FINANCIAL
SERVICES
COUNCIL

Treasury Laws Amendment (Making Multinationals Pay Their Fair Share–Integrity and Transparency) Bill 2023

FSC Submission to Senate Economics Committee

July 2023

FSC FINANCIAL SERVICES COUNCIL

Contents

1 About the Financial Services Council

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advice licensees. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing more than $3 trillion on behalf of over 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is one of the largest pool of managed funds in the world.

The FSC's mission is to assist our members achieve the following outcomes for Australians:

- to increase their financial security and wellbeing;
- to protect their livelihoods;
- to provide them with a comfortable retirement;
- to champion integrity, ethics and social responsibility in financial services; and

FINANCIAL SERVICES COUNCIL

- to advocate for financial literacy and inclusion.

2 Introduction

The FSC thanks the Senate Economics Committee for the opportunity to provide a submission on the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023* (**the Bill**).

The FSC thanks the Government for its engagement on the proposals and for improvements made to the proposals during the consultation process, on which the FSC made previous submissions.[1]

The FSC's submission relates to Schedule 2 to the Bill (the interest limitation or thin capitalisation rules), and the comments in the explanatory memorandum about public Country-by-Country reporting (**public CbCR**).

3 Schedule 2 – Interest limitation (thin capitalisation) rules

3.1 Denial of interest deductions for borrowings relating to offshore expansion (s25-90)

The FSC welcomes the Government's decision to remove from the Bill proposed changes to deny interest deductions for certain borrowings relating to offshore investments and expansion.

The FSC has a number of Australian-based members that are growing their businesses internationally, and this proposed change would have directly increased the tax burden on these businesses, putting them at a competitive disadvantage compared with other countries that permit these types of deductions.[2]

Removal of deductions for these borrowings would mean affected businesses would have faced a tax increase in the short term, but in the long term they would have more likely refinanced by borrowing overseas, often at higher cost than borrowing in Australia. This means the tax change would likely have raised little tax revenue. In fact, the change could have resulted in lower overall tax revenue because of reduced taxable profit in Australia and reduced activity in the borrowing/lending market in Australia.

The FSC was also concerned that the proposed changes had significant retrospective impact, the policy argument for the changes was unclear, and the remaining interest limitation rules adequately deal with the relevant concerns.[3]

Given these concerns, the FSC welcomes the removal of the changes from the Bill.

---

[1] Relevant FSC submissions are available from the FSC website: https://fsc.org.au/resources/submissions
[2] See Deloitte submission on the interest limitation rules, available from: https://treasury.gov.au/consultation/c2023-370776
[3] As argued in previous FSC submissions, see footnote 1.

FSC FINANCIAL SERVICES COUNCIL

3.2 Debt deduction creation rules

The Explanatory Memorandum (**EM**) to the Bill identifies a concern with debt deductions created in connection with an acquisition from an associate entity or distributions or payments to an associate entity. The EM states the proposed Subdivision 820-EAA seeks to directly address this risk by disallowing debt deductions to the extent that they are incurred in relation to debt creation schemes that lack genuine commercial justification.

These proposed debt creation rules were not previously subject to public consultation. There is substantial technical detail to these rules, and unintended consequences are likely – potentially major consequences.

The FSC is concerned that the lack of consultation on these measures is not good regulatory practice, and submits that it would have been better practice for these measures to be subject to separate consultation rather than included in the Bill without consultation.

The EM states that the rules are intentionally broadly drafted to apply to schemes of varying complexity, however the FSC submits that the current drafting is much more extensive in scope than required to capture debt creations that lack genuine commercial justification – we note there is no purpose test in the rule or other safeguard to ensure it is only these types of transactions that are caught.

As a result, the rules as drafted are likely to deny debt deductions for many common and simple commercial transactions.

The rules purport to update or modernise the old debt creation rules previously found in Division 16G of the Income Tax Assessment Act 1936 (**ITAA 1936**) – however, the FSC submits that the rules do far more than update or modernise the rules and come without the significant safeguards and exclusions found within the old Division 16G.

The rules do not appear to distinguish between the artificial 'creation' of additional debt as opposed to the genuine debt funding of the expansion of an entity's business capacity via the acquisition of business assets, be that trading stock, shares, capital assets or debt. The rules in their current form are likely to mean all related party transactions need to be equity funded – this ignores the vital role debt plays in funding and capital management. Requiring related party transactions to be equity funded would put a serious brake on economic activity in Australia.

