30 October 2023

Email to: MNETaxIntegrity@treasury.gov.au

International Tax Unit
Corporate and International Tax Division
Treasury
Langton Cres
Parkes ACT 2600

Dear Sir/Madam,

Submission on the "Multinational tax integrity – strengthening Australia's interest limitation (thin capitalisation) rules"

Opal Group is the leading private provider of residential aged care in Australia. Opal Group provides specialist aged care services for a range of needs, including dementia and respite care services. It currently owns and operates residential aged care facilities (RACFs) located in metro and regional areas across Australia.

Purpose

We are writing this submission in response to the proposed amendments to Australia's thin capitalisation rules contained in *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share - Integrity and Transparency) Bill 2023*, as released in October 2023 and its potential impact on debt deductions available to aged care providers such as the Opal Group.

Opal Group strongly supports the overarching policy intent of the rules and the proposed reforms, being to prevent multinational groups from engaging in base erosion and profit shifting practices (as it relates to deductible debt within the group), by taking advantage of the differences between jurisdictions' tax systems to minimise overall group tax liabilities. In doing so, we also make recommendations to consider amending the legislative framework to address unintended consequences of the thin capitalisation rules (both current and proposed), which has the potential to impede investment within the Aged Care sector and negatively affect the ability to meet the growing demand for residential aged care services.

Under the thin capitalisation rules, a wholly Australian based asset or business, such as the Opal Group, can be brought into the scope of thin capitalisation rules due to unrelated foreign investors or shareholders, regardless of whether any international related party transactions, guarantees, security or credit support is entered into. We consider this is inconsistent with the policy aim of the thin capitalisation rules, being to target profit shifting by multinational groups. The application of thin capitalisation rules for wholly Australian based operations (with solely Australian assets) means there is a potential for denial of debt deductions in situations where there is no risk of base erosion or profit shifting or loss to the Australian tax base. As such, in these specific situations, the thin capitalisation rules should not apply or be appropriately drafted to prevent unintended consequences that are not commensurate with the risk to the domestic tax base.

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Background on Opal Group

Opal Group manages 99 residential aged care communities in metro and regional areas in New South Wales, Victoria, Queensland, Western Australia, and South Australia. Opal Group is an owner and operator of all of its aged care homes and is a substantial investor in Australian freehold land and buildings. As a leading aged care provider in Australia, Opal Group looks after over 7,000 residents in its care communities and employs over 1,000 personnel in Australia.

Operators in the aged care industry in Australia and approved care providers, such as Opal Group, operate in a heavily regulated industry and are governed under the *Aged Care Act 1997*, along with associated Prudential Regulations. This includes regulation by the Australian government in relation to the allocation of residential and home care placements, Australian government financial assistance, pricing to residents and the funding arrangements of operators as it relates to residents. This is considered critical in providing quality care options for elderly Australians who can no longer live unassisted in their homes. The continued investment in the aged care industry by private providers such as Opal Group is integral to supplement not-for-profit and government providers to service Australia's ageing population.

Opal Group is the result of the merger of Domain Aged Care Group and Principal Healthcare Group in 2008. The two businesses formed an integrated group that owns and operates aged care homes and is now known as Opal Healthcare.

Since its merger, Opal Group's shareholders consist of a range of Australian and foreign investors, each holding less than a majority interest in Opal Group and has consistent ownership percentages across the group

Policy intent of the thin capitalisation rules

The proposed thin capitalisation rules, or interest limitation rules, were released by Treasury as part of the Australian Government's commitment on multinational tax integrity. As outlined in the Explanatory Memorandum (EM) to the Bill, the proposed amendments are intended to *'combat multinational profit shifting and tax avoidance by ensuring that debt (interest) deductions are linked to an entity's economic activity and taxable income in Australia'*. Further it is highlighted *'the amendments address risks to the domestic tax base arising from the excessive use of debt deductions, which amount to base erosion or profit shifting arrangements'*.

Consistent with the Organisation for Economic Cooperation and Development's (**OECD**) best practice guidance, the EM recognises that the proposed rules are not effective for certain types of entities, including financial entities and ADIs. However, the proposed rules as currently drafted may also have unintended consequences for other regulated industries, such as the aged care sector.

