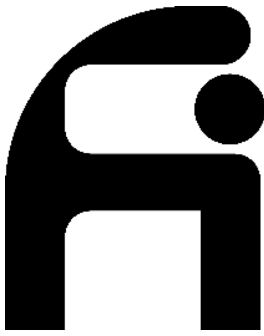

Australian
Finance
Industry
Association

**13 April 2023**

Ms Diane Brown

Deputy Secretary

Revenue, Small Business and Housing Group

The Treasury

Langton Crescent

Parkes ACT 2600

Submitted via email to: MNETaxIntegrity@treasury.gov.au

Dear Ms Brown,

**Re: Multinational Tax Integrity – strengthening Australia's interest limitation (thin capitalisation) rules**

The Australian Finance Industry Association (AFIA) is the only peak body representing the entire finance industry in Australia.[1] We appreciate the opportunity to respond to Treasury's consultation on the proposed integrity measures to address risks to Australia's domestic tax base stemming from the use of excessive debt deductions, referred to as: *Multinational Tax Integrity – strengthening Australia's interest limitation (thin capitalisation) rules.*[2]

We represent over 150 members, including bank and non-bank lenders, finance companies, fintechs, providers of vehicle and equipment finance, car rental and fleet providers, and service providers in the finance industry. We are the voice for advancing a world-class finance industry and our members are at the forefront of innovation in consumer and business finance in Australia. Our members finance Australia's future.

We collaborate with our members, governments, regulators and customer representatives to promote competition and innovation, deliver better customer outcomes and create a resilient, inclusive and sustainable future. We provide new policy, data and insights to support our advocacy in building a more prosperous Australia.

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[1] Australian Finance Industry Association (afia.asn.au).
[2] https://treasury.gov.au/consultation/c2023-370776

**INTRODUCTORY COMMENTS**

Changes to the thin capitalisation rules will significantly affect AFIA's membership.[3] AFIA is proud to be the only peak body representing Australia's entire finance sector, which contributes approximately $185.1 billion to Australia's Gross Domestic Product (GDP).[4]

According to the Australian Bureau of Statistics (ABS), Australia's total annual GDP to September 2022 was $2.3 trillion.[5] Yet, the Reserve Bank of Australia (RBA) estimates total credit provided to Australian businesses and consumers is $3.46 trillion.[6] This means the total amount of credit in the Australian economy is equal to 150.43 per cent of Australian GDP.

Through providing credit, the Australian finance sector stimulates our economy. This helps individuals and businesses to invest, thrive, achieve their aspirations and fulfill their dreams.

Therefore, we suggest any changes to the thin capitalisation rules take care not to undermine the Australian finance sector's core role in our economy.

AFIA emphasises that any changes which are pursued should allow for longer lead times than presently proposed.[7] If the proposals are pursued, they should be delayed for at least 18 months. This would better permit affected entities to properly assess the impact of the enacted law and modify their processes and procedures to ensure compliance with the new rules.

This is particularly important for AFIA members that are classified as financial entities for thin capitalisation purposes because they are registered under the *Financial Sector (Collection of Data) Act 2001*. In Treasury's consultation paper in August 2022, it was indicated financial entities would continue to be subject to the existing thin capitalisation rules.[8]

Financial entities expected to remain subject to the existing thin capitalisation rules because the OECD acknowledged the fixed ratio rule was unlikely to be effective for financial entities because they are net lenders and are subject to regulatory capital rules.[9] Accordingly, AFIA members that are classified as financial entities for thin capitalisation purposes because they

