Addressing profit shifting through the artificial loading of debt in Australia

Proposals Paper
14 May 2013

© Commonwealth of Australia 2013

ISBN 978-0-642-74905-5

This publication is available for your use under a Creative Commons Attribution 3.0 Australia licence, with the exception of the Commonwealth Coat of Arms, the Treasury logo, photographs, images, signatures and where otherwise stated. The full licence terms are available from http://creativecommons.org/licenses/by/3.0/au/legalcode.

Use of Treasury material under a Creative Commons Attribution 3.0 Australia licence requires you to attribute the work (but not in any way that suggests that the Treasury endorses you or your use of the work).

Treasury material used 'as supplied'

Provided you have not modified or transformed Treasury material in any way including, for example, by changing the Treasury text; calculating percentage changes; graphing or charting data; or deriving new statistics from published Treasury statistics — then Treasury prefers the following attribution:

Source: The Australian Government the Treasury

Derivative material

If you have modified or transformed Treasury material, or derived new material from those of the Treasury in any way, then Treasury prefers the following attribution:

Based on The Australian Government the Treasury data

Use of the Coat of Arms

The terms under which the Coat of Arms can be used are set out on the It's an Honour website (see www.itsanhonour.gov.au)

Other Uses

Inquiries regarding this licence and any other use of this document are welcome at:

Manager
Communications
The Treasury
Langton Crescent Parkes ACT 2600
Email: medialiaison@treasury.gov.au

Consultation Process

Request for feedback and comments

This paper provides an outline and explanation of an integrated set of measures designed to ensure that multinational entities (MNEs) do not artificially load debt in Australia.

The paper also seeks comments on a range of issues including those associated with implementing a worldwide gearing test for inbound investors within the thin capitalisation rules. Other comments on the measures are also welcome.

Closing date for submissions: 12 July 2013

Email:	thincapitalisation@treasury.gov.au
Mail:	Manager International Tax Integrity Unit The Treasury Langton Crescent PARKES ACT 2600
Enquiries:	Enquiries can be initially directed to Michael Atfield
Phone:	02 6263 3920

CONTENTS

FOREWORD v

ADDRESSING PROFIT SHIFTING THROUGH THE ARTIFICAL LOADING OF DEBT IN AUSTRALIA BY MULTINATIONALS 1

1. INTRODUCTION 1

2. WHAT ARE THE MAIN FEATURES OF THE REFORMS? 2

3. WHY IS THE GOVERNMENT UNDERTAKING THESE REFORMS? 2

3.1 Tightening the safe harbour settings in the thin capitalisation rules 2

3.2 improving the integrity of the foreign non-portfolio dividend exemption 4

3.3 Repealing the special rule for deductibility of interest expenses incurred in deriving certain foreign exempt income 5

3.4 The combined effect: a debt loading structure 5

4. WHAT ARE THE DETAILS OF THE ANNOUNCED REFORMS? 7

4.1 Thin capitalisation reforms 7

4.2 Reforming the exemption for foreign non-portfolio dividends 8

4.3 Removing the deduction for interests expenses incurred in earning exempt foreign income 9

APPENDIX A 11

OPERATION AND POLICY INTENT OF EXISTING LAW 11

FOREWORD

It is important that Australia secures a fair, competitive and sustainable tax base for the future prosperity of this nation. Left unchecked, profit shifting and international tax avoidance is a threat to Australia's sovereignty.

International tax rules that give multinational enterprises access to tax arrangements that are not available to domestic firms provides them an unfair competitive advantage. It also means other taxpayers either face a larger tax burden or accept a lower level of government services.

The Government is committed to taking what action it can within the current international tax rules to protect the integrity of Australia's corporate tax base. International tax reform is also increasingly on the agenda of G20 Finance Ministers and Leaders.

The OECD report *Addressing Base Erosion and Profit Shifting* outlines the underlying causes and challenges and highlights the need for a comprehensive approach. The report also acknowledges the need for unilateral action, including the need for immediate action from tax administrators to address compliance issues.

There is a limit to what any one country can do acting alone to reform international tax rules. Achieving fundamental reform will require international cooperation to reach a broad consensus on the way forward. Australia is at the forefront of G20 efforts in this area.

