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22 December 2023

Committee Secretary
Senate Standing Committee on Economics (Legislation)
PO Box 6100
Parliament House
Canberra ACT 2600

By email: economics.sen@aph.gov.au

Dear Committee Secretary,

Parliamentary Amendments to Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023

The Corporate Tax Association (CTA) welcomes the opportunity to provide the Committee with a submission in relation to the parliamentary amendments to *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share - Integrity and Transparency) Bill 2023* (Bill). A list of the 156 CTA corporate members and more information on the role of the CTA can be found here.

The CTA fully supports the broad policy intent of the wider Bill and acknowledges the parliamentary amendments are an improvement on previous iterations of the initial Bill. We note the government's election commitment to raise revenue from the measure over the forward estimates and how this plays to a minor degree into the government's wider budget strategy[1]. However, we want to make it clear that there are legitimate concerns with the current draft rules and suggest that with some relatively minor changes, the rules will better balance the government's election commitment with sound tax policy.

As such, we make the following recommendations for the Committee's consideration. Acting on these is important, particularly for Australian outbound groups expanding offshore and inbound groups investing in critical capital-deepening activities in Australia. In our view, the overarching 30% tax EBITDA rules, transfer pricing rules, and a more workable debt deduction creation rule will deal with integrity issues associated with excessive debt funding from related parties, and better align our rules with international best practice without unduly impacting revenue forecasts and budget outcomes.

[1] The Budget revenue forecast of the measure is approximately $700 million per year. Large business corporate tax revenues are around $100 billion a year, so the impact is less than 1% of large business corporate revenue collections.

Recommendations

1 Further refinement of the debt deduction creation rule (DDCR)

The underlying policy intent of the DDCR is to prevent the artificial creation of debt deductions where related parties use related party debt to acquire certain assets from related parties or undertake debt-funded reorganisations involving related parties.

Importantly, the DDCR rules are to apply first so taxpayers must initially work through these provisions, secondly, apply transfer pricing rules to any remaining debt deductions, and then finally apply the tax EBITDA tests as a cap. In effect, the starting position of the rules is that no related party debt deduction is allowed (i.e. we have a 0% related party EBITDA regime subject to exceptions despite comments made by some to the contrary). As was noted in the EM to the original Bill, the intent of the DDCR was a modernisation of the old debt creation rules. As drafted (and amended to date), whilst the draft rules are now more focussed on artificial transactions, they are still wider in scope than the original policy intent and can still impact related party debt-funded transactions in the ordinary course of business that are not an integrity concern. As the DDCR is applied first, it is critical that it should only deny related party debt deductions that are artificial and contrived, otherwise the other wider rules are superfluous. In our view, some simple amendments will ensure they operate as intended whilst minimising compliance costs for both the ATO and taxpayers:

a) Amend section 820-423AA to ensure the debt-funded acquisition of trading stock from related parties is excluded from the application of subsections 820-423A(2) and (5).

b) Clearer wording is required to remove residual uncertainty from subparagraph 820-423A(5)(b)(ii). This can be done by removing that sub-paragraph but adding the words “directly or indirectly” in sub-paragraph (i) before “fund”, such that the relevant financial arrangement is captured if it is used to directly or indirectly fund one of the specified ‘excluded’ payments in sub-section 820-423(5A). This is particularly important for cash pooling arrangements in place where it may be difficult to trace the use of borrowed funds to an excluded distribution and to also ensure that companies that are undertaking expansion projects but continue to pay dividends are not adversely impacted.

c) Clarifying the exclusions in subsection 820-423AA(1) to ensure capital contributions that are new contributions of foreign equity (but technically not new membership interests) are not caught by the rules. This is necessary because in some jurisdictions (e.g. USA and Australia) capital can be contributed without a new membership interest being issued.

d) Ensuring transactions currently not subject to the tax EBITDA rules (because the taxpayer is currently below the $2 million debt deduction threshold) are not subject to the DDCR in the future.

e) Ensuring the Explanatory Memorandum (EM) and Supplementary EM include specific examples of the types of transactions that are intended to be captured by the DDCR and those that are not considered artificial, contrived or lacking commercial justification.

f) Legislative clarity that taxpayers undertaking reorganisations to comply with the DDCR will not be subject to the anti-avoidance rule in section 820-423D or the general anti-avoidance provisions.

g) Legislative clarity that Division 7A loan arrangements (which are of themselves anti-avoidance rules requiring the payment of interest) are not then also impacted by the DDCR.

h) That consistency with the wider thin capitalisation rules is provided by using the term "associate entity" rather than "associate pair".

2 Other minor technical amendments in the Bill and associated government amendments

a) Amend subsection 820-52(1A) so that carry forward tax losses (at least those incurred prior to the commencement date of the new rules) do not form part of the tax EBITDA calculations in years after the commencement date.

b) Making the third-party debt test more workable for domestic outbound groups by clarifying the minor and insignificant foreign assets exclusion.

