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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAX AND SUPERANNUATION LAWS AMENDMENT (2014 MEASURES NO. #) BILL 2014

EXPLANATORY MEMORANDUM

(Circulated by the authority of the
Treasurer, the Hon J. B. Hockey MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	*Definition*
AASB	Australian Accounting Standards Board
ADI	authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
CFC	controlled foreign company
IASB	International Accounting Standards Board
IFRS	international financial reporting standards
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
NANE	non-assessable non-exempt
non-ADI	not an authorised deposit-taking institution

Chapter 1
Thin capitalisation

Outline of chapter

1.1 Schedule # to this Bill tightens the debt limit settings in the thin capitalisation rules to ensure that multinationals do not allocate a disproportionate amount of debt to their Australian operations. Schedule # also increases the *de minimis* threshold to minimise compliance costs for small businesses, and introduces a new worldwide gearing test for inbound investors.

Context of amendments

1.2 The current thin capitalisation rules were introduced in 2001 following the Ralph Review. It was intended to prevent multinationals from profit shifting by allocating a disproportionate amount of debt in their Australian operations, and claiming excessive debt deductions in Australia, thereby reducing their Australian taxable income. If the Australian operations are funded by excessive debt, they are said to be 'thinly capitalised'.

1.3 Multinationals have the flexibility to determine where international financing can occur and how debt will be allocated within the group, through intra-group funding arrangements. This provides them with the opportunity to influence the jurisdiction that deductions for interest are claimed, for example, by allowing them to claim a greater proportion of debt deductions in higher taxing jurisdictions where debt deductions are often more valuable. This can effectively reduce or negate Australian income tax while improving after tax profits for the multinational group.

1.4 The thin capitalisation rules operate by disallowing a proportion of otherwise deductible debt related expenses where the debt allocated to a multinational's Australian operations exceeds certain limits (or where there is a capital shortfall in the case of authorised deposit-taking institutions (ADIs)). These limits are determined by reference to the greater of a 'safe harbour' debt amount, an 'arm's length' debt amount and, currently for certain outbound investors the 'worldwide gearing' debt amount. This does not prevent the Australian operations from assuming higher levels of debt; however, the debt deductions will be denied where

the relevant debt limits are exceeded. For ADIs (principally banks), the tests are framed as a minimum requirement for equity capital, which are based on prudential regulatory requirements.

1.5 Setting these debt limits involve balancing a number of factors, including minimising unnecessary compliance costs for multinationals, ensuring that the debt limits do not impede the efficient allocation of capital, and maintaining the integrity of the revenue base.

1.6 When first introduced, the debt limits were intended to provide broad coverage to accommodate commercial gearing levels across a range of industries. While gearing practices vary, recent data[1] suggests these limits are now higher than the normal gearing levels of most corporates with truly independent financing arrangements, which is often less than 1:1 on a debt-to-equity basis.

1.7 The gap between the statutory debt limits and the actual gearing levels of most companies can have a distorting effect on debt allocation decisions for the Australian operations of domestic and foreign multinationals. It may encourage multinationals to allocate excessive debt to Australia for tax purposes, rather than for commercial reasons.

1.8 To address this, the Government announced on 6 November 2013 that it would proceed with reforms to tighten the thin capitalisation limits. It also announced that it would increase the *de minimis* threshold to minimise compliance costs for small businesses, and introduce a new worldwide gearing test for inbound investors.

Summary of new law

1.9 The thin capitalisation rules will be tightened to prevent erosion of the Australian tax base by:

- reducing the maximum debt limit from 3:1 to 1.5:1 (on a debt-to-equity basis) for general entities and from 20:1 to 15:1 (on a debt-to-equity basis) for non-bank financial entities;

- reducing the 'outbound' worldwide gearing ratio from 120 per cent to 100 per cent with an equivalent adjustment to worldwide capital ratio for ADIs; and

[1] Based on 2011 tax return data for a large number of taxpayers.

- increasing the safe harbour capital limit for ADIs from 4 per cent to 6 per cent of their risk weighted Australian assets.

1.10 To minimise compliance costs for small businesses, the *de minimis* threshold for the application of the thin capitalisation limits will be increased from $250,000 to $2 million of debt deductions.

1.11 To provide greater flexibility for inward investors, a new 'inbound' worldwide gearing ratio test will be introduced. This test allows the financial markets to limit gearing, and mirrors market outcomes for businesses that, as a whole, have naturally higher gearing levels. This will provide a further option to inward investing entities, where they do not fall within the safe harbour limit, and do not meet the arm's length debt test. To minimise compliance costs, this test will utilise the consolidated financial statements that are already required to be prepared by the foreign parent.