The OECD will present an 'action plan' to G20 Finance Ministers in July this year. As G20 chair in 2014, Australia can play a prominent role in determining and driving this reform agenda.

This discussion paper demonstrates our commitment to a thorough and multi-phased consultation process. We will always endeavour to engage in a genuine process of consultation to identify and prevent unintended consequences.

These are important and necessary reforms that will improve the integrity of Australia's tax system, I welcome your participation in this process.

The Hon David Bradbury MP
Assistant Treasurer

ADDRESSING PROFIT SHIFTING THROUGH THE ARTIFICIAL LOADING OF DEBT IN AUSTRALIA BY MULTINATIONALS

1. INTRODUCTION

1. On 14 May 2013 the Government announced a number of changes to protect the Australian corporate tax revenue from erosion by addressing loopholes and profit shifting opportunities. The measures outlined in this paper seek to address profit shifting opportunities that arise when multinational entities (MNEs) have the ability to artificially load excessive amounts of debt in their Australian operations.

2. The implications of these integrity concerns go beyond the negative impact on the revenue. If unaddressed, they also reduce the efficiency, fairness and sustainability of the tax system.

3. When some taxpayers avoid or minimise their tax in a sustained way the tax burden eventually falls more heavily on other taxpayers.

4. Further, when some businesses avoid tax this leads to an unfair competitive advantage over businesses that do the right thing and don't seek to avoid tax. If this is allowed to persist it will ultimately distort investment decisions.

5. A system with integrity is also a healthier system that breeds compliance. Tax avoidance can distort social and economic interactions, favouring those who can best afford to develop and implement the most effective tax strategy. This creates distrust and a reluctance to comply when others are not.

6. The current thin capitalisation regime was introduced in 2001 following the Ralph Review. It was intended to prevent MNEs artificially loading debt in their Australian operations, thereby reducing their Australian taxable income. MNEs have flexibility in determining where international financing can occur and how debt will be allocated within the group. This allows them the opportunity to manipulate in which jurisdiction deductions for interest are claimed. This can effectively reduce or negate Australian income tax while improving after-tax profits for the group.

7. The rules, when first introduced, were intended to provide broad coverage to accommodate commercial gearing levels across a range of industries. 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. As a result, the rules are ineffective in stopping MNEs from artificially loading debt in their Australian operations.

8. The Commissioner of Taxation has observed some aggressive tax structures that seek to take advantage of the generosity of the current rules and allow profits to be shifted through excessive debt allocations. The structure involves exploiting a combination of the current thin capitalisation settings, an inconsistency in the law to not impede Australian firms investing overseas and a measure that was intended only to reduce compliance costs. It is now clear that these provisions are being abused as part of a profit shifting strategy that results in no significant change to economic activity in Australia. Shutting down this aggressive tax planning requires all three elements to be addressed simultaneously.

2. WHAT ARE THE MAIN FEATURES OF THE REFORMS?

10. This package of measures is intended to:

- Tighten the safe harbour settings in the thin capitalisation rules while still ensuring taxpayers have access to other tests where they have higher borrowings at commercially independent levels;
- Implement the 2009-10 Budget announcement to reform the exemption for foreign non-portfolio dividends (section 23AJ of the *Income Assessment Act 1936)*; and
- Repeal the special rule that allows tax deductibility for interest expenses incurred in deriving exempt foreign income (section 25-90 of the *Income Assessment Act 1997)*.

11. To provide time for taxpayers to rearrange their financing arrangements, these measures will have effect for income years that commence on or after 1 July 2014.

