ATO is concerned with debt deductions claimed as a consequence of transactions occurring before 1 July 2023 these should be dealt with under the integrity rules existing in Australia's taxation laws at the time the transaction occurred, including for example the General Anti-Avoidance Rule in Part IVA of the ITAA 1936 and Transfer Pricing Rules in Division 815 of the ITAA 1997 (noting that Treasury has separately proposed amendments to the transfer pricing rules to increase the potential application to related party debts[16]).

> **Submission**
> Where the Government proceeds with the rule, the Debt Deduction Creation Rules in the proposed subdivision 820-EAA should be amended to clarify that the provisions do not apply to debt deductions of an entity in an income year starting on or after 1 July 2023 that relate to:

[14] https://www.andrewleigh.com/labor_s_plan_to_ensure_multinationals_pay_their_fair_share_of_tax_media_release
[15] https://www.oecd.org/tax/beps/beps-actions/action4/
[16] Per the proposed addition to subsection 815-140(1)(a) of the *Income Tax Assessment Act 1997* (Cth).

- the acquisition of a CGT asset, or legal or equitable obligation; or
- the issuance of a debt interest to an associate pair.

that occurred prior to 1 July 2023.

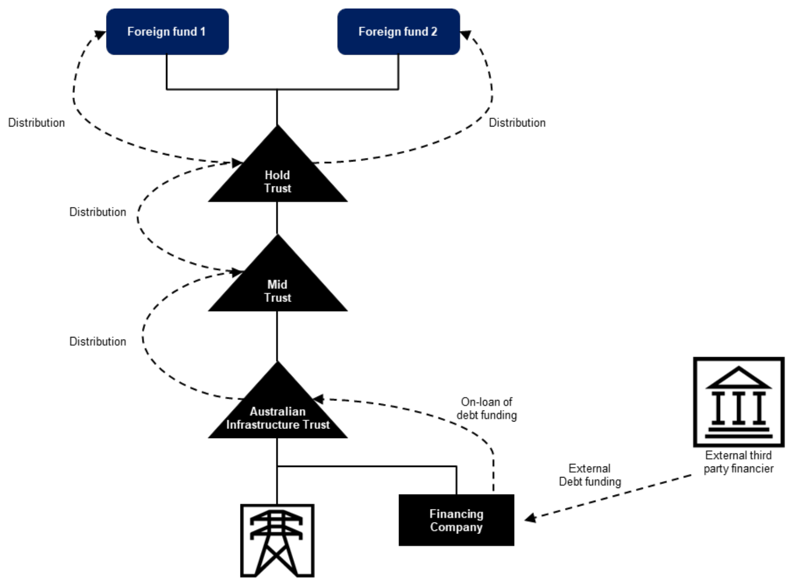
Item 2: Incorporate an exception for conduit financing arrangements

The proposed thin capitalisation rules (in particular the TPDT) include specific provisions to allow the interest limitation rules to operate in practice given the extensive commercial use of conduit financing arrangements in the market.

However, the proposed drafting of the Debt Deduction Creation Rule has the potential to undermine the ability for taxpayers to claim a debt deduction for genuine commercial debt that is arranged through such a conduit financing structure. Essentially, this is because the conduit financier (e.g. the Finance Company) and the ultimate borrower (e.g. the Asset Trust) will be an “associate pair” and therefore any borrowing between the entities to (a) acquire assets from a related entity or (b) fund a distribution to the investors would become non-deductible - despite the debt being genuine third party debt that is sourced through the conduit financing entity. This is likely to have a material adverse impact on commercial arrangements in the market as it is commonplace for an associate group to increase its external third party debt in order to fund a distribution or return equity to the investors.

To demonstrate the potential impact on ordinary commercial arrangements, Figure 2 provides an illustration of the typical conduit financing structure where debt is borrowed from third parties through a Finance Company and is used to repay existing debt and fund a distribution to the investors. Based on the proposed Debt Deduction Creation Rule, the debt deduction in the Australian Infrastructure Trust in this example could be disallowed due to the distribution paid to the investors.

