

18/04/2023

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Via email: [MNETaxIntegrity@treasury.gov.au](mailto:MNETaxIntegrity@treasury.gov.au)

Dear Kathryn,

**AustralianSuper submission to Multinational Tax Integrity – draft amendments - strengthening Australia’s interest limitation (thin capitalisation) rules**

AustralianSuper welcomes the opportunity to provide a submission in response to the release of exposure draft legislation *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation* (“Exposure Draft”).

AustralianSuper is Australia’s leading superannuation fund and is run only to benefit members. Over 3 million Australians are members of AustralianSuper and we invest over \$280 billion of their retirement savings on their behalf. Our purpose is to help members achieve their best financial position in retirement.

AustralianSuper strongly supports the overarching policy intent of the draft amendments: strengthening Australia’s thin capitalisation rules in line with the Organisation for Economic Cooperation and Development (“OECD”)’s best practice guidance, and preventing multinational groups from engaging in base erosion and profit shifting practices (as it relates to deductible debt within the group).

This submission makes a number of recommendations to ensure the amendments do not have unintended consequences, which may impede infrastructure investment by Australian superannuation funds and negatively affect investment returns for Australian superannuation fund members. Detailed comments in relation to the Exposure Draft are provided in the **Attachment**.

We are strongly supportive of the proposed amendment to the definition of ‘associate entity’, so that it does not apply to complying superannuation funds. We appreciate that Treasury has taken on board this key recommendation from our previous submission dated 2 September 2022. We include minor suggestions to ensure this amendment achieves its intent.

Finally, we recommend that strong consideration be given to a post-implementation review of these reforms. This would reflect the significance of these changes to investment in Australian assets and the potential for unintended consequences to become clear once the rules are applied in practice. A post-implementation review would enable further refinements to be made to the legislation if necessary.

We would be pleased to provide additional information or to discuss this submission in further detail. If that would be of assistance, please do not hesitate to contact me or Nick Coates, A/g Head of Government Relations and Public Policy ([ncoates@australiansuper.com](mailto:ncoates@australiansuper.com)).

Regards



**Peter Curtis**

Chief Operating Officer

**Attachment:** Detailed comments in relation to the Exposure Draft

## Attachment: Detailed comments in relation to the Exposure Draft

### 1 'Associate entity' – complying superannuation fund exemption

AustralianSuper is strongly supportive of the change in the definition of 'associate entity' in the Exposure Draft, which has been amended so that it does not apply to a complying superannuation fund ("CSF"). We welcome the Explanatory Memorandum's acknowledgment that, in recognition of the variety of investments they hold, the definition of 'associate entity' in section 820-905 can operate too broadly in relation to superannuation funds.

The change will ensure that wholly Australian-based portfolio investments will not be brought into the scope of the thin capitalisation rules merely by virtue of CSFs investing directly in them.

However, to ensure that the objectives of this change are met, we recommend two modifications to proposed subsection 820-905(1A):

- the subsection should be extended to wholly-owned entities (both directly and indirectly wholly owned<sup>1</sup>) of a CSF. This would ensure that the exception matches the investment structures that are commonly used by CSFs; and
- clarifying that, for the purposes of the new subsection, the trustee of a CSF is the 'other entity' referred to in subsection 802-905(1), and not the 'first entity'. This could be achieved by means of legislative amendment or within the final Explanatory Memorandum to confirm the intended interpretation and remove any potential ambiguity.

#### 1.1 Wholly-owned entities of superannuation funds

As currently drafted, the new subsection achieves its aim to the extent that a CSF *directly* holds the relevant portfolio investments (see Diagram #1 below).

Superannuation funds commonly invest in unlisted investments indirectly via a wholly owned Australian subsidiary or special purpose vehicle ("SPV") (typically a unit trust). The use of an SPV is for non-tax reasons – the use of an SPV assists with limiting legal liability exposure of the CSF to the investment and with ring-fencing of legal liability exposure between separate unrelated portfolio investments. This is important for ensuring that investments are structured in manner that supports the best financial interests of CSF members.

As additional context to the use of wholly owned SPVs, superannuation funds invest in a diversified range of unlisted portfolio investments across various asset classes which reflects a superannuation fund's role in acting as the manager of the funds of its members. Relevantly, each unlisted portfolio investment is both invested and managed separately such that, other than from a portfolio construction and member option perspective, there is effectively no commercial connection or integration between the unlisted investments managed by a superannuation fund. This also drives the use of wholly owned SPVs to ensure separation of portfolio investments for investment management purposes.

Notably, in circumstances where a CSF invests via an SPV, the new subsection as currently drafted may not apply (see examples in Diagrams #2 and #3 below). This is despite the fact that the economic ownership of the underlying portfolio investment is the same.

To achieve its intended aim, the exemption should be amended to cover these situations.

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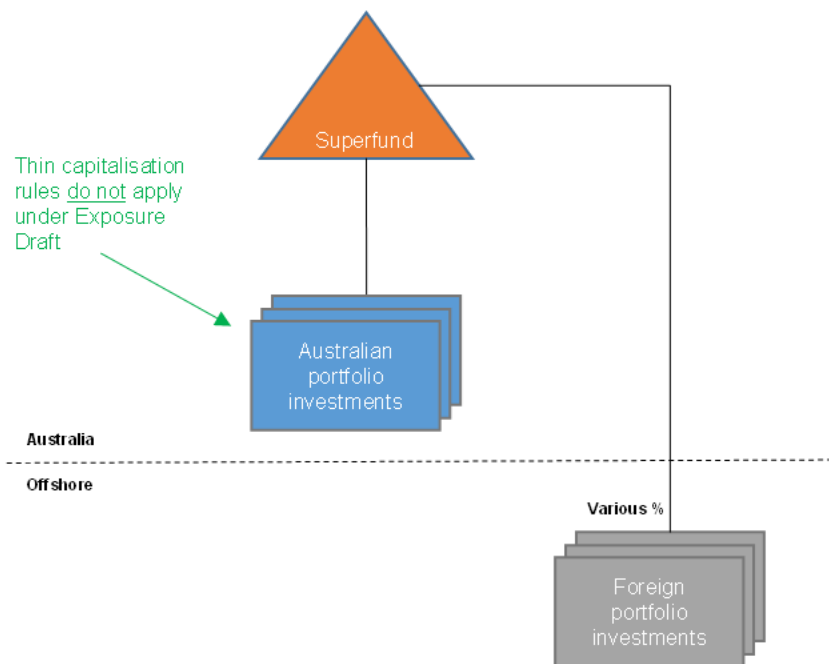
<sup>1</sup> This would also cover both a wholly owned entity directly held by a CSF, and a wholly owned entity that is held in a chain of SPVs

### Scenario 1: Superannuation fund directly holding portfolio investments

Under the current drafting of the CSF associate entity exemption, where a CSF holds both wholly Australian based portfolio investments and offshore portfolio investments, the CSF's status as a 'general class investor'<sup>2</sup> will *not* cause the CSF's wholly Australian based portfolio investments to also be general class investors. The CSF will not cause these investments to be drawn into the thin capitalisation rules. This is on the basis that, under the proposed exemption, a wholly Australian based portfolio investment will not be an 'associate entity' of the CSF.<sup>3</sup> This outcome is consistent with the policy intent of the CSF exemption.

