



FINANCIAL
SERVICES
COUNCIL

Multinational Tax Integrity – interest limitation rules

FSC Submission to Treasury

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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
- to advocate for financial literacy and inclusion.

2 Submission

The FSC thanks Treasury for the opportunity to provide a submission on draft legislation to implement changes to Australia’s interest limitation, or thin capitalisation, rules (**the Draft Legislation**).

In this submission, all references to legislation are to the Income Tax Assessment Act 1997 unless otherwise specified.

3 Repeal of Section 25-90

The inclusion in the Draft Legislation of the repeal of section 25-90 was surprising to the FSC's members. This section permits tax deductions for borrowings relating to the earning of offshore Non-Assessable Non-Exempt (**NANE**) income.

The repeal of section 25-90 had not been previously mentioned in the Government announcements nor in any of the previous consultations on the proposed changes to the thin capitalisation provisions. The FSC considers that the repeal of section 25-90 is a separate and unrelated policy decision to the amendment of the thin capitalisation provisions to move to an earnings-based test.

Furthermore, the FSC's members query the policy rationale for the change as expressed in the draft EM to the draft Bill which states the following:

1.118 Section 768-5 of the ITAA 1997 deems certain foreign equity distributions as non-assessable non-exempt (NANE) income of an entity. At the same time, sections 25-90 and 230-15 of the ITAA 1997 provide that interest expenses incurred to derive this NANE income are deductible. This is contrary to the general rule in Australia's tax system which provides that expenses incurred in deriving NANE income are non-deductible.

1.119 Additionally, the policy intent of the new earnings-based tests is to limit the amount of deductible interest expense by reference to earnings – that is, an entity is only able to increase its net interest deductions in Australia by increasing earnings in Australia. The rules described in the paragraph above go against the policy underlying the new rules as it gives rise to a double benefit; the benefit of the income being NANE income and the benefit of a deduction for the interest expenses incurred to derive such NANE income.

1.120 To address this double benefit and ensure the effectiveness of the thin capitalisation rules, sections 25-90 and 230-15 are amended so that they do not allow a deduction for interest expenses incurred to derive the NANE income under section 768-5.

The FSC does not support the argument that section 25-90 goes against the policy underlying the movement to an earnings based test or that this could give rise to a double benefit. This is because section 25-90 applies to interest deductions in relation to foreign source income that are non assessable non exempt income – as a result this income does not increase a tax based EBITDA cap on allowable interest deductions.

Furthermore, it is not clear how the movement to an earnings based test from an assets based test results in a fundamental change in tax outcomes.

We also note the proposed change is likely to cause difficulties with tracing the source and destination of funding, particularly for complex financial businesses with numerous sources and uses of funding (this is discussed further below).

3.1 History of Section 25-90

The history of section 25-90 is relevant to this submission.

Australia's outbound international income tax rules were set around 25 years ago by the Review of Business Taxation (**the Ralph Review**), were continued through the Reform of International Taxation (**RITA**), and remain in place today.

The Ralph Review delivered its final report "A New Tax System Redesigned" in July 1999. In a press release of 11 November 1999, the then Treasurer adopted a number of international tax recommendations of the Ralph Review – under the heading "Responding to Globalisation" the then Treasurer stated:

Steps will be taken to ensure that Australia receives a fairer share of tax paid by multinational enterprises. In addition, measures will be introduced so that Australian businesses are not hindered from expanding overseas and that Australia becomes a more attractive investment destination.

The Ralph Review had recommended a substantial overhaul of the thin capitalisation rules – one aspect of which was extending the rules to Australian based multinational investors. The Ralph Review recommended the repeal of the quarantining rules then in force, which restricted deductibility of interest to foreign income, together with the suggested expansion of the thin capitalisation rules. The thin capitalisation rules were to provide the mechanism for regulating interest borrowed to invest in controlled foreign entities. Section 25-90 went hand in hand with the expansion of the thin capitalisation rules to outbound investors.