Figure 2: *Illustration of conduit financing of third party debt to pay a distribution to investors*



We believe an outcome where debt deductions are disallowed due to the existence of a conduit financing arrangement would be inconsistent with the policy objective which is described in the EM which is to "*disallow debt deductions to the extent that they are incurred in relation to debt creation schemes that lack genuine commercial justification*"[17] or "*where artificial interest-bearing debt is created within a multinational group*"[18]. We therefore recommend modifying the proposed Debt Deduction Creation Rule to exclude conduit financing arrangements.

Submission:
The Debt Deduction Creation Rule in Subdivision 820-EAA should include modifications for conduit financing arrangements, similar to the modifications provided for in the TPDT.

Item 3: Incorporate an exception for post-acquisition group restructures

The proposed Debt Deduction Creation Rule does not include any modifications for genuine group restructuring - particularly in the period following a transaction. It is common practice for institutional investors to acquire third party assets or businesses and subsequently restructure the group to facilitate integration with existing businesses or separate the business based on its functional use. This type of post-acquisition restructuring is particularly common in transactions with ASX listed groups where the transaction is commonly governed by a Scheme of Arrangement that does not facilitate restructuring prior to the acquisition.

The proposed Debt Deduction Creation Rule means that any subsequent restructuring of a group that involves related party debt funding would be adversely impacted. This is despite the related party debt funding for the original acquisition being permitted and outside the scope of the proposed Debt Deduction Creation Rule.

We recommend amending the Debt Deduction Creation Rule to allow a deduction where a restructure occurs within a 12 month period of an original acquisition from a third party. This application of the rules would be consistent with a similar integrity rule concerning the resetting of an assets tax base in accordance with section 716-440 of the ITAA 1997 (the **Anti-Churn Rule**). The purpose of the anti-churning rules was to prevent foreign resident taxpayers from undertaking group restructures to obtain unintended tax benefits[19]. Relevantly, the anti-churning rule includes relief for post-acquisition restructures that occur within 12 months of the original acquisition of the entity - thereby facilitating the ability for genuine commercial group restructuring to occur[20].

The inclusion of a similar 12 month rule in the Debt Deduction Creation Rules would ensure that genuine commercial restructuring can continue to occur, whilst also achieving the policy outcomes of preventing debt deduction creation schemes that are not commercially justifiable.

Submission
The Debt Deduction Creation Rule in subdivision 820-EAA should be amended to apply to assets acquired outside an initial 12 month period to ensure that genuine commercial restructuring can occur without the arrangements being adversely impacted.

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Finally, we acknowledge that the Senate Standing Committees on Economics is likely to receive submissions from other interested parties in respect of the proposed Interest Limitation Bill. As part of preparing this submission, we have identified various technical deficiencies in respect of the specific text of the Bill. We expect that the Senate Standing Committees on Economics will review these items in conjunction with other submissions made by professional bodies or industry groups and have therefore not sought to address these technical matters in our submission.

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[17] Paragraph 2.146 of the Explanatory Memorandum to the Bill.
[18] Paragraph 2.149 of the Explanatory Memorandum to the Bill.
[19] Paragraph 1.257 of the EM to *Treasury Laws Amendment (Income Tax Consolidation Integrity) Bill 2018.*
[20] Paragraph 1.173 of the EM to *Treasury Laws Amendment (Income Tax Consolidation Integrity) Bill 2018 and paragraph 5.49 of the* Board of Taxation's June 2012 Report.

The Foreign Funds value and appreciate the ability to provide our views through the Senate consultation process.

Yours sincerely

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Appendix A

Examples to highlight the disproportionate outcomes for investors in Australian trusts

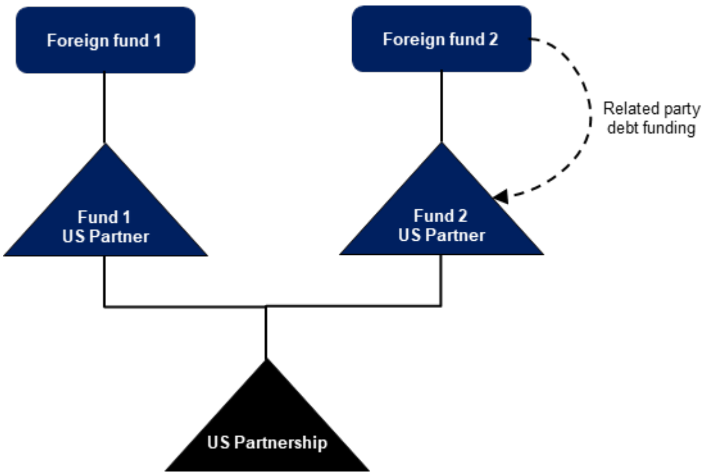
Example 1: comparing a US partnership to an Australian trust

