Deloitte.

Inbound and outbound investment – Bill introduced

24 July 2014

On 17 July 2014, the Government released *Tax and Superannuation Laws Amendment (2014 Measures No. 4) Bill 2014* (the Bill). The Bill includes:

- Repeal of the current section 23AJ of the *Income Tax Assessment Act 1936*, and introduction of new subdivision 768-A in the *Income Tax Assessment Act 1997* in respect of **distributions and non-share dividends received from foreign companies**;
- Amendments to the **thin capitalisation regime**; and
- Integrity measures in respect of the **capital gains tax provisions applying to non-residents**. This item is not further addressed in this Brief.

These measures were announced in the 2013-14 Federal Budget (May 2013). Exposure draft (ED) legislation was previously released in May 2014.

The thin capitalisation changes and the introduction of new subdivision 768-A are forecast to raise $755 million over the forward estimates period.

The Government announced in November 2013 that it would not proceed with the repeal of section 25-90. In the 2014-15 Federal Budget, the Government announced that it had not yet made a decision on a “targeted anti-avoidance” provision to address certain conduit arrangements and was still seeking advice on this matter. No further announcement has been made as yet on this measure.

Snapshot

- The reforms to Section 23AJ largely reflect the Budget announcement and the ED, and are generally as expected. New subdivision 768-A will be wider in some respects and narrower in other respects as compared to section 23AJ. The interaction with the controlled foreign company (CFC) rules has been clarified
- The announced changes to the thin capitalisation rules – reduced safe harbour, tightening of the existing outbound worldwide gearing (WWG) test and increase in the de minimis exemption – largely reflect the Budget announcement and the ED
- The new inbound worldwide gearing test will be beneficial in some circumstances. An integrity rule has been added: this was not in the ED

1 Distributions from foreign companies

1.1 Introduction

Section 23AJ broadly provides that a non-portfolio dividend paid by a foreign company to an Australian company is non-assessable, non-exempt (NANE) income. Section 23AJ is based on a legal form concept of shares.

Section 23AJ is to be repealed and replaced with a new subdivision 768-A, which is aligned to the tax concepts of debt interests and equity interests in Division 974. Subdivision 768-A will apply to distributions and non-share dividends **made after Royal Assent** is given to the amending legislation.

1.2 Summary

Under subdivision 768-A, a distribution that meets the following will be NANE income	
There is a **foreign equity distribution** – being a distribution or a non-share dividend made by a foreign resident company, **in respect of an equity interest** in the company	That distribution is made **directly or indirectly** (through interposed trusts or partnerships) to an Australian resident corporate tax entity (company, corporate limited partnership, corporate unit trust or public trading trust)
The recipient entity has a **10% or greater participation interest** (direct and indirect) in relation to the company that made the distribution	The recipient is **not acting in the capacity of a trustee, other than** a trustee of a corporate unit trust or public trading trust
The new subdivision 768-A both:	
Narrows the former section 23AJ: by excluding shares which are not equity interests for Australian tax purposes. Under subdivision 768-A, distributions on such interests will no longer be NANE income	**Widens** the former section 23AJ: by including legal form debt that is a non-share equity interest for Australian tax purposes. The EM notes that certain convertible notes may be classified as a non-share equity interest, and as a result, any related non-share dividends should be NANE income under subdivision 768-A

Where a foreign equity distribution passes through one or more interposed partnerships or trusts (including nominees and custodians), the distribution should relevantly retain its character where it can be attributed to an underlying foreign equity distribution. This is contrary to the current practice of the Australian Taxation Office.

In determining the participation interest, this will test the direct and indirect interest of the Australian resident entity in the foreign resident company based on paid-up share capital, voting rights and rights to capital and distributions (other than on winding up).

When applying subdivision 768-A for the purpose of computing the attributable income of a CFC, section 389A is to be disregarded. That is, for the purposes only of applying subdivision 768-A, the concept of equity interest in Division 974 is to be applied to CFCs. This should ensure that the NANE income treatment is preserved where a foreign equity distribution is received by a CFC.

