THE TAX INSTITUTE

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Dear Michael

ADDRESSING PROFIT SHIFTING THROUGH THE ARTIFICIAL LOADING OF DEBT IN AUSTRALIA

The Tax Institute thanks Treasury for the opportunity to make this submission in response to the Proposals Paper entitled "Addressing profit shifting through the artificial loading of debt in Australia" dated June, 2013 (the "**Paper**").

Overview

Amendments to our domestic tax rules which govern the tax treatment of financial transactions involving multinationals (including allowable debt levels) should be dictated by broader considerations such as:

- How our tax system compares with and also interacts with those of our key treaty and trading partners, including the impact of any changes to our tax system on those trading partners;
- The combined impact of any such changes;
- Acceptable levels of debt funding for Australian operations;
- The appropriateness of the base to which our current thin capitalisation rules are applied in light of the current circumstances of the Australian economy (including an expanding services sector);
- Maintaining a level playing field between Australian based businesses and non-Australian based businesses with operations in Australia; and
- The appropriateness of the bright line tests used to bestow particular tax treatment/s.

We broadly agree that the Australian tax system should neither encourage excessive levels of debt nor discourage commercially appropriate levels of gearing. We also

broadly agree that inconsistencies in the current system of delineating between debt and equity with reference to both Division 974 as well as the more traditional paradigm based on "shares" gives rise to both inappropriate arbitrage opportunities and adverse tax outcomes.

As such, we are broadly supportive of the announced changes to the thin capitalisation regime and the reforms to the exemption for foreign non-portfolio dividends.

However, the narrow focus of the announced changes to the safe harbour limits constitutes a missed opportunity to reconsider the appropriateness of the base to which our thin capitalisation rules are applied.

Further, we consider the announced repeal of section 25-90 to be misguided as it will not achieve its intended objectives and will instead cause much collateral damage for well-meaning taxpayers.

We note the oft repeated comments in the Paper as to the need to counter "aggressive tax planning". Our tax system should be robust and based on sound principles. However, countering tax planning that undermines these principles should occur via deliberate deployment of the general or any specific anti-avoidance rules rather than blunt changes to principles-based rules. This is because such blunt changes have the potential to disadvantage taxpayers who have a relatively low tax risk profile.

We urge the Government to reconsider alternative methods by which to address the integrity concerns set out in the Paper, including the potential to deploy the existing general anti-avoidance rules or the inclusion of a specific anti-avoidance rule restricting section 25-90. At the very least, we urge the Government to clarify that the announced repeal of section 25-90 will not apply to deny the application of section 25-90 in relation to outgoings incurred in producing income that is exempt by virtue of sections 23AI and 23AK.

We would be pleased to discuss such alternative methods in greater detail.

SECTION 1: THIN CAPITALISATION

Our understanding of the Government's main announced changes to the thin capitalisation rules are set out below, for ease of reference:

- The safe harbour gearing ratio will be tightened from 3:1 (Debt to Equity) to 1.5:1.
- The worldwide gearing test ratio will be tightened from 120% to 100%.
- The worldwide gearing test will also be extended to inbound investors (the test currently only applies to outbound investors).
- The arm's length debt test will be retained but referred to the Board of Taxation for simplification/reduction in compliance costs.
- The current *de minimis* threshold of $250,000 will be increased to $2 million of debt deductions.

Tightening of the safe harbour ratio

We note the comments in the Proposals Paper with respect to current debt levels and recent trends[1]. Anecdotal evidence provided to us is consistent with Treasury's analysis in suggesting that the current debt levels appear to be at a medium to long-term norm or close enough thereto.

Furthermore, as noted in our submission to the Business Tax Working Group dated 21 September 2012:

> *[The assertion that] … Australia's current thin capitalisation regime "could be seen as overly generous" when assessed against the thin capitalisation regimes of other countries … accords with the experience of our members and prevailing research on this issue.*
>
> *As such, some tightening of the thin capitalisation rules is unlikely to significantly affect the decisions of marginal foreign investors so long as Australia's thin capitalisation rules are not altered to be overly restrictive when considered in comparison to the regimes of competing foreign investment destinations.*

As such, the tightening of the thin capitalisation safe harbour ratio from 3:1 (Debt to Equity) to 1.5:1 should not significantly reduce the relative attractiveness of Australia as a foreign investment destination, nor unduly influence an entity's choice of capital structure either in Australia or on a worldwide basis.