3. WHY IS THE GOVERNMENT UNDERTAKING THESE REFORMS?

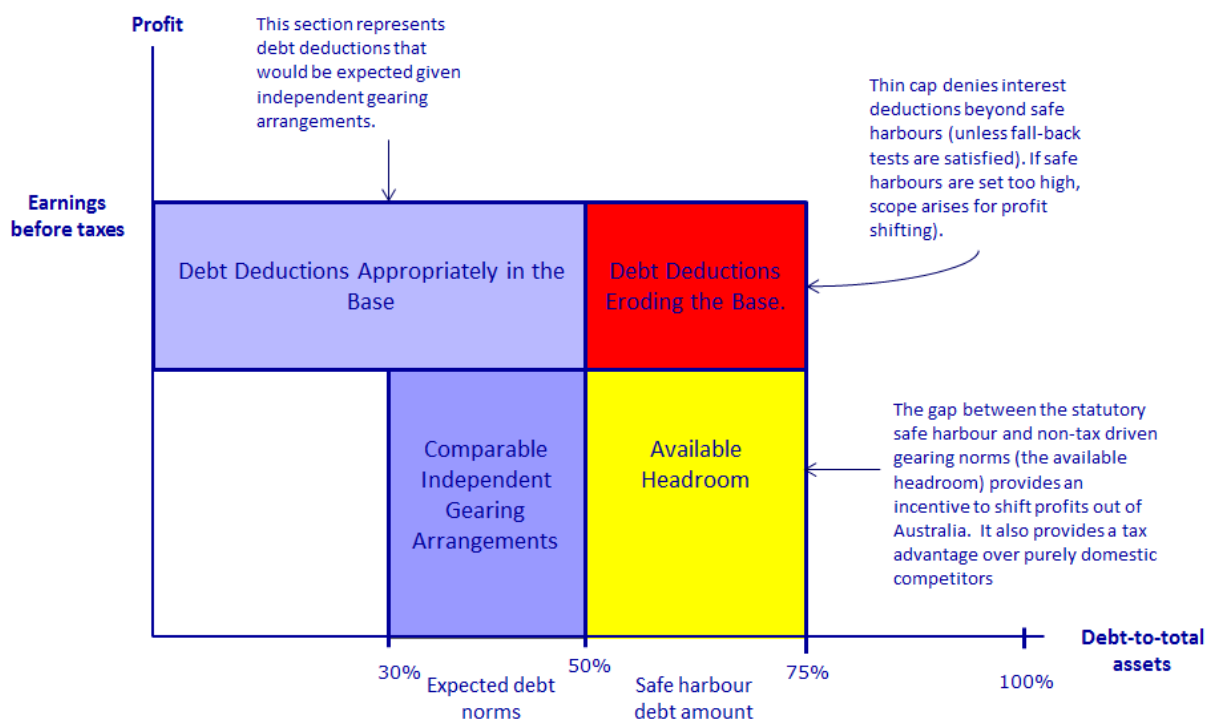
3.1 TIGHTENING THE SAFE HARBOUR SETTINGS IN THE THIN CAPITALISATION RULES

12. When introduced in 2001, the current thin capitalisation safe harbour settings were generous when compared with actual gearing levels of most companies with truly independent arrangements. This divergence has since been exacerbated by the deleveraging that has occurred following the global financial crisis.

13. This discrepancy means the current rules are ineffective in achieving their stated policy objective of ensuring that debt is not artificially loaded in the Australian operations. MNEs are able to gear their Australian operations up to the current 'safe harbour' ratio of 3:1 debt to equity, despite their global (consolidated) gearing ratio being substantially lower (often less than 1:1).

14. The Reserve Bank of Australia's Financial Stability Review of March 2013 indicates that business gearing levels have remained at relatively low levels. Among listed non-financial corporates, the aggregate gearing (book value debt-to-equity) ratio was estimated to be 54 per cent as at December 2012. According to Treasury analysis of the 2011 financial statements for 2044 ASX listed companies (other than banks) 95 per cent of those companies had gearing levels less than 1.5:1.

15. This divergence means taxpayers can load debt into Australia using the difference between debt levels that would be adopted for non-tax reasons and the safe harbour limit.



16. The safe harbours for banks (and non-bank financial entities) will also be changed to bring the prescribed percentage of risk-weighted Australian assets back into line with the prudential standards set out in Basel III.

17. The worldwide gearing test will have its ratio tightened. The worldwide gearing test permits gearing to the level of the worldwide group of which the entity is a member. The test currently allows gearing in Australia to be equal to 120 per cent of the group's global gearing. This will be reduced to 100 per cent so that deductible expenses for gearing in Australia is proportionate to the global gearing of the group. A ratio of 100 per cent directly addresses the issue of debt being artificially loaded in Australia that the rules are designed to address.

