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Budget 2013-14 targets debt funding by multinationals

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The 2013-14 Australian budget presented on 14 May 2013 contains several tax proposals that will affect cross-border business. No change to the corporate income tax rate was announced, but the government has proposed a tightening of the thin capitalization and interest deductibility rules. It also proposes to abolish deductions for interest expense on debt used to fund the acquisition of foreign affiliates to counteract what it perceives as abusive debt pushdown transactions by multinationals. Further, there are proposed changes to the foreign dividend exemption, the nonresident capital gains tax (CGT) rules, the consolidation regime and the research and development (R&D) credit. The government has specifically linked a number of the announcements to the OECD base erosion and profit-shifting (BEPS) project.

Thin capitalization rules

The thin capitalization rules, which limit the amount of tax-deductible debt that can be allocated to the Australian operations of foreign and Australian multinationals, would be amended for income years that commence on or after 1 July 2014.

The general thin capitalization safe harbor currently limits debt to 75% of adjusted Australian assets, which equates to a 3:1 debt-to-equity ratio. The government has announced that the general safe harbor would be reduced to 60% (i.e. 1.5:1 debt-to-equity ratio). Nonbank financial entities would have their safe harbor reduced from 95.24% (20:1 debt to equity) to 93.75% (15:1 debt to equity), and the safe harbor capital limit for banks would increase from 4% to 6% of risk-weighted Australian assets. The worldwide gearing test for Australian multinationals would be reduced from 120% to 100%.

Affected businesses will need to test their debt levels against the reduced safe harbors, and evaluate any opportunities to restore debt capacity via asset revaluations or other balance sheet items. Businesses whose debt exceeds the new safe harbors may need to consider recapitalizing to prevent a disallowance of interest expense and undue withholding tax costs.

There is, however, some positive news. Most importantly, the government has confirmed that the arm’s length debt test will be retained. This may provide relief to businesses affected by the reduced safe harbors if they can support higher gearing on an arm’s length basis. This is particularly relevant for asset-intensive infrastructure businesses and businesses with strong current or expected profitability levels, such as those owning valuable off-balance sheet intangibles. While the government has decided to retain the arm's length test, it has asked the Board of Taxation to consider ways to improve the operation of the test and make it easier to comply with and administer.

Other positive aspects are the extension of the worldwide gearing test to inbound investors (allowing Australian operations to be geared at the same level as the worldwide group, even if that exceeds the safe harbor), and an increase in the *de minimis* exemption threshold from AUD 250,000 to AUD 2 million of debt deductions per annum, which would reduce compliance costs for smaller businesses.

Other measures affecting debt funding

The most dramatic proposed change to Australia's interest deductibility rules is the abolition of section 25-90 of the *Income Tax Assessment Act (ITAA) 1997,* which currently allows deductions for interest expense on debt used to fund investments in foreign subsidiaries and other foreign non-portfolio equity investments.

The government considers that this provision is being abused and, therefore, has decided to abolish it completely. This is a very significant change in the tax regime for Australian multinationals and foreign multinationals that hold foreign subsidiaries via Australia. It is a complete reversal of the policy decision taken in 2001 (on the introduction of the current thin capitalization regime), which eliminated the need to trace the use of borrowed funds to determine interest deductibility.

Australian companies would again be required to trace the use of borrowed funds and face the disallowance of interest expense if the funds are used to fund foreign investments rather than domestic operations. This is likely to be a difficult and impractical exercise.

The proposed abolition of section 25-90 means that outbound investors that fall within the thin capitalization safe harbor still may have interest deductions denied to the extent their debt relates to investments in foreign subsidiaries. Australian companies that require funding for foreign acquisitions may need to source this from equity raisings or profits.

This proposal is likely to be seen as disproportionate to the issues that have been identified by the government, and is likely to encounter strong opposition through the consultation process. If approved, this proposal would apply for income years that commence on or after 1 July 2014.

Foreign dividend exemption

The foreign non-portfolio dividend exemption (section 23AJ of the *ITAA 1936*) would be amended so that it applies to returns on foreign non-portfolio equity interests and aligns with the debt/equity classification rules. This change counteracts the use of certain hybrid preference shares that are treated as in substance debt for thin capitalization and interest deductibility purposes, but currently qualify for the dividend exemption as they are equity in legal form.

A more welcome change is the extension of the section 23AJ exemption to dividends received by an Australian company via a partnership or trust. This is a sensible result, which overcomes the view of the Australian Taxation Office (ATO) that the existing law does not extend to dividends flowing through partnerships or trusts. The government also announced the repeal of section 404 of the *ITAA 1936*, which exempts certain portfolio dividends from taxation via the CFC rules. If approved, these proposals would apply for income years that commence on or after 1 July 2014.

Taxation of gains made by nonresidents on Australian real property and mining interests

The government has announced changes that strengthen Australia's foreign-resident CGT regime in relation to disposals of indirect interests in Australian real property, including mining interests.

The first change addresses perceived flaws in the "principal asset test," which compares the value of land and non-land assets to determine whether a disposal of interests in an entity is subject to CGT. Dealings (e.g. receivables) between entities within the same Australian tax consolidated group would be ignored to prevent multiple counting that would otherwise inflate the proportion of non-land assets.