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[3] Australian Treasury, *Multinational Tax Integrity – strengthening Australia's interest limitation (thin capitalisation) rules*, released 16 March 2023
[4] IBIS World, *Finance in Australia* (31 March 2022): Finance in Australia - Market Size | IBISWorld.
[5] Australian Bureau of Statistics (ABS), *Key National Accounts Aggregates* (September 2022), Table 1, Column CT: Australian National Accounts: National Income, Expenditure and Product, June 2022 | Australian Bureau of Statistics (abs.gov.au)
[6] RBA, *Lending and Credit Aggregates* (September 2022), Table D2, Column H: Statistical Tables | RBA.
[7] Explanatory Memorandum, Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation (Exposure Draft), 26[1.134]-[1.135].
[8] Australian Treasury, *Government election commitments: Multinational tax integrity and enhanced tax transparency* (August 2022), 6.
9 Australian Treasury, *Government election commitments: Multinational tax integrity and enhanced tax transparency* (August 2022), 6.

are registered under the *Financial Sector (Collection of Data) Act 2001* are at a disadvantage to other entities, because they have no lead time to prepare for the proposed new rules and the policy rationale for amending the rules for financial entities remains unclear.

Furthermore, any such changes should only be prospective after enactment of the new rules rather than retrospective, following best practice. Under the current proposals, there is a risk of retrospectivity, given the present commencement dates.[10]

For example, any affected entities that have a year ended 30 June 2023, will have to comply with the new rules from 1 July 2023. However, it is likely that the new rules will not have been enacted by 1 July 2023. This does not allow sufficient time for affected entities to assess the impact of the enacted law and implement changes to processes and systems.

It does not seem reasonable to expect AFIA members to incur compliance and implementation costs, based on the proposed rules before there is certainty that Parliament has enacted the new rules.

The Australian Law Reform Commission (ALRC) has articulated the importance of avoiding retrospective laws at length, indicating:[11]

> *One element of the rule of law is that laws are capable of being known in advance so that people subject to those laws* ***can exercise choice and order their affairs accordingly. It follows that laws should not retrospectively change legal rights and obligations…***

***Outline of the existing thin capitalisation rules and proposed changes***

Thin capitalisation rules are integrity measures to address risks to Australia's domestic tax base stemming from the use of excessive debt deductions in Australia.

This consultation seeks feedback on two documents:

1. The *Treasury Laws Amendment (Measures for Future Bills) Bill 2023*: *Thin capitalisation interest limitation* ('the draft bill'), and;
2. The accompanying explanatory memorandum.[12]

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[10] Explanatory Memorandum, Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation (Exposure Draft), 26[1.134]-[1.135].
[11] ALRC, *Traditional Rights and Freedoms—Encroachments by Commonwealth Laws (ALRC Interim Report 127)*, 249[9.1].
[12] Explanatory Memorandum, Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation (Exposure Draft).

AFIA notes the **existing rules** for financial services entities include three tests to work out the maximum amount of deductible debt:

1. For financial entities, there is an asset-based safe-harbour test. Debt deductions are limited based on a comparison of actual deductible debt with the lower of:[13]
    - 93.75% (or 15/16th) of an entity's adjusted net assets, OR;
    - 60% (or 3/5th) of an entity's adjusted net assets plus 100% of an entity's on-lending assets.[14]
2. There is an alternative 'worldwide gearing debt amount' methodology.[15]
3. There is also an alternative 'arms-length debt amount' methodology.[16]

Under the existing rules, financial entities are defined as:[17]

> *An entity other than an ADI that is:*
>
> (a) *a registered corporation under the Financial Sector (Collection of Data) Act 2001;*
>
> *(b) a securitisation vehicle;*[18]
>
> *(c) an entity that is a financial services licensee within the meaning of the Corporations Act 2001 whose licence covers dealings in securities, managed investment products or government debentures, stocks and bonds and which carries on a business of dealing in securities, but not predominantly for the purposes of dealing in securities with, or on behalf of, the entity's associates.*
>
> *(d) an entity that is a financial services licensee within the meaning of the Corporations Act 2001 whose licence covers dealings in derivatives and which carries on a business of dealing in derivatives, but not predominantly for the purposes of dealing in derivatives with, or on behalf of, the entity's associates*

The draft bill would replace these tests for financial services entities that were previously financial entities under the paragraph (a) definition of financial entities for thin capitalisation purposes, being entities that are registered under the *Financial Sector (Collection of Data) Act 2001*. The treatment of such financial entities would become the same as other (non-financial) entities.