In February 2003 the Board of Taxation delivered its report to the Treasurer containing its recommendations for the reform of international taxation. The then Treasurer released the report and outlined a legislative program which was designed to improve the competitiveness of Australian companies with offshore operations. The Treasurer stated:

The reforms will encourage the establishment in Australia of regional headquarters for foreign groups and improve Australia's attractiveness as a continuing base for our multinational companies.

The policy settings were revised so that non-portfolio dividends from any country were exempted from income tax. The intent behind this change was that Australian owned businesses should not be subject to higher income tax than their commercial competitors. There was an important proviso that the benefits were only available in situations where they operated active businesses. More mobile passive income, such as dividends, interest and royalties were outside the regime – being subject to income tax on an accruals basis such as through the CFC regime.

A critical element in pursuing this objective to encourage Australia as a regional holding company jurisdiction is the ability to deduct financing costs. The original recommendation to introduce section 25-90 was partly due to compliance costs as it was acknowledged that taxpayers were using a tracing of funds approach so foreign investments were equity funded and domestic income producing assets were to the extent possible debt funded.

Nevertheless, it can be seen as a complimentary measure in the context of the overall reform of Australia's outbound income taxation rules.

As noted, section 25-90 was introduced in order to reduce complexity and uncertainty associated with having to trace the use of funds to determine whether interest expense was deductible. At the same time, the significant tightening of the thin capitalisation regime in 2001 ensured that integrity of the interest deductibility regime was not compromised. The further strengthening of the interest deductibility rules to adopt earnings based rules makes the retention of section 25-90 even more appropriate today.

In 2013, the then Government introduced a proposal paper to remove section 25-90. This proposal was subject to considerable debate at that time. The FSC considers the policy arguments which ultimately supported the decision not to repeal section 25-90 are still valid today and are not impacted by the movement to earnings based test.

The 2013 proposal paper set out some specific examples of the mischief it was said that 25-90 was facilitating in relation to inbound financing structures. However, it was determined that the repeal of section 25-90 would not address the purported mischief and instead would create a significant compliance burden on Australian taxpayers for no significant revenue gain.

This can be illustrated by the exchange that was recorded in Hansard between Senator Milne and the Deputy Secretary of Treasury Rob Heferen, in 2014 in relation to the decision not to repeal sec 25-90:¹

***Senator MILNE:** That is a long way of saying that Treasury changed its mind in terms of its recommendation in relation to repealing these provisions. Why wouldn't we have just repealed the provisions and addressed the other side of the argument? The only reason you would keep something like that is that it did not prevent people carrying out legitimate business, which is what you have just said. Why did we not just address that separately, rather than leave this in here? It is increasingly costing the taxpayer. What is it actually costing us? What is your projection on what it will cost by keeping it?*

***Mr Heferen :** Very little. In the unfortunate world of public policy and public policy advising, we do it in reasonably constrained environments; but you learn a lot of things when you go through consultation. Originally the government, back in November 2013, announced that there were a range of things that the previous government had on the books and also that the Howard government had on the books as far as tax goes that it would not proceed with, some it would proceed with and some it would change. The 25-90 one was one that would change. What it said was, 'What we will do is not proceed, but we will explore a targeted anti-avoidance provision.'*

We then worked it through with the Tax Office. On the ones that we were actually worried about, there were seven or eight identified. As was worked through quite closely, what we then found was that actually all of those ones that we were worried about would have the facility to restructure and still claim whatever deduction they could. They were large enough and sophisticated enough to have sufficient debt to fund their Australian operations and sufficient equity to fund their foreign operations. They would have to do

¹ [ParlInfo - Economics References Committee : 09/04/2015 : Corporate tax avoidance \(aph.gov.au\)](#)

some tracing of the funds. So there were some extra compliance costs, but for these large corporations it was probably not much.

As it turned out, the revenue that we at one stage thought would be obtained from that was a mistake. Really, there was no upside with proceeding. The measure would have only had downsides, because what it would have done was prevent legitimate activity taking place. It was one of those very salutary lessons for people like me and people who work with me in our jobs. We realised what seemed like a good idea at the time turned out to be not what we thought, largely because of the capacity of the firms—which we thought the arrangements were targeting—to be able to get around what was being provided.