Diagram #1 below illustrates this situation.

**Diagram #1 – Superfund directly holding portfolio investments**



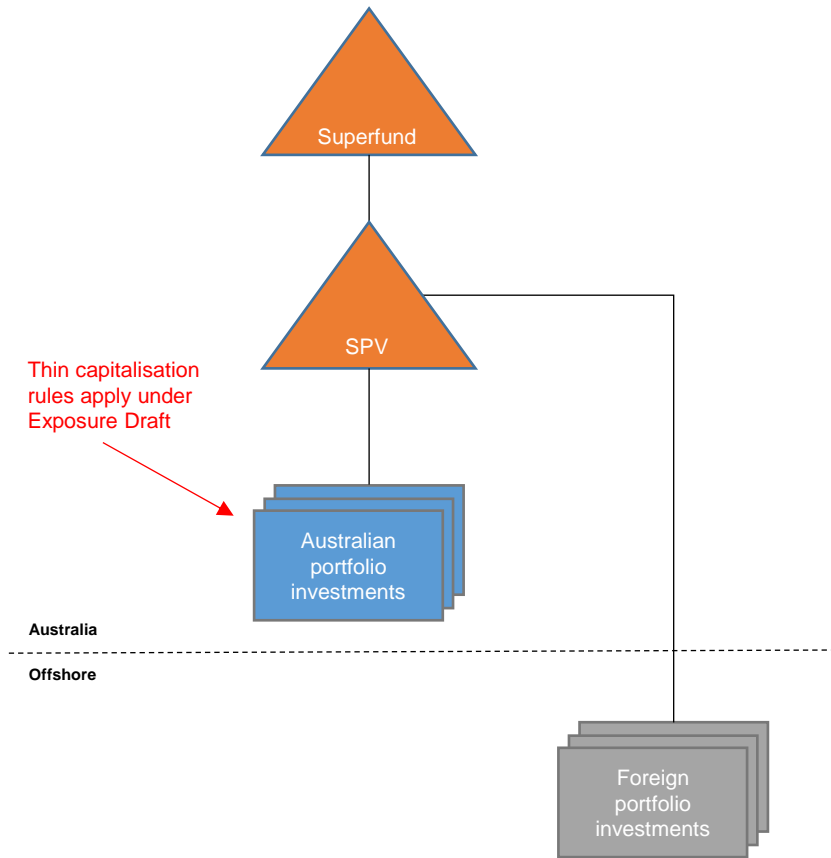
<sup>2</sup> Exposure Draft – subsection 820-43(2)

<sup>3</sup> Exposure Draft – subsection 820-905(1A)

**Scenario 2: Superannuation fund indirectly holding portfolio investments via wholly owned SPV**

However, as illustrated in Diagram #2, the exemption in the Exposure Draft will not apply where the superannuation fund instead holds the portfolio investments via a wholly owned SPV. In this situation, the wholly owned SPV's status as a 'general class investor' (due to the SPV's own holdings of foreign portfolio investments) will draw its wholly Australian based portfolio investments into the thin capitalisation rules. This is on the basis that the Australian portfolio investments will be considered associate entities of the SPV<sup>4</sup>.

**Diagram #2 – Superfund indirectly holding portfolio investments via SPV**

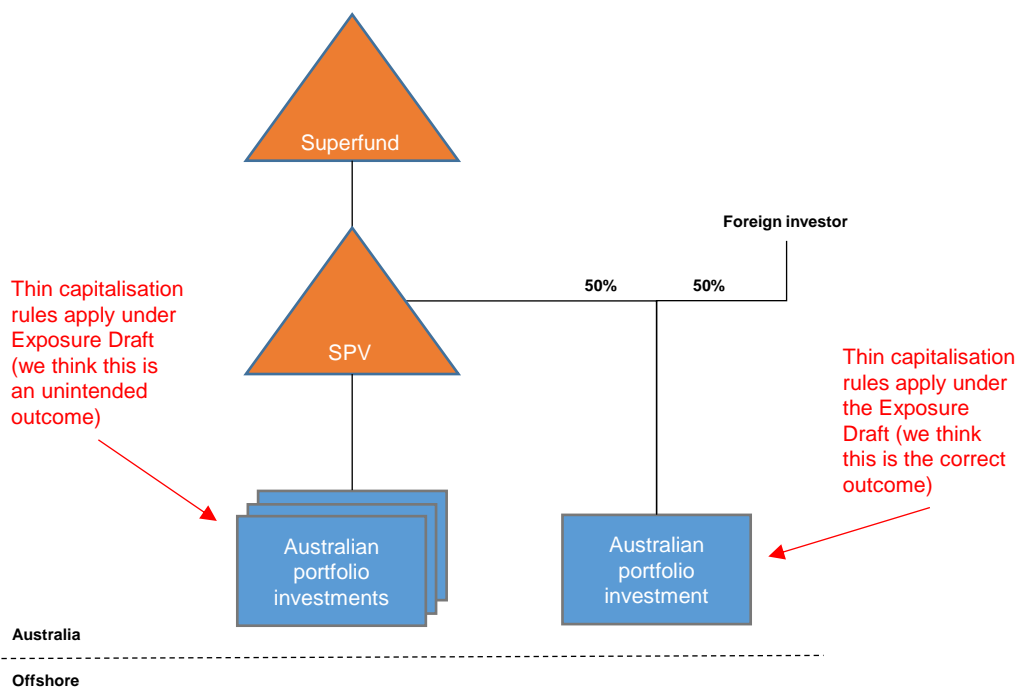


<sup>4</sup> Section 820-905(1) of the *Income Tax Assessment Act 1997* ("ITAA 97")

**Scenario 3: Superannuation fund indirectly holding portfolio investments via SPV (including co-investors)**

A similar situation arises where the SPV holds a wholly Australian based portfolio investment with a foreign co-investor (e.g. 50/50 split ownership). In this scenario, it is appropriate that the 50/50 owned portfolio investment should be subject to thin capitalisation as a general class investor due to its foreign ownership. However, due to the associate entity deeming provisions<sup>5</sup>, the SPV would also be a general class investor due to it being an associate entity of the 50/50 portfolio investment. Consequently, the SPV's other wholly Australian based portfolio investments would also be general class investors due to being associate entities of SPV. Diagram #3 below illustrates this situation.