As highlighted by Treasury in the EM, while the core objective of the policy underpinning the proposed thin capitalisation rules is to *'increase revenue (taxes payable) by limiting the amount of debt deductions entities can claim in Australia for tax purposes'*, it is recognised that this should be balanced *'against supporting genuine commercial activities and investment in Australia and minimising compliance burdens on industry'*. The EM further states the rules are complex and may *'give rise to genuine unintended consequences'*. As it relates to the aged care sector, the proposed rules as drafted do not appear to contain provisions to address certain key factors in the Australian regulatory landscape designed to facilitate a growing aged care sector, as further outlined below.

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Impact of the proposed rules

As an aged care provider in Australia, Opal Group's operations are entirely domestic and it operates an integrated model as owner and operator of aged care homes. As an integrated group, the Opal Group owns entirely Australian assets, conducts operations entirely in Australia and does not operate through foreign subsidiaries or branches. Furthermore, the debt arrangements of the Opal Group relate entirely to third party debt from commercial lending institutions used to fund Australian economic activity, with the relevant Australian entities in the Opal Group forming the 'obligor group' to the external debt arrangements and recourse held against Australian assets of the group.

As outlined above, providers in the aged care sector such as Opal Group are also subject to specific regulatory requirements outside Australia's tax regime, including the 'Living Longer Living Better' reforms introduced by the Australian Government in 2014 which contains regulations in relation to payments from residents. In particular, as a result of these regulatory reforms the Opal Group receives refundable deposits and accommodation bonds from residents which are held as refundable accommodation deposits (**RADs**). Operators in the industry receiving RADs are subject to specific Prudential Regulations under the *Aged Care Act 1997* (see s. 52N.1) in relation to the permitted uses of these funds. The RADs form important sources of funds, guaranteed by the Australian Government in the event of default and refundable to residents when they leave or pass away, which reduce the overall level of external debt required for funding capital investment in residential aged care in Australia. Under these regulations, regulated providers are permitted to invest the funds which also form a source of interest income. As it is relevant to the intended objective of the proposed thin capitalisation rules, the regulations applying to the aged care sector in effect reduce the overall debt burden or debt deductions required for commercial activities and investment in the Australian aged care industry.

While Opal Group's operations are domestic and it does not operate through foreign subsidiaries or branches, the Opal Group is subject to Australia's thin capitalisation rules as a result of ultimate foreign ownership of certain non-controlling investors or shareholders in the group. The Opal Group does not enter into related party transactions with Australian or foreign controlled investors. In particular, no guarantee, security or other form of credit support is provided to the Opal Group by its investors.

While the factors outlined above do not exhibit risks of potential for profit shifting or risk to the domestic tax base, particularly as they relate to debt deductions of the Australian operations, the thin capitalisation rules as currently drafted may still apply to deny debt deductions in relation to the commercial activities and investment in the Australian aged care sector.

The specific regulatory context in which aged care providers such as Opal Group operate within Australia may result in the following implications under the current drafting of the proposed thin capitalisation rules (as further presented in a simplified example in Appendix 1):

- A component of the capital of aged care providers (i.e. RADs), which reduces the overall debt deductions linked to the economic activity and taxable income in Australia, is not a debt interest which gives rise to debt deductions for thin capitalisation purposes. The RADs are received and held by the Approved Provider within the group under the Australian regulations.
- Under the Fees and Payments Principles 2014 outlined by the Australian Government under the *Aged Care Act 1997* in relation to the permitted uses of RADs, where capital funded by RADs is loaned to an Australian associate, the funds must be provided on a 'commercial basis' and therefore apply interest. This domestic regulated on-lending of funds does not create net

debt deductions to the Australian tax base (i.e. interest income and interest expense is recognised in Australia).

- The current drafting of the proposed thin capitalisation rules results in an outcome whereby potential denials may be realised by a group governed by the Aged Care Act 1997 due to the regulatory requirement to apply interest on any regulated permitted use loans funded by RADs between entities in the Australian group due to the restrictive requirements of the current fixed ratio test (**FRT**), group ratio test (**GRT**) and third party debt test (**TPDT**). This is compounded where the entirely Australian operations of the group is required to consider the proposed debt deduction creation rules, which as drafted have potential broad application. The operation of these rules may therefore inhibit genuine commercial activities and investment in Australia's aged care sector, regardless of the potential risks of profit shifting or risk to the domestic tax base.
- The application of the rules as drafted also result in significant additional compliance burden on the Australian operations of aged care providers in monitoring and applying the outcomes under the tests in relation to regulated lending activities between Australian entities.