3 Change the commencement date of the EBITDA rules to the first income year commencing on or after 1 July 2024.

Given the length of time involved in getting the rules to their current state, and that the rules will not be finalised until early 2024, a 12 month deferral in the commencement date is warranted.

More detailed information on these recommendations is included in an attachment to this letter.

We would welcome the opportunity to discuss this matter with you further. Should you have any questions or wish to arrange a meeting, please contact Simon Staples at [redacted] or on [redacted]

Yours sincerely,

[redacted]

Michelle de Niese
Executive Director

ATTACHMENT : FURTHER INFORMATION ON THE RECOMMENDATIONS

Summary

The CTA understands that the focus of the Committee's inquiry is in relation to the technical amendments to *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share - Integrity and Transparency) Bill 2023* (Bill).

Where possible, we have provided potential legislative drafting suggestions (marked up in red) and have provided examples of the potential impacts of current drafting that require amendment or further clarification.

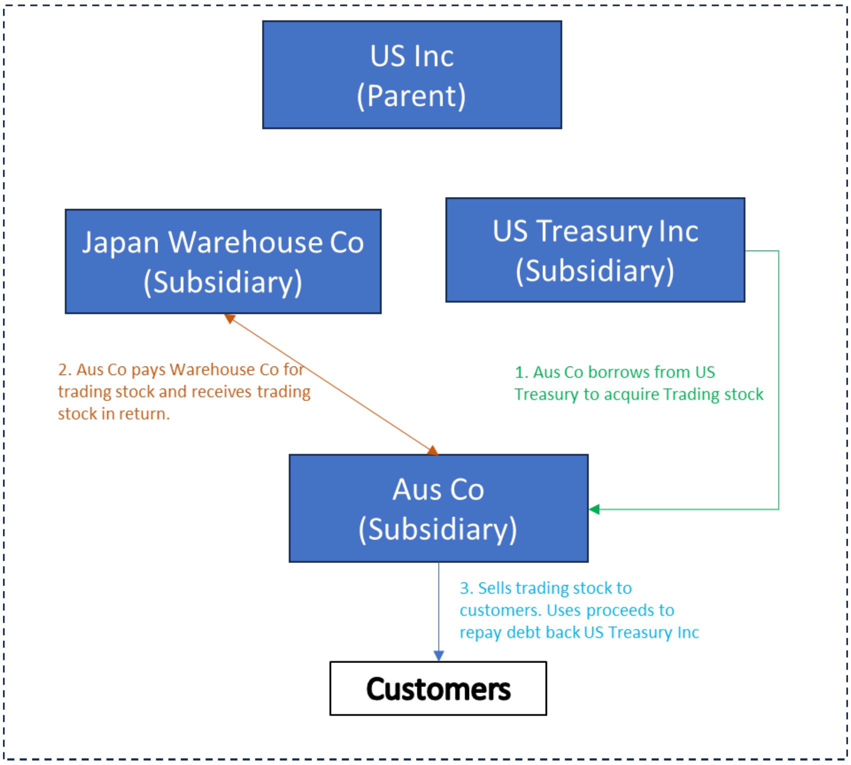
1 Recommendations in relation to the DDCR

a) Trading stock should be excluded from the DDCR

It is unclear why related party debt funding of trading stock is denied under the DDCR. This appears to be a deliberate policy view that the related party debt deductions should be denied, but taxpayers can debt fund the purchase of trading stock from unrelated parties, albeit at a higher cost.

Related party debt (and cash pooling/management systems) are efficient forms of finance. If taxpayers must now use external third-party debt to fund the acquisition of trading stock, the pricing of debt may be more costly, and it is likely such funding would be exempt from withholding tax which would not be the case if related party debt is used. Businesses will need to restructure these transactions and then decide whether this unnecessary additional cost should be passed on to the end user.

This is illustrated in Example 1 below:



In this example, Aus Co is a wholly owned subsidiary of a listed US multinational (US Inc) that sells trading stock to customers in Australia. US Inc has a centralised Treasury organisation based in the US (US Treasury Inc) which is responsible for managing the global financial operations of the group.

US Inc also has a centralised warehouse (Japan Warehouse Co) which acts as a distributor of widgets to the different jurisdictions in which it operates. Aus Co borrows $2 million from US Treasury Inc and uses those funds to acquire trading stock from Japan Warehouse Co. Aus Co sells trading stock to its customers with the net proceeds used to repay the loan to US Treasury Inc and where applicable, returns excess profits to US Inc which is then paid to external shareholders.

The current drafting of subsection 820-423A(2) would disallow debt deductions as the drawdown was used to make a payment to a foreign related party and trading stock is not subject to an exclusion in section 820-423AA.

If the concern is that structures and transactions of this nature lack commercial justification or are artificially contrived, then we submit that the anti-avoidance provision of the DDCR in section 820-423D or the General Anti-Avoidance provisions in Part IVA could apply.