Separate rules apply to Authorised Deposit Taking Institutions (ADIs), which are not substantially impacted by the draft bill.

[13] Division 820 of the ITAA 1997.
[14] For Authorised Deposit-Taking Institutions (ADIs), there is a separate test of 6% of risk weighted assets plus T1 prudential capital deductions.
[15] Division 820 of the ITAA 1997.
[16] Division 820 of the ITAA 1997.
[17] Section 995-1(1) of the ITAA 1997.
[18] As defined in subsection 820-942(2) of the ITAA 1997.

The new rules introduce three **alternative tests,** two of which are which are based on earnings. The three new tests are outlined below. They are:

1. **The fixed ratio test** – which would allow a financial entity to claim **net debt** deductions up to 30 per cent of its tax 'Earnings Before Interest, Taxes, Depreciation and Amortisation' (EBITDA). The explanatory memorandum notes this is broadly equivalent to 30 per cent of the entity's taxable income or tax loss adjusting for deductions for net interest, decline in value, capital works and prior year tax losses.[19]
2. **The group ratio test** – would allow financial entities to deduct net debt deductions beyond the amount allowed under the **fixed ratio test** based on a 'relevant financial ratio of the worldwide group'. Which is to say a relevant ratio of the worldwide group replaces the threshold of 30 per cent of tax EBITDA.[20]
3. **The external third party debt test** – would allow financial entities to deduct all debt deductions which are attributable to third party debt and that satisfy certain other conditions. According to the explanatory memorandum, this test: 'replaces the arm's length debt test for all entities previously subject to the arm's length debt test'.[21]

The first test, that is, **the fixed ratio test**, would be the **default test** under the new thin capitalisation rules, unless an **eligible financial entity** specifically **elected** to apply one of the other two tests.[22] Only one of the three tests can be applied in any given tax year.

Under the proposed changes, denied deductions under the fixed ratio test may be carried forward for up to 15 years, subject to satisfaction of an amended Continuity of Ownership Test (COT). However, entities would lose the right to carry forward denied deductions if an entity changes to another methodology.

### Changes to the definition of financial entity

The draft bill proposes to amend the relevant definition of 'financial entity' by repealing subparagraph (a) of the definition in s 995-1(1) of the *Income Tax Assessment Act 1997* (Cth) (the ITAA 1997).[23]

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[19] Explanatory Memorandum, Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation (Exposure Draft), 5[1.12].
[20] Explanatory Memorandum, Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation (Exposure Draft), 5-6[1.15]-[1.16].
[21] Explanatory Memorandum, Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation (Exposure Draft), 6[1.17].
[22] Explanatory Memorandum, Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation (Exposure Draft), 9[1.28].
[23] Explanatory Memorandum, Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation (Exposure Draft), 8[1.24].

The explanatory memorandum asserts that the purpose of this changed definition is the perception of 'integrity concerns' regarding whether certain class of entities should:

> ***[G]enuinely be considered financial entities,*** *with access to generally more favourable taxation treatment'.*[24]

In other words, questions have been raised as to whether certain classes of entities registered under the *Financial Sector (Collection of Data) Act 2001* are bona fide financial entities.

AFIA represents bona fide financial entities who hold relevant licences to conduct business as financial entities. We consider repealing this section of the definition will exclude genuine financial entities. The consequence of this change, which has been implemented without sufficient consultation, will have detrimental economic consequences and hamper investment in the Australian economy, especially from multinational groups with the most access to capital.