Recommendations:

Given the underlying economic fundamentals and regulatory requirements applying to the aged care sector in Australia, which utilise the proceeds of such regulated fund for operating, acquiring and developing solely Australian-based assets, we, respectfully, recommend for Treasury to consider amendments to the thin capitalisation rules as currently drafted. To facilitate Treasury's deliberations, this could for example include consideration of the following:

- Specific provisions are currently included in the proposed thin capitalisation rules to address certain types of entities (ADIs, financial entities, AMITs, securitisation vehicles, forestry industry, etc.) where it is recognised the proposed rules may not be effective or result in unintended consequences. Further amendments to the rules, or a specific carve out, addressing regulated lending between Australian entities under the *Aged Care Act* (or for other regulated industries) should also be considered. For example, this could include:
    - Clarifications to the scope of the thin capitalisation rules contained in s820-46(1).
    - Amendments to address regulated permitted lending arrangements in defining 'debt deductions', 'disallowed amount' or 'net debt deductions' under s820-50.
    - Amendments to the provisions of the TPDT and associated 'conduit financing' provisions as they apply between Australian entities that are part of an 'obligor group', including amendments to permit regulated lending between Australian entities. For example, amendments to remove or refine the requirement in the 'conduit financing' provisions for the 'relevant debt interest' to be financed 'only from the proceeds from the ultimate debt interest' may enable genuine lending on commercial terms between Australian entities (e.g. consistent terms to an ultimate debt interest of the obligor group).

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- Under the proposed rules, the arm's length debt test (**ALDT**) has been replaced by the TPDT, which contains more restrictive conditions for its application. The ALDT previously provided the ability to support debt deductions for commercially justifiable levels of debt for Australian operations and could best take into account a taxpayer's commercial circumstances, as opposed to the 'shortcut' safe harbour method. In the absence of the ALDT in the current provisions, additional specific amendments would be required to address unintended consequences for Australian taxpayers of genuinely commercially justifiable levels of debt. For example, this could include amendments to provide the Commissioner the ability to issue regulations or make a determination to address unintended consequences in the drafting of the provisions where it is 'fair and reasonable' to conclude it does not result in excess debt deductions or risk to the Australian tax base.

- The rules as currently drafted continue to have effect for income years from 1 July 2023 and will therefore have retrospective effect. Furthermore, as currently drafted there is no 'grandfathering' or similar provision for existing assets or projects. The inclusion of any 'grandfathering' provision would enable aged care providers with regulated on-lending arrangements additional time to assess the implications of the measures on current commercial debt arrangements and regulated lending arrangements, as well as potentially provide time for further consultation.

- To the extent a grandfathering provision is not included, post-implementation review should be conducted to understand the practical consequences and issues which have emerged since the introduction of the rules to highlight the impact they may have on continued investment and successful operation of regulated industries such as the aged care sector.

