21 July 2023

Committee Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

By electronic upload

Dear Sir/Madam

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

The Property Funds Association of Australia (**PFA**) welcomes the opportunity to make a submission to the Senate Standing Committee on Economics (**Committee**) in respect of its inquiry and report on the provisions of the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023* (**Bill**).

The PFA is the peak body representing the Australian unlisted wholesale and retail property funds sector. As the professional association for Australian Financial Services Licensed (AFSL) property fund managers, their advisors, consultants and representatives, we support and promote investment into unlisted property trusts, funds and syndicates, and assist members in developing and operating their businesses.

Our submission relates to Schedule 2 of the Bill, which proposes to introduce a new framework and regime for Australia's thin capitalisation rules. The provisions in the Bill represent a fundamental change to the existing thin capitalisation framework and will significantly impact taxpayers that are currently subject to the rules.

Although the provisions in the Bill have been refined to address stakeholder feedback, we are concerned that the replacement of the existing asset-based thin capitalisation rules with the proposed new earnings-based rules will adversely impact taxpayers in the property funds sector.

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Our principal concerns relate to the following aspects of Schedule 2 of the Bill:

- Commencement date and potential retrospective application to taxpayers
- Disproportionate impact on trust groups compared to consolidated corporate groups
- New Subdivision 820-EAA introducing debt deduction creation rules that were not part of the exposure draft legislation

Further comments outlining our concerns are contained in **Appendix A**.

Treasury acknowledged in Attachment 2 of the Explanatory Memorandum (**EM**) that the changes to the thin capitalisation rules “are a very complex undertaking with broad application” and that “there are potential risks for unintended consequences which may only come to light as taxpayers seek to apply the new rules”.

Given the current economic environment, particularly with regards to increasing interest rates and availability of debt, the PFA is of the view that Schedule 2 of the Bill should be delayed by at least 12 months to provide taxpayers sufficient time to understand the impact of the changes and their obligations under the new rules.

We also suggest a post-implementation review be scheduled to assess whether the new thin capitalisation rules are achieving their intended purpose, or whether there are unintended outcomes.

The PFA appreciates the opportunity to provide a submission to the Committee and any opportunity to provide further information.

Should you have any questions in relation to this submission please contact me on 02 9020 4000.

Yours faithfully

Alexander King
Treasurer
Property Funds Association of Australia

Appendix A

We have set out below more detailed comments on our concerns with the proposed new thin capitalisation rules in Schedule 2 of the Bill.

Commencement date

Schedule 2 of the Bill will take effect for income years commencing on or after 1 July 2023. This means the new thin capitalisation rules, if the Bill is enacted in its current form, will apply retrospectively for taxpayers with financial years ending on 30 June. The impact of the new rules on taxpayers will continue to be uncertain until at least 31 August 2023, when the Committee's report is scheduled to be completed.

We believe the start date of Schedule 2 of the Bill should be deferred by at least 12 months and apply to income years commencing on or after 1 July 2024. Taxpayers could also be provided a transitional period for existing arrangements.

This would provide taxpayers an opportunity to review their existing arrangements, understand the impact of the new thin capitalisation rules, and undertake any necessary restructuring. It may also assist taxpayers with the associated compliance costs of adopting the new rules, which we believe are likely to be significantly higher than what is estimated in the EM.

Impact on trust groups

We consider the new thin capitalisation framework may disallow interest deductions for common commercial transactions involving trust structures. As such, the new rules would disproportionally impact the property funds sector and result in inequitable outcomes.

Trust group structures are generally used to acquire and hold real estate assets in the property funds sector. It is common for a property fund to use a trust structure where the borrowings are structurally separated in a holding trust, from the income producing real estate assets that are held in special purpose vehicle (**SPV**) trusts.

The use of such a trust group structure is mostly driven by commercial and financial reasons. However, under the proposed new thin capitalisation rules, trust groups structured in this way may be denied interest deductions for what are common commercial arrangements.

We have included an example demonstrating the potential outcomes in **Appendix B**.

Throughout the consultation process, stakeholders noted the draft legislation was weighted towards accommodating corporate structures and that further consideration was required for trusts and partnerships. This included facilitating excess interest capacity for trust groups, to reflect the existing arrangements possible under current law.

However, Attachment 2 of the Bill notes that although feedback was considered on the inclusion of an ability to share excess interest capacity within trust groups, it was ultimately decided against including this for simplicity and integrity reasons.

Attachment 2 of the Bill suggests that, in the absence of specific excess capacity rules, a trust group may opt to simplify its operating structure by limiting the number of interposed trusts. However, this does not appropriately recognise the significant risk and costs associated with restructuring existing arrangements. This issue is exacerbated by the proposed commencement date, which does not provide trust groups sufficient time.