**Changes to the deductibility of financing costs for offshore investments**

The draft bill also proposes to amend paragraph 25-90(b) and paragraph 230-15(3)(c) of the ITAA 1997 in a manner that any financing costs that have a nexus with deriving non-assessable non-exempt (NANE) income from offshore investments in no longer deductible.[25]

This was not mentioned in Treasury's consultation paper in August 2022.

While this may have the potential to raise revenue for Australia's domestic tax base by disallowing financing costs, there is a potential risk this amendment will be detrimental to Australia's domestic tax base as multinational groups with offshore operations will seek to refinance any debt in Australia by raising debt in offshore countries via offshore subsidiaries.

If that were the case, there could be a significant impact on the amount of credit in the Australian economy, the revenue collected from Australian lenders and employment in relation to supporting treasury services.

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[24] Explanatory Memorandum, Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation (Exposure Draft), 8[1.24]-[1.26].
[25] Explanatory Memorandum, Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation (Exposure Draft), 23[1.118] – [1.120].

AFIA's recommendations

1. Further consultation is required on these changes before implementation, given the impact they could have on the finance sector's $185.1 billion contribution to GDP.[26]

2. If these changes are adopted a lead time of at least 18 months must be added, so that the legislation does not take effect until 18 months after the bill receives Royal Assent. [27]

3. Any changes to thin capitalisation rules should be prospective after enactment of the new rules, not retrospective, in form and effect, so businesses can plan with certainty and sovereign risk is minimised.[28]

4. AFIA would welcome further explanation as to the policy rationale for the proposed amendments which target perceived non-bona fide financial entities which are being applied to the financial sector generally. Such an approach could have deleterious unintended consequences.[29] Instead, there should be a targeted measure dealing with perceived non-bona fide financial entities only to ensure that genuine financial entities that contribute to the Australian economy are not unfairly disadvantaged. Treasury should reconsider whether there is a genuine need for a broad based amendment to the definition of 'financial entity' by repealing paragraph (a) of the definition in s 995-1(1) of the ITAA 1997. It may be more appropriate to amend the definition to align with genuine financial services groups that carrying on business of providing financial services to customers in Australia. If Treasury pursues this amendment, clarification should be provided in the explanatory memorandum regarding why those financial entities and groups (including AFIA members) that genuinely provide financial services to customers in Australia present risks to Australia's domestic tax base stemming from the use of excessive debt deductions.

5. Alternatively, Treasury should consider amending the definition of 'financial entity' in paragraph (c) in subsection 995-1(1) of the ITAA 1997. Many entities that are 'genuinely' registered under the *Financial Sector (Collection of Data) Act 2001* will also have an Australian Financial Services License (AFSL) that covers dealing in a financial product by issuing, applying for, acquiring, varying or disposing of a financial product in respect of i) interests in managed investment schemes or ii) securities. These entities may otherwise qualify as a 'financial entity' under the paragraph (c) definition of financial entity if they carry on a business of dealing in securities, but not predominantly for the purposes of dealing in securities with associates. This definition could be extended to entities that

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[26] IBIS World, *Finance in Australia* (31 March 2022): Finance in Australia - Market Size | IBISWorld.
[27] Explanatory Memorandum, Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation (Exposure Draft), 26[1.134]-[1.135].
[28] ALRC, *Traditional Rights and Freedoms—Encroachments by Commonwealth Laws (ALRC Interim Report 127)*, 249[9.1].
[29] Explanatory Memorandum, Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation (Exposure Draft), 8[1.24]-[1.26].

both have the relevant AFSL license and carry on business of providing financial services to customers in Australia. Such an amendment would ensure that any non-bona fide financial entities to the financial sector do not seek to use the AFSL license criteria and business dealings to qualify as a financial entity to the detriment of 'genuine' financial services groups. Alongside this, there is also a need to ensure s 995-1(1)(b)-(d) of the ITAA 1997 are consistent with ss 820-584 and 820-39.