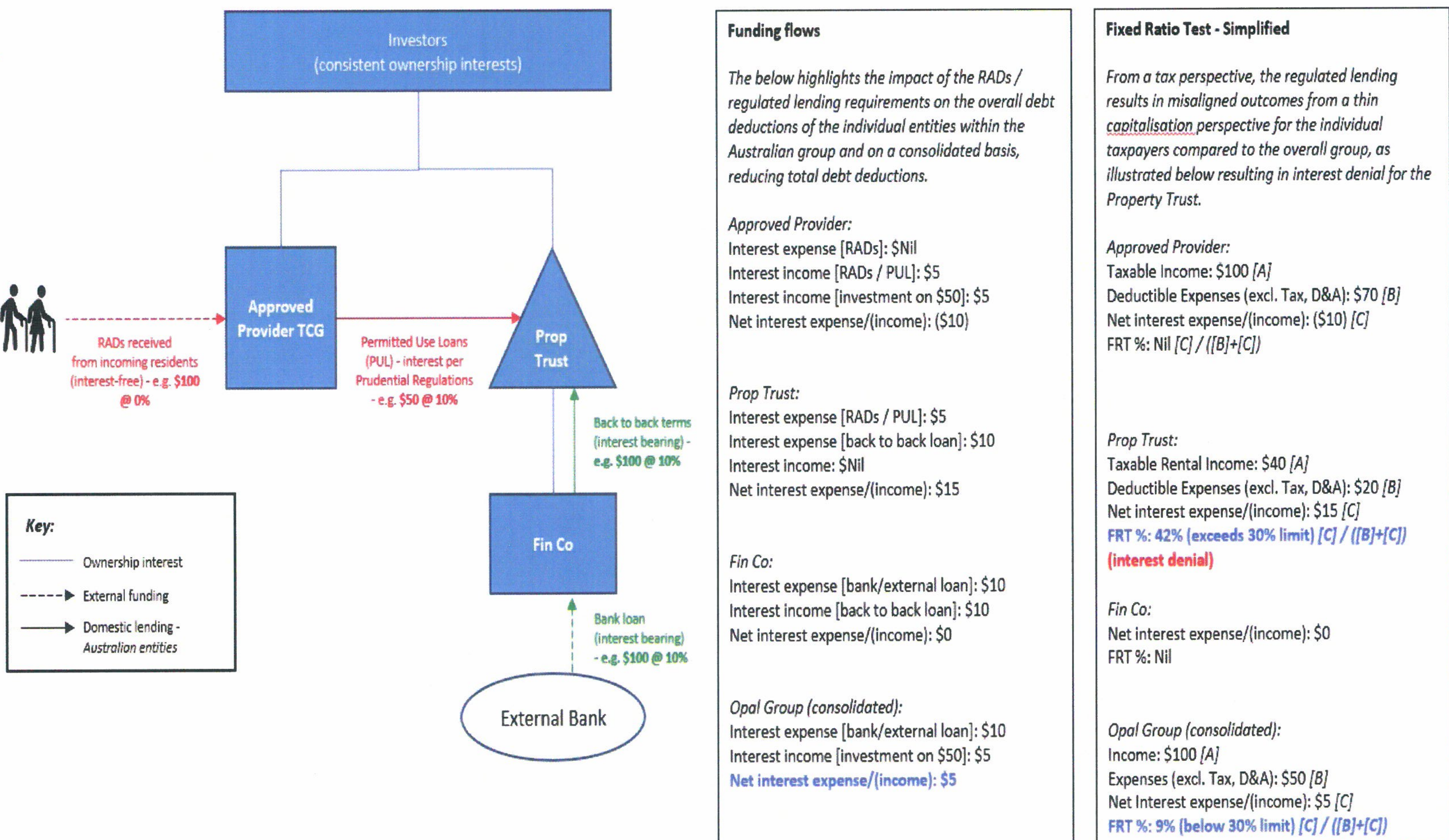
If you would like to discuss any aspect of this submission further, please contact myself on 02 9324 8762 or email: Ben.Feek@opalhealthcare.com.au .

Yours sincerely

Ben Feek
Chief Financial Officer

Opal HealthCare

Appendix 1: Simplified Illustration – potential impact of the Fixed Ratio Test on domestic regulated lending:



Funding flows

The below highlights the impact of the RADs / regulated lending requirements on the overall debt deductions of the individual entities within the Australian group and on a consolidated basis, reducing total debt deductions.

Approved Provider:
Interest expense [RADs]: $Nil
Interest income [RADs / PUL]: $5
Interest income [investment on $50]: $5
Net interest expense/(income): ($10)

Prop Trust:
Interest expense [RADs / PUL]: $5
Interest expense [back to back loan]: $10
Interest income: $Nil
Net interest expense/(income): $15

Fin Co:
Interest expense [bank/external loan]: $10
Interest income [back to back loan]: $10
Net interest expense/(income): $0

Opal Group (consolidated):
Interest expense [bank/external loan]: $10
Interest income [investment on $50]: $5
Net interest expense/(income): $5

Fixed Ratio Test - Simplified

From a tax perspective, the regulated lending results in misaligned outcomes from a thin capitalisation perspective for the individual taxpayers compared to the overall group, as illustrated below resulting in interest denial for the Property Trust.

Approved Provider:
Taxable Income: $100 *[A]*
Deductible Expenses (excl. Tax, D&A): $70 *[B]*
Net interest expense/(income): ($10) *[C]*
FRT %: Nil *[C] / ([B]+[C])*

Prop Trust:
Taxable Rental Income: $40 *[A]*
Deductible Expenses (excl. Tax, D&A): $20 *[B]*
Net interest expense/(income): $15 *[C]*
FRT %: 42% (exceeds 30% limit) *[C] / ([B]+[C])*
(interest denial)

Fin Co:
Net interest expense/(income): $0
FRT %: Nil

Opal Group (consolidated):
Income: $100 *[A]*
Expenses (excl. Tax, D&A): $50 *[B]*
Net Interest expense/(income): $5 *[C]*
FRT %: 9% (below 30% limit) *[C] / ([B]+[C])*