Taxpayers will need to continue to monitor BEPS related developments in connection with Action 2: hybrid mismatch instruments. Any legislative or other developments under Action 2 will need to be considered in conjunction with subdivision 768-A.

Deloitte.

1.3 Next steps

Some of the next steps for business arising from the measures are:

- Need to review existing offshore structures to determine whether distributions and non-share dividends received after Royal Assent will be NANE income
- Need to consider consequential impacts in respect of associated borrowing costs and foreign exchange movements
- Need to consider consequential impacts in respect of the thin capitalisation provisions
- Planning of optimal funding structures for future offshore investments

2 Thin capitalisation

2.1 Introduction

Tightening the safe harbour debt limit in the thin capitalisation regime (e.g. reducing the maximum debt-to-equity ratio from 3:1 to 1.5:1 for general entities and from 20:1 to 15:1 for non-bank financial entities)	Reducing the **existing WWG** test for outbound investors from 120% of worldwide gearing to 100%
Increasing the de minimis threshold from $250,000 to $2 million per annum of debt deductions (e.g. interest expense) to minimise compliance costs	Introducing a **WWG test for inward investors**, provided that Australian assets are less than 50% of the worldwide assets (see 2.3 below)
The thin capitalisation amendments will apply to **income years commencing on or after 1 July 2014**. There is no transitional relief	

2.2 Implications

The changes to the safe harbour limits, the existing WWG test and the de minimis exemption are consistent with prior announcements and the ED. An integrity measure has been incorporated into the new inbound WWG test, as compared to the ED.

Where taxpayers continue to rely on the safe harbour, the reduction from 3:1 to 1.5:1 (or from 75% of assets (less non-debt liabilities) to 60%) will effectively require a reduction in maximum debt levels of 20%. On the other hand, for taxpayers with debt deductions up to $2 million per annum (eg, debt levels of approx. $25 million at a rate of 8% per annum), such taxpayers will be excluded from the thin capitalisation regime.

Many taxpayers have been preparing for the tightening of the thin capitalisation limits by making use of alternative methodologies under the thin capitalisation rules.

2.3 Next steps

Taxpayers who have not yet prepared for the thin capitalisation changes should consider the following:

- Review current and forecast debt levels and balance sheets to determine compliance with the reduced safe harbour. If debt levels exceed the safe harbour, remedial action is required
- Determine optimal course of action including analysis of:
    - Undertaking asset revaluations for thin capitalisation purposes, including recognition of intangibles that cannot be recognized for accounting purposes
    - Application of the arm’s length debt test, which will become more widely used

    - Adoption of existing WWG test or the new inbound WWG test, if relevant
    - Refinancing activities, and review of consequential tax impacts
- Implementation of optimal strategy

Taxpayers who have not yet prepared for the new thin capitalisation regime need to act now.

2.4 Inbound worldwide gearing test

A beneficial aspect of the thin capitalisation changes is the introduction of a new inbound WWG test for certain foreign controlled entities. This is an optional test in addition to existing tests. For inbound investors who exceed the reduced safe harbour, it will be necessary to undertake a strategic assessment of the optimal solutions, including consideration of the inbound WWG test.

For some foreign owned corporate groups, the worldwide debt levels (external funds lent to the worldwide group) will not exceed the debt levels permitted by the safe harbour. In such cases, the inbound WWG test will not assist. However, there will be cases where foreign groups have worldwide debt levels in excess of the safe harbour. In these cases, the inbound WWG test becomes an option to consider.

Eligible entity + Eligible accounts + Integrity measure does not apply

Use the worldwide group accounts to determine the the
worldwide gearing debt amount of the Australian entity

The new inbound WWG test for inward investing entities (non-ADI) is based on the premise that such entities should be able to claim interest deductions on debt where they are geared to a level not exceeding the external gearing level of the worldwide group. The key aspects of the new inbound WWG test are set out below.