For example, an Australian entity borrowing (whether from related or unrelated parties and regardless of whether that funding is on arm's length terms) to fund its associate (domestic or foreign) on arm's length terms would be denied debt deductions on that borrowing. As a result, the Australian entity would be taxed on gross interest income. This would mean a corporate group would be forced to raise finance on an entity-by-entity basis, potentially resulting in large increases in the cost of funds and putting a drag on economic activity.

Furthermore, the rules have retrospective effect as drafted, as they apply to debt deductions after 1 July 2023 but in respect of loans put in place before 1 July 2023. The FSC submits it

FSC FINANCIAL SERVICES COUNCIL

is inappropriate for such broad-ranging provisions, not previously subject to consultation, to have significantly retrospective application.

The FSC also submits it will be particularly difficult for taxpayers to practically trace back borrowings, in some instances over significant periods of time, to comply with the rules.

Given the above, the FSC therefore submits the rules have significant reach beyond the stated policy intention.

The FSC **recommends** the changes in relation to debt creation be removed from the Bill and instead be subject to full and comprehensive consultation to ensure the rules are properly targeted and do not give rise to unintended consequences.

3.3 Third-party debt test – application to partnerships and trusts

The FSC submits the third-party debt test in the interest limitation rules appears to be problematic for partnerships and trusts. Most investment vehicles in Australia use trust structures, while partnerships are also extensively used in the Australian economy.

This problem occurs because the proposed third party debt test requires an entity to be an Australian resident (in proposed s820-427A(3)), which uses the definition of 'resident' in s995 of the ITAA 1936. This definition can only be satisfied by individuals or companies and not trusts or partnerships (in particular, trusts use the term 'resident trust estate' instead of 'resident').

As a result of the above, it appears that the proposed third-party debt test does not apply to trusts and partnerships. The FSC assumes this is not a deliberate policy decision and so recommends that it should be fixed.

The FSC **recommends** that the proposed third party debt test be amended so that it can apply to trusts and partnerships.

3.4 Application of rules to Attribution Managed Investment Trusts

The FSC submits that there is a technical problem in Schedule 2 with the definition of taxable income for Attribution Managed Investment Trusts (**AMITs**) – this effectively means that interest deductions would be denied for AMITs.

As noted in Section 3.3 above, the proposed third-party debt test does not apply to trusts and partnerships, so an AMIT will likely need to apply the EBITDA test.

However, the EBITDA test relies on the concept of taxable income (see s820-52(1)), a calculation which is adjusted (in part) for trusts by s820-52(4) to use the concept of "net income" (see also EM at 2.68). However, this trust adjustment does not work correctly for AMITs, because s95AAD of the ITAA 1936 means "net income" is not used for AMITs.

As a result, neither the main EBITDA test, nor the third-party debt test, are available for AMITs that incur interest expense.

FSC FINANCIAL SERVICES COUNCIL

Therefore, the Schedule as currently drafted will place a substantial tax penalty on AMITs that borrow, which would include many infrastructure and property investment funds. The FSC presumes that this is not an intended consequence of the Schedule, as the issue does not exist for trusts that are not AMITs.

The FSC **recommends** that the EBITDA test be amended so that it applies correctly to AMITs.

3.5 Distributions from trusts

Section 820-52(6)(b) excludes distributions from trusts in the calculation of taxable income of a trust beneficiary (see also EM at 2.69) where the beneficiary is an associate of the trust.

This means that where a trust receives all its income through one or more subsidiary trusts (which can be a common practice in investment management), the income from the subsidiary trusts is fully omitted in calculating EBITDA. This in turn means that the 'head' trust is unable to use the EBITDA test at all, and would be subject to substantial tax penalties if it incurs any interest expense.

The FSC **recommends** that the EBITDA test be amended so that it correctly applies to trusts that invest through subsidiary trust structures.

3.6 Associate entity test exemption

The FSC welcomes the Bill providing for an exemption from the 'associate entity' test for superannuation funds.

