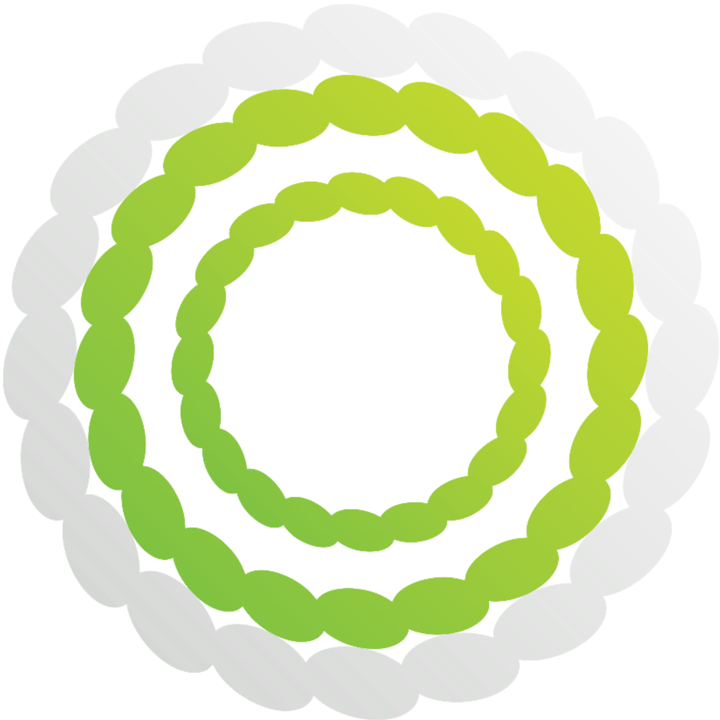
26 June 2023

Australia 2023/10



Tax Insights

Australian multinational tax laws introduced

Snapshot

Prior to the 2022 election, the Labor Party, then in Opposition, proposed three main multinational tax measures, broadly being:

1. A new thin capitalisation regime (based broadly on the OECD's EBITDA interest limitation approach);
2. Increased tax transparency, including public country by country (CbC) reporting; and
3. Denying deductions for payments to low corporate tax jurisdictions attributable to intangible assets (the intangibles measure).

The Labor Party (now in Government) reaffirmed its commitment to these proposals in the October 2022 Budget. The Government issued Exposure Draft (ED) legislation earlier this year on all three measures and undertook consultation. With some variation in the detail, each of the three measures were proposed to commence from 1 July 2023.

26 June 2023

On 22 June 2023, the last sitting day of Parliament before the slated 1 July 2023 start date, the Government introduced a new Bill into Parliament titled: Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023 (**Multinational Tax Bill** or **Bill**). The Multinational Tax Bill as introduced deals with two of the multinational tax measures:

1. New interest limitation rules; and

2. An element of the tax transparency measures (stage 1), but not the public CbC reporting (stage 2).

The public CbC measure and the intangibles measure were not included in the Bill, although there is commentary in the accompanying Explanatory Memorandum (**EM**) on these measures. In addition, on 23 June 2023, the Government issued revised exposure draft legislation (not introduced into the Parliament) dealing with the intangibles measure.

Status and timing

The Multinational Tax Bill has been referred to the Economics Legislation Committee for review. The Committee is not due to report until **31 August 2023**. It is therefore expected that the passage of the Bill will not occur until after the report has been released. It is possible that the Committee's report could recommend changes to the Bill.

In respect of the revised ED on the intangibles measure, there is no specified period of further consultation, although it is assumed that the Treasury will conduct public consultation in the usual way.

Notwithstanding the less than optimal legislative status and the proximity to 30 June 2023, the Government is (with one exception) holding firm to the July 2023 start date for the measures. More specifically, the Multinational Tax Bill provides that:

- The EBITDA interest limitation measure will apply to income years commencing on or after 1 July 2023; and
- The stage 1 tax transparency measures will apply to financial years commencing on or after 1 July 2023.

The revised ED on the intangibles measure continues to propose that this measure will apply to payments, credits, etc on or after 1 July 2023.

The only modification to the original timeline is in respect of the public CbC reporting measure, which is now proposed to start from 1 July 2024. Helpfully, there is also guidance that the four additional disclosures that depart from other global regimes: "related party expenses, the effective tax rate disclosure and the two intangible assets disclosures" will not proceed.