It is recommended that a new subsection 820-423AA(4) should be inserted to exclude the acquisition of trading stock from the application of subdivision 820-423EAA. As trading stock is a defined term in section 995-1 of the *Income Tax Assessment Act 1997*, this can be achieved as follows:

Acquisition of trading stock

(4) For the purposes of paragraph 820-423A(2)(a), the acquisition of *trading stock.

b) Remove residual uncertainty from subparagraph 820-423A(5)(b)(ii)

This sub-paragraph has undergone considerable revision in the current draft, primarily due to the previous wording being extremely broad. Whilst the revision is more focused on linking the related party borrowing to the funding of a "bad" distribution or payment, it is still likely to adversely impact "good distributions" such as the payment of a dividend. Whilst we recognise the rules are trying to "future proof" the provision and be mechanical in operation, the uncertainty in the future that somehow a dividend paid out of cash reserves is linked to an earlier unrelated borrowing is concerning.

It is recommended that the drafting of subparagraph 820-423A(5)(b)(ii) be made clearer by removing the word 'facilitate' and replacing it with alternative wording to ensure it meets the stated policy objective. We understand from our discussions with Treasury and the ATO during the consultation process that their main concern is that both direct and indirect borrowings to fund "bad" distributions should be captured. Accordingly, our recommendation is for that specific language to be used (as it is elsewhere in the Tax Act).

This can be achieved by making the following minor changes to the current drafting of subsection 820-423A(5):

Financial arrangements involving associated pairs

(5) This subsection applies if all of the following conditions are satisfied:
(a) an entity (the payer) obtains proceeds from entering into or having a *financial arrangement with another entity;
(b) the payer uses the financial arrangement to directly or indirectly fund~~:~~
~~(i) fund; or~~
~~(ii) facilitate the funding of;~~

one or more payments or distributions, of which one or more is a payment or distribution that, to an extent:

~~(iii)~~ (i) the payer makes to an entity (an associate recipient) that is an *associate pair of the payer; and
~~(iv)~~ (ii) is covered by subsection (5A) (which is about types of payments or distributions);
…

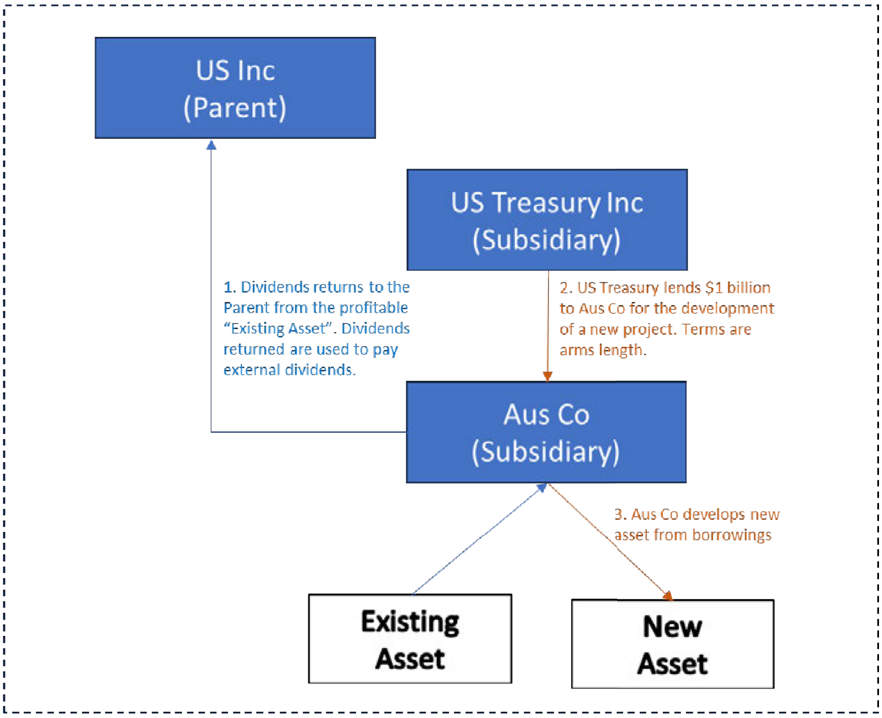
In our view, as the word 'facilitate' in subparagraph 820-423A(5)(b)(ii) is undefined, it takes its ordinary meaning and is defined as *"to make an action or a process possible or easier"*. We note paragraph 1.49 of the latest EM tries to provide clarity on the term facilitate (to be something equivalent to "indirect") but with respect, is more confusing (and of course is not legally binding). It states:

> *"…. [f]or the payer to facilitate the funding of a payment or distribution, there must be an indirect connection between the use of the financial arrangement and the funding of the payment or distribution. This may involve a consideration of whether the use of the financial arrangement can reasonably be said to have allowed for, directly or indirectly, the funding of the payment or distribution."*

As can be seen, the EM seems to "decouple" the use of the borrowing (which is the current legal test) to a test that the borrowing has reasonably allowed directly or indirectly, the funding of the payment or distribution. As such, the current drafting could see debt deductions being denied due to the mere existence of certain payments (such as a dividend) even where the related party debt was not used to fund that payment directly or indirectly, as it has potentially "allowed" the payment or distribution.