The FSC submits this exemption should apply to a wider range of entities, specifically AMITs, Managed Investment Trusts (**MITs**), and Corporate Collective Investment Vehicles (**CCIVs**), collectively '**investment funds**'.

The FSC submits the reasons for the superannuation fund exemption stated in the Explanatory Memorandum (**EM**) to the Bill (see paragraphs 2.162 and following) apply just as much to other investment funds. Specifically:

- Investment funds, just like superannuation funds, collectively have significant investments in different assets.
- Investment funds, just like superannuation funds, are important sources of capital investment for Australian assets, particularly infrastructure assets.
- Under current interest limitation rules, some investment funds may have a relatively large number of associate entities, which would bring their investments into scope of the thin capitalisation rules.
- Investment funds, just like superannuation funds, are subject to a strong regulatory regime.
- Investment funds, just like superannuation funds, generally do not exercise any meaningful control over associate entities.

Given all the above points, the FSC submits the associate entity definition is not fit-for-purpose for investment funds, similar to it being not fit-for-purpose for superannuation funds.

FSC FINANCIAL SERVICES COUNCIL

The Bill does partly deal with this issue by providing an exemption for wholly-owned subsidiaries of superannuation funds, which would include investment funds that are wholly owned by a superannuation fund (see EM at 2.163). However, this partial exemption creates a competitive non-neutrality, by providing an advantage for wholly owned investment funds but not for independent investment funds.

Under the approach in the Bill, independent investment funds with substantial borrowings (such as infrastructure or property funds) will be at a competitive disadvantage compared to wholly owned (subsidiary) investment funds. The FSC submits there is no good public policy rationale for the interest limitation rules introducing a competitive disadvantage for independent investment funds.

We note investment funds are currently investing, or considering investing, in a variety of asset classes that would satisfy important Government investment priorities, such as renewable energy, electricity transmission and housing. In many cases these categories of investments will be geared, and potentially subject to the interest limitation rules.

As at March 2023, there was just under $500 billion invested in retail unit trusts,[4] while large superannuation funds had just over $1 trillion invested indirectly through investment structures including unit trusts[5] – some of which would be wholly owned by the fund (and so covered by the proposed exemption), but much would not (and so would not be covered by the exemption). By comparison, the value of investments made directly by superannuation funds (ie not via an investment fund or other investment structure) was just over $1 trillion at March 2023.[6]

As such, the value of investments that are covered by the proposed exemption is likely to be similar to the value of investments not covered by the exemption.

Given the above, the FSC **recommends** the Bill be amended so that the proposed exemption from the associate entity test for superannuation funds should also apply to other investment funds that satisfy the existing 'widely held' test, specifically MITs, AMITs and CCIVs.

3.7 General comments

The EM raises concerns that stakeholders did not respond to questions about measuring the compliance costs of the interest limitation proposals (page 85). We note that the consultation on the most recent version of the proposals (in March 2023) did not include questions relating to measuring compliance costs, and the FSC was not formally asked questions about estimating the compliance costs of the proposals.

---

[4] Source: ABS Managed Funds: https://www.abs.gov.au/statistics/economy/finance/managed-funds-australia/latest-release#public-offer-retail-unit-trusts
[5] Source: Table 1b of https://www.apra.gov.au/quarterly-superannuation-statistics
[6] Source: Table 1b of https://www.apra.gov.au/quarterly-superannuation-statistics

FSC FINANCIAL SERVICES COUNCIL

4 Public Country-by-Country reporting

The EM to the Bill provides details about the Government's proposals relating to public Country-by-Country reporting (**public CbCR**) in Attachment 1.

The FSC supports transparency and disclosure of tax information to assist investment managers in making decisions about where to invest, and helps investors make ESG-related decisions.

The FSC submits that the information that is disclosed needs to be useful and relevant to investment managers, and aid in public debate on issues. For this reason, the FSC has argued[7] that mandatory disclosure of tax information should:

- mirror the disclosures agreed in other significant jurisdictions. This facilitates consistency and comparability while reducing confusion.
- protect commercial-in-confidence information, in particular mandatory disclosure should not force businesses to publish information that will provide an unwarranted benefit to their competitors. There are no benefits to investors, or the general economy, from forcing businesses to disclose commercially sensitive information.