18. The worldwide gearing test, currently only available to outbound investors, will also be extended to inbound investors. This test better reflects the policy intent of the thin capitalisation rules to prevent the excessive allocation of debt to Australia for tax purposes. It allows the Australian operations to claim deductions on their debt where they are geared to the same level as the global group.

19. The arm's length test will also be retained for those taxpayers whose gearing levels are above the relevant safe harbour limits or their worldwide gearing ratio where those borrowings are comparable to independent commercial arrangements.

20. The arm's length test will, however, be referred to the Board of Taxation to consult on ways to make the arm's length test more effective by reducing compliance costs and making it easier for the Australian Taxation Office to administer while having regard to the policy objective of the thin capitalisation rules.

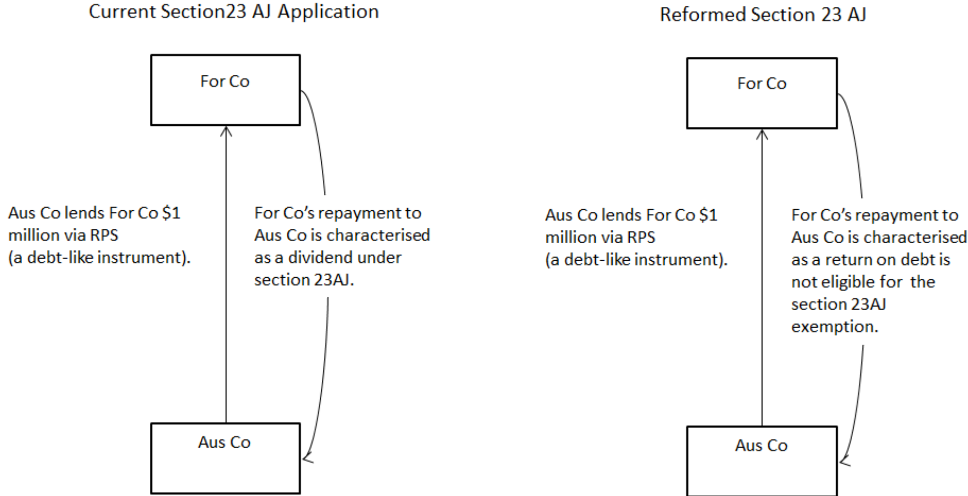
3.2 IMPROVING THE INTEGRITY OF THE FOREIGN NON-PORTFOLIO DIVIDEND EXEMPTION

21. The 2009-10 Budget contained an announcement to reform the foreign non-portfolio dividend exemption. Non-portfolio interests are those that are 10 per cent or greater. The exemption for non-portfolio dividends is intended to apply in respect to returns on substantial equity holdings. It was not intended to apply to returns on debt interest or interests that are, in substance, portfolio investments (that is, interests of less than 10 per cent).

22. Dividends for the purposes of this exemption are currently determined by their legal form rather than their substance. This approach differs from the substance-based approach used in the debt and equity rules, which applies for thin capitalisation and section 25-90 purposes.

23. The change seeks to address an arbitrage opportunity that currently exists as the relevant provision does not properly align to the tax concepts of debt and equity throughout the rest of the income tax law. This change reinforces the underlying policy intent that the exemption is intended for dividends received on non-portfolio equity interests.

REFORMS TO THE EXEMPTION FOR FOREIGN NON-PORTFOLIO DIVIDENDS (SECTION 23AJ)



3.3 Repealing the special rule for deductibility of interest expenses incurred in deriving certain foreign exempt income

24. The final part of this package is the repeal of the provision that allows tax deductibility for interest expenses incurred in deriving certain exempt foreign income (section 25-90). This provision was introduced with the 2001 thin capitalisations reforms as a compliance saving measure. However, as mentioned above there is now evidence that it is being used as a central step of an aggressive tax scheme. Consistent with general tax principles, entities will now need to establish a link between the interest expense and assessable income.