The FSC considers the above logic still remains valid today and amending the thin capitalisation rules to move to an earnings based test does not alter this position.

3.2 Discussion

Australia currently has an income tax regime in place which seeks to encourage Australia as a regional holding company jurisdiction. The amendments proposed in the Draft Legislation released on 16 March 2023 represented a significant policy shift from this position. The current international income tax rules focus on ensuring that Australian resident entities paid either Australian tax or a comparable rate of tax offshore. So, for example, dividends received from comparable tax jurisdictions benefit from tax exemption while those from lowly taxed jurisdictions do not – shareholder relief being limited to a credit for foreign taxes paid.

Attempts to position Australia as a jurisdiction where holding companies are located (either domestic or foreign owned) which then acquire foreign companies will be frustrated if the holding company cannot borrow to fund its acquisitions.

Using debt to fund foreign acquisitions is to be expected. Generally, debt reduces a company's average cost of capital. This is not done to avoid tax. Companies have been doing what Government policy has encouraged them to do.

Repealing section 25-90 will increase the average cost of capital and make Australia less competitive in the global market. The repeal would mean that Australian based multinationals will be forced to raise equity finance, which is more expensive than debt, or else borrow in foreign jurisdictions – where debt margins may well be higher for foreign owned borrowers (and the benefit to the Australian economy from the use of Australian finance will be lost).

Most other OECD countries allow a deduction for interest incurred to derive dividends from foreign subsidiaries, subject to earnings-based interest limitation rules. The proposed repeal of section 25-90 will put Australia out of step with other major developed economies in the OECD, including the UK, Germany, Canada, the US, France, Spain, and Japan.

As a result, Australia will become uncompetitive as a holding company jurisdiction and Australian multinationals will be disadvantaged relative to foreign multinationals. As an example, Australian multinationals may be unable to compete with foreign multinationals in bidding for new foreign assets, or may move their global operations offshore in their entirety.

3.3 Interest limitation rules remain appropriate

The FSC submits that the interest limitation (thin capitalisation) rules prevent the artificial loading of debt into Australian entities. It is this regime that is relevant for the restriction of such behaviour. The extension of the thin capitalisation rules to outbound investors (see Section 3.1 above) went hand in hand with the introduction of section 25-90. It is not appropriate to amend section 25-90 while retaining thin capitalisation rules as they currently stand and after the introduction of the other proposed amendments – particularly in relation to outward investing entities.

The FSC submits that it is not clear why a deduction should be denied in relation to debt that is used in the business and is not in excess of the accepted debt norms as determined by the operation of the appropriate interest limitation provisions. The current thin capitalisation provisions only consider a taxpayer's Australian assets when calculating the safe harbour debt amount – for example, see the method statement in subsection 820-100(2), which will remain in place following the changes, which deducts controlled foreign entity equity amounts from total assets.

In relation to the proposed changes to the safe harbour provisions, the FSC submits that the exclusion of NANE dividends from foreign subsidiaries in the calculation of 'Tax EBITDA' under the Fixed Ratio Test and Group Ratio Test already appropriately reflects the policy position that Australian taxpayers should not be able to increase the capacity for interest deductions through the production of exempt or tax deferred income.

The definition of External Third Party Earnings Limit also includes a limitation in section 820-61(2)(d) that requires the proceeds from relevant third-party borrowings to be used wholly to fund assets that are used within an Australian permanent establishment or assets held for the purposes of producing assessable income. As this section already requires establishing a nexus between a borrowing and the production of assessable income, the repeal of section 25-90 is not necessary.

3.4 Retrospective impact of the repeal of Section 25-90

One of the consequences of section 25-90 is that Australian taxpayers are usually not required to trace the use of funds to determine the tax deductibility of any associated interest costs. As a result, Australian taxpayers (to varying degrees) operate on a pool of funds basis given that money is generally fungible. This means most Australian taxpayers do not have the ability nor the records / documentation to be able trace the use of funds from their current funding sources.