Further, we note that for those entities that would otherwise have a higher gearing ratio than either the safe harbour ratio or their worldwide gearing ratio, the arm's length debt test will be retained and simplified via a Board of Taxation review process.

As such, we consider the tightening of the thin capitalisation safe harbour ratio to be appropriate in the circumstances. Nevertheless, as:

- our economy is arguably in a transitionary state at the present time (including the longer term trend expansion in the services sector);
- debt level norms may shift over time as a consequence of a variety of factors (including the cost of debt capital);
- our key treaty and trading partners continue to review and modify the tax treatment of financial transactions involving multinationals (including allowable debt levels and limitations on interest deductions based on earnings); and
- even the revised arm's length debt test may be relatively difficult/costly to apply, resulting in greater reliance on the safe harbour ratio;

we recommend that the Government commits to reviewing the appropriateness of the revised safe harbour ratio after a period of time. We also recommend that the Government tasks Treasury to collect sufficient and appropriate data in the mean time to facilitate such a review.

[1] Notably, the data referred to in paragraph 14 of the Proposals Paper only relates to ASX listed non-financial corporate entities and may not therefore be representative of the wider corporate taxpayer population (putting aside Australian subsidiaries of non-Australian based businesses).

We also encourage the Government to ensure that commercially realistic and practical transitional relief is made available in order to protect taxpayers seeking to comply with the revised rules.

Similarly, we consider the tightening of the worldwide gearing test ratio to 100% and expansion to inbound investors to be appropriate. While such a tight ratio eliminates any leniency in the system that may have reduced compliance costs, taxpayers that are unlikely to satisfy this test or an applicable safe harbour ratio can nevertheless rely on the arm's length debt test instead.

Appropriateness of base to which thin capitalisation safe harbour ratios are applied

The announced reforms to the thin capitalisation rules are a missed opportunity to reconsider the appropriateness of the base to which our thin capitalisation safe harbour ratios are applied.

Specifically:

- While the 1:5 to 1 Debt to Equity ratio is broadly in line with our major trading partners, the inclusion of third party debt in 'maximum allowable debt' for thin capitalisation purposes contrasts with the thin capitalisation rules of our major treaty and trading partners (e.g. United States, Canada). This difference will be especially relevant if the arm's length debt test is retained in some form. While we are cognisant of the original rationale for the inclusion of third party debt in this test, this policy setting in the context of the revised safe harbour ratio may negatively impact Australia's international competitiveness as an investment destination.

- The announced reforms are a missed opportunity to shift our thin capitalisation rules away from an asset basis towards a model focussed on earnings, as has been the case with other comparable jurisdictions in recent years (e.g. the United Kingdom, United States). While we do not advocate replacing the current asset basis entirely, the addition of an earnings based test as an additional safe harbour would more accurately reflect the current circumstances of the Australian economy, including an expanding services sector. An additional earnings based safe harbour will also achieve the objectives of the thin capitalisation regime more directly[2].

We recommend that the Government review the appropriateness of the base to which our thin capitalisation safe harbour ratios are applied to more accurately reflect the current circumstances of the Australian economy (including an expanding services sector).

Increase in *de minimis* threshold

The increase in the de minimis threshold will be welcome relief from the compliance costs incurred in applying the thin capitalisation tests for the many small to medium enterprises that have already expanded overseas or are planning to do so.

However, the increase in the *de minimis* threshold will not preclude the potential application of the new transfer pricing rules in Subdivision 815-B to small and medium

[2] A similar mechanism constituted Option A.4 of the Business Tax Working Group's Discussion Paper of August 2012.

enterprises in relation to whether their capital structures are consistent with arm's length conditions. Perversely, the increase in the de minimis threshold could actually result in some small and medium enterprises being in a worse tax position.