We submit that any mischief (such as the implicit concern with borrowing to pay a dividend appears to have) could be dealt with under the anti-avoidance provision of the DDCR in section 820-423D. We also understand the drafting preference is to have subsection 820-423A(5) deal with the matter in the first instance. However, the absence of examples in the EM and Supplementary EM makes it unclear how the provisions apply (without amendment). In any event, EM examples will not override the actual language in the Act, which as noted, is too broad and will capture ordinary transactions.

This is illustrated in Example 2 below:



In this example, Aus Co is a wholly owned subsidiary of a listed US multinational (US Inc) which is operating a gas-fired power station that it developed many years ago. It is quite profitable and has been regularly paying dividends to US Inc from cash generated from the existing project.

In 2025, it is looking to build a new renewable energy project that will take three years to construct but wishes to continue to pay dividends to US Inc from its existing asset's operating cash flows, as US Inc relies on these profits to pay its dividends to ultimate shareholders. Accordingly, Aus Co intends to borrow $1 billion from the US treasury subsidiary of US Inc (US Treasury Inc) to develop the new project. The interest rate is set on arm's length terms.

On the current drafting, paragraph 820-423A(5)(b)(ii) may apply to disallow debt deductions as the new financial arrangement may have facilitated the funding of the dividend as it "made it easier" to pay the dividend.

Thus, the mere existence of a dividend and a financial arrangement that are unrelated or linked may result in the deductions being disallowed despite Aus Co borrowing from a related party to directly fund its capital expenditure and the dividend being paid out of cash flows. As there is no purpose test associated with these rules, this outcome will apply as a matter of course.

The rule may then potentially create a behavioural response so that new assets are held in a separate group, or the group borrowing potentially more expensive third-party debt (on the assumption that this would not of itself trigger the anti-avoidance rule in section 820-423D).

c) Ensure new capital contributions, not just new membership interests, are excluded

It is recommended that the exclusion in subsection 820-423AA(1) should be amended to clarify that it also applies to the increase in contributed equity as well as new membership interests.

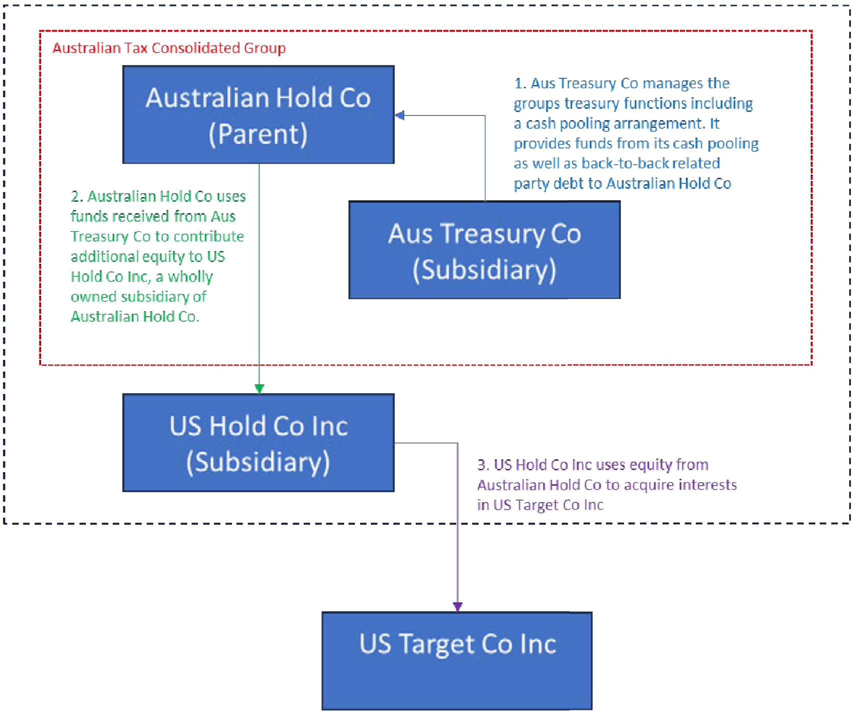
This can be achieved as follows:

> (1) For the purposes of paragraph 820-423A(2)(a), the acquisition of a *CGT asset is covered by this section if:
>
> (a) the CGT asset is a *membership interest in or is an increase in an existing membership interest of:
>
> (i) an *Australian entity; or
>
> (ii) a *foreign entity that is a company; and
>
> (b) the membership interest or the increase in the existing membership interest has not previously been held by ~~any~~ any associate.

As currently drafted, paragraph 820-423AA(1)(b) says that a membership interest must not have been "previously held by any entity" (i.e. is "new"). Thus, the provision allows borrowing to fund capital injections into a new or existing business. This makes policy sense as the borrowing is effectively being used to fund the acquisition of a new or expanding income-producing activity.

In this context, it is noted that, in some countries (including Australia and the US), equity can be subscribed without the need for new membership interests to be issued. Rather, equity is contributed to an existing membership interest to increase the capital base. The current drafting of the exclusion would be that such capital contributions would be impacted by the DDCR.