We note this outcome does not arise for tax consolidated groups. As a result, trust groups are at a disadvantage compared to tax consolidated groups.

We submit that the proposed thin capitalisation framework should apply to trust groups under the same principles that apply to consolidated corporate groups. For example, by amending the Fixed Ratio Test to allow surplus debt capacity of a trust to be attributed to another trust in the direct or indirect ownership chain.

We also suggest that the introduction of the rules be deferred by 12 months, or a transitional period, to allow trust groups to restructure their existing arrangements and comply with the new rules.

Debt deduction creation rules

Schedule 2 to the Bill includes a new Subdivision 820-EAA to the Income Tax Assessment Act 1997 (**ITAA 1997**) to introduce "debt deduction creation rules".

The stated intention of the proposed new rules is to disallow debt deductions to the extent they are incurred in relation to debt creation schemes that lack genuine commercial justification. However, the provisions appear to be drafted more broadly than the stated purpose and may result in the denial of debt deductions in a wider range of ordinary circumstances, which would not normally be considered debt creation schemes.

For example, the second type of arrangement that is targeted by these rules broadly involves an entity borrowing from an associate to fund a payment (which could include the repayment of loans or return of capital) or distribution to that, or another, associate. As currently drafted, the rules could apply to any situation where the borrower uses the proceeds of the debt *predominantly* to increase the ability of any entity (including itself) to make a payment or a distribution to an associate.

While the rule appears to be designed to apply to returns of capital or dividends funded by related party debt, it may apply more broadly to simple and commercially accepted transactions, such as obtaining debt or refinancing involving a related party.

The new debt deduction creation rules were not part of the exposure draft legislation. If enacted in their current form, there are concerns the rules may unintentionally apply to common and low-risk arrangements.

There are also concerns that proposed Subdivision 820-EAA of the ITAA 1997 may have an effective retrospective impact, inappropriately impacting pre-existing arrangements that are compliant with the current thin capitalisation regime.

We submit that the proposed Subdivision 820-EAA should be subject to further consultation and guidance to ensure its impact is in line with the intended policy outcome.

Appendix B – Application to Trust Groups

It is common in the property funds sector for groups to use trust structure where the borrowings are structurally separated in a holding trust, from the income producing real estate assets that are held in special purpose vehicle (**SPV**) trusts. Commercial and financial reasons for operating under such a structure include:

- The holding trust is borrowing over a portfolio of assets, which are held by wholly owned property trusts. The holding trust borrows in respect to the entire portfolio, rather than borrowing at a property trust level.

  Borrowing at the holding trust on the entire portfolio may provide the best terms for borrowing and lower the cost of capital for the portfolio.

- Arrangements with co-investors where each investor separately arranges their debt and equity capital for investment. This could be due to a range of factors including different risk profiles, financing terms or each investor's cost of capital.

- A holding trust has acquired the property holding trust from a third party and has used external third-party debt to partially finance the transaction.

The diagram below at figure 1 is an example of property fund using a trust structure where the third-party debt is at the holding trust level, with the real estate assets held in wholly owned special purpose trusts.

We note the current thin capitalisation rules accommodate the above structure without any adverse impacts. The current rules achieve this by allowing the trusts in the group to utilise excess debt capacity of another entity (referred to as the "associate entity excess amount").

Under the proposed new thin capitalisation rules, we note the above trust group may be adversely impacted with debt deductions potentially being denied.

The outcomes for the trust group in figure 1 under the proposed new thin capitalisation rules would be:

- The property trusts generate all the tax EBIDTA but have no (or minimal) debt deductions.

- The holding trust has no (or minimal) tax EBITDA, as distributions from the property trusts are excluded. Meanwhile, the holding trust holds the debt and incurs debt deductions.

- Applying the fixed ratio test to the tax EBITDA of the holding trust results in no (or minimal) debt deductions being available to the head trust.

  Under the rules as currently drafted, the head trust cannot share any of its excess debt deductions other trusts in the group.

- While there is a rule that allows excess deductions to be carried forward, these will be permanently lost if the group switches from the fixed ratio test to the group ratio test or third-party debt test in a later year.

  We note that the group ratio test and third-party debt test may not support the trust group's ability to claim the third-party debt deductions, where they are denied under the fixed ratio test.

Consequently, debt deductions may be denied for all entities in the trust group.

We note this outcome doesn't arise for tax consolidated groups. Accordingly, trust groups are disadvantaged under the proposed new thin capitalisation rules compared to tax consolidated groups.

Figure 1: *Trust group with external debt funding at holding trust level*