Comparison of key features of new law and current law

New law	***Current law***
The safe harbour debt limit for general entities (non-ADI) is 1.5:1 on a debt-to-equity basis.	The safe harbour debt limit for general entities (non-ADI) is 3:1 on a debt-to-equity basis.
The safe harbour debt limit for financial entities (non-ADI) is 15:1 on a debt-to-equity basis.	The safe harbour debt limit for financial entities (non-ADI) is 20:1 on a debt-to-equity basis.
The safe harbour capital limit for an ADI is increased to 6 per cent of its risk weighted Australian assets.	The safe harbour capital limit for an ADI is 4 per cent of its risk weighted Australian assets.
The worldwide debt limit for outward investing entities (non-ADI) allows the Australian operations, in certain circumstances, to be geared at up to 100 per cent of the gearing of the entity's worldwide group.	The worldwide debt limit for outward investing entities (non-ADI) allows the Australian operations, in certain circumstances, to be geared at up to 120 per cent of the gearing of the entity's worldwide group.
The worldwide capital amount for ADIs allows the entity's Australian operations to be capitalised at 100 per cent of the capital ratio of the Australian entity's worldwide group.	The worldwide capital amount for ADIs allows the entity's Australian operations to be capitalised at 80 per cent of the capital ratio of the Australian entity's worldwide group.
The *de minimis* threshold is debt deductions of $2 million or less.	The *de minimis* threshold is debt deductions of $250,000 or less.
A new worldwide gearing debt limit	There is currently no equivalent test.

will be available to inward investing entities, to be applied if the entity's chooses.	

Key concepts and summary of current framework

1.12 There are a number of debt limits currently set out in Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997). These debt limits vary depending on whether the entity is inward investing or outward investing, and the type of entity (general, financial or ADI).

Outward and inward investing entities

1.13 Different debt limit tests also apply depending on whether an entity is an inward investing entity or an outward investing entity.

1.14 An inward investing entity is a foreign controlled Australian resident entity, and any foreign entity that carries on business at or through an Australian permanent establishment, or has direct investments within Australia.

1.15 An outward investing entity is an Australian resident entity that controls any foreign entity or carries on business at or through an overseas permanent establishment, and an Australian associate entity of another outward investor.

ADI or non-ADI (general and financial)

1.16 An ADI is an authorised deposit-taking institution for the purposes of the *Banking Act 1959*.

1.17 In the case of non-ADIs, debt deductions will be disallowed where the maximum allowable debt is exceeded. In the case of ADIs, debt deductions will be disallowed where the minimum capital requirement is not met.

1.18 A non-ADI entity is further classified as being either a financial entity or a general entity. A financial entity is defined in section 995-1 of the ITAA 1997. A general entity is any entity that is neither a financial entity nor an ADI.

Summary of current debt limits

Maximum allowable debt (non-ADI)

1.19 A taxpayer's maximum allowable debt for both inward investing entities (non-ADI) and outward investing entities (non-ADI) is the greater of the following amounts:

- the safe harbour debt limit: different limits apply depending on whether the entity is a general entity or a financial entity; or
- the arm's length debt limit: this limit seeks to benchmark commercial or truly independent debt outcomes.

1.20 Outward investing entities (non-ADI) may also elect to apply the worldwide gearing ratio limit, which allows gearing of the Australian operations based on the debt-to-equity ratio of the worldwide group.

Minimum capital amount (ADIs)

1.21 An ADI's minimum capital amount for both inward and outward investing entities is the lesser of the following amounts:

- the safe harbour capital amount: this limit is based on the entity's risk-weighted Australian assets; or
- the arm's length capital amount: this limit seeks to benchmark commercial or truly independent debt outcomes.

1.22 Outward investing entities (ADI) may also elect to apply the worldwide capital amount.

Detailed explanation of new law

Safe harbour debt limit (non-ADI)

1.23 The thin capitalisation rules, when first introduced, were intended to provide broad coverage to accommodate commercial gearing levels across a range of industries.

1.24 However, the gearing ratio allowed in the safe harbour debt limits is now much higher than the normal gearing levels of most corporates with truly independent arrangements.

1.25 To address this, the safe harbour debt limit for:

- outward investors (general);
- inward investors (general); and
- inward investment vehicles (general)

will be reduced from 3:1 to 1.5:1 on a debt-to-equity basis. ***[Schedule #, Part 1, items 1, 3 and 5, method statements in sections 820-95, 820-195, 820-205]***

1.26 The safe harbour debt limit for:

- outward investors (financial);
- inward investors (financial); and
- inward investment vehicles (financial).

will also be reduced from 20:1 to 15:1 on a debt-to-equity basis. ***[Schedule #, Part 1, items 2, 4 and 6, method statements in subsections 820-100(2), 820-200(2), 820-210(2)]***

Safe harbour capital amount (ADIs)

1.27 In contrast to non-ADIs, the safe harbour test for ADIs is determined by reference to a minimum capital amount (rather than a maximum allowable debt). Debt deductions claimed by the ADI may be disallowed if the minimum capital requirement is not met.