This is illustrated in example 3 below:



In this example, Australian Hold Co is the head of an Australian multinational group. Aus Treasury Co is a wholly owned subsidiary that manages the treasury function on behalf of the worldwide consolidated group.

Aus Treasury Co uses a combination of related party borrowings and funds sourced from its global cash management system and lends this to Australian Hold Co, which uses the cash to contribute capital into its existing wholly-owned US Hold Co parent entity.

US Hold Co Inc then uses the additional capital received to fund the acquisition by US Hold Co parent of US Target Co, which is wholly unrelated to the group. That subscription is in addition to existing contributed capital in US Hold Co as it does not involve the issue of new membership interests per se.

The current drafting would disallow the deduction for interest to Australian Hold Co as US Hold Co has not issued it with new membership interests. This fact pattern is, however, aligned to the policy intent and therefore the drafting as proposed above could be introduced to ensure the deduction remains available.

Another example would involve Australia Hold Co utilising related party borrowings to contribute additional equity into an Australian joint venture unit trust. Instead of issuing new units in the joint venture trust, Australia Hold Co contributes equity to the existing units that it holds in the trust. The current drafting would also disallow the deduction for interest in this situation.

d) <u>Ensure transactions currently not subject to the tax EBITDA rules (because the taxpayer is below the $2 million debt deduction threshold), are not subject to the DDCR in the future</u>.

Currently, the language proposed in ss.820-423A(2) and (5) do not require that the acquirer/disposer or payer/recipient events ("underlying transactions") take place whilst the relevant taxpayer group is subject to thin capitalisation rules.

The thin capitalisation rules might not apply either because the $2 million debt deduction threshold is satisfied (which is quite common in Australian privately owned groups), or the relevant taxpayer group is simply not in the thin capitalisation rules.

However, based on the language proposed, the DDCR rules are enlivened once the taxpayer group is subject to the tax EBITDA rules in the future.

This should not be the case. If the taxpayer group is not subject to the tax EBITDA rules at the time of the relevant transaction, then a subsequent (and typically unrelated) event that brings the taxpayer group into the tax EBITDA rules with debt deductions in excess of $2 million should not result in debt deductions being denied as the nexus between the underlying transactions and the debt deductions being denied by these proposed rules is not readily apparent.

It is recommended that if the taxpayer group is not subject to the tax EBITDA rules at the time of the transaction, then the transaction should not be caught by the DDCR once the tax EBITDA rules start to apply to the taxpayer group.

This can be achieved by inserting a new paragraph into subsection 820-423A(2) and (5) as follows:

(2) This subsection applies if all of the following conditions are satisfied:

a) an entity (the ***acquirer***) *acquires a *CGT asset (other than a CGT asset covered by section 820-423AA), or a legal or equitable obligation, either directly, or indirectly through one or more interposed entities, from one or more other entities (each of which is a ***disposer***);
b) one or more of the disposers (each of which is an ***associate disposer***) is an associate entity of the acquirer;
c) the entity mentioned in subsection (1) (the ***relevant entity***) is:
   (i) the acquirer; or
   (ii) an associate pair of the acquirer; or
   (iii) an associate pair of an associate disposer;
d) <u>the relevant entity satisfies subsection 820-423A(1)(a) at the time of the acquisition mentioned in paragraph (a);</u>
e) the relevant entity's *debt deduction mentioned in subsection (1) is, wholly or partly, in relation to any of the following:
   (i) the acquisition mentioned in paragraph (a) of this subsection;
   (ii) the acquirer's holding of the CGT asset, or legal or equitable obligation.
f) the relevant entity's debt deduction mentioned in subsection (1) is referable to an amount paid or payable, either directly or indirectly, to any of the following:
   (i) an associate pair of the relevant entity;
   (ii) an associate pair of the acquirer;
   (iii) an associate pair of an associate disposer.

(g) the acquisition mentioned in paragraph (a) of this subsection is not covered by section 820-423AA (which is about exceptions);
(h) the relevant entity has *not* made a choice under subsection 820-46(4) to use the third party debt test for the income year mentioned in subsection (1) of this section.

(5) This subsection applies if all of the following conditions are satisfied:

(a) an entity (the ***payer***) enters into or has a *financial arrangement with another entity;

(b) the payer uses the financial arrangement to:

(i) fund; or

(ii) facilitate the funding of;

one or more payments or distributions of which one or more is a payment or distribution that, to an extent:

(iii) the payer makes to an entity (an ***associate recipient***) that is an *associate pair of the payer; and

(iv) is covered by subsection (5A) (which is about types of payments or distributions)

(c) the entity mentioned in subsection (1) (the ***relevant entity***) is any of the following:

(i) the payer;

(ii) an associate pair of the payer;

(iii) an associate pair of an associate recipient;

(d) the relevant entity satisfies subsection 820-423A(1)(a) at the time of the financial arrangement mentioned in paragraphs (a) and (b);

(e) the relevant entity's *debt deduction mentioned in subsection (1) is, wholly or partly, in relation to the financial arrangement mentioned in paragraph (a) of this subsection;

(f) the relevant entity's debt deduction is referable to an amount paid or payable, either directly or indirectly, to any of the following:

(i) an associate pair of the relevant entity;

(ii) an associate pair of the payer;

(iii) an associate pair of an associate recipient.