We set out below some preliminary comments on the measures. More detailed comments will follow.

New interest limitation rules

In broad terms, the Government's proposal is to align the Australian interest limitation rules to OECD best practice based on EBITDA, in place of the longstanding asset-based thin capitalisation rules.

Exposure Draft legislation was released on 16 March 2023. A link to our publication on that Exposure Draft can be found here, and a further publication on the interaction with the transfer pricing rules is available here.

There was considerable feedback given to Treasury during the consultation period with a total of 54 submissions received. The Multinational Tax Bill responds to some of that feedback, both in a favourable and an unfavourable manner, and also extends the proposal in some important respects.

The broad framework remains the same in that there are three potential tests available to "general class investors", being the:

- Fixed Ratio test (FRT), a default test being 30% of tax EBITDA.
- Group Ratio test (GRT).
- Third party debt test (TPDT).

The main changes to between the ED and the Bill are as follows:[1]

- The changes to section 25-90 have been removed (which will be welcome news to many Australian multinationals) and so-called "targeted" debt creation rules have been introduced in place (which on current drafting are anticipated to give rise to a number of issues);
- Adjustments have been made to the third-party debt test in an attempt to broaden its availability;
- With respect to the fixed ratio test:
    - changes have been made to limit double counting through partnerships, trusts and non-consolidated corporate groups;
    - the carry-forward of disallowed deductions is now subject to a business continuity test;
    - the 'depreciation' component of EBITDA has been broadened,
- The definitions of 'debt deduction' and 'net debt deduction' have been adjusted; and
- The exclusion of financial entities registered under the Financial Sector (Collection of Data) Act has been narrowed.

We comment below on some of the key changes as between the ED and the Multinational Tax Bill.

Section 25-90

A significant surprise in the ED was the proposal to amend sections 25-90 and 230-15 to effectively deny a tax deduction for interest costs relevantly connected with the derivation of non-assessable non-exempt (NANE) dividend income from foreign affiliates. This has been removed from the Multinational Tax Bill, following widespread stakeholder concerns of the negative consequences of the proposal. The Government has stated that the proposed amendment has been "deferred", and that there will be a further consultation process on this issue. No details of that consultation have yet been announced.

Debt deduction creation rules

Seemingly as a consequence of deferring the 25-90 proposal, the Government has moved to address debt creation concerns.

A new anti-debt deduction creation regime would deny interest deductions relevantly connected with two broad scenarios: acquisitions of assets from associates, and payments or distributions to associates. Whilst the EM states that the rules apply to "schemes that lack genuine commercial justification" and "artificial interest-bearing debt", there are no such legislative requirements. Further, there is no purpose test in the initial application of the rules.

Firstly, the rules could apply in relation to the acquisition of a CGT asset (or the acquisition of a legal or equitable obligation) acquired (directly or indirectly) from a relevant associate. The relevant concept of associate has been widened by the new definition of "associate pair". The EM states that "For example, debt deductions arising from debt created by an entity would generally be disallowed if the debt created funded the acquisition of:

- Shares in a foreign subsidiary from a foreign associate; or
- Business assets from foreign and domestic associates in an internal reorganisation after a global merger."

[1] Refer also to the Government's Summary of Consultation Process Outcomes statement

There is no requirement that the debt is related party debt or that there is an overall increase in the level of borrowings of the group.

Further, the measure can also deny interest deductions where funds are borrowed from a relevant associate and used predominantly to fund or help make a payment or distribution (including interest or dividend) to a "recipient associate". By way of example, the EM states that "debt deductions arising from related party debt created by an entity to fund or increase the ability of the entity to make payments to a foreign associate as part of an entirely internal restructure would generally be disallowed."

The rules are drafted extremely broadly and could potentially apply to many arrangements, including regular commercial transactions.

Consideration will need to be given as to whether debt deductions relating to pre-existing arrangements could be denied from the commencement of the rules.

In addition, even if the debt creation requirements are not met, there is a specific power for the Commissioner to nonetheless make a determination that the debt creation rules apply where there is a principal purpose to avoid the debt creation rules.