This is because the protection offered from the transfer pricing provisions in relation to the deductibility of certain interest costs is only available where the thin capitalisation rules apply to that taxpayer (Section 815-40). As a consequence, all taxpayers that will no longer be subject to the thin capitalisation rules as a result of the increase in the *de minimis* threshold will now be exposed to the potential application of the new transfer pricing rules in Subdivision 815-B in relation to whether their capital structures are consistent with arm's length conditions (see further below).

In addition, small to medium enterprises that become exempt from the thin capitalisation provisions as a consequence of the increase in the *de minimis* threshold will now be required to incur high compliance costs of preparing transfer pricing documentation to show that their capital structures were consistent with arm's length conditions for purposes of the transfer pricing rules.

We recommend the Government gives further consideration to how the thin capitalisation rules interact with the transfer pricing rules in Subdivision 815-B (see further below).

Interaction of thin capitalisation rules and transfer pricing rules

Based on recent amendments to the transfer pricing rules, the thin capitalisation safe harbour limits remain in effect, subject to the arm's length principle underlying the transfer pricing provisions. That is, after the recent rewrite of the transfer pricing provisions, the ability of taxpayers to be able to rely on the thin capitalisation safe harbour ratios so as at keep compliance costs to a minimum can be circumvented by transfer pricing legislation that has an overlapping sphere of operation.

When the current thin capitalisation rules were introduced into the tax laws, paragraphs 11.11 and 11.35 of the Explanatory Memorandum to *New Business Tax System (Thin Capitalisation) Bill 2001* clearly articulated the intended policy outcomes with respect to the introduction of the safe harbour limits:

> *Paragraph 11.11 The objective of the thin capitalisation regime is to ensure that multinational entities do not allocate an excessive amount of debt to their Australian operations. This is to prevent multinational entities taking advantage of the differential tax treatment of debt and equity in order to minimise their Australian tax. The most appropriate method of assessing whether in fact the Australian operations of a multinational entity are sufficiently capitalised is by the application of an arm's length test. Such a test requires the analysis of the assets, liabilities and cash flow of the Australian operations of the entity to ascertain if the level of debt of the operation is in fact commercially justifiable for an independent entity. After significant consultation with industry representatives, it was recognised that the application of this test may be quite onerous leading to an increase in compliance costs. To reduce the compliance burden, a safe harbour approach was adopted as the rule of general application. The safe harbour allows sufficient protection of the Australian tax base to be provided whilst simultaneously minimising compliance costs."*
>
> *…*

Paragraph 11.35 As discussed, the thin capitalisation measures have been designed to ensure that multinational entities do not shift an excessive amount of debt to their Australian operations thereby reducing their Australian tax obligations. This objective is sought to be implemented in an effective manner whilst considering the compliance impact on taxpayers. To minimise the compliance burden on taxpayers, the measures have adopted:

- *a safe harbour approach;*
- *optional application of an arm's length test;*
- *optional application of a worldwide gearing test in certain circumstances;*
- *[…]."(emphasis added)*

It is clear from the above extracts that the arm's length test in the thin capitalisation rules was intended as an optional test rather than as the primary test due to the compliance cost burden for taxpayers associated with the arm's length test.

However, as the law currently stands, this policy intention has been circumvented due to recent amendments to the transfer pricing rules[3]. As is made clear by the Explanatory Memoranda to *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No.1) 2012* and *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* (paragraphs 1.108 and 3.148 respectively), these amendments are intended to allow the Commissioner of Taxation to have regard to a notional arm's length capital structure that has a lower debt to equity ratio than the actual capital structure a taxpayer has, for purposes of pricing related party debt, irrespective of whether the taxpayer's actual capital structure falls within the safe harbour limits in the thin capitalisation rules.

That is, even where a taxpayer's gearing ratio is lower than the safe harbour ratio, some part of that taxpayer's actual interest deductions may nevertheless be denied via application of the transfer pricing rules (by denying a deduction for interest costs greater than the amount that would have been payable in respect of the notional arm's length capital structure).