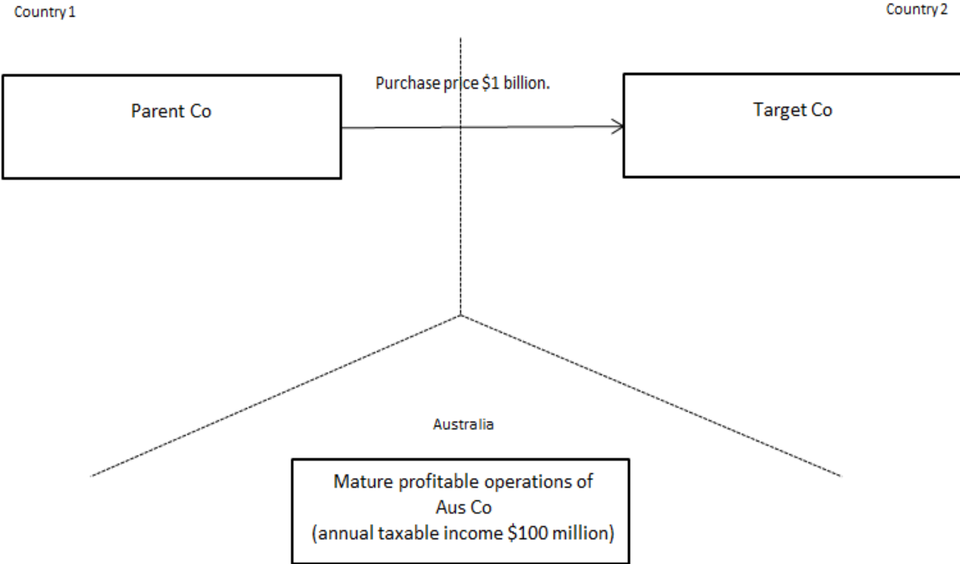
3.4 The combined effect: a debt loading structure

25. An example of a debt dumping structure that uses the profit shifting and arbitrage opportunities presented above is described below. This structure exploits the overly generous thin capitalisation rules, the loophole in the exemption for foreign non-portfolio dividends (that is the exemption applying to 'debt') and the 'compliance cost saver' provision (that is, the deduction for interest expenses incurred in deriving certain exempt foreign income).

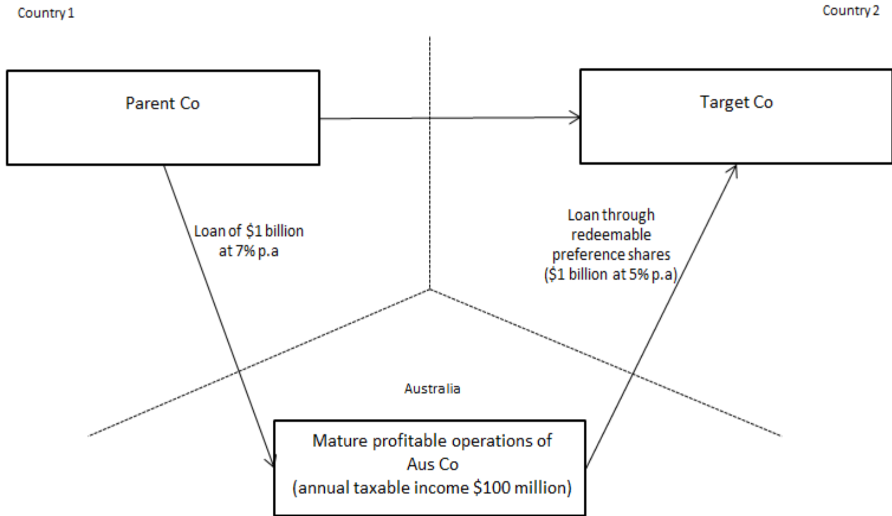
26. The combined effect is to wipe out the Australian taxable income of a mature Australian company. The Commissioner of Taxation has observed replication of this structure.

Step 1: Parent Co acquires Target Co.

Parent Co has a wholly owned Australian subsidiary. Parent Co has also directly acquired Target Co.



Step 2: Parent Co restructures to bring Target Co under the ownership of Aus Co.