1.28 Under the current law, an inward investing ADI is required to have capital equal to 4 per cent of its Australian risk-weighted assets. An outward investing ADI is subject to the same minimum requirement, but must also have capital to match certain other Australian assets.

1.29 Under the new law, the safe harbour capital limit for inward and outward investing ADIs will be increased from 4 per cent to 6 per cent of their risk-weighted assets. ***[Schedule #, Part 4, items 12 to 14, method statement in subsections 820-310(1) and 820-615(3), and section 820-405]***

1.30 The 'risk-weighted assets' of the entity means the sum of the assessed risk exposures calculated in accordance with the prudential standards determined by the prudential regulator in the jurisdiction of the foreign bank or by the Australian Prudential Regulation Authority (APRA).

Worldwide gearing debt limit for outward investing entities (non-ADI)

1.31 Currently, an outward-investing entity that is non-ADI which is not also an inward investing vehicle may exceed the safe harbour debt amount without having deductions denied if it does not exceed the worldwide gearing debt amount.

1.32 The effect of the worldwide gearing rule is to allow the Australian operations, in certain circumstances, to be geared at up to the level of the gearing of the Australian entity's worldwide group.

1.33 The worldwide gearing ratio applying to general and financial outward investors, will be reduced from 120 per cent of the gearing of the entity's worldwide group to 100 per cent of the gearing of the entity's worldwide group. ***[Schedule 1, Part 2, items 9 and 10, method statements in section 820-110]***

1.34 For the purposes of this test, the gearing of the entity's worldwide group is determined by reference to method statements contained in section 820-110 of the ITAA 1997.

1.35 A new worldwide gearing test will also be introduced for inward investing entities (non-ADI), should these entities choose to apply it. The new test is explained below.

New worldwide gearing debt limit for inward investing entities (non-ADI)

1.36 The worldwide gearing test, currently only available to outward investing entities that are also not foreign controlled, will also be extended to inward investing entities that are not an ADI ***[Schedule #, Part 6]***. The new test will also be available to an entity that is both an inward investing entity (non-ADI) and also an outward investing entity (non-ADI) ***[Schedule #, Part 2, item 8, paragraph 820-90(2)(c)]***.

1.37 This will provide further flexibility to inward investing entities (non-ADI) that do not meet the safe harbour test or the arm's length debt test.

1.38 Allowing a worldwide gearing test to be available to inward investing entities (non-ADI) also better reflects the policy intent of the thin capitalisation rules to prevent the disproportionate allocation of debt to Australia for tax purposes. It achieves this by allowing the Australian operations to claim deductions on their debt where they are geared to the same level as the global group.

1.39 As a result, the new worldwide gearing test for inward investing entities (non-ADI) will provide greater flexibility by allowing the

financial markets to limit gearing in cases where the statutory safe harbour limits are exceeded.

1.40 Under the new law, the maximum allowable debt for an inward investing entity (non-ADI) in an income year will be the greatest of the following amounts, as calculated under Subdivision 820-C of the ITAA 1997:

- the safe harbour debt amount;
- the arm's length debt amount;
- the worldwide gearing debt amount (unless the entity's worldwide equity is negative).

[Schedule #, Part 6, items 16 and 17, section 820-190]

Which types of entities can choose to apply the new test?

1.41 The new worldwide gearing test will be available to all inward investing entities (non-ADI), should they choose to apply it. That is, any of the following entities can choose to apply the new test:

- inward investment vehicles (general);
- inward investment vehicles (financial);
- inward investors (general); and
- inward investors (financial).

[Schedule #, Part 6, item 20, sections 820-216 to 820-219]]

1.42 If an inward investing entity (non-ADI) is also an outward investing entity (non-ADI), then it can also choose to apply the new worldwide gearing test. That is, the new worldwide gearing test will apply to:

- an entity that is an inward investing entity (non-ADI); and
- an entity that is both an inward investing entity (non-ADI) and also an outward investing entity (non-ADI).

[Schedule 1, Parts 2 and 6, items 8 and 17 respectively, paragraphs 820-90(2)(c) and 820-190(c)]

1.43 This ensures that entities that are both inward and outward investment vehicles have access to the new inbound worldwide gearing

test, as they cannot use the existing outbound worldwide gearing test under subsection 820-90(2) of the ITAA 1997.

