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Senate Standing Committees on Economics
PO BOX 6100
Parliament House
CANBERRA ACT 2600

Dear Sir/Madam,

TREASURY LAWS AMENDMENT (MAKING MULTINATIONALS PAY THEIR FAIR SHARE - INTEGRITY AND TRANSPARENCY) BILL 2023

BDO refers to the invitation by the Senate Standing Committees on Economics to provide comments to this inquiry on the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023* (**Bill**) and accompanying Explanatory Memorandum (**EM**). BDO is pleased to provide feedback and comments in relation to the Bill. While it was pleasing to see some of the feedback provided by the Australian tax community in response to the Consultation Paper and Exposure Draft ("ED") Bill being reflected in the Bill, there are some further important matters that require consideration prior to finalising the legislation.

In summary, BDO's comments and suggestions for changes to improve the Bill are:

Thin capitalisation amendments - see Appendix 1

- The fixed ratio test (FRT) tax EBITDA
  - Reduction of tax EBITDA for non-deductible research and development expenditure- should be a reduced for notional R&D deduction amounts that are deemed to be non-deductible.
  - Increase of tax EBTDA for previous year losses deductions.
  - Modify the exclusion of dividends and associated trust/partnership distribution Income from the tax EBITDA to allow sharing of the thin capitalisation debt deduction limit to account for debt funding at the ownership level.
- External Third Party Debt Test (ETPDT),
  - the ETPDT is punitive in its application and provides very little flexibility for groups entering into third party financing arrangements via a conduit associate entity.
  - The requirement for entities to be an "Australian resident' may preclude trusts and partnerships from eligibility for the ETPDT.
- Debt Deduction Creation Rule
  - The Debt Deduction Creation rule should have a principal purpose test so that it only applies where the arrangement has a principal purpose to create debt deductions.

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Without such a principal purpose test genuine commercial transactions, restructuring and capital reorganisation activity could be inappropriately disadvantaged.

BDO's detailed comments in this regard are in the attached Appendix 1.

Disclosure of subsidiaries - see Appendix 2

BDO has concerns about:

- Implications for directors in declaring that the disclosures are 'true and correct', which is not terminology that is currently included in the director's declaration, nor is it used for audit purposes.
- What are the evidentiary requirements that auditors will need in supporting subsidiary disclosures?

BDO's detailed comments in this regard are in the attached Appendix 2.

Should you have any questions or wish to discuss any of the comments made in our submission, please do not hesitate to contact me on 02 9240 9736 or lance.cunningham@bdo.com.au.

Yours sincerely

Lance Cunningham

BDO National Tax Technical Leader

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APPENDIX 1

BDO Submission to the Senate Standing Committees on Economics Revised Multinational tax integrity – strengthening Australia's interest limitation (thin capitalisation) rules

BDO has considered the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share integrity and transparency) Bill 2023 (Bill)* which strengthens the thin capitalisation rules in Division 820 of the ITAA 1997. The Bill introduces new earnings-based tests for certain entities, to determine whether to disallow an amount of an entity's debt deductions (e.g. interest) based on the entity's earnings or profits, replacing the current asset-based thin capitalisation tests. We provide the following comments on the Bill.

Fixed Ratio Rule

Non-deductible Research and Development Expenditure

Where entities undertake eligible Research & Development ("R&D") activity and make a claim under the R&D tax offset incentive, those R&D amounts that would otherwise be deductible under other provisions are specifically treated as non-deductible for income tax purposes. The purpose of this adjustment is to ensure that a taxpayer does not receive a double tax benefit (i.e. a tax deduction in addition to the R&D income tax offset). As the Bill stands, an entity may experience increased debt deduction capacity where they incur relevant R&D expenditure by virtue of this expenditure being treated as non-deductible. In the interests of being even-handed, BDO suggest Treasury could consider a reduction adjustment in calculating tax EBTIDA to eliminate the impact of non-deductible R&D expenditure. This should prevent an inadvertent increase in the fixed ratio earnings limit for entities making a claim under the R&D tax incentive.

