Accountants & Advisors

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Committee Secretariat
Senate Standing Committees on Economics
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Dear Committee Members

Senate Inquiry into Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill [Provisions] 2023 (the Senate Inquiry)
Submission by SW Accountants & Advisors

SW Accountants & Advisors Pty Ltd (**SW**) welcomes the opportunity to make a submission to the Economics Legislation Committee (**Committee**) in relation to the Senate Inquiry to the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill [Provisions] 2023* (the **Bill**).

In this submission, we have provided you with a brief background of SW's business and clients, and comments in the context of your terms of reference. SW is an independent professional services firm in Australia with over 40 partners and 300 staff nationally. SW provides a wide range of accounting, business advisory, corporate finance, tax and audit services to listed AREITs, unlisted property trusts, private property developers and private property investors that have foreign controllers. In particular, SW is a member of the SW International network and Praxity Alliance, a global network and global alliance of independent professional services firms. This positions SW to provide professional services to both domestic clients and international clients engaging in business in Australia.

We are aware that industry bodies (including the Property Council of Australia) will be raising a number of technical issues that arise from the Bill. The purpose of this submission is to provide further details on issues that we have observed that are particularly relevant to our clients.

Yours sincerely

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1. Overview

1.1. SW's role as a trusted advisor in the Australian property sector

SW is proud to have a history of over 80 years providing professional services to clients in the Australian property sector. With global capital becoming increasingly important in the investment and growth of the Australian property sector, SW leverages its experience being a trusted advisor to domestic and international clients to provide the specialist skills and capability necessary to realise property development projects and investments in Australia. This is done in part through SW's membership to the SW International Network and the Praxity Alliance. SW also has experience in providing professional services in a number of property asset classes, including commercial and industrial properties, renewables, residentials and build-to-rent (**BTR**) developments.

In providing professional services to domestic and international clients in the Australian property sector, SW has gained insights into the commercial realities of the structures used to invest in property. As such, SW holds a privileged position being a trusted advisor to key stakeholders in the Australian property sector. It is with this privilege that SW understands it has a responsibility to provide a submission to the Committee that addresses the inequity and unfairness that property owners will face under the Bill, if it is passed unamended.

We note that SW has been part of consultations of other industry bodies in providing submissions to address issues in the Bill. The purpose of SW's submissions is to address issues that we have identified that are relevant to our clients.

2. General comments on the Bill

At SW, we recognise that a well-functioning tax system is critical to ensuring that the Federal Government can fund the essential services that the Australian public demand. SW agrees with the broad intended objectives of the Bill, however, we have major concerns with certain elements of proposed legislation.

In particular, SW has major concerns as to the third party debt test and the apparent unavailability of clients with trust structures to have access to this test as an alternative to the fixed ratio test (**FRT**).

This outcome, we consider, is clearly at odds with the stated objective of the third party debt test. In this regard, the Explanatory Memorandum states as follows:

> *…the third party debt test balances the tax integrity policy intent and the need to ensure genuine commercial arrangements are not unduly impeded.*

The way that the proposed legislation is currently drafted, the third party debt test is not made available to trusts. We assume that this is a drafting oversight – such an outcome would seem so contrary to the stated policy intent that it seems inconceivable that this exclusion would be intentional.

There are also other concerns with the third party debt test as currently expressed, which are commented on below.

The other major concern SW has with the proposed legislation, is the way that the FRT operates with reference to the Tax EBITDA calculation and the exclusion of income distributions from subsidiary trusts. SW is very concerned that the way that the Tax EBITDA definition is currently expressed will significantly and adversely affect property trusts that are foreign controlled (relative to property trusts that are not subject to the thin capitalisation regime) and the many investors that rely on investment returns from this sector, many of which are SW's clients.

As an illustration of the expected outcome, SW clients that are foreign controlled would not (under the current Bill) be able to access the third party debt test. Our modelling of a sample of our clients indicates that for property trusts with 100% Australian bank debt can have denials of debt deductions of between 30% and 100%. This outcome is considered incongruous for a high yielding property investments with modest gearing of under 50% and only Australian bank debt.

If the legislation is left unamended, the Bill will have the following effect on the property trust market generally:

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- Foreign cornerstone investors who are financing BTR developments will try to exit the market and new foreign investors are unlikely to enter the market to fund the development of any new BTR property projects;
- Property trusts that are subject to thin capitalisation will provide lower after-tax returns to investors compared to entities that are not subject to the new measures. Therefore, market pricing for property trusts will be distorted to preference entities that are not subject to the thin capitalisation regime, and
- Property trusts will have less cash to reinvest in sustainable Australian real property assets which provide significant contribution to the Australian economy.

We have provided more detailed comments on specific elements of the Bill, with suggested amendments.

3. Comments on specific points

The Committee has asked for comments on the provisions of the Bill. We have provided our comments below and references to the specific provisions of the Bill. We have also included suggestions as to how our concerns may be addressed.