This outcome effectively defeats one of the intended policy objectives of the thin capitalisation safe harbour limits – minimising the compliance burden on taxpayers – as many taxpayers will also need to undertake an arm's length analysis in order to satisfy themselves that their interest deductions are allowable under the transfer pricing rules. The proposed reduction in the safe harbour gearing limits will reduce the incidence but not eliminate entirely the need for some taxpayers to undertake arm's length analyses relating to their capital structure.

This situation is at odds with one of the policy intentions underpinning the thin capitalisation provisions and has led to reduced tax certainty, increased compliance costs and an increased risk of disputation with the Australian Taxation Office ("**ATO**") for taxpayers that are otherwise within the safe harbour limits.

In recognition of the greater role that the thin capitalisation rules will play in limiting debt deductions as a consequence of the tightening of the safe harbour ratio, we recommend the Government also amends the transfer pricing rules in Subdivision 815-B to ensure that where a taxpayer's gearing ratio falls within the safe harbour ratios,

[3] Specifically section 815-25 in Subdivision 815-A and section 815-140 in Subdivision 815-B of the *Income Tax Assessment Act 1997*

that a taxpayer's debt deductions are priced for purposes of the transfer pricing rules on the basis of the taxpayer's actual gearing ratio and not by reference to a notional arm's length capital structure.

SECTION 2: REFORMS TO THE EXEMPTION FOR FOREIGN NON-PORTFOLIO DIVIDENDS

We support a greater move towards the consistent treatment of funding instruments based on substance rather than form, including via the announced reforms to the exemption for foreign non-portfolio dividends.

The limited use of the substance-focussed bright line tests in Division 974 of the *Income Tax Assessment Act 1997* was likely appropriate for a period after their introduction to allow for the resolution of any implementation issues.

However, we are cognisant of the arbitrage opportunities available to both wholly domestic as well as multinational groups as a result of inconsistent classification of funding instruments within our Tax Acts – most particularly, the lack of a comprehensive approach to the treatment of returns on equity interests and/or 'shares'. As such, we are supportive of the recently announced Board of Taxation review into the debt and equity tax rules, including examination of "the potential for broader application of the current debt and equity rules to ensure consistent policy outcomes."

We note that the announced reform to the exemption for foreign non-portfolio dividends was intended to form part of the broader rewrite of the foreign source income rules which has stalled since Treasury's Exposure Draft of 2010. It is our view that the now much delayed rewrite of our foreign source income rules should be informed by and progress alongside the OECD's work program, rather than be subject to it.

We strongly recommend that the Government confirms the priority of this rewrite, as well as the likely date of progress/completion of the same in order to prevent further such integrity issues from arising. To the extent possible, we also strongly recommend the enactment of certain provisions of the proposed rewrite, including the repeal of the provisions dealing with tainted sales and services income.

<u>Extension to subdivision 768-G</u>

In order to ensure consistency of application, we recommend that the application of subdivision 768-G of the *Income Tax Assessment Act 1997* also be simultaneously extended to apply where a trust or partnership is interposed. That is, as section 23AJ is to be amended to apply where an Australian company receives section 23AJ dividends through a trust or partnership, subsection 768-550(2) should also be amended to accommodate non-portfolio interests held through partnerships and trusts.

By way of explanation, subdivision 768-G concerns the reduction in capital gains and losses arising from CGT events in relation to certain voting interests (i.e. where there is a direct voting percentage of 10% or more) in active foreign companies.

Under current legislation, subsection 768-550(2) means that an entity cannot have a direct voting percentage in a company where a trust or partnership is interposed between the entity and the company. The Explanatory Memorandum to *New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004* states that subsection 768-550(2) provides that this definition is consistent with section 23AJ.