6. AFIA would welcome further consultation on the appropriate definition of 'financial entity' for the purposes of Division 820 of the ITAA 1997 to ensure that the thin capitalisation rules are fit for purpose, give rise to appropriate outcomes for genuine financial serv ices groups and do not give rise to inappropriate outcomes for any non-genuine financial services groups.

7. If these changes are pursued, substantial examples should be provided in the explanatory memorandum accompanying any final bill. The absence of any examples will make implementation of the new rules more difficulty and give rise to uncertainty. These examples must outline how the changes would apply in practice to financial entities. For example:
    a. The explanatory memorandum should outline how interest rate swaps (and other derivatives) are dealt with under the each of the new tests, both in working out debt deductions, net debt deductions, GR group third party interest expense and financial statement net third party interest expense.
    b. The explanatory memorandum should outline how genuine commercial leasing arrangements are dealt with under the each of the new tests, including in working out debt deductions, net debt deductions, GR group third party interest expense and financial statement net third party interest expense. It is currently unclear, whether you should include the 'time value of money component' of rental payments made or received in these calculations.
    c. The explanatory memorandum should provide an example how capital allowances under Subdivision 40-B and a balancing adjustment under Subdivision 40-D of the ITAA 1997 are applied in working out the amount of 'tax EBITDA.'
    d. The explanatory memorandum should provide examples of 'amounts in the nature of interest' and 'any other amount is calculated by reference to the time value of money.' For example, is it Treasury's intention that any gains or losses arising under Division 230 of the ITAA 1997 using a compounding accruals calculation includes an amount calculated by reference to the time value of money? Further, where an amount partly includes an amount calculated by reference to the time value of money, is an apportionment required?

8. Treasury should consider whether the definition of 'net debt deductions' should include 'net debt deductions' that are included in assessable income as a result of an entitlement to a trust distribution. For example, if a financial services group borrows funds to invest in units in a trust which are lent by the trust to third parties, it would seem appropriate to include any share of the net income of the trust that comprises net debt deductions in the group's net debt deductions in the same way as if the group had lent the funds directly to third parties.

9. Treasury should reconsider whether it is necessary that 'net debt deductions' include an amount included in assessable income that is 'any other amount that is calculated by reference to the time value of money.'[30] While the definition of debt deduction includes any other amount calculation by reference to the time value of money,[31] debt deductions currently exclude hedging costs, foreign currency losses and rental expenses.[32] Including income amounts or parts of income amounts in the definition of 'net debt deductions' would seem to give rise to an asymmetric outcome.

10. Further, Treasury should reconsider whether it is necessary that 'any other amount that is calculated by reference to the time' is deemed to be an amount of interest included in the audited consolidated financial statements for the purposes of calculation the 'GR group net third party interest expense'.[33] This is not a concept that exists for financial accounting purposes and would give rise to significant compliance costs to work out this amount for a global accounting group. Rather, there should be a direct link to the audited consolidated financial statements, as prepared in accordance with accounting principles, to reduce compliance costs and approximate the group ratio earnings limit.

11. Treasury should outline in the explanatory memorandum how the new rules are aligned with 'OECD best practice' which is referenced in the explanatory memorandum without support from OECD materials.

12. Treasury should consider how these changes may impact Groups with securitised funding arrangements. Treasury should have regard to the Explanatory Memorandum to the *Taxation Laws Amendment Act (No. 5) 2003*, which introduced amendments to ensure bona fide securitisation vehicles did not inappropriately have a proportion of their interest deductions denied under the thin capitalisation rules.[34] For example:
    a. A securitisation entity that does not meet the definition of a 'securitisation vehicle' in subsection 820-942(2) of the ITAA 1997 may be a 'general class investor' and

30 Proposed subparagraph 820-45(3)(b)(iii).
31 Subparagraph 820-40(1)(a)(i) of the ITAA 1997.
32 Refer subsection 820-40(3) of the ITAA 1997.
33 Proposed paragraph 820-53(1)(b).
34 Supplementary Explanatory Memorandum, *Taxation Laws Amendment Act (No. 5)* 2003, [1.4]-[1.20].