**Diagram #3 – Superfund indirectly holding portfolio investments via SPV (including co-investor scenario)**



We believe that the policy reasons for amending the definition of ‘associate entity’<sup>6</sup> so that wholly Australian based portfolio investments of a CSF are not drawn into the thin capitalisation rules should equally apply to the wholly Australian based portfolio investments of a SPV.

In this regard, we submit that the situations depicted in Diagrams #2 and #3 would represent unintended outcomes as the application of thin capitalisation rules should not differ between scenarios where a CSF holds wholly Australian based portfolio investments either directly or via a SPV. We also note that the scenarios depicted in diagrams #2 and #3 wouldn't arise if each of the CSF's portfolio investments were held in separate SPVs, which would represent a misaligned outcome.

We do not consider that this change would increase the scope for base erosion or profit shifting between jurisdictions as the thin capitalisation rules would still apply to Australian portfolio investments that qualify as general class investors for other reasons (e.g. having the requisite foreign ownership or foreign investment). Rather, the change would merely be a recognition that CSF's commonly make their investments through SPVs.

<sup>5</sup> Subsections 820-905(3A) and (3B), ITAA 97

<sup>6</sup> Exposure Draft – section 820-905(1)(1A)

## **Policy consistency with ‘Excluded Entity’ rules in GloBE Model Rules (Pillar Two)**

The extension of the CSF associate entity exemption in the Exposure Draft to wholly owned entities of a CSF would be consistent with the extension of the definition of ‘Excluded Entity’ in the OECD’s GloBE Model Rules (Pillar Two) to entities that are owned by an ‘Excluded Entity’<sup>7</sup>.

The concept of ‘Excluded Entity’ includes pension funds. The OECD’s commentary on the rule extending the definition of ‘Excluded Entity’ to entities owned by an Excluded Entity *“recognises that Excluded Entities may be required, for regulatory or commercial reasons, to hold assets or carry out specific functions through separate controlled entities”*<sup>8</sup>. This is consistent with the legal and commercial reasons for the use of SPVs by a CSF as outlined above. The policy rationale for extending the definition of an ‘Excluded Entity’ under the GloBE Model Rules to entities owned by an ‘Excluded Entity’ supports the extension of the carve out in proposed subsection 820-905(1A) of the Exposure Draft to entities that are wholly owned by a CSF.

### **Recommendation: Extend the exemption from the definition of ‘associate entity’ to include wholly owned entities of a CSF**

We recommend that section 820-905(1A) in the Exposure Draft be extended to wholly owned entities (both directly and indirectly wholly owned<sup>9</sup>) of a CSF.

We consider this recommendation to be technical in nature only and is consistent with the broader policy aim of ensuring that the investment by a CSF in wholly Australian assets does not, of itself, cause such assets to be drawn into the thin capitalisation rules.

## **1.2 Ambiguity in current drafting of subsection 820-905(1A)**

Subsection 820-905(1)<sup>10</sup> forms part of the definition of ‘associate entity’ and refers to both the ‘first entity’ and also to the ‘other entity’<sup>11</sup>. Broadly speaking, the first entity is an associate entity of the other entity where the other entity holds a 50% associate interest in or has sufficient influence over the first entity (as set out in section 820-905).

Under the current wording of proposed subsection 820-905(1A), there is potential ambiguity as to whether the trustee of a complying superannuation entity is exempt from subsection 820-905(1) as the ‘first entity’ or ‘other entity’.

Based on the policy intent of proposed subsection 820-905(1A) and in order to give effect to the CSF associate entity exemption, the reference to ‘the trustee of a complying superannuation entity’ should only be read as a reference to the ‘other entity’<sup>12</sup>. However the current drafting of subsection 820-905(1A) is not explicit in this regard as it merely refers to subsection (1) not applying the trustee of a complying superannuation entity (other than a self-managed superannuation fund).

### **Recommendation: Clarification of subsection 820-905(1A)**

We recommend that the wording of subsection 820-905(1A) be refined to clarify that the trustee of a complying superannuation entity is a reference to the ‘other entity’ and not the ‘first entity’ mentioned in subsection 820-901(1).

Alternatively, clarifying language could be included within the final Explanatory Memorandum to confirm the intended interpretation and remove any potential ambiguity.

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<sup>7</sup> Article 1.5.2 of the OECD GloBE Model Rules (Pillar Two)

<sup>8</sup> Paragraph 43 – OECD Commentary on the GloBE Model Rules (Pillar Two)

<sup>9</sup> This would also cover both a SPV directly held by a CSF, and a SPV that is held in a chain of SPVs

<sup>10</sup> ITAA 97

<sup>11</sup> Subsection 820-905(1)(a) – ITAA 97

<sup>12</sup> Subsection 820-905(1) – ITAA 97

## 2 Debt attributable to overseas permanent establishments

We recommend that an exclusion for debt attributable to an overseas permanent establishment is included in the general class investor provisions. The exclusion should apply to each of the fixed ratio test, group ratio test and external third party debt test.

Australian superannuation funds are significant investors in key Australian infrastructure and commercial property assets and this will continue to be the case. However, as Australian superannuation funds grow in size and sophistication, they continue to look to diversify their portfolios globally to reduce risk and locate quality investment opportunities in pursuit of maximising member returns. Accordingly, foreign investment is and will continue to be a critical component of Australian superannuation funds' investment portfolios. In the case of AustralianSuper, approximately half of the portfolio is represented by overseas investments<sup>13</sup>.

When investing offshore, Australian superannuation funds may seek to invest via transparent structures (where it is feasible to do so) in order to prevent double taxation on foreign income. Superannuation funds are taxable in Australia on their global income but, unlike corporate taxpayers, are not able to benefit from exemptions that prevent double taxation of foreign income and gains. Examples include the exemption for foreign non-portfolio dividends<sup>14</sup>, the exemption for capital gains from the disposal of shares in a foreign company<sup>15</sup> and the foreign branch income exemption<sup>16</sup>.

This lack of access to double taxation relief on foreign income incentivises superannuation funds, where feasible, to invest in foreign assets using transparent investment structures for both Australian and foreign income tax purposes (e.g. foreign limited partnerships that are treated as foreign hybrid limited partnerships for Australian income tax purposes<sup>17</sup>). This is particularly the case for US investment and the US is a primary jurisdiction where Australian superannuation funds deploy capital for foreign investment. By using transparent investment structures, superannuation funds may be entitled to an Australian foreign income tax offset on any foreign income tax paid<sup>18</sup>, thus potentially neutralising any double taxation outcome. This would not be the case where superfunds invest into foreign assets via opaque investment structures (e.g. a US company) that incur entity level taxation in the foreign country.

The use of transparent investment structures to preserve the ability to claim foreign income tax offsets (to relieve double taxation outcomes) also ensures Australian superannuation funds and their members are not placed at a competitive disadvantage when competing for quality foreign assets with other global investors, including global pension funds that are non-taxable in their residence country.