1.44 The new worldwide gearing test does not apply to ADIs, as these entities apply a separate worldwide capital test.

Is the new test mandatory to apply?

1.45 An inward investing entity does not need to apply the new test if it satisfies another applicable debt limit test.

1.46 For example, if an inward investing entity applies the relevant safe harbour debt limit and determines that it has not exceeded its maximum allowable debt, then it does not need to also apply the new worldwide gearing test.

How does the new test work?

1.47 The calculation of the worldwide gearing debt amount differs depending on the type of entity:

- For an inward investor (general), the worldwide gearing debt amount is calculated using the steps outlined in paragraph 1.48 (also see section 820-218 of the ITAA 1997).
- For an inward investor (financial), the worldwide gearing debt amount is calculated using the steps outlined in paragraph 1.49 (also see section 820-219 of the ITAA 1997).
- For an inward investment vehicle (general), including where it is also an outward investing entity, the worldwide gearing debt amount is calculated using the steps outlined in paragraph 1.50 (also see section 820-216 of the ITAA 1997).
- For an inward investment vehicle (financial), including where it is also an outward investing entity, the worldwide gearing debt amount is calculated using the steps outlined in paragraph 1.51 (also see section 820-217 of the ITAA 1997).
- For an outward investing entity (non-ADI), that is also not an inward investment vehicle (general or financial), the worldwide gearing debt amount continues to be calculated under section 820-110.

1.48 For an entity that is an inward investor (general), the worldwide gearing debt amount is calculated as follows:

Step 1: Divide the entity's worldwide debt for the income year by the entity's worldwide equity for that year (see further below for an explanation of worldwide debt and worldwide equity).

Step 2: Add 1 to the result of step 1.

Step 3: Divide the result of step 1 by the result of step 2.

Step 4: Multiply the result of step 3 above by the result of step 4 in the method statement in section 820-205.

Step 5: Add to the result of step 4 the average value, for that year, of the entity's associate excess amount. The result of this step is the worldwide gearing debt amount.

[Schedule #, Part 6, item 20, section 820-218]

1.49 For an entity that is an inward investor (financial), the worldwide gearing debt amount is calculated as follows:

Step 1: Divide the entity's worldwide debt for the income year by the entity's worldwide equity for that year (see further below for an explanation of worldwide debt and worldwide equity).

Step 2: Add 1 to the result of step 1.

Step 3: Divide the result of step 1 by the result of step 2.

Step 4: Multiply the result of step 3 above by the result of step 5 in the method statement in section 820-210(2).

Step 5: Add to the result of step 4 the average value, for that year, of the entity's zero capital amount (that has arisen because of the Australian investments). The result of this step is the worldwide gearing debt amount.

[Schedule #, Part 6, item 20, section 820-219]

1.50 For an entity that is an inward investment vehicle (general), including where the entity is also an outward investing entity, the worldwide gearing debt amount is calculated as follows:

Step 1: Divide the entity's worldwide debt for the income year by the entity's worldwide equity for that year (see further below for an explanation of worldwide debt and worldwide equity).

Step 2: Add 1 to the result of step 1.

Step 3: Divide the result of step 1 by the result of step 2.

Step 4: Multiply the result of step 3 above by the result of step 4 in the method statement in section 820-195 (or, if the entity is also an outward investing entity (non-ADI), multiply by the result of step 6 in the method statement in section 820-95).

Step 5: Add to the result of step 4 the average value, for that year, of the entity's associate excess amount. The result of this step is the worldwide gearing debt amount.

[Schedule #, Part 6, item 20, section 820-216]

1.51 For an entity that is an inward investment vehicle (financial), including where the entity is also an outward investing entity, the worldwide gearing debt amount is calculated as follows:

Step 1: Divide the entity's worldwide debt for the income year by the entity's worldwide equity for that year (see further below for an explanation of worldwide debt and worldwide equity).

Step 2: Add 1 to the result of step 1.

Step 3: Divide the result of step 1 by the result of step 2.

Step 4: Multiply the result of step 3 above by the result of step 5 in method statement in subsection 820-200(2) (or, if the entity is also an outward investing entity (non-ADI), multiply by the result of step 7 in the method statement in 820-100(2)).

Step 5: Add to the result of step 4 the average value, for that year, of the entity's zero-capital amount (other than any zero-capital that is attributable to the entity's overseas permanent establishments).

Step 6: Add to the result of step 5 the average value, for that year, of the entity's associate entity excess amount. The result of this step is the worldwide gearing debt amount.

[Schedule #, Part 6, item 20, section 820-217]

Further explanation of the steps in the method statements

1.52 Steps 1 to 3 under each of the calculations set out above is intended to obtain a gearing ratio for the entity (further explanation of step 1 is below).