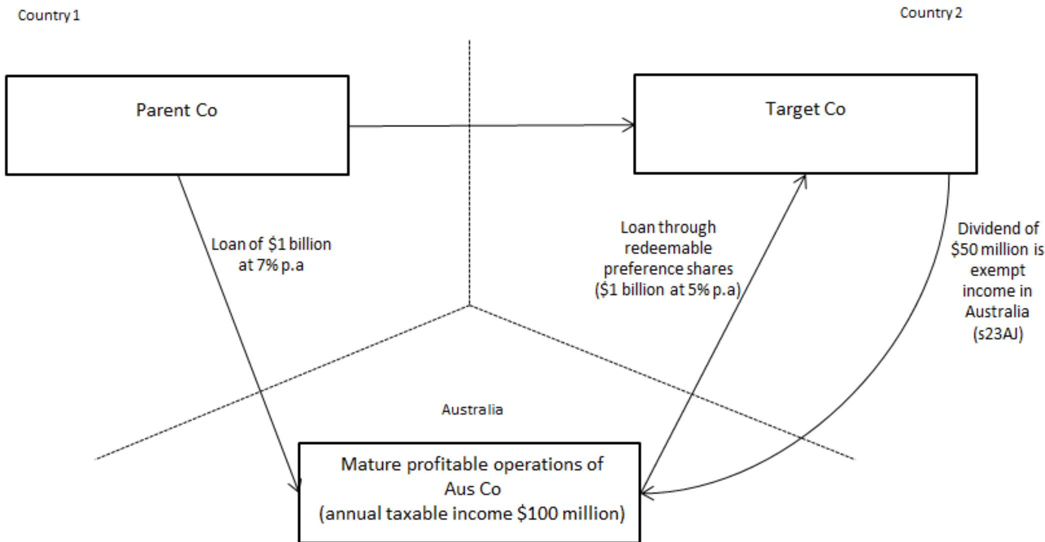
Aus Co finances the transaction with a related party loan from Parent Co.

Aus Co takes ownership of Target Co by 'on-lending' funds borrowed from Parent Co by subscribing to redeemable preference shares issued by Target Co.

Note:

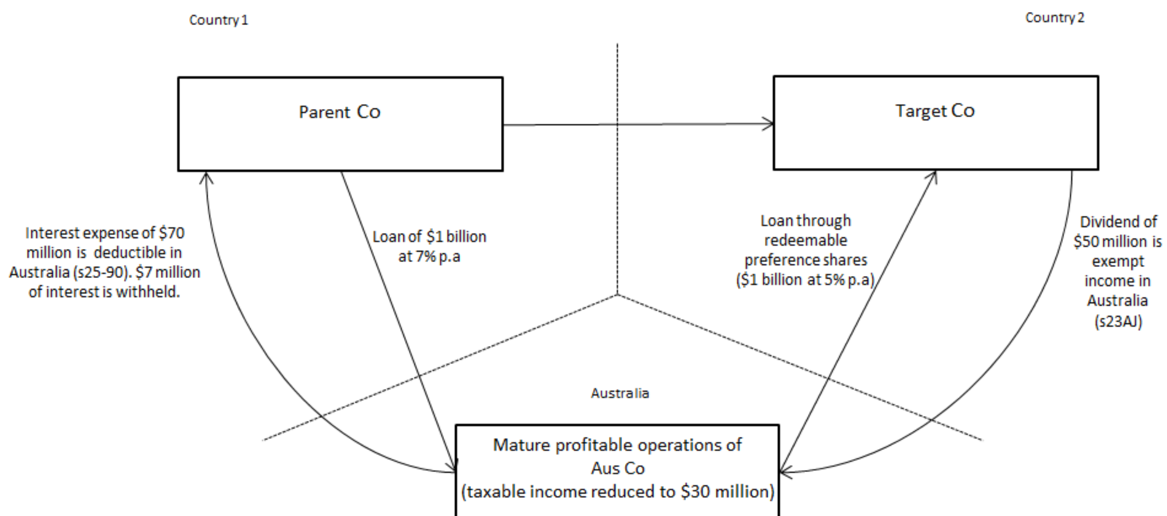
1. In this case the redeemable preference shares are treated as 'debt' under the Australian tax debt equity rules.