Diagram #4 below illustrates a simple transparent foreign investment structure.

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<sup>13</sup> As at 30 June 2022

<sup>14</sup> Subdivision 768-A – ITAA 97

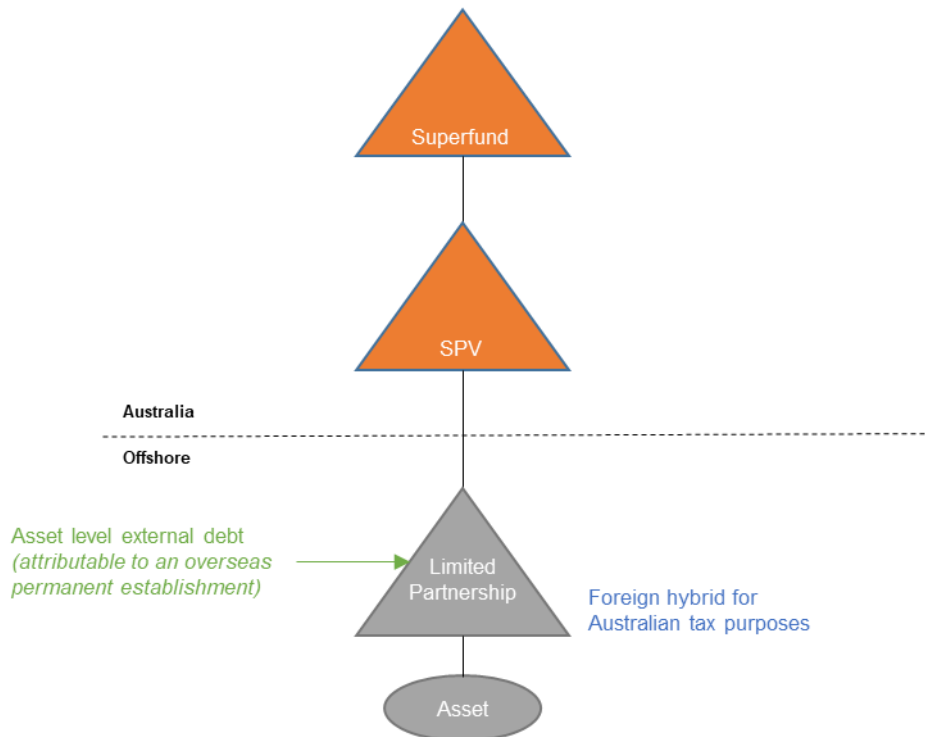
<sup>15</sup> Subdivision 768-G – ITAA 97

<sup>16</sup> Section 23AH – ITAA 97

<sup>17</sup> Division 830 – ITAA 97

<sup>18</sup> Section 770-10 – ITAA 97

**Diagram #4 – Superannuation fund holding offshore portfolio investment via transparent structure**



As depicted in Diagram #4 above, the foreign portfolio investments (e.g. infrastructure and property) will generally have asset level external debt. The existing thin capitalisation rules applying to outward investing entities (non-ADI) contain a provision that operates to disregard “*debt that is attributable to an overseas permanent establishment*” when computing adjusted average debt<sup>19</sup> and, relevantly, in the context of certain transparent investment structures (such as Diagram #4), the asset level debt should be debt that is attributable to an overseas permanent establishment.

The exclusion for debt attributable to overseas permanent establishments has not been replicated in the Exposure Draft rules that apply to general class investors. As a consequence, pursuant to the Exposure Draft, asset level debt in certain foreign transparent structures would be brought within the scope of Australian thin capitalisation under the general class investor provisions. Using Diagram #4 as an example, this occurs as a result of the foreign hybrid rules in Division 830 of the ITAA 97 which effectively requires an Australian tax return to be prepared for the foreign limited partnership pursuant to Division 5 of the ITAA 36.

From a policy perspective, regardless of the change from an asset-based test to a profits-based test, there should not be any policy reason for removing the carve out for debt attributable to an overseas permanent establishment. Such debt (and all associated debt deductions) is both borrowed and relates to assets wholly outside of Australia and therefore should not pose any base erosion or integrity risk to Australia. Accordingly, we consider this omission most likely to be an oversight in drafting rather than by design.

We also note that a carve-out for debt attributable to an overseas permanent establishment has been retained in the existing asset based thin capitalisation provisions and new Exposure Draft provisions as they apply to ADIs and financial entities.<sup>20</sup> This further suggests there has been no fundamental change in policy regarding this carve-out.

If the exclusion for debt attributable to overseas permanent establishments is not retained for general class investors, this will likely have a negative impact on after-tax returns for some existing offshore investments of Australian

<sup>19</sup> Current subsection 820-85(3) – ITAA 97

<sup>20</sup> For example, Exposure Draft - subsection 820-85(1) and subsection 820-85(3)



superannuation funds. It will also curtail the ability of Australian superannuation funds to structure future offshore investments efficiently. Both represent negative outcomes for members of Australian superannuation funds.

### **Recommendation: Restore the exclusion for debt attributable to overseas permanent establishments**

We recommend that an exclusion for debt attributable to an overseas permanent establishment is included in the general class investor provisions. The exclusion should apply to each of the fixed ratio test, group ratio test and external third party debt test.

## **3 Disproportionate impact to trust structures**

Unit trust structures are commonly used investment vehicles or SPVs (including by Australian superannuation funds) for investing in capital intensive sectors in Australia (e.g. infrastructure and property). One of the key benefits for utilising unit trusts is they enable cash to be distributed to investors without the cash trap risks that can arise with companies.<sup>21</sup>

Our general observation is that the Exposure Draft rules appear to be less favourable to unit trust structures as compared to corporate structures, by and large due to the function of tax consolidation and the single entity rule. Some examples include:

- **Fixed ratio test (varying tax EBITDA, depending on level in a structure)** – the amount of tax EBITDA in an entity will vary depending on the level at which the entity sits in an asset/project group structure. Depending on where external debt within an asset/project structure is borrowed, this may have a distorting impact in applying the fixed ratio test to a trust structure versus a corporate group that is consolidated for tax purposes (and benefits from the single entity rule).
- **External third party debt test (recourse for payment only to the borrower)** – the requirement that the lender under a debt arrangement only has recourse for payment to the assets of the borrower entity<sup>22</sup> would not encompass commercially common situations where security under a debt arrangement is spread across multiple entities of an economic asset group and/or includes the interests in the borrower entity (not just its assets). This issue should be less pronounced for corporate groups that are consolidated for tax purposes, but would be an issue for an asset/project group structured with unit trusts.
- **External third party debt test (conduit financier rules)** – asset groups that use a central financing entity which on-lends funds to other entities in the group is a commercially common arrangement and one which has been recognised by Treasury through the inclusion of conduit financier rules in the Exposure Draft<sup>23</sup>. However the potentially very strict requirements to qualify for these rules would be difficult to meet for many common on-lending arrangements that occur within asset/project groups. The requirements should be less problematic for corporate groups that are consolidated for tax purposes but would be difficult to meet for trust structures.