3.1. Third party debt test

3.1.1. *Definition of Australian resident (and exclusion of trusts)*

Issue

As noted above, the way in which the third party debt test is currently expressed, trusts are effectively precluded from accessing it. This is because the requirement in existing section 820-427A(3)(e) of the Bill that the entity issuing the debt interest be 'an Australian resident'. An 'Australian resident' is defined in section 995(1) of ITAA 1997 with reference to the definition of a 'resident of Australia for the purposes of' ITAA 1936. Critically, the definition of 'resident of Australia' in section 6(1) of ITAA 1936 does not include a resident trust estate.

It is assumed that this outcome arises from an unintended drafting glitch, as there does not appear to be any reasonable policy or commercial basis to exclude trusts from access to the third party debt test in the new rules, that would preclude property trusts from reliance upon it. Indeed, such an outcome appears quite contrary to the stated intention of the third party debt test.

Recommendation

To rectify this issue, we recommend that section 820-427A(3) of the Bill be amended to include the words included in bold:

> *3) A debt interest issued by an entity satisfies the third party debt conditions in relation to an income year if the following conditions are satisfied:*
>
> > …
> >
> > *(e) the entity is an Australian resident **or a resident trust estate as defined in Division 6 of Part III of the ITAA 1936**.*

For this change to be effective, we also recommend that similar amendments be included in the following paragraphs:

- section 820-427B(4)(b)(ii), and
- section 820-427C(g).

3.1.2. *Security arrangements*

Issue

Another issue SW has concerns with in relation to the third party debt test is the restrictive rules proposed to be imposed in relation to the provision of cross guarantees by members of the group as security for the external debt.

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Under the Bill, property trusts are precluded from accessing the third party debt test due to the trusts within the property trust group providing cross guarantees to external lenders due to the application of section 820-427A(3)(c)(ii). Entities that have a portfolio of assets used to secure a debt facility to provide commercial comfort to lenders and more favourable pricing, should not be precluded from accessing the third party debt test. From a policy perspective, property trust groups should not be placed in a worse position than single asset holding trusts.

Recommendation

We recommend that section 820-427B of the Bill be amended to insert the following after subsection 820-427B(4):

> *(5) In applying subsection 820-427A(3) in relation to the income year, in relation to a relevant debt interest or the ultimate debt interest mentioned in subsection 820-427C(1), disregard section 427A(3)(c)(ii) to the extent the rights under or in relation to a guarantee, security or other form of credit support are between members of an obligor group.*

3.1.3. *Credit support for BTR developments*

Issue

Trusts are effectively precluded from accessing the TPDT where credit support is provided by a parent entity unless the credit support rights are provided in relation to development of real property assets (subsection 820-427A(4)). However, the exception provided by subsection 820-427A(4) to allow credit support for developments ceases if the credit support extends beyond the development phase. It is our experience that banks require the parent entity to provide credit support beyond the development phase of BTR developments. Credit support is required until the property is almost fully leased. It can take 1 to 2 years to reach the point that the banks no longer require credit support from a parent entity.

Recommendation

We recommend that the exception provided in subsection 820-427A(4) be extended to apply for up to 2 years post completion of the development.

3.1.4. *Interest rate hedging – conduit financier rules*

Issue

As part of the third party debt test, the Bill appropriately provides a limited concession for arrangements where a conduit financier is interposed between the third party lender and the ultimate borrower of the funds. Whilst the inclusion of such rules is welcomed, SW is concerned as to the exclusion of costs associated with interest rate swaps from the conduit financier rules.

It is submitted that there is no policy reason for excluding costs associated with interest rate swaps from the conduit financier rules. An interest rate swap is a genuine commercial transaction generally entered into by borrowers to reduce exposure to interest rate fluctuations.

SW has observed that property trusts (like many other businesses) commonly enter into interest rate hedging arrangements with Australian banks for this purpose – that is, to reduce exposure to interest rate fluctuations in order to provide stability of returns for its many investors. Where the arrangements are entered into with Australian third parties (such as Big 4 banks), there is no base erosion that would occur in relation to such arrangements. In fact, under the current rules, the income would be assessable to Australian banks and should be deductible to the property trusts. On this basis, we recommend that symmetry in the system be retained by either removing the current restriction or at least limiting its application to arrangements with associated/related parties.

Recommendation

We recommend that either:

- section 820-427B(2) be removed from the Bill, or

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- alternatively, that this provision be amended to include the bolded words:

  Disregard subsection 820-427A(2) in relation to a relevant debt interest mentioned in subsection 820-427C(1) ***where the debt deduction is paid to an *associate entity***.

3.1.5. *Foreign currency hedging arrangements – conduit financier rules*

Issue

SW has a similar concern with the exclusion from the conduit financier element of the third part debt test of foreign currency hedging arrangements. For illustration, a property trust may have debt funding provided by foreign (unrelated) parties denominated in a foreign currency. In order to manage the foreign exchange risk, the property trust hedges the foreign currency exposure and on-lends money to the group in AUD. This is a common and commercial practice SW has observed in the property trust market.

Given Australia is a net capital importer, and it is ordinary commercial practice to hedge foreign denominated loans, borrowers and conduit financers should not be precluded from using the third party debt test simply because of the existence of foreign currency hedging arrangements.