Tax EBITDA

The fundamental concept of tax EBITDA has been modified as compared to the ED:

- Tax EBITDA has been boosted, by expanding the tax deprecation add back from deductions under "Subdivision 40-B and Division 43" to now include deductions under "Divisions 40 and 43 … other than deductions for the entire amount of an expense incurred by an entity".
- Tax EBITDA calculated for a trust or partnership now prima facie includes their net income (recognising that trusts and partnerships strictly do not calculate "taxable income"), but does not appear to include "determined trust components" of an attribution managed investment trust (AMITs) - meaning that AMITs will have zero tax EBITDA. This appears to be an oversight in the drafting.
- Tax EBITDA has been narrowed to exclude all dividend income as well as the gross up for franking credits.
- Special provisions have been included to address interests in partnerships and trusts. The broad objective is to ensure that amounts included in the net income of partnerships and trusts, and hence included in the Tax EBITDA of a partnership or a trust, are not counted again in the Tax EBITDA of a partner or a beneficiary, who is a relevant associate of the partnership or trust.

These last two measures effectively mean that in most non-tax consolidated cases, whether joint venture companies, partnerships or trusts, any relevant debt needs to be issued by the entity conducting the relevant business and income earning activities, and not at the level of the shareholder, partner or beneficiary, in order for the interest to be deductible.

For existing structures where the debt is at the investor level, seeking to restructure the debt into the joint-venture company, partnership or trust risks the operation of the new debt creation rules (with the result that interest on the restructured loan could be fully non-deductible).

Carry forward of FRT disallowed amounts

Where a debt deduction is denied under the FRT in a particular year, such amounts can broadly be carried forward for 15 years. Where a company has failed the continuity of ownership test, the Bill has been widened to allow carry forward where the business continuity tests are met. A modified version of the trust loss rules has been introduced that must be satisfied in order for a trust to carry forward any FRT disallowed amounts.

Choice

The FRT remains the default test, and a taxpayer can choose to apply either the GRT or TPDT for an income year. In an acknowledgement of consultation concerns, the Bill contemplates that a choice can be revoked, albeit subject to a number of tests and only with the Commissioner's approval.

Third party debt test

The third party earnings limit has been expanded to include debt deductions directly associated with hedging or managing the interest rate risk in respect of the debt interest, unless paid, directly or indirectly, to an associate entity. While this is a welcome change, as hedging deductions were non-deductible under the TPDT based on the ED, the rationale for the inability to deduct hedging costs under a back-to-back arrangement with an associate entity is unclear.

The TPDT and in particular, the third party debt conditions have been modified:

- The ED required that the lender's recourse was limited to assets of the borrower, whereas this has now been narrowed to "Australian assets" of the borrower, and is expressed to generally exclude "rights under or in relation to a guarantee, security or other form of credit support" (even where such rights are provided by an Australian entity). Further, if recourse extends to other assets such as assets of subsidiaries or shares / units in the borrower, the conditions are not met (although see the wider security net in the context of conduit financing noted below). The highly restrictive third party debt conditions will continue to mean that much funding provided by unrelated entities, including banks, will not be eligible for the TPDT.
- The ED required that the entity use the funds wholly in connection with (broadly) Australian operations, whereas as this test has been modified in a number of ways including that the borrower uses all or substantially all of the borrowed funds to fund its commercial activities in connection with Australia, not including a foreign permanent establishment, associate entity debt, controlled foreign entity debt or controlled foreign entity equity. Importantly, the exclusion for "associate entity debt" will prevent the conduit financing rules from application in many typical on-lending arrangements, which must be assumed to be unintended.
- The third party debt test now contains a limited carve out for certain credit support arrangements that provide direct or indirect recourse to the assets of an Australian entity or non associated foreign entity. It appears that the carve out only applies where the credit support is considered an Australian asset held by the borrower and the debt financing wholly relates to the creation or development of a CGT assets that are real property situated in Australia.
- The third party debt conditions continue to require that the borrower is an "Australian resident", which does not technically include a trust or partnership.