Some of the above points are discussed more generally in section 4 below.

## **4 External third party debt test**

We are supportive of the introduction of the external third party debt test. In particular, we support the introduction of a test that is intended to be simpler to apply to genuine third-party debt arrangements than the existing arm's length debt test ("ALDT"). We acknowledge that this test is narrow by design.<sup>24</sup> However, we submit that the current drafting would not enable many ordinary and genuine third party debt arrangements to access it and, in some cases, will likely lead to increased complexity. Both of these outcomes would be counterproductive to the purpose and intention of this test.

<sup>21</sup> The ability of companies to distribute cash to shareholders is governed by the Corporations Act.

<sup>22</sup> Exposure Draft – paragraph 820-61(2)(c)

<sup>23</sup> Exposure Draft – subsection 820-61(5)

<sup>24</sup> Explanatory Memorandum to the Exposure Draft – para 1.71

In this regard, there are several features of the currently drafted external third-party debt test rules that we consider would preclude its application to genuine third party debt arrangements, make the test very complex to apply and/or potentially give rise to unintended outcomes. These features are:

- Third party lender recourse limitations (section 4.1)
- Choice requirements for all 10% associate entities (section 4.2)
- Irrevocable choice to apply the third party debt test without a fallback (section 4.3); and
- Restriction on common on-lending structures and uncertainty regarding the application of the 'same terms' condition (section 4.4).

From the perspective of Australian superannuation funds, the CSF associate entity exemption in the Exposure Draft<sup>25</sup> will help to reduce the risk of denial of debt deductions on third party debt in certain investment scenarios (e.g. investments owned wholly or in majority by one or more Australian superannuation funds). However, Australian superannuation funds will continue to participate in many consortium investments in Australian assets with other types of investors which cause the thin capitalisation rules to apply. This will include investments with large capital requirements such as Australian infrastructure and commercial property.

AustralianSuper and other Australian superannuation funds are significant consortium participants in large infrastructure and commercial property projects in Australia. These investments require significant capital outlay and thus tend to be highly leveraged in order to support investor return requirements and thus make the investment commercially viable. Moreover, these types of assets generally support higher levels of debt by having high certainty of cash flows over long periods. As such, the ability to utilise the third party debt test will be an important feature for future investment in such assets by Australian superannuation funds, and is critical to ensuring that there is no additional impediment to investment in Australian infrastructure and property assets by Australian superannuation funds, or negative impact on the financial returns for members of Australian superannuation funds.

#### **4.1 Security requirements – recourse for payment only to the assets of the borrower**

Under the Exposure Draft rules, for a debt interest to qualify for the external third party debt test, the lender under the debt interest can only have recourse to the assets of the borrower entity<sup>26</sup>.

As noted in our previous submission, AustralianSuper and other CSFs are not permitted to borrow at a fund level<sup>27</sup>. This means that any external borrowing relating to unlisted portfolio investments will be project/asset financing to fund or refinance a particular investment, with security provided over only that investment to the external financiers. Based on our experience, standard third party debt security arrangements will involve the provision of security over the shares/units of the borrower entity (not just the borrower's assets) and, where relevant, across multiple entities that form an economic asset/project group.

The diagrams below illustrate examples of the external lender security arrangements applicable to AustralianSuper's investments in Australian infrastructure and property.

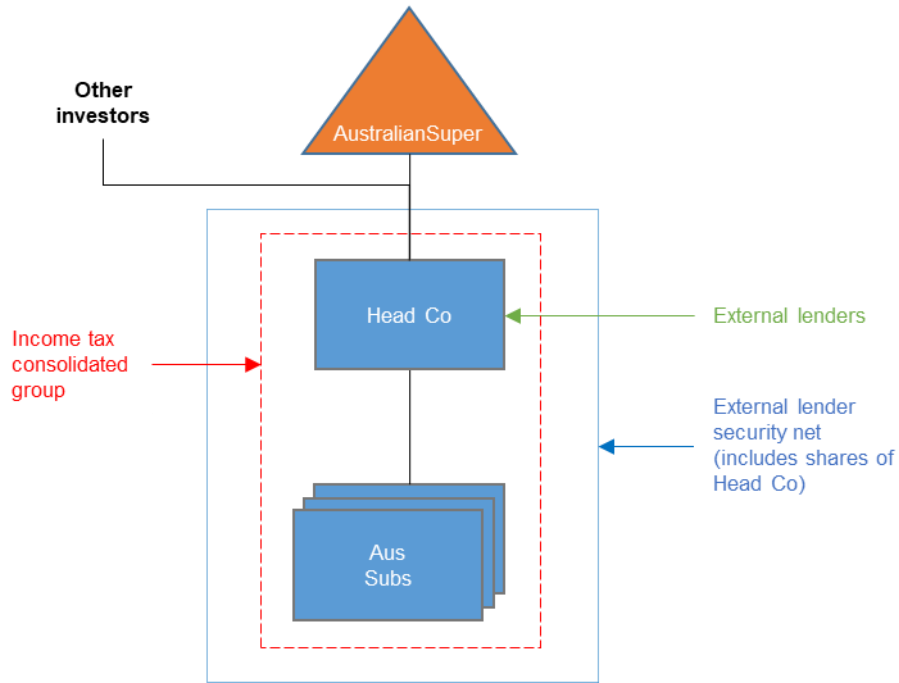
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<sup>25</sup> Exposure Draft – subsection 820-905(1A)