We also note that Australian taxpayers have borrowed money on a good faith basis, based on the tax rules in place at the time – and these rules (generally) did not require the tracethrough of sources and use of funds, and these rules did not deny deductions for borrowings to fund offshore NANE income.

This will all change if section 25-90 is repealed.

While the tracing of funding to use of funds could potentially be built over time, this will take time and significant resources to do.

In the interim, until such point that these systems and processes can be put in place the impact of the repeal of section 25-90 would be difficult to discern. It is likely that proxy methods (in regulations or ATO rulings) would be required for the calculation given the difficulty of tracethrough noted above. A change to the current legislative framework forcing taxpayers to rely on what could be somewhat arbitrary proxy methods is unlikely to be good tax policy.

The impact of this retrospectivity is accentuated by the lack of consultation to date on the repeal of section 25-90 and the extremely short time frame to the potential enactment of the appeal with it proposed to apply for income years starting on or after 1 July 2023.

If the Government persists with the NANE amendments, then the FSC submits that grandfathering of existing arrangements is necessary. Many taxpayers will have borrowed to acquire foreign investments in full compliance with, and reliance upon, existing legislation and explicit Government policy – it is inappropriate that a financial penalty should be suffered by those taxpayers where that policy is subsequently altered. In such a case, we submit that interest on facilities entered into prior to the enactment of the legislation should continue to be deductible for the life of the facility.

Given the above, the FSC **recommends**:

- Section 25-90 should be retained in its current form, and deductions should continue to be allowed for interest costs connected with the derivation of NANE dividend income from foreign subsidiaries (in section 768-5 of the Act). Any concerns in relation debt loading in Australia are appropriately addressed by the broader interest limitation measures.
- If there are specific integrity issues with borrowing to derive NANE foreign dividend income, then these issues should be clearly enunciated, and referred to the Board of Taxation for consultation and development of a targeted solution developed that continues to support genuine commercial activity and the promotion of Australia as an investment destination.
- If the Government still wants to pursue the repeal of section 25-90 that it should articulate the policy rationale for this and have a separate consultation with stakeholders on whether the repeal of 25-90 is the best avenue to address the Government's policy objectives.
- If it is determined that the NANE amendments will go ahead with effect from 1 July 2023, then grandfathering of existing arrangements is necessary, with interest on facilities entered into prior to the enactment of the legislation should continue to be deductible for the life of the facility.

4 Exemption for widely held investment funds

The FSC welcomes the proposal in the legislation to provide an exemption for superannuation funds from the definition of 'associate entities'.

Under the draft legislation, an entity can only elect to use the external third party debt test if all 'associate' entities also make that same election. Given the broad definition of 'associate' entity, there would be substantial problems for superannuation funds if the exemption were

not provided. This is because a number of unrelated superannuation funds could be treated as associates of each other based on their independent decisions to place money into a particular investment. Every one of the 'associated' superannuation funds might need to make the same election for the election to work for any one fund. This would be difficult if not impossible to achieve in practice.

Given these strong arguments for an exemption for superannuation funds, the FSC submits that the same arguments should apply to Managed Investment Trusts (**MITs**), Attribution MITs (**AMITs**), and Corporate Collective Investment Vehicles (**CCIVs**), particularly because these other types of fund are required to meet a 'widely held' test. Therefore, the policy rationale for excluding superannuation funds also applies to these other investment funds.

If this exemption is not provided to investment funds more broadly, then this will create a number of important problems:

- This will create an artificial incentive for superannuation funds to hold investments directly rather than through independent asset managers.
- This will disadvantage superannuation funds that already invest into assets indirectly through a chain of one or more investment funds, particularly if these indirect investments are hard to unwind.
- This will discourage the uptake of the CCIV for investment funds that have borrowings, including property and infrastructure funds.

The FSC **recommends** the proposed exemption for superannuation funds should also apply to other investment funds that satisfy the existing 'widely held' test, specifically MITs, AMITs and CCIVs.