In addition, the conduit financing rules relating to the TPDT have been modified:

- The security under the ultimate external loan can extend to assets of the borrower and other Australian resident members of the "obligor group" which is a new concept (although the exclusion for rights under or in relation to a guarantee, security or other form of credit support still generally applies aside from the carve out noted above).
- Certain terms of each on-lending are still required to be the same as the ultimate debt interest, however, in a positive development, only terms relating to a cost under the ultimate debt must be the same, and certain terms of the on-lending can be disregarded (including the on-charging of reasonable administrative costs of the conduit financier in relation to the ultimate debt interest).
- The conduit financing rules now cater for successive on-lending scenarios The conduit financier and borrowers must be "Australian residents", which does not technically include trusts or partnerships.

The various conditions mean that the conduit financing conditions will be challenging to meet at best, and in many cases, cannot be satisfied.

Importantly, the requirement for all relevant associate entities to make the TPDT choice has been replaced by a deemed TPDT choice for each entity that:

i. Is in the same "obligor group" as the borrower entity that makes the TPDT choice (or is deemed to have made the choice in relation to another obligor group);
ii. Has a sufficient economic interest in the borrower entity (determined using a modified associate entity test); and
iii. Is required to lodge an Australian income tax return.

The deemed TPDT choice also applies for an entity that has entered into a cross staple arrangement with a borrower entity that has made the TPDT choice (or is deemed to have made the choice in relation to another obligor group.

Restructurings

Given the impending start date and the restrictive nature of the tests, especially the TPDT, it is likely that consideration will be given to restructuring or refinancing existing arrangements, such as in non-consolidated cases where there is a mismatch between the entity(ies) with the debt and the entity(ies) with the business operations and tax EBITDA. Further, those entities with genuine third party debt may not be able to access the TPDT under the current form of their arrangements.

This raises the potential risk that various anti-avoidance measures could apply, including the new debt deduction creation rules. This will require consultation with the ATO in order that restructurings that are consistent with the policy intent are not at risk.

Next steps

Whilst the Bill has been introduced into Parliament, it will be subject to review via the Selection of Bills Committee. It is likely that the Committee will seek submissions and may hold hearings.

In introducing the Bill into Parliament, Andrew Leigh (Assistant Minister for Competition, Charities and Treasury, Assistant Minister for Employment) stated that "Treasury will continue to engage with industry to ensure the changes operate as intended". It therefore appears that the Government acknowledges that amendments may be made to the Bill at least in respect of technical matters. In any event, the final form of the law is unlikely to be known until September 2023 at the earliest.

Transparency

The Multinational Tax Bill includes changes to financial reporting disclosures as required by the Corporations Act. Australian public companies (listed and unlisted) will be required to provide a "consolidated entity disclosure statement" as part of their annual financial reporting. This applies to financial years commencing on or after 1 July 2023.

For each entity that was part of the financial statements consolidated group at the end of the year, the information required in the statement includes:

- Entity name;
- Entity status: body corporate, partnership or trust;
- For a body corporate: the place of formation or incorporation;
- Whether the entity was an Australian tax resident or a foreign resident, and if a foreign resident, the jurisdiction(s) in which that entity is tax resident.

The disclosure of subsidiary information was only one component of the Government's previously announced enhanced transparency measures. Of the two EDs released relating to enhanced transparency earlier this year, the second dealing with a broad public CbC reporting measure, for all large multinational groups (wherever headquartered) if the group had a subsidiary or branch in Australia was not introduced to Parliament.

In the EM, the "Impact Statement" contains some commentary about the measures previously released by ED. In respect of public CbC reporting, following consultation with 55 submissions being received, the EM states that the implementation of this aspect will be delayed by one year to 1 July 2024, and that the disclosure requirements will be better aligned with the EU requirements. Notably, the EM notes that the four additional disclosures that depart from other global regimes: "related party expenses, the effective tax rate disclosure and the two intangible assets disclosures" will be removed from the law. Additionally, further consultation with industry on the appropriate level of disaggregated reporting and the measure more broadly will be undertaken.

There has been no mention of the transparency measure to introduce a public register of beneficial ownership. The proposal requiring tenderers for Australian government contracts worth more than $200,000 to disclose their country of domicile has been scrapped and will be implemented via administrative changes.

Intangibles

The Government had previously issued an ED in March 2023 on the intangibles measure. A link to our publication on that ED is here. The original ED had been subject to considerable comment and concerns in the consultation period.