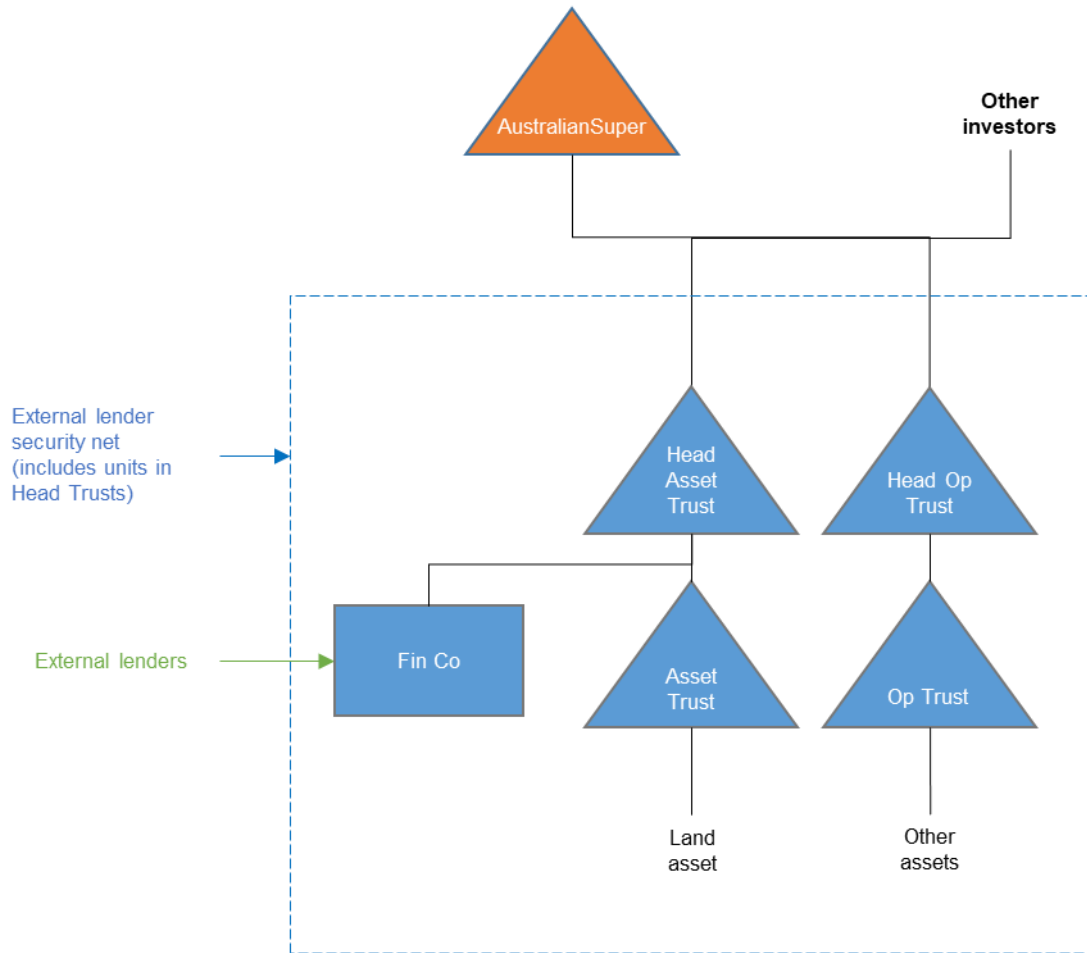
<sup>26</sup> Exposure Draft – paragraph 820-61(2)(c)

<sup>27</sup> Section 67 of *Superannuation Industry (Supervision) Act 1993*

**Diagram #5 – AustralianSuper portfolio investment – corporate structure**



**Diagram #6 – AustralianSuper portfolio investment – trust structure**



The current Exposure Draft rules would not support the application of the external third party debt test to the above scenarios, or to other external debt arrangements entered into by many of AustralianSuper’s portfolio investments. Our view is that this would be a direct contravention of the core policy intent behind this test, being to accommodate and not unduly impede genuine commercial external financing arrangements relating only to Australian operations and investments.

The measure does not recognise that typical investment structures used to acquire and hold infrastructure or commercial property assets in Australia comprise multiple entities, usually unit trusts, that all form part of the same economic asset group. The use of multiple entities within an investment structure is typically optimal as it provides for greater flexibility on various matters such as further investments, co-investment, liquidity and financing.

Whilst we are supportive of having appropriate integrity measures to prevent misuse of this test, this particular measure is currently too narrow and will preclude most genuine third party debt arrangements in practice.

Fundamentally, there should be no mischief or integrity concerns in allowing debt deductions where external lenders have security over or recourse to the assets of all the economic group entities (including the interests in those economic group entities) if the business of those entities is limited to investing, directly or indirectly, in Australian assets or operations. In this regard, we submit that the key integrity focus should be how to appropriately define or ringfence the relevant economic group entities.

## **Recommendation: expansion of assets that can be subject to lender recourse**

We recommend that the third party debt test provisions be amended to permit third party lenders to have security over or recourse to all the assets of the entities within the same ‘economic asset group’ to which the relevant external debt relates, including the interests in all of these entities.

In defining the concept of an ‘economic asset group’, one suggestion is to draw upon the legislative concepts behind the head company of a tax consolidated or multiple entry tax consolidated group. That is, an appropriate head or top entity (or entities) is first determined, then all other wholly owned Australian entities between this head/top entity and the relevant Australian assets or business form part of the ‘economic asset group’ for these purposes. If, by way of example, we were to apply this concept to diagrams #5 and #6 above, the following entities would be part of the ‘economic asset group’ in each case:

- Diagram #5 – Head Co and its Australian subsidiaries. In this instance, the ‘economic asset group’ aligns with the tax consolidated group due to the portfolio investment being held within a corporate structure.
- Diagram #6 – Head Asset Trust, Asset Trust, Head Op Trust, Op Trust, and Fin Co. This portfolio investment is structured with unit trusts (other than Fin Co) and is a stapled structure. As tax consolidation is not available to this group, the assets subject to recourse under external third-party debt sit across multiple entities beyond the borrower entity (Fin Co).

An alternative to an ‘economic asset group’ would be to ensure that recourse for payment for a lender under the external third party debt test can be extended to security held by a lender in an ‘obligor group’ or within a ‘security pool’. Under commercial external lending arrangements, a lender will often have security over the assets of all group entities in a contractually defined ‘obligor group’, or ‘security pool’. This concept that is used by commercial lenders could be leveraged for the purposes of the external third party debt test.

If Treasury does not consider the above recommendations appropriate or within the scope of the policy or design approach for the third party debt test, we strongly recommend, at a minimum, expanding the recourse permitted under this test to include the interests of the borrower (and not just the borrower’s assets).

## **4.2 10% associate entities – choice of external third party debt test requirement**

Under the Exposure Draft rules, an entity cannot make a choice to apply the external third party debt test if it has associate entities that own an interest in the entity (based on a 10% control interest test)<sup>28</sup> that do not also make the choice to apply the external third party debt test. The policy behind the restriction is to ensure that “*general class investors and their associates are not able to structure their affairs in a way that allows them to artificially maximise their tax benefits by applying a combination of different thin capitalisation tests*”<sup>29</sup>.

Whilst we support the inclusion of appropriate integrity measures to the third party debt test, there are significant challenges with this particular requirement that will likely result in the test becoming unworkable in many instances. Notably, this will be the case in many instances where there is practically no risk of investors and their associates structuring their affairs in a way that allows them to artificially maximise their tax benefits by applying a range of different thin capitalisation choices.

For example, a consortium investment will have multiple unrelated investors, many holding a relatively low interest in the investment (e.g. 10-15%). These investors would typically have limited governance rights, will not be able to control the investment and will not be involved in the day-to-day operations of the investment. Making matters more complex, these investors may also hold interests in various other entities that are ‘10% associate entities’, but in respect of other unrelated Australian investments, and have similar limited governance rights and control over those other unrelated investments.