1.53 Step 4 is intended to apply that gearing ratio to the amount of the entity's Australian adjusted assets, as determined by reference to entity's equivalent safe harbour gearing amount.

1.54 For financial entities, an additional step has been included to add the entity's zero capital amount to permit higher levels of gearing where the financial entity has assets that are effectively allowed to be fully debt funded.

1.55 For both general and financial entities, the associate excess amount is added to determine the worldwide gearing debt amount. Associate entity equity is deducted from an entity's assets as an integrity measure to prevent over-gearing from the cascading of equity through chains of entities. The associate entity equity rule can produce harsh outcomes where the value of the associate entity equity is not used to fully leverage debt in the associate. In order to address this, the 'associate entity excess amount' allows excess debt capacity of an associate entity to be carried back to the entity with the equity investment.

'Worldwide debt' and 'worldwide equity' under step 1

1.56 For step 1 (under all of the inward calculations set out above), the entity's 'worldwide debt' and 'worldwide equity' will, for the purposes of the new test, be determined by reference to amounts shown in the audited consolidated financial statements that are prepared by the entity's foreign parent, provided the statements satisfy specified requirements. ***[Schedule #, Part 6, item 21, section 820-933]***

1.57 That is, for the purposes of the new test for inward investing entities (non-ADI), accounting concepts are used to determine:

- the amount of the entity's 'worldwide debt';
- the amount of the entity's 'worldwide equity'; and
- the entities that are to be included in the worldwide group, as the inclusion of entities in the audited consolidated financial statements are based on the accounting concept of control.

1.58 The reliance on accounting concepts is intended to minimise compliance costs, as the calculation of the maximum allowable debt will

be based on figures that are already required to be calculated as part of the foreign parent's consolidated financial reports.

1.59 The consolidated financial statements must be prepared in accordance with any of the following standards:

- international financial reporting standards (IFRS) that are made or adopted by the International Accounting Standards Board (IASB); or
- the accounting standards that are permitted or required in any of the following jurisdictions:
  - the European Union;
  - the United States of America;
  - Canada;
  - Japan;
  - any other jurisdiction that the Minister specifies by legislative instrument.

[Schedule #, Part 6, item 20, subsection 820-217(5)]

1.60 These jurisdictions are broadly based on those that are currently accepted for the separate existing requirement for inward investing entities to prepare financial statements for their permanent establishments (see subsections 820-960(1C) and (1D) of the ITAA 1997). However, allowance has been made to allow for other jurisdictions to be included where the Minister specifies. Whilst New Zealand is specifically mentioned in subsection 820-960(1C) of the ITAA 1997, it has not been listed separately, as it is considered to have adopted IFRS.

1.61 This requirement does not mean that the entity's foreign parent needs to be resident in a listed jurisdiction. Rather, the entity's foreign parent must have complied with all applicable accounting standards that are required or permitted in a listed jurisdiction in preparing its consolidated financial statements.

1.62 The consolidated financial statements must also show certain amounts that are relevant to the calculation of the new test. These amounts include the following (however described):

- liabilities;

- provisions;
- contingent liabilities;
- liabilities in relation to distributions to equity participants, for example, dividends that have been declared but not yet paid;
- liabilities relating to employee benefits; and
- net assets (or equity).

[Schedule 1, Part 6, item 21, paragraph 820-933(4)(b)]

1.63 It is not necessary for these amounts to be separately presented on the statements if this type of presentation is not required by the relevant accounting standards. For example, it would not be necessary to separately disclose liabilities relating to employee benefits as a separate line item on the statement of financial position, if a relevant accounting standard allowed this amount to be presented as part of a more general category of liabilities. However, it is necessary for these amounts to be calculated in accordance with the relevant accounting standards on a consolidated basis, and for these amounts to be reflected in the financial statements in a way those standards permit.

1.64 To calculate the amount of worldwide debt under step 1, the following steps must be followed:

Step 1: start with the total amount of liabilities.

Step 2: reduce the result of step 1 by the amount of provisions and contingent liabilities;

Step 3: reduce the result of step 2 by the amount of liabilities in relation to distributions to equity participants;

Step 4: reduce the result of step 3 by the amount of liabilities relating to employee benefits. The result of this step is the entity's worldwide debt for the income year.

[Schedule 1, Part 6, item 21, subsection 820-933(2)]

1.65 This calculation is intended to better reflect the amount of 'debt' for the consolidated group. As accounting standards generally use the concept of liability, which is broader than the concept of debt, various adjustments are made to the consolidated liabilities to deduct certain amounts of liabilities that are non-debt in nature. For example, liabilities relating to employee benefits and those that relate to declared unpaid distributions.