Tax Outcomes — section 23AJ



While the arrangement between Aus Co and Target Co is treated as a 'loan' the repayments by Target Co to Aus Co are treated as being an exempt foreign non-portfolio dividend.

Tax Outcomes — thin capitalisation, sections 23AJ and 25-90 interactions



The payment by Aus Co on the loan to Parent Co is classed as 'interest' and is deductible in Australia under section 25-90.

In this case Parent Co would be subject to interest withholding tax on the interest income.

The combined effect of the return on the loan by Aus Co to Target Co being incorrectly treated as an 'exempt foreign non-portfolio dividend' and the deduction for the interest payment from Aus Co to Parent Co allows Aus Co to shield its Australian profits from Australian taxation.

In the above example Aus Co derives exempt foreign dividends of $50 million. It also receives a $70 million tax deduction (with $7 million withholding tax payable on behalf of Parent Co). Aus Co's taxable income is reduced from $100 million to $30 million with no significant change to economic activity undertaken in Australia.

4. What are the details of the announced reforms?

4.1 Thin capitalisation reforms

27. The settings applicable to the current thin capitalisation rules will be changed by tightening safe harbour limits and worldwide gearing ratios:

- for general entities, the safe harbour debt limit will be reduced from 3:1 to 1.5:1 on a debt to equity basis (or 75 per cent to 60 per cent on a debt to total asset basis);

- for non-bank financial entities, the safe harbour debt limit will be reduced from 20:1 to 15:1 on a debt to equity basis (or 95.24 per cent to 93.75 per cent on a debt to total asset basis);

- for banks, the safe harbour capital limit will be increased from 4 per cent to 6 per cent of the risk weighted assets of their Australian operations;

- for outbound investors, the worldwide gearing ratio will be reduced from 120 per cent to 100 per cent (with an equivalent change to the worldwide capital ratio for banks);

28. To reduce compliance costs and ensure small businesses are excluded from the regime, the current *de minimis* threshold will be increased from $250,000 to $2 million of debt deductions.

29. In addition, the Government has asked the Board of Taxation to consider ways to improve the operation of the arm's length test. The Board of Taxation is expected to report its findings by December 2014.

4.1.1 Extending the worldwide gearing test to inbound investors

30. As part of these reforms, inbound investors will now have access to a worldwide gearing test. This will operate as an additional safe harbour to an entity's relevant debt or capital limit.

31. A worldwide gearing test allows a proportionate allocation of debt to Australia to that of the worldwide group. The reduction of the safe harbours and introduction of a worldwide gearing test reduces the ability of MNEs to artificially load debt in Australia while recognising that some global groups will have gearing levels for legitimate commercial reasons.

32. The worldwide gearing test currently applies only to outbound investors. Comments are welcome on whether the 'outbound' worldwide gearing test can be applied to inbound investors or whether a modified test would better achieve the policy intent.

Consultation Questions

1. What, if any, modifications need to be made to the existing worldwide gearing test in order for it to apply to an inbound investor?

2. Are there any additional compliance costs (when compared to an outbound investor) from applying a worldwide gearing test for an inbound investor?

3. If so, what are the increased costs attributed to and how can they be ameliorated?

4.2 Reforming the exemption for foreign non-portfolio dividends

33. The Government will implement reforms to the exemption for foreign non-portfolio dividends that were announced in the 2009-10 Budget as part of the reforms proposed to the foreign source income anti-tax deferral (attribution) rules. The 2009 -10 reforms were:

- to treat arrangements based on their substance rather than legal form, with interest received on debt instruments being taxable in Australia; and
- ensuring dividends from in-substance portfolio holdings in foreign companies (less than 10 per cent) that currently have access to the exemption will now be excluded from the exemption and therefore taxable. This will be achieved by repealing section 404 of the *Income Tax Assessment Act 1936*.

34. The Government will also extend the application of the exemption so that it applies where the Australian company receives foreign non-portfolio dividend income through an investment in a trust or partnership. This reform is as a result of consultations that took place on the attribution rules reforms following the 2009-10 Budget announcement. An initial draft of the provision was set out in the Controlled Foreign Companies exposure draft legislation that was released in February 2011.