In circumstances such as this, we would question the ability of these investors to control or have any genuine influence over the tax affairs of the investment (or potentially multiple investments) including the choice to apply a particular thin capitalisation method for an income year.

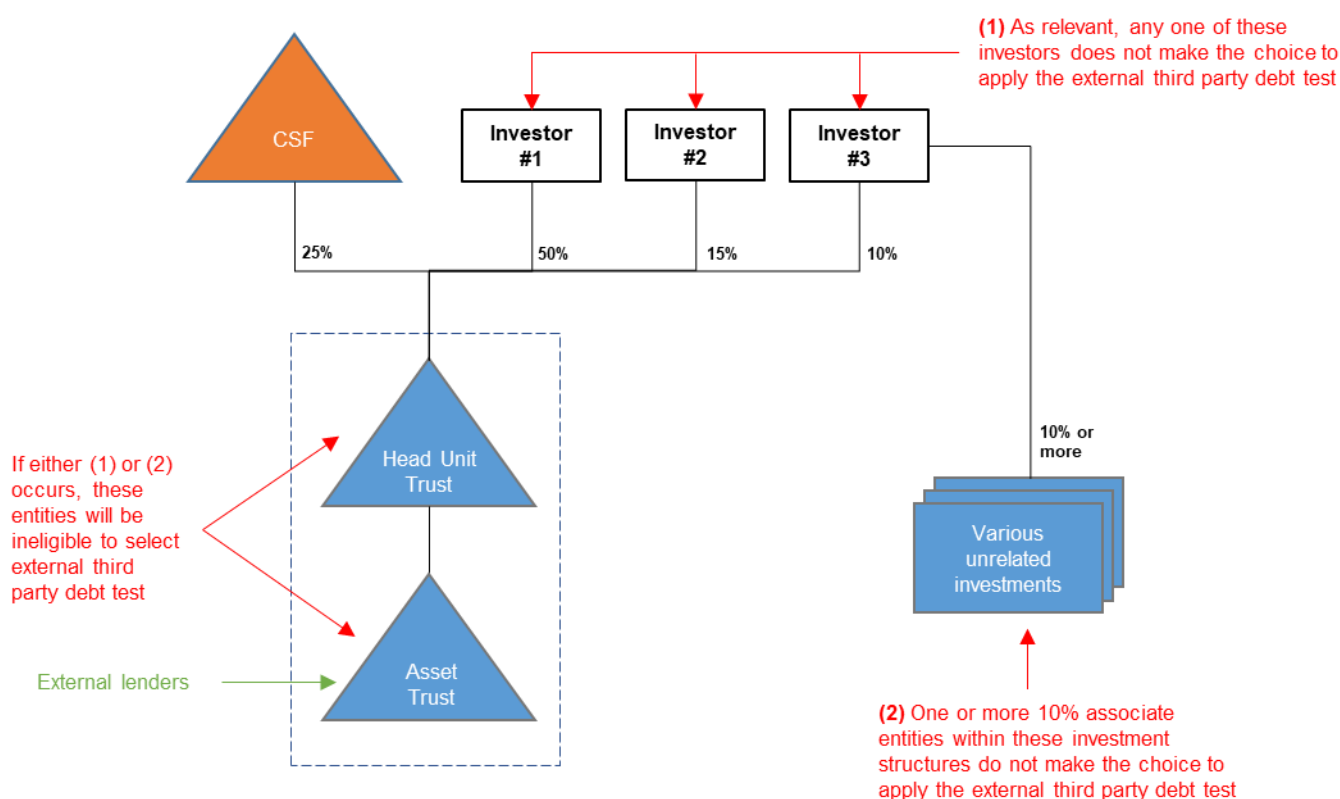
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<sup>28</sup> Exposure Draft – subsection 820-43(5)-(6)

<sup>29</sup> Explanatory Memorandum – paragraph 1.33

Diagram #7 below and the subsequent comments are intended to illustrate some of the fundamental challenges with this requirement in a typical consortium investment scenario. However, even outside of a consortium context, we query why from a policy standpoint there should be any concern with different thin capitalisation tests for general class investors being applied to commercially unrelated investments merely because there is an associate entity relationship between investment entities. We submit that this would function as an unnecessary and overly restrictive limit to the third party debt test.

**Diagram #7 – Illustration of 10% associate entity testing requirements – Consortium portfolio investment scenario**



In the diagram above, if only one investor (e.g. Investor #3 with a 10% interest) or any of its 10% associate entities (including 10% associate entities within investment structures for unrelated assets) were to apply a thin capitalisation test for an income year that was not the external third party debt test this would, of itself, preclude the third party debt test from applying to this investment for that income year. This outcome seems overly punitive considering the limited influence that a 10% investor would actually exert over the investment. All the external debt for this investment is borrowed at the asset level and is not linked to the debt funding of a 10% investor, or to the debt funding of 10% associate entities within investment structures for unrelated assets. Therefore the choice of a different thin capitalisation test by these entities for commercially unrelated assets or business activity should not prevent the application of the third party debt test in this scenario.

This requirement would also be difficult to administer from the perspective of the investor group and/or manager as there would be a requirement to track the thin capitalisation election choices of all of its investors with a 10% or greater interest (and all of their 10% associate entities). Practically, obtaining certainty each income year over all relevant '10% associate entity' elections across an investor group would be unworkable in many instances. This

would also be highly complex, onerous and costly to administer which is inconsistent with the aim of the external third party debt test to be a more streamlined test with lower compliance costs compared to the arm's length debt test.

AustralianSuper alone holds interests in many Australian infrastructure and property assets via consortium arrangements – these are investments by AustralianSuper, alongside other unrelated investors (both Australian and foreign), in Australian assets that require significant capital outlay from the investor group. Many other CSFs hold similar types of interests in consortium investments into Australian unlisted infrastructure and property, with CSF ownership in such assets certain to increase in line with the growth of the superannuation sector. The requirement in the Exposure Draft for all 10% associate entities to apply the external third party debt test<sup>30</sup> will increase compliance costs and invariably inhibit the use of the external third party debt test for certain investments and therefore negatively impact the returns for members.

### **Recommendation: Ringfencing of choice to entities within an 'economic asset group'**

We recommended removing the '10% associate entity' election requirement from the third party debt test and replacing it with a requirement that all entities with a defined 'economic asset group' apply the same thin capitalisation test in an income year. We consider this type of ringfencing over the choice requirement would provide a better balance between integrity and operation.

In defining the concept of an 'economic asset group' for these purposes, we would propose to utilise the same definition as recommended to be utilised for the lender recourse requirement (please refer to our comments in the recommendation in section 4.1 above). In this regard, linking the same definition or concept to multiple integrity provisions should minimise complexity.