The following example demonstrates how surplus debt capacity at a US partnership level flows through to the partners on a proportionate basis and can be applied against interest expense at the partner level – effectively allowing the partnership's tax EBITDA to be used once by the partnership and the partners collectively. This can be contrasted with the Australian unit trust structure where the surplus debt capacity is restricted to the Asset Trust (i.e. no sharing with the unitholders).

The difference in the outcomes for taxpayers under the existing US and Australia's proposed interest limitation rules is summarised in the table below (highlighting the effectiveness of the attribution model under the US rules):

Item	US Partner	Aus Trust Beneficiary
Interest expense (before Interest Limitation Rule)	$1,500,000	$1,500,000
Excess Taxable Income (from Partnership)	$1,800,000	-
Deductible / (Disallowed) interest expense	$1,500,00	($1,500,000)
Excess debt capacity attributed to next level	$300,000	-

1.1 US Partnership Structure



Partnership Section 163(j) calculation, with partner level allocations

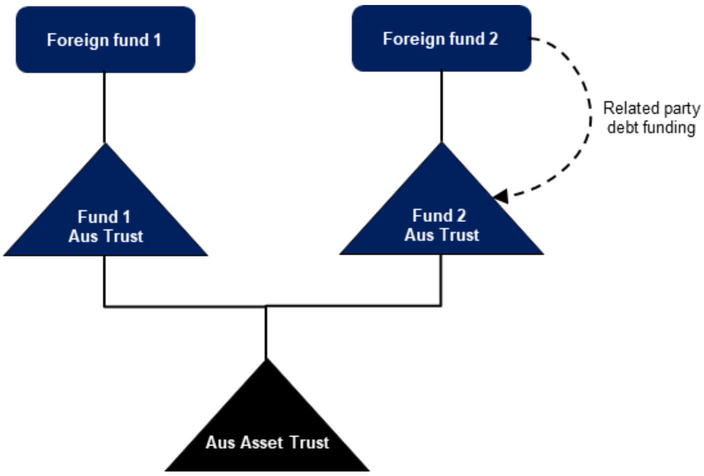
Item	US Partnership	Partner 1	Partner 2
Adjusted taxable income	$12,000,000	-	-
Business interest expense	-	-	$1,500,000
Excess Taxable Income (from Partnership)	n/a	$1,800,000	$1,800,000
Deductible business expense	-	-	$1,500,000
Excess Taxable Income (debt capacity)	**$3,600,000**	**$1,800,000**	**$300,000**

Notes:

- Excess Taxable Income is calculated as the amount of Adjusted Taxable Income in excess of what is needed to deduct its business interest expense (i.e.. $12m x 30%)
- US Partner 1 and US Partner 2 are allocated the $3,600,000 Excess Taxable Income of the US Partnership equally. This Excess Taxable Income increases each partner's adjusted taxable income increasing the deductible borrowing capacity at the partner level.
- US Partner 2 has deductible business interest expense.

- US Partner 2 utilises Excess Taxable Income of $1,800,000 from US Partnership to increase the deductible borrowing capacity at the partner level and thereby claim a deduction for business interest expense at the US partner level.

1.2 Australian Trust Structure



Fixed Ratio Test calculation, with beneficiary level allocations

Item	Asset Trust FRT	Fund 1 Aus Trust FRT	Fund 2 Aus Trust FRT
Income	$12,000,000	$5,000,000	$5,000,000
Depreciation	$2,000,000	-	-
Debt deductions	-	-	($1,500,000)
Taxable income	**$10,000,000**	**$5,000,000**	**$3,500,000**
Tax EBITDA	$12,000,000	-	-
FRT debt capacity (30% tax EBITDA)	$3,600,000	-	-
Debt deduction denials	**-**	**-**	**$1,500,000**