(g) the relevant entity has not made a choice under subsection 820-46(4) to use the third party debt test for the income year mentioned in subsection (1) of this section.

Later transactions with unrelated parties

We note that transactions between unrelated corporate groups might be inadvertently impacted by these rules. Take the following scenario:

- A corporate group not subject to the thin capitalisation rules transfers a CGT asset to a related company ("SPV") using related party debt to fund the transfer.
- Years later, an unrelated corporate group ("Purchaser Group") purchases the SPV and refinances the vendor's related party debt using its own related party debt.
- Purchaser Group is subject to the tax EBITDA rules.

Under the DDCR tests in subsection 820-423A(2), even though the acquirer was unrelated to the acquirer/disposer at the time of the underlying transactions, the new acquirer is impacted by the rules as the association test in paragraph (b) is at the time of the original acquisition, but the association tests in paragraph (e) is at the time of applying the thin capitalisation rules.[2]

It is recommended that the test in paragraph (e) should be connected to the underlying transaction in paragraph (a) – if the relevant entity's debt deduction is to an associate pair, that association should have existed at the time of the transaction in paragraph (a). If not, then these rules should not apply.

This can be achieved by inserting another paragraph in subsections 820-423A(2) and (5) as follows:

(2) This subsection applies if all of the following conditions are satisfied:

(a) an entity (the ***acquirer***) *acquires a *CGT asset (other than a CGT asset covered by section 820-423AA), or a legal or equitable obligation, either directly, or indirectly through one or more interposed entities, from one or more other entities (each of which is a ***disposer***);

(b) one or more of the disposers (each of which is an ***associate disposer***) is an associate entity of the acquirer;

(c) the entity mentioned in subsection (1) (the ***relevant entity***) is:

(i) the acquirer; or

(ii) an associate pair of the acquirer; or

(iii) an associate pair of an associate disposer;

(d) the relevant entity's *debt deduction mentioned in subsection (1) is, wholly or partly, in relation to any of the following:

(i) the acquisition mentioned in paragraph (a) of this subsection;

(ii) the acquirer's holding of the CGT asset, or legal or equitable obligation.

(e) the relevant entity's debt deduction mentioned in subsection (1) is referable to an amount paid or payable, either directly or indirectly, to any of the following:

(i) an associate pair of the relevant entity;

(ii) an associate pair of the acquirer;

(iii) an associate pair of an associate disposer.

(f) The requirements of paragraph (e) of this subsection must also have been satisfied at the time of the transaction in paragraph (a) of this subsection;

(g) the acquisition mentioned in paragraph (a) of this subsection is not covered by section 820-423AA (which is about exceptions);

(h) the relevant entity has *not* made a choice under subsection 820-46(4) to use the third party debt test for the income year mentioned in subsection (1) of this section.

(5) This subsection applies if all of the following conditions are satisfied:

(a) an entity (the ***payer***) enters into or has a *financial arrangement with another entity;

(b) the payer uses the financial arrangement to:

(i) fund; or

(ii) facilitate the funding of;

one or more payments or distributions of which one or more is a payment or distribution that, to an extent:

[2] See Appendix

(iii) the payer makes to an entity (an ***associate recipient***) that is an *associate pair of the payer; and

(iv) is covered by subsection (5A) (which is about types of payments or distributions)

(c) the entity mentioned in subsection (1) (the ***relevant entity***) is any of the following:

(i) the payer;

(ii) an associate pair of the payer;

(iii) an associate pair entity of an associate recipient;

(d) the relevant entity's *debt deduction mentioned in subsection (1) is, wholly or partly, in relation to the financial arrangement mentioned in paragraph (a) of this subsection;

(e) the relevant entity's debt deduction is referable to an amount paid or payable, either directly or indirectly, to any of the following:

(i) an associate pair of the relevant entity;

(ii) an associate pair of the payer;

(iii) an associate pair of an associate recipient.

(f) The requirements of paragraph (e) of this subsection must also have been satisfied at the time of the transaction in paragraph (a) of this subsection;

(g) the relevant entity has not made a choice under subsection 820-46(4) to use the third party debt test for the income year mentioned in subsection (1) of this section.

e) Include examples and analysis in the EM and Supplementary EM

It is recommended that the EM and Supplementary EM contain examples of transactions where the DDCR will apply and examples where it will not. The provisions are complex, and the absence of examples creates uncertainty that will be a time-consuming, resource-intensive and costly compliance exercise for the ATO and businesses impacted by the rules to unravel. Legislative guidance can assist in this regard if it is capable of being considered by a Court. We do not recommend that examples simply be provided via ATO guidance, as that happens after the legislation is already passed, and in any event, is not capable of being considered by a Court in interpreting the underlying policy intent of the relevant provisions.

f) Taxpayers undertaking reorganisations to comply with the DDCR should not be subject to section 820-423D or Part IVA.