1.66 For an income year, the consolidated financial statements that are to be relied upon for the purposes of the test must be the statements for an annual period that ends no later than 12 months before the start of the income year ***[Schedule #, Part 6, item 21, paragraph 820-933(4)(d)]***. This would allow the new test to be calculated for an income year using the consolidated financial statements prepared by the entity's foreign parent for the previous accounting period.

1.67 This requirement is intended to balance the need to ensure that the most recent financial statements are used (to increase the relevance and reliability of the amounts used in the test) whilst recognising that the consolidated financial statements are prepared on a historical basis and may lag the income year in which the new test is being applied.

1.68 To ensure the integrity of the new worldwide gearing test, the consolidated financial report will need to be audited in accordance with a foreign law to which the foreign parent is subject. ***[Schedule #, Part 6, item 21, paragraph 820-933(4)(c)]***

1.69 The auditor's report must also be unqualified ***[Schedule #, Part 6, item 21, paragraph 820-933(4)(c)]***. This is intended to enhance the reliability and integrity of the financial information being relied upon for the purposes of the new test.

Worldwide capital amount for outward investing entities (ADIs)

1.70 Outward investing entities that are ADIs can currently use the worldwide capital amount test in section 820-320 of the ITAA 1997, if they are also not a foreign controlled Australian entity throughout the income year.

1.71 Currently, the worldwide capital amount allows an Australian ADI with foreign investments to fund its Australian investments with a minimum capital ratio equal to 80 per cent of the Tier 1 capital ratio of its worldwide group.

1.72 Under the new law, the worldwide capital amount will allow an Australian ADI with foreign investments to fund its Australian investments with a minimum capital ratio equal to 100 per cent of the Tier 1 capital ratio of its worldwide group. ***[Schedule #, Part 3, item 11, method statement in subsection 820-320(2)]***

1.73 For the purposes of this test, the Tier 1 capital ratio (and more broadly, the worldwide capital amount) is determined by reference to the method statements contained in section 820-320 of the ITAA 1997.

De minimis threshold

1.74 Currently, the thin capitalisation rules do not disallow any debt deductions of an entity, if the entity and all its associate entities have debt deductions of $250,000 or less (the *de minimis* threshold).

1.75 To reduce compliance costs and ensure that small businesses are protected from the effects of the thin capitalisation debt tests, the current *de minimis* threshold will be increased from debt deductions of $250,000 or less, to $2 million or less. ***[Schedule #, Part 5, item 15, section 820-35]***

Consequential amendments

1.76 As a result of the changes to the thin capitalisation debt limits, several consequential amendments have been made to update figures and calculations contained in various examples throughout Division 820 of the ITAA 1997. ***[Schedule #, Part 7, items 24-25, 27, 30, 33, 35-36, 38-40, 42, 44-45 and 47]***.

1.77 Consequential amendments have also been made to update cross-references to the revised debt limits, in various method statements throughout Division 820 of the ITAA 1997. ***[Schedule #, Part 7, items 26, 37, 41, 49 and 50]***

1.78 As the *de minimis* threshold has increased from $250,000 of debt deductions to $2 million of debt deductions, various cross-references to the threshold amount have been updated to reflect the new threshold amount. ***[Schedule #, Part 7, items 23, 34, 43, 46, 48 and 51]***

Application provision

1.79 The amendments apply to income years starting on or after 1 July 2014 ***[Schedule #, Part 8, item 55]***.

Chapter 2
Foreign dividends

Outline of chapter

2.1 Schedule # to this Bill reforms the exemption for foreign non-portfolio dividends.

Context of amendments

2.2 Currently, a non-portfolio foreign dividend (that is, a dividend on a voting interest of at least 10 per cent in a foreign resident company) is non-assessable non-exempt (NANE) income when paid to an Australian resident company (see section 23AJ of the *Income Tax Assessment Act 1936* (ITAA 1936)).

2.3 The intention of this exemption is to make non-portfolio returns on equity to Australian resident companies exempt of Australian tax, to remove the Australian tax burden from active business income earned by a foreign subsidiary of an Australian owned company. This helps ensure that the foreign subsidiaries are able to compete on an equal footing with other businesses located in that foreign country.

2.4 However, under the current rules, the exemption can also apply in circumstances where the investment instrument is treated as a debt instrument, for example, in the case of redeemable preference shares. This has led to unintended consequences arising from the interaction of the thin capitalisation rules, the core tax rules for determining what is debt and what is equity (the debt equity rules) and the exemption. This arises in circumstances where an Australian company uses a 'debt instrument' which also qualifies for the exemption to fund an offshore expansion. Offshore acquisitions effected in this way are currently unconstrained by the thin capitalisation rules contrary to the initial policy intent.