The second change, also involving the principal asset test, would treat mining information and other intangibles connected to mining rights as part of those rights, thereby counteracting the recent Federal Court decision in *Resource Capital Fund III LP v Commissioner of Taxation*. This change would increase the likelihood that Australian mining companies would qualify as land rich, meaning that their foreign-resident shareholders would be subject to CGT on disposals of shares.

If the law is enacted as proposed, it will be of critical importance that the relevant project assets are appropriately identified and valued to support the CGT outcome, as there is likely to be increased scrutiny by the ATO on valuation methodologies and assumptions adopted in these cases.

These changes to the principal asset test would apply to CGT events occurring after 7.30 p.m. (AEST) on 14 May 2013.

Withholding tax regime for foreign residents disposing of taxable Australian property

The government has announced the introduction, from 1 July 2016, of a 10% non-final withholding tax on gross proceeds payable to foreign residents on disposals of taxable Australian property. The withholding obligation would apply irrespective of whether the relevant assets are held on capital or revenue account. This measure would not apply to residential property transactions under AUD 2.5 million or to disposals by Australian residents.

Details of this measure are subject to further consultation by the government. Depending on the outcome of the consultation, the withholding regime may impose significant responsibilities on a purchaser when deciding whether to withhold, and is likely to require sellers to prove their tax liability, of lack thereof, to the ATO on an up-front basis.

Changes to consolidation regime

The government has announced changes to the tax consolidation regime to close identified loopholes and to improve the integrity of the regime. Specifically, the proposed amendments (which would apply as from 14 May 2013) are intended to ensure that:

- Consolidated groups would no longer be able to access double deductions by shifting the value of assets between entities;
- Nonresidents would no longer be able to “churn” assets between members of a consolidated group to allow the same ultimate owner to claim double deductions;
- The consolidation regime’s treatment of certain deductible liabilities would be amended so that they are not taken into account twice; and
- The tax treatment of intra-group assets and liabilities is consistent with the economic substance of transactions.

In addition, in response to the Board of Taxation’s review of the consolidation regime, the government has foreshadowed further technical amendments to the regime that are expected to be introduced subject to fiscal constraints and legislative priorities.

Most of the 26 recommendations made by the Board of Taxation relate to integrity matters that are highly technical in nature. In this regard, corporate taxpayers have long struggled not only with the complexity of the consolidation regime, but also with the countless amendments (and repealed amendments) that have taken place since the tax consolidation regime commenced. To this end, the Board of Taxation’s recommendations are, on the whole, unlikely to improve taxpayers’ understanding of some of the more esoteric aspects of the tax consolidation regime. In any event, the government’s response to the recommendations does not provide any further meaningful information in relation to potential date of effect, or the timeframes for implementing the recommendations. However, the Board did make a number of excellent recommendations to significantly simplify the tax consolidation regime for small business groups. It is, therefore, particularly disappointing that the government’s response to the small business recommendations is, consistent with its responses to most of the others, that it “will consider the issue further, as legislative priorities and fiscal constraints allow.” In our view, such a non-committal response risks the perception that the small business recommendations are to be indefinitely consigned to the back-burner.

The government also has announced a tripartite review in relation to the operation of multiple entry consolidated (MEC) groups involving Treasury, the ATO and private sector experts. The tripartite review is intended to focus on inconsistencies identified by the Board of Taxation in the treatment of MEC groups (when compared to ordinary tax consolidated groups). In particular, the government has indicated that it is concerned with three scenarios, including where an asset belonging to a member of a MEC group is transferred to an existing or newly established eligible tier-1 company in the same group, and the shares in that eligible tier-1 company are subsequently disposed of tax free by the nonresident shareholder. The tripartite working group will also consider any other tax advantages that it can identify that are available to MEC groups, but not to consolidated groups.

Better targeting of R&D incentives

Reconfirming previous announcements, large Australian business is expected to be denied access to the R&D tax incentive with effect from 1 July 2013. Multinational companies and groups with income assessable in Australia of AUD 20 billion or more would no longer be eligible to make a claim for the R&D incentive after the income year ended 30 June 2013, removing access to an additional 10% net tax benefit available in respect of eligible R&D expenditure. Notably, the new test would still allow multinational groups with a turnover of more than AUD 20 billion, but less than AUD 20 billion assessable in Australia, to access the Australian R&D tax incentive.

CFC reforms

Long-awaited reforms to Australia's controlled foreign company (CFC) regime, originally announced in the 2009-2010 budget, have been put on hold by the government pending the completion of the OECD's BEPS review. The OECD regards CFC rules as an integral part in tackling BEPS and is expected to release a report to the G20 in July 2013.

The Australian Treasury has released an issues paper seeking the views of stakeholders on matters relating to BEPS (by 31 May 2013). The issues paper highlights areas of risk, such as the borderless digital economy and the increasing mobility of capital and intellectual property.

The proposed CFC reforms were endorsed by the Board of Taxation and would enhance the competitiveness of Australian multinationals in foreign markets. It is now unclear whether the reforms will proceed in their current form or whether any aspects might be changed in light of the BEPS project.