Consultation Question

1. What, if any, issues need to be considered in extending the non-portfolio dividend exemption to include investments through trusts and / or partnerships?

2. Are there any interaction issues with any announced changes in this package that also need to be taken into account?

4.3 Removing the deduction for interests expenses incurred in earning exempt foreign income

35. The final aspect of this package is to remove the special rule that allows a tax deduction for interest expenses incurred in deriving non-assessable non-exempt income. That is, section 25-90 of the *Income Tax Assessment Act 1997* will be repealed. An equivalent change will also be made to a similar provision in the taxation of financial arrangement rules.

36. As mentioned above, while originally intended as a compliance saving measures, the evidence shows that the provision is being used as a means to shift profits out of Australia. Therefore, the Government considers that the compliance benefits of section 25-90 are outweighed by the risks to the integrity of the corporate tax base.

37. Taxpayers with genuine interest expenses that relate to assessable income will still be able to deduct these expenses under general taxation principles.

38. As noted in the Assistant Treasurer's press release of 14 May 2013, the Australian Taxation Office will commence consultations with taxpayers and Industry to progress any necessary guidance material, including on appropriate and practical ways to allocate interest expenses in accordance with the general deduction rules.

APPENDIX A

OPERATION AND POLICY INTENT OF EXISTING LAW

THIN CAPITALISATION RULES

1. The policy intent of the thin capitalisation rules is to improve the integrity and fairness of the income tax law by preventing multinational enterprises from shifting profits out of Australia by allocating an excessive amount of debt to their Australian operations.

2. The rules consist of a number of debt limit tests. These tests calculate the maximum debt deductions allowed to be claimed for a multinational's Australian operations. If the Australian operations have debt deductions above the maximum allowed (the debt limit test), these deductions will be denied. Conversely, where the Australian operation's debt deductions do not exceed the maximum allowed, no deductions will be denied.

3. Under the current rules, investors (both inbound and outbound) may elect to apply, either:

   - The safe harbour debt limit — different entity categories have different safe harbour limits; or

   - The arm's length debt limit — commercial or truly independent debt outcomes.

4. Outbound investors may also elect to apply the worldwide gearing (or capital) ratio limit, which is based on the debt to equity ratio of the worldwide group.

5. The thin capitalisation rules do not apply to purely Australian domestic firms; nor do they apply to Australian operations that have debt deductions under $250,000 (the *de minimis* threshold).

6. Generally, entities choose which debt limit to use depending on: which one is easiest to apply (lowest compliance costs) or the most generous (highest threshold).

7. Under the rules, the entities through which inbound and outbound investors conduct their Australian operations are divided into three categories, each of which have different safe harbour limits:

   - General entities — current maximum debt limit of 3:1 (on a debt to equity basis) or 75 per cent (on a debt to total assets basis);

   - Non-bank financial entities — current maximum debt limit of 20:1 (on a debt to equity basis) or 95.24 per cent (on a debt to total assets basis); and

   - Banks — current minimum equity amount of 4 per cent of the risk weighted assets (as determined under Australian Prudential Regulation Authority regulations) of the Australian operations.

SECTION 25-90

8. Section 25-90 was introduced as a compliance saving measure at the same time as the 2001 thin capitalisation reforms on the basis that the thin capitalisation rules would be the sole determinant of interest deductibility. The introduction of section 25-90 removed the requirement for taxpayers to trace interest expense deductions to the funds borrowed.

NON-PORTFOLIO DIVIDEND EXEMPTION (SECTION 23AJ)

9. Following changes made in 2004, the policy intent of the non-portfolio dividend exemption is now principally designed to remove the Australian company tax burden from active business income earned by a foreign subsidiary of an Australian owned company. The exemption helps ensure that the foreign subsidiaries are able to compete on an equal footing with other businesses located in that foreign country.

10. Currently the exemption applies to dividends paid to an Australian company that holds at least 10 per cent of the voting power in the foreign company paying the dividend. Dividends for these purposes are determined by their legal form rather than their substance. This approach differs from the substance-based approach used in the debt and equity rules, which is applicable for thin capitalisation and section 25-90 purposes.