On this basis, we recommend that the provisions be amended as set out below.

Recommendation

We recommend that section 820-427A(2) be amended to insert the following in bold:

> *For the purposes of subsection (1), treat a *debt deduction of an entity as being attributable to a *debt interest issued by the entity if:*
>
> *…*
>
> ***(c) the debt deduction is directly associated with hedging or managing the foreign currency risk in respect of the debt interest.***

We recommend that the following be inserted into section 820-427C(2) after paragraph 820-427C(2)(d)(ii):

> *(e) disregard the terms (if any) of the ultimate debt interest that have the effect of allowing the recovery of reasonable costs that relate to the conduit financer managing foreign exchange risks with third parties.*

3.2. Fixed Ratio Test (FRT)

Issue

SW has a major concern with the way that the FRT is currently expressed in the Bill, in particular with the way that distribution income is dealt with. We have set out below two specific issues in this regard.

Our modelling of a sample of our clients indicates that for property trusts with 100% Australian bank debt can have denials of debt deductions of between 30% and 100% of debt deductions. This outcome is considered incongruous for a high-yielding property investments with modest gearing of under 50% and only Australian bank debt.

This outcome for a 100% owned group of trusts is contrasted with the position of 100% owned group of companies that are able to and have elected to form a tax consolidation group. If the property trust group was treated as a single economic entity (like a consolidated tax group), the application of the FRT would give rise to no interest denial. The outcome of this comparison makes little sense and is clearly an unfair outcome for 100% owned property trust groups.

Importantly, it is likely to be common for property trust groups that debt will be at the head trust level, rather than at the subsidiary property-owning level. This will lead to an overreach of the FRT provisions that would be disproportionate with its policy objectives.

We have provided further detail below as to how this anomaly arises under the current wording of the FRT and recommendations as to how it might be addressed. In essence, the two key issues involve the way that the Tax EBITDA relevant to the FRT is calculated under the existing Bill.

3.2.1. *Rules relating to duplication of trust income*

Issue

The FRT is a test that essentially caps deductible interest at 30% of a tax-based Tax EBITDA. In determining this Tax EBITDA, the Bill requires essentially that income distributions from a subsidiary trust (or, indeed, any trust in which a 10% or greater interest is held) are to be disregarded. . The stated purpose of this rule (refer to paragraph 2.69 of the Explanatory Memorandum to the Bill) is to ensure that there is no double counting of income for the purposes of the subsidiary entity's gearing as well as the parent entity. This objective is certainly understood – it is agreed that there is a risk where a subsidiary trust has its own debt deductions, without an integrity measure there could be double leverage of essentially the same amount of earnings. However, not allowing distributions from a sub trust to be counted towards the Tax EBITDA of the head trust is disproportional to the objective of ensuring that there is no double counting of income.

SW strongly believes that the rule as currently expressed will present major inequitable outcome for property trust groups. We have proposed amendments below.

Recommendation

We recommend that either:

- section 820-52(6) of the Bill removed in its entirety from the Bill. If Treasury is concerned about the potential for double counting of earnings, it is suggested that an 'economic group' concept be considered for groups of entities that are not a consolidated tax group, or
- amend the legislation to allow a proportional ownership % of the excess FRT capacity of a sub trust to be 'pushed up' to the head trust. This is similar to the concept of associate entity excess amounts in the current thin capitalisation rules.

3.3. Commencement date

The changes being effected by the Bill are profound, overreaching and the proposed commencement date of 1 July 2023 (given that the legislation remains in Bill form and subject to the review process being undertaken by the Committee) is regarded as quite inadequate. To allow sufficient time for the necessary amendments to be made to the Bill (to rectify the issues noted above), and for the final legislation to be digested by the business community, we submit that there are compelling grounds to support a deferral of the start date by 12 months to 1 July 2024.

As a minimum, we submit that the commencement date for the Bill should be for income years commencing after 1 January 2024 or a later time to ensure that the legislation does not have retrospective application.

Although we acknowledge that the proposed changes were announced in the October 2022 Budget, the Bill contains significant differences both relative to the announcement and also from the Exposure Draft that was released on 22 June 2023.

4. Conclusion

Internationally, there is growing interest in the investment and growth of the Australian property sector. Any changes to the thin capitalisation regime should be balanced, measured, and cognisant of the commercial realities and impact on property trusts, a key stakeholder contributing to Australia's economy and housing supply.

Any reform of the thin capitalisation regime must take due account of international competition for global capital and the policy objectives intended. As discussed above, the purpose of the Bill is to address risks to Australia's domestic tax base arising from excessive use of interest expenses or debt deductions, which amount to base erosion or profit shifting arrangements. However, as outlined in the issues, the unintended effects on property trusts generally are overreaching, disconcerting, and if passed unamended, will have adverse tax consequences that will not be aligned with the policy objectives. Should any legislative change be necessary, it must be appropriate, proportionate and supported by sufficient time for consultation and implementation prior to commencement.

SW fully supports, and will continue contributing to, the ongoing reform of Australia's current tax laws, particularly in dealing with tax issues affecting the Australia property sector, to ensure the future success of Australia.