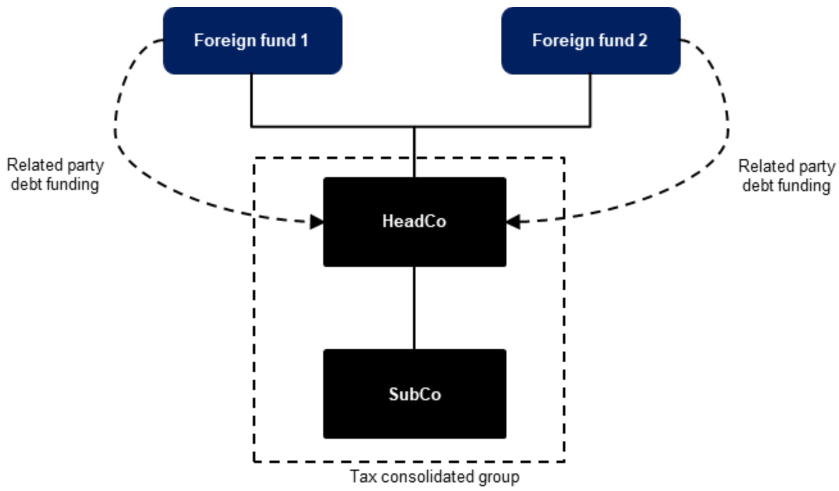
Example 2: comparing Australian company group to Australian trust group

The following example demonstrates that Tax EBITDA within an Australian tax consolidated group is calculated on a whole of group basis (i.e. at the head company level and all of its wholly owned subsidiaries). This can be contrasted with the Australian unit trust structure where the surplus debt capacity is restricted to the Asset Trust (i.e. no sharing with the Hold Trust). This is a significantly different outcome, despite having identical trading income, tax depreciation and interest expense.

The outcomes for a corporate vs partners/unitholders is summarised as follows:

Item	Corporate	Aus Hold Trust
Interest expense (before Interest Limitation Rule)	($3,000,000)	($3,000,000)
Debt capacity under FRT (30% tax EBITDA)	$3,600,000	-
Debt deductions disallowed	**-**	**($3,000,000)**

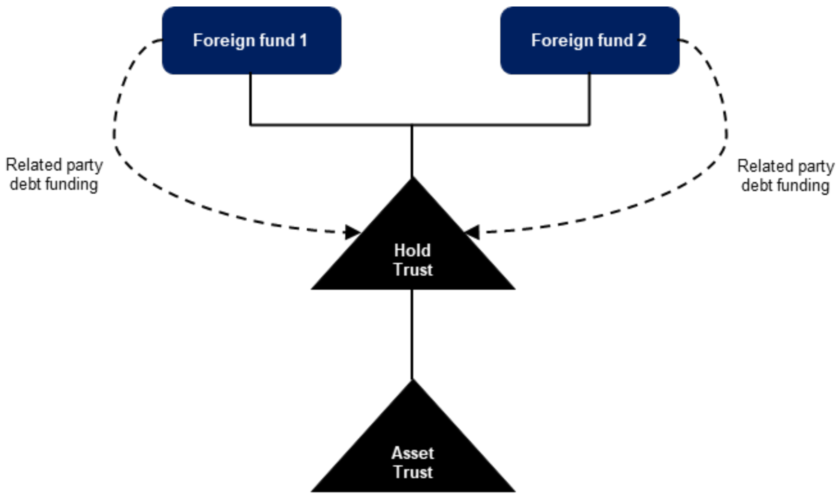
2.1 Australian Corporate Structure



Tax consolidated group tax EBITDA calculation

Item	Corporate FRT
Income	$12,000,000
Depreciation	($2,000,000)
Debt deductions	($3,000,000)
Taxable income	**$7,000,000**
Tax EBITDA	$12,000,000
FRT Limit (30%)	$3,600,000
Debt deduction disallowed	**-**

2.2 Australian Trust Structure



Asset Trust tax EBITDA calculation

Item	Asset Trust FRT	Head Trust FRT
Income	$12,000,000	$10,000,000
Depreciation	($2,000,000)	-
Debt deductions	-	($3,000,000)
Taxable income	**$10,000,000**	**$7,000,000**
Tax EBITDA	$12,000,000	-
FRT Limit (30%)	$3,600,000	-
Debt deduction disallowed	**-**	**($3,000,000)**