Direct voting percentage

*1.39 The concept of **direct** voting percentage has been used to ensure that it relates to a voting interest that an entity owns directly in another company. In other words, if there is a trust or a partnership interposed between the shareholding entity and the other company, then the first-mentioned company will be taken to not hold a direct voting percentage in the other company.*

*1.40 The **direct voting percentage** that an entity has in a foreign company is equal to the voting interest it holds in that foreign company (within the meaning of section 160AFB of the ITAA 1936) as a percentage of the voting power of that company (within the meaning of that section). **[Schedule 1, item 3, subsection 768-550(1)]***

*1.41 However, the application of section 160AFB is modified for the purposes of this measure to ensure that if a partnership or trust is interposed between the shareholding entity and the company in which the shares are held the direct voting percentage in the company will be zero. **[Schedule 1, item 3, paragraph 768-550(1)(b) and subsection 768-550(2)]***

1.42 This modification for the purposes of the definition of 'direct voting percentage' is consistent with the application of the non-portfolio dividend exemption in section 23AJ of the ITAA 1936, which is only available in respect of non-portfolio dividends that have been paid to an Australian resident company by a foreign resident company.

SECTION 3: REMOVING THE DEDUCTION FOR INTEREST EXPENSES INCURRED IN DERIVING CERTAIN FOREIGN EXEMPT INCOME

Section 25-90 of the *Income Tax Assessment Act 1997* is reproduced below for ease of reference.

An Australian entity can deduct an amount of loss or outgoing from its assessable income for an income year if:

a) the amount is incurred by the entity in deriving income from a foreign source; and
b) the income is non-assessable non-exempt income under section 23AI, 23AJ or 23AK of the Income Tax Assessment Act 1936; and
c) the amount is a cost in relation to a debt interest issued by the entity that is covered by paragraph (1)(a) of the definition of debt deduction.

Scope of repeal

Amounts exempt under section 23AI or 23AK are exempted from taxation precisely because the profit supporting the dividend (i.e. the same economic gain) has already been taxed in Australia under the controlled foreign company or former foreign investment fund rules. As such, it is entirely inappropriate for a deduction to be denied for funding costs incurred in deriving amounts that have already been subject to taxation in Australia and which would be subject to double taxation but for sections 23AI or 23AK. This is especially so since it is unclear whether such interest costs would be otherwise deductible (i.e. can otherwise have been incurred in deriving attributable income under the CFC and formerly the FIF regime). Furthermore, is it unclear to us

how the interaction between section 25-90 and either section 23AI or 23AK could be used “as a central step of an aggressive tax scheme.”

We urge the Government to clarify that the announced repeal of section 25-90 is not intended to apply with respect to amounts exempt from taxation under sections 23AI and 23AK of the *Income Tax Assessment Act 1936*.

The current law

In our view, the current law, specifically section 25-90, section 23AJ and the thin capitalisation regime, is part of a comprehensive and principled basis for the taxation of international arrangements.

The capacity to deduct interest costs incurred in producing exempt income in the form of section 23AJ dividends, subject only to the limitations of the thin capitalisation regime (which applies to limit debt as a percentage of Australian assets) is an intended feature of our international taxation system. In our view this outcome does not give rise to a structural flaw, for the reasons set out below.

Section 25-90 is not a mere ‘compliance cost saving’ provision. Instead, the section is in line with the objectives of the *Review of International Taxation Arrangements* as well as the objectives of the thin capitalisation regime.

We submit that the rationale underpinning section 25-90 remains appropriate in the present day, and will not in and of itself allow the type of “aggressive” tax strategies set out in the Proposals Paper. In fact, the effective application of the debt/equity rules to the section 23AJ exemption will be sufficient to address the structure set out in the Proposals Paper. The further limitation of interest deductibility via tightening of the thin capitalisation safe harbour ratio should operate to further limit the ‘headroom’ available to multinationals.

The repeal of a provision based on sound principles that does not give rise to a structural flaw in order to address ‘aggressive’ tax strategies is inappropriate. Such strategies should generally be addressed via deployment of anti-avoidance rules.

More broadly, should the Government no longer consider the principles underpinning section 25-90 to be appropriate, we urge the Government to articulate the change in circumstances from 2001 to the present day that have led to this view. We do not consider a miscalculation of the cost of this measure to be a sufficient reason for its repeal, as the measure forms part of a comprehensive and principled basis for the taxation of international arrangements i.e. we reject the classification of section 25-90 as a mere compliance cost saving measure, the allowing of which may be re-evaluated depending on the cost to Government. Furthermore, we urge Treasury to reconsider the actual cost of allowing section 25-90 to remain on foot, in light of the capacity to deduct the same funding costs under section 8-1 if section 25-90 is repealed, following the necessary restructuring (see further below).

