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Thin capitalisation and section 23AJ exposure draft

On 8 May 2014, the Government released exposure draft (ED) legislation relating to the **thin capitalisation** regime in Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997), and reform of current **section 23AJ** of the *Income Tax Assessment Act 1936* (ITAA 1936). These measures were originally announced in the 2013-14 Federal Budget and discussed in the 14 May 2013 Proposals Paper *Addressing profit shifting through the use of artificial loading of debt in Australia*.

Broadly, the proposed amendments in the ED are consistent with the previous Budget announcement and involve the following changes:

- Tighten safe harbour debt limits in the thin capitalisation regime
- Reduce the existing worldwide gearing test for outbound investors from 120% of worldwide gearing to 100%
- Increase the de minimis threshold from $250,000 to $2 million of interest expense p.a.
- Introduce a new worldwide gearing test as an option for inbound investors
- Reform the exemption for foreign non-portfolio dividends.

Submissions on the ED are due by 6 June 2014.

The 2013-14 Federal Budget announcement and the 14 May 2013 Proposals Paper also proposed to repeal section 25-90, which allows tax deductibility for interest expenses incurred in deriving exempt foreign dividend income. Subsequently, the Coalition Government announced on 6 November 2013 that it would not proceed with the repeal of section 25-90 but would instead introduce a "targeted anti-avoidance provision after detailed consultation with stakeholders". The ED does not include the targeted integrity measure.

We have set out below our preliminary, high level comments on the ED.

Thin capitalisation

As per the 2013-14 Federal Budget announcement, the ED:

- Reduces the general (non-ADI) safe harbour from 75% to 60% of assets (net of non-debt liabilities), or expressed differently, reduces the safe harbour from 3:1 to 1.5:1 (on a debt-to-equity basis)
- Reduces the safe harbours for financial entities (non-ADI) and ADIs, in accordance with the announcement
- Reduces the existing worldwide gearing test available to outbound entities from 120% of worldwide gearing to 100%
- Introduces a new worldwide gearing test for inbound entities (see below)
- Increases the de minimis threshold from $250,000 to $2 million of interest expense p.a. to minimise compliance costs

The rules commence for income years starting on or after 1 July 2014. There are no transitional measures. The thin capitalisation ED appears to have some drafting and cross referencing errors which will be corrected in the consultation phase.

As a separate matter, it is noted that the Board of Taxation is still reviewing the arm's length debt test.

Worldwide gearing test for inbound entities

The main matter of substance is the introduction of the new worldwide gearing test as an option for inbound entities. The rationale for the new worldwide gearing test is that it "better reflects the policy intent of the thin capitalisation rules" and allows "Australian operations to claim deductions on their debt where they are geared to the same level as the global group". This effectively allows financial markets to determine thin capitalisation compliant gearing levels.

The intention is that the new worldwide gearing test should be made available to inbound entities and also to entities that are both inbound and outbound – although there appear to be some drafting matters that need to be addressed.

To access the new worldwide gearing test, it is necessary that there are eligible financial statements. Broadly, these are audited consolidated financial statements prepared under "recognised overseas accounting standards". The ED provides that if there are two or more sets of eligible financial statements, where "the entities in relation to which each set of financial statements have been prepared are not identical", the new worldwide gearing test is not available. This matter needs to be clarified.

Where the new worldwide gearing test is available, this could be beneficial for Australian businesses owned by foreign groups that have substantial leverage.

Exemption for foreign non-portfolio dividends (Section 23AJ)

Section 23AJ of the ITAA 1936 is to be repealed and new subdivision 768-A is to be inserted into the ITAA 1997.

The key concept for non-assessable non-exempt income (NANE) treatment under subdivision 768-A is that of a "foreign equity distribution", being a "distribution or non-share dividend made by a company that is a foreign resident in respect of an equity interest in the company". The NANE character should remain where the foreign equity distribution flows through a trust or a partnership.

The new subdivision 768-A both:

- Narrows the former section 23AJ by excluding shares which are debt interests for Australian tax purposes
- Widens the former section 23AJ by including non-share equity interests for Australian tax purposes. The EM notes that the change will permit the exemption on a broader range of equity interests.

The Australian shareholder is still required to be a company, not being a company in the capacity of a trustee. The Australian shareholder must have a direct and / or indirect participation interest (rather than a voting interest) of at least 10% (winding up rights are disregarded).

The ED does not expressly provide a start date for subdivision 768-A however, it is also expected to apply for income years starting on or after 1 July 2014, as per the 2013-14 Federal Budget announcement. This needs to be confirmed.

The portfolio dividend exemption in section 404 of the ITAA 1936 (i.e. in the CFC rules) is also to be repealed. The commencement date for the repeal of Section 404 needs to be clarified.

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