2.5 Also, the exemption in section 23AJ only applies only in instances where the dividend is received directly by the Australian company from the foreign company. That is, where a dividend from a foreign company passes through a trust or partnership it is no longer eligible for the exemption. There is, however, no economic difference between holding the equity interests directly or indirectly through a trust or partnership.

Summary of new law

2.6 The exemption for foreign dividends has been modernised and re-written into the ITAA 1997 to:

- ensure that it applies to returns on instruments treated as 'equity interests' under the debt-equity rules. This is intended to exclude any returns on 'debt interests' from the exemption and also allow the exemption to apply in respect of a broader range of equity-like interests, rather than interests that involve significant voting rights;
- allow it to apply where a distribution flows through interposed trusts and partnerships other than corporate tax entities; and
- allow it to apply in respect of distributions of a non-share dividend, which is not included in the definition of a distribution.

2.7 In addition, the ability to pool portfolio dividends (that is, where the interest is less than 10 percent) in an offshore entity in order to qualify for an exemption under section 23AJ of the ITAA 1936 will be removed. This type of arrangement is contrary to the intention of the exemption, which is intended to apply to non-portfolio dividends where the interest is at least 10 per cent.

Comparison of key features of new law and current law

New law	***Current law***
The exemption will apply where an Australian company holds a participation interest of at least 10 per cent in a foreign company.	The exemption for non-portfolio dividends applies where an Australian company holds a voting interest of at least 10 per cent (the non-portfolio test).
The exemption will apply where the foreign equity distribution is made in respect of an equity interest in the foreign company. This will ensure that the exemption is not available in respect of returns on debt interests. It will also allow the exemption to apply in respect of a broader range of equity interests, not only voting interests.	The exemption for non-portfolio dividends applies where the dividend is made in respect of a voting interest in the foreign company. As a result, some returns on debt-like interests (such as redeemable preferences shares) may currently be eligible for the exemption.

The exemption will apply in respect of distributions of a non-share dividend.	The exemption for non-portfolio dividends does not apply in respect of a non-share dividend.
The exemption for foreign dividends will apply where a dividend flows through an interposed trust or partnership, other than a corporate tax entity.	The exemption for non-portfolio dividends does not apply to dividends that flow through interposed trusts or partnerships.
The ability to pool portfolio dividends in an offshore entity to qualify for the non-portfolio exemption will be removed.	It is possible to pool portfolio dividends in an offshore entity in order to qualify for the non-portfolio exemption.

Detailed explanation of new law

Foreign equity distributions on participation interests

2.8 The new exemption for foreign equity distributions on participation interest replaces the existing test in section 23AJ of the ITAA 1936 for non-portfolio dividends.

2.9 If an Australian company holds a participation interest of at least 10 per cent in a foreign company, and receives a foreign equity distribution from the foreign company either directly or indirectly through one or more interposed trusts and partnerships, the distribution is NANE income for the Australian corporate tax entity. ***[Schedule #, Part 1, item 4, Subdivision 768-A]***

Participation interest

2.10 As noted above, for the distribution to be NANE income, the Australian company must satisfy the participation test ***[Schedule #, Part 1, item 4, paragraph 768-5(1)(b)]***. This participation test needs to be satisfied at the time the foreign equity distribution is made ***[Schedule #, Part 1, item 4, paragraph 768-5(1)(b)]***.

2.11 The participation interest includes both direct and indirect participation interests ***[Schedule #, Part 1, item 4, section 768-15]***. Direct and indirect participation interests are existing concepts which are calculated by reference to rules set out in Subdivision 960-GP of the ITAA 1997.

2.12 However, for the purposes of the new NANE exemption for foreign equity distributions, any rights that the Australian company may have on winding-up are disregarded in determining the participation interest ***[Schedule #, Part 1, item 4, section 768-15]***. The rights on winding-up

may vary considerably from other interests and can therefore distort the participation test.

Foreign equity distribution

2.13 The exemption applies where a foreign resident company pays a foreign equity distribution to an Australian company. ***[Schedule #, Part 1, item 4, paragraph 768-5(a)]***

2.14 A foreign equity distribution is a distribution or non-share dividend made by a company that is a foreign resident in respect of an equity interest in the company. ***[Schedule #, Part 1, item 5, subsection 995-1(1) definition of 'foreign equity distribution']***

2.15 A key feature of the new law is that the distribution will only be NANE income where the distribution is made in respect of an equity interest ***[Schedule #, Part 1, item 4, section 768-5]***. This is intended to:

- modernise the exemption by aligning it to the concepts of 'debt interests' and 'equity interests' as defined in Division 974 of the ITAA 1997;
- ensure that the exemption not available in respect of returns on debt interests, such as redeemable preference shares;
- allow the exemption to apply in respect of a broader range of equity interests, not only voting interests; and
- ensure that the deduction under section 25-90 of the ITAA 1997 operates as intended, by ensuring that any debt 'on-lent' to an offshore entity will give rise to assessable interest income in Australia, with any funding costs of the Australian company being deductible under the general deduction provision in section 8-1 of the ITAA 1997, rather than section 25-90 of the ITAA 1997.