Fixed ratio test - tax EBITDA - adjustment for previous year losses deductions

We note that compared to the ED Bill, the Bill proposes to change the calculation of the tax EBITDA for the purposes of the fixed ratio test by not adding back prior year tax losses brought forward claimed as a tax deduction. The EM to the Bill notes that the fixed ratio method "ensures that an entity's debt deductions are directly linked to its economic activity". BDO appreciates the importance of preventing entities from artificially manipulating the calculation of tax EBITDA to achieve a more desirable tax outcome. However, we question whether calculating tax EBITDA net of tax losses claimed as a tax deduction achieves this purpose. As it stands, an entity's ability to claim a tax deduction is reduced where tax losses from prior years are claimed as a deduction. BDO submits that an entity's fixed ratio earnings limit should not be affected by the deduction of prior year tax losses carried forward. This mechanism creates an outcome where two entities with identical current year profitability would have different fixed ratio earnings limits, depending on the quantum of losses carried forward from prior years. BDO suggests that Treasury may wish to consider reinstating the adjustment to add back tax losses claimed as a tax deduction in calculating an entity's tax EBITDA for an income year so that it aligns with its current year economic activity.

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Dividend and trust/partnership Distribution Income

The proposed tax EBITDA add back of all dividends and distributions from associated partnerships and trusts has the effect of preventing deductibility of interest expenses in relation to income producing equity interests in companies and associated partnerships and trusts by eliminating the income from these investments from the tax EBITDA. This creates a real disincentive for entities acquiring equity interests using debt capital. If there is a motive for the government wanting to stop debt capital being deployed in funding equity investments, an explanation should be provided in the EM.

The rationale in the EM for the exclusion of dividends and distributions from partnerships and trusts from the tax EBTDA of theses entities is to ensure amounts of income that are included in the tax EBITDA of the dividend paying company or distributing partnership/trust are not also included in the dividend recipients, partner or beneficiary's tax EBITDA (i.e. to ensure there is no double counting of the debt deduction limit in cascading distributions within a group). This rational does not explain the elimination of dividends from non-associated companies. There is no explanation for the difference in treatment between dividends and distributions from partnerships and trusts. We submit that any proposed exclusion for dividends should not apply to dividends from non-associates in the same was as applies to distributions from no-associated partnerships and trusts.

This rationale in the EM also assumes all debt funding would be in the lower level distributing company, partnership, or trust; whereas in many cases the debt funding is at the higher level equity owning entity with no or low amounts of debt funding at the lower level. BDO submits that as an alternative to a total exclusion for dividends and distributions from associated partnerships and trusts the Bill be amended to include a mechanism to share the debt deduction limit between the lower level company trust or partnership and the higher level equity owning entity. The "associate entity excess amount" in the current Thin Capitalisation rules currently achieves this outcome. We suggest a similar mechanism be introduced to achieve the appropriate level of debt funding to be spread between the equity owning entities and the operational entities. This would prevent debt funded equity holders from being unfairly disadvantaged.

We suggest any mechanism to share the debt deduction limit between the lower level companies trusts or partnerships and the higher level equity owning entities in a group would have to account for the effect of the carried forward deductions for FRT disallowed amounts. To achieve this, we recommend that a reporting requirement be introduced that identifies adjustments required to the higher level equity owner entities debt deduction limit to account for this impact year on year basis. Any such adjustment should also take account any permanent disallowance on expiry of the 15 year carry forward period. BDO recommends that an annual statement be issued to associated shareholders/ partners/ unit holders each year disclosing the adjustment required to the shareholder's/partner's/ unit holder's debt deduction limit.

External Third-Party Debt Test

We refer to the BDO submission to Treasury in response to the ED [BDO Submission | multinational tax integrity - BDO Australia], in which expressed BDO's view regarding the narrow parameters allowed in the ETPDT. Whilst we acknowledge some practical changes included in the Bill, our view remains that

the ETPDT is punitive in its application and provides very little flexibility for groups entering into third party financing arrangements via a conduit associate entity, regardless of loan terms being identical.

Australian residency and use of funds requirements

The Bill includes a requirement for entities electing to apply the ETPDT to be an "Australian resident" as defined in section 995 ITAA 1997. This appears to be problematic for partnerships and trusts as it is not clear whether they are included in the definition of "Australian resident" in section 995. This could exclude them from applying the ETPDT.

The Bill also requires that all group entities in a conduit financing arrangement must be Australian entities, this requirement is problematic in that it prevents an Australian resident entity issuing a debt interest to a foreign associate conduit finance entity, regardless of whether the terms of the debt are identical to those of a debt interest issued by an external third party.

We are concerned that the ETPDT's narrow design parameters will preclude its application in a range of common commercial circumstances applicable to highly geared groups, disincentivising foreign investment in Australia.

Debt Deduction Creation Rule

Principal purpose test

The EM explains that the "New 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". However, the Bill disallows an interest deduction in all scenarios where a relevant transaction is undertaken and in funding the transaction, a debt deduction arises. Whilst BDO appreciates this purpose, BDO submits that the operative provisions in the proposed section 820-423A (2) and (5) should include a requirement for the principle purpose or one of the principle purposes of a relevant transaction or scheme to be the creation of debt deductions.

