THE TAX INSTITUTE

THE MARK OF EXPERTISE

10 June 2014

General Manager
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The Treasury
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By email: taxlawdesign@treasury.gov.au

Dear Mr Atfield,

Thin capitalisation and 23AJ

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to the *Tax and Superannuation Laws Amendment (2014 Measures No. 3) Bill 2014: Thin capitalisation and 23AJ* (**Exposure Draft**). Our comments focus specifically on the proposed increase to the *de minimis* threshold.

In accordance with Item 15 of Part 5 of the Exposure Draft, section 820-35 of *Income Tax Assessment Act 1997* will state:

> ***820-35 Application—$2 million threshold***
>
> *Subdivision 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 total debt deductions of that entity and all its *associate entities for that year are $2 million or less*

Section 815-140 of the *Income Tax Assessment Act 1997* states:

> ***815-140 Modification for thin capitalisation***
>
> *815-140(1) This section modifies the way an entity to which section 815-115 applies works out its taxable income, or its loss of a particular *sort, for an income year, if:*
>
> *(a) Division 820 (about thin capitalisation) applies to the entity for the income year; and*
> *(b) the *arm's length conditions affect costs that are *debt deductions of the entity for the income year.*
>
> *815-140(2) If working out what those costs would be if the *arm's length conditions had*

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*operated involves applying a rate to a *debt interest:*

(a) work out the rate as if the arm's length conditions had operated; but
(b) apply the rate to the debt interest the entity actually issued.

Note:

Division 820 may apply to reduce or further reduce debt deductions.

The wording of section 815-140(1)(a) above excludes entities to which Division 820 applies from the transfer pricing requirement in section 815-140(2). Our preferred interpretation of section 820-35 is that Division 820 technically applies to entities within the *de minimis* threshold in that section and that those entities can therefore satisfy section 815-140(1)(a). We suggest that this interpretation be confirmed in the Explanatory Memorandum to the Exposure Draft.

The alternative interpretation is that entities within section 820-35 cannot satisfy section 815-140(1)(a). This would result in unintended consequences for a number of taxpayers by increasing rather than decreasing the amount of tax they would be required to pay. The increase in the *de minimis* threshold only exacerbates this problem under the alternative interpretation. This concern is best illustrated by the example below.

Example under alternative interpretation

A taxpayer is the Australian subsidiary of a foreign-based multinational enterprise. It has a gearing ratio of 3:1 to stay within the current thin cap safe harbour limits. Its only debt (and its only international related party dealing) is an AUD30 million loan from its foreign parent company on which it pays interest at a rate of 6%. It paid interest of $1.8 million to its foreign parent during the year. It has $10 million of equity.

Under the current rules

The entity's debt deductions exceed thus exceed the current $250,000 *de minimis* threshold.

Assumptions:

- An arm's length capital structure for the entity is 1:1.
- An arm's length interest rate on an arm's length capital structure for the entity is 6%.

Analysis:

Under the transfer pricing rules, and apart from the operation of section 815-140 of the *Income Tax Assessment Act 1997* discussed below, the arm's length conditions (i.e. an arm's length capital structure of 1:1) are deemed to replace the actual conditions (i.e. a capital structure geared at 3:1). The entity on a self-assessment basis or the ATO subsequently would have regard to the reconstruction provisions in section 815-130

and could recharacterise $10 million of the related party debt as equity, being the amount in excess of an arm's length amount of debt based on an arm's length capital structure of 1:1 (ie $20 million of debt and $20 million of equity). As a consequence, the $600,000 of interest paid on the $10 million of recharacterised debt would be disallowed as a deduction.

However, the above outcome does not arise under current law due to the operation of section 815-140. The effect of section 815-140 is to allow taxpayers to gear up to the thin capitalisation safe harbour limits notwithstanding a different gearing outcome arises under the transfer pricing rules.

Given that the entity is within the thin capitalisation safe harbour limits and has paid an arm's length rate of interest on its related party debt, the transfer pricing rules would not apply to disallow any interest expense.

A similar example is given in TR 2014/D3 at paragraphs 53-60 and reference is also made to the Explanatory Memorandum to *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* at paragraphs 3.143-3.149.

Under proposal to increase the de minimis threshold to $2 million

The facts and assumptions are the same as in the above example. The only change is that, based on the alternative interpretation, Division 820 does not apply to this taxpayer as its debt deductions would be less than the proposed $2 million *de minimis* threshold.

Analysis:
Application of the transfer pricing rules, apart from section 815-140, would be the same as described above (i.e. $600,000 of interest would be disallowed as a deduction).

However, on the alternative interpretation, section 815-140(2) does not apply to the entity as the thin capitalisation rules do not apply to the entity due to its interest expense being below the $2 million *de minimis* threshold (paragraph 815-140(1)(a)).

Consequently, the transfer pricing rules would apply to disallow $600,000 of interest as a deductible expense. The entity is therefore worse off than it was before the *de minimis* threshold was increased. In our view, such an outcome could not have been intended by the government.

The Tax Institute supports in principle the proposed increase in the *de minimis* threshold, however, the proposed increase in its current form will leave some taxpayers worse off, if the alternative interpretation of section 820-35 and 815-140 applies.

This concern was raised on pp 4-5 of The Tax Institute's submission[1] dated 19 July 2013 to Treasury on the Proposals Paper entitled "*Addressing profit shifting through the artificial loading of debt in Australia*" dated June, 2013.

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If you would like to discuss any of the above, please contact either me or Tax Counsel, Thilini Wickramasuriya, on 02 8223 0044.

Yours sincerely

Michael Flynn
President

[1] http://www.taxinstitute.com.au/submissions/addressing-profit-shifting-through-the-artificial-loading-of-debt-in-australia