The Multinational Tax Bill did not address the intangibles measure. The EM to the Bill nonetheless commented on this measure:

- The start date for this measure remains 1 July 2023;
- The global implementation of Pillar 2 will address some of the concerns, but the Government remains concerned about the tax risks in the period prior to sufficient level of take-up of Pillar 2;
- The Government remains concerned about "embedded royalties" which may not be addressed by Pillar 2;
- The Government will further consider stakeholder feedback from consultation on the original ED;
- Interactions between Pillar 2 and the intangibles measure will be further considered and reviewed during the implementation of Pillar 2.

On 23 June 2023, the Government issued a revised ED on the intangibles measure, which narrows the potential scope of the measure as compared to the original ED. It is not clear when the Government expects to finalise the Revised Intangibles ED and introduce a Bill into Parliament. The next Parliamentary sitting is from 31 July 2023.

In broad terms, the intangibles measure applies to significant global entities (SGEs) and has two linked elements:

- The identification of in-scope intangibles arrangements, which is focussed on relevant arrangements, relevant intangible assets and relevant exploitation of such assets; and
- The identification of a low corporate tax jurisdiction (LCTJ).

The broad scope of the rules remains unchanged – the main changes in the revised intangibles ED relate to a narrowing of the LCTJ test, as well as a series of carveouts in cases where, notwithstanding that the income is relevantly derived in a LCTJ, the income is nonetheless subject to a sufficient level of tax.

Low corporate tax jurisdiction

The LCTJ test continues to seek to identify those countries where the relevant rate of corporate income tax is less than 15% or specifically nil. However, the proposed test will essentially be tied to a foreign country's headline rate of corporate income tax applicable to income derived by a SGE in the ordinary course of carrying on a business. If for example, a country has a headline rate of corporate income tax of more than 15%, it will remain a non-LCTJ even if there is an exemption from tax for particular industries or particular types of income.

Subject to sufficient tax

Even if income is relevantly derived in a LCTJ, the income will be treated as if it is not derived in a LCTJ where the income is subject to sufficient tax, which relevantly means:

- That the income is "subject to foreign income tax" at a rate of 15% or more, which can take into account State and municipal taxes; or
- That the income is included in Australian assessable income under the Australian CFC rules.

Australian royalty withholding tax

Where an in-scope intangibles payment is relevantly derived in a LCTJ, is not subject to sufficient tax as noted above and is, wholly or partly, subject to Australian royalty withholding tax which has been paid, the deduction denial will be scaled down to reflect the Australian tax already paid.

Preparing for implementation

Most taxpayers who are SGEs, incur interest expense in excess of $2 million or which have international dealings will be affected by one or more of the measures. The measures take effect from next week, 1 July 2023. Taxpayers with financial years or income years other than 30 June will need to ascertain the relevant start dates for the various measures. In addition, Pillar 2 will become applicable in Australia and other key jurisdictions in 2024.

Taxpayers will need to understand the relevant changes, assess the potential impact and plan how to appropriately react to the proposed changes. All of this is occurring at a time when the final form of the law across all of these measures is not yet known, and is unlikely to be finalised for some months.

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Contacts

Richard Lambkin
Partner
Tel: +61 3 9322 5788
rlambkin@deloitte.com.au

Sharon Murray
Partner
Tel: +61 3 9671 7939
sharmurray@deloitte.com.au

David Watkins
Partner
Tel: +61 2 9322 7251
dwatkins@deloitte.com.au

Jacques Van Rhyn
Partner
Tel: + 61 7 3308 7226
jvanrhyn@deloitte.com.au

Christopher Ferguson
Partner
Tel: + 61 3 9671 8638
chrferguson@deloitte.com.au

Claudio Cimetta
Partner
Tel: + 61 3 9671 7601
ccimetta@deloitte.com.au

Geoff Gill
Partner
Tel: + 61 2 9322 5358
gegill@deloitte.com.au

Aparna Rao
Partner
Tel: + 61 2 9322 5832
aprao@deloitte.com.au

Amelia Teng
Partner
Tel: + 61 3 8486 1118
amteng@deloitte.com.au

Mark Hadassin
Partner
Tel: +61 2 9322 5807
mhadassin@deloitte.com.au

Cindy Perryman
Partner
Tel: +61 3 8486 1231
cperryman@deloitte.com.au

Max Persson
Partner
Tel: +61 2 9322 7538
mpersson@deloitte.com.au