2.16 A foreign equity distribution also includes a non-share dividend ***[Schedule #, Part 1, item 4, section 768-10]***, which is a dividend on a non-share equity interest. A non-share equity interest is an equity interest in a company that is not in legal form solely a share in the capital of the company. To be a non-share equity interest, it is necessary for the whole interest, or part of it, to be in the form other than a share. An example of a non-share equity interest is a stapled security.

Interposed trusts and partnerships

2.17 Under the new law, a foreign equity distribution can be NANE income for an Australian company, even if it passes through interposed trusts and partnerships, provided that the interposed trusts and partnerships are not corporate tax entities. ***[Schedule #, Part 1, item 4, subsection 768-5(2)]***

2.18 This represents a change from the current law, which allows a dividend to be NANE under section 23AJ only in instances where the dividend is received directly by the Australian company from the foreign company.

2.19 Allowing the exemption to apply where a foreign equity distribution has flowed through interposed trusts and partnerships is intended to reflect the fact that there is no economic difference between holding equity interests directly or indirectly through a trust or partnership.

2.20 The new law provides that an amount will be NANE income for an Australian beneficiary or partner where:

- the amount is ultimately received by an Australian corporate beneficiary of a trust, or an Australian corporate partner in a partnership; and
- the amount would otherwise be included in the trust or partnership's assessable income under Division 5 or 6 of Part III of the ITAA 1936; and
- the amount can be attributed, either directly or indirectly through one or more interposed trusts and partnerships that are not corporate tax entities, to a foreign equity distribution; and
- at the time distribution is made, the Australian trust or Australian partnership satisfies the participation test explained above; and
- the Australian beneficiary or partner does not receive the distribution in the capacity of a trustee.

[Schedule #, Part 1, item 4, subsection 768-5(2)]

2.21 The distribution will not be NANE where it flows through an interposed trust or partnership that is a corporate tax entity ***[Schedule #,***

Part 1, item 4, paragraph 768-5(2)(c)], as a corporate tax entity is not a flow-through vehicle.

Repeal of portfolio dividend exemption for controlled foreign companies

2.22 The initial policy rationale for section 404 of the ITAA 1936 was to allow certain dividends to remain NANE income if they did not meet the requirements in section 23AJ of the ITAA 1936. This situation might arise where, for example, the regulatory requirements in some foreign jurisdictions limit the voting interests able to be held by foreigner investors because those jurisdictions do not attach voting rights to equity (and therefore the test in section 23AJ of the ITAA 1936 would not be satisfied).

2.23 However, the need for section 404 of the ITAA 1936 has diminished, given the exemption for foreign equity distributions (explained above) will no longer rely upon the concept of voting rights.

2.24 In addition, section 404 of the ITAA 1936 poses an integrity risk. Currently, the operation of section 404 of the ITAA 1936, and its interaction with section 23AJ of the ITAA 1936, can result in Australian taxpayers paying no Australian tax on dividends derived from their (in substance) foreign portfolio share holdings when received through an interposed controlled foreign corporation (CFC).

2.25 This occurs where a CFC receives portfolio dividends from its offshore investments that can be pooled together and repatriated back to Australia as a non-portfolio dividend, which is currently NANE income under section 23AJ of the ITAA 1936. This result arises because all dividends (both portfolio and non-portfolio) paid to a CFC resident in a listed or section 404 country are treated as being exempt if the paying entity is also a resident of a listed or section 404 country.

2.26 In contrast, dividends received directly from foreign portfolio holdings are taxable in Australia.

2.27 To address these issues, section 404 of the ITAA 1936 will be repealed, together with the associated regulations which set out the section 404 countries. ***[Schedule #, Part 2, item 6]***

Consequential amendments

2.28 Several consequential amendments have been made to:

- update various cross-references to section 23AJ of the ITAA 1936, and replace these with references to the new revised exemption in section 768-5 of the ITAA 1997 ***[Schedule #, Part 3, items 7-9, 14-22]***; and

- remove various cross-references to section 404 of the ITAA 1936, given this section will be repealed ***[Schedule #, Part 3, items 10, 12 and 13]***.