Given this perspective, the FSC welcomes the Government's proposed changes to its public CbCR proposals contained in the EM, including:

- the deferred start date, which will (broadly) align the start of Australia's measures with the start of other similar international regimes and allow further consultation; and
- the removal of several Australia-specific reporting requirements which would have imposed large and unnecessary burdens on businesses, likely have confused the public, and might have required businesses to disclose valuable and sensitive information to competitors.

The FSC also welcomes the Government's commitment to further consultation on these measures (EM at page 63 and press release of 23 June 2023 from Minister Leigh[8]). The FSC is keen for this consultation to provide substantial time for stakeholders to review proposals and engage with the consultation, and for the measures to provide business with adequate time to prepare.

The FSC also supports various statements from the Government about the general approach to public CbCR:

- Public CbCR should have regard for commercially sensitive information and supporting investment intentions in Australia and the need for consistency in disclosure (EM at page 49).
- Public CbCR should not impose excessive compliance costs (EM at page 50).

---

[7] See FSC submission on exposure draft legislation for public CbCR: https://treasury.gov.au/consultation/c2023-383896
[8] See: https://ministers.treasury.gov.au/ministers/andrew-leigh-2022/media-releases/treasury-laws-amendment-making-multinationals-pay-their

- The Government is interested in consistency and comparability of data (see in particular the commentary in EM on page 50).

While welcoming these changes, the FSC queries several points:

- The EM implies that the revised Australian public CbCR rules will apply without a materiality or substance test (pages 62–63). The FSC is concerned that this will mean the rules are not calibrated to the size of the business in Australia. Other jurisdictions which are adopting the rules on public CbCR, such as the EU, have rules that are proportionate to the size of the business.
  - The Australian proposals mean a multinational business that is considering starting business operations in Australia could effectively be subject to extensive reporting requirements, even if the size of their Australian operations is very small. This could discourage multinational businesses from expanding into Australia, causing potential losses to Australian consumers.
- The EM states that the improved transparency will contribute to reducing the large corporate groups' income tax gap (pages 50 and 52). The FSC questions whether this will occur in practice, as the Australian tax gap for large corporate groups is trending downwards without these measures, is low compared to the tax gaps for other cohorts,[9] and is low by global standards.
- The EM states that tax transparency can support better access to capital (page 53). As noted earlier, fund managers can find it useful to have increased information about the companies they are investing in; but requiring a company to disclose commercially sensitive information is likely to deter investors in that company, rather than help the investors. In addition, requiring companies to disclose information that confuses the public could also deter investment in companies.
  - For these reasons, the FSC supports efforts to amend the public CbCR rules to ensure it is consistent with the disclosure regimes in other comparable jurisdictions, including provisions to protect commercially sensitive information.
- The EM raises concerns that stakeholders did not respond to questions on measuring the compliance costs of the public CbCR proposals (footnote 54 and page 58). We note that the consultation on the most recent version of the proposals (in April 2023) did not include questions relating to measuring compliance costs, and the FSC was not formally asked questions about measuring the compliance costs of the proposals.
  - The consultation for the Exposure Draft legislation only lasted two weeks. While industry has been aware of the Government's broad policy intent for some time, the Exposure Draft was a significant departure from expectations and a two-week window did not allow stakeholders sufficient time to review

[9] See: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Large-corporate-groups-income-tax-gap/?anchor=Trendsandlatestfindings1#Trendsandlatestfindings1
See also: https://www.ato.gov.au/general/tax-and-corporate-australia/we-have-confidence-in-the-tax-compliance-of-large-corporate-groups/

the proposals and respond in detail, including providing estimates of compliance costs and unintended consequences.

4.1 Harmonisation of Australian tax reporting requirements

The FSC notes the introduction of public CbCR will mean that Australia will have several different and inconsistent tax disclosure regimes, operating on different timetables, with different data requirements, released through different reports in different online locations on different timetables.

This includes the ATO's corporate tax transparency report, the Board of Tax's tax transparency code, tax reporting in public financial reports, and (shortly) public CbCR.

These inconsistencies are unlikely to assist public understanding – instead, users of the data are likely to be confused and misled by the differences in the reports.

Given this, the FSC **recommends** a review be announced into the various regimes that mandate the disclosure of tax information of individual businesses, with the aims of consolidating and harmonising these regimes.