For completeness, in our experience, portfolio investments typically enter into asset level borrowings (e.g. security is restricted to entities within the economic asset group only). The ringfencing of the choice requirement to entities within that economic asset group would also be consistent with this commercial reality.

### **4.3 Irrevocable choice – risk associated with making the choice**

The Exposure Draft provides that an entity can make a choice to apply the third party debt test for an income year<sup>31</sup> and that such a choice, once made, cannot be revoked.<sup>32</sup> Critically, once such a choice has been made there appears to be no ability to rely on an alternative test, i.e. the fixed ratio test or group ratio test.<sup>33</sup>

This inability to 'fallback' on an alternative test carries significant risk for portfolio investments of CSFs where thin capitalisation rules will apply per the Exposure Draft. This is because, in the event it is subsequently determined that a taxpayer was not eligible to have made the choice to apply the external third party debt test to a particular income year (e.g. the third party debt test conditions were not actually satisfied for that year), the taxpayer would not be able to claim any debt deductions for that year.

This would be an extremely punitive outcome, especially when considering the requirement for all '10% associate entities' to have made the same election for the income year.<sup>34</sup> As discussed in section 4.2 above, there will be significant challenges complying with the choice condition for all '10% associate entity' (including being able to objectively evidence that this requirement is satisfied), especially in a consortium context and where minority investors hold 10%+ interests in other commercially unrelated investments that are subject to the thin capitalisation rules.

Whilst we understand the policy intent behind having an irrevocable choice, the inherent uncertainty and significance of the downside risk in making the choice to apply the third part debt test (in particular in certain investment scenarios such as consortium investments) may ultimately lead to investors and/or managers deciding to apply the fixed ratio test or group ratio test instead, even if this results in lower debt deductions claimed in respect of genuine third party

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<sup>30</sup> Exposure Draft – subsection 820-43(5)-(6)

<sup>31</sup> Exposure Draft – subsection 820-43(4)

<sup>32</sup> Exposure Draft – subsection 820-43(4)

<sup>33</sup> Exposure Draft – subsection 820-43(1)

<sup>34</sup> Exposure Draft – subsection 820-43(5)



debt. We submit that this type of outcome would be incongruent with the policy of the having an alternative external third party debt test available.

The inherent uncertainty around the legitimacy of the choice coupled with the potential severity of downside impact presents as an additional investment complication and potential impediment to investment by CSFs in key Australian infrastructure and property assets.

### **Recommendation: Allow a fallback to others tests in certain circumstances**

We recommended that amendments be made to allow taxpayers who have previously made a choice to apply the external third party debt test to apply the fixed ratio test (but not the group ratio test) but only in the event that it is subsequently determined that the taxpayer was not eligible to use the third party debt test for the particular year.

Moreover, to prevent any risk or concern around ‘gaming the tests’, an additional condition could be introduced to limit debt deductions for the applicable prior income year. In this regard, the limit could be the *lower* of: (i) the amount available applying the fixed ratio test; and (ii) the amount that would have been deductible had the third party debt test applied.

We consider that the combination of limiting the fallback position to the fixed ratio test (with its debt deduction cap) would provide the right integrity measures around the choice.

## **4.4 Conduit financier rules – on-lending through multiple entities and ‘same terms’ condition**

We are supportive of the introduction of the conduit financier rules in the Exposure Draft<sup>35</sup> and the explicit recognition of the role that a centralised borrowing entity can have in streamlining external borrowing arrangements. Conduit financier entities are commonly used in many of AustralianSuper’s portfolio investments (e.g. as illustrated in Diagram #6 above).

However, pursuant to the Exposure Draft and accompanying Explanatory Memorandum, the rules as currently drafted could have a significantly narrower application than perhaps intended. Specifically, we refer to the requirement for the terms on which debt is on-lent by a conduit financier to be the “same terms” as the ultimate debt interest<sup>36</sup>.

On its face this requirement is potentially very prohibitive and its workability will ultimately turn on how strictly it is interpreted. In this regard, save for the explicit concession for the amount of debt on-lent by the conduit financier to an associate entity, it’s unclear whether “same terms” is intended to mean exactly the same terms or in substance the same terms. It is unclear whether it is in relation to all terms relating to the ultimate debt interest or only some of the terms, e.g. loan term, interest rate, interest capitalisation, repayment, etc.

The suite of terms in the agreement with external debt providers will generally be more complex and extensive than what is contained within on-lending agreements between associate entities. This additional complexity reflects that arrangements with external debt providers may need to cater for the way in which borrowed funds are raised. As such, depending on how strictly the concept is applied, there may be significant practical challenges in satisfying the “same terms” condition for many external debt arrangements (e.g. section 128-F compliant facilities, syndicated facilities).

Based on our experience with portfolio investments, there are many other common commercial arrangements involving a centralised borrowing entity for an economic asset group that may not satisfy the conduit financier “same terms” condition. Some examples include:

- Hedging – a centralised borrowing entity will often enter into swap or hedging arrangements to manage currency or interest rate risk; and

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<sup>35</sup> Exposure Draft – subsection 820-61(5)

<sup>36</sup> Exposure Draft – paragraph 820-61(5)(e)



- Margin – a small margin will often be charged by the centralised borrowing entity to cover the borrowing entity’s operating costs.

Many groups will also on-lend funds sourced by a centralised borrowing entity to the ultimate borrower entity through a chain of entities, rather than directly from the centralised borrowing entity to the ultimate borrower entity. A simple example would be where a finance entity borrows from a third party and on-lends those funds to a head trust which then on-lends those same funds to an asset trust (i.e. the ultimate borrower). The current conduit financier rules in the Exposure Draft would not cater for this common scenario due to the requirement for the ultimate borrower (i.e. the asset trust) to have issued a debt interest to the conduit financier (i.e. the finance entity).<sup>37</sup>

Our view is that the situations outlined above are standard in typical commercial arrangements involving a centralised borrowing entity. We are supportive of integrity measures relating to the conduit financier rules in the Exposure Draft but consider that the rules, as currently drafted, will be too prohibitive, create additional uncertainty and risk for AustralianSuper and other superannuation funds (as investors or co-investors in many assets that fall under the thin capitalisation rules) and may not cover many normal commercial arrangements.

**Recommendation: Allow on-lending through chains of entities and provide clarity on meaning of ‘same terms’**

We recommend revising the drafting to allow the original debt to be on-lent through multiple associate entities (i.e. a chain of entities).

We also recommend providing additional guidance (and some accompanying examples) in the Explanatory Memorandum to clarify the intended meaning and scope of the “same terms” condition. It would be especially welcomed if additional guidance could provide clarity with respect to common commercial arrangements involving a conduit financier, such as those outlined above.

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<sup>37</sup> Exposure Draft – paragraph 820-61(5)(c)