As section 820-423D is drafted it is not clear that taxpayers who may fall foul of the DDCR can rearrange their affairs to ensure they are compliant without enlivening the anti-avoidance rule. This is complicated by the fact the test in section 820-423D is a principal purpose test of avoiding the DDCR.

The EM notes at paragraph 1.44:

> *"The anti-avoidance rules in section 820-423D may also apply to any avoidance schemes relating to the debt deduction creation rules. However, these rules are not intended to apply to schemes where a taxpayer is merely restructuring, without any associated artificiality or contrivance, out of an arrangement that would otherwise be caught by the debt deduction creation rules. The application of section 820-423D will ultimately depend on the facts and circumstances of each case."*

To provide legislative clarity of this intent, wording to the effect of the above paragraph should be included in the operative provisions in section 820-423D. The EM should also contain an example of this provision in action – for instance, confirming that the use of external debt in lieu of related party debt is not caught by section 820-423D.

For completeness, further legislative clarity that the general anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936*, should not apply to arrangements undertaking that seek to comply with the intent of the DDCR.

g) Legislative clarity that Division 7A loan arrangements are not impacted by the DDCR.

Currently, under Division 7A of the *Income Tax Assessment Act 1936* (which is a specific anti avoidance rule), certain distributions from a trust to a private company can be deemed an unfranked dividend. To avoid triggering Division 7A, a trustee can enter into a "complying loan agreement" where the trust wishes to retain the use of the funds. Complying loan agreements must charge interest at a punitive benchmark interest rate and have minimum loan repayments.[3]

In such cases, as a trust and corporate beneficiary will be associates, the distribution could fall foul of the DDCR. The effect would be that as well as requiring punitive interest to be charged (and thus interest income received by the private company), the trust is also denied a deduction on the same amount. That is, the tax laws currently deem a punitive interest rate to be charged, and it appears the DDCR then denies the same interest deduction.

Other issues on the interaction of the DDCR and private groups

More broadly, there are areas of the tax law (and the way that it is currently administered) that could be impacted by the DDCR. These include the following examples:

- The ATO issued TR 2005/12 dealing with the deductibility of interest expenses incurred by trustees on funds borrowed in connection with the payment of distributions to beneficiaries.

- More recently, the ATO also issued PCG 2022/2 outlining the ATO's compliance approach to Section 100A. In the PCG, the ATO identified a number of "Green Zone" scenarios where a company or trust beneficiary allows their present entitlements to be made available to the distributing trusts ("trustee retention of funds") by way of loan on commercial terms.

We recommend Division 7A loan arrangements should not be impacted by the DDCR.

[3] See: Trust entitlements | Australian Taxation Office (ato.gov.au)

h) Consistency with the wider thin capitalisation rules is provided by using the term "associate entity" rather than "associate pair" in the DDCR

For the wider purposes of the thin capitalisation rules, the "association" test refers to the requirements of "associate entity" in section 820-905 of the *Income Tax Assessment Act 1997*. By contrast, the DDCR create a new category of "associate pair" which ultimately refers back to the definition of "associate" in section 318 of the *Income Tax Assessment Act 1936* in assessing "association" which is much broader than the associate entity test.

It is submitted there may be transactions between associate pairs (particularly in a trust scenario where the definition of associate pair/associate is very broad) that are not associate entities that can produce some unintended outcomes. This could include family associations in particular.

To provide some consistency in assessing the "association" between the thin capitalisation rules and the DDCR (which are both in the same division of the Act) it is recommended that the same associate entity test be applied for both rules.

2 Other minor technical amendments in the Bill and associated government amendments

a) Treatment of carry forward tax losses (including those that existed prior to the tax EBITDA rules)

It is recommended that the proposed subsection 820-52(1A), which requires carry forward tax losses to be used in the calculation of taxable income, be removed from the Bill (or at least only apply to tax losses incurred after the commencement of the tax EBITDA rules).

Prior to the commencement of the tax EBITDA rules, asset values rather than earnings were used to determine interest denial. These rules worked well for groups in start-up mode, or suffering economic losses, as they were not dependent on earnings. Critically, the rules involved a year-on-year calculation, with attributes of prior years' outcomes not impacting current year calculations.

A shift to an earnings-based approach creates challenges for entities in start-up mode or those with economic losses. Given this, the design of earnings-based rules globally allow for disallowed debt deductions in one year to be carried forward – essentially smoothing out debt deductions over a period of up to 15 years. This generally accords with international standards.

However, as the current draft rules operate, carry forward tax losses are included in the yearly calculation, even in circumstances where the tax loss arises from items other than interest (such as depreciation or economic losses) and even where the tax losses are incurred prior to the tax EBITDA rules operating. Thus, in addition to potentially denying a debt deduction in the year the loss is incurred, any carry forward tax loss can also impact future years' debt denial with the effect of further deferring any recoupment of debt deductions to later years, if they are able to be recouped at all.