subject to new Subdivision 820-AA as the exemption for special purposes entitles in section 820-39 of the ITAA 1997 is not being amended to prevent Subdivision 820-AA from applying to a special purpose entity although we would expect Division 820 should provide an exemption for all aspects of the thin capitalisation rules for special purposes entitles which satisfy section 820-39 of the ITAA 1997.

b. An income tax consolidated group may have a member that meets the definition of 'securitisation vehicle' in subsection 820-942(2) of the ITAA 1997 and is a financial entity under the paragraph (b) definition, or it may have a member that meets the definition of a financial entity under the paragraph (c) or (d) definitions. Regarding the proposed amendments to section 820-583, it unclear whether the intention of the proposed amendments is to ensure the income tax consolidated group is not a financial entity for thin capitalisation purposes, unless the head company of the income tax consolidated group meets the relevant definition or whether the single entity rule would apply such that the head company of the income tax consolidated group would be treated as if it was a financial entity for thin capitalisation purposes. In this example, Treasury could also consider the situation where the securitisation vehicle satisfies the conditions in section 820-39 of the ITAA 1997, whether the group may be precluded from making a choice to apply the external third party debt test having regard to proposed subparagraph 820-43(5)(a)(ii) of the draft bill and how Division 820 applies to the securitisation vehicle.

13. AFIA would welcome further explanation as to the policy rationale for why debt deductions disallowed over the previous 15 years under the fixed ratio test are subject to the COT but not the business continuity test. This could be explained in the explanatory memorandum.

14. Income tax consolidated groups that were previously financial entities because the head company or a member was registered under the *Financial Sector (Collection of Data) Act 2001* should be able to elect to choose to be treated as an ADI under Subdivision 820-EA. This would enable financial entities and groups (including AFIA members) that genuinely provide financial services to customers in Australia to have an equivalent thin capitalisation rule applying for banks and non-banks that may be undertaking similar activities and completing in the Australian market. The proposed amendments to the repeal subparagraph (a) of the definition in s 995-1(1) of the ITAA 1997 would now appear to preclude many taxpayers, if eligible, from making this election.

15. The external third-party debt test may be attractive to groups predominantly funded by third party debt. However, many groups may have small amounts of associate debt for cash pooling or liquidity purposes. As a compliance cost saving measure, Treasury should consider whether any associate debt deductions should still be allowable to the extent that the group's debt deductions to associates do not exceed $2 million.

16. Treasury should consider whether the amendments to paragraph 25-90(b) and paragraph 230-15(3)(c) of the ITAA 1997 would adversely affect Australia's domestic tax base and employment. Further consultation should be undertaken in this regard.

17. If the amendments to paragraph 25-90(b) and paragraph 230-15(3)(c) of the ITAA 1997 are pursued, Treasury should consider providing transitional relief for exiting debt arrangements. This is because of the commercial and compliance issues associated with the proposed amendments. For example:
    a. The amendments may trigger material adverse change or affect provisions in lending agreements.
    b. Many borrowers will have fixed term lending arrangements which cannot be repaid or refinanced on or before the commencement of the new rules without significant financial penalties.
    c. Many borrowers will have pooled funds from multiple sources and, given that money is fungible, it would be impossible to determine which funds were used for income producing purposes and which funds were used for investing in offshore subsidiaries that may produce NANE dividends.

**CLOSING COMMENTS**

Thank you for the opportunity to comments on these proposals.

I would appreciate the opportunity to discuss our recommendations and provide Treasury with further information as may assist its further considerations on these matters.

Should you wish to discuss our submission or require additional information, please contact me at sebastian.reinehr@afia.asn.au or on 0474 704 992.

Yours sincerely

Roza Lozusic
**Executive Director, Policy and Public Affairs**