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18 April 2023

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AUSTRALIAN SECURITISATION FORUM SUBMISSION THIN CAPITALISATION AMENDMENT EXPOSURE DRAFT

1 The Australian Securitisation Forum ("**ASF**") welcomes the opportunity to provide comments on the Exposure Draft, "Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitations" ("**ED**").

2 The ASF is the peak industry body representing the Australian securitisation and covered bonds markets. The goals of the ASF are to facilitate the formation of industry positions on policy and market matters, represent the Australian industry to local and global policymakers and regulators and to advance the professional standards of the securitisation industry.

3 The ASF makes particular comment in relation to:

(a) the need to reinstate the scope of section 820-39 of the 1997 Act;

(b) improving the definition of "financial entity" in section 995-1 of the *Income Tax Assessment Act 1997* (Cth) ("**1997 Act**") to ensure that all entities which are appropriately characterised as "financial entities" are included; and

(c) the amendment to section 820-583(3)(a) of the 1997 Act.

4 The ASF is concerned that the proposed amendments will cause substantial issues for the securitisation industry, making many transactions economically unviable, and thereby reducing competition and capital flows in industries supported by these forms of financing.

The effects would be anti-competitive in nature because authorised deposit-taking institutions ("**ADIs**") are effectively exempt from the new rules, whereas non-bank lenders would (on the current draft) be economically prohibited from carrying out these transactions.

5 The securitisation market is large, with AUD$42.7bn of issuances across 67 transactions between January 2022 and December 2022, of which 80% of the volume completed was issued by the non-bank sector.[1]

Section 820-39

6 Section 820-39 is a key aspect of the thin capitalisation rules supporting the securitisation industry. Securitisation SPVs are by their nature very highly geared; in most cases, gearing is effectively 100%. Section 820-39 grants those entities an exemption from Subdivisions 820-B, 820-C, 820-D and 820-E if they are:

(a) established for the purpose of managing some or all of the economic risk associated with assets, liabilities or investments;

(b) geared to at least 50%; and

(c) an insolvency-remote special purpose entity according to the criteria of an internationally recognised rating agency.

7 Under section 820-584, securitisation SPVs meeting the conditions in section 820-39 are treated as not being a member of a consolidated group or MEC group for the purposes of applying the thin capitalisation rules to the head company of the group.

8 Section 820-39 has not been amended to exclude insolvency remote SPVs from the new Subdivision 820-AA. Therefore:

(a) non-consolidated insolvency remote SPVs which are not "securitisation vehicles" within the definition in section 820-942 (and which would therefore be classified as a general class investor); and

(b) insolvency remote SPVs which are part of a consolidated or MEC group which is classified as a general class investor,

will not be able to access the exclusion in section 820-39.

9 It is vital that all insolvency remote SPVs continue to have access to the exemption in section 820-39, as securitisation transactions are not commercially viable where the SPV is not tax neutral.

10 It is not the case that the "net debt deduction" mechanism will mean that securitisation transactions are not adversely affected by the new rules. A securitisation SPV subject to the new thin capitalisation rules may in many cases not be in a position of having no net debt deductions as defined in section 820-45(3). For example:

(a) a securitisation SPV may acquire assets that produce collections that are not classified as "interest" – for example, leasing companies may receive lease payments which are not

[1] Westpac, "Australian Securitisation: 2022 Year in Review 2023 Year Ahead" dated 20 December 2022.

"interest, amounts in the nature of interest, or amounts calculated by reference to the time value of money" per section 820-45(3)(b). Such a securitisation SPV may consistently have a portion of its debt deductions denied, which may make such transactions economically unviable;

(b) a securitisation SPV may purchase a book of receivables on-market at a discount (to reflect its current market value), which would result in that entity deriving a proportion of its gains in the form of collections which are not themselves classified as interest or amounts calculated by reference to the time value of money;

(c) in the calculation of their profit or loss, a securitisation SPV may also make gains or losses from other sources of income, e.g. acquiring and disposing of authorised investments at a profit, or insurance or derivative arrangements, and not all such arrangements would produce income that is interest or calculated by reference to the time value of money; and

(d) in times of economic stress, a securitisation SPV may receive less interest income from its receivables than it pays in interest to securityholders. The present rules may result in the denial of debt deductions to a securitisation SPV at precisely the time it is in economic distress.