Our further comments on the current basis for the taxation of international arrangements are set out below.

The thin capitalisation regime

The Explanatory Memorandum to the *New Business Tax System (Thin Capitalisation) Bill 2001* which introduced the current thin capitalisation regime relevantly noted[4]:

> *Paragraph 3.7 The new thin capitalisation regime will impose a limit on the extent to which the Australian operations of Australian outward investors can be funded by debt. Accordingly, the current limitations imposed by section 79D and section 8-1 (in relation to exempt income) on interest deductions will be removed in so far as they apply to debt deductions and do not relate to an entity's overseas permanent establishment. Therefore, expenses relating to those deductions will be able to be deducted when incurred in earning exempt foreign income and will no longer be quarantined, subject to the limits imposed by the new thin capitalisation provisions.*

It is our understanding that the simultaneous introduction of section 25-90 and the thin capitalisation regime was intended to reflect the policy intention that the (then new) thin capitalisation rules, and not section 8-1 should constitute the sole limitation on the deductibility of interest expenses in Australia.

Broadening of section 23AJ

It is our understanding that the broadening of section 23AJ as a consequence of the *Review of International Taxation Arrangements* was intended to reflect the international trend towards taxing earnings on a territorial (i.e. source) basis, so as to then exempt such income until it reached the hands of final shareholders.

The following extract from the Board of Taxation's report entitled "International Taxation", which culminated in the Government-accepted Recommendation 3.9 (a general exemption for foreign non-portfolio dividends received by Australian companies and their controlled foreign companies) is particularly relevant:

> *In policy terms, such a change would also produce greater consistency for foreign income. Active income would be subject to CIN [capital import neutrality] at the corporate level — that is, it would be taxed only in the country of source. Low taxed passive income would be subject to attribution under the CFC regime.*
> *…*
>
> *This policy and compliance approach could greatly simplify the system.*[5]

In our view this rationale remains relevant in the current environment, for the following reasons:

- A broad exemption is necessary to maintain Australia's international competitiveness. Specifically, comparable jurisdictions with which Australia competes for foreign investment generally operate on an exemption (rather than taxation and credit) basis. Examples include the United Kingdom, the Netherlands and Singapore.

- As per the principles underpinning the *Review of International Taxation Arrangements,* the taxing rights in relation to the income underpinning the

[4] Explanatory Memorandum to the *New Business Tax System (Thin Capitalisation) Bill 2001*
[5] Paragraphs 3.105 and 3.106, Board of Taxation report, "International Taxation".

payment of a section 23AJ exempt dividend have been allocated to the country in which that income was sourced. As such, it is inappropriate for Australia to seek to tax such amounts further when repatriated as doing so would place Australian outbound investors at a competitive disadvantage.

- Australia's controlled foreign company ("**CFC**") provisions deliberately apply only to passive income i.e. the section 23AJ exemption generally only effectively applies to active income. The logical extension of this policy setting is that repatriated dividends should not be further taxed in Australia.

Rationale for section 25-90

There is no rationale for denying a deduction for interest solely because the outgoing is incurred in deriving income that is exempt pursuant to section 23AJ.

This is because:

- The section 23AJ exemption does not carve the amount out of the corporate tax net altogether i.e. the basis of the exemption is an exercised preference for an exemption system rather than a taxation and credit system on the dual bases of fundamental international taxation principles and resulting compliance cost savings.

- Any income that is not subject to taxation at the company level will still be taxed when distributed to shareholders via the requirement to pay income tax (for Australian shareholders). Amounts paid to non-resident shareholders will either be subject to dividend withholding tax or the relevant exemption in the conduit foreign income rules will be limited by the anti-streaming rules.

- The return on debt capital (i.e. interest) will also generally be subject to tax in the hands of the recipient either via corporate tax (for Australian lenders) or interest withholding tax (for non-resident lenders) unless a specific exemption applies (such as section 128F).

- For the section 23AJ exemption to apply on an in-substance basis i.e. in order to ensure that tax is effectively levied at source and then in the hands of the final shareholder, the costs incurred in deriving such income should be deductible (see further below).