Eligible entities: the new inbound WWG test is available to	
An outward investing entity (non ADI) which is also an inward investor	An inward investing entity (non ADI)
Eligible accounts: the key concept is that there must be "audited consolidated financial statements" for the entity. This requires that there be consolidated financial statements:	
Which include the Australian entity and one or more other entities, and one of those entities is a "worldwide parent entity" (ie, an entity not controlled by another entity)	Which have been prepared in accordance with "recognised overseas accounting standards", being standards adopted by the EU, USA, Canada, China, Japan, New Zealand or a jurisdiction specified by legislative instrument, or international financial reporting standards made or adopted by the International Accounting Standards Board
Which have an unqualified audit opinion	Which relate to the most recent period that ends (generally) on or before the end of the year of income of the Australian entity

Deloitte.

Worldwide gearing debt amount: The next step is to work out the "worldwide debt" for the worldwide group, which is a proxy for the debt of the worldwide group. The "worldwide debt" is then used to compute a WWG ratio and the worldwide gearing debt amount for the Australian entity. This exercise is based on the audited consolidated financial statements of the worldwide group, and does not involve Division 974 concepts.

The starting point is the total liabilities in the worldwide group accounts ***reduced*** by the following nine specific amounts (which are akin to non-debt liabilities):

Liabilities as per worldwide consolidated accounts, reduced by		
Provisions	Unpaid distributions to equity participants	
Trade payables	Deferred tax liabilities	Employee benefit liabilities
Current tax liabilities	Deferred revenue	Liabilities relating to insurance
Other liabilities specified by legislative instrument		
equals Worldwide debt		

Using a simple example, the WWG ratio to be applied to an Australian entity which is part of a worldwide group would be as follows:

Worldwide consolidated accounts			
Assets*	**200**	Borrowings	140
		Trade payables	10
		Provisions	10
		Total Liabilities	**160**
		Equity	**40**

Worldwide debt = Total liabilities ($160) less provisions ($10) and trade payables ($10) = **$140**

Step 1	Worldwide debt / equity	140/40 = 3.5
Step 2	Step 1 amount + 1	3.5 + 1 = 4.5
Step 3	Step 1 amount / Step 2	3.5/4.5 = 0.77

- * Assume that of the $200 of worldwide assets, $50 relates to the Australian subsidiary, and there are no non-debt liabilities in the Australian subsidiary
- Also assume that there is no "associate entity excess amount"

Expressed differently, the WWG ratio can be viewed as follows:

$$= \frac{\text{Worldwide debt}}{\text{Total assets, reduced by provisions, etc}} = 140 / 180 = 0.77$$

Step 4 is that the WWG ratio at step 3 (0.77) is applied against the Australian assets, reduced by non-debt liabilities (calculated in the normal way). Finally, the "associate entity excess amount" (if any) is added to the result of step 4 to determine **the worldwide gearing debt amount for the Australian entity**.

Example (cont): Based on the assets of the Australian subsidiary ($50) and assuming no non-debt liabilities, the worldwide gearing debt amount of the Australian subsidiary is = $50 x .77 = $38.5
By comparison, the safe harbour debt amount would be $50 x 60% = $30

Integrity measure: an integrity measure has been incorporated into the provisions as compared to the ED. Essentially, the new inbound WWG test will not be available if the Australian assets represent more than 50% of the worldwide assets. The EM indicates that the rationale is that where the Australian assets represent a majority of the worldwide assets, the Australian gearing and asset base could be seen to be unduly driving the worldwide gearing. The EM goes on to say that this is directed at excluding certain "high gearing structures, such as private equity investment schemes, where a foreign entity with high levels of related party debt (often provided by shareholders) acquires an Australian target company, being the worldwide group's main asset". An "anti-stuffing" rule has also been added which seeks to counteracts the acquisition of non-Australian assets with a more than incidental purpose of diluting Australian assets to less than 50% of worldwide assets.

Deloitte.

Contacts

Vik Khanna
Partner, International Tax
Tel: +61 3 9671 6666
vkhanna@deloitte.com.au

Peter Madden
Partner, International Tax
Tel: +61 2 9322 7449
pmadden@deloitte.com.au

Claudio Cimetta
Partner, International Tax
Tel: +61 3 9671 7601
ccimetta@deloitte.com.au

David Watkins
Partner, National Tax
Tel: +61 2 9322 7251
dwatkins@deloitte.com.au