11 The Explanatory Memorandum to the *Taxation Laws Amendment Bill (No. 5) 2003* (Cth), which introduced section 820-39, described how the definition of "securitisation vehicle" in section 820-942 did not capture all bona fide securitisation programs and as a result, they were being inappropriately captured by the thin capitalisation rules. Section 820-39 was enacted to resolve this problem. The Explanatory Memorandum noted at paragraphs 1.4-1.6 (emphasis added):

> 1.4 The zero capital amount provides a carve out of certain assets from the thin capitalisation regime and as a consequence allows full debt funding of those qualifying assets. Assets held by a securitisation vehicle are included in the zero capital amount provided that the definition of securitised asset and securitisation vehicle as set out in section 820-942 are satisfied.
>
> 1.5 This treatment reflects that securitisation vehicles are tax neutral entities established to pool assets and are generally funded entirely through the issue of debt interests without the need to hold equity.
>
> 1.6 The securitisation industry is complex and dynamic. Many securitisation programs are not able to avail themselves of the benefits of the zero capital treatment provided under the current thin capitalisation legislation. <u>In particular, the current definitions do not contemplate origination, warehousing, two-tiered securitisation or synthetic securitisation. Nor do the current rules allow any residual equity holding in a securitisation vehicle. As a consequence, many bona fide securitisation vehicles will inappropriately have a proportion of their interest deductions denied under the thin capitalisation rules.</u>

Such considerations clearly remain the same today.

12 The capacity for a securitisation SPV to elect into the external third party debt test does not resolve the problem, as it may be unable to require all of its relevant associate entities to make the same election (see section 820-43(5), noting that section 820-43(5)(a)(ii) appears to conflict with paragraph 1.33 of the EM about which associates must make the election). The 10% "associate entity" test is well below the level at which entities may have any control over another entity's decision-making.

13 The ASF proposes that Subdivision 820-AA be covered by section 820-39 as follows:

> *(1) Subdivision 820-AA, 820-B, 820-C, 820-D or 820-E does not apply to disallow any debt deduction of an entity for an income year if the entity meets the conditions in subsection (3) throughout the income year.*
>
> *(2) Subdivision 820-AA, 820-B, 820-C, 820-D or 820-E does not apply to disallow any debt deduction of an entity for an income year that is an amount incurred by the entity during a part of that year, if the entity meets the conditions in subsection (3) throughout that part.*

Proposed amendment to the definition of "financial entity"

14 The ED repeals subsection (a) of the definition of "financial entity" in section 995-1 of the 1997 Act, which presently states, "a registered corporation under the *Financial Sector (Collection of Data) Act 2001*". The draft explanatory memorandum ("**EM**") accompanying the ED notes that this is because (at paragraph 1.24):

> non-ADI corporations can register under that Act for reasons unrelated to income tax. As a result, an increasing number of entities are now purporting (for tax purposes) to be financial entities.

15 The ASF would be grateful for more clarity about the Treasury's concerns about the entities currently registered under the *Financial Sector (Collection of Data) Act 2001* (Cth).

16 The repeal of subsection (a) leaves only the following types of entities as "financial entities" under the remaining paragraphs of the definition in section 995-1:

(b) securitisation vehicles as defined in section 820-942 of the 1997 Act;

(c) holders of an Australian Financial Services Licence ("**AFSL**") which carry on a business of dealing in securities (other than those dealing in securities with or on behalf of the entity's associates); and

(d) AFSL holders which carry on a business of dealing in derivatives (other than those dealing in derivatives with or on behalf of the entity's associates).

17 Many genuine entities which use securitisation as a means of funding their activities would not qualify as "financial entities" under this proposed more limited definition, noting that even many ordinary lending activities such as corporate lending do not require an AFSL.

Securitisation vehicles

18 For the reasons expressed above, most securitisation SPVs will not necessarily be "securitisation vehicles" as defined in section 820-942, and the head company of a tax consolidated group which has securitisation vehicle members would not be itself a securitisation vehicle.

19 It would be more suitable to change subsection (b) to "an entity which qualifies for the exemption in section 820-39".

AFSL holders

20 In respect of paragraphs (c) and (d), some securitisation industry participants only hold an Australian credit licence under the *National Consumer Credit Protection Act 2009* (Cth), or hold no licence at all, such entities may instead utilise the AFSL of an external trustee, or satisfy the licencing requirements of the *Corporations Act 2001* (Cth) by their trusts having an external trustee which is an authorised representative or delegate of an AFSL licensee. Corporate borrowers do not require an AFSL.