- Thin capitalisation rules were introduced to limit the capacity for arbitrage that exists as a consequence of the difference between the corporate tax rate and the relevant withholding rate. Section 25-90 is not the cause of the remaining capacity for arbitrage. Most amounts currently deductible under section 25-90 only will likely continue to be fully deductible under the general deduction provision if section 25-90 is repealed, if the necessary restructuring and tracing is undertaken.

- As such, removing section 25-90 will not eliminate or even limit the capacity for Australian entities to gear up to the safe harbour debt amount. Should the Government consider the thin capitalisation rules to be inadequate for this purpose, we would be pleased to discuss further. Alternatively, a review by an

independent body such as the Board of Taxation of the thin capitalisation regime and the appropriateness of current settings may be appropriate.

Section 25-90 interaction with the broadened section 23AJ

It is our understanding that the current interaction of section 25-90 and the broadened section 23AJ was intended and appropriate. This is because for the section 23AJ exemption to apply on an in-substance basis i.e. in order to ensure that tax is effectively levied at source and then in the hands of the final shareholder, the costs incurred in deriving such income should be deductible.

That is, section 25-90 is not merely a compliance cost-saving provision, the section is also in line with the principles underpinning the *Review of International Taxation Arrangements*.

Section 25-90 remains appropriate in the present day and does not result in a structural flaw in our international taxation system, either alone or as it interacts with the broadened section 23AJ, for the same reasons that the broadened section 23AJ remains appropriate in the present day (as set out above).

Notably, no amendments to section 25-90 were made or even proposed at the time that the application of section 23AJ was broadened. It is our understanding that this is because as at the time of the broadening of section 23AJ, the thin capitalisation rules were intended to continue to be the primary limitation on the deductibility of interest in Australia i.e. the tool by which the "headroom" (as that term is used in the Paper) would be limited and in some cases eliminated.

<u>Limiting debt deductions in Australia</u>

The thin capitalisation rules (and not section 8-1) continue to be the most appropriate tool by which to restrict the deductibility of interest in Australia, because:

- The thin capitalisation rules apply in respect of the *Australian* assets of the multinational group. As such, the percentage of Australian income on which the tax payable can be eliminated is already in effect limited via the thin capitalisation rules, albeit via the use of Australian assets as a proxy for Australian income.

- The application of the principle that interest should only be deductible if incurred in the production of assessable income (i.e. a matching principle) is not appropriate in the context of the principles underpinning the *Review of International Taxation Arrangements* for the reasons set out above.

- The thin capitalisation rules are already supported by the general anti-avoidance rules in Part IVA (in extreme cases) and also currently supported by the transfer pricing rules in both the existing Division 13 and the new Division 815.

- That the matching principle still applies with respect to the taxation of individuals is not inconsistent with the above, as the taxation of business income is based on fundamentally different principles and businesses do not typically incur private expenses.

Adverse impacts from the repeal of section 25-90

The repeal of section 25-90 will result in:

- Increased compliance costs as a consequence of the changes to funding and investment practices in order to satisfy the practical imperative to trace the use of borrowed funds;

- The need for restructuring of transnational debt to ensure that interest continues to be deductible on a go-forward basis (including potential for realising foreign exchange gains and losses and an increased tax risk from the potential applicability of the general anti-avoidance rules to such restructuring);

- The potentially high cost of the restructuring of such debt, including in the form of break fees with respect to existing debt, and the potential need to raise equity at a time when the cost of capital is high; and

- A high capacity for capricious outcomes on a transitional basis for those taxpayers that have reasonably relied on section 25-90 since its introduction, including the denial of debt deductions for taxpayers that have comparably modest levels of debt and have not engaged in any behaviour that could be classified as "aggressive". The consequences of the repeal of section 25-90 will be borne most heavily by taxpayers that are not able to restructure their long term debt at all. Such outcomes arbitrarily punish taxpayers for legitimately taken commercial decisions;

- A very short effective transitional period and therefore very little time for taxpayers to restructure. In light of the current state of this announcement, the uncertainty surrounding the ATO's response, the upcoming Federal Election and the likely resulting disruptions to the legislative timetable and the lack of clarity as to when these announced changes will become law, the time that taxpayers will have between the enactment of the resulting law and commencement is likely to be very short.