In the absence of a principal purpose requirement, BDO is concerned that genuine commercial transactions, restructuring and capital reorganisation activity will deny interest deductibility in relation to debt interests issues to related parties even where issued on arm's length terms. The risk of genuine commercial activities and transactions being captured by these rules would act as a real disincentive for investment in Australia.

Retrospective application Grandfathering and effective date

When enacted, the Bill proposes to operate for income years commencing on or after 1 July 2023. The draft Bill does not include any grandfathering for existing debt arrangements or any transitional relief. Whether intended or unintended, this means the changes may apply to existing debt, not just borrowings entered into during the income years commencing on or after 1 July 2023. BDO is concerned that without grandfathering or transitional relief, this will be potentially adverse for taxpayers who have borrowed based on the existing safe harbour debt amount and may have modelled the viability of their investments on interest deductions which may cease to be available from 1 July 2023, when the legislation is to have taken effect.

If grandfathering of existing arrangements is not accepted, a model for a transitional approach could be found in the approach taken when introducing amendments for stapled structures (which allowed a 7 to 15 year transitional period to allow existing arrangements to be restructured).

Alternatively, in recognition that the proposed debt deduction rules were not included in the Exposure Draft version of the Bill, BDO submits the effective date starting date for the Debt Deduction Creation rule be postponed until at least 1 July 2024. This would provide taxpayers with some time to consider the effect of the changes and to ensure their compliance.

Transfer Pricing

The amendments to section 815-140(1)(a) removes the concessional treatment in respect of the quantum of loans for general class entities utilising the FRT and the GRT on the basis that the proposed changes to section 820 no longer limit the debt composition of an entity’s balance sheet.

Unless electing to apply the arm’s length debt test, general class investors have not historically been required to undertake a quantitative assessment of arm’s length debt capital. Given that these requirement are new and that the attached compliance burden may be significant for some entities, BDO recommends that the ATO publish guidance in the form of a practical compliance guideline or taxation ruling, explaining the ATO’s views as to the most appropriate methodologies in confirming the arm’s length nature of a taxpayer’s balance sheet.

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APPENDIX 2

BDO Submission to the Senate Standing Committees on Economics
Revised Multinational tax transparency – disclosure of subsidiaries

BDO has considered the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share - Integrity and Transparency) Bill 2023 (Bill)* introducing additional disclosure requirements for public companies in preparing financial statements in relation to their subsidiaries. BDO queries the implications for auditors regarding the evidence required to provide an audit opinion in relation to the disclosures and the implications for directors in declaring that the disclosures are 'true and correct'.

Audit evidence requirements

The new requirements require public companies to include a 'consolidated entity disclosure statement' which includes specific information for entities in the consolidated group to be disclosed. It is assumed that this disclosure is to be included in the financial statements of the relevant public company and that these financial statements are required to be audited.

Whilst the new disclosure requirements may not present a significant additional audit burden, there are some components included in the mandatory disclosures that may present some practical challenges. In reviewing the required disclosures, auditors will need to understand the evidentiary requirements in supporting subsidiary disclosures. As an example, the requirement in "*(vii) if the entity was a foreign resident as described in subparagraph (vi), a list of each foreign jurisdiction in which the entity was, at that time, a resident for the purposes of the law of the foreign jurisdiction relating to foreign income tax (within the meaning of that Act)*".

Implications for director's declarations

The broader overarching concern from an audit standpoint is the statements required from directors, and obligations applicable to directors and auditors in respect of these statements. In addition to the above reporting obligations, the existing declaration of the directors (and for listed companies the existing declaration of the chief executive officer and chief financial officer) currently required under the *Corporations Act 2001* will be expanded to include a declaration that the consolidated entity disclosure statement is in their opinion 'true and correct' at the end of the financial year. This term of 'true and correct' is not terminology that is currently included in the director's declaration, nor is it used for audit purposes. It suggests a level of absolute assurance as opposed to reasonable assurance and ignoring any concept of materiality.

This raises the question of what evidence would be sufficient to attest to this being 'true and correct' and the impact on the audit opinion in the event that sufficient evidence to support the disclosure is not available or if the auditor disagrees with the director's declaration.

If the Auditing and Assurance Standards Board (AUASB) has not been consulted in drafting the Bill, BDO submits that the AUASB be consulted to provide further clarity to directors, officers and auditors regarding their obligations under this legislation.