21 Even securitisation industry participants that hold AFSLs of the type contemplated in paragraphs (c) and (d) will be challenged by the limitation on dealings on behalf of the entity's associates, due to the operation of section 820-584. That is, under section 820-584, entities which qualify for the exemption in section 820-39 are treated as not a member of a consolidated tax group, and thereby become associates of the head entity.

22 Making the holding of an AFSL the primary means of satisfying the definition of "financial entity" results in a fundamental tax concept being linked to the holding a licence provided under a different Act, in a different area of law governed by a different regulator. The requirements to hold an AFSL may well change over time.

Proposed wording

23 As a result of these difficulties in applying paragraphs (b), (c) and (d) of the "financial entity" definition, it is subsection (a) that provides the clearest qualification as a financial entity and is heavily relied upon within the financial services industry. The proposed wholesale deletion of subsection (a) is therefore problematic.

24 Given the concern of the Treasury to limit the concept of "financial entity" to genuine financial entities, the ASF proposes the following wording to replace subsection (a) of the definition:

> *A registered corporation under the Financial Sector (Collection of Data) Act 2001, which substantially derives its profits from the provision of finance.*

25 For situations where such a financial entity is a member of a consolidated group then the definition could be further modified to require that, having regard to the Single Entity Rule (section 701-1), the head company substantially derives its profits by engaging in the provision of finance.

26 Further, we propose that the remaining section 995-1 "financial entity" definition paragraphs (b) to (d) be reconsidered in light of the problems highlighted above, particularly concerning the operation of section 820-39 and section 820-584.

Section 820-583(3)

27 Section 820-583 operates to classify the head company of a consolidated group, in certain circumstances deeming that head company is a financial entity because there is a financial entity in the consolidated group. The proposed amendments to section 820-583(3)(a) appear to now require that the head company itself satisfies the definition of "financial entity".

28 It is unclear whether this outcome was intended.

29 Under the current wording of section 820-583(1), a head company of a consolidated group is an "outward investing entity (non-ADI)" for a period if (and only if) "it is … an outward investor (financial) for that period (because of subsection [820-583(3)]".

30 Subsection 820-583(3) deems the head company of a consolidated group to be an "outward investor (financial)" if:

(a) the head company satisfies the condition in the second column of item 1 or 3 of the table in subsection 820-85(2);

(b) there is at least one member of the group that is a financial entity; and

(c) no member of the group is an ADI.

31 Column 2 of items 1 and 3 of the table in subsection 820-85(2) each state, "the relevant entity is not a financial entity, nor an ADI, at any time during that period".

32 Therefore, if a head company of a consolidated group is not itself a financial entity or an ADI, but a member of the group is a financial entity, the head company is a financial entity.

33 Under the ED, section 820-583(1) and (2) are repealed and replaced.

34 Section 820-583(3) still requires that there is at least one group member which if a financial entity, and no member of the group is an ADI. However, section 820-583(3)(a) is amended to require the head company to satisfy the condition in the second column of items 2 or 4 of section 820-85(2).

35 Section 820-85(2) is replaced by the ED. Column 2 of items 2 and 4 of the table in new subsection 820-85(2) each state, "the relevant entity is a financial entity throughout that period".

36 Therefore, a head company must itself be a financial entity under the proposed new rules.

37 This gives rise to a situation where, if a group has a financial entity but the head company is not itself a financial entity, the head company is neither a financial entity nor a general class investor (because of section 820-583(1)). It would appear that the head company is then outside the scope of the thin capitalisation rules.

38 The changes to section 820-583(4), which refer to the unamended section 820-583(6) would appear to lead to different outcomes depending on whether the head company is an inward or outward investor.

39 The draft Explanatory Memorandum does not really clarify the matter. It states at paragraph 1.132:

> Consequential amendments are made to paragraph 820-583(3)(a) to reflect the updated table items in subsection 820-85(2). Similarly, paragraph 820-583(3)(b) is now redundant given that the head company needs to be a financial entity throughout the period.

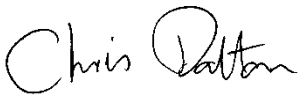
40 However, the EM makes no further comment about the need for the head company to itself be a financial entity, and the ED does not repeal section 820-583(3)(b).

41 The ASF would be grateful for more clarity around the Treasury's intentions regarding the classification of head companies.

Concluding remarks

42 The ASF is grateful for the opportunity to provide this submission and we would be pleased to discuss it with you in greater detail at your earliest convenience.

Yours sincerely,



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