This is demonstrated in the simple example below which compares results where carry forward losses are not used in the calculation, and where such losses are used.

No carry forward tax loss in calculation			
		Year 1	**Year 2 (no carry forward loss)**
1	Current taxable income	-100	100
2	Carry forward loss		
3	Taxable income after carry forward loss	-100	
4	Div 40 addback	100	100
5	Debt deduction addback	30	30
6	EBITDA	30	230
7	30% EBITDA	9	69
8	Debt deduction denial	21	
9	Additional debt deduction		21
	Debt deduction carry forward	21	0

Carry forward tax loss in calculation				
		Year 1 (carry forward loss)	**Year 2 (carry forward loss)**	**Year 3 (carry forward loss)**
1	Current taxable income	-100	100	100
2	Carry forward loss		-100	
3	Taxable income after carry forward loss	-100	0	100
4	Div 40 addback	100	100	100
5	Debt deduction addback	30	30	30
6	EBITDA	30	130	230
7	30% EBITDA	9	39	69
8	Debt deduction denial	21		
9	Additional debt deduction		9	12
	Debt deduction carry forward	21	12	0

The first table shows the result of not including carry forward losses, showing recoupment of denied debt deductions in year 2. The second table shows the result when taking into account carry forward losses showing the debt deduction denial taking longer to recoup. Whilst it is recognised that debt deduction denial will in most cases be recouped, the economic effect of including carry forward losses is deferral rather than recoupment.

Whilst this may be a design feature to generate more government revenue, it should be noted this is only a temporary revenue take. The commercial business concern is that where economic losses are showing up as tax losses that may not be caused by debt deductions at all, the deferral further impacts start-ups and firms suffering from market downturns. From a policy perspective, this can create distortions in the market as new startups can be disadvantaged relative to existing mature taxpayers who are at a different stage in the business life cycle.

b) Clarifying the minor and insignificant assets exclusion from the third-party debt test

We note the third-party debt test has changed to enable recourse to minor and insignificant ineligible (non-Australian) assets (sec 820-427A(30)(c)). This change is welcomed, but further legislative clarity and the determination of the scope of the exclusion is needed.

We note the EM at paragraph 1.30 states that:

> *"determining whether recourse to ineligible assets is minor and insignificant will generally require a consideration of the ineligible assets to which recourse for payment of the debt can be had and whether those ineligible assets are of a minor and insignificant nature"*.

This statement adds little, if anything, by way of explanation or guidance.

3 Defer the commencement date of the EBITDA rules to the first income year commencing on or after 1 July 2024

Given the delay in finalising the Bill, we suggest that Schedule 2 of the Bill also applies to assessments for the income years starting on or after 1 July 2024. This is consistent with the commencement date of the DDCR.

This can be achieved as follows:

> 144 Application
> (1) The amendments made by Part 1 of this Schedule apply in relation to assessments for income years starting on or after ~~1 July 2023~~ 1 July 2024.
> (2) However, the amendments made by that Part to section 820-980 of the *Income Tax Assessment Act 1997* do not apply in relation to records mentioned in that section (disregarding those amendments) that relate to one or more income years starting before ~~1 July 2023~~ 1 July 2024.

APPENDIX : DDCR APPLYING TO UNRELATED TRANSACTIONS - SEC 820-423(2)

The following table (via Yes answers for each paragraph condition) shows how the current provisions impact certain unrelated transactions when earlier transactions were not caught by the thin cap rules due to the $2 million threshold.

	CONDITION	YES or NO
(a)	an entity (the ***acquirer***) *acquires a *CGT asset (other than a CGT asset covered by section 820-423AA), or a legal or equitable obligation, either directly, or indirectly through one or more interposed entities, from one or more other entities (each of which is a ***disposer***);	Y
(b)	one or more of the disposers (each of which is an ***associate disposer***) is an associate pair of the acquirer;	Y
(c)	the entity mentioned in subsection (1) (the ***relevant entity***) is: (i) the acquirer; or (ii) an associate pair of the acquirer; or (iii) an associate pair of an associate disposer;	Y
(d)	the relevant entity's *debt deduction mentioned in subsection (1) is, wholly or partly, in relation to any of the following: (i) the acquisition mentioned in paragraph (a) of this subsection; (ii) the acquirer's holding of the CGT asset, or legal or equitable obligation.	Y
(e)	the relevant entity's debt deduction mentioned in subsection (1) is referable to an amount paid or payable, either directly or indirectly, to any of the following: (i) an associate pair of the relevant entity; (ii) an associate pair of the acquirer; (iii) an associate pair of an associate disposer.	Y
(f)	the acquisition mentioned in paragraph (a) of this subsection is not covered by section 820-423AA (which is about exceptions);	Y
(g)	the relevant entity has *not* made a choice under subsection 820-46(4) to use the third party debt test for the income year mentioned in subsection (1) of this section#.	