While we appreciate the Government's announcement that the ATO will consult with the tax community with a view to lessening the impact of the amendment on well-meaning taxpayers, we note that the consequences of the repeal are nonetheless likely to be highly disruptive.

Our response to arguments for the repeal of section 25-90

The Paper notes repeatedly that "the evidence shows that the provision is being used to shift profits out of Australia" (page 9) and that "there is now evidence that it [the provision] is being used as a central step of an aggressive tax scheme" (page 5).

We query whether the nature as well as the extent of the 'profit shifting' referred to in the Paper would be possible following the tightening of the thin capitalisation ratio as well as the reform to the exemption for foreign non-portfolio dividends. We also query whether the repeal of section 25-90 is even necessary to stop such 'profit shifting'.

We query the extent to which it is appropriate to repeal a section based on fundamental principles within our international tax system in order to counter specific instances of

"aggressive tax" practices, especially where those practices do not demonstrate a structural flaw in the principles-based system.

In this regard, we consider that the general anti-avoidance rules would likely be applicable to the type of 'aggressive' tax practice described in the Proposals Paper, despite the recent case of *Noza Holdings*[6], which was exceedingly fact-specific in nature. While section 25-90 specifically bestows a deduction in certain circumstances, the general anti-avoidance rule may nevertheless apply where a taxpayer has specifically structured their tax affairs in order to avail themselves of the resulting deduction. Such an outcome is potentially 'enhanced' as a result of the recent amendments to the general anti-avoidance rule.

We query the extent to which repealing section 25-90 will have the desired effect of limiting profit shifting, as a consequence of the capacity to restructure to ensure that the debt can be traced back to assessable income from Australian operations. Paragraph 3.4 of the Explanatory Memorandum to the *New Business Tax System (Thin Capitalisation) Bill 2001* is enlightening in this regard:

> *… section 8-1 denies deductions incurred in earning exempt (foreign) income. However, because all of these rules rely on tracing the use of borrowed funds, it is relatively easy to circumvent their operation by establishing a use of funds that ensures deductibility.*

Should the Government be of the view that even after the announced reforms to the thin capitalisation safe harbour ratio and the exemption for foreign non-portfolio dividends:

- There is scope for 'aggressive' tax practices to continue;
- There is scope for "headroom" (as that term is used in the Paper); and
- The "headroom" inappropriately allows multinationals to gear their Australian operations more highly than is commercially reasonable;

we query why the Government considers that the repeal of section 25-90 would be an appropriate or even effective tool to address these concerns. Furthermore, we query why this function would not instead be better performed via an evaluation of the balance of the thin capitalisation regime via an independent body, such as the Board of Taxation or the limitation of section 25-90 via a specific integrity rule.

<u>The way forward</u>

As set out above, we consider the announced repeal of section 25-90 to be misguided as it will not achieve its intended objectives and will instead cause much collateral damage for well-meaning taxpayers. As such, we strongly recommend that the Government reconsiders the appropriateness of the announced repeal.

Failing the above, we strongly recommend that the Government at least clarifies that section 25-90 will continue to apply in respect of interest incurred in deriving income that is exempt as a consequence of sections 23AI and 23AK.

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[6] *Commissioner of Taxation v Noza Holdings Pty Ltd* [2012] FCAFC 43

Furthermore, we recommend that the Government clarifies any specific concerns with the "headroom" available to taxpayers and why the announced tightening of the thin capitalisation rules and reforms to the exemption for foreign non-portfolio dividends will not be sufficient to address the Government's concerns. We would be pleased to discuss the Government's concerns in more detail, including with respect to other amendments that may address these concerns without such adverse effects for well-meaning taxpayers and without jeopardising Australia's international competitiveness.

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Should you wish to discuss any of the above, please do not hesitate to contact either me or Tax Counsel, Deepti Paton on 02 8223 0044.

